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MULTIFAMILY HOUSING

HUD Missed Opportunities to Reduce Costs on Its Uninsured Section 8 Portfolio





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This report was prepared to comply with the requirements of section 532 of the 1998 Appropriations Act for the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies (P.L. 105-65, Oct. 27, 1997), which requires a GAO study of HUD's portfolio of properties with Section 8 project-based rental assistance that are not insured by the Federal Housing Administration. As agreed, this report provides information on the Section 8 rental assistance provided to properties in HUD's uninsured Section 8 portfolio, the financial benefits that may be available to state and local housing finance agencies under the Section 8 program, and the information HUD and the state agencies have on the physical and financial condition of the properties in their respective uninsured Section 8 project-based portfolios.

We are sending copies of this report to congressional committees and subcommittees interested in housing; the Honorable Andrew M. Cuomo, Secretary of Housing and Urban Development; the Honorable Jacob Lew, Director of the Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

If you or your staff have any questions about this report, please call me at (202) 512-7631. Key contributors to this report are listed in appendix VIII.

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Director, Housing and Community
Development Issues

B-281431

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Executive Summary

Purpose

Section 8 rental housing assistance is the main form of federal housing assistance for the nation's low-income residents. Section 8 assistance is tied either to units in specific properties (project-based assistance) or to families and individuals who live in affordable rental housing of their choice (tenant-based assistance). The residents of housing units that receive project-based assistance are required to pay a portion of their income for rent (generally 30 percent), while the Department of Housing and Urban Development (HUD) pays the balance. HUD provides Section 8 project-based rental assistance to units in approximately 22,000 multifamily properties, almost half of which are insured by HUD's Federal Housing Administration (FHA). The remaining properties, which are not insured by FHA, are referred to collectively as HUD's "uninsured" Section 8 portfolio.

A mandate for a study of the uninsured portfolio was included in HUD's fiscal year 1998 appropriations bill (P.L. 105-65, Oct. 27, 1997). Accordingly, this report examines (1) the information HUD has on the Section 8 assistance provided to properties in the uninsured portfolio, (2) the financial benefits that may be available to state and local housing finance agencies that participate in the Section 8 program and the impact of these benefits on the Section 8 program's costs, and (3) the information HUD and the state agencies have on the physical and financial condition of the properties in their respective uninsured Section 8 project-based portfolios.

Background

As of December 1998, according to HUD's data, the uninsured Section 8 portfolio consisted of 12,708 contracts between HUD and property owners. These contracts cover 632,216 assisted units associated with eight programs, including a state agency program. Most of these programs were established in the 1970s to develop housing for low-income households, using various types of financing and long-term (20- to 40-year) Section 8 contracts. While some of the properties were financed by loans and grants from HUD, others were financed by bonds issued by state and local housing finance agencies (state and local agencies). All but one of the housing development programs were terminated in 1983 because of high costs, but many of the Section 8 contracts for properties developed through these programs are still in effect. HUD will continue to incur rental assistance costs until these contracts expire.

During the late 1970s and early 1980s, the cost of bonds to finance housing development rose with interest rates to unprecedented levels. HUD

therefore authorized higher mortgage interest rates and higher rental assistance payments to cover the higher bond financing costs, first in 1980 and then in 1981. Only the Section 8 contracts covered by the 1981 authorization required the agencies to refund (refinance) their bonds when interest rates declined and to provide all of the savings (the difference between the original and the current debt service costs) to the federal government.

The Stewart B. McKinney Homeless Assistance Amendments Act of 1988, enacted primarily to assist the nation's homeless, included one section (1012) that provided for the state agencies to share the bond refunding savings that they were formerly required to return to the federal government and to use these savings to provide affordable housing for households with very low incomes. While section 1012 originally applied only to refundings associated with Section 8 contracts covered by HUD's 1981 authorization, an October 1992 amendment to section 1012 apparently provided for sharing the savings from refunding bonds associated with other Section 8 contracts—savings that some state agencies were generally accustomed to retaining.

In 1992 and 1993, HUD's Office of the Inspector General released two reports that examined whether bond-financed Section 8 properties were refinanced as intended and if HUD realized the appropriate savings from the bond refundings.[1] The reports disclosed, among other things, that HUD had not fully realized potential savings from bond refundings and identified actions that HUD could take to realize additional savings.

Results in Brief

According to HUD's data, rental assistance payments for the uninsured Section 8 portfolio totaled over $3.3 billion in fiscal year 1998. A majority of these payments—about $2.3 billion—were associated with the two largest programs in the uninsured portfolio, one of which is the state agency program. Although nationwide data were not available for assessing the relationship of Section 8 rents to market rents, the design of the program was such that Section 8 subsidies sometimes support higher rents than the properties could command without federal assistance. The federal government will continue to incur these high rental assistance costs each year until its existing Section 8 contracts expire, generally from within the next 5 years to about 20 years. Contracts in the state agency program will generally be among the last to expire.

[1]Interim Audit Report Bond Refundings of Section 8 Projects, Office of the Inspector General (93-HQ-119-0004, Oct. 30, 1992) and Multi-Region Audit of Refunding of Bonds for Section 8 Assisted Projects, Office of the Inspector General (93-HQ-119-0013, Apr. 30, 1993).

Under the Section 8 program, state and local agencies may derive financial benefits, or savings, from refunding (refinancing) their tax-exempt bonds. In addition, the agencies may receive one of two available fees for administering their Section 8 contracts. The agencies are required to use the savings from refunding their bonds, and in some cases may use a portion of their fee, to provide affordable housing for low-income residents within their jurisdictions. GAO found that HUD has not resolved three long-standing issues associated with these financial benefits. As a result, HUD has missed opportunities to reduce its Section 8 costs, particularly in the state agency program. First, HUD has not issued guidance to the state agencies on how to comply with the October 1992 amendment to section 1012 of the McKinney Act, which provides for the agencies to share certain bond refunding savings with the federal government. As a result, some state agencies have retained all of the savings, which accrue annually, while other agencies have shared the savings. Second, HUD has not provided clear guidance to the state and local agencies for calculating rent increases after refunding bonds. Consequently, the Section 8 rental assistance program is incurring excess costs that could have been avoided. Finally, HUD has allowed some state agencies to collect both of the available fees for administering their Section 8 contracts, despite a 1980 HUD regulation prohibiting dual fees. As a result, HUD has added, at a minimum, tens of millions of dollars to the Section 8 program's cost. HUD has known about these issues since at least 1992, when the Inspector General first reported on them, but it has not acted quickly or effectively to resolve them. Thus, the federal government has lost opportunities to share bond refunding savings and has incurred excessive rental assistance and administrative fee payments. GAO makes recommendations to HUD on each of these issues to reduce the Section 8 costs borne by the government (see ch. 3).

As of December 1998, HUD had limited information on the physical condition of properties in the uninsured portfolio and no information on their financial condition. According to the Department's central database, which included the results of inspections for about 63 percent of the properties, most of the properties were in satisfactory or better physical condition; however, these ratings were not based on objective criteria and their reliability is therefore unknown. Ten state agencies, which monitor about half of the properties in the state agency program,[2] told GAO that 95 percent of the properties in their portfolios were in satisfactory or

[2]GAO surveyed 10 state agencies (California, Illinois, Maryland, Massachusetts, Michigan, Minnesota, New Hampshire, Oregon, Tennessee, and Wisconsin) to obtain information on the methods they used to monitor their properties and on the physical and financial condition of the properties. GAO also visited 5 of the 10 agencies.

better physical condition. Moreover, according to these agencies, only a very small fraction of their properties (under 4 percent) warranted special monitoring because of financial or other problems. In mid-1998, HUD began to establish centralized procedures, including objective rating criteria, to improve the monitoring of multifamily properties in its uninsured and other portfolios.

Principal Findings

Information on the Uninsured Portfolio Varies by Program

About 68 percent of the $3.3 billion in rental assistance for the uninsured portfolio went to two of eight programs—the elderly/disabled loan program and the state agency program. The average per-unit costs for the eight programs varied widely, primarily because of differences in the ways properties were financed. The per-unit costs and, to a lesser extent, tenants' income levels determine the Section 8 rent subsidies that HUD must pay for assisted units. For several of the programs, including the state agency program, HUD's subsidies tended to be high because (1) the assisted rents were initially set above market levels to encourage the production of affordable housing and (2) the formulas for automatic rent increases (which, until recently, were provided each year) tended to be generous, according to HUD. The Congress now prohibits automatic rent increases for properties whose rents exceed the rent standards—called fair market rents—that HUD develops annually for geographic locations, such as large metropolitan areas. GAO determined that the Section 8 contract rents for about 75 percent of the assisted units in the uninsured portfolio exceeded HUD's fair market rents. HUD's fair market rents may not be the same as actual market rents because they do not reflect the differences in market value that may be found from one neighborhood to another within a geographic location. However, nationwide data on rents for particular neighborhoods were not available for assessing the relationship of Section 8 contract rents to market rents. Nevertheless, the history and design of the Section 8 project-based program, together with information from two states and a study of 53 bond-financed Section 8 properties,[3] indicate that some Section 8 contract rents exceed market rents in the uninsured portfolio. When Section 8 contract rents exceed market rents, the Section 8 subsidies support higher rents than the properties generally could command without federal assistance. Moreover, these high subsidy costs will continue until the existing Section 8 contracts expire. While many of

[3]HUD's Local Multifamily Portfolio, John Nuveen & Co., Inc. (July 1997).

the contracts will be expiring in the next 5 years, those in the state agency program will generally expire in 10 to 20 years.

HUD Has Missed Opportunities to Reduce Costs in the State Agency Program

HUD has not issued clear guidance to the state agencies on sharing savings with the federal government when they have refunded bonds associated with certain Section 8 contracts covered by the October 1992 amendment to section 1012 of the McKinney Act**.** While HUD has required the agencies to share savings when their Section 8 contracts include explicit requirements for providing savings to the government, it has not required the agencies to share when their contracts do not include such requirements. In April 1996, HUD tried to require the state agencies to share their savings by publishing a regulation that was intended to establish the applicability of the October 1992 amendment to all refundings by the state agencies. However, because HUD omitted citations to two relevant provisions of the McKinney Act, the regulation did not have its intended effect. Moreover, in the view of the National Council of State Housing Agencies and some state agencies, the amendment generally applies to state agencies only when their Section 8 contracts specify that they are to provide bond refunding savings to the government. GAO visited five state agencies that refunded nearly all of their bonds in the mid-1990s. Three of these agencies generally do not share bond refunding savings with the federal government except when their contracts direct them to provide the savings to the government. The other two agencies share savings with the government whether or not their contracts direct them to provide the savings to the government.

When bonds issued by state and local agencies have been refunded but rents subsidized by the government under Section 8 contracts have not been reduced to reflect the bond refunding savings, rent increases based on HUD's general method for calculating increases will be excessive. Although the Inspector General recommended in 1992 that HUD take action to prevent these excessive rent increases, HUD initially disagreed with the recommendation, maintaining it did not have the authority to limit Section 8 rent increases. Then, in August 1997, HUD issued a notice establishing procedures for considering the savings when calculating rent increases for contracts that provided for returning the savings to the government. However, the notice did not include a methodology for implementing the procedures or an example of a calculation. Furthermore, the notice was issued for 1 year, and HUD did not renew it when it expired. HUD officials told GAO that renewing the notice should not have been necessary because the procedures apply to rent increases over the lives of the Section 8

contracts. Two of the five state agencies that GAO visited calculated rent increases subject to the notice. One agency complied with it, and the other did not.

HUD compensates the state and local agencies for administering their Section 8 project-based rental assistance contracts. The state agencies are entitled to receive either an annual contributions contract fee—a per-unit fee provided by HUD—or an override fee—a fee that represents the difference between an agency's borrowing (bond issuance) and lending rates.[4] The agencies are not allowed to receive both fees, according to a Section 8 regulation promulgated in 1980. Nevertheless, in 1992 the Inspector General found, in reviewing the refunding of bonds associated with Section 8 contracts, that some state agencies were receiving both fees for administering their Section 8 contracts. One agency, for example, received annual contributions contract fees of $634,000 and override fees of $584,000 for administering the same Section 8 contracts during the same period. The state agencies have argued, in essence, that they are entitled to both fees because HUD effectively approved these fees when it approved agreements between the Department and the agencies to share bond refunding savings (called McKinney Act refunding agreements).[5] To resolve this issue for agencies whose refunding agreements it approved, HUD required the agencies in 1996 to request waivers of its regulation prohibiting dual fees. However, as of June 1999, HUD had not taken action on these requests, and the agencies were continuing to receive dual fees. In addition, HUD has not identified all agencies that are collecting dual fees and has not taken any action when dual fees are being collected for contracts that are not under refunding agreements approved by the Department.

[4]Local agencies are not eligible for an override fee because they issue tax-exempt bonds under the United States Housing Act of 1937 and are subject to HUD's regulations. State agencies issue tax-exempt bonds under the Internal Revenue Code.

[5]Refunding agreements identify the total savings that will become available from refunding bonds associated with Section 8 contracts. The agreements specify the amounts that will be provided to the agencies and to the federal government under section 1012 of the McKinney Act, as amended.

HUD's Information on the Physical and Financial Condition of the Uninsured Portfolio Is Limited, but State Agencies Report That Few Properties Have Problems

While HUD requires annual physical inspections of the properties in its uninsured portfolio, it did not, until recently, have objective criteria for ranking the properties' condition. Thus, although the ratings in HUD's central database showed that most of the properties were in satisfactory or better physical condition, the ratings were subjective and their reliability was therefore limited. The 10 state agencies that GAO surveyed reported that 95 percent of the properties, representing 97 percent of the apartment units, in their portfolios were in satisfactory or better physical condition. Although all 10 agencies used HUD's terms—superior, satisfactory, below average, or unsatisfactory—to rate the physical condition of their properties, their ratings were also subjective. Consequently, the state agencies' ratings are subject to the same limitations as HUD's.

Information on the financial condition of properties in the uninsured portfolio is also limited. Although HUD requires annual audited financial statements for properties in most of the uninsured programs, its central database did not, as of December 1998, include information on the results of these audits. As a result, overall conclusions on the financial status of the uninsured portfolio cannot be drawn at this time. HUD does not require the state agencies to assign a rating to the financial condition of their properties. Nevertheless, 5 of the 10 state agencies that GAO surveyed had rated the financial condition of their properties. These agencies reported that about 97 percent of their properties were in satisfactory or better financial condition. In addition, seven of the agencies had rated the overall condition of their properties—assessing their management as well as their physical and financial condition—and reported that 95 percent were in satisfactory or better overall condition. Finally, the 10 state agencies reported that fewer than 4 percent of the properties in their portfolios had problems serious enough to warrant special monitoring attention.

In mid-1998, HUD established the Real Estate Assessment Center to collect and analyze data on multifamily properties in several portfolios, including the uninsured Section 8 portfolio; develop an objective system for rating the physical condition of these properties; and analyze financial information on the properties. Currently, trained contractors are inspecting the properties using the Center's new rating system, and many property owners are required to submit audited financial statements to the Department electronically by June 30, 1999.

Recommendations

This report recommends that the Secretary of Housing and Urban Development (1) clarify the requirements for state housing finance agencies to share the savings from refunding bonds with the federal government, (2) clarify and reissue HUD's guidance on calculating rent increases when savings have resulted from refunding bonds, and (3) enforce the Section 8 regulation prohibiting dual fees.

Agency Comments and GAO's Evaluation

GAO provided copies of a draft of this report to HUD and to the National Council of State Housing Agencies[6] for review and comment. HUD disagreed with GAO's recommendation that it clarify the requirements for state housing finance agencies to share the savings from refunding certain bonds with the federal government. According to HUD, the recommendation directs the Department to take action where its legal authority is unclear and proposes that HUD retroactively recover savings that state agencies have not shared. However, given that this issue has not been resolved for over 6 years, GAO's recommendation directs HUD to determine whether the state agencies are required to share certain bond refunding savings with the government and, if they are, whether the Department can enforce the requirement prospectively. Therefore, GAO did not change the recommendation. However, GAO recognizes that the draft executive summary—which stated that HUD has not issued guidance to the state agencies directing them to share certain bond refunding savings—may have implied that the legal issue had been resolved. GAO therefore revised this statement for clarity and greater consistency with the discussion of this issue in the body of the report.

HUD questioned GAO's support for the statement that, without clarification of the McKinney Act's shared savings provision, state agencies may retain "tens of millions" of dollars that they could be legally required to share with the government. GAO agrees with HUD that for contracts that do not include a requirement for providing bond refunding savings to the government, these savings will generally be smaller than for contracts that do include this requirement. This is because the interest rates—and hence the bond refunding savings—are generally lower for the contracts without the requirement. GAO also agrees with HUD that the data needed to prepare a comprehensive estimate of the potential savings are not available. Therefore, GAO did not include an estimate of potential savings in the final

[6]The National Council of State Housing Agencies is a national nonprofit organization that assists state housing agencies in advancing the interests of lower-income and underserved people through the financing, development, and preservation of affordable housing. Members operate in every state, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

report and concluded that HUD may have missed opportunities to provide additional bond refunding savings to the government.

HUD agreed with GAO's recommendation on clarifying and reissuing its guidance on calculating rent increases when savings have resulted from refunding bonds and plans to implement the recommendation. While not disagreeing with GAO's recommendation that the Department enforce its Section 8 regulation prohibiting dual fees, HUD indicated that it views the dual fees as an incentive needed for state agencies to refund their bonds and share the savings with the government. However, the agencies were explicitly required by their Section 8 contracts to provide all of the savings to the government in most instances when shared savings agreements were executed. In addition, although the Department says that dual fee transactions will return savings in excess of $150 million to the Treasury over the life of the Section 8 contracts, it does not have the information needed to determine whether these savings will be sufficient to offset the excess costs of the dual fees provided to the agencies. GAO did not change its recommendation in response to these comments.

Both HUD and the National Council of State Housing Agencies disagreed with a statement in the draft report that the federal government's costs are higher than they should be when Section 8 rents exceed market rents. GAO revised this statement to describe rather than evaluate the impact of the Section 8 program's design on the federal government's subsidy costs. As revised, the report says that when Section 8 contract rents exceed market rents, the Section 8 subsidies support higher rents than the properties generally could command without federal assistance.

Like HUD, the National Council disagreed with and misinterpreted GAO's recommendation that HUD clarify when state agencies are required to share bond refunding savings with the government. According to the National Council, GAO wrongly concluded that HUD has the authority to require state agencies to share certain bond refunding savings with the federal government. In fact, as discussed, the report recommends that the Secretary determine whether the state agencies are required to share certain bond refunding savings. Nevertheless, as discussed, GAO revised a sentence in the executive summary that may have caused some confusion. The National Council also disagreed with the report for not recognizing that HUD effectively waived its prohibition of dual fees by approving bond refunding transactions under which state agencies received both fees. As the draft report stated, this is the position of the state agencies. However,

HUD is required by statute to issue formal waivers when it does not enforce a regulation such as the prohibition of dual fees.

HUD's and the National Council's comments and GAO's evaluation of them are discussed in more detail in chapters 2, 3, and 4 and in appendixes VI and VII.

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Abbreviations

FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development
OIG	Office of the Inspector General
PAS	Program Accounting System
REMS	Real Estate Management System
VA	Department of Veterans Affairs

Background

Section 8 rental housing assistance, managed by the Department of Housing and Urban Development (HUD), is the main form of federal housing assistance for low-income residents. In fiscal year 1998, total Section 8 expenditures were about $15.5 billion. Under Section 8, residents in subsidized units generally pay 30 percent of their income for rent and HUD pays the balance. Section 8 rental assistance is tied either to units in specific properties (project-based assistance) or to families and individuals who live in affordable rental housing of their choice (tenant-based assistance). Some properties that received project-based assistance also received federal mortgage insurance through HUD's Federal Housing Administration (FHA). The primary goal of the Section 8 project-based program was to encourage developers to build or rehabilitate properties for lower-income families by providing rental assistance contracts for a negotiated number of units for periods ranging from 20 to 40 years. Authorized in 1974, project-based assistance was, with one exception, repealed by the Congress in 1983 because of its high cost. That exception was the assistance used to provide housing for the elderly and the disabled.

Over half of HUD's portfolio of approximately 22,000 multifamily properties that receive Section 8 project-based rental assistance do not receive federal mortgage insurance. Collectively, these properties are referred to as HUD's uninsured Section 8 portfolio. A mandate for us to study this portfolio was included in HUD's fiscal year 1998 appropriations bill (P.L. 105-65, Oct. 27, 1997). The uninsured portfolio includes properties for the elderly and disabled that have been financed by direct loans and capital advances (grants) from HUD, as well as properties financed by state and local housing finance agencies, referred to as state and local agencies in this report.

The Uninsured Section 8 Project-Based Portfolio

Eight programs provide rental assistance to residents of properties in the uninsured Section 8 project-based portfolio. As shown in table 1.1, five of the programs developed housing for low-income residents using varying financing methods.

Table 1.1: Housing Development Programs in the Uninsured Section 8 Project-Based Portfolio

Housing development programs with project-based rental assistance	Financing method	Initial term of Section 8 contract	Program's status
Elderly/disabled loan program	Government loans from HUD at below-market interest rates that were established annually by the Congress	20 years	Terminated in the early 1990s; replaced with the capital advance program
Elderly/disabled capital advance program[a]	Capital advances (grants) from HUD	5 or 20 years (depending on when a property was initially developed)	Ongoing
State agency program	State government tax-exempt bonds	20 to 40 years	Terminated in 1983
New construction/ substantial rehabilitation program	Various methods, including local government tax-exempt bonds and some state tax-exempt bonds	20 to 40 years	Terminated in 1983
Rural rental housing program	Government loans from the Rural Housing Service with a 1-percent interest rate	20 years	Terminated in 1983[b]

[a]The rental assistance contracts under this program are not funded under the same appropriations account as the Section 8 rental assistance program, but the project-based assistance under this program is substantially the same as Section 8 project-based assistance except that the subsidy is limited to operating costs.

[b]The Department of Agriculture continues to fund the Rural Rental Housing development program, but HUD no longer provides new Section 8 project-based assistance. The Rural Housing Service has its own rental subsidy program.

The three remaining programs represented in the uninsured Section 8 project-based portfolio were established in the 1980s to provide long-term rental assistance to existing properties that were formerly in FHA's insured portfolio.[1] Section 8 assistance was extended through these programs as a means of retaining affordable housing for low-income residents. First, the loan management set-aside program provided Section 8 rental assistance to financially troubled projects using 15-year Section 8 contracts. Second,

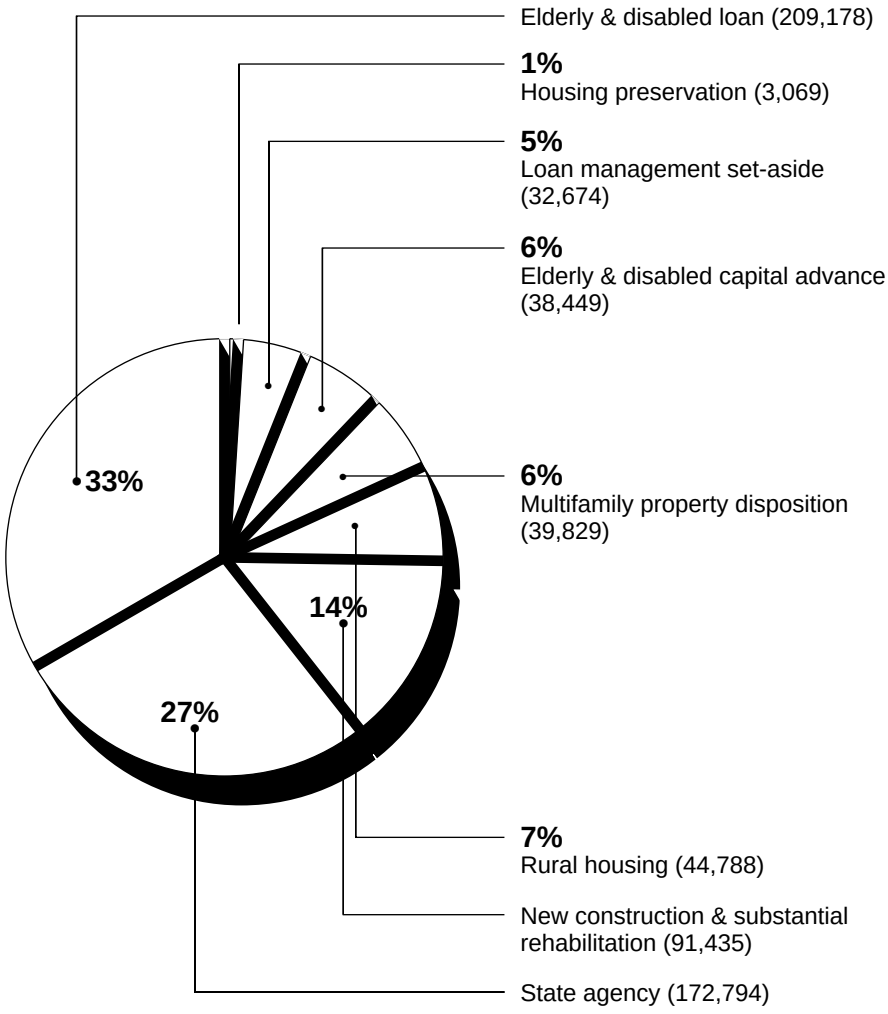
[1]The uninsured portfolio also includes properties that receive rental assistance under HUD's rental assistance payment and rent supplement programs (representing 371 contracts covering 30,250 units). These programs, which were precursors of the Section 8 program, are not discussed in this report.

the multifamily property disposition program also used 15-year contracts to provide rental assistance to properties acquired by new owners through foreclosures when borrowers defaulted on loans insured by FHA. Finally, the housing preservation program provided rental assistance to property owners who were approaching eligibility to pay off their mortgages as an incentive for them to maintain some of the units in these properties as affordable low-income housing. Preservation contracts were executed for varying terms, depending on, among other things, the availability of appropriations. The Department no longer funds new project-based contracts under these three programs.

According to HUD's data, as of December 1998, the uninsured Section 8 project-based portfolio consisted of 12,708 active contracts for 12,488 properties covering 632,216 assisted units. (See app. I for more detailed information, by program, and app. II for a discussion of the databases we used to identify the universe of uninsured Section 8 contracts.[2]) Figure 1.1 shows the number and percentage of assisted units in the uninsured portfolio that are funded through each of the rental assistance programs. A majority of the units in this portfolio—60 percent—are associated with the elderly and disabled loan program and the state agency program.

[2]This universe includes 13,046 active contracts, 12,708 of which cover properties in the eight programs discussed in this report.

Figure1.1: Percentages and Numbers of Assisted Project-Based Units, by Program



Note: Percentages do not add because of rounding.

Source: HUD's Real Estate Management System and Section 8 expiring contracts database, as of Dec. 1998.

Bond Financing for Properties in the Uninsured Portfolio

Some properties in the uninsured portfolio were financed by state and local housing finance agencies with the proceeds of bonds that are exempt from federal taxation. Specifically, during the 1970s and early 1980s, tax-exempt bonds were used to finance the development of the 2,278 properties in the state agency program and a portion of the 1,678

properties in the new construction and substantial rehabilitation program.[3] State housing finance agencies (state agencies) generally issued bonds as instrumentalities of the state under section 103 of the Internal Revenue Code. Section 8 assistance for properties financed by state agencies was generally approved from Section 8 funds allocated to these agencies and is identified in HUD's data systems under the state agency program. Local agencies and instrumentalities (local agencies) generally issued tax-exempt bonds under Section 11(b) of the United States Housing Act of 1937. The state and local agencies used the bond proceeds to provide mortgages for constructing or substantially rehabilitating properties for use as affordable housing for low-income people under the Section 8 program. The monthly mortgage payments are used to repay the bonds with interest.

During the late 1970s and early 1980s, interest rates rose to unprecedented levels. To continue the development of affordable rental housing despite rising interest costs, HUD authorized special financing in 1980 and again in 1981. This special financing allowed for higher mortgage interest rates, which then increased the costs of HUD's Section 8 rental assistance. The Section 8 contracts that received the special financing authorized in 1980 did not require state and local agencies to refund (refinance) their high-interest bonds if interest rates later dropped. But as interest rates remained high and HUD concluded that special financing would be required for an extended period of time, the Department took steps to reduce Section 8 costs in the future when interest rates declined. As a result, the Section 8 contracts that received special financing beginning in October 1981—called financing adjustment factor contracts—did require state and local agencies to refund their bonds when interest rates fell and provide the savings to the government. HUD also required property owners with financing adjustment factor contracts to accept reduced Section 8 contract rents (subsidies) to reflect the decrease in borrowing costs resulting from refunding the bonds.

In 1987, after interest rates started to decline, HUD asked the housing agencies to refund the bonds associated with financing adjustment factor contracts. The savings from bond refundings can be substantial. For example, a local agency refunded bonds for three mortgage loans totaling over $14 million. The savings from these refundings, which will be realized over the lives of the mortgages, are estimated to be $6.4 million. These

[3]While the Section 8 contracts associated with properties financed by local agencies are included with others under the overall new construction and substantial rehabilitation program, HUD's Section 8 data do not identify those with bonds issued by local agencies. This program also includes some properties financed by state agencies that were not processed under the state agency program.

savings represent the difference between the cost of the mortgages needed to repay the original bonds and the cost of the mortgages needed to repay the refunded bonds.

The Congress, in passing the Stewart B. McKinney Homeless Assistance Amendments Act of 1988, approved a provision that permitted state agencies to keep half of the savings from refunding bonds associated with financing adjustment factor contracts. While the McKinney Act provided primarily for assistance to the nation's homeless population, section 1012 created an incentive for the state agencies to refund bonds associated with these contracts. Without the McKinney Act's shared savings provision, the state agencies would have been contractually required to provide 100 percent of the savings to the government.

As amended in April 1992, section 1012 extended this benefit to local agencies. Finally, as amended in October 1992, the section provided for state and local agencies and the federal government to share the savings from refunding bonds associated with Section 8 contracts entered into between 1979 and 1984. This period generally covered the contracts that received special financing, including the financing adjustment factor contracts, and some contracts that did not receive special financing.

In 1992 and 1993, HUD's Office of the Inspector General (OIG) released two reports that examined whether (1) bond-financed Section 8 properties were refinanced as intended and (2) HUD realized the appropriate savings from the bond refundings.[4] The initial report, which included 18 recommendations, was issued as an interim report before the audit work was completed because the Inspector General believed the potential for cost savings and the need to improve internal controls warranted prompt corrective action. The final report, issued on April 30, 1993, included six additional recommendations. The reports disclosed, among other things, that HUD had not fully realized potential savings from bond refundings and identified actions that HUD could take to realize additional savings.

In January 1997, the Inspector General determined that HUD had not taken the corrective actions it had agreed to take in response to several of the key recommendations in these reports. Therefore, the Inspector General reopened the recommendations. The reopened recommendations include those addressing the extent to which agencies are required to share bond refunding savings with the government, excess rent increases to owners,

[4]Interim Audit Report Bond Refundings of Section 8 Projects (OIG 93-HQ-119-0004, Oct. 30, 1992) and Multi-Region Audit of Refunding of Bonds for Section 8 Assisted Projects (OIG 93-HQ-119-0013, Apr. 30, 1993).

and dual fees for administering Section 8 contracts. As of June 1999, these issues had not been effectively resolved. These issues are discussed further in chapter 3.

How Bond Refunding Savings Are Shared

To share the savings from refunding bonds, HUD enters into agreements with state and local agencies that identify (1) the total amount of savings that will become available as a result of the refundings and (2) the amounts that will be provided to the agencies and to the federal government each year throughout the lives of the Section 8 contracts. HUD refers to the shared savings agreements as refunding agreements. According to HUD's data, as of September 30, 1998, the Department had approved 245 refunding agreements that will provide $1.1 billion in bond refunding savings over the lives of the Section 8 contracts, $633 million of which is to be provided to the U.S. Treasury. In negotiating refunding agreements with agencies, HUD reviews the agencies' bond refunding documents.[5]

The responsibility for making the shared savings payments varies, depending on the method selected to share the savings. Two methods are available for state and local agencies and the federal government to share savings. The first, called the rent reduction method, reduces the federal government's Section 8 costs directly. Under this method, the mortgage is refinanced and the Section 8 contract rents are reduced to reflect the new, lower cost of bond financing. HUD periodically pays the agency its share of the savings that accrue over the life of the mortgage and the Section 8 contract. A few agencies have used this method to share savings.

An alternative method of sharing savings, called the trustee sweep method, is used by most state and local agencies that share savings, according to HUD. Under this method, neither the mortgage nor the Section 8 contract rents are reduced after the bond is refunded. Instead, an independent third party—a trustee—receives the mortgage payments from the Section 8 property owners and uses these funds to repay the bond principal and interest. The remaining balance (bond payments minus mortgage payments) represents the savings from refunding the bonds. Semiannually, the trustee pays the state or local agency its share of the savings and pays the federal share to the U.S. Treasury. Thus, the federal government

[5]State agencies issuing bonds under the Internal Revenue Code did not usually need HUD's approval to issue bonds. As a result, the Department generally does not review state agency bond transactions. However, HUD does review the state agency bond refunding transactions associated with McKinney Act refunding agreements.

receives reimbursement for a portion of the excess financing costs being borne by the Section 8 program.

Using the trustee sweep method eliminates the need for agencies to refinance mortgages and amend their Section 8 contracts with owners and for HUD to set up accounts to pay the state or local agencies their share of the bond refunding savings. Thus, it imposes less of an administrative burden on both the state agencies and the Department. According to HUD officials, many agencies would not have participated in the refunding program if the trustee sweep method had not been available. However, the trustee sweep method allows Section 8 costs (expenditures) to remain artificially high—that is, the costs continue to reflect the original high interest rates. As is discussed further in chapter 3, the trustee sweep method can result in excess rent increases for many contracts. This occurs because many Section 8 contracts receive automatic rent increases on the basis of a factor that is applied to total Section 8 costs—that is, to the debt service as well as the operating costs.

Contract Administration Fees in the Uninsured Portfolio

State and local housing finance agencies that administer Section 8 contracts for HUD receive compensation for carrying out their administrative responsibilities. This compensation is paid to the agencies for performing administrative tasks, such as conducting management reviews of the Section 8 properties and inspecting the properties at least annually. All of the agencies are eligible for what is called an annual contributions contract fee. Alternatively, state agencies that finance Section 8 property mortgages with the proceeds of state tax-exempt bonds issued under the Internal Revenue Code may receive what is referred to as an "override fee" instead of an annual contributions contract fee.

The annual contributions contract fee is generally a per-unit cost (equal to 3 percent of the annual fair market rent for a 2-bedroom unit) multiplied by the number of units in the property. An override fee represents the difference between the agency's borrowing (bond issuance) and mortgage lending rates. This difference, which the Internal Revenue Service refers to as arbitrage, cannot exceed 1.5 percent for all of the properties the agency has financed through the bond proceeds. Because local housing finance agencies generally issued bonds under the United States Housing Act of 1937, they are not eligible for the override fee available to state housing finance agencies under the Internal Revenue Code. Under a Section 8 regulation promulgated in 1980 (24 C.F.R. 883.606), a state housing finance

agency that chooses to collect an override fee cannot receive an annual contributions contract fee.

Objectives, Scope, and Methodology

Section 532 of the 1998 Appropriations Act for the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies (P.L.105-65, Oct. 27,1997) requires that GAO submit a report to the Congress on the uninsured Section 8 portfolio. Accordingly, this report examines (1) the information HUD has on the Section 8 assistance provided to properties in the uninsured portfolio, (2) the financial benefits that may be available to state and local housing finance agencies that participate in the Section 8 program and the impact of these benefits on the Section 8 program's costs, and (3) the information HUD and the state agencies have on the physical and financial condition of the properties in their respective uninsured Section 8 project-based portfolios.

To determine what information the Department maintains on the Section 8 assistance provided to uninsured properties and the physical and financial condition of these properties, we obtained several HUD databases that were used to develop the information responding to these objectives and met with officials from HUD's Office of Housing and Office of the Chief Financial Officer. (See app. II for additional information on the databases used in this review.) We also obtained information from HUD officials on the improvements the Department is implementing for monitoring the physical and financial condition of its properties under the Real Estate Assessment Center. We did not evaluate the effectiveness of HUD's new processes.

To develop information on the benefits available to state and local agencies that participate in the uninsured Section 8 program and the impact of these benefits on the Section 8 program's costs, we interviewed officials from HUD, state agencies, and the National Council of State Housing Agencies. We sent a data collection instrument to state housing finance agencies in Illinois, Maryland, Massachusetts, Minnesota, and New Hampshire. We also reviewed HUD documents—including legal opinions, regulations, notices, and handbooks—and literature on tax-exempt bonds from bond-rating agencies.

To obtain information on the physical and financial condition of the properties in the state agencies' uninsured Section 8 project-based portfolios, we selected five state agencies in addition to the five that provided information on Section 8 benefits—California, Michigan, Oregon,

Tennessee, and Wisconsin. These 10 state agencies have portfolios of varying sizes and serve different geographical regions, including rural and urban areas. We sent a data collection instrument to the 10 state agencies to obtain information on (1) their overall monitoring approaches and the primary methods they use to evaluate the physical and financial condition of their portfolios and (2) the physical and financial condition of the uninsured Section 8 properties in their portfolios. In addition, we visited the Illinois, Maryland, Massachusetts, Minnesota, and New Hampshire agencies, where we discussed monitoring approaches, reviewed specific project files, and obtained documentation on policies and procedures.

We conducted our work from August 1998 through July 1999 in accordance with generally accepted government auditing standards.

Agency Comments

We provided copies of a draft of this report to HUD and to the National Council of State Housing Agencies for review and comment.[1] Their comments, which are reproduced in appendixes VI and VII, are discussed and evaluated as applicable in the remaining chapters of this report.

[1]The National Council of State Housing Agencies is a national nonprofit organization that assists state housing agencies in advancing the interests of lower-income and underserved people through the financing, development, and preservation of affordable housing. Members operate in every state, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

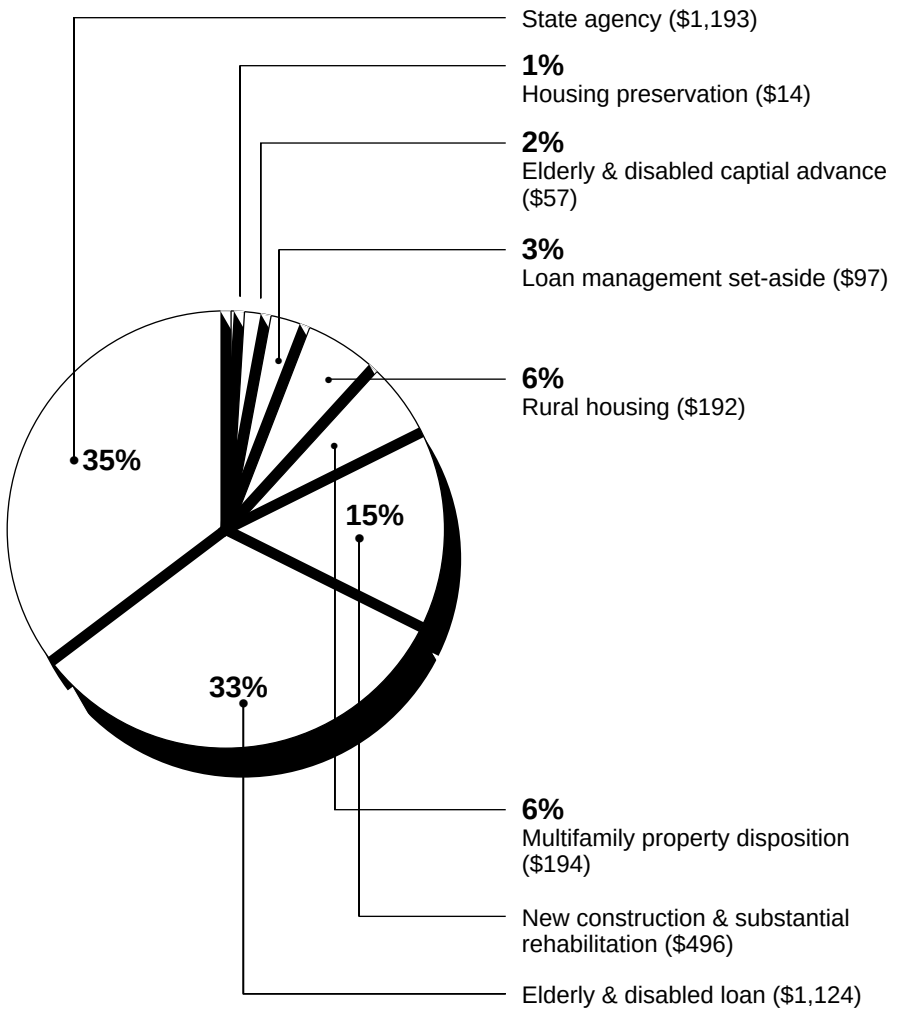
Section 8 Assistance Provided to Properties in the Uninsured Portfolio

According to HUD's data, rental assistance payments for the uninsured Section 8 portfolio totaled over $3.3 billion in fiscal year 1998. A majority of these payments—about $2.3 billion—were associated with the two largest programs in the uninsured portfolio, the state agency and the elderly/disabled loan programs. The average payment per rental unit varied significantly from program to program, reflecting in large measure the different financing methods used in the various programs. Complete data were not available for comparing assisted rents to market rents—the commonly accepted standard for assessing the reasonableness of rents. Nevertheless, on the basis of information that is available, some assisted rents exceed market rents. When Section 8 contract rents exceed market rents, the Section 8 subsidies support higher rents than the properties generally could command without federal assistance. Moreover, the federal government will continue to incur these high rent costs each year until its existing Section 8 contracts expire. These contracts will expire at various times, from within the next 5 years to about 20 years. Contracts in the state agency program will generally be among the last to expire.

Section 8 Expenditures and Per-Unit Costs Vary Widely by Program

Section 8 rental assistance payments for the uninsured portfolio totaled over $3.3 billion during fiscal year 1998. This amount represents net expenditures—that is, fiscal year 1998 expenditures to property owners minus any offsetting collections received during the period. As shown in figure 2.1, about 68 percent of the portfolio's rental assistance expenditures are distributed among the two largest programs in the uninsured portfolio—the state agency program and the elderly/disabled loan program.

Figure 2.1: Section 8 Contract Expenditures for Fiscal Year 1998, by Program



Notes: Dollars are in millions.

Percentages do not add because of rounding.

Source: Extract of fiscal year 1998 expenditures and receipts from HUD's Program Accounting System.

The average per-unit subsidy costs for fiscal year 1998 for the eight programs also varied considerably. As shown in table 2.1, the average

per-unit costs ranged from $1,492 for the elderly/disabled capital advance program to $6,903 for the state agency program.

Table 2.1: Average Per-Unit Subsidy Cost, by Section 8 Program, Fiscal Year 1998

Program	Average per-unit cost
Elderly/disabled capital advance	$1,492
Loan management set-aside	2,966
Rural housing	4,281
Housing preservation	4,696
Multifamily property disposition	4,870
Elderly/disabled loan	5,374
New construction/substantial rehabilitation	5,421
State agency	6,903

Source: Extract of fiscal year 1998 expenditures and receipts from HUD's program accounting system.

An important reason for the variation in average per-unit costs is that the programs were financed in different ways. For example, the federal government provides grants to develop properties under the elderly/disabled capital advance program. Because the government makes an investment up front, the Section 8 program's subsidies need to cover only the operating costs for properties in this program. In contrast, properties under the other development programs were financed with mortgage loans. Their Section 8 subsidies are considerably higher because they must cover both the mortgage debt service and the operating costs.

Another factor that affects the level of Section 8 subsidies is tenants' income. As discussed in chapter 1, residents generally pay 30 percent of their income for rent, and HUD pays the balance. As a result, differences in tenants' income levels can influence the average per-unit costs for these programs. Thus, one factor contributing to the high per-unit costs in the state agency program may be the residents' low income levels. According to the 10 state agencies we surveyed, about 93 percent of the households receiving Section 8 project-based rental assistance at their multifamily properties had very low incomes—defined by HUD as at or below 50 percent of the local area's median income.

Officials from HUD's Office of Housing, including the Directors for Business Products and Portfolio Management, identified these and other financing and programmatic differences, summarized below, that can affect the per-unit cost of the programs.

- The state agency program allowed more flexibility than most of the other programs in setting initial contract rents. The rents could be higher than those permitted under HUD's standard new construction/substantial rehabilitation Section 8 program. According to Office of Housing officials, the higher rent structure allowed the state agencies to develop properties that offered more amenities than the typical Section 8 property insured by FHA. In particular, the officials said, the higher rents allowed the state agencies to develop some properties in affluent suburban neighborhoods that were compatible with the housing in those neighborhoods. The officials also said that a number of state agency properties received a financing adjustment factor that allowed higher contract rents to support the high mortgage interest rates prevailing during the early 1980s.
- The elderly/disabled loan program also allowed greater flexibility in setting initial contract rents, which often exceeded market rents. In addition, the properties were generally more costly to develop because they were mid-rise and/or high-rise buildings that provided more amenities, such as emergency call systems, than most of the other subsidized new construction/substantial rehabilitation properties. These higher costs are offset to some extent by below-market interest rates, which the Congress established annually for the program. Although interest rates were below market when the financing for the properties was approved, some of the rates are now higher than current market interest rates.
- The rural housing program serves low-income persons, including the elderly and disabled, but properties under this program have lower per-unit costs than similar properties in HUD's uninsured portfolio. According to HUD officials, the rural housing properties are older than the HUD properties and are built in rural areas, where construction costs are generally lower than in urban areas. In addition, the properties were financed with loans that generally had subsidized interest rates of 1 percent.

Each program's per-unit costs reflect the influence of a variety of factors on the long-term costs of Section 8 rental assistance, and each program's costs need to be evaluated in the context of these factors. Furthermore, the per-unit costs may not reflect all of the costs that the government incurs for some programs. For example, the per-unit costs for grant programs, such as the elderly/disabled capital advance program, and for interest subsidy programs, such as the rural housing program, do not include the costs of the federal grants or interest subsidies provided under these programs. Additional data—which may or may not be available for

all of the programs—and in-depth analyses would be required to estimate the total per-unit costs of these programs to the government.

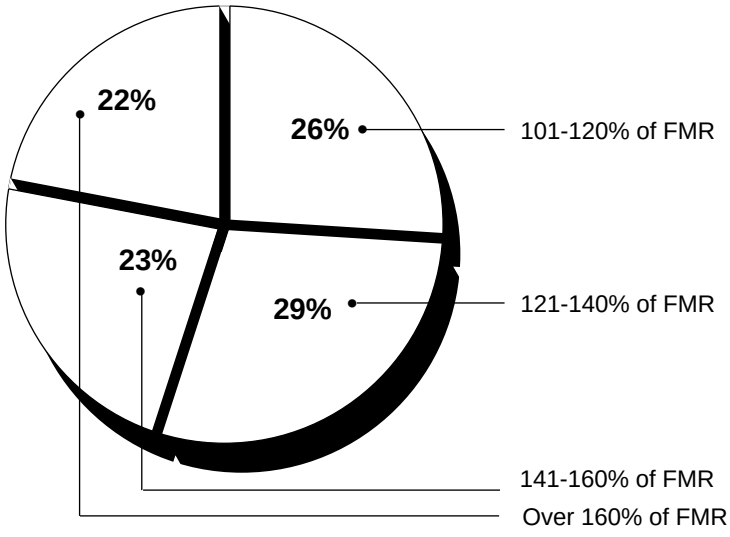
HUD's Rent Standard Is Used to Limit Rent Increases, but Portfolio Data on Actual Market Rents Are Not Available

The Congress, beginning in fiscal year 1995, limited the annual rent increases that, until then, were automatic for many Section 8 properties. Under this congressional limit, automatic rent increases are no longer allowed for properties whose Section 8 contract rents exceed HUD's rent standard—fair market rents—unless the property owners provide independent studies showing that the Section 8 contract rents do not exceed actual market rents.[1] To establish fair market rents, HUD annually samples market rents for geographic areas, such as large metropolitan areas, and sets the fair market rent somewhat below the average for the geographic area. In some cases, the area covered by HUD's fair market rent is too wide to reflect differences in the rents paid in different submarkets, or neighborhoods, within the geographic area covered. By contrast, market rents reflect the rents paid for comparable units in particular neighborhoods. As a result, HUD's fair market rents for Section 8 properties may not reflect the actual market rents in neighborhoods where Section 8 properties are located.

According to HUD's data, most of the rents for Section 8 units in the uninsured portfolio exceed HUD's fair market rents and are therefore subject to the congressional limit on rent increases. As of December 1998, the rents for 474,270 of 632,216 assisted units in the uninsured portfolio exceeded fair market rents. These units represent 75 percent of the assisted units in the uninsured portfolio. As shown in figure 2.2, for 22 percent of these 474,270 units, the Section 8 rents were greater than 160 percent of HUD's fair market rents.

[1]In the tenant-based section 8 program, fair market rents are used as limits for rents the Department will subsidize.

Figure 2.2: Unit Rents Exceeding HUD's Fair Market Rent Levels, December 1998



FMR=fair market rent

Source: HUD's Section 8 expiring contracts database, Dec. 1998.

Among the uninsured programs, those that use Section 8 assistance to support property mortgages generally have rents that exceed fair market rents. Thus, most of the units in four of the housing development programs — the state agency, elderly/disabled loan, rural housing, and new construction/substantial rehabilitation programs—have Section 8 contract rents that exceed HUD's fair market rents. These programs account for over 80 percent of the assisted units in the entire uninsured inventory. As shown in table 2.2, the rents for between 72 and 91 percent of the units associated with the four programs exceeded HUD's fair market rents. (See app. III, table III.1 for additional details on these rent levels by program.)

Table 2.2: Percentage of Assisted Units With Section 8 Rents Exceeding HUD's Fair Market Rents, by Program, in HUD's Uninsured Section 8 Portfolio, December 1998

Program	Percentage of units with rents exceeding fair market rents
State agency	91
Elderly/disabled loan	88
Rural housing	86
New construction/substantial rehabilitation	72
Preservation	42
Loan management set-aside	24
Property disposition	21
Elderly/disabled capital advance	5

Note: These data cover 12,288 of the 12,708 contracts in HUD's uninsured portfolio for which data on rents and HUD's fair market rents were available.

Source: HUD's Section 8 expiring contracts database, Dec. 1998.

Because data on actual market rents for particular neighborhoods were not available for comparison with Section 8 contract rents, we could not determine to what extent the contract rents exceeded the actual market rents in this portfolio. However, some properties in the uninsured Section 8 portfolio have rents in excess of actual market rents.

When Section 8 contract rents exceed market rents, the Section 8 subsidies support higher rents than the properties generally could command without federal assistance. In the uninsured portfolio, as in the FHA-insured portfolio, where HUD found that many of its Section 8 rents exceeded market rents,[2] the assisted rents were initially set above market levels to encourage the production of new affordable housing. These rents were then increased automatically each year through the application of set formulas that, according to HUD, tended to be generous.[3] A July 1997 study of 53 bond-financed properties, the majority of which are included in the uninsured Section 8 portfolio, reported that some of the properties had rents that were well above comparable market levels.[4]

[2]Our 1996 report on HUD's portfolio reengineering proposal discusses high rents in the FHA-insured portfolio, and a study by Ernst & Young for HUD on the potential cost to the government of reducing Section 8 rents in the insured portfolio to market rents. See Multifamily Housing: Effects of HUD's Portfolio Reengineering Proposal (GAO/RCED-97-7, Nov. 1996).

[3]A problem with automatic rent increases, according to Office of Housing officials, is that they allow a percentage increase in both operating costs and mortgage debt service, even though debt service is a fixed amount that does not increase.

[4]HUD's Local Multifamily Portfolio, John Nuveen & Co., Inc. (July 1997).

In addition, since the Congress limited automatic Section 8 rent increases, some owners have not requested rent increases. Officials at two of the five state agencies we visited said they have not processed Section 8 rent increases for owners because the Section 8 rents for properties in their portfolios are generally higher than market rents. Officials at another state agency we visited said that before the Congress limited automatic rent increases, they had attempted to increase rents only for the uninsured Section 8 properties in their portfolio that needed increases to cover their costs. However, as long as the Section 8 program's rules required automatic annual rent increases, the agency had to provide them according to a formula that sometimes provided more assistance than the officials considered necessary.

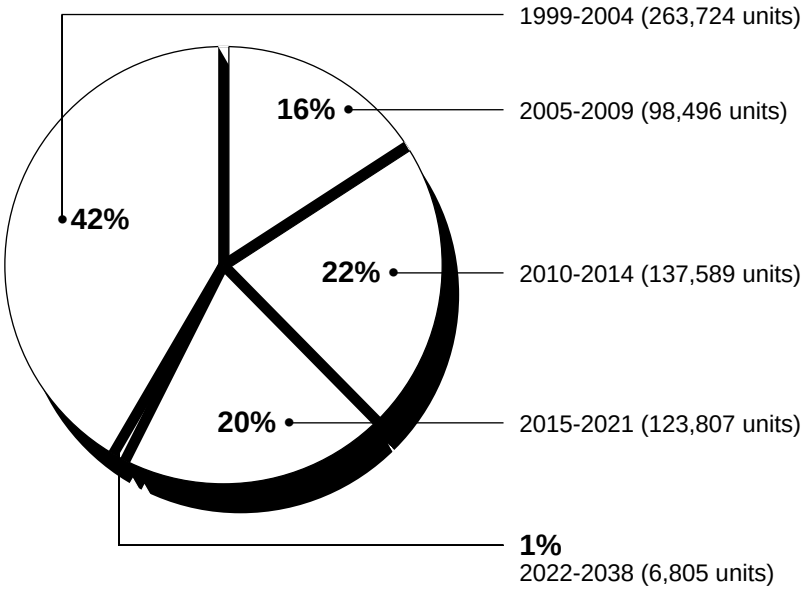
Besides limiting automatic rent increases, the Congress has taken some other steps to reduce high Section 8 costs. For example, the Congress enacted "mark to market," or multifamily portfolio reengineering, legislation in 1997 to bring rents in the FHA-insured Section 8 portfolio in line with market rents. Under this legislation, Section 8 contract rents are to be reset to market levels and mortgage debt is to be reduced if necessary to permit a positive cash flow. These efforts were designed not only to reduce the costs of expiring Section 8 contracts but also to address problems at financially and physically troubled projects, correct management and ownership deficiencies, and preserve the affordability and availability of low-income rental housing. More recently, in HUD's fiscal year 1998 appropriations legislation, the Congress placed limits on the contract rents that will be allowed when Section 8 contracts in the uninsured Section 8 portfolio expire and are renewed. According to the legislation, contract renewal rents are authorized at the lower of (1) a level that provides sufficient income to support rents based on actual costs (budget-based rents) or (2) existing rents subject to a new adjustment factor that allows increases on operating costs, in contrast to the current factor that allows increases on both operating and debt service costs.

Section 8 Contracts for Programs in the Uninsured Portfolio Will Expire at Various Times

As discussed in chapter 1, the Section 8 contracts for properties in the uninsured portfolio were initially made for periods ranging from 20 to 40 years. Currently, the contracts covering 42 percent of the assisted units will expire by the end of 2004. However, a number of contracts in the uninsured portfolio have 15 to 20 years remaining (see fig. 2.3). A majority of the assisted units—about 58 percent—are under contracts that will expire between 2005 and 2038. As a result, the federal government will

continue to incur costs under these rental assistance contracts for many years.

Figure 2.3: Dates When Section 8 Contracts for Uninsured Properties Will Expire



Note: Excluded from this analysis are 1,795 units covered by 54 Section 8 contracts whose expiration dates are unknown.

Percentages do not add because of rounding.

Source: GAO's analysis of HUD's Section 8 expiring contracts database, Dec. 1998.

From program to program, contracts will expire at different times. For example, the vast majority of the contracts for the loan management set-aside program and the rural housing program will expire between 1999 and 2004, while most of the contracts for the state agency program will expire later—between 2010 and 2021. (See app. III, table III.2, for additional information on when contracts will expire, by program.)

Agency Comments and Our Evaluation

In commenting on the draft report, HUD and the National Council disagreed with our statement that the federal government's costs are higher than they should be when Section 8 rents exceed market rents. We revised this

statement to describe rather than evaluate the impact of the Section 8 program's design on the federal government's subsidy costs. As the draft report observed, HUD originally set Section 8 rents above market rents to encourage the production of low-income housing and then automatically increased the rents each year until 1995, using formulas that tended to be generous. As a result, Section 8 rents sometimes exceed market rents. While the draft report concluded that, in these instances, the program's costs are higher than they should be, the revised report observes that when Section 8 rents exceed market rents, the Section 8 subsidies support higher rents than the properties generally could command without federal assistance.

HUD further disagreed with our comparison of Section 8 rents with HUD's fair market rents. The draft report recognizes that HUD's fair market rents are not equal to market rents and describes the methodology used to set the fair market rent for a particular area at a level below the average rent for that area. Moreover, as the draft report states, national data on market rents were not available. Despite their limitations, fair market rent data are the only comparative rent data that HUD maintains for all Section 8 contracts. The Department itself compares fair market rents with Section 8 rents, posting the results in a database on its Internet Web site. In addition, the Congress requires that fair market rents be used to limit some Section 8 rent increases. Therefore, we did not revise the report in response to this comment.

Finally, according to HUD, the draft report provided no evidence, apart from the fair market rent data, that some Section 8 rents were higher than market rents. However, in addition to noting the impact of the program's design on subsidy and rent levels, the draft report cited (1) a July 1997 study of 53 bond-financed Section 8 properties that found the rents for some were well above comparable market levels, (2) officials at two state agencies who said that the Section 8 rents for properties in their portfolios were generally higher than market rents, and (3) an official at another state agency who said that HUD's former rent increase formula sometimes required the agency to provide more rental assistance than the officials considered necessary. In light of this evidence, we did not revise the report in response to HUD's comment.

HUD Has Missed Opportunities to Reduce Its Costs in the State Agency Program

Financial benefits available to state and local agencies under the Section 8 program include savings from refunding bonds and a fee for administering Section 8 contracts. Agencies use these benefits to provide affordable housing for low-income residents in their states. We found that HUD has not resolved three long-standing issues associated with these financial benefits, missing opportunities to reduce its Section 8 costs. First, HUD has not provided the state agencies with a clear interpretation of an amendment to the McKinney Act that provides for agencies to share savings with the government from refunding bonds associated with certain Section 8 contracts. As a result, after refunding bonds, some state agencies have retained all of the savings that accrue annually, while other agencies have shared the savings with the government. Second, HUD has not provided the agencies with clear guidance for calculating rent increases after bonds have been refunded. Without such guidance, some agencies have not reduced the costs of financing in their calculations and have thus approved unduly high rent increases. Finally, some state agencies have been collecting two fees for administering their Section 8 contracts, despite a long-standing HUD regulation prohibiting dual fees. Because HUD has not enforced its regulation, the federal government has provided excess funding to state agencies for administering Section 8 contracts. Taking action on each of these issues could reduce the Section 8 costs borne by the federal government.

Requirements for Sharing Refunding Savings Remain Unclear

After more than 6 years, HUD has not clarified a provision for state agencies to share certain bond refunding savings with the government. This provision is set forth in section 1012 of the McKinney Act, as amended in October 1992. On its face, the amendment appears to require the state agencies to share savings; however, the National Council of State Housing Agencies and some state agencies maintain that the amendment applies only to Section 8 contracts that explicitly give HUD the right to bond refunding savings—that is, only to financing adjustment factor contracts. While a HUD legal opinion stated that, on the basis of the express language of the statute, the Department could apply the amendment to state agencies for all contracts issued between 1979 and 1984, the Department has not issued clear guidance to this effect. Over the years, many state agencies have refunded bonds, often retaining all of the savings. Meanwhile, HUD's inaction has potentially deprived the federal government of opportunities to share savings and reduce Section 8 costs.

Section 1012 of the McKinney Act Provides for Sharing Bond Refunding Savings

Section 1012 of the Stewart B. McKinney Homeless Assistance Amendments Act of 1988 permitted state agencies to keep half of the savings from refunding bonds associated with financing adjustment factor contracts to provide affordable housing for households with very low incomes. Financing adjustment factor contracts required agencies to refund high-interest bonds when interest rates declined and to provide all of the interest savings to the federal government (see ch. 1). Without the McKinney Act's shared savings provision, the state agencies would have been required to provide 100 percent of the savings to the government under these contracts with HUD. The contracts also required property owners to accept reduced Section 8 contract rents (subsidies) to reflect the decrease in borrowing costs resulting from refunding the bonds.

In 1992, the Congress amended section 1012 twice. First, in April 1992, the Congress expanded the shared savings provision for financing adjustment factor contracts to local agencies. Then, in October 1992, the Congress authorized both state and local agencies to share the savings from refunding bonds associated with Section 8 contracts entered into between calendar years 1979 and 1984. The Section 8 contracts executed during this 6-year period include (1) the financing adjustment factor contracts, (2) the contracts that received special financing authorized in 1980 when interest rates were high but do not include a contractual requirement to provide any bond refunding savings to the government, and (3) some contracts that did not receive special financing.

Both of the 1992 amendments to section 1012 provided the local agencies, which generally issued bonds under HUD's regulations, with a new financial benefit. Before the amendments were passed, HUD had required these agencies to return all bond refunding savings to the government—whether their Section 8 contracts required them to do so or not. After the amendments were passed, the local agencies were entitled to half, rather than none, of the savings. However, section 1012, as amended in October 1992, if applied to state agencies, would reduce by half the financial benefit that some state agencies are generally accustomed to receiving for refunding bonds associated with all Section 8 contracts except financing adjustment factor contracts. These state agencies generally retain all of the savings except for financing adjustment factor contracts.[1] HUD officials said the Department does not have the leverage over state agencies that it has over local agencies because it does not have

[1]To preserve developments—avoid loan prepayments and conversions of Section 8 properties to market-rate housing—one of the five state agencies in our study (Illinois) provided savings to some property owners in the form of loans. These loans will be paid over time from Section 8 rental assistance payments.

the authority to review and approve most state bond issuances. HUD officials also said that, in general, the state agencies receive wide latitude and responsibilities under the Section 8 program while HUD's role is confined to receiving certifications that the program has been executed and, occasionally, to auditing the agencies' activities. HUD does, however, review information on state agencies' bonds before entering into agreements (called refunding agreements) with the agencies to share bond refunding savings with them under the McKinney Act.

HUD Never Resolved Uncertainty About Congressional Intent

We found that although the Department has expressly required the state agencies to comply with the shared savings requirements in section 1012 covering financing adjustment factor contracts, it has not expressly required the state agencies to comply with the shared savings provision in the October 1992 amendment covering Section 8 contracts executed between 1979 and 1984. HUD officials told us that many state agencies have consistently questioned HUD's authority to require the state agencies to share savings from refundings that do not require HUD's approval. HUD officials also said that the scant legislative history of the October 1992 amendment focuses on providing a benefit to local agencies and says nothing about the state agencies, raising a question as to whether the Congress intended the amendment to affect the savings from refundings that state agencies carry out under the Internal Revenue Code—refundings that do not require HUD's review and approval.

In May 1993, in response to a request from the Office of Housing, HUD's Office of the General Counsel issued a formal legal opinion addressing this question. The legal opinion concluded that HUD could require the state agencies to share savings from refundings associated with all contracts covered by the October 1992 amendment. However, the May 1993 legal opinion acknowledged that state housing finance agencies might challenge HUD if the Department sought to enforce the clear facial reading of the statute because the legislative history did not address state agencies. The Office of Housing was concerned about the Department's ability to prevail in a lawsuit over the issue. From October 1992 until early 1996, the Department took no steps to require the state agencies to share the savings from refunding bonds associated with contracts that (1) received the special financing authorized in 1980 but do not include a contractual requirement to provide the bond refunding savings to the government or (2) were entered into between 1979 and 1984 but did not receive special financing.

In April 1996, HUD published regulations that were intended to clarify the rules that applied to state and local agencies. However, from the start, the rulemaking caused confusion for the state agencies because HUD added language to a section of the Code of Federal Regulations that otherwise applies primarily to local agencies issuing bonds under the United States Housing Act of 1937. The Office of Housing official in charge of the rulemaking said that the new rule was intended to require state agencies to begin sharing bond refunding savings in compliance with the October 1992 amendment. However, he and other HUD officials agreed that the regulations did not meet their stated objective because of a typographical error. Instead of citing two relevant paragraphs of the McKinney Act, the published regulations cite two paragraphs that do not apply to state agencies. The two relevant paragraphs that HUD intended to cite (1) identify the universe of contracts subject to the shared savings requirements as those issued between 1979 and 1984 and (2) specify the purposes for which McKinney Act savings can be used. The Office of Housing official in charge of bond refundings said that no state agencies have initiated shared savings agreements for new bond refundings since this regulation was passed.

In addition, HUD officials acknowledged that by (1) amending the rules that generally applied only to local agencies and (2) not clearly stating in the rulemaking that the Department was extending the requirements for sharing savings to all state agency contracts covered by the October 1992 amendment to the McKinney Act, HUD might not have resolved the confusion and controversy over this issue even if it had not made a typographical error in the final rule. The HUD officials were uncertain how to correct the rulemaking. HUD officials in the Office of the General Counsel and the Office of Housing responsible for interpreting and implementing the McKinney Act concluded that the question always comes back to the question of what the Congress intended—and they acknowledged that they did not know the answer to this important question. Since the McKinney Act amendment was passed in 1992, a number of state agencies have refunded bonds associated with Section 8 contracts issued between 1979 and 1984 and have not shared the savings with the government. While we agree with HUD that the savings at issue will generally be smaller than the savings for the financing adjustment factor contracts, which supported mortgage rates as high as 12 and 13 percent, we believe that HUD may have missed opportunities to provide additional bond refunding savings to the government. At the state agencies we reviewed, mortgage rates supporting the refunded bonds that may be subject to the McKinney Act varied, generally ranging between 7.25

percent and 10 percent. Furthermore, the bond refunding savings for contracts other than financing adjustment factor contracts that one state agency shares with the federal government total about $14 million.

Extent to Which States Share Bond Refunding Savings Varies

During the early to mid-1990s, state agencies were refunding the bonds associated with Section 8 contracts to lower rates. For example, almost all of the bonds associated with contracts for Section 8 project-based assistance at the five state agencies we visited were refunded during this time. We found that the five agencies shared savings differently. Specifically, the Illinois, Maryland, and Massachusetts agencies generally share savings only for financing adjustment factor contracts, while the Minnesota and New Hampshire agencies share savings for other contracts as well.

While none of the five state agencies shared savings for all contracts entered into between 1979 and 1984—the time period addressed in the October 1992 McKinney Act amendment—some agencies shared savings only for financing adjustment factor contracts while others shared savings for these and other contracts entered into between 1979 and 1984.[2] For example, the Massachusetts agency shares savings for its 35 financing adjustment factor contracts but does not share savings for the other 70 contracts entered into between 1979 and 1984. In contrast, the New Hampshire agency shares savings for 38 of the 48 contracts associated with refunded bonds that it entered into between 1979 and 1984. The 38 contracts include both financing adjustment factor and other contracts.

According to a HUD official, the agencies that shared savings for both financing adjustment factor and other contracts entered into between 1979 and 1984 may have believed they were required to share savings under the McKinney Act. We found, for example, that the Minnesota agency determined that it was required to share savings both for financing adjustment factor contracts and for contracts that received special financing but did not explicitly require savings to be returned to the government.

However, other states concluded, independently of HUD, that the McKinney Act generally was applicable only to financing adjustment factor contracts. For example, an official of the Maryland agency said that, according to the agency's bond counsel, except for financing adjustment factor contracts,

[2]As discussed previously, HUD authorized higher interest rates and Section 8 subsidies, but only the financing adjustment factor contracts require agencies to refund the related bonds when interest rates decline.

the shared savings requirements of the McKinney Act are applicable only when the Section 8 property mortgage is refinanced after a bond has been refunded—that is, when the contract reduction method (see ch. 1) is used. A legal opinion from Maryland's bond counsel, issued in 1996 in conjunction with a bond refunding, discussed in detail the reasons for believing that only financing adjustment factor contracts are subject to the shared savings requirements of the McKinney Act. In concluding, the bond counsel noted that HUD does not have any formal policy requiring the states to share savings for contracts that do not have the financing adjustment factor. The bond counsel said, however, that HUD might in the future develop a policy for such refundings, which would require savings to be shared and could be applied retroactively. While maintaining that the state agency would likely prevail in a legal case on the issue, the bond counsel acknowledged that a court could uphold such a claim by HUD.

HUD's Guidance Has Not Eliminated Excess Section 8 Rent Increases

HUD's general method for calculating automatic rent increases for Section 8 properties does not consider the savings from bond refundings. To avoid increased costs to the government from excessive rent increases to owners when bonds have been refunded, in 1997, HUD issued a notice requiring adjustments to the calculation of rent increases for financing adjustment factor contracts. However, we found that the notice has several serious shortcomings, and agencies' compliance with and understanding of this notice varies. As a result, the Section 8 program is incurring excess costs that it could have avoided.

HUD's Rent Increase Notice Is Flawed

Issued on August 1, 1997, HUD Notice H 97-49 was intended to prevent excessive rent increases following refundings of bonds associated with financing adjustment factor contracts.[3] The notice establishes a requirement for (1) calculating the contract rents that would have resulted if the Section 8 contracts and mortgages had been reduced to reflect the bond refunding savings and (2) applying the annual Section 8 rent adjustment factor to this calculation. However, the notice does not explain the methodology for implementing the procedure, nor does it provide an example of a calculation. In addition, the notice was issued for 1 year—until August 1998—and the Department let it lapse without renewing it. While HUD officials told us that renewing the notice should not have been necessary because the procedures apply to rent increases over the lives of the Section 8 contracts, we do not believe the Department can

[3]HUD Notice H 97-49 is titled Backing-Out Trustee Sweep Savings Before Calculating AAFs for Projects Which Originally Received a FAF and Whose Bonds Were Refunded.

hold its field office staff and state and local agency staff accountable for complying with the requirements of notices that are no longer in effect. Furthermore, we found that the Department's general guidance on Section 8 rent increases, provided in notices H 97-14 and H 98-3, contained no reference to the limit on rent increases contained in notice H 97-49.

The rent increase notice was issued 5 years after HUD's Inspector General reported, in 1992, that Section 8 contracts were receiving excessive rent increases after bonds were refunded and recommended that the refunding savings be backed out before the rent increases were calculated. In 1993, the Department disagreed with the Inspector General's recommendation, citing a HUD legal opinion stating that HUD did not have the authority to limit Section 8 increases. After the Inspector General reopened this recommendation in 1997, the Department obtained a second legal opinion, which found that HUD could limit the rent increases for financing adjustment factor contracts.

Agencies' Compliance With HUD's Rent Increase Limit Varies

Since HUD issued its notice, two of the five state agencies we visited have increased rents for financing adjustment factor Section 8 contracts. We found that the Minnesota Housing Finance Agency complied with the notice for contracts subject to the limitation while the Massachusetts Housing Finance Agency did not.

A Massachusetts Housing Finance Agency official told us in September 1998 that the agency did not adjust the rent increases because it had not received the implementing information from HUD that the notice said would be provided. A HUD assessment of compliance with the rent increase notice, initiated in Feburary 1999, also found that the Massachusetts Housing Finance Agency was not adjusting the rent increases for financing adjustment factor contracts. The Massachusetts agency responded to HUD that it had not complied with the notice because (1) it was not included in the Department's rent adjustment procedure notices, (2) it had expired in August 1998, and (3) HUD had never provided the information required to implement the notice. An internal HUD review has recently identified other agencies that did not comply with the notice when they processed rent increases subject to the notice.

Currently, the number of rent increases being processed for financing adjustment factor contracts may be small because of other limits on overall rent increases mandated by the Congress. However, many of the state agency contracts will be in effect for the next 15 to 20 years, and the

rent increase limits are therefore likely to become more applicable in the future.

HUD Has Not Enforced Its Prohibition of Dual Fees

Even though HUD prohibits the collection of dual fees, some state agencies have been collecting them for at least 6 years with HUD's knowledge. That is, some agencies have been collecting an annual contributions contract fee and an override fee, although HUD's regulations require state agencies to choose only one of these fees for administering Section 8 contracts on behalf of the Department. As a result, HUD has added, at a minimum, tens of millions of dollars to the Section 8 program's costs. The Department is attempting to resolve the issue for some of the agencies that have been collecting dual fees for administering Section 8 contracts associated with shared savings (refunding) agreements approved by HUD because of fee information provided to the Department in this process. However, we found that HUD has not identified all state agencies that receive dual fees and has not taken any actions when dual fees are being collected for contracts that are not subject to shared savings agreements with HUD. Finally, HUD does not appear to have considered options for recovering the override fee after it is no longer needed to secure the bonds.

HUD's Regulation Allows One of Two Types of Fees, and Agencies' Charters Limit the Fees' Use

State and local housing finance agencies that administer Section 8 contracts for HUD receive compensation for carrying out their administrative responsibilities. While all of the agencies are eligible for an annual contributions contract fee, provided by HUD, state agencies that finance Section 8 property mortgages with the proceeds of state tax-exempt bond proceeds issued under the Internal Revenue Code may instead receive an override fee (see ch. 1). But whether an agency is eligible for one or both fees, it is allowed to receive only one fee under a Section 8 regulation promulgated in 1980 (24 C.F.R. 883.606).[4]

According to this regulation, a state housing finance agency that chooses to collect an override fee cannot receive an annual contributions contract fee. HUD first prohibited dual fees in 1977 when it indicated that it would allow the state agencies to receive an annual contributions contract fee only when the interest rates that they were charging on their Section 8 property mortgages were equal to the agencies' cost of borrowing. HUD expected the state agencies to take the annual contributions contract fee only in the rare instances when they issued their bonds under HUD's

[4]According to HUD officials, the regulation can be waived by the Assistant Secretary for good cause and in writing because it is not a statutory requirement.

regulations, which do not permit an agency to charge more than its cost of borrowing.

According to the National Council of State Housing Agencies, the charters and authorizing statutes of state agencies restrict their spending to public purpose programs, including the costs of administering those programs. For example, the Minnesota agency said that all income from any source is dedicated to providing affordable housing and covering the operating costs necessary to fulfill its mission. Thus, the agency said, after covering its operating costs and meeting its loan loss reserve requirements, it invests the balance of its override fees in affordable housing activities. Similarly, the Maryland agency said that it uses its override fees to pay the debt service on its bonds and the direct costs associated with the bonds, such as the legal fees. Each year, the agency determines how much of the fees it can use for other purposes without jeopardizing its bond rating. The excess revenue may be used only for affordable housing, community development, and budgeted departmental operating costs.

HUD's Response to the Dual Fee Issue Has Been Slow and Inconsistent

In 1992 and 1993, HUD's Inspector General reported that two state agencies were receiving dual fees. For example, the Inspector General found that the Oregon state agency had received override fees of $584,000 and annual contributions contract fees of $634,000 for the same Section 8 contracts during the same period.[5] The Inspector General recommended that HUD's Office of Housing (1) direct the field offices to ensure that annual contributions contract fees are not allowed when override fees are being collected and (2) determine the amount of dual fees HUD had paid to agencies and require them to return the overpayment to the Department. In response to the Inspector General's recommendations, HUD identified a number of state agencies that were receiving dual fees and sent letters in August 1994 telling them to stop collecting dual fees unless they had received a waiver of the regulation prohibiting dual fees.[6] The Inspector General closed the recommendations on the basis of this action.

[5]The dual fees cover 11 projects from 1984 through June 30, 1992. The annual override fee for most of this period was set at one-third of the maximum allowable amount (0.50 percent) and was increased to the maximum (1.50 percent) when the bonds were refunded in 1990. The Inspector General estimated that the higher override fee reduced the bond savings—and thus increased the override fee—by $2.3 million.

[6]We could not determine how many dual fee agencies HUD initially identified and sent letters to. However, a memorandum from the National Council of State Housing Finance Agencies indicates that 14 agencies were to receive the letters. Subsequently, in 1996, HUD identified 17 agencies that it believed receive dual fees.

Six months later, however, in February 1995, HUD reversed its position, stating that it would not enforce the dual fee prohibition for Section 8 financing adjustment factor contracts associated with bonds that had been refunded with the Department's approval.[7] This letter said, however, that all bond-financing proposals submitted to HUD in the future must comply with the dual fee prohibition. According to HUD officials, the Department changed its position after some state agencies questioned the Department's legal authority to enforce the dual fee prohibition. The agencies pointed out that when HUD negotiated shared savings agreements with them, it reviewed bond refunding documents that showed the agencies would receive an override fee. The agencies maintain that the documents provided HUD with the information needed to determine that the agencies were also receiving annual contributions contract fees. The agencies believe that HUD therefore implicitly or explicitly approved the dual fees for these contracts when it approved their refunding agreements.

After finding that HUD had changed its position and was not going to enforce the dual fee prohibition in existing cases, the Inspector General reopened the recommendation. Also, in October 1996, the Inspector General requested that HUD not process any waivers before the Inspector General completed a corrective action verification that would be initiated the following month on the bond refunding audits.

The debate between HUD and the Inspector General over the dual fee issue has not been resolved. While HUD has required the 17 dual fee agencies it identified to request waivers of the dual fee regulation and 14 agencies have done so, HUD has approved only one waiver request—that of the Oregon Housing Finance Agency. According to HUD officials, the Department did not complete action on the remaining waiver requests because in 1997 the Inspector General argued that the dual fee agencies have created a valid debt to HUD and that under the Federal Claims Collection Act, as amended, HUD requires approval from the Department of Justice to waive its regulation prohibiting dual fees. In an October 1998 legal opinion, HUD's Office of the General Counsel did not determine whether the payment of dual fees created a debt to HUD. It did agree that if a debt had been created, the Department would need approval from the Department of Justice to waive the prohibition on dual fees.[8]

[7]In 1996, HUD told agencies that the Department would have to execute formal waivers of the dual fee prohibition and therefore required them to request waivers of its regulation.

[8]Under the Federal Claims Collection Act of 1966, as amended, and implementing regulations, the Department of Justice's concurrence is required to terminate the collection of any claim exceeding $100,000.

In November 1998, we met with the Deputy Assistant Secretary for Housing and other officials to determine the status of HUD's actions. As a result of this meeting, the Deputy Assistant Secretary established a team to resolve the issue; however, as of June 1999, it had not been resolved, and HUD has yet to take action on the waiver requests. According to HUD, the program office (Housing) has asked the Office of the General Counsel for advice on the options available to the Department for resolving the issue.

HUD Has Not Identified All Contracts or All Agencies With Dual Fees

We found that HUD, in attempting to implement the Inspector General's recommendation that it identify state agencies that receive dual fees, has focused only on contracts that are subject to refunding (shared savings) agreements with HUD. However, we found that the agencies also receive dual fees for Section 8 contracts that are not subject to refunding agreements. For example, four of the five state agencies we visited received dual fees for 84 contracts with refunding agreements and about 139 contracts with no refunding agreements. The bonds associated with most of these latter contracts have been refunded, and the agencies receive override and administrative fees. According to HUD officials, if the Department approves the agencies' requests for waivers of the dual fee prohibition, the approvals would cover only the dual fees associated with contracts that require the agencies to share savings with the government under refunding agreements with HUD. HUD would limit its approval to these contracts because they alone provided the Department with an opportunity to implicitly approve the dual fees.

We also found that the Department had not identified all of the state agencies that receive dual fees. For example, although HUD had not linked the Maryland agency with dual fees, we found that the agency had received dual fees for 14 of its 35 Section 8 contracts. We confirmed that HUD had correctly identified the Massachusetts, Minnesota, and New Hampshire agencies as dual fee agencies.

In fiscal year 1998 alone, HUD paid these four state agencies over $5.3 million in administrative fees, while the agencies were also receiving override fees on the related bonds under the Section 8 program. Because state agencies do not generally account for their override fees on a project-by- project basis, we could not determine the amounts of the related override fees associated with the Section 8 contracts for the four states. However, we found that, in 1998, one agency received override fees of close to $490,000 and administrative fees of almost $423,000 for the same Section 8 contracts.

Finally, an official at the Massachusetts agency—one of the dual fees agencies identified by HUD that applied for a waiver in 1997—told us that his agency does not believe it is violating HUD's dual fee prohibition. The official stated that HUD's policy was applicable only when a bond's original financing was in place. The agency maintains that since the bonds have been refunded, the prohibition no longer applies. Despite its position on the legitimacy of receiving dual fees after bonds have been refunded, the Massachusetts agency filed a waiver request with HUD in 1997 so that it could continue to receive dual fees. Moreover, the agency received a letter from the Department in 1995 indicating that future bond refunding proposals must comply with the dual fee prohibition.[9] Finally, in 1996 in the Code of Federal Regulations, HUD reiterated its policy that the dual fee prohibition applies to bond refundings (24 C.F.R. 811.110 (b)).

One Approved Waiver and Pending Waiver Requests Rely in Part on Pledges of Fees as Security for Bonds

In June 1997, the Assistant Secretary for Housing-Federal Housing Commissioner approved the Oregon Housing and Community Service Department's request for a waiver of the dual fee prohibition, relying in large part on the Oregon agency's pledges and uses of fee income. According to the letter approving the waiver, the Oregon agency has pledged both the override and the contract administration fees as security for the bonds and this pledge is contained in official bond documents. The letter said that HUD did not wish to upset the existing security arrangements relied on by bond rating agencies and purchasers of the bonds. The letter also recognized that the Oregon agency had allocated the override fee to several affordable housing programs. The Assistant Secretary also stated that in collecting duplicate fees, the Oregon agency relied on decisions HUD made in processing and approving the bond refunding transactions.

Most of the 14 waiver requests submitted by state agencies also state that the documents provided to HUD for shared savings agreements indicated that the state agencies would continue to collect both the override fees permitted by the federal tax laws and the Section 8 administrative fees. Many of the waiver request letters, including the Oregon letter, indicated that the override fee was needed to support state housing programs but was also restricted because it was pledged as security to the bondholders.

[9]The 1995 letter said that HUD would not require compliance with the dual fee prohibition when HUD had approved refunding agreements. As discussed above, in 1996, HUD required the agencies to request waivers of the regulation. HUD is required by statute to issue a formal waiver when it does not enforce a regulation.

From discussions with state agencies, we understand that an override fee may be restricted for a period of time but may become available to an agency while a bond is still outstanding. Some states may use their override fees for their housing programs or their expenses, while others may keep the fees in their bond accounts, investing them to earn investment income. The fee amounts remaining in the bond accounts accrue to the agencies when the bonds are paid off. In 1997, at least one HUD official asked whether the dual fee issue could be resolved by allowing the state agencies to keep the override fees while required by bond pledges and then require the agencies to return the fees to HUD. The Department does not appear to have pursued this suggestion for resolving the dual fee problem.

According to a 1997 study by a bond rating agency, state agencies have built up equity over the last two decades in bond accounts associated with Section 8 contracts primarily by accumulating override fees.[10] Thus, the financial outlook for state agencies' Section 8 bonds was expected to remain very strong, in large part because the agencies have sufficient equity available in the event of significant increases in nonperforming loans. For example, the study indicated that agencies typically had equity in excess of 12 percent of the bonds outstanding. One agency's equity ($87 million) was equal to 56 percent of its outstanding bonds ($154 million). The state agencies will generally continue to receive the override fees annually throughout the terms of their Section 8 contracts, many of which have another 15 to 20 years remaining.

Conclusions

For more than 6 years, HUD has missed opportunities to protect the federal government's interests and to reduce Section 8 rental assistance costs:

- Because HUD has not resolved the applicability of the October 1992 amendment of the McKinney Act to state agencies, the Department may have missed opportunities for the government to obtain certain bond refunding savings. If HUD determines that this provision is applicable to state agencies and that it can begin to require them to share the bond refunding savings, these savings will reduce the Section 8 costs that the federal government will bear for many years to come.
- By taking so long to publish procedures for limiting Section 8 rent increases after bonds have been refunded, HUD missed opportunities to lower the Section 8 program's long-term costs. Moreover, by failing to

[10]Bonds Secured by Section 8 Subsidies – A Tale of Two Outlooks, Moody's Investors Service, Nov. 1997.

ensure compliance with the procedures after publishing them in a notice, allowing the notice to expire after 1 year, and not providing promised guidance or examples of calculations for implementing the procedures, HUD missed further opportunities to control the program's costs.

- Finally, by failing to enforce its regulation prohibiting dual fees, HUD has added tens of millions of dollars to the Section 8 program's costs. If allowed to continue, the fee payments will unnecessarily increase the program's costs for the next 15 to 20 years. In the meantime, a bond agency's data indicate that the state agencies are accruing significant amounts of equity from override fees that will be fully available to the agencies when the bonds are paid off, if not sooner. In addition, HUD has not identified all of the contracts or all of the state agencies receiving dual fees. Because it did not recognize that some agencies were receiving dual fees for contracts that are not subject to refunding agreements approved by HUD, the Department missed opportunities to enforce the dual fee regulation in these cases where, in the opinion of HUD officials, the agencies do not have a basis for requesting waivers. Furthermore, Housing officials do not appear to have considered options other than waiving the dual fee prohibition. One such option would allow the agencies to continue receiving both fees until the documented bond commitments have been satisfied and then requiring the agencies to return the fees to HUD. In this way, the government could limit the impact of the excess fee costs on the Section 8 program.

Recommendations

We recommend that the Secretary of Housing and Urban Development determine whether the state agencies are required, under the McKinney Act, to share savings from refunding bonds associated with all contracts entered into between 1979 and 1984. If so, the Department should revise its applicable rules and regulations to clarify the requirements for sharing bond refunding savings with the federal government. For contracts associated with bonds that have already been refunded, HUD should determine whether it can require the state agencies to begin sharing the Section 8 savings they currently retain.

To ensure that state and local housing finance agencies comply with HUD's guidance on deducting bond refunding savings before calculating rent increases, we recommend that the Secretary require the Department to provide the state and local agencies with the appropriate methodology and examples of calculations and ensure that the rule is kept current and integrated into the Department's guidance on annual Section 8 rent increases.

To eliminate excess costs from paying dual fees to state agencies administering Section 8 rental assistance contracts, we recommend that the Secretary require the Department to enforce its regulation prohibiting dual fees unless there is a documented, sound, and equitable basis for waiving the regulation. To enforce the regulation, the Department should identify all Section 8 contracts for which state agencies receive both an administrative fee under the Section 8 contract and an override fee, including those contracts that are not subject to a refunding agreement with HUD.

Agency Comments and Our Evaluation

In commenting on the draft report's discussion and recommendation concerning the applicability of the McKinney Act's shared savings provision (section 1012, as amended in October 1992) to state agencies, HUD says that the draft report and recommendation direct the Department to take action where its legal authority is unclear. In fact, the draft report recommended that HUD clarify its legal authority (determine whether the state agencies are required, under the McKinney Act, to share savings from refunding certain bonds with the government) and revise its rules and regulations accordingly. However, we recognize that a statement in the executive summary may have caused some confusion, and we have revised it for clarity and greater consistency with our discussion in the body of the report. Specifically, the draft executive summary said that HUD has not issued guidance to the state agencies directing them to comply with the October 1992 amendment to section 1012 of the McKinney Act, which requires the agencies to share certain bond refunding savings with the government. As is consistent with the discussion in this chapter, the final report states that HUD has not issued guidance to the state agencies on how to comply with the October 1992 amendment to section 1012 of the McKinney Act, which provides for the agencies to share certain bond refunding savings with the federal government.

Although HUD has not resolved the applicability of the McKinney Act amendment to state agencies, HUD's previous actions indicated that the Department believed it could require state agencies to share these savings. For example, the comments do not recognize that (1) the Department's Office of the General Counsel concluded that HUD could require state agencies to comply with the shared savings provision and (2) HUD attempted in 1996 to require the agencies, by regulation, to share these savings. Today, more than 6 years after the shared savings provision was amended, HUD has not clarified the provision's applicability to the state agencies. In the absence of a clear interpretation, some state agencies

have retained the bond refunding savings, while others have shared the savings with the government. Thus, HUD's inaction may have deprived the federal government of opportunities to share savings and reduce its Section 8 costs.

In further commenting on this recommendation, HUD says that we recommend that the Department retroactively recover the portion of the bond refunding savings that some state agencies have retained in their entirety. In fact, our recommendation is prospective, stating that if HUD finds the agencies are required to share their savings, then it should determine whether it can require them to begin sharing the savings they currently retain.

In a final comment on this recommendation, HUD questions whether data exist to support our statement that, without clarification of the McKinney Act's shared savings provision, state agencies may retain "tens of millions" of dollars that they could be legally required to share with the government. This figure, cited to convey the magnitude of the savings at issue, was based primarily on information we had obtained on Section 8 bond refundings by state agencies with and without shared savings agreements. It also considered the bond refundings savings, amounting to millions of dollars annually, that two state agencies in our review share with the government for contracts other than financing adjustment factor contracts. Nonetheless, we agree with HUD that the savings for contracts other than financing adjustment factor contracts will generally be smaller than the savings for financing adjustment factor contracts, which supported mortgage rates as high as 12 and 13 percent. For example, as indicated in the final report, the mortgage rates for contracts other than financing adjustment factor contracts at the state agencies we reviewed generally range between 7.25 percent and 10 percent. We also agree with HUD that the data needed to prepare a comprehensive estimate of the potential savings are not available. We revised the final report to state that, in our view, HUD may have missed opportunities to provide additional bond refunding savings to the government to offset the related Section 8 costs, and we deleted the estimate of potential savings.

In response to our recommendation that HUD ensure the currency of its rule on deducting bond refunding savings before calculating rent increases and integrate this rule into its guidance on annual Section 8 rent increases, HUD agreed to reissue its expired notice and to evaluate the need for cross-referencing other Section 8 rent directives. HUD also agreed to ensure compliance with its rent-adjustment rule by providing state and local

agencies and HUD field staff with clarifying instructions for compliance with the notice.

In commenting on our recommendation that the Department enforce its regulation prohibiting dual fees unless there is a documented, sound, and equitable basis for waiving the regulation, HUD said that if the refunding agreements it approved had been accompanied by executed waivers of the dual fee prohibition, no dispute about dual fees would have arisen. We agree with HUD that waivers, if executed in compliance with the Department's waiver rules and applicable federal laws, would have avoided the issue. However, waivers have not been executed, and the issue remains unresolved.

HUD also suggests that we consider the dual fee as an incentive that encouraged state agencies to refund the bonds associated with their Section 8 contracts and, hence, provide bond refunding savings to the government. According to HUD's estimate, these savings will exceed $150 million over the lives of the contracts. Whether these savings will offset the costs of the dual fees is unknown because neither the number of state agencies that take dual fees nor the number of contracts associated with dual fees is known. Nevertheless, we estimated in our draft report that dual fees add tens of millions of dollars to the Section 8 program's costs. We based this estimate on the fees paid in 1998 to four state agencies for administering contracts that are also associated with override fees. As we indicated in the draft report, these fees totaled $5.3 million for 1 year. Most state agencies' contracts will be in effect for another 10 to 20 years, and administrative fees, which are tied to unit costs, are likely to increase. Thus, the dual fees for these four agencies alone will add tens of millions of dollars to the Section 8 program's costs. Furthermore, the draft report indicates that 14 state agencies have requested waivers of the dual fee prohibition and shows that HUD has not identified all state agencies that receive dual fees. Thus, we believe our estimate of tens of millions of dollars in dual fee costs is conservative. We revised the final report to say that the dual fees have added, at a minimum, tens of millions of dollars to the Section 8 program's costs.

Finally, HUD does not indicate in its comments how it will identify the state agencies that receive dual fees for Section 8 contracts that are not subject to refunding agreements approved by HUD. As discussed in the report, HUD officials said that, for these contracts, they had no basis for approving waivers of the dual fee regulation. We urge the Department to respond

expeditiously so that these fees do not continue to burden the Section 8 program.

In commenting on the draft report, the National Council of State Housing Agencies disagreed with—but misstated—our conclusion and recommendation about the McKinney Act's requirements. According to the Council, we wrongly concluded that HUD has the authority to require state agencies to share certain bond refunding savings with the federal government. In fact, the draft report recommended that the Secretary determine whether the state agencies are required, under the McKinney Act, to share certain bond refunding savings. This recommendation is based on our conclusion that HUD has not provided the agencies with a clear interpretation of the McKinney Act's shared savings provision (section 1012, as amended in October 1992), and, as a result, some state agencies are sharing certain bond refunding savings with the government while others are not. The Council also disagreed with the report for not recognizing that HUD effectively waived its prohibition of dual fees by approving refunding transactions under which state agencies receive both fees. As the draft report clearly states, this is the position of the state agencies. However, HUD is required to issue formal waivers when it does not enforce a regulation such as the dual fee prohibition.

HUD's Information on the Physical and Financial Condition of the Uninsured Portfolio Is Limited, but 10 State Agencies Reported Few Problems in Their Portfolios

To monitor the physical and financial condition of properties in the uninsured portfolio, HUD requires annual physical inspections and generally requires annual audited financial statements. The 10 state agencies we surveyed reported having monitoring policies and procedures in place that conformed to HUD's guidance. As of December 1998, HUD had limited information on the physical and financial condition of the uninsured portfolio. According to the Department's central database, the majority of the properties were in satisfactory or superior physical condition; however, these ratings were not based on objective criteria, and their reliability was therefore unknown. The 10 state agencies reported that nearly all of the properties in their uninsured Section 8 portfolios were in satisfactory or superior condition, yet their ratings, like HUD's, were subjective. Also as of December 1998, HUD's database contained no information on the financial condition of properties in the uninsured portfolio. According to the 10 state agencies, a very small fraction of their properties (under 4 percent) warranted special monitoring because of financial or other problems. In mid-1998, HUD began to establish centralized procedures, including objective rating criteria, to improve the monitoring of multifamily properties in its uninsured and other portfolios.

HUD and State Agencies Monitor Conditions to Ensure Compliance With Federal Requirements

HUD field offices currently administer about 80 percent of the uninsured Section 8 housing assistance contracts, while state or local housing finance agencies generally administer the balance. Under their contracts with HUD, the state and local agencies are responsible for monitoring the physical and financial condition of the Section 8 properties in their portfolios, as well as for evaluating other aspects of the properties' management, such as their leasing and occupancy procedures. The purpose of this monitoring is to ensure that property owners and managers comply with the terms of their Section 8 subsidy contracts, regulatory agreements, and other administrative requirements.

HUD requires annual physical inspections of properties in the uninsured portfolio. According to HUD's handbooks, HUD field staff, HUD contractors, or state or local contract administrators should visit Section 8 properties at least annually to perform physical inspections and to determine whether property owners are providing decent, safe, and sanitary housing. The physical inspections are to include examinations of buildings, grounds, and mechanical systems. The 10 state agencies we surveyed reported having policies and procedures in place for performing the minimum number of physical inspections that HUD requires. In addition, most of the agencies reported using HUD's inspection forms to perform

these inspections. The agencies also said they usually increase the frequency of their inspections when they identify unsatisfactory conditions.

HUD requires most property owners to submit annual audited financial statements to HUD or its contract administrators, who are then required to perform oversight reviews.[1] Besides reviewing the required financial audits, state agencies reported using other procedures to monitor their properties, such as examining operating reports, approving budgets and rent increases, processing requests for using cash reserves, analyzing monthly financial reports, and making on-site management assessments. In addition, each agency identified methods it used to strengthen its monitoring of properties with operating difficulties, such as financial instability, physical and maintenance problems, and management or ownership concerns.

Information on the Physical and Financial Condition of Uninsured Section 8 Properties Was Limited

Information on the physical and financial condition of uninsured Section 8 properties was limited. We obtained information on the uninsured Section 8 portfolio as a whole from HUD's central database. However, the information in this database on the properties' physical condition was subject to several limitations: Inspection results were reported for only 63 percent of the properties, 42 percent of the inspections were at least 3 years old, and the ratings assigned by inspectors were not based on objective criteria. The database contained no information on the results of the annual financial audits that HUD requires. While the information on the physical condition of properties in the 10 state agencies' uninsured Section 8 portfolios was more recent—based primarily on inspections performed in 1998—the ratings were also subjective because they were not based on objective criteria. Five of the state agencies rated the financial condition of their properties, and seven agencies rated the overall condition of their properties, taking into account their management as well as their physical and financial condition. The information provided by the state agencies is presented in more detail in appendix IV.

The 10 state agencies we surveyed were responsible for monitoring 1,167 of the 2,278 properties that, as of December 1998, were in the uninsured

[1]According to HUD officials, property owners who executed Section 8 contracts with HUD before 1980 may not be required to submit audited financial statements to HUD or its contract administrators.

Section 8 portfolios administered by 30 state agencies nationwide.[2] About 43 percent of the 1,167 properties were designed specifically for the elderly (41 percent) or the disabled (2 percent), and 57 percent of the properties were designed for families or families and the elderly.

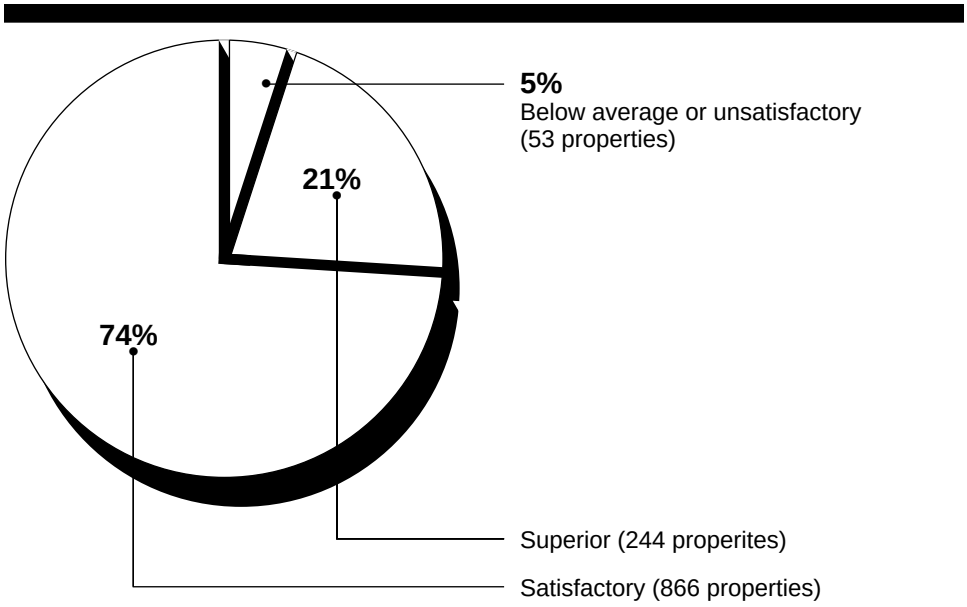
Most Properties Were Reported in Good Physical Condition, but the Ratings Assigned During Inspections Were of Limited Use

HUD's information on the physical condition of properties in the uninsured portfolio was limited. As of December 1998, HUD's central database contained information on the results of inspections performed at 7,867 properties, or 63 percent of 12,488 properties in the uninsured portfolio. The proportion of inspections reported for the uninsured programs ranged from 29 percent for the elderly/disabled capital advance program to 89 percent for the loan management set-aside program. However, for 42 percent of the uninsured properties, inspections had not been performed within the past 3 years. According to the ratings assigned during these inspections, 92 percent of the 7,867 properties were in "satisfactory" or "superior" physical condition, while 6 percent were in "below average" or "unsatisfactory" condition. However, these data have limitations because, until very recently, HUD lacked uniform standards for reporting the physical condition of its multifamily portfolio. Without such standards, property ratings were assigned subjectively, making comparisons among properties, field locations, and programs difficult and questionable. HUD recognizes that without uniform and objective physical inspection standards, the data are of limited use in overseeing the portfolio. As discussed later in this chapter, the Department has developed new property inspection standards designed to address the shortcomings of the prior inspection standards.

The 10 state agencies we surveyed reported that 95 percent of the properties in their portfolios were in satisfactory or superior physical condition. (See fig. 4.1.) These properties represent 97 percent of the apartment units in their portfolios. While all of the agencies used HUD's rating scale of superior, satisfactory, below average, or unsatisfactory to classify the physical condition of their properties, they used their own criteria and judgment to assign the ratings. As a result, the ratings are difficult to compare and their reliability is unknown. (See app. IV, table IV.2, for a state-by-state summary of the properties and units in each rating category.)

[2]The state agencies may also administer other Section 8 project-based contracts associated with properties that were not included in the scope of this review, such as FHA-insured properties with project-based assistance or moderate rehabilitation properties.

Figure 4.1: Physical Condition of Properties, as Reported by 10 State Agencies



Note: Information is based primarily on the results of the most recent (1998) physical inspections.

Source: GAO's analysis of information provided by the 10 state agencies.

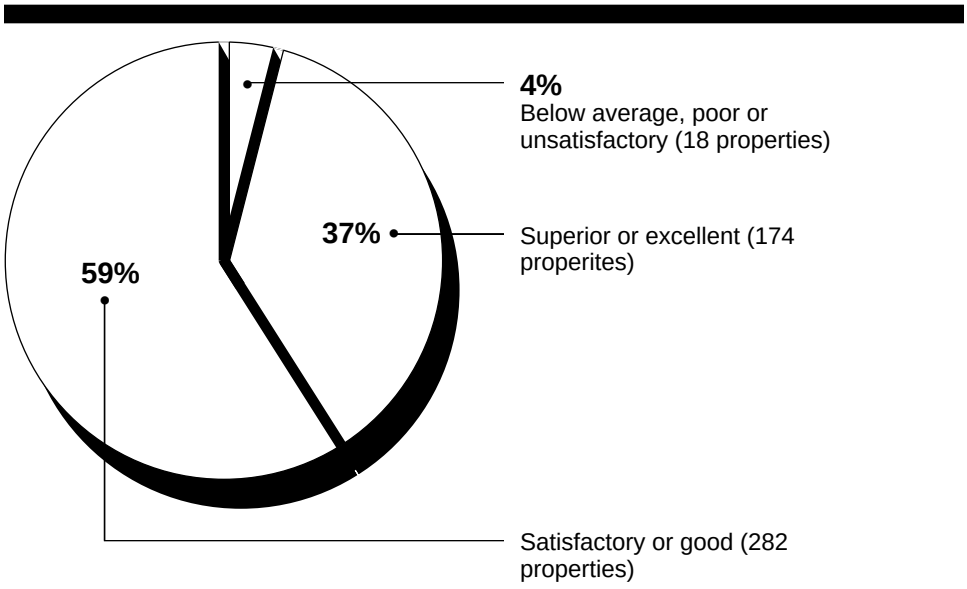
HUD's Database Has No Information on the Results of Financial Audits, but State Agencies Reported Few Financial Problems

Even though HUD requires property owners to submit annual audited financial statements, HUD's central database contained no information on the financial condition of the uninsured portfolio. As of December 1998, the database included dates relevant to the audited financial statements, such as when the audits were performed or when HUD received the statements. But the database did not contain the results of the audits. As a result, no conclusions can be drawn about the financial status of the uninsured portfolio.

HUD does not require the state agencies to assign a rating to the financial condition of their properties. Nevertheless, 5 of the 10 agencies we surveyed—California, Michigan, New Hampshire, Tennessee, and Wisconsin—had rated the financial condition of their properties. As shown in figure 4.2, these five states reported that about 96 percent of the 474 properties in their portfolios were in satisfactory, good, excellent, or superior financial condition while about 4 percent were in below average, poor, or unsatisfactory condition. (See app. IV, table IV.3, for a state-by-state summary of financial condition ratings.) Some of the underlying factors the agencies considered in evaluating a property's

financial stability included cash reserve levels, cash flow, debt service coverage, operating expenses, and liquidity.

Figure 4.2: Financial Condition of Properties, as Rated by Five State Agencies



Source: GAO's analysis of information provided by the California, Michigan, New Hampshire, Tennessee, and Wisconsin housing finance agencies.

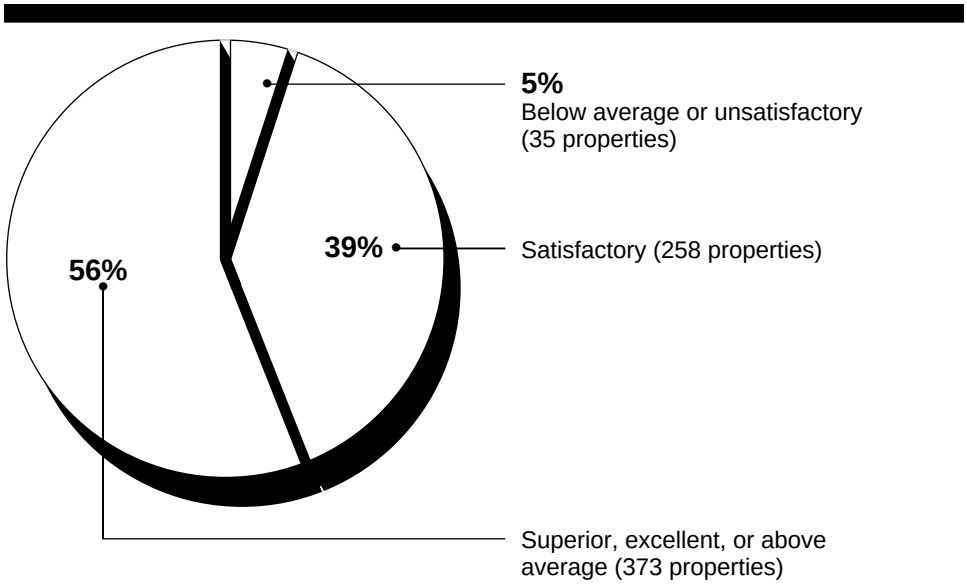
According to State Agencies, Few Properties Have Overall Operating Problems or Require Special Monitoring

Though not required by HUD, ratings of the overall condition of their properties were provided by 7 of the 10 state agencies we surveyed. To determine the overall condition of their properties, the state agencies generally considered the properties' management and physical and financial condition.[3]

As shown in figure 4.3, the seven agencies reported that 95 percent of the 666 properties in their portfolios were in satisfactory or better overall condition and that only 5 percent were in below average or unsatisfactory condition. According to the National Council of State Housing Agencies, the healthy overall physical and financial condition of the properties in the state agency portfolio is largely attributable to the successful asset management and oversight practices employed by the state agencies. (See app. IV, table IV.4, for a state-by-state summary of overall ratings.)

[3]The Minnesota and Oregon agencies did not provide either financial or overall ratings for the 350 properties in their portfolios because their monitoring systems did not collect information in ways that would allow them to do so.

Figure 4.3: Overall Condition of Properties, as Rated by Seven State Agencies



Source: GAO's analysis of the overall condition ratings provided by the California, Illinois, Maryland, Massachusetts, Michigan, New Hampshire, and Tennessee housing finance agencies.

In addition, the 10 state agencies reported that only 45—or fewer than 4 percent—of the 1,167 properties in their portfolios warranted special or extra monitoring attention. The reasons cited for assigning properties to the special monitoring category included financial problems, deferred maintenance, occupancy issues, and/or concerns over management or ownership. Special monitoring usually involved increased oversight, such as additional site visits and evaluations, additional financial or operational reporting requirements, or specific workout agreements. (See app. IV, table IV.5, for data on each state's special monitoring.)

HUD Is Taking Action to Obtain More Reliable and Complete Data on Its Portfolios

HUD is taking steps to improve the reliability and availability of its data on the multifamily properties in its various portfolios, including both the uninsured and insured Section 8 portfolios. In September 1998, HUD formed the Real Estate Assessment Center in Washington, D.C., to improve its processes for monitoring the physical and financial condition of its properties. The Center has central responsibility for accumulating and analyzing the results of (1) the physical inspections of HUD's properties nationwide and (2) the annual audited financial statements for HUD's entire

portfolio. Multifamily asset managers will then use the results of these analyses to develop oversight strategies for individual properties.

In the past, HUD lacked an objective system for classifying the results of the physical inspections it requires for its multifamily uninsured and insured properties. The Real Estate Assessment Center developed such a system. The system uses a point scale to translate the results of an on-site evaluation into an overall, quantitative rating for each property. HUD has acquired and trained contractors to perform physical inspections using the Center's new inspection protocol. By the end of 1999, the Department expects to have baseline data on over 30,000 multifamily properties, including uninsured and insured Section 8 properties and insured properties that do not receive Section 8 assistance.

At the end of April 1999, the contractors had completed physical inspections at 4,513 properties under various multifamily housing programs. Of 2,401 uninsured properties that were inspected, 39 percent were in excellent condition, 46 percent were in good condition, 13 percent were in fair condition, and 2 percent were in poor condition.[4] (See app. V, table V.1, for additional information on the results of the inspections.)

The Real Estate Assessment Center has also developed a central system for analyzing financial information from the annual audited financial statements that the owners of multifamily properties are required to submit under the terms of their Section 8 housing assistance payment contracts. The Center will compare this financial information with specific performance ratios, compliance indicators, and other standards and benchmarks for individual portfolios and for the industry as a whole. HUD expects these comparisons to provide information that its field offices will find useful in their monitoring and enforcement efforts. In general, the owners of properties in the rural housing and state agency programs are not required to report to the Center because they do not submit their annual audited financial statements to HUD. The Center required all other owners to submit their 1998 audited financial statement information by June 30, 1999.

[4]About 61 percent of the 2,401 inspections were performed at properties in the elderly/disabled loan portfolio, while the remainder were performed at other uninsured properties. The Real Estate Assessment Center was unable to provide a breakdown showing how many of the remaining properties were in the state agency portfolio of 2,278 Section 8 properties.

Agency Comments and Our Evaluation

According to the National Council of State Housing Agencies, our draft report did not adequately stress the connection between the superior physical and financial condition of uninsured properties in the state agency program and the state agencies' management and oversight. However, the scope of our review was not sufficient to link the condition of the properties to the state agencies' management and oversight. Specifically, to satisfy the mandate, we agreed to determine how the state agencies oversee the Section 8 properties in their portfolios and to provide information on the physical and financial condition of the properties in 10 state agencies' portfolios. These properties account for about 50 percent of the properties in the state agency program. However, we included in the final report the Council's opinion that the physical and financial health of the properties in the state agency portfolio is largely attributable to the successful asset management and oversight practices employed by the state agencies.

Information on the Size of the Uninsured Section 8 Portfolio

This table provides additional information on the number of properties, contracts, and assisted units in the uninsured portfolio, broken out by the eight programs making up this portfolio.

Table I.1: Number of Uninsured Section 8 Properties, Contracts, and Units, by Program, as of December 1998

Program	Properties	Contracts	Total assisted units
Elderly/disabled loan	4,446	4,451	209,178
State agency	2,278	2,280	172,794
New construction/substantial rehabilitation	1,678	1,708	91,435
Rural housing	1,518	1,525	44,788
Elderly/disabled capital advance	1,510	1,510	38,449
Loan management set-aside	513	678	32,674
Multifamily property disposition	521	530	39,829
Housing preservation	24	26	3,069
Total	**12,488**	**12,708**	**632,216**

Source: HUD's Real Estate Management System (REMS) and Section 8 expiring contracts database, as of Dec. 1998.

Information on the HUD Databases Used to Analyze the Section 8 Uninsured Portfolio

This appendix provides more detailed information on the Department of Housing and Urban Development's (HUD) databases we used to determine what information HUD has on the Section 8 assistance provided to, and the physical and financial condition of, the Section 8 properties that are not insured by HUD's Federal Housing Administration (FHA).

To develop information on the Section 8 assistance provided to uninsured properties, including data on expenditures, rents, and expiring contracts, we obtained three database files from HUD—two from the Office of Housing and one from the Office of the Chief Financial Officer. The first file from Housing, a database on Section 8 contracts expiring through the year 2038, included all insured and uninsured contracts receiving Section 8 project-based assistance as of December 1998. The second file, a data extract from HUD's Real Estate Management System (REMS)—the Department's official source of information on multifamily housing—contained information on all active uninsured properties as of December 24, 1998, including information on the various programs that make up HUD's uninsured Section 8 portfolio. The file from the Office of the Chief Financial Officer contained fiscal year 1998 expenditure and receipt data for all Section 8 contracts from the Department's Program Accounting System (PAS). These three database files provided us with the information found in chapters 1 and 2.

To determine the expenditures and per-unit costs associated with uninsured Section 8 contracts, we used PAS to calculate the net expenditures (expenditures minus receipts) during fiscal year 1998 for each of the eight primary programs in the portfolio. We then calculated the average per-unit subsidy cost for each program. After comparing the results of the two sets of calculations to identify any significant variances, we met with HUD officials to discuss the reasons for, and the factors potentially contributing to, those we found.

We used HUD's database of expiring Section 8 contracts and the data extract from REMS to provide information on the Section 8 contract and fair market rents for properties in the uninsured portfolio. To do this, we matched the universe of 12,708 uninsured contracts from REMS with corresponding information on the contract and fair market rents from the expiring Section 8 contracts database. For each of the eight programs, we then determined the percentage of units whose contract rents exceeded the fair market rents for their area. We also used the expiring contracts database to identify the expiration dates associated with project-based contracts in the uninsured portfolio. We then analyzed each contract's

expiration date to identify variances among the eight programs in the uninsured portfolio.

To ascertain the physical and financial condition of the uninsured properties, we matched the universe of uninsured properties in the data extract from REMS with source tables in REMS that contained physical and financial information. We included in our analysis only the results of the most recent physical and financial reviews, excluding the results of older reviews included in the tables for some properties. We then aged these results for each of the programs in the portfolio. Although REMS contained rating data from the physical inspections of many of the uninsured properties in the portfolio, it did not contain corresponding information from the financial reviews.

To ensure the reliability of the information in this report, we met with HUD officials to discuss various data issues and reviewed selected data fields in each of the three files for completeness, accuracy, and relevance. For example, we found that some recently renewed contracts had not yet been included in the universe of active uninsured contracts. We discussed this issue with Housing officials, who developed a methodology to ensure that these contracts were included in the active uninsured portfolio. We also monitored efforts by the Multifamily Data Quality Task Force to identify, measure, and fully verify "critical" Section 8 data elements in REMS—some of which are used in this report. Such elements include data on financing, units, and contract rents in the uninsured portfolio. To check the expenditure and per-unit cost information for accuracy and completeness, we matched the universe of active uninsured Section 8 contracts with the PAS expenditure data and tested the key data elements to identify data that were missing or inaccurate. In 1997, HUD reported that PAS was in compliance with the Federal Manager's Financial Integrity Act. In addition, HUD's Office of the Inspector General examined funding and expenditure data as part of its financial audit for fiscal years 1996-97 and did not identify data errors associated with Section 8 contract expenditures that were material to HUD's financial statements. We also reviewed the Department's methodology for developing the ratios of contract rents to fair market rents. On the basis of these reviews, we determined that the data were sufficiently reliable to use in this study. We made some minor adjustments—affecting 75 contracts—to the universe of active uninsured Section 8 contracts. We discussed these changes with HUD officials, who agreed that our adjustments were reasonable.

Information on Section 8 Contract Rents and Expirations

This appendix provides more detailed information on (1) Section 8 contract rents in relation to HUD's fair market rents and (2) Section 8 contract expirations for the uninsured portfolio.

Table III.1 relates to table 2.2 in chapter 2, which identifies, for each of the programs in HUD's uninsured Section 8 portfolio, the percentage of assisted Section 8 units whose Section 8 rents exceed HUD's fair market rents. This table breaks out the overall percentage into four other categories, which show the extent to which the rents exceed the fair market rents.

Table III.1: Percentage of Assisted Units Whose Section 8 Contract Rents Exceed HUD's Fair Market Rents for Programs in HUD's Uninsured Section 8 Portfolio, as of December 1998

	Percentage of assisted units				
Program	With rents between 101 and 120 percent of fair market rents	With rents between 121 and 140 percent of fair market rents	With rents between 141 and 160 percent of fair market rents	With rents over 160 percent of fair market rents	Total with rents exceeding fair market rents
State agency	17	24	23	28	91
Elderly/disabled loan	19	23	20	25	88
Rural housing	20	31	23	12	86
New construction/ substantial rehabilitation	29	22	14	8	72
Preservation	27	12	4	0	42
Loan management set-aside	19	3	0	1	24
Property disposition	17	3	1	0	21
Elderly/disabled capital advance	4	1	0	0	5

Note: These data cover 12,288 of the 12,708 contracts in HUD's uninsured portfolio for which data on rents and HUD's fair market rents were available.

Source: HUD's Section 8 expiring contracts database, Dec. 1998.

Table III.2 relates to figure 2.3 in chapter 2, which shows when uninsured Section 8 contracts will expire. This table breaks out the expiration dates for contracts in each of the programs that make up HUD's uninsured Section 8 portfolio.

Table III.2: Percentage of Contracts Expiring Within Indicated Fiscal Year Ranges, by Program, as of December 1998

Program	1999-2004	2005-2009	2010-2014	2015-2021
Loan management set-aside	99	0	0	0
Rural housing	97	2	0	2
Preservation	92	0	0	0
Property disposition	58	29	12	0
New construction/ substantial rehabilitation	48	16	25	10
Elderly/disabled loan	41	33	25	1
Elderly/disabled capital advance	15	4	16	62
State agency	6	8	41	42

Source: GAO's analysis of HUD's Section 8 expiring contracts database, Dec. 1998.

Size and Condition of the Uninsured Portfolio for 10 State Housing Finance Agencies

This appendix augments chapter 4 by providing information on the size of each state agency's uninsured portfolio, the physical and financial condition of properties in the portfolio, and the number of properties receiving special monitoring attention.

Table IV.1 profiles the portfolios of the 10 state agencies we reviewed.

Table IV.1: Numbers of Properties, Project-Based Section 8 Contracts, and Units in the Portfolios of the 10 State Agencies Reviewed by GAO

State agency	Properties	Section 8 contracts	Total units	Section 8 units
California	123	129	8,466	8,364
Illinois	120	120	20,286	16,183
Maryland	57	57	5,179	4,705
Massachusetts	152	152	17,731	16,526
Michigan	116	116	19,425	19,020
Minnesota	232	232	15,028	13,353
New Hampshire	63	63	2,268	2,244
Oregon	122	122	4,045	4,010
Tennessee	37	37	1,835	1,814
Wisconsin	145	150	11,508	11,508
Total	**1,167**	**1,178**	**105,741**	**97,727**

Source: GAO's analysis of information provided by the 10 state agencies.

Table IV.2 summarizes the physical condition ratings that the state agencies assigned to properties in their portfolios. Since the agencies used their own criteria in developing and assigning the ratings, it is difficult to compare the overall condition of their respective portfolios.

Table IV.2: Physical Condition of Properties, as Rated by the 10 State Agencies

	Superior		Satisfactory		Below average		Unsatisfactory	
State agency	**Properties**	**Units**	**Properties**	**Units**	**Properties**	**Units**	**Properties**	**Units**
California	0	0	122	8,426	1	40	0	0
Illinois	89	13,583	31	6,703	0	0	0	0
Maryland	15	1,855	32	2,670	7	528	3	96
Massachusetts[a]	0	0	146	17,466	6	265	0	0
Michigan	29	4,326	85	14,845	2	254	0	0
Minnesota	18	1,822	197	12,165	14	792	3	249
New Hampshire	4	200	59	2,068	0	0	0	0
Oregon[b]	26	965	80	2,549	12	357	0	0
Tennessee	20	1,082	17	573	0	0	0	0
Wisconsin	43	3,872	97	7,393	4	237	1	6
Total	**244**	**27,705**	**866**	**75,038**	**46**	**2,473**	**7**	**351**

[a]The Massachusetts agency rates the physical condition of its properties as meeting or not meeting the agency's standards. Massachusetts officials agreed to our classification of the physical condition of these properties as "satisfactory" or "below average."

[b]Information was not available for four of Oregon's properties.

Source: GAO's analysis of property condition ratings provided by the 10 state agencies.

Table IV.3 summarizes the financial condition ratings assigned by 5 of the 10 housing agencies.

Table IV.3: Financial Condition of Properties, as Rated by Five State Agencies

State agency	Superior or excellent	Satisfactory or good	Below average, poor, or unsatisfactory
California	0	122	1
Michigan	109	0	7
New Hampshire[a]	10	44	0
Tennessee	15	22	0
Wisconsin[b]	40	94	10
Total	**174**	**282**	**18**

[a]New Hampshire did not provide ratings for nine properties.

[b]Wisconsin did not rate one of its properties.

Source: GAO's summary of information provided by the five state agencies.

Table IV.4 summarizes the overall condition of properties in the portfolios of the seven state agencies that rated the overall condition of their properties. The agencies typically considered such factors as a property's physical, financial, and management condition in assigning the ratings.

Table IV.4: Overall Condition of Properties, as Rated by Seven State Agencies

State agency	Superior, excellent, or above average	Satisfactory	Below average or unsatisfactory
California	0	122	1
Illinois	89	29	2
Maryland	15	30	12
Massachusetts[a]	137	0	13
Michigan	109	0	7
New Hampshire	9	54	0
Tennessee	14	23	0
Total	**373**	**258**	**35**

[a]Massachusetts did not provide information on two properties.

Source: GAO's summary of information provided by the seven state agencies.

Table IV.5 summarizes the number of properties receiving special monitoring attention by each state agency at the time of our inquiry.

Table IV.5: Number of Properties Receiving Special Monitoring Compared With the Total Number of Properties for Each of the 10 State Agencies

State agency	Properties in the agency's portfolio	Properties receiving special monitoring
California	123	1
Illinois	120	2
Maryland	57	4
Massachusetts	152	5
Michigan	116	7
Minnesota	232	11
New Hampshire	63	2
Oregon	122	12
Tennessee	37	1
Wisconsin	145	0
Total	**1,167**	**45**

Source: GAO's analysis of information on special monitoring provided by the 10 state agencies.

Results of Inspections Under HUD's New Inspection Program

Table V.1 summarizes the results of the physical inspections completed under a new inspection program conducted by HUD's Real Estate Assessment Center. These inspections were completed by the end of April 1999 at 4,513 of the properties in HUD's portfolio of about 30,000 insured and uninsured properties.

Table V.1: Number of Properties Inspected by April 1999 and Their Physical Condition Ratings

Program	Number of properties inspected	Rating			
		Poor	Fair	Good	Excellent
Uninsured					
Elderly/ disabled	1,462	1%	10%	43%	46%
All other uninsured[a]	940	4%	19%	50%	27%
Subtotal	2,401				
Insured	1,746	3%	16%	51%	30%
HUD-held	366	6%	27%	47%	20%
Total/average	**4,513**	**3%**	**15%**	**48%**	**34%**

[a]The category "all other uninsured" can include properties in the state agency, new construction/substantial rehabilitation, rural housing, loan management set-aside, property disposition, and preservation programs. HUD could not provide us with information on the number of properties in each program included in this category.

Source: HUD's Real Estate Assessment Center.

Comments From the Department of Housing and Urban Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

JUL 13 1999

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Ms. Judy A. England-Joseph
Director
Housing and Community Development Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Ms. England-Joseph:

In response to your letter of June 18, 1999, to Secretary Cuomo, I am providing comments of the Office of Housing concerning your proposed report, Multifamily Housing: HUD Missed Opportunities to Reduce Costs on It's Uninsured Section 8 Portfolio (GAO/RCED-99-217).

We appreciate this opportunity to comment prior to issuance of the final report.

Sincerely,

William C. Apgar
Assistant Secretary for Housing-
Federal Housing Commissioner

Enclosure

HUD COMMENTS IN RESPONSE TO GAO REPORT ON
UNINSURED SECTION 8 PORTFOLIO

Introduction

Celebrating its twenty-fifth anniversary, the Section 8 rental assistance program is the largest housing program in the nation's history. The Section 8 program successfully helps 3 million families around the country afford decent housing, more than double the number of families assisted by the next largest housing program. Unfortunately, GAO's report on the uninsured Section 8 portfolio largely ignores the overall success of the Section 8 program despite Congress' request for a general study of the portfolio. Instead, the report focuses on a narrow range of issues, using very limited information to draw unjustified conclusions. In particular, the report:

See comment 1.

- **Claims high costs for the program without evidence** The report claims that to "the extent that Section 8 rents exceed market rents, the federal government's costs are higher than they should be." In fact, this is not true. There are many examples of neighborhoods where market rents are low enough that they do not provide sufficient income to build and operate decent housing. Even assuming GAO's statement were true, however, the report makes no attempt to estimate the scale of these supposed extra costs, nor does it mention that there are also properties with Section 8 rents below market rents. In fact, GAO admits that "nationwide data on rents for particular neighborhoods were not available for assessing the relationship of Section 8 rents to market rents." The only evidence GAO provides is the relationship between Section 8 rents and HUD's FMRs, which are set by Congress at a level below average rents. Because of this, it is not surprising that the majority of rents for the uninsured Section 8 program are above FMRs. Despite this problem with the only significant data presented by GAO, the report uses it and other mistaken conclusions to paint a picture of the Section 8 program as too expensive.

See comment 2.

See comment 3.

- **Suggests "missed opportunities" for savings while ignoring savings achieved** In ten years of working with State and local housing agencies to refund bonds on Section 8 properties and reduce their debt service and subsidy costs, HUD has saved the Treasury $616 million and provided for distribution of $493 million to agency programs for affordable housing. While ignoring these savings, which are numbers certified from the closing documents of each transaction, the GAO claims that "tens of millions" of additional savings could have been achieved. Nowhere does GAO provide evidence to support the amount of this claim, nor does the report highlight that State and local agencies are required to invest any of these "missed" savings in affordable housing. In fact, it is possible that had HUD followed GAO's suggested course of action, the refundings never would have occurred and substantial savings for the Federal government would have been lost, not gained. This is because the fees GAO points to as potential "savings" were part of the incentives for agencies to refund the bonds in the first place.

See comment 4.

See comment 5.

See comment 6.

See comment 7.

See comment 8.

See comment 9.

- **Directs HUD to take action where legal authority is unclear** Not only does GAO suggest HUD could have achieved additional savings in refunding transactions that have already returned substantial savings to the Federal government; the report also claims additional potential savings from transactions HUD has not pursued for good reason. As communicated to GAO at numerous times, the legal authority to require state and local housing agencies to share refunding proceeds in certain cases is dubious at best. Furthermore, the report greatly exaggerates the practical leverage HUD has to extract savings from State and local housing agencies on transactions which HUD has no role in approving or carrying out.

Given the problems outlined above, what emerges from the report is a biased view of the uninsured Section 8 program. A more balanced portrait would reveal a program that provides quality housing to hundreds of thousands of American families at a fair price, a program that has successfully recovered over half-a-billion dollars for American taxpayers, and an important example of strong partnership between Federal, State and local housing agencies.

The remainder of this response focuses on the three specific recommendations contained in the report.

GAO Recommendation No. 1: HFA noncompliance with McKinney sharing.

The Draft Report sets forth GAO's "missed opportunity" thesis that State HFA's have closed bond refundings of projects technically eligible for McKinney 50/50 sharing of HAP savings which did not require legal review by HUD. The GAO contends that substantial HAP savings could be recovered by a process of retroactive computation of savings to recapture 50 percent for the Federal government. GAO provides no data base in support of its contention that "tens of millions" of dollars could be recovered. HUD believes no such data base exists, because HUD cannot be expected to know the financing details of transactions not requiring HUD approval in which State agencies refund their bonds. A memorandum from former Assistant Secretary for Housing Retsinas to the HUD Inspector General in September 1993 stated that a decision had been made not to try to recover savings from past non-FAF refundings. We believe that this was a sound policy decision by the former Assistant Secretary, particularly in view of the dubious legal basis for such an effort.

Because it is quite possible that the McKinney Act, particularly read in combination with legislative history, does not support GAO's conclusion, we believe that the GAO interpretation of the Act would prove to be a weak justification for proceeding against the agencies. The report arguably mischaracterizes the requirements of Section 1012 of the McKinney Act, i.e., it states that the Act requires agencies to share the savings with the Government. However, Section 1012 actually requires HUD to share 50 percent of any savings resulting from a bond refunding with the agency. Section 1012 places no explicit requirement on the agency to refinance projects, nor share any

savings upon a refinancing. HUD rights in this regard are dependent upon the applicable regulation and contractual arrangements between HUD and the agencies.

Committee Report language indicates that retroactive sharing was adopted in 1992 to allow HUD to compensate the 200 local Public Housing Authority issuers which participated in the HUD refunding program prior to McKinney enactment and received no savings. HFAs arguably could find ample basis to contest the retroactive application of Section 1012 to these bond refundings. It must be recognized that the transactions at issue were done without HUD approvals. For non-FAF projects, there is no regulatory requirement for HUD approval of bond refundings that are not subject to HUD 11b regulations. With the exception of Ohio, the States issue pursuant to the Internal Revenue Code and do not need Section 11b to qualify bonds as tax exempt. The GAO position requires a leap of faith that the 1992 amendment supplanted all preceding legal inhibitions on HUD's right to mandate shared savings bond refundings. HUD would also face practical difficulties in seeking compliance. In a non-FAF project, absent state agency cooperation, HUD has no authority to reduce rents unilaterally. In addition, HUD could not use a trustee sweep structure without the execution of indenture amendments by the trustee and the HFA to incorporate the standard shared savings provisions.

See comment 6.

Finally, in considering such an effort, the risk/reward equation deserves attention. During much of the pre-FAF period, bond yields were not as high as in late 1981 through early 1983. Many HFA refundings may have been done so that HFA's could maximize override to the full 1.5 percent permitted by the Tax Code, in which case there may not be much net project debt service savings to recapture. On the other hand, a HUD effort to now seek retroactive reimbursement could be viewed as inappropriate and inconsistent with HUD's continuing efforts to work with its state agency partners in developing major housing initiatives.

See comment 10.

GAO Recommendation No. 2: Clarify HUD instructions on rent increases in FAF refunded projects.

The GAO has identified concerns with HUD guidance on rent increases for properties that underwent bond refundings, particularly a Notice issued in 1997. Notice H 97- 49 will be reissued shortly, although it is clear that the procedure for adjusting rents set forth therein was to be an annual exercise in that it is part of the calculation of annual adjustment factors. GAO is also inaccurate in stating that this Notice did not provide examples of calculations. It attached one form and cross-referenced four worksheets which were attachments to H 97-14. In addition to reissuing relevant Notices, the Office of Housing will issue to agencies and HUD field staff clarifying instructions to assure compliance with rent adjustment policy and evaluate the need to cross-reference other Section 8 rent directives.

See comment 11.

GAO Recommendation No. 3: Dual fee collection issue.

Section 1012 of the McKinney Act, enacted in November of 1988, provided state agencies with an incentive to refund high interest bonds by allowing states to share in savings with the Federal government. The legislation applied to projects that were state financed and received a financing adjustment factor under Section 8 of the United States Housing Act of 1937. In some instances, the terms of the bond refunding transactions allowed state agencies to collect both an administrative fee and a bond yield override.

The GAO Report in chapter 3 asserts that HUD's dual fee policy will add "tens of millions" of dollars of cost to the program without providing specific data or calculations to justify this claim. HUD can respond with precision that the dual fee transactions will return to the Treasury savings that will exceed $150 million over the life of the housing assistance contracts. The dual fees were part of the calculation State and local agencies made in deciding whether to undertake the transactions that returned these substantial savings to the Treasury. Because the need for incentives to attract business is a reality in any market, including the refinancing of affordable housing, we cannot accept the easy assumption made by GAO that dual fees constitute a cost without any redeeming benefit.

See comment 12.

Furthermore, these transactions were approved by HUD officials, approvals that very likely would have gone undisputed had they been accompanied by waivers. State and local agencies relied on these approvals in pledging one or both of the fee income streams to help secure the bond issues. If HUD chose to collect one of these fees retroactively, any attempt to do so would be complicated by the pledges. These security arrangements provided a basis for ratings assigned by the rating agencies which in turn affected the information offered to investors by investment bankers selling the bonds, both initially and in the secondary market. Thus, potential litigants claiming adverse impact from HUD retroactive enforcement could include not only the agencies but investors, financial advisers, rating agencies, municipal bond analysts, traders, dealers, investment bankers, and credit enhancers.

See comment 13.

Despite these problems with any retroactive collection, the report places the burden of blame on Housing for the time consumed in pursuing an outcome to this issue. Housing has been neither dilatory nor indifferent in seeking closure with the OIG. In response to the 1993 OIG audit finding, the Assistant Secretary for Housing issued a number of instructions to the field within the following months. In September of 1994, the Council of State Housing Finance Agencies responded on behalf of all of its members by objecting to an attempt by HUD to revise the terms of its original approvals to the dual fee agencies. Their letter emphasized the consequences of upsetting bond security pledges of the fee income and the fact that much of the income helps to finance HFA programs of affordable housing, both McKinney Act very low income housing and programs serving a broader income range.

See comment 14.

After confirming with program counsel that a waiver process could be justified on a case by case basis and discussing this with OIG staff, Housing in February 1995 sent letters to each HFA Director to state that the regulation would be enforced with respect to new proposals submitted for HUD review and that the agencies could rely on previous HUD approvals which allowed two fees in the FAF refunding program. In December of 1995, the OIG reopened the issue and advised Housing either to stop dual fee collection or determine if it was appropriate to issue waivers, clearly suggesting that the OIG did not at that time object to issuing retroactive waivers. Housing relied on this OIG position in proposing a process by which each HFA would apply for and attempt to justify a waiver. No comment was provided by the OIG until July 25,1997, when OIG reversed its position and objected to the issuance of waivers, even though such waivers would have been legally permissible at the time of the original transaction approvals. At that point, Housing had already initiated a waiver which, following concurrence by the Associate General Counsel, was issued to Oregon on June 18th, 1997. OIG also questioned whether the dual fee collections contravene the Debt Collection Act of 1982, as amended. In response to the OIG's concerns, the Office of Housing stopped processing waiver requests and asked the HUD Office of General Counsel to review the facts, issues, and relevant law, and reexamine whether waiver requests can be lawfully entertained by the Department. OGC is reviewing the issues at this time. HUD will determine how to proceed once it has received OGC's guidance.

While this process of trying to resolve the dual fee issue has been lengthy, HUD has been forced to respond to changing recommendations from OIG. GAO makes little recognition of these changing recommendations, choosing instead to fault HUD. For example, while originally suggesting that HUD examine the alternative of processing retroactive waivers on the dual fee transactions, OIG later switched its position and objected to the waivers. In the executive summary, however, GAO's report states only that "HUD required the agencies to request waivers of its regulation prohibiting dual fees. However, as of June 1999, HUD had not taken action on these requests." Rather than recognizing that HUD reacted to OIG's recommendation in stopping the processing of these waivers, the report omits this fact, instead mistakenly leaving the appearance that HUD has done nothing to resolve the dual fee issue for three years.

The following are GAO's comments on the Department of Housing and Urban Development's letter dated July 13, 1999.

GAO Comments

1. The scope of the report reflects the requirements in Public Law 105-65 for a GAO study on the uninsured Section 8 portfolio. The mandate did not call for an evaluation of the Section 8 rental assistance program. It did, however, focus on the three topics discussed in our report, including the information HUD has on the Section 8 assistance provided to properties in the uninsured portfolio and the physical and financial condition of these properties. To provide this information, we relied primarily on data that were available from the Department.

2. See chapter 2, Agency Comments and Our Evaluation.

3. See chapter 2, Agency Comments and Our Evaluation.

4. The draft report contained information on the savings that bond refundings have provided to the government and on how the state agencies use their share of the savings. Chapter 1 of the draft report stated that as of September 30, 1998, the Department had approved 245 refunding agreements that would provide $1.1 billion in bond refunding savings over the lives of the Section 8 contracts. Of this amount, $633 million would be provided to the U.S. Treasury, and the remainder would be provided to state and local agencies. Furthermore, according to the draft report, the agencies use their bond refunding savings to provide affordable housing for low-income residents in their states. This information also appears in the final report.

5. See chapter 3, Agency Comments and Our Evaluation.

6. We do not agree with HUD that the report greatly exaggerates the practical leverage the Department has to extract savings from state and local housing agencies on transactions that HUD has no role in approving or carrying out. In fact, we believe that HUD has not effectively used the authority it does have to establish and enforce Section 8 program requirements. The Department believes that since the state agencies, unlike local agencies, do not need its approval to issue tax-exempt bonds, it cannot establish requirements for state agencies issuing bonds for Section 8 properties. We do not agree that this limitation exists. For example, at a minimum, the Department could require the state agencies to notify the Department when they plan to refund Section 8 bonds

associated with Section 8 properties. Such notification would provide the Department with the information it needs to ensure compliance with shared savings requirements. Furthermore, the Department would not have to rely solely on the state agencies to obtain this information. State and local bond activities are reported in national publications, such as The Bond Buyer.[1] This publicly available information would allow the Department to monitor the state agencies' compliance with a reporting requirement, if necessary.

7. See comment 1 on the scope of this congressionally mandated study. We also note that HUD's assertions about the Section 8 program are not supported by objective data. For example, as discussed in the report, the portfolio reengineering program that the Congress recently established is designed not only to reduce the costs of expiring Section 8 contracts (reset them to market levels) but also to address problems at financially and physically troubled projects and to correct management and ownership deficiencies.

8. See chapter 3, Agency Comments and Our Evaluation.

9. See chapter 3, Agency Comments and Our Evaluation.

10. See chapter 3, Agency Comments and Our Evaluation.

11. The form and worksheets cited by HUD did not include examples of calculations showing how to adjust rents after bonds have been refunded. The form and worksheets were developed several years before the Department introduced its rent adjustment policy.

12. See chapter 3, Agency Comments and Our Evaluation.

13. See chapter 3, Agency Comments and Our Evaluation.

14. This chronology of the dual fee issue, much of which appeared in our draft report, does not alter the facts that 6 years have passed since the Inspector General notified the Department of the dual fee situation and HUD has not yet resolved this problem. In addition, HUD has neither identified all of the agencies that receive dual fees nor taken steps to identify and enforce its dual fee regulation in cases that are not covered by refunding agreements. Therefore, we did not revise the report in response to these comments.

[1]The Bond Buyer is a daily newspaper serving the municipal bond industry.

Comments From the National Council of State Housing Agencies

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

National Council of State Housing Agencies

July 7, 1999

Ms. Judy A. England-Joseph
Director, Housing and Community
Development Issues
United States General Accounting Office
Washington, DC 20548

Dear Judy:

Thank you for the opportunity to review the GAO's June 18 draft report on uninsured multifamily properties financed under the Section 8 program. We appreciate that you made some changes to the previous draft based on our earlier comments and conversations with your staff. We are deeply disappointed, though, that so few of our comments, and those of the HFAs that responded separately, are reflected in this report.

We continue to have the following objections to the report:

See comment 1.

- It fails to explain adequately why Section 8 rents are higher under the uninsured Section 8 New Construction and Substantial Rehabilitation program than under other Section 8 programs;

See comment 2.

- It wrongly concludes that HUD has the authority to require HFAs to share savings from non-FAF bond refundings when no such authority exists in law, regulation, or the original financing agreements between HUD and the HFAs;

See comment 2.

- It does not recognize that HUD effectively waived its prohibition on the collection of "dual fees" by approving refunding transactions under which HFAs received both administrative fees and a permissible spread under IRS regulations;

See comment 3.

- It fails to link the superior physical and financial condition of the uninsured HFA inventory with effective HFA management and oversight; and

- It ignores the impact some cost-saving proposals may have on tenants, projects, communities, HFAs, and affordable housing.

See comment 1.

Uninsured Section 8 Rents Are Often Higher Than Market Rents by Design

We disagree with the report's statement that "[t]o the extent that Section 8 contract rents exceed market rents, the federal government's Section 8 costs are higher than they should be," and the implication that state HFAs are somehow responsible for these high rents.

The Section 8 New Construction and Substantial Rehabilitation program statute, regulations, and contracts all expressly authorized the development of apartments with contract rents higher than comparable market rents. Market rents simply did not provide a sufficient incentive for the development of decent, safe, and sanitary affordable housing. HUD's housing assistance payments contracts specifically require that the initial difference between the contract rents and comparable rents be maintained for the term of the contract. Additional evidence of the program's original design is the publication of separate Fair Market Rents, which continued until just several years ago.

See comment 2.

HUD Has No Authority To Require State HFAs to Share Savings From Non-FAF Bond Refundings

We continue to disagree with the report's conclusion that the Stewart B. McKinney Homeless Assistance Amendments Act of 1988, as amended, requires HFAs to share non-FAF bond refunding savings with the federal government. Our interpretation of that law and that upon which the HFAs, with the advice of counsel, relied absent clear guidance to the contrary from HUD, is that it does not authorize HUD to require HFAs to share those savings. The non-FAF Section 8 contracts with HFAs contain no requirements that HFAs share any refunding savings with HUD.

The relevant provision, Section 1012 of the McKinney Act amendments, states that: "The Secretary *shall make available to* the State housing finance agency...an amount equal to 50 percent of the *amounts recaptured* from the project..." (italics added). Since the Section 8 contracts and agreements on non-FAF projects did not give HUD the right to recapture savings from bond refundings, this language could not create any new affirmative obligation for the HFAs to return savings to HUD. In addition, because the provision refers to amounts recaptured from "the project," HFAs and their counsel reasonably interpreted this to mean that if individual project mortgages were not refinanced with lower debt service requirements, HUD would not have the authority to reduce the Section 8 rents and recapture savings. The intent of the McKinney Act provision was to direct the federal government to share savings it would otherwise have received with HFAs for affordable housing purposes.

We appreciate the report's clarification that HFAs use savings from bond refundings only for affordable housing purposes and not for their own enrichment. The core, singular value the Section 8 program has for HFAs is the assistance it provides them to serve families in need of affordable housing. The impression that HFAs may be hoarding savings for their own benefit must be dispelled because HFAs channel all their resources into the efficient delivery of affordable housing.

HUD Must Not Retroactively Change the Terms of Refunding Agreements It Approved

See comment 2.

The report points out that some HFAs have been collecting both an administrative fee and an override (the permissible spread under IRS regulations), even though HUD regulations require state agencies to choose only one of these fees. The report fails to make clear that HUD approved the transactions providing for HFA collection of these so-called "dual fees." HFAs have since relied on the receipt of those fees in making bond and affordable housing program commitments.

Since HUD was aware of the structure of these transactions, we believe that by agreeing to the refunding agreements, HUD effectively waived the regulation in question. Furthermore, the regulation prohibiting "dual fees" can reasonably be interpreted to apply only to the terms of the original financing, so HUD-approved refundings are not subject to it. Above all, however, we recommend that HUD explicitly grant the waivers some HFAs have requested or others HUD may judge are necessary for additional HFAs to resolve this unfair but festering question about these transactions.

Uninsured Section 8 Properties Are in Superior Condition Because of Excellent HFA Oversight and Management

See comment 3.

The report does not stress nearly strongly enough the connection between the superior physical and financial condition of the uninsured properties and HFA oversight and management. Congress in mandating this study asked GAO to analyze the extent and effectiveness of HFA oversight of the physical and financial management and condition of Section 8 projects. Yet, the report does not clearly draw the connection between the healthy financial and physical condition of the properties and effective HFA oversight and management. While we recognize the limitations preventing GAO from conducting a larger study of all uninsured properties, we are confident that in the states GAO did visit it was clear that the quality of the inventory was due to the HFAs' successful asset management practices.

For example, the Massachusetts Housing Finance Agency has saved the federal government millions of dollars by verifying tenant incomes and

closely analyzing owners' payment requests. The Minnesota Housing Finance Agency and others have used their resources to keep the properties in prime condition, avoid defaults, and preserve at-risk Section 8 housing from prepayments and opt-outs.

Arbitrary, Retroactive Cost-Saving Measures Threaten Tenants, HFAs, Owners, Communities, and Affordable Housing

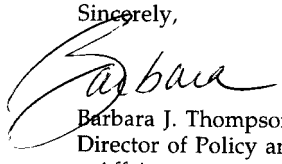
HFAs must maximize their resources to serve their customers and maintain their operations. For HFAs, maintaining adequate reserves and financial stability is integral to their success. Strong bond ratings have a direct impact on their ability to deliver housing affordably. The report ignores this fundamental element of HFA motivations, possibly leading readers to misunderstand why HFAs must secure their bond issues as strongly as possible. Many of the savings measures the report recommends HUD pursue would threaten the HFAs' ability to maintain the strength of their current operations.

See comment 4.

For example, the report identifies the Congressional limitation on further Section 8 rent increases where contract rents exceed Fair Market Rents but does not analyze the impact this limit may have on HFAs and individual Section 8 projects or bonds issued to finance them. While the rent limitation has not resulted in state agency project or bond defaults yet, it is a long-term risk against which the states and projects must be protected. HFAs have always had to pursue as much security for their bonds as possible to protect themselves against future uncertainties. Both Moody's Investors Service and John Nuveen & Co., Inc. analyzed this risk in recent reports and concluded that the rent limit may threaten some projects and bonds soon.

Thank you again for this opportunity to comment on this report. The report shows that the uninsured Section 8 properties financed and overseen by state HFAs are in good hands, as demonstrated by their excellent physical and financial condition. Unfortunately, it fails to convey, as I hope this letter has, the important reasons why HFAs have taken the actions they have to date and the expertise they have deployed for the public's benefit.

Sincerely,



Barbara J. Thompson
Director of Policy and Government Affairs

The following are GAO's comments on the National Council of State Housing Agencies' letter dated July 7, 1999.

GAO Comments

1. See chapter 2, Agency Comments and Our Evaluation.

2. See chapter 3, Agency Comments and Our Evaluation.

3. See chapter 4, Agency Comments and Our Evaluation.

4. The recommendations in the report provide the potential for HUD to achieve Section 8 savings by clarifying the applicability of a legal provision for sharing certain bond refunding savings with the government and by enforcing compliance with a HUD notice on rent increases and a HUD regulation prohibiting dual fees. The scope of the report reflects the requirements in Public Law 105-65 for a GAO study on the uninsured Section 8 portfolio. This mandate did not call for GAO to evaluate the impact of the congressional limit on certain Section 8 rent increases. Nevertheless, the Moody's Investors Service report cited by the National Council did consider the impact of this limit and noted that no state agency's bonds have been downgraded and none has been assigned a negative outlook because of it. Moody's report characterized the outlook for almost $4.5 billion in state agencies' outstanding debt as stable. In fact, according to the report, 122 Section 8 bond programs, which rely primarily on Section 8 project-based subsidies and account for over $4 billion in debt, received outstanding ratings. Additionally, Moody's reported that it had upgraded eight state agencies' Section 8 programs and given positive outlook ratings to another three programs because of their exceptionally strong credit characteristics. By contrast, Moody's projected a negative outlook for about $305 million in local agencies' outstanding Section 8 debt, citing negative factors such as the rent increase limit and the risks inherent in single projects. According to the report, Moody's downgraded 15 local issues and gave negative outlook ratings to 10 local bond programs.

GAO Contacts and Staff Acknowledgements

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