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MULTIFAMILY HOUSING

Progress Made in Establishing HUD's Office of Multifamily Housing Assistance Restructuring



**Resources, Community, and
Economic Development Division**

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Congressional Committees

The Department of Housing and Urban Development's (HUD) permanent "mark-to-market" program was recently established to restructure HUD's multifamily portfolio of insured Section 8 housing projects by resetting rents to market levels and reducing mortgage debt if necessary to permit a positive cash flow.¹ The Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act of 1998² authorized the program and established the Office of Multifamily Housing Assistance Restructuring (OMHAR) within HUD to administer it. Currently, the rents for many of the HUD-assisted and -insured multifamily housing projects substantially exceed the market level, which results in higher subsidies under the Section 8 program. HUD received \$3.8 billion for Section 8 project-based subsidies in fiscal year 1998.

The act requires us to audit the operations of OMHAR annually during the first 2 fiscal years following the date of enactment and as appropriate after that. This initial report reviews the status of OMHAR's development, focusing on (1) its organization and staffing and how it relates to HUD's overall structure, (2) whether it is on schedule to meet its key operational and reporting requirements, (3) the procedures and systems it will use to oversee the mark-to-market program's implementation, (4) the status of projects included in the three mark-to-market demonstration programs and how HUD is using information gathered from these programs, and (5) the actions it has taken to obtain information and feedback from parties that will be affected by the mark-to-market program.

Results in Brief

Because a Director for the Office of Multifamily Housing Assistance Restructuring was not appointed until October 21, 1998, HUD had not made final decisions at the time of our review on the Office's staffing and organization or on how the Office would relate to HUD's overall structure. In addition to the 10 staff currently assigned to work on the mark-to-market program, HUD's preliminary plans call for hiring approximately 75 staff—most of whom would be hired from outside the Department—for the Office of Multifamily Housing Assistance Restructuring. The act provides the Director special compensation

¹HUD's Section 8 program provides rental subsidies for low-income families. These subsidies are linked to either the apartment (project-based) or the resident (tenant-based).

²Referred to in this report as "the act" (P.L. 105-65, Oct. 27, 1997).

authority to pay employees of the Office at a higher level than other HUD employees in order to obtain the skills and expertise needed to accomplish the program's purposes.

HUD has made considerable progress toward meeting its key operational requirements for implementing the mark-to-market program. For example, HUD issued interim regulations for the program on September 11, 1998, and expects to complete such important tasks as developing an operating procedures manual in October 1998, when the program is mandated to begin. However, because of delays in obtaining contract support and the sheer volume of tasks that HUD needs to complete, some of these tasks either have been or will be completed behind their original schedule. For example, HUD initially planned to publish the interim program regulations by August 1998 and final regulations by October 1998. However, the interim regulations were not published until September 11, 1998, and the final regulations are not expected to be published until 3 months after the Director's appointment.

The HUD officials responsible for the mark-to-market program are in the process of establishing or planning several procedures and systems designed to oversee the implementation of the program. These include (1) a system for measuring the performance of the entities responsible for carrying out restructuring transactions on HUD's behalf, (2) an Internet-based system to track the actions taken by these entities in carrying out mark-to-market functions, and (3) an audit guide to test these entities' compliance with the program's requirements and objectives. In addition, mark-to-market officials were planning procedures to oversee specific components of the program, such as the processes that administrative entities use to decide new rents for restructured properties, determine projects' rehabilitation needs, and restructure project mortgages. HUD deserves credit for focusing on oversight procedures prior to the program's implementation. However, as of October 14, 1998, most of these procedures and systems were still being developed.

The amount of information that HUD can use to assess the outcomes under the three restructuring approaches being tested under the demonstration program is limited because a relatively small number of transactions to restructure Section 8 projects have been completed. Furthermore, all but four of the completed transactions were processed under one of the three restructuring approaches being tested. Nevertheless, according to HUD mark-to-market officials, they have used information from the demonstrations to identify, evaluate, and improve upon, as necessary, the

processes used by HUD field offices and third parties in carrying out restructuring activities. For example, HUD has used information from the demonstration program to help develop process flow charts and operating procedures for the permanent program.

In accordance with legislative requirements, HUD mark-to-market staff have taken actions to obtain information and feedback from affected parties. Specifically, they (1) have developed program guidance that includes steps to involve affected parties including tenants and neighborhood associations, at various points in the restructuring process, such as when a project's rehabilitation needs are being determined, and (2) have held three public forums to obtain recommendations from organizations representing affected parties (such as state and local housing finance agencies, tenants, and project owners) on implementing certain legislative provisions. In addition to the legislatively required actions, HUD invited organizations representing project owners and managers, tenant groups, nonprofit organizations, lenders, coalitions of local and state government agencies, and other advocacy groups to submit ideas and comments on developing the program and to participate in meetings to discuss these issues.

Background

Approximately 8,500 projects that have been financed with Federal Housing Administration (FHA)-insured mortgages are also supported by project-based Section 8 housing assistance payments contracts.³ In 1996, a HUD contractor estimated that for approximately 63 percent of these multifamily projects, the rents are higher than those of comparable unassisted rental units in the same housing rental market, which increases the costs of the Section 8 program to the federal government. However, if the Section 8 assistance is reduced, owners of many of the FHA-insured housing projects are likely to default on their mortgage payments, resulting in substantial claims to the FHA General Insurance Fund. In addition to the cost of insurance claims, defaults on mortgage payments could leave tenants without adequate affordable housing.

The original project-based Section 8 contracts that were entered into in the 1970s and 1980s were typically for 15, 20, or 40 years and began expiring in the early 1990s. The Congress and HUD have worked together to

³FHA mortgage insurance protects lenders from financial losses stemming from borrowers' defaults on the mortgage loans. When a default occurs on an insured loan, a lender may "assign" the mortgage to HUD and receive payment from FHA for an insurance claim. In addition to mortgage insurance, many FHA-insured multifamily properties receive some form of subsidy from HUD, such as Section 8 rental subsidies tied to some or all units (Section 8 project-based assistance).

renew expiring contracts for 1 year. As its long-term Section 8 contracts expire and its 1-year contracts are renewed annually, HUD estimates that its annual renewal costs will increase steadily. For example, HUD estimated that if no actions were taken, the annual cost of renewing project-based Section 8 contracts would rise to over \$7 billion—or approximately one-third of HUD’s current total budget—by 2007. To address these escalating costs, the Congress appropriated \$30 million to conduct a mark-to-market demonstration program in fiscal year 1996. This demonstration was intended to test various methods of restructuring the financing of insured Section 8 properties, generally by adjusting rents to market levels and reducing the mortgage debt to reflect any decline in net operating income resulting from the rent adjustment. Near the end of fiscal year 1996, the Congress repealed the demonstration program but authorized a new demonstration for fiscal 1997.

To deal with Section 8 contract expirations occurring in fiscal year 1999 and thereafter, the Congress legislated a permanent mark-to-market program in October 1997.⁴ This legislation also extended the fiscal year 1997 demonstration program through fiscal 1998 with modifications as a transitional program while HUD developed regulations to implement the permanent program. The intended goals of the permanent mark-to-market program are to reduce the costs of expiring Section 8 contracts, address financially and physically troubled projects, correct management and ownership deficiencies, and preserve the affordability and availability of low-income rental housing. (See app. I for an overview of the mark-to-market process.)

The act directed HUD to select capable entities to carry out restructuring under the mark-to-market program on behalf of the federal government. These entities are referred to as participating administrative entities (PAE). Entities eligible to apply to become PAEs include public agencies, such as state housing finance agencies, local housing agencies, nonprofit organizations, and these entities in partnership with each other or with private entities. The act specifies selection criteria such as experience in working directly with tenant organizations and other community-based organizations; experience with multifamily housing financing and restructuring; a history of stable, financially sound, and responsible administrative performance; and financial strength.

⁴The Multifamily Assisted Housing Reform and Affordability Act of 1997 was enacted in title V of P.L. 105-65. Subtitle A of the 1997 act contains the FHA-Insured Multifamily Housing Mortgage and Housing Assistance Restructuring Program.

Staffing and Organizational Decisions Not Final Because of Delays in Appointing an OMHAR Director

The act established OMHAR as an entity within HUD and required the Office to be under the management of a presidentially appointed and Senate-confirmed Director. Section 572(a) of the act specifies that not later than 60 days after its enactment (Oct. 27, 1997), the President should submit a nomination for the Director for OMHAR to the Senate. However, the Director was not nominated until September 29, 1998. The Senate confirmed the nomination on October 21, 1998.

The act authorizes the Director to hire personnel to carry out OMHAR's functions. However, because the Director was not appointed until October 21, 1998, HUD staff began formulating organization and staffing plans for OMHAR in the Director's absence. HUD anticipates very targeted hiring of staff for OMHAR with expertise to carry out critical policy development, oversight, and decision-making functions. Section 574(a),(b) of the act allows the Director to pay OMHAR's employees (1) without regard to certain provisions of pay schedules used to hire most federal employees⁵ and (2) comparably to the officers and employees of the Federal Deposit Insurance Corporation. In effect, this authority allows the Director to compensate OMHAR employees at a higher level than other HUD employees to obtain the skills and expertise needed to accomplish the program's purposes.

HUD plans to hire these staff in phases. OMHAR will have approximately 75 to 85 staff at its peak; however, this number may increase if additional hiring authority is obtained. Some HUD personnel are expected to be detailed to OMHAR, but according to mark-to-market officials, most will be hired from outside HUD. For the first quarter of fiscal year 1999, the 10 existing HUD staff working on the mark-to-market program will be detailed to OMHAR and additional support will be provided by HUD staff with collateral assignments. HUD envisions that these senior core staff will be assisted by 10 staff hired for 1-year terms. HUD intends on hiring additional staff with 4-year terms in three phases—at the end of October and December 1998 and the end of February 1999. Of the 75 additional staff expected to be hired during fiscal year 1999, approximately 15 will be distributed among five HUD field offices,⁶ and the remainder will be located in headquarters.

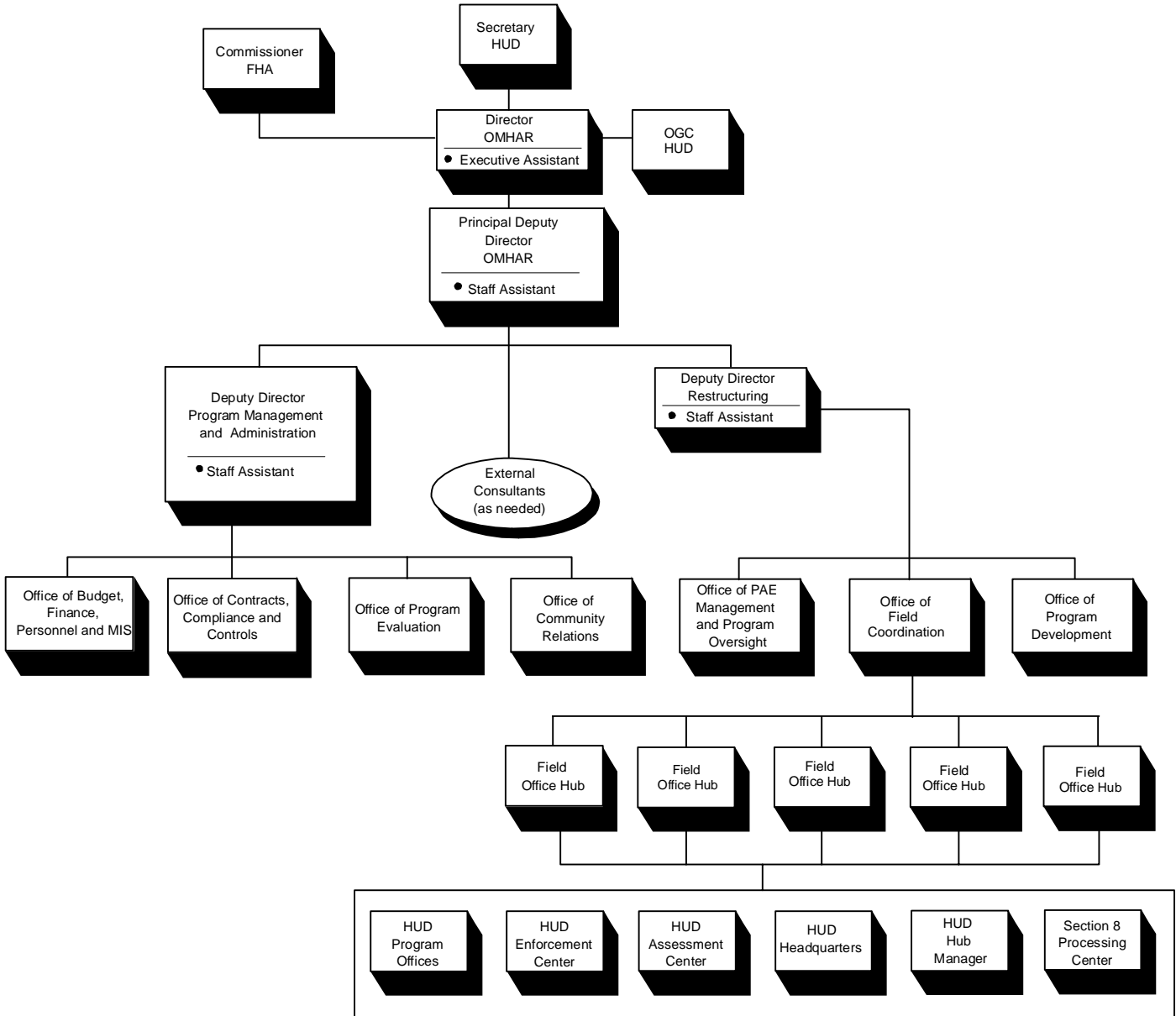
⁵These provisions relate to classification and General Schedule pay rates and are set forth in title 5 of the U.S. Code.

⁶These five field offices will be referred to as OMHAR hubs. At the time of our review, HUD had not yet decided which five field offices would be designated as OMHAR hubs.

Because mark-to-market is a relatively short-term effort—authority for both the program and OMHAR terminates on September 30, 2001⁷—HUD plans to focus staff resources on inherently governmental functions and will generally not hire internal staff to carry out commercial functions that are readily obtainable through private-sector vendors. Instead, HUD expects to obtain capacity for such functions through contracts to support internal staff. While HUD’s plan to oversee the contractors is not yet final, HUD anticipates having several staff dedicated to managing the contractors. These staff would include the chief of a newly created office of contracts, compliance, and controls; three contract analysts/government technical representatives; a records management analyst; two internal review specialists; and a clerical support staff member. Figure 1 illustrates OMHAR’s proposed organizational structure.

⁷The mark-to-market program established by the act is referred to as the “permanent” program in the sense that it is not a “demonstration” program. However, under section 579 of the act, authority for the permanent program terminates in 2001.

Figure 1: OMHAR's Proposed Organizational Structure



Housing experts involved with mark-to-market issues, including representatives of advocacy groups, whom we contacted were concerned that a Director of OMHAR had not yet been appointed at the time of our discussions. For example, one representative was concerned that the delay in the Director's appointment limited the Director's opportunity to participate directly in developing the program's regulations. In addition, according to some representatives, the delay in appointing the Director and implementing the program sent a negative message to stakeholders about the administration's support of the program. In response to this concern, HUD mark-to-market officials said that the administration has been supportive of the program and has provided access to any resources necessary to prepare for its implementation.

HUD Has Made Progress in Preparing for Mark-To-Market Program, but Some Key Tasks Are Behind HUD's Original Schedule

As mandated in the act, HUD is required to implement the mark-to-market program for Section 8 contracts expiring in fiscal year 1999 (beginning Oct. 1, 1998) and thereafter. Despite delays in hiring a management studies contractor and a voluminous number of tasks to complete, HUD has made considerable progress toward this end. For example, HUD has published interim regulations for the mark-to-market program and is expecting to develop an operating procedures manual and to select its partners (the PAES) to perform the restructurings in October 1998.

However, in spite of HUD's efforts, some of these tasks either have been or will be completed behind their original schedule. For example, in May 1998, HUD had planned to issue the program's interim regulations by August and to have final regulations in place by October 1998. Now, HUD expects to have only the interim regulations in place by October 1998. Final regulations are to be developed 3 months after the OMHAR Director's appointment. Also, while HUD originally planned to begin briefing PAES on their responsibilities in September 1998, because of delays in selecting the PAES, briefings are not scheduled to begin until October. Of eight key tasks, such as preparing briefing manuals and conducting technical assistance briefings for field office staff, HUD had completed one as of September 8, 1998, the most recent date for which this information was readily available. The remaining seven were in progress, although three of these were behind HUD's original schedule. Appendix II provides a more detailed description of HUD's progress in carrying out eight key tasks needed to implement the mark-to-market program.

In addition to the operational tasks that HUD must perform, the act places some reporting and other requirements related to the mark-to-market

program on HUD. For example, the act requires the OMHAR Director to report certain information to the Secretary of HUD and for the Secretary to submit information on OMHAR's operations to the Congress and the Office of Management and Budget. (See app. III for information on the mark-to-market reporting requirements.) The act also requires that prior to issuing final regulations, HUD seek recommendations on the implementation of the mark-to-market program from individuals and organizations affected by the program and convene at least three public forums so that those individuals and organizations can express their views concerning the proposed disposition of the recommendations. This requirement is discussed in greater detail later in this report.

While most representatives of the groups involved with mark-to-market issues whom we contacted were generally complimentary of mark-to-market officials' efforts to implement the program, many expressed concerns about the delays HUD has experienced in issuing the program's regulations and soliciting and selecting its administrative partners. For example, there were concerns that the delay in publishing the interim regulations could limit the time that affected parties have to review and comment on them before they become effective and that entities that are eligible to serve as PAES might not be able to develop a sufficient understanding of the regulations before having to decide if they want to participate in the program. According to HUD mark-to-market officials, the public will have 45 days to comment on the interim regulations, which they believe is a sufficient amount of time. Although the regulations become effective 30 days after publication, which will be before the end of the comment period, these officials said that the comments received will be considered in developing the program's final regulations. Furthermore, these officials said that the published notice soliciting PAES contains an adequate description of the scope of work for entities to decide whether they want to participate.

HUD's Procedures to Oversee Mark-To-Market Program's Implementation Are Under Development

Because HUD is responsible for establishing effective management controls over the program's implementation, the HUD officials developing the mark-to-market program were establishing or planning several procedures and systems to oversee its implementation.⁸ However, as of October 14, 1998, most of these procedures and systems were not yet in place, and many of the related details remained to be developed.

⁸The legislation gives the Secretary of HUD the responsibility for carrying out mark-to-market operations until a Director for OMHAR is appointed.

HUD Is Developing Controls Over Program Operations and Compliance

Among other things, management controls can include (1) controls over program operations, which are policies and procedures that management implements to reasonably ensure that a program meets its objectives, and (2) controls over compliance with laws and regulations, which are policies and procedures to reasonably ensure that resources are used consistent with laws and regulations.⁹ Because many of the functions necessary under the mark-to-market program will be carried out by the PAES rather than by HUD, it will be particularly important for HUD to establish procedures ensuring that all the parties involved are carrying out their responsibilities in ways that meet the program's objectives and are in compliance with the program's requirements. To its credit, HUD has focused on developing oversight procedures prior to the program's implementation.

In general, to oversee the operations of the HUD field offices and PAES in the mark-to-market program, HUD is developing a plan for centralized review and oversight. Within its general oversight system, HUD has either developed or is planning three key components to help ensure that field offices and PAES carry out the program in a way that meets its objectives and is in compliance with requirements: (1) performance measures to judge the effectiveness of PAES' activities and a system of compensating PAES, (2) an Internet-based tracking system to monitor and analyze actions taken by HUD field offices and PAES in carrying out mark-to-market functions, and (3) an oversight and audit guide to test compliance with the program's requirements and objectives. As of October 14, 1998, HUD was still in the process of developing all three of these components. The components and their status are presented in table 1.

⁹Government Auditing Standards, 1994 Revision (GAO/OCG-94-4, June 1994).

Table 1: Key Components of HUD's Oversight of Field Offices' and PAEs' Activities in the Mark-To-Market Program

| Task | Purpose | Performed by | Status |
|--|---|---|--|
| Performance measures to judge the effectiveness of PAEs' activities and a system for compensating PAEs | To allow HUD to assess PAEs' performance and compensate them accordingly. —HUD may provide incentives to reward superior performance (§513(a)(2)(I)) or may terminate its agreement with a PAE for failure to comply with requirements (§513(a)(2)(F)). —HUD is to compensate PAEs for all reasonable expenses incurred as necessary to perform their duties under the act (§513(a)(2)(H)). | Developed by HUD officials responsible for mark-to-market, with assistance from HUD's management studies contractor, who is to make recommendations for improvements to the fee structure used under the demonstration program. | According to mark-to-market officials, procedures to judge the effectiveness of third parties' activities will be included in an oversight and audit guide, which was not yet final as of October 14, 1998. The compensation structure was also not final as of that date. |
| Internet-based tracking system to monitor actions taken by HUD field offices and PAEs in carrying out mark-to-market functions | To allow HUD to track transactions completed by its field offices and PAEs, including project- and loan-related information, and analyze the social, economic, and administrative implications of restructuring. —HUD is to report annually to the Congress on the actions taken under the mark-to-market program and on the status of eligible projects (§520(a)). | The tracking system was developed by a HUD contractor. Another contractor, the management studies contractor, then evaluated the system and recommended changes. | As of October 14, 1998, HUD was in the process of implementing a system for use under the fiscal year 1998 demonstration program. At that time, HUD was also working with the management studies contractor to identify changes necessary for the permanent program and expected the system to be ready for assigning projects to PAEs, tracking PAEs' fees, and tracking projects under the permanent program in November 1998. |
| Oversight and audit guide to test compliance with program's requirements and objectives | To identify internal control objectives and tests that can be used to determine if the program's goals, objectives, and requirements are being met. According to mark-to-market officials, the guide will allow all parties involved in the restructuring process to know that their work will be reviewed and to be aware of exactly what they will be held accountable for doing. | Developed by HUD's management studies contractor. | This guide was still under development as of October 14, 1998. |

Note: All section citations refer to P.L. 105-65.

HUD Is Developing Procedures to Monitor Program's Key Components

In addition to the processes described in table 1 for HUD's general oversight of field offices' and PAES' performance under the mark-to-market program, HUD is responsible for monitoring several specific components of the program as they are implemented. These components include (1) screening owners and projects to determine their eligibility for restructuring, (2) setting projects' rents, (3) determining projects' rehabilitation needs, (4) restructuring projects' mortgages, (5) recapturing Section 8 funds, (6) reviewing restructured properties, and (7) using technical assistance funds. As of October 14, 1998, HUD had developed procedures to oversee two of these components but was still in the process of developing oversight procedures for the other five. The program's components and the description and status of HUD's procedures to oversee their implementation are presented in appendix IV.

Data on Completed Restructurings Are Limited, but Demonstrations Have Provided Information on Process

HUD's ability to evaluate the results of the various restructuring approaches allowed under the mark-to-market demonstration programs is limited because a relatively small number of demonstration transactions have been fully completed. The Congress authorized these demonstrations for fiscal years 1996-98 to explore approaches for restructuring the financing of and reducing the Section 8 assistance provided for properties eligible for the mark-to-market program. Despite the fact that relatively few transactions have been fully completed, HUD mark-to-market officials believe that the experience and process of carrying out the demonstrations have yielded information useful for implementing the permanent program.

Demonstrations Were Established for Fiscal Years 1996-98 to Test Mark-To-Market Approaches

In April 1996, the Congress passed legislation authorizing the fiscal year 1996 mark-to-market demonstration—a voluntary program. The repeal of this demonstration near the end of fiscal year 1996 did not nullify any agreements or proposals that had already been considered under the program, and HUD continued to process proposals that had been received prior to its termination.¹⁰ For project-based Section 8 contracts expiring in fiscal years 1997 and 1998, the Congress again authorized optional demonstration programs to explore approaches to restructuring the debt secured by these properties while minimizing adverse impacts on tenants,

¹⁰The fiscal year 1996 demonstration program was repealed by section 212 of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act of 1997 (P.L. 104-204, approved Sept. 26, 1996).

owners, and communities.¹¹ As authorized by the legislation, restructuring transactions were performed by HUD field offices, by HUD in partnership with state and local housing finance agencies (HFA), and by HUD in joint ventures with nonprofit entities. As of October 2, 1998, the latest date for which information was readily available, HUD had executed contracts with 25 HFAs and entered into 4 joint venture agreements with nonprofit entities to restructure projects under the demonstrations.

**Relatively Few
Demonstration
Transactions Have Been
Completed**

As of October 2, 1998, nearly 300 properties were participating in the demonstration programs. Restructuring had been completed for 42 of these properties, and all but 4 (which were processed under a joint venture arrangement) of these had been processed by HUD staff. None of the restructurings had been completed under HFA arrangements as of that date. Consequently, information that HUD could use to assess outcomes under the various restructuring approaches has been limited. Table 2 shows the number of projects participating in each component of the demonstrations and their status.

¹¹Sections 211 and 212 of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act of 1997 (P.L. 104-204, approved Sept. 26, 1996) and section 522(b) of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act of 1998 (P.L. 105-65, enacted Oct. 27, 1997).

Table 2: Number and Status of Projects Participating in Mark-To-Market Demonstration Programs

| Demonstration program | Number of participating projects | Party responsible for processing restructuring transactions | Status of participating projects |
|-----------------------|----------------------------------|---|---|
| Fiscal year 1996 | 36 ^a | HUD, with assistance from a contract financial adviser. | As of September 30, 1997, five project-restructuring transactions had been completed under the 1996 demonstration. ^b |
| Fiscal year 1997 | 120 | As of October 2, 1998, —22 projects were assigned to a joint venture arrangement; —17 projects were assigned to HFAs; and —approximately 81 projects were assigned to HUD field offices. | As of October 2, 1998, 33 project transactions had been completed under the HUD field office component of the 1997 demonstration, and 4 had been completed under the joint venture component. |
| Fiscal year 1998 | 126 | As of October 2, 1998, —23 projects were assigned to a joint venture arrangement; —52 projects were assigned to HFAs; and —approximately 51 projects were assigned to HUD field offices. | As of October 2, 1998, no project transactions had been completed under the fiscal year 1998 demonstration. |
| Total | 282 projects participating | | 42 restructuring transactions completed |

^aHUD received 110 voluntary proposals from owners to participate in the fiscal year 1996 demonstration. Of these, HUD rejected 21 as either ineligible or incomplete. HUD rejected 53 of the remaining 89 proposals because the project's financing arrangements precluded mortgage restructuring, the proposal did not meet the program's objectives, or the proposal did not demonstrate a resolution approach that was different from proposals already in process. HUD accepted the remaining 36 proposals with specific modifications and conditions.

^bFive other projects originally submitted under the 1996 program were completed under the 1997 program. Owners of 14 projects elected not to participate further in the demonstration. As of September 8, 1998, the remaining 12 projects were held in abeyance because they were financed with certain bonds, and the bond issuers had to agree to the restructuring. These 12 would no longer be eligible to be restructured under the 1996 demonstration program. According to HUD mark-to-market officials, if the owners of these projects choose to pursue restructuring, they could currently be considered for participation in the 1998 demonstration.

Source: HUD.

Activities Under Demonstrations Have Provided Information on Mark-To-Market Process

Despite the relatively few demonstration transactions that have been fully completed, according to HUD mark-to-market officials, they have used information from the demonstrations to identify, evaluate, and improve, as necessary, the processes used by HUD field offices and third parties in carrying out restructuring activities. Specifically, information from the demonstrations was used to help develop process flow charts and an operating procedures manual for the permanent mark-to-market program. These charts and the manual were compiled by mark-to-market officials, with assistance from HUD's management studies contractor, by reviewing and documenting HUD's policy and program requirements under the demonstrations, identifying weak policies and procedures in the process, and recommending improvements in the program's design and delivery.

In addition, a front-end risk assessment of the fiscal year 1997 demonstration program identified some concerns, which HUD mark-to-market officials told us that they had considered in establishing the permanent program. For instance, the front-end risk assessment noted that concerns over potential tax liabilities kept many owners from participating in the program, owing either to an inability or an unwillingness to handle the tax consequences or a resistance to participating until anticipated changes to the tax legislation became known.¹² (See app. II for more information on resolution of the tax issue.)

The 1997 front-end risk assessment also identified communication and the coordination of HUD's functions as an area of concern. For instance, the risk assessment stated that HUD's information technology staff ideally should have been involved in developing information systems for the fiscal year 1997 demonstration program earlier in the process to ensure that all departmental documentation and other information technology requirements were met. The risk assessment concluded that, in general, the program's staff should be representative of all applicable areas of HUD or should involve appropriate personnel from the earliest stages of the process to avoid the need to substantially modify processes late in the program. According to HUD mark-to-market officials, they have applied this "lesson learned" by involving other areas within HUD's Office of Multifamily Housing, such as Section 8 and Multifamily Claims staff, and other HUD offices, such as the Office of Policy Development and Research and the Office of General Counsel, throughout the development of the permanent program.

¹²The demonstration program did not include legislative provisions offering property owners any relief from the tax liabilities that could be incurred in the restructuring process.

According to mark-to-market officials, the demonstration programs also provided other information useful for working out the details of the permanent program. For instance, mark-to-market officials believe that their efforts in developing agreements with state and local HFAS laid the foundation for HFAS' participation in the permanent program as PAES. Similarly, issues raised by the nonprofit partners under the joint venture arrangements have been instructive as mark-to-market officials consider details and policies under the permanent program, such as issues related to adjusting rents to market levels without mortgage restructuring and the compensation structure for nonprofit partners.

With respect to the lessons learned from the component of the demonstration program carried out by HUD field offices, mark-to-market officials said that they have compiled an ongoing question-and-answer document to respond to the issues raised by the field offices involved. These mark-to-market officials said that they have communicated with the field offices to discuss the advantages and disadvantages of certain approaches and to develop responses to the questions. According to these officials, this effort has assisted in developing the permanent program by giving them a better understanding of the potential effects of policy decisions on the participating field offices.

HUD Has Obtained Input From Affected Parties and Developed Plans for Their Continued Involvement

Under the mark-to-market legislation, HUD must establish procedures to provide an opportunity for parties affected by restructuring to participate in the process. The act also requires HUD to hold at least three public forums to obtain recommendations on the implementation of certain legislative provisions. In accordance with these requirements, HUD's program guidance includes steps for involving affected parties in the restructuring process, and, on October 1, 1998, mark-to-market staff held the three required public forums. In addition, in preparing to implement the program, HUD has sought input from a variety of groups representing those affected by the program.

Program's Guidance Includes Opportunities for Participation by Affected Parties

Section 514(f) of the act requires HUD to establish procedures to provide an opportunity for tenants, neighborhood residents, local government, and other affected parties to participate in the restructuring process. These procedures must require consultation with affected parties in connection with, at a minimum, a project's mortgage restructuring and rental

assistance sufficiency plan,¹³ any proposed sale or transfer of the project to another entity, and the rental assistance assessment plan developed to determine whether to renew the project's Section 8 assistance with project-based or tenant-based assistance. The act further directs that, to the extent practicable and consistent with the need to accomplish the restructuring of Section 8 projects in an efficient manner, the procedures should give all such parties an opportunity to provide the PAE with comments in writing, in meetings, or in another appropriate manner.

HUD has addressed this legislative requirement by outlining procedures in the program's draft operating procedures manual for affected parties' participation. The manual identifies several points when affected parties must be given the opportunity to participate. For instance, the manual requires a PAE to conduct at least one consultation meeting before a project's physical needs assessment is completed. The consultation meeting is to provide the PAE with an opportunity to receive oral presentations and comments and respond to tenants' and communities' concerns regarding the mortgage restructuring and rental assistance sufficiency plan, the rental assistance assessment plan, and any proposed sale or transfer of the project. In addition, within 10 days of the PAE's completion of the proposed rental assistance assessment plan, the owner must send a notice and provide an opportunity to comment to the project's residents, a local government representative, a representative of the public housing authority, and representatives of neighborhood residents or other affected parties, as determined by the PAE.

Section 514 of the act also authorized up to \$10 million annually in funding for tenant groups, nonprofit organizations, and public entities for building the capacity of tenant organizations, technical assistance, and tenant services. HUD has designated a portion of these funds to enhance opportunities for affected parties to participate in the mark-to-market process through the Outreach and Training Grants (OTAG) program. Under the program, \$6 million is available to provide technical assistance for tenants of eligible mark-to-market projects so that the tenants can (1) participate meaningfully in the mark-to-market program and (2) affect decisions about the future of their housing. Grant funds can be used for, among several other activities, organizing residents of eligible low-income

¹³Each project undergoing restructuring is required to have a mortgage restructuring and rental assistance sufficiency plan, which provides the details of a project's restructuring.

housing so that tenants can effectively participate in the mark-to-market process.¹⁴

HUD Has Held Required Public Forums

The act also specifically requires that, in addition to obtaining public comments before publishing the program's final regulations, HUD seek recommendations from various parties on how it should implement the legislative provisions governing the selection of PAES and requiring that certain Section 8 contracts be renewed as project-based assistance. To seek views concerning HUD's proposed disposition of these recommendations, the legislation requires HUD to convene at least three public forums involving organizations representing state and local HFAS, other potential PAES, tenants, project owners and managers, state and local governments, and mortgagees. HUD held these forums on October 1, 1998, in New York, Chicago, and San Francisco; these locations were selected because, in part, of the levels of contract expirations in these areas. However, when the forums were held, the process of selecting PAES—one of the forum topics on which HUD was soliciting recommendations—was already under way. According to HUD mark-to-market officials, interested parties had extensive opportunities to provide input prior to the start of the PAE selection process.

HUD Has Obtained Input From Affected Parties in Preparing to Implement the Program

Going beyond these legislative requirements, on December 18, 1997, HUD's Office of Multifamily Housing began a consultation process with representatives from a wide variety of national advocacy groups interested in HUD's implementation of the permanent mark-to-market program. Organizations representing owners and managers of FHA-insured assisted housing, tenant groups, nonprofit organizations, lenders, coalitions of local and state government agencies, and other advocacy groups were invited to submit ideas and comments on developing the new program. HUD received concept papers from housing groups representing several interested parties and from February 2 through 27, 1998, held 13 full-day meetings to discuss various issues related to mark-to-market's implementation. According to HUD mark-to-market officials, the information presented during these consultations was used in developing the mark-to-market program and considered by the Department in drafting the program's interim regulations.

¹⁴In addition, \$1 million in fiscal year 1998 and, subject to appropriations, \$8 million in fiscal 1999 is available under HUD's Intermediary Technical Assistance Grant program. Under this program, intermediaries provide technical assistance funds to subrecipients, including grantees under the Outreach and Training Grants program, to, among other things, help tenants participate meaningfully in the mark-to-market process and have input into and set priorities for project repairs.

In addition to the concept papers and meetings, mark-to-market officials have also coordinated separately with the National Council of State Housing Agencies and individual housing finance agencies to obtain feedback from them regarding HFAS' involvement in the mark-to-market program. For instance, in May 1998, the mark-to-market official responsible for the HFA component of the 1997 and 1998 demonstration programs met with the Council to obtain HFAS' views on the compensation structure for their participation in the program. According to mark-to-market officials, they have been meeting with HFAS on a continuing basis to discuss the program and hear their concerns because their involvement as PAES is key to the program's success.

The representatives of groups involved with mark-to-market issues whom we contacted generally believed that HUD's efforts to obtain input on the program's implementation were productive. However, three of these representatives were concerned that, since the meetings in February, HUD had not given any indication of its tentative decisions on the issues discussed. Some of these representatives said that, without knowing HUD's intentions prior to the Department's publication of the interim regulations for public comment, their groups may be less able to provide meaningful input on the program's implementation, particularly if the interim regulations govern the program for a period of time. According to HUD mark-to-market officials, it would have been inappropriate to solicit information from the public during the process of writing the regulations. Accordingly, at the meetings in February, mark-to-market officials notified participants that there would be no further discussions until the regulations were completed and that any further comments would have to be submitted during the comment period.

Agency Comments

We provided HUD with a draft of this report for its review and comment. HUD agreed that our report accurately described the Department's efforts in developing and implementing the mark-to-market program. HUD stated that our review was helpful to the Department in confirming that it was focusing its attention and efforts on issues that needed to be addressed. HUD also noted that it had developed an extremely aggressive work plan to accomplish the development and implementation of the mark-to-market program and that while some key tasks were accomplished later than provided for in its original schedule, a small but efficient core group of mark-to-market staff members have accomplished several significant work items, even in the absence of a Director. HUD suggested some minor

technical changes, which we have incorporated. The complete text of HUD's comments appears in appendix V.

Scope and Methodology

Section 577 of the act requires us to audit the operations of OMHAR annually for the first 2 fiscal years following the date of enactment (Oct. 27, 1997). For this assignment, our work focused on the status of OMHAR's development and HUD's plans for implementing the permanent mark-to-market program. To carry out the assignment's objectives, we interviewed the HUD officials responsible for mark-to-market operations and reviewed documentation related to their plans for developing OMHAR and implementing the program, including their work plans, time frames, and draft program guidance. We also discussed HUD's efforts to develop OMHAR and prepare for the program's implementation with representatives of groups involved with issues related to mark-to-market, including two independent housing consultants, the National Council of State Housing Agencies, the National Leased Housing Association, the National Housing Law Project, the National Alliance of HUD Tenants, and the National Housing Conference. Because OMHAR was not yet established and HUD's plans for implementing the permanent mark-to-market program were still being developed, we did not attempt to evaluate the effectiveness of OMHAR's operations or HUD's implementation plans.

We performed our work at HUD in Washington, D.C., from March through September 1998 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretary of Housing and Urban Development. We will make copies available to others on request. Please call me at (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix VI.



Judy A. England-Joseph
Director, Housing and Community
Development Issues

List of Committees

The Honorable Connie Mack
Chairman
The Honorable John F. Kerry
Ranking Minority Member
Subcommittee on Housing Opportunity
and Community Development
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Christopher S. Bond
Chairman
The Honorable Barbara A. Mikulski
Ranking Minority Member
Subcommittee on VA, HUD, and
Independent Agencies
Committee on Appropriations
United States Senate

The Honorable Rick A. Lazio
Chairman
The Honorable Joseph P. Kennedy II
Ranking Minority Member
Subcommittee on Housing and
Community Opportunity
Committee on Banking and
Financial Services
House of Representatives

The Honorable Jerry Lewis
Chairman
The Honorable Louis Stokes
Ranking Minority Member
Subcommittee on VA, HUD,
and Independent Agencies
Committee on Appropriations
House of Representatives

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Abbreviations

| | |
|--------|---|
| AFR | applicable federal rate |
| FERA | front-end risk assessment |
| FHA | Federal Housing Administration |
| FMR | fair market rent |
| GAO | General Accounting Office |
| HFA | housing finance agency |
| HUD | Department of Housing and Urban Development |
| IRS | Internal Revenue Service |
| MAHRAA | Multifamily Assisted Housing Reform and Affordability Act of 1997 |
| MRRAS | mortgage restructuring and rental assistance sufficiency (plan) |
| OMHAR | Office of Multifamily Housing Assistance Restructuring |
| OTAG | Outreach and Training Grant |
| PAE | participating administrative entity |
| RFQ | Request for Qualifications |

Overview of the Mark-To-Market Process

As the Department of Housing and Urban Development (HUD) plans to implement it, the process to be used under the permanent mark-to-market program has nine phases: (1) screening owners and projects for eligibility, (2) assigning projects for restructuring, (3) preserving affordable housing, (4) collecting data, (5) underwriting, (6) approving the loan, (7) closing, (8) distributing postclosing documents, and (9) servicing and monitoring. This appendix describes the key activities that are to occur during each of the nine phases, as outlined in HUD's draft operating procedures manual.

1. Screening Owners and Projects for Eligibility: The first phase of the restructuring process is determining a project's eligibility. To be eligible to participate in the mark-to-market program, a project must be financed by a Federal Housing Administration (FHA)-insured or Secretary-held mortgage, receive project-based assistance, and have rents that exceed comparable market rents.¹ HUD has established additional criteria for determining if a project is eligible to (1) renew its Section 8 contract at market rents and restructure the project's debt, (2) renew its Section 8 contract at market rents without restructuring the project's debt, or (3) renew its Section 8 contract at the lesser of the project's current rents with an operating cost adjustment factor, budget-based rents with an operating cost adjustment factor, or base rents with an operating cost adjustment factor.² HUD will extend the Section 8 contracts for projects with contracts that are due to expire while they are in the mark-to-market "pipeline," such as projects undergoing eligibility determinations, or while they are participating in the development of a mortgage debt restructuring plan. Under these circumstances, a project's Section 8 contract may be extended at the project's current contract rent for up to 9 months, with the option of a further extension of 3 months.

A project may not be restructured, and its contract may not be renewed if its owner has engaged in material adverse financial or managerial actions or omissions with regard to the project or other federally assisted, financed, or insured projects. Furthermore, a project may not be restructured if its condition is too poor to be rehabilitated at a reasonable cost or if the owner fails to comply with the requirements for

¹Under the legislation, some projects are exempt from restructuring; these include projects for the elderly and homeless and projects financed with state or local government financing (P.L. 105-65, sec. 514(h)). A bill, H.R. 4194, would amend this provision to specify that state- or local-financed projects would be exempt only if restructuring is incompatible with the terms of the financing or illegal under applicable law.

²An operating cost adjustment factor allows for rent adjustments to ensure adequate coverage for inflationary conditions. The operating cost adjustment factor is determined annually by the Secretary of HUD.

restructuring. Such projects are to be directed into HUD's enforcement program.

2. Assigning Projects for Restructuring: During the second phase of the mark-to-market process, HUD assigns multifamily projects to its administrative partners, who will actually perform the restructuring, which are referred to as participating administrative entities (PAE). Assets are first assigned to state and local housing finance agencies (HFA) that HUD has selected as PAES. After this first round of assignments, non-HFA entities that HUD has selected to be PAES can bid for the rights to restructure projects that remain.

3. Preserving Affordable Housing: One of the goals of the act is to preserve the affordability and availability of low-income rental housing through mortgage restructuring. As part of the restructuring process, a mortgage restructuring and rental assistance sufficiency plan is to be developed for each project. The development of this plan is expected to take, on average, 9 months. One element of the mortgage restructuring and rental assistance sufficiency plan is a rental assistance assessment plan, which the PAE develops to determine whether Section 8 assistance should be renewed as project-based or tenant-based assistance. The plan must also include a use restriction whereby the project's owner agrees to maintain affordability for at least 30 years.³ Other elements required in the mortgage restructuring and rental assistance sufficiency plan, which will be developed in later phases, include a new rent subsidy level, a plan to restructure the debt, and a plan to finance the rehabilitation needs of the project.

4. Collecting Data: During the fourth phase of the process, the PAE collects and assesses project-specific data from project owners, lenders, servicers, or other third parties to be used during the underwriting and loan approval phases. The PAE is also to collect and analyze market studies, appraisals, and physical needs assessments to determine market rents, expenses, and the projects' rehabilitation needs.

³In exchange for an agreement to restructure the mortgage, the owner must agree to two affordability requirements: (1) the project must remain affordable for at least 30 years, and (2) the owner may not refuse to lease a reasonable number of units to rent certificate and voucher holders (P.L. 105-65, sec. 514(e)(6) and (9)). In addition, section 515 (b) of the act specifies that owners must accept a project-based contract if offered this assistance. To maintain affordability, HUD is requiring that project rents remain at either of the following levels: (1) rents are such that 20 percent of all units in the project are affordable to residents with incomes at 50 percent of median income, or (2) rents are such that 40 percent of all units in the project are affordable to residents with incomes at 60 percent of median income.

5. Underwriting: Once the data collection is complete, the fifth phase in the mark-to-market process is underwriting. During the underwriting phase, the size of the restructured first and the new second mortgage will be determined. The existing project mortgage will be restructured to provide a first mortgage that is sustainable at restructured market rents. The second mortgage may not exceed the difference between the restructured or new first mortgage and the current unpaid principal balance and must be an amount that can reasonably be expected to be repaid. The term of the second mortgage shall equal the term of the first mortgage. However, the only payments that need to be made on the second mortgage before repayment of the first are an amount equal to 75 percent of excess project income.

6. Approving the Loan: The sixth phase of the process is the loan's approval. It is in this phase that the PAE reviews the mortgage restructuring and rental assistance sufficiency plan to ensure that all required HUD forms have been filled out completely and accurately and then delivers the plan to the OMHAR hub for approval.⁴

7. Closing: After the OMHAR hub grants approval of the plan, the seventh phase of the process is loan closing. Closing is the phase during which HUD, the PAE, the owner, and affected lenders or servicers fulfill the legal requirements for (1) executing the mortgage restructuring and rental assistance sufficiency plan, (2) restructuring the project's debt, and (3) renewing the project's Section 8 contract.

8. Distributing Postclosing Documents: During the eighth phase of the process, the postclosing documents are distributed to the parties (such as servicers, asset managers, and Section 8 contract administrators) who are responsible for loan servicing and asset management functions after restructuring.

9. Servicing and Monitoring: The ninth phase is loan servicing and monitoring. During this phase, servicers, asset managers, escrow agents, Section 8 contract administrators, and monitors have responsibilities to oversee the loans. The servicers of the first and second mortgages are responsible for the cash management function, which includes billing and collecting payments, and accurately accounting for and reporting payments. The asset managers of the first and second mortgages are responsible for ensuring that the underlying collateral is maintained in

⁴HUD anticipates that five field offices will have mark-to-market responsibilities. These field offices will be referred to as OMHAR hubs.

Appendix I
Overview of the Mark-To-Market Process

decent condition. The asset managers of the second mortgage are also responsible for ensuring that only eligible expenses have been deducted from project revenue to maximize excess project income, which can be used to pay off the second mortgage. The escrow agents are responsible for managing the accounts that will be used to finance the immediate rehabilitation needs of the projects, identified through the restructuring process. The Section 8 contract administrators are responsible for ensuring that the projects are maintained in decent, safe, and sanitary conditions by the projects' owners. Monitors, referred to as restructuring use agreement monitors, are responsible for ensuring that the owners or future purchasers of the projects maintain the affordability and use restrictions agreed to during the restructuring process.

Summary and Status of Operational Tasks Needed to Implement the Mark-To-Market Program

| Task | Purpose | Performed by | Status |
|---|--|---|---|
| Issue interim and final regulations | To implement the mark-to-market program. The final regulations are required to be issued by the later of October 27, 1998, or 3 months after the Director of OMHAR has been appointed (§522(a)(1)(2)). | OMHAR's Director to issue both; however, the Secretary of HUD is required to issue the interim regulations if a Director is not appointed | Behind original schedule. The interim regulations were published September 11, 1998, and became effective 30 days later. HUD had originally expected to issue the interim regulations by August 1998 so that the final regulations could be issued in October 1998. According to mark-to-market officials, now the final regulations are not expected to be published until 3 months after the appointment of the OMHAR Director. |
| Solicit and select third parties, referred to as PAEs | To allow HUD to work with PAEs, which will actually restructure the mortgages and rental assistance payments of eligible multifamily projects (§513(a)(1)). | HUD | Behind original schedule. HUD published the Request for Qualifications (RFQ) to solicit PAEs on August 17, 1998. HUD had originally planned to publish the RFQ in June 1998 in order to have the PAEs selected by August 1998. HUD will select the PAEs in two phases ^a and, as of September 8, 1998, expected to complete the selection process by October 29, 1998. |
| Conduct technical assistance briefings for the PAEs on the mark-to-market process | To familiarize the PAEs with the restructuring process and their responsibilities, which include determining owners' eligibility, determining rent levels, restructuring loans, underwriting new or modified loans, managing the closing process, distributing documents after closing, and servicing the loans. | HUD, with assistance from management studies contractor | Behind original schedule. The briefing sessions for PAEs will begin in October 1998. HUD had originally planned to begin briefing the PAEs in September 1998. |
| Develop an operating procedures manual | To set forth a uniform process for restructuring FHA-insured Section 8 projects. | HUD, with assistance from management studies contractor | As of September 8, 1998, the operating procedures manual was in draft form, but sections of the draft were expected to be ready for departmental clearance by September 11, 1998. |

(continued)

**Appendix II
Summary and Status of Operational Tasks
Needed to Implement the Mark-To-Market
Program**

| Task | Purpose | Performed by | Status |
|--|---|-------------------------------------|---|
| Enter into portfolio restructuring agreements with PAEs | To establish the obligations and requirements of the PAEs in developing mortgage restructuring and rental assistance sufficiency plans in accordance with the act (§513(a)(1)). Also, to identify the eligible multifamily housing projects for which a PAE is responsible and to clarify the duties that a PAE will typically perform. | HUD | HUD will enter into portfolio restructuring agreements with the PAEs as soon as possible after they are selected. However, the time period for completing this process will depend on the length of time involved in negotiating the agreements. |
| Prepare briefing manuals and conduct technical assistance briefings for HUD field office ^b staff on the permanent program | To instruct the field offices on their responsibilities, which include coordinating the flow of cases to PAEs and Section 8 contract administrators, determining projects with Section 516 violations ^c that require enforcement action, and monitoring the performance of the PAEs. | HUD's management studies contractor | As of September 8, 1998, HUD expected the briefing manuals to be completed by the end of September, so that the briefing sessions could commence in October 1998, after the PAEs are selected. |
| Request a revenue ruling from the Internal Revenue Service (IRS) on the tax liabilities for owners participating in the mark-to-market program | To obtain a favorable tax ruling regarding potential tax consequences for project owners whose mortgages are restructured. ^d | HUD | In late 1997, HUD initiated discussions with the Treasury Department to obtain a ruling on the proper income tax treatment of the components of the mortgage refinancing contemplated in section 517(a) of the act, which provides for a restructured or new first mortgage that is sustainable at market rents and a second mortgage that is an amount equal to the difference between the restructured first mortgage and the indebtedness under the existing insured mortgage. The act specifies that interest charged on the second mortgage cannot exceed the applicable federal rate (AFR). Since (1) section 7872 of the Internal Revenue Code, in general, defines a below-market loan as any loan on which the interest rate charged is less than the AFR and |

(continued)

**Appendix II
Summary and Status of Operational Tasks
Needed to Implement the Mark-To-Market
Program**

| Task | Purpose | Performed by | Status |
|--|--|------------------|---|
| Prepare a front-end risk assessment (FERA) report for the permanent mark-to-market program | To identify risks related to fraud, waste, and abuse of federal resources and to document both the existing program controls and management's plans for implementing additional controls that mitigate the identified risks. | A HUD contractor | <p>(2) section 7872(b) provides that the borrower of a below-market term loan is to be treated as having received cash from the lender in an amount equal to the excess of the amount loaned over the present value of all payments required under the loan, the ruling was required to determine if a project's owner, whose second mortgage bears interest below the AFR, would be responsible for paying taxes on this amount.</p> <p>In August 1998, IRS ruled on this request, holding that the second mortgage loans made in accordance with the Multifamily Assisted Housing Reform and Affordability Act of 1997 are exempt from section 7872 of the Internal Revenue Code. In the ruling, IRS concluded that the legislative history of section 7872 indicates that most government-subsidized loans, such as government-insured residential mortgage loans, were intended to be exempted from section 7872 and that the factors justifying an exemption of second mortgages under the 1997 act were similar to the factors justifying the exemption of government-subsidized loans.</p> <p>Furthermore, IRS concluded that the interest arrangements of the second mortgage loans were not structured with a principal purpose of avoiding federal tax.</p> <p>HUD received proposals in response to the Request for Contract Services for the FERA on August 17, 1998. As of September 8, 1998, review of these proposals was complete, and the contract was expected to be awarded by September 11, 1998. The FERA was expected to be finished 60 days after the selection of a contractor.</p> |

(Table notes on next page)

**Appendix II
Summary and Status of Operational Tasks
Needed to Implement the Mark-To-Market
Program**

Note: All section citations refer to P.L. 105-65.

^aThe act provides selection criteria for PAEs based on their experience and capacity and requires that HUD give priority to public agencies during the selection process (§513(b)(1)). Accordingly, during the first phase of the selection process, HUD will review and consider only responses from state or local HFAs. HFAs that are not selected in the first phase may resubmit their proposals by responding to the specific deficiencies identified. During the second phase, HUD will review proposals from rejected HFAs from the first phase and all non-HFA entities. The non-HFAs will usually only be considered for jurisdictions in which no HFA exists or is qualified.

^bBriefing sessions will be held for staff in the five OMHAR hubs. In addition, HUD scheduled a session for October 6, 1998, to discuss the Section 8 renewal policy with field office staff in its multifamily program centers and multifamily hubs.

^cSection 516 violations refer to projects that are ineligible for either Section 8 contract renewal or debt restructuring because the owner has engaged in material adverse financial or managerial actions or omissions or because the project's poor condition cannot be remedied in a cost-effective manner (§516(a)).

^dWith a favorable tax ruling, owners would not incur tax liabilities as a result of the restructuring process.

Summary of HUD's Reporting Requirements for the Mark-To-Market Program

The Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRAA) requires the OMHAR Director to report certain information to the Secretary of HUD and requires the Secretary of HUD to submit information on OMHAR's operations to the Congress and the Office of Management and Budget. Table III.1 provides a summary of the reports required by the legislation and the status of actions taken by HUD. For these mandated reports, it is HUD's interpretation of the act that the reporting requirements become effective once the permanent mark-to-market program is operational. The table also includes information on three other required reports: one on equity-sharing partnerships and the two others on demonstration program activity. As the table shows, HUD is in the process of issuing a report on the possible ways that equity-sharing partnerships may be used as options in implementing the mark-to-market program and has submitted reports on the 1996 and 1997 demonstration programs.

Table III.1: Summary of HUD's Reporting Requirements for the Mark-To-Market Program

| Report's description | Date and/or frequency required | Status |
|--|--|--|
| OMHAR's Director must submit a report to the Secretary of HUD regarding the activities, determinations, and actions of the Director. | Semiannually (§573(b)) | According to HUD's interpretation of the act, this report will be initiated once the OMHAR Director is in place. ^a |
| The Secretary of HUD must report figures to the Congress identifying (1) each project for which the participating administrative entity has developed a rental assistance plan that determines that the tenants generally supported tenant-based assistance but under which the assistance was renewed with project-based assistance and (2) each project for which the participating administrative entity has developed a plan under which the assistance is renewed as tenant-based assistance. | Semiannually, starting April 27, 1998, for 2 years and annually thereafter (§520(b)) | According to HUD's interpretation of the act, this reporting requirement becomes effective once the permanent mark-to-market program is operational, by the later of October 1998 or appointment of the OMHAR Director. ^a |
| To ensure compliance with the legislation, the Secretary of HUD must conduct reviews and report to the Congress on actions taken under the legislation and on the status of eligible multifamily housing projects. | Annually (§520(a)) | According to HUD's interpretation of the act, this reporting requirement becomes effective once the permanent mark-to-market program is operational, by the later of October 1998 or appointment of the OMHAR Director. ^a |
| The Secretary of HUD must submit a copy of the financial operating plans and forecasts for OMHAR to the Office of Management and Budget. These annual plans and forecasts are supposed to be included in the federal budget and in HUD's congressional justifications for each fiscal year. | Annually, before the beginning of each fiscal year (§575(a)) | HUD is planning to prepare this report for the beginning of fiscal year 1999 to be included in the federal budget for fiscal year 2000 and HUD's congressional justifications. |

(continued)

Appendix III
Summary of HUD's Reporting Requirements
for the Mark-To-Market Program

| Report's description | Date and/or frequency required | Status |
|---|---|---|
| The Secretary of HUD must submit a report on the results of OMHAR's operations to the Office of Management and Budget. | Quarterly and at the end of each fiscal year (§575(b)) | HUD is planning to prepare this report for the beginning of fiscal year 1999 to be included in the federal budget for fiscal year 2000 and HUD's congressional justifications. |
| The Secretary of HUD must submit a report to the Congress on possible ways that equity-sharing partnerships may be used as options in implementing the mark-to-market program if the prohibition is lifted. | February 15, 1998 (directed by the conference report of P.L. 105-65) | As of September 8, 1998, this report was circulating through the Department for concurrence and signature. In their formal comments on our report draft on October 2, 1998, HUD officials said that the internal clearance of the equity-sharing report had been completed and letters transmitting the report to the Congress were being prepared. |
| The Secretary of HUD must submit reports to the Congress describing and assessing the status of the projects in the demonstration programs. | Semiannually for the 1996 demonstration (P.L. 104-134, §210(g)); quarterly for the 1997 and 1998 demonstrations (P.L. 104-204, §212(m)(1)(A)) | HUD issued reports for the 1996 and 1997 demonstrations through the fourth quarter of 1997. HUD submitted the last report, covering demonstration program activities through the fourth quarter of fiscal year 1997, on March 28, 1998. |
| The Secretary of HUD must submit a final report on the demonstration programs upon their completion. | Not later than 6 months after the end of the demonstration program (P.L. 104-134, §210(g); P.L. 104-204, §212(m)(1)(B)) | HUD is planning to prepare these reports for the 1996 and 1997 demonstration programs. As of September 8, 1998, HUD was in the process of updating its data to obtain the information needed for these reports. |

Note: Except where noted, all section citations refer to P.L. 105-65.

^aSubsequent to our review, the nominee for OMHAR Director (who had been nominated by the President on Sept. 29, 1998) was confirmed by the Senate on October 21, 1998.

HUD's Procedures for Monitoring Key Components of the Mark-To-Market Program

| Program component | Explanation or related legislative provision(s) | Performed by | Monitoring procedures |
|---|--|---|--|
| Screening of owners and projects to determine eligibility for restructuring | <p>To be eligible for restructuring, a project must meet certain legislatively mandated criteria, including the following:</p> <ul style="list-style-type: none"> —It must consist of more than four dwelling units. —It must have rents that, on an average per-unit or per-room basis, exceed the rents of comparable properties in the same market area. —It must receive project-based Section 8 assistance. —It must have a HUD-insured or HUD-held^a mortgage. <p>In addition, under the legislation, a project is ineligible for restructuring if</p> <ul style="list-style-type: none"> —the owner has engaged in material adverse financial or managerial actions or omissions or —the property is in poor condition that cannot be remedied in a cost-effective manner. <p>HUD is to establish an administrative review process to appeal any final decision regarding rejection of an owner or project for restructuring. (§512(2), 516(a), 516(b)(2)(C))</p> | <p>HUD field offices initially screen projects to determine their eligibility on the basis of information provided by the owners, field office staff, third-party appraisers working for the field offices, and HUD's Assessment and Enforcement Offices. Field offices are to make their screening determinations on the basis of legislative criteria, which are identified in HUD's mark-to-market draft operating procedures manual. Field offices assign eligible projects to OMHAR, which will then assign the projects to PAEs for further processing. For projects with contract rents below the owners' estimate of market rents, field offices are to review the owners' estimate, based on their knowledge of the market area. Assistance from HUD appraisal staff or a third-party review should be obtained if there is any doubt as to the actual market rents.</p> | <ul style="list-style-type: none"> —Directors in HUD's multifamily hubs and program centers^b are required to authorize, by signature, the initial eligibility determination for each project. —For projects identified as having below-market rents, field office supervisory review is required to confirm that contract rents are actually below market. —For projects identified as potentially ineligible because of poor condition or adverse owner determination, the field offices and/or PAEs must recommend potential remedies to OMHAR; OMHAR makes determinations regarding whether to assign such projects to PAEs for restructuring or to deny the owners the right to restructure. —Owners have 30 days to dispute decisions of the field offices regarding project eligibility with respect to poor condition or adverse owner determination. At the end of this period, OMHAR may affirm, modify, or reverse decisions. |

(continued)

**Appendix IV
HUD's Procedures for Monitoring Key
Components of the Mark-To-Market
Program**

| Program component | Explanation or related legislative provision(s) | Performed by | Monitoring procedures |
|----------------------|--|---|--|
| Rent-setting process | <p>Section 8 contracts may be renewed as either project-based or tenant-based.</p> <p>—Project-based renewals are mandatory for projects located in tight rental markets, that have a predominant number of units occupied by the elderly or disabled, or that are held by a nonprofit cooperative ownership housing corporation or trust.^c</p> <p>Restructured rents are to be based on equivalent market rents charged for at least two comparable properties in the same market area. If rents based on two comparable properties cannot be determined, rents can be set equal to 90 percent of the fair market rent (FMR).^d</p> <p>—PAEs can approve exception rents^e up to 120 percent of FMR for no more than 20 percent of all units covered by the portfolio restructuring agreement between the PAE and HUD with contracts that expire in a fiscal year.^f</p> <p>(§515(c)(1), 515(c)(2)(A), 514(g)(1), 514(g)(2))</p> | <p>The PAE, in consultation with the owner, determines whether to renew Section 8 assistance as project-based or tenant-based. On the basis of its assessment of comparable rents and input from an appraiser and the project owner, the PAE also determines restructured rent levels. If the PAE determines that a project would have negative net operating income at market-level rents, the PAE may issue a "Finding of Special Need" and calculate exception rents for the property.</p> | <p>—After the PAE, in consultation with the owner and lender, develops the draft mortgage restructuring and rental assistance sufficiency (MRRAS) plan for a project, including the determination of project-based or tenant-based Section 8 assistance and the restructured rent levels, the OMHAR hub must review the draft plan and will either approve or reject it.^g</p> <p>—According to mark-to-market officials, oversight of the exception rent authority is being worked on and will be addressed in the oversight and audit guide, which was still being developed as of October 14, 1998.</p> |

(continued)

**Appendix IV
HUD's Procedures for Monitoring Key
Components of the Mark-To-Market
Program**

| Program component | Explanation or related legislative provision(s) | Performed by | Monitoring procedures |
|---------------------------------------|---|---|--|
| Determination of rehabilitation needs | <p>The physical needs of each project must be evaluated. Rehabilitation may be paid from project accounts not required for project operations, increases in budget authority for Section 8 assistance contracts, capital grants, or through the debt-restructuring transaction.</p> <p>—HUD may make grants for the capital costs of rehabilitation to owners of projects if the owners demonstrate that capital grant assistance is needed for rehabilitation of the projects and that project income is not sufficient to support such rehabilitation.</p> <p>Rehabilitation will be only for the purpose of restoring the project to a nonluxury standard adequate for the rental market intended at the original approval of the project-based assistance. Each owner or purchaser of a project to be rehabilitated under mark-to-market must contribute, from nonproject resources, at least 25 percent of the amount of rehabilitation assistance received.^h</p> <p>(§514(e)(3), 517(b)(7), 531)</p> | <p>The owner or purchaser of a project must evaluate its rehabilitation needs and take actions as necessary to rehabilitate and maintain the project in decent, safe condition. The PAE, with support from a qualified inspector, must review the owner's evaluation and conduct an independent assessment of the project's rehabilitation needs. The PAE is ultimately responsible for determining the rehabilitation actions necessary to maintain the project in decent and safe condition, for determining their cost, and for identifying the source(s) of funding. HUD can delegate to state and local governments the responsibility for administering capital grants.</p> | <p>—The PAE must submit a draft mortgage restructuring and rental assistance sufficiency plan, which includes the determination of a project's rehabilitation needs, to the OMHAR hub. The OMHAR hub must review the draft plan and will either approve or reject it.</p> <p>—According to mark-to-market officials, details on capital grants will be generally discussed in the operating procedures manual. Instructions for the oversight of the grant funds will be addressed in the oversight and audit guide, which was still being developed as of October 14, 1998.</p> |

(continued)

**Appendix IV
HUD's Procedures for Monitoring Key
Components of the Mark-To-Market
Program**

| Program component | Explanation or related legislative provision(s) | Performed by | Monitoring procedures |
|---|---|--|--|
| Restructuring of mortgages | <p>Each project's restructuring plan must include</p> <ul style="list-style-type: none"> —a restructured or new first mortgage, sustainable at the restructured rent levels; and —a second mortgage no greater than the difference between the restructured or new first mortgage and the indebtedness under the existing mortgage, in an amount that can reasonably be expected to be repaid. <p>The size of a project's restructured first mortgage and second mortgage must be determined. (§517(a))</p> | <p>The PAE, in consultation with the owner and lender, determines the size of the restructured first mortgage and second mortgage.</p> | <p>The PAE submits the project's mortgage restructuring and rental assistance sufficiency plan, which includes the PAE's conclusions regarding the new first mortgage and second mortgage, to the OMHAR hub. Depending upon the details of the MRRAS plan, the OMHAR hub will perform either an administrative review or a technical review, after which it can accept or reject the plan.ⁱ</p> |
| Recaptured Section 8 funds | <p>HUD will recapture budget authority not required for contracts amended or terminated as part of restructuring and use it to provide housing assistance for the same number of families that were covered by that contract for its remaining term; any budget authority saved by shifting to project-based or tenant-based assistance will be rescinded. (§523(c))</p> | <p>Within HUD's Office of Multifamily Housing, the Office of Program Management and Oversight will be responsible for administering recaptured Section 8 budget authority.</p> | <p>According to mark-to-market officials, the procedures for monitoring this function will be defined in the oversight and audit guide, which was still being developed as of October 14, 1998.</p> |
| Annual reviews of all restructured properties | <p>At least annually, PAEs qualified as Section 8 contract administrators must review the status of all restructured projects, including on-site inspections to determine compliance with housing codes and other requirements of the legislation and restructuring agreements. (§519(b))</p> | <p>PAEs that are qualified to be Section 8 contract administrators are responsible for annual project reviews. If a PAE is not qualified to be a Section 8 contract administrator, either HUD or a qualified state or local housing agency will be responsible for this required review.</p> | <p>According to mark-to-market officials, these procedures will be addressed in the oversight and audit guide, which was still being developed as of October 14, 1998. In general, HUD currently intends to require the PAEs to submit monthly reports and to have HUD field staff conduct semiannual monitoring reviews.</p> |

(continued)

**Appendix IV
HUD's Procedures for Monitoring Key
Components of the Mark-To-Market
Program**

| Program component | Explanation or related legislative provision(s) | Performed by | Monitoring procedures |
|----------------------------|---|---|---|
| Technical assistance funds | HUD can provide up to \$10 million annually in funding to tenant groups, nonprofit organizations, and public entities for capacity-building and technical assistance in furthering the purposes of the mark-to-market program. (§514(f)(3)) | HUD will select grantees on a competitive basis either to provide direct technical assistance or to act as intermediaries by administering a program of technical assistance grants to subrecipients. | Grantees and intermediaries must submit quarterly performance reports to OMHAR. HUD will ensure that this reporting requirement is met by including provisions in the grant agreement and addressing this issue in the oversight and audit guide, which was still being developed as of October 14, 1998. |

Note: All section citations refer to P.L. 105-65.

^aA "HUD-held" mortgage is one for which HUD has paid an insurance claim and is now, in effect, the lender.

^bHUD's multifamily housing services are delivered through 18 hubs located in 18 cities, with staff stationed in 33 program centers.

^cCurrently, the act appears to require that all three conditions (i.e., located in a tight rental market, predominant number of units occupied by the elderly or disabled, and held by a nonprofit cooperative ownership housing corporation or trust) be met for project-based renewal to be mandatory. However, a bill, H.R. 4194, would amend this provision so that only one of three need be met for mandatory project-based renewal.

^dIn general, the fair market rent for an area is the amount that would be needed to pay the gross rent (shelter rent plus utilities) of privately owned, decent, safe, and sanitary rental housing of a nonluxury nature with suitable amenities.

^eUnder section 514(g)(3) of the act, a project eligible for an exception rent will receive a rent calculated on the actual and projected costs of operating the project, at a level that provides income sufficient to support a budget-based rent that consists of the debt service of the project; operating expenses, including contributions to reserves and the costs of maintenance and necessary rehabilitation; allowance for potential operating losses due to vacancies and failure to collect rents; allowance for a reasonable rate of return to the project owner; and other expenses determined by the PAE to be necessary for the project's operation.

^fUpon a finding of special need, HUD can waive the 120-percent rent limit for up to 5 percent of all units subject to restructuring in any fiscal year and can waive the 20-percent limit on number of units.

^gIn addition, section 515(c)(2)(C) of the act requires each PAE to report regularly to the OMHAR Director, identifying (1) each project for which the tenants of the project generally supported tenant-based assistance but for which the assistance was renewed as project-based and (2) each project for which assistance is planned to be renewed using tenant-based assistance.

^hPAEs may provide an exception from the 25-percent contribution requirement for housing cooperatives.

ⁱOMHAR hubs are to perform administrative reviews of plans considered "conforming," which are plans with the following characteristics: (1) the new first mortgage is at least 60 percent of the existing mortgage's unpaid principal balance, (2) rehabilitation costs are no more than \$5,000 per unit, (3) the PAE is not involved as a lender or as a provider of any credit enhancement for the project's mortgage, and (4) no conflicts of interest exist among the parties involved in the restructuring. Plans that do not have all four of these characteristics are considered "nonconforming." OMHAR hubs are to perform technical reviews of nonconforming plans.

Comments From the Department of Housing and Urban Development



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OCT - 2 1998

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

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

Dear Ms. England:

The following is in response to your September 10, 1998, letter which solicited the Department's comments on your Office's draft proposed report entitled "MULTIFAMILY HOUSING: Development of HUD's Office of Multifamily Housing Assistance Restructuring" (GAO/RCED-99-5, Code 385712).

I would like to express my appreciation for the opportunity to review and comment on your Office's draft report summarizing HUD's efforts to develop the mark-to-market (M2M) program and implement "The Multifamily Assisted Housing Reform and Affordability Act of 1997(MAHRAA)." We commend your staff on the quality and depth of the questions raised during the course of their review. Our sessions with them were helpful in confirming that we are focusing our attention and efforts on issues which need to be addressed.

As you may know from your staff's review of the M2M program, HUD is working diligently to successfully develop and implement the permanent M2M program pursuant to the legislative requirements of MAHRAA. This complex program is being designed to incorporate the various goals and objectives identified in the enacted legislation. The key goals being to preserve low-income rental housing affordability and availability while reducing long-term subsidy costs and claim costs to the government, address the physical condition of these properties, reform the design and operation of the Department's rental housing assistance programs, protect the interest of tenants and address problem projects.

Since the enactment of the MAHRAA legislation in October 1997, the HUD M2M staff developed an extremely aggressive workplan to accomplish the development and implementation of this program. While some key tasks have been accomplished later than provided for in HUD's original schedule, it should be noted that, even in the absence of a Director, a small but efficient core

**Appendix V
Comments From the Department of Housing
and Urban Development**

group of M2M staff members have accomplished several significant work items. These items include, but are not limited to, conducting working group focus meetings with the industry; obtaining a favorable revenue ruling from the IRS; drafting and publishing the interim M2M regulations; drafting and publishing the RFQ for PAE proposals; developing and conducting a pre-submission conference for interested PAEs; publishing a Notice of Fund Availability for Outreach and Training Grants and Intermediary Technical Assistance Grants and announcing approved groups; developing and implementing a budget and staffing plan; and developing and implementing a procurement plan. This M2M staff, with assistance from various contract staff, is also drafting an operating procedures guide, developing an oversight and audit guide to identify program risks and safeguards to address these risks, developing a web-based tracking and underwriting system, and developing technical assistance briefings and holding public forums. In addition to working on the permanent program tasks identified above, the M2M staff is also effectively administering the Demonstration Program. The Department is very pleased with the progress made to date in the implementation of MAHRAA.

Based on our review of the Draft Report to Congressional Committees on the Development of HUD's Office of Multifamily Housing Assistance Restructuring, we believe that your staff has accurately described the Department's efforts to date in developing and implementing MAHRAA. While we agree that the report is accurate in most material matters, we have the following minor comments:

Now on p. 1.

1. Page 2, second sentence under "Results in Brief." The Deputy Secretary has approved an initial staffing level of seventy-five new positions for the Office of Multifamily Housing Assistance Restructuring (OMHAR). Additional hiring authority may be sought, if necessary.

Now on p. 5.

2. Page 8, last sentence. Based on the current approved staffing plan, OMHAR will have a staff of approximately seventy-five at its peak. However, this number may increase if additional hiring authority is obtained. Also, there are currently 10 existing HUD staff assigned to work on the M2M program with additional support being provided by HUD staff with collateral assignments.

Now on p. 8.

3. Page 12, heading. It should be indicated that some key tasks are behind "HUD's original" schedule.

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Now on p. 14.

4. Page 23, status of participating demonstration projects. As an update, a total of 33 HUD deals and four joint venture deals have closed.

Now on p. 31, footnote b.


5. Page 45, footnote b. The session to discuss the Section 8 renewal policy has been scheduled for October 6, 1998.

Now on p. 33.

6. Page 48, status of equity-sharing report. The internal clearance of the report is complete and the letters transmitting the report to the various Senate and Congressional members are currently being prepared.

Should you have any additional questions pertaining to this report, please do not hesitate to call Genevieve Tucker of the M2M staff at (202) 708-0614 ext. 2548. We look forward to working with you and your staff in the future.

Sincerely,


Ira G. Peppercorn

Ira G. Peppercorn
General Deputy Assistant Secretary
for Housing

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