STATEMENT OF NATIONAL HOUSING DEVELOPMENT CORPORATION (NHDC)

on the January, 2004 General Accounting Office (GAO) Report on Maturing HUD Mortgages:
“Multifamily Housing: More Accessible HUD Data Could Help Efforts
to Preserve Housing for Low-Income Tenants” (GAO-04-20)

before the

HOUSE FINANCIAL SERVICES COMMITTEE

Testimony Presented by O. Angie Nwanodi, Director of Policy

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I am pleased to have the opportunity to testify before the House Committee on Financial services regarding the GAO report “Multifamily Housing: More Accessible HUD Data Could Help Efforts to Preserve Housing for Low-Income Tenants” published in January 2004.

On behalf of National Housing Development Corporation (NHDC), I commend Chairman Oxley and Representative Frank for commissioning the report and thank the Subcommittee on Housing and Community Opportunity for its continued interest in preserving affordable multifamily housing. I would also like to acknowledge Comptroller General Walker and his staff at the GAO for a job well done and for adding to the body of data available on at-risk units that need to be preserved.

NHDC is a national nonprofit dedicated to preserving the affordability of existing multifamily housing. Our mission is “to preserve affordable housing in partnership with local communities, empowering individuals and revitalizing communities.” NHDC’s vision is of a comprehensive national preservation policy designed specifically to address our nation’s ongoing need for long-term affordability and recapitalization in aging multifamily housing.

Since its inception in December 1999, NHDC has preserved more than 3,000 multifamily units in seven states, most with some form of federal subsidy and generally considered to be ‘at-risk’ of imminent or impending loss of affordability.

Concurrence With The GAO Report

Overall, NHDC concurs with the GAO report’s findings regarding mortgage maturity and the accessibility of HUD data. Specifically,

1. No current HUD program exists to specifically address potential loss of affordability due to mortgage maturity;

2. Virtually no focus exists at the state and local level on the issue of mortgage maturity;
3. Data available through HUD Databases, though widely available and easily accessible via the world wide web, could be more user friendly;
4. Some states and localities have, with some success, made efforts to prioritize traditional preservation transactions (primarily opt-outs / pre-pays) through a variety of means, including federal sources of funding and unique state and local initiatives and vehicles such as housing trust funds and property tax incentives.
5. Market conditions and owner motivation are the primary factors in determining whether mortgage maturity (or other preservation-triggering event, i.e. opt- out or prepayment) will adversely affect the long-term affordability of a property or make likely the displacement of its residents.

That said, however, we believe the scope of the GAO's report should have been broader, and should have raised, even if unable to answer them, some of the critical questions that must be answered if Congress is to take next steps to ensure that opportunities and tools to preserve at-risk units exist.

My comments this morning will focus on the unique and recurring challenges inherent to preservation precisely because market factors (including property condition) and owner motivation largely control whether federally subsidized properties will leave the affordable inventory, as well as on recommendations for more effective preservation efforts going forward.

THE NATURE OF PRESERVATION: ATTRIBUTES OF THE AT-RISK INVENTORY

To have an effective dialogue around preservation, we must recognize its key attributes and how they differ from the issues and challenges attendant to new construction.

As a general rule, the following principles hold true for preservation transactions:

1. Preservation is **cheaper** than new construction on a per unit basis.[1]
2. Preservation is **more politically palatable** than new affordable developments. NIMBY forces generally do not oppose the rehabilitation of an existing property, whereas many new tax credit or other affordable developments can and have been stopped by local opposition.

   In fact, we believe a successful preservation project can serve to galvanize community stakeholders, including NIMBYs, and may ultimately serve to build positive attitudes towards affordable housing generally.
3. Preservation is a **more cost-effective** use of current federal housing funds than new construction deals, and helps retain past federal investments in housing.

[1] In making this observation, NHDC does not intend to infer that funding for new construction should be cut, nor does it contend that new construction is not a necessary part of our national housing policy.

4. Preservation is **necessary** if we are to meet federal housing goals and are to avoid falling further behind in meeting the ever-growing national demand for affordable housing
5. Preservation transactions represent **a perpetual crisis** waiting to happen. By their nature, federal programs, contracts and subsidies are finite sources available to a property or owner for a finite term. Therefore, unless we formulate an appropriate response, we will always face the question of 'what happens when …' and, if past performance is a predictor of future response, we will search for answers immediately before or just after the crisis is upon us.

   For this reason, we must establish and fund a national policy of recycling existing multifamily assets when they come to the end of their regulated affordability, regardless of the source.
6. Preservation transactions are **extremely difficult to do**. Preservation deals are difficult to acquire and are equally (if not more) difficult to manage. As difficult as it is, the test of successful preservation is not acquisition. Cash flow and residual value are the true tests --- that is, the long-term viability of projects.
7. The structure of our **existing federal funding programs increases the cost of preservation**, and unnecessarily so. To successfully compete for at-risk assets in the marketplace, preservation acquirers need *interim* capital rather than permanent finance.

COMMENTS ON THE GAO REPORT IN LIGHT OF THESE PRESERVATION PRINCIPLES

1) We Cannot Take Program Funding Availability For Granted

In its report, the GAO mentions program funding availability as a factor that could affect the future rate of rental assistance contract renewals. It does so, however, in a way that appears to minimize the potential negative effects lack of such funding could have on the ability of families to remain in affordable housing after mortgage maturity.

While it is true that to date a high percentage of rental assistance contracts have been renewed, it does not necessarily follow that the trend will continue, particularly as we approach the later years of the study when large numbers of units face both mortgage maturity and rental assistance contract expiration.

This year's debate over the calculation of Section 8 voucher funding as well as recent concerns regarding the rising costs of funding Section 8 should cause us to pay close attention to whether full funding for existing subsidies is likely to exist by the end of the coming decade, particularly given the persistent growth in demand for affordable units and rental assistance nationwide.

As the report notes and Assistant Secretary Weicher's letter confirms, where market conditions make a conversion the owner's likely choice, residents do not have as of right protection of the rental subsidies they received before their property's mortgage matured. Although they may be "eligible to apply" and may even qualify for enhanced vouchers, as the report emphasizes, impediments such as high security deposits could serve to effectively displace low-income renters.

Even if the federal government were to authorize and fund the much needed preservation programs we believe it should, rental assistance and other existing subsidies will still be necessary to reach many of our nation's low-income renters.

2) State and Local Agencies Alone Cannot Solve the Preservation Dilemma

Although the GAO report does not claim that state and local agencies can be the preservation panacea, some of the report's conclusions could be interpreted to mean that the most significant part of the preservation challenge is a lack of access to HUD data by these agencies.

However, long after HUD data becomes more accessible and user friendly to state and local agencies, these agencies will continue to face tough choices in funding transactions, and many preservation transactions will fall by the wayside. In some instances, market rate conversions may occur due to a failure to prioritize preservation at the local level. However, even where states and localities target preservation through set-asides and other mechanisms, the fact remains that they are splitting existing pots of money, almost universally oversubscribed, to meet a myriad of housing needs.

3) State and Local Funding Is Insufficient to Meet the Overall Preservation Need

Although the GAO report references state and local funding sources to encourage owners to keep their properties in the affordable inventory, in those states and localities where affordable housing production and preservation has been prioritized and federal funding supplemented with state and local dollars, demand still dwarfs supply.

For example, although it was a hard-won victory for Los Angeles housing advocates and is important for the commitment it symbolizes, the City's $100 million Housing Trust Fund doesn't buy or build much in a market where $200,000 - $300,000 per unit is the norm. The Housing Trust Fund is also incremental, scheduled to be funded over multiple years.

In addition, most states and many localities are facing significant shortfalls in their budgets. As a result, some states and localities, such as Texas, which does not have a state income tax, have sought to increase tax revenues by limiting the amount of property tax abatement available to for-profit and out-of-state nonprofit developers.

In California, the state budget crisis affected housing funding so much in 2002 that many existing and badly needed new state programs, including two preservation programs totaling $15 million were only able to be funded through Proposition 46, a historic $2.1 billion voter-approved bond measure.

4) The Federal Programs That States and Localities Have Used to Preserve At-Risk Housing To Date Are Not Flexible or Efficient Enough for Many At-Risk Properties

We wish to recognize that the HOME, CDBG and Low Income Housing Tax Credit (LIHTC) programs referenced in the report are important and necessary tools in the quest to affordably house all Americans.

However, even though states and localities have used these and other federal sources to preserve multifamily units with some success, NHDC does not believe that these funds are the most effective way to preserve at-risk housing. The common denominator that these programs share (along with various soft sources of funding) is that they are competitive, and therefore contingent, resources.

In a housing world where our stated goal is to create incentives for market-driven owners to choose continued affordability or a buyer committed to continuing affordability, we essentially handicap preservation-minded buyers by limiting their funding sources to a hodge-podge of funding programs, often allocated at separate times, and which routinely take a year or more to access (*if* the resource is awarded).

Naturally, such buyers are at a severe competitive disadvantage as compared to buyers using conventional finance with the ability to guarantee closing within a reasonable timeframe. Those owners who have chosen against extending affordability are highly unlikely to entertain an offer from say, a nonprofit intending to apply for tax credits for the purchase, while those who may entertain such offers essentially demand a premium for enduring the uncertainty and long waits associated with our existing federal programs.

In this way, **our existing (permanent) finance system skews the market, ironically *raising* the cost of acquiring affordable housing** with dollars that are already in short supply.

Much better would be a separate, parallel housing finance system, designed specifically to respond to at-risk properties' needs. The affordable housing community needs access to significant amounts of revolving capital that can be deployed as needed on an interim basis to seize on market opportunities to keep affordable properties in the inventory and to add as many units as possible to the stock.

5) Nonprofit Ownership Does Not Necessarily Reduce the Risk of Affordability Loss

In the GAO analysis of the few properties that have experienced mortgage maturity to date and of the remaining inventory, much seems to be made of the fact that some 38% of properties with HUD mortgages are owned by nonprofits.

While many nonprofits are absolutely dedicated to affordable housing, as properties age, they present new and more difficult challenges than in their younger years. The complexities of ongoing management of (and capital improvements to) decades-old properties can be overwhelming for some nonprofit organizations.

For this reason, funding for ongoing capacity-building and technical assistance for organizations dealing with aging assets will be essential to ensuring that the recapitalization of nonprofit-owned affordable housing is successful and that it results in an operationally viable, stabilized property with a new useful life and adequate reserves to maintain it properly over its new life.

6) Creating Incentives To Extend Affordability for Properties with Maturing Mortgages Would Only Be A Temporary Remedy.

The GAO report contrasts the various incentives HUD has in place for opt-outs and prepayments with the lack of incentives for owners with maturing mortgages. NHDC wishes to concur with and reiterate the GAO's finding that, "these incentives do not directly address the termination of the affordability requirements," for either mortgage maturity or opt-outs and prepayments. The best the incentives do is buy another five years of affordability, after which new approaches for preservation must be attempted.

The **existing incentives to keep properties affordable after a preservation-triggering event occurs do not address our national need for policies that ensure long-term affordability**, protect previous federal investment in multifamily housing and plan for the recapitalization and rehabilitation of our aging stock.

Additional Preservation Issues That Congress Should Study

1. Cost Comparison Between New Construction and Preservation
2. Efficiency and Effectiveness of Existing Programs for Preservation Transactions (What is the Cost of Waiting?)

Questions The Federal Government Must Ask and Answer To Succeed At Preservation

1. Under what circumstances will we preserve the existing multifamily stock? (Viability)
2. If so, who should own it and how do we encourage and reward them? (Capacity)
3. What level of rehabilitation and recapitalization should we strive for? (Vitality)
4. How will we prevent recurring end-of-use crises? (Rapid response vs. proper response)

RECOMMENDATIONS FOR A MORE COMPREHENSIVE FEDERAL APPROACH TO PRESERVATION

1. **Broaden the Definition of Preservation**.

Of course, the current definition of preservation and the benefits that flow to preservation-eligible properties should be expanded to include maturing mortgages, which exhibit the same characteristics and pose the same challenges as opt-out / prepayment properties[2].

Beyond that change however, Congress should further broaden the way it defines preservation as well as the scope of preservation activities for which federal dollars can be used. This more inclusive definition of preservation should **include unsubsidized, market-rate housing** that is currently affordable to low- and moderate-income Americans, and should allow federal dollars to be used to acquire such properties in exchange for long-term affordability. This would allow us to add new units to the affordable inventory before market conditions begin to squeeze out low- and moderate-income families currently in unrestricted apartments that are unprotected from future upswings in the market.

NHDC completed one such bond transaction in which we made a loan to the nonprofit (housing was not its primary mission) owner to cover a gap in financing, and in exchange, placed a regulatory agreement on the property that ensured tax credit rents for fifteen years, while at the same time opening up twenty percent (20%) of the units to Section 8 voucher holders[3].

In addition, Congress should broaden the definition of preservation to include a **focus on risk factors** other than contractual and use-restriction issues, **such as physical needs**. As our housing stock ages, an increasing number of federally assisted units are in need of significant reinvestment, rehabilitation and renovation.

It seems counterintuitive to construct beautiful new tax credit and bond properties while allowing older properties to languish and deteriorate, often in the same communities and

[2] Representative Frank's new bill, H.R. 4679 (introduced June 24, 2004) would accomplish this if passed.

[3] In the process of negotiating the transaction, NHDC discovered that the local housing authority was having difficulty with voucher utilization, and could not get many owners to accept vouchers.

sometimes on the same block. If neighborhood revitalization is to continue to be a goal in our housing efforts, we must reinvigorate our older properties and recapitalize them to achieve as close to a new useful life as is possible.

2. **Authorize and Fund Preservation Intermediaries**

The Millennial Housing Commission (MHC) made this recommendation in 2002 (http://www.mhc.gov/MHCReport.pdf). The House of Representatives passed such authorization by a vote of 405-5 in the 106th Congress.

NHDC urges the Congress to revive Section 402 of S. 2733[4] (July, 2000; 106th Congress; Parallel legislation: Section 410 of H.R. 202[5]).

Such legislation would authorize national, regional and local nonprofits and intermediaries dedicated to preserving at-risk multifamily properties for long-term affordability. In doing so, Congress would be encouraging the transfer of at-risk assets into the hands of organizations with a commitment to long-term affordability in order to minimize the risk of future end-of-use crises.

In addition, such legislation would fund capacity-building for intermediaries and other preservation entities, ensuring that when at-risk assets with complex challenges enter the market, the preservation community will be well-equipped to respond and to succeed in the long-term.

3. **Create a New, Separate, Revolving Source of Preservation Funding.**

The fund should be substantial, dedicated exclusively to the interim preservation of existing affordable multifamily properties by eligible preservation entities and intermediaries (see Recommendation #2 supra). That is, the fund should be recyclable for the ongoing preservation of at-risk or affordability favorable assets. Interim funds should stay with the property only long enough to stabilize it and access permanent financing.

[4] http://frwebgate.access.gpo.gov/cgibin/getdoc.cgi?dbname=106_cong_bills&docid=f:h202eh.txt.pdf
[5] http://frwebgate.access.gpo.gov/cgibin/getdoc.cgi?dbname=106_cong_bills&docid=f:s2733is.txt.pdf

Essentially, the housing community needs a revolving fund that is well capitalized and that will permit affordability-minded buyers to compete favorably in the acquisition bidding process against buyers without a commitment to affordability.

In conjunction with the other preservation tools we recommend herein, this tool would serve as an equalizer between affordability-driven buyers and market-rate buyers seeking to convert the units. Such a fund would create a warehouse/refuge for at-risk properties so that preservation buyers could acquire them without overpaying, while simultaneously working to assemble permanent financing.

In today's environment of oversubscribed block grant funds, a revolving fund such as this would allow preservation-oriented acquirers to seek the various existing funds (HOME, CDBG, LIHTC, AHP, etc.) without the downside of losing the deal to market if they do not receive their requested award.

4. **Enact a Preservation Tax Credit (Exit Tax Relief)**

The Millennial Housing Commission (www.mhc.gov) also recommended that Congress enact what many call 'exit tax relief.' Last November, Representative Ramstad concurred. He introduced H.R. 3485[6], the "Affordable Housing Preservation Tax Relief Act of 2004," which would offset the capital gains owed by an owner provided that the sale of the property is a 'qualified preservation transaction' with a capable and committed 'preservation entity.'

In its report to Congress, the MHC found that many owners of assisted housing that needs to be preserved and recapitalized choose to hold on to the property rather than take the large 'exit tax' hit that today's tax code requires.

NHDC strongly urges Congress to move forward with a preservation tax credit that can be allocated to states and used to buy out owners of assisted housing that are for all intents and purposes trapped in transactions made decades ago.

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[6] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h3485ih.txt.pdf

5. **Provide Incentives for Owners To Properly Plan for Rehabilitation**

One of the reasons we have continually faced the deterioration of our privately-held, federally-assisted stock is because our tax code penalizes proper, responsible ownership.

Today, the Internal Revenue Code requires that monies set aside for capital improvements be taxed in the year when they are reserved, and then depreciated as part of an owner's basis once it is spent on rehab.

Instead of promoting what sound property management requires (adequate planning and savings toward future capital needs), our tax code provides a powerful incentive to distribute cash flow to investors rather than set aside a portion in reserve accounts.

If an owner today chooses to set aside $100,000 out of a property's cash flow in a separate reserves-for-replacement account, the account is subject to taxation, usually at a high rate, leaving somewhere around half ($50,000 - $60,000, depending on the tax bracket of the owner or investor) of the intended investment available for future rehabilitation. Even if an owner was willing to take the tax hit associated with the reserve account, an investor in the property is understandably less than eager to receive, say, $200,000 in distributions only to be taxed on $300,000 once the tax due on the phantom income (due to the reserve account deposit) is added to their tax liability.

Congress should eliminate these existing tax barriers to responsible long-term planning for capital needs in multifamily housing. Instead of the policy we have today, we ought to encourage the creation of pre-tax holding accounts for rehab so that owners have an incentive to save today towards the roof replacements and other capital items the property will need in ten, fifteen or twenty years.

In sum, removing this savings disincentive from the tax code would require a two-prong approach. First, allow for pre-tax reserve accounts, and second, disallow reserve account deposits from inclusion in an owner's basis.

CONCLUSION

Together, these policies can work to strengthen the tools already available to affordable housing developers and can create the parallel funding sources for preservation that our nation's housing policy needs in order to break the never-ending cycle of crisis at expiration, whether it be mortgage maturity, opt-out, prepayment, subsidy contract expiration or deferred maintenance.

On behalf of National Housing Development Corporation, I would like to once again thank the Committee for the opportunity to testify on the ongoing preservation needs of our nation's affordable housing stock.

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