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THE POTENTIAL LOSS OF ASSISTED HOUSING UNITS AS CERTAIN MORTGAGE-INTEREST SUBSIDY PROGRAMS MATURE

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PREFACE

This analysis was conducted by the Congressional Budget Office for hearings held by the Subcommittee on Housing and Community Development of the House Committee on Banking, Finance and Urban Affairs. It was prepared by Wilhelmina A. Leigh and Carla Pedone of the Human Resources and Community Development Division, under the supervision of Nancy Gordon and Bruce Vavrichek. Questions may be addressed to Wilhelmina A. Leigh (226-2659).

Between 1961 and 1973, the federal government agreed to subsidize, and in most cases to insure, the mortgages on about 5,600 rental housing projects under the Below Market Interest Rate (BMIR) program of Section 221(d)(3) and the Section 236 program. 1/ As a result, about 700,000 low- and moderate-income families are now housed at reduced rents. Although the mortgages are generally subsidized for 40 years, in certain instances project owners were given permission to prepay their mortgages any time after the first 20 years and thereby end the restriction that they lease their units to lower-income tenants at controlled rents. As the twentieth anniversary dates on the first of these projects have approached, concern is being expressed about whether the government should respond to the loss of a potentially significant number of these units from the assisted housing stock and, if so, what form the response should take.

This paper deals with three topics:

- The nature of the housing programs involved;
- The extent to which mortgages can be prepaid and the maximum possible resulting loss in subsidized housing units; and
- Issues and options facing the Congress in determining whether and, if so, how to respond.

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1. These programs—like most housing programs—are commonly referred to by the section number of the federal housing statute that created them, in most cases the National Housing Act of 1934 as amended over the years.

NATURE OF THE PROGRAMS

Several programs are involved in the issue of restricting the use of subsidized housing units. 2/ Some provide the basic mortgage-interest subsidy, while others give supplementary assistance for some of the lowest-income tenants or for projects that are experiencing financial strain.

Mortgage Interest Subsidies

The first broadly available mortgage subsidy program for rental housing—the BMIR program—was authorized in 1961. Under that program, the federal government provided an up-front subsidy, effectively reducing the interest rate on privately written 40-year mortgages to 3 percent. 3/ The owners of BMIR projects, in turn, agreed to rent all their units to tenants whose incomes at the time they moved in were no greater than 95 percent of the median for families in the area, adjusted for family size. Closings on the first BMIR mortgages took place in 1962, and the program remained active for several years thereafter.

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2. The Section 8 new construction program, in which developers of selected projects can opt out before the end of their assistance commitments, is not discussed in this paper.

3. The government provided the subsidy by purchasing market-rate mortgages from private lenders, then either reselling the loans at reduced prices as 3-percent interest-rate mortgages, or holding them in federal portfolios while charging project owners only 3 percent interest. A companion program—the Section 221(d)(3) Market Rate (MR) mortgage insurance program, authorized in 1954—is not discussed here, because it does not provide an interest subsidy and does not subject the projects to use restrictions unless they are also receiving supplementary rental assistance.

In 1968, the BMIR program was replaced by the Section 236 program. Under that program, the Department of Housing and Urban Development (HUD) provides monthly payments sufficient to lower the effective interest rate on project mortgages to 1 percent. 4/ The projects were rented only to families whose incomes at the time they moved in were 80 percent or less of the area's median, adjusted for family size. 5/ The Section 236 program was active until January 5, 1973, when it was suspended as part of a moratorium on new federal housing assistance. Since then, only projects with preliminary commitments outstanding as of that date have gone forward.

Both BMIR and Section 236 projects could be sponsored by public entities, by nonprofit organizations, or by for-profit organizations whose ongoing pre-tax return on investment is limited to 6 percent per year on the original investment--generally a down payment amounting to 10 percent of the initial cost of the project. 6/ The after-tax return for these so-called "limited-dividend" sponsors is also affected by provisions of the federal tax code that allow project owners to write off the value of their buildings for tax purposes on favorable terms. The value of these tax provisions is largely

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4. In addition to providing interest subsidies, the federal government insures most BMIR and Section 236 mortgages. About one-fifth of all Section 236 projects are, however, financed by state housing finance agencies (HFAs), generally through tax-exempt bonds. Mortgages on these projects usually are not insured by HUD.

5. In the early years of the program, the income limit was set at 135 percent of the limit for public housing in the area.

6. Public entities and nonprofit sponsors were not required to provide down payments.

exhausted within 15 to 20 years after these developments were completed or sold to new owners. 7/

Most tenants in BMIR and Section 236 projects benefit from the reduced mortgage interest rates paid by the project owners, although the rules on rent differ in the two cases. In BMIR projects, a fixed rent is established at a level sufficient to amortize a 3-percent mortgage; plus an allowance set by HUD to cover operating costs; plus, in the case of limited-dividend sponsors, an allowance for their return on investment. Tenants whose incomes rise above 110 percent of the income limit for new occupants—95 percent of the area's median—have their rents raised by 10 percent.

The rent rules in Section 236 projects are more complex. Rent payments for most tenants in these projects are limited to the amount needed to amortize a 1-percent mortgage; plus an allowance for operating costs; plus, in the case of a limited-dividend sponsor, an allowance for

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7. Before the passage of the Economic Recovery Tax Act (ERTA) in 1981, owners of all rental housing projects, including those serving lower-income tenants, could depreciate their projects for tax purposes over 20 to 40 years using the 125 percent declining balance method for existing structures, or the 200 percent declining balance method for newly built ones. Since passage of ERTA, owners of newly built or newly purchased low-income projects have been permitted to depreciate their projects over 15 years using the 200 percent declining balance method. The Tax Reform Act (TRA) of 1986 further alters the tax treatment of lower-income housing, moving to a 27.5 year write-off period using straight-line depreciation. TRA also provides buyers of low-income rental projects tax credits for up to 10 years, with the yearly credit equal to 4 percent of the acquisition cost of existing units set aside for low-income tenants, and 9 percent of the construction or rehabilitation cost of newly built or rehabilitated units rented to low-income tenants.

return on investment. This amount is referred to as the "basic rent." When 30 percent of a tenant's adjusted income exceeds the basic rent, the tenant is charged 30 percent of income up to a maximum—the so-called "market rent." 8/ This "market rent" is identical to the basic rent, except that it includes an allowance to cover the mortgage insurance premium and the component meant to amortize the unit's mortgage is calculated at a level sufficient to pay off the loan at the full unsubsidized interest rate at which it was written. 9/ Any amounts collected by landlords over the basic rents revert to HUD.

Supplementary Assistance

While the mortgage interest subsidies provided under these programs are sufficient to make the units affordable to moderate-income families, low-income and especially very-low-income families—the primary target group

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8. Until the early 1980s, tenant rent payments in this and in other federal housing assistance programs were limited to 25 percent of adjusted income, rather than 30 percent. Throughout this statement, reference is made to the current tenant rent contribution of 30 percent of adjusted income, although in all instances the 25-percent-of-income rule applied when the programs were first created.

9. This "market rent" might be higher or lower than the market rent as it is usually defined—namely, the going rate for similar units in the area. The relationship between the two concepts depends mostly on whether market conditions have improved or deteriorated since the project was built. Similarly, the Section 236 program's "market rent" generally differs from the so-called Fair Market Rent (FMR) or "allowable rent," which is the maximum rent that HUD subsidizes in the Section 8 existing-housing program. The FMR for a two-bedroom unit is set at the 45th percentile of rents paid by renters that have moved into a standard existing nonsubsidized dwelling unit of that size during the past two years. FMRs for other sized units are specified percentages of this amount.

of most federal housing assistance—generally still find them too expensive. 10/ To make the dwellings more affordable for these people, the government has provided several different types of supplementary assistance over the years.

The earliest secondary subsidy was the rent supplement program, authorized in 1965. Under that program, HUD subsidizes project owners for up to 40 years to reduce rents for some low-income tenants. Rents for assisted tenants are set to be equal to the greater of:

- o 30 percent of adjusted income; or
- o 30 percent of the fixed rent in the BMIR program, or 30 percent of the basic rent in the Section 236 program. 11/

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10. The terms "very-low-income, "low-income," and "moderate-income" are commonly used to describe the target populations of federal housing assistance programs, but not always in a consistent manner. "Low-and moderate-income" is commonly used to refer to either: (a) families with incomes no greater than 80 percent of the median for families in an area, or (b) families with incomes no greater than 95 percent of the area's median. "Low-income" is used in some contexts to refer to families with incomes no greater than 80 percent of the area's median and in other instances to families with incomes between 50 percent and 80 percent of the area's median. "Very-low-income" is generally used to refer to families with incomes no greater than 50 percent of the area's median. In each case, the income limit relative to the area's median is adjusted for family size.

    As used here, "very-low-income" refers to families with incomes no greater than 50 percent of the area's median adjusted for family size; "low-income" refers to families with incomes no greater than 80 percent of the area's median; and "moderate-income" refers to families with incomes between 80 percent and 95 percent of the area's median.

11. Rent supplements were also used in conjunction with Section 221(d)(3) Market Rate projects.

Beginning in 1974, "deep subsidy" rental assistance payments (RAP) were made available for some low-income tenants in Section 236 projects. Rental charges are limited to 30 percent of adjusted income, with RAP making up the difference between that amount and the unit's basic rent.

Since 1976, supplementary assistance has also been provided through the Section 8 existing-housing program. Like the RAP program, Section 8 aid limits tenants' rent payments to 30 percent of adjusted income. Initially, Section 8 assistance was used primarily to assure a steady stream of rental income for projects in financial distress. This aid is known as the Section 8 loan management set aside (LMSA) program. In addition, some units were converted from rent supplements or RAP to Section 8 assistance, in part because Section 8 provides a budgetary cushion to cover inflation in the operating costs of projects. Conversion also allowed shortening the term of supplementary aid from 40 years following the origination of the mortgage to 15 years following the date of conversion. Project owners can, however, opt out of both Section 8 LMSA and conversion contracts at five-year intervals during the 15-year term. 12/

Another form of supplementary assistance is the "troubled projects" flexible subsidy program. This program—authorized in 1978—provides cash grants and loans on favorable terms to fund deferred maintenance and

12. Beginning in fiscal year 1983, all new LMSA contracts were written for 5-year terms, while Section 8 conversion contracts continue to be written for 15-year terms, with 5-year options for the project owners to cancel.

rehabilitation needs, physical modifications, operating deficits, and replacement reserves to meet future needs. 13/ Since 1983, flexible subsidies have been financed exclusively out of funds collected from Section 236 tenants paying more than the basic rent, though the use of funds is not limited to Section 236 projects.

A final means of providing supplementary assistance to troubled BMIR and Section 236 projects is through what is referred to as a "transfer of physical assets," or TPA. 14/ In essence, this transfer involves a change in the ownership of a project, often from a financially pressed entity to one with greater resources. Under a TPA, the new owner—usually a profit-motivated organization—assumes the assets, liabilities, and obligations of the original sponsor in return for the release of some or all of the original owner's interests in the property. All TPAs must be approved by HUD, which requires that the new owners complete all deferred maintenance and needed capital improvements and eliminate any outstanding financial delinquencies. Unlike other forms of supplementary assistance, TPAs do not require the infusion of federal funds, but they generally result in lower federal revenues. TPAs are of benefit to the new owners in large part

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13. Until 1982, flexible subsidies were also available for projects with HUD-insured market-rate mortgages where some of the units also received rent supplements or had been converted from rent supplements to Section 8 assistance.

14. This description of TPAs is taken in large part from The Subsidized Housing Handbook: How to Provide, Preserve and Manage Housing for Lower-Income People (Berkeley, California: The National Housing Law Project, 1982).

because they may depreciate their projects anew after the purchase, realizing the associated tax benefits. 15/

Owners whose projects remain financially troubled despite supplementary assistance may default on their mortgages, leading to insurance claims against HUD by the individuals or organizations holding the mortgages. As a first step, HUD pays the insurance claim, obtains the mortgage, and works with that project owner to restore the financial viability of the development. If that is not possible, the project becomes the property of HUD through foreclosure and is eventually resold—often with supplementary Section 8 assistance that commits the new owner to maintain the project as low-income housing for 15 more years after acquisition. This process is known as the property disposition program. 16/

Program Costs and Types of Households Assisted

All projects assisted under the BMIR and Section 236 programs involve government subsidies, but the resulting federal costs occur in quite different time periods, depending on the form of the subsidy. BMIR loans that have been purchased and resold by the government require no ongoing outlays and generate no ongoing receipts. Instead, net outlays occurred at the time the

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15. Before 1985, both sellers and buyers could realize substantial benefits as a result of the exemption of TPAs from the original issue discount (OID) provisions in the tax code. With the elimination of this exemption in the Deficit Reduction Act of 1984, the number of TPAs has declined substantially. The Tax Reform Act made no further change.

16. Unlike owners with LMSA and conversion contracts, owners receiving Section 8 property disposition assistance may not opt out at five-year intervals.

government purchased these mortgages and resold them at a discount. BMIR and Section 236 mortgages held by the government may generate revenues in the form of monthly mortgage payments, but they were originally financed by government borrowing and so contribute to ongoing interest payments on the national debt. Finally, outstanding Section 236 mortgages not held by HUD—the majority of all outstanding loans—involve federal outlays each year to cover the mortgage interest-reduction payments. 17/

In fiscal year 1985, BMIR and Section 236 mortgages held by the federal government generated about $160 million in revenues, but the extent to which this amount falls short of the federal costs occasioned by the original borrowing is difficult to estimate. Interest-subsidy payments for outstanding Section 236 mortgages not held by the government cost approximately $500 million, or an average of about $1,000 per unit. 18/ Less is known about the cost of supplementary rental assistance received by some BMIR and Section 236 units. Available data suggest that, in 1985, assistance under RAP amounted to about $2,200 per unit receiving this form of aid. It is likely that roughly comparable subsidies were provided through rent supplements and additional Section 8 aid.

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17. This discussion considers only the budgetary impact of the mortgages. It does not consider the effect of supplementary assistance to prevent defaults that would otherwise result in claims against HUD's insurance funds.

18. This figure excludes an estimated $44 million in intradepartmental transfers of interest subsidies for HUD-held mortgages.

Unfortunately, little is known about the incomes of the households living in BMIR and Section 236 projects. Available data suggest that in 1981 about 2 percent of all Section 236 tenants had incomes higher than 80 percent of the area's median, 28 percent had incomes between 50 percent and 80 percent of the median, and the remaining 70 percent had incomes below 50 percent of the median. 19/ Comparable information is not available for tenants of BMIR projects.

USE RESTRICTIONS UNDER THE MORTGAGE SUBSIDY PROGRAMS

The duration of the use restrictions on BMIR and Section 236 projects is affected by whether and when owners prepay their mortgages. During the first 20 years after the final endorsement dates on the initial mortgages, owners can prepay only with permission from the Secretary of HUD, which can be granted only under extremely stringent conditions. In such cases, however, the mortgage-related use restrictions end when the mortgages are paid off.

Several types of owners remain subject to the use restrictions for the next 20 years as well, again unless the Secretary grants permission for them to prepay their mortgages, which requires that the specified conditions be met. These groups include nonprofit and public sponsors, limited-dividend sponsors whose projects receive rent supplements or RAP assistance, and limited-dividend sponsors who purchased their projects from nonprofit ones.

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19. Income data for tenants are taken from: Paul Burke, "Trends in Subsidized Housing, 1974-1981," Department of Housing and Urban Development (March 1984).

Similarly, project owners who have received flexible subsidies must maintain the low- and moderate-income character of their projects for the entire lives of the original mortgages. 20/

The remainder of this paper focuses on the group of owners that can prepay their mortgages after 20 years and, thereby, end the mortgage-related use restrictions—that is, on limited-dividend sponsors who do not receive rent supplements or RAP aid and who have never been awarded flexible subsidies. Even for this group, however, other constraints on the use of their projects may exist. In particular, if they have received LMSA or conversion assistance, their Section 8 units must still be made available to low-income tenants at rents set by HUD until the owner can opt out of that commitment as well—an option that occurs every five years.

As of November 1986, about 1,170 BMIR project mortgages covering 148,000 dwelling units and about 3,870 federally insured Section 236 project mortgages covering 433,000 units were outstanding (see Figure 1 and the top panel of Table 1). Unfortunately, data provided by HUD do not make it possible to identify precisely those projects whose owners will be able to end the use restrictions associated with their mortgages by prepaying them after 20 years. If one bears in mind the qualifications described in the notes to Table 1, however, it appears that owners of about 540 BMIR projects with

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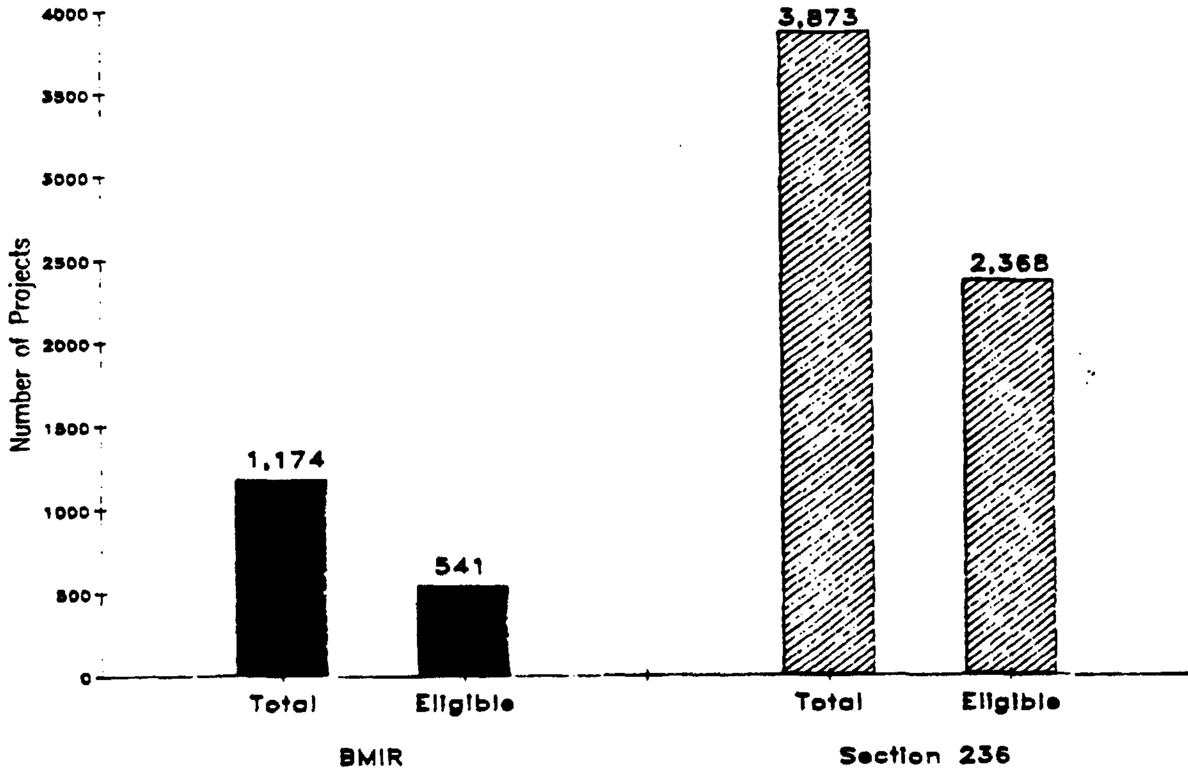
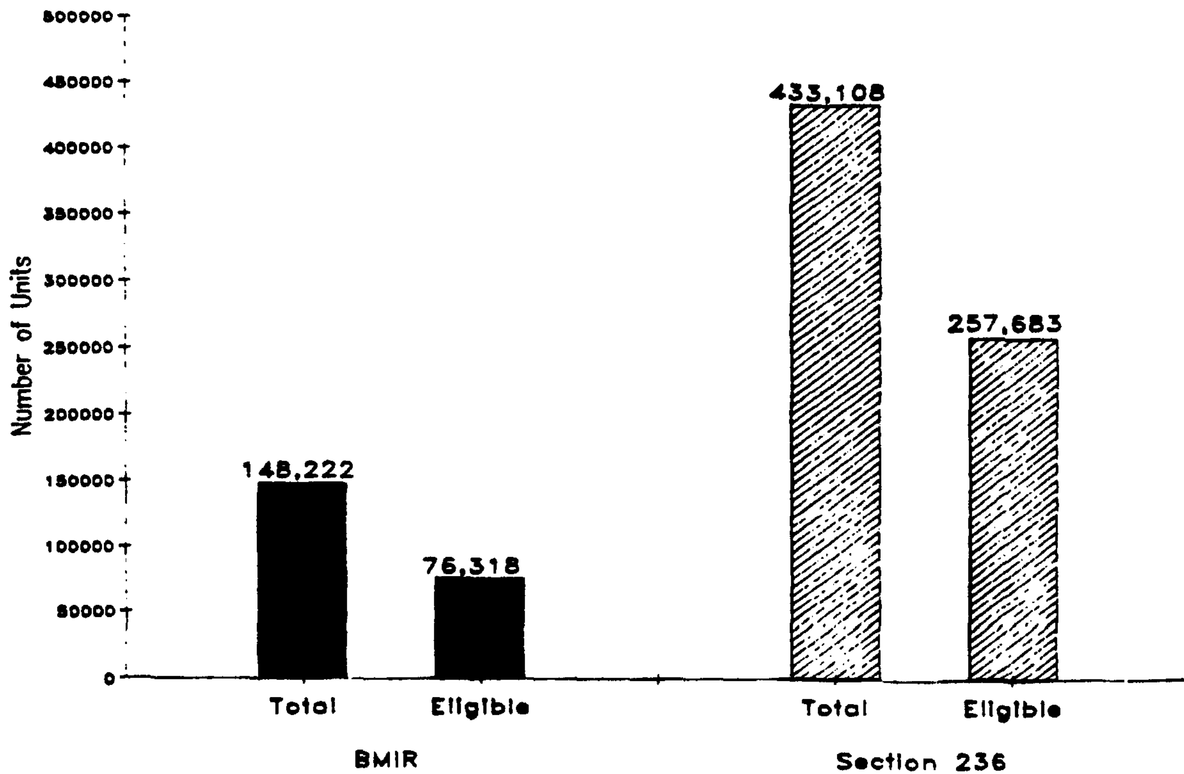
20. Projects financed with tax-exempt bonds issued by state housing finance agencies are also likely to have use restrictions covering the lives of the mortgages.

Figure 1. Estimated Number of Projects Assisted Under the BMIR and Section 236 Programs: Total and with Mortgages Eligible for Prepayment





SOURCE: CBO tabulations based on data provided by the U.S. Department of Housing and Urban Development (HUD) in the fall of 1986.

TABLE 1. NUMBER OF PROJECTS AND UNITS ASSISTED UNDER THE BMIR AND SECTION 236 PROGRAMS BY THEIR ESTIMATED ELIGIBILITY FOR MORTGAGE PREPAYMENT AFTER 20 YEARS a/

	Currently Assisted	Mortgages Potentially Eligible for Prepayment from 1986 to 2001 b/	
		Number	Percent c/
	Federally Financed or Insured		
Section 221(d)(3) BMIR			
Number of projects	1,174	541	46
Number of units	148,222	76,318	51
Section 236			
Number of projects	3,873	2,368	61
Number of units	433,108	257,683	60
Total			
Number of projects	5,047	2,909	58
Number of units	581,330	334,001	57
	State Financed		
Section 236			
Number of projects	529	d/	d/
Number of units	115,529	d/	d/

SOURCE: CBO tabulations based on data provided by U.S. Department of Housing and Urban Development (HUD) in the fall of 1986.

NOTE: In order to show the patterns of potential prepayments that would end use restrictions, the estimates presented in the tables have not been rounded. On the other hand, the specific estimates should be used with considerable caution, because of the qualifications described in footnote b.

a. Projects that have received flexible subsidies are excluded. Although the mortgages on these projects may be prepaid after 20 years, their low-moderate income character must be preserved for 40 years.

(continued)

TABLE 1. Footnotes continued

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b. The estimated number of projects with mortgages potentially eligible for prepayment includes those owned by limited dividend sponsors, not receiving assistance through the rent supplement or RAP programs at present, and never having received flexible subsidies. Several qualifications apply to these estimates. First, the data may include some projects initially but not currently sponsored by nonprofit entities. Because owners of such projects cannot prepay their mortgages without HUD's permission, the number of projects characterized here as eligible for prepayment is overstated.

   Second, HUD data indicate that 114 BMIR projects completed between 1962 and 1965 had mortgages eligible for prepayment and expiration dates for the prepayment restriction between 1982 and 1985. These projects are not included here.

   Third, expiration dates for the prepayment restriction are measured from the dates at which the final endorsement of the original project mortgages were entered into HUD's data system, rather than from the actual final endorsement dates. Reckoning from the data entry dates could have erroneously shifted the distribution of expiration dates forward by several months.

c. Mortgages potentially eligible for prepayment as a percent of all mortgages currently assisted in the same program.

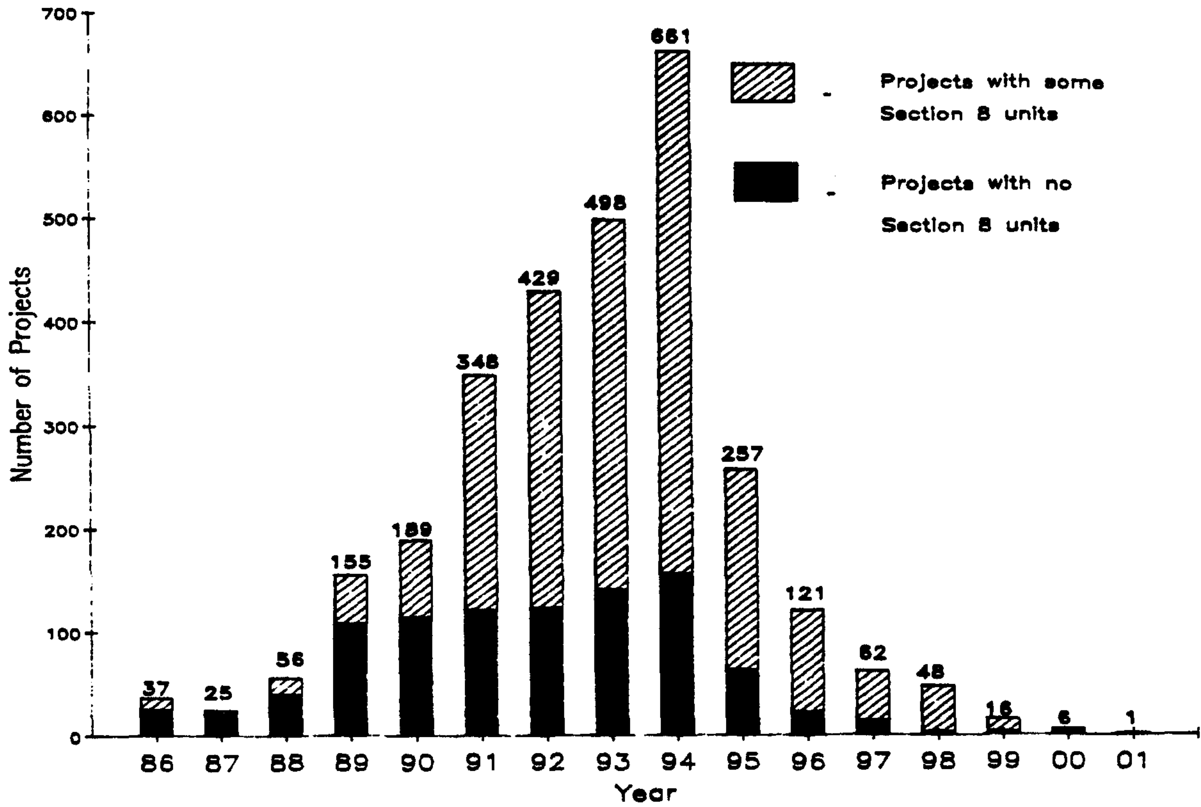
d. Limited available information suggests that almost all of these mortgages contain restrictions on the use of the projects for their entire original terms, regardless of whether they can be prepaid. The proportion eligible for prepayment is not known.

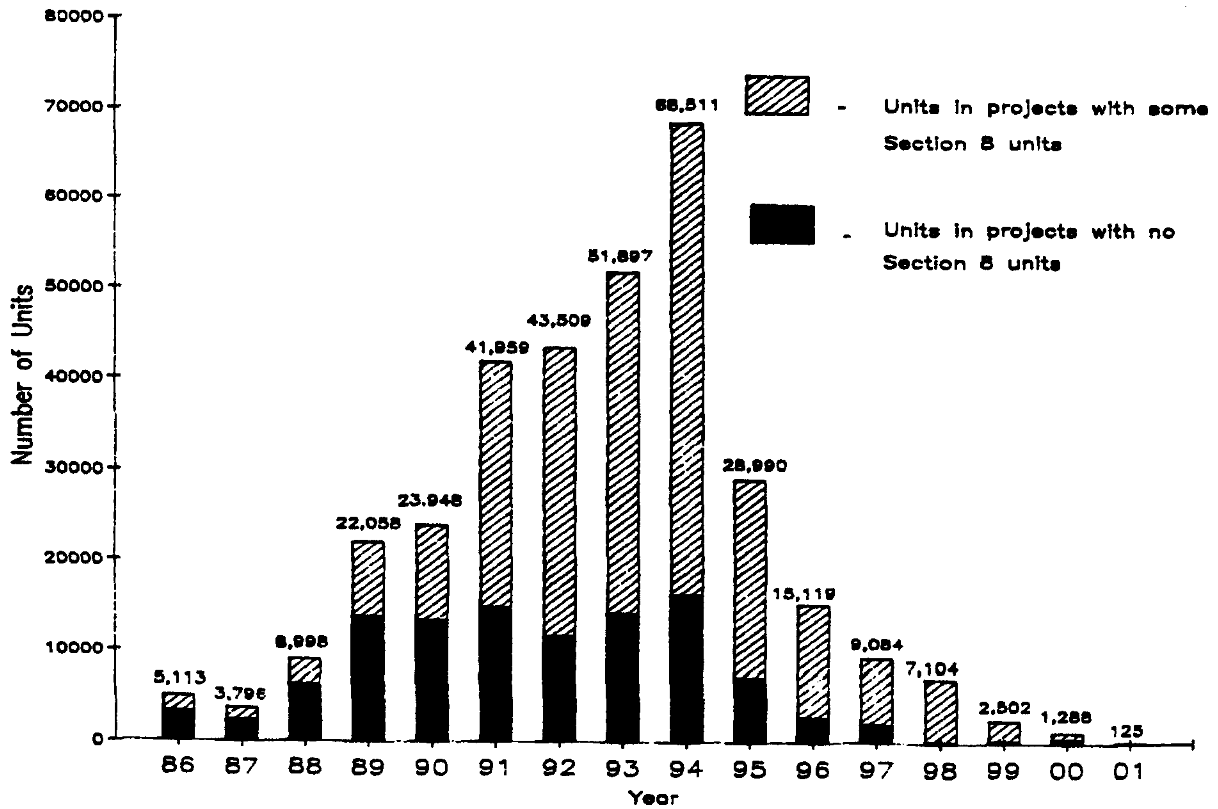
76,000 units and about 2,370 Section 236 projects with another 258,000 units are able to end the mortgage-related use restrictions between 1986 and 2001. The remaining 40 percent—or roughly 2,140 projects—must abide by the use restrictions for the entire 40-year term, unless the Secretary grants permission for prepayment, which requires meeting stringent conditions. In addition, another roughly 530 projects containing 116,000 units were financed by the states, and also received federal interest subsidies under the Section 236 program, but were not federally insured (see the bottom panel of Table 1). The limited available information suggests that these project owners are also subject to use restrictions for the full terms of the original mortgages, regardless of whether or not they can prepay them.

While a few project owners have already ended their mortgage-related use restrictions, most opportunities to do so will occur during the next decade (see Figure 2 and Table 2). In 1987 and 1988, owners of fewer than 60 projects per year will be able to end these use restrictions. The number will jump to about 150 in 1989 and grow steadily in the five years thereafter. It will reach a peak in 1994 of more than 650 projects with over 68,000 units, and then decline through 2001.

Unfortunately, it is impossible to forecast how many of the 2,900 project owners who are able to end their mortgage-related use restrictions between 1986 and 2001 will do so and, consequently, how many of the 334,000 units in these projects will actually be lost from the assisted housing stock. The likelihood of opting out will depend primarily on the value of the buildings in alternative uses—such as renting the units to higher-income households, converting the buildings to nonresidential uses, or demolishing

Figure 2. Estimated Number of BMIR and Section 236 Projects With Mortgages Eligible for Prepayment, 1986-2001





SOURCE: CBO tabulations using data provided by the U.S. Department of Housing and Urban Development (HUD) in November 1986.

TABLE 2. ESTIMATED EXPIRATION OF PREPAYMENT RESTRICTIONS ON BMIR AND SECTION 236 PROJECTS FROM 1986 to 2001 a/

Year in Which Prepayment Restrictions Expire	All Projects With Expiring Prepayment Restrictions		Projects Without Section 8 Assistance		Projects with Section 8 Assistance		
	Number of Projects	Number of Units	Number of Projects	Number of Units	Number of Projects	Units Without Section 8	Units With Section 8
1986	37	5,113	24	3,199	13	825	1,089
1987	25	3,796	20	2,314	5	604	878
1988	56	8,998	39	6,173	17	1,204	1,621
1989	155	22,058	107	13,615	48	4,430	4,013
1990	189	23,948	113	13,199	76	4,900	5,849
1991	348	41,959	120	14,663	228	14,703	12,593
1992	429	43,509	122	11,381	307	16,312	15,816
1993	498	51,897	140	13,948	358	16,923	21,026
1994	661	68,511	155	15,938	506	23,946	28,627
1995	257	28,990	62	6,903	195	9,031	13,056
1996	121	15,119	22	2,684	99	5,313	7,122
1997	62	9,084	13	1,897	49	2,876	4,311
1998	48	7,104	2	104	46	2,390	4,610
1999	16	2,502	2	204	14	922	1,376
2000	6	1,288	2	385	4	527	376
2001	1	125	0	0	1	0	125
Total	2,909	334,001	943	106,607	1,966	104,906	122,488

SOURCE: CBO tabulations using data provided by U.S. Department of Housing and Urban Development (HUD) in November 1986.

NOTE: See Note to Table 1.

a. In addition to the qualifications described in the notes to Table 1, several more apply to the HUD data used here. First, owners of projects receiving Section 8 assistance will be eligible to prepay their mortgages on the dates shown. They will, however, remain subject to restrictions on the use of their Section 8 units for some time thereafter.

Second, owners of the 35 projects (containing 3,018 units) that have received assistance under the Section 8 property disposition program are subject to use restrictions for 15 years after they acquired their properties. For these properties, the expiration dates shown are inaccurate because they reflect the 20th anniversary of the initial mortgage, which is no longer in force.

Third, for a number of projects that were identified as receiving LMSA or conversion assistance, the number of Section 8 units was missing and was therefore excluded from the total number of Section 8 units, thereby underestimating it. On the other hand, for projects receiving property disposition assistance, all of which lacked the number of Section 8 units, it was assumed that 100 percent of the units received assistance. The net impact of these two adjustments is likely to be an underestimate of the total number of Section 8 units because there were many more instances of LMSA projects without unit totals than there were of property disposition units that may have been overcounted.

them to make way for other forms of development—about which no information exists at present. Those owners whose projects are much more valuable for other uses will almost certainly prepay their mortgages. Others, whose projects have few if any alternative uses, almost certainly will keep their buildings in the assisted housing stock. A third group falls between these two extremes.

The presence of units with Section 8 assistance could affect both whether and when project owners who are able to end their mortgage-related use restrictions by prepayment would do so. Of the estimated 2,900 projects at issue, nearly 2,000—containing about 225,000 units—are also receiving Section 8 assistance for an average of about one-half of their units. The units receiving Section 8 aid would continue to be subject to use restrictions at least until the first five-year anniversary of the Section 8 contracts after prepayment. Owners of projects containing these units might be less inclined to prepay their mortgages, because Section 8 assistance provides them with a steady source of income. If they decided to do so, however, their timing might depend on the type of alternative use for their projects. Those owners who could obtain substantially higher rents might prepay their mortgages as soon as they became eligible in order to make their non-Section 8 units available to higher-income households. Those who planned to convert their buildings to nonresidential use or to demolish them might wait to prepay until they could opt out of the Section 8 obligation as well.

Taking into account the presence of Section 8 assistance permits alternative estimates of the maximum number of housing units that could be lost from the assisted stock in each year. Data are not available, however, on the starting dates of the Section 8 contracts, so the five-year anniversary dates are also not known. 21/ The maximum annual reductions in the stock of federally assisted housing shown in Table 3 are based on three sets of assumptions:

- All owners prepay their mortgages as soon as they are able to end their mortgage-related use restrictions and Section 8 contracts expire during that same year. Thus, all units leave the assisted inventory in the twentieth anniversary years of these mortgages.
- All owners prepay their mortgages as soon as they are able to end their mortgage-related use restrictions, but Section 8 contracts expire five years later. Thus, Section 8 units leave the assisted inventory five years after the non-Section 8 units.
- Owners without any Section 8 units prepay their mortgages as soon as they are able to end their mortgage-related use restrictions, but owners of projects with some Section 8 units do not prepay until five years later.

In the first 10 years, the largest reductions in the assisted housing stock would occur under the first scenario, while portions of that reduction would be delayed in the other two cases. For the three years ending in 1988, for instance, at most nearly 18,000 assisted housing units might be lost under the first scenario, compared with at most 15,000 under the second scenario, and at most 12,000 under the third scenario. In all cases, the amounts represent less than 1 percent of the stock of assisted housing in

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21. Data on the starting dates of Section 8 contracts are available in a data base different from the one used for this analysis. Thus far, however, attempts to merge the two data bases have been unsuccessful.

TABLE 3. MAXIMUM NUMBER OF BMIR AND SECTION 236 UNITS THAT COULD BE REMOVED FROM THE FEDERALLY ASSISTED HOUSING STOCK UNDER THREE SCENARIOS a/

Year in Which Prepayment Restrictions Expire	All Units Leave When Prepayment Restrictions Expire	Section 8 Units Stay Five Years Longer b/	Projects with Any Section 8 Units Stay Five Years Longer b/
1986	5,113	4,024	3,199
1987	3,796	2,918	2,314
1988	8,998	7,377	6,173
1989	22,058	18,045	13,615
1990	23,948	18,099	13,199
1991	41,959	30,455	16,577
1992	43,509	28,571	12,863
1993	51,897	32,492	16,773
1994	68,511	43,897	24,381
1995	28,990	21,783	17,652
1996	15,119	20,590	29,980
1997	9,084	20,589	34,025
1998	7,104	23,520	38,053
1999	2,502	29,753	52,777
2000	1,288	13,968	22,472
2001	125	7,122	12,435
2002	0	4,311	7,187
2003	0	4,610	7,000
2004	0	1,376	2,298
2005	0	376	903
2006	0	125	125
Total	334,001	334,001	334,001

SOURCE: CBO tabulations using data provided by U.S. Department of Housing and Urban Development (HUD).

NOTE: See the Notes and footnotes on Tables 1 and 2.

a. See the text for additional detail.

b. These estimates assume that expiring Section 8 contracts are renewed by HUD.

1987. Moreover, it is important to remember that these scenarios present a range of estimates of the **maximum** number of units that might be lost. The actual numbers are likely to be substantially smaller. Between 1980 and 1985, owners of only about 10 percent of the projects on which mortgage-related use restrictions could be ended chose to do so. On the other hand, if all such project owners chose to prepay their mortgages between now and 2001, a maximum of 334,000 units—or about 8 percent of the current number of rental assistance commitments—would be lost.

Another factor that could affect the likelihood of units leaving the assisted stock is the physical and financial soundness of the projects. Data on a sample of BMIR and Section 236 projects indicate that 40 percent of all those whose mortgage-related use restrictions could be ended by prepayment will experience shortages in the funds needed for anticipated nonroutine repairs and capital replacement during the next five years (see Table 4). In particular, about 610 out of 650 projects with anticipated large per-unit repair costs—$600 or more per year—expect to have shortages in needed funds, ranging from $120 to over $2,000 per unit per year. It is not obvious, however, how the financial and physical condition of projects will relate to the likelihood of owners opting out of the programs. The poor financial shape of some projects might indicate a lack of profitable alternatives, so they will stay in the programs. Other projects might be in bad financial and physical condition precisely because their owners plan to convert them to alternative uses.

TABLE 4. ANTICIPATED NONROUTINE REPAIR AND CAPITAL REPLACEMENT COSTS BY AVAILABILITY OF FUNDS TO COVER COSTS OVER THE NEXT FIVE YEARS FOR BMIR AND SECTION 236 PROJECTS WITH EXPIRING PREPAYMENT RESTRICTIONS a/

Amount of Anticipated Repairs Per Unit Over Next Five Years	With Funds to Cover Repairs b/		Without Funds to Cover Repairs c/		Percent Without Funds to Cover Repairs
	Number	Percent	Number	Percent	
			PROJECTS		
$0 - 299	1,020	60	100	9	9
$300 - 599	630	38	430	38	40
$600 - 899	40	2	390	34	91
$900 or More	0	0	220	19	100
All	1,690	100	1,140	100	40
			UNITS		
$0 - 299	111,900	61	16,800	14	13
$300 - 599	67,800	37	41,000	34	38
$600 - 899	2,300	1	35,100	29	94
$900 or More	0	0	28,100	23	100
All	182,000	100	121,000	100	40

SOURCE: Estimates based on 1985 data provided by U.S. Department of Housing and Urban Development (HUD).

NOTE: Details may not add to totals because of rounding. Percentages are based on unrounded numbers, however. Also, the totals presented here do not agree with those in Tables 1 and 2 because the information in this table is taken from a 1985 sample of projects, which excludes all projects insured after 1974—about 18 percent of the total.

a. Available funds include annual residual cash—that is, total project income less expenditures for administration, operations (including maintenance and routine repairs), utilities, taxes, insurance, mortgage debt service, insurance premiums, and interest on other notes, plus one-fifth of the reserve balance. In addition, because projects often pay for some of their nonroutine repairs and capital replacement needs from their ordinary maintenance and repair funds, 25 percent of past average annual expenditures for these items was added to available resources.

b. Projects with funds have annual shortages of $120 per unit or less to cover anticipated nonroutine repairs and capital replacement needs during the next five years.

c. Projects lacking funds have annual shortages of over $120 per unit to cover anticipated nonroutine repairs and capital replacement needs during the next five years.

ISSUES FACING THE CONGRESS

In deciding whether to respond to the loss of subsidized housing units that occurs when project owners opt out of the BMIR and Section 236 programs, the Congress faces a basic dilemma. To help low-income households with their housing expenses would require higher federal expenditures or lower revenues. In turn, these alternatives would add to the federal budgetary deficit at a time of extreme fiscal stringency. Should the Congress decide to respond, it could act to keep the total number of assisted housing commitments from falling, or it could provide additional assistance for a smaller number of households than were displaced or a shorter period of time than the original 40-year terms of the existing mortgages. Moreover, in designing any response, the Congress would need to resolve a number of specific issues:

- Which tenant households should be assisted?
- What form should the aid take? and
- How long should it be available?

In terms of eligibility, the government could assist all tenants displaced from BMIR and Section 236 projects, regardless of their current incomes, at least during the period in which they are seeking new housing. Alternatively, the government could assist only those displaced tenants whose incomes are sufficiently low that they remain in the group currently targeted for housing assistance. Or, given that housing assistance programs are not entitlements, the government could spread the limited subsidy around and aid a totally new subset of income-eligible households rather than those previously assisted under the BMIR and Section 236 programs.

Aid to displaced tenants could be provided in cash or in kind—the former being relevant primarily to temporary assistance. Similarly, direct spending programs or provisions of the tax code could be the vehicle for a response. Direct spending would require a greater administrative network than tax provisions, but would permit both greater control over total costs and stricter targeting of expenditures. This decision also relates to the desired mix of project-based versus tenant-based subsidies, since the latter would be difficult to implement through the tax code. Project-based subsidies might be provided by attempting to keep the current projects in the BMIR and Section 236 programs, or by constructing new projects. Tenant-based subsidies could be provided through vouchers or certificates. A major factor in choosing the form of aid would be the relative cost of assisting a household.

The duration of the replacement assistance would, in turn, probably be linked to the type of aid provided. Transition aid is usually limited in length compared with assisted housing commitments, and therefore costs less. Similarly, tenant-based subsidies are generally authorized for shorter terms than project-based subsidies, thereby providing the flexibility to change the program's features to meet future needs. In contrast, project-based subsidies provide housing assistance for lengthy periods without further Congressional action.

POLICY ALTERNATIVES

In the face of mortgage prepayments and the resulting loss of units from the assisted housing stock, the Congress could respond with a variety of policy

alternatives, or it could continue current law. The BMIR and Section 236 programs were originally designed with specified terms and, therefore, with expiration dates. They have largely met their initial goals of providing decent affordable housing to low-income households for 20 years or more. In addition, allowing these projects to be removed will involve no further costs to the federal government and, in the case of Section 236 projects, will actually reduce federal outlays for mortgage-interest subsidies. On the other hand, leaving current law in place will reduce the number of housing assistance commitments both now and in the future, leading to higher-cost or lower-quality housing for the displaced tenants.

Current policies could be continued indefinitely or until more data are collected to evaluate whether alternative policies are desirable and, if so, what types. In order to make more informed judgments, information would be needed on the potential magnitude of the problem, the characteristics of affected tenants, and the impacts of alternative strategies.

Initial estimates of the magnitude of the problem could be based on the number of owners who opted out of the programs. Forecasts of the eventual magnitude of the problem could be refined by collecting data on the financial, physical, and local market conditions of these projects and by comparing characteristics of the projects of owners who actually prepaid their mortgages with the characteristics of projects whose owners could have ended their mortgage-related use restrictions but chose not to do so.

Other information that might be used in assessing the need for a response include the incomes of tenants in these projects and the availability of private low-income housing in their localities. Moreover, whether provisions of the Tax Reform Act are stimulating a significant expansion in the construction of housing for low-income households—thereby mitigating the need for any response—would be clearer in a few years.

Finally, improved data would especially be needed to evaluate the potential effectiveness and costs of strategies designed to retain units in the BMIR and Section 236 programs. Such analyses would permit a comparison of these new approaches with other, existing housing programs about which much is already known.

The remainder of this section examines several specific options for responding to the potential loss of units assisted under the BMIR and Section 236 programs. First, transitional aid could be provided for displaced residents of projects whose mortgages are prepaid and whose use restrictions are thereby ended. Second, attempts could be made to induce project owners to keep their housing units in these programs. Finally, the Congress could offset some or all of the lost housing commitments by authorizing other forms of housing assistance for low-income families.

Provide Transitional Aid to Displaced Tenants

One approach would be to provide transitional assistance to displaced tenants either in the form of cash payments or temporary housing subsidies.

The loss of housing assistance and the necessity to move from their subsidized units could be quite unexpected for many tenants who did not know the terms of the mortgage agreements, and could lead to difficulties in their finding suitable new housing. On the other hand, housing assistance programs are not entitlements, and some people argue that the government has no obligation to continue to help affected households. Indeed, a large fraction of households eligible for housing assistance currently do not receive any aid, and it might be considered unfair to continue aiding households who have already benefited from these programs.

Transitional Cash Payments. One specific alternative is to provide assistance through temporary cash payments to displaced households. Payments—perhaps related to family size—could be provided as a lump sum or as monthly income supplements for a limited period of time after displacement. Moreover, they could be made available to all affected households or only to those with very low incomes. Such aid could help reduce financial difficulties for these affected households as they find new residences, although some people object to the lack of government control over the use of aid made available as cash. Moreover, in the long run, it would do little to prevent the higher housing costs or lower quality of housing that many tenants would experience upon displacement.

Housing Subsidies. Another alternative is to provide some form of housing subsidy to those displaced households who remain eligible for other types of housing assistance. For example, they could be given priority for housing commitments already available under other housing programs.

Although this alternative would not add to federal outlays, it would prolong the wait for assistance by other eligible households. Moreover, even with the priority, some displaced tenants might be without housing assistance for a period of time. Alternatively, funding could be provided for additional vouchers or Section 8 existing-housing certificates that are specifically tied to these households, and that would expire when the households left the program. This option would not adversely affect other eligible households, but would be more expensive than providing temporary cash payments, particularly because the subsidy could remain with some households for many years.

Provide Incentives for Owners To Keep Their Projects in the Programs

Alternatively, owners could be encouraged to keep their BMIR and Section 236 projects in the programs beyond the first 20 years of their mortgages. If successful, such actions would prevent the dislocation of current tenants and would retain a source of reduced-rent housing reserved for lower-income households—essentially postponing the displacement problem for 20 years. Preserving this housing stock might be particularly important in areas with current shortages of housing usually rented by lower-income households.

On the other hand, some of the additional federal expenditures would benefit owners whose projects have little value for unsubsidized uses and who would have kept their projects in the program without any extra inducements. Thus, an unknown—but possibly large—portion of federal outlays would not result in retaining any additional units. Moreover, about

one-quarter of the households living in these projects have higher incomes than the current target population for most federal housing assistance. Consequently, any funds used to extend the subsidy term for these projects would involve aiding families who are at least somewhat better off than those who are currently eligible for rental assistance in other programs but who do not receive it.

Options likely to be successful in retaining a project in these programs would differ with both the financial and physical conditions of the housing projects. In particular, the options considered here are distinguished according to the project's need for funds for capital improvements or repairs.

Options for Projects Needing Funds for Capital Improvements or Repairs. As noted earlier, 40 percent of the projects for which prepayment would end the mortgage-related use restrictions have insufficient funds in replacement reserves to cover impending repair needs. In particular, almost all projects with anticipated per-unit repair and replacement costs of $600 per year or more—about one-fifth of all those with mortgages eligible for prepayment—expect to have funding shortages.

Owners of these projects might be induced to keep their units in the programs by helping them finance improvements. Such aid—which would be conditional on the projects continuing to meet the use restrictions for the full terms of the mortgages—would also help assure that the projects would be attractive as subsidized housing and could reduce defaults and subsequent insurance claims against HUD. On the other hand, this approach could be

viewed as a reward for not maintaining projects in sound financial and physical condition, and additional federal expenditures might still be needed in the future to keep some of these projects solvent.

Options for financing capital needs through direct spending include: increasing funding for grants or reduced-interest loans under the flexible subsidy program; providing interest subsidies for private repair loans; renewing contracts under the LMSA program; and authorizing increases in allowable rents to generate additional cash flow for necessary repairs. Alternatively, capital needs could be financed through tax expenditures, for example, by permitting more favorable depreciation terms. Unfortunately, it is extremely difficult to assess the likely effectiveness and cost of any of these approaches with currently available data.

Options for Projects in Sound Condition. Sixty percent of the projects with expiring use restrictions appear to have sufficient funds to cover impending repair needs. In some of these cases, owners might be induced to stay in the programs by increasing the effective return on their investment. This goal could be accomplished by raising their pre-tax returns on investment, changing the tax code to provide greater after-tax returns, or a combination of these approaches.

One way to raise pre-tax returns would be to lift the current 6 percent cap and allow project owners to raise their rents while still imposing some limits. This strategy would increase housing costs for many tenants,

however, including some of those with the lowest incomes. 22/ To avoid moving, families not receiving supplementary rental assistance would have to reallocate their incomes to afford their higher rents, although in most instances they would still be paying less than would be required to rent comparable unassisted dwellings. Tenants receiving supplementary rental assistance would be protected from the rent increases, which would, instead, be passed along automatically to the federal government.

A variation of this approach would be for the government to provide supplementary rental assistance to all eligible tenants who faced rent increases. This approach would increase housing costs only for ineligible tenants who were paying the so-called "market rent," because the costs for low-income tenants would be transferred entirely to the federal government. On the other hand, federal outlays would rise as a result.

A different approach would be to keep rents at their current levels but increase project owners' after-tax return on investment by providing more favorable tax treatment. For example, part or all of their pre-tax returns

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22. If owners were allowed to raise rents, both the basic rent and the market rent in the Section 236 program, as well as the fixed rent in the BMIR program, would increase. Tenants without supplementary rental assistance who were paying 30 percent of their incomes toward rent in the Section 236 program would only be affected if the basic rent were raised above their current rental contributions. However, all tenants who were paying the basic rent—those with the lowest incomes who were not receiving supplementary assistance—would face increased housing costs. Moreover, to the extent that fewer households would pay rents higher than the basic rent, residual funds that would have been available for the flexible subsidy account would be reduced.

could be exempt from taxation, or tax credits could be provided. The entire cost of this approach would be borne by the federal government through lower revenues, but it would leave the housing costs of all tenants unchanged, regardless of their incomes.

Offset Some or All of the Lost Housing-Assistance Commitments Through Other Programs

Whether or not attempts are made to retain projects in the BMIR and Section 236 programs, some mortgages will be prepaid. If the Congress wishes to offset some or all of the resulting reduction in housing assistance commitments, two general approaches could be used: subsidize newly built projects under currently active programs, or help lower-income families pay for existing rental housing—that is, use project-based or tenant-based subsidies, respectively.

Project-Based Subsidies. BMIR and Section 236 projects could be replaced with newly built projects by increasing funding for public housing, for Section 202 housing for the elderly and the handicapped (all of which also receive Section 8 assistance), or for projects subsidized under the rental housing development grant program (HoDAG). In contrast to BMIR and Section 236 projects, nearly all of the public housing or Section 202 projects would serve very-low-income families. On the other hand, using these programs would be considerably more expensive than providing housing assistance through tenant-based subsidies. While replacing mortgage subsidy programs with HoDAG projects would be less costly than relying on public

housing or on Section 202, less of the replacement housing would benefit very-low-income families unless supplementary assistance were also provided.

Tenant-Based Subsidies. Alternatively, replacement commitments could be provided at much lower cost—perhaps only one-half that of new construction programs—by using Section 8 existing-housing certificates or housing vouchers. Both programs tie assistance directly to low-income households who rent physically standard units of their choosing in the private market. The Section 8 existing-housing program limits out-of-pocket costs for all participants to 30 percent of adjusted family income, while requiring that they lease units renting for no more than HUD-established maximums. In contrast, the voucher program allows participants to pay more than 30 percent of income for housing. In so doing, it opens a greater share of the market to them, while leaving them with fewer funds for purchasing other goods if they choose a higher priced unit.

CONCLUSION

The maturing of the BMIR and Section 236 programs means that some dwelling units will be lost from the assisted housing stock, thereby displacing some current and future tenants. On the other hand, allowing owners to remove their projects from these programs—as under current law--avoids the increased spending or lowered revenues associated with almost all direct responses. Providing transitional aid in the form of cash payments or temporary housing subsidies would ease the potential hardship for current tenants, and would be less expensive than providing other housing assistance,

primarily because of its limited duration. It would do nothing, however, to help tenants who would have moved into these units in future years, had the projects remained in the programs.

Attempting to induce BMIR and Section 236 project owners to stay in these programs could be either more or less costly than providing subsidies for displaced tenants to rent existing housing in the private market; it would depend on the costliness of the inducement, the number of owners paid who would have remained in the program without any inducement, and the allowable rents in the markets where the projects are located. Tenant-based subsidies would, however, be much less costly than building new housing projects, although they would be of less value to families living in tight rental markets or to those requiring large units that might be in short supply even in looser markets. In terms of who would benefit from possible responses, expanding currently active housing programs would direct a larger share of available aid to very-low-income families than would attempting to induce owners to stay in the BMIR and Section 236 programs.

Alternatively, any direct action could be postponed to allow time for HUD to gather information on the extent to which owners decide to opt out of these programs, the characteristics and experiences of tenants living in the affected units, and the kinds of inducements that might be successful in encouraging owners to remain in the programs, if deemed appropriate. While much is known about the operation of currently active housing programs, data about the BMIR and Section 236 projects are extremely limited.