

THE URBAN PROSPECT

Housing, Planning and Economic Development in New York

May/June 1995

Volume 1, Number 3

Budget Cuts Highlight City Housing Priorities

Mayor Giuliani's proposed Fiscal Year 1996 budget, released in late April, provides further evidence of the public sector's retrenchment from involvement in housing and community development. It not only deepens the cutbacks made during the past several years, but also offers little promise that there is a light at the end of the tunnel.

During Mayor Koch's final term, a period when little federal development assistance was available, the city made an unprecedented commitment to housing development, creating nearly 40,000 units of affordable housing in eight years. That effort served as a catalyst for renewed private-sector investment in low-income neighborhoods and is credited with reversing the decline of many of them.

As the severity of the city's fiscal crisis became evident during Mayor Dinkins's tenure, the trajectory of city capital spending turned down, capped by a commitment made to the bond rating agencies in late 1993 that capital spending and long-term borrowing would be cut back drastically. During the waning months of the Dinkins administration, the Department of Housing Preservation and Development's fiscal 1994 capital budget was slashed by over \$100 million. Additional incremental cuts were made in Mayor Giuliani's first budget. Even so, the extent of the city's cutbacks were masked somewhat by an injection of new federal money, particularly the \$250 million received over two years through the HOME program.

The budget picture took another turn for the worse during the past year as a decline in the city's property tax base necessitated further cuts. The state constitution limits the amount of debt a municipality can issue to 10 percent of the value of its real property. Consequently, Mayor Giuliani ordered agency heads to prepare for capital budget decreases of 30 percent. The Mayor's proposed budget for Fiscal 1996 reflects those cuts.

The Mayor's proposal for HPD's capital budget totals \$341 million — about 40 percent less than it was just three years ago. Moreover, capital spending on housing is budgeted to rise at just a 5.4 percent annual rate through 2005, suggesting that the administration does not expect

either a quick recovery in the city's fiscal condition or much help from Washington or Albany.

Mayoral Priorities Clear

The Mayor's proposed budget clearly reflects several of his previously articulated housing priorities.

The rehabilitation and disposition of occupied in rem buildings continues to be the administration's top priority, consuming about 36 percent of HPD's capital dollars. Spending on the in rem effort for FY96 and FY97 is actually up from that projected when the administration first took office. Reflecting the administration's preference for ownership and for-profit disposition approaches, spending on the Tenant Interim Lease program has been increased while spending on not-for-profit programs has been reduced. Proposed spending on HPD's new Neighborhood Entrepreneur Program is \$51.7 million in FY96 and \$260.3 million over the next four years. The magnitude of the city's task of rehabilitating and privatizing the occupied in rem stock is underscored by the ten-year budget projection, according to which spending on in rem disposition will still total over \$130 million in FY2005.

Another of the Giuliani administration's frequently stated preferences is the creation of home ownership opportunities; the Nehemiah and Housing Partnership programs that provide them will be held approximately at the current levels. Most of the direct cash subsidy for home ownership programs comes from the state, and the recently adopted state budget holds those subsidies at the level they have maintained for the past several years. The Mayor has also made a public commitment to fund the 1,100-unit Nehemiah project at Spring Creek, although capital funds for that project are not in the coming year's budget proposal.

A third housing effort to which the administration appears committed is the SRO Loan Program, which creates housing for homeless individuals under not-for-profit ownership and management. The Mayor's budget proposes a \$38 million allocation for that program for FY96 and annual budgets in the neighborhood of \$30 million thereafter. The administration

HUD WATCH

Undoing Section 8

Driving the Clinton Administration's plan for reinventing HUD — and stimulating increased Congressional scrutiny of the agency — is the impending budget crisis of federally-assisted private housing. As long-term project-based subsidy contracts entered into in the 1970s and early 1980s come up for renewal, HUD is thrust into the budget spotlight just as the federal deficit becomes the principal focus of national politics. As a result, the funding requirements of assisted housing are sure to dominate the national housing policy debate for the next several years.

Approximately 2 million privately-owned rental units receive project-based federal assistance, including about 800,000 units of HUD-insured and assisted Section 236 and Section 221(d)(3) housing, FmHA Section 515 housing, and HUD's own portfolio of foreclosed projects. The bulk of the subsidized stock, however, is Section 8 housing. There are about 1.2 million project-based Section 8 units, including about 800,000 built or substantially rehabilitated during the program's ten-year productive life that began in 1975.

Most of the units were initially funded with 20-year subsidy contracts that are now coming up for renewal (some early projects were initially given 5-year contracts that were subsequently renewed for 20 years). Projects receive an average federal subsidy of about \$7,400 per year for each affordable housing unit; under federal accounting rules the full value of the contract must be appropriated during the year the contract is renewed. With most of the contracts coming up for renewal during the next seven years, the cost of Section 8 subsidies (including tenant-based certificates and vouchers) are projected to soar from \$7.3 billion in 1995 to \$15.7 billion in 1997. According to HUD estimates, if all contracts are renewed for the life of the properties' mortgages, the total cost will be more than \$80 billion (in present value).

About three-quarters of Section 8 new construction and substantial rehabilitation projects receive federally subsidized rents exceeding the local Fair Market Rent (FMR); nearly 40 percent exceed FMR by 20 percent or more. These rents were initially set to cover the operating costs, limited profits, and debt service of the projects, and are increased annually. In an effort to contain the costs of contract renewals, the administration proposes to "mark-to-market" these rents — reset them at prevailing market rates. In most cases that will require a restructuring of project debt. To the degree that projects are FHA insured, a write-down of debt will be charged as a loss to the FHA's insurance funds. While the strategy may result in real savings, it can also be seen as a maneuver to shift the program's costs "off-budget." Although

Congressional Republicans pronounced the administration's plan for reinventing HUD "dead on arrival," the budgetary implications of the expiring contracts will likely push Congress in a direction similar to HUD's proposal.

No Simple Formula

Complicating the task, Section 8 housing was developed utilizing a variety of financing methods. Properties are also found in a variety of market contexts and maintenance conditions. Consequently, there does not appear to be a single restructuring approach that could deal effectively with the entire portfolio.

About half of all Section 8 new construction and substantial rehabilitation units were financed with private mortgages insured by the FHA. About one-quarter were financed with State Housing Finance Agency (SHFA) mortgages, but only about 25 percent of those carry FHA insurance (some are privately insured). Another 10 percent were financed through municipal agencies utilizing tax-exempt bonding authority; it is not clear what percentage of them are federally insured. Some projects have subsidy contracts that run for the entire life of the mortgage but most do not.

Any write downs or foreclosures of mortgages carrying federal insurance would show up as claims against the FHA's insurance funds and would not necessarily injure mortgage or bond holders. However, marking-to-market rents in uninsured or privately insured projects could cause state and municipal finance agencies to default on bonds they have issued or to make large claims on private insurers. HUD officials and key legislators have recently indicated that they do not intend to mark down subsidy contracts for uninsured projects. Current HUD plans call for subjecting 906,000 housing units to the mark-to-market approach, including about 404,000 Section 8 new construction and substantial rehabilitation units, 403,000 Section 236/Below Market Interest Rate units with Loan Management Set-Asides (LMSA), and 99,000 other units, mostly 221(d)(4)'s with LMSA.

According to implementing legislation HUD has drafted, as contracts expire the agency would write down mortgages to a level consistent with the amount of debt that a project can carry at market rents. The remainder of the original mortgage amount, if FHA-insured, would be held by HUD as a non-amortizing second mortgage. HUD's current legal authority allows it to effect such recapitalizations only when it pays a full claim and takes control of the real estate; the agency is seeking legislative authority to restructure the debt without paying a full claim, and to encourage borrowers to voluntarily restructure prior to contract expiration. Moreover, under existing federal law, the debt forgiven would be treated as taxable income to the borrower. Legislation would be necessary to hold borrowers harmless in mark-to-market recapitalizations.

The majority of projects in HUD's assisted portfolio are unable to pay current debt at market rents, but are fundamentally sound and should survive with a restructuring of their

mortgages. In many respects, such projects would be least affected by the mark-to-market approach; decreased rental income would be offset by lower debt service payments. In cases where market rents exceed contract rents, projects would actually benefit from terminating subsidy contracts. They could refinance mortgages privately and charge the higher market rents. Still another portion of the portfolio would not be viable even if its entire debt burden were erased; market rents may not be sufficient to cover maintenance and operating costs. They will be foreclosed, and some even demolished.

Assuming that the deferred portions of the loans are not repaid, HUD estimates that the restructuring will result in partial payment claims on FHA of \$21,000 for the typical Section 8 new construction or substantial rehabilitation unit and \$9,000 per unit for other assisted properties. These losses would be more than offset by savings in rent subsidies, and HUD estimates that the restructuring will save at least \$6 billion on a present value basis. That savings would be generated appears to be confirmed by a recent study prepared on behalf of the Mortgage Bankers Association, the National Association of Home Builders and several other groups by Recapitalization Advisors, Inc. Analyzing the effects of the mark-to-market proposal on 450,000 Section 8 units where the subsidy contract is shorter than the FHA-insured mortgage term and contract rents are above market, the consultants estimated present discounted savings of \$13.7 billion from reduced subsidy levels compared to \$8.2 billion in losses for FHA's insurance fund.

Tenants in Motion

Central to the Administration's reinvention proposal is an intention to encourage better management of assisted housing by subjecting it to market forces. One element of that strategy is embodied in the plan to set rents at market levels. Another is the proposal to switch from project-based to tenant-based subsidies by giving eligible tenants portable housing certificates similar to the current Section 8 existing housing certificates.

The move toward tenant-based subsidies could have profound effects on some projects and their residents. Those that are poorly managed and maintained, or are located in highly undesirable areas, could be further undermined by an exodus of tenants. At the other end of the spectrum, projects in high-rent areas may be unaffordable even to tenants with Section 8 certificates, leading to their displacement in favor of higher-income tenants. (HUD proposes to give elderly tenants special vouchers that will allow them to pay more than the applicable FMR.) Projects in the middle tier may not be affected much in the short-term, as most tenants may elect and be able to remain in place. However, as normal turnover of tenants occurs, and others lose their eligibility as their income increases, the number of subsidized tenants in any given project will gradually dwindle.

Tenant-based subsidies have some policy appeal because they allow greater choice — tenants would have the mobility to seek out the best employment, educational and housing opportunities they could find. For the federal government there are other advantages: as individual recipients gradually leave the program (through higher incomes, death, etc.) the certificates would be subject to "recapture." HUD could then reissue the certificates to other eligible households or choose not to reissue them, thereby contracting program expenditures. Most project owners, of course, would prefer the predictability that project-based subsidies provide and they probably offer some administrative savings to the government as well.

Clearly, a major factor in assessing the impact on individual projects is the level at which the rents are set. The initial rent levels will not necessarily be the applicable Fair Market Rent; HUD intends to set rents at levels comparable to other assisted and unassisted housing in the market area. If the rent determination process yields the equivalent of prevailing "street rents," projects in low-income urban and rural areas may have difficulty meeting maintenance and operating expenses. Eventually all rents will be market-determined as attrition of subsidized tenants occurs.

Approximately 80 percent of households in HUD-assisted housing have incomes less than 60 percent of their area's median. Those living in projects that are still viable after restructuring, and where the market rent is equal to or less than the FMR, should not be adversely affected and may even benefit from the increased choice tenant-based subsidies provide. Low-income tenants in projects where market rents exceed the applicable FMR, however, would not be able to afford them and would be forced to find other housing. Ironically, such displacement would probably further concentrate the poor into low-income neighborhoods, negating one of the justifications for tenant-based subsidies. Tenants in extremely poor-quality housing that HUD forecloses and possibly demolishes will also be displaced, although many residents of such housing may welcome the opportunity to relocate. At any rate, as normal tenant turnover occurs in the formerly assisted stock, that housing may be lost as an affordable housing resource, depending on the market rents prevailing. Recapitalization Advisors Inc. estimates that

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City Budget

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will, however, attempt to fund it entirely with federal money beginning in FY99. Given HUD's uncertain future, that raises concerns about the long-term stability of the program's funding.

End of an Era

Where the budget cutbacks are most evident are in the city's efforts to rehabilitate vacant city-owned buildings and to engage in neighborhood-wide rebuilding projects.

Under the Mayor's budget proposal, the LISC/Enterprise program would receive no further funding while the Vacant Building Program will receive its final appropriation this year. These two programs were the workhorses of the city's massive effort to rehabilitate vacant in rem buildings. As the city's inventory of larger vacant buildings has been depleted, these programs have largely run their course. HPD will continue to fund the CityHome program, however, which is designed to recycle small vacant buildings.

The proposed cuts will have the greatest impact on specific neighborhoods previously slated for intensive public investment. These "neighborhood initiatives" were to include combinations of housing rehabilitation and new construction in geographically concentrated zones, including Melrose Commons in the Bronx, Bradhurst in Harlem, and Clinton on the west side of Manhattan. Most such projects will be stretched out or delayed, rather than abandoned. Funding for the Gateway Estates project in Brooklyn, a new construction project, is also to be delayed.

The Mayor's budget will also "zero out" the Mixed Income Rental program, which was to create rental apartments through new construction. Only one of the originally planned eight projects will be funded. The long-term capital plan includes funding for new rental housing beginning in FY2000, but such distant budgeting represents little more than the administration's acknowledgment that new rental construction would be desirable.

Of great concern to many in the housing community is funding for HPD's "preservation" programs, particularly Participation (PLP) and Article 8-A loans, which help to finance the rehabilitation and repair of privately-owned multiple dwellings. Concern has been increasing that a new wave of owner abandonment of economically distressed rental buildings is on the horizon, especially since the city's admission that it is no longer vesting tax-delinquent properties. Recognizing that the city cannot let that situation persist indefinitely, those involved in housing and community preservation are anxiously awaiting news of an alternative approach. If an alternative to in rem vesting is to have any housing preservation value, the PLP and 8-A loan programs can be expected to figure prominently. The administration's budget, however, offers little clue as to its thinking; the PLP program is maintained at prior-year levels and the 8-A loan program is slated for a modest cut. ■

Section 8

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53,000 households will be displaced in projects where market rents exceed FMRs and 117,000 in projects that cannot survive at market rent levels.

New York's Exposure

New York has a large inventory of Section 8 housing. There are approximately 50,000 Section 8 new construction and substantial rehabilitation units in the city, and about 63,000 state-wide. There are also about 15,000 LMSA units in the city.

The largest holders of Section 8 mortgages in the metropolitan area are the New York State Housing Finance Agency (HFA), which holds mortgages on approximately 10,600 units, and the New York City Housing Development Corporation (HDC), which has about 4,300 Section 8 units in its portfolio. The HFA reports that about 5,200 Section 8 units in its portfolio are not FHA insured, while almost all of HDC's are. Data developed by the Department of City Planning indicates that about 20 percent of the city's Section 8 stock is uninsured, and hence would not be affected according to HUD's current mark-to-market intentions.

New York's Section 8 assisted housing stock is generally of a high quality and that, combined with a tight rental market, suggests that there will not be a mass exodus of tenants from assisted housing. The rent-setting formula will be critical, however.

There are approximately 8,000 Section 8 new construction and substantial rehabilitation units in Manhattan south of 110th Street on the west side and 96th Street on the east side; virtually all of those apartments could probably command market rents in excess of the \$785/month FMR currently permitted for a two-bedroom unit (without utilities) under the Section 8 certificate program. Based on their distribution among the various communities, that may also be true of about half the units in Queens and one-quarter in Brooklyn, giving a total of about 15,000 city-wide. However, some of these units are not federally insured (and hence will not be affected), others have subsidy contracts that run for the full mortgage term, and still others are owned and managed by non-profit organizations which presumably would not seek to maximize rental income over what is needed to cover costs. Because there are no reliable tabulations according to these classifications, it is difficult to estimate the total number of tenants who would be vulnerable to displacement.

At the other extreme are projects in very low-income areas of the city where market rents are often insufficient to cover the maintenance and operating costs of housing. Some 10,000-15,000 units may be located in such market areas. It would be damaging to those projects to subject them to the same market rent levels that are currently producing disinvestment and abandonment of unassisted private buildings. ■