

**Testimony of Ira G. Peppercorn, Director, Office of Multifamily Housing**

**Assistance Restructuring, before the**

**Subcommittee On Housing and Transportation**

**United States Senate**

**August 5, 1999**

Mr. Chairman, Ranking Member Senator Kerry, and Members of the Subcommittee, my name is Ira Peppercorn and I am the Director of the Office of Multifamily Housing Assistance Restructuring (OMHAR) at the United States Department of Housing and Urban Development (HUD).

I am pleased to have the honor and privilege of testifying before you today on OMHAR's activities and progress. Late last year, I appeared before the full committee during my confirmation hearing. I believed then, and believe even more strongly now, that one of the greatest challenges facing this nation is how to provide decent, safe, and affordable housing for low-income families while not placing an unfair burden on American taxpayers. With a unified effort, I am confident that this challenge can be met.

More than twenty-five years ago, the Federal Government created what has become the largest rental housing subsidy program in the nation's history: Section 8.

Beginning in the mid-1970s, in an effort to spur the construction of affordable housing and encourage private owners to come into the program, the federal government offered high rental subsidies and entered into contracts with owners that called for automatic annual rent adjustments.

The Section 8 program now helps 3 million families around the country – in urban centers and rural communities, in high-rise apartments and developments designed for seniors and families – more than double the number of families assisted by the next largest federal housing program, public housing. About one-half of these subsidies are "project-based," i.e., tied to particular buildings, and the other half are "tenant-based,"

i.e., portable housing vouchers.

**The Problem**

Today, the Section 8 program is at a crossroad, facing a challenge that could threaten its viability for the next 25 years and beyond. Most of the Section 8 contracts that were signed that were signed when the program began were for twenty years. The mortgages insured by the Federal Housing Administration were typically 40-year mortgages. Over the past 20 years, subsidies on some properties escalated to far exceed rents for comparable apartments on the private market.

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When we looked at the implications nationally, we could see that without aIf there is no change in the way the project-based program is administered before fiscal year 2000, the new budget authority required annually to renew expiring project-based subsidy contracts would increase from the \$1.2 billion it cost in fiscal year 1997 to almost \$7.4 billion by fiscal year 2006.

Given the magnitude and import of the problem, it was clear that long-term, viable solutions could only be brought about through effective legislation that began to strike at the core issues.

There was bipartisan and widespread recognition of the fact Both Republicans and Democrats felt that something had to be done. Mack quote. And, wWhen Housing Secretary Andrew Cuomo characterized the problem of excessive rents as supported legislation that would both increase funding for Section 8 contract renewals and lower rents to owners, he said the problem of excessive rents constituted nothing short of an affordable housing crises for the nation,. Senator Connie Mack, a former chairman of this subcommittee and chief sponsor of the Mark-to-Mark legislation, agreed.

In Jacksonville, Florida, I recently toured a neighborhood where the federal government was paying six to seven hundred dollars, or more, for properties where most would agree that the rent should be significantly less. Right here in Washington, DC, the average HUD-subsidized rent is \$734, while the comparable unsubsidized apartment rents for only \$500.

"By lowering HUD rental subsidies on project-based Section 8 apartments to the same level as rents in the private market," Cuomo said, "HUD will stop wasting taxpayer dollars on ridiculously high subsidies."

Yet, if we simply cut rents, many owners would default on their mortgages. Default could mean an explosion of families with no place to go, devastating deterioration in impacted communities, loss of valuable affordable housing stock built at taxpayer expense, and multibillion dollar claims to the FHA insurance fund, which has over 50 billion dollars in multifamily investments.

In addition, we would run the risk of worsening the physical condition of these properties. Currently, it is estimated that approximately 15 percent of federally assisted multifamily housing projects are physically distressed., including a significant number that suffer from mismanagement.

At the current rate of Section 8 spending, taxpayers will save approximately \$1.6 billion over five years by cutting excessive subsidies so that private landlords receive rents from HUD that are more in line with prevailing market rents, and billions more in the years ahead, while preserving affordable housing for thousands of needy families.

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### **Congress Responds**

In 1997, after years of debate and experimentation, Congress passed the Multifamily Assisted Housing Reform and Affordability Act (MAHRA), which created the Office of Multifamily Housing Assistance Restructuring (OMHAR).

With the establishment of OMHAR, Congress for the first time addressed the physical, financial and social aspects of excessive rental subsidies in a comprehensive, balanced way.

It was Congress's decision at that time to create an entity within HUD, but that had some degree of separation, whose mission it was to take on the task, get it accomplished, then sunset.

The intent was to create an organization within HUD that could be market driven and. That could rely Relying upon innovative federal, state and local partnerships, but which would also have a strong oversight role and some degree of separation. This organization would work with its partners to and sound managerial practices, OMHAR has begun begin the difficult process of lowering rent subsidies to market rents for thousands of projects, restructuring debt, and and initiating the physical rehabilitation and repair of properties suffering from years of neglect. It would rely on market standards for establishing new rents, expense levels and rehabilitation needs. It was also Congress's decision at that once the organization's time to create an entity within HUD, but that had some degree of separation, whose mission wasit was to take on the task, get it accomplished, it wouldthen sunset.

Enacting the legislation that created OMHAR, however, was just the starting line. To get to the finish line, OMHAR would have to must balance the varying interests of owners, lenders and residents, while recognizing, and allowing for, differing social, economic, and political goals.

## Complex Challenges

This was, and is, a significantly complex challenge. Many competing interests, needs and goals have to be reconciled/balanced. First, the reality of the budget implications would have to be balanced against the need to be fair to the owners under the Section 8 program. Let me illustrate the complexity. Apartment owners participating in the Section 8 program believe they have been operating in good faith. Now, if they are not treated fairly, they fear the big hand of government coming in and hurting the businesses they have strived so hard to build. This could mean the potential of a loss of even more affordable housing. cutting their income. And any time you threaten to cut someone's income, there is real, legitimate fear. Other owners might stay in the program only because they felt they could not sell their apartments because of the possibility of facing significant income taxes, despite the Treasury Department's favorable revenue ruling, and might not be motivated to continued maintaining the properties in good shape. Still other owners could potentially go into financial default.

Many owners are concerned about having rents reduced that they now believe are fair, and about adjusting to a new, uncertain system. Owners who want to exit the program may want to sell their properties to others, including non-profits, and this raises the possibility of facing significant income taxes, despite the Treasury Department's favorable revenue ruling.

And there are other challenges as well. Another challenge is to balance the needs and rights of the owners with those of the tenants. Many tenants feel that they have not played enough of a role in the management of their developments or been afforded opportunities for ownership. Some tenants groups believed that this could change if they had access to information regarding their properties. Yet, if this was emphasized too strongly, some owners have stated that they would prefer not to participate in the program. At the same time, the interests of families living in subsidized housing have not always been a priority given today's competing political agendas and the fact that poor people lack political clout. And these problems are growing. According to a recent "State of the Cities" report issued by the Administration, the poverty rate in cities rose from 14.2 percent to 20.6 percent in 1995. Some tenants groups believed that this could change if they had access to information regarding their properties. Yet if this was emphasized too strongly, then some owners have stated they would prefer not to participate in the program.

A third challenge is in the legislation itself. The legislation emphasizes the social needs of preserving housing were emphasized along with the need to save money for the federal treasury. If the preservation side was emphasized too strongly and money was not saved, then there would be no need for the program and, in fact, the financial situation and budgetary pressures could worsen. But Yet if it was not emphasized strongly enough, then we would run the risk of the properties not being maintained well in the long term and would worsen the affordable housing stock.

Fourth, there was an inherent tension in of whether this new organization was going to be in or outside of the Department of Housing and Urban Development. There were those who argued

that putting it completely inside of HUD would doom it to failure. Yet there were others who believed that since both the FHA mortgages and the Section 8 funding were inside of the Department, that it was HUD's right and obligation to manage the restructuring effort. Moreover, significant management reforms over the past few years would help it to succeed.

What was created was a middle course, but the arguments of where it should be continue. Questions regarding OMHAR's relationship to HUD, the speed with which the organization has begun to carry out its mission, differentiating functions performed by OMHAR versus the commercial function that Congress intended to be performed by public and private vendors, and designing an effective management system for this dynamic new government/business model made our challenges greater.

Fifth, there was a need to balance the interests and needs of the federal taxpayer with the desire to move much of the work to other entities, primarily state and local housing finance agencies. On the one hand, if the federal government established rules and guidelines, there are somewhere those who would argue that we are too prescriptive. Yet others argued that if we do not establish a strict enough standard, then we will be certain to repeat the failures of other programs. This tension existed in the pricing of the restructuring services as well, with some arguing that we should pay these entities whatever they deemed reasonable and others arguing that fees should be set by the marketplace.

OMHAR also faced an immediate and novel administrative challenge. Created as a separate office within the Department, we were also imbued with some responsibilities and authority characteristic of independent agencies. Questions regarding OMHAR's relationship to HUD, the speed in which the organization has begun to carry out its mission, differentiating functions performed by OMHAR versus commercial function that Congress intended to be performed by public and private vendors, and designing an effective management system for this dynamic new government/business model made our challenges greater.

OMHAR represents a new approach to problem solving at all levels of government. Through Mark-to-Market, we're moving away from a federalized standard way of setting Section 8 rents to market-driven rents that are set at the local level, using comparables and more accurate, relevant information. It is about building a new system from the ground up and moving to real rents rather than ones based on theoretical formulas. It is about reaching out and forming partnerships with state, local, private and non-profit organizations across the country.

Within all of these challenges, though, exists a remarkable opportunity to put our affordable housing stock on a solid financial, physical and socially oriented footing. By steering a course through this sea of challenges, we have the opportunity to create significant reform in our nation's housing system.

When I testified last October, I noted that although tremendous progress had been made, from a regulatory and process standpoint, the key challenge was going to be operational. I still believe that today.

These challenges provide a remarkable opportunity to correct the mistakes of the past and modernize an essential part of our system of housing finance. I have traveled around the country and asked those who have met with us if they believe the current system for setting fair market rents is impartial and reflects the true market. The answer is virtually universal skepticism.

### **OMHAR Establishes New Model**

In order to accomplish this reform, we had to build the infrastructure for a new organization. Our goal and our direction has been to build a system that will work for all of the program's constituencies. One that will achieve a balance between the competing goals of preserving housing and saving money for the federal government, a balance between government oversight and free market innovation, a balance between the federal responsibilities and the local knowledge, and a balance between individual rights and collective responsibility.

When I had the honor of testifying before this committee last October, I noted that although tremendous progress had been made, from a regulatory and process standpoint, the key challenge was going to be operational. I still believe that today.

Our goal has been to act prudently and deliberately to build a rock solid foundation for the Mark-to-Market program, focusing our efforts in three areas: a consultative process to develop the regulations and operating procedures, creating the organization to guide the process, and engaging and overseeing the PAEs.

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There is also the opportunity to establish a new series of partnerships across the nation. Congress assessed the situation and determined that the Mark-to-Market program should not just be federally based, but should involve decentralized partnerships with organizations outside of the beltway, such as state and local housing finance agencies, who know their state and local markets. Agencies taking part in the effort are referred to as Participating Administrative Entities

(PAEs).

To build a consultative process, and to learn the lessons from the past, we reached out to an array of groups across the country. We met with property owners, mortgage bankers, residents and resident advocates, public organizations, financial organizations and a host of others. Beyond the public forums held in New York, Chicago, and San Francisco, which were required by law, HUD and OMHAR staff held 13 full-day meetings for the express purpose of soliciting input from a wide variety of national advocacy and trade groups in the preparation of the regulations and operating procedures.

This was duly noted in a October 1998 General Accounting Office (GAO) report, of xxxxxx, which statednoted that, "HUD... began a consultation process with representatives from a wide variety of national advocacy groups interested in HUD's implementation of the permanent Mark-to-Market program." , "

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In doing so, we not only learned about the needs and interests of the various groups, we also learned the lessons of the past. If there was a theme that surfaced over and over again it was that we shouldn't rush to do deals, that we should build the system properly, that we should resist the pressures to be too lax in our underwriting, and that we should make sure we have a structure for accountability.

That is exactly what we have been doing. We have acted in a deliberate, thoughtful and measured way, despite all of those who would want to know, "Is it done yet?" "How many deals have you done?" or "Why can't you move any faster?" To give in to this pressure in the face of what history has taught us, in the face of criticism from those who would then say that we said it was done before it was, and in the face of those who would have correctly asked if we had the right standards first, would have been the biggest mistake we could have made. A recent GAO report made reference to this innovative approach when it stated, "Because many of the functions necessary under the Mark-to-Market program will be carried out by the PAEs rather than by HUD, it will be particularly important for HUD to establish procedures ensuring that all the parties involved are carrying out their responsibilities in ways that meet the program's objectives and are in compliance with the program's requirements. To its credit, HUD has focused on developing oversight procedures prior to the program's implementatio

### **Establishing A New System**

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We have acted prudently and deliberately to build a rock solid foundation for the Mark-

to-Market program, focusing our efforts in three areas: a consultative process to develop the regulations and operating procedures, creating the staffing and offices for OMHAR, and engaging and overseeing the PAEs.

Despite the need to get all of the systems right on the front end, there has also been tremendous time pressure in order to ensure that we both preserve the housing and put this system on a solid financial and market oriented footing. In order for OHMAR to begin its work as quickly as possible, all of the key elements that would ensure the organization's success had to be accomplished at virtually the same time.

During the early months of our existence, we engaged in a broad, consultative process with groups from many different interest areas and many different parts of the country.

We sought input from other agencies and organizations, such as Fannie Mae, RTC, and private organizations that set up similar systems with both financial and human components.

Beyond the public forums held in New York, Chicago, and San Francisco, which were required by law, HUD and OMHAR staff held 13 full-day meetings for the express purpose of soliciting input from a wide variety of national advocacy and trade groups in the preparation of the regulations and operating procedures.

- Interim Regulations for the program were issued on September 11, 1998, and the Program Operating Procedures Guide was issued on April 19, 1999. Final regulations have been signed into clearance and are currently going through that process. In the meantime, we are operating under full legal authority with the interim regulations. are currently in the process of being reviewed and cleared.
- OMHAR has become physically established, first with our headquarters in Washington and, subsequently, with three field offices in New York, Chicago, and San Francisco. Our approach reflects the business model of locating key offices closest to the core number of properties to be restructured and our various constituencies.
- We created an administrative infrastructure to hire people was established that utilized many of the tools of the existing federal system, but which was to reach out and bring in the best talent from both the public and private sectors. As of July 31, 1999, almost two-thirds of our staff are either on-board or in the process of being hired. I'm enormously proud of the people with whom I have the honor of working – of their intelligence, commitment, and attitude of teamwork.
- Through a competitive bidding process, we have procured a variety of financial advisor and other contract support services to highly qualified, well-established firms. We brought in some of the nation's leading housing experts, including the person who literally "wrote the book" on Mark-to-Market. Following the strict conflict of interest standards placed on OMHAR by this body, we have placed our contractors under conflict of interest standards much higher than is required by most other federal agencies.

- ork. , bid out contracts, build our organization, and monitor and manage the entire process.

Setting up a new system within the federal government, with its personnel and procurement requirements, is not easily accomplished. However, we have made significant progress in developing a streamlined process that enables us to avoid delays in the future.

We have brought on dedicated, experienced national experts who are committed to OMHAR's mission and challenges. As of July 31, 1999, almost two-thirds of our staff are either on-board or in the process of being hired. I'm enormously proud of the people with whom I have the honor of working – of their intelligence, commitment, and attitude of teamwork.

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- We developed a contract, –called a portfolio restructuring agreement, – thatwhich would be the mechanism to create partnerships between OMHAR and the Participating Administrative Entities (PAEs).
- We have built an information system for managing the in-flow and restructuring status of properties, as well as for communicating with our partners. In this new "Internet" age, we have made use of the World Wide Web. As we develop information, such as procedures, forms, pocket guides, PAE best practices, informative brochures for the general public, tenants, and owners, or materials for our training sessions, we publish it on our Web page.

As the enclosed chart willth note, all of these accomplishments have taken place at virtually the same time and through the channel of the many challenges and conflicts we face.

## **PARTNERSHIPS**

b One of the most important aspects of the process has been the creation of viable partnerships with state and local housing finance agencies. We understand clearly that one of the goals of the statute was to partner with organizations who had the commitment to the success and growth of their communities. This has been one of our highest priorities.

We have reached out in innumerable ways to contract with state and local housing finance agencies around the country. Starting with the publication of a Request for Qualifications soliciting public and non-public PAEs on August 17, 1998, OMHAR beganproceeded to receive and review responses from potential PAEs in late 1998.

The next step in building Our approach foundation has been to engage PAEs, train them, assign assets to them, and develop internal controls for overseeing their progress.

We have reached out in innumerable ways to contract with state and local housing finance agencies around the country. Starting with the publication of a Request for Qualifications soliciting public and non-public PAEs on August 17, 1998, OMHAR proceeded to receive and review responses from potential PAEs in late 1998.

We engaged in extensive discussions negotiations with the state and local housing finance agencies from across the country on numerous panels, during on an extensive training program in January, during on National Council of State Housing Agencies and their members in eight full-day sessions induring March and April 1999 in route to developing a standard form contract and scope of work acceptable to all public PAEs, and during on meetings between OMHAR staff and individual HFAs. Since last April, OMHAR has been working to resolve state-specific compensation and legal issues.

### **Process is Working**

The process is clearly working. Partnership agreements have been signed between 29 PAEs, including 26 public agencies and 3 non-publics. OMHAR expects more PAEs to be engaged in the next few weeks.

Although the process we have used with the HFAs – to engage in dialogue, to listen to their concerns, to amend contracts to increase base and incentive fees, to expand reimbursable expense, to train, to work with their schedules – has taken time, we believe that it has been time well spent. I should also note that it was only toward s the end of this process that we began to see numbers of properties of any significant magnitude coming to us for restructuring. during this period no properties came in for restructuring.

The process is clearly working. Partnership agreements have been signed with 29 PAEs, including 26 public agencies and 3 non-publics. OMHAR expects more PAEs to be engaged in the next few weeks. We will do everything in our power to continue a constructive dialogue with potential public PAEs, but our mandate is to move forward with restructuring properties.

At the same time, however, we recognize that it may not always be possible to partner with state or local housing agencies. For example, there may be jurisdictions in which no public PAE elects to participate, particularly in cases where they lack the capacity to process high volumes of properties. Still others may be disqualified or have conflict of interest issues. When feasible and reasonable, every effort will be made to work with state HFAs.

In doing this, we have also created a system for monitoring and providing oversight of the PAEs, which includes appropriate internal controls and maintaining an appropriate balance between

government oversight and flexibility for PAE task completion. These controls provide for the centralized guidance and tracking needed for a decentralized national network of partners. OMHAR has created training, well- defined responsibilities, procedures and products, management support, and information systems.

We cannot emphasize this point strongly enough. We certainly could have taken the approach of giving little guidance and little oversight, yet the same GAO study mentioned above noted that:

"Because many of the functions necessary under the Mark-to-Market program will be carried out by the PAEs rather than by HUD, it will be particularly important for HUD to establish procedures ensuring that all the parties involved are carrying out their responsibilities in ways that meet the program's objectives and are in compliance with the program's requirements. To its credit, HUD has focused on developing oversight procedures prior to the program's implementation."

We have developed a strategic plan for monitoring and providing oversight of the PAEs, which includes appropriate internal controls and maintaining an appropriate balance between government oversight and flexibility for PAE task completion. These controls provide for the centralized guidance and tracking needed for a decentralized national network of partners. OMHAR has created training, well defined responsibilities, procedures and products, management support, and information systems.

We have built an information system for managing the inflow and restructuring status of properties, as well as for communicating with our partners. In this new "Internet" age, we have made use of the World Wide Web. As we develop information, such as procedures, forms, pocket guides, PAE best practices, informative brochures for the general public, tenants, and owners, or materials for our training sessions, we publish it on our Web page.

OMHAR's oversight of the PAEs will also will include internal controls to address conflict of interest issues. PAEs are required to submit conflict of interest statements before assets are assigned. OMHAR is also reviewing other, more complex, conflict issues. For example, the Mortgage Bankers Association has brought to OMHAR's attention the possible conflict that might arise when an HFA is asked by OMHAR to underwrite a transaction, on behalf of the federal government, and also chooses to act as a lender to provide financing for the same transaction from its own funds. This could alter the level playing field in the competition between private mortgage bankers and the PAE as a public lender.

With the foundation firmly in place, OMHAR is actively engaged in assigning assets to begin the restructuring process. More than 600 of the expected 3,000 (or greater) total properties that OMHAR expects to be restructured have been received by OMHAR. Two-thirds of these properties have been assigned to PAEs under contract with OMHAR.

## **Toward Tomorrow**

Over the next two years, as we carry out the business of bringing rents more in line with prevailing market levels and restructuring mortgages, we will focus on ensuring that the transactions go smoothly, and that they are done in the best interests of residents, owners, lenders, communities, and taxpayers. We will strive to ensure accountability amongst all parties, and we will make sure that we maintain proper oversight.

We also will continue to do what we have done all along – reach out to all stakeholders involved in an effort to make our services better, find new, creative and effective ways of preserving affordable housing, and keep the Congress informed of our progress.

No house can be built without a foundation; no road without and infrastructure. That is why we have taken the time to build the system right. To bring on good people, to create and information system, to establish guidelines, to develop a monitoring and oversight system, and to perform a host of other duties that are essential to creating a high- quality organization.

We have done this in an environment of competing challenges and conflicts. As I have noted earlier, there are many. We will continue to look for ways to fix andy continue to improve what has been created. We will find ways to make the system work as good as it possibly can. We have learned from the mistakes of the past and know that we have to be fair, yet firm. For we are managing with the public trust.

Now the real work begins. Now we must put into place the plan that Congress established – putting our assisted housing stock on a stable, market- oriented footing.

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Closing themes:

1. tremendous challenge met  
setting conflict of interest standards oversight  
protecting the system
2. reasonable price to govt.
3. moving program forward  
pricehg