CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

September 7, 2001

S. 1254
Mark-to-Market Extension Act of 2001

As reported by the Senate Committee on Banking, Housing, and Urban Affairs on August 1, 2001

SUMMARY

S. 1254 would make several substantive changes to the Multifamily Assisted Housing Restructuring and Affordability Act of 1997 (MAHRA) and extend it for five years beyond its current expiration date of September 30, 2001. That law authorizes the so-called mark-to-market approach for renewing Section 8 Housing Assistance Payment (HAP) contracts and for the restructuring of certain mortgages insured by the Federal Housing Administration (FHA). Under the mark-to-market approach, HAP contracts are renewed at market rents for FHA-insured projects that currently receive above-market rents and, if necessary, the mortgages for those projects are written down to levels that could be supported by the lower rents. S. 1254 also would require the General Accounting Office (GAO) to report on the status of mark-to-market activities over the next five years.

CBO estimates that enacting S. 1254 would prevent some projects from defaulting on FHA-insured mortgages and thus reduce direct spending by $319 million over the 2002-2006 period. Because the bill would affect direct spending, pay-as-you-go procedures would apply. We also estimate that implementing S. 1254 would reduce discretionary spending by $106 million over the 2002-2006 period, assuming that future appropriations are reduced to reflect the lower costs of Section 8 contracts.

S. 1254 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA). Reauthorization of the mark-to-market program would extend cooperative agreements between the Department of Housing and Urban Development (HUD) and participating state and local agencies, and any costs incurred by those agencies as part of the agreements would be voluntary.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of S. 1254 is shown in the following table. The costs of this legislation would fall within budget functions 370 (mortgage and housing credit) and 600 (income security). For this estimate, CBO assumes that the legislation will be enacted early in fiscal year 2002 and that the necessary amounts will be appropriated each fiscal year. Outlay estimates are based on historical spending patterns associated with the mark-to-market program.

ESTIMATED BUDGETARY EFFECTS OF S. 1254

	By Fiscal Year, in Millions of Dollars					
	2001	2002	2003	2004	2005	2006
DIRECT SPENDING						
FHA Multifamily Mortgage Insurance Fund						
Spending Under Current Law						
Estimated Budget Authority	645	2,546	1,826	883	312	134
Estimated Outlays	645	2,546	1,826	883	312	134
Proposed Changes						
Estimated Budget Authority	0	-313	0	0	0	0
Estimated Outlays	0	-313	0	0	0	0
Proposed Spending Under S. 1254						
Estimated Budget Authority	645	2,233	1,826	883	312	134
Estimated Outlays	645	2,233	1,826	883	312	134
Section 8 Contracts						
Spending Under Current Law						
Estimated Budget Authority	0	0	0	0	0	0
Estimated Outlays	4,390	3,933	3,460	3,039	2,817	2,715
Proposed Changes						
Estimated Budget Authority	0	0	0	0	0	0
Estimated Outlays	0	-1	-2	-2	-1	0
Proposed Spending Under S. 1254						
Estimated Budget Authority	0	0	0	0	0	0
Estimated Outlays	4,390	3,932	3,458	3,037	2,816	2,715
Total Changes in Direct Spending						
Estimated Budget Authority	0	-313	0	0	0	0
Estimated Outlays	0	-314	-2	-2	-1	0

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	By Fiscal Year, in Millions of Dollars					
	2001	2002	2003	2004	2005	2006
SPENDING SUBJECT TO APPROPRIATION						
Spending Under Current Law						
Estimated Authorization Level [a]	12,105	16,165	17,110	17,761	18,271	18,753
Estimated Outlays	16,515	17,525	18,265	18,620	19,094	19,603
Proposed Changes						
Administrative Expenses						
Estimated Authorization Level	0	24	24	18	15	10
Estimated Outlays	0	23	24	18	15	10
GAO Reports						
Estimated Authorization Level	0	1	1	1	1	1
Estimated Outlays	0	1	1	1	1	1
Section 8 Contracts						
Estimated Authorization Level	0	-37	-67	-58	-32	-13
Estimated Outlays	0	-36	-65	-56	-31	-13
Proposed Spending Under S. 1254						
Estimated Authorization Level	12,105	16,153	17,068	17,722	18,255	18,751
Estimated Outlays	16,515	17,513	18,225	18,583	19,079	19,601

a. The amount shown for 2001 is the amount appropriated for the housing certificate fund and administrative expenses in that year. The 2002-2006 levels are CBO baseline projections, assuming adjustments for anticipated inflation and the renewal of all units.

BASIS OF ESTIMATE

CBO estimates that enacting S. 1254 would reduce direct spending by a total of $319 million over the 2002-2006 period. Such savings would result principally from avoiding some of the defaults on FHA-insured mortgages that are anticipated under current law. Those estimated FHA savings would be reflected in the budget on a present-value basis as "loan modifications" under the provisions of the Federal Credit Reform Act, which establishes present-value accounting for federal loan programs.

Subject to the availability of appropriations, CBO estimates that implementing S. 1254 would cost a total of $95 million over the 2002-2006 period to support the continuation of the Office of Multifamily Housing Assistance Restructuring's (OMHAR's) mark-to-market activities under the five-year extension of MAHRA, and to fund GAO reports on the status of mark-to-market activities. CBO also estimates that implementing S. 1254 would result in savings of $201 million over the next five years from the reduction of HAP contract rents to market levels, assuming that appropriations are reduced accordingly. Thus, CBO estimates that implementing this bill would reduce discretionary spending by $106 million over the 2002-2006 period.

Background

In 1997, MAHRA was enacted to address financial problems in the Section 8 program for affordable housing assistance. At that time, over 4,000 multifamily projects with FHA-insured mortgages were receiving project-based rent subsidies under Section 8 of the United States Housing Act of 1937. The majority of these projects had units with rents that exceeded those for comparable unassisted units. The original HAP contracts attached to these projects were written for periods typically ranging from 15 to 40 years—mostly expiring over the 1998-2004 period. However, HUD no longer had the authority to renew these contracts at more than 120 percent of the fair market rent except under certain circumstances. Consequently, few of these projects would have remained financially viable when their rental income was reduced to market rates. With reduced rents, such projects would have been expected to default on their mortgages, generating large losses to the FHA insurance fund and possibly displacing many tenants in these projects.

The mark-to-market process usually involves reducing a project's rents to market levels and then either modifying or refinancing the existing mortgage at an amount that could be supported by the new market rents (this process is often referred to as a "full" restructuring). Specifically, FHA prepays all or a portion of the owner's existing mortgage debt through a partial payment of claims (PPC) and then takes back a second mortgage, and in some cases a third mortgage, to recover some of the PPC. In some instances, though, only a property's rent is reduced to market levels; this type of restructuring (referred to as a "lite" restructuring) usually occurs when the project is physically and financially sound enough to operate at market-level rents with its existing mortgage. When MAHRA expires, HUD will still be required to renew HAP contracts at market levels, but the authority to restructure mortgage debt will no longer be available for projects that have yet to enter the mark-to-market program. Without that authority, many projects would enter into default after rents are reduced to market levels.

Direct Spending

CBO estimates that enacting S. 1254 will result in savings principally by avoiding defaults on FHA-insured multifamily mortgages that otherwise would occur under current law. We expect that a small amount of savings also would occur because rents will be reduced prior to HAP contract expiration for a small number of projects.

Avoiding FHA Multifamily Defaults through Mark-to-Market. Based on information from OMHAR, CBO estimates that by the end of fiscal year 2001, about 1,730 projects will have undergone or will be in the process of undergoing some form of mark-to-market restructuring. By enacting S. 1254, CBO estimates that an additional 840 properties with FHA-insured mortgages would have their mortgage debt restructured. The majority of these mortgage debt restructurings would result in savings to the FHA insurance fund. However, some of these restructurings would contribute to increased costs because they would be associated with projects that are not expected to default. On balance, CBO estimates that enacting S. 1254 would result in net savings of $313 million in 2002.

Number of Projects that would be Restructured under S. 1254. Restructuring the majority of these 840 projects would stem from the simple five-year extension of the mark-to-market authority. Because there is relatively little incentive for owners to begin the mark-to-market process prior to the expiration of their HAP contracts, we estimate that only about 30 of the 840 projects will have their mortgage debt restructured prior to their HAP contract expiration date. Restructuring those projects will not only result in savings to FHA (by avoiding defaults), but also result in savings to existing HAP contracts (these savings are explained in the next section).

Based on information from OMHAR, CBO estimates that about 100 of the 840 estimated restructurings would occur because of several substantive amendments S. 1254 would make to the mark-to-market program. These include:

- About 30 restructurings would stem from the provision in the bill that would permit projects under HUD's preservation programs to undergo mortgage restructurings. Currently such properties are excluded from the mark-to-market process.

- About 30 restructurings would stem from the provision in the bill that would allow projects that have already completed rent restructurings (so called "lite" restructurings) to apply for a full mortgage debt restructuring. In most cases, MAHRA currently terminates a project's eligibility for a "full" restructuring after it has completed a "lite" restructuring.

- About 20 restructurings would stem from the provision that would limit an owner's contribution for certain large cost rehabilitation requirements to no more than 25 percent of rehabilitation costs. Limiting the required contribution for these items, such as air conditioning, may make full restructuring more attractive to owners that otherwise would opt for rent restructuring only.

- The remaining restructurings would stem from the provision that would require HUD to produce the rent comparability studies. These studies, which owners are currently required to conduct, are the basis for determining mark-to-market eligibility. CBO expects that transferring this responsibility to HUD would increase the number of projects that enter the program.

Savings from Mortgage Debt Restructuring. Based on a review of financial information on over 4,000 projects, including projects that have defaulted on FHA-insured mortgages as well as projects for which mortgage restructurings have been completed, CBO estimates that the cost of restructuring mortgage debt is less expensive than the cost of default by about $1 million per project, on average. Our analysis indicates that over several years defaulted projects cost the FHA insurance fund an average of $2 million per project, while restructured projects have cost the FHA insurance fund an average of $1 million each since the program began operations in 1999. Included in the costs of defaults are the payments covering the remaining balance on the mortgage (about $1.3 million per project), and the expenses of maintaining and preparing the property for sale (about $600,000 per project). These estimates reflect the fact that two out of three projects that have defaulted since 1985 were eventually sold for $10 or less.

The cost of restructuring mortgage debt includes the payment covering the remaining balance on the mortgage (an estimated 80 percent of the loan's unpaid balance or about $1 million per project), the fees paid to the public or private organization that assists OMHAR with mark-to-market activities (about $50,000 per project), and the FHA subsidy cost associated with guaranteeing the new first mortgage ($30,000 per project), less the present value of expected receipts from repayments on the second mortgage ($200,000 per project). Because properties that are projected to be restructured in the 2002-2006 period have unpaid mortgage balances that are significantly higher than the historical average, CBO has adjusted the historical averages proportionately to estimate future savings. Also, CBO has increased the expected receipts from repayments on the second mortgage by about $30,000 per project to reflect a provision in S. 1254 that would remove some constraints on the size of the second mortgage, resulting in increased repayments.

The additional restructurings that could occur under S. 1254 would, on balance, reduce the cost to the FHA insurance fund over the remaining life of the affected loan guarantees. If the mark-to-market program ends—as under current law—CBO assumes, based on discussions with HUD and OMHAR, that about 480 of the 840 projects whose mortgages have not yet been restructured would default. The remaining 360 projects are assumed to either be sustainable at market rents or would not have rents reduced to market in the near future. For these projects that are not expected to default, enacting this bill would result in restructuring costs only.

Included in these 360 projects that are not expected to default are the majority of the 100 projects that would undergo mortgage debt restructurings as a result of the amendments S. 1254 would make to the mark-to-market program. Many of these amendments would result in "full" restructurings for properties that are not expected to default. Without this legislation, such properties would either not enter the mark-to-market program or would opt for a rent restructuring only. As a result, CBO estimates that over one-half of the 100 additional "full" restructurings attributed to these amendments would actually increase costs to the FHA insurance fund, reducing overall estimated savings.

Because enacting S. 1254 would change the expected cash flows associated with the FHA multifamily loan guarantee program, this legislation is considered to be a modification of existing federal loan guarantees. Under credit reform procedures, the costs of a loan modification are estimated on a net present value basis in the year in which the legislation is enacted. Assuming that the bill is enacted early in fiscal year 2002, CBO estimates savings of $313 million in that year.

Reduction in Rents for Units Subject to Mortgage Restructuring. CBO expects that under the bill, some projects would have their mortgages restructured prior to the expiration of their HAP contracts. This would result in savings from funds that have already been appropriated for housing assistance payments. Under the existing mark-to-market authority, only a small number of project owners had their mortgages restructured prior to the expiration of their HAP contracts. Because CBO anticipates similar behavior over the next five years, we estimate that about 30 of the 840 projects will have their rents reduced and mortgage debt restructured prior to their HAP contract expiration. CBO estimates that the average savings would amount to roughly $200,000 per project, resulting in a total estimated savings of $6 million over the next five years.

Spending Subject to Appropriation

Office of Multifamily Housing Assistance Restructuring. CBO estimates that OMHAR would incur costs of $90 million over the 2002-2006 period, subject to the availability of appropriations, to continue its mark-to-market activities for an additional five years. Such funding would cover costs associated with the salaries and expenses of OMHAR personnel and contractor support. CBO estimates that OMHAR would require appropriations of $24 million in each of fiscal years 2002 and 2003. By fiscal year 2004, however, CBO predicts that the number of mortgage restructurings would begin to decline. Consequently, we estimate that OMHAR would require appropriations of only $18 million in fiscal year 2004, $15 million in fiscal year 2005, and $10 million in fiscal year 2006.

GAO Reports. CBO estimates that it would cost GAO about $5 million over the 2002-2006 period, subject to the availability of appropriated funds, to provide five reports (four annual reports and one final report) to Congress on the activities conducted under MAHRA's five-year extension. Based on information from GAO, CBO estimates that each report would cost about $1 million to produce.

Section 8 Rental Assistance. CBO estimates that by extending MAHRA through 2006, the transition to market rents for projects with expiring HAP contracts would occur at a faster pace than expected under current law. CBO estimates that implementing the bill would result in discretionary savings of $36 million in 2002 and $201 million over the 2002-2006 period, assuming that appropriations are reduced to reflect the lower cost of the HAP contracts.

Information provided by HUD indicates that those properties estimated to have above-market rents that were not assigned to OMHAR for restructuring over the last few years had their rents increased, on average, by the rate of inflation at their first HAP contract renewal. In contrast, those projects that were assigned to OMHAR for restructuring over the same time period had average rent reductions of 13 percent. CBO estimates that this trend in rent determination is an indication that OMHAR would reduce rents to market levels more rapidly than would be expected under current law.

PAY-AS-YOU-GO CONSIDERATIONS

The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. The net changes in outlays that are subject to pay-as-you-go procedures are shown in the following table. For the purposes of enforcing pay-as-you-go procedures, only the effects in the current year, the budget year, and the succeeding four years are counted.

	By Fiscal Year, in Millions of Dollars										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Changes in outlays	0	-314	-2	-2	-1	0	0	0	0	0	0
Changes in receipts	Not applicable										

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

S. 1254 contains no intergovernmental or private-sector mandates as defined in UMRA. Reauthorization of the mark-to-market program would extend cooperative agreements between HUD and participating state and local agencies, and any costs incurred by those agencies as part of the agreements would be voluntary.

PREVIOUS CBO ESTIMATE

On August 23, 2001, CBO transmitted a cost estimate for H.R. 2589, the Office of Multifamily Housing Assistance Restructuring Act of 2001, as ordered reported by the House Committee on Financial Services on July 25, 2001. H.R. 2589 would reauthorize MAHRA for the next three years while S. 1254 would provide for a five-year extension (2002 through 2006) and would make several substantive changes to the mark-to-market program. Consequently, CBO estimates that 840 mortgage debt restructurings would occur under S. 1254, reducing direct spending by $319 million and reducing discretionary spending by $105 million (assuming future appropriations are reduced accordingly) over the next five years.

In contrast, CBO estimates that enacting H.R. 2589 would result in 680 mortgage debt restructurings, reducing direct spending by $307 million and reducing discretionary spending by $114 million over the 2002-2006 period.

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