LOCAL INITIATIVES SUPPORT CORPORATION

Recapitalizing Affordable Rental Housing:

A Handbook for Nonprofit Owners

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LOCAL INITIATIVES SUPPORT CORPORATION

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Foreword

Thousands of aging affordable rental properties need some form of recapitalization to remain viable. Many of these are either already owned by nonprofit organizations, or are only likely to continue as affordable housing if they are acquired by nonprofits. Yet many of these nonprofit organizations are single-purpose entities whose sole asset is the property itself. These groups have asset management experience limited to this single property and may find it challenging even to assess the capital needs of their aging building, much less address the complex regulatory, financial, and architectural issues involved in a comprehensive building recapitalization. Even for larger groups with more diverse assets, the prospect of taking on a major building rehabilitation can be overwhelming, and there is always temptation to put off the beginning of such a bewildering and unpredictable process until another day.

Most recapitalization efforts are undertaken because the property needs repairs to remain safe, economical to operate, and competitive in the marketplace. But owners undertaking building rehabilitation also have an opportunity to improve energy efficiency, create healthier living spaces, and choose building materials that are produced in a more environmentally sound manner. Multifamily buildings are, by design, likely to be more efficient in their consumption of energy, water, building materials, and land. Although energy efficiency, healthy buildings, and renewable materials are not the primary focus of this guide, more and more building owners are making "green" building a central part of their recapitalization efforts, and many are finding it not only affordable, but cost-effective.

This guide is intended for nonprofit owners of affordable rental housing who need to recapitalize their properties, or who are contemplating the purchase and rehabilitation of existing affordable rental housing. There are other guides covering the technical issues surrounding the purchase and extension of subsidies for affordable rental buildings, such as LISC's *Stemming the Tide*. There are also numerous guides on building inspections, construction, and property management. This guide is unique in that it is written specifically for the nonprofit practitioner and combines many of the technical elements of assisted affordable housing preservation, along with an in-depth look at assessing physical needs. As such, this publication is intended to expand on *Stemming the Tide* and therefore presumes a working knowledge of the technical material in that publication.

The first chapter of this guide starts with a broad assessment of the recapitalization strategy, with a particular look at why and how a nonprofit can contemplate working with other partners. Chapter Two looks at issues particular to the process of renewing project-based Section 8 contract assistance,

which is a critical resource for many affordable rental properties. In Chapter Three we consider the issues particular to HUD Section 202 Elderly Multifamily Properties, including refinancing existing HUD mortgages and the use of tax credits. Chapter Four summarizes the different types and relative merits of financial resources available for recapitalizing projects. Chapter Five provides an in-depth discussion of capital needs assessments (CNAs), including what should be covered and how to get the most out of your CNA consultant. The final chapter provides guidance on a number of special regulatory issues that can help to shape the project strategy.

The task of preserving affordable rental housing is critical in many communities and to many families and individuals. LISC hopes that this guide will help nonprofit groups prepare to meet that challenge.

Vincent F. O'Donnell
Vice President of Preservation
Local Initiatives Support Corporation
June, 2005

CHAPTER ONE

Recapitalization Strategy

Bart Lloyd

Defining a recapitalization strategy for a nonprofit-controlled affordable housing development begins with asking three distinct questions. First, what is the nature of federal assistance and the ownership structure of the project? Second, what is the scope of the project's physical and rehabilitative needs? And third, what internal competencies and long-term goals does the nonprofit bring to the recapitalization effort? While each of these questions raises distinct sets of issues, there are also some overlapping considerations that inform and complicate the analysis.

Each of these questions contains elements and issues that limit the options for how to proceed. For some projects, the requirements of the original assistance program will limit the choices available. For example, Section 8 assisted Moderate Rehabilitation projects are not eligible for Low Income Housing Tax Credits unless they abandon the project-based Section 8 assistance, and projects whose original mortgages are not prepayable will have difficulty accessing private activity tax exempt bonds and the four percent Low Income Housing Tax Credits that accompany them. For others, the rehabilitation needs of the project will be determinative: a project with significant rehabilitation needs will often have to access Low Income Housing Tax Credits in order to obtain sufficient renovation funding; a project with very few physical needs will often be able to raise adequate capital simply by refinancing existing debt. And sometimes the ability or the inclination of the organization to access different recapitalization programs will drive the strategy. A small nonprofit with a single project may not want to complicate its relationship to the project by accessing a program that requires a for-profit partner. On the other hand, a nonprofit intent on expanding its mission or mandate may want to utilize Low Income Housing Tax Credits on its flagship project as an experiential stepping stone to embarking on other projects. Further complication arises from the unique resources and at times idiosyncratic approaches different states apply to providing affordable housing resources.

Finding the right strategy for the project and the organization will entail both an inward and an outward analysis. An inward look to the project and the organization can clarify strengths, resources and needs. Looking outward to the landscape of available resources can reveal what is available to accomplish both the project's needs and the organization's goals.

Types of Federally Assisted Housing

Four types of federally assisted affordable housing projects are covered by this handbook: those financed with Section 221(d)(3) Below Market Interest Rate (BMIR) HUD insured loans; Section 236 HUD assisted loans; projects developed or redeveloped as Section 8 New Construction, Substantial Rehabilitation or Moderate Rehabilitation projects (some of which were financed with HUD 221(d)(4) mortgage insurance and others by state and local housing finance agencies or private lenders without HUD insurance); and Section 202 HUD assisted elderly projects. In addition, several complicating subsequent programs, which if applicable to a particular project will often affect recapitalization strategy, were established by HUD to address later-developing issues: the Section 8 Loan Management Set-Aside (LMSA) program and the Flexible Subsidy program were developed in the late 1970s to address increasing defaults arising from market and affordability issues; and the ELIHPA and LIHPRHA preservation programs were established in the early 1990s by HUD to address a concern that prepayments and program opt-outs by owners would result in a significant loss of the affordable housing inventory. While a summary of the historical context of each these HUD programs is set forth in LISC's earlier guide *Stemming The Tide: A Handbook on Preserving Subsidized Multifamily Housing*, a short

summary of each of the basic four follows. The complicating subsequent programs are discussed in Chapter 6.

The Section 221(d)(3) BMIR program provided a HUD insured below market interest rate loan (generally at three percent) and, in some cases, subsequent Section 8 LMSA assistance to a private owner to encourage the development and operation of affordable rental housing. The program began in the early 1960s and was eventually supplanted and replaced by the Section 236 program.

The Section 236 program was established in 1968 and was HUD's primary housing production program over the next 5 years, with some approved projects completed after 1973. It assisted both nonprofit and for-profit owners, providing an interest reduction payment (IRP) to the mortgagee to cover the cost between the market interest rate on the mortgage and the project's payment on a hypothetical mortgage at one percent, as well as Rent Supplement assistance or Section 8 assistance for eligible tenants. Most early projects had Rent Supplement assistance (later converted to Section 8) for 20 percent to 40 percent of the project's tenants. Later Section 236 projects, as well as projects that developed financial problems, received additional Section 8 and, in some cases, Rental Assistance Payments (RAP). The Section 236 program subsidized both HUD insured and state agency financed (non-insured) projects.

Section 8 project-based assistance was provided to housing constructed under the new construction/ substantial rehab programs from 1974 through the mid 1980s, and to housing renovated under the moderate rehabilitation program in the 1980s. The programs assisted housing financed by state and local finance agencies as well as privately financed HUD housing insured under Section 221(d)(4). Many nonprofit-sponsored projects utilized the tax benefits of accelerated depreciation through equity syndication by structuring limited partnership ownership entities with nonprofits either as general partners or special limited partner sponsors, and with individuals as the limited partners.

The Section 202 program was created in 1959 and provided direct government loans or grants to nonprofits to develop housing for the elderly and handicapped. In 1990 the program financing was converted from direct government loans and Section 8 assistance (which was added in the late 1970s) to capital grants and project rental assistance contracts (PRAC). While many of the issues discussed in this handbook will apply to Section 202 recapitalizations (especially, but not limited to, projects that were financed prior to 1990), there are many issues that are unique to Section 202 recapitalization issues, and are discussed in Chapter 3.

Project Needs and Possibilities

Taking stock of the project's needs and possibilities requires reviewing the agreements and structure under which the project was originally developed, evaluating the physical condition of the project, and assessing the federal and state programs available for recapitalization and the organization's particular approach to these resources. Some of the important issues to consider in that review are summarized below.

Existing Partner Motivations and Requirements

Nonprofit-sponsored projects that were developed with equity syndication from the mid 1970s through the mid 1980s under HUD and state programs with individuals as limited partners have likely exhausted all of the tax benefits that originally induced the partners to invest. In many cases, the partnership is now detrimentally affecting the partners because it is generating taxable "phantom income" gains (because increasingly substantial principal payments made under the mortgage are not deductible for tax purposes as expenses). Conversely, as projects approach the maturation of the mortgage and the end of the project's use restrictions, the potential residual value of the project becomes significant to the partners. While the problem of phantom income will increase over time, so may the prospect of a significant future reward. Accordingly, some partners may be interested primarily in terminating the investment and the phantom income, while others may have expectations of significant gains. One approach that helps determine which of the camps a project's partners are in is to solicit the interests of the limited partners in selling (or making a charitable donation of) their limited partner interests. Alternatively, the partnership agreement's disposition provisions should be reviewed carefully.

The general partner has a fiduciary obligation to the limited partners to obtain a commercially reasonable price for the project. To the extent limited partner consent is required, some require affirmative consent of the limited partners, while others provide for deemed consent (upon notice to the partner, a failure to object within a particular time period will be deemed to be consent). Projects that are close to the end of their restrictions, with significant potential gain and a

requirement of affirmative consent for disposition from the limited partners, can create a troubling dynamic. The ability to obtain consent to a disposition at a price that is discounted to reflect the existing use restrictions and the preservation of the project as affordable housing is increasingly difficult as one approaches the end of the restrictions. An additional consideration is one of timing: assembling resources and obtaining funding approval can be a drawn out process. Sponsors should take care to ensure that the limited partner's consent provides sufficient time to obtain the resources and accomplish the recapitalization, in particular where a project contemplates applying for nine percent Tax Credits or other competitively allocated resources that may take more than one funding round in order to be to be successful.

Prepayment Prohibitions and Rights

Sponsors should review carefully both the mortgage program under which the project was built and any subsequent financing the project obtained, as either or both may contain a prohibition of the right to prepay the original project mortgage, which will significantly affect the range of the project's recapitalization possibilities. Some prepayment requirements for HUD programs are discussed in Chapter 6. For projects with state and local financing, the issue is state-specific: some housing finance agencies and local public lenders prohibit prepayment in almost all circumstances, while others actively promote prepayments that result in affordable housing preservation.

Tenant Protections

Sponsors should also carefully evaluate the effect of any recapitalization on tenants that do not have Section 8 assistance. The Low Income Housing Tax Credit program provides development subsidies to projects in exchange for affordable rents for tenants at either 50 percent or 60 percent of area median income. This is neither as deep nor as individually tailored a subsidy as the Section 8 program (see Chapter 4). In most prepayments of Section 236 or Section 221(d)(3) BMIR projects (notably excluding nonprofit-sponsored projects – see Chapter 6 for additional discussion), most current tenants who are income eligible and do not have Section 8 assistance will receive enhanced Section 8 vouchers to protect them from rent increases. Over time, these tenants will leave and be replaced by a next generation of tenants that may not have Section 8 vouchers. In partially-assisted Section 236 de-coupling recapitalizations, HUD has approved waivers to allow the decoupled IRP to be allocated disproportionately to the units without Section 8 assistance while the Section 8 rents are marked up to budget (not to exceed market), thereby preserving additional affordability. In projects either currently or prospectively without Section 8 assistance, sponsors should carefully evaluate the demand for apartments affordable to tenants at 50 percent of median income or 60 percent of median income, as the band of tenants with qualifying incomes can be quite narrow. In many areas, the market rents are below the rents that appear affordable to families at 50 percent and 60 percent median incomes.

REAC Scores and Physical Needs

A project's Real Estate Assessment Center (REAC) scores, assigned after a HUD-sponsored physical inspection, are good first indicators of potential problems and a need for a recapitalization. REAC scores below 60 are referred to HUD's Enforcement Center for correction, and recurring REAC scores below 60 can lead to foreclosure and removal of the owner. In order to develop a recapitalization strategy, however, a capital needs study is warranted. The REAC report focuses largely (although not exclusively) on safety elements, while the capital needs study provides a broader review of the current status of all of the project's physical elements, and the likely costs of repair and replacing them in the future. This report, prepared generally by an architectural or an engineering firm, serves as the basis for establishing a long-term plan to address the physical needs of the project. Chapter 5 provides a detailed discussion of the important aspects of commissioning and reviewing capital needs studies.

State and Local Programs and Resources

Sponsors should review the potential resources available in the state and locality in which the project is located. Examples of available programs in selected states are outlined in the Appendix.

To Partner or Not to Partner

A threshold consideration for nonprofits with projects that need renovation and/or recapitalization is how the recapitalization program may affect their relationship to the project. As described in Chapter 4, for some sponsors the recapitalization of an existing nonprofit owned project can be completed comparatively simply with a refinancing of existing debt and locally available grant funds. When these sources alone are sufficient, the nonprofit's relationship to the project need not be more complicated than possibly engaging the assistance of an outside consultant who knows the applicable programs to make sure it gets done promptly and effectively.

In many cases, however, access to existing tax-driven recapitalization resources (primarily, but not exclusively, the Low Income Housing Tax Credit authorized under Section 42 of the Internal Revenue Code and described in Chapter 6) will be the primary feasible resource. Access to that resource will require the nonprofit to both create a partnership with a for-profit entity that can utilize the tax benefits and embark on a journey into an idiosyncratic and complex regulatory world that may have significant differences from the regulatory scheme under which the project was originally developed. Both issues should be duly considered by the nonprofit's board of directors, as they can have significant and long lasting effects on the organization's relationship to the project.

Maintaining the core mission of the nonprofit while undertaking a tax credit-driven recapitalization with a for-profit partner providing recapitalization funds in return for tax benefits can in many cases be a delicate balance. Typically, the nonprofit creates a new wholly-owned subsidiary (or affiliated) corporation, which it designates as the general partner of the partnership. The for-profit partner buys the limited partner interest in the partnership. The new tax credit partnership will then purchase the property from the existing nonprofit (or nonprofit controlled) owner. The for-profit limited partner provides investment in exchange for tax benefits, and would like someone amongst the development team to be contractually responsible in the event those benefits do not materialize. To the extent the nonprofit accepts this responsibility and thereby risks funds that would otherwise be available for nonprofit mission purposes, it can lead to potential conflicts.

In the tax credit partnership this issue surfaces in two somewhat distinct elements of the transaction: the guarantees to be provided by the parent nonprofit to the limited partner of the partnership; and in the obligations of the general partner to the partnership as a whole. Many for-profit partners will ask the nonprofit sponsor to contractually guarantee that the project: will qualify for tax credits; will be renovated with the funds available; will be completed and placed in service within the timeframe contemplated; will be occupied by qualifying tenants; and its operations over the next 15 years will be financially viable and meet its obligations under any mortgages. Separately, the for-profit partner will often ask that the affiliated corporation that has been created by the nonprofit to serve as general partner make similar guarantees and, in the event those guarantees are not met, risk being removed as general partner of the partnership.

The IRS has indicated concern that guarantees provided to a for-profit limited partner by a nonprofit sponsor in tax credit transactions could amount to an inappropriate private inurement, and if enforced could effectively be a transfer to private for-profit entities of funds that may have been donated to the nonprofit organization and should be retained for its charitable mission purposes. In response, many partnership agreements now limit the guarantees to be provided by the nonprofit to guarantees that can be back-stopped by other guarantees (such as the guarantee of on-time within-budget completion being back-stopped by the builder's guarantee of on-time within-budget completion) and guarantees that are limited to the funds (such as the developer fee) coming out of the transaction to the nonprofit.

Not all guarantees that for-profit partners request of nonprofit sponsors fit so neatly into the limiting principle. For example, some syndicators request a buy-back guarantee, requiring that the sponsor buy back the for-profit partner's investment in the event the project fails to qualify for tax credits or experiences other drastic and substantial early failings. Some nonprofit sponsors agree to such guarantees because they are comfortable (and/or they have professional advisors who have given them comfort) that such risks are sufficiently remote that there is no likelihood that the guarantee would ever need to be enforced. Other nonprofits refuse to give such guarantees and will only work with for-profit partners who do not require them. To a great extent the analysis can be reduced to its economic components – a for-profit limited partner will invest more with guarantees, and less without. The nonprofit sponsor will in most cases be able to quantify their comfort level, and the issue will become problematic only if they are unable to balance the financial and physical needs of the project with their own comfort.

For nonprofits that remain uncomfortable with that balance, and smaller nonprofits that may not have the need or desire to obtain the necessary development capacity, the alternative is often to bring in a skilled developer (which can be either nonprofit or for-profit) and have the developer both undertake and oversee the renovation work and provide the financial guarantees. In such an arrangement, the development fees that arise in connection with the recapitalization will be paid in whole or part to the developer as compensation. The nonprofit sponsor can nonetheless structure the arrangement in a manner that best meets their needs. While the basic trade-off results in the nonprofit having a limited role in the development process, they can

often negotiate to retain input, control and approval rights over certain aspects of the recapitalization (such as property management approval and selection, and significant scope of rehabilitation choices that are made in the course of the development process) that they have identified as important.

An important additional consideration to be added to the mix is the Section 42 nonprofit right of first refusal. This section of the tax code authorizes the Low Income Housing Tax Credit partnership to grant to a nonprofit a right of first refusal to purchase the project at the end of the 15 year initial compliance period for the sum of the outstanding debt plus the partnership's exit taxes (i.e. – taxes arising due to the sale or transfer of the project to the nonprofit). This right of refusal in theory allows the nonprofit the right to control the property's ultimate disposition – and to preserve it as affordable housing. For some nonprofits the right of refusal will be a significant positive factor in deciding to temporarily forego other rights in order to address physical needs and ensure the project's long term preservation.

Keeping the Board of Directors on Board

For many nonprofits, significant time and effort will be devoted to educating the organization's board of directors as to the project's possibilities, the attendant risks and issues, and the elements of choosing a recapitalization path. Large all-volunteer boards may want to consider appointing a smaller sub-committee of members with sufficient time to dedicate to the task of learning the issues. In most cases, the sub-committee will commit to attending informational meetings, which will be open to all of the rest of the board. Because the recapitalization process and the choices that are made by the sponsor can have profound effects on both the sponsor and the project, it is important that the board allow sufficient time for the issues to be fully vetted by the members.

Additionally, many nonprofits take the recapitalization learning process as an opportunity to re-assess their mission and organizational priorities. For some, the forces that shaped their formation are no longer the same as the current forces affecting their constituents and members, and roles that need to be filled today are not the same as roles that needed to be filled many years ago. The project's recapitalization is often a rare and unique financial opportunity in the organizational life of the nonprofit, and a similarly rare and unique opportunity to focus on the organization's continued relevance to its constituent community.

CHAPTER TWO

Section 8 Renewal Issues

Emily Achtenberg

Introduction

In any project where some or all of the units are assisted under a HUD project-based Section 8 contract, HUD rules governing the contract renewal rents and other terms will significantly affect opportunities for recapitalization and refinancing. This chapter discusses the basic Section 8 rules that affect recapitalization as set forth in MAHRA,[1] as elaborated in HUD's Section 8 Renewal Guide,[2] and as applied in practice (based on recent experience).

While the basic regulatory scheme for Section 8 contract renewals has been in effect for several years, HUD's policies and practices are continuing to evolve. Currently, there are numerous areas of uncertainty and conflicting interpretations among field offices. Some policies appear to be undergoing revision but changes have not been clarified in writing. Additionally, as the first generation of post-MAHRA renewal contracts reach their five-year benchmarks, new issues are emerging that the Section 8 Renewal Guide does not adequately address. Forthcoming revisions to the Section 8 Guide should help to resolve these issues along with many of the questions raised in this Chapter.

Renewal Options: General Framework

Since the enactment of MAHRA, owners whose Section 8 contracts expire have generally been eligible to renew under one or more of the following options:[3]

1. Mark Up to Market (MUM): under certain circumstances, for-profit owners may increase rents to comparable market levels – either automatically, or at HUD's discretion. Rents are annually adjusted by an Operating Cost Adjustment Factor (OCAF)[4] during the contract term, and are subject to a market comparability redetermination after 5 years.

This option is available to existing nonprofits whose ownership entities are structured as for-profit corporations, partnerships, or limited liability corporations (LLCs). Alternatively, nonprofit- controlled for-profit purchasers may qualify under the Nonprofit Transfer program (a component of Mark Up to Budget, or MUB),[5] a special version of which has more flexible eligibility rules. However, because this program is not available to related-party purchasers, it has limited value for nonprofit recapitalization transactions.

2. Regular Renewal: owners may renew at existing rents with an OCAF- or budget-based increase, not to exceed comparable market rents. Rents are annually adjusted by OCAF or on a budget basis during the contract term, and are subject to a market comparability redetermination after 5 years.

For nonprofit owners (including nonprofit-controlled for-profit entities), this option may include a budget-based increase to finance capital repairs under the Nonprofit Capital Needs program (a component of *Mark Up to Budget*). The increase may cover rehabilitation debt service or increased replacement reserve contributions (for the project as a whole, including any non-Section 8 units).

3. Mark to Market (M2M): owners of HUD-insured projects with above-market rents are generally required to reduce rents to market levels, with debt restructuring (Fulls) or without (Lites). These renewals must be approved by the former Office of Multifamily Housing Assistance Restructuring (OMHAR), now the Office of Affordable Housing Preservation (OAHP; see “Mark to Market,” p. 9). Rents are adjusted by OCAF during the contract term and are subject to a market comparability redetermination after 5 years.

4. Exception Project Renewal: owners of non-insured and certain other types of projects may renew at the

lesser of existing OCAF-adjusted rents or budget-based rents, without a market cap. Subsequent rent adjustments during the contract term are OCAF- or budget-based, with no market comparability test. Eligible projects include bond-financed projects (including those with HUD mortgage insurance, where debt restructuring conflicts with the bond financing requirements), Section 202s, and Section 8 Moderate Rehabilitation SROs.

5. Preservation Demonstration Project Renewals: projects that participated in the federal preservation programs (ELIHPA or LIHPRHA) or in certain predecessor programs to Mark to Market may renew in accordance with the terms of their existing use or contractual agreements with HUD, to preserve comparable owner benefits.

6. Additionally, owners may elect to opt out of their Section 8 contracts after notifying tenants one year in advance. In most cases, eligible tenants will receive Enhanced Vouchers.

Contract Term

Unlike the original Section 8 contracts whose multi-year funding was appropriated upfront, all post-MAHRA renewal contracts are subject to annual appropriations. The minimum renewal term is one year, except for Mark Up to Market contracts which require five years.

For the past several years HUD has permitted contract terms of up to 20 years at the owner's request, and has generally required a 20-year contract for Mark Up to Budget. While still subject to annual appropriations, these long-term contracts are critical to the underwriting of refinancing transactions, which typically have at least a 20-year loan term and (if tax credits are involved) a 15-year tax credit compliance period. To the extent that lenders and equity investors will accept the appropriations risk, the Section 8 units can then be underwritten at the allowable Section 8 rents for the duration of the longer contract term.

Mark Up to Market/ Budget: Current Issues

The Mark Up to Market/ Budget programs have been widely utilized to facilitate preservation and recapitalization of existing Section 8-assisted projects, with at least 80,500 units in 800 projects participating to date. Several issues have recently emerged which could affect the future utility of these programs.

Post-Rehabilitation Rents

In the past, although not specifically authorized by the Section 8 Renewal Guide, HUD has permitted owners renewing under Mark Up to Market to obtain renewal rents at the level of post-rehabilitation comparable rents, for implementation upon completion of rehab. HUD has recently suggested informally that this practice will be discontinued. Since lenders and equity investors require HUD approval of the Section 8 rents before issuing their commitments, this change will reduce the amount of supportable debt in a refinancing transaction where there is a spread between pre- and post-rehabilitation rents.

However, the Section 8 Renewal Guide explicitly allows increases to post-rehabilitation rent levels under Mark Up to Budget where rehabilitation is scheduled. Accordingly, eligible nonprofits may want to proceed under this option where it is advantageous (with market rents justified on a budget basis).[6]

Preservation Projects

Many preservation projects acquired by nonprofits (including nonprofit-controlled for-profits) 15 years ago, under ELIHPA or LIHPRHA, are now in need of recapitalization. Until recently, these projects were precluded from participating in Mark Up to Market because successive appropriations bills had imposed a one-year limitation on their Section 8 renewal contract terms (conflicting with the 5-year minimum required for Mark Up to Market). This barrier has been eliminated in recent appropriations language on a year-to-year basis.

However, because preservation projects are subject to low and moderate income use restrictions, their participation in Mark Up to Market requires HUD approval on a discretionary basis and rents can be marked-up only to the use-restricted level. Although some nonprofit preservation projects may meet the stated criteria for discretionary mark-up (vulnerable tenant population, low vacancy area, high local priority), and may not have restrictions that independently affect their Section 8 rents, their eligibility for Mark Up to Market is currently uncertain.

Alternatively, nonprofit-owned preservation projects may be eligible for Mark Up to Budget, as currently provided in the Section 8 Renewal Guide. To date, existing use restrictions have not been a factor for eligibility or rent-setting in this program. However, HUD has suggested informally that Mark Up to Budget may not be available in the future if it is inconsistent

with the project's existing HUD use restriction (e.g., if Section 8 rents are not currently budget-based). This issue requires further clarification by HUD.

Existing MUM & MUB Projects: Year 5 Issues

Nonprofit owners who took advantage of Mark Up to Market/ Budget in the early years of these initiatives were limited to 5-year contracts that are now reaching the end of their terms. In seeking to renew their contracts, these owners face a variety of eligibility issues which are not adequately addressed in the Section 8 Renewal Guide and which require further clarification. For example:

Renewed Eligibility

Some projects that originally Marked Up to Market may now have comparable market rents that are below current Section 8 Fair Market Rents (FMRs) — or even have project rents that are above-market — which would preclude them from renewing again under this option. Others may have low and moderate income use restrictions associated with an earlier transaction (e.g. from tax credits or tax-exempt bonds). If these restrictions are taken into account, renewed eligibility for Mark Up to Market will be at HUD's discretion. Additionally, rents could be reduced to levels that could jeopardize continued project feasibility, based on existing debt service requirements. Projects that originally Marked Up to Budget may be ineligible to renew again under the same option unless they have additional rehabilitation needs justifying a higher rent.

Alternative Eligibility

Alternatively, existing MUM or MUB projects with below-market rents may be eligible to renew under Regular Renewal (Option 2), with an OCAF or budget-based increase. With above-market rents and FHA insurance, they may be eligible for debt restructuring under Mark to Market (Option 3).[7] If uninsured, they may qualify as exception projects (Option 4) and be able to maintain current rents. In the latter case, it is not clear whether they would be characterized as "initial renewals," requiring the rent to be justified on a budget basis under the "lesser of" test, or as "subsequent renewals," permitting the existing rent to be retained and OCAF-adjusted.

Another area of uncertainty for these projects relates to the allowable distributions associated with their previous mark-up status. For example, under Mark Up to Market, any dividend restrictions linked to the underlying original Section 8 contract or to the existing subsidized mortgage[8] are suspended during the Mark Up to Market contract term. Similarly, under Mark Up to Budget, nonprofit owners or mortgagors (who were prohibited from receiving distributions under the underlying original Section 8 contract or subsidized mortgage) may have received a regulatory waiver to allow a six percent return on equity.

Once the MUM or MUB contract terminates and is replaced with an alternative renewal contract, the survival of these benefits is currently uncertain. If a reversion to the original dividend restrictions is required, any excess cash flow will be characterized as residual receipts. Additionally, any budget-based rent calculation utilizing the pre-MUM or MUB dividend restrictions could result in a substantial rent decrease.

For MUM or MUB projects with long-term contracts, there is no redetermination of eligibility at Year 5. However, market rents must be redetermined using a new comparability study, with a corresponding readjustment (up or down) of Section 8 contract rents to market levels. For MUM projects, the rent adjustment is automatic; for MUB projects, a budget justification is likely required to increase rents to higher market levels.

In either case, for projects in declining markets, there is a risk that rent reductions could jeopardize project feasibility. Current HUD policies do not permit termination of an existing Section 8 contract before its expiration date (even where there is a potential for mortgage default and foreclosure). Accordingly, especially where market conditions are uncertain, building an adequate debt service cushion into an MUM/MUB refinancing transaction may be prudent. Also, given that OCAFs (between the five year intervals) can never reduce rents, owners may want to set aside reserve funds out of interim cash flow to hedge against this possibility.

Budget-Based Rent Issues: Debt Service Increases

According to the Section 8 Renewal Guide, if an above-market insured project seeks to refinance to achieve exception project status, the original debt service must be utilized in any budget-based rent computation. HUD has recently suggested informally that this principle also applies to below-market insured projects that refinance.[9] In other words, in these projects Section 8 rents generally cannot be increased on a budget basis to cover additional debt service (for rehabilitation, acquisition, or equity takeout).[10]

This approach is inconsistent with HUD's policies for non-Section 8 units in projects seeking to recapitalize under the IRP decoupling program, or the new 250(a) prepayment notice program, which permit debt service increases up to allowable program limits (see Chapter 6). Unless exceptions are permitted, there could be significant discrepancies between the Section 8 and non-Section 8 rents in these projects, and opportunities for refinancing will be significantly constrained.

To the extent that Section 8 rents cannot be increased on a budget basis for additional debt service, there may still be opportunities to refinance within the existing OCAF-adjusted rent envelope. Additionally, nonprofit owners may be able capture real estate tax savings, reductions in annual replacement reserve contributions, or other operating cost efficiencies to increase debt service without increasing rents. Further clarification is needed from HUD regarding these possibilities.

Bond-Financed Projects

In most state agency bond-financed projects with uninsured mortgages, the original Section 8 contracts were coterminous with the 30- to 40-year bond terms. In the past, these contracts survived any prepayment or refinancing of the underlying bond-financed mortgage debt. HUD has recently reversed this policy with respect to Section 8 contracts in bond-financed projects entered into prior to February 1980, and now takes the position that these contracts automatically terminate upon prepayment.

The new policy applies retroactively to projects that previously refinanced, as well as prospectively to projects that may refinance in the future.[11] Affected owners have three available options. First, they can voluntarily amend the existing contract language to permit its extension through the original mortgage term. Alternatively, they can terminate the existing contract and renew under any post-MAHRA renewal option for which they are eligible. Finally, they can terminate the existing contract and opt out of the Section 8 program.

For nonprofit owners of bond-financed projects, this policy shift may offer new opportunities for rent increases and recapitalization by creating premature renewal. For example, projects with below-market rents may be eligible for Mark Up to Market/ Budget. Above-market rent projects may be able to budget-justify their rents as exception projects, and secure future OCAF increases without being subject to a market cap (which previously limited their rent adjustments). At the same time, owners who shift to a post-MAHRA renewal must give up the remaining years of a secure, fully-funded contract with no appropriations risk.

In any case, these options are available only to the extent that the housing finance agency or other bond issuer permits owners to prepay or refinance their original mortgages in the first place. Some agencies have restrictive prepayment policies, which may be ripe for reconsideration to the extent that new recapitalization opportunities are now available.

Mark to Market

The Mark to Market program has become a significant recapitalization tool for both nonprofit and for-profit owners. To date, some 1,800 properties have completed full debt restructuring and another 690 have undergone rent restructuring only (Lites), with another 400 in the processing pipeline.[12]

Current Status and Authority

The statutory authority for the Office of Multifamily Housing Assistance Restructuring (OMHAR), a quasi-independent office within HUD which has administered Mark to Market since its inception, expired on October 1, 2004. The program is now administered by the Office of Affordable Housing Preservation (OAHP), located within HUD's Office of Housing. Many OMHAR staff, including the director, have retained equivalent positions within OAHP. No significant program or policy changes are expected to result from this transition.

The statutory authority for the entire Mark to Market program sunsets on October 1, 2006. While extensions have been enacted in the past, the future of the program after the sunset date is currently uncertain.

Eligibility

Recent statutory and policy changes have expanded the scope of projects that are eligible to participate in Mark to Market. Eligible projects now include:

- Projects financed under the HUD/HFA coinsurance program (but not Risk Sharing);
- Projects with above-market rents at subsequent renewal, whose rents were below-market at original renewal (these projects originally renewed under a different option);

- "Look-back" projects, whose rents were above-market at any time before the initial contract renewal date – even if they are now below-market.[13] This category includes Watch List properties where restructuring was discontinued, and projects whose rents were formerly restructured as Lites. To the extent that Mark to Market can provide additional resources for recapitalization, it may be an attractive option for these and other eligible projects.
- "Early look" projects, whose contracts will expire in the future (including after the Mark to Market sunset date, October 1, 2006). Rents in these projects will not be reduced until contract expiration. During the balance of the original HAP term, the excess rent will be captured as an additional contribution to replacement reserves.

HUD has recently provided additional guidance on Mark to Market eligibility issues, including "look back" and "early look" projects.[14]

Underwriting

Recent changes in HUD's underwriting approach for Mark to Market projects have enhanced opportunities for recapitalization.

Significant Additions

For certain types of improvements that will directly improve residents' living conditions but are not mandated by normal rehabilitation standards, the required owner contribution is reduced from 20 percent to three percent.[15] These must be new items or substantial upgrades, not simply replacements of an existing system. Eligible items include: new central air conditioning (where none existed before, or the existing through-wall system was inefficient); new central heating (to replace an old baseboard system); new community building; new security cameras and fences (where none existed before); new elevator (where none existed before); new computer center (capital costs only, not including computer hardware or software).

Capital Needs Assessments

HUD has become sensitive to early failed restructurings with inadequate resources for repairs and has encouraged PAEs to adequately assess project capital needs, both immediate and long-term. Experience suggests that nonprofit owners who undertake their own capital needs studies, supplemented with architectural/ engineering reports as needed, can substantially influence the scope, cost, and schedule of rehabilitation and replacement reserve work that is included in the restructuring plan, especially where the owner's proposed program is more comprehensive. PAEs are instructed to rely on actual bids secured by owners in pricing specific rehabilitation items. Owners may want to use existing replacement reserves and residual receipts to complete immediate rehabilitation needs prior to closing, to the extent feasible, in order to reduce the size of the required owner contribution.

Operating Assumptions

Recent HUD guidance emphasizes that operating expenses should be set at reasonable levels required to operate the property on a stabilized basis for 12 months after closing. The minimum vacancy and bad debt allowance required for first mortgage underwriting is generally seven percent, and higher if justified by prevailing market conditions. Debt service coverage must be sufficient to provide an adequate cushion on top of the Incentive Performance Fee (IPF), with a total acceptable return equal to $300 - $400 per unit per year. Debt service coverage may be reduced below 1.20 only where the Section 8 market rents substantially exceed the affordable rents used in underwriting (for 20 percent of the units), where the actual vacancy rate is expected to be less than 7 percent, and where the operating expense cushion is adequate (at least 7-10 percent on top of expenses). The debt service coverage cannot be less than 1.05 - 1.10 (on top of the IPF). Higher debt service coverage in Mark to Market underwriting results in more debt being transferred to the second or third mortgage.

Additional Funds

Pursuant to HUD's "Additional Funds" (AF) policy, owners and purchasers can bring additional resources to their Mark to Market transactions without decreasing HUD's contribution to restructuring (the "baseline claim").[16] The additional funds – from tax credits, tax-exempt bond financing, HOME/CDBG funds, or other state or local resources – can be used to achieve a greater level of rehabilitation and to cover reasonable acquisition costs in a transfer. The AF transaction must result in significant benefits to residents and the property, and must be able to close in a timely manner consistent with the debt restructuring schedule.

The level of rehab, supportable first mortgage, and owner contribution must be at least the same as required in the baseline transaction. Tax credits and grant funds (but not loans secured by the property) may be used to meet the owner's 20 percent contribution. However, if tax credits or grants are used, no CRP is permitted.

To date, only two dozen of the 1,300 projects that have completed debt restructuring have been AF transactions. A major obstacle is the difficulty of synchronizing the restructuring timetable with state tax credit application and allocation schedules. HUD has recently adopted a more flexible approach to processing and closing AF transactions, in an effort to facilitate them.

Second Mortgage Assignment

Pursuant to a recent MAHRA amendment, in lieu of forgiveness HUD may assign the deferred second mortgage to the acquiring entity, if the project is being purchased by a qualified nonprofit organization. HUD guidance provides for a 3-year window from the date of mortgage restructuring during which an eligible community-based nonprofit (including a nonprofit-controlled partnership or LLC) can purchase the property and request either mortgage assignment or forgiveness.[17]

The mortgage assignment option is useful vehicle for channeling cash flow to the owner where there are dividend restrictions associated with the underlying original Section 8 contract or the existing subsidized mortgage.[18] Under Mark to Market, the new provisions for allocating owner fees (CRP and IPF) and surplus cash, which supersede the original dividend restrictions, are associated with the HUD second mortgage and would disappear if that mortgage were forgiven. If the second mortgage is instead assigned to an entity affiliated with the nonprofit purchaser, the underlying restrictions will continue to be suspended – while 100 percent of distributable cash flow is allocated to the nonprofit and its affiliate.

At the same time, mortgage assignment or forgiveness are only available in conjunction with a transfer of ownership. Moreover, the nonprofit purchaser cannot be a related party or affiliate of the seller. These policies limit the utility of these tools for nonprofit recapitalization transactions.

Chapter 2 Notes

[1] The Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRA), as amended.

[2] "Section 8 Renewal Policy: Guidance for the Renewal of Project-Based Section 8 Contracts," January 19, 2001, available at http://www.hud.gov.

[3] For a more detailed description of these options, see *Stemming the Tide: A Handbook on Preserving Subsidized Multifamily Housing,* and "Renewal Options for Expiring Project-Based Section 8 Contracts," both available at http://www.lisc.org/resources.

[4] Published by HUD on an annual basis. The OCAF percentage is applied to the Section 8 gross rents, less debt service, to allow for increases in operating expenses plus cash flow.

[5] Both the Nonprofit Transfer program and the Nonprofit Capital Needs program, described in Chapter 15 of the Section 8 Renewal Guide, were originally known as "Mark Up to Budget," a term which has remained in common usage and which will be utilized in this chapter. However, only the Nonprofit Capital Needs program actually requires budget-based rents.

[6] It appears that where post-rehabilitation rents are requested, HUD will process the project under the Capital Needs program (regardless of whether a transfer of ownership is involved), which requires a budget justification.

[7] However, the Mark to Market program sunsets on October 1, 2006 under current law.

[8] Projects with original dividend restrictions linked to the underlying Section 8 contract are primarily "new regulation" Section 8 new construction, substantial rehab, and bond financed projects, with contracts awarded after 11/1/79, 2/20/80, and 2/29/80, respectively. Projects financed and insured under Section 236 or 221(d)(3)BMIR have dividend restrictions linked to their subsidized mortgage Regulatory Agreements.

[9] This limitation also applies to Section 202 projects that refinance pursuant to HUD's prepayment notice; see Chapter 3.

[10] Mark Up to Budget, which explicitly permits eligible nonprofit owners to increase Section 8 rents on a budget basis for rehabilitation debt service, is presumably an exception to this policy.

[11] The new policy interpretation is based on a HUD legal opinion dated May 17, 2002. To date, it has not been released in writing.

[12] As of May, 2005.

[13] The eligibility of "look back" projects was added to the MAHRA statute in 2002.

[14] Section 8 HAP Renewal and OAHP Referrals, May 5, 2005 Memorandum from Charles H. Williams, Deputy Assistant Secretary, OAHP and Stillman D. Knight, Deputy Assistant Secretary, Multifamily Housing Programs.

[15] The provision for significant additions was added to the MAHRA statute in 2002. Implementing guidance reduces the owner contribution to 3 percent.

[16] Mark to Market Operating Procedures Guide, Appendix R: Additional Funds Transactions, January 2003.

[17] See Note 14.

[18] See Note 8.

CHAPTER THREE

Section 202 Elderly Multifamily Properties

Vincent F. O'Donnell

Introduction and Background

The federal government's principal vehicle for production of affordable elderly multifamily housing since 1959 has been Section 202 of the National Housing Act. Since its inception, this program has supported the creation of 207,000 units of affordable senior housing. Many of these properties are now aging and in need of recapitalization, in order to support system replacements, reconfiguration and additional services to meet the changing needs of a population that has been aging in place.

Section 202 developments created from about 1977 until 1990 were financed with 40-year direct federal loans at then-prevailing interest rates, often higher than ten percent. Some of these properties also receive project-based Section 8 rental assistance (referred to as 202/8 projects). However, the combination of high interest rates and remaining mortgage terms of 15 years or less is inefficient leverage compared to what is available under a refinancing at current rates. As a result, the current Net Operating Income (NOI) of many properties could support debt increases greater than $10,000-$12,000 per unit, if prepayment and refinancing were permissible. That new debt capital can be put to effective use for the needs of aging properties, including repairs, system upgrades, reconfiguration and social service needs of the residents. In some cases, equity released through refinancing can even be used to further a nonprofit's mission at another location.

Individual Section 202 projects vary as to whether they have the right to prepay the existing federal direct loan. If they do, additional questions must be addressed, including: whether the level of Section 8 assistance will be reduced to reflect the lower debt service; whether Rent Supplement payments may continue after a prepayment; how the Section 202 character of the property will be maintained; how FHA-insured replacement financing will be underwritten; what returns are permitted to refinancing owners; and whether a project will be subject to Mark to Market mortgage restructuring if it is refinanced with FHA mortgage insurance.

To resolve these issues, Congress passed Section 811 of the American Homeownership and Economic Opportunity (AHEO) Act of 2000, which provides authority for the prepayment of a Section 202 or 202/8 Direct Loan. HUD subsequently issued implementing regulations at 24 CFR 891.530. In addition, Section 831 of AHEO provides authority for the combination of Low Income Housing Tax Credits with Section 202 projects. Finally, Section 612(h) of the 2002 Labor, Health and Human Services, and Education Appropriations Act amended the MAHRA statute to deal with Section 8 renewal issues. This created an exemption from mortgage restructuring, and from Section 8 market rent comparability requirements, for Section 202 or 202/8 projects refinanced with FHA insurance, provided they are processed under the requirements of Section 811 of AHEO.

To conform field instructions to these new statutory provisions, HUD issued Notice H 2002-16 on August 23, 2002. This notice supersedes all previous notices on the subject of Section 202 prepayment, including Notice H 2000-26. HUD provided additional and superseding guidance in Notice H 2004-21, issued on November 12, 2004, regarding FHA underwriting, developer fees and return on equity.[1]

As a result of these field instructions, recapitalization of Section 202 projects, including the use of Low Income Housing Tax Credits (LIHTC), is now practical, even though many questions and issues remain.

The Peter Sanborn Place Section 202 development in Reading, Massachusetts (see table on next page) is an example of a well-managed property in good condition, but which suffered from the need for upgrades required to serve a population that has aged in place and has become increasingly frail. For that modest set of needs, refinancing proceeds and reserves were sufficient, without the additional complexity of other resources such as Low Income Housing Tax Credits" (see "Special Features for Section 202 Properties," p. 37).

General Provisions

HUD Hub office directors have the authority to process and approve prepayments conforming to the Notice's requirements. However, HUD Headquarters must review and approve all field office decisions. Waivers of this Notice may be granted only by the HUD Headquarters Office of Multifamily Asset Management.

There are no restrictions on the form of substitute financing in a Section 202 prepayment. Conventional, tax-exempt and FHA-insured loans are all permitted. For FHA financing, both notices address certain underwriting and processing considerations, as described below.

Notice H 2002-16 restates the criteria established by Section 811 of AHEO when prepayment and refinancing of a Section 202 or 202/8 Direct Loan require HUD approval: the project sponsor must agree to operate the project until the maturity date of the original loan under terms at least as advantageous to existing and future tenants as required by the original loan or by any rental assistance contract (including Section 8 and Rent Supplement); and any refinancing must result in a lower interest rate on the principal of the loan for the project and in reductions in the debt service related to such loan.[2]

Types of Prepayment

There are two distinct prepayment scenarios, corresponding to projects whose mortgages may be prepaid as of right, and those that require HUD approval for prepayment. Section 202 projects approved approximately from 1977 to 1982 have loan documents allowing owners to prepay and refinance without HUD approval. For projects developed later, HUD approval is required prior to a prepayment, according to the procedures detailed in Notice H 2002-16. There are certain benefits to processing under Notice H 2002-16 ("under the Notice"), and owners with the right to prepay are permitted to elect to process under its provisions.

When prepayment is done as of right, then in effect the property ceases to be a Section 202 project. On the other hand, when HUD approval is required, or when the owner elects to process a prepayment-eligible project under the terms of Notice H 2002-16, the Section 202 character of the property is maintained through a recorded Use Agreement.[3] In any event, continuation of the Section 8 Housing Assistance Payments (HAP) contract will enable the project to continue to serve extremely low income residents.

When HUD approval is not required:

- The following language must appear in the Note in order for the owner to prepay without HUD consent: "Privilege is reserved to pay the debt in whole or an amount equal to one or more monthly payments on principal next due, on the first day of any month prior to maturity, upon at least thirty (30) days prior written notice to the Payee."
- A 30 day written notice to the HUD Hub office and to the residents is required. The form of this notice is not specified. Note that the "Wellstone Notice" required for prepayment of Section 236 and 221(d)(3) BMIR projects does not apply to Section 202 prepayments.
- All HUD Flexible Subsidy and HELP Loans must be repaid upon prepayment of the Section 202 loan. However, any Flexible Subsidy Use Agreement remains in effect until the maturity date of the original Section 202 Direct Loan.
- If the owner elects to process under the terms of Notice 2002-16, including the recording of a Section 202 Use Agreement, the project will then remain exempt from MAHRA requirements. This may permit the owner to retain above-market Section 8 rent levels as a so-called "exception project,"[4] and to continue Rent Supplement payments.[5] It should be noted that, whether or not the prepayment occurs under the Notice, any non-FHA replacement financing will also result in the project being exempt from Mark to Market mortgage restructuring and eligible for continuation of above-market Section 8 rents.
- Even when HUD's permission to prepay is not required, there is a checklist process to ensure that the project is eligible for prepayment by right.[6] HUD Headquarters' Office of Asset Management must approve the prepayment, even though approval authority is given to the Hub Director.

Section 202 Refinance Example: Peter Sanborn Place

Sponsor	United Church Homes of Reading/ Sanborn Home Care
Original Financing	Completed January, 1982; 9.25 percent, 40 year loan
Number of Units	74
Number of Section 8 Units	73
Prepayment as of Right?	Yes
Physical Condition	Needed capital replacements, modernization and ADA retrofits.
Financial Condition	Stable, with excess replacement reserves
Market Condition	Rents are at 95 percent of FMR; Full occupancy
Resources Used in Transaction	New debt and excess replacement reserve proceeds
Per Unit New First Mortgage	$65,405
State/Local Gap Funding or Subsidy	None
Benefits of Refinancing	Rehabilitation to enhance accessibility of individual apartments for aging in place (walk in showers, raised lavatories, accessible and safety fixtures, full kitchen rehab). Common area improvements, including keyless entry door systems, new and increased lighting, oil tank removal, and many other cosmetic updates.

Sources of Funds	
MassHousing Mortgage (5.04%; 40yrs)	$4,840,000
Excess replacement Reserves	661,447
Total Project Sources	$5,501,447

Uses of Funds	
Payoff of existing debt	$3,462,328
Construction	1,114,064
MassHousing Financing Fees	116,384
Consulting/Overhead	96,800
Other Soft Costs	99,460
New Replacement Reserves	340,000
Reserve for Resident Services	272,411
Total Project Cost	$5,501,447

When HUD approval is required:

- HUD approval is required whenever the Note does not contain the explicit prepayment right, and whenever an owner voluntarily elects to process under the terms of Notice H 2002-16.
- A Use Agreement must be executed by the Owner and HUD and recorded upon HUD approval of the prepayment transaction. The Use Agreement will regulate the project until the maturity date of the original Section 202 Direct Loan.
- The requirements are the same as for projects that have the right to prepay for: repayment of Flexible Subsidy and HELP loans; for a 30 day notice to HUD Hub office and to the residents; and for use of the checklist process.

For projects that require HUD's prepayment approval, the continuing owner must be either the current owner, or a for-profit limited partnership whose sole general partner is the current owner or a corporation owned and controlled by the current owner; or a new Section 202-eligible owner, under Transfer of Physical Assets (TPA) procedures.

In addition, HUD 2530 clearance is required whether there is a new ownership entity or the existing owner remains. This process requires owner certification and HUD confirmation that there is no record of previous owner default or noncompliance.

Section 8 Contracts

At least 50 percent of the savings resulting from reduced Section 8 or other rental housing assistance must be made available to benefit the tenants, including:

- Payment of not more than 15 percent of the cost of supportive services, including service coordinators and congregate services.
- Rehabilitation, modernization or retrofitting the property.
- Construction of additional facilities, including assisted living, in the project (or, with HUD approval, in the same community). Resources from more than one project may be pooled.
- Reduction of rents for tenants without rental assistance, based on a pro-rata allocation of savings.

In practice this means that the costs of the first three items above may be paid for out of refinancing proceeds.

Under current HUD policy, project-based Section 8 contract rents will not be increased "at the time of prepayment processing" to support additional debt service for rehabilitation or other project needs.[7] When a prepayment occurs during the term of a project-based Section 8 contract, existing rents may be kept in place, provided HUD approves the owner's budget justification.

When the Section 8 contract expires, the standard renewal procedures of the Section 8 Renewal Guide apply. Projects retaining their Section 202 character as a result of processing under Notice H 2002-16 (as well as non-Notice projects refinancing without FHA mortgage insurance) can be treated as "exception projects" under Chapter 6 of the Renewal Guide, retaining above-market rents. As with all Section 8 contract renewals, future contracts will be subject to annual appropriations, regardless of the contract term. There is discussion in the industry as to whether elderly projects or FHA-insured senior housing are less likely to be subject to involuntary conversion from project-based Section 8 to vouchers in the future, but as yet no consensus is reflected in the debt or equity markets.

Use of Other Project Funds

The project may use excess residual receipts over $500 per unit for not more than 15 percent of the cost of increased supportive services.

The project may use excess replacement reserves over $1,000 per unit for rehabilitation, modernization and retrofitting, or for additional facilities, as with Section 8 savings.

When LIHTC equity is provided, developer fee is limited to 15 percent of acceptable development cost, as defined by the respective State LIHTC program, or the maximum fee allowed by each State's LIHTC program.[8]

Surplus cash distribution is limited to six percent of owner equity that was paid at the refinancing of the project, including LIHTC equity but not including government funds such as HOME and CDBG).[9]

A subsidy layering review is required if the project will use more than one government financing source, including Section 8 assistance, FHA mortgage insurance, Rent Supplement, Low Income Housing Tax Credits (LIHTC), HOME Funds, CDBG funds or other State or local government funds.

Tenant Notification

Whether or not HUD permission is required for a prepayment, owners must notify tenants of their intention to refinance at least 30 days before submitting the request to HUD. The tenant notice must be delivered to each tenant and be posted in three common locations, including the project office. For buildings higher than 4 stories, posting may replace individual delivery.

During the 30 day notice period, tenants and their representatives have the right to inspect and copy all materials to be submitted to HUD, and to make written comments. The owner must prepare a written evaluation of tenant comments and address any negative comments in the application to HUD. The owner's submission to HUD must include all tenant comments, the owner's evaluation and a certification of compliance with tenant participation regulations (24 CFR Part 245) that are applicable when major changes are made to a project.[10]

When HUD prepayment approval is required, or when an owner elects to process under Notice H 2002-16, the owner's tenant notice must describe how the prepayment is at least as advantageous to existing and future tenants as the subsidy arrangement prior to the prepayment. Specifically, the plan must describe: any increases in supportive services, including service coordinators or congregate services; rehabilitation, modernization or retrofitting the property; construction of additional facilities, including assisted living, in the project (or, with HUD approval, in the same community); reduction of rents for tenants without rental assistance; and compliance with Section 504 handicap adaptability requirements.

Use Agreement

The specimen Use Agreement that is required for all prepayments processed under Notice H 2002-16 (whether on a mandatory or voluntary basis) is contained in Attachment 4 of the Notice. An executable copy must be included in the prepayment application. The Use Agreement, when required, must be executed and recorded prior to prepayment, and must be in a superior position to any replacement financing.

The principal provisions, applicable for not less than the remainder of the original Section 202 loan term, are as follows:

- The owner must continue to operate the project on terms at least as advantageous to existing and future tenants as the terms required by the original Section 202 or any Section 8 or other rental assistance program.[11]
- As applicable: (a) subject to appropriations, HUD must provide, and the owner must accept, Section 8 contract renewals under then-current HUD rules; or (b) the owner will continue to operate the project in accordance with the requirements of any Rent Supplement Contract and applicable HUD requirements.
- HUD and affected tenants have third party enforcement rights, including injunctive relief and damages, in the event of a breach or a threatened breach.
- The owner may not impede reasonable tenant organizing activity and may not unreasonably withhold use of a community space for tenant organizing purposes.
- The project must continue to provide rental housing for very-low income, low-income or moderate-income elderly or disabled persons as approved by HUD (based on the rental subsidy status) for the life of the Use Agreement.[12] The terms of tenancy must be at least as advantageous to existing and future tenants as the terms required by the original loan.
- Section 8 tenant-based subsidies must be accepted, and Federal, State or local laws prohibiting discrimination must be observed.
- Any future owner must either be a nonprofit mortgagor entity or a limited partnership whose general partner is controlled by a nonprofit affordable housing provider; be HUD-approved; and assume the obligations of the Use Agreement.
- Admission is limited to very low-, low- and moderate-income tenants, as determined by HUD income limits; initial and annual income certifications are required of all tenants, and in-place tenants who become over-income for Section 8 or Rent Supplement must pay the unsubsidized rent.
- Rents must be approved by HUD, based on increases in operating, maintenance and property tax expenses.[13]
- Additional requirements include: annual audits; standard covenants to maintain the property; making project documentation available on HUD's request; and an annual certification of compliance.

Flexible Subsidy, Help Loans, and Rent Supplement Contracts

Any HUD Flexible Subsidy and HELP loans must be repaid upon prepayment of the Section 202 loan. Flexible Subsidy use agreements will remain in effect.

If the prepayment is done under the terms of Notice H 2002-16, a Rent Supplement contract may be continued to its original maturity date. However, HUD must grant a waiver of 24 CFR 215.35.[14]

Processing and Approval

HUD recommends that owners considering prepayment consult with the local HUD Project Manager to review all applicable requirements and the proposed sources and uses of funds. A checklist is provided in Attachment 2 to Notice H 2002-16, containing the agenda for the pre-application meeting and the required contents of the prepayment application.

The local HUD office must process a prepayment application within 30 days (or within FHA timeframes, if applicable). For prepayments not requiring HUD approval, the local office verifies the right to prepay and determines loan payoff amounts (including any Flexible Subsidy and HELP loans).

For Rent Supplement projects, unless the prepayment is processed under Notice H 2002-16, standard Section 8 vouchers (not Enhanced Vouchers) will be obtained to replace the Rent Supplement contract, which will be terminated at prepayment.[15] If the prepayment is processed under Notice H 2002-16, a waiver of 24 CFR 215.35 must be requested from Headquarters.

For applications requiring prepayment approval, a more extensive review of all requirements is conducted by the Hub Office, following the checklist in Attachment 2, and the checklist is submitted to Headquarters for review and approval. As noted below, if FHA mortgage insurance or Risk Sharing is used with the replacement financing, there are additional underwriting requirements.

HUD's approval letter will incorporate the final agreed-to prepayment proposal by reference, provide payoff amounts and request evidence of recordation of the Use Agreement, if applicable.

FHA Mortgage Insurance and Risk-Sharing

If FHA insurance or Risk Sharing will be used for replacement financing, the sponsor and FHA-approved lender may submit the financing request concurrently with the prepayment application. However, HUD advises that the sponsor discuss or obtain any required prepayment approvals before submitting a formal mortgage insurance application or Risk-Sharing request, with the attendant fees.

FHA mortgage insurance processing rents used for project-based Section 8 assisted units will be "the current or to be adjusted Section 8 contract rents for the project, even if the contract rent is in excess of the market rent."[16]

However, Risk-Sharing processing rents will be the lesser of (a) comparable unassisted market rents (not published Section 8 Fair Market Rent) or (b) current Section 8 or other project-based rental assistance contract rents. In order to extend the new favorable Section 8 contract rent underwriting to Risk-Sharing projects, a regulation change is required. HUD has indicated that it may consider such a change.

Appraisals for FHA mortgage insurance may now also be based on current Section 8 or other project-based rental assistance contract rents. Section 8 projects, retirement centers with amenity packages or projects with entrance or life-care fees may not be used as comparables.

Section 8 rent comparability guidelines do not supersede FHA MAP or TAP underwriting instructions.

Although Notice H 2002-16 is silent on the point, Section 811(b) of AHEO provides that "For purposes of underwriting a loan insured under the National Housing Act, the Secretary may assume that any Section 8 rental assistance contract relating to a project will be renewed for the term of such loan."

A refinancing owner may not take out equity, but a seller may receive equity based on the lesser of the sales price or the property's unassisted market value.

Chapter 3 Notes

[1] Except where noted, the policies described here are found in Notice H 2002-16.

[2] HUD has interpreted these statutory conditions to mean that there must literally be some reduction of debt service (even if only $1). HUD has been asked to permit debt service to be increased further, to finance uses other than retirement of the original debt. For example, Net Operating Income may be increased through lower operating costs (e.g., property tax reduction or utility savings) or through cost-based rent increases, to support increased debt.

[3] A specimen is included in Appendix 4 of Notice H 2002-16.

[4] See Chapter 6 of HUD's Section 8 Renewal Guidebook, available at http://www.hud.gov. See also "Renewal Options for Expiring Project-Based Section 8 Contracts" (May 1, 2001 REV 2) by Emily P. Achtenberg, available at www.lisc.org/resources.

[5] An additional requirement is a waiver of 24 CFR 215.35 by HUD Headquarters.

[6] Although it has been argued that HUD does not have the authority to require a notice or to condition a prepayment-by-right on HUD approval, HUD requires these procedures in order to confirm that the documents do in fact permit prepayment.

[7] Section 811 of the AHEO statute requires "reductions in debt service related to such loan," but is silent regarding the rent level after a refinancing, and regarding debt service to finance costs beyond the refinancing itself.

[8] Notice H 2004-21 increased the fee from nine percent.

[9] Notice H 2004-21 removed a previous exclusion of LIHTC equity from the basis for return, in response to industry concerns that there should be an adequate source of funds for ongoing regulatory compliance, deferred developer fees and asset management.

[10] Note below that HUD is not required to review tenant comments or the owner's evaluation unless the prepayment is processed under the Notice.

[11] Some concern has been expressed in the industry regarding the possible implication that an owner would need to continue to provide the benefits of Section 8 rental assistance even if annual appropriations were terminated by Congress.

[12] HUD has been asked to provide relief from this requirement to the extent that Congress may in the future terminate the availability of Section 8 rental assistance.

[13] HUD currently interprets this to mean that rents may not be increased to cover the debt service on capital improvements.

[14] The rent supplement regulation at 24 CFR 215.35 (rev. April 1, 1995), which was saved by 24 CFR 200.1302(a) in the current CFR, and Section 4 of the standard form Rent Supplement Contract have language that limits the rent supplement contract to the term of the mortgage.

[15] Note that the Checklist refers to replacing a terminated Rent Supplement contract with Enhanced Vouchers, but enhanced vouchers are not authorized by Section 8(t), the applicable statute, in this situation. Elsewhere, the Notice correctly refers to Regular Vouchers as the replacement subsidy.

[16] This provision was added by Notice H 2004-21.

CHAPTER FOUR

Financial Resources

Bart Lloyd

The landscape of resources currently available to recapitalize existing affordable housing projects owned or controlled by nonprofits includes one primary state-allocated federal program (the Low Income Housing Tax Credit); HUD's Section 8 Mark Up to Market/ Budget programs; and a range of somewhat idiosyncratic state funding, tax credit and preservation programs. While the Low Income Housing Tax Credit and state tax credit programs require a for-profit investor partner, the other resources are generally also available to owners and projects for which the retention of (or conversion to) status as a nonprofit owned project is either preferable or the only feasible alternative.

Low Income Housing Tax Credits

Low Income Housing Tax Credits are available to the owner of a qualified project based on the project's cost and continued usage as low income housing for a period of not less than 15 years (the "Credit").[1] The Credits are claimed by the owners of the project. In the nonprofit context, this ownership arrangement usually takes the form of a limited partnership in which the for-profit entity purchases a 99.9 percent limited partnership interest in order to claim the Credits, and the nonprofit owns a 0.1 percent general partner interest in order to control and operate the project. The for-profit entity, which is often a bank, an insurance company, or other financial institution such as Fannie Mae, will either purchase the limited partnership interest directly, or through an equity fund that has been put together by a syndicator to purchase such interests.

An excellent Low Income Housing Tax Credit resource and guide is *The Developer's Guide to the Low Income Housing Tax Credit,* published by the National Council of State Housing Finance Agencies (NCSHA).[2] The state housing finance agencies are, in most states, in charge of the administration of the Credit, and the NCSHA is their national association.

While a detailed analysis and description of the Credit is beyond the scope of this handbook, a few of the basics and highlights applicable to nonprofit owners seeking to recapitalize existing projects are as follows:

- There are two distinct sources of Credit: a nine percent "Per Capita" Credit that comes from a population-based annual allocation of Credits to the States, and a four percent "Bond" Credit that comes with projects financed with tax exempt private activity bonds. Both the nine percent Per Capita Credit and the four percent Bond Credit are authorized under Section 42 of the Internal Revenue Code.
- In order to qualify for Credit, an existing project must spend at least $3,000 per tax credit unit or, if greater, ten percent of the adjusted basis of the building, on rehabilitation.
- In order to qualify for Credit with respect to a project's acquisition, the project must not have been placed in service (i.e. transferred) within the past ten years, and must be transferred to a new ownership entity that is not "related" to the current owner for tax purposes. For nonprofit owners seeking to recapitalize their own projects this raises 'related party' issues discussed in Chapter 6.
- Nonprofits can avail themselves of several explicit advantages, including the special right noted in Chapter 1 to buy back the property from the limited partnership at the end of the 15 year compliance period for a price equal to the amount of outstanding indebtedness, plus the taxes applicable to the sale, under a nonprofit "right of first refusal."

In most states, the nine percent Per Capita Credits are much sought after and, except for projects with significant physical needs, may be difficult to obtain.

Conversely, the four percent Bond Credits that accompany tax exempt private activity bonds are in most states more readily available, and are generally better suited for projects with lesser physical needs. For most nonprofits considering recapitalization of a project, the question as to which Credit resource to use starts with an analysis as to whether a project can be adequately recapitalized with tax exempt bonds and four percent Bond Credits. In most cases, the decision to pursue nine percent Per Capita Credits will be made only if a recapitalization utilizing the four percent Bond Credits is not feasible (or, as in some states, is unobtainable).

Four Percent Bond Credits and Tax Exempt Private Activity Bond Financing

The use of tax exempt private activity bonds in the financing of the acquisition and rehabilitation of the project will qualify the project for four percent Bond Credits. Four percent Bond Credits are in most respects the same as nine percent Per Capita Credits. The most significant distinction, in addition to some different timing requirements, is that rehabilitation costs on four percent Bond Credits projects are eligible for Credits at a lower applicable rate than nine percent Per Capita Credits. The practical effect is that much less Credit can be raised with respect to rehabilitation costs, and as a result four percent Bond Credits are usually, although not exclusively, used for projects with smaller rehabilitation needs.

Obtaining four percent Bond Credits starts with the process of identifying which governmental entity can issue tax exempt housing bonds with respect to the project, and their requirements in connection with tax exempt bond issuance. Private activity tax exempt bonds are different from other tax exempt bonds such as 501(c)(3) bonds and governmental bonds in that they are issued to benefit private enterprises such as privately owned affordable housing projects. Tax exempt bond issuance on behalf of such private enterprises is limited by federal law to the amount of tax exempt private activity "volume cap" available within each state. The amount of volume cap available for statewide issuance in 2005 was equal to the greater of $239.2 million or $80 per resident, and the authorized uses are qualified housing (multi-family and first time homebuyer single-family loans), student loans, and economic development activities. Each state has its own process for allocating private activity volume cap authority amongst the authorized uses, and between issuers.

For nonprofit multi-family housing recapitalizations there are several issuer choices available in most states. Most states have a state housing finance agency (HFA), and many cities, counties, local housing authorities and local and statewide economic development authorities are authorized by their charter to issue tax exempt multi-family housing bonds.

The choice of which issuer to use will depend upon a number of factors, including the willingness of the issuer to finance the type of project proposed, the process for volume cap allocation within the state, and the requirements of the issuer relating to the financing.

The willingness of the potential issuer to finance multi-family projects will vary from state to state and from issuer to issuer. Not all issuers that are authorized to finance private multi-family developments do so. Some concentrate their activities on single-family loans. Others, such as public housing authorities, may concentrate their issuance activities on their own housing authority-owned projects, and do very little private activity financing. Conversely, in some states public housing authorities, economic development agencies, and state housing finance agencies will all be active and in some respects competitive in financing privately owned multi-family housing, and nonprofits seeking to recapitalize their projects will be able to shop between potential issuers for the best terms available.

The private activity volume cap allocation process is different in each state, and is currently undergoing changes in many states. Generally some form of appointed state public finance management board is charged with deciding how volume cap gets allocated amongst potential issuers. In some the division is purely by mathematical formula. In still others a lottery system is used. In many the allocation process stems from a time at which demand for tax exempt bond financing was high and the supply of private activity volume cap was quite scarce. In recent years, the dynamics have changed as the amount of private activity volume cap was increased substantially. This recent increase in supply was accompanied by a narrowing spread in the market between taxable and tax exempt financing rates, reducing the advantage of tax exempt financing compared with the costs and, consequently, decreasing the demand for tax exempt bond issuance. In some states, despite these changing market conditions, demand for volume cap still significantly exceeds supply. However, in most states in recent years there has been a mismatch – a relative surplus of volume cap, which is allocated to issuers

and users by mechanisms developed to cope with a shortage. Some states are rethinking their allocation process, and actively seeking to make sure that all available volume cap gets utilized.

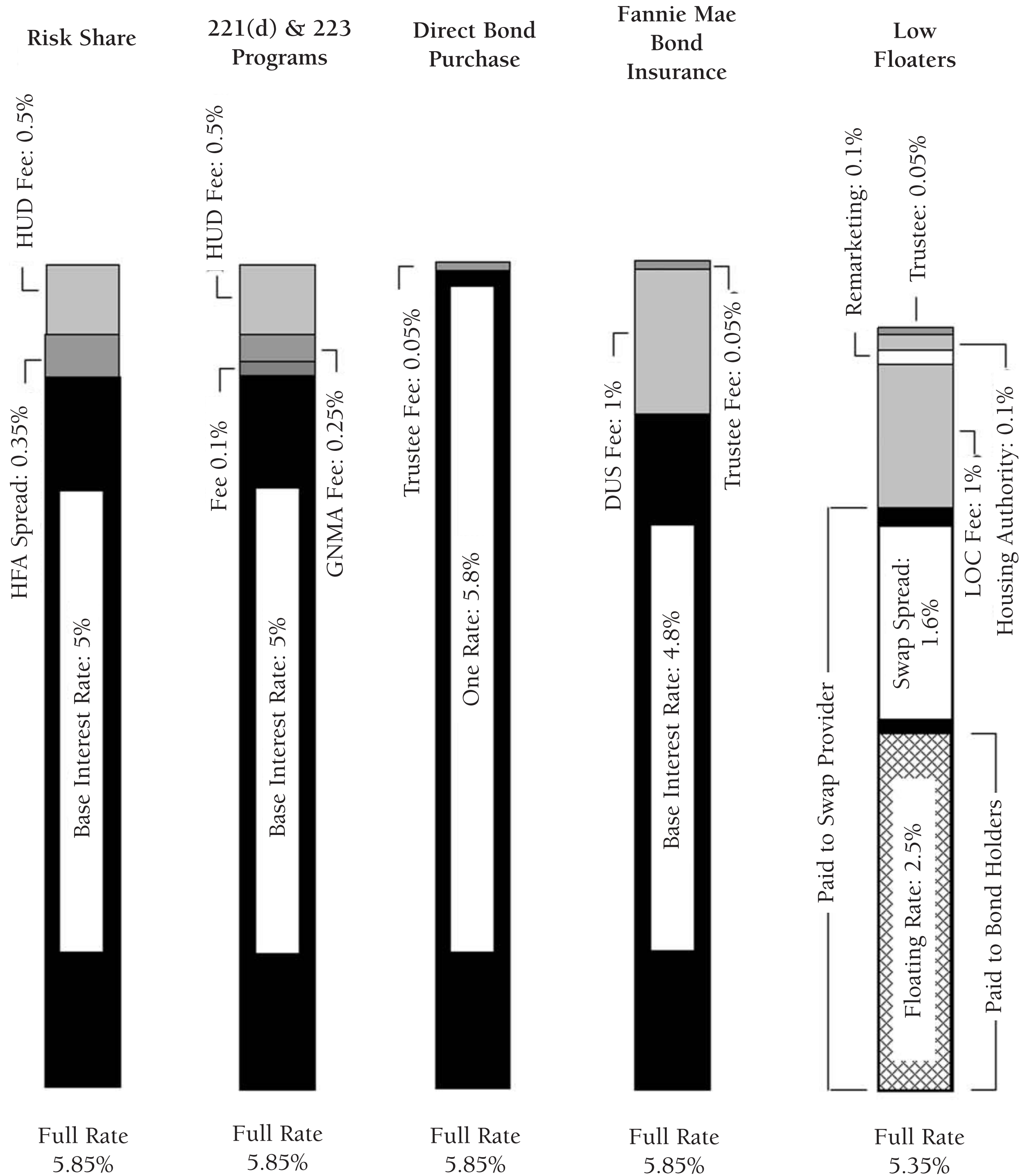
Each issuer will have their own requirements with respect to their financing of the project. In general, most issuers will require a third party such as HUD, Fannie Mae, or a rated bank or insurance company to guarantee, or "credit enhance," either the mortgage being financed or the bonds. The following are the most widely used programs:

- Many state housing finance agencies participate in and offer HUD risk sharing, a program under which HUD guarantees the mortgage and the housing finance agency agrees to reimburse HUD for a share of any losses. Under this program the housing finance agency sets the underwriting requirements and processes the loan. The housing finance agency elects the percentage of risk for which it will agree to reimburse HUD, and for some agencies the amount of that election (if the HUD share is above 50 percent) will result in HUD also processing the loan.
- HUD also offers multifamily mortgage insurance under its 221(d)(3) and 221(d)(4) programs for substantially rehabilitated projects, and under its 223(a)(7) and 223(f) program for refinancing of existing projects without significant rehabilitation. While HUD has the authority to underwrite these loans on their own, they also have empowered certain private mortgage companies to undertake the underwriting process on their behalf under the multi-family accelerated processing (MAP) program. HUD insurance in most instances is less expensive and can result in more financing for the project than other forms of credit enhancement, but also takes more time to obtain. The so called MAP lenders tend to be more expeditious than HUD at processing HUD insurance. Nonetheless the 223(a)(7) and 223(f) generally take a minimum of three months to process, and the 221(d)(3) and 221(d)(4) program can take from four to nine months or more in some states.
- Fannie Mae and Freddie Mac offer direct bond purchasing, which tends to take less time than HUD processing but may result in a smaller mortgage and less financing for the project because of more restrictive underwriting standards. For projects with significant rehabilitation needs, a bank letter of credit will also be needed to cover the project during the rehabilitation period.
- Fannie Mae and Freddie Mac also offer multi-family housing bond credit enhancement, which is similar to direct bond purchase except that the bonds are sold in a public offering (and so may obtain a better rate), and is only available for bond issues greater than three million dollars in size.
- A letter of credit (LC) from a rated bank can be used to credit enhance bonds as "low floater" bonds. Under this credit enhancement structure the LC serves as a guarantor and liquidity facility to the bond holders, and the interest rate on the bonds is re-priced daily, weekly, or monthly, and accordingly "floats." The risk of a floating interest rate is usually addressed through a derivative product such as an interest rate swap or cap that is purchased in connection with the issuance of the bonds. The LC structure is relatively quick to process, is suitable for both small and large projects, and will often result in the lowest effective interest rate for the mortgage. The primary drawback of this structure is the term of the LC, as banks are often reluctant to issue them for greater than five to ten year terms. While provisions are made in the bond documents so that a replacement LC can be obtained and/or the bonds can be converted to fixed rate bonds during the term of the LC, the risk that no LC will be available is a concern for both the nonprofit owner/sponsor and the Tax Credit investor because this term is less than the 15 year initial compliance period of the Tax Credits.
- A bond insurance company can provide credit enhancement of larger projects (or aggregated bond issues that finance several projects together). Bond insurance costs will vary widely depending on the facts and circumstances of each project, and is most competitive for projects with very strong operating histories and significant governmental assistance such as Section 8.

Figure 4.1 illustrates the layers of cost that contribute to the ultimate yield of these different structures.

Tax exempt bonds impose additional requirements with respect to the project being financed. The two most notable are a minimum rehabilitation requirement equal to 15 percent of the amount of the project financed with tax exempt bonds, and a regulatory agreement which imposes affordability requirements for the project. Both of these requirements are co-extensive with Credit requirements, and as a practical matter in many cases the tax-exempt bond requirements will be effectively superseded by the more stringent Credit requirements.

Figure 4.1



An additional requirement that often raises issues, particularly in recapitalizations with significant subordinate debt, is that in order for the entire project to qualify for Credit, at least 50 percent of the total costs that are includable in basis (plus land) must be financed with tax exempt volume cap bonds.[3] In instances where less than 50 percent of long term debt is to be financed with tax exempt bonds, owners will often finance a portion of the project with "callable" tax exempt bonds (sufficient to meet the 50 percent test and qualify the entire project for Credits), which are to be retired once the project is complete and placed in service.

Nine Percent Per Capita Credits

Each state receives an annual per capita allocation of Credits, which are allocated to projects and sponsors within the state on the basis of the state's annually adopted Qualified Allocation Plan (QAP). Per capita allocated Credits will fund a significant portion of a project's cost (30-40 percent of acquisitions costs, and 70-90 percent of rehabilitation costs). Demand for Per Capita Credits outstrips supply in most states by a factor of two or three to one. Most states direct their usage to projects with significant physical needs, and to areas in which the economics of affordable housing development are most difficult.

In most states the Per Capita Credit is competitively allocated during one or more funding rounds. Prospective sponsors submit their proposals by a specified date, and the allocating agency scores and ranks the proposals in accordance with the priorities listed in the QAP. For some projects the uncertainty and the duration of the process are problematic. However, in recent years an increasing number of states have established preservation set-asides or priorities that reflect the emphasis placed on retention of existing affordable housing, and in such states nonprofit recapitalizations may benefit from that preference.[4] Awards are often made from two to six months after the submission date, and many worthy projects do not receive an award on their initial application. Most allocating agencies will meet with prospective applicants prior to application submissions and discuss frankly the project's likelihood of success and realistic timing projections.

Projects that receive an award of Credits are required to either be completed within the year that the Credit is awarded, or to make sufficient progress within six months of the allocation that they will qualify for a carry-over allocation. A carry-over allocation allows the project to be placed in service by the end of the calendar year following the allocation.

Mark Up to Market and Mark Up to Budget[5]

HUD's Section 8 Mark Up to Market and Mark Up to Budget programs can provide opportunities for nonprofit owners to significantly enhance the amount of debt that can be supported in a recapitalization. Under Mark Up to Market, eligible for-profit owners and purchasers (including nonprofit controlled entities) can increase Section 8 rents to market comparable levels, either automatically or at HUD's discretion. Under Mark Up to Budget, nonprofits can increase Section 8 rents to market in order to undertake capital improvements or facilitate transfers from for-profit to nonprofit ownership. Mark Up to Budget is available to nonprofit owned as well as nonprofit controlled properties. Both Mark Up to Market and Mark Up to Budget permit early termination of an existing post-MAHRA Section 8 contract, in order to facilitate participation of nonprofit owners.

Nonprofits seeking funds for renovations can utilize the Mark Up to Budget capital improvements program to cover the annual cost of rehab financing or replacement reserve contributions, which must be justified on a budget basis. As a practical matter, most nonprofits seeking to recapitalize through a related-party ownership transfer (typically involving Low Income Housing Tax Credits) will also proceed under the capital improvements program because the nonprofit transfer component of Mark Up to Budget is not available for related-party sales. Some nonprofit controlled owners may be eligible to recapitalize under Mark Up to Market, which does not preclude related-party sales.

Taxable Project Financing

For many projects taxable financing will be a significant part of the recapitalization. For projects utilizing nine percent Per Capita Credits, tax exempt financing is generally prohibited. In addition, many smaller projects (and larger projects in markets where rents are low) will not have sufficient operating income to support a large enough mortgage to economically or practically access tax exempt financing. The following are the most widely used taxable financing programs:

- Housing Finance Agency taxable financing insured under HUD's Risk Share program and financed with taxable bonds.

- HUD insured financing accessed through a MAP lender and insured by HUD under the 221(d)(3), 221(d)(4) or 223(f) programs. Note that the 221(d)(3) and 221(d)(4) programs have minimum rehabilitation requirements, while the 223(f) has a limitation as to the maximum rehabilitation that can be done in connection with the refinancing. In almost all cases the mortgages are packaged with other similar mortgages (with GNMA insurance added to provide default liquidity) and resold by the MAP lender to investors – often to a public or privately held Real Estate Mortgage Investment Conduit (REMIC), in a process known as securitization.
- Fannie Mae or Freddie Mac taxable financing can be obtained from their authorized servicers.
- Private banks can provide taxable financing. Compared to the HUD and Fannie Mae or Freddie Mac loan products, most banks are not competitive because they are not willing for regulatory reasons to provide the kind of long term loans that a recapitalization generally requires. Regulators generally discourage long term lending by banks because of the potential for rate mismatch arising due to the short term nature of their funding source (deposits). However, some banks, in order to meet Community Reinvestment Act requirements, are willing to make longer term loans that can sometimes be competitive. In addition, banks that are members of the Federal Home Loan Bank (FHLB) system can use longer-term FHLB advances to fund longer-term loans without creating potential rate mismatch issues.
- Some Housing Finance Agencies or other governmentally created entities can provide taxable financing without the traditional forms of credit enhancement, at a lower cost. For example, the Massachusetts Housing Partnership (MHP) acts as an intermediary between the bank and the borrower to provide longer term taxable financing to the project than the bank would otherwise be able to provide, at a discounted rate. In MHP's case, the bank's underlying commitment to provide what amounts to discount-rate financing is a legally-mandated concession given in exchange for the Commonwealth's approval of an out-of-state bank's purchase of a Massachusetts bank.

State and Local Government Programs

Many states and cities have additional state and city sponsored programs that can be accessed as part of a recapitalization. The Appendix has examples of programs available in selected states. The following are indicative of some of the types of programs available:

HOME Funds
Federal HOME funds are allocated by HUD through a formula to states and other Participating Jurisdictions, which are cities, counties, and consortia of governmental units. HOME funds have a set-aside for nonprofit Community Housing Development Organizations (CHDOs). HOME funds, which can be used for both loans and grants, are for a variety of housing related programs, and recapitalizations and housing preservation activities are not emphasized by all states and participating jurisdictions. The application and funding process varies; many jurisdictions have competitive HOME funding rounds that are held in conjunction with their Credit funding rounds, while others accept applications on a rolling basis.

Housing Trust Funds
A number of states have housing trust fund programs. Some are funded by specific revenues (such as deed transfer taxes), some are funded by retained earnings of the housing finance agency, and others are funded by annual appropriations from the legislature. Notably, in many states the housing trust funds are awarded on a rolling basis (similar to private activity volume cap), and will be better suited from a timing perspective to being an additional resource that is included as a part of a four percent Bond Credit recapitalization.

State Low Income Housing Tax Credits
Several states have state Low Income Housing Tax Credit programs modeled after the federal Section 42 Credit program. In most, the state credit is separable and strippable from the Section 42 Credit in order to allow in-state buyers to purchase the local credit and national syndicators to purchase the Section 42 Credit. Some states provide an alternative structure whereby the credit can be structured as a loan instead of as a credit.

Real Property Municipal Tax Abatement
Some states and many individual cities have programs that encourage the use of whole or partial real property municipal tax abatements to assist in the recapitalization and preservation of affordable housing developments. In some, the abatement is not available to affordable housing projects that are owned by tax credit partnerships (even if the general partner is a nonprofit), but only to nonprofits who

hold the property in their own name. In most, the abatement arises because of the nonprofit nature of the owner, and as a result does not increase the amount of financing that a lender is willing to provide a project, since a for-profit lender would not qualify for the abatement were they to become an owner through foreclosure. In such cases, the abatement increases the cash-flow available only to the nonprofit owner in connection with the project.[6] Alternatively, many states and cities are able to enter into limited term real estate tax agreements (sometimes called payment in lieu of tax or PILOT agreements) with respect to affordable housing projects. Increased cash flow arising from PILOT agreements is generally able to be financed.

Housing Finance Agency (HFA) Preservation Programs
Many HFAs financed Section 8 assisted developments under HUD's new construction and substantial rehabilitation programs from the mid 1970s to the mid 1980s with HFA bonds and no FHA insurance. Many of these projects have significant excess funds (known as "residual receipts") and other excess reserves. For bond-financed projects whose Agreement to Enter into Housing Assistance Payment Contract (AHAP) was executed prior to February 29, 1980 (known as "old reg" projects) the ownership of those excess reserves is often claimed by the HFA. Several of the HFAs have instituted preservation programs, which provide for a sharing of the excess reserves in old reg projects in return for extended affordability commitments. For bond-financed projects whose AHAP was executed after February 29, 1980 (known as "new reg" projects), HUD claims ownership of the residual receipts. In certain instances HUD has authorized the release of those residual receipts in connection with a preservation recapitalization.

Many HFAs also have recapitalization funds available in connection with HUD's Financing Adjustment Factor (FAF) program. The FAF program provided HFAs with funds that arose in connection with interest rate savings from the refunding of the bonds underlying the loans to certain Section 8 assisted projects. While most FAF funds have been expended, some states have remaining funds that they have made available as soft financing for recapitalizations.

Donation Tax Credits
At this writing, Missouri and Illinois have enacted laws creating donation tax credits, which provide an allocated state credit to the owner of a property donated to a nonprofit that intends to use the property as affordable housing. The donation credits are based on the value of the property donated and typically sold to a local investor/taxpayer. Proceeds from the sale of the donation credits are paid to the prior owner. The donation credits can, for some owners, result in an after-tax result that is better than the after-tax result of selling the project for cash. An owner must apply to the state for the credit prior to making the donation. In a tax credit transaction, the donation is made to the nonprofit, which in turn sells the property to the tax credit partnership for full value.

Recapitalizing as a Nonprofit-Owned Project

In certain circumstances, a recapitalization of the project under continued nonprofit ownership may be preferable to forming a tax credit partnership and accessing tax credits, and in some circumstances it will be the only feasible recapitalization alternative.[7] Because there may be fewer resources available under this alternative, such a strategy may not provide sufficient funds for projects that have significant rehabilitation needs. However, as a general matter nonprofit recapitalization programs have significantly fewer complexities than other options, and the nonprofit will retain substantially more control of the project's rehabilitation, operations, and disposition.

The primary tools available for a recapitalization as a nonprofit owned project are: refinancing proceeds, utilizing either taxable or tax exempt financing; HUD's Section 8 Mark Up to Budget program for capital needs of nonprofit-owned or –controlled projects (see Chapter 2); HUD's Section 236 decoupling program (see Chapter 6); subordinate loans through either HUD or state programs; state or local real property tax exemptions and payment-in-lieu-of-tax programs; and private and state grant programs.

In many cases the most significant source of new recapitalization proceeds will be refinancing – utilizing existing cash flow, lower rates (in some instances), and a new loan amortization schedule to finance a larger mortgage than the remaining balance of the original project mortgage. This opportunity is highly sensitive to market interest rates and is more clearly beneficial when market rates are less than the project's original mortgage interest rate. An important tool in this regard is the availability of and eligibility of the project for 501(c)(3) bonds – tax exempt bonds that are available to finance projects owned by nonprofits. While 501(c)(3) bonds share many similarities with tax exempt private activity bonds described above (especially with regard to issuer and credit enhancement considerations), there are some important distinctions:

- Unlike private activity bonds, 501(c)(3) bonds do not require private activity volume cap, and accordingly the volume cap allocation process is avoided;
- Interest payments made on 501(c)(3) bonds are not subject to the alternative minimum tax, which in most interest rate environments will result in the rate paid on the bonds (and passed through to the mortgage) being slightly less than on tax exempt private activity bonds; and
- No minimum rehabilitation of the project is required.

The Mark Up to Budget program described above is an additional resource for both first mortgage refinancing and for obtaining subordinate financing for capital improvements. Under this program, described in Chapter 15 of HUD's Section 8 Renewal Guide, nonprofits can, on a budget basis, mark the Section 8 contract on the project up to (but not over) market comparable rents to finance needed capital improvements.

The state and local resources listed in the previous section (except state tax credits) can be utilized in connection with a recapitalization as a nonprofit. In addition, some of the states attach preferences and/or reserve certain of the resources (HOME funds, real estate tax abatements) exclusively to assist nonprofit-owned or preservation projects.

Chapter 4 Notes

[1] The Low Income Housing Tax Credit is primarily authorized in Section 42 of the Internal Revenue Code, and accordingly such credits are often referred to as "Section 42" credits.

[2] Available at www.ncsha.org.

[3] If less than 50 percent of the aggregate basis of the project is financed with tax exempt private activity bonds, the project will still qualify for Credits. However, the amount of Credits the project qualifies for is significantly less: equal to the pro rata percent of the aggregate basis of the project that is financed with the bonds.

[4] See, for example, *Affordable Housing Preservation Initiatives: A State-by-State Summary*, available from the National Housing Trust at http://www.nhtinc.org/index.asp.

[5] For more information on renewal of expiring project-based Section 8 contracts see Chapter 2, or also LISC's *Stemming the Tide: A Handbook on Preserving Subsidized Multifamily Housing*, available at www.lisc.org/preservation.

[6] A notable exception is the new refinancing guideline for Section 202 projects (Notice H 04-21) under which HUD allows nonprofit-based tax abatements to be included in underwriting.

[7] A countervailing consideration to note is that preservation of the project as a HUD-designated nonprofit project will mean that in most cases the nonprofit will be prohibited from retaining and using surplus cash from the project for non-project purposes and without HUD's permission. For further discussion, see Dividend Limitations in Chapter 6.

CHAPTER FIVE

Capital Needs Assessments

Edward J. Daly and David Whiston

What is a Capital Needs Assessment?

Capital needs assessments (here called CNAs) are also known as Physical Needs Assessments (PNA), Physical Condition Assessments (PCA), reserve studies (typically for condominium associations), HUD Comprehensive Needs Assessments (CNA) or capital plans. These terms are sometimes used interchangeably, though they often refer to very specific products. They all share a common basis: a report on a property which estimates its repair and replacement needs over an extended period of time, often analyzing the way in which resources need to be accumulated to pay for these needs (reserve analysis).

Identifying Capital Needs of Aging Properties – Why Bother?

CNAs act as valuable management and investment tools for both non-profit and for-profit real estate owners and managers. A property owner should consider conducting a CNA when a property has significant physical problems in order to put these existing problems in perspective against other ongoing needs and future needs of the property. A leaky roof may be an expensive problem to fix, but the ongoing need to replace refrigerators when they fail will remain. Additionally, an aging boiler can't be expected to last forever, even if it works well today.

Increasingly, public agencies and other lenders require a CNA as part of the underwriting process for the acquisition, financing or recapitalization of existing properties. They may also require a periodic CNA as a normal part of asset management procedures. These CNAs are designed not only to ensure the adequacy of any proposed rehabilitation, but also to set appropriate replacement reserve levels going forward.

CDCs and other housing providers have successfully used high-quality CNAs to bolster the case for additional resources (loans and grants) or reallocation of funds to reserves which can be shown to be inadequate.

Conducting a CNA when pressing physical problems don't exist can be helpful in avoiding unpleasant surprises, such as a boiler failure on New Year's Eve. If an owner can anticipate that a building's boiler has five to seven years of useful life remaining, they can accumulate funding to pay for the expense and schedule the replacement in the summer when the boiler is not in use. This should lower the cost and avoid consequential damages to the building and its residents.

A high-quality CNA can help property owners keep abreast of evolving code issues such as life safety, energy conservation and handicapped access. The standards set by these codes may either be mandatory or simply present opportunities to improve the property, but should be considered when assessing the building's needs. A thoughtful CNA will help avoid a mistake such as renovating the community room kitchen without incorporating the required accessibility features.

A high-quality CNA will help the owner of affordable housing operate its properties with an eye to local market standards. Even in areas that lack enough affordable housing, competition within the subsidized housing market may exist. High vacancy rates and even abandonment have been seen in both urban and rural communities due to competition from newer subsidized properties.

A high-quality CNA can also help guide spending decisions by laying out the long-term or life cycle costs of various materials. Looking at twenty years of costs can help assess whether a more expensive, but also more durable, option can turn out to be less costly in the long run.

Most importantly, a high-quality CNA contains an integrated analysis of replacement reserve accounts. This allows the CDC to plan for the future in light of known resource allocations. It is helpful to know that all the roofs will need to be shingled twelve to fourteen years from now and that the cost will increase projected capital spending in those years from $8,000 per year to over $40,000. But if the study doesn't reveal whether the reserves will be able to pay for the work or how much the CDC needs to increase annual contributions to reserves, the CNA has left out a key component.

For many owners and regulators, the most important aspect of a comprehensive capital plan is the analysis of the adequacy of the replacement reserve fund. If potential future shortfalls in funding can be anticipated, they can often be avoided with only marginal near term increases in annual contributions to reserves. This hypothesis is confirmed by an analysis of 183 multifamily properties conducted by On-Site Insight, Inc. (OSI).

The properties in OSI's sample included family and elderly developments in urban and rural locations in eighteen states. Properties ranged in size from six to 775 units and ranged in age from one to 35 years. Sixty-five percent of the properties were more than twenty years old.

As Figure 5.1 shows, only seventeen percent of the properties in this sample had enough internal resources (initial reserve for replacement and stream of annual contributions to reserves) to pay for all of their anticipated capital needs. While this reflects an unfortunate lack of attention to long-term property management, the chart also shows that a large number of properties could have been made "healthy" with modest adjustments in reserve funding. With another $120 per unit per year in annual contributions to reserves, an additional eleven percent would be adequately funded. With up to $360 per unit in additional annual contributions, a further twenty three percent could be put on a sound footing. The complete study can be found at www.on-site-insight.com/hudemo.htm.

A Cautionary Note About "Rules of Thumb"

Property owners and lenders often use a standard rule of thumb for allocating annual contributions to reserves. For many years people in the industry have been using something on the order of $360/unit/year ($30/unit/month) as a guideline. This in fact was the first standard used by the Massachusetts Housing Finance Agency (MassHousing) when it began requiring reserve studies in the mid 1980s.

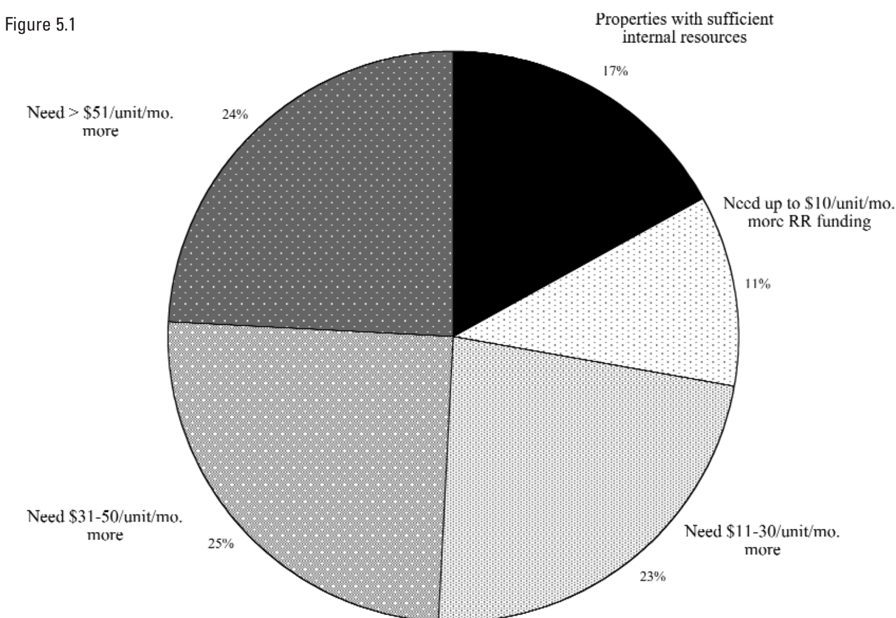
The table on page 30 lists some relatively short-lived items found in nearly all apartments with some standard quantities and unit costs. If one applies an expected useful life to each, one can then determine the annual "cost" or the annual contribution needed to reserve for the items when they are new.

That is, if the average unit has 600 square feet of carpet which costs $2.00 per square foot (installed) and is expected to last ten years, then the owner should be saving $120 every year to fund its replacement.

As the table shows, eight in-unit items alone will consume all of the $360 per unit rule of thumb in this hypothetical property. This would leave nothing for the remaining in-unit components (such as paint, doors, and fixtures) and nothing for roofing, siding, heating and air conditioning, window and door replacement, parking and grounds repairs, or anything else the property will need in the long run.

If the "rule of thumb" is so inadequate, and considering the underfunding found in the study cited above, one

Distribution of sample by relative "health"



Item	Quantity	Unit Cost	Total Cost	Expected life Useful Life	Annual Cost
Carpet	600 sf	$2.00	$1,200	10 yrs	$120.00
Refrigerator	1 ea	$450.00	$450.00	15 yrs	$30.00
Stove	1 ea	$300.00	$300.00	20 yrs	$15.00
Cabinets	1 ea	$2,400.00	$2,400.00	20 yrs	$120.00
Countertop	1 ea	$250.00	$250.00	10 yrs	$25.00
Kitchen Floor	1 ea	$150.00	$150.00	15 yrs	$10.00
Bath Floor	1 ea	$150.00	$150.00	10 yrs	$15.00
Water heater	1 ea	$300.00	$300.00	10 yrs	$30.00
Total Annual cost for These Items					**$365.00**

could reasonably wonder how could all these properties have survived over the years. The real-life pressures on owners and managers have forced them to operate with inadequate capital budgets. Many owners and managers report funding capital improvements from the operating budget, if this resource exists. Sometimes repairs are made instead of replacement, as when managers patch a hollow core door instead of replacing it. Most often, needed work is simply deferred as long as possible. Painting is done every ten years instead of every five; double-glazed windows with failed seals are not re-glazed; torn or burned carpets are not replaced. These deferrals can lead to other larger problems (unpainted trim begins to rot, for example) but at the very least they begin to affect a property's marketability and value.

This is not to imply that most affordable properties are physically distressed and only marginally marketable. What is clear is that many CDCs and others are spending from reserves as fast as they are making annual contributions, leaving the reserves too thin to cover major costs.

History of Capital Planning in HUD-Assisted Multifamily Housing

Capital planning as it is known today began with a HUD-sponsored study of public housing in 1983. This study (MODUSA) came out of a Congressional mandate to conduct a sample survey of all Public Housing and Indian Housing Authorities nationwide to determine the backlog of modernization needs. Congress ultimately never funded the backlog, but the study did lead eventually to some improvements in the HUD capital allocation system. It also led to the "observable systems" approach to multi-family building inspection.

In 1986/87 MassHousing became concerned that its portfolio of multifamily properties might be putting its bond rating at risk if future repair and replacement needs were not properly funded. The portfolio exceeded 400 properties statewide, with a total unit count in excess of 50,000. In 1988 they directed the private owners of these subsidized developments to prepare and submit 20-year capital needs assessments to MassHousing in a standard format, including unit cost estimates, expected useful lives, and inflation rates that were item specific. MassHousing then analyzed whether a simple trending of current annual deposits to the property's dedicated reserve for replacement account would be adequate to support the spending plan. Significantly, very few properties (even in this well-built and well-run portfolio) could pay for all anticipated capital requirements (without upgrades) from existing resources. Some real-estate consulting firms developed models that would also analyze replacement reserves on an annual cash-flow basis.

This approach to asset management spread to several other state housing finance agencies, including Rhode Island (RIHMFC), Virginia (VHDA), Connecticut (CHFA), Michigan (MSHDA), New York and New Hampshire. The implementation varied widely. Most agencies could not impose this requirement on owners, but did require such a study as part of any application for rent increases, for a change in annual contributions to reserves, or any financial re-structuring. MassHousing required all owners to submit reports at least twice, and still requires or commissions reports on a regular basis.

In 1990 the Federal National Mortgage Association (Fannie Mae) established consistent standards for the private lenders operating under its authority when conducting due-diligence on the underwriting of multi-family loans and refinancings. Fannie Mae developed a uniform framework for capital needs assessments. This consisted of three components:

1. A set of reporting forms capturing the items to be evaluated, their age, expected useful life, replacement cost and repair/replacement timing;
2. A table of expected useful lives for hundreds of components, which distinguishes between family and elderly developments.

3. A narrative "Guidance to the Evaluator" which described the approach to inspection and instructions on analysis and completion of the forms.

The Fannie Mae forms aggregate and trend costs on a year-by-year basis, but do not provide for any replacement reserve analysis. They have become extremely valuable to the Fannie Mae Delegated Underwriting and Servicing (DUS) lenders and have been made available for HUD's use in the Mark to Market program.

In the late 1980s, HUD was faced with managing hundreds of transactions that were triggered by the right of owners nationwide to exercise their contract rights to pay off HUD mortgages and convert developments to market rate use. The Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA) "preservation" program was designed to preserve affordability, while allowing owners access to built-up equity. Every property that participated in the program underwent a Preservation Capital Needs Assessment (PCNA) aimed at understanding current repair and replacement needs and determining an appropriate lump sum deposit to reserves to meet reasonably anticipated future needs. HUD contracted directly with real estate consultants and others to conduct PCNAs. These PCNAs were adequate snapshots of current conditions, but very poorly designed to capture the future needs on a year-by-year basis.

In 1995 HUD established the Comprehensive Needs Assessment program. This general assessment tool focused on properties not eligible for LIHPRHA. It attempted to quantify current and future needs and the resources (both at the property and from outside sources) available to pay for repairs. HUD required owners to hire third-party contractors to prepare the CNAs. The program eventually made a huge breakthrough in clarifying HUD's intentions regarding enforcement of handicap accessibility requirements required by Section 504 of the Rehabilitation Act of 1973.[1] Major drawbacks were the definitions of line-item reporting categories (e.g., windows and doors are lumped together) and the aggregation of time periods (Years 2 through 8 are combined in a presumed 20 year planning period). The program also lost focus when considerations of social service needs and the like were appended onto the reporting requirements for capital improvements.

One major current HUD program involves trying to reduce future Section 8 subsidy obligations to assisted properties without losing the affordability restrictions. When Section 8 rents exceed market levels at the time of contract renewal, the property may be subject to subsidy reduction and debt restructuring as a condition of renewal under HUD's Mark to Market (M2M) program. M2M requires HUD's private sector agents (Participating Administrative Entities, or PAEs) to hire consultants to prepare physical needs assessments using the Fannie Mae model discussed above. The M2M guidelines establish inspector credentials, mandate consultation with tenants, categorize needs by immediacy and severity, require attention to accessibility and environmental concerns, and require evaluation of market-comparable upgrades identified by an appraiser. The responsibilities of HUD's Office of Multifamily Housing Assistance Restructuring (OMHAR) have been transferred to the new Office of Affordable Housing Preservation (OAHP), which will continue to accept applications for the Mark to Market program until September 30, 2006.[2]

Section 202 Recapitalizations

The newest use of CNAs has been in the recapitalization of older Section 202 developments. This program, created by the Housing Act of 1959, provides direct loans to non-profits to develop and rehabilitate multifamily properties for the elderly and disabled. In the late 1970s Section 202 loans were linked to Section 8 subsidies to assure affordability to low-income residents. The older properties have both aging building components and, increasingly, frail elderly residents who would prefer to remain in place. Recapitalization of these properties recognizes the need to replace durable, long-lived systems like roofing, windows, and mechanical systems, while adapting common areas and units to the requirements of seniors and persons with disabilities. One strategy used by sponsors is to combine tax-exempt debt, Fannie Mae credit enhancement, and equity from Low Income Housing Tax Credits (LIHTC). Bond regulations and tax credit rules may specify a minimum up-front rehabilitation cost per unit. CNAs in this context need to balance current and future needs with extraordinary sensitivity to the requirements of these third-party interests.

A Word About REAC

One of the major multifamily initiatives that has come out of HUD in the past five years has been the use of a new basic physical inspection system under the auspices of the Real Estate Assessment Center (REAC). These inspections are conducted using hand-held computers to evaluate subsidized properties based on a

newly-developed Uniform Physical Conditions Standard (UPCS). Although designed for regulatory purposes, these inspections might in some cases give a property owner useful guidance about current physical deficiencies, but they have no forward-looking component. At best, a REAC/UPCS score is a snapshot of current conditions.

Components of a Well-Designed Capital Plan

How will a CDC know whether the sample report they are looking at is a high-quality one? How will a nonprofit know whether they got real value for the investment in the planning study they just commissioned?

An effective capital plan is composed of the following elements:

- The inventory component needs to include all of the systems, not just those which require attention now or in the near future. An item that has recently been replaced, and may not be expected to need attention again for the next twenty years, should still be listed for reference. If the assessor has made an assumption that a particular item represents an operating cost concern, the analysis should be shown to facilitate discussion and remediation.
- Each system or item included needs to have its age identified. In older properties, ages of components may not coincide with the development's age. Ages may vary widely between items and even across a single item. Unit flooring may have been installed over a five-year period which began eight years ago.
- Expected useful life estimates are the key to replacement timing. Capital planning is built on the idea that even systems that operate properly now will eventually fail. Expected lives should be adjusted from the norms found in various tables to the actual conditions at each development. Expected lives should be adjusted for climate, original materials and installation, maintenance practices, and resident demographic profiles. For example, elderly and family occupancy present different issues.
- Cost estimating is the hardest part of capital planning. The consultant should have access to good costs adjusted for the local area. The ability to adjust costs for individual building circumstances and the relative purchasing power of the CDC is equally important.
- A year by year cost summary of all of the anticipated capital needs will show not only how much needs to be spent but when. A relatively steady level of expenditures is much easier to anticipate than one with large swings. While a steady level may be desirable from a financial viewpoint, peaks and valleys might more accurately describe the real needs of the property, especially at single-building developments.
- Narrative presentations are usually necessary to describe the current condition, the maintenance history, and the rationale behind the consultant's cost and timing decisions. Narratives allow for a description of the cause of current problems, details on location of problems, or discussion of alternatives like rebuilding a pump motor instead of replacing the whole pump.
- Photographs can be invaluable tools when the report has a non-technical audience or is shared with a third party like a lender or regulator. These readers may never have been in a boiler room or crawl space. They may be unfamiliar with technical terms. Photographs can also support the findings and recommendations of the consultant. Showing the extent of the siding damage or the width of the foundation cracks can overcome a lot of resistance.
- Accessibility is not just good marketing, it is the law. All properties receiving direct federal financial assistance should have made common areas fully accessible a decade ago and need to have a plan for making units accessible as required. A useful capital plan integrates any accessibility needs with the other work required.
- Most importantly, in order to be useful, the CNA must evaluate existing capital reserves and annual contributions to reserves against the long-term spending plan. Only this analysis will let the CDC know the optimum annual contribution to reserves in a way that can be convincingly presented to others. The reserve plan should reflect real life constraints that are at odds with making the "optimum" contribution.

Formats for Capital Plans

HUD Formats

In the LIHPRHA and ELIHPA Preservation programs, HUD required reports attempting to establish the value of the property by deducting the cost of immediate needs. This approach lacked the needed focus on long-range planning. The format had adequate specificity about work to be done and location, but used a cost form (FHA Form 2326) designed around trade divisions. These plans often concealed as much as they revealed. The reserve analysis only accounted for the first time

anything needed to be replaced. This underestimated the need for short-lived items like unit carpet and refrigerators. It did not include the cost of accessibility improvements and ignored future inflation.

HUD's Comprehensive Needs Assessment (HUD CNA) format, still in use by some HUD offices, was limited by a planning spreadsheet that grouped costs into broad ranges like "Years 9-15" and into broad categories like "Hot water and boiler systems." However, it did mandate significant discussions of resident needs, accessibility deficiencies, and potential outside resources which might be tapped to pay for capital costs.

M2M and Fannie Mae

One widely known format for CNAs is contained in the Fannie Mae Physical Needs Assessment Guidance to the Property Evaluator. As noted above, this document was developed for Fannie Mae for use by that agency and its lenders. Subsequently it was licensed for use in HUD's M2M program. This format and the accompanying guidance forces the evaluator to look at a relatively large number of discrete items and allows for the evaluation and recording of unlimited other items. It forces the evaluator to be explicit about expected useful life assumptions and establishes some norms for evaluating useful life. Its major limitation is that it does not analyze the adequacy of replacement reserves. [3]

ASTM Baseline Property Condition Assessment Process

This Standard has been issued by ASTM International (formerly The American Society for Testing and Materials) to "define good commercial and customary practice…for conducting a baseline property condition assessment" for both multifamily residential and other commercial properties. It does not include any spreadsheet models or reserve analysis. It references the Americans with Disabilities Act (ADA) as the accessibility standard and not Section 504/Uniform Federal Accessibility Standards. While ADA covers accessibility standards for places of public accommodation, unlike Section 504 Standards, it does not cover dwelling units. Recipients of Federal funds are required to follow Section 504 Standards. While designed initially for commercial properties, it has been used in some housing evaluations. The ASTM Standard allows for sampling not only of dwelling units, but allows for "representative observations" of all systems and buildings, which in some instances may overlook important information. This is a significant potential limitation.

All of the major national formats focus on costs—sometimes only immediate needs and sometimes longer-term. The HUD CNA format attempted to make the critical connection between costs and resources, but its utility is limited by the focus on social concerns and the awkward categories. Some state housing finance agencies, notably MassHousing, have developed formats which do evaluate annual cost totals against a stream of annual contributions to reserves. They require CNA consultants to aggregate all costs to an annual total, which is compared with the year by year expected balances in reserves. The model accounts for inflation and for interest earned on reserve deposits. Custom formats have also been developed by individual consulting firms. These vary widely in the level of detail and sophistication of analysis.

It is important for any consumer of CNA services to remember that even the most impressive looking format, full of "bells and whistles," is of very little use if the people carrying out the study don't have the skills and support to do it right. CDCs should be very cautious of firms with little housing experience, firms unfamiliar with the building type or local environment, and firms where one team conducts the field work and another develops the analysis.

How to Hire and Manage a Third Party Consultant

Why Use a Third Party?

CDCs often ask why they should go to the trouble of hiring a third party when they have in-house staff with good building skills and staff with good financial skills. There are several things to think about before deciding to conduct an in-house CNA.

Many regulatory agencies and programs like HUD's Comprehensive Needs Assessment and Mark to Market programs require the use of third party consultants. These firms, like appraisers and accountants, provide an independent, neutral evaluation of conditions which is a necessity in due diligence situations. Even when not required, the independence of the assessor can be of value to the CDC when presenting a CNA to a lender or regulator.

A thoughtful needs assessor brings the experiences of other clients to bear in analyzing each property. Property owners gain by exposure to best practices, new products, and specialized skills not found in their organization.

Even if the CDC has staff with the skills to produce a CNA, it may not be the best use of their time, especially if there is a large portfolio to evaluate. An independent assessor can be expected to accomplish the task more quickly than relying on the "spare time" of the property managers, superintendents, and office staff.

If a CDC does decide to undertake the process itself, remember that the work will require:

- A through field evaluation tool covering all systems in a consistent manner;
- Staff with 40 or more available hours to see it through;
- Building technology skills covering both architectural and mechanical systems;
- A truly objective point of view, even if that leads to questions about things like staffing or past rehab decisions;
- A reliable source of cost and useful life data (RS Means, Marshall and Swift); and
- A detailed cost estimating and financial analysis spreadsheet model.

How to Select a Firm

There are a growing number of firms providing CNA services to residential and commercial property owners. These include architectural or engineering firms, environmental site assessment firms, home inspectors, and real estate consulting firms dedicated to capital planning. Some use in-house staff, some rely heavily on subconsultants, and some use a network of "affiliates" or stringers to do the fieldwork.

As in the choice of any professional consultant, the owner needs to be concerned with the technical qualifications, the experience, and the competence of the consultant. In choosing a CNA vendor, the owner ought to ask some additional questions.

Who does mechanical systems evaluations? Many multifamily buildings have a variety of sophisticated and expensive mechanical and electrical systems like boilers for heat and hot water, central air handling equipment, elevators, and fire alarm systems. The evaluation of the adequacy, efficiency, and expected useful lives of this kind of equipment requires specialized skills. This work is beyond the capacity of the layman and even outside the skill set of most architectural firms. Because mechanical and electrical equipment is critical to operations and life safety and because the cost of replacing the systems is both so high and typically cannot be spread out, having strong mechanical evaluation skills on the assessor's team is critical.

Is the format accessible to all constituencies? When management commissions a CNA it is important that the resulting report have as much utility as possible. If it is to be submitted to a lender or regulator, it must of course meet the minimum standards set by the third party as with the M2M program or Fannie Mae DUS lending programs. But this is only the beginning. In order to have the most value to the owner, the report must be a useful tool in itself. Ask to see a sample report for a property like the one under consideration and ask the following questions:

- Does it have a readable, project-specific narrative section, or does it all sound like boilerplate?
- Does it have a cost estimation summary that clearly states the expected costs over the planning period (typically 20 years)?
- Does it contain detailed quantities or is everything on a per unit or lump sum basis?
- Does the format allow for sufficient customization or do the hallway doors, the closet doors, the entry door, the service doors and the roll-up garage door all get lumped together under "Doors"?
- Are there charts and graphs to aid understanding and simplify presentation to others?
- Are there color photos to document and clarify the findings?
- Can a third-party reader, like a lender, envision the property itself from the combination of narrative, photos and spreadsheets?

A helpful CNA is not only accessible to the Director of Maintenance and the financial team, but should be clear enough for the CDC's Board of Directors to understand and detailed enough to be useful to the building superintendent.

Can the assessor think about maintenance as well as capital concerns? In order to maximize the value to the owner, the CNA consultant should have a process and a product that helps improve maintenance, especially of complex and expensive mechanical systems. It is not enough to state that the circulating pump has failed after five years when it was expected to last fifteen years. An experienced consultant should be able to distinguish between a poorly sized pump, a poorly made or installed pump, and a poorly maintained pump. All three can cause premature failure, and before buying a new one management should know why the first one failed.

Can the consultant produce multiple scenarios and adjust variables? Long range planning always involves some unknowns. How fast will prices for repair and remodeling rise in the next twenty years? At what rate will rents rise given market forces, regulatory restraints and the goals of the CDC? What sort of rate of return can be expected on the replacement reserve account? No matter how good the inventory, cost estimates and expected life projections of the plan are, variables like this can make a big difference in the long-term financial stability of the property. Can this consultant advise about appropriate levels and can he or she show alternate plans based on the same set of known conditions?

Is price important? Of course price is important, but the owner should ultimately be concerned about value. A low-cost CNA that requires several rounds of negotiation with the lender or regulator uses time and energy that could better be used elsewhere. A low-cost CNA which calls for brick pointing but is silent on the underlying causes of the cracks can lead to false security about the building as a structure and as an asset. A low-cost CNA which contains only tables of numbers provides little in the way of support for board presentations or guidance to site staffs. Price is one element of value, but so is the quality of the product.

One way to reduce cost is to be able to provide the most support to the consultant (see below). Another strategy is to bundle a number of properties, or the whole portfolio, into a single contract. This is especially effective if the consultant is from out of town and needs to include the direct costs of travel and lodging in the fee.

How to Get the Most out of the Consultant Fee

In order to maximize the value of the CNA, the owner must see it as a collaborative effort between the client and the consultant. The collaboration begins before the inspection starts and continues even after the report is finalized. CDCs need to think of the CNA as a process and not just a product.

Before the Inspection

All high-quality CNAs make use of historic information about the property. The assessor will want to know when major work like roofing and boiler replacement was last done (if ever) and will want to know about past replacement of short-lived items like unit carpet and individual domestic hot water heaters. Having this information available in advance or on the day of the inspection will help the assessor evaluate the current condition of the property. It will also help establish future replacement schedules. If records show that all carpets were replaced between 1994 and 1998, and a second round of carpets was begun in 2002, then the assessor can evaluate whether this timing makes sense at this property given the materials, climate, household composition and other factors.

If the CDC can provide the actual costs of these past activities, these will provide one valuable measure on which to base future cost estimates. While there are several reliable third-party cost estimating sources like RS Means, and some consulting firms have developed their own price book, costs for simple items such as a 30 gallon domestic hot water heater can vary widely depending on the market. A CDC with an extensive portfolio and a long history in the community may be able to negotiate a reduced rate from local suppliers. At the other extreme, a nonprofit may have only a small property in a hard-to-serve rural community where they need to pay full retail for appliances as well as the cost for installation. Accurate cost estimates for a specific operation is one key to a CNA that has real value.

Pre-planning should also include finding the architectural plans. While it is possible to produce a CNA without a set of site and building plans, the result will be higher cost, lower quality or both. The service contracts for major equipment like elevators, fire alarms and emergency generators also provide helpful detail.

The interaction during a CNA is not only between the consultant and the owner, but also among the consultant, the owner, and the residents. Management and the consultant should work in advance to select the appropriate unit sample. In some cases this is dictated by a third party. In other cases management needs to make sure that the sample size gives the CDC confidence that all relevant observations are being made. Notifying residents in advance makes the assessor's job easier, minimizes disruption of residents' lives, and avoids problems between property staff and residents.

During the Inspection

The most important assistance the owner can provide during the inspection is the availability of good escorts. The assessor evaluating the mechanical systems should have the property's most experienced mechanical person with him or her. Not only will the assessor be able to ask questions about ages, maintenance practices, operational problems and "What's behind this door?" but the assessor may also

be able to share ideas about how to improve operations or save money without expensive upgrades or replacements. The person inspecting the apartment interiors also needs an escort. Ideally this person should also be familiar with the ages of finishes and equipment, replacement cycles, and typical maintenance practices. To assist the assessor, it is just as important that this escort knows the residents, is known by the residents, and knows the neighborhood if the assignment is for a scattered site property. This will maximize the time the assessor spends actually looking at conditions and minimize the time spent waiting for people to answer the door. Finally, on the day of inspection, make sure that an extension ladder, if needed, is available to provide access the roof. Site escorts should have all the keys they need to electric closets, roof hatches, storage buildings and the like.

Reviewing the Report

Read the report. Really read the report. The CNA may be the key piece of due diligence needed to secure funding for refinancing. Because the process can be costly and only done infrequently, the CNA deserves careful review by all interested parties. Key staff such as the building superintendent, property manager, and CFO should all read the report. After the report is read and understood, the CDC should work with the consultant to adjust the assumptions (such as cost, useful life, and interest rates) based on the organization's knowledge of local conditions and the CDC's own policies.

Follow Up

In choosing a capital-planning consultant, a property owner should make sure that the person who led the field investigation is available to meet with management, either in person or by phone, to go over the report. Be skeptical if the only interaction is with a "report reviewer" and not the inspecting professional. This review meeting is essential in maximizing the value to the CDC. It is at this point that the questions from careful reading get answered. It is here that conflicts between past practice and consultant recommendations get ironed out. This is when additional documentation on ages and actual costs can be presented to be incorporated into the final report. Remember, this is your document – it will only be useful if understood by the property owner, if the information can be communicated to others, and if there is a reasonable chance of carrying out the plan.

Roles of a Planner and Architect or Engineer

While most CNAs done for property management, asset management, or even due diligence purposes do not require the engagement of a registered architect or professional engineer, there are clearly cases where this is appropriate. Licensed professionals are necessary when:

- Structural problems have been identified;
- The use of space is going to be changed, for example by converting apartments to congregate living;
- A building permit is required, or designed solutions are needed.

From time to time, the CNA firm will recommend employing a specialty consultant to work with them on a plan. They may suggest that a structural engineer or elevator specialist work alongside the inspection team if there are specific problems identified in advance. A thoughtful CNA consultant also recognizes when there are problems outside their area of competence and may recommend during or after the inspection that the client engage other professionals either to perform additional destructive testing or to develop a proposal for a design solution.

Capital planning is not the same as design, though the need for a designer may flow from the capital plan recommendations. Alternately, a substantial rehabilitation requiring a design professional may be the catalyst to undertake a capital plan. The different points of view expressed by the planner and the designer may need to be reconciled by the CDC. It is important that the CDC actively understands and manages the interaction between these two professions so as to maximize the value of all of the consulting work.

Sometimes CNA firms are asked to develop long-range plans based on an architect's scope and cost estimates for a major rehabilitation. When the scope is well developed and the cost estimate is broken down by work item, and not just broad categories like "Metals" or "Concrete," this can be a useful way to proceed. If an owner takes this approach, they can expect there to be some give and take among the client and the two consultants. The CNA firm may feel certain elements are being replaced prematurely or that the focus of the rehab plan is on highly visible items while neglecting important infrastructure. Try to remember that the current project is only one event in the life of the building, and that compromises might need to be made in order assure financial stability at the lowest cost over the long term.

Topics for CDCs

The Use of a CNA When Recapitalizing

While CNAs are used more and more for routine property management and asset management purposes, they should be seen as a key component of any recapitalization strategy. Good forensic evaluations of the site, the building envelope, and the mechanical and life safety systems are necessary to produce realistic costs for capital improvements. Using freed up income to pay for the increasing operating costs for insurance, utilities and the like makes lots of sense. Putting some of that money into capital improvements is also a good idea. Putting the right amount of money into the right capital improvements at the right time is not only the goal of the CNA, but will prove most valuable to the CDC in the long run.

Refinancing may be the best (and perhaps the only) opportunity to get significant new capital to apply to physical needs. The CNA should allow the CDC to distinguish between ongoing replacement needs like appliances and carpet and "big ticket" items like boiler replacement, new siding, new windows, or an elevator upgrade.

Some capital items lend themselves to replacement over time. Not all tenants impose the same wear and tear on the appliances. A tired but functional bathroom vanity probably is not going to be replaced until a new tenant moves in. Not all air conditioner compressors will fail at once. An annual stream of contributions to reserves can be set to roughly match the rate of expenditure for work items that can be or should be spread over time.

While air conditioners might best be replaced over a five or ten-year period, other replacements need to be done at one time either because the item is essential to the building's functioning (replacing a leaky roof) or because of economies of scale (replacing old windows). Most of these durable, but expensive items have long useful lives. However, when they fail, they are expensive to replace. If the CDC has been extraordinarily foresighted and has had good relations with a progressive lender and regulator, the property may have been accumulating this needed money in its reserve account. More likely, the CNA will show a shortfall in reserves at the time the major costs are anticipated. They may show up as immediate needs, which certainly should be incorporated into the recapitalization.

What about the case where the big ticket items function adequately now, have some useful life remaining, but are anticipated to need replacement in the next three to five years? Most reserve accounts will be inadequate and not enough time remains for an increase in annual contributions to do much good. This is the opportunity (if there is a high-quality CNA in place) to do one of two things. One choice is to "prematurely retire" that aged but still functioning fire pump, and replace it now with some of the proceeds of the refinancing. The other possibility is to use the proceeds to fund the reserve by an amount equal to the cost of replacing the fire pump when it is expected to fail in four years.

Both strategies have some risk. If a property manager buys a new one now, they risk being seen as "wasting" some portion of the item's value since they have replaced it when it still works. On the other hand, if management increases reserves rather than replace the boiler immediately, there is a risk that the boiler could fail at the least convenient time – for example, the coldest New Year's Eve on record – requiring rental of a portable boiler and other extra expenses associated with a time-critical system failure. Of course, there is also the possibility that the boiler could last longer than expected, providing the owner the financial windfall of extra service life along with the security of an adequate reserve account when replacement does become necessary.

Special Features for Section 202 Properties

Section 202 has been the federal government's primary production program for elderly multifamily housing for many years. Many of these properties are now aging in place, as are their residents. The properties are due for recapitalization, to undertake major capital improvements and reconfigurations, and to develop new services to meet changing resident needs. Responding to Section 202 sponsors, lenders, state housing agencies and others, Congress and HUD have adopted guidelines for prepayment and refinancing of existing Section 202 loans.[4] This represents a significant opportunity to relieve unfavorable debt burdens assumed twenty or more years ago (see Chapter 3).

One of the first Section 202 refinancings in the country, and possibly the first by a state agency, involved Peter Sanborn Place in Reading, MA (see transaction summary on page 15). Like many Section 202 properties, it is physically attractive, well-managed and financially viable. Over time, it had aged to a point where capital improvements were in order. Its residents

had aged as well; many now needed some modifications to their units and/or additional services in order to continue living independently.

A key element of the transaction at Peter Sanborn was a massive reduction in debt costs from the original mortgage loan at 9.25 percent. The Massachusetts Housing Finance Agency (MassHousing) was able to provide a new mortgage loan at 5.04 percent, freeing up $1.7 million for building improvements, resident services, and new replacement reserves. The recapitalization facilitated major kitchen and bath renovations for improved accessibility and functionality for a frail, elderly population. Other initiatives included common area lighting upgrades, a keyless entry system, 24-hour resident supervision, and an escrow to pay for other supportive services.

While most of the capital improvements were to be funded out of MassHousing financing proceeds, the CNA consultant had a significant role in helping establish a viable replacement reserve funding plan for the development's ongoing operation, and in determining how much of the existing reserves could be dedicated to the immediate rehab program. HUD has made third-party capital needs assessments an integral part of the rapidly-growing Section 202 refinancing program. On some of these, sponsors have been hard pressed to find significant capital improvements to undertake immediately. Instead, they have substantially recapitalized existing replacement reserves to meet needs further down the road which were documented by the CNA.

Sustainable Rehabilitation

The limited budgets associated with assessments of sustainable rehabilitation opportunities typically result in a focus on retrofits of property elements and systems. More effective CNAs will guide readers to consider alternative approaches to addressing a problem (e.g. converting to natural gas, or dual fuel technology when an oil-fired heating plant is to be replaced, or moving to more durable siding materials when the T1-11 siding goes). The idea here is to get the most "bang for the rehab buck," and make life better and easier for residents and management and maintenance staff.

In this vein, there is growing interest today in "high-performance" housing solutions to capital improvement needs, including energy efficient and green technologies. While a detailed exploration of such matters is beyond the scope of this handbook, substantial rehab programs offer an opportunity to strategically combine various improvements in a way that can achieve utility cost savings, reduce consumption and waste of building materials, and improve resident comfort and health. Combining solutions can offset undesired effects of a single solution. For instance, replacing leaky windows (an unintended source of fresh air in apartments) without attention to ventilation may simply swap one form of resident discomfort with another. Also, combining improvements in a manner that creates recognizable energy benefits can be used to leverage funds for other work. Many utility companies around the country now offer attractive conservation incentive programs. These often can be combined with special energy loans and foundation grant resources.

When developing a recapitalization program for an older facility, sponsors would often be well-advised to look at opportunities to tighten up their building envelope, such as adding insulation when replacing a roof. Another option for sponsors to consider is upgrading HVAC and domestic hot water generation systems. This might entail moving from one large heating boiler to two or more smaller boilers with comparable total capacity. Operating only as many boilers as are needed at any time reduces overall energy usage. It is also possible that with a tighter envelope, boilers and or AC chillers could be re-sized downward. Finally, the use of energy-efficient permanent lighting and appliances reduces a property's base energy load and may qualify for utility rebates.

In the area of high-performance housing solutions, considerable weight should still be given to well-established and proven technologies. A CDC should be properly skeptical of exotic new technology that may not provide promised results or that prove difficult to maintain (e.g. heating or cooling equipment made overseas, and those beyond the maintenance capacity of the local HVAC contractor).

Environmental Considerations

For an entity looking to acquire an existing facility, particularly one that is mature, a Phase I environmental assessment, separate from the capital needs assessment, will likely be in order. These typically include a review of historic records to identify potentially adverse previous uses of the property (for example presence of abandoned underground gasoline storage tanks), visual assessment of potential existing hazards (abandoned maintenance facilities and electrical transformers), and generally limited materials testing for radon, lead-based paint and asbestos.

Two of the better understood environmental hazards in older multifamily properties – lead-based paint and asbestos – are also significant potential legal liabilities, and enormous expenses if remediation is required.

While there isn't room here to cover these issues in depth, development sponsors and managers should be mindful of these in the course of recapitalizing properties built before the late 1970s, when both materials were phased out of wide-spread use.

Lead Based Paint (LBP)

Before 1977, lead was widely used to enhance the color and durability of paints. Many of the qualities that made it useful in paint and plaster products contribute to its health effects. It does not decompose and can't be excreted by the body; it builds up in blood and soft tissue instead. In adults, it can contribute to high blood pressure. It is a greater risk to children; its neuro-toxic effects include impaired IQ, shortened memory and attention span, and learning disabilities.

While lead-based paint has not been applied legally in residential structures for 25 years, it can still be found in older properties. A CDC looking to acquire an existing older property should seek and review the results of past testing from the current/past owner. If they are not available, the buyer should undertake testing; this must be done by licensed specialists. HUD has very specific standards for risk associated with LBP, and well-established guidelines for testing. There are two basic abatement options – encapsulation of sound, intact LBP materials with approved paint products, and removal. All LBP removal work must also be done by licensed contractors. It is intrusive and must be done under strict guidelines, including clean-up and post-abatement testing. This can be a very costly endeavor, fundamentally altering rehab plans and budgets.

Asbestos

Asbestos is a naturally occurring fibrous material that was used for years in fire-proofing and insulation materials. Damage or deterioration of asbestos-containing materials (ACMs) can result in the release into the air of microscopic fibers, which can then be inhaled. Asbestos has been linked to cancer and asbestosis (a chronic disease making breathing progressively more difficult). The hazards associated with ACMs have been known for some time, and asbestos has largely been removed from the marketplace. It can still be found in older properties, notably in boiler room plumbing insulation, vinyl flooring (both in tile and in the mastic used in installation), 'popcorn' ceiling finishes, and some siding and roofing materials. ACMs that are intact and in good condition do not pose a health hazard and need not be abated. ACM flooring can be encapsulated with carpet or vinyl material. However, where sound ACMs are identified, an 'operating and maintenance' or O & M plan should be developed to establish clear guidelines for handling this material going forward.

If demolition or rehab activity will disturb or damage such materials, this must be addressed very carefully, often at considerable expense. Remediation of these materials must be conducted carefully (wetted, containerized and labeled, and delivered to specially designated landfills). Cautious lenders may even forgo planned foreclosures on properties with widespread asbestos problems. Many old properties, with two layers of asphalt roof shingles, are now experiencing huge disposal costs associated with asbestos in the original materials.

Mold

An emerging environmental concern today is mold. Its health effects are less well understood, and unlike lead-based paint and asbestos there are no established standards for unacceptable conditions. Exposure to mold can have moderate to serious consequences for some persons, particularly those with respiratory conditions. Allergic reactions, asthma and fatigue are common outcomes.

Many types of mold exist. One closely linked to adverse health effects is *Stachybotrys chartarum*, a greenish black mold that grows on drywall, ceiling tiles and wood. (The black mold seen on bath tiles is not *Stachybotrys chartarum*.)

Mold can be found almost anywhere in the presence of moisture and oxygen; its growth can be controlled through attention to indoor moisture. Moisture problems can have various causes, including water infiltration from outside, plumbing deficiencies, and uncontrolled humidity (some energy-conscious design and construction practices in the past several decades have contributed to tightly-sealed and inadequately ventilated buildings).

There are a few questions to consider about mold risk in the context of a capital improvement program.

- Are there recognized moisture problems in the building?
- Are residents reporting musty or moldy odors?
- Are residents reporting health problems?
- Has maintenance been deferred?

Of course, property sponsors and managers should establish effective maintenance practices after rehabilitation, in order to reduce the chances of future

mold problems. Fix plumbing leaks and halt water infiltration. Enlist resident cooperation in reporting problems in their units. Keep HVAC drip pans clean and unobstructed. Prevent moisture build-up by increasing building ventilation and venting moisture-producing appliances outside.

The EPA has published a useful general resource on this issue, "Mold Remediation in Schools and Commercial Buildings." It includes a detailed discussion of appropriate remediation actions.

References

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How Buildings Learn. (Viking) Copyright 1994 by Stewart Brand. Wonderful examples of what can happen to buildings over time, written for those who would rather keep buildings than build buildings.

The Visual Display of Quantitative Information. (Graphics Press) Copyright 1983 by Edward Tufte. The finest book ever on how to make, read, and analyze charts and graphs.

Structural Investigation and Repair of Single and Multifamily Buildings. Copyright 1996 by Rene Mugnier, P. E. Written for the lay person and filled with photographs of old buildings in distress.

The Rehab Guide - Innovative and State-of-the Art Technology and Techniques for Housing Rehabilitation. US Department of Housing and Urban Development Office of Policy Development and Research February 2000. A very helpful learning tool with lots of graphics, photos and sources.

Residential Rehabilitation Inspection Guide. Prepared for U.S. Department of Housing and Urban Development Office of Policy Development and Research by the National Institute of Building Sciences April 2001. Includes a table of expected useful lives for building components.

Chapter 5 Notes

[1] Section 504 prohibits exclusion from or denial of federal government benefits because of a handicap. HUD has issued implementing regulations at 24 CFR 8 and 24 CFR 9.

[2] See *Stemming the Tide* at http://www.lisc.org/preservation.

[3] The *Fannie Mae Physical Needs Assessment Guidance to the Property Evaluator* is not in the public domain. The forms and expected useful life tables were developed for Fannie Mae by ON-SITE INSIGHT Inc. of Needham MA. Copyrights are shared between Fannie Mae and ON-SITE INSIGHT. Fannie Mae holds the rights to use the guidance and forms in its DUS and other lending programs and has licensed its use to HUD solely in connection with the implementation of the Multifamily Assisted Housing Reform and Accountability act of 1997. All other rights in use are the property of ON-SITE INSIGHT.

[4] HUD Notice 2002-16, "Prepayment of Direct Loans on Section 202 and 202/8 Projects with Inclusion of FHA Mortgage Insurance Guidelines" and Notice H 2004-21, "Amendments to Notice H 2002-16: Underwriting Guidelines for Refinancing of Section 202 and 202/8 Direct Loan Prepayments."

CHAPTER SIX

Special Regulatory and Underwriting Issues

Emily Achtenberg and Bart Lloyd

Partnership and Low Income Housing Tax Credit Issues

"Related Party" Issues

Recapitalizations of nonprofit owned projects seeking to utilize Credits typically encounter "related party" problems in two distinct aspects of the transaction: with regard to the project's acquisition and with regard to debt financing that may be provided by or flow through the nonprofit to the project.

The Credit applicable to the acquisition of the project (as distinct from the Credit applicable to the rehabilitation of the project) will often be the most substantial aspect of a project's overall Credit eligibility. Section 42(d)(2)(B)(iii) provides a special requirement that with respect to the acquisition the project must not have been placed in service by the taxpayer or by any person who was a related person with respect to the taxpayer. This will often complicate acquisition by one limited partnership owned or controlled by a nonprofit from another limited partnership owned or controlled by the same nonprofit. In the event this transfer is deemed to be one between related parties, the entire acquisition Credit will be lost. Moreover, Section 42(d)(2)(D)(iii) sets forth specific related party tests applicable to acquisitions for Credit purposes. In general, a party (and parties controlled by that party) holding an interest of greater than ten percent in both the buyer and the seller will be considered related with respect to the acquisition of a project.

The related party acquisition problem is typically solved by having the nonprofit own less than ten percent of the new limited partnership acquiring the project. Since in most cases the nonprofit will own only a 0.1 percent interest of the new limited partnership, the problem arises not with the internal ownership arrangement per se, but with two other financial elements of ownership: the split within the new partnership of the rights to cash flow and the rights to refinancing/sale proceeds. Most syndicators and investors are buying the limited partnership interest for tax credits, not cash flow or disposition proceeds, and the nonprofit sponsored general partner will usually want those financial elements as part of their compensation. Accordingly, in most instances the distributions of cash flow and refinancing/sale proceeds will be heavily weighted towards the general partner. However, in a nonprofit recapitalization the related party acquisition considerations will make that sharing arrangement problematic, and the nonprofit will not be allowed to take more than nine percent of either cash flow or refinancing/sale proceeds. In such circumstances, the operational cash flowing to the nonprofit may be less (unless there is qualified debt to soak up available cash – see below), and the nonprofit will be relying more strongly on its rights under the Section 42 (i)(7) nonprofit right of first refusal to control the project's ultimate disposition.

A second "related party" issue that arises in nonprofit recapitalizations is with regard to debt that is either provided by or flowing through the nonprofit to the project. Project and partnership debt to the nonprofit that wholly owns the general partner of the partnership can raise problematic tax issues that may detrimentally affect the partnership's allocation of Credits to the limited partner that is purchasing the Credits. Debt financing being held by the nonprofit that desires to act as the general partner can arise in numerous ways: as seller financing (to reflect the difference between fair market value and the nominal sales price), as "pass through" financing whereby a state or governmental grant program is passed through the nonprofit to

the project as a loan, under HUD's Mark to Market program by the assignment to the nonprofit of the HUD-held subordinate debt, or as a loan of developer fee or other funds of the nonprofit. This problem is typically avoided by having the general partner (which is usually a corporation or limited liability company created by the nonprofit) be owned in part by an unrelated, but friendly, entity. For debt purposes, two entities are related if they are owned 20 percent or more by the same party. Consequently, transferring 21 percent of the shares of the general partner to an unrelated nonprofit will leave the recapitalizing nonprofit in control of the general partner (with ownership of 79 percent), but also result in an unrelated entity that avoids the tax allocation problems of related party debt.[1]

Buying Out Limited Partners

Nonprofit controlled projects with limited partners can sometimes better facilitate a recapitalization by buying out existing limited partners over time. Sponsors negotiating directly with their limited partners (or, as is often the case, their heirs and successors) should keep in mind that an inherent conflict exists between their interests as prospective purchaser and their fiduciary obligations as general partner. This conflict should not preclude either the negotiations or the purchase, but sponsors should take care to ensure that the limited partner is adequately represented in the negotiations to make an informed decision, and that the sponsor is comfortable that on balance, the purchase is fair. Sponsors should also take care that the subsequent recapitalization (provided that it is somewhat proximate in time to the purchase of the limited partnership interest) does not result in a significant windfall to the sponsor that could have been passed along to the limited partner.

Notwithstanding the foregoing, limited partnership interests are highly illiquid, difficult to finance, and generally have low market value. Exceptions exist where the property has significantly appreciated in value and the project's use restrictions are at or near their end. However, even in those exceptional instances, unless explicitly provided for in the partnership agreement, while the general partner does usually have an obligation to try and maximize cash flow to the partnership, the general partner does not have an obligation to sell the property in order to maximize the limited partner's disposition returns.

In the negotiations with the limited partner, the nonprofit sponsor may in some cases be able to enhance an offer to purchase the interest by having the interest be wholly or partially donated to the nonprofit as a charitable contribution. While there are limits to the use of such a donation treatment that depend in part on the individual circumstances of the limited partner (and so will not be applicable or attractive to all limited partners equally), for some limited partners a charitable donation – or part donation, part sale (often called a "bargain sale") – will result in a better after-tax result than having been paid wholly in cash.

Special Section 8 and Rental Assistance Issues

Section 8 Project-Based Underwriting

Current renewal authority for project-based Section 8 contracts (even those of up to 20 years in duration) is subject to annual appropriations. Different lenders and investors have significantly varying comfort levels (and underwriting standards) with respect to that appropriations risk. While there are some additional variations, there are generally three approaches to the issue. A few lenders and investors are comfortable assuming that all Section 8 contracts will be perpetually renewed, although some make further distinctions, and for instance might be more comfortable that elderly Section 8 contracts will be renewed than that family Section 8 contracts will be renewed. Others are comfortable assuming that the assistance may end and that vouchers will be given to qualifying tenants, and therefore require significant 'transition reserves' to be maintained at the project to be available in the event the Section 8 contract is not renewed. Lenders and investors size the amount of such a transition reserve based on an attrition analysis which assumes that at the time of non-renewal (or sooner) all eligible tenants receive enhanced Section 8 vouchers, and that over time (from three to ten years) the units upon turnover will convert to the lower of the applicable market or Credit rents (i.e. rents affordable at 50 percent or 60 percent of median income). Other lenders and investors are unwilling to accept any appropriations risk and will not underwrite on any Section 8 income that is above the lower of market or Credit rents (or, for syndicators, invest in projects with loans that are underwritten based on Section 8 income above the lower of those rents). For many lenders and investors, the issue and

which of the three assumptions will apply is not fixed by principle: their comfort level will be significantly influenced by such factors as the strength of the surrounding market, the amount of disparity between the Section 8 rents and the Credit rents, and the importance of the project to HUD and the community.

With respect to projects seeking to refinance with HUD/FHA insurance (including risk-sharing), HUD has recently clarified[2] that tax credit units with project-based Section 8 can be underwritten for debt purposes at the Section 8 rents, as long as they are at or below market. Recent additional guidance[3] now permits HUD/FHA to underwrite refinanced Section 202 units with project-based Section 8 at above-market contract rents, though this policy does not apply to non-Section 202 projects or to FHA Risk Sharing. A regulatory change is required in order to include Risk Sharing projects: HUD is expected to address that in the near future.

Tenant-Based Enhanced Section 8 Vouchers

In many recapitalizations, eligible tenants without project based Section 8 assistance will be protected from rent increases through receipt of a tenant based Section 8 Enhanced Voucher that is triggered by the prepayment inherent in a refinancing.[4] However, with respect to most nonprofit owned projects, which do not have the right to prepay without HUD approval, mortgage prepayment will not trigger enhanced voucher eligibility. Nonprofit owned projects which have Flexible Subsidy assistance may receive enhanced vouchers at HUD's discretion if they are "the subject of a transaction under which the project is preserved as affordable housing."[5] As a policy matter, HUD will typically insist on the project providing tenant protections as a condition of its prepayment approval (see "HUD 250(a) Prepayment Notice," page 48).

For projects that are eligible for enhanced vouchers, potential lenders and investors may have widely different practices regarding the treatment of the enhanced voucher income for loan and investment underwriting purposes. Many are willing to apply an attrition analysis that assumes the enhanced vouchers leave the project over a three to ten year period, while others are unwilling to assume any enhanced voucher income after the first year. As this guide was in final editing, HUD was proposing amendments to the Section 8 program that would restrict the "enhanced" nature of enhanced vouchers to one year. While the outcome of this proposal is unclear, the proposal alone will reduce the underwriting flexibility of some lenders with respect to enhanced vouchers.

Section 8 Moderate Rehabilitation

Projects that obtained project-based Section 8 assistance under HUD's moderate rehabilitation program (active in the mid to late 1980s) are not eligible for Low Income Housing Tax Credits pursuant to a specific statutory exclusion. A recent Internal Revenue Service private letter ruling confirmed that this is true even if the Section 8 contract has been restructured under MAHRA and re-issued as a Section 524 contract. At this juncture, owners of mod-rehab assisted projects face a difficult choice: they must terminate the project-based Section 8 contract in order to qualify for Tax Credits. In such event the existing tenants who qualify will be given enhanced tenant-based Section 8 vouchers.

Rent Supplement Contracts

Some projects (particularly, but not exclusively, Section 236 bond-financed projects) still have project-based Rent Supplement contracts that provide rental assistance to tenants. While Rent Supplement contracts are similar in many ways to Section 8, there are important differences. Unlike new (post-MAHRA) Section 8 contracts, ongoing Rent Supplement contracts are not subject to annual appropriations. Most remaining Rent Supplement contracts are coterminous with the original bond financing, typically having 30-40 year terms.

Rent Supplement contracts are not eligible for Mark Up to Market or Mark Up to Budget. In theory, owners can obtain budget-based rent increases. However in practice a lack of budgetary authority for such rent increases under the Rent Supplement program severely constrains the ability to obtain any significant increases.

The termination of a project-based Rent Supplement contract does not qualify the recipients for tenant-based enhanced vouchers, unless the termination is in connection with another event which would qualify the project for Enhanced Vouchers – such as prepayment of a Section 236 loan. Tenants covered by an expiring Rent Supplement contract are eligible for enhanced vouchers if a project-based Section 8 contract in the development is also expiring. Otherwise, eligible tenants will receive regular vouchers on termination or expiration of a Rent Supplement contract.

Housing Authority Project-Based Section 8 Vouchers

Project-Based Section 8 Vouchers from the state or local housing authority are a resource that can aid significantly in the recapitalization of partially-assisted projects. State and local housing authorities have the ability to project-base (in contracts of up to 10 years in term, subject to annual appropriations) up to 20 percent of the tenant-based vouchers that they administer. Current rules with respect to this program are in a state of flux: HUD issued proposed new rules for the program in March, 2004[6] and received numerous public comments. As of this writing, HUD has not yet adopted the proposed rules (although they are expected to be forthcoming soon), and accordingly the prior notice issued in January, 2001[7] is currently the controlling authority.

Under current rules, HUD can provide Project-Based Vouchers for up to 25 percent of the units in a building (100 percent for projects providing housing for elderly or disabled or families receiving supportive services). Previously, housing authorities had only been allowed to project-base Section 8 in new construction or substantially rehabilitated projects, but a change to the authorizing statute in 2001 expanded the potential recipients to existing housing that is not undergoing substantial rehabilitation.

Rent levels for Project-Based Voucher units can be as high as 110 percent of the Fair Market Rent even if the regular voucher payment standard is lower. For Project-Based Voucher units in tax credit projects which are located outside a "qualified census tract" and which have tax credit rents above 110 percent FMR (or any applicable exception payment standard), the rent may exceed 110 percent FMR (or the applicable exception payment standard), up to the rent charged for a tax credit unit.[8] In all cases, the rent "must be reasonable in relation to rents charged in the private market for comparable unassisted units."

Housing Authority Project-Based Vouchers are similar in many ways to HUD Project-Based Section 8 subsidies, but with some significant distinctions. Tenants must be selected either from the housing authority's waiting list or from a waiting list that is open to all persons on the housing authority's list. In order to award project-based assistance to a project, the housing authority must have advertised, in a newspaper of general circulation, the availability of the assistance.[9]

It is not yet clear which, if any, of the proposed changes to the rules promulgated in March, 2004 will be adopted. Some significant considerations (among many others) that are included in the proposed rules and may affect nonprofit recapitalizations are as follows:

- Eligibility would be limited to buildings where no more than 25 percent of the units, including the Project-Based Voucher units, are "federally assisted." While the statute (and the current rule) caps the project-based voucher units at 25 percent, it does not refer in that limitation to any consideration of other subsidies that might be provided to other units in that building. "Federally-assisted" units would include other Section 8 units.
- Extensions after the initial 10 year contract term would be limited to one year.
- Family high-rise buildings would be ineligible.
- Rents would be capped at the regular voucher payment standard (instead of 110 percent FMR), with mandatory annual adjustments based on rent reasonableness. If the payment standard goes down, the rent must be reduced. This will be problematic for project underwriting. In addition, since FY 2005, funding for PHAs for Section 8 vouchers is effectively budget-based, not unit-based. In this context, funding shortfalls and the requirement to cure past "over-leasing" make it difficult or impossible for some PHAs to commit to project-based voucher rents above the normal payment standard.
- The requirement that units must be located in a census tract with a poverty rate of less than 20 percent would be eliminated.
- Projects that have already received public funds (such as tax credits) on a competitive basis would be eligible for selection (at the Housing Authority's option) without additional competition.

HUD Program Issues

Mark to Market Restructuring

Projects with Section 8 assistance at rents above market and mortgages that are HUD-insured or HUD-held are eligible for HUD's Mark to Market mortgage restructuring program (see also Chapter 2). Under the Mark to Market program, previously run by OHMAR but now run by the Office of Assisted Housing Preservation (OAHP), HUD reduces the rents to market levels. In some cases, if the project is sustainable at the reduced rents, no

other action is taken (in this instance, the rent reduction is known as a "Lite"). However, in many cases, the reduction in rent portends significant difficulties at the project, in which case the project is recommended for a full "Restructuring" to address physical needs at the project and reduce the "must-pay" first mortgage to an amount sustainable at the market rents. In cases where the mortgage is restructured, the amount of the prior mortgage that is not sustainable at market rents is bifurcated into a new cash flow mortgage (collecting at least 75 percent of available cash flow after certain priorities) that is subordinated to the sustainable first mortgage. In either case, the proposed transaction is administered by a third party firm with professional underwriting expertise (known as a Participating Administrative Entity or PAE), on behalf of HUD and OAHP.

Under some circumstances, where an existing nonprofit is seeking to recapitalize through a sale to an affiliated nonprofit purchaser, HUD may agree to assign the junior mortgage to the nonprofit or to forgive it. This enables the nonprofit to collect 100 percent of the cash flow, while enhancing its control over the future disposition of the property. Additionally, the purchaser may be able to include a developer fee in the restructuring transaction. However, these significant benefits require a waiver of certain related-party restrictions, and are only available where the nonprofit can demonstrate that debt relief or assignment is necessary for the recapitalization plan.[10]

Special considerations to note about the Mark to Market program:

- Pursuant to the Mark to Market Operating Procedures Guide, eligibility for assignment of the junior mortgage is limited to a three-year period from the restructuring date;
- Projects that previously accepted a Lite rent reduction are eligible to re-enter the program and request a full Restructuring;
- Projects that were previously deemed ineligible because their mortgages were not deemed above market are able to request that determination to be revisited;
- Under current law, the program's tools (including both the authority to restructure and the authority to forgive or assign the junior mortgage) are scheduled to sunset September 30, 2006.

Section 236 Decoupling

Section 236 assisted projects receive an Interest Reduction Payment (IRP) that subsidizes the mortgage to an effective one percent interest rate. In part because the IRP constitutes funds that were budgeted from the year of original project approval (and are therefore not drawn from current budget authority), the IRP represents a useful and enduring preservation resource at little current cost to HUD. In 1999 HUD obtained statutory approval for a decoupling program which allows the IRP payment stream to be preserved and utilized in recapitalizations and refinancings.

The parameters and requirements of the HUD decoupling program are set forth in Notice H 2000-08. In general, a decoupling allows the IRP streamto be retained and separately financed in return for committing to five additional years of adherence to the Section 236 restrictions. Two considerations are worthy of note.

First, there are some significant concerns amongst tax counsel as to whether an IRP decoupling can be done in conjunction with a nine percent Per Capita Credit transaction. Most tax counsel are comfortable that an IRP decoupling in conjunction with a four percent Bond Credit transaction is not problematic. In a nine percent Per Capita Credit transaction there is, however, currently significant uncertainty amongst tax counsel as to how to properly characterize for tax purposes the IRP payment stream. If it is deemed federal financing, the project would not qualify for nine percent Credits. Absent a favorable revenue ruling on the issue from the IRS (which has been requested), many counsel are reluctant to provide supporting legal opinions in IRP decoupling/nine percent Per Capita Credit transactions.

For Section 236 decoupling projects with partial Section 8 assistance it is often advisable to obtain a waiver which allows the IRP assistance to be skewed, and protect unassisted tenants from rent increases, while marking the Section 8 rents up to market. In some instances that will result in extending the IRP payment stream for a longer time than currently scheduled. For projects with 100 percent Section 8 assistance, HUD will generally require that the gross Section 8 rents be reduced from the market rents by the amount of the IRP. On a waiver basis, HUD has allowed both the IRP and full market Section 8 assistance for projects that have significant physical needs or that are located

in an area with lower market rents, as long as rents are computed on a budget basis. This waiver is not available for transactions involving equity takeout unless there is a transfer of ownership to a non-related owner.

Dividends For Nonprofits

In most HUD-assisted projects that are specifically designated as nonprofit owned, HUD does not allow nonprofit owners to retain and use excess project revenues. Such excess revenues are required to be deposited in residual receipt accounts and may be withdrawn and used only with HUD's permission. HUD has allowed residual receipts to be used for project purposes that benefit the residents and to facilitate capital improvements.

Exceptions exist with respect to projects that go through the Section 8 Mark Up to Budget process, where nonprofits can receive a good-cause regulatory waiver allowing a six percent distribution to be utilized for non-project purposes consistent with their nonprofit mission, and to repay surplus cash or residual receipts notes given in favor of secondary financing. In addition, some nonprofits that acquired and preserved projects under LIHPRHA are authorized to receive an eight percent distribution pursuant to their HUD Use Agreements. Note that the nonprofit dividend restrictions for Section 8 New Construction/Substantial Rehabilitation projects derive from the underlying Section 8 contract – and therefore continue after a refinancing. In contrast, the dividend restrictions for nonprofit Section 236 and Section 221(d)(3) BMIR projects derive from the financing – and therefore expire on prepayment.

Junior Financing with FHA-Insured Debt

A significant consideration for a lender willing to provide the project financing secured by a mortgage that is subordinate to HUD-insured first mortgage debt is HUD's Note and Mortgage Rider requirement. In order to obtain HUD's approval to place a lien against the project, junior financing must contain specific language, set forth in Appendix G of Handbook 4350.1, relating to the priority of HUD's mortgage, and prohibiting certain actions, including assignments of rents, distributions and loan repayments outside of the normal surplus cash distribution process, and foreclosure transfers unless they have been approved by HUD as a transfer of physical assets. While some lenders balk at the HUD rider requirements, in many cases an additional liquidity reserve can be established as part of the recapitalization to protect the junior lender and give them comfort that they can enforce their liens, albeit in a somewhat slower and more protracted process than would otherwise apply.

ELIHPA and LIHPRHA Issues

Section 236 and 221(d)(3) BMIR projects that were preserved under ELIHPA or LIHPRHA through a transfer to nonprofit ownership (or by an existing nonprofit controlled partnership) encounter a number of complications in recapitalizing, several of which have not as of this writing been resolved with certainty. While the issues are common to all preservation projects, ELIHPA restrictions expire at the end of the original mortgage term (which may be soon), while LIHPRHA restrictions endure for the remaining useful life of the project (at least 50 years). This creates more flexibility for ELIHPA project owners to consider the relative proximity of recapitalization opportunities outside the ELIHPA context.

Upon prepayment, ELIHPA or LIHPRHA projects that are not 100 percent assisted with project based Section 8 may not be able to obtain Enhanced Vouchers for the non-Section 8 units to cushion necessary rent increases. In most decoupling or refinancing transactions, the housing's status as "eligible low income housing" as defined in LIHPRHA is the triggering event for Enhanced Voucher eligibility, under Section 8(t) of the National Housing Act. It is not currently clear whether a project that has already received preservation incentives under ELIHPA or LIHPRHA will still be considered "eligible low income housing" for purposes of Enhanced Voucher eligibility.

An additional issue is the financing potential of the project in light of the use, rent, occupancy, dividend and other restrictions that may be reflected in the HUD Use Agreement. Although some public lenders are comfortable with these restrictions, many private lenders are not. Further, any HUD approval of proposed financing or refinancing may be conditioned on additional rent protections for tenants in unassisted units, which will decrease the financing potential of the project. Nonprofit owned projects may also need to obtain waivers to pledge excess cash flow, retain dividends, or utilize residual receipts.

A significant additional currently unresolved LIHPRHA issue is the amount of income that is available for financing. The LIHPRHA statute contemplated a fixed "preservation equity" that was to be established at the time of the LIHPRHA closing, and that would serve as the basis for limiting the maximum amount of return that a participating owner could receive for the next 50 years. In the 8 to 12 years that have passed since the LIHPRHA closing, circumstances have often changed, and in many cases (mostly in strong markets) more cash flow and net operating income can now be obtained on a market basis than was originally approved under the "preservation equity" concept.

In addition, significant new debt can often be financed by the same net operating income as a result of lower interest rates and mortgage amortization. It is not clear what, if any, limitations apply to the uses of such net operating income for debt-service and for other purposes.[11]

ELIHPA and LIHPRHA projects with HUD-insured mortgages and above-market rents are eligible for Mark to Market restructuring in conjunction with an ownership transfer. Nonprofits seeking to recapitalize through a related-party sale may be able to take advantage of this opportunity (see Mark to Market, above). In the past, ELIHPA and LIHPRHA projects with nonprofit owners or purchasers have also been eligible for the Section 8 Mark Up to Budget program; however, this policy may be undergoing revision at HUD (see Chapter 2).

Maturing Subsidized Mortgages

Many older nonprofit-owned Section 236 or 221(d)(3) BMIR projects are now approaching the end of their subsidized mortgage terms (40 years). Refinancing, either at mortgage term or through a prepayment, is typically an important component of any revitalization strategy. These projects face special regulatory challenges in developing a viable recapitalization and refinancing plan. These projects fall into several different categories:

- Projects contractually ineligible to prepay without HUD consent ("locked-out" projects; see below).
- Projects that are eligible to prepay but, for one reason or another, have not. This may be due to a weak market, disorganized ownership, or other negative circumstances.
- Preservation projects that received incentives under ELIHPA or LIHPRHA. These projects retained their original subsidized mortgages and typically do not now require HUD's consent to prepay. However, they may not be eligible for certain benefits that would facilitate recapitalization (see below).

Ineligibility for Incentives

Projects with maturing subsidized mortgages are generally unable to access or utilize the recapitalization incentives that are available to other Section 236 and 221(d)(3) BMIR projects. For example:

- Enhanced Vouchers are not available to non-Section 8 tenants in prepayment-eligible projects once the subsidized mortgage reaches maturity. In "locked-out" projects, non-Section 8 tenants are not eligible for Enhanced Vouchers even if the owner secures HUD's consent to prepay (see below) except, at HUD's discretion, in projects that previously received Flexible Subsidy assistance. In ELIHPA or LIHPRHA preservation projects that have a right to prepay, the status of Enhanced Voucher eligibility for non-Section 8 tenants is currently uncertain.
- IRP Decoupling is not available upon mortgage maturity (because the IRP subsidy terminates). This program is also less useful for refinancing closer to mortgage maturity, as the remaining IRP term diminishes.
- Mark Up to Market/Budget may not be available for Section 8 units in projects that have not previously refinanced because they are located in weaker markets. Projects with market rents below FMRs, "locked-out" projects, and Preservation projects may not be eligible, at least for Mark Up to Market (see Chapter 2).

Flexible Subsidy Loans

Additionally, any outstanding Flexible Subsidy loans associated with the project are due and payable with accrued interest at mortgage maturity (or at sale or refinancing, if sooner). Many nonprofit sponsor/mortgagors received Flexible Subsidy assistance in the 1970s and 1980s, pursuant to Section 201 of the Housing and Community Development Amendments of 1978, under a special "operating assistance" program for "troubled projects," either in the form of a grant or a one percent deferred-payment loan. Later, many nonprofit-controlled partnerships acquiring projects under ELIHPA received deferred Flexible Subsidy

"capital improvement" loans, with interest rates ranging from one to three percent (simple or compounded). After 20 years, the repayment obligation associated with these loans may be substantial.

In the past, HUD has generally not required repayment of Flexible Subsidy loans prior to mortgage maturity when a subsidized project is transferred subject to the existing mortgage debt. When the existing HUD mortgage is refinanced, HUD has occasionally extended Flexible Subsidy capital improvement loans to be coterminous with the new financing, in conjunction with IRP decoupling transactions. In at least one other instance, HUD granted a waiver for partial prepayment and partial deferral. HUD has recently indicated, however, that they are reconsidering their practice on the issue – and will be reviewing each request on its merits.

Recapitalization Strategies

While preservation advocates are seeking legislative solutions to these problems, under current law the recapitalization of subsidized projects at mortgage maturity is a challenge – especially if there is a significant non-Section 8 tenant population that cannot afford rent increases. Where there is no prepayment "lock-out," nonprofit owners may want to prepay and refinance prior to mortgage maturity, to the extent feasible, in order to access Enhanced Vouchers for non-Section 8 tenants. Owners of Flexible Subsidy projects may want to pursue IRP decoupling to secure the benefit of an extended due date for the Flexible Subsidy loan. Projects subject to a prepayment "lock-out" may also be able to refinance, but without the benefit of Enhanced Vouchers (see below). To the extent that Enhanced Vouchers are not available, recapitalization strategies will be more dependent on tax credit equity and deferred loans.

"Locked Out" Projects Requiring HUD Consent to Prepay

Types of Projects

There are several different types of projects that cannot prepay (and, therefore, refinance) without HUD consent. These include:

- Subsidized (Section 236 or 221(d)(3) BMIR) projects with original nonprofit mortgagor owners (including some that were transferred to limited partnerships but retained their original nonprofit regulatory agreements);
- Insured subsidized projects with continuing Rent Supplement contracts that did not convert to Section 8;
- Some, but not all, projects that received Flexible Subsidy loans (regardless of whether the Flexible Subsidy loan has been prepaid); and
- Other miscellaneous project types. For example, some projects acquired through HUD's property disposition process require HUD consent to prepay. Section 236 or 221(d)(3) BMIR projects that were originally prepayment-eligible, but waived their prepayment rights by marking up to market, also fall into this category.

HUD 250(a) Prepayment Notice

When an owner cannot prepay without HUD consent, Section 250(a) of the National Housing Act directs HUD to condition approval of prepayment on a determination that: the project is no longer meeting a need for rental housing in the area; adequate notice to tenants and an opportunity to comment has been given; and there is a plan for providing relocation assistance for adequate, comparable housing for any low income tenant who is displaced. A new Notice sets forth the conditions under which HUD will approve prepayments in certain types of "locked-out" projects, pursuant to Section 250(a), for the purpose of refinancing and recapitalization before mortgage maturity.[12] The Notice is generally applicable to subsidized (Section 236 and 221(d)(3) BMIR) projects where the mortgage note or Flexible Subsidy contract requires HUD prepayment approval. Key provisions include:

- The owner must execute a new Use Agreement maintaining the existing rent and affordability restrictions for at least the original mortgage term.
- The initial rent for the non-Section 8 units can include a budget-based increase for rehabilitation financing, capped at 30 percent of 80 percent area median income (AMI) (for Section 236 projects) or 30 percent of 95 percent AMI (for Section 221(d)(3) BMIR projects). Rents will be adjusted annually by a median income factor, which has not yet been specified by HUD. No rent increase will be approved if an immediate equity takeout is proposed, or if the project is purchased for an above-market price.
- Section 8 rents will be determined in accordance with renewal options for which the project is eligible (see Chapter 2). The Section 8 contract must be renewed, if required by the existing Regulatory Agreement.
- No current tenants may be displaced, including for the purpose of increasing the number of tax credit

units. The owner must demonstrate how current tenants will be protected from rent increases.

- No use agreement is required for subsidized projects where HUD determines that there is no continuing need for lower income housing, or for unsubsidized projects. In these cases, a relocation plan for current tenants is required.
- In all cases, the owner must notify tenants, HUD, and the state or local government of the proposed prepayment at least 150 days in advance. Recipients have 30 days to comment. Any state or local notice laws must be taken into account.

Additional Recapitalization Issues

The extent to which the new policy will facilitate nonprofit recapitalizations will depend, in part, on individual project circumstances. In some cases the Use Agreement may severely restrict the potential income of the project and the amount of financing that can be obtained. The HUD Notice raises many questions which will need to be resolved, including:

- How will existing non-Section 8 tenants be protected from rent increases without the availability of Enhanced Vouchers (or regular vouchers)? In projects with a significant proportion of non-Section 8 tenants, the lack of voucher availability may limit the potential for recapitalization.
- For "locked-out" projects seeking to utilize IRP decoupling, how will conflicts between the program rules be reconciled? For example, the HUD Section 250(a) prepayment notice permits debt service increases for rehab only, while the HUD decoupling notice permits increases for acquisition and rehab debt service. The HUD prepayment notice requires that future rents must be adjusted by a median income factor while the HUD decoupling notice requires budget-based rent increases.
- How will inconsistencies in rent policy for Section 8 and non-Section 8 units be resolved? For example, the HUD prepayment notice permits budget-based increases for rehab debt service while Section 8 renewal policy does not (except for Mark Up to Budget — see Chapter 2).
- Can the term of Flexible Subsidy loans be extended in conjunction with refinancing approvals under the Notice?
- Is the Notice applicable to projects that are "locked out" not by the terms of their financing documents, but by virtue of their deed restrictions (Property Disposition projects) or Section 8 contracts (Section 236 and 221(d)(3) Mark Up to Market projects)? If not, what rules govern these prepayments?

Chapter 6 Notes

[1] Finding a compatible organization willing to serve as the 21 percent part owner of the general partner can be difficult and should be done with an open discussion of some potential consequences for such entities. In addition to the administrative burdens, there are issues relating to the organization's authority to act in that capacity (i.e. as a passive shareholder), as well as to potential repercussions between the entities. One notable issue for housing nonprofits to consider is HUD's 2530 Previous Participation process – whereby entities are cleared for future participation in HUD programs based on their previous activities. HUD's 2530 certification currently requires entities to disclose their previous participation relating to all interests of greater than 10 percent in any general partners involved with HUD assisted projects, and participation in a single troubled project can result in significant processing delays for future activities. This potential issue – which runs to both parties - can be avoided (with some increase in administrative burdens) by having the 21 percent of the general partner that needs to be owned by an unrelated party be held by three unrelated parties, each of which own seven percent of the general partner.

[2] Revisions to Chapter 7 of MAP Guide, 4/19/04.

[3] Notice H 2004-21, "Amendments to Notice H 2002-16: Underwriting Guidelines for Refinancing of Section 202 and 202/8 Direct Loan Prepayments."

[4] The voucher is described as "enhanced" because the payment amount is not limited to the regular Section 8 voucher payment standard, but instead is in most cases the local market rate for similar units. When a tenant leaves the project and moves elsewhere in the community, the Section 8 voucher goes with them, but reverts to the regular voucher payment standard. See *Stemming the Tide*, Chapter 2.

[5] Section 223(f) of the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (12 U.S.C. 4113(f)).

[6] See 69 Federal Register 12950.

[7] See 66 Federal Register 4633.

[8] This is a special benefit for Project-Based Voucher units in low FMR areas. See Notice PIH 2002-22, "Housing Authorities with Section 8 Project-Based Assistance under the Housing Choice Voucher Program," November 1, 2002.

[9] The advertising requirements are slightly different for projects with greater than 25 percent project based units (elderly, handicapped, families with services), and for projects that are either new construction or substantial rehabilitation: under these conditions the housing authority "must establish policies for public advertisement and competitive selection of units to be assisted…." This leaves open the possibility that a different selection mechanism (such as, for instance, a Section 42 Credit "request for proposals") is an appropriate selection process.

[10] The eligibility requirements for nonprofit purchasers seeking second mortgage relief or assignment are set forth in Appendix C of the Mark to Market Operating Procedures Guide. A waiver is required in the nonprofit recapitalization context because Appendix C prohibits transfers to affiliated entities. The assignment of the junior mortgage to the nonprofit can be advantageous in a so-called "additional funds transaction" by preserving the junior mortgage for Low Income Housing Tax Credit purposes, generating additional funds for an expanded scope of rehab work under a nonprofit controlled limited partnership. The nonprofit may be able to demonstrate that the mortgage assignment was necessary to bring these additional funds and benefits to the project.

[11] The logically consistent resolution, that the authorized amount of net operating income is equal to the sum of (1) amount that serviced debt and (2) the amount that was available for distribution at the time of the LIHPRHA transaction, has yet to be explicitly adopted by HUD, and several transactions have apparently been approved with no such limitations.

[12] Notice H 2004-17, "Prepayments Subject to Section 250(a) of the National Housing Act," August 30, 2004.

Appendix

Resources Available for Affordable Housing Recapitalization in Selected States[1]

Bart Lloyd

California	Program Overview	Funding Amount Available	Application Process	Underwriting Issues
Tax-Exempt Bond Program	• California Debt Limit Allocation Committee (CDLAC) administers program • State and local governmental agencies and joint powers authorities can issue tax-exempt bonds • Awarded in three allocation rounds and to three sub-pools: the General Pool (Projects having more than 50% of total units designated as Restricted Rental Units); the Mixed Income Pool (Projects having 50% or fewer of total units designated as Restricted Rental Units); and the Rural Project Pool	• State bond volume cap in 2004 was $2.8 billion, of which $1.55 billion was reserved for Qualified Residential Rental Projects	• Developer completes Qualified Residential Rental Project Application • Applications are typically due to CDLAC at the beginning of the first, second and third quarter each calendar year	
HOME Funds	• The Department of Housing and Community Development (HCD) administers program in California	• Approximately $75 million was available in 2004	• Application deadlines are outlined in the Notice of Funding Availability (NOFA)	
Tax-Exempt Bridge Financing Program	• CalHFA administers program • Offers tax-exempt bridge loans for projects receiving 4% tax credits • Available to for-profit, nonprofit and public agency sponsors • Can be used for new construction or acquisition/rehabilitation developments utilizing 4% tax credits and CalHFA permanent financing	• Amount necessary to meet the tax credit allocation committee's tax-exempt funding requirements • Max Amount: up to 90% of investor's equity proceeds • Loans are typically committed for up to 55% of eligible basis	• For application process, contact CalHFA's Multifamily Programs Division, or visit www.calhfa.ca.gov	• Interest Rate: Tax Exempt: 4%; Taxable Rate: varies • Loan Term: 1 to 3 year term, fully amortized, with annual level payments • Lien Priority: Second priority loan behind the CalHFA permanent mortgage • Prepayments: Permitted after first year
Preservation Acquisition Program	• CalHFA administers program • Fund is comprised of monies authorized by Bond Funds and funds from CalHFA • Projects unable to secure permanent financing after acquisition may request that Bond Fund monies be converted to long term, residual receipt financing	• The funding amount available is up to 100% of acquisition cost	• Rolling application process • The program contemplates a 90-day process from the time CalHFA receives a complete application to funding of the acquisition loan	• Minimum 110% debt service coverage
The Housing and Emergency Shelter Trust Fund Act of 2002 (Proposition 46)	• CalHFA administers program • $2.1 billion dollar bond measure that was passed by the voters in California in November, 2002 • CalHFA Multifamily Programs Division utilizes funds to preserve existing government assisted rental housing for low to very low income individuals	• Each year, $42.75 million of fund is allocated to preservation financing	• For application process, contact CalHFA's Multifamily Programs Division, or visit www.calhfa.ca.gov	
HUD Section 202 Refinancing Program	• CalHFA administers program • CalHFA refinancing program offers lower interest rates and extended amortization terms • Eligible sponsors may also use the CalHFA refinancing program for the acquisition and rehabilitation of existing 202 properties • Owners must agree to maintain affordable occupancy restrictions and to undertake appropriate rehabilitation	• The loan amount is the lesser of Section 8 contract rents or comparable market rents • Loan to value not to exceed 90% of appraised value	• For application process, contact CalHFA's Multifamily Programs Division, or visit www.calhfa.ca.gov	• Interest Rate: 5.50% • Payments: interest-only payments during rehab period. Fully amortized payments after rehab period. • Term: up to 2 years for rehabilitation period, up to 30 years after rehabilitation period • Minimum 110% debt service coverage ratio
QAP Highlights	• The California Tax Credit Allocation Committee ("TCAC") administers program	• Approximately $70.0 million in 2004	• TCAC usually holds two application cycles each year, one in March and one in July. Awards are usually made in late May and late September.	• California does not have a preservation set-aside

[1] For information on other states, please see "Affordable Housing Preservation Initiatives: A State-by-State Summary," published by the National Housing Trust and available at www.nhtinc.org. Readers should check directly with the appropriate agency for any updated guidelines, funding amounts, deadlines and priorities.

Illinois	Program Overview	Funding Amount Available	Application Process	Underwriting Issues
Tax-Exempt Bond Program	• IHDA administers program • IHDA issues tax-exempt and taxable bonds to provide construction and permanent financing for multifamily rental developments • Funds can be used for 1) New Construction; 2) Substantial Rehabilitation; 3) Moderate Rehabilitation	• $5 million minimum • $25 million maximum	• Loan Commitment may be issued approximately 3-6 months after receipt of a complete application, depending on the form of credit enhancement	• Most bond financing requires credit enhancement to achieve the lowest possible interest rate • If the funds will be used for construction, additional lines of credit are required
HOME Funds	• IHDA administers program • Some Illinois cities, counties or combinations (called HOME "Participating Jurisdictions," or PJ's) get their federal HOME fund allocations directly from HUD • Any affordable housing developer or organization wishing to do business in these areas of the state should therefore apply not to IHDA, but directly to the local PJ	• IHDA allocates HOME funds according to a ranking system, explained in application packets	• Rolling application process	• Applicable funding categories include: 1) Rehab and new construction of affordable multifamily housing; 2) Rehab of rural small rental properties; and 3) Rehab and new construction of supportive housing for the homeless
Donation Tax Credit Program	• Illinois Housing Development Authority (IHDA) administers the program • In Illinois, program called Affordable Housing Tax Credit Program (IAHTC) • Provides donors to qualified nonprofit affordable housing sponsors with a tax credit on their Illinois income tax equal to 50% of the donation • The City of Chicago's Department of Housing (CDOH) administers the program in the City of Chicago	• Total allocation for 2005 is $15 million, with $11.3 allocated to IHDA and $3.7 million allocated to CDOH	• Applications for the IAHTC program will be accepted at any time, save the week before, week of, and week after a LIHTC application submission deadline.	• Donors may transfer some or all of their IAHTCs to another individual or entity • If the amount transferred is less than $100,000 the donation must be 10% of the amount transferred • If the amount transferred is greater than $100,000 the donation must be $10,000
Affordable Housing Trust Fund	• IHDA administers program • available to both nonprofit and for-profit entities and units of local government • Funds may be distributed in the form of a loan or a grant	• Total of $16 million to $20 million is available per year • The maximum funding typically awarded is $750,000 per project	• Rolling application process	
Chicago Low-Income Housing Trust Fund Rental Subsidy (CLIHTF)	• The Rental Subsidy Program provides annual subsidies to rental property owners • The owners use the subsidies to reduce rents for tenants with annual household incomes that do not exceed 30% of area median income	• For available funding amounts, contact CDOH	• For information regarding the application process, contact CDOH	
Real Estate Tax Reduction & Abatement Opportunities	• Some developments may be eligible for real estate tax reductions • Contact the county assessor's office for more information			
QAP Highlights	• IHDA administers program	• Approximately $14.5 million per year	• Two annual application rounds.	• IHDA has a preservation set-aside of $3.0 million • Minimum rehab requirements for rehab or $8000 per uni

Massachusetts	Program Overview	Funding Amount Available	Application Process	Underwriting Issues
Tax-Exempt Bond Program	• MassHousing administers program	• Massachusetts volume cap is approximately $526 million, of which approximately $150 million is available for multifamily housing	• Rolling application process	
HOME Funds	• The Department of Housing and Community Development (DHCD) administers program	• Allocated in entitlement/ consortium communities and non-entitlement/non-consortium communities • In entitlement/consortium communities, DHCD will award the lesser of $750,000 per project and up to $50,000 per HOME-assisted unit • In non-entitlement or non-consortium communities, the maximum award is up to $65,000 per HOME-assisted unit, up to a per project maximum of $750,000	• Application deadlines correspond with the QAP, which are usually in February and September each year	
Affordable Housing Trust Fund	• MassHousing and the Department of Housing and Community Development (DHCD) jointly administer the funds • Developments are underwritten by MassHousing staff, recommended by a selection committee of senior staff of the two agencies, and approved by the director of DHCD	• The AHTF is a $20 million fund; $16,250,000 of the fund is for Production and New Affordability allocation; and $3,000,000 is for Discretionary allocation • Max funding for Production and New Affordability projects is the lesser of $1,000,000 per project or $50,000 per assisted unit • Max funding for Discretionary projects is $2,000,000	• Rolling application process	• There will be an annual funding reservation of up to $2,000,000 of the Production allocation which may be used to fund projects for the homeless or for individuals and families with incomes in between 0% to 30% of AMI • For these projects: 1) allocated funds may be used for acquisition and rehabilitation of existing units; and 2) the $50,000 per unit limit may be exceeded for these projects
Priority Development Fund	• MassHousing administers program • To be eligible: 1) Rental developments must receive first mortgage financing from MassHousing; and 2) Project must involve the new production of affordable housing units • To be considered new production, projects must either entail construction of new housing units (including adaptive re-use of commercial or other structures), or return to productive use existing housing units that have been vacant for at least two years	• Maximum amount is $75,000 per unit	• Priority Development Fund and MassHousing financing applications are submitted at the same time	
The 80/20 Program	• MassHousing administers program • The 80/20 Program provides tax-exempt and/or taxable financing for the acquisition, rehabilitation and/or new construction of multifamily rental apartments in developments that reserve at least 20% of units for occupancy by households earning less than 50% of the median area income	• The maximum amount available is 90% of the appraised value of the project	• Applications submitted directly to MassHousing	• Underwriting rates are established monthly; the actual rate is locked in when the bonds are issued • 30- and 40-year fully amortizing terms are available • Credit enhancement is often provided through HUD/HFA Risk Sharing Program
Bridge Loans	• MassHousing administers program • Because MassHousing's bridge loan interest rates are typically lower than investors' required rates of return on equity, this product helps to maximize the amount of capital made available through syndication of the credit	• The sum of the bridge loan and any MassHousing construction/permanent loan may not exceed 90% of Total Development Cost	• Applications are submitted directly to MassHousing • For more information, contact the Rental Programs and Development Department at MassHousing	• Interest rates: Fixed rate is 150 Basis Points above 10-Year Treasury; Floating rate is 150 Basis Points above 1-Year LIBOR • Loan terms: 1-2 years for construction period loan
QAP Highlights	• Department of Housing and Community Development (DHCD) administers program	• Approximately $3.5 million	• Two annual application rounds.	• Preservation set-aside: approximately 35% of available tax credits were allocated for preservation projects in 2004 • Minimum rehab requirement for 4% tax credit projects is greater of $3000 per unit or 10 % of the depreciable basis of the building

Michigan	Program Overview	Funding Amount Available	Application Process	Underwriting Issues
TEAM Program—Tax-Exempt Bond Financing	• Michigan State Housing and Development Authority (MSHDA) administers tax-exempt bond financing through the TEAM Program • MSHDA tax-exempt financing is available for developments in which 40% to 100% of the units are targeted to lower income households	• The maximum funding amount available is 90% of the total development cost	• Applications for the TEAM Program can be submitted at any time by using the Combined Application for Rental Housing Programs available from MSHDA	• The current loan rate for 1) non-distressed areas is 5.5%, and 2) eligible distressed areas is 5% with 0.5% deferred • Loan terms: MSHDA offers a 35-year loan term, with a 20-year prepayment restriction • The required debt service coverage ratio is 1.1
HOME Funds	• MSHDA administers program	• Maximum amount available is equal to the lesser of 1) the total project development costs; or 2) the minimum required for project feasibility; or 3) MSHDA established program limits	• Application for HOME Funds can be submitted at any time by using the Combined Application for Rental Housing Programs available from MSHDA	
Modified Pass-Through Program	• MSHDA administers program • These bonds are secured solely by the assets of the borrower, the properties being financed and by some form of credit enhancement provided by the borrower • Nonprofit projects do not require unified volume cap or housing tax credit, both of which are required for for-profit projects	• Project tax-exempt bond limitation of $9.5 million	• Applications for the Modified Pass-Through Program can be submitted at any time by using the Combined Application for Rental Housing Programs available from MSHDA	• Loans must be for the production of affordable housing units by new construction or rehab • For rehab projects, the amount of the construction contract must be at least 40% of the acquisition cost, and two major building systems must be scheduled for replacement or significant upgrade
QAP Highlights	• MSHDA administers program	• Approximately $12 million per year	• Two annual application rounds.	• Minimum rehab requirements for rehab projects is $7500 per unit; for preservation projects, minimum rehab is $15,000 per unit
Tax-Exempt Bond Program	• The Department of Economic Development administers program in Missouri	• In 2004, the state volume cap was approximately $422 million (amount allocated to multifamily housing has not yet been published)	• Rolling application process	
HOME Funds	• MHDC administers program	• Approximately $11.1 million will be available in 2005	• The deadline for proposal submission is typically in late October	
Missouri Affordable Housing Assistance Program (Donation Tax Credit Program)	• The Missouri Housing Development Commission (MHDC) administers program • The State offers an income tax credit for any eligible firm or eligible individual that donates to a nonprofit community based organization • The credit is equal to 55% of the value of the contribution	• Program offers $10 million in tax credits annually for specific housing developments with $1 million annually for administrative costs	• MHDC will accept applications from July 1 through April 30 of each year	• To be eligible for an AHAP credit, the donations must assist in the production of a specific affordable housing development or, in some cases, provide assistance for administrative costs of the organization
Housing Trust Fund	• MHDC administers program • Grants and/or low interest loans are awarded to organizations providing housing assistance to individuals	• Annual funding has been approximately $4 million during the past few years	• The deadline for proposal submission is typically in late October	
QAP Highlights	• MHDC administers program	• Approximately $9.9 million of Federal LIHTC's and approximately $9.9 million of State LIHTC's available in 2005	• The deadline for proposal submission is typically in late October, and recommendations are made to the Commission in January or February	• Missouri does not have a preservation set-aside • For tax-exempt bond financed rehab developments: 1) Developments located in rural (non-MSA) areas, the construction costs for rehabilitation must equal or exceed 15% of the total replacement costs; 2) For developments located in urban (MSA) areas, the construction costs for rehabilitation must equal or exceed 25% of the total replacement costs

North Carolina	Program Overview	Funding Amount Available	Application Process	Underwriting Issues
Tax-Exempt Bond Program	• The North Carolina Housing Finance Agency (NCHFA) administers program • To be eligible, project must: 1) have been placed in service on or before December 31, 1986; 2) require rehabilitation expenses in excess of $10,000 per unit; and 3) not have an acquisition cost in excess of 60% of the total replacement costs	• Maximum amount available is $15 million per project	• Preliminary application due January 7 • Full application due May 6	• Projects with existing tenants must provide the NCHFA with complete information regarding tax credit eligibility at the time of application
HOME Funds	• NCHFA administers program	• Approximately $32 million available each year	• For further information on the application process, contact NCHFA at www.nchfa.org	
NC Housing Trust Fund	• NCHFA administers program • The trust fund can be used to finance rental housing development for families and seniors	• The NC Housing Trust Fund is a $50 million fund	• For information regarding the application process, contact the North Carolina Housing Coalition at www.nclihc.org	
QAP Highlights	• NCHFA administers program	• Approximately $14 million per year	• Application deadlines for 9% and 4% tax credits are as follows: 1) January 7: Deadline for submission of preliminary applications; and 2) May 6: Deadline for full applications	• Minimum rehab requirement is $15,000 per unit • NC has a rehabilitation set-aside that is the lesser of 1) twenty 20% of the state's total federal tax credit ceiling, or 2) the amount required for ten projects

New York	Program Overview	Funding Amount Available	Application Process	Underwriting Issues
Tax-Exempt Bond Program	• The New York State Housing Finance Agency administers program	• The state volume cap in 2004 was $1.4 billion, of which approximately $425 million was allocated for multifamily housing	• Rolling application process	
HOME Funds	• New York State Housing Trust Fund Corporation (HTFC) administers program	• Approximately $39 million available in 2005	• The application process varies by region • For application deadlines, contact the local regional office	• Funds may be used to pay for acquisition, rehabilitation, construction, and certain related soft costs
Housing Trust Fund (HTF)	• The Division of Housing and Community Renewal (DHCR) administers program • HTF provides funding to eligible applicants to construct low-income housing, to rehabilitate vacant or under-utilized residential property (or portions of a property), or to convert vacant non-residential property to residential use for occupancy by low-income homesteaders, tenants, tenant-cooperators or condo owners	• Approximately $29 million available in 2005 • Funding is limited to $55,000 per unit	• The application process varies by region • For application deadlines, contact the local regional office	• Project sponsors must ensure long-term (15-30 years) use by low and/or very low-income persons • Seed money funding is limited to $5,000 per unit and a maximum amount of $45,000 for the entire project
Empire Housing Fund Program	• The New York State Housing Finance Agency administers program • The Empire Housing Fund Program (EHF) in an interest-free loan to Mitchell-Lama housing companies or cooperatives that is payable (or which may be refinanced) at the end of the mortgage	• For funding availability, contact the New York State Housing Finance Agency	• For information regarding the application process, contact the New York State Housing Finance Agency	• The funds are usually provided as low interest or, in some cases, no interest loans
The HOPES Program	• The New York State Housing Finance Agency administers program • The HOPES Program (Housing Opportunity and Preservation for the Empire State) is an HFA initiative to provide low cost, flexible financing for the preservation, rehabilitation and creation affordable multifamily rental housing	• Minimum loan amount of $1,000,000 • No maximum loan amount for third party credit enhancement • Approximately $32.2 available each year	• For information regarding the application process, contact the Housing Policy Coordination Department at the New York State HFA • The DHCR publishes application deadlines each year no later than January	• Minimum rehab requirements: For tax-exempt bond financed projects, rehabilitation costs must not be less than 15% of the bond amount • Loan terms: maximum permanent mortgage term is generally 30 years
QAP Highlights	• In New York, the DHCR is the lead Housing Credit Agency			• New York does not have a preservation set-aside

Affordable Housing Recapitalization Glossary

2530 Previous Participation Clearance:
A process (named for the required Form HUD 2530) whereby a proposed recipient of HUD assistance certifies, and HUD reviews, previous participation in HUD programs, including any history of default or noncompliance.

Additional Funds Policy:
Allows owners and purchasers to bring additional resources such as tax credits, tax-exempt bond financing, HOME/CDBG funds, or other state or local resources to a Mark to Market transaction without decreasing HUD's contribution to restructuring. The transaction must result in significant benefits to residents and the property, and must be able to close in a timely manner consistent with the debt restructuring schedule.

Annual Adjustment Factor:
Mechanism for adjusting rents in certain types of Section 8-assisted properties, including Section 8 New Construction/ Substantial Rehab. HUD publishes annual percentage factors by unit type and region.

Below Market Interest Rate:
(BMIR). See Section 221(d)(3) BMIR.

Capital Needs Assessment:
A report on a property estimating repair and replacement needs over an extended period of time, often analyzing the way in which resources need to be accumulated to pay for these needs (reserve analysis). Also known as Physical Needs Assessments (PNA), Physical Condition Assessments (PCA), reserve studies, HUD Comprehensive Needs Assessments (CNA) or capital plans.

Capital Recovery Payment (CRP):
In a Mark to Market transaction, a 7 to 10 year payback, with interest, of new capital invested by an owner in the project. The CRP may be paid monthly after project expenses, replacement reserves and debt service payments on the first mortgage. Unpaid amounts may accrue.

Decoupling:
A program to permit owners or purchasers of Section 236 housing to retain the Interest Reduction Payments (IRP) contract and subsidy after refinancing or adding new debt to the existing Section 236 mortgage. The existing use restrictions must be extended for five years beyond the outstanding mortgage term. Authorized by Section 236(b) and (e)(2) of the National Housing Act. See also: IRP.

Emergency Low Income Housing Preservation Act (ELIHPA): 1987 statute authorizing the original federal preservation program. Program active 1987 - 1992.

Eminent Domain:
Authority of a government entity to forcibly acquire real estate for a public purpose, with compensation at Fair Market Value.

Enhanced Vouchers:
Tenant-based Section 8 assistance provided to eligible residents when owners prepay their subsidized mortgages or opt out of project-based Section 8 contracts. Rents are set at market comparable levels, instead of the regular voucher payment standard, as long as the tenant elects to remain in the housing.

Federal Housing Administration (FHA):
Originally an independent agency established under the National Housing Act of 1934 to improve housing standards and conditions, FHA is now a part of HUD. Its goal is to provide an adequate home financing system through insurance of mortgages, and to stabilize the mortgage market.

Flexible Subsidy:
A direct HUD loan or grant for rehabilitation or operating losses, available to eligible owners of certain HUD-subsidized properties. Owners must continue to operate the project as low and moderate income housing for the original mortgage term. Not currently active.

Full/Full Restructuring:
A transaction carried out under Mark to Market involving both rent reduction and bifurcation of the HUD-insured debt into performing and deferred loans.

Incentive Performance Fee:
An annual distribution to the owner of a Mark to Market property subject to satisfactory project operation and management and equal to 3 percent of Effective Gross Income. The amount is subordinate to regular operating expenses, replacement reserves, debt service and Capital Recovery Payments with a minimum of $100 a unit and a maximum of $200 a unit.

Interest Reduction Payment (IRP):
In a Section 236 project, the Interest Reduction Payment or interest subsidy provided by HUD on a monthly basis, which makes up the difference between the mortgage debt service actually paid and the debt service that would have been paid at an interest rate of 1 percent.

Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA):
1990 statute authorizing the "permanent" federal preservation program. Program active 1990 - 1996.

Lite/ OMHAR Lite:
Renewal of a Section 8 contract that has over-market rents, in which contract rents are reduced to market without debt restructuring pursuant to MAHRA.

Loan Management Set-Aside (LMSA):
A form of project-based Section 8 assistance used primarily for Section 221(d)(3) BMIR and Section 236 housing. These contracts were added after the housing was developed and were short-term, renewable.

Multifamily Assisted Housing Reform and Affordability Act (MAHRA):
1997 statute authorizing the Mark to Market program and renewals of expiring Section 8 contracts.

Mark to Market:
A program enabling owners of above-market Section 8 properties with HUD-insured mortgages to reduce rents, restructure the existing debt, and generally renew project-based Section 8 subsidy contracts. Authorized by MAHRA and administered by PAEs under contract to HUD/OAHP. Owners who participate in debt restructuring must agree to 30-year Section 8 renewals, and underlying use restrictions for a portion of the units. Tenants and state/ local governments have an opportunity to participate in the restructuring plans.

Mark Up to Market:
A program enabling eligible owners of below-market Section 8 properties (insured and uninsured) to renew expiring subsidy contracts at comparable market rents. Contracts must be at least 5 years.

Office of Affordable Housing Preservation (OAHP):
Formerly, the Office of Multifamily Housing Assistance Restructuring (OMHAR), HUD established this office to oversee the continuation of the Mark to Market program and potentially to provide assistance in the oversight and preservation of other affordable housing programs.

Operating Cost Adjustment Factor (OCAF):
Percentage factor used to adjust Section 8 project-based rents. Published by HUD on an annual basis. The OCAF percentage is applied to the Section 8 gross rents less debt service, i.e. to operating expenses plus cash flow.

New Construction/ Substantial Rehab:
A form of project-based Section 8 assistance used in the original development and financing of the housing. Projects are both insured and uninsured (with private or state/local bond financing). These contracts are long-term (20-40 years). Active 1976 - 1985.

Participating Administrative Entity (PAE):
The Participating Administrative Entity is responsible for structuring Mark to Market transactions at the local or state level, under contract with HUD. PAEs may be public or private entities or joint ventures.

Project-Based Section 8:
A program providing rental assistance on behalf of some or all of the units in a project occupied by

eligible tenants, for a specified contract term. Tenants pay 30 percent of adjusted income for gross rent including utilities. The subsidy is attached to the unit and stays with the housing after the tenant leaves.

Real Estate Assessment Center (REAC):
Office within HUD responsible for tracking, monitoring and enforcing the regulatory agreements of multifamily housing projects with FHA insurance or project-based assistance.

Rent Supplement:
An older HUD project-based rental subsidy program used for some 221(d)(3) and 236 properties. The subsidy contract is coterminous with the mortgage. Most rent supplement contracts in HUD-insured projects were converted to Section 8 in the 1970s.

Residual Receipts:
Cash account maintained under joint control of the owner and HUD (or HFA) into which is deposited all surplus cash generated over and above the allowable limited dividend. The disposition of residual receipts at the end of the Section 8 contract and/or mortgage is governed by the Regulatory Agreement.

Right of First Refusal:
Right to match the terms and conditions of a third-party offer to purchase the property, within a specified time period. Holder must be notified of the third party offer and may be required to close by a designated date.

Section 202:
A HUD program created in 1959 that provided direct government loans or grants to non-profits to develop housing for the elderly and handicapped. Currently, the program provides capital grants and project rental assistance contracts.

Section 221(d)(3) BMIR:
A HUD program under which the federal government provided direct loans at a below-market interest rate (3 percent) and mortgage insurance to private developers of low and moderate income housing. Active 1963 - 1970.

Section 236:
A program under which HUD provided interest subsidies (known as Interest Reduction Payments or IRP subsidies) and mortgage insurance to private developers of low and moderate income housing. The interest subsidy effectively reduced the interest rate on the loan to 1 percent. Active 1968 - 1975.

Section 811 of the American Homeownership and Economic Opportunity (AHEO) Act of 2000:
Permits a prepayment and refinancing of a Section 202 or 202/8 Direct Loan under certain circumstances.

Tenant-Based Section 8:
Rental assistance provided on behalf of eligible tenants, currently known as vouchers. The subsidy is attached to the tenant and moves when the tenant leaves (see also Enhanced Vouchers).

Transfer of Physical Assets (TPA):
The sale of a property which is subject to a HUD-insured or HUD-held mortgage that will not be terminated in conjunction with the sale. The transfer must be approved by HUD and carried out in accordance with required HUD procedures.

Wellstone Notice:
Notice required to be given by owners of prepayment-eligible projects, prior to prepaying the subsidized mortgage or terminating mortgage insurance. Must be given to tenants, HUD, and state/local government, at least 150 days but no more than 270 days prior to prepayment.

About the Authors

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Vincent F. O'Donnell is Vice President of Preservation at LISC. Mr. O'Donnell has worked for over thirty years in the nonprofit and public sectors to promote affordable housing. Prior to joining LISC, Mr. O'Donnell was Director of Development at Community Economic Development Assistance Corporation (CEDAC), a Massachusetts agency where he developed an extensive preservation effort working with nonprofits, municipalities and state government. Mr. O'Donnell serves as a board member of a number of housing and preservation-related organizations.

David Whiston has been with ON-SITE INSIGHT, Inc. since 1988 and President since 1995. Mr. Whiston has led work on several hundred capital needs assessments nationally – both for due diligence and asset management, including assignments for federal, state and local housing agencies, and private development and management firms. He has considerable direct experience in urban and rural federal housing initiatives.

LISC established its Affordable Housing Preservation Initiative in 2001 to strengthen efforts toward preservation and promote preservation-oriented policy. Since then, LISC has helped nonprofit community development corporations (CDCs) acquire and preserve housing developments, build partnerships with housing authorities and other organizations, and advocate for government policies that can reduce the loss of affordable homes and apartments. Local LISC offices help identify properties at risk, raise awareness of the potential impact on the surrounding community, and maintain long-standing partnerships with CDCs, other nonprofit and for-profit developers, banks, foundations, and state and local governments. The national housing preservation staff specializes in assessing preservation opportunities, advising on project strategy, and developing innovative financing. Other resources include National Equity Fund, Inc. (NEF), a LISC subsidiary, which mobilizes private equity investments fueled by Low Income Housing Tax Credits; the Community Development Trust (CDT), launched by LISC as the nation's first mission-driven real estate investment trust to preserve affordable housing by providing a secondary market for small affordable housing loans and making direct equity investments; and LISC's Housing Authority Resource Center (HARC), which builds affordable housing partnerships with local housing authorities. Visit www.lisc.org/preservation for more information about LISC's Affordable Housing Preservation Initiative.

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