

**Department of HUD [Docket No. FR-5299-N-01]**

**Request for Recommendations Regarding Administrative and Procedural Changes to Expedite the Approval of Applications for FHA-Insured Multifamily Mortgages Involving Low-Income Housing Tax Credits or Tax-Exempt Bonds**

**Agency:** Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD

**Action:** Notice

The Community Builders, Inc., offers the following comments in response to the above-indicated Request and Docket No, relative to Section 2832 of HERA. Our comments address some “administrative and procedural” changes that HUD could adopt to expedite review and approval of multifamily housing projects involving low-income housing tax credits (LIHTCs) or tax-exempt housing bonds under the jurisdiction of HUD. Our comments are organized into four types of HUD-assisted multifamily projects used in conjunction with LIHTCs and tax-exempt bonds: (1) Section 202 projects, including the development of new Section 202 projects and the refinancing of Section 202 direct loans; (2) Section 8, Rent Supp and RAP projects; (3) FHA-insured projects; and (4) Public Housing HOPE VI and Mixed-Finance projects.

**Section 202 Program**

**General Issues.** The successive adaption of the Section 202 program from a loan and operating subsidy program, to a capital grant and operating subsidy program, and then to program allowing mixed-finance processing to leverage other public and private sources of financing has resulted in a patchwork of HUD regulations and processing. The overlay of these varied requirements has made the program unresponsive to the realities of leveraged real estate involving private sector lenders and investors. It is exceedingly difficult to develop new Section 202 projects and preserve existing ones as a result.

***New Section 202/Mixed-Finance Projects—Recommendations***

- **Ownership Structure:** HUD’s interpretation of the non-profit ownership criteria, as applied to the owner general partner, has impeded the ability of sponsors of Section 202 projects to (a) partner with other larger non-profits (necessary in the current economy to attract financing; and (b) address the complex tax issues introduced by the mixed-finance structure. HUD’s current interpretation requires a single non-profit sponsor to control the general partner of the project ownership entity, and does not permit any other shareholder of the general partner. This affects two main problems.

First, if a local non-profit community development corporation wants to partner with a larger non-profit affordable housing developer to leverage the larger non-profit’s assets and significant tax credit experience and capacity to co-develop a project, both the local non-profit and the larger non-profit developer will want to have an ownership interest in the general partner. This is not permitted under current HUD policy.

Second, in order to avoid related party issues arising from the multi-tiered finance structure, the general partner of the owner of a Section 202 project often needs to have a minority co-owner/shareholder. Yet if any party owns more than 79% of the general partner interest and also makes a loan to the project owner, there is a risk of re-allocation of credit that could deprive the equity investor of the credits it is buying. This could result in a loss of equity contributions to the project. The sponsor/general partner sponsor is often called upon to loan grant funds or provide a seller loan to the project owner to meet project capital needs. Therefore, it is common in LIHTC projects to have 21% or more of the general partner owned by another non-profit to avoid these risks. However, HUD's current interpretation requires a single sponsor and therefore does not permit this minority-shareholder strategy.

For of these reasons, we recommend that the project requirements should be interpreted to include ownership by more than one non-profit entity.

- **Distribution of Proceeds.** Currently, in a Section 202 mixed-finance transaction, surplus cash flow, acquisition payments to a seller and developer fees are limited in ways which are inconsistent with other HUD programs and which limit the economic value to both the sponsor/developer and the new investor. We recommend:
  - Increasing the allowable cash distribution from 6% of equity to 10% of equity;
  - Allowing surplus cash after the aforementioned distribution to retire Seller Notes prior to funding residual receipts;
  - Allowing original 202 sponsors to receive proceeds from the sale of 202 properties to a new limited partnership to the extent that doing so does not increase the cost to HUD;
  - Allowing a reasonable (i.e., as per the LIHTC allocating agency Qualified Allocation Plan) developer's fees to be paid to the project sponsor/developer in order to ensure that the developer is adequately compensated for its investment and risk, and has sufficient liquidity to respond to project overruns and other contingencies.

**Refinancing Direct HUD 202 Loans—Recommendations.** When refinancing an existing Section 202 direct loan, the sponsor/owner requires considerable flexibility in order to preserve and extend the useful life of the asset. The current approach (as set forth in HUD Notice H 2002-16 and H 2004-21) is overly restrictive, provides disincentives rather than incentives for preservation and poses serious hurdles for engaging an equity investment partner, particularly as follows:

- **Debt Service Limits.** Under current HUD policy, refinancing must result in a lower interest rate and reductions in debt service. This policy limits the underwriting of the new loan to be based on the current debt service and restricts the sponsor's ability to maximize the debt raise. In today's economy and restricted debt and equity markets, an owner needs to have more flexibility in order to order to assemble an optimal financing package. More specifically, since Section 202 refinancings often do not meet the 9% LIHTC thresholds for preservation set asides, the limit on the debt raise

- **Rent Increases & Contract Replacement.** Under current policy, Section 8 contract rents cannot be increased at the time of prepayment and refinancing. In markets where the contract rents are below comparable market rents, this restricts the project's ability to raise maximum debt, which negatively affects the feasibility of a recapitalization transaction as above. In all markets, whether rents are below or above market, the inability to request a renewal of the HAP contract at the time of prepayment and obtain a 20-year contract is a key investor deterrent. We recommend that rents in a refinancing scenario be set at the higher of current rent or market rent, and that regardless of the duration of the existing Section 8 Contract, HUD allow for termination and replacement with a new 20-year contract.
- **Developer Fee Limits.** When LIHTC equity is provided in a Section 202 mixed-finance transaction, a local/state credit allocation agency often limits the developer fee allowed to a nonprofit developer based on the charitable intent of the Section 202 program. Such limitations unduly constrain the ability of nonprofit developers to effectively compete for scarce LIHTC allocations, assemble other needed financing to preserve Section 202 projects and meet the investor's liquidity requirements (i.e., to ensure the developer's performance under construction, operating and LIHTC guarantees) in a market where investors are risk averse, selective and demanding. Accordingly, we recommend that HUD encourage local/state credit allocating agencies not to limit the developer fee a nonprofit developer can receive below what is standard and customary for other types of LIHTC transactions.
- **Developer Fee Uses.** Current HUD policy (implemented through conditions in approval letters) restricts the use of any developer fee received in connection with a refinancing only for the benefit of the project or the residents. This is a disincentive for a sponsor seeking to rehabilitate an existing Section 202 project, as it cannot use any of the fee to cover staff salaries and other overhead expenses associated with the refinancing of the project. We recommend that a portion of the developer fee be able to be applied to standard and customary staff and overhead expenses.
- **Access to Sale Proceeds & Ground Lease Payments.** Under current policy, a sponsor/owner seeking to refinance a Section 202 loan may not access the equity that it has previously invested in the project. HUD requires that any such proceeds be used for the benefit of the existing project or residents. We recommend that this restriction be eliminated, with appropriate controls, as an incentive for preservation and to encourage the development of additional projects. The previous non-profit owner, upon the sale and/or ground leasing of the property to the new owner entity, should be able to receive funds in the form of sale proceeds and/or ground lease payments that can be used to carry out its charitable activities.
- **Seller Note Payments.** As implemented through conditions in approval letters, upon the sale of the property to a new owner entity, HUD currently allows the previous owner to take back a seller note so that the new entity can maximize the LIHTC basis associated with the acquisition of the property

by the new owner. However, beyond allowed distributions, the new owner is unable to access excess cash flow to pay down the seller note, which discourages use of this facility. Given this issue, we recommend that limitations on the use of excess cash flow for seller note debt services be lifted.

- **Seller Note Security.** HUD also requires that any such seller note not be secured by a mortgage. This causes potential tax issues and hinders the ability to find an equity investor in LIHTC projects. Accordingly, we recommend that prohibition of securing a seller note with a subordinate lien be overturned.
- **Seller Note Forgiveness.** Under current HUD policy (implemented through conditions in approval letters), HUD has required that, in the event that HUD becomes the owner of the property through foreclosure or a deed-in-lieu of foreclosure, the seller note will automatically be forgiven. This causes potential tax and “real debt” issues in a LIHTC project and exacerbates the current problem of finding a tax credit investor. Accordingly, we recommend that in the event of foreclosure or a deed-in-lieu of foreclosure event that a seller note not be automatically forgiven.
- **Section 8 Assistance & Risk Share Loans.** With an FHA-insured mortgage, at the point of prepayment and refinancing, HUD assumes that a Section 8 contract will be renewed coterminous with the new loan, which resolves a major investor problem related to limited HAP contract terms at the time of prepayment. However, HUD does not currently allow an HFA to make a similar assumption about the extension of the Section 8 contract under an HFA-financed Risk-Share loan. We recommend that HFAs be similarly be allowed to assume that Section 8 assistance will be renewed for the term of a Risk-Share loan.
- **Mixed-Finance Training.** While processing of Section 202 loans is delegated to the appropriate Field Office, and Field Office personnel are generally familiar with Section 202 rules, a “reorientation” for Field Office personnel to mixed-finance processing would help provide consistency across the Field Offices in addressing and solving routine issues in mixed-finance transactions.

### **Section 8, Rent Supp, RAPs**

**General Issues:** A key component of a viable preservation transaction is a long-term rental subsidy commitment. Assisted properties are predominantly subsidized through Section 8 project and tenant-based assistance as well as project-based vouchers. However, some are assisted through Rent Supplement and Rental Assistance Payments (RAP), which are the predecessors to the Section 8 program. The differences and inconsistencies among the various rental subsidy programs and their misalignment with the LIHTC program make preservation transactions unduly complicated and difficult to finance.

**Section 8, Rent Supp, RAPs—Recommendations:** Overall, we recommend converting the Rent Supp and RAP subsidy programs to the Section 8 program, and aligning Section 8 rent and income requirements with LIHTC program requirements. More specific issues and recommendations are as follows:

- **Federally-Published Income Limits.** Currently, the basis for setting rents and the resulting income limits are different under the Section 8, Rent Supp and RAP programs. We recommend that the basis for setting rents in the Rent Supp and RAP programs be made consistent with the Section 8 program for each geographic unit.
- **PBVs in LIHTC projects.** Currently, in LIHTC projects with Project Based Vouchers, rents are capped at the LIHTC rent ceiling. This is inconsistent with the market-based ceiling for rents under the Section 8 Project Based Assistance program, and makes underwriting more complex in partially-assisted buildings. Accordingly, Project Based Voucher rents should be capped at market similar to PBAs so these projects can maximize their debt.
- **Tenant Income Certification.** Currently, the tenant income certification process for the Section 8 and LIHTC programs are different. The Section 8 program requires that certifications be undertaken annually on the anniversary of the award of the HAP contract; the LIHTC program requires that certifications be undertaken upon lease renewal. To the extent feasible, it is recommended that the Section 8 tenant certification be aligned to the LIHTC certification requirements when LIHTC projects incorporate any form of Section 8 operating subsidies.
- **Section 8 Contract Renewal/Extensions.** Currently, an owner of a Section 8-assisted project with the original long-term Housing Assistance Payment contract in mid-term seeking to preserve the project through recapitalization must do so under the remaining term of the HAP assistance. The limited remaining term of the contracts and uncertainties of the current renewal process are problematic to most equity investors as they typically seek HAP contract terms to run at least concurrent with the 15-year LIHTC compliance period. Accordingly, we recommended that HUD provide an option to terminate and then renew the HAP contract at the time of refinancing so that the term of the new contract is coterminous with the initial compliance period.
- **Section 8 Overhang.** Preserving properties in markets where Section 8 contract rents are above LIHTC rents has become increasingly difficult as investors typically demand additional operating reserves to hedge against the untimely payment and/or permanent loss of Section 8 subsidies. Although recent appropriations to re-establish timely and full-funding of the Section 8 program are a solid step in ultimately addressing this problem, investors and lenders in the near term will continue to demand some hedge against this risk. Until full confidence is restored in the funding of the Section 8 program, it is recommended that HUD/FHA either offer a guarantee of full Section 8 funding or some type of “second-strip” subordinate financing in proportion to the amount of the Section 8 overhang similar to a second-strip facility some state housing finance agencies have offered in response to this issue.

## **Administrative & Procedural Changes for FHA Insured Mortgages**

**General Issues.** FHA Insurance and HUD Risk-Share processing are both complex and inordinately time consuming, and not aligned with other HUD processes. FHA interest rates are not competitive with other comparable products in the marketplace.

### ***FHA Insured Mortgage—Recommendations***

- **One-Stop Processing.** HUD information coordination and response time are frequently inconsistent and unclear. In particular, HUD should clarify the review period for each request and a “no later than” approval date. We recommend that HUD adopt a “one-stop” application process similar to some states when more than one HUD approval is required in a single project (e.g. prepayment, FHA mortgage underwriting, Section 8 Mark-Up-to-Market approval, Enhanced Vouchers, etc).
- **Rate Disparity.** Historically, rates on FHA loans have been higher than other reasonably comparable products on the market, though this is often compensated for by better underwriting terms relative to amortization and debt coverage. The reasons for such disparity should be explored and corrected where possible.
- **Subordinated Debt.** Onerous HUD subordination requirements limit the ability to add a subordinate mortgage in an existing or new FHA deal. This also relates to the Section 8 overhang issue and the ability to leverage the full potential of the Section 8 rents above LIHTC rents. We recommend that HUD/FHA adopt subordination language that will readily permit second mortgage financing.
- **Transaction Costs & Debt Raise Issues.** FHA requirements including the definition of substantial rehabilitation for Section 221(d)(4) projects, calculation of replacement cost and “as-is” market value also impact transaction costs and debt raise. We recommend that these requirements be reviewed and streamlined as feasible.

## **Public Housing-HOPE VI & Mixed Finance**

**General Issues.** Private owners, developers and managers working in partnership with Public Housing Authorities in the redevelopment of distressed public housing under the HOPE VI and Mixed-Finance Programs have faced substantial underfunding of negotiated Annual Contributions Contract payment amounts due to the chronic underfunding by Congress of the Public Housing Operating Fund in the HUD budget. The underfunding of the Operating Fund has led HUD to subsequently underfund PHAs who in turn prorate the funding of ACC contracts with private owners/managers. Such “pro-rations” significantly stress the operations of affected projects.

According to a recent survey of owners participating in these programs by the National Housing & Rehabilitation Program, as many as 30 percent of HOPE VI projects involving private sector partners

struggle with this problem. Aside from affecting operating projects, this problem has begun to affect the investment underwriting of the HOPE VI and Mixed-Finance programs. Investors now routinely require project owners/managers to substantially increase a project's operating reserves to offset expected ACC pro-rations. In response, owners/managers must access additional forms of other public subsidies to meet increased operating reserve requirements, all of which add time and cost to affected projects.

***HOPE VI & Mixed Finance—Recommendation.*** We are confident that HUD will do everything within its permitted means to urge Congress to fully fund the Public Housing Operating Fund. However, many in the industry are not sanguine that Congress will do this despite HUD's requests, and that ACC pro-rations will continue to be a critical constraint on the HOPE VI and Mixed-Finance programs and HUD's proposed Choice Neighborhood initiative. Accordingly, we recommend that HUD direct the demonstration authority that it is seeking under the HUD Transformation Initiative in its FY 2010 budget to allow Section 8 Project Based Vouchers to be used in conjunction with public housing units to be applied firstly to new transactions under the HOPE VI, Mixed Finance and Choice Neighborhoods programs. As a secondary priority, we recommend that HUD apply such PBVs to existing HOPE VI and Mixed Finance projects most severely affected by ACC pro-rations as a means to preclude "transformation" rights accorded owners/managers.