

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR-4099-N-01]

Office of the Assistant Secretary for Housing—Federal Housing Commissioner

Mark-to-Market/Portfolio Reengineering Demonstration: Notice of Demonstration and Initial Program Guidelines

AGENCY: Office of Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Notice of demonstration program and initial guidance.

SUMMARY: This notice announces a demonstration program that is designed to restructure the financing of projects that have FHA-insured mortgages and that receive Section 8 rental assistance. The purpose of this Congressionally authorized demonstration is to test the feasibility and desirability of multifamily projects meeting their financial and other obligations with or without FHA insurance and with or without above market Section 8 assistance and utilizing project-based assistance or, with the consent of the project owner, tenant-based assistance. In negotiating agreements with eligible project owners, HUD must act to, among other things, take into account the need for assistance of low- and very low-income tenants; address structural problems of projects; and protect the financial interests of the Federal Government. This notice also provides initial guidance on how the Department plans to operate the demonstration program. HUD anticipates that, over time, it will publish additional guidance that reflects in more detail how the program will operate as well as the experience derived through the execution of successful agreements with project owners.

DATES: This demonstration program guidance is effective July 2, 1996. In a separate notice, HUD will publish information requirements that demonstration participants will need to comply with.

FOR FURTHER INFORMATION CONTACT: George Dipman, Office of Multifamily Housing, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC. 20410-4000; Room 6174; telephone (202) 708-3321. (This is not a toll-free number.) Hearing or speech-impaired individuals may call 1-800-877-8399 (Federal Information Relay Service TTY).

SUPPLEMENTARY INFORMATION:

I. Background:

This demonstration, titled FHA Multifamily Demonstration Authority, is authorized by section 210 of the Departments of Veterans Affairs and Housing and Urban Development and Independent Agencies Appropriations Act (Pub. L. No. 104-134, 110 Stat. 1321, April 26, 1996). It reflects concern of both the Congress and the Administration about social issues and budgetary costs associated with the renewal of Section 8 project-based assistance contracts on multifamily properties having FHA-insured mortgages. As of August 1995, the HUD portfolio contained 8,563 projects, with a total of over 850,000 units, that have HUD insured loans supported by Section 8 rental assistance contracts. Under existing contracts, most of which are due to expire over the next few years, many projects receive project-based Section 8 rental assistance for rents that exceed those charged on comparable, unassisted units within the local market. At the same time, these projects often have substantial unmet capital needs. The Federal assistance, in the aggregate, is costly. If assistance contracts were to be renewed on a long term basis, based on current contract rent levels, the annual cost to the Federal Government would increase dramatically by the year 2000. Consequently, Congress has opted not to renew Section 8 contracts on these projects for more than one year, while the Department seeks alternative solutions to the housing and budget issues.

For many project owners, if their level of Section 8 assistance is reduced or eliminated, and all else remains constant, the likelihood is that they will be unable to continue to meet project financial obligations, including mortgage debt service payments, current and future capital needs, and operating expenses such as project reserve and repair costs. This could lead to mortgage defaults, deterioration of this important housing stock, and the possible displacement of thousands of low-income families and seniors nationwide.

Over the past year, Congress, owners, lenders, tenants, and other interested parties have proposed various alternative solutions to this long term and serious problem. Congress has authorized this demonstration, enabling HUD to test various methods of restructuring the financing of these projects. One goal of the demonstration program is to test alternative creative solutions that will provide long-term viability of the properties as affordable

housing, which will benefit local communities and their tenants.

The remaining sections of this notice provide the following information:

Section II. Summarizes provisions of Section 210, including project owner eligibility requirements, and tools that HUD can employ to carry out the demonstration.

Section III. Describes HUD's primary objectives in implementing the demonstration, and how HUD anticipates working with owners in reaching agreements.

Section IV. Employs a Question and Answer format to address a variety of specific issues, and is intended to further clarify HUD's approach to implementing the demonstration program.

Section V. Describes certain certifications that HUD makes in connection with publication of this notice of demonstration program.

II. Section 210—Goals, Mandates and Tools

A. Eligible Program Participants

Eligible projects, defined in the legislation, include those multifamily properties

1. Whose owners agree to participate; and
2. Whose mortgages are FHA insured and which receive project-based assistance under Section 8 of the United States Housing Act of 1937; and
3. Whose present Section 8 rents are, in the aggregate, in excess of the Fair Market Rent (FMR) for the area in which the project is located.

B. Goals

Consistent with the legislative objectives, HUD's goal will be to carry out this demonstration program in a manner that will:

1. Result in significant discretionary cost savings through the reduction of above-market Section 8 assistance through early terminations and restructuring of long-term project-based assistance contracts.
2. In the least costly fashion—
 - a. Maintain existing housing stock in a decent, safe, and sanitary condition;
 - b. Minimize the involuntary displacement of tenants;
 - c. Restructure mortgages in a manner that is consistent with local housing market conditions;
 - d. Support fair housing strategies;
 - e. Minimize any adverse income tax impact on property owners; and
 - f. Minimize any adverse impact on residential neighborhoods; and
3. Protect the financial interests of the Federal Government.

Congress provided, in addition, that in determining the manner in which a mortgage is to be restructured or the subsidy reduced, the Secretary may balance competing goals relating to individual projects in a manner that will further the purposes of this demonstration.

C. Mandates

Section 210 provides that, under the demonstration, HUD can pursue these goals with respect to project mortgages securing up to 15,000 units. Moreover, Congress has appropriated \$30,000,000 for the cost of modifying mortgage loans, as such costs are defined in section 502 of the Congressional Budget Act of 1974, as amended. Also, the legislation authorizes HUD to directly enter into joint venture arrangements with third parties, under which the Secretary may assign some or all of the functions, obligations and benefits of the Secretary, and to purchase reinsurance, enter into participations, or otherwise transfer the economic interest in contracts of insurance or mortgage insurance premiums on such contracts of insurance. (This notice, however, does not address the implementation of the third party joint venture component of the demonstration. Guidelines for joint venture partners shall be released at a later date.)

D. Tools

The demonstration program will use a variety of tools and authorities to restructure the financing of assisted FHA-insured projects. The basic approach will work through the voluntary participation of the project owners and lenders to move rents and operating costs toward market levels immediately or over time, and to reduce the outstanding principal balance to reflect any decline in net operating income that may result. The restructuring process attempts to put the projects on a sound financial and physical footing with market rents, sufficient to service the remaining debt and operating costs, including replacement reserves.

Reasonable rehabilitation costs may be supported first through the release of reserves and residual receipts accounts, and then by further reduction of the principal balance. Extraordinary rehabilitation needs may require capital infusions from partners and state and local government assistance.

Existing tenants will continue to be assisted with tenant based Section 8 assistance or by project based Section 8 assistance. Section 8 assistance for projects with contracts expiring in 1997 shall be renewed only after annual

budget authorizations by Congress. To support mixed-income developments, some tenants who receive tenant-based assistance and vacate the project may be replaced with families that are not eligible for Section 8 assistance.

Post workout refinancing methods may include leaving the existing FHA-insured loan in place, refinancing the mortgage with an FHA-insured mortgage under an FHA refinancing program, obtaining a new loan and FHA insurance, and financing through conventional sources.

Existing tax law will apply to reengineered, assisted FHA projects. Mitigating any tax consequences resulting from debt cancellation will be the responsibility of the owner. HUD will consider any approach that is revenue neutral to the property owners and investors.

Depending on the particular characteristics of a project, HUD and an owner and, where applicable, with the consent of affected third parties, could enter into a restructuring agreement that includes, but is not limited to, one or more of the following actions:

1. Restructuring rents at or above market where, in the latter instance, market rents are insufficient to cover operating costs irrespective of debt service;
2. Forgiving and cancelling any FHA-insured mortgage debt that a demonstration project cannot carry at market rents while bearing reasonable operating costs;
3. Paying all or a portion of a project's debt service, including monthly payments from the appropriate Insurance Fund for the full remaining term of the insured mortgage;
4. Replacing FHA mortgage insurance with uninsured debt or continuing FHA mortgage insurance, if warranted;
5. Not renewing expiring existing project-based assistance contracts with the provision of tenant-based assistance to previously assisted households;
6. Providing project-based assistance with rents at or below fair market rents for the locality and negotiating other terms acceptable to HUD and the owner;
7. Deciding to remove, relinquish, extinguish, modify, or agree to the removal of any mortgage, regulatory agreement, project-based assistance contract, use agreement, or any restriction that had been imposed by the Secretary, including the restriction on distribution of income; and
8. Requiring the owner of an assisted property to apply any accumulated residual receipts toward effecting the purposes of the reengineering initiative.

III. HUD's Portfolio Reengineering Program—Overview

HUD's Portfolio Reengineering program, which will implement the Demonstration, is designed to soften the impact of Section 8 budget reductions. Under its Portfolio Reengineering program, HUD seeks to reduce Federal assistance payments while stabilizing projects physically and financially and reducing reliance on Federal insurance, and to do so with the least possible disruption to tenants and neighborhoods.

These objectives will be accomplished by, among other things, (1) reducing rents and operating costs to market levels; (2) making corresponding reductions in the principal balances of outstanding mortgages; and (3) improving the ability of the current assisted residents to pay market rent levels. Reengineering may also provide tenants with tenant-based rental assistance or continued project-based rental subsidies at lower rent levels.

HUD will implement the demonstration through a combination of HUD field and headquarters staff, private consultants and third parties or joint venture partners. As previously noted, these guidelines do not address guidelines for the involvement of joint venture partners. Guidelines for joint venture partners will be released at a later date.

Project readiness will be a significant criterion for allocating demonstration resources. HUD seeks reengineering projects with very real prospects for support from the existing mortgagee, owners, new lenders, and the community, including tenants.

Under the demonstration, HUD intends to ensure that affected tenants and representatives of the local community and government have a meaningful opportunity to review and react to a proposed agreement before any agreement is finalized.

Reviews of proposals made under the demonstration will be conducted on an "open window" batched basis with monthly reviews by a loan workout committee that will consider various workout approaches as described in section II. D. Proposals that contain a number of the following characteristics will be given priority if demand for the demonstration exceeds authority and resources. HUD may add additional priority criteria, in future notices that provide additional guidance under the demonstration. HUD prefers projects and proposals that meet the following criteria:

1. Have Section 8 contracts that extend beyond 1997, and which reduce

rental assistance over the remaining life of the contract, or use rental assistance to prepare the project for market rents;

2. Reduce rents to market rents, rather than to an above-market level;

3. Minimize the impact of credit subsidy requirements resulting from the modification of the existing mortgage debt or the provision of new FHA insurance;

4. Maximize reduction of Federal expenditures through—

a. Low principal reduction (i.e. minimum partial payment of claim);

b. Section 8 savings; or

c. Reduced operating costs;

5. Eliminate project-based rental assistance in favor of tenant-based rental assistance;

6. Eliminate or reduce the existing FHA mortgage insurance;

7. Achieve restructuring through the use of non-HUD personnel;

8. Preserve some long-term affordability;

9. Serve housing needs of low- and very low-income tenants; and

10. Illustrate efforts to raise the economic value of property by increasing the earning power of the existing tenant population through initiatives such as education, job training and entrepreneurship.

IV. Ongoing Clarification of Demonstration Guidelines

The primary goal of the Portfolio Reengineering Demonstration is to provide HUD, Congress, and assisted FHA project owners and tenants a testing ground for wide-scale restructuring and stabilizing of this endangered housing resource. As the demonstration evolves, questions that arise through field testing approaches to reengineering will be answered through periodic published question and answer bulletins. The following "Qs and As" address some issues already communicated to HUD.

Q. One goal of the demonstration is to test alternative creative solutions that will provide long term viability to the properties and their tenants. What kind of alternative creative solutions would be considered?

A. HUD will give highest priority in restructuring to owners who can demonstrate a decreasing need for Section 8 assistance because of the implementation of programs which enhance the ability of assisted residents to pay an increasingly greater portion of the market rent. The additional effects of increased tenant earning capacity will be to reduce other governmental expenditures and increase tax receipts and also to stabilize and enhance property values. Illustrations of

alternative solutions, in addition to reliance on the financing and rehabilitation tools specified above, include investment of owner and/or project resources targeted at resident job training and placement, education, self-sufficiency, enterprise development, entrepreneurship and social services; and commitments from community related organizations to assist in similar endeavors. Owners whose proposals include such initiatives should outline specifically the goals they plan to achieve and how the implementation of such programs will result in enhanced financial capacity for the real estate and the tenants.

Q. What is the definition of market rents?

A. Market rents refers to the rent achievable by the project without rent subsidy when competing in the market place for new tenants. Two or more market rent projections for a given project may be considered in reengineering negotiations. For example, there may be a market rent for a project in "as-is" condition, another rent for a rehabilitated project, another rent for a project to which amenities have been added, and still another rent that is achievable two or three years after restructuring is completed and income mixing has occurred.

Q. How will operating expenses be determined for the purposes of calculating the mortgage supportable after rents are moved to market?

A. HUD's due diligence contractor will evaluate project operating statements, will reduce costs that are a product of HUD requirements and processes that can be eliminated, and HUD will negotiate the balance of any operating expenses that appear to exceed market levels with the owner in light of industry standards for market rate developments.

Q. Will HUD keep existing FHA insurance in place after restructuring?

A. It is HUD's preference to extinguish existing insurance immediately or over time and transition reengineered projects to freshly underwritten permanent financing. This preference is driven by both HUD budget considerations, and well established banking principles regarding the restructuring of troubled assets. However, HUD will consider extenuating circumstances that may justify leaving existing insurance in place.

Q. Will projects with HUD held mortgages be considered for the demonstration?

A. No. The demonstration is limited to insured mortgages.

Q. What rehabilitation levels and capital improvements will be supported by the demonstration?

A. Restructuring must be designed to ensure the long term physical integrity of the project. HUD will consider rehabilitation necessary to achieve that objective. In addition, HUD will consider the addition of amenities when the owner can demonstrate they will support higher market rents that will reduce net long term costs to the Federal Government. This could include, for example, improvements that promote the economic self-sufficiency of the tenants. Any project rehabilitation or capital improvements supported by HUD will comply with 24 CFR part 50.

Q. What owner administrative costs will HUD allow to be offset in the workout process?

A. Non-profit owners may include reasonable transaction costs and administrative fees as eligible uses of funds in loan workouts.

Q. How will the demonstration approach projects in which market rents are insufficient to support operating costs?

A. These projects are not included in the initial focus of the demonstration, but will be addressed in future guidelines.

Q. Will the demonstration include projects in which restructuring occurs in conjunction with a sale or transfer to a new owner?

A. Yes.

V. Other matters

Executive Order 12612, Federalism

The General Counsel, as the Designated Official for HUD under section 6(a) of Executive Order 12612, Federalism, has determined that the provisions in this NOFA are closely based on statutory requirements and impose no significant additional burdens on States or other public bodies. This notice does not affect the relationship between the Federal Government and the States and other public bodies or the distribution of power and responsibilities among various levels of government. Therefore, the policy is not subject to review under Executive Order 12612.

Executive Order 12606, The Family

The General Counsel, as the Designated Official under Executive Order 12606, *The Family*, has determined that this notice does not have potential for significant impact on family formation, maintenance, and general well-being, and, thus, is not subject to review under the order. The notice implements a statutorily

authorized demonstration program and is intended to find ways of reducing the impact on families that might otherwise not be caused by the nonrenewal of Section 8 project-based rental assistance.

Dated: June 26, 1996.

Nicolas P. Retsinas,

*Assistant Secretary for Housing—Federal
Housing Commissioner.*

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