RD UNDERWRITING POLICIES – PRESERVATION CHALLENGES

Background:

On September 30, 2013, the National Rural Development (RD) Office issued an Unnumbered Letter (UL) that is intended to provide guidance on underwriting policies for multifamily transactions. This UL was not released by the agency until November 2013, due to the government shut-down in October. The policies contained throughout the UL will not perpetuate preservation but will negatively impact a portfolio of affordable housing that needs preservation capital. In addition, the UL, if not substantially changed, will create material barriers, set unrealistic standards and separate RD from many common sense approaches used in the preservation of affordable housing by entities across the country.

Issues:

A cross section of interest groups representing owners, operators, funding partners, managers, non-profit and for-profit small businesses, local and state government agencies, banks and financial institutions who are RD’s business partners in the delivery of decent, safe and sanitary housing sent a letter to the national RD office asking that the UL be rescinded and a meeting be convened to discuss preservation policies at the agency. The organizations also represent the residents these business partners serve. Our collective goal is to preserve the affordable housing opportunities provided by the Section 515 portfolio, which is a critically important resource for families living in rural areas.

Collectively, these groups believe that the UL is the wrong approach to preserving housing and protecting families and the elderly. The UL adds a series of new practices and policies, crippling preservation and reversing regulations and handbook provisions through an internal memo. The UL also continues many policies that have hobbled preservation efforts and industry stakeholders have urged re-examination of these policies for some time. One example of new policies is eliminating the ability of new capital to earn any return, discussed more below. Furthermore, an example of a pre-existing problem, even before the UL, is processing each transfer through a separate local office where staff has had limited training or support and is also overburdened with inspection monitoring and audit review requirements. RD must consolidate processing with specialized staff.

Specifically, the new policies that are the most disturbing include the following:

- The UL requires that owners must obtain a Comprehensive Needs Assessment (CNA), and that reserves should be sized to 100 percent of the CNA. Amounts each year must equal the minimum projection for each year of the projections. Stakeholders have previously advised RD that CNAs are projections only, not hard standards, and RD is misusing this projection too.
• Perhaps most troubling, RD effectively abrogates its transfer regulations at 7 CFR 3560.406, and its responsibility to reasonably permit transfers. The UL prohibits transfers unless the owner obtains a CNA and funds the full CNA. The new UL imposes this requirement even if the current reserves are fully funded and the owner has performed all of its obligations and funded all reserves under the existing RD Loan Agreement. Clearly, RD is imposing new burdens on the owner – essentially new fees in the nature of a tax – which is not currently a contractual obligation of the owners. This effectively takes from the owner the ability to operate and transfer its asset in any sort of reasonable manner.

• The UL eliminates equity pay out for a seller or return to owner (RTO) increase for a purchaser if any new direct Agency funds are used in the transfer. As RD is well aware, many transactions are supported by third-party funds, such as equity raised through the Low Income Housing Tax Credit (Housing Credit) program. The partners that enter the purchasing entity rely on distributions to pay certain of their operating costs, as well as to fund a portion of the developer fee that the transaction cannot support at closing. That developer fee, including the deferred portion, is often a material basis for raising the Housing Credits. That is to say, the developer fee goes into basis and Housing Credits are generated from that basis, which are then used to help attract new partners and private capital.

• The new RTO is now set based on the general partner's contributions, not the owner’s contributions, as Housing Credit proceeds are excluded. This specifically contradicts existing RD guidance and ignores the equity investor’s contribution. At the same time, limited partnerships and other entities, created to bring in and use private capital “may” be denied an RTO where the general partner is a non-profit corporation trying to advance affordable housing. This appears to violate 7 CFR 3560.68(a), which provides no such distinction for eligible limited partnerships. RD is ignoring the basic tax-incentivized structure and punishing investors who work with non-profit general partners.

• Furthermore, soft debt, paid as a percentage of net cash flow usually, is a benefit to the project and by extension, RD as lender and subsidy provider. The new calculations of RTO, resulting in proposed RTOs insufficient to meet project financial obligations, including soft debt.

• The UL continues RD’s recent practices of regulating sales prices, interfering with transactions between parties. The UL now sets sales price at the lesser of the value reached by an independent third-party appraiser or the amount of debt that RD will allow based on the rents RD has permitted. As RD knows from prior stakeholder letters and meetings, RD’s use of appraisals has already created barriers to permitting new debt and investment. This new barrier greatly increases the problem.

• The UL contains unclear language about the nature and treatment of the Reserve Account. The Reserve Account is there for the benefit of the project and residents but is funded by owners from pre-tax dollars and is the owner’s asset.

• The UL also contains a restatement of some of the guidance for the Multifamily Preservation and Revitalization (MPR) Demonstration program. Over the past several years, RD has both tried to terminate this program and has tried to promote this program.
The UL does not address the impediments to the program. Specifically, MPR suffers from slow implementation of the debt deferral even after approval, which can easily take many months. Also, MPR creates an event that may be subject to federal taxation and RD has failed to clarify its treatment with its sister federal agency at the Internal Revenue Service.

- The UL requires RD staff to use a “Hyperion” report to evaluate the quality and acceptability of transfer underwriting, but provides no means for any party to the transaction other than RD to access its contents. If this reporting capacity will be used to approve or disapprove transfer transactions, RD should make it easily available to those who will be subjected to RD’s determinations; as well RD’s funding partners who depend on transparent feasibility decisions from RD.

- RD’s objection now to tiered rents has become an issue preventing several transactions because, in sum, certain unit rents are not higher.

- The new UL also requires project loan accounts to transfer from DIAS to PASS even though 7 CFR 3560.406 (j) (3) excludes monthly payment DIAS loans from that requirement. Many potential purchasers value a DIAS loan for its rapid pay down of principle and this new requirement would discourage some transfers from occurring.

- Finally, the new UL does not establish when its advice becomes effective and draws into question what standards would apply to transactions already submitted to RD for consideration. While we maintain this guidance is so flawed it should be withdrawn immediately, any new guidance should establish which transactions would be considered “grandfathered” under new guidance.

**Recommendations:**

The organizations want to work with the agency and Congress on developing solutions that will keep the financial integrity of the properties intact and also provide the necessary assistance to the residents who live in these properties. We would ask that the Senate Banking, Housing and Urban Affairs Committee and House Financial Services Committee hold hearings on RD’s preservation policies. RD should re-issue the guidance that resolves the concerns of the stakeholders.