Housing Bond Report

A MONTHLY PUBLICATION ON THE LOW-INCOME HOUSING TAX-EXEMPT BOND INDUSTRY

May 2003, Volume VI, Issue V, Published By Novogradac & Company LLP

Section 202 Changes Spur Activity

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Since its inception in 1960, the U.S. Department of Housing and Urban Development's (HUD) Section 202 program, involving direct loans and grants to not-for-profit organizations, has funded more than 3,500 affordable apartment complexes developed and owned by not-for-profits for elderly and disabled occupancy. Now, because of important Congressional and HUD action, these properties are receiving new attention in the larger housing and investment community because of their potential for both refinancing and for attracting low-income housing tax credit (LIHTC) investment.

Under the program's prior long-time structure - direct funding by the federal government without financial intermediaries and strictly not-for-profit ownership - Section 202 projects had provided virtually no opportunities and little interest to lenders, underwriters and syndicators. The not-for-profit community jealously guarded the program and periodic disputes in Congress and at HUD were more often over the nature of the not-for-profit sponsors, how "national" they could be and how "local" they must be, rather than any fundamental change or broader participation. In 1999, however, the not-for-profit community began to recognize that Section 202 properties developed in the 1960s, 1970s and 1980s were in need of repair, and that refinancing, as well as limited involvement by private investors, coupled with retained not-for-profit control, could be a valuable tool to preserve aging projects. Their support led to passage of certain provisions in the American Homeownership & Economic Opportunity Act of 2000, which opened the way to ownership restructuring, together with easier prepayments and refinancing.

HUD Notice H2002-16, released in August 2002, describes the procedure for prepayment of HUD-held Section 202 mortgages, new ownership structures and new regulatory terms applicable to redeveloped Section 202 properties. The Notice has been subject to much review by not-for-profit owners, lenders and tax credit equity investors, and activity is increasing both with individual projects and significant portfolios.

Refinancing is now available, not only through FHA mortgages and 501(c)(3) bonds (traditional not-for-profit financing tools), but also through multifamily bond volume cap allocations, which carry with them the potential for the so-called "automatic" 4 percent low-income housing tax credit. The choice likely depends upon a project's capital needs. If refinancing proceeds and existing project reserves are not sufficient to address these needs, then a changed ownership structure bringing in LIHTC equity can fill the gap. According to Thomas J. Vespa, of Stern Brothers, an investment banking firm based in St. Louis, "The prior two years' lag in activity probably stemmed not only from nonprofit hesitancy and unfamiliarity with alternative funding tools, but also uncertainty and ambiguity in HUD's guidance."

Economic issues are important when reviewing Section 202 transactions. Not-for-profit owners often operate without regard to excess cash flow. While these projects may often receive Section 8 subsidy in excess of comparable market rents, these rents are required to maintain the higher level of services provided to elderly tenants. With effective current debt service coverage of 1.0 on their current loans, it can be difficult to refinance Section 202 projects and generate excess proceeds, even with today's significant interest rate reductions of 300 to 400 basis points.

As explained in H2002-16, there are two types of Section 202 prepayment events. The first involves prepay-

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ment of loans that do not require HUD approval. These loans were generally made between 1977 and 1982, and may be repaid upon 30 days' notice to HUD, without significant HUD review and processing. For these "prepayable" projects, an owner may choose to process under the terms of the notice in order to retain above-market Section 8 rents, where prepayment might cause other treatment under MAHRAA.

The second class of loans constitutes the primary purpose for which the prepayment portion of the notice was published. These involve Section 202 direct loans that may not be prepaid without HUD approval. HUD must approve refinancing of these loans in all cases, and owners of the refinanced property must execute a new-use restriction extending to the original term of the prepaid Section 202 loan - not an issue to not-for-profit owners and also not an issue to new investors because those original terms are generally shorter than required by the LIHTC.

For projects moving forward under H2002-16 requirements, refinancing raises a number of issues not uncommon to other HUD-financed properties. First, there is the question of disposition of reserves, both residential receipts and replacement accounts. The 2000 Act mandates making these receipts available for specific purposes. As described in the notice, amounts in excess of $500 per unit held in a project's residual receipts account may be used to pay a portion of supportive tenant services. Replacement reserves in excess of $1,000 per unit can be used for renovation, retrofitting or construction of related facilities. Section 8 contract savings that may result from refinancing can also be used for rent reductions. Other innovative uses have been suggested and are considered by HUD. Many believe that, in time, these uses can include the provision of new affordable housing not directly tied to the specific community that the project served initially. Such uses were permitted through the 1980s when HUD allowed the conversion of subsidized not-for-profit projects to for-profit ownership in order to attract equity investment. Existing flexible subsidy loans are to be repaid at the time of prepayment but, with some difficulty, can be deferred by waiver.

As suggested above, Section 202 projects restructured under the notice may retain their exemption from Mark-to-Market, but will be renewed at the lesser of budget-based or current rents adjusted annually. As is true with most HUD-assisted projects, field officers and HUD's Washington staff share decision-making on all of the foregoing.

Refinancings are occurring with full FHA insurance and risk-sharing arrangements, as well as conventional financing, and by state and local bond issuances, with and without tax credits. HUD's notice provides that a LIHTC project may now be owned by a for-profit limited partnership of which the current not-for-profit owner, another experienced not-for-profit or a corporation controlled by such a not-for-profit is the sole general part-

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ner of the new owner. Only a 9 percent developer fee calculated under the applicable state LIHTC program is permitted. All participants, of course, must have HUD Previous Participation (2530) clearance.

The notice also provides that owners of refinanced projects can receive a distribution of only 6 percent of equity, and states that neither tax credit equity nor other governmental funds may be included in the equity base. While this may cause some investor concern, it is also possible to take some sting out this distribution limitation by obtaining HUD approval for fees contained in borrower partnership agreements, to be calculated "above the line." HUD headquarters must approve the method of determining equity and distribution levels but is able to consider reasonable proposals.

Significant opportunities now exist for entrepreneurs to meld their skills, particularly through the use of volume cap bond allocations and low-income housing tax credits, with the needs of the not-for-profit community so that new equity investment can be provided to address the needs of aging Section 202 properties. Some concerns similar to those raised in other sales of property by not-for-profit organizations to for-profit entities are raised with these Section 202 changes, however. For instance, where the not-for-profit or an affiliate remains as the managing general partner, the structure must provide the not-for-profit with appropriate consideration to avoid concerns regarding excess private inurement. At the same time, purchasing entities in these transactions will often rely on seller financing to reach an appropriate purchase price, and the terms of such seller "take-back" financing must be crafted to avoid a reduction in eligible tax credit basis. Finally, care must be taken to avoid a repeat of some abusive transactions that occurred in the early 1980s when, under a different set of tax circumstances with incentives provided principally by accelerated depreciation and mismatching of accounting basis between buyers and sellers, a large number of HUD-assisted projects were transferred from not-for-profits to for-profits with mixed results in terms of addressing the physical needs of the projects and their residents.

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