

## PPC Processing, FHA Modernization and PETRA — Signs of Innovation at HUD

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As we have noted repeatedly, the Obama administration's Department of Housing and Urban Development (HUD), headed by Shaun Donovan and staffed with experienced veterans from the multifamily industry, has been remarkably active in program development, while managing and administering an enormous increase in FHA activity, the maturing of several existing HUD-subsidized portfolios, and entry into the HUD multifamily arena by many newcomers, drawn by available and predictable subsidies, funding and financing.

HUD has worked to lead in industry recovery and stabilization, early on, by quick and strong administration of American Recovery and Reinvestment Act (ARRA) TCAP funds and additional public housing capital funds, followed by appropriate modification of FHA programs and institution of revised policies for partial payment of insurance claims, and most recently, development and submission to Congress of the Preservation, Enhancement, and Transformation of Rental Assistance Act of 2010 (PETRA). HUD has been and looks to be a source of much innovation moving forward. This Alert briefly discusses some of these matters.

### PETRA

PETRA, initially called TRA or Transforming Rental Assistance, represents an initiative HUD has been working on for months, and provides the outline for serious changes to public housing and other rental subsidy platforms. While still subject to much criticism from the multifamily community, PETRA's goals are noteworthy, and its provisions will likely be pivotal in policy discussions over the next 18 months. At its core, PETRA seeks to coordinate rental subsidy programs that currently fall outside

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of common Section 8 project-based boundaries, including public housing operating subsidies. HUD now provides rental assistance to more than 4.5 million households through roughly 13 different rental and often overlapping subsidy programs. PETRA presents a multi-year plan to consolidate these programs into fewer tiers of long-term project-based and tenant-based assistance, including flexibility to address public housing capital requirements, increased resident mobility and, hopefully, simplified program administration.

If PETRA were passed in its current form, all rental subsidy programs (outside of Section 202/811 PRAC, unless this program is also designated by the HUD Secretary) would be reconfigured to fit within one of three program umbrellas: project-based Section 8; project-based vouchers; and tenant-based vouchers.

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Existing project-based Section 8 contracts (commonly, HAP Contracts) would remain largely unchanged, as the current program, largely governed under the Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRAA), is not directly addressed in PETRA. Other outlier subsidy programs, however, including Section 8 Mod Rehab, Rental Supplement (Rent Supp) and Rental Assistance Payments (RAP), along with some portion of public housing units will be consolidated, under a new Section 8(n), with project-based Section 8 HAP Contracts substantively similar to those falling under MAHRAA, but including long-term use obligations for the owner and some modified annual rent adjustment mechanisms. PETRA does represent one potential solution to the approximately 40,000 units of RAP and Rent Supp “orphan projects” with assistance contracts that are now expiring or have already expired, and for which no replacement funding or program is generally available.

With respect to public housing units, as drafted, PETRA would establish additional requirements specifically addressing conversion from traditional public housing (PHA-owned Section 9 units) to new Section 8(n) project-based HAP Contracts.

While common “disposition” processes will not be required for “conversion,” tenant participation, residency limits for “extremely low income,” Section 3 contracting and other public housing administrative requirements would remain in place for converted Section 9 properties.

Project-based vouchers (PBVs) will be generally extended to owners of partially assisted or “small” projects. Section 8(o), under which PBVs are currently governed, will be modified by PETRA to increase the number of units that may be covered, increase contract terms, and provide some discretion to the Secretary in establishing maximum rent limits, among other changes. In some cases, PHAs may have as much as 40 percent of their Section 8 voucher authority administered as PBVs.

HUD hopes that PETRA will also permit leveraging of additional resources to meet the capital and operating needs of the projects, as it has been done in public housing mixed financed projects. PBVs and conversion of public housing units to project-based Section 8 can be readily foreseen as providing a more predictable source of operating income than current PHA funding mechanisms, allowing for greater access to private financing and equity sources. HUD’s 2011 budget asks for \$350 million for PETRA’s first phase, but its cost, uncertain at this time, may rise in out years as specific tenant mobility provisions kick in – including the need for funding of additional vouchers to tenants

of converted projects, where project-based subsidy remains and tenants who leave after some lengthy period of residence are entitled to receive tenant-based subsidy for use elsewhere.

As one might expect, PETRA, as presented by the Obama administration, grants a great deal of discretion to the Secretary in development and application of many finer points such as rent setting, eligibility, transferability of this new subsidy, physical standards and other substantive matters. Congressional members and staff currently view PETRA respectfully, but its costs skeptically, and that is certain to result in some revision. We will keep you informed of progress as this important and comprehensive initiative moves forward.

### MULTIFAMILY FINANCE

In developing and implementing changes to its multifamily insurance programs (MAPs), HUD has stressed three primary goals: (1) to be a reliable source of liquidity, particularly as a counter-cyclical tool, (2) to support production, particularly with respect to affordable housing, and (3) to manage its insurance risk.

In figures released in April, HUD indicated it had 736 projects totaling more than \$12 billion in its firm commitment pipeline. Its multifamily insurance commitments are averaging nearly \$900 million a month and volume is up between 250 and 400 percent in the last year, depending on the index used. The key factor in this rising activity, of course, is the availability of HUD credit for health care and multifamily projects at a time when most other capital providers have limited their activity. With this increased demand and associated pressure on the FHA system, HUD reasonably wants to assure that production goals and needs are met responsibly. In that vein, HUD has announced in several forums plans to tighten its underwriting standards, to increase required lender experience and capitalization, and lender and project monitoring.

With respect to supporting production, HUD recently instituted an important change in project financing limits, now permitting deletion of land value from the maximum mortgage calculation. This modification can make FHA programs available in higher-cost areas, where they have otherwise realized minimal activity.

At a different level, HUD has strong concerns that FHA programs may not be doing as much as they might be in support of affordable multifamily development and preservation. In one example, in fiscal year 2009, out of 661 initial endorsements, only 22 project loans closed with housing tax credits. To improve

this record, HUD is defining “affordable housing” which, going forward, would qualify for somewhat more generous underwriting standards than market-rate properties. HUD also understands that it is currently an available and advantageous credit enhancer and can use this time and circumstance to strengthen its programs with respect to market-rate properties.

While always subject to change, under currently foreseen plans not yet finally resolved, but soon to be addressed in a Mortgagee Letter, projects meeting the affordability criteria would be processed at 1.15 debt service coverage, and 87.5 percent loan ratios. Additionally, if a project receives Section 8 for at least 90 percent of its units or if all the units are rented to tenants at LIHTC income levels with rents at least 20 percent below market, the project could be underwritten using 95 percent occupancy. For Section 221(d)(4) affordable properties, lenders would be able to underwrite projects with 90 percent project-based Section 8 at a debt service coverage of 1.11 percent and a maximum loan ratio of 90 percent. Without project-based Section 8, debt service coverage for affordable 221(d)(4) properties would be 1.15 and loan ratios maximized at 87.5 percent. 223(f) affordable properties with 90 percent project-based assistance would be at the 1.15/87.5 percent standard and without Section 8 they would appear to be at a slightly higher standard, even if affordable, of 1.176/85 percent. Market-rate refinancings would require debt service coverage of 1.20 and loan ratios of approximately 83.3 percent. Also included in prospective changes will be modestly higher escrow requirements for operating deficits, working capital, and substantial rehab construction contingencies.

HUD is also planning to distinguish between market-rate and “affordable” project underwriting by instituting a change in application processing. Market-rate construction and sub-rehab projects will undergo a two-stage process that will eliminate direct-to-firm applications. Sponsors/lenders would also be required to attend a concept or predevelopment meeting with appropriate field-office staff to better develop estimates of the probability of success for the given application. Affordable projects would also require a “concept meeting,” but would retain direct-to-firm options. The pre-application meeting for market-rate projects will require a 15-basis-point non-refundable fee that will be credited against a 30-basis-point firm commitment fee. Affordable projects skipping the pre-application would not have to pay this fee.

While there are many more multifamily lenders, the MAP program is limited to about 90 lenders with demonstrated

experience underwriting multifamily and healthcare loans. In the long run, HUD expects to further segment multifamily lenders so that not all would be able to process all types of multifamily loans. Greater experience and depth will enable lenders to process more complicated transactions and provide the basis for which each might be qualified under specific programs. New and existing lenders will generally be required to demonstrate a level of competence based on experience in four types of projects: market-rate refinances, affordable housing refinances, new construction/substantial rehabilitation market-rate, and new construction/substantial rehabilitation affordable. Lenders might also be restricted geographically, with mortgagees qualifying for various types of lending in specific regions, rather than under the current system, under which an approved lender is free to operate nationwide.

Much of the above is general, and has yet to be set in stone. We will keep you informed of further progress as plans solidify and are implemented.

#### PARTIAL PAYMENT OF CLAIMS

HUD’s use of partial payment claims (PPCs) for multifamily properties continues to be refined. As discussed above, HUD-FHA’s insured multifamily and health care loan programs are experiencing an extraordinary increase in demand as other sources of finance have slowed, and in some cases, dried up – with some exception for those sold to Fannie Mae and Freddie Mac. The quality of HUD-FHA borrowers has improved, particularly with maturing loans, as strong entrepreneurs have sought alternatives to conduits and banks. While HUD’s programmatic changes discussed elsewhere in this Alert are intended to assure higher-quality loans, we believe that the quality of both new and refinanced HUD loans is already improving, together with that of their sponsors. At the same time, we are involved with more partial payments of claim (PPCs) involving troubled multifamily and health care projects, almost exclusively involving market conditions rather than owner or manager failings.

Over the past 18 months we have worked through a good number of HUD PPCs in multiple contexts and project financing configurations. During that time, the PPC program has undergone a good bit of tweaking in response to new scenarios and novel circumstances. We have seen it mature rapidly into a much more effective tool for preservation and providing significant savings to FHA insurance funds. Many of these tweaks have occurred as we and others have worked with HUD to improve

the screening of projects. Today, while HUD's rules remain stringent, we believe them to be fair and to represent a good balance between holding owners responsible for misdeeds and missteps, while recognizing that market conditions have caused great difficulty that can be responsibly relieved at lower cost than would be incurred by simply awaiting project failure. PPC restructurings can be and are being completed with benefit to all stakeholders.

An abridged explanation: PPCs have been used for more than 15 years to avoid HUD payment of full mortgage insurance claims for financially troubled projects. Rather than full claim payment, (i) an insured loan is re-sized to a sustainable level, (ii) the insured mortgagee receives payment on a partial claim and retains the balance as an insured loan, and (iii) HUD, in recognition of its partial insurance payment, receives a second mortgage in the amount of the claim payment. HUD second loans are due and payable upon the earlier of a stated maturity, or the sale or refinancing of the property. Given the interplay of resulting extended use restrictions, housing tax credit LURAs, and concern over out-year viability, we have recently seen the maturity date of the resulting HUD-held second mortgage extended from the once-common ten years, to as long as 20 years, providing some predictable and viable outlook for recapitalization and full repayment.

In seeking a PPC, HUD will require owners and lenders to coordinate their efforts and application for review by both field office and HUD headquarters. The process and variables are complex, but HUD headquarters staff charged with administration of this program can now be counted on to perform a justifiably thorough but thoughtful review, without overly strict and rote application of outdated rules. In the past, we have seen review of the same material by headquarters and field offices result in opposite conclusions, i.e., the field offices more often in support with headquarters in denial, with concern over proposal viability and long-term outlook for the project. With headquarters continuing to upgrade functional and comprehensive evaluation tools, projects are, in our experience, now presented with an underwriting conclusion that reduces FHA claim amounts while supporting new Ginnie Mae issues for resulting restructured first liens.

We, HUD, and some lenders, have now worked through multiple PPCs, under varied complexities in ownership and financing. While early issues arising from existing tax-exempt and taxable bonds, multiple layers of soft financing and interplay of state

agency and tax credit equity requirements did cause delay and even halts to PPC processing, they are not now first-impression matters. HUD headquarters and some HUD field offices have even coordinated their efforts and administration well, to accomplish TPAs with change of general partners, simultaneously with PPC processing.

New issues do continue to arise, as projects move forward with differing variables. HUD can now be expected to undertake a closer review of a project's long-term physical viability. In addition, mechanisms to set interest rates for resulting first lien and HUD-held second lien debt have been recently modified to more accurately take into account market conditions. Nevertheless, with each change to the PPC process we have seen "lessons learned" applied by HUD well. With thoughtful and appropriate PPC application and, of course, actual project need, HUD can be expected to exhibit knowledgeable understanding and appropriate flexibility – rather than presenting a "guess what color I am thinking when your square peg does not fit into this circle" machination.

We will keep you abreast as further refinements are made in this important tool.

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