

**CITIZENS HOUSING & PLANNING ASSOCIATION (CHAPA)
COMMUNITY ECONOMIC DEVELOPMENT ASSISTANCE CORPORATION
(CEDAC)
LOCAL INITIATIVES SUPPORT CORPORATION (LISC)**

May 1, 2001 REV 1

RETAINING IRP SUBSIDY THROUGH DECOUPLING AND NOTE PURCHASE
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INTRODUCTION

For projects assisted under Section 236 of the National Housing Act, HUD provides a monthly Interest Reduction Payment (IRP) subsidy to reduce the effective mortgage interest rate paid by the project to 1%. HUD has promulgated guidance¹ to permit the continuation of IRP subsidy when the project secures new financing under two separate options:

- **Section 236(b): Note Purchase** - when the Section 236 mortgage is *purchased* by a state or local agency which is an approved 236 lender, and the HUD mortgage insurance is terminated. Any additional debt issued by the new lender must be evidenced by a separate note which is secured under the original Section 236 mortgage (as modified or restated).
- **Section 236(e)(2): Decoupling** - when the Section 236 mortgage is *prepaid and refinanced*. The IRP assistance is severed from the original Section 236 mortgage and applied to the new financing.

The ability to retain the IRP subsidy in conjunction with new financing is an important preservation tool for Section 236 projects. While several Section 236(b) transactions have been completed in Massachusetts and elsewhere pursuant to existing statutory authority,² no formal program guidance has previously existed. The HUD Notice helps to codify this recent transactional experience while simultaneously implementing the new Section 236(e) program³ which attempts to address the limitations of 236(b) and to provide greater flexibility for lenders, owners, and purchasers.⁴

¹Notice H 00-8 (HUD), "Guidelines for Continuation of Interest Reduction Payments After Refinancing," May 16, 2000. Available on the web at <http://www.hudclips.org>.

²Section 236(b) of the National Housing Act generally authorizes state and local public agencies who are approved by HUD to issue Section 236-assisted mortgages. Examples of 236(b) transactions in Massachusetts include Pondview Apartments and Mass Pike Towers (Boston), Pine Estates II (Brockton), Mohawk Forest (North Adams), and Leisure Towers (Lynn).

³Section 532 of the Department of VA and HUD/IA Appropriations Act, 2000 (Public Law 106-74, October 20, 1999, establishing Section 236(e)(2) of the National Housing Act.

⁴For example, Section 236(b) transactions have been burdened by the process and cost of securing the existing lender's consent (usually FNMA) to the 236 note sale. Where the notes are held by participating investors, multiple consents may be required. In some cases, the lender has refused to sell the note or has demanded a high premium. Section 236(e) avoids these problems because prepayment of the note (unlike purchase) does not require noteholder consent.

While HUD has recently provided additional guidance on some matters,⁵ the Notice raises many issues that require further clarification. Importantly, the guidelines are designed to provide a "safe harbor" for transactions that may be approved at the HUD field office level. Transactions that depart from this framework but do not conflict with applicable statutes may still be approved with a Headquarters waiver. HUD intends to use the case-by-case experience gained from transactions approved under this Notice as guidance for future regulations.

The Notice does not address the use of "pooled" IRP funds for rehabilitation grants, which may be provided to eligible properties when IRP funds are recaptured from other projects due to mortgage prepayment or foreclosure (Section 236(s)). It is anticipated that this program will be addressed in a forthcoming Notice.

GENERAL ISSUES

- 1. Eligible Projects.** Eligible projects must be currently receiving Section 236 IRP assistance, with insured, HUD-held, or non-insured public agency mortgages.
- 2. Eligible Mortgagors.** In general, the owner or purchaser must be a non-profit or limited dividend mortgagor, or a cooperative or public entity. Builder-seller and investor-sponsor mortgagors may also be eligible for 236(e) transactions.
- 3. Eligible Lenders.** For 236(b), the mortgagee must be a state or local public agency that is approved by HUD as a Section 236 lender. Under 236(e), the transaction may be financed by any type of lender. However, a state or local public agency must perform the regulatory oversight functions required by the IRP contract (including administration of IRP subsidy payments, rent increase processing, physical inspections, and monitoring to ensure owner compliance). Alternatively, the lender must be an FHA-approved mortgagee, the mortgage must be HUD-insured, and HUD will perform the oversight functions.
- 4. IRP Assistance.** IRP assistance will be provided to the new mortgagee on a monthly basis, in accordance with terms of the IRP contract. The IRP contract is executed by the owner, the lender, HUD, and in the case of certain 236(e) transactions, by the state or local regulatory agency.

In most cases, the existing IRP payment schedule will be retained for the remaining term of the Section 236 mortgage. Subject to mortgagee and HUD approval, the owner may elect to *reduce* the monthly and annual payment and extend the IRP contract term in order to fully utilize the original funding commitment. However, the new payments may not *exceed* the monthly, annual, or total amounts provided under the existing contract. In no event will the remaining IRP subsidy be paid out as a lump-sum.

⁵See Memoranda from Shaun Donovan, "Revisions, Questions, and Answers Regarding HUD Notice H 00-8" (November 6, 2000); and "Additional Revisions and Information Regarding HUD Notice H 00-8" (February 21, 2001).

HUD may suspend IRP assistance if the owner fails to comply with the terms of the IRP contract or Use Agreement (see below).

- 5. Basic Structure.** The project must continue to comply with the essential requirements of the Section 236 program after the transaction is completed. This includes: maintenance of budget-based rents (Basic Rent and Market Rent)⁶; compliance with HUD occupancy and habitability standards; retention of income eligibility limits for initial occupancy (80% of area median); and compliance with HUD financial reporting requirements.

The owner may charge tenants less than the Basic Rent only if there is an identifiable subsidy to make up the difference (e.g. Section 8 rental assistance, owner contribution). Skewing of costs from one unit to another is not permitted (outside of Mark-Up to Market; see below).

In a Section 236(b) transaction, the original mortgage note (as modified or restated) must remain identifiable as the basis for continuing IRP assistance. The owner must demonstrate how the project will remain financially feasible under the continued Section 236 regime.

- 6. Use Agreement.** The owner must enter into a Use Agreement extending the applicable Section 236 requirements (see above) for at least five years beyond the term of IRP assistance.⁷ This includes maintenance of the Basic and Market rent structure. If IRP assistance is extended beyond the existing mortgage term (due to a reduction in the monthly payment amount), the five-year mandatory extended use period commences at the expiration of the new IRP contract term.

Any use restrictions associated with other federal assistance (e.g. CDBG, HOME, LIHPRHA/ELIHPA, or Low Income Housing Tax Credits) must continue at least through the Section 236 extended affordability term. The owner must also agree to renew any existing project-based Section 8 contracts, if offered by HUD, during the extended use period. If the Section 8 contract is not renewed, the project must continue to operate as a Section 236 project.

- 7. Rent Increases.** The owner may request a budget-based rent increase in conjunction with the Section 236(b) or (e) transaction to cover debt service on any new financing (for acquisition, rehab, or equity takeout). The potential for operating cost savings due to proposed rehabilitation

⁶Section 236 now provides two options for determining Basic Rent and Market Rent. Under the traditional approach, Basic Rent is the rent required to operate the project with a mortgage bearing interest at 1%, and Market Rent is the rent required to operate the project at the actual mortgage interest rate (236(f)(1)(A)(ii)(I) and (iii)(I)). The difference is the IRP subsidy.

Under the alternative method, HUD may establish a higher Basic Rent at an amount not to exceed the comparable market rent less IRP subsidy, and a Market Rent capped at the comparable market rent, if the owner agrees to additional use or prepayment restrictions (236(f)(1)(A)(ii)(II), (iii)(II), and (iv)). This option was designed, in particular, for Section 8 units in a Section 236 property that are being marked-up to market. HUD has explicit authority to establish Basic and Market rents for Section 8-assisted units that are higher than the Basic and Market rents for non-Section 8 units in the same project (236(f)(1)(A)(v)).

⁷The five-year extension of existing affordability restrictions is mandated by statute only for Section 236(e) transactions. HUD has chosen to apply the same standard to projects financed under Section 236(b).

and other factors will be considered.

In general, the new Basic Rent cannot exceed the market comparable rent decreased by the value of the IRP subsidy.⁸ Importantly, HUD will consider omitting the IRP deduction for projects needing significant repairs or located in areas with lower market rents, as long as the rents are computed on a budget basis. This alternative approach is not available for transactions involving equity takeout by an existing owner, or for ownership transfers at an above-market price.⁹

Additionally, Basic Rents for non-Section 8 units cannot be increased by more than 10%. This limitation does not apply to the Basic Rents for any Section 8 units, if the project is eligible for Mark Up to Market (see below).

For preservation projects (financed under LIHPRHA or ELIHPA), no rent increase is permissible as a result of the 236(b) or (e) transaction. It is unclear whether this limitation also applies to operating cost increases that may be needed, e.g. when an undermaintained property is transferred to new ownership.

The local public agency (lender or regulatory agent) will process Section 236 rent increases pursuant to existing rules and regulations, with HUD retaining final approval authority.

8. **Section 8 Units.** Rent increases for units receiving Section 8 assistance will be governed by applicable rules and procedures for Section 8 contract renewal, including Mark Up to Market if applicable (see "Section 8 Renewal Policy: Guidance for the Renewal of Project-Based Section 8 Contracts," Chapter 3 (January 19, 2001)). In general, the maximum rent for such units (Basic Rent) is the market comparable rent adjusted for the value of the IRP subsidy. However, it appears likely that HUD's new policy allowing the disregard of IRP deduct under certain circumstances (see above) would apply to any Section 8 units as well as non-Section 8 units in an eligible project.¹⁰
9. **Return on Equity Component/ Allowable Distribution.** The budget-based rent computation must include an allowance for the owner's return on equity. If the lender is a public agency, HUD may accept the agency's formula for this budget component. Alternatively, HUD may establish the allowance at: (1) 10% on 10% of the amount of new mortgage debt (for transactions with new FHA insurance or risk-shared financing combined with Tax Credits); or (2) 6% of original equity (for 236(b) transactions and potentially others). Reasonable debt coverage may be included in the

⁸However, the applicable statute mandates a market cap only when the alternative definition of Basic and Market rent is used, as described above. The traditional Section 236 rent computation can result in a Basic Rent which is equal to (or greater than) the market comparable rent if supported on a budget basis.

⁹See Memorandum from Shaun Donovan, "Additional Revisions and Information Regarding HUD Notice H 00-8," February 21, 2001.

¹⁰Under the statute, the IRP adjustment for Section 8-assisted 236 units is permissive, not mandatory (Section 524(a)(5), Public Law 106-74).

budget-based rent.¹¹

Additionally, the Notice appears to state that amount of surplus cash that can actually be *distributed* to owners is limited to 6% on original equity. However, the HUD IRP Agreements require this limitation only for previously insured 236(e) transactions, and not for previously uninsured or 236(b) projects where distributions are governed by state or local law. These instructions are internally contradictory as well as contrary to recent transaction experience, and require further clarification.

10. **Fees.** The lender or oversight agency may propose to become the Section 8 contract administrator for the property only if it has been approved as a Section 8 Contract Administrator. The agency may receive a fee for Section 8 contract administration or for Section 236 oversight, but not both. If the agency is not the Section 8 contract administrator, a reasonable oversight fee may be built into the Basic Rents.
11. **Tenant Protections.** No tenant may be involuntarily displaced as a result of the 236(b) or (e) transaction. If Tax Credits will be utilized, units occupied by ineligible tenants should not be included as tax credit units in order to avoid tenant displacement. Enhanced Vouchers will be provided to eligible tenants in prepayment-eligible projects that prepay or terminate mortgage insurance (except for households assisted under project-based Section 8 contracts, which must be renewed). This includes projects which have received Flexible Subsidy assistance.
12. **Repayment of HUD Debt.** Any outstanding HUD debt (other than the Section 236 mortgage) must be repaid in conjunction with the transaction, to the extent that such repayment is financially feasible and consistent with the long-term preservation of the housing. Field offices are authorized to approve deferred payment of Flexible Subsidy rehab loans, Section 241 rehab or equity loans, and Section 106(b) loans on a case-by-case basis.¹²
13. **Tenant Participation.** All transactions are subject to HUD tenant participation requirements (24 CFR 245). This includes posting of rent increase notices and opportunity for tenant review and comment, and non-interference by the owner with reasonable efforts of tenants to organize and to obtain rental assistance.
14. **Subsidy Layering.** All transactions are subject to HUD Subsidy Layering approval (see HUD Notice H95-4).

APPLICATION PROCEDURES

1. **Applicant.** For a Section 236(b) transaction, the proposal must be submitted by the public

¹¹See Memorandum from Shaun Donovan, "Revisions, Questions, and Answers Regarding HUD Notice H 00-8," November 6, 2000.

¹²See Memorandum from Shaun Donovan, "Revisions, Questions, and Answers Regarding HUD Notice N 00-8," November 6, 2000.

agency that will acquire the Section 236 mortgage. For a Section 236(e) transaction, the proposal must be submitted by the owner or purchaser with a letter of support from the proposed mortgagee.

2. General Requirements. In general, the proposal should describe:

- how the remaining IRP assistance will be utilized;
- the effect of the transaction on existing tenants; and
- how the project will be maintained (financially and legally) as a low income housing resource for at least the remaining term of the existing or new IRP contract, plus five years.

3. Proposal Contents. The proposal submission should also address the following:

- **Sponsor:** describe the sponsor's experience and qualifications in multifamily housing development and management.
- **Project:** identify the project location, size, and age; the mortgage history and current status; the current owner and proposed purchaser entity; and the contract status of units receiving project-based or tenant-based rental assistance.
- **Mortgagee or Public Agency Capacity/Authority:** for 236(b), the public agency must provide a legal opinion that it has the authority and capacity to act as a 236(b) lender (if it is not already approved). If the public agency will provide regulatory oversight, it must also provide evidence of its experience and capability to perform the functions required by the IRP contract.
- **FHA Insurance Termination:** for 236(b), provide evidence of the current mortgagee's willingness and ability to sell the Section 236 note to a public agency.
- **Physical Improvements:** describe the property's existing physical conditions and the proposed scope and cost of rehabilitation (including a detailed rehab cost breakdown, if applicable).
- **Affordability:** describe how the project will be maintained as a long-term, low income housing resource for the term of the IRP assistance plus five years.
- **Tenant Protections:** describe how tenants will be protected from rent increases due to the proposed transaction and the nature of subsidies to be provided.
- **Sources and Uses:** provide a complete sources and uses statement for the transaction.
- **Other Assistance:** identify all other proposed federal, state, or local assistance to the project and the nature of any associated use restrictions.

4. HUD Approvals. The proposal should identify any HUD approvals required to complete the transaction, e.g for:

- mortgagee or public agency approval;
- transfer of IRP assistance to the new lender;
- Previous Participation Clearance (2530) for the owner or purchaser;
- transfer of the Section 8 HAP contract (and of Section 8 contract administration, if applicable);
- an increase in the Basic and Market rents, if applicable;
- issuance of Enhanced Vouchers to eligible tenants;
- Subsidy Layering;
- Risk-Shared financing, if applicable; and
- any waivers requested.