

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR-4162-N-03]

Portfolio Reengineering—Fiscal Year 1998 Transition Program Guidelines

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

ACTION: Notice of guidelines.

SUMMARY: HUD is currently implementing a statutory demonstration program authorized for fiscal year (FY) 1997. The Demonstration Program is directed at FHA-insured multifamily projects that have project-based Section 8 contracts with rents in excess of 120 percent of fair market rents. That program has been extended by Congress through FY 1998 with certain modifications as a transitional program while HUD develops regulations to implement the new authority for a non-demonstration FHA-insured mortgage and rental assistance restructuring program.

This notice provides guidelines for the FY 1998 Transition Program. It also identifies projects that will continue to proceed under the FY 1997 Demonstration Program unmodified by these transitional provisions. Finally, it clarifies HUD policy concerning delegation of responsibilities to joint venture designees. This clarification applies to both the FY 1998 Transition Program and the FY 1997 Demonstration Program.

FOR FURTHER INFORMATION CONTACT: Dan Sullivan, Housing Project Manager, Office of Multifamily Housing, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410-4000; Room 6106; Telephone (202) 708-2300, ext. 2062. (This is not a toll-free number.) Hearing or speech-impaired individuals may call 1-800-877-8399 (Federal Information Relay Service TTY). Internet address: Dan_Sullivan@hud.gov.

SUPPLEMENTARY INFORMATION:

I. Paperwork Reduction Act Statement

Paperwork Reduction Act Statement

The information collection requirements contained in this notice and in the notice published on January 23, 1997, at 62 FR 3566 have been approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520), and assigned OMB control number 2502-0519. An agency may not conduct or sponsor, and a person is not required to respond to,

a collection of information unless the collection displays a valid control number.

II. Background

The FY 1997 Demonstration Program was authorized by sections 211 and 212 of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 1997 (FY 1997 Appropriations Act) (Pub. L. 104-204; 110 Stat. 2874, 2895-2904; approved September 26, 1996). HUD is currently implementing the FY 1997 program under Guidelines published on January 23, 1997, at 62 FR 3566. (See also FY 1997 Portfolio Reengineering Request for Qualifications published on July 16, 1997, at 62 FR 38109.)

The Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRA) was enacted in title V of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 1998 (FY 1998 Appropriations Act) (Pub. L. 105-65; 111 Stat. 1344, 1384; approved October 27, 1997). Subtitle A of MAHRA contains the FHA-Insured Multifamily Housing Mortgage and Housing Assistance Restructuring Program. That program provides authority to deal with Section 8 contract expirations occurring in FY 1999 and later. In accordance with section 522(a) of MAHRA, the new non-demonstration program will be initially implemented by an interim rule to be followed by a final rule.

Section 522(b) of MAHRA contains transition provisions for projects with Section 8 contracts expiring in FY 1998. For these projects, the transition provisions direct HUD to apply all the terms of sections 211 and 212 of the HUD FY 1997 Appropriations Act except for two provisions in section 212. First, the 50,000 unit limitation in section 212(k) does not apply. Second, the mortgage restructuring provisions in section 212(h)(1)(G) do not apply. In addition, HUD is directed to apply section 517(a), Mortgage Restructuring, of MAHRA.

Section 517(a) provides for a new second mortgage loan program from HUD that is available to eligible project owners as part of a prepayment on the existing unpaid principal balance on the first mortgage so that the restructured or new first mortgage is sustainable at rents determined under section 514(g) of MAHRA. The amount of the second mortgage cannot be more than the difference between the restructured or new first mortgage and the indebtedness under the existing insured mortgage. The second mortgage is further limited

to an amount that can reasonably be expected to be repaid.

Section 517(a) contains other requirements for the second mortgage, including a requirement that at least 75 percent of excess project income be applied to the second mortgage note.

Section 514(g), which, as noted above, is used in determining the amount of the restructured or new first mortgage, in general, requires the use of market rents based on at least two comparable properties, or, if those rents cannot be determined, on 90 percent of the applicable fair market rents. Section 514(g) also authorizes budget-based exception rents. In general, such rents cannot exceed 120 percent of fair market rent (FMR). Up to 5 percent of the units subject to mortgages restructured in a fiscal year may have rents that exceed this limit based on a finding of special need.

Under the transition program there are two statutory bases for debt forgiveness and two statutory bases for providing budget-based rents. Debt forgiveness can be authorized under section 212(h)(1)(H) and also under section 517(a) but only when application of the "reasonably be expected to be repaid" limitation results in a second mortgage that is less than the amount required to pay down the first mortgage to a sustainable level. Budget-based rents are authorized under section 212(h)(1)(I) and, as discussed above, under the exception rent provisions in section 514(g)(2) and (3).

These Guidelines implement all of these authorities in a manner that is consistent with overall statutory requirements, and in particular, with the requirement in section 522(b) to apply section 517(a).

III. Projects Continuing Under the FY 1997 Demonstration Program

Any project covered by a Demonstration HAP Contract that was executed on or before September 30, 1997 shall continue to be processed under the provisions of the January 23, 1997 Guidelines unmodified by section IV. of today's **Federal Register** notice. Certain of these Demonstration HAP Contracts may be extended for a period not to exceed 120 days in accordance with section 212(g)(2) of the FY 1997 Appropriations Act, as added by section 523(f) of MAHRA. Section 212(g)(2) authorizes these extensions for contracts originally executed before February 1, 1997 and for contracts originally executed before October 1, 1997 in connection with a restructuring under the joint venture approach, if HUD, in its sole discretion, determines that the renewal period needs to exceed one year

(i) for the pre-February 1, 1997 contracts, due to the delay in publishing the January 23, 1997 Guidelines and (ii) for the pre-October 1, 1997 contracts, due to a delay in implementation of the joint venture agreement. The two categories described involve not more than 21 and 25 projects, respectively. A project continuing under the FY 1997 Demonstration Program is not subject to the FY 1998 Transition Program Guidelines (see section IV. of this notice), but is subject to the revision to joint venture designee policy in section V. of this notice.

IV. FY 1998 Transition Program Guidelines

A. Applicability of the January 23, 1997 Guidelines

Because MAHRA applies almost all of the statutory provisions for the FY 1997 Demonstration Program to the FY 1998 Transition Program, sections IV. through IX. of the January 23, 1997 Guidelines (62 FR 3569–3581), as augmented by this notice, constitute the FY 1998 Transition Program Guidelines. Except for statutory references, all references in sections IV. through IX. of the January 23, 1997 Guidelines to “FY 1997” mean “FY 1998.”

In section III.B. of the January 23, 1997 Guidelines (62 FR 3568), the definitions of “FMR” and “in the aggregate” apply to the FY 1998 Transition Program.

B. General Eligibility

This section IV.B. applies instead of section IV.B.1., General Eligibility, of the January 23, 1997 Guidelines (62 FR 3569). For a project to be eligible for the FY 1998 Demonstration Program, the owner must agree to participate. The project must be subject to an FHA-insured mortgage and supported by project-based Section 8 Housing Assistance Payments (HAP) contracts with rent levels which, in the aggregate, exceed 120 percent of FMR. In managing its workload, HUD will give preference to projects with contracts expiring in FY 1998.

C. Disqualified Owner

The following conforms the Guidelines to the amendment to section 211(b)(4)(B) of the HUD FY 1997 Appropriations Act made by section 10006 of the 1997 Emergency Supplemental Appropriations Act, Pub. L. 105–18; 111 Stat. 158; approved June 12, 1997 which added “affiliate of the owner” to the definition of “owner.” In section IV.C.3. of the January 23, 1997 Guidelines (62 FR 3569), Disqualified Owners, the term *owner* also means an

affiliate of the owner and the term *purchaser* also means an affiliate of the purchaser. The terms *affiliate of the owner* and *affiliate of the purchaser* mean any person or entity (including but not limited to, a general partner or managing member, or an officer of either) that controls an owner or purchaser, is controlled by an owner or purchaser, or is under common control with the owner or purchaser. The term *control* means the direct or indirect power (under contract, equity ownership, the right to vote or determine a vote, or otherwise) to direct the financial, legal, beneficial or other interests of the owner or purchaser.

D. Demonstration Approaches/Underwriting

1. Mandatory FY 1998 Transition Program Approaches

This section applies in place of the guidance in sections IV.E.1., Mandatory Demonstration Approaches, through and including section IV.E.1.b., Debt Forgiveness, of the January 23, 1997 Guidelines (62 FR 3569–3571).

With respect to any eligible project, HUD must perform an analysis under section 517(a)(1)(B) of MAHRA. HUD is obligated to require a new second mortgage to the extent that it makes a determination that a new second mortgage can reasonably be expected to be repaid.

To the extent that the combination of the new first mortgage and the new second mortgage is less than the outstanding principal balance of the existing insured mortgage, immediately before it is restructured or refinanced, HUD will consider debt forgiveness or budget basing, or a combination of these, pursuant to sections 212(h)(1)(H) and 212(h)(1)(I) and sections 514(g)(2) and (3) and 517(a).

a. Mortgage Restructuring.

Under the Mortgage Restructuring approach, the unpaid principal balance (UPB) on the existing FHA-insured mortgage loan is paid down to, or refinanced by a new first mortgage at, an amount equal to the Supportable Debt. The reduction in the first mortgage UPB is effected by an advance of funds from HUD. This advance is secured, in whole or in part, by a second mortgage note. The portion of the advance that is secured by the second mortgage cannot exceed the amount that HUD determines can reasonably be expected to be repaid.

(1) Supportable First Mortgage Loan

The amount of the UPB of the supportable first mortgage loan after restructuring is determined by applying a 1.10 or greater debt service coverage ratio, at the interest rate and term

approved by HUD, to the adjusted NOI. The amount may, at HUD's option, be adjusted if the security for the existing FHA-insured loan includes vacant land or other non-income producing assets with additional market value. HUD will require that the restructured or new first mortgage carry an interest rate and term that is competitive in the market.

(2) Second Mortgage Loan.

The initial unpaid principal balance of the second mortgage loan will equal the lesser of:

(a) The amount required to pay down the existing FHA-insured mortgage loans(s) to a sustainable level; or

(b) An amount HUD determines can reasonably be expected to be repaid.

The second mortgage loan shall bear interest at a rate less than or equal to the long term applicable Federal rate, as set forth pursuant to section 1274(d) of the Internal Revenue Code of 1986 (26 U.S.C. 1274(d)). The term of the second mortgage shall be equal to the term of the restructured or new first mortgage.

The interest rate and payment and other terms of the loan will be established by HUD, consistent with section 517(a) of MAHRA. Principal and interest on the second mortgage loan will be payable out of Net Cash Flow (discussed below), and unpaid interest will accrue.

(3) Debt Forgiveness.

HUD may forgive a certain portion of the outstanding balance of an existing FHA-insured loan to the extent HUD determines that a second mortgage cannot reasonably be expected to be repaid.

(i) Amount of Debt Forgiveness.

The amount of the debt that may be forgiven is equal to—

(a) If HUD will make a second mortgage loan, the outstanding UPB of the existing FHA-insured mortgage loan(s) at the time of restructuring minus the sum of UPB of the restructured or new first mortgage and the UPB of the second mortgage loan determined under section IV.D.1.a.(2) of this notice; or

(b) If there will be no second mortgage loan from HUD, the outstanding UPB of the existing FHA-insured mortgage loan(s) at the time of restructuring minus the market value. The project's “market value” will be determined based upon an appraisal of the project's as-is value prepared in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP). The appraisal will take into consideration, among other factors, the current market rents for unsubsidized units in the local market area, the project's current operating expenses, any necessary reserves for long term capital

replacements, any necessary rehabilitation costs (see section IV.E.2.b.(1)(c), Determining the Level of Required Physical Improvements, of the January 23, 1997 Guidelines (62 FR 3572)), and any anticipated costs relating to the transition of the project to market rents.

(4) Restructuring Payment.

The amount of the restructuring payment made by HUD shall equal the UPB of the existing FHA-insured mortgage loan(s) minus (i) the supportable debt, (ii) all contributions made by the owner (and the owner's partners/investors) in connection with the restructuring, as determined by HUD, and (iii) all excess funds in the project's reserve for replacement account, and (iv) all funds in the project's residual receipts account and any other escrows and reserves, as determined by HUD, plus (v) reasonable, cost effective rehabilitation costs approved by HUD, and (vi) reasonable transaction costs approved by HUD.

(5) Use of Net Cash Flow.

For purposes of the Mortgage Restructuring approach, "Net Cash Flow" means that portion of the NOI that remains after the payment of all required debt service payments on the first mortgage loan. Net Cash Flow shall be applied as follows: *first*, to payment to the holder of the first mortgage loan of any past due principal or interest, and required escrows and reserves, on such mortgage loan; *second*, to the extent of the remaining Net Cash Flow to any other expenditures approved by HUD; and *third*, to the extent of the remaining Net Cash Flow, to be distributed with at least 75 percent to payment of principal and interest due on the second mortgage and up to 25 percent to an escrow account for payment to the owner after the requirements of section IV.D.2. of this notice have been met.

(6) Funding of Rehabilitation Costs.

If the FHA-insured mortgage loan will be refinanced with non-FHA-insured financing, the HUD-approved rehabilitation costs will be financed with funds available in the project's residual receipts account and excess funds in the project's reserve for replacements account, as of the date of the mortgage restructuring. If the rehabilitation costs exceed the amount of such funds, the rehabilitation costs may be funded by (a) a contribution of cash equity from the owner's partners/investors, and/or (b) the proceeds of the non-FHA-insured refinancing loan, and (c) to the extent that other sources of funds are unavailable, and at HUD's sole

discretion, through a loan or grant from HUD.

If the FHA-insured mortgage loan is retained or refinanced with another FHA-insured loan, the HUD approved rehabilitation costs will be financed with funds available in the project's residual receipts account and excess funds in the project's reserve for replacements account, as of the date of the mortgage restructuring. If the rehabilitation costs exceed the amount of such funds, the rehabilitation costs may be funded by (1) a contribution of cash equity from the owner's partners/investors, (2) the proceeds of a non-FHA-insured rehabilitation loan, (3) the proceeds of an FHA-insured rehabilitation loan, and/or (4) to the extent that other sources of funds are unavailable, through a loan or grant from HUD.

For owners who want to refinance the original FHA-insured loan, mortgage insurance from the following FHA programs may be provided:

- (a) Section 223(f), acquisition and refinance with limited renovations—loan to value limit of 85 percent; or
- (b) Section 223(a)(7), refinance of an insured loan to lower the interest rate and to fund rehabilitation costs—loan limit is up to the original insured principal amount.

b. Budget-Based Rents.

The provisions of section IV.E.1.c., Budget-Based Rents, of the January 23, 1997 Guidelines (62 FR 3571) apply, subject to the following. The above referenced Budget-Based Rents provisions implement the authority under section 212(h)(1)(I) of the 1997 Appropriations Acts. Budget-based rents under that authority may not exceed the expiring contract rents, and there is no percentage limitation on the number of units that may receive budget-based rents. Sections 514(g) (2) and (3) of MAHRA also authorize the use of budget-based rents. Those sections have a general limit of 120 percent of FMR but allow up to 5 percent of all units subject to mortgages restructured within the fiscal year to exceed that limit. While there is no express statutory requirement in section 514(g)(2) or (3) limiting budget-based rents to no more than the expiring contracts rents, it is HUD policy to approve budget-based rents only at or below expiring contract rents.

32. Owner's Distribution From Net Cash Flow

This section IV.D.2. applies instead of section IV.E.2.b.(2), Owner's Distribution from Net Cash Flow, of the January 23, 1997 Guidelines (62 FR 3569).

As an incentive to maintain the property the owner may receive an annual distribution of up to 25 percent of Net Cash Flow ("Owner's Distribution").

The Owner's Distribution will be held in an escrow account and paid to the owner only after HUD or its representative inspects the project and finds that all units are in substantial compliance with maintenance standards set forth by HUD as part of the restructuring agreement. Any owner who fails to deposit all Net Cash Flow to the escrow account will waive its rights to future distributions.

E. Project Underwriting—Market Rents

In estimating a project's net operating income under section IV.E.2.b. of the January 23, 1997 Guidelines (62 FR 3572), market rents will be established through an appraisal of the property that utilizes at least two comparables. If two comparables cannot be found, HUD may authorize the appraiser to use 90 percent of the applicable fair market rents.

F. HUD Housing Notices

The following sections of the January 23, 1997 Guidelines referred to Housing Notice H 96-89, issued October 15, 1996: Sections V.F. (62 FR 3574); V.B.2. (62 FR 3575); VI.D. (62 FR 3576); and VI.L. (62 FR 3577). Housing Notice H 97-66, issued November 12, 1997, reinstates H 96-89 with certain exceptions. The reader should refer to both Housing Notices. They are available through HUDCLIPS, which is on HUD's web site. The location (URL) for the HUDCLIPS Database Selection Screen is <http://www.hudclips.org/subscriber/cgi/legis.cgi?legis>. These notices are in the Handbooks and Notices—Housing Notices database. Enter only the number without the letter prefix (e.g., 97-96) in the "Document Number" to retrieve the program notice.

G. Obsolete Provisions

Section V.G., Funding and Unit Limitations, of the January 23, 1997 Guidelines (63 FR 3574) described limitations as they existed in FY 1997 and does not apply.

Section IX.A., Participation of Projects with Post-FY 1997 Expirations, of the January 23, 1997 Guidelines (62 FR 3581) does not apply. (See section IV.B of today's notice for guidance on preference for projects with contracts expiring in FY 1998.)

H. Sunshine Provision

This section IV.H. applies instead of section X.B., Sunshine Provision, of the January 23, 1997 Guidelines (62 FR

3581). In order that others may learn from the experience of the FY 1998 Transition Program, all proposals accepted by HUD to participate in the FY 1998 Transition Program may be posted on HUD's Web Page (www.hud.gov/fha/mfh/mfhsec8.html). The posted information will include, but not be limited to, the final restructuring commitment, detailed financial information regarding the asset and tenant issues. Owners will be requested to waive the provisions of the Privacy Act (5 U.S.C. 552a) and the Trade Secrets Act (18 U.S.C. 1905).

V. Revision to Joint Venture Designee Policy for Both the FY 1997 Demonstration Program and the FY 1998 Transition Program

Section VII.A. of the January 23, 1997 Guidelines (62 FR 3578, 2d col.) contained a statement encouraging designee applicants to "develop partnerships with each other as well as with other private and public entities * * *." This inaccurately stated the policy set out in section 212(d)(3) of the FY 1997 HUD Appropriations Act. Rather, designee applicants are encouraged to develop partnerships with each other and to contract or subcontract with other private and public entities, including the entities

listed in section VII.A. of the January 23, 1997 Guidelines.

Section VII.B.2.a. of the January 23, 1997 Guidelines (62 FR 3580) stated in part, "It is possible that HUD would delegate all of its powers to the designees including the ability to authorize full or partial mortgage prepayment and would rely solely on a post-restructuring audit to verify that the interests of the Federal Government are fairly represented in the transaction." Section VI.B.2.b. of the January 23, 1997 Guidelines (62 FR 3580) stated in part, "The Joint Venture Designees will be responsible for all decision making. HUD approvals will be based on representations and certifications made by the Designee." These two statements do not apply to the FY 1998 Transition Program.

A Joint Venture Designee will be responsible for decision making as set out in its agreement with HUD. All other provisions of section VII. continue to apply to the FY 1997 Demonstration Program and the FY 1998 Transition Program.

VI. HUD Findings and Certifications

A. Environmental Impact

A Finding of No Significant Impact with respect to the environment has been made in accordance with HUD

regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969. The Finding of No Significant Impact is available for public inspection between 7:30 a.m. and 5:30 p.m. weekdays in the Office of the Rules Docket Clerk at the above address.

B. 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 notice 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.

Dated: June 22, 1998.

Art Agnos,

Acting General Deputy Assistant Secretary for Housing—Deputy Federal Housing Commissioner.

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