

September 16, 2016

TO: State Directors
Rural Development

ATTN: Program Directors
Multi-Family Housing

FROM: Tony Hernandez /s/ *Tony Hernandez*
Administrator
Housing and Community Facilities Programs

SUBJECT: March 1, 2017, Pilot Program to Promote Non-Profit Participation in
Transactions to Retain the Section 515 Portfolio

The Agency recognizes the need to preserve affordable rental housing is greater today than ever before. Particularly critical is the preservation of Rural Development's (RD) Section 515 properties that may exit the program by paying off a final loan. When properties exit the program, families living at the property may lose their home and will lose the Rental Assistance (RA) needed to make their home affordable. The loss of Section 515 housing may also affect the availability of affordable housing in many rural communities with a critical housing need for very low and low income families.

Preserving the Section 515 portfolio is a task that requires collaboration with current owners as well as the public and private sectors. In rural markets, non-profit organizations play a vital role in RD's preservation efforts by acquiring and maintaining Section 515 properties. RD is considering various regulatory changes that may help preserve the Section 515 portfolio and encourage greater participation by non-profit organizations whose mission is to meet the affordable housing needs of the communities they serve.

EXPIRATION DATE:
September 30, 2017

FILING INSTRUCTIONS:
Housing Programs

This unnumbered letter (UL) announces Rural Development's (RD) intent to conduct limited research under its authority found at section 506(b) of the Housing Act of 1949, as amended (42 U.S.C. §1476(b)), beginning March 1, 2017. The scope and implementation of this research, as established in this UL, will be limited to Section 515 transfer applications, completed on or after March 1, 2017, where the purchasing entity is a qualified non-profit organization and the Section 515 property will exit the program due to maturity or final payment of all remaining mortgages on or before December 31, 2030. The Agency will review the demonstration program's results in increasing transfers to qualified non-profit organizations after 2 years from the effective date of this UL (March 1, 2019), to determine if the incentives outlined herein should be revised, be discontinued, or made permanent through rulemaking. Applications for transfer with non-profit incentives under this demonstration program must be received no later than March 1, 2019. Applications must be complete in accordance with HB-3-3560 Chapter 7 by that date. The limited research will be tracked and incorporated through version 5.0 of the Preliminary Assessment Tool (PAT).

RD estimates a substantial number of multi-family housing properties in the RD portfolio will exit the program through 2030. The Agency is aware of the dire need to preserve its portfolio of affordable rental housing maturing and has been proactively offering other alternatives to retain Section 515 and 514 housing, including:

1. Revising the 2015 MPR Multi-Family Housing Preservation and Revitalization (MPR) Demonstration Program Notice of Solicitation of Applications (NOSA) to allow owners of existing properties where all Section 515 loans mature by December 31, 2018, to apply for debt deferral and extend their loan term to keep the rental assistance on their property;
2. Allowing owners to reamortize their existing loan balance for up to 20 years; and
3. Setting aside and encouraging the use of Section 515 funds allowed by the Housing Act of 1949, as amended, to increase non-profit participation.

For the research pilot under this UL, an eligible non-profit organization may be a corporation, a partnership including a limited partnership, or a Limited Liability Company, legally organized under the state and local laws. If the applicant is a limited partnership both the general and limited partner must be a non-profit entity. For a Limited Liability Company (LLC), there must be a non-profit entity as the sole managing member. For a corporation, in addition to the conditions outlined in 7 CFR §3560.55, the corporation must be designated a section 501 (c) (3) or (c) (4) organization under the Internal Revenue Code.

If there are any conflicts between guidance issued in this UL to the October 26, 2015 UL entitled "Underwriting Guidance For Transfer and MPR Transactions for Fiscal Year 2016", the guidance in this UL will take precedence.

The following are areas where RD will implement limited changes for transfers to eligible non-profit entities in order to test the effectiveness of incentives to increase non-profit participation in preserving RD multifamily properties and ultimately make more informed rulemaking.

Return-on Investment (ROI) for Non-Profit Entities Current agency regulations do not require non-profit entities to make an initial equity contribution, therefore they have not been eligible to earn a ROI under 7 CFR §3560.68(d), as any return is based on the initial investment. Today, transfers of Section 515 properties often require the layering of multiple funding sources; non-profit purchasers may invest their own entity's resources, in addition to third-party funds, without the ability to receive a return on their investment. RD recognizes this is not a viable long-term solution for non-profits as many non-profits have limited resources.

RD is working to increase non-profit participation in the program. Under this UL, Section 515 loan transfers to program eligible non-profit entities will be able to earn a return on their own resources initially invested in the property when the property is estimated to leave the Section 515 program as a result of the natural maturity or final payment of its loan before or in 2030. In the event of a portfolio transaction involving transfer of properties to a non-profit organization for preservation, all properties that are part of the portfolio will be considered eligible for the purposes of determining the non-profit's ROI if at least one of the properties will exit the program by 2030.

By allowing non-profit organizations to earn an ROI on their initial investment, RD anticipates that non-profit organization participation in the preservation of RHS' multifamily portfolio may increase. For eligible non-profit entities that make an investment, the Agency will follow the same ROI methodology addressed in the October 26, 2015, UL entitled "Underwriting Guidance for Transfer and MPR Transactions for Fiscal Year 2016" available on the Agency's public website (<http://www.rd.usda.gov/publications/regulations-guidelines/unnumbered-letters>), Attachment B. This change may provide another tool to finance retention of affordable housing. This UL enabling non-profit organizations to earn ROI on their investment supersedes guidance on this matter in previous ULs.

Pursuant to 7 CFR §3560.68(d), non-profit organizations are currently eligible to receive reimbursement for Asset Management Expenses (AME), up to \$7500 per entity, pro-rated across all owned RD MFH properties (HB-2-3560 Section 4.19). Examples of reimbursable expenses include fidelity bond, errors and omission insurance for Board members, time spent reviewing and approving capital budgets and review of financial reports. Under this UL, non-profits eligible to earn an ROI will have the option of choosing either the allowable ROI based on their initial investment or the AME, but not both.

Developer Loan Frequently non-profit organizations receive a grant and relend the funds to a new eligible non-profit purchasing entity. This is commonly referred to as a developer loan. This practice is often required in the grant agreement, which requires funds be used for capital improvements. A developer loan may be included for the purpose of calculating ROI in the manner addressed in the October 26, 2015 UL if all of the following conditions are met:

1. Any developer loan must be from a non-profit organization. This may include a loan from the non-profit purchaser;
2. The developer loan must be non-amortizing with the principal and interest fully deferred for the term of the RD loan. These terms must be stipulated within the developer loan documents;

3. Only the portion of the developer loan used for eligible Section 515 rehabilitation costs will be included in the eligible basis for ROI (HB-1-3560 Section 12.6 A);
4. The developer loan may be payable upon sale (after maturity of the Section 515 loan) if proceeds are available, otherwise the loan is forgiven; and
5. All RD underwriting standards noted in the October 26, 2015 UL apply.

Loan to Value (Security Value) Security Value (SV) is defined in 7 CFR §3560.63(a). RD is responsible for determining the SV and uses the SV to determine the maximum loan that may be placed on a property.

In determining the SV the appraiser values the real estate as well as intangible assets in financing the property, such as interest credit subsidy for the Section 515 loan, low interest loans from non-Agency sources, tax credits and grants. The October 26, 2015, UL limited the value of intangible assets that may be included in the SV to only Federal direct or Federal intermediary lending programs and did not take into consideration the favorable financing afforded by state or local loan programs. These loans are often critical in bridging any 'gap' or cash shortage in development budgets. Including the value of other programs' favorable financing increases the security value, enhancing non-profits' ability to finance transaction costs instead of using their own scarce financial resources. In addition to the October 2, 2015 UL guidance allowing the value of Federal direct or Federal Intermediary loans in the SV, RD will include the value of state or local loans provided at favorable rates in the calculation of intangible assets so long as an agency accepted appraisal documents the value.

Grants Currently, the Agency does not recognize grant dollars as the applicant's own resources and does not include them in the ROI methodology. This reflects a time when non-profit organizations relied on debt for their low income housing financing and RD lent up to 102 percent of the construction cost. Today, Section 515 transfers to non-profit organizations are more complex and require multiple funders of both equity and debt.

For transfers of Section 515 properties exiting the program to eligible non-profit entities, the Agency will consider any grant dollars awarded to the non-profit applicant as the applicant's own resources and will include the amount in the ROI methodology so long as the grant is provided by a federal, state or local Government, or other source as approved by the Agency, and used for payment of hard costs of construction. The non-profit applicant must submit a written commitment of the grant that includes the grant amount and conditions. Deferred or soft loans are not eligible for inclusion in the ROI determination.

Hard Cost Contingency A hard cost contingency is used to meet unforeseen hard costs during construction such as additional labor and materials and is required by most third-party funders and investors. Today, RD's regulations do not identify contingency as an eligible Section 515 loan purpose.

The Agency recognizes the need for a hard cost contingency when rehabilitation is being performed and will allow this as an eligible Section 515 loan purpose for transfer and rehabilitation of Section 515 properties estimated to exit the program through final loan maturity or payoff by 2030. As an eligible loan cost, the budgeted hard cost amount will be included in

the ROI methodology. The budgeted amount is generally calculated as a percentage of the construction costs and limited to the amount required by any third-party funder. In no case, for the purposes of this research, will the budgeted amount be more than 10 percent of the construction costs. Prior RD approval will be required on all change orders which document the contingency funds are used solely for hard costs. If any contingency funds remain at the completion of rehabilitation, the funds may be used for additional improvements to the property, as approved by RD, or deposited to the project reserve account. RD will require a self-certification that the contingency was used for additional improvements to the property within 30 calendar days following the completion of the planned rehabilitation work and final acceptance by RD as evidenced by approval on RD Form 1924-12. RD reserves the right to revisit the use of the budgeted contingency and make adjustments to the ROI if the funds were used for items other than eligible hard costs.

Attachment A provides a chart summarizing the policy updates for qualified non-profits in this UL.

The points of contact for this UL are the Preservation and Direct Loan Division (PDL) staff. A PDL staff member is assigned to assist State Office and field office staff with Transfers and MPR Transactions to help address questions and concerns raised by the respective underwriter with these transactions. If there are questions regarding the content of this UL, please contact your assigned MFH PDL staff member.

Attachment

**PROPOSED REGULATORY CHANGES
ELIGIBLE NONPROFITS**

This UL proposes to test limited regulatory changes to increase nonprofit participation in the Section 515 program. The changes include allowing an eligible nonprofit to earn a Return on Investment (ROI), allowing hard contingency as an eligible Section 515 loan purpose and inclusion of any value for non-Agency loans provided at favorable rates in the Security Value determination.

1. Return on Investment (ROI):
 - a. Eligible nonprofits to earn a return based on the investment of their own resources following the ROI methodology.
 - b. Grant funds used for hard costs of construction to be included in the ROI methodology.
 - c. Loans made by nonprofits (aka Developer Loans) to a nonprofit purchasing entity to be included in the ROI methodology subject to certain conditions being met.

2. Security Value:
 - a. The Agency to include the value of state or local loans provided at favorable rates, in the Security Value determination.

3. Hard Cost Contingency
 - a. Allows hard cost contingency as an eligible Section 515 loan purpose allowing it to be included in the ROI methodology subject to certain conditions being met.