FINAL REPORT
OF THE TASK FORCE ON
RURAL RENTAL HOUSING
PRESERVATION

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The Housing Assistance Council is a national nonprofit corporation headquartered in Washington, D.C., and founded in 1971. HAC helps local organizations build affordable homes in rural America by providing below-market financing, technical assistance, research, training, and information services. HACs programs focus on local solutions, empowerment of the poor, reduced dependency, and self-help strategies. HAC is an equal opportunity lender. HACs web address is www.ruralhome.org.

The National Housing Law Project is a national housing law and advocacy center. NHLPs goal is to advance housing justice for the poor by increasing and preserving the supply of decent affordable housing, by improving existing housing conditions, including physical conditions and management practices, by expanding and enforcing low-income tenants’ and homeowners’ rights, and by increasing opportunities for racial and ethnic minorities. More information is available at www.nhlp.org.
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EXECUTIVE SUMMARY

The Section 515 Rural Rental Housing (RRH) program has produced over 550,000 decent, safe, sanitary, and affordable homes since it was created over 40 years ago. This housing continues to fulfill a dire need, often providing the only decent and affordable rental housing in rural communities. Residents’ incomes average less than $10,000 per year, and more than half of resident households are headed by elderly persons or persons with disabilities.

There are significant challenges to the preservation of these properties as decent, affordable housing for low-income people. Loans financing over 50,000 units of Section 515 housing have already been prepaid and many more are likely to be prepaid over the next several years; it can be assumed that some of those 50,000 units are no longer part of the affordable housing stock, while others are. At the same time, the age and condition of the Section 515 inventory threaten its continued viability as decent housing. Finally, Congress has cut back the program’s funding dramatically for the past ten years, and very few new units are being built.

Recognizing the importance of preserving the stock of Section 515 developments, the John D. and Catherine T. MacArthur Foundation funded the Housing Assistance Council and the National Housing Law Project to undertake a variety of activities, including convening a task force to study the topic and develop recommendations. Twelve experienced individuals agreed to serve on the task force, representing the many interests involved: owners, tenants, private lenders, RHS, local nonprofit developers, and national nonprofit housing organizations. The task force held three meetings and numerous conference calls between August 2004 and February 2005. This report presents the group’s findings and recommendations.

The Task Force agreed on three broad recommendations and several categories of more detailed recommendations:

• **Strengthen incentives and administrative processes to encourage responsible stewardship of the 515 portfolio.**
  ➢ Give more authority to the Rural Housing Service National Office and take other steps to ensure timely, consistent, coordinated actions by USDA Rural Development and RHS offices.
  ➢ Facilitate transfers of properties to owners that commit to keeping them decent, safe, sanitary, and affordable for long-term occupancy by low- and very low-income households.
  ➢ Identify special strategies to preserve small properties in remote areas.
  ➢ Improve information sharing and communications.

• **Preserve for long-term occupancy by low- and very low-income households all properties currently in the Section 515 portfolio that are needed in their communities. Revitalize the properties’ physical condition so that all are, and are maintained as, decent, safe, and sanitary housing.**
- Increase the supply and efficiency of funding from all sources for all preservation purposes (revitalization, refinancing by remaining owners, and financing by new owners).
- Empower and enable third-party funding.

- **Protect tenants.**
  - Protect tenants against displacement, ensure that their homes remain decent, safe, sanitary, and affordable, and ensure that the housing is managed in a manner that protects their interests.
INTRODUCTION

The Section 515 Rural Rental Housing (RRH) program has produced over 550,000 decent, safe, sanitary, and affordable homes since it was created over 40 years ago. This housing continues to fulfill a dire need, often providing the only decent and affordable rental housing in rural communities. Residents’ incomes average less than $10,000 per year, and more than half of resident households are headed by elderly persons or persons with disabilities.

There are significant challenges to the preservation of these properties as decent, affordable housing for low-income people. Loans financing over 50,000 units of Section 515 housing have already been prepaid and many more are likely to be prepaid over the next several years. Since prepayment of a Section 515 loan removes the program’s regulatory restrictions, it may mean that a property is no longer available for low-income residents. Alternatively, a community’s housing market or the restrictions imposed by another subsidy program may keep the property rents at affordable levels. No data are available regarding the income levels now served by prepaid properties. It can be assumed that some of the 50,000 prepaid units are no longer part of the affordable housing stock, while others are.

The age and condition of the Section 515 inventory also threatens its continued viability as decent housing. A recent study conducted for the U.S. Department of Agriculture’s Rural Development mission area, which oversees Section 515 and the Rural Housing Service, determined that no property in the inventory has adequate reserves or sufficient cash flow to do needed repairs and for adequate maintenance over time.

Finally, Congress has dramatically cut back the program’s funding for the past ten years, and very few new units are being built. The number of Section 515 units prepaid in fiscal years 2003 and 2004 exceeded the number of new units produced under the program. The same thing is likely to happen in 2005. Unless USDA and Congress take affirmative steps to preserve the existing Section 515 housing stock, the imbalance between preservation and production is likely to repeat in future years and, indeed, accelerate.

Decent rental housing affordable for the lowest income rural residents remains desperately needed. More than one-third of rural renters pay more than the federal standard of 30 percent of their income for their housing costs, and rural renters are twice as likely as rural owners to live in physically substandard housing. Section 515 financing for property developers, particularly when coupled with rental assistance to tenants, enables these developments to serve the poorest rural residents, those whose very low incomes generally put them beyond the reach of other housing subsidy programs.

This introduction reviews the origins of the preservation and prepayment issues, Congress’s efforts to address the issues, and RHS’s administration of the existing preservation program. It highlights the problems that have plagued the program and summarizes the Task Force’s recommendations.
The Origins of the Prepayment Issue

Private enterprise had a minimal role in the development and management of subsidized housing prior to 1968. Developments produced before that time were all owned and operated by public bodies or nonprofit agencies, but unit production was small and inadequate to meet the growing demand. In an effort to address poverty, the lack of affordable housing, and the future housing needs of a growing country, President Lyndon Johnson, as part of his “Great Society” program, proposed to increase housing production dramatically by creating new affordable housing programs that were open to private enterprise.

Johnson’s vision was incorporated into the Housing Act of 1968, which created a number of programs that allowed private developers to secure subsidized loans for the production and ownership of rental housing for low-income households, as well as other financial and tax incentives that encouraged them to enter these new programs. Twenty-year use restrictions were included in most of the new programs.

The Section 515 RRH program, which predated the Great Society housing programs, was not altered by the 1968 legislation except in one respect: an interest subsidy was authorized for borrowers who were not able to obtain credit elsewhere on terms that would allow them to charge rents affordable for low-income tenants. For-profit developers did not obtain the interest credit subsidies because they would have been able to get credit from other sources.

Use restrictions were not placed on the 515 program because they were not needed. Nonprofit or public agencies who had a mission to fulfill were not expected to prepay their loans and no significant consequences were expected as a result of private developers prepaying their federal loans because the private replacement loans were expected to have interest rates comparable to the federal market interest rate at which the loans were originally financed.

In 1973 the Farmers Home Administration (FmHA), the predecessor agency to the current Rural Housing Service, opened the subsidized RRH program to private developers who could not obtain non-federal loans on terms and conditions that enabled them to serve low- and very low-income households, but neither restricted their capacity to prepay the loans nor placed use restrictions on the properties.

Passage of the Emergency Low Income Housing Preservation Act of 1987

In 1978, the RRH prepayment issue publicly reared its head for the first time when the private owner of a small senior development in southern Ohio prepaid its loan and, through rent increases, displaced its elderly residents. When litigation failed to stop the displacement, resident representatives lobbied Congress for use restrictions on the RRH program, which were enacted in 1979. That legislation placed restrictions for 20 years on newly developed subsidized housing and for 15 years on unsubsidized housing. It imposed those restrictions retroactively on all projects developed prior to 1979, with the use restrictive period commencing at the time the loan was originally made.
Private owners and developers persuaded Congress that the retroactive restrictions were unconstitutional. Those provisions were repealed in 1980. Owners were once again free to prepay pre-1979 loans, and they did so in increasing numbers as development and inflation were driving up real estate prices in some parts of the country and affordable housing tax incentives, which encouraged many of the owners to enter the program, were expiring.

Because 57 percent of RRH residents were, and are, elderly or disabled, prepayments garnered substantial and unfavorable publicity. By 1986, the prepayment issue became such a concern that Congress placed a moratorium on all prepayments until it could deal with the issue, and then enacted the Emergency Low-Income Housing Preservation Act of 1987, commonly known as ELIHPA.

ELIHPA’s rural prepayment restrictions sought to preserve housing by offering incentives to owners who would remain in the program, allowing prepayments when the housing was no longer needed or if there was no adverse impact on minority housing opportunities and current residents would not be displaced. If minority housing opportunities were adversely affected or residents displaced, ELIHPA required owners to offer to sell their developments at fair market value to nonprofit or public agencies. FmHA would finance such sales, but if no nonprofit or public agency made a reasonable purchase offer within six months, an owner was free to prepay its loan. This scheme was not, however, implemented as anticipated.

**Implementation of ELIHPA**

FmHA, a highly decentralized agency, allowed the program to be administered at the state level. This resulted in two problems: uneven and improper program administration and the granting of excessive incentives for owners to remain in the program.

The National Rural Preservation Task Force, which was convened by the Housing Assistance Council in 1989, reported that nearly all the prepayments approved in the first several years after the passage of ELIHPA were probably illegal. In other words, the state and local offices administering the program authorized prepayments that should not have been approved, continuing a pattern of resident displacement. At the same time, they approved incentives, primarily equity loans and increased rates of return, to owners to remain in the program without a clear showing that the owners could or would prepay. While these commitments preserved a significant number of units, they also alienated owners because, after Congress reduced the funding for the Section 515 program in 1994, the primary incentives – equity loans – were not actually made available to the owners until several years after the owners entered into the incentive agreements.

To ameliorate these problems, the National Rural Preservation Task Force recommended that a national office of preservation be established and that all prepayments be reviewed and approved in that office. Congress enacted the task force’s recommendation into law in 1992 and at the same time it extended ELIHPA’s applicability to developments that were financed between 1979 and 1989. The national Office of Rental Housing Preservation was not established by the agency until 1997. In the
meantime, improper prepayments continued to be approved and excessive incentives offered. In some instances, the incentive waiting period extended to nearly eight years.

The RHS national preservation office improved the program’s administration, but did not resolve a number of issues. First, the preservation program’s regulations were inadequate. For example, there were no standards for determining whether a prepayment would have a material impact on minority housing opportunities.

Second, program funding continued to be insufficient to grant incentives, finance transfers and improvements, and provide the subsidies necessary to protect residents from displacement. This forced nonprofit and public entities to devise creative mechanisms with which to fund preservation efforts, such as securing third party financing. Because agency regulations did not contemplate these new financing schemes, the agency had to issue special notices to implement them and required that each transaction be approved by the RHS administrator under special exception authorities. This has complicated and slowed the transfer process and alienated owners who are eager to leave the program in a timely fashion.

Importantly, Congress has also never addressed the issue that some residents of RRH would be displaced by prepayments. It has not protected them with a program comparable to HUD’s enhanced voucher program, which allows residents to stay in their developments with the agency paying the difference between the old rent level and new market rate rent levels. Nor has Congress considered proposed legislation that would provide “exit tax relief” to private owners who transferred developments to other entities that would maintain the properties’ long-term affordability. These proposals would enable “exiting” owners to avoid substantial capital tax obligations that they face when they sell developments that have benefited from accelerated depreciation.

More significantly, neither the agency nor Congress has ever dealt with some fundamental prepayment and preservation issues. For example, until very recently, RHS had not attempted to define the magnitude of the prepayment problem in terms of units and costs, including costs for adequate Section 521 Rental Assistance to tenants of Section 515 developments.

**Recent Developments**

Over the last few years, Section 515 preservation activities have increased and all parties have learned about both positive and negative aspects of the current framework. The 2004-2005 Task Force’s work has benefited greatly from these lessons and from the willingness of numerous parties – including sellers, purchasers, private lenders, tenant advocates, and USDA’s Rural Housing Service – to share information with the group. Their experiences influenced the recommendations presented below.

Several specific events related to rural prepayment and preservation have occurred in the second half of 2004 and early in 2005. At the end of August a U.S. Court of Claims decision in *Franconia Associates v. The United States* found the government liable for breaking its contracts with Section
515 owners by restricting their ability to prepay. The court held that the owners were entitled to damages for profits they lost because of these restrictions. The government may still appeal the decision. The ruling does raise serious questions about Congress’s approach to preserving Section 515 projects as affordable housing and presents the possibility of an additional multi-million dollar cost to the government.

In November, USDA Rural Development released a study prepared by consultants who examined the physical condition of a sample of 515 developments and made recommendations related to preservation and prepayment. Rural Rental Housing – Comprehensive Property Assessment and Portfolio Analysis (generally known as the CPA) reported that about only 10 percent of Section 515 units in the current portfolio might prepay in order to convert to market rate housing, and suggested that RD allow them to do so, while protecting the tenants currently occupying those units. Rural Development’s primary concern, the CPA’s authors recommended, should be on the refinancing and physical revitalization of the rest of the portfolio.

The CPA’s findings and its major recommendations are reflected in the Administration’s budget proposal for RHS programs in fiscal year 2006, issued in early February 2005. The budget would reduce Section 515 funding to $27 million from its 2005 level of $100 million, providing no money for new construction. Budget documents state that RD/RHS’s emphasis would be on revitalization of existing properties, with $214 million to be used for the previously seldom-funded Section 542 voucher program to protect tenants whose landlords prepay. The agency plans to introduce legislation to expand the Section 542 program and implement its revitalization plans.

Finally, also new are the agency’s regulations and processes for its multifamily programs, including Section 515 prepayment. The rules, known as the 3560 regulations because they are codified at 7 C.F.R. Part 3560, took effect on February 24, 2005. Administrative Notice (AN) 4010, issued September 23, 2004, clarifies some parts of the process of transferring property ownership when an owner has not first applied to prepay.

Recognizing the importance of preserving the stock of Section 515 developments, the John D. and Catherine T. MacArthur Foundation funded the Housing Assistance Council and the National Housing Law Project to undertake a variety of activities, including convening a task force to study the topic and develop recommendations. Twelve experienced individuals agreed to serve on the task force, representing the many interests involved: owners, tenants, private lenders, RHS, local nonprofit developers, and national nonprofit housing organizations. The task force held three meetings and numerous conference calls between August 2004 and February 2005. This report presents the group’s findings and recommendations.
Recommendations

As issues remain unresolved, the Section 515 RRH program is now at a major crossroads. In most rural areas, Section 515 housing is the only decent and affordable rental housing available to very low-income residents. Unless substantial resources are made available soon, the supply of such housing will drop in a relatively short period of time, as properties continue to leave the program and the overall condition of the remaining stock deteriorates. Many rural areas will be deprived of critically needed housing.

Solutions to this crisis must consider the interests of many parties. In the simplest terms, owners want the initial terms of their contracts with RHS to remain unchanged – in other words, they want prepayment restrictions to be lifted. Tenants want to have the option of staying in their homes at rents they can afford and with the properties’ physical needs met. Affordable housing advocates want to protect current tenants against prohibitive rent increases or displacement, and to ensure that the overall supply of affordable rental units at least does not diminish, and preferably increases. Lenders want a program that is easy to execute and incorporates prudent underwriting and operating standards. Clearly these goals are not always compatible, but significant common ground exists.

The Task Force agreed on three broad recommendations and several categories of more detailed recommendations:

• **Strengthen incentives and administrative processes to encourage responsible stewardship of the 515 portfolio.**
  - Give more authority to the Rural Housing Service National Office and take other steps to ensure timely, consistent, coordinated actions by USDA Rural Development and RHS offices.
  - Facilitate transfers of properties to owners that commit to keeping them decent, safe, sanitary, and affordable for long-term occupancy by low- and very low-income households.
  - Identify special strategies to preserve small properties in remote areas.
  - Improve information sharing and communications.

• **Preserve for long-term occupancy by low- and very low-income households all properties currently in the Section 515 portfolio that are needed in their communities. Revitalize the properties’ physical condition so that all are, and are maintained as, decent, safe, and sanitary housing.**
  - Increase the supply and efficiency of funding from all sources for all preservation purposes (revitalization, refinancing by remaining owners, and financing by new owners).
  - Empower and enable third-party funding.

• **Protect tenants.**
  - Protect tenants against displacement, ensure that their homes remain decent, safe, sanitary, and affordable, and ensure that the housing is managed in a manner that protects their interests.
The RHS prepayment and preservation process is at a critical turning point. Ever greater numbers of owners are seeking to leave the program, properties are aging and experiencing the effects of deferred maintenance, and those who wish to preserve the properties are frustrated by information shortages and long time lines. A variety of parties can address these issues, particularly if they work cooperatively together: RD/RHS, Congress, private lenders, owners, residents, housing advocates. Their failure to act will result in the loss of a critical supply of rental housing in rural America.
DETAILED RECOMMENDATIONS

Strengthen incentives and administrative processes to encourage responsible stewardship of the 515 portfolio.

- Give more authority to the Rural Housing Service National Office and take other steps to ensure timely, consistent, coordinated actions by USDA Rural Development and RHS offices.

Highest Priority Recommendations

- Centralize and standardize Rural Development activities. The Task Force endorses the recommendation in the Comprehensive Property Assessment (CPA) to involve the National Office (whether through a new Office of Portfolio Revitalization or the current Office of Rental Housing Preservation) in administration of complex and moderately difficult restructures, but emphasizes the need for consistency in all transactions. Local offices must take direction from the National Office. Either:

  - RD must provide greater authority to the RHS Administrator by delegating authority over prepayments and transfers of physical assets (TPAs; i.e., sales without prepayment requests) from the Under Secretary for Rural Development to the RHS Administrator; or
  - RD/RHS must develop better automation and templates for all documents involved in prepayments and TPAs.

  A legislative alternative would reorganize the structure of USDA to provide the RHS Administrator greater authority over RD staff with respect to prepayments and TPAs.

- Revise and simplify the prepayment and transfer of physical assets processes. RHS must remove bottlenecks, excessive documentation requirements, and duplicative efforts from the processes for prepayment, transfers, and obtaining subordination approvals for owners who intend to remain in the Section 515 program by securing outside financing for repair or rehabilitation of their developments. Although AN 4010 sought to clarify some parts of these processes, it does not go far enough. RHS should:

  - specify the essential documents needed for transactions;
  - develop document templates;
  - provide written conditional commitments for resources and transactions that can be used to secure outside financing;
  - eliminate outdated regulatory requirements; and
  - specify conditions under which it will accept studies and assessments such as comprehensive needs assessments (CNAs), appraisals, market studies, rehabilitation...
specifications, and underwriting standards completed by third parties that will finance, insure, or purchase loans that will finance sales and/or rehabilitation of Section 515 developments. When CNAs are performed by others, RD should not conduct a separate inspection of the same type. Third party assessors should be required to have expertise in Section 504 accessibility requirements. The agency should not require that work needed to ensure Section 504 compliance be completed before a transfer occurs.

Additional Recommendation

- Use expert outside contractors. RHS’s Preservation Office should be authorized to contract with private contractors, such as the Participating Administrative Entities used by HUD’s Office of Multi-family Housing Assistance Restructuring, to handle prepayments and property transfers when the agency judges such contracting to be cost-effective. Any outsourced work must use standardized processes and documents.

Background

One of the prominent and useful features of the Farmers Home Administration (FmHA) was its network of field offices throughout rural America, overseen by state offices whose directors reported to the FmHA Administrator. When USDA was reorganized in the early 1990s, this direct line of authority disappeared (in addition, many county-level field offices were closed or consolidated). The Rural Housing Service (RHS) exists only at the national level; at the state and sub-state level its programs are operated by Rural Development (RD) offices that are also responsible for utility and business programs. RD state directors report to the Under Secretary for Rural Development. RHS promulgates regulations and issues directives to RD staff, but has no authority over them.

Because the Rural Development field staff is not directly responsible to RHS National Office staff, it frequently operates semi-independently. Thus each of the 47 RD State Offices may interpret differently the requirements for prepayment and preservation or for the transfer of physical assets. Individual staffers who lack knowledge and experience with prepayment requests or transfers may not follow RHS regulations and policies. The Task Force appreciates the agency’s efforts to standardize its processes and to provide guidance to field staff, but more is needed.

RD field staff also have not always worked cooperatively with third party funders. Local organizations that have purchased and refinanced Section 515 properties report that RD does not always accept comprehensive needs assessments (CNAs), appraisals, market studies, rehabilitation specifications, and underwriting prepared by or for other funders. The time and expense of completing deals are increased when these tasks must be done a second time by RD staff or contractors.
Another identified reason for delay is the RHS/RD requirement that work needed to ensure compliance with Section 504 accessibility requirements must be completed before a sale. This means additional time will pass before the sale can be closed, and the purchaser who is funding and contracting for the work must coordinate with the seller, who still owns the property.

➢ **Facilitate transfers of properties to owners that commit to keeping them decent, safe, sanitary, and affordable for long-term occupancy by low- and very low-income households.**

**Highest Priority Recommendations**

- Enable consolidation of loans. RHS should allow purchasers to consolidate multiple loans made to multiple entities for multiple developments into a single loan to facilitate financing alternatives and allow for preservation of smaller projects. The Task Force appreciates the fact that multiple properties can currently be treated as a single property.

- Enable consolidation of owner entities. As recommended in the CPA, RHS should go beyond its current policy of allowing consolidation of separate owner entities in specific limited circumstances. The agency should codify the existing possibilities in its regulations and should encourage consolidation because it avoids the complexities of having, for example, several different loans subordinated to one new loan.

- Cover up-front costs for nonprofit and public agency purchasers. Currently a nonprofit organization or public agency can request a grant from RHS of up to $20,000 to cover due diligence expenses related to the purchase of a prepaying property, but they are not always aware that these funds are available. The agency must:
  - ensure that sufficient funds are available to provide these grants;
  - ensure that nonprofits know they can obtain these grants; and
  - provide a clear process for requesting these grants.

- Increase the amount of up-front cost reimbursements. Congress should increase the dollar amount of these grants from the current $20,000 to an amount that is reasonable and necessary for each specific project, based on the project budget; nonprofits and public agencies report that their due diligence costs are always more than $20,000 and can be as high as $100,000.

- Cover up-front costs for the TPA process. Grants to cover due diligence costs should be available for nonprofit organizations purchasing through the transfer of physical assets process as well.
Additional Recommendations

- Update and simplify TPA regulations. RHS should update and simplify its Transfer of Physical Assets regulations to facilitate transfers of developments to purchasers who will preserve their long-term affordability for low-income tenants.

- Provide management fees for nonprofits. RHS should make asset management fees for nonprofit purchasers consistently available nationwide, and should establish a minimum fee of $10,000 per property (regardless of the number of units). Other reimbursement mechanisms should also be considered.

- Standardize requirements for nonprofits’ structures. The structural requirements for nonprofits (board composition, etc.) should be the same in both the TPA and prepayment processes.

- Broaden the nonprofit definition. A for-profit limited partnership with a nonprofit-controlled general partner should be defined as a nonprofit entity for acquisition purposes. This change would enable prepaying owners to sell properties more easily to partnerships formed to use Low Income Housing Tax Credits.

- Enact exit tax relief. The tax code should be amended to provide exit tax relief for owners who sell to purchasers who will commit to preserve their properties’ long-term affordability for low-income tenants.

- Allow all entities an opportunity to purchase with restrictions. When an owner has requested permission to prepay and an adverse impact on minority residents has been identified, but no nonprofit or public agency purchases the property, any other type of purchaser that would commit to maintaining the property’s affordability should be given the opportunity to purchase it (within the 180-day period required by the statute) before it is sold without restrictions.

Background

Preservation efforts too often overlook the potential to preserve Section 515 properties through sales to purchasers who will commit to preserve their properties’ long-term affordability for low-income tenants. Such sales help all parties to achieve their goals: owners leave the Section 515 program, tenants keep their homes at affordable rents, communities’ stock of affordable housing units does not change, and buyers (which may be nonprofit housing organizations, public agencies, or for-profit entities) fulfill their missions. RHS’ prepayment process requires a number of steps before a sale to a nonprofit or public agency, however, and the agency’s transfer of physical assets (TPA) process functions only when the buyer and seller have already begun working together.

Furthermore, the TPA regulations are overly restrictive and do not reflect transfer practices that RHS has approved within the last several years in order to facilitate the preservation of
developments. As a consequence, most preservation transfers cannot be processed without the Administrator’s explicit exception authority. Those regulations were not included in the agency’s new multifamily regulations, which took effect on February 24, 2005.

RHS has taken steps towards facilitating the transfer process. For example, on September 23, 2004 it issued Administrative Notice 4010 (now Attachment 7-A to HB-3-3560), which encourages RD staff to use all means at their disposal to enable transfers to proceed smoothly. AN 4010 does not have the force and effect of law, however, and its provisions must be codified into regulations to become fully effective.

One significant hurdle negates many owners’ interest in selling. Most Section 515 properties developed since the mid 1980s include tax credit financing, and tax liabilities for the tax credit investors are triggered by property sales. These “exit taxes” are a strong disincentive for owners to sell these properties, even when they would otherwise be interested in selling.

Identify special strategies to preserve small properties in remote areas.

Special preservation strategies are needed for small developments located in remote rural areas. There are no economies of scale in purchasing, rehabilitating, or operating these properties, so potential purchasers do not find it cost-effective to preserve them. Yet often the residents of these small, remote communities very much need these homes. The Task Force identified some possibilities, but urges additional study to identify the most useful strategies. Congress must provide USDA with enough funds to consider and act on such strategies itself or to contract with an outside entity to undertake this work.

Recommendations

- Simplify the transfer process. Simplification of the transfer process, both in the prepayment context and outside it, as proposed in numerous other Task Force recommendations, will help encourage purchasers to consider these properties.

- Cover purchasers’ costs. Funding must be identified for purchasers who will commit to preserve their properties’ long-term affordability for low-income tenants, to cover the costs involved in purchasing and operating small, remotely located developments. The Task Force supports the CPA’s proposal to provide debt relief for these properties.

- Encourage and assist conversion to resident cooperatives in cases where tenants are willing to take on the responsibilities of ownership and have incomes high enough to cover the costs of ownership. USDA Rural Development’s Rural Business-Cooperative Service should be involved in facilitating these arrangements.
Permit mixed uses. Legislative and regulatory changes should be made to enable properties to be categorized and used for family or elderly occupancy, temporary shelter, or assisted living, or combinations of these uses, as needed, subject to fair housing laws.

Permit partial demolition. Legislative or regulatory changes should be made to allow partial demolition when only part of an existing development is still needed in its market area.

Expand information availability. RD/RHS should provide information to assist owners and potential purchasers in connecting small properties with others:

- The agency should identify potential bundles of properties in each state, so that small or remote properties can be bundled with larger ones for sales.
- The agency should map all subsidized rental housing – 515, 202, 811, 236, public housing, tax credit developments, etc. – so owners or managers of nearby properties can be identified and contacted as potential purchasers.

Treat portfolios as single properties. RD/RHS, state tax credit allocating agencies, and others should be empowered to handle portfolio transfers as single deals, rather than considering each development within a portfolio separately.

**Improve information sharing and communications.**

All parties involved in multifamily housing – developers, owners, tenants, would-be purchasers, neighbors, and advocates – can benefit from the availability of information. In order to help preserve properties, potential purchasers and advocates must be able to learn projects’ names and locations, the agency’s assessment of their conditions, and the like. Community residents and advocates should be able to find out how RHS/RD has handled specific prepayment requests. Owners should be able to contact other owners and developers to discuss bundling opportunities. The public should have access to information about potential changes in the character of properties in specific communities. Relevant information includes:

- what properties are in the Section 515 portfolio – currently, this information is available only from RD State Offices, most of which require Freedom of Information Act requests before releasing it;
- what properties’ owners have requested permission to prepay – currently, one must register with individual State Offices to receive notices; the Task Force understands that RHS intends to provide a single online database (PIX) and an e-mail notification system to disseminate information about prepayment actions; and
- what decisions RHS has made regarding prepayment requests – it seems the only way to determine this is to contact the relevant State Office or the national Office of Rental Housing Preservation and ask.
RD/RHS has already taken steps to improve information sharing and communications among interested parties, and should continue to do so.

**Recommendations**

- Inform PHAs about prepayments. RHS should obtain from HUD a database of contact information for public housing agencies serving rural areas and add them to its list for e-mail notices of prepayment actions. Entities on all State Offices mailing lists should be added to this e-mail list as well, and it should be advertised so that others know how to join it.

- Make property information readily available. The public should have ready access to information from a single source about projects in the 515 portfolio. The agency need not disclose confidential information submitted by owners.

- Make prepayment decision information readily available. Information about RD/RHS staff determinations with respect to prepayments should be readily available to the public so that tenants, advocates, and others can ensure that decisions are being made consistently and in accordance with regulations.

- To facilitate information sharing and communications among all parties:
  - RD/RHS should continue holding state-level meetings between owners interested in leaving the program and entities interested in purchasing developments as low-income housing. The agency has held such meetings in several states, and they have fostered communications between the parties.
  - As workable strategies (best practices) are developed for particular situations, they should be described in writing and made readily available to stakeholders.
  - The Task Force strongly encourages that the PIX database be launched as soon as possible.

**Summary of Recommendations on Incentives and Administrative Processes**

USDA/Rural Development/Rural Housing Service should:

- Give more authority to the RHS National Office to ensure timely, consistent, coordinated actions by USDA Rural Development and RHS offices.
- Centralize and standardize RD activities.
- Revise and simplify the prepayment and TPA processes.
- Use expert outside contractors.
- Enable consolidation of loans.
- Enable consolidation of owner entities.
- Cover up-front costs for nonprofit and public agency purchasers.
• Update and simplify TPA regulations
• Provide management fees for nonprofits
• Standardize requirements for nonprofits’ structures.
• Allow all entities an opportunity to purchase with restrictions.
• Simplify the transfer process.
• Cover purchasers’ costs.
• Encourage and assist conversion to resident cooperatives.
• Permit mixed uses.
• Permit partial demolition.
• Expand information availability.
• Treat portfolios as single properties.
• Inform PHAs about prepayments.
• Make property information readily available.
• Make prepayment decision information readily available.
• Facilitate information sharing and communications among all parties.

Congress should:

• Reorganize RD to provide RHS with greater authority, in the event that the department does not undertake an internal reorganization.
• Increase the amount of up-front cost reimbursements available to nonprofit and public agency purchasers.
• Cover up-front costs for the TPA process.
• Broaden the definition of nonprofit to include a for-profit limited partnership with a nonprofit-controlled general partner.
• Enact exit tax relief.
• Allow all entities an opportunity to purchase with restrictions.
• Permit mixed uses.
• Permit partial demolition.
Preserve for long-term occupancy by low- and very low-income households all properties currently in the Section 515 portfolio that are needed in their communities. Revitalize the properties’ physical condition so that all are, and are maintained as, decent, safe, and sanitary housing.

- **Increase the supply and efficiency of funding from all sources for all preservation purposes (revitalization, refinancing by remaining owners, and financing by new owners). Remove barriers raised by regulations and processes where needed.**

Throwing money at a problem does not solve it. It is a fact, nevertheless, that the shortage of funds available for preservation has contributed to an inability to retain some properties as affordable housing and has strained relationships between the parties – in short, it has served no one’s best interests. The Task Force appreciates the fact that RHS has recognized the need to increase its own resources (for example, the Administration’s budget for fiscal year 2006 requests more than $200 million for vouchers to protect tenants in prepaying properties) and to attract resources from other sources for revitalization. In addition, the Task Force is certainly aware of the need to prioritize government spending; it believes that protection of past government investment in Section 515 properties, as well as fairness to all parties, merit attention.

The Task Force acknowledges and appreciates USDA’s efforts to date.

**Highest Priority Recommendations**

- Improve communications between RD and state agencies. Each RD State Office should communicate proactively with its state’s housing agency(ies) about priorities, available funds, etc., in order to coordinate efforts. It would be advisable to include other interested parties as well.

- Make 9 percent tax credits available. RHS should request a letter ruling from the Internal Revenue Service that would permit use of 9 percent Low Income Housing Tax Credits in Section 515 deals where the debt will be restructured, as they are allowed to be used in HUD Mark to Market situations. If this goal cannot be accomplished by RHS, it should be enacted in legislation.

- Set aside tax credits for Section 515 preservation. State allocating agencies should set aside Low Income Housing Tax Credits for Section 515 preservation projects, with a provision allowing unused setaside credits to be reallocated for other purposes. RHS should request such setasides, and should ask the National Council of State Housing Authorities (NCSHA) to support them.

- Set aside HOME and CDBG funds for Section 515 preservation. HOME participating jurisdictions and Community Development Block Grants (CDBG) entitlement areas and states...
should establish setasides of HOME and CDBG monies for Section 515 preservation, with provisions allowing unused setaside funds to be reallocated for other purposes. RHS should request such setasides.

- Use voucher funding as an incentive. RD=s voucher program should allow owners to choose whether to provide enhanced vouchers to tenants or to accept an equivalent dollar amount as an incentive to retain use restrictions. This flexibility is currently provided under Section 502(c) for Rental Assistance that can be offered as an incentive to owners to stay in the 515 program.

- Make RHS regulations consistent with other government and private sector financing standards for underwriting and process.

**Additional Recommendations**

- Continue to provide incentives for owners to remain in the 515 program.

- Forgive RHS debt. As recommended by the CPA, RHS should be authorized to use debt forgiveness to facilitate purchases and rehabilitation by entities who will commit to retain properties as affordable housing in the long term. In addition, Congress should authorize RHS to use debt bifurcation, i.e., turning part of the existing debt into a soft second mortgage.

- Allocate more RHS funding for preservation. RHS should allocate more funding for preservation activities, including owner incentives.

- Request more RHS funding for preservation. USDA/RD/RHS should request additional appropriations for preservation, including owner incentives, and for Rental Assistance.

- Make subordination of Section 515 debt easier. RHS=s willingness to subordinate existing Section 515 loans is a very useful tool to attract new financing from other lenders, and the Task Force encourages its further use. To make the process faster, RD/RHS should base subordination decisions on satisfaction of specified criteria rather than requiring an administrative waiver for every subordination decision.

- Allow above-market rents when needed to cover costs. The Task Force does not suggest making tenants bear the difference in costs, but RHS should:
  - ✓ use debt forgiveness to reduce project costs; and
  - ✓ for units with Rental Assistance, approve exceptions to its general rule capping project rents at market rents.

- Keep the Community Reinvestment Act (CRA) strong. Congress should strengthen CRA provisions, and the Federal Deposit Insurance Corporation, Federal Reserve Board, Office of
the Comptroller of the Currency, and Office of Thrift Supervision should implement the Community Reinvestment Act fully in rural areas in order to encourage private lender involvement in rental housing preservation.

- Congress should appropriate additional funds for preservation, including owner incentives, and for Rental Assistance.

Background

RHS has some useful tools already available to increase available funds. For example, it can choose to allocate Section 515 funding among a variety of preservation activities, including owner incentives. In the past, the amounts RHS has made available for preservation activities, including owner incentives, have not been sufficient to meet demand. This has alienated owners and made transfers more difficult and time consuming. The Task Force, unlike the Comprehensive Property Assessments authors, supports the continued use of incentives. Owners should not be overpaid, but incentives are a form of long-term tenant and community protection, and all parties agree that tenants need to be protected.

RHS currently has authority to forgive debt when justified by an appraisal; if 515 debt exceeds the appraised value of a property, RHS/RD can forgive the debt above the appraised value. Broader debt relief authority could enable property owners to access new debt for rehabilitation and modernization, and could also facilitate purchases and rehabilitation by owners who will retain properties as affordable housing. New RHS authority for debt bifurcation – i.e., turning part of the existing debt into a soft second mortgage – could also be of value if it is available to owners on terms that increase their access to property cash flow.

Additional funds could be provided to owners by RHS/RD allowing above-market rents in limited situations, when Rental Assistance is available to absorb the cost. Since Section 515 rents are calculated based on project budgets, sometimes after a refinancing or an ownership transfer along with renovation a properties calculated rents exceed market rents. RHS regulations do not allow project rents to exceed market rents, so in such a situation the property owner is prohibited from collecting enough rent to cover costs. Even a mission-driven purchaser is unlikely to be able to acquire and renovate a development that cannot cover its own costs.

The tax credit program deserves special attention because the majority of purchases and restructures of Section 515 developments rely on housing tax credit financing (while usually including other financing as well). Tax credit funding could be even more useful for these deals, however. First, the presence of Section 515 funding has been considered a federal subsidy that makes these projects eligible for tax credits on only 4 percent of the cost of acquisition and rehabilitation. Availability of 9 percent tax credits would attract larger equity investments in the rehabilitation of 515 properties. Second, while the National Housing Trust has determined that in their tax credit programs the vast majority of states have setasides or priorities for preservation and/or rural areas,
very few have setasides or priorities for rural preservation per se.

- **Empower and enable third-party funding.**
  
  o Facilitate greater private lender involvement in preservation. RHS, in partnership with Fannie Mae and Freddie Mac, should work to define the transaction types where third-party debt can be used in the preservation of the Section 515 portfolio. In addition, RHS should:
    
    - eliminate the zero-based budget concept to build reserves for future capital needs;
    - allow operating deficit reserve accounts; and
    - incorporate risk management concepts in underwriting and property operations.

  o Enable the secondary market’s involvement in preservation. Fannie Mae and Freddie Mac should continue and expand current efforts to encourage private lender involvement in preservation. To aid in that effort, RHS should leverage the resources of the secondary market by:
    
    - making it easy for the GSEs and lenders to use their current lending programs and guidelines for financing preservation properties;
    - partnering with the GSEs to find solutions to preservation and involve them in key discussions and initiatives; and
    - continuing to keep Fannie and Freddie abreast of the agency’s goals, priorities, and decisions that affect Section 515 preservation.

**Background**

Investment by private lenders is essential. The current approaches to preservation do not adequately address the requirements for long-term economic viability of properties and do not make room for the use of third-party debt financing concepts. The current Section 515 program is administered based upon the way it was created, when the government was the only lender and thus the only party subject to the risk of the transaction. To encourage third party debt providers, the program must be modified to account for the different risk tolerance of private lenders. Subordination by itself does not accomplish this. Properties must have a mechanism for recapitalization, they must have adequate protections for market risk, and they must be operated in a manner that will allow for long-term viability. The regulations still contain concepts that pose barriers and disincentives to Fannie Mae’s and Freddie Mac’s lender networks. Fannie Mae and Freddie Mac should be involved in efforts to maintain and increase preservation participation by lenders. They also need to be part of the solutions offered to make this happen.
Summary of Recommendations on Preservation and Revitalization

USDA/Rural Development/Rural Housing Service should:

- Improve communications between RD and state agencies.
- Ask state allocating agencies to set aside tax credits for 515 preservation.
- Permit operating deficit reserve accounts.
- Make RHS regulations consistent with other government and private sector financing standards for underwriting and process.
- Continue to provide incentives for owners to remain in the 515 program.
- Allocate more RHS funding for preservation.
- Request more RHS funding for preservation.
- Make subordination of Section 515 debt easier.
- Allow above-market rents when needed to cover costs.
- Facilitate greater private lender involvement in preservation.
- Enable secondary market involvement in preservation.

Congress should:

- Amend the tax statute, if necessary, to ensure that 515 properties are eligible for 9 percent tax credits.
- Enable RD voucher funding to be used as an incentive to owners.
- Authorize RHS to forgive and bifurcate debt.
- Appropriate additional funds for 515 preservation.
- Strengthen the Community Reinvestment Act.

State tax credit allocating agencies should:

- Set aside tax credits for 515 preservation.

HOME participating jurisdictions and CDBG entitlement areas and states should:

- Set aside HOME and CDBG funds for 515 preservation.

The Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision should:

- Implement the Community Reinvestment Act fully in rural areas.
Protect tenants.

- **Protect tenants against displacement, ensure that their homes remain decent, safe, sanitary, and affordable, and ensure that the housing is managed in a manner that protects their interests.**

**Recommendations**

- Use vouchers to protect tenants. Residents who are threatened with displacement from their homes by prepayments approved by the ELIHPA process, foreclosures, or maturing 515 mortgages must be protected by:

  - the issuance of vouchers that are comparable to HUD Enhanced Vouchers in that they allow the residents to remain in their homes for indefinite terms as long as the housing remains decent, safe, and sanitary;
  - require landlords to accept the vouchers and allow residents to remain in their homes;
  - maintain the residents' rent, including the cost of utilities, at 30 percent of household income even if rents are subsequently increased;
  - allow residents to use the vouchers in other decent housing in the community or in other communities; and
  - remain in the community for use by other tenants after the original tenants move away, leave the program, or die.

- RHS must adhere to the residents' full statutory right to appeal any decision made by an owner or RHS that would terminate their right to continue to live in their homes.* This includes the right to appeal a decision that an owner is entitled to prepay the RHS loan or a decision by RHS to foreclose on a loan without maintaining use restrictions on the development after foreclosure.*

- RHS must ensure that residents receive clear, adequate, and appropriate notices of any impending action with respect to their developments, that they be accorded one or more meetings with RHS staff at which any impending action is reviewed and discussed in detail, and that tenants receive routine and detailed updates of developments with respect to any impending action that affects their homes.* All notices to residents must be in plain English and where appropriate translated into other languages for residents who are not fluent in English.

* There was not unanimity on the points in this section where asterisks appear. At least one participant, Colleen M. Fisher from the Council for Affordable and Rural Housing (CARH), does not agree that residents have such a statutory appeal right, nor that it is reasonable to require resident comments as noted above. CARH continues its longstanding position supporting full owner prepayment rights, but CARH’s overall agreement with this report reflects its commitment to affordable housing and housing preservation.
RHS must ensure that residents are consulted and invited to comment upon any decision that RHS must make with respect to their development.* This includes decisions with respect to prepayment, revitalization, or foreclosure. Residents frequently have better knowledge and information about the condition of a development than anyone else.

- Inform and consult residents whenever an owner proposes to take actions that would affect the residents without causing their permanent displacement. This includes decisions to revitalize a development or to transfer it to a new owner. All notices must be in plain English and translated into other languages where appropriate.

- Standardize determinations of impact on minority housing opportunities. RHS must establish a process and clear standards through which RD/RHS staff will determine whether a prepayment will have a material impact on minority housing opportunities. It must be clear that unwarranted assumptions have no place in such determinations. Delete “disproportionate” from the section of the regulations relating to impact on minority housing opportunities.

- Define comparable housing and market area clearly. The Task Force endorses the definitions in RHS’s Multi-Family Housing Project Servicing Handbook (HB-3-3560, Section 15.22) of comparable housing and of the market area served by a project seeking to prepay, and believes those provisions should appear in the regulations rather than solely in the handbook.

- Protect tenants when loans are accelerated and paid off. RHS or HUD should provide enhanced vouchers for these tenants. Better coordination between HUD and RD regarding voucher allocation is essential. Beginning on the national level, the two departments must work together to give priority to these tenants in the allocation of Section 8 vouchers.

- Do not allow acceleration to be used to circumvent the prepayment process. Expand §3560.456(a) of RHS’s regulations so that alternatives to acceleration, including civil money penalties, can be considered any time a borrower defaults on a 515 mortgage, even if the agency is not sure the borrower is seeking to avoid the prepayment process.

Background

Residents of Section 515 properties typically have annual incomes of less than $10,000. More than half are elderly or are persons with disabilities. Given their circumstances, prepayments, transfers, and foreclosures of Section 515 loans, at the very least, greatly increase residents’ anxiety about their ability to remain in their homes and communities and, more likely, cause their rents to increase or force their relocation to other housing.

Under current RHS regulations, residents of Section 515 housing receive limited and generally inadequate notices of impending action, and are provided little or no opportunity to comment upon,
let alone, affect, what will happen to their homes and to them. When a prepayment or foreclosure is
approved under conditions that do not require the owner to maintain the units as affordable housing,
the residents have no right to remain in their homes, nor to continue paying affordable rent, and no
assurance that they will be able to relocate to other subsidized housing or be provided other forms
of subsidies that will enable them to move into other decent and affordable housing in their
community. They are provided letters of priority entitlement that give them priority to move to
other RHS financed rental housing, but provide them with no assurances that such housing is
available in their community or even nearby communities, that units are vacant and available in such
housing, or that the rents in the units will be comparable to the rents that they are paying for their
current homes.

Some of the other tenant protections in the ELIHPA-established prepayment process have been
inadequately or improperly implemented. For example, the new multifamily housing regulations
require a determination whether a prepayment will have a disproportionate adverse impact on
minority housing opportunities (‘3560.658(b)). The word “disproportionate” does not, however,
appear in the governing statute (‘502(c)(5)(G)(ii)). While RHS directs RD staff to look at certain
data, RHS has never established standards for determining whether a prepayment will have a
material impact on minority housing opportunities. As a consequence, decisions are made according
to varying standards.

Standardization is also needed in RD staff determinations whether there is “an adequate supply of
safe, decent, and affordable rental housing within the market area of the housing”
(‘(502)(c)(5)(G)(ii)(II)). If there is not enough, an owner cannot prepay; thus these are very
important concepts. Currently, however, the regulations (‘3560.11) do not define comparable
housing. They define market area as the geographic or locational delineation of the market for a
specific project, including outlaying [sic] areas that will be impacted by the project, i.e., the area in
which alternative, similar properties effectively compete with the subject property. The terminology
in RHS’s Multi-Family Housing Project Servicing Handbook (HB-3-3560, Section 15.22) is far
more clear and easier to apply: RD staff must assess the availability of comparable housing in the
community . . . [to] determine if there is sufficient housing that is comparable in size and rent to
house project tenants in the local community without causing them rent overburden.

Finally, it is possible, though not common, for an owner to remove a Section 515 loan without
applying for prepayment or going through the prepayment process by defaulting on the loan. When
RHS responds by accelerating the loan, the owner is allowed to pay off the RHS loan without any
use restrictions being placed against the property. The Task Force’s recommendations related to
acceleration are intended to protect tenants in this situation regardless of an owner’s intent.
Summary of Recommendations on Protection of Tenants

USDA/Rural Development/Rural Housing Service should:

- Use vouchers comparable to HUD Enhanced Vouchers.
- Allow residents to appeal decisions that would terminate their tenancy.
- Provide clear, adequate, and appropriate notices to tenants.
- Ensure that residents are consulted and invited to comment on any decision made with respect to their developments.
- Inform and consult residents whenever an owner proposes to take actions that would affect the residents without causing their permanent displacement.
- Delete “disproportionate” from the regulations relating to impact on minority housing opportunities.
- Standardize determinations of impact on minority housing opportunities.
- Define comparable housing and market area clearly.
- Protect tenants when loans are accelerated and paid off.
- Do not allow acceleration to be used to circumvent the prepayment process.

Congress should:

- Authorize RD/RHS to issue vouchers that are comparable to HUD Enhanced Vouchers.