THE MARK-TO-MARKET EXTENSION ACT OF 2007
H.R. 647
Testimony before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Housing and Community Opportunity
By Amy S. Anthony, President
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Good afternoon, Madame Chairwoman and members of the committee, and thank you very much for this opportunity to appear before you to discuss the extension of the Mark-to-Market program.

My name is Amy Anthony, and I am President of Preservation of Affordable Housing, Inc., or POAH. My organization, which is based in Boston, is a national non-profit which is focused exactly as our name says, on the preservation of affordable housing, specifically privately – owned housing with deep public subsidy to make rents affordable to those on the lowest rungs of the economic ladder. POAH has been in existence for just over six years, and currently owns and manages 4,615 affordable rental homes in eight states and the District of Columbia. The more than 10,000 residents who live in POAH-owned homes typically earn 30% to 50% of area median income. Generally, they are low-wage workers and their children, or seniors on fixed incomes, or are disabled—in short, among the most vulnerable of our citizens.

POAH is also a founding member of Stewards of Affordable Housing for the Future, or SAHF, an organization representing seven of the largest national nonprofit owners of affordable rental housing. Drawing upon the practical experiences of its members, SAHF has developed a set of policy proposals to preserve properties within the HUD inventory. I speak to you today on behalf of my SAHF colleagues, as well, and before concluding I will offer some legislative suggestions on behalf of SAHF.

I would like to introduce my comments about the Mark-to-Market program by talking first about preserving affordable housing. While preservation is a small aspect of the country's overall approach to increasing housing affordability, it is an essential effort, and is making a difference in the communities which each member of this committee represents.

What is preservation? At POAH, preservation refers to a strategy to maintain the long-term affordability of already built rental housing which is usually privately owned but operates with deep public subsidy to make rents affordable to households earning, on average, $16,000 or less.

Between 1965 and 1990, $60 billion in federal funding was invested to create this housing--privately-owned, affordable rental homes for families, the disabled and the elderly. These homes were built in big cities, small towns and rural areas across the country. They were multi-story high-rises and single family bungalows. But all were built according to the same premise: that the government would provide funds to underwrite construction and operating costs, and in return, owners would promise rents affordable to low income families and seniors on fixed incomes for the duration of the fixed financing period. However, with the expiration of each financing agreement structured in past decades, the leverage for keeping rents affordable is lost.

POAH, and nonprofit owners like us, preserve this housing by purchasing the properties from owner seeking to exit the program. We are able to structure long-term financing to ensure continued 'affordability' -- meaning that the rents do not cost low- and moderate-income households more than 30% of their annual income. All of the buildings we purchase are older, and many are tired after decades of hard wear and tear. As part of the purchase, we attend to physical improvements wherever possible, to ensure that on our watch the property can again provide a long-term source of decent, safe and attractive housing that benefits families, neighborhoods and communities.

Why preserve this housing? There is no question of the need. Each member of this committee no doubt is familiar with the desperate bind low-wage workers or elderly pensioners can face in the search for decent, clean, safe housing they can afford. Harvard University's Joint Center for Housing Research asserts that across America there are now 5.4 million more low income households than there are affordable apartments available.

Decent, safe, affordable housing is part of our self-definition as Americans. As a country, we believe that no one should be homeless, and we understand fundamentally that a stable home contributes to healthy children, healthy families and healthy communities.

Beyond any moral or civic motivation, preservation is responsible. It is good stewardship. It is environmentally friendly. It wastes less, and conserves more. Preservation recognizes that these properties—the buildings, the land, the homes—represent an essential resource that should not be thrown away thoughtlessly. Billions of taxpayer dollars were invested in to create and sustain these homes, and there is a fiduciary responsibility to their care. Losing these homes diminishes supply, drives up demand, raises prices and further divides the housed from the unhoused. Losing these homes to a lack of will or foresight is the worst kind of waste.

Preservation is also realistic. Given the current cost of capital, land, labor and building materials, as well as the reluctance and even refusal of many communities to consider large-scale rental developments, it should be no surprise that—according to the same Joint Center research—for every two affordable units which drop out of inventory, on average only one new unit is built. Most new affordable housing production is—for both zoning and financial reasons—on a significantly smaller scale than what was built previously. So it is not only that, without preservation, we are losing 150-unit, deeply affordable housing developments and replacing them with 40-unit tax credit developments—although that is the case. It is also emphatically that we are losing 150-unit developments in communities with good schools and job growth, and replacing them with 40-unit developments in more remote places, where jobs are fewer and services are less, because such locations are more feasible economically and sited more easily. That is the tide of resource allocation that preservation seeks to stem.

The other compelling reason to preserve and improve existing affordable homes is basic common sense: preservation costs less.

For all of these reasons, preservation is essential. Low wage workers, families of modest means, elders and the disabled on fixed incomes must live somewhere. If this housing is lost, where will they go?
And that is why Congressional action is essential. I want to urge this committee and the Congress as a whole to move forward with the greatest dispatch with legislative support for preservation. I cannot underscore too strongly the immediate and pressing need for Congressional action to address preservation. Our enormous national investment in affordable housing is maturing, the market is intervening, and with each passing day, in every corner of the country, America is losing these homes. We need speedy and effective action by this body to affirm the importance of housing preservation with both strong,

comprehensive legislation and funding sufficient to allow HUD to meet all of its fiduciary obligations.

That is my broad challenge to Congress. Today, the immediate issue before us is extending the life of the Mark-to-Market program. I want to support that extension generally, and talk specifically about some methods of improving this important and forward-looking program.

In its first decade, the Mark-to-Market program has generally proven to be an essential tool in the effort to preserve affordable housing, as well as a creative model for a new way forward in the partnership between government and nonprofit housing owners, one we believe can be extended and improved to benefit thousands of additional homes. The HUD Office of Affordable Housing Preservation, or OAHP, reports that through last week, it had completed 1,613 full restructurings to preserve 132,664 units, resulting in multiple millions of dollars in rent subsidy savings to HUD.

POAH has purchased 15 Mark-to-Market properties in three states and the District of Columbia. Collectively, these transactions have preserved and physically restored nearly 1600 rental homes serving working families, seniors and the disabled. We have found that the underwriting in Mark-to-Market transactions is sound, and that the refinanced properties are therefore better positioned to survive fluctuations in operating expenses such as utility or insurance costs. We also observe that Mark-to-Market is especially useful in weaker economic markets, where it enhances the value of available state resources.

Of course such results are important, and noteworthy, and I am sure that Deputy Assistant Secretary Toon will have more to say about the results his department has realized under the Mark-to-Market program. While Mark-to-Market is important for its results, it is also important as a prototype of what a new HUD—a reconstituted HUD—could achieve. The Mark-to-Market program is central to the good news from HUD.

Mark-to-Market is deal-oriented. It aims for a bottom line outcome which benefits the agency, the new owner, the residents and the community. Mark-to-Market deals have a give-and-take calculus which mirrors that in the broader real estate marketplace. This is in part because the OAHP staff are not paralyzed by precedent. Their program was created with the benefit of advice from the marketplace, from a panel of expert real world practitioners who counseled Congress on creating a program which could operate like the private sector while realizing public benefit. Mark-to-Market is further bolstered by the use of PAEs, Participating Administrative Entities, which investigate each deal in the context of its locale, determine alternatives beneficial both to the agency and the deal, and push for timely resolution. All of these elements are business-like in their motivation, and combine to give the program its real-world feel.

I also want to compliment the staff at OAHP. POAH has worked closely with OAHP staff on 15 Mark-to-Market deals, and they are to be commended. Although the federal bureaucracy is often criticized for its lack of originality or efficiency or imagination, we have found this group to be responsive and committed partners in meeting the preservation challenge.

While I want to encourage the committee to move forward with extending this important program, my support presumes certain improvements which we deem essential to its future success.

First, HUD's primary goal for Mark-to-Market transactions should be preservation, not improving its own balance sheet. To that end, when the purchaser of a Mark-to-Market property is a qualified nonprofit owner, HUD should not demand repayment of any portion of secondary debt from state or local dollars contributed to the deal specifically so that housing can be preserved. We believe that HUD's efforts to the contrary, the motivation for which is unclear, are specifically undermining efforts to preserve affordable housing.

Congress clearly intended, in extending Mark-to-Market five years ago, to enhance preservation purchases by nonprofit organizations committed to long-term, responsible ownership. More recently, however, HUD has made it a practice in Mark-to-Market deals to require repayment of junior debt. The source of funds for such repayment is generally dollars which states and localities have contributed to the preservation purchase. HUD contends it is making this demand to ensure that the seller does not realize undue profit from the Mark-to-Market restructuring. Such targeting of sellers is misplaced and is in fact based on a false premise. Moreover, it is a disincentive to states to participate in these restructurings, rather than encouraging their close participation in underwriting the appropriateness of the transaction.

Without incentive, owners seeking to realize the maximum compensation from an aging deal can simply wait until the mortgage expires, and take their chances in the open market—removing preservation from the calculus. When a socially-motivated owner has lived up to his or her initial agreement with the government, has operated a property well and maintained its affordability over time, and is seeking at exit simply to recover their own initial investment in order to meet the tax costs of exiting, HUD's position is in fact a significant step in the wrong direction, one which discourages owners from an appropriate transfer of the asset and which potentially sets the stage for abandonment of many projects.

In reauthorizing Mark-to-Market, Congress should clarify its expectations around debt forgiveness when an existing owner seeks to sell the property to a nonprofit purchaser. Mark-to-Market should not exist as a mechanism to break the government's original commitment to these early, steadfast owners.

Second, the legislation should remove the artificial three-year period during which HUD will assign or forgive such debt, an unwritten rule reportedly imposed by the Office of General Counsel. Preservation transactions often involve generations of private owners with significant estate or other tax considerations typically requiring far longer than three years to resolve. HUD's own data indicates that by the end of the last fiscal year, three-quarters of the closed portfolio had passed its eligibility date for debt forgiveness. Legislation should cure this circumstance, by extending the period from three to five years, and by including a two-year refresher window for revisiting early deals. Too many of the transactions undertaken in the early years of Mark-to-Market received insufficient financing for physical rehab and should be revisited.

The physical needs of properties which were restructured early on in the program were purposefully, but mistakenly, overlooked. These buildings are already showing signs of their underfunding, and because they are hamstrung with debt, cannot access other resources. Without legislative action, their long-term future as both affordable homes and community assets is in jeopardy.

According to OAHP, the average dollars spent on rehab for a property that has gone only through restructuring is between $2,000 and $3,000. However, when properties benefit from nonprofit debt assignment, the forgiven debt becomes an asset, counted in basis for the purposes of tax credit allocations. As such, the average rehab on these properties is approx $25,000. The two-year refresher window we are seeking through legislation would create a new opportunity for these early deals to benefit from debt assignment.

In the category of legislative improvements, I want to briefly mention exception rents. Congress needs to lift the exception rent cap so that OAHP remains able to restructure properties in certain unusual markets. In these locations, contract rents of up to 120% of fair market are still insufficient to support basic operations. It is worth noting that approximately two-thirds of properties which have already been restructured using exception rents have still realized savings to HUD, since even at the 120% level, the rents were lower than they had been before restructuring.

SAHF has a robust and lengthy list of policies it believes can be enhanced legislatively. These include:

- authorizing project-based subsidies in lieu of enhanced vouchers;
- allowing new preservation owners to rely on 20-year Section 8 contracts;
- allowing Rent Supplement and RAP contracts to be converted to Section 8 contracts; and,
- allowing maturing mortgages to be eligible for new Section 8 contracts.

I will provide written details of all of these items as part of the Committee's record.

You have also asked for thoughts about what might be expected if the Mark-to-Market legislation fails to pass. Certainly one outcome can be seen in what OAHP calls "Mark-to-Market lite". The Agency has completed 730 so-called 'lite' restructurings of 68,812 units. Lites, which re-set the rents without refinancing the mortgage, may help HUD's treasury but certainly do not benefit the long term certainty and condition of decently-preserved affordable housing.

Preserving affordable housing is what we at POAH do, and we welcome every tool which can assist us in achieving that goal. The Mark-to-Market program has proven its value, and the OAHP staff have proven that agility and creativity are possible in its administration. This is a style of governing that should be applied more broadly across the agency. But we should also be mindful that "Mark-to-Market" is a program within the *Office of Affordable Housing Preservation*—a name which suggests a wide-ranging mandate, one which would appropriately attend to the legions of properties needing concern and redress all across the country, not only those within a narrow bureaucratic window. I urge the Committee to consider the mandate and the funding of this office as part of your deliberations..

We are grateful to this Committee for your willingness to hear our ideas, and for the cooperation which we anticipate in the weeks and months ahead toward our shared goal of a stronger, more thoughtful, more resilient program to preserve affordable housing.

Thank you again for the opportunity to be heard this afternoon on this very important matter.

PRESERVATION EMPOWERMENT ACT OF 2007
Illustrative Transactions and Data

TITLE I
Short title; definitions

Within the Preservation Empowerment Act of 2007, SAHF proposes to define a qualified preservation owner as an entity that, in connection with its purchase of a project, agrees to a use restriction that retains the use and affordability of the property for a term of not less than 40 years *and provides an* assignable right of refusal *in favor of the State housing credit agency.*

TITLE II
In the case of a preservation transaction, permit owners to replace fully funded Sec. 8 contracts with new, long-term contracts subject to annual appropriations.

Authorize owners, or purchasers at the time of acquisition, to terminate the remaining portion of 40-year project-based Sec. 8 contracts on properties with state- or locally financed debt, provided that they (1) enter into new 20-year project-based Sec. 8 contracts subject to annual appropriations, (2) enter into commitments to preserve the affordability of the housing for at least 40 years, assuming continued rental assistance, and (3) receive the approval of any state or local lender that will continue to hold a loan secured by the property after the termination.

DATA

Between 2007 and 2033, the contracts will expire on more than 170,000 apartments with project-based Sec. 8 and state- or locally financed debt.

Contracts on more than 41,000 units are set to expire from FY07 through FY11.

Comprehensive data on the number of units and their locations is available via the SAHF Web site.

Source: HUD

Bridle Path. The long-term HAP contract on this 104-unit elderly affordable housing community in Randolph, Massachusetts, will expire in 2013. Preservation of Affordable Housing (POAH), a national, not-for-profit housing organization dedicated to preservation, intends to acquire and rehabilitate the property. To attract lenders and equity investors in order to compete with for-profit purchasers who would keep open the option of converting to market, POAH's acquisition/rehab. financing plan calls for termination of the existing HAP contract and its replacement with a new, long-term contract subject to annual appropriations. MassHousing is the lender and will continue to hold the loan after the HAP contract is terminated.

POAH intended to acquire the property under the Nonprofit Transfer Program, which is designed to encourage the transfer of Sec. 8 properties to qualified not-for-profit buyers. The program offers the ability to (1) mark below-market rents up to market, (2) terminate existing contracts early, and (3) obtain a new 20-year Sec. 8 HAP contract subject to annual appropriations. Chapter 15 does not make eligibility for any one of these tools contingent on the use of all of them, but the local office of HUD has insisted that Bridle Path may not use the second and third (replacement of the existing contract with a new 20-year contract), because it will not need the first (rent mark-up), as rents are already at market.

Absent a HAP contract of sufficient duration to cover at least the LIHTC compliance period, MassHousing must underwrite the property assuming that rents will fall to the tax credit rent level when the current

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contract expires, resulting in a 10 percent ($1.5M) reduction in supportable debt and thus fewer overall resources leveraged for preservation.

TITLE III
Permit access to distributions of excess cash flow and access to equity for not-for-profit housing providers.

1. *Override HUD regulations that restrict distributions to not-for-profit parent organizations.*

   Elaboration. In the treatment of "surplus cash" or "residual receipts," HUD regulations differentiate between profit-motivated, limited-distribution, and not-for-profit owners. For example, in HUD's "Regulatory Agreement for Insured Multi-Family Housing Projects (With Sec. 8 Housing Assistance Payments Contracts)," a profit-motivated owner is entitled to a distribution of any cash remaining "at the end of a semiannual and annual fiscal period" after the payment of all debt service, required deposits to the reserve for replacement account, and other obligations of the project.

   Limited-distribution owners are entitled to a payment of distributions (limited to 6 percent of their initial equity investment) before the residual receipts balance is calculated.

   Not-for-profit owners, on the other hand, are entitled to no distribution. Any cash remaining after the obligations of the project have been met are collected in a "residual receipts" account that is controlled by HUD and remains with the property.

	OWNERSHIP TYPE		
	Profit-Motivated	**Limited-Distribution**	**Not-for-Profit**
Total Revenues	$500,000	$500,000	$500,000
Operating Expenses	$260,000	$260,000	$260,000
Debt Service	$200,000	$200,000	$200,000
Reserve deposits	$10,000	$10,000	$10,000
Total cash expenses	$470,000	$470,000	$470,000
Cash remaining at end of fiscal period	$30,000	$30,000	$30,000
	Distribution of cash remaining at end of fiscal period		
Permitted distribution	$30,000[1]	6 percent of initial equity investment	$0
Residual receipts	$0	Balance remaining after distribution	$30,000 (stays with property)

[1] HUD refers to a payment to a profit-motivated owner as a payment of "surplus cash," not a "distribution."

2. *Specifically authorize a nonprofit housing provider to place any proceeds from the sales of properties it owns into a trust fund for the use of the seller or its nonprofit parent in furtherance of its affordable housing mission.*

   Pilgrim Tower North. PTN was developed as a Sec. 236 property owned by the Retirement Housing Foundation (RHF), a national, not-for-profit housing organization. Located in Pasadena, California, the property provides 258 apartments to elderly renters; 205 of the apartments benefit from project-based Sec. 8.

   In 1986, ownership of the property was syndicated to a limited partnership with a for-profit managing general partner wholly controlled by RHF. At the time, the limited partners set the terms of their exit, requiring that RHF assume the Sec. 236 mortgage, Flex. Sub. loan, and HAP contract. Once RHF had assumed these obligations, it turned around and sold the property to a new limited partnership, this time with a not-for-profit managing partner.

   RHF realized a substantial gain on the sale of the property to the new limited partnership. The proceeds were deposited in a trust account. The trust agreement negotiated with HUD permits expenditures for a broad range of affordable housing activities. Thus far, RHF has tapped into trust monies to purchase land on which it will later build a LIHTC property and to preserve properties within its Massachusetts portfolio. In terms of permitting access to proceeds and assuring maximum flexibility in their use, this transaction could serve as a model.

3. *Permit the HUD Secretary the discretion to authorize sellers to retain proceeds as they exit the field of affordable housing and transfer ownership to preservation purchasers.*

   Paraclete Manor. This 120-unit Sec. 202 property was constructed in Kansas City, Missouri, in 1964 and faced serious rehabilitation needs by the time the original owner offered it for sale in 2005. With an outstanding Sec. 202 mortgage of $418,000 and two Flex. Sub. loans totaling $1,973,385, the property was so loaded with debt that any additional borrowing would have resulted in substantial rent increases on both the assisted (102) and unassisted (18) apartments. Neither the Sec. 8 program nor the market would support such increases.

   In addition, the nine-story property required substantial rehabilitation, including a new elevator and heating plant. Many of the units had their original kitchens and bathrooms. The plan submitted to HUD by Preservation of Affordable Housing (POAH), a national, not-for-profit housing organization interested in acquiring and preserving the property, called for renovations of approximately $8,300 per apartment, an amount far beyond the minimal level of rehabilitation that could have been supported using replacement reserves.

   To support the acquisition/rehab., POAH put together a financing plan that included federal and state tax credit equity of nearly $2 million. It also obtained a new Risk Share first mortgage of more than $1.8 million. Given the magnitude of the unpaid balance of the Flex. Sub. debt, the deal could not proceed unless HUD permitted POAH to assume and extend this debt. HUD denied this request, citing proceeds to the seller as the cause for the denial.

   Despite letters of support from the Mayor of Kansas City and state and local elected officials, as well as the endorsement of the tenants, who were pleased with POAH's plans for rehabilitation and to bring a service coordinator to the property, the transaction did not go forward. The owner has decided to sell after the existing use agreement has expired, after which HUD will have no say regarding the terms or conditions of the sale.

TITLE IV
Extend the period of eligibility for not-for-profit purchase incentives and clarify that HUD may not require repayment of any portion of junior M2M debt in transactions deploying such incentives.

Modify the Mark-to-Market statute to extend the period of eligibility for not-for-profit purchase incentives and to clarify that HUD may not require a repayment of any portion of junior M2M debt in cases of acquisitions by not-for-profit purchasers using purchase incentives and state or locally allocated housing resources.

The Willows. The Willows provides 263 affordable rental apartments to a combination of elderly and family households in Bartlesville, Oklahoma. All four of the properties went through Mark-to-Market (M2M) restructuring in April of 2001. In 2006, Preservation of Affordable Housing (POAH), a national, not-for-profit housing organization, responded to a broker's solicitation, making a bid to purchase the properties from the for-profit owner. The bid was accepted, and POAH was given less than a year to put together a capital plan and acquire the properties.

The properties required new exterior siding, windows, and the replacement of many interior components, including mechanical systems. POAH also intended to introduce resident services. Recognizing that the scope of need at the properties went far beyond the reserves made available by the M2M restructuring, POAH applied for 9 percent LIHTCs and pursued funding through the Federal Home Loan Bank of Topeka. It received a commitment of $500,000 from the FHLBank and a resolution of support from the local government.

In its capital plan, POAH intended to bring roughly $6.4 million to the table in LIHTC equity and to hold rents constant. From HUD, POAH requested the assignment of subordinated M2M debt. Though it had the discretion to approve this request, HUD denied it. In addition, HUD required as a condition of the sale that POAH pay down the subordinated debt by 25 percent. To accommodate these demands, POAH would have had to undertake less rehab., lower the properties' reserves, or reduce its already modest purchase price offer. As the first two options were unacceptable to POAH given its long-term ownership horizon and the third would have undermined its position in a competitive acquisition environment, POAH was forced to walk away from the transaction.

The properties' rental assistance contracts expire in 2011. Sale to a qualified not-for-profit presents the only viable alternative in terms of recapitalizing the properties and repositioning them for the long-term. As things stand now, options available to the current owner upon contract expiration include renewal at a rent level insufficient to accomplish the necessary rehab. or opt out.

TITLE V
Authorize preservation project-based assistance in lieu of enhanced voucher assistance.

Authorize project-based assistance in lieu of enhanced vouchers to make it possible both to protect existing tenants in a project and to preserve the affordability of units at the project where an owner or purchaser seeking to preserve affordability at the property chooses to do so.

Fairweather Apartments. Located on Boston's North Shore, the Fairweather Apartments comprises 321 affordable apartments spread among four properties. The limited-dividend owner is exiting, and Preservation of Affordable Housing (POAH), a national, not-for-profit housing organization dedicated to preservation, is in the process of acquiring and preserving the properties.

In order to refinance and secure the resources to make needed renovations to the Fairweather, POAH will prepay the existing subsidized mortgages. This act will however trigger the issuance of enhanced vouchers. Because enhanced vouchers are tenant-based and not project-based, lenders make some assumptions about attrition and underwrite a property's financing accordingly. At the Fairweathers, project-basing just a under half of the enhanced vouchers would increase the underwritable debt by more than 13 percent, providing greater resources to support the acquisition and rehabilitation of the property. In short, project-basing would permit the new owner to better leverage existing subsidy dollars.

TITLE VI
Convert Rent Supp / RAP contracts to project-based Sec. 8.

Congress should permit owners to convert Rent Supp and RAP subsidies to project-based Sec. 8 assistance. This action would protect low-income tenants in danger of losing their homes, save valuable rental housing, and in some cases make it possible to mark rents up to market to facilitate rehabilitation. This proposal has been scored on a preliminary basis by the Congressional Budget Office as creating a $410 million savings in fiscal year 2007 and a $292 million savings in fiscal year 2008. The savings is derived from the cancellation of long-term contracts and their replacement with one-year contracts subject to annual appropriations. This proposal is retroactive with respect to elderly housing projects to October 1, 2006.

DATA

Between 2007 and 2029, the Rent Supp/RAP contracts will expire on more than 32,000 apartments nationwide.

Contracts on more than 7,100 units are set to expire from FY07 through FY11.

Comprehensive data on the number of units and their locations is available via the SAHF Web site.

Source: HUD

Viewpoint Apartments. Located in Sandusky, Ohio, Viewpoint is a 153-apartment Sec. 202 property. Thirty of the units benefit from Rent Supp assistance; 54 have project-based Sec. 8. The rest of the units are unassisted. In 2006, National Church Residences (NCR), a national, not-for-profit housing organization, was approached by the owner, the local Kiwanis organization, which was interested in selling. At the time, the building was suffering a high vacancy rate due to a preponderance of unmarketable efficiency units. The operational burden of the vacancies was putting the entire building at risk.

Located in a weak market area, the property was unable to support new debt. In order to reconfigure some of the efficiencies into 1-bedroom units and address existing rehab. needs, NCR applied for 9 percent LIHTCs and sought permission from HUD to assume the existing mortgage. In order to maximize its LIHTC equity, NCR formed a limited partnership with a for-profit general partner, which NCR wholly controlled. Given the for-profit ownership structure, HUD denied NCR's request to assume the Sec. 202 mortgage. NCR was thus forced to prepay the mortgage, which resulted in cancellation of the Rent Supp contract. Lacking adequate project-based assistance, NCR was unable to leverage new debt. In the end, the entire acquisition/rehab. was financed with LIHTC equity and state trust fund monies. (NCR inquired as to whether the balance of the fully funded Rent Supp contract could be made available to the property when the contract was canceled and was told that it could not.)

The tenants in units formerly assisted with Rent Supp received regular vouchers, but the payment standard on the vouchers (set by the local public housing agency) is lower than the Rent Supp rents (set by HUD). The underwriting was additionally complicated due to the fact that vouchers are portable, not project-based. The net effect of the cancellation of the Rent Supp contract was a reduction in the amount of rehab. that could be accomplished. Alternatively, if NCR had been able to convert the Rent Supp contract to a project-based Sec. 8 contract, the building would have been able to support a new first mortgage and thus a greater level of rehab. For preservation purchasers who are recapitalizing with the twin goals of renewed affordability and long-term ownership, accomplishing necessary rehab. at the point of recapitalization is essential.

TITLE VII
Preserve the affordability of older properties without project-based Sec. 8 rental assistance.

Award 15-year project-based preservation assistance, as a matter of right, to a qualified preservation owner/buyer who (1) agrees to enter into a commitment to preserve the affordability of the housing for at least 40 years, assuming continued rental assistance, and (2) receives state or locally allocated housing resources, including but not limited to low income housing tax credits, state or local funds, or tax-exemption.

Kirby Manor. Built in Cleveland in 1970, this 202-unit, Sec. 202 building was on its way to default when National Church Residences (NCR) acquired it from its original not-for-profit owner (Catholic Charities). Lacking any form of project-based rental assistance — despite average tenant incomes of just $10,000 per year — and with a 10 percent vacancy rate, the property was unable to cover even its basic operating costs.

NCR recognized that addressing the high vacancy rate meant combining some of the 300–square foot, studio apartments into 600–square foot, 1-bedroom units. When other rehab. needs were added to the costs associated with this unit reconfiguration, total redevelopment costs came to just under $16 million. To finance these expenses, NCR pursued LIHTC equity, creating a for-profit ownership structure. As a result of HUD agreeing to let this new ownership structure assume and subordinate the existing Sec. 202 mortgage, NCR was also able to take on new debt in the form of a 221(d)(4) mortgage.

The redevelopment of Kirby Manor was completed in December 2005. The property has a natural turnover rate of about 10 percent and is fully leased. New tenants may earn up to 50 percent of the area median income. The gap between what existing tenants can pay and the building's operational needs is covered by a $1 million rental reserve made possible by a contribution of HOME funds from the city of Cleveland.

DATA

From August 2007 through July 2017, mortgages on 2,044 properties will mature, according to HUD.

Of these properties, 636 (51,523 units) have 100 percent rental assistance. Within the 1,408 properties with partial rental assistance, there are 102,321 assisted apartments and 179,099 apartments overall. Forty-one properties with a combined total of 7,062 units are completely unassisted.

A U.S. Government Accountability Office study published in April 2007 found that owners of properties with rental assistance on fewer than 50 percent of the units were more likely to opt out. Of the 2,044 properties with maturing mortgages, 592 fall into this category. These properties have a combined 20,447 assisted units and 79,343 overall units.

Comprehensive data on the number of units and their locations is available via the SAHF Web site.

Source: HUD

Absent a new form of project-based Sec. 8, properties such as Kirby Manor can be preserved only with other available resources (e.g., LIHTCs), which brings about a gradual loss of units that are affordable to the nation's lowest-income renters.

TITLE VIII
Permit HUD to assign Flexible Subsidy loans.

The Flexible Subsidy program provided financial assistance to several types of federally assisted housing from the late 1970s through 1996. This proposal envisions using this debt as a tool to promote the sale of properties to nonprofits and to attract state and local resources to support preservation. It does so by authorizing HUD to forgive such debt or assign it to a nonprofit in connection with a transfer of the property to a nonprofit, just as the HUD Secretary is authorized to forgive or assign subordinate Mark-to-Market debt. This proposal also prohibits HUD from requiring any repayment of the Flexible Subsidy debt in connection with its forgiveness or assignment if the not-for-profit purchaser is utilizing any state or locally allocated resources in connection with the transfer.

Vanderbilt Apartments. National Church Residences (NCR) acquired this 151-unit elderly property from a not-for-profit seller. The property had originally been developed under Sec. 236 and had project-based Sec. 8 on 96 of the apartments and a Flexible Subsidy loan. At the time of acquisition, the vacancy rate in the unsubsidized efficiency units at Vanderbilt was 54 percent (with 19 of the 35 units vacant). NCR intended to address this issue via a unit reconfiguration that would result in no net loss of assisted apartments.

In addition to resolving the vacancy issue via a unit reconfiguration, NCR intended to address the long-term physical health of the building. The recapitalization plan called for the replacement of all flooring, appliances, and cabinetry; extensive site work; a new roof; refurbishing all bathrooms; upgrades to common areas; and the installation of a security system, among other things.

To rehabilitate this HUD-insured property, NCR brought LIHTC equity and local housing trust fund monies to the table. HUD marked the rents up to market as requested by NCR under the Nonprofit Transfer Program. HUD also required, however, that NCR repay 25 percent of the outstanding Flex. Sub. loan. Since NCR intended to assume the underlying (1 percent) Sec. 236 loan and was bringing no new hard debt to the transaction, it paid HUD using HOME funds and a Housing Trust Fund Loan from the City of Asheville. Had the HUD Secretary been authorized to assign the Flex. Sub. loan to NCR, the loan could have been counted in eligible basis, which would have increased NCR's ability to leverage LIHTC equity.

TITLE IX
Extend permanently HUD's authority to approve transfers of project-based rental assistance as a means of preserving affordability for the nation's lowest-income renters.

In instances in which preservation owners wish to transfer project-based rental assistance from one property to another in order to preserve the physical or financial viability of the transferring property; to create affordable housing opportunities in areas served by employment, educational, or similar amenities; or to deconcentrate poverty, the HUD Secretary should be authorized to permit the transfer of such assistance. This authority should be permanent.

Three of the above examples illustrate appropriate potential uses of Sec. 318 authority, which should be streamlined:

- The Willows. These properties had partial Sec. 8 assistance and a unique configuration of apartments and single-family homes. In its acquisition plan, POAH sought permission to transfer rental assistance from the single-family homes to some of the unassisted apartments at the property. POAH intended to use the single-family homes to provide first-time homeownership opportunities for current tenants or for other low-income families within the community. POAH found, however, that local HUD officials were both uncomfortable with the single-family home sale concept and unwilling to support the transfer of rental subsidy.

- Vanderbilt and Viewpoint. Each of these properties was partially assisted and had a relatively high percentage of unmarketable efficiency units. Even though the unit reconfigurations were necessary to restore each property to a sound operational footing, NCR encountered strong resistance at HUD — in one case at Headquarters and in the other at the local office. HUD's strong adherence to the concept of "one-for-one replacement" was at the root of its intransigence. A more robust application of Sec. 318 should provide the flexibility necessary to preserve properties without reducing the overall number of assisted apartments. For example, the HUD Secretary should be authorized to permit the transfer of rental assistance from properties undergoing a unit reconfiguration to properties that have unassisted apartments.

Preservation of Affordable Housing, Inc.
Amy S. Anthony, President

July 30, 2007

The Honorable Barney Frank
Chairman, Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515-6050

Re: Assignment of M2M Debt to Qualified Non-Profit Purchasers

Dear Mr. Chairman:

I am writing to provide some background information with respect to correspondence you have received on the subject of HUD's new policy regarding assignment of M2M debt to qualified non-profit purchasers for post M2M projects, and to urge you to continue to press for changes to that policy to more accurately reflect Congress' intent. The policy is set forth in HUD Notice H 2007-05, "Guidelines for Assumption, Subordination, or Assignment of Mark-to-Market (M2M) Program Loans in Transfer of Physical Assets (TPA) and Refinance Transactions" issued on July 6, 2007

In a letter to you dated April 16, 2007, L. Carter Cornick III, HUD's General Deputy Assistant Secretary for Congressional and Intergovernmental relations set forth the rationale for the policy, as well as an illustrative recent example. That example happened to be of a transaction in which Preservation of Affordable Housing, Inc. (POAH) was a party, and as to which we have direct knowledge. The example is fairly typical of many other potential transactions, and while apologizing in advance for the lengthy dive into the relevant details, it is a good one around which the substantive issues involved in the policy could be illustrated in light of actual impacts.

The Case at Issue

The example used in the April 16, 2007 letter was of Sugar River Mills in Claremont, New Hampshire. The letter states that the owner entered M2M in 2004 with a project appraised at \$5.2 million and a 1st mortgage balance of \$8.2 million, and that after restructuring the project had a 1st mortgage of \$1.2 million, a M2M 2nd of \$5.1 million, and a M2M 3rd of \$0.6 million. Under our purchase and sale agreement, the seller would receive \$1.2 million. Mr. Cornick's letter makes the point that the \$1.2 million seller's "cash out proceeds at sale is equity that certainly did not exist pre-M2M."

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A little history would better inform the analysis of whether the cash out to the proposed seller is inappropriate or problematic.

In Sugar River Mills, as in many other similar developments in the late 1970's and early 1980's, HUD was trying to encourage the development of decent safe and affordable housing in challenged markets that were – for fundamental economic reasons – not creating such housing. In Claremont, and elsewhere, the market rent (even for market housing!) did not support the construction of new rental housing. In order to encourage the production of such housing – HUD took a budget based approach to the development process – and for the most part ignored the market. Accordingly – in Sugar River Mills in 1982, HUD approved rents that were 15 to 20% higher than current market rents (see the e-mail attached from the original Sugar River Mill developer). This is a sufficiently common characteristic of Section 8 deals of that time that it has its own term in HUD parlance – the "initial difference."

Induced by HUD's agreement to provide over-market rents to cover the cost of construction, as well as tax benefits and a 6% return on equity, the original owner invested $1.8 million into the project (along with HUD's original $8.1 million loan). For the next twenty years the project went smoothly – the housing was (and remains) a mainstay of the community.

HUD could have honored its initial commitment to owners by keeping rents at the levels required to service the properties' outsized debt, allowing owners to recapture their equity contributions through sale once mortgages fully amortized. That was the original deal. However, 20 years into the transaction, HUD was feeling significant budgetary pressure – and one of the main sources of that pressure was its Section 8 obligations. At the same time, it was noticed that there was a surplus in the FHA insurance fund. HUD realized that one way it could alleviate the Section 8 pressure was by making claims against the FHA insurance fund, and reducing its Section 8 payment obligations. This was the genesis of the M2M program.

It should be noted that in this process, HUD 'did the right thing' – by also providing for necessary physical improvements to the property at the time that the mortgage was restructured. However – it also compelled owners to go through M2M, leaving them with rent levels which could not service their significant subordinate debt, and no prospect of being able to recover their initial investments. To address this potential inequity, the qualified non-profit transfer aspect created an outlet by which owners could exit the program.

In Sugar River Mills, had the project not been restructured, the owners would have owned a $5.1 million debt-free property (its appraised value in 2002) by holding on to their original deal with HUD until the maturation of the original mortgage in 2023.

In 2004, the owners had a negative capital account of slightly over $3.6 million. Selling the building to POAH for $1.2 million over the outstanding mortgages would mean that, after the owners repaid the treasury for the tax losses that they had taken over their 22 years of ownership, they would get nothing of their original $1.8 million back.

In the April 16, 2007 letter – HUD states that it created the equity in these properties with the M2M restructuring. However, a review of the underlying facts reveals that it is not quite so simple. The owner would have had the ability to recoup more than its initial equity investment in the property if HUD had stuck to the original deal. By forcing a restructuring (in order to serve HUD's own financial exigencies), HUD positioned the owner such that they would never likely recover that investment.

The Policy More Broadly

While HUD's rationale for implementing its new policy has some superficial appeal, it cannot justify the policy's significant negative impact on preservation transactions. This policy should be eliminated because (1) it impedes the preservation of affordable housing, (2) it is contrary to legislative intent, (3) it diverts scarce housing resources from state and local allocating entities to HUD, and (4) it interferes with owners' legitimate claims to recovery of their initial equity investments. These issues are detailed below.

1. The policy impedes efforts to preserve threatened affordable housing.

The requirement that half of any seller proceeds be applied to repayment of junior M2M debt imposes a burden which in many cases is more than most transactions can bear, blocking the outcome which would be best for the property. Where applied, this policy has the effect of impeding the transfer of M2M properties from for-profit owners seeking to exit to not-for-profits with the resources and commitment to preserve the properties' affordability for the long run.

POAH's acquisition and rehabilitation of the Sugar River Mills property would not have been financially feasible under this policy. That transaction moved forward again only as a result of HUD's agreement to significantly reduce the amount of required repayment of M2M debt from $1.2 million to $200,000. While we sincerely appreciate HUD's accommodation in this regard (approved only because the transaction went under agreement prior to the policy being proposed), the fact is that absent such an accommodation – the deal would have died. The limited partner indicated unequivocally that it would not consent to any sale that did not clear the partner's exit tax liabilities – that they would rather hold on forever.

In the case of Sugar River Mills it should also be noted that the general partners were retiring – and were selling their entire portfolio. A policy that precludes such exits risks creating an economically moribund result – with disinvestment by the owners being one of several significant detrimental long-term consequences.

This is not the sole instance of the subject policy impeding a socially desirable preservation transaction. We know firsthand of a post M2M project that we proposed to purchase in Oklahoma - with significant unfunded rehab needs – that was not able to be preserved because of HUD's M2M prepayment requirements. We have reason to believe that there are many others similarly situated.

2. The policy is contrary to legislative intent.

This policy has the effect of undermining congressionally furnished incentives designed to encourage non-profit transfers, and as such it is contrary to legislative intent.

3. The policy diverts scarce housing resources from state and local allocating entities to HUD.

Most not-for-profit purchasers use tax credits and other state and local resources to make preservation transactions work. Proceeds to the seller in such transactions are the direct result of the state or local entity contributing resources, accordingly repayment of HUD M2M debt from seller proceeds represents a diversion of state and local resources from the preservation transaction to HUD. This state of affairs is not only inequitable, but also likely to discourage state and local entities from contributing resources to support non-profit transfers.

Another troubling element of this policy is the implied lack of faith in state and local entities' ability to allocate their resources effectively. In these transactions, any proceeds to the seller reflect the state and local allocating entities' assessment of the allocation of resources necessary and appropriate to make the transaction work. By imposing limits on seller proceeds through this policy, HUD is implicitly second-guessing and over-ruling these local decisions.

We believe the better policy is for HUD to trust these entities to make appropriate decisions regarding the use of their resources.

4. The policy interferes with owners' legitimate claims to initial equity investments.

As noted above – had HUD not created the M2M program to solve its own financial issues, the owners would have been able to recoup their original investment by staying in the deal until the mortgage matured. Nonetheless – we recognize that there is a line where fairness turns to abuse, and HUD has a responsibility to make sure that owners are not overpaid as a result of the non-profit transfers of M2M restructured projects. Our suggestion to HUD is that the bright line is the owner's initial equity contribution: unless the proposed sale would result in more than the owner's initial equity investment being returned, HUD should yield to the decisions of state and local entities in the allocation of their own resources - and not interfere with the owner's legitimate claim to recover their investment. Such interference is both unfair and hinders socially desirable transactions.

In the Sugar River case referenced above, for example, the owner is recovering $1.2 million in proceeds from the sale to POAH. This equates to just two-thirds of their initial $1.8 million investment, but it is enough to allow them to exit and transfer the property to POAH, which will rehabilitate and preserve it as healthy affordable housing.

In sum, the new policy represents a significant step in the wrong direction. Instead of encouraging additional resource being drawn in to preserve properties and encourage their transfer to socially motivated owners – it discourages both the additional resources and the transfer. In addition it sets the stage for economic abandonment of many projects.

As we all look at supporting legislation that would broaden the number of properties eligible to participate in the qualified non-profit transfer program – it is especially incumbent upon us all to make sure that we keep it working successfully.

Sincerely

Amy S. Anthony

Amy S. Anthony
Executive Director

Cc Ted Toon
Carter Cornick