FREQUENTLY ASKED QUESTIONS: HOUSING NOTICE 2012-08

This Frequently Asked Questions (FAQ) document provides clarification to Housing Notice 2012-08, *Updated Requirements for Prepayment and Refinance of Section 202 Direct Loans*. Notice 2012-08 implements the American Homeownership and Economic Opportunity (AHEO) Act of 2000, as amended. The Department intends to issue an update to Notice 2012-08 in the near future. In the interim, staff should refer to Notice 2012-08, along with this FAQ document, for guidance on Section 202 prepayments.

I. PROCESS

Q: Is it true that any prepayment application approved before publication of the Notice is to be processed under old guidance, and any prepayment application approved after publication of the notice must meet the requirements of the new guidance?

A: Yes. Notice 2012-08 applies to all prepayment requests that were not approved by HUD Headquarters prior to the date of publication of the Notice (May 4, 2012). This includes prepayment requests that were in process, but were not approved prior to May 4, 2012. Please note: an Owner does not need to re-submit the entire prepayment package, but may be required to provide updated or supplementary information to ensure compliance with Notice 2012-08.

Q: The Notice states that the field office must forward a copy of the recorded Use Agreement (UA) to Headquarters (HQ) as part of the submission for approval of a request. However, the UA wouldn't be recorded prior to HQ approval. How should the field office meet this requirement?

A: The field office will send the proposed UA to the Office of Asset Management for review in conjunction with the prepayment request/recommendation. After the prepayment and closing, the field office will send a copy of the recorded UA to HUD HQ Office of Asset Management.

Q: If materials that have been submitted to HUD as part of a prepayment application change, does this trigger the start of a new 30-day tenant notification and comment period?

A: No. The Owner must comply with the tenant notification requirements in Section IX of the Notice. Materials in the prepayment request are subject to change but this does not trigger the start of a new tenant notification and comment process.

Q: Should the field office continue to use the checklist that was attached to Notice 02-16?

A: No. The field office may copy pages 21 and 22 of Notice 2012-08 and use this as a checklist with the up to date submission requirements, as a way to track each item received/reviewed by the field. Under XIII, HUD Processing, paragraph A 8, states that the Hub submission and recommendation should include all items listed in Section X (Structure of the Transaction, Additional Considerations) of this Notice. The submission to HQ should also include all submission requirements in Section XII, B, Owner Submission Requirements.

Q: V.L. p. 7 says that if the prepay transaction does not involve an FHA insured loan, the Hub may be required to perform a Part 50 environmental review if the transaction involves substantial rehab. Who determines if this requirement is triggered?

A: The Hub may not waive the Part 50 Environmental review, but this review is not required in all cases. The Regional Environmental Officer can help determine if the review is triggered. Staff should carefully consult the regulations at 24 CFR Part 50.19 to determine if the project is categorically excluded from the environmental review requirements.

II. USE OF PROJECT FUNDS

Q: Section V.J of the Notice states that residual receipts in excess of $500 per unit may be used for the cost of activities designed to increase the availability or provision of supportive services or for other purposes. Is this still true, given the restrictions on residual receipts and/or is prior HQ approval needed to allow the funds to be used? What guidance should Owners and field offices use in determining the allowable use of Residual Receipts to support the 202 prepayment activities?

A: The 202 prepayment statute (AHEO, as amended), and Notice 2012-08, provides that the Secretary shall allow a project sponsor that is prepaying and refinancing to use residual receipts held for the project in excess of $500 per individual dwelling unit for the cost of activities designed to increase the availability or provision of supportive services. HUD Notice H-2012-14 requires Section 202 projects with a new regulation Section 8 HAP contract to use residual receipts in excess of $250 per unit to off-set Housing Assistance Payments (HAP). (See HUD Notice H-2012-14, footnote 3).

An Owner of a Section 202 project that is planning a prepayment and refinance may use funds in excess of $500 per unit for supportive services purposes. The funds specified for use over the $500 per unit balance should be set aside in an account separate from the residual receipts account at the time that the prepayment application is submitted to HUD (but not before such time) so that they can be readily drawn upon pursuant to the uses approved in the prepayment request. The Multifamily Hub/PC will review the Owner's proposed use of these funds to ensure that they meet the statutory requirement of increasing the availability or provision of supportive services at the subject property, and that the use of all funds in excess of $500 per unit is justified.

Pursuant to Housing Notice 2012-14, all new regulation 202/8 residual receipts in excess of $250 per unit must be used to make Housing Assistance Payment off-sets. The Owner must begin making off-sets as instructed in Notice 2012-14. If and when the Owner submits a prepayment application that includes supportive services, the Owner may segregate funds in excess of $500 per unit in a distinct account as described above. After these funds are segregated, off-sets required by Notice H-2012-14 must continue for the balance remaining in the residual receipts account (i.e., $500 per unit to $250 per unit).

III. SECTION 8 CONTRACT RENEWALS

Q: If an owner recently executed a 20 year HAP contract, do they need to terminate the HAP and execute a new 20 year contract and preservation exhibit?

A: Yes. All owners must agree to terminate the existing contract and renew the contract for a term of 20 years, and to execute the required Preservation Exhibit, using the process described in the Notice.

Q: Some 202 owners with Project Assistance Contract (PAC) assistance are proposing to prepay and refinance. Does HUD have the ability to renew PAC contracts for a 20 year term?

A: No. HUD does not have authority to renew PACs for 20 year terms. These contracts may be renewed upon expiration for one-year terms.

IV. SECTION 8 RENT SETTING

Q: For projects with Section 8 HAP contracts, what rents will be used going forward after the prepayment and refinance?

A: The owner is required to execute a new 20 year renewal contract, to which the Preservation Exhibit must be attached. Rents under the renewal contract are established based on the statutory formula corresponding to the renewal option that the owner selects (e.g., under Option 4, initial rents are the lesser of (i) existing rents as multiplied by OCAF, or (ii) budget-based rents). Rents are adjusted annually in the manner prescribed in the renewal contract.

Q: If the owner is submitting a budget to set rents for the new 20 year contract, will the Owner use the old 202 Direct Loan debt service, or the new debt service that will take effect as part of the prepayment/refinance?

A: As reflected in the recently published page changes to the Section 8 Renewal Guide (http://portal.hud.gov/hudportal/documents/huddoc?id=Transmittal_5-18-12.pdf), if an Owner is submitting a budget to set Section 8 contract rents, the Owner **must** list the current debt service in the budget. In the context of a prepayment, the current debt service is the debt service that will take effect when the prepayment is completed and the new loan closes. The Owner is not permitted to use the old 202 Direct Loan debt service.

Q: Section V.D of the Notice states: "Section 202 projects anticipating a reduction in debt service costs as a result of the prepayment may receive a Section 8 rent increase to fund operational needs other than increased debt service if the rent increase can be justified." What constitutes "operational needs"?

A: Please refer to Chapter 7 of HUD Handbook 4350.1 for guidance on eligible expenses.

Q: Section V.D of the Notice states: "Section 202 projects anticipating a reduction in debt service costs as a result of the prepayment may receive a Section 8 rent increase to fund operational needs other than increased debt service if the rent increase can be justified under a budget-based rent increase calculation." Does this mean that the owner must demonstrate debt service savings to justify a rent increase?

A: No. The owner (of a project with a Direct Loan interest rate higher than 6%) must demonstrate debt service savings (even $1) stemming from a reduced mortgage interest rate as a threshold to obtain approval for the prepayment. This debt service savings requirement is not related to whether the project is eligible for a rent increase.

Q: Section IV of the Notice states that Owners that do not require HUD approval for prepayment may voluntarily comply with the Notice. What benefit do Owners attain by doing so?

A: If the Owner has a Section 8 HAP contract renewed under Option 4, the Owner may continue to receive OCAF rent adjustments which may be at or above market levels. Please see the Section 8 Renewal Policy Guidebook, Chapter 6. If the Owner does not voluntarily comply with the Notice, the project loses its exemption from Mark-to-Market (M2M) restructuring if it is has a FHA insured or HUD held mortgage.

Q: Can an owner include debt service coverage in the Section 8 budget, similar to the way Section 236 Owners are permitted a debt service coverage line item as described in the November 6, 2000, Shaun Donovan memo?

A: Yes. Providing for adequate Debt Service Coverage (DSC) is necessary to ensure sound mortgage underwriting and to satisfy programmatic conditions of both FHA insured and non-FHA insured lenders. FHA, for example, requires DSC equal to 1.11 for 221(d)(4)'s with 90 percent or greater rental assistance and for 223(f)'s of a Section 202 property. Conventional lenders will generally require higher DSC due to the lack of FHA credit enhancement. For conventionally financed transactions, the conventional lender will determine the necessary DSC. However, please note that the Section 8 project rents must be determined according to the applicable renewal option, and constrained by market comparables or OCAF. HUD will not entertain a budget-based rent adjustment above market to fund this DSC.

In order to ensure that Section 8 rents subject to budget based formulation provide adequate DSC to satisfy FHA and conventional lender requirements, the following requirements apply:

1. For FHA-insured mortgages that are debt service constrained (Criteria 5 for FHA financed projects), Project Managers must ensure that the rents used in the loan underwriting equal the rents derived through the budget based Section 8 rent setting process. Using HUD's "Budget Worksheet" (form HUD-92457-A) staff must ensure that the DSC required in the underwriting is

added to the full debt service. For FHA insured loans, the coverage may not exceed program limits. Project Managers responsible for setting the Section 8 budget based rents must work closely with the Asset Development staff reviewing the FHA application to ensure that the correct DSC amounts are included in the budget based rent formulation.

2. For FHA-insured mortgages that are constrained by some other criteria (e.g. Criteria 1, 3, 4 or 10), Project Managers must also ensure that DSC for the mortgage amount derived by the controlling criteria is added to the full debt service. Again, for FHA insured loans, the coverage applicable to the controlling mortgage that is added to the full debt service may not exceed program limits. Project Managers responsible for setting the Section budget based rents must work closely with the Asset Development staff reviewing the FHA application to ensure that the correct DSC amounts are included in the budget based rent formulation.

3. For conventionally financed loans, the lender will determine the required DSC. Project Managers must obtain information on the loan underwriting from the project owner in order to determine what DSC amount to include in the rent formulation.

Q: If the prepayment involves the use of LIHTCs, what compliance fees may be included in the Section 8 budget?

A: In cases involving the use of Low-Income Housing Tax Credits (LIHTC), allowed project expenses may include only those usual and customary fees and expenses for operating a tax credit project, including payment of the equity syndicator's asset management fees; state allocating agency's compliance and asset monitoring fees; mandatory interest payments of up to one percent due on subordinate debt provided by a governmental lender; and deferred developer's fees, plus interest accrued at the applicable federal rate, which may be deferred for no more than 12 years. The deferred developer's fee may be included as an operating budget line item but may only be paid from surplus cash. The project rents may not exceed market rents for comparable units in the area. At the end of the 12-year fee deferment period, the project rents must be reassessed, since the deferred fee will have been fully paid.

V. DISTRIBUTIONS

Q: Please clarify the allowable distributions available to a Section 202 Owner in conjunction with a prepayment and refinance or acquisition. Notice 2004-21 specified that an Owner could take an annual distribution from surplus cash equal to 6 percent of the Owner equity that was paid at the refinancing of the project. Are owners still allowed a 6 percent distribution? How is this calculated?

A: As specified in Notice 2004-21, the maximum annual distribution from surplus cash is 6 percent of the Owner's (purchaser's) equity that is paid at the refinancing of the project. Other government funds (i.e., HOME funds, CDBG funds, etc.) will not be considered Owner's equity. LIHTC equity is not other government funds. LIHTC equity may qualify as Owner's equity, as may a Developer Fee, but only if this Developer Fee is contributed as a source of funds for closing. This distribution is authorized on FHA insured as well as conventional transactions.

Q: May a Section202 Owner request a waiver to receive unlimited distributions?

A: No, the distribution should be calculated using the above formula.

Q: Is it possible for the buyer to recognize any cash flow from the operation of the project, or reduced debt service, or will all cash flow be required to be deposited in the residual receipts account?

A: The Purchaser/Owner may realize a 6 percent distribution on equity contributed at the time of the refinance, as described above. Distributions are paid from available surplus cash at the end of the project's fiscal year. HUD does not monitor or approve how the Owner uses the allowable distribution. The Owner may also take the allowable Developer Fee, in the form of a Deferred Developer Fee, from surplus cash, using the required form of Residual Receipts Note (form HUD-91710M, Residual Receipts Note for Nonprofit Borrowers) or Promissory Note. All remaining surplus cash must be deposited in the residual receipts account.

VI. RE-REFINANCES

Q: Will HUD process re-refinances of 202 projects in accordance with Notice H 2004-21, Notice H 2012-08, or in accordance with the MAP Guide?

A: Re-refinances of 202 projects will be processed in accordance with the MAP Guide. Notice 2012-08 does not apply to re-refinances of Section 202 properties, except Section IX. All the requirements in Notice 2012-08 related to use of proceeds, contract renewals and use agreements apply only to the first refinance of a Section 202 Direct Loan. These requirements/restrictions do not apply in the case of a re-refinance. Notice 2004-21 also applies to the first refinance of a Section 202 Direct Loan, rather than a re-refinance.

Q: Section V(d) of the Notice discusses the exemption status of loans just refinanced one time. Is it true that a 202 is only eligible for Mark-to-Market restructuring after the second refinance has been closed and the contract comes to termination?

A: Yes. Assuming the project is re-refinanced using FHA insurance, applicability for M2M is triggered at the expiration of the Section 8 contract if rents at that time are above-market. The refinance may occur in the midst of a contract term. The referral to OAHP for M2M restructuring and rent adjustment to market would occur when the existing Section 8 contract expires. If the project is re-refinancing with FHA insurance, underwriting should assume market rents at the time of contract expiration and the lender should underwrite an A piece and a B piece to the loan to account for the rent adjustment.

Q: Is a new Section 202 Use Agreement required at the time of a re-refinance?

A: No. A re-refinance does not require execution of a new 202 Use Agreement.

Q: The Use Agreement explicitly requires under paragraph 7 to use "refinance proceeds" solely in accordance with the requirements of the initial 202 refinance. Should note the Use Agreement provide that such requirements are only applicable in connection with only the initial refinance of the 202 loan?

A: Paragraph 7 of the Use Agreement is being revised to clarify that the Use Agreement is only applicable in connection with the initial refinance of the Section 202 loan.

Q: Is a new 20-year HAP Contract renewal required at the time of a re-refinance?

A: No. However, the Owner may request a 20 year contract.

VII. USE OF PROCEEDS

Q: The Notice describes how to calculate a Developer Fee but does not specify the acceptable uses of the Developer Fee. Are there restrictions on how an Owner may use the Developer Fee?

A: The Section 202 prepayment statute (American Homeownership and Economic Opportunity Act (AHEO), as amended) specifies an allowable Developer Fee. The calculation of this fee has changed from prior 202 prepayment notices to reflect the change in statute; the Fee is now calculated based on the total development cost rather than anticipated repair costs. HUD will not monitor the use of the fee by the Owner.

Q: Section VII.B.4.b states that the Developer Fee can be based on 15percent of the "cost of acquisition;" however, this section is specific to properties that are not being sold. How can there be "acquisition" costs with no sale? Can you confirm that a Developer Fee is permitted on sales transactions?

A: To clarify, a Developer Fee is allowed in an acquisition or a refinance. In the event of a sale of a property, a Developer Fee is allowed. The Developer Fee flows to the purchaser, not the seller. The purchaser will be authorized a Developer Fee based on 15percent of the cost of the acquisition.

Q: May an Owner use proceeds from the new loan to purchase a property?

A: Yes, the proceeds from the new loan may be used to purchase a property, provided that the property meets the requirements outlined in Section VII.B.6 of the Notice (i.e., restricted as elderly housing, receiving HUD assistance, providing services).

Q: Section VII.B.1 says "Proceeds from the refinance may be used for not more than 15 percent of the cost of increasing the availability or provision of supportive services." What documentation will HUD require to verify the total cost of supportive services is being met?

A: HUD may request a social services plan to determine the total cost of the supportive services, the share of those costs to be funded by proceeds from the loan, and the viability of the supportive service plan. If the Owner is proposing to exceed the 15 percent threshold, the field office may submit a waiver request to the HUD HQ Office of Asset Management along with the prepayment request, or it may be submitted separately.

Q: May the Owner use project revenue to pay a subordinate loan?

A: 202 prepayment transactions may include subordinate debt. A good guideline for allowable secondary financing is provided in Chapter 8 of the MAP Guide. Typically secondary financing involves a surplus cash note, or is provided in the form of soft debt from a state or local government source.

Q: If the Owner is proposing "the addition or rehabilitation of related facilities," including "cafeterias or dining halls, infirmaries or other health facilities," as discussed in the Notice, what guidelines will HUD staff use to evaluate such proposals?

A: Under AHEO, as amended, and under the Notice, a 202 owner may propose such additions or facilities. Staff will evaluate on a case-by-case basis with consideration of the asset management of such projects. If the Owner is proposing to use FHA insured financing, meals and infirmaries are not permitted, except under a Section 231 loan, pursuant to the MAP Guide.

Q: If the Owner has other senior projects which are in financial difficulty, may the excess proceeds be used to keep such projects from defaulting on their debt, funding deficits or repairs?

A: HUD will evaluate such requests on a case-by-case basis as part of the prepayment application. The project receiving proceeds must meet all the eligibility requirements set forth in Section VII.B.6 of the Notice, and the proceeds must be used to ensure the long-term viability of the receiving project, rather than addressing a short-term or stop-gap financial need.

Q: The Notice excludes sales from the requirements of Section VII and VIII, Paragraph D. The implication is that any time there is a sale and a payoff of the original 202 Direct

Loan, that there does not have to be a justification of the use of the buyer's acquisition/rehabilitation loan proceeds. Is this correct?

A: No. In the case of a sale, there will be no restrictions on the use of sales proceeds from the transaction that flow to the selling Owner. This includes LIHTC and identity-of-interest transactions. However, HUD will carefully review the proposed use of the buyer's acquisition/rehabilitation loan proceeds coming into the project to ensure the proceeds will be used in accordance with the Notice.

Q: The Notice specifies that the proceeds will be monitored through Annual Financial Statements. Will Development or Asset Management have responsibility for this monitoring?

A: HUD Asset Management staff will review Annual Financial Statements to see that any funds not expended at closing are in a segregated account. Asset Management will also check that, at the five year mark after closing, the funds have been expended.

VIII. DEBT SERVICE SAVINGS

Q: Please clarify the term "proceeds from the refinance." Does this refer to debt service savings earned every month from the reduced debt service, or is this a lump sum of funds generated from the refinance that may only be used for the purposes described in the Notice?

A: "Proceeds" from the refinance are the loan proceeds that come into the project (i.e. the new loan, or other sources such as LIHTC equity or soft debt) at the time of the refinance. The 202 prepayment statute (AHEO) was amended to do away with the concept of ongoing "debt service savings." For Direct Loans with an interest rate of greater than 6%, the Owner must demonstrate a reduction in debt service as a threshold requirement for HUD approval of the prepayment. However, HUD will not calculate or monitor ongoing "debt service savings."

Q: In the event of a sale, is debt service savings required for deals with a Direct Loan interest rate of greater than 6%?

A: Yes

Q: The Notice does not state any requirement for escrowing of debt service savings. May a Hub develop a protocol to escrow and monitor debt service savings?

A: No. Debt service savings escrows are not permitted.

Q: Many properties that refinanced under the old 202 prepayment Notice have debt service savings agreements. If a property re-refinances, will these debt service savings continue to be escrowed?

A: No

Q: How will a project be able to continue to generate monthly debt savings if the budgets are processed using current debt service (which will be less than existing debt service)?

A: HUD is requiring Owners to use current debt (the new debt service to take effect at the closing of the refinance/acquisition) in Section 8 budgets. Because the new debt service is lower, it is likely that a project will not be able to generate monthly debt service savings. AHEO, as amended, removes any reference to ongoing debt service savings. For projects with Direct Loan interest rates above 6%, the Notice requires Owners to show in pro forma numbers that there is a lower interest rate and/or a lower loan payment – but debt service savings may not necessarily flow on an ongoing basis.

Q: May a 202 Owner submit a budget that includes a line item for "debt service savings?"

A: No. Owners may reprogram income and expenses into eligible project uses described in Chapter 7 of HUD Handbook 4350.1. Debt service savings is not an eligible expense.

Q: For transactions with interest rates in excess of 6% with rehab needs, is the test to determine debt service savings based on matching savings only to the amount being refinanced (comparing debt service on the existing permanent loan to debt service on the portion of the new loan that will be used to pay off the existing 202 debt)?

A: No. The statute does not provide for a distinction between portions of the debt.

IX. SALES PROCEEDS

Q: HUD has stated that the Notice lifts restrictions on sales proceeds for a nonprofit seller. Where is this language in the Notice and what does this mean?

A: Under the Applicability section of the Notice is language that Section VII pertaining to use of proceeds does not apply to sales transactions. What this means is that the seller may realize proceeds from the sale, and these proceeds are not restricted. HUD will not establish trust funds or escrow accounts for sales proceeds. Instead, HUD will carefully review the use of proceeds coming into the Section 202 project with the purchaser. This applies to identity-of-interest sales as well. If this is an FHA transaction, this policy overrides restrictions on sales proceeds in Section III.G of Notice 04-21.

Q: Are there restrictions on proceeds to a seller when the project is going through a re-refinance?

A: If the project is conventionally financed prior to the re-refinance, there are no restrictions on sales proceeds. If the project is FHA-insured prior to the re-refinance, restrictions on sales proceeds are lifted if the Owner complies with Housing Notice 2011-31.

X. PRE-1974 Section 202 Projects

Q: If a pre-1974 project does not need substantial rehab, can it still obtain approval for prepayment – for example, if a project has excellent REAC scores and the Capital Needs Assessment does not point to significant repair needs?

A: HUD recognizes that, notwithstanding good REAC scores, many older projects require significant structural repairs. HUD will consider waivers of the Notice requirement that all pre-1974 projects complete substantial rehab if the Owner submits a Project Capital Needs Assessment (PCNA) that evidences the project does not require substantial rehabilitation to ensure its long-term viability. The waivers must be submitted to HUD HQ Office of Asset Management and may be submitted as part of the prepayment request, or prior to the prepayment request. The PCNA must accompany the Hub/PC waiver request to HUD HQ.

Q: If a pre-1974 project can demonstrate a reduction in debt service, does it need to complete substantial rehab?

A: The Owner may request a waiver of the requirement for substantial rehabilitation. To be eligible for a waiver, the Owner must submit a Project Capital Needs Assessment (PCNA) that evidences that substantial rehabilitation is not necessary for the long-term viability of the project. Waivers must be submitted to HUD HQ Office of Asset Management and may be submitted as part of the prepayment request, or prior to the prepayment request. The PCNA must accompany the Hub/PC waiver request to HUD HQ.

Q: The Notice states that for pre-1974 properties, the rents for unassisted tenants may not increase as a result of the prepayment/refinance. If the voucher program or the SPRAC program requires tenants to pay at least 30percent of their income for rent, may existing residents be required to increase their rent contribution to 30 percent?

A: No. The Owner must use the proceeds from the new financing to protect residents from rent increases, throughout the household's tenure in the project.