

Council for Affordable and Rural Housing



Serving the Affordable Housing Needs of Rural America

Testimony of Betty Bridges

President

Council for Affordable and Rural Housing

Before The U.S. House of Representatives

Committee on Financial Services

Subcommittee on Housing and Community Opportunity

June 19, 2003

121 N. Washington Street, Suite 301 Alexandria, Virginia 22314 (703) 837-9001 (703) 837-8467
carh@carh.org www.carh.org

On behalf of the Council for Affordable and Rural Housing (“CARH”), I would like to thank the Committee for its interest in rural housing and for the opportunity to address the issues preventing us from reaching our goal of providing decent, safe and sanitary housing for all Americans. Those of us in the field, working with federal, state and local governments have, together accomplished much, but there is more to do. Indeed, we now face a two-pronged problem: expanding resources to meet growing affordable housing needs while preserving the existing housing stock that already meets many of the current needs.

I, myself, have seen the rural housing issue from many different sides. I was an official with the Farmer’s Home Administration for 29 years, in my home state of North Carolina. And for about 11 years I have worked for private entities that develop and finance rural affordable housing. I am currently Executive Vice President for Third Renaissance, and before that I was Executive Vice President of Regency Investors, Inc. Third Renaissance is currently developing several apartment complexes by combining private investment with public resources from the U.S. Department of Housing and Urban Development (“HUD”), Rural Housing Service (“RHS”), and the State of North Carolina.

My experience is typical for CARH members. CARH is a national trade association with headquarters in Alexandria, Virginia, and it represents the interests of over 300 members that include for-profit and non-profit entities, as well as local housing authorities and financial institutions. Each of these members have a hand in this industry. CARH members build, develop, finance, manage, own and supply products to the rural housing industry. We have a common goal, which is to expand the supply and provide a sound product to our customers and end users, affordable housing residents.

We understand that the Committee has certain specific questions that were supplied to us and that we will address in order.

1. CARH generally has a productive working relationship with RHS. That is not to say we agree on everything or on most things, but we have generally maintained professional business relations with the Agency. I believe this is because we generally recognize that we have the same overall goal of providing decent, safe, sanitary affordable housing to rural America. However, CARH members experience a high degree of frustration at the lack of resources and consistency among State Office staffs. RHS is not fully able to meet its intended purpose and goals because (a) it is organized in a manner that inhibits the sharing of information and training, thereby greatly adding to transaction costs and preventing many meritorious transactions, (b) it is not adequately funded to either expand or maintain its housing stock, and is unable to effectively coordinate with existing resources from other agencies, and (c) its programs are subject to artificial statutory restrictions that limit development and preservation. All of these points are addressed in CARH’s March 2003 Position Paper On Aging Section 515 Rural Housing Portfolio. I urge you to review this paper, which was the culmination of months of hard work by a broad spectrum of CARH members.

2. The rural housing market is a paradox in that it has changed greatly in recent years, and at the same time, not at all. What I mean by that is that the tools and resources for financing affordable rural housing have become increasingly complex and sensitive to national financial markets. Yet, at the same time, local market conditions remain local and

isolated with dispersed housing and employment patterns. The main differentiation we see between rural rental and homeownership is really a matter of income. With rural incomes less than those in urbanized areas, and with general population ages higher, rural markets require a significant percentage of rental housing. This is borne out by the current occupancy statistics in RHS' 515 program, where the average tenant income is about \$8,100 per year, and nearly 60 percent of households are elderly or disabled. However, if Congress is going to consider measures like the single-family housing tax credit, S.198, then rural areas would likely need such measures more than urbanized areas due to lower overall income ranges.

3. We understand that there are various discussions and contacts between HUD and USDA on homeownership programs. However, we believe that S.198, and H.R. 1913 (the Rural Housing Tax Credit Act) have the greatest likelihood of achieving real progress on this point. We understand that HUD instituted a rural housing office several years ago, but we have not seen any material coordination in the field among multifamily or voucher programs.

4. We believe that expanding the definition of rural areas to reach larger, yet still rural communities is a sound idea. Rural communities do not stop being rural simply because a few new people move into the area. However, we would not want to disregard areas already defined as rural.

5. RHS' "3560" regulation, published June 2, 2003, is an important step in streamlining and modernizing RHS regulations.

RHS staff have consulted with stakeholders about this rule for about seven years and it is high time that it has been published in a proposed form. CARH is just beginning to assemble member comments, but we note that the proposed rules are stale in many areas, which is a clear result of this seven year process. That statement by itself speaks volumes—RHS did not take seven years, but because RHS is not traditionally high on USDA's list of priorities, it appears that USDA took seven years.

We have concerns about certain details of this rule consolidation, but we welcome constructive change. RHS has an extremely onerous process for transferring properties within the 515 system, and an even more difficult system for prepaying and refinancing outside the 515 system. The result is what one industry commentator calls "a toll-road with no exits."

Specifically, when the RHS 515 program was enacted, RHS sought to have owners refinance out of the program at the earliest opportunity, as a way to expand the overall supply of housing in rural areas, and to return valuable funds to the government. Perhaps as a result of this, RHS has extremely onerous and convoluted loan assumption and transfer rules making transfer difficult if not impossible and taking anywhere from one to three years to complete.

At the same time, owners cannot prepay their loans. We appreciate, Mr. Chairman, that you proposed an amendment last year to H.R. 3995 to restore contractual prepayment rights to owners of section 515 properties. The ability of owners to prepay their loans and leave the program, in accordance with the agreements they entered into with the federal government, was abrogated in statutes enacted in 1988 and 1992. Similar legislation also

abrogated prepayment rights of owners of HUD 236 and 221(d)(3) BMIR projects. Congress removed these restrictions from HUD projects in 1996 and we feel strongly that the failure to take similar action for 515 project owners is not justified.

Prepayment restrictions that violate contract provisions are now being successfully challenged in court. The Supreme Court's unanimous decision in *Franconia Associates v. United States*, decided last year, characterized the statute restricting prepayment rights as a repudiation of the contract and as dishonoring an obligation. A trial to determine monetary damages is now in progress. The Ninth Circuit and federal district courts in Idaho in the *Kimberly* cases have ruled that the abridgement of contract rights is improper and have set aside the offending statute in those cases.

In order to protect tenants in HUD projects from losing subsidized rents after loan prepayment, Congress in 1996 authorized enhanced vouchers, capable of subsidizing rents up to market levels, to be awarded to tenants to enable them to remain in their projects. Tenants also have the option to move to another project with a regular voucher. The enhanced voucher authority was extended in 1999 to situations where owners of Section 8 projects do not renew expiring contracts. HUD has issued approximately 115,000 enhanced vouchers. We believe similar tenant protection provisions can be successfully used to permit tenants of 515 projects losing subsidized rents because of loan prepayments to remain in their projects. Unfortunately, the Committee last year chose to make the availability of appropriations for enhanced vouchers a precondition rather than a consequence of prepayment of 515 loans. Based on the strong and unwavering support shown by Congress since 1996 to provide enough funds for all enhanced vouchers needed after prepayment of HUD loans or opt out of Section 8 contracts, we feel it is unnecessary to require advance funding to protect tenants when 515 loans are prepaid. To the extent such a provision operates to restrict prepayment it also is a breach of contract. We urge that such a precondition provision be dropped from any legislation restoring contractual prepayment rights of owners of 515 projects.

6. The current preservation activities at RHS are wrapped up in a series of contradictions. The National Office staff has come up with several creative proposals and transaction structures for preserving affordable housing. Primary among these is to subordinate RHS loans to new third-party debt, such as tax-exempt bond or home loan bank funding, and maintaining Interest Credit and Rental Assistance subsidies. However, any transfer or preservation process must be processed by the State Office staff. Those staffs do not report to the RHS National Office and do not follow national policy, creating a chaotic situation. State offices have significant local knowledge and experience, but either do not have the opportunity to see the volume of transactions necessary to become efficient in processing, or simply disagree with National policy. We at CARH support restoring owner's prepayment rights so owners can have the deal they originally agreed to. However, most owners seek to preserve their housing and we need a greatly simplified process for doing so. This seemingly simple issue takes on magnified importance when you factor in that preservation and refinancing often includes the Low-Income Housing Tax Credits, HOME Funds, and Home Loan Bank loan programs. We must have a simple process at RHS with transparent benefits before we can have widespread participation from other funding sources. People and agencies are very reluctant to invest time and money unless they can see a process that is both clear and cost effective. We believe that the entire 515 portfolio is at risk of imminent deterioration because of the "toll road with no exit"

mentality forced on owners and managers. We do not see a significant loss of housing from the affordable stock, even if prepayment rights are restored because we believe that most owners, if allowed, will move to other affordable housing programs that pay greater returns yet maintain affordability. Enticing owners to stay through a streamlined process will only help. Indeed the June 2002 General Accounting study referred to in our Aging Portfolio Paper, notes that only about 3,500 of the 16,000 plus 515 properties are capable of obtaining higher market rents.

7. The Section 521 Rental Assistance (“RA”) program generally works well, though there is not enough funding. The RA program really can only be analyzed in conjunction with the 515 program, since RA cannot exist without a corresponding 515 loan. Section 515 loans are serviced on a budget-based method so that State Office Rural Development (“RD”) staff scrutinize operating expenses. In many places this has resulted in significantly below-market rents that do not pay for ongoing maintenance costs. In other places, there is no discernible market, since this is rural housing, and funding is simply insufficient to match operating costs. Agency rules are geared toward the lowest income applicants, which places even greater pressure on resources and do not use methods to match subsidy dollars with residents that can afford to pay rents at that subsidy level.

8. There are few programmatic overlaps between HUD and RHS. Indeed, there is no discernible coordination on handing out vouchers to rural residents. At its June Meeting, the CARH Board endorsed HUD’s Office of Multifamily Housing Assistance Restructuring (“OMHAR”) business plan to coordinate with and advise RHS on its portfolio. Outside of RHS there is a lot of frustration with the “toll road with no exit” problem. There is a tremendous desire to work with a set staff of policy makers that can consistently tackle the problems we have noted above.

9. RHS has not had any significant new construction over the last five years. Resources for the Section 515 program are a fraction of historical levels.

10. The Section 538 program is an excellent idea, but the 538 statute, as enacted, makes implementation with other programs difficult. The size of rural properties are relatively small, so most Section 538 developments need to leverage funds with tax credits and other resources. The development and lending industries have not been keen on learning a whole new program structure for small, isolated developments. We understand that RHS staff have worked hard to resolve issues with the secondary mortgage market buyers. RHS proposed changes to the 538 regulations on June 10, 2003. RHS staff has been excited about the 538 closings to date, and while we support that enthusiasm, we have to note that the handful of 538 closings to date are well below industry expectations. We hope that the regulatory changes and greater acceptance by the secondary mortgage market will speed up lending. However, we note that certain program structures, such as conditioning lender foreclosure rights on prior RHS approvals, will likely never be workable. The 538 program, must be revised on a statutory level so that it operates consistent with current commercial standards, and we urge further hearings on this point.

CARH would like to amplify and add to the answers provided above. CARH members are concerned that program neglect will cause the successful Section 515 rural multifamily housing portfolio to deteriorate. There is a clear need for maintaining and expanding affordable

housing. Studies conclude that there are nearly 14 million families and elderly persons with critical housing needs, which includes a significant proportion of rural residents. See, for example, Stegman, Quercia, McCarthy, “Housing America’s Working Families,” New Century Housing (June, 2000). This need falls disproportionately on nonmetropolitan areas, as concluded by the General Accounting Office’s September 2000 report entitled “Rural Housing Options for Optimizing the Federal Role in Rural Housing Development.” As such, federal programs addressing housing needs also need to confront rural housing needs if we are going to include all Americans in our national economy. Unfortunately, the gains we have made in providing affordable housing through the Section 515 program are eroding. There is an overall shrinking of the rental housing supply, as detailed by the Millennial Housing Commission, “Meeting Our Nation’s Housing Challenges,” May 30, 2002, pp. 16-19 (“MHC Report”).

Real estate of all types must be periodically updated and rehabilitated. See, “What We Have Learned About Properties, Owners, And Tenants from the 1995 Property Owners and Managers Survey,” by Howard Savage, U.S. Census Bureau. See also, “Homeowner Remodeling Trends Affect Contractor Workloads,” Housing Economics, April 1990. This is especially true of apartment complexes like these that are in constant use, successfully providing homes to hundreds of thousands of Americans. RHS itself estimates that 4,250 Section 515 properties with 85,000 units “will physically deteriorate to the point of being unsafe or unsanitary within the next 5 years.” See, USDA OIG Report “Rural Development Compliance with Federal Managers’ Financial Integrity Act Reporting Requirements,” March 2002. There are many different ideas that can address these problems.

Make RHS Structure More Rational

RHS is administered on a state-by-state basis with State Directors reporting to the Under Secretary for Rural Development instead of the Administrator. This creates a jumble of interpretations for what should be a uniform set of standards. We recommend that RHS have uniform national standards and lines of authority, similar to current HUD operations.

RHS already has a Preservation Office, but that office suffers from the same balkanized implementation as the rest of the Agency. We recommend elevating the authority of the Preservation Office and authorize it to centralize preservation processing. By “preservation” we mean maintaining both the physical repair and the low-income character of the housing at issue. The main goal of the Preservation Office should include reviewing and restructuring financing on aging properties. RHS should administratively adopt a recovery program that will expedite transfers, prepayments and loan workouts, within the Preservation Office.

Make Servicing Assets Fair and Effective

State Rural Development (“RD”) Offices review and set budgets and rents through a time-consuming review for any rent increase, no matter how small. We ask that RHS adopt a policy that allows cost-of-living increases based on general economic data. We also recommend that RHS permit full budgeting of owner distributions. Current RHS regulations discourage owners from advancing funds to properties to meet short-term needs, so we recommend that RHS allow owners a priority repayment in order to encourage advances to protect operations.

New Section 515 loans are rare as the program is at historically low funding levels. Where the alternative new funding is provided through other federal or State agencies, the underwriting standards of those agencies should be used, and RHS should utilize subordination regulations to encourage new financing. RHS staff training should emphasize compatibility with other programs. Specifically, CARH members report success with HOME funding and with state-administered federal tax credit programs. Yet State RD treatment of these funds varies widely, with some states reportedly seeking to keep out such funding. Moreover, an RHS Administrative Notice caps certain underwriting standards as if the property were Section 515 financed, even when no such financing is used or available.

Moreover, RHS operations would benefit from increased flexibility on occupancy limits, adjusting occupancy categories (elderly, non-elderly disabled) and income rates to match local market conditions and subsidy rates.

Servicing is made even more difficult because USDA's Office of General Counsel typically refuses to talk to the public, let alone confer about differing legal interpretations. We recommend that OGC represent RHS before the public and work with the public, as is typical at other government agencies.

Streamline Transfer Rules

Owners that seek to maintain low-income restrictions through a transfer face a complicated and daunting process. Because State Directors administer the program, the exact interpretations of the rules vary generally from state-to-state. This also creates a Catch-22 situation because owners cannot readily prepay out of the program or transfer and refinance within the program. We believe that the only solution is to have a firm processing deadline and informal appeal rights to the RHS National Office.

Streamline Prepayment Rules

There has been significant confusion between mortgage prepayment and market-rate conversion, with a generalized fear that one automatically leads to the other. Prepayment can, but does not necessarily lead to market-rate conversion. CARH supports restoring owners' prepayment rights, as already mentioned. Regardless of whether those rights are restored through the courts or by Congress, RHS should institute a streamlined prepayment process for owners maintaining affordability.

Restore RHS' Budget

RHS' budget has been severely limited in recent years and the multifamily housing production budget is a fraction of that appropriated by Congress in years past. Over the past several years, funding for the Section 515 program went from \$540 million in Fiscal Year 1994 to approximately \$115 million in Fiscal Year 2003. We recommend restoring RHS' budget to levels experienced in the 1990s. Additional funding would allow for new construction as well as meeting the needs of the existing portfolio.

Enact a New Cost Effective Program

In light of funding shortages, we have analyzed various ways to utilize federal funds to achieve maximum financial leverage. We recommend a new interest credit program to leverage federal funds, perhaps through the Nation's Federal Home Loan Banks. This would allow owners to leverage federal funds through new loans, and by operating through a government-sponsored enterprise rather than a federal agency we can cure the tax credit investment problem discussed below.

Recycle Prepayment Proceeds to Create Revolving Fund

Congress should permit prepayment funds received by USDA to be used as new funding. This would help USDA recycle funds and maintain affordable housing in needed areas.

Provide Vouchers

RHS properties would benefit greatly from an allotment of Section 8 vouchers. Currently, rural properties cannot easily access HUD Section 8 vouchers. We recommend a set aside of Section 8 vouchers for Section 515 properties that prepay.

Convert Certain Rental Assistance

Presently, RA terminates when the Section 515 loan is prepaid. We recommend converting RA to Section 8 so subsidy continues after prepayment.

Make the Tax Credit More Responsive to Rural Housing

Many RHS properties developed in the past 15 years have been made possible by the Tax Credit, but many other properties cannot be developed because owners cannot reach the 9% Credit. We believe that the Tax Credit rules under Section 42 of the Internal Revenue Code should be clarified to permit the 9% credit for RHS programs, similar to the treatment of HUD's HOME and CDBG programs. We also recommend that Section 42 be amended to provide for a small statutory set aside for properties located in rural housing areas as designated by RHS. This will also help open credit to needy rural areas. We further believe that current rent limits need to be addressed. CARH supports H.R. 284, introduced by Representatives Amo Houghton (R-NY) and Richard Neal (D.-MA), which would amend the Internal Revenue Code to allow states to use the higher of the area median income ("AMI") or the statewide median income for the purpose of calculating income limits.

Provide Exit-Tax Relief

Owners are "locked-in" by exit tax liability, which prevents transfer and refurbishment. CARH recommends elimination of exit taxes by limiting taxation to actual distributions to owners.

Conclusion

CARH's examination of rural housing needs has been extensive but that work continues just as CARH members continue to work to provide affordable housing. We appreciate the hard work and good intentions of this Committee and of RHS and RD staffs. We have identified many areas where we can all work together to make progress. Some of these points require a further federal financial commitment, but most do not. These non-financial, structural changes will make transfers, prepayment and preservation easier and will help address affordable housing concerns.

Again, we appreciate this opportunity to testify before the Committee. We look forward to working with you Mr. Chairman and members of the Committee as you contemplate ways to enhance affordable housing choices for rural residents throughout the country.