Public Policy Through Negotiation: the Mark-to-Market Experience

by

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Abstract

The traditional policy making process includes problem setting and solving; agenda setting, agreement getting and implementation. These stages take place chronologically through a top-down process in which public policies are usually made by “policy makers” and implemented bureaucratically. Since 1990s, public policy scholars have critiqued the old public policy paradigm and have proposed “a new paradigm”. An example of that “new paradigm” was taking place in the federal government’s affordable rental housing policies.

This thesis is concerned with looking at an example of how a top-down policy became converted to the “new paradigm”. It is concerned with how and why the change took place and how it actually played out in practice in the affordable housing field.

This thesis firstly introduces the affordable housing programs produced through a top-down process, and then it analyzes the program flaws and the fundamental reason that caused the program flaws. After an introduction of the federal government’s solution, Mark-to-Market under a “new paradigm”, the thesis describes a successful example, the Hawthorne project, under Mark-to-Market and implemented through negotiation. It finally argues that because the affordable housing crisis in 1990s was very urgent and the HUD subsidy structure was very complicated, a top-down policy making could not work in that situation. On the contrary, the federal government made Mark-to-Market under a new paradigm through negotiation and policy debates among all the related parties. Mark-to-Market solved the problems by decoupling HUD’s multiple functions to the market and implemented on a project base through negotiation among practitioners. Finally, policy making through negotiation not only makes policies more efficient and economically sound, but also makes policies adjustable to the evolving market, which is more sustainable.

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Chapter one: Introduction

A traditional policy making process includes problem setting and solving; agenda setting, agreement getting and implementation. These stages take place chronologically through a top-down process in which public policies are usually made by “policy makers” and implemented bureaucratically. This traditional paradigm has been critiqued by public policy’s scholars since early 1990s. For example, David Osborne and Ted Gaebler critiqued the old policy making paradigm, “American society embarked on a gigantic effort to control what went on inside government…..In attempting to control virtually everything, we became so obsessed with dictating how things should be done — regulating the process, controlling the inputs — that we ignored the outcomes, the results.”¹ They also argued that the traditional paradigm prevailed until 1970s when the new forms of governance had begun to emerge.

Moreover, Charles Lindblom and Edward Woodhouse challenged the traditional policy making in two aspects: they argued that it is misleading to refer to those in positions of authority as “the policy makers” because in reality lots of people and social powers influence policy making and policy outcomes; good policies are produced through a complex economic system and through the contributions of millions of people interacting with each other. “If social problem solving is faring poorly, if the policy making process is yielding seriously defective outcomes, then it may be desirable to greatly expand the range of policy alternatives being considered. That will require looking at the deeper

processes by which the “underlying consensus” is formed”. In other words, when the traditional paradigm does not work well even causes “defective outcomes”, a new policy making paradigm, the “deeper processes”, will be required to replace for the top-down traditional paradigm.

Therefore, the “traditional policy making paradigm” stands for a staged, top-down policy making process, in which the policies are dictated by “policy makers” from the “top” and implemented by the “bottom”; while the “new policy making paradigm” asks for an interaction process in which the “bottom”, the practitioners, participate in the policy making process and policies are made through negotiation between all the stake holders.

A transition from the traditional paradigm of public policy making to the new paradigm has taken place in the affordable rental housing policies. Specifically, Section 221(d) (3), Section 236, and Section 8 programs are typical examples of a traditional paradigm under which the department of Housing and Urban Development (HUD) made policies to encourage the private sector to participate in affordable housing industry, and the private sector implemented those policies.

Each of the above affordable rental housing programs was set up to patch the flaws in the previous program. All of them had been working well until new problems were triggered under the new economic environment and by the embedded program flaws. A new program was then initiated to fix the existing one that did not work well any longer.

Section 221(d) (3) program, the original program, was established to rectify the sins of urban renewal by housing displaced families and low- and moderate-income families. It

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was then replaced by the next program, Section 236 with a deeper subsidy offered by HUD. HUD finally established Section 8 to offer a rent subsidy in addition to the Section 236 interest reduction payment to increase the effective demand of low- and moderate-income families. As HUD patched existing program flaws, it added more and more subsidy obligations on its shoulders.

Not surprisingly, when the fundamental economic environment changed and the administrations turned over in early 1990s, existing program flaws caused new problems. However, at this time, the “traditional policy making paradigm” could not provide policy alternatives to fix the “defective outcomes” resulted from the existing affordable housing policies any longer. As a result, the federal government made a fundamental program shift by creating a new housing policy, Mark-to-Market, to change the subsidy structure and decouple HUD’s functions. Because the problems had been complicated due to layered subsidies and HUD’s conflicting objectives, Mark-to-Market was created by negotiation to “expand the range of policy alternatives”\(^3\) and finally fixed the new problems triggered in the new market environment.

This thesis is written to show how the old paradigm became the new and why. The thesis is organized into four chapters. Chapter Two introduces the three affordable housing programs, Section 221(d) (3), Section 236, and Section 8, produced under the old policy making paradigms, and then analyzes the policy flaws and the fundamental problems in these three programs. It then introduces the Multifamily Assisted Housing Reform and Affordability Act (MAHRA) legislation process and analyzes its uniqueness. Chapter Three describes a Mark-to-Market project in Missouri and analyzes it as a successful

\(^3\) Lindblom and Woodhouse, P.4.
example under Mark-to-Market through negotiation among related parties. The last chapter discusses the significant implications of the new policy making paradigm followed by a conclusion.
Chapter Two: Housing Policy from Old Paradigm to New Paradigm

2.1 Introduction of Section 221 (d) (3), Section 236, and Section 8 programs

To rectify the sins of urban renewal, the federal government started the Section 221 (d) (3) program to house displaced families, low income families, and moderate income families by encouraging private developers to build new affordable rental housing. Under the Section 221(d) (3) program that was authorized in 1961, the rent was set based on operation cost and debt service level, and the federal government directly offered below-market interest rate (BMIR) loans at 3% to reduce development and operation cost. Therefore, the rents for Section 221 (d) (3) properties were below market rents, and HUD only approved rent increase to match increased operating costs in order to keep after debt service cash flow flat and to save any cash flow above a stipulated limit in the properties’ residual receipt accounts.

The National Housing Act of 1968 replaced Section 221(d) (3) program with Section 236 program. Under the Section 236 program, the federal government provided a monthly Interest Reduction Payment (IRP) subsidy to make the effective mortgage interest rate 1%. The difference between the actual debt service and the debt service at 1% interest rate was paid by the government to the mortgagees as IRP payment on behalf of the owners. Section 236 also required budget-based rents to keep the rents affordable to low- and moderate-income families.

In addition to mortgage subsidies, the federal government also provided Federal Housing Administration (FHA) mortgage insurance to guarantee that the FHA would pay the mortgage outstanding balance in case the owners defaulted. Owners could also adopt
accelerated depreciation and mortgage interest deductions to offset their income tax liabilities. In exchange for the above benefits, the owners were required to keep the rental properties affordable to low- and moderate-income households at controlled, budget-based rents for 20 years. Finally, most of the property owners were provided an option to prepay the 40-year term mortgages and to opt out of the affordability program after the 20 year affordability period.

Because both Section 221 (d) (3) program and Section 236 program were produced to encourage private developers to build affordable rental housing, these programs were called “production programs” that provided supply side subsidies. Under these supply-side subsidies, new housing starts peaked in 1972 at 2.4 million units, nearly four hundred thousand of which resulted from programs subsidized by the Department of Housing and Urban Development (HUD). 4

However, the budget-based rent approach had many limitations: it required HUD to track properties’ operating costs to set the “right” rents, placing heavy administration burden on HUD; the budget-based rents had an inherent tension between the properties’ affordability and the properties’ long term viability because HUD consciously encouraged deferral of reinvestment for maintaining properties’ physical condition; and budget-based rents did not provide positive incentives for the owners to manage the properties well. When the Middle Eastern oil embargo made properties’ operating costs jumped up in 1974, the budget-based rents had not been affordable to low- and moderate-income families any longer, and the affordable rental housing market consequently

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became over supplied. As a result, the overly aggressive supply-side subsidies made HUD one of the nation’s leading owners of housing through default, generating exaggerated fears of foreclosure and scandal in the subsidized housing sector. More over, lots of properties were built in wrong place where the rental income could not cover operation due to low occupancy. Therefore, under the Housing Act of 1974, the Nixon administration radically shifted its subsidy approach from the debt side by providing subsidized financing to the equity side through subsidizing rents. The Section 8 program was initiated to provide direct rental subsidies to low- and moderate- income families. In both project based Section 8 projects and tenant based Section 8 projects, the tenants only pay 30% of their adjusted family income and the federal government pays the difference between the Section 8 contract rent and the amount of rent paid by the tenants. Older Section 8 projects typically consisted of projects financed under Section 221(d) (3) or Section 236 with below-market rents due to their subsidized mortgages and ongoing rent regulation. The Section 8 contracts were added on top of the Section 221(d) (3) and Section 236 mortgage subsidies in order to fill the gap between the budget-based rents and the rent affordable to the tenants.

Newer Section 8 projects were originally developed in the late 1970s and 1980s. These projects are called Section 8 New Construction/ Substantial Rehabilitation (NC/SR) projects and they typically provided project based rental subsidy for 100% units and longer term subsidy contracts with 20 years term for FHA-insured projects and 30-40 years term if financed with state or local tax-exempt bonds.

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5 Sternlieb and Listokin, p.31.
Recognizing the limitations of the budget-based rent approach in the older Section 8 properties, HUD set rents based on market rent levels as estimated by HUD’s Fair Market Rents (FMRs) in the newer Section 8 program, and rent increases were governed by Annual Adjust Factors (AAF s) decided by HUD. Because some of the Section 8 NC/SR properties were built in a high inflation era, their construction cost and on-going debt service expenses were much higher than the old Section 8 properties. As a result, some properties’ HUD contract rents had to be set above the comparable market rents, and HUD had to use the FMR in a larger geographic area to justify the rather high rents. Similar to the previous two production programs, HUD provided project based rental subsidy in order to encourage developers to build affordable housing in that high inflation area. Therefore, the Section 8 NC/SR program was actually a supply side program.

2.2 Section 221 (d) (3), Section 236, and Section 8 programs in the traditional policy making paradigm

Each of the three programs was initiated to solve one problem caused by the program flaws in the previous program. Section 221 (d) (3) was initiated to produce more affordable units for the residents who were displaced in urban renewal, Section 236 was initiated for replacing Section 221 (d) (3) to provide a deeper interest rate subsidy to affordable housing developers, older Section 8 was designed to fill the gap between the budget-based rents and the rents affordable to the low- and moderate- income families, and newer Section 8 was established to fix the limitations of budget-based rents. Therefore, all the three programs were conceived from “the top”, and the policy makers attempted to “control virtually everything” to make sure their policy goal was implemented correctly.
Specifically, HUD dictated how things should be done by regulating both the implementation process and the project details such as rent assumptions, interest rate, and underwriting standards. The implementation players then executed the programs according to the guidelines dictated by HUD. In this top-down policy making process, an underlying assumption was that the guidelines were correct and made economic sense. Unfortunately, the guidelines in the above three affordable housing programs were constructed with fundamental flaws.

2.3 Common flaws in Section 221 (d) (3), Section 236, and Section 8 programs:

1) HUD’s multiple roles generated conflicting objectives

To encourage the private sector to build affordable rental housing, the federal government had provided subsidies from both supply side and demand side through Section 221 (d) (3), Section 236, and Section 8 programs. As one of the fastest-growing cabinet departments in terms of budget authority, assigned itself multiple roles gradually through different policies. It was a mortgage lender and asset manager with $42 billion in loan risk outstanding (through FHA insurance or HUD-held loans), a subsidy provider with an annual contractual outflow of about $20 billion through all forms of Section 8(FHA annual Reports 1995-1998), a policy maker, and a policy administrator. In short, HUD not only played a role in policy making arena, but also entered into the real estate market and the financial market in order to implement its policy. “Affordable housing is a

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6 HUD is an asset manager because it holds some properties’ mortgage notes after FHA paid mortgage insurance for the default properties. Before an owner pays off the property’s mortgage, HUD has the first claim on the property. As an asset manager, HUD keeps track of all the properties’ invoices and makes sure they are in good physical condition.

hybrid between private market-rate housing and a host of (largely non-economic) public purpose objectives. Harmonizing these fundamentally conflicting objectives has been challenging.⁸ A traditional top-down approach required HUD to control everything from policy making to implementation, which had been administratively demanding and placed heavy burden on HUD. When the role in “private market” and the role with “public purpose” centralized on HUD with conflicting objectives, HUD’s hybrid roles became more challenging.

HUD’s multiple roles did help the federal government achieve its political goal of providing affordable rental units. Under Section 221(d) (3) program and Section 8 program, “From nearly 200,000 subsidized new housing starts in the late 1960s (about one-seventh of total new production), the pace rose rapidly to a peak of almost 450,000 new subsidized units, about one-fifth of total (housing) production, by the early 1970s.”⁹ The following Section 8 program provided more flexible subsidies by assigning HUD another role of rent subsidizer so as to match the new affordable rental units with the families who needed them. However, the multiple roles generated some serious problems for HUD’s policy making:

i) The above three programs were developed with short term consideration in mind as opposed to thinking through the long term implications.

The Section 221(d) (3) and Section 236 programs were initiated to generate more rental properties without a consideration that these supplies would work only if there

⁹ Peter D. Salins, ed., p. 33.
were effective demands. The programs were successful in terms of building a large number of affordable housing properties in the short run. However, they were questionable in terms of the properties’ long term viability: the budget-based rents were administratively demanding because HUD had to spend lots of human resources and capital resources to set the “right” rents; budget-based rents left little capital for the properties’ necessary maintenance; and as the utility cost increased significantly due to the Middle Eastern oil embargo in 1974, the operating cost jumped a lot so that the budget-based rents were no longer affordable to low- and moderate- income families.

ii) To achieve current policy goals, the federal government put off until tomorrow what it did not have to deal with today

The mismatched affordability restriction and the mortgage amortization period is a good example of putting off problems until tomorrow but only achieving current policy goals. When the Section 221(d) (3), Section 236, and Section 8 programs were initiated, the use restrictions only assured 20 year affordability while the mortgage amortization for subsidized affordable rental housing was 40 years, which meant that the owners were offered an option to prepay the mortgages and end up their obligation to keep the rental housing affordable after 20 years. In Section 221 (d) (3) and Section 236 programs, the 20 years use restriction as opposed to 40 years was not offered due to HUD’s neglect, but offered as an incentive for the private sector to build affordable housing in a short run. From the federal government’s point of view, the prepayment option in the Section 8 NC/SR program was offered under a bet that the inflation would be higher than the Annual Adjustment Factors (AAF) in the HUD
contract, so the surrounding market rents as well as the low income families’ income would increase faster than the affordable housing’ rents that were initially set above the market. In such a condition, HUD expected that it would pay less amount of rental subsidy as the surrounding rents caught up the HUD contract rents, and the 20 year use restriction also provided flexibility for HUD’s future decision. However, HUD did not expect that when a strong market made surrounding rents higher than the affordable housing’s rents, the owners tended to opt out of the subsidizing programs to put their properties in market and make more money. Unfortunately, the above scenario did happen: when local rental market became strong twenty years later after HUD initiated the production programs, the owners started to opt out of the affordable housing programs and converted their properties to market rate rental housing. Facing the shrinking affordable rental stock, HUD found that the 20 year opt out option they offered to the owners was simply too lucrative, while HUD did not get any upside of the 20 year use restriction. Therefore, the federal government had to find a way to preserve affordable housing when the incentives were gone and the owners were about to opt out. In short, the mismatched affordability term and mortgage term partially caused the preservation of affordable housing issue.

Millennium Housing Commission described the scenario, “In the early 1990s, substantial numbers of federally assisted units became vulnerable to prepayment or opt out in the midst of strong real estate market. This confluence of circumstances brought about the most pressing crisis in the history of federal involvement in affordable housing. Where local market supported an economic decision to do so and as their federal contracts expired, many private owners of assisted properties
exercised their right to prepay their subsidized mortgage notes or opt out of their HAP contract. As a result, many units were lost from the rent-restricted inventory. Under this situation, HUD had to either pay a higher subsidy to make the owners keep their properties affordable or see the affordable rental stock shrink and spend more money to build new affordable rental housing.

The mismatched use restriction period and the mortgage amortization period helped policy makers realize the production goal but left potential problems. President of Recaptalization Advisors, Inc. David Smith commented, “The presidents such as Lyndon Johnson and Jimmy Carter tended to leave some political legacies so that their successors would keep their programs going on.” (David Smith, 03/20/03) In other words, the “policy makers” knew that there would be some problems in these programs several years later, but they made an assumption that the following policy makers could fix the problems by initiating new policies. Therefore, when the policy makers decided to realize short term policy goals of producing affordable housing and leave the potential problems to the following administrations, the preservation of affordable housing issue had been doomed to take place.

iii) The federal government assigned itself multiple roles to transfer equity risk, debt risk, and market risk from the private sector to the government

A real estate project is typically financed by both equity and debt. To encourage private developers to build affordable housing, HUD required little equity contribution by aggressive underwriting. As a result, developers didn’t face any

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investment risk, so they didn’t have incentives to reduce risk through careful development. Moreover, FHA provided mortgage insurance to transfer lender’s risk to the federal government due to the higher debt risk generated from aggressive underwriting. Finally, to reduce market risk faced by both the equity side and the debt side, HUD provided rental subsidy to match supply and demand so as to transfer market risk to the government. In short, the federal government assigned itself multiple roles to transfer equity risk, debt risk, and the market risk from the private sector to the government.

A property’s value consists of its discounted future cash flow from operating the property. Consequently, HUD created part of the subsidized rental properties’ value by providing rental subsidies under Section 8 program. In the situation where the affordable housing rent was higher than its comparable fair market rent, HUD’s rental subsidy actually boosted the property value higher than the value the physical property should have deserved in the market. However, Section 8 obligated HUD to pay on going subsidies almost forever: “Unlike other procurement programs using long-term budget authority, Section 8 is unique in that, while the appropriation covers the lion’s share of the capital and operating expenses, it fails to purchase the capital asset for the public benefit within the subsidy term. This subsidy structure not only requires budget authority renewals to fund ongoing operating subsidies to serve those tenants whose rents cannot cover operating costs, but also permits any principal amortization paid by the subsidy to accrue to the benefit of the private owner.”

other words, as the total rental income including HUD’s rental subsidy paid down a property’s mortgage, the owner would own a larger share of the property. As a result, HUD is virtually helping private owners to amortize their mortgages with only 20 years affordability use restriction. Therefore, the federal government’s subsidy did not require much return from the owners, and the federal government did not own any share of the affordable housing properties subsidized by the government. “The current course means an unending cycle of budgetary brinkmanship attendant to the passage of each year’s new budget authority — or worse, a decision to abandon assisted affordable housing altogether.”

In addition to play the role as a subsidy provider, HUD lent lower interest loans to developers and owners under the name of FHA playing the role as a debt holder (mortgagee) as well. Unfortunately, the economic interest of the subsidizer is always different from the interest of the lenders: expensive lending with higher interest rates would make the mortgagee better off while making the subsidizer worse off by requiring deeper subsidies for the properties; aggressive lending with less debt service payment would make the development deals work and reduce the subsidy amount but would generate higher risk to lenders and mortgage insurers.

Under the significant risk transferred from the developers and some of the mortgage lenders, the federal government faced either a win-win situation or a lose-lose situation. For instance, when the affordable housing owners operate the affordable housing properties well, FHA can get mortgage payments from the properties.

borrowing mortgages from FHA, so its mortgagee’s position is stable; when the operation income cannot support the operation expenses for the properties, the owners tend to default, which may cause FHA to not only lose future mortgage income but also pay mortgage insurance to the mortgage investors. In reality, HUD got into a difficult situation when it faced expiring use restrictions for keeping the housing affordable: on the one hand, renewing the contracts with higher rent would cause HUD’s outlay to exceed its budget, however, if HUD declined to renew the insured Section 8 contracts, current owners would choose to default or to repay the mortgage and opt out the programs so that HUD would pay a huge amount of insurance payment for the FHA insured mortgages and lose many affordable housing properties. In the end, HUD would inevitably lose something.

2) Policy goals overrode good real estate principles

To control program implementation, HUD entered the market as a mortgage provider, asset manager, and mortgage insurance provider. However, when HUD faced a choice of realizing the current policy goals or participating in real estate like a market player, its policy goals always dominated the market reality. As a result, although HUD’s choices helped the federal government to realize the political goal of providing affordable housing for low- and moderate-income families, these choices did not always make economic sense.

By providing deep subsidies, HUD encouraged developers to build properties in economically distressed neighborhoods or in the areas without enough demand; HUD set
the rents that were not comparable with the local markets; and the first mortgage
underwritings were very aggressive.

More critically, HUD did not understand some issues such as the significance of long
term management. Under an assumption that the following policy makers could fix
potential problems embedded in the properties, HUD dictated its programs in spite of the
unsound guidelines. The following aspects are the list of ways in which policy goals
overrode "good real estate principles".

i) Location

Location is a critical element that affects the success of a real estate project. However,
some subsidized rental properties were located in neighborhoods that were not viable
or lacked of market demand. These properties finally faced high vacancy rates and the
lack of maintenance. Even if HUD could solve their financial problems; it could not
resolve the serious social problems. Housing alone could not solve the social
problems which had to be solved by a comprehensive community initiative including
economic development, job training, etc.

On the contrary, some properties were built in urban peripheral area under
developers' consideration of reducing development cost. As the cities sprawled, these
urban peripheral parcels appreciated a lot and the surrounding housing market
became stronger. When the market rents became higher than the affordable housing’s
rents, the owners intended to transfer these properties to market. Therefore, once the
affordability contract expired, the owners didn’t have incentives to renew the
contracts but to catch the unintended profit as a windfall due to urban growth In such
a situation, the federal government faced losing affordable rental properties in a rather strong housing market.

**ii) Rent assumptions:**

It was a good intention for HUD to build affordable rental housing where the low income families were underserved. However, there was an economic reason that the market did not want to build affordable housing in that area: either because the market was too weak to consume any additional units or because the interest rate was rather high, making borrowing too expensive for a project located in a distressed area. HUD always faced a dilemma to set appropriate rents in weak markets: if the rents were set too high, no one would occupy the units, but if the rents were set too low, rental income would not be able to cover operating expense-- HUD would loose in either way if the rents were set too high or too low.

Specifically, when the properties’ rents were set higher than local market rent, these properties would be less competitive to reach enough occupancy rates to make the project break even. Moreover, HUD had to pay higher subsidy than it should have paid for. When the rent was set lower than comparable market rent due to lower development cost, the rent could not support enough operating expenses, the properties were under maintained, which was incompatible with HUD’s objective of providing decent housing for low- and moderate- income families. Therefore, if HUD wanted to serve the distressed area, it should have also provided comprehensive service beyond housing to improve the living quality in the neighborhood in stead of developing projects that did not make economic sense.
Section 221 (d) (3) BMIR (Below Market Interest Rate) and Section 236 programs adopted below market interest to reduce debt service requirements and thereby reduced the break even rent level. However, some properties failed soon because they were located in weak markets where even the budget-based rents were higher than the local market comparable rents. Other properties failed later because the rents were too low to support operation expenses. In Section 8 new construction projects, properties combined market interest rate and project-based rental subsidies required higher rents to support debt service expenses so that their rents were initially set above market rents. The subsequent automatic annual rent adjustments kept the rents high during contract period. Years later, the above-market rents required HUD to provide deep subsidy out of its budget.

iii) A life-long budgeting

The physical development is first step for providing affordable housing, and it is followed by a long-term management period that usually runs for at least forty years. In order to keep affordable housing physically sound for the long-run, a developer must balance the initial development cost and life-long maintenance cost; in addition, a developer must consider enough capital reserve and operation reserve\textsuperscript{13} in the project’s underwriting and initial budgeting. When HUD faced the above choices, it chose for cheaper construction cost without sufficient replacement reserve\textsuperscript{14}, which would save total development cost, increase annual debt service available, and save

\textsuperscript{13} Capital reserve is a permanent account set aside for repairs and improvements to the property that can’t or would not be expected to be included in the operating budget. Operating reserve is a permanent account set aside to cover unanticipated increases in annual operating expenses or shortfalls in income.

\textsuperscript{14} More discussion on replacement reserve is covered in the next section: aggressive underwriting.
the subsidy provided by HUD. However, cheaper materials caused more maintenance cost or replacement cost in the future; the lack of replacement reserve caused problems for properties in need of capital improvements. In addition, HUD didn’t provide enough financial incentives to make developers to consider their projects in the long run, and the owners didn’t care about replacement reserve. As a result, the under-maintained affordable housing properties lost their competence in the market and their vacancy rates increased. When the properties got into financial trouble that rental income could not cover its operation cost, the properties faced default risk and then the default risk was transferred to FHA, and HUD also faced the loss of affordable rental units.

iv) Property management

Property management has even more significance for affordable housing compared with market rate housing. The property management for affordable housing requires property managers to provide community based service and to satisfy economically tough families’ special demands. However, at the beginning of the production programs, HUD always short changed the management line. Moreover, under the budget-based rent assumptions in the production programs, “Parsimony goes unrecognized, but profligacy is rewarded with higher rents (and, until HUD changed its formulas, with higher management fees).”¹⁵ When a affordable housing property’s management was in bad quality or low income families could not get enough service or help, the property would lose competence.

¹⁵ David Smith, p. 146.
3) Underwriting standards

i) The economics of aggressive underwriting

In regular residential development underwriting, there are two factors that limit the mortgage size: debt service coverage ratio (DSCR) and loan to value ratio (LTV). Mortgagees will agree to lend the amount of mortgage that satisfies both of the two limits.

\[ DSCR = \frac{Net\ \text{Rental}\ \text{Income} - operating\ expenses}{debt\ services} \times 100\% \]

\[ LTV = \frac{mortgage\ amount}{total\ development\ cost} \times 100\% \]

Consequently, leverage ratio = \( \frac{property\ value}{equity\ input} \) \times 100\%

Aggressive underwriting for affordable rental housing development generated two negative effects: physically, lots of subsidized rental housing can’t be kept in a good shape in the long run due to underestimated operation reserve; financially, lower development cost and operation cost artificially raise properties’ value and earning power, and consequently increased properties’ leverage ratio.

Underestimated operating expenses can boost NOI. Given a DSCR required by the lender, higher NOI can support more debt service so as to increase the loan size. In other words, if the operating expense is artificially reduced, the property’s earning power will be over estimated. Artificially increased loan amount generally can’t pass the second test of LTV because the mortgage amount is always too large compared
with total development cost. Before the federal government initiated Low Income Housing Tax Credit, a project’s development financial sources were mainly from subsidized mortgages. To get a larger mortgage amount, HUD allowed developers to boost properties’ earning power. At the same time, because the HUD contract rent level was set based on development cost, HUD tended to keep the development cost low so as to reduce its rent and consequently the rental subsidy amount. Both the over-served mortgage size and the limited development cost made LTV too large to pass lenders’ test. Therefore, HUD both provided FHA mortgage insurance to guarantee affordable housing’s debt payment and allowed the projects not to pass the LTV test. As a result, lots of affordable properties were highly leveraged in the production oriented programs.

Modern finance theory argues that there is a trade-off between the benefits generated by high leverage and the risk of financial distress. High leverage in affordable rental properties generated high tax shield enjoyed by the owners but increased the owners’ default risk: the less owners’ equity accounts for the total property value, the less the owners have incentive to manage their properties well; the less the owners’ equity accounts for the total property value, the easier the owners go to default once they meet any hard situation. Furthermore, most of the mortgages under the production programs were insured by FHA so that the default risk was transferred to HUD. High leverage made attractive offers to the private sector that participated in affordable housing industry, but brought financial distress pressure to HUD. To encourage the production of affordable rental housing, the government adopted aggressive
underwriting by using high loan-to-value ratio, low debt service coverage ratio, and low replacement reserve assumptions.

Creating subsidized rental housing was the federal government’s political goal; new lending meant generating income to lenders; and developing projects means generating developer fees to the developers. The above financial and political interests aligned developers, lenders, and the government to keep initial development cost low, to make aggressive underwriting assumptions, and to underestimate the costs of ongoing operations.

Because the development budget for affordable housing construction was always tight, development cost was kept low by using rather cheap materials or cheap finishes; debts were able to cover 90% to 100% of total development cost (including developers’ profits) instead of the conventional loan to value ratio limit\(^\text{16}\); debt service coverage ratio was generally allowed to hit 1.10 even 1.05 for nonprofit borrowers, so that the properties could borrow more capital from the mortgage issuers and make the development work; and not enough replacement reserve assumption was adopted in order to get enough net operation income to support debt.

As Millennial Housing Commission described below, the small replacement reserve was justified by that

\[ \text{"...the remainder of the capital needs would be financed by future tax-shelter resyndication, or by conversion to market-rate use at the end of the regulated use period."} \]

However, neither of the above approach is appropriate today. As summarized by Millennial Housing commission:

\(^{16}\) Conventional Loan To Value ratio (LTV) limit: the amount of loan can’t be larger than a certain percentage of the total property value or development cost.
"Tax-shelter resyndication was eliminated by the Tax Reform Act of 1986. Reliance on conversion to market-rate use more or less guarantees a medium-term 'preservation crisis' for each property and, accordingly, is increasingly regarded as a bad approach. For that matter, reliance on a future sale of any sort is increasingly regarded as an inappropriate approach for funding predictable capital needs."\(^{17}\)

Once again, HUD was skewed towards its short-term production goal on the replacement reserve issue.

**ii) The underlying reason for the above program flaws was the over controlled top-down nature of federal affordable housing policies**

It was because the market would not build affordable housing for low- and moderate-income families, the federal government had to exercise its authority to regulate the market and even play in the market in spite of the potential problems that might be generated from the policies under a certain economic environment.

However, under a top-down policy making approach, the federal government tried to control everything and dictated not only how things should be done, but also how much and how many should be done. Moreover, once HUD was obligated to keep its affordable rental stock, it had no choice but to add more obligations on itself; once the affordable housing industry was totally regulated by the federal government, it lost the ability to adjust to the evolving local market. Therefore, when the economy

\(^{17}\) Millennial Housing Commission, *Subsidized Rental Housing Committee Background Paper: Pre-LIHTC Affordable Housing—Historical Context*, July 26, 2001. p. 3.

\(^{18}\) During 1981-1985, tax law allowed real estate owners to use accelerated depreciation. Consequently, the properties' book value reduced quickly and owners gained tax benefit from the accelerated depreciation especially through the first eight years. Under the favorable tax law, it was expected that owners could sell their properties and get larger gain than under unfavorable tax laws, and the new owner could use the purchase price to restart accelerated depreciation, which would generate tax shelter for new owners. Therefore, extra capital would be raised through a purchase and sale transaction between two legal entities and it was reasonable to assume that new owners would use the extra capital to catch up under served replacement reserve.
changed and the subsidy structure turned more and more complicated, an affordable housing crisis was triggered.

2.4 The evolving market environment

The Section 221 (d) (3), Section 236, and Section 8 programs required the affordable housing owners to keep 20 years affordability. 20 years later since the federal government initiated the above three programs, the affordability contracts started to expire and the economy had changed considerably:

1) Long term interest rate

Long term interest rate reflects how expensive the borrowing is. Because multifamily housing was financed by forty year or thirty year mortgages, the change of conventional 30 year mortgage rate can be considered as a proxy to reflect the change of multifamily first mortgage rate. As showed on the following chart, 30 years conventional mortgage rate had dropped from the highest rate of 18.45% in October, 1981 to a low point of 6.83% in October, 1993.

In the chart below, the gray line is the 30 years conventional mortgage rate change from 1971/04 to 2003/03. Because the affordability restriction for affordable rental housing was 20 year, owners had an option to prepay their mortgages, refinance their property, and even opt out affordable programs after the 20 year use restriction period. It is assumed that other things being equal, the larger the interest decreased after twenty years, the more attractive refinancing was to the affordable housing owners. Therefore, the first point on the black line reflects the properties got mortgages in 1971/04 and their use
restriction expired in 1991/04 where the point is located at. Consequently, the black line reflects the mortgage rate decrease twenty years after the properties firstly got financed. The higher the black line is the more possible owners would like to refinance their properties. Therefore, it might be expected that other things being equal, the incentive for owners to refinance their properties had increased through the early 1990s to the beginning of year 2002.

Data source: Federal Reserve Bank of St. Louis.
http://research.stlouisfed.org/fred/data/irates.html

2) The income profile of the low- and moderate- income residents

Under Section 8 rental subsidy contract, affordable housing tenants pay 30% of their family income and HUD pays the difference between the HUD contract rent and the rent paid by the tenants. Therefore, within HUD’s eligible family income range, the less rent the tenants pay, the more HUD has to fill the rent difference.
Ms. Maria Maffei, a Vice President at Recapitalization Advisors, Inc., made a point that the income profiles of the low- and moderate- income tenants has changed during recent years, and affordable housing tends to accommodate more lower income families. During her ten years of affordable housing experience, Ms. Maffei observed a trend that HUD has been paying deeper and deeper rental subsidies due to the decreasing family income of the affordable housing tenants. Therefore, the increasing HUD contract rents due to initial high rents in Section NC/SR properties and the AAF trending, together with the decreasing tenants’ family income has placed heavier subsidy burden on HUD since the Section 8 program started.

In short, under the evolving market environment, the decreased interest rate implicated that refinancing had become more attractive to affordable housing owners, and the decreased family income of affordable housing tenants demanded of HUD deeper and deeper subsidies under the Section 8 contracts. Therefore, when a large amount of Section 8 contracts started to expire, the owners had strong economic motivations to refinance or opt out of the affordability programs; and HUD got heavier pressure on its subsidy outlay. Under such an economic situation, both the owners and the federal government had strong interest to restructure the existing affordable rental housing’s capital structure and rent level.

2.5 The budget-outlay crisis and the preservation of affordable housing issue

In 1994, after Republicans gained the control of Congress, committee staff Mr. Stephen Kohashi in Senate HUD, VA and Independent Agencies Subcommittee pointed out HUD’s outlay crisis in his article Housing Budgetary Analysis (Nov. 29, 1994, discussion
draft). Mr. Kohashi expressed concern that HUD would experience a huge outlay increase in each year from 1996 on if HUD renewed all the expiring Section 8 contracts that were initially signed around 20 years ago. At that time, the affordable rental properties faced two kinds of situations: if a property was located in a weak market, rental income was too low to cover operation expenses so that its owner was not able to maintain the properties well, the owner tended to opt out of the programs; on the other hand, if a property was located in a strong market, rent was allowed to rise above local Fair Market Rents. The existing subsidy programs would become very expensive for HUD to afford. Moreover, many of the private owners had been getting old and they started to consider cashing out their investments and retiring; after accelerated depreciation, properties had started to generate phantom income\(^\text{19}\) so that owners had to pay income tax (based on properties’ book value) in every year even when their properties had not made any “real” income any longer. Therefore, expiring affordability contracts and subsidized mortgage contracts, local rental market trend, owners’ retirement problem, and properties’ phantom income have put more than 800,000 units of affordable housing in danger.

HUD had a major set of issues to resolve if it wanted to keep its affordable rental housing stock. It had to renew affordability contracts in spite of the unrealistic high contract rent and rehabilitate the properties, which was simply too expensive to be afforded by the federal government. Even if HUD could find the money to pay for the subsidies, the unreasonable high rents would change the programs’ image and the federal government

\(^{19}\) Phantom income: Reportable or taxable income which does not generate cash flow. In subsidized rental housing cases, when mortgage amortization (owner payoff mortgage principal to own more share of the property) exceeds depreciation expenses (the amount book value the owner is losing from the property), the amount of that excess amortization will become taxable as ordinary income.
would lose its political support for the affordable rental housing programs. Alternatively, if HUD’s budget was not able to be increased, HUD would lose part of the affordable housing stock. Obviously, either of the situations would generate an affordable housing crisis. Therefore, HUD was faced with the challenge of finding a way to both prevent its outlay from increasing and preserve the affordable rental properties available to low- and moderate-income families in the long run.

In the past, the way out would have been to create new programs to “fix” the problems of the previous production effort. Unfortunately, the affordable housing industry had lost the self-adjusting ability to the evolving economy due to the regulated but unrealistic rents set up by the highly regulated HUD programs. Since the federal government established the Section 221 (d) (3) program, it had kept adding subsidies out of its budget in each of the new program such as the Section 236 program and the Section 8 program. Under these subsidy programs, HUD had played roles on both the equity and the debt sides in the affordable housing industry, and it was impossible for the federal government to come up with more resources to save the expiring affordable housing stock. Therefore, when the federal government could not offer more subsidies from “the top” by initiating a new program, the top-down policy making process could no longer work and a fundamental change was needed. As former Senator Mr. Connie Mack commented, an effort to “reform the National assisted and insured multifamily housing portfolio” was necessary in order to handle the most difficult problem in housing at that time. 20 The reform should not only change the way the federal government had regulated the

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affordable rental housing industry for almost forty years, but also change the way the federal government set up the existing programs.

2.6 MAHRA Legislation and post MAHRA debate

1) The basic idea of Mark-to-Market

The outlay crisis pointed out by Mr. Kohashi in 1994 presented an emerging disaster: the tremendous outlay increase would take place from 1996 going forward. Therefore, the federal government had to take action soon and the practitioners and current owners must be prepared to implement once the new solutions were found. The solution for reducing the HUD outlay was not as simple as just cutting the rental subsidies: the reason why the private sector built affordable rental housing was the federal government’s promise of providing subsidies; if the government just cut the subsidies they had promised to the owners when it met an outlay problem, the government would lose the trust from the private sector. Therefore, any solution would have to not only solve the outlay crisis without reducing the affordable rental housing stock but also satisfy the private sector.

As the first step towards the solution, the staff in the subcommittee on VA, HUD and Independent Agencies proposed the idea of reducing the Section 8 contract rents for the properties that had over-market rents. If the reduced rental income could not cover debt service, the unpaid balance could be bifurcated into two loans, a performing first mortgage and a deferred second mortgage. A third, non-performing mortgage is also possible, as a loan to address rehabilitation needs. In this way, the federal government would attain savings in the Section 8 account while minimizing losses to the FHA insurance fund, maintain the physical and economic stability of the properties, and
protect the interests of project residents. Consequently, the success would be measured in terms of: saving Section 8 funds, mitigating losses to the FHA insurance fund, and maintaining the properties physically and financially sound.

To analyze the feasibility of the preliminary idea proposed by Congress staff, Congress hired practitioners to analyze the feasibility of the debt restructure plan. In February 1995, Mr. David Smith, on behalf of the National Assisted Housing Management Association (NAHMA), testified before the Subcommittee on VA, HUD and Independent Agencies Committee on appropriations. Mr. Smith summarized the Mark-to-Market concept's goal: control the growth of discretionary federal housing expenditures; restore discipline and accountability to property operations; and empower residents and improve communities through resident choice. He argued that HUD would firstly reset (reduce) properties' rents, then reduce first mortgage amount, and finally pay off unpaid balance by using FHA insurance fund. By doing so, Mark-to-Market would provide an opportunity to make existing affordable rental properties financially and physically sound. Based on Mr. Smith's analysis, Mark-to-Market would cost the FHA insurance fund around $8.5 billion and it would trigger about $12.4 billion in assignment; once rents were reset HUD should recovery about $3.9 billion in newly reconstituted mortgages, a recovery rate of 35 cents on the dollar; resetting rents will save a minimum of $920 million per year in annual Section 8 subsidies, or about $4.6 billion over a typical five-year contract.21

In short, Mark-to-Market was to decouple HUD's multiple roles to the market so that the affordable rental housing industry was able to adjust to the evolving economy. In addition,

21 The above data is from the Written Testimony before the Senate Subcommittee on VA, HUD and Independent Agencies regarding Mark to Market written by Mr. David Smith, 1995. The article is available at www.recapadvisors.com
the federal government switched its policy making approach from dictating how the work should be done to a focus on long term outcomes and results by leaving rooms for market solutions. It was expected that the federal government would only create a policy frame and leave room for the market to realize the policy goals. By decoupling HUD’s functions, the policy goals would be realized through negotiation between related parties in the market rather than through regulations from “the top”.

2) Demonstration activities

This fundamental shift from a top-down process to a decoupled interaction process was seen as so adventurous that the federal government wanted to make experiment before it initiated a nation wide undertaking. Moreover, because the FHA multifamily inventory included a cohorts generated from different affordable housing programs, it was unrealistic to dictate one set of guidelines for all the cohorts. Therefore, Congress hired practitioners from both public agencies such as Housing Finance Agencies (HFAs) and private companies such as Housing Investment, Inc.\(^{22}\) to write demonstration guidelines. Based on the guidelines, Congress authorized a Portfolio Reengineering Demonstration Program in FY 96, FY 97, and FY 98 in order to test in what degree the federal government should regulate, how much room should be left for the market players to negotiate, and how the existing affordable rental property owners would react facing the new policy. In the demonstration period, HUD experimented with three different types of restructuring agents: HUD field offices, interested state housing finance agencies (HFAs),

\(^{22}\) Housing Investments, Inc. staffs POAH, Inc., the none-profit developer that took the Hawthorne properties going through Mark-to-Market.
and joint ventures between HUD and qualified nonprofit entities. These restructuring agents would perform a function as the portfolio reengineering underwriters.

In the demonstration transactions, the restructuring agents negotiated with the property owners on new HUD contract rent, operation cost, and loan sizes so as to restructure and refinance the properties’ debt. Because the conflict of interest among different parties was very complicated, the negotiations were challenging: FHA’s interest was to keep their insurance payment low, so they hoped the restructuring agents to underwrite a larger first mortgage size and less rehabilitation; the first mortgage lender, generally state HFAs, always made conservative assumptions on their first mortgage underwriting so their interest on first mortgage underwriting was conflicted with FHA’s interest; the developers hoped to do more rehabilitation work so that they would earn more developers fee, but that would increase FHA insurance payment; the owners hoped to get more cash flow distribution so that higher rents would make the properties more profitable, but higher rents would cost HUD more subsidies; more rehabilitation work would improve the properties’ physical quality, which would finally benefit low income families but required higher FHA insurance payment. Therefore, the restructuring agencies had to balance the different interest among different parties to make the deals work, which made the negotiations very intense.

The demonstration activities brought some intriguing observations and insights to the restructuring agents and HUD.

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23 The FHA insurance payment will be mainly decided by two factors: Total development cost including acquisition and rehabilitation, and the performing first mortgage. Other things being equal, the higher the total development cost, the more the FHA insurance payment is required; the lower the performing first mortgage, the more the FHA insurance payment is needed. A more concrete discussion is in the next chapter.
Firstly, there were fewer properties than expected that wanted to go through the whole debt restructuring process. Because every property was unique, different transactions included different executions. For example, some of the properties in the demonstration activities just went through refinance, some of them only reduced rent without refinance, and some of them restructured their debt by paying part of the existing debt and refinance. Some properties with higher rents didn’t ask for FHA insurance payment because these properties’ owners did not want to go through a complicated debt restructuring process. As a result, the owners simply delayed the properties’ debt problems to the future.

Secondly, some owners participated in the demonstration activity on a conditional basis only if they could be financially better off. Some owners even felt betrayed: they built affordable housing under the production programs in the market that did not support affordable housing economically, but twenty years later Congress decided that the government could not afford to support the properties. In addition, either an unfavorable deal or too complicated transaction process would keep the owners away from the debt restructuring. Because the projects had to be done by negotiation between owners and restructuring agents, the final results must be agreed on by both parties, which made both the owners and HUD better off.

Finally, as the demonstration program went on, some public restructuring agencies such as state HFAs would no longer work as restructuring agencies. It was mainly because the transactions were more rigorous, more time-consuming, but less profitable than their expectations; the debt restructuring was a real estate work out and the ability to negotiate in controversial situations was not the expertise the public agencies had or wanted to
develop; and as both first mortgage lenders with lots of local business relationships and a restructuring agencies, state HFAs faced conflicting objectives in their work.

The demonstration activities provided experience and lessons to Congress, HUD, Section 8 administrators, and the restructuring agents. The policy makers figured out what the owners wanted and how to align their interest with the market players to preserve affordable housing. Some debt restructuring rules were changed based on the feedbacks from the demonstration deals. (Appendix 1, the difference between demonstration rules and final Mark-to-Market rules)

A significant change was the owner incentives. The initial debt restructuring process required owners to fund significant rehab and transaction costs with little if any return on their new cash investment, which made the debt restructuring less attractive. These costs were then transferred to buyers as part of the acquisition cost and buyers needed to pay rehab and transaction costs too. Therefore, sales of affordable housing became rare. Under this situation, Congress held several stakeholders’ meetings to invite owners, developers, and other debt restructuring practitioners to discuss difficulties raised in the demonstration process. After the stakeholders’ discussions, the new owner incentives were announced in 2001, fall. Under the new regulations, the owners could get returns on their cash contributions, buyers could get part of recover on their transaction costs, HUD would pay 80% of closing costs instead of 50% in previous guidance, a Capital Recovery Payment (CRP) payment could be underwritten into a transaction to repay the required owner capital contribution with a seven to ten year period and 350 basis points over the comparable term Treasuries, and an Incentive Performance Fee ("IPF") would be payable annually to owners who met sound management criteria to encourage good long term
property management. These new owner incentives provided more incentives for owners and buyers to go through debt restructuring process and operate properties well in the long run.

Moreover, the demonstration activities confirmed that nonprofits’ mission could align their interest with the government and they acted as nexus of the real estate transactions by using their real estate specialties. In many cases, when the properties could not do well and would be abandoned by the owners, local residents and community development corporations would acquire them and take care of them. Nationwide nonprofits have a mission of preserving affordable housing with real estate specialties; local community development corporations have local connections and more experience on comprehensive community-based programs. Therefore, they are ideal candidates to acquire at-risk affordable rental properties and keep their affordability in the long run.

3) MAHRA legislation

Under an intention to make the affordable rental housing stock financially and physically sound, Congress enacted the Multifamily Assisted Housing Reform and Affordability Act (MAHRA), commonly referred to as the “Mark-to-Market” legislation in October, 1997. At that time, the transactions in demonstration period were still in closing. Noticeably, MAHRA legislation took place four years later after Mr. Kohashi first pointed out the HUD’s outlay crisis. The four years debate was resulted from the intense negotiations among interest parties. For example, many owners did not want to go through the Mark-to-Market process, so Congress had to negotiate with developers and owners to come up with more attractive restructuring plan and make the owners comfortable. Another debate
took place between Congress and HUD. Congress did not trust HUD on administering Mark-to-Market, so who would perform the administration function in Mark-to-Market became a major political fight between them. In order to solve the political conflict, Congress established an independent office, The Office of Multifamily Housing Assistance Restructuring (OMHAR) to administer the Mark-to-Market program in the MAHRA Act. Although the OMHAR was within HUD, it was under the management of a Director who would be pointed by the President and approved by Congress. Therefore, the administrator of MAHRA was independent from both HUD and HFAs.

Recapitalization Advisors, Inc. summarized the MAHRA legislative summary: “

I. Applicable properties:

Properties receiving Section 8 subsidies (including New Construction/ Substantial Rehab, Loan Management Set Aside (LMSA), Moderate Rehab, Property Disposition, and Conversions from Rent Supplement or §23); rent above Fair Market Rent (FMR), with FHA insured mortgage or HUD hold mortgage

II. Eligible entities who do the Mark-to-Market debt restructuring:

Participating Administrative Entities (PAEs) mainly including state finance agencies, and other private companies such as Recapitalization advisors, Inc. The PAEs are responsible to OMHAR and have principal responsibility for all relevant decisions, including the amount of mortgage re-sizing as well as the property-based versus resident-based issue. However, PAEs must accept comment from all affected stakeholder groups including residents and the community.

III. Mortgage restructuring plans

Reduce Section 8 rent down to market rent; properties pay off existing debt; borrow new first mortgages under reduced rent; and borrow a 'soft second' loan at 1% matures from the FHA insurance fund. The subordinate second mortgage will expire when the first mortgage is fully repaid, and in the interim consumes 75% of the cash flow.
IV. PAE decide if a property is project based or tenant based Section 8 as well as ongoing program monitoring

V. Rehabilitation

PAE may approve developers to use federal funds for up to $5,000 per apartment (provided the owner contributes 20% of the cost from non-property sources).

VI. Ongoing affordability restriction will be 30 years

VII. Timing:

Under the debt restructuring period for Mark-to-Market, properties’ section 8 contracts can be temporarily extended for one year under existing contract rents; new rent and extended section 8 contract will be adopted after restructuring. This timing restriction will create a sense of urgency for the owners, developers, and PAEs throughout the process.24

All in all, owners would get these benefits under MAHRA incentives: partial payment of claim on the current insured mortgage; refinancing with or without FHA mortgage insurance or other forms of credit enhancement; existing property cash reserves including replacement reserves and residual receipts; the PAE can offer 10% of any excess funds left from the transaction proceeds to the owner; federal rehab grants up to $5,000 per apartment with the owner contribution at least 25% of the total rehab costs from non-property sources.

4) Post MAHRA debates

The MAHRA legislation was not the end of the Mark-to-Market policy making process; it was in the middle stage of the Mark-to-Market experience followed by lots of negotiations and policy debates during implementation.

24 Recapitalization Advisors, Inc. [Online article] URL: www.recapadvisors.com
Because the Mark-to-Market underwriting procedure was very property specific, MAHRA legislation left several "blanks" to be decided by the practitioners in the underwriting process through negotiation. Specifically speaking, Mark-to-Market set up a seven-step underwriting sequence, but several important underwriting standards were to be decided by PAEs such as which properties were eligible for Mark-to-Market, operating budget projection, debt service coverage ratio, how much was the second soft mortgage, and what will be owners’ tax situation after Mark-to-Market debt restructuring [Appendix 2]. The above unsolved questions left enough room for deal makers to innovate. MAHRA, as a framework, provided lots of options for owners, developers, and affordable housing lenders. As Mr. Smith commented, "Real estate is inherently dynamic, yet the HUD portfolio has been static. Placing the inventory under constructive tension encourages new thinking, innovation, ownership transfers from the less to the more capable (whether nonprofit or for-profit), and a fresh look at a complacent inventory".25 In other words, once MAHRA left room for the market players to negotiate, the market power would make the deals economically sound. The negotiation way to realize policy goals would make the affordable housing industry adjust to the new economic situation even the economy kept evolving.

More importantly, there were several unsettled issues that would affect owner and developers’ incentive on participating Mark-to-Market. Those issues were:

i) The soft debt—second mortgage forgiveness issue

25 David Smith, P. 164.
A key incentive in Mark-to-Market was the subordinate mortgage provided by the FHA insurance claim fund. Under MAHRA legislation, the second mortgage could be forgiven if the acquirer is a community-based, tenant-endorsed nonprofit. However, the forgiven debt couldn't be included in acquisition bases, so the Low Income Tax Credit proceeds would be reduced. Therefore, the developers suggested a secondary mortgage assignment rather than forgiveness to generate more Tax Credit proceeds so as to increase financial resources.

In July 18, 2002, OMHAR issued a revision on its previous draft Appendix C issued on March 18, 2002. In this revision, OMHAR allowed a community-based, tenant-endorsed nonprofit acquirer to go through second mortgage assignment as opposed to forgiveness, which provided two incentives for Mark-to-Market projects:

- Debt forgiveness would decrease the acquisition price because the purchaser did not need to pay off existing second mortgage. However, if the project also used LIHTC financing, so the reduced acquisition price would reduce LIHTC eligible basis and consequently reduce the equity amount raised through LIHTC syndication. Debt assignment, on the contrast, did not decrease eligible acquisition basis so that it provided higher equity contribution through LIHTC and consequently provided more financial resource for rehabilitation.

- Assignment provided more incentive for nonprofits through cash flow distribution by establishing eligibility for Owner Incentives (the Capital Recovery Payment).  

26 Capital Recovery Payment (CRP): the CRP requires acquirer/new owner contribute cash in development phase as part of the development financial resources. As a return, a schedule can be underwritten to repay
and Incentive Performance Fee\textsuperscript{27}) and the 75%/25% cash flow split. Without assignment, the owner incentives were not available and distributions were governed by the pre-existing regulatory agreement or HAP contract under debt forgiveness. As a result, forgiveness may limit Owner Incentives or permit no distribution for nonprofit mortgagors. Therefore, debt assignment to the nonprofits was preferred to forgiveness on its provision of long term incentive.

In order to avoid legal problems with the second mortgage assignment, the related parties had to be very careful on the closing process: first, the mortgage restructuring note was executed by the seller; then the seller assigned the note to the nonprofit acquirer and the acquirer immediately reassigned the debt to the general partner or other "unrelated party" approved by OMHAR; finally, the acquirer took title and assumed the debt.

ii) IRS ruling on the tax consequences of FHA multifamily restructuring

According to the MAHRA Act, the new second mortgage was issued at below "Applicable Federal Rate (AFR)", generally at 1\% and qualifies as indebtedness under general principles of federal income tax law. Under §7872 of the Internal Revenue Code, a below-market loan was defined as any loan on which the interest rate charged was less than the AFR. Therefore, Section 7872 (b) provided that the borrower cashed in an amount equal to the difference between the present value of the owner's CRP contribution. The repayment terms include a rate at 350 basis points over the like-term Treasury bond and 7 to 10 years amortization.

\textsuperscript{27} An Incentive Performance Fee (IPF) is an annual payment to owners who meet sound management criteria. The IPF is equal to 3\% of gross property income (with a minimum of $100 per apartment per year and a maximum of $200 per apartment per year) and subject to a surplus cash calculation.
mortgage amount under current below market interest rate and the present value of
the mortgage amount under the market interest rate on the date the loan was made.
Therefore, the mortgage borrower should pay tax on this amount of income, which
would reduce the second mortgage incentive provided by MAHRA and generate a
negative impact on the program as well as owners’ willingness to go through Mark-
to-Market. During the demonstration period, restructuring agents and owners found
this unfavorable code on the second mortgage and recognized it as a negative impact
on Mark-to-Market. Later on, they discussed this issue with IRS, which generated lots
of debates.

On September 17, 1997, House of Representatives, Subcommittee on Housing and
Community Opportunity, and Committee on Banking and Financial Services held a
hearing on the Tax Consequences of FHA Multifamily Restructuring. During that
hearing, representatives Leach (ex officio), Kelly, Hill, LaFalce, Kennedy, Gutierrez,
J. Maloney of Connecticut, and Redmond listened to the analysis and arguments from
related parties including tax accountants, lawyers, and real estate and policy
consultants such as Mr. David Smith. In that hearing, Mr. David Smith suggested IRS
to make a new ruling in stead of legislation, which may avoid long time negotiation.
Because of conflict of interest, this debate kept almost a year until IRS issued a new
ruling on the tax consequence of MAHRA second mortgage. Under the new IRS
ruling, most government-subsidized loans, such as government-insured residential
mortgage loans, were intended to be exempt from §7872 according to the legislative
history of §7872. Therefore, the second mortgage under Mark-to-Market should be
exempt from section 7872.
After these debates were settled, Mark-to-Market finally set up solid guidelines to restructure expiring Section 8 contract. Looking at the Mark-to-Market legislation process, it started from Mr. Kohashi’s article about the HUD outlay crisis, after the policy makers and policy consultants figured out the problems and the new policy goals, a demonstration period was initiated in which the federal government only provided a policy frame and a clear political goal of keeping existing affordable property stock while reduce HUD’s outlay, finally, the MAHRA Act was passed based on the experiment result of the demonstration activities and some of the guidelines were still in debates that would be solved by the market power through negotiation. Therefore, the Mark-to-Market experience was totally different from the traditional policy making paradigm of the top-down process.

2.7 The program uniqueness in Mark-to-Market

1) From dictating the process to decoupling: the fundamental program shift of Mark-to-Market

Mark-to-Market recognized more market power as opposed to government power in the affordable rental housing arena. In the highly regulated affordable housing industry, the federal government finally recognized rents based on fair market rent, and the debt restructuring was realized by negotiation between lenders, borrowers, investors, and other related parties rather than dictating numbers. Mr. David Smith commented on Mark-to-Market legislation that “The Mark-to-Market legislation represents an affirmative decision by Congress to disengage from the regulatory constraints and contractual
obligations that resulted from the Section 8 production programs”. Specifically, HUD disengaged itself by decentralizing some of its functions:

- **Devolve mortgage issuance**

  Some of the new first mortgages for affordable housing properties is issued by State Housing Finance Agencies and then sold in secondary mortgage market to use financial market’s specialties in stead of being operated solely by FHA. Although secondary market has played an important role in Section 236 program by purchasing mortgages from FHA to replenish FHA’s funding resources, a fully developed secondary market in late 1990s can benefit subsidized rental housing industry a lot more. Decentralizing mortgage issuance from FHA to State Housing Finance Agencies utilized HFAs’ local specialties so as to have better control on the quality and performance of the mortgages; more financial entities participating in affordable rental housing industry made this niche market more liquid; advanced financial instruments such as derivatives and sophisticated financial engineering technologies help investors and mortgage issuers price, manage, and hedge risk more effectively; a developed financial market as a whole provides more capital for affordable rental housing.

- **Devolve workload**

  Congress has devolved workload from HUD to Participating Administrative Entities (PAEs) to restructure the debt and subsidies on the HUD-insured portfolio carrying above-market Section 8 subsidies. Currently, PAEs include public agencies such as State Housing Finance Agencies and for-profits such as
Recapitalization Advisors, Inc. in Boston. Local PAEs are able to use their specialties on understanding affordable rental housing industry and local real estate market to underwrite new operating budget, new debt service coverage ratio, new FHA insurance amount, and new second mortgage amount for Mark-to-Market.

By disengaging HUD's multiple roles, the federal government is able to avoid conflict of interest among HUD's multiple roles and use more market power to ensure affordable rental housing sound in a long run.

2) The role of nonprofits

Because Mark-to-Market allows nonprofits to go through second mortgage forgiveness, nonprofit developers are encouraged to participate in this program. David Smith argued that "Over the past decade, when the HUD affordable housing debate has focused predominantly on preservation rather than new development, policy makers have explicitly favored direct nonprofit ownership."\(^{28}\) First of all, the nonprofits' mission and social concern always align their interest with the policy goals of the federal government. Therefore, their common interest always makes a good start for their negotiation that makes their bargaining more efficient. Secondly, lots of community based nonprofits have local specialties. In order to keep subsidized rental housing physically sound in a long run, owners must keep good property management that requires not only a good physical maintenance but also a relationship building with local residents and with the whole community. Lots of nonprofit owners offer job training, first time home buyer

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\(^{28}\) David Smith, p.176.
assistance, and day care service in addition to providing affordable rental housing, and these community oriented services build a good community environment that also benefit the property. Thirdly, nonprofits have not only specialties on real estate deal making but also a good understanding on subsidized rental housing business that is different with regular real estate deals. Finally, lots of grants available solely to nonprofit developer/owners, together with nonprofits’ favorable tax position contribute more financial resources for preserving affordable housing. In short, nonprofits’ mission and local specialties are able to ensure long term healthiness of subsidized rental housing, which just accords with the federal government’s political goal.

Among the nonprofits, POAH, Inc. actively involved in the Mark-to-Market policy making process by providing suggestions in the demonstration program and by negotiating with OMHAR on specific guidelines in one of the earliest Mark-to-Market implementation project, the Hawthorne project. The Hawthorne project not only was a successful Mark-to-Market project but also showed how the nonprofit, POAH, Inc. negotiated with related parties to work out the project and participated the policy making process.
Chapter three: A successful project in Mark-to-Market: The Hawthorne properties

Since the MAHRA Act in 1997, seven hundred projects have gone through the Mark-to-Market process. In those projects, the Hawthorne project dealt with all the program legacies discussed in the Chapter Two. As the first project combined multiple resources to complete the debt restructuring process, the developer, Preservation of Affordable Housing, Inc. (POAH, Inc.), directly negotiated with the OMHAR on all the restructuring details. In order to show how Mark-to-Market worked on a specific deal, this chapter describes the original problems faced by the developers, the challenges and solutions during the Mark-to-Market process, and the insights from the Hawthorne experience.

3.1 Introduction of the Hawthorne project

The “Hawthorne properties” was a federally subsidized affordable housing complex located in a low density suburban area east of the center of Independence, Missouri, at the intersection of Missouri Highway 291 and U.S. Highway 24. It was a family development constructed from 1966 through 1971 in order to provide affordable rental units for the families earning at or below 50 percent of the area median income. The Hawthorne properties were financed under Section 221(d) (3) program and then they got project based Section 8 subsidy. The Hawthorne properties included attached townhouses and small apartment buildings comprised of five separate properties with totally 750 units:

<table>
<thead>
<tr>
<th>Properties</th>
<th>Units</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hawthorne Properties North</td>
<td>188</td>
<td>(North of Highway 24)</td>
</tr>
<tr>
<td>Hawthorne Properties South</td>
<td>187</td>
<td>(South of Highway 24)</td>
</tr>
<tr>
<td>Hawthorne Properties East</td>
<td>131</td>
<td>(South of Highway 24)</td>
</tr>
</tbody>
</table>
Hawthorne Properties West  75 units  (South of Highway 24)  
71 Hawthorne Properties  164 units  (South of Highway 24)  

The complex offers very spacious accommodations to families with two-story townhouse style and basements, and the entire development is situated on an open 70-acre site.

The properties were managed by NEF Management Inc. (NEFMI). Rents for the families that occupy the Hawthorne properties were very affordable with the vast majority units (92%) subsidized under the federal Section 8 rental subsidy program and the rents for the remainder of the units limited by regulatory agreements. Although the properties were well maintained and well managed, most of the systems were over 25 years old and needed renovation to stop further deterioration and to reduce high maintenance costs that would affect operations. In addition, the Hawthorne properties faced a loss of affordability due to the expiration of the Section 8 contract. In July of 1999, the Hawthorne properties were purchased from Midland Properties Inc. (a private for-profit owner/manager) by the nonprofit NEF Properties, Inc. (after the purchase, NEF Properties, Inc. changed the company name to Preservation of Affordable Housing, Inc.), the management company of the Hawthorne properties. POAH, Inc. was staffed by Housing Investments, Inc., a Boston based for profit affordable housing developer who used to be hired by Congress to write the Demonstration guidelines for Mark-to-Market. Therefore, the POAH staff was quite familiar with the MAHRA Act and when they purchased the Hawthorne properties, they had an intention of bringing the Hawthorne properties to go through Mark-to-Market.

Before going through Mark-to-Market, the Hawthorne properties were losing money due to high debt service expenses. According to the audit information provided by POAH,
Inc., these properties had totally $228,955 financial loss in year 2000. The total debt service amount was $1,429,048, which consumed 31% of the net rental income.

Under the Jurisdiction of the Multifamily Assisted Housing Reform and Affordability Act (MAHRA), Congress had mandated that expiring Section 8 contracts be renewed at levels no higher than those of comparable market housing. In the case of the Hawthorne project, this would result in a reduction in the current Section 8 contract rents upon renewal. Therefore, the nonprofit developer, POAH, Inc. faced challenges to rehabilitate and keep the Hawthorne properties affordable in the long run.

3.2 Challenges and solutions

1) The Origin of the challenges

Going through Mark-to-Market would directly generate two results: on the one hand, HUD would save rental subsidy, which made HUD better off; on the other hand, reduced rental income would put more pressure on properties’ operating budget. Even before the rent reduction, the Hawthorne properties had been losing money, the reduced rent would make the owner worse off without other financial solutions.
Exhibit 2  Rent reductions and the subsequent HUD rental subsidy savings under Mark-to-Market

### Hawthorne North

<table>
<thead>
<tr>
<th>Unit Type</th>
<th># of Units Currently Assisted</th>
<th>Current Assisted Rent ($/pmm)</th>
<th>Market Rent ($/pmm)</th>
<th>HUD Subsidy Savings ($/pmm)</th>
<th>Annual Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1BR</td>
<td>30</td>
<td>500</td>
<td>450</td>
<td>50</td>
<td>18,000</td>
</tr>
<tr>
<td>2BR</td>
<td>111</td>
<td>597</td>
<td>517</td>
<td>80</td>
<td>106,560</td>
</tr>
<tr>
<td>3BR</td>
<td>41</td>
<td>810</td>
<td>661</td>
<td>149</td>
<td>73,392</td>
</tr>
<tr>
<td>Tot/Wgt.Ave:</td>
<td>182</td>
<td>629</td>
<td>538</td>
<td>91</td>
<td>197,952</td>
</tr>
</tbody>
</table>

Percentage Reduction in Rents: 14.41%

### Hawthorne South

<table>
<thead>
<tr>
<th>Unit Type</th>
<th># of Units Currently Assisted</th>
<th>Current Assisted Rent ($/pmm)</th>
<th>Market Rent ($/pmm)</th>
<th>HUD Subsidy Savings ($/pmm)</th>
<th>Annual Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1BR</td>
<td>38</td>
<td>525</td>
<td>450</td>
<td>75</td>
<td>34,200</td>
</tr>
<tr>
<td>2BR</td>
<td>61</td>
<td>620</td>
<td>548</td>
<td>72</td>
<td>52,740</td>
</tr>
<tr>
<td>3BR</td>
<td>72</td>
<td>862</td>
<td>660</td>
<td>201</td>
<td>173,964</td>
</tr>
<tr>
<td>Tot/Wgt.Ave:</td>
<td>171</td>
<td>701</td>
<td>573</td>
<td>127</td>
<td>260,904</td>
</tr>
</tbody>
</table>

Percentage Reduction in Rents: 18.15%

### Hawthorne East

<table>
<thead>
<tr>
<th>Unit Type</th>
<th># of Units Currently Assisted</th>
<th>Current Assisted Rent ($/pmm)</th>
<th>Market Rent ($/pmm)</th>
<th>HUD Subsidy Savings ($/pmm)</th>
<th>Annual Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1BR</td>
<td>16</td>
<td>536</td>
<td>450</td>
<td>86</td>
<td>16,512</td>
</tr>
<tr>
<td>2BR</td>
<td>56</td>
<td>630</td>
<td>561</td>
<td>69</td>
<td>46,176</td>
</tr>
<tr>
<td>3BR</td>
<td>44</td>
<td>911</td>
<td>661</td>
<td>250</td>
<td>132,132</td>
</tr>
<tr>
<td>Tot/Wgt.Ave:</td>
<td>116</td>
<td>724</td>
<td>584</td>
<td>140</td>
<td>194,820</td>
</tr>
</tbody>
</table>

Percentage Reduction in Rents: 19.34%
Hawthorne West

<table>
<thead>
<tr>
<th>Unit Type</th>
<th># of Units Currently Assisted</th>
<th>Current Assisted Rent ($/pump)</th>
<th>Market Rent ($/pump)</th>
<th>HUD Subsidy Savings ($/pump)</th>
<th>Annual Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>2BR</td>
<td>38</td>
<td>549</td>
<td>590</td>
<td>41</td>
<td>18,696</td>
</tr>
<tr>
<td>3BR</td>
<td>33</td>
<td>788</td>
<td>661</td>
<td>127</td>
<td>50,280</td>
</tr>
<tr>
<td>Tot/Wgt.Ave:</td>
<td>71</td>
<td>660</td>
<td>623</td>
<td>37</td>
<td>31,584</td>
</tr>
<tr>
<td>Percentage Reduction in Rents:</td>
<td>5.62%</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

71 Hawthorne Place

<table>
<thead>
<tr>
<th>Unit Type</th>
<th># of Units Currently Assisted</th>
<th>Current Assisted Rent ($/pump)</th>
<th>Market Rent ($/pump)</th>
<th>HUD Subsidy Savings ($/pump)</th>
<th>Annual Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1BR</td>
<td>21</td>
<td>535</td>
<td>450</td>
<td>85</td>
<td>21,420</td>
</tr>
<tr>
<td>2BR</td>
<td>66</td>
<td>629</td>
<td>567</td>
<td>62</td>
<td>48,852</td>
</tr>
<tr>
<td>3BR</td>
<td>58</td>
<td>883</td>
<td>660</td>
<td>223</td>
<td>155,208</td>
</tr>
<tr>
<td>Tot/Wgt.Ave:</td>
<td>145</td>
<td>717</td>
<td>587</td>
<td>130</td>
<td>225,480</td>
</tr>
<tr>
<td>Percentage Reduction in Rents:</td>
<td>18.07%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

HUD Total Annual Savings 910,740

Resource: Mark-to-Market underwriting exhibits as of March, 2002, made by a private PAE Foley & Judell

It was expected that HUD would save totally $910,740 per year on its subsidy expenses by reducing Hawthorne properties’ rents. At the same time, however, the properties’ net operation income (NOI) was expected to decrease, which would consequently decrease the amount mortgage the properties can support. When POAH, Inc. just started to consider the Hawthorne transactions, there were only limited financial resources for the nonprofit to preserve the Hawthorne properties’ affordability without Mark-to-Market transaction: first mortgage under a lower interest rate compared to the Hawthorne
properties' original interest rate; Low Income Housing Tax Credit (LIHTC); and existing replacement reserve. However, these 30 year old properties needed significant rehabilitation work, which could not be covered by the above available resources. Therefore, the core challenge for POAH was to raise enough financial sources to payoff exiting high debt load and support enough rehabilitation so as to keep the Hawthorne properties affordable to low- and medium-income families in the long run.

2) High Existing Insured Debt Load

Challenge

The Hawthorne properties had close to $3million outstanding first mortgage balance and more than $15million outstanding second mortgage balance before the transaction. Therefore, the financial sources of any refinancing under Mark-to-Market must cover these outstanding debts and significant rehabilitation expenses. The $15million was borrowed under LIHPRHA program\(^\text{29}\) in 1995 and each of the five Hawthorne properties had a FHA insured second mortgage under 221(f) program. An inevitable process in the transaction process would be prepaying the first and the second mortgage. However, due to the legacy from LIHPRHA debt restructuring transaction, the prepayment of the second mortgage faced much difficulty:

\(^{29}\) LIHPRHA: Low Income Housing Preservation and Resident Homeownership Act (1990). Enacted by Congress in 1992, LIHPRHA was designed to keep owners of older assisted housing from buying out of subsidized mortgages, and thus reducing the number of available affordable housing units. As part of the National Affordable Housing Act, the law codifies steps an owner of a property must take in order to sell it or end HUD's affordability restrictions, provides incentives to owners to stay in HUD's programs, and gives advantages to tenants and nonprofits in purchasing buildings should the owner choose to sell. However, LIHPRHA approved some second mortgages that made the properties mortgage outstanding even much higher than the properties' value. As a result, the title of the properties became a question that if the properties were owned by the property owners or by mortgage holders.
After the LIHPRHA transaction of the Hawthorne properties closed in 1995, the five second mortgages were sold as a part of Ginnie Mae and the certificate from that was included by Fannie Mae in a $325 million REMIC that had Fannie Mae as trustee. The coupon rate on each of the five second mortgages was 9.25% (above market) with expectation of receiving this current above-market rate until June 1, 2005. If the current owner prepaid the mortgage, Ginnie Mae, Fannie Mae, and the REMIC investors would lose money. Therefore, all the above financial institutions wanted to keep the mortgage from prepayment.

Negotiations and Solutions

Mr. Carl White in POAH, Inc. argued, “It is unclear whether the original investors in these bonds (backed by these mortgages) discounted the acquisition price of the debt they purchased due to the obviously weakened prepayment limitation”. Mr. White also found some unique paragraphs in the Rider II of HUD form 94139D. Paragraph 2 in Rider II stated that no prepayment could occur prior to June 1, 2005; but after that date prepayment could occur with 30 day notice. However, that statement was followed by

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30 Ginnie Mae: Ginnie Mae was created in 1968 as a wholly owned corporation within the Department of Housing and Urban Development (HUD.) Ginnie Mae has operated as a wholly owned government association since the 1968 amendments.

31 RMBS: Residential Mortgage Backed Securities

32 Fannie Mae: Fannie was also created in 1968 as Ginnie Mae’s private counterpart. It has been the biggest secondary mortgage market player with the second highest corporation asset value in the U.S. Fannie Mae purchases mortgages, pools the mortgages, and converts the packages to securities and sells them to investors so as to replenish capital for the primary mortgage market.

33 REMIC: Real Estate Mortgage Investment Conduit. The REMIC is a multiple-class mortgage cash flow security, backed residential mortgage loans, which generally have been pooled together MBS trusts. REMIC securities restructure interest and principal payment into separately traded securities. By redirecting the cash flow from the underlying standard MBS, the issue can create a security having several classes, also called tranches, which may carry different coupon rates, average lives, prepayment sensitivities and final maturities. Investors with different investment horizons have the opportunity to own a tranche that satisfies their investment criteria and portfolio needs. These tranches may be designed to deemphasize the option risk of the underlying mortgage or accentuate it.
“the indebtedness may be prepaid in whole or in part without the consent of the holder
and without prepayment penalty if the U.S. Department of Housing and Urban
Development ("HUD") determines that prepayment will avoid a mortgage insurance
claim and is therefore in the best interest of the Federal Government.” And the paragraph
5 stated that “In the event that rental assistance is not extended under 24 CFR Part 248, or
as provided in 24 CFR Section 242.1046 (b) the Commissioner is unable to develop a
revised package of incentives to the owner comparable to those received under the
original approved plan of action, the Commissioner may require the holder of this Note to
accelerate this Note and the Second Deed of Trust securing the same. Any such
acceleration shall not be construed as a prepayment hereunder.” Therefore, the investors
might have priced the five years prepayment possibilities in the purchase price so they
would have earned extra benefit after year 2000, five years after the issuance of the
second mortgages.

At that time, the Mark-to-Market Extension Act of 2001 had been passed and it reflected
Congress’s interest in including LIPHRA transactions within the Mark-to-Market
program. Although HUD appeared to have the authority to authorize a prepayment based
on the MAHRA statute and the general provisions of Rider II (above) and the more
targeted provisions of Paragraph 5 of Rider II, they had been unwilling to exercise this
authority due to its conflict of interest with Fannie Mae, the large amount of the
prepayment, and consequently the potential responsibilities in case the transaction went
wrong.

In March, 2002, Mr. Carl White in POAH, Inc. talked with the attorney who represented
Midland Properties Inc. at that time on the closing issues. The attorney suggested that this
Paragraph 5 was unique at the time and was in response to the LIPHRA program. Because the LIPHRA Section 8 Housing Assistance Payments contract (HAP contract) had five year term, if the HAP contract was not extended beyond its initial five year term, the obligations that run with the LIPHRA transaction could be revisited.

In a memo on May 20, 2002, Ms. Anthony, president of POAH, Inc., together with Mr. White suggested two approaches for prepayment:

- **Defeasance:** in which an escrow (e.g., Treasuries) would be substituted for the underlying mortgage as the security for the debt (principal and interest payments through the prepayment date) and the existing lien on the property would be cancelled; and,

- **Timed Payoff:** in which an escrow (e.g., Treasuries) would be established as a sinking fund adequate to support the servicing of the second mortgage debt during the three year interim up to the prepayment date with the mortgage remaining in place during that period.

On June 19, 2002, HUD portfolio director Donna Rosen wrote an official letter to Mr. Michael Daze, Associate General Counsel in Fannie Mae to address the second mortgage prepayment issue, “our ability to restructure the debt on these properties, and to ensure the long-term viability of these assets, is dependent on defeasance of the existing 241 loans. I understand that a strategy for doing this is being developed between the owner and Fannie Mae. OMHAR supports this strategy, and will work with all parties involved, to bring about this transaction”. She continued, “In closing, OMHAR views this transaction as a critical step in the long term preservation of this important affordable
housing resource in Independence Missouri. The participation of Fannie Mae in the preservation of this housing by means of the defeasance arrangement discussed above would greatly assist OMHAR and HUD in their efforts to preserve affordable, subsidized rental housing consistent with the mandates given us by Congress.”

Finally, after the several month negotiations, the common interest of preserving affordable housing aligned OMHAR with POAH, Inc. to support POAH’s acquisition and rehabilitation on the Hawthorne properties, and Fannie Mae agreed on the prepayment under OMHAR’s support through a mortgage defeasance, which was a critical step in the transaction.

3) Lack of financial resources

Challenge

The almost 30 year old Hawthorne properties needed significant rehabilitation to keep it in good physical quality. Under the minimum rehab requirement in the Mark-to-Market program required by HUD, POAH, Inc. needed to spend at least $6,991,910 as rehabilitation expenses or $9,651 per unit. Therefore, POAH faced a challenge to raise sufficient capital to support necessary rehabilitation as well as payoff existing high debt load.

The most innovative feature of the Mark-to-Market program is the bifurcated mortgage structure, which means the FHA insured mortgage would be bifurcated to supportable debt and unsupportable debt, and HUD would issue a second mortgage for the
unsupportable debt. Under the new incentive to nonprofits, HUD would assign the second mortgage for the nonprofit owners.

Because of the LIPHRA restructuring, the Hawthorne properties had more than $13 million debt “unsupportable” by the properties’ rental income. Under Mark-to-Market guidelines, the purchaser can get FHA insurance claim due to the unsupportable debt due to the reduced rent. The insurance amount is equal to the reduction in first mortgage debt, plus 80% percent of rehab and transaction costs, plus 100 percent of the initial reserve deposit and developer fee, minus the existing reserve balance carried forward. Exhibit 3 shows a simpler calculation:

**Exhibit 3 FHA insurance claim calculation**

Calculated FHA claim amount=Total development cost including acquisition
- New first mortgage
- Existing replacement reserve
- Other resources

Where acquisition price was usually decided by

- Unpaid balance of loans to be restructured
- Immediate rehabilitation cost
- Transaction cost
- Initial Deposit of Replacement Reserve

Under this calculation, HUD’s contribution is on the left side of the equation while the contributions from a property and its owner are on the right side of the equation. The more the property can support and the developer can find financial resources, the less HUD needs to contribute. Therefore, there is a conflict of interest between HUD and the developer, and both parties hoped its counterparties could contribute more. How to
balance related parties’ interest while provide sufficient financial resources for project proceeds is always challenging.

A fundamental program shift in Mark-to-Market was that deal makings were realized by negotiation between related parties instead of implementing guidelines dictated by policy makers. In the case of the Hawthorne project, the solutions were found through brainstorming and negotiating between the nonprofit developer, POAH, Inc. and other related parties such as OMHAR, the PAE, and the Missouri Housing Development Commission (MHDC). Because POAH was the first nonprofit developer to negotiate with OMHAR under the new incentive of second mortgage assignment, POAH, Inc. worked directly with OMHAR Washington rather than an outside PAE. The negotiation made all the related parties better off and solved the properties’ problems and challenges.

Solution 1: Adequate Operating Cost Assumptions

The amount of first mortgage is decided by properties’ NOI. Because the rent has been regulated by HUD, operation assumptions will directly affect the amount of first mortgage. Conservative assumptions assume high operation cost that is in favor of long term property maintenance but will reduce debt service amount so that HUD has to pay higher FHA insurance claim. Aggressive assumptions assume a lower operation cost that may generate insufficient maintenance budget, but higher NOI can support higher first mortgage and therefore the insurance claim amount will be reduced. In the underwritings in Section 221 (d) (3), Section 236, and Section 8 programs, HUD typically adopted the aggressive way so that the properties could borrow more first mortgages than they should have supported under a realistic assumption. The above unrealistic underwritings were
just implemented in these old affordable housing programs through a top-down process. However, during the Hawthorne properties’ debt restructuring process, POAH, Inc. attempted to negotiate with the OMHAR to reach a balance between what was needed to stabilize a property over the long term (20 years) and the cost to the Federal Government (size of the FHA Insurance Claim). As described by an OMHAR contractor, “the task is Solomonic.” However, as government representatives, there is strong incentive on the part of the OMHAR and OMHAR contractors to minimize the size of the FHA Insurance claim. During the negotiation on operation expenses underwriting, POAH had to justify its operation assumptions based on prosperities’ long term sound condition and to convince OMHAR on the operating costs. Mr. White commented in his memo,

“POAH’s negotiation with OMHAR on operating costs was fairly arduous, but we feel that we ultimately substantiated our demands for adequate underwriting assumptions which set precedents for negotiating future restructure deals.”

The negotiation result consequently became a guideline for later nonprofit Mark-to-Market purchase.

**Solution 2: Owner Retention of benefits from external financing**

Similar to the operation assumption case, external financing also raised a conflict of interest between an ample development resources and FHA’s insurance payment size. Although it seems obvious in retrospect, initially OMHAR expected to be able to reduce the size of the FHA Insurance Claim as a result of the new external resources brought by the owner to a transaction. For example, OMHAR’s position was that higher supportable loan proceeds (due to 6.50 % interest rate on tax exempt debt as opposed to an 8 ½%
market interest rate) should directly reduce the size of the FHA claim needed to make Sources equal Uses. Neither POAH, nor the Missouri Housing Development Commission (MHDC)—the source of the tax exempt financing—would do the transaction under these terms. After POAH convincing OMHAR its development budget and justifying the necessity of enough financial resources, OMHAR ultimately agreed that any external resources brought to a transaction by the Owner were for the benefit of the Owner and the property, and so these external resources would not reduce the FHA Insurance Claim.

As a result of these POAH negotiations, OMHAR adopted an approach in which the calculation of supportable debt is based on market assumptions (for rents, operating costs, loan terms, rehabilitation) with no assumption of external financial assistance being available. The FHA claim payment is now “sized” on this “base case” and then locked at that amount. The subsequent underwriting overlaying external financing does not reduce the FHA claim amount, which ultimately benefits the Owner and the property. The Base Case is now central in OMHAR processing and is consistently applied by OMHAR in determining rehab and transaction costs amounts that OMHAR will “pay for” under the determination of the FHA claim under the base case. (Note: FHA claim amount is actually reduced somewhat under external financing, since the Base Case does not recognize the normal M2M developer fee to the non profit sponsor.)

Moreover, under the Base Case underwriting, OMHAR gave the developer incentive to maximize external financial resources adding on top of the FHA insurance claim. With enough development resources, the developer can spend more on rehabilitation so that reduce long term maintenance cost compared with rather high maintenance cost in lots of affordable housing deals in which only limited amount of development financial resource
is available. Specifically, in the Hawthorne case, by bringing higher loan proceeds and tax credit equity, POAH increased rehabilitation cost from $2,350/unit under OMHAR-only execution to over $10,000/unit in the final transaction by combining all the financial resources together.

Solution 3: Assignment of Second Mortgage:

As we have seen in the sources and uses chart in Exhibit 6, the FHA insurance payment is a key source for the Hawthorne transaction. The FHA insurance payment is secured by a second mortgage that is a cash flow note where the recipient of the funds is the "borrower/maker" being the property seller and the Note is held by the Secretary of HUD or his assigns. Under the MAHRA legislation, this mortgage can be forgiven if the purchaser is a nonprofit. However, this amount will not be calculated as an acquisition basis if the second mortgage is forgiven, which will reduce tax credit equity generated based on acquisition basis and construction cost. Therefore, the Hawthorne transaction creatively used second mortgage assignment instead of forgiveness to both maintain the eligible acquisition basis and retain whatever cash flow benefits would accrue (to the holder of the Note) if the Note had been forgiven.

There were two potential negative tax consequences under the assignment: 1) a deemed cancellation or discharge of a portion of the OMHAR debt; and, 2) problems with partnership allocations of tax items (between GP and limited partners, including tax credit allocations). The above two negative tax consequences would arise if the both

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34 LIHTC: Low Income Housing Tax Credit. To calculate the amount of LIHTC generated by development (in Hawthorne case, 4% LIHTC): Eligible basis × Affordable unit rate (Hawthorne project was 99.7%) × Basis Boost 100% × Tax Credit rate (3.45% at closing) × 10 years × Investor price (0.79 at closing). Therefore, the "eligible basis" will affect the amount of equity significantly.
entities at both ends of the loan are deemed by IRS as the same or related entities. There are several tests in the IRS Code for evaluating the degree of relationship between the entities. First, an entity is deemed unrelated to its parent or subsidiary as long as it owns less than 80% of the capital stock of the sister entity. Second, the same persons/entities (or related persons/entities) should not own more than 50% of the organizations at each end of the debt. This test includes a test that the same person or entity does not own more than 50% of the entities at both ends of the debt; and, that the combined ownership by an entity (at both ends of the debt) does not exceed 50%.

To conform to the tax code, POAH discussed with its lawyers and OMHAR and they created a complicated ownership structure and an assignment procedure (Exhibit 4 and Exhibit 5):

**Step 1:** The HUD Secretary will assign the OMHAR Mortgage Debt to the Purchaser.

**Step 2:** Prior to its taking title to the Project, the Purchaser then reassigned the OMHAR Mortgage Debt to Preservation of Affordable Housing LLC, (“POAH LLC”) an entity that qualifies as a Priority Purchaser by virtue of its control by the non profit Preservation of Affordable Housing, Inc. (“POAH, Inc.”), an Illinois not for profit corporation and tax exempt organization under Section 501 (c) (3) of the Internal Revenue Code.

**Step 3:** The buyer took the title of the five Hawthorne properties and the vacant land adjacent to the properties.

**Step 4:** LendLease joined in Hawthorne Associates, L.P. as a limited partner. It made tax credit syndication to contribute $ 11,341,850 equity through LIHTC.
By going through the above transaction process, POAH passed the IRA tests and avoided the potential unfavorable tax problems.

POAH did extensive negotiation with OMHAR on the second mortgage assignment. At that time, the appraisal value of the Hawthorne properties was $24,450,000 that was higher than the unpaid mortgage balance of $18,209,397. Therefore, maintaining acquisition balance without deducting second mortgage forgiveness made economic sense and therefore the LIHTC equity raise was justified. However, if the properties’ appraisal value hadn’t been higher than the unpaid balance, the acquisition basis would not have been maintained as high as the unpaid balance.
Exhibit 4: ownership structure and the second mortgage assignment procedure

Step 1
- Interim Trust (prior to assignment)
- Assignment of OMHAR 2nd Mortgages
- Hawthorne Associates assigns to POAH LLC prior to Buyer assuming OMHAR debt from Seller and before the buyer taking the title

Step 2
- Proceeds from Buyer
- POAH LLC
  - 50% POAH Inc.
  - 55% HII

Step 3
- FHA Insurance Payments

Step 4
- Assignment of FHA Insurance Payments

Key:
- FHA
- POAH LLC (60% POAH Inc. and 60% H)
- Hawthorne Associates
- Buyer
- Seller
- OMHAR 2nd Mortgages
- HUD Secretary

Table:

<table>
<thead>
<tr>
<th>Developer</th>
<th>Sponsor</th>
<th>&quot;Seller&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>POAH LLC</td>
<td>POAH LLC</td>
<td>POAH LLC</td>
</tr>
<tr>
<td>- Developer fee $2.5M</td>
<td>- $700K from debt budget (&quot;Organizational&quot; line)</td>
<td>- $600K from sale</td>
</tr>
<tr>
<td>- $80K from sale</td>
<td>- Incentive at Exe (2½% gross of Inc)</td>
<td>- Debt service on $510k loan from sale</td>
</tr>
<tr>
<td>- 75% of or as debt service on 2nd</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

** POAH LLC is operating company for POAH Inc.
Solution 4: Combining closing process

The Hawthorne transaction had been complicated, and working on five properties would make the processing more arduous. Therefore, POAH convinced related parties to combine the five properties and close them together. Finally, the Hawthorne transaction was closed on October 25th, 2002.

3.3 Transaction steps and legal considerations
To pass all the legal requirements under the Mark-to-Market transaction, POAH, Inc. designed a rather complex ownership structure and a strict transaction procedure:

**Transaction steps**

1) The FHA insurance payment (five separate amounts totaling $15,388,540) was wired to the five existing limited partnership owners ("Sellers"), and the OMHAR debt secured this payment between Sellers and the HUD Secretary.

2) HUD Secretary assigned OMHAR debt to Hawthorne Associates, L.P.

3) Hawthorne Associates, L.P. assigned OMHAR debt to POAH LLC.

4) Hawthorne Associates, L.P. ("Purchaser") borrowed bond funds from MHDC in the amount of $20,000,000 to be used to acquire the properties (since it needs to use bond funds for purchasing to ensure good use of funds). Acquisition price of six properties was $17,620,000 (see note #1). However, Purchaser also needed to contribute $1,750,000 as the additional cost to defease the second mortgage, giving a total of $19,370,000 from Purchaser to Seller.

5) The Purchaser acquired the five properties and the “Pool Parcel” with the bond funds. The transaction included:

   - Seller’s paid off of first mortgage ($2,839,848) and the defeasance of second ($15,400,000 estimate). This required total of $17,839,848; see “Seller Account” below.

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35 The transaction steps are quoted from a working memo written by Mr. Carl White.
Sellers transferred to Purchaser the six properties, Replacement Reserve escrows (which were released as Source in the amount of $830,000), FHA Insurance payment proceeds, and the securing OMHAR debt obligation and any remaining obligations.

**Seller Account at this point:**

<table>
<thead>
<tr>
<th>FUNDS RECEIVED BY SELLER:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FHA Insurance Payment</td>
<td>$15,388,540</td>
</tr>
<tr>
<td>Acquisition Price</td>
<td>$17,620,000</td>
</tr>
<tr>
<td>Additional defeasance</td>
<td></td>
</tr>
<tr>
<td>Funds from Purchaser</td>
<td>$1,750,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$34,758,540</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FUNDS SPENT BY SELLER:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Payoff of first</td>
<td>$ 2,839,848</td>
</tr>
<tr>
<td>Defeasance of second</td>
<td>$15,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$17,839,848</td>
</tr>
</tbody>
</table>

| Remaining                                      | $16,918,692 |
| FHA funds to be transferred to Purchaser      | $15,388,540 |
| Remaining with Seller                         | $1,530,152 |

**Distributions by Seller**

- Payment to POAH Inc. for
  - Previous acquisition costs                  $ 600,000
- Loan to Hawthorne Associates, L.P.
  - of Pool Parcel acq price funds              $ 85,000
  - **Total**                                   $ 685,000
- Remaining                                    $ 845,152
- Loan to Hawthorne Associates, L.P.
  - For development                             $ 845,152
Purchaser Account at this point:

FUNDS RECEIVED BY PURCHASER

FHA Insurance Payment
Assumed from Seller $15,388,540
Remaining Bond funds
Available $630,000
Existing RR escrows released
By MHDC to Purchaser $830,000
Seller Loan from
Pool parcel proceeds $85,000
Seller Loan from excess
Acquisition proceeds $845,152
Loan from MHDC first
Mortgage payoff (see note #2) $275,000

Total $18,053,540

6) Admission of Investor Partner
(Expect $1M at admission)
Total equity contribution $11,082,160

TOTAL SOURCES TO COVER REMAINING USES

$29,135,700

TOTAL REMAINING USES

Development:
All Improvements
(includes A&E) $15,497,090
All Const Period Interest $1,268,800 (Note 3)
All other General Dev Costs $3,872,300 (from Dev budget)
Less defeasance contribution
Paid at beginning of Transaction ($1,750,000)
Fees, Reserves, misc. $4,505,500

Subtotal $23,393,690

Paydown of construction loan:

($20M- $14,190,000 perm) $5,810,000

Total $29,203,690

DIFFERENCE ($67,990)

Difference to be made up at end of const period from contingency or from revenue from operations during construction.

Note 1): Acquisition price: $17,620,000 comprised of:

1st mortgage UPB: $2,839,848 (Sept 2002)

2nd mortgage UPB: $13,263,474 (Sept 2002)

Previous acquisition costs: $600,000 (to be allocated to each property)

Pool Parcel: $85,000 (appraised value- has not debt)

Existing Replacement Reserves: $830,000 (to be released as Source)

Note 2) MHDC agreed to contribute the proceeds that it received from the existing first mortgage (Hawthorne West) to the development effort. Specifically, POAH, Inc. got a grant from MHDC and made a loan to Hawthorne LLP.

Note 3): Construction period interest based on separate construction draw schedule that uses the FHA insurance payment proceeds and other sources (see above) available at the start of construction. This calculation assumed a small revenue amount from the investment of these “cash-at-closing” funds (1.5% x balances).

3.4 Achievements

Passing through all the hurdles during the debt restructuring process, the Hawthorne project combined the FHA insurance Claim Payment with new tax exempt bond from the Missouri Housing Development Commission (MHDC) and equity raised through the sale
of the 4% Low Income Housing Tax Credits linked to the tax exempt debt. By combining these resources, the transaction was able to support and expand rehabilitation scope, to more adequately cover transaction cost, and to provide the majority of the funds needed to build a new Community Center/Management office at the site. Significantly, POAH became the first Nonprofit to Negotiate Mark-to-Market under New OMHAR Incentives that was published in September 2000 by OMHAR for supporting nonprofit purchase of FHA insured properties with expiring Section 8 contracts. By negotiating directly with OMHAR on the new guidelines, POAH took the lead in addressing the many inevitable issues and made transaction a precedent of following nonprofit purchase deals.

With enough resources under the debt restructuring, the Hawthorne properties could go through significant rehabilitation including replacement of kitchen cabinets, countertops and sinks (all units); furnaces and AC (all units); roofs (new standing seam metal roof on all mansard roof units, ¾ of units); window replacement (3/4 of units); patio doors (3/4 of units); smoke detectors (hard wired in all units to meet code); landscaping (entire 70 acre site). Although the units had been well maintained over time, many of the systems (e.g., roofs, HVAC, kitchen cabinets) were original and had exceeded their useful life. Without the refinance opportunity outlined above, current operations could not support this needed renovation from replacement reserves. POAH renovated the units on a rotating basis with residents stay in place without causing any displacement.

In addition, at the center of the renovation plan—and literally at the center of the development – POAH, Inc. is currently constructing a new community center that includes offices for Hawthorne property management and social service stuff, a center for the extensive boy and girls club program currently operated at Hawthorne, a gymnasium,
and a new day care center for 90 children. For years, Hawthorne management had operated out of two cramped vacant units. The Hawthorne social service program (staffed by a director and three staff members who coordinate programs including visiting nurse, GED, computer training and operate an ongoing clothes closet and food pantry) had struggled to operate programs from vacant units. The boys and girls club that served over 100 children run its after-school program in vacant units. With over 745 families, there was no day care on site. The proposed new community center addressed all of the deficiencies. The 20,000 square foot center that was designed to accommodate all of these uses and is located on one edge of the large common area at the center of the development. The day care center was supported through the federal Head Start Program ensuring that the facility would be affordable to Hawthorne families.

The total cost of renovation and new construction outlined above was $15 million. POAH, Inc. combined the five Hawthorne properties into a single project to simplify underwriting and brought the ownership structure more in line with actual day-to-day operations.

Finally, from the government’s point of view, the success of Mark-to-Market is measured in saving Section 8 funds and in mitigating losses to the FHA insurance fund. In the Hawthorne project, the debt restructuring saved HUD $910,740 rental subsidy expense per year. Although FHA paid out more than $15 million from its insurance fund, the payment had saved the five Hawthorne properties that had deserved more than $24.45 million even before rehabilitation.
Exhibit 6: the Hawthorne Project Transaction Sources and Uses

<table>
<thead>
<tr>
<th>Sources</th>
<th>Uses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>First Mortgage from MHDC</td>
<td>Acquisition</td>
<td>$ 18,904,400</td>
</tr>
<tr>
<td>FHA insurance payment</td>
<td>Construction</td>
<td>$ 14,723,993</td>
</tr>
<tr>
<td>Tax Credit Equity</td>
<td>Architects &amp; Engineers</td>
<td>$ 900,000</td>
</tr>
<tr>
<td>Existing Replacement Reserve</td>
<td>Financing Costs</td>
<td>$ 3,645,407</td>
</tr>
<tr>
<td>Deferred Developer Fee</td>
<td>Other fees</td>
<td>$ 4,542,000</td>
</tr>
<tr>
<td>Cash Flow from Not-for-profit (MHDC)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total Sources</strong></td>
<td><strong>$ 42,715,800</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Total uses</strong></td>
<td><strong>$ 42,715,800</strong></td>
</tr>
</tbody>
</table>

Hawthorne Project Financial Resources

3.5 Experience and insights

The Hawthorne project was one of the earliest implementation projects after the MAHRA legislation, it was the first project combining multiple resources together, and the project was full of negotiation between the nonprofit developer, POAH, Inc., the OMHAR, and other related parties. In the Hawthorne project, POAH’s mission of preserving affordable housing aligned the interest between the nonprofit developer and the government. Once the government and the nonprofit created trust based on their common interest, they
combined their specialties on policy making and deal making to find solutions that made subsidized rental housing physically and financially sound in the long run.

Although the Hawthorne project took place in the implementation process following the MAHRA legislation, the Hawthorne project justified several unsettled rulings in the MAHRA Act. The debt restructuring of the Hawthorne properties not only directly affected HUD’s Mark-to-Market implementation policies but also showed how the nonprofit developer, POAH, inc., put all the resources together to keep the affordability of the subsidized rental housing in the long run. Consequently, all of the following Mark-to-Market participants would benefit from the model that POAH, Inc. had mutually developed during the debt restructuring process for the Hawthorne’s properties. The Hawthorne model created greater efficiency and lower transaction costs on later Mark-to-Market deals, and the Mark-to-Market experience had moved beyond from making one deal to creating a new policy making paradigm.
Chapter Four: Discussion on the new policy making paradigm

4.1 The new policy making paradigm in Mark-to-Market

Mark-to-Market is not only unique in that the federal government made a dramatic program shift from highly controlled affordable housing programs to decoupling its functions to the market, but also unique in its policy making process under a new policy making paradigm that public policy was made and implemented through negotiation.

There were several reasons that made this new policy making paradigm necessary in Mark-to-Market. First of all, the urgent HUD outlay crisis did not allow the federal government to go through a top-down process which usually takes a long time from policy initiate to practitioners’ participation. In other words, when federal government found that it had to take action in two or three years, they recognized that a traditional top-down process was not able to solve the problems in such a short period. Secondly, the subsidy structure for affordable rental housing had been too complicated to add more regulations on top of it, and the federal government could not make more regulation without hurting itself due to its multiple roles in the subsidy programs. In stead, the federal government had to decouple HUD’s multiple functions to the market and let the market adjust the deal structures. Thirdly, each of the affordable housing deal was unique so that one set of dictated guidelines would not work on all the different deals. Finally, once the federal government decided to decouple HUD’s roles, it had to recognize the power of the market. The decoupled roles would have to participate in the market by negotiating on the Mark-to-Market deals on a project basis. Therefore, negotiation was an indispensable process in Mark-to-Market, which was totally different from a
traditional policy making paradigm. As James Wilson argued in his book *Political Organizations*, “where both benefits and costs are concentrated, policy changes will generally only occur as the result of negotiating bargains among preexisting associations or of changing the political balance of powers among them. The former involves a tedious process of mediation, …”36 Because Mark-to-Market’s benefits (to low- and medium-income families, affordable housing owners and developers, and mortgage lenders) and costs (to the federal government) were concentrated, Mark-to-Market was created and implemented by “negotiating bargains” rather than a top-down process.

Because all the related parties shared the goal of making a viable deal, negotiation realizes the market power in the Mark-to-Market’s implementation process. In an efficient market, once a deal worked out through negotiation, all the stakeholders are typically better off. In Mark-to-Market, each of the transactions (with external financing) is ultimately a balance among the interests of the OMHAR, the first mortgage lender, the affordable housing equity investors, the developer, and the purchaser. Therefore, the stakeholders can work out the deals only through negotiation rather than implementing the guidelines and the process dictated by the policy makers. In the first several implementation deals such as the Hawthorne project, the developers negotiated directly with OMHAR on Mark-to-Market details and these negotiations finally affected the implementation rules for the later Mark-to-Market deals.

4.2 The new policy making paradigm under a dynamic market

Although the preserving of affordable housing issue was caused by the previous policy flaws, those flaws did not necessarily mean that the previous subsidization policies were totally wrong. On the contrary, it was because the market situation became so different that the existing programs did not fit with the market any more. Likewise, today’s programs such as Mark-to-Market will probably meet hard situation after several years due to the market change, but at least a process of negotiation will have been set up between the federal government and the market sector.

It seems that policy making is always a follower of the market. In a traditional policy making paradigm, it typically takes a long time to solve a problem by initiating a new program or a new policy and dictating the practitioners to implement it. When a top-down process is too time consuming to solve a problem in time, or the problem is too complicated to be dictated and implemented in a top-down way, a interactive policy making process is needed. When the policy making is realized through negotiation with less control from “the top” than the traditional paradigm, the market power will be realized in the new policy and the policy making process. Therefore, when the market evolves again, the stakeholders will then adjust their situation through negotiation under certain policy frames, and find a way to solve the problems. As long as the policy makers figure out a policy making paradigm to solve these problems, their policy goals and social goals will always be realized. Policy making through negotiation will make policies more flexible to the evolving market.


**Conclusion**

Subsidized rental housing is a hybrid between private market-rate housing and a host of (largely non-economic) public purpose objectives. Therefore, harmonizing these fundamentally conflicting objectives has been challenging. To encourage developers to build affordable housing, the federal government assigned itself multiple roles in Section 221 (d) (3), Section 236, and Section 8 programs: it was a mortgage issuer to issue mortgage in the name of Federal Housing Administration (FHA), a mortgage insurer in the name of FHA, a subsidize provider in the name of HUD, a policy maker, and a policy administrator. In short, the federal government not only played a role in policy making arena, but also entered the financial market in order to implement its policy.

Ideally, once the federal government starts to play its role in the subsidized rental market, it should have acted as a market player and been able to manage its economic risk. However, the multiple roles made the federal government could hardly avoid risks such as an outlay crisis or properties’ default due to its conflicting goals. Therefore, when lots of affordable housing owners started to opt out of the affordability contracts even chose default in the mid 1990s, the federal government faced a huge amount of financial loss due to the mortgage insurance payment and unnecessarily high rental subsidies, and a loss of its affordable housing properties.

Because of the HUD outlay crisis and the preserving affordable rental housing issue had to be solved urgently and the affordable housing subsidy structure had been too complicated, a traditional top-down policy making process could not work any longer. Therefore, the federal government invited practitioners to discuss and brainstorm
solutions. Under a temporary policy framework, Congress initiated a Demonstration program to make experiments on real deals. Based on project feedbacks and policy debates between Congress and the practitioners, MAHRA was enacted in 1997. Under the MAHRA Act, the federal government decoupled some of its existing functions: it disengaged its mortgage originator’s role to state Housing Finance Agencies and private banks, and it disengaged the program administration role to the Participating Administrative Entities (PAEs) to perform most of the functions required to restructure the debt and subsidies on the HUD-insured portfolio with above-market Section 8 subsidies. Therefore, market power was recognized through negotiation among different stakeholders. Under a new policy making paradigm, Mark-to-Market not only mitigated HUD’s outlay crisis by reducing rents but also preserved the affordable rental housing stock. Finally, policy making through negotiation not only makes policies more efficient and economically sound, but also makes policies adjustable to the evolving market and more sustainable. Whether or not a “market-oriented” solution will allow subsidized housing to “live happily ever after” remains unclear. The new paradigm may be replaced by another in the future. But for the time being there is a sense that a successful way has been found out of a complex dilemma.
Bibliography


Millennial Housing Commission, *Subsidized Rental Housing Committee Background Paper: Pre-LIHTC Affordable Housing—Historical Context,* July 26, 2001.


Smith, David A. Written testimony before the Senate Housing Subcommittee regarding S. 2733 (07/18/00) [WWW document]. URL http://www.recapadvisors.com (Visited Feb. 2003).

Appendices

Appendix 1: The difference between the demonstration rules in FY 1998 and the MAHRA rules

Resources: Recapitalization Advisors, Inc.
www.recapadvisors.com

<table>
<thead>
<tr>
<th>Component</th>
<th>FY98 Demonstration</th>
<th>MAHRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner participation</td>
<td>Voluntary</td>
<td>Mandatory</td>
</tr>
<tr>
<td>Eligibility Rent Level (maximum)</td>
<td>Above 120% of FMR</td>
<td>Above market comparables</td>
</tr>
<tr>
<td>Rehabilitation Resources</td>
<td>HUD loan or grant, use of project funds, no mandatory owner match</td>
<td>Limited use of HUD and project funds, required 20% owner match</td>
</tr>
<tr>
<td>Term of Use Agreement</td>
<td>20 years</td>
<td>30 years</td>
</tr>
</tbody>
</table>
## Appendix 2: Mark-to-Market underwriting sequence: Activities, Policy Questions, and Legislative Resolution

Resources: Recapitalization Advisors, Inc.  
www.recapadvisors.com

<table>
<thead>
<tr>
<th>Step</th>
<th>Activity</th>
<th>Policy question raised</th>
<th>Legislative answers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1</td>
<td>Identify above-market properties</td>
<td>• Should below-market properties be restructured also, and if so, how?</td>
<td>• No, leave as is, but when in doubt, allow intake</td>
</tr>
</tbody>
</table>
| Step 2 | Determine new market rents | • Formula or property specific?  
• Are properties allowed a transition?  
• Who does it? | • Comparable where identifiable; 90% of FMR where not  
• Unspecified  
• PAE |
| Step 3 | Satisfy old mortgage  
Absorb claim in FHA insurance fund | • If default, full assignment, partial payment of claim, or a new hybrid?  
• What about uninsured mortgages (for example, state HFA)? | • Partial payment of claim authorized without mortgagee consent  
• Uninsured properties exempted |
| Step 4 | Determine new net operating income | • Section 8 property or tenant based?  
• Changes in operating budget?  
• Need for repairs or renovations?  
• Increased reserves? | • Mostly property, but PAE can voucher  
• Expected; up to PAE  
• HUD grant with owner 25% match  
• Likely in underwriting |
| Step 5 | Establish new debt service | • Protect owners’ cash flow?  
• What level of coverage?  
• What happens to properties with zero cash flow? | • No  
• Unspecified  
• Budget-based exception (likely with zero debt service) |
| Step 6 | Price new mortgages | • New FHA insurance or not?  
• What happens to reduced debt?  
• Owners’ tax consequences? | • PAE within limits  
• Soft second mortgage  
• Unlegislated; legislation hopes for a favorable revenue ruling from Treasury |
| Step 7 | Sell new mortgages  
Recover on old FHA claims | • Are properties held in HUD inventory?  
• Who sells the loans? | • Unspecified  
• Unspecified |