

improvements until a total of 10 percent is reached. While borrowers are permitted to request adjustments to their reserve contributions, there is no systematic provision for reevaluating reserves over the life of the project. A recent study found that while an average MFH project has accumulated \$5,000 in reserves per unit at the end of 10 years and maintained at that level thereafter, the full cost of rehabilitation is likely to be close to \$16,000 per unit. When rehabilitation is needed and the reserve is inadequate to meet the need, the project owner usually applies for a subsequent loan, which, if received, requires that rents be increased. In recent years, RHS has been experiencing a growing number of requests for subsequent loans and rent increases to cover costs of rehabilitation, while funding for such loans has been limited.

Increasing the reserve requirements would be appropriate to address the physical needs and the life expectancy of most MFH projects. It will help reduce the need for subsequent loans or servicing actions, and improve the long-term physical condition of projects and help protect the MFH portfolio from defaults. In existing projects where RHS is taking servicing actions, the proposed rule would help ensure that each project's physical needs are addressed in current servicing actions and, thus, reduce the need for attention at a later date. Such servicing actions include write-downs of existing loans. Thus, it is possible that the proposed rule would result in additional write-downs as a means of addressing the need for the project improvements. To date, RHS has written-down only a limited number of MFH loans. Further, the additional reserve requirement will be reflected in project costs, which means that rents will increase, and the amount of rental assistance payments needed to maintain existing contracts for such assistance will increase.

Investment Earnings on Reserve Account Funds

RHS has found that most project owners are putting their reserve funds in accounts that earn no or minimal income. The average reserve account has been earning only 2 percent interest annually. Project owners indicate that, under current regulations and tax rules, they have few options for investing these funds and face a strong disincentive for investing them in a manner that maximizes their return. The disincentive is due to Internal Revenue Service (IRS) rules that treat income earned on reserve accounts as investment income for the owner and,

thus, taxable, rather than project income.

The proposed rule makes two changes to address these limitations. First, it allows a greater number of investment options. These options include relatively conservative investment vehicles that are used by other public agencies and are not expected to pose a significant increased risk to the funds. This change would give owners more flexibility for investing their reserve funds and is expected to result in greater returns on these funds and thus more income to be put toward better project operations and capital improvements. The increase in interest income would lower the amount needed from tenant rents and rental assistance to meet project needs.

Second, the rule addresses the issue of "phantom income," the interest income earned on reserve accounts. This income is committed to the project but not accessible to the owner. To ease the burden of paying taxes on this "phantom income," the rule allows owners, with RHS' approval, to withdraw up to 25 percent of the annual interest income earned on the reserves to cover the tax expense. The 25 percent allowance was determined to be a reasonable estimate of the tax rate for the average investor. It was decided to use a single rate for all owners to simplify the administration of this feature. RHS also consulted with OIG and the American Institute of Certified Public Accountants (AICPA) in arriving at the 25 percent figure.

Prepayment Policies and Procedures

The agency, borrowers, and tenant advocates agreed that the prepayment request process is a difficult and confusing process. Agency staff in the National Office recognized that they were spending a great deal of time providing technical assistance to Field Offices in responding to prepayment requests. Borrowers commented that the process was unduly burdensome to borrowers who were within their rights to request prepayment. Tenant advocates pointed out that tenants are virtually excluded from the process because the process complexity makes it difficult for tenants to take action. Discussion of these concerns at the stakeholders meetings indicated that RHS needed to clarify many of the policies toward prepayment and where possible, make policy changes that would help simplify the process. Consequently, the proposed rule includes changes to agency policy regarding tenant notification and projects on the waiting list for incentives.

Tenant Notifications

Stakeholders suggested changes to the content and timing of tenant notifications to provide tenants with the information they need to participate in the prepayment process. The proposed rule replaces the requirement for one early tenant notification with a series of notifications aimed at keeping the tenants informed of the Agency's and the borrower's decisions throughout the process.

Waiting List

One of the most common complaints heard about the prepayment process is its open-ended nature. Borrowers who are approved for incentives and agree to stay in the program in exchange for incentives may have to wait years before the funds for the incentives become available. The current waiting list includes requests for incentives dating back to 1996. The proposed rule establishes a maximum time on the waiting list of 15 months and allows borrowers three choices at the end of that time: (1) Stay on the waiting list and continue waiting for the incentives, (2) withdraw from the list and continue operating the property for program purposes, or (3) offer to sell the property to a nonprofit organization. This last option may allow some properties, eventually to prepay if they complete the process involved in offering the project for sale and fail to receive a bona fide offer. However, this option responds to the reality that the agency may not always have the resources to keep borrowers in the program indefinitely and that costly legal battles are likely if they do not allow the borrowers other options. Currently, the prepayment waiting list contains approximately 15 properties that have exceeded the 15-month time period. However, this number would be expected to grow appreciably over the next few years without a significant increase in funding for incentives to accommodate the anticipated increase in number of projects meeting the 20-year statutory restrictions on use.

Further, it is believed that many borrowers have not applied for prepayment incentives and joined the waiting list because of the extended time period they must currently remain on the list. If the 15-month maximum time period is implemented, a greater number of these borrowers may seek prepayment with the expectation that they will be allowed to exercise one of the three options at the end of the 15-month time period. If borrowers do prepay and convert their apartment complexes to market rate units, RHS