

will take measures to protect the tenants at these properties by providing them a letter of priority entitlement (LOPE) that gives them priority in agency-financed housing elsewhere. However, if alternative vacant RHS financed rental housing is not available in the market, the impacted tenants face displacement or rent overburden if they remain in place.

#### Incentives

The proposed rule clarifies the Agency's policy on incentives and adds several requirements to help ensure that the limited amount of funding available for incentives, as discussed in the overview section of this analysis, is used efficiently to benefit the program. For example, the proposed rule outlines the process a borrower must follow when requesting permission to prepay and be eligible to receive incentives.

In addition, the proposed rule clarifies that third-party equity loans are an option for borrowers who are seeking equity loans through the prepayment process. The use of third-party equity funding stretches RHS incentive funds by providing resources from alternative funding sources. However, it should be noted that debt costs from other sources might be higher than financing received under the Section 515 program. For example, Section 515 funding is lent at an effective 1 percent interest rate and amortized for 50 years, whereas, third-party funds may be lent at rates ranging from interest free to market rate depending upon the source of the funds, with amortization periods ranging from fully deferred to 30 years. All proposed third-party incentive loans must be underwritten and reviewed to the same standard as RHS Section 515 lending to ensure that no project is made financially unfeasible as a result of a third party loan.

#### Initial Operating Capital

Under current regulations, borrowers are required to pay the equivalent of 2 percent of the cost of developing a project into an account for initial operating costs. They earn no interest on this account, which also receives funds from other sources including rental income. If, within 2 years, the project is operating successfully and there is sufficient capital in the operating account to maintain the financial soundness of the account, the borrower may take out up to the full amount of his /her contribution. While on deposit in the operating account, the borrower receives no return on investment for the funds. After 2 years, any portion of the contribution that is still in the account

must remain there for meeting ongoing operating capital needs.

During the stakeholder meetings, borrowers expressed concern that the current regulation does not allow them sufficient time to recover their contribution, even when a project is functioning well and no longer needs the additional capital. RHS determined that the 2-year limit was originally due to difficulties in tracking the funds within the projects overall budget, and that its new ADP system, MFIS III, has the capacity to provide better tracking and disclosure of these funds. Therefore, RHS has included a provision in the proposed rule that would extend the time limit for the recovery of initial operating capital from 2 to 7 years. In selecting 7 years for the new limit, RHS received input from field staff and industry groups indicating that the prospects for recovery after 7 years were minimal, either because financial soundness could not be established or the owner was willing to leave his/her contribution in the account.

This change would allow more borrowers to fully recover the payments they made to initial operating capital accounts. It is uncertain how many borrowers would benefit from the change and how many dollars these borrowers would be allowed to recover from these accounts. Because of the limitation on recovery from only financially sound accounts, it is unlikely that there would be immediate, negative impacts on the performance of the MFH programs. However, it should be noted that by allowing borrowers to recover funds from initial operating capital accounts, these funds would not be available for ongoing capital needs. The potential withdrawal of initial operating capital is not considered to have significant impacts on rents and, thus, costs to the Government and tenants. While it would tend to make it more difficult to avoid rent increases, it is far outweighed by other changes in the proposed rule, specifically, the raising of reserve requirements and additional earnings on reserve accounts.

#### Other Changes to the Rule

##### *Conventional Rents for Comparable Units*

RHS has developed the concept "Conventional Rents for Comparable Units" (CRCU). This is one of the most comprehensive policy issues that 7 CFR part 3560 will introduce. The concept is applicable to loan origination, budgets, loan servicing, replacement reserve set-asides, preservation, and other program areas. In essence, rents will be capped

at conventional rents for comparable units in the area where the housing is located. Comparable units would be those equivalent to RHS financed units in terms of quality and amenities. If no such units are located in the same community, units from a similar community could be used for comparison. Comparable units also means that the units the Agency finances would meet a standard of economical development, *i.e.*, modest in size, facilities and design, yet compatible with the community.

RHS will continue to require that rents be based on the project's operating costs. However, under the proposed rule, RHS would not approve project proposals, servicing actions, or prepayment incentives that involve rents above the CRCU, except in exceptional circumstances, where such rents are determined to be in the best interest of the Government and the tenants of the project.

By placing an upper limit on rents, RHS expects to protect the Government from investing in projects that may be wasteful or fraudulent, and to ensure that projects are competitive so that vacancy and other market-driven problems can be avoided. In this way, the CRCU should improve the long-term viability of MFH projects, limit the costs of RA, and reduce the risk of defaults.

However, the proposed rule maintains flexibility for serving areas where MFH projects provide the only decent, safe and sanitary rental housing in a local housing market, or where a significant amount of the substandard housing rents for less than the cost of operating an MFH project. In such cases, RHS may base the CRCU on rents outside the local community. It may also grant an exemption for exceptional circumstances.

CRCU will create a definitive underwriting standard. It will apply to leveraging other low-interest loan funds or paying for additional owner contributions (up to 3 percent return on investment (ROI) over required contribution); improving project design and amenities (within the definition of economical development); and adjusting reserves or other serving actions. In areas where rents are below CRCU, Rental Assistance (RA) costs and loan levels may increase. However, it will also ensure "marketable units" should the Agency lose RA.

The Agency is asking public input on whether exclusions to CRCU may be needed in certain areas of the country where conventional rents may not be adequate to fund operation and maintenance, debt service and replacement reserve expenses plus an