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**Special Attention of**

All Multifamily Hub Directors  
All Multifamily Program Center Directors  
All Project Managers  
All Regional Directors  
All Field Office Directors  
Contract Administrators

**Notice H 03-28**

Issued: December 1, 2003

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**Cross References**

Notices: H 97-49, H 99-19

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**Subject**

Guidance on Asset Management Issues Concerning Bond Financed Section 8 Projects

**A. CONTRACT RENEWALS AND PREPAYMENT OF MORTGAGES IN PROJECTS SUBJECT TO BOND REFUNDING AGREEMENTS**

- 1. BOND CALL PROTECTION AND MORTGAGE PREPAYMENT LOCKOUTS.** Tax-exempt housing bonds are usually sold to investors with redemption (prepayment) restrictions which assure that no change in the interest rate will occur during the first 10 years of the term to maturity. The mortgage loans funded with the bond proceeds typically contain prepayment lockout provisions mirroring the redemption provisions in the bonds. In the Section 8 bond refunding program, depending on the closing date, the 10-year prepayment lockout provisions in the bonds and in the underlying mortgages may run concurrently with, or expire before the Housing Assistance Payments Contract ("HAPC").

The latter case requires special attention due to a unique feature of the Section 8 bond refundings: namely, HUD's agreement with the Issuer to share the savings of Section 8 subsidy resulting from reduced debt burden generated by the refunding ("HAP Savings"). Pursuant to Section 1012 of the Stewart B. McKinney Homeless Assistance Amendments Act of 1988 (P.L. 100-628), as amended by section 163 of the Housing and Community Development Act of 1992, (P.L. 102-550) ("McKinney Act"), 50 percent of the HAP Savings is made available to the State or local housing finance agency or authority initiating the refunding ("Issuer") to be used only for providing decent, safe, and sanitary housing affordable to very low-income families and persons. The remaining 50 percent of HAP savings typically takes the form of a cash rebate from the bond trustee to the U.S. Treasury, rather than a recapture of contract authority and reduction of rents. These rebates,

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known as “trustee sweeps,” continue only for the contract term, including 5-year renewals, specified upon execution of the original HAPC. HUD’s agreement to share 50 percent of the savings with the Issuer and the Issuer’s agreement to properly spend its share of the trustee sweep rebates on very-low income housing, are memorialized in a Refunding Agreement executed by HUD and the Issuer.

In the event of a request to prepay a mortgage while the HAPC is still in effect, HUD will require that the Treasury savings continue. A prepayment prior to trustee sweep expiration will not be approved by HUD unless two conditions are met. First, the mortgagor must agree to compensate the Treasury for 50 percent of the remaining savings installments. This may be done by one of three means: (1) continuation of the sweep schedule in the new financing; (2) a lump sum prepayment of the present value of the remaining savings (using the Treasury 10-year Note as the discount rate); or (3) reduction of HAPC rents for the value of the remaining savings. Second, the Issuer’s written consent must be obtained. The Issuer in its discretion may require reimbursement of its remaining savings or may forego such savings to accommodate a refinancing or sale of the project.

This policy applies to all prepayments (which require HUD’s or the Issuer’s prior written consent) that occur prior to HAPC expiration, subject to the following exceptions.

- a. OVERRIDE OF PREPAYMENT LOCKOUTS.** In cases of imminent mortgage default or physical deterioration threatening the health and safety of residents, the Field Office Housing Director may recommend that cancellation of remaining Treasury savings is urgently needed to facilitate a refinancing or other relief. This is a last resort. If the Office of Asset Management concurs in such recommendation, the remaining sweeps will be terminated to permit reduction of the note rate to a level that the project can support. HUD’s evaluation will take into account REAC and FASS scores, the extent of owner efforts to avoid default, i.e., cash infusions to cover operating deficits, and reasonableness of proposed refinancing terms. Depending upon the extent of the need for project relief, HUD may request that the Issuer also terminate its remaining savings, but HUD cannot mandate such action by the Issuer.
  - b. INVOLUNTARY PREPAYMENTS.** Any event, such as mortgage default or property destruction/condemnation, which automatically triggers mandatory special redemption of bonds as required by the bond trust indenture, effectively terminates trustee sweeps. In the event of a mortgage default, contract rents may be adjusted, if so provided by the HAPC, to the level appropriate to support project solvency, or the contract may be replaced by tenant-based assistance. If rents are not reduced until HAPC expiration, the HAP savings will continue.
- 2. PROJECT-BASED CONTRACT RENEWALS.** As stated above, HAPC expiration terminates trustee sweeps. In the event of contract renewals, the project debt service should be adjusted to take into account the post-HAP financing terms. Most of the local issuer bond refundings of insured 20-year HAPC projects provided at closing for execution by the mortgagor and HUD of a mortgage modification and allonge agreement (the “MMAA”) which resets the note rate upon HAPC expiration to a substantially reduced rate approximating the refunding bonds yield plus an ongoing trustee/servicer fee. For example, a 12 percent FAF project, which was refunded at a bond yield of 6.75 percent in a trustee sweep transaction, would receive a mortgage rate reduction to 7 percent when the 20-year HAPC expires. (The new mortgage interest rates will generally be in a range of 6.5 to 7.5 percent depending upon bond market yields at the time of the refunding.) In contrast, State Agency refundings of FHA-insured HAP 20-year projects did not involve owner participation and have no automatic note rate reduction built in.

In those projects that executed the MMAA and renew their HAPC without a mortgage restructuring, debt service will be reduced in light of the reduced note rate. Owners who did not execute the MMAA should be encouraged to do so as soon as possible to reduce debt service. Otherwise, the project in a trustee sweep refunding would be burdened with the original mortgage interest rate set at the time of final endorsement. In local agency refundings that closed without MMAAs, HUD required a trust indenture provision instructing the trustee to consult HUD on the appropriate modification at the time of HAPC expiration.

In the absence of MMAAs in projects requesting contract renewals, the instructions in the Section 8 Guide will effect the necessary note rate modification. An owner could not expect to submit a budget based on the original note rate without reference to the lower rate on the underlying refunding bonds. In accordance with the Section 8 Guide, the owner would be referred to HUD's instructions in the OCAF Worksheet or, for budget based renewals, to Chapter 7 of Handbook 4350.1.

**3. REFUNDINGS SUBJECT TO MCKINNEY ACT SHARED SAVINGS AGREEMENTS.**

Section 1012(a) of the McKinney Act defines "qualified project" as "any State financed project or local government or local housing agency financed project, that (1) was (A) provided a financial adjustment factor under section 8 of the United States Housing Act of 1937, or (B) constructed or substantially rehabilitated pursuant to assistance provided under a contract under section 8(b)(2) of the United States Housing Act of 1937 (as in effect on September 30, 1983) entered into during any of calendar years 1979 through 1984; and (2) is being refinanced. (The term "entered into" means the Agreement to enter into the HAPC, i.e., the "AHAP".) In accordance with a standard Refunding Agreement executed by HUD and the Issuer, neither party may agree to a prepayment prior to HAPC expiration unless the other party consents. The Issuer may require that its remaining share of savings be honored, but unlike HUD it has discretion to forego remaining savings. The Treasury share must be continued or prepaid as discussed above. Some Issuers have already agreed to prepayments and termination of their savings to accommodate refinancings which fund project physical repairs and/or cure operating deficits, or to transfer physical assets to a nonprofit owner.

- 4. RE-REFUNDINGS OF MCKINNEY ACT QUALIFIED PROJECTS.** Because interest rates have declined in the years since the first round of Section 8 bond refundings, Issuers may find a second refunding cost effective. The question arises, would a re-refunding be subject to the same rules as the original transaction, specifically, the McKinney Act requirements for Federal/Issuer sharing of savings, restriction of Issuer savings to programs of very low-income housing, and HUD prior review of proposed bond financing terms and use of savings? The Office of HUD General Counsel advises that the answer in each case is YES. This authority will be exercised with flexibility and sensitivity to Issuer objectives, to the extent consistent with the statutory mandate to restrict savings to provide decent, safe, and sanitary housing affordable by very low-income households. HUD recognizes that projects have aged in the several years since the first refundings and wishes to support, not restrict Issuer preservation programs. The McKinney Act allows HUD some discretion in calculating the savings on a case-by-case basis. The calculation of the debt service savings subject to the McKinney requirements is a net calculation. HAP rents will remain at a level necessary to maintain physical quality, to ensure operating solvency, and to fund adequate project reserve balances. If the re-refunding savings exceed these amounts, only the excess is subject to the McKinney rules. There may be cases of substantial project need in which no McKinney savings are derived from the debt service savings.

Re-refunding transactions will be reviewed pursuant to the regulatory provisions of 24 CFR 811.110(g) as to use of HAP Savings. Proposals for spending HAP savings are to be submitted in a Plan attached as an exhibit to the Refunding Agreement and will be reviewed by the HUD Office of Multifamily Asset Management, Room 6160, HUD Building, 451 7<sup>th</sup> Street, SW, Washington, DC 20410. Processing will be streamlined compared to the detailed financial review used in the original FAF bond refundings and will rely heavily upon Field Office findings concerning the physical and financial condition of the projects. Issuer proposals for use of savings to correct project deficiencies will be evaluated by Field Office asset managers.

The Issuer request for approval by the Office of Asset Management should include:

- (1) a description of how the proposed use of additional debt service savings meets the McKinney Act housing affordability objectives;
- (2) a summary of projected financing terms, including sources and uses statement, bond yield, debt service savings and, to the extent that such savings will not be used for project needs, a revised trustee sweep savings schedule (upon closing, the Issuer or its bond counsel should confirm these terms as final or provide a certification of revised terms);
- (3) if a proposal involves execution by HUD of FHA mortgage modification or other documents or raises regulatory issues, the Issuer should submit drafts to the HUD Field Office Counsel; and
- (4) if the proposal includes revisions of the existing Refunding Agreement, such proposed changes must be submitted to HUD headquarters and need not be submitted to Field Counsel.

**5. HUD AUTHORITY TO REDUCE CONTRACT RENTS.** HUD will review all refinancings and bond refundings of Section 8 projects in the light of Section 142(d) of the HCD Act of 1987 and applicable HAPC provisions, which MAY authorize reduction of contract rents to the extent that the periodic mortgage payment is reduced as a result of the transaction. The Office of General Counsel has opined that HUD may reduce rents in the event of a refinancing or refunding that lowers the Owner's debt burden, if the HAPC so provides. Rent reductions commensurate with total gross debt service savings are not statutorily mandated. Field Offices have discretion to forego rent reductions, or reduce rents for only a portion of the debt service savings, as judged necessary to address a project's physical and operating needs.

## **B. SERVICING OF MCKINNEY ACT SHARED SAVINGS BOND REFUNDINGS**

**1. ANNUAL RENT ADJUSTMENTS FOR PROJECTS WHICH RECEIVED A FINANCING ADJUSTMENT FACTOR (FAF) AND PARTICIPATED IN THE HUD FAF BOND REFUNDING PROGRAM.** The instructions contained in Housing Notice H 97-49 and reinstated and extended on July 14, 1999, by Notice H 99-19 remain valid in substance, although the internal HUD process with respect to Headquarters offices no longer applies. With the Notice issued today, HUD emphasizes that the rent adjustment described in the previous Notices must be carried out annually. Some HUD field staff has misconstrued this process to be a one-time exercise. That is incorrect. This clarification and the illustration set forth below result from audit findings by the Office of Inspector General, which were reiterated in a report of the General Accounting Office (GAO/RCED-99-217) released in July 1999. Because some HUD field staff and contract administrators expressed confusion about the H 97-49 procedures, this Notice presents in Appendix

A an illustration of a sample case to serve as further guidance. The instructions of H 97-49 are discrete instructions applicable only to FAF bond refunding projects and are not superseded or otherwise affected by rent adjustment issuances of general application, such as H 98-03 and H 97-14, and basic instructions for rent adjustments by means of the statutory Annual Adjustment Factors (“AAFs”). Although rent adjustment notices until now have not referenced H 97-49, these outstanding instructions and all future ones should be read and interpreted in the light of the policies and procedures of H 97-49. Because FAF refundings that use the trustee sweep method of subsidy recapture did not reduce rents or amend the mortgage note rate, these projects have been denied annual adjustments, which in some cases may be essential to project solvency. Reduction of the rent base as described herein can alleviate this problem by providing room for application of the AAFs.

- 2. MONITORING OF MCKINNEY ACT AGENCIES’ USE OF FUNDS.** HUD has previously provided to participating agencies the instructions set forth in Notice H 97-5, “Guidance on Use and Administration of Savings,” concerning ways in which State and local housing agencies may use shared Section 8 savings in compliance with statutory limitations of such funds to decent, safe and sanitary housing for very low-income persons and families. These McKinney Act statutory requirements are implemented in the Section 8 bond refunding regulations at 24 CFR Part 811, Section 110(g). Documents required by HUD pursuant to this mandate are: a standard Refunding Agreement for execution by HUD and each Agency after a bond refunding closes; and an annual certification and triennial audit concerning use of funds, which must be submitted by each Agency. These documents must be submitted to the Office of Asset Management in HUD Headquarters. There is no need to submit to HUD Field Offices. To the extent that HUD field staff are enlisted in monitoring agency performance, the above Office will assure that they receive relevant agency documents concerning use of savings. The Section 8 project physical inspection and financial reporting requirements continue to apply in accordance with HUD procedures. These are separate from, and should not be confused with, McKinney Act program reporting requirements.
- 3. USE OF SAVINGS FOR PROJECT PURPOSES.** The Issuer’s obligation to use these savings for very low-income housing may be satisfied by allocating savings to the Section 8 project, which was refunded. Most agencies have chosen to spend their savings on programs of their design, but many others have responded to verifiable project physical and/or operating needs by assigning all or a substantial portion of savings to help finance correction of project deficiencies. Section 204 of the HUD 1998 Appropriations Act (Public Law 105-65) authorized HUD to allocate up to 15 percent of any Issuer’s 50 percent share of savings to provide an incentive to project owners to refinance their debt at a lower interest rate. In view of the willingness of Issuers to negotiate effectively with owners to finance legitimate project needs, but in consideration of agency reluctance to use their savings to pay owner incentive fees, HUD has not found it appropriate to implement this authority.

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John C. Weicher  
Assistant Secretary for Housing –  
Federal Housing Commissioner

## Appendix A

The backing out process in effect converts periodic payments of FAF debt service savings by bond trustees (“trustee sweeps”) to the contract rent reductions which would have occurred if the refunding had resulted in reduction of the mortgage note interest rate. In the latter case, the post-refunding rents would be the same on both lines 2 and 4 of the Section 8 Annual Contract Rent Adjustment Worksheet, HUD-9833B (the “Form”). In trustee sweep cases, which are nearly all of the FAF refunding portfolio, the line 2 rents are the rents in effect before and after the refunding. The trustee sweep savings must be deducted on line 3 to arrive at the line 4 rents, which serve as the true rent base for purposes of applying the AAF factors.

The amount to be entered on line 3 of the Form is derived by converting the standard semiannual trustee sweep savings schedule to the monthly payment format used in mortgage loans. This process is illustrated in the attached sample Form in which lines 1-4 are filled in to show the adjusted rent base to which the AAF is applied. Note that the sweep installments are not always equal in amount: semiannual bond debt service is not on a level annuity plan; since the periodic retirement of bond principal does not occur in equal installments, the debt service savings will differ from one installment to the next. Each Contract Administrator (“CA”) must carry out this conversion. Savings sweep schedules, if not previously provided to the CA, should be requested from the Office of Asset Management (Attention: Sheila Stewart, 202-708-0614, extension 2553). To derive a MONTHLY savings amount, the CA should add the semiannual sweep payment closest to the upcoming HAPC anniversary date to the next semiannual sweep payment and divide this sum by 12. The result is then doubled, because the sweep schedule prepared by HUD lists only the 50 percent Treasury share of savings. However, no doubling is done for a non-State Agency refunding that closed prior to January 1, 1992.

In the example of the Belhaven Garden project of 30 units, the semiannual sweep totals of \$13,800 for November 2002 and \$13,600 for May 2003 are added, then divided by 12, and the result doubled to arrive at total monthly savings of \$4,567. This is divided by 30 to give the monthly per unit amount of \$152 to be entered on line 3 of the Form.

The total monthly savings must then be apportioned over the unit type columns of line 1 of the Form. This is done by dividing the savings amount by the number of units in the project to arrive at a flat per-unit savings amount to enter in each column of line 3. Once the savings amounts in line 3 are deducted, the result entered in line 4 is the adjusted rent base to which the AAF factors are applied.

In all other respects, the annual AAF rent adjustment process is the same as for non-FAF refunded projects.