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MATURING SUBSIDIZED MORTGAGES: THE NEXT FRONTIER OF THE EXPIRING USE CRISIS

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MATURING SUBSIDIZED MORTGAGES: THE NEXT FRONTIER OF THE EXPIRING USE CRISIS

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EXECUTIVE SUMMARY

Over the next decade, close to 17,000 units in 130 federally- and state-financed developments in Massachusetts could be lost as affordable housing as they reach the end of their 40-year subsidized mortgage terms. The maturing mortgage crisis represents the latest challenge to the privately-owned subsidized housing stock, its lower income residents, and the communities where these developments are located.

Since 1987, some 6,700 net affordable units have been lost as owners have prepaid their subsidized mortgages or opted out of their rental subsidy contracts. While Massachusetts has also had a strong track record in subsidized housing preservation, recent experiences with maturing mortgage properties--including the loss of more than 800 affordable units at 3 Boston developments--suggest that new approaches will be needed in the future.

The study reveals some of the characteristics of this housing that pose special challenges for preservation and tenant protection, as well as the unique benefits that make these developments especially worth preserving.

- While fewer than half the units have project-based rental subsidy, their rents are generally affordable to very low income households--a unique benefit offered by 40-years of budget-based rent regulation. Without additional project-based subsidy, it will be very difficult to preserve the current occupancy profile of the housing in the future.

- Many maturing mortgage properties are located in strong market neighborhoods where they are vulnerable to conversion pressures. Outside the major cities, the loss of an existing subsidized property will often put the municipality out of compliance with Chapter 40B.

- Since Enhanced Vouchers (tenant-based rental subsidy) are not directly authorized when a subsidized mortgage expires, there is a substantial risk of tenant displacement. Even with Enhanced Vouchers, the unique role currently played by many of these properties in preserving racial and economic diversity in their communities will be lost upon tenant turnover.

- While 20% of the units are at immediate risk (through 2010), 50% will not reach mortgage maturity until at least 2015. These properties provide a significant opportunity for cost-effective "preemptive" preservation.

To address these challenges, state legislation is needed to provide, at a minimum, a meaningful Right of First Offer and a Right of First Refusal to DHCD (or its designee) when a subsidized property is offered for sale, including adequate tenant protections (S. 666/ H. 3573). Additionally, adequate state resources should be targeted to facilitate the acquisition and preservation of at-risk properties on a timely basis, and to permit qualified community-based non-profit purchasers to compete on a level playing field with

private buyers. To promote cost-effective preservation, MassHousing should permit high-risk subsidized properties to refinance prior to mortgage maturity, in exchange for extended affordability restrictions. Finally, federal legislation is needed to permit owners to project-base Enhanced Vouchers and to expand the scope of Enhanced Voucher eligibility.

MATURING SUBSIDIZED MORTGAGES:
THE NEXT FRONTIER OF THE EXPIRING USE CRISIS

I. Introduction

Over approximately the next decade, close to 17,000 affordable housing units could be lost in Massachusetts as their federally- and state-subsidized mortgages mature, terminating all associated use and affordability restrictions. Most of this housing, developed 30-40 years ago under various federal and state mortgage subsidy programs, is only partially assisted with project-based Section 8 rental subsidy; but 100% of the units are affordable due to budget-based (and tiered) rent restrictions.

To the extent that the properties have Section 8 assistance, the maturing mortgage crisis overlaps with larger crisis of expiring Section 8 subsidy contracts. However, the unique characteristics of this housing (rent and occupancy structure, community context, and regulatory constraints) pose special risks and challenges for public policy. In particular, the partial nature of project-based Section 8 assistance makes it more difficult to preserve this housing. There is also a substantial risk of tenant displacement since Enhanced Vouchers are not directly authorized when a subsidized mortgage matures. Even with Enhanced Vouchers, the unique role currently played by many of these properties in preserving racial and economic diversity in their respective neighborhoods and communities will be lost upon tenant turnover.

Inadequate tools and funding currently exist to protect existing tenants and preserve these valuable affordable housing resources. The analysis of the maturing mortgage inventory which follows concludes with proposed legislative and policy initiatives to facilitate constructive solutions to this new expiring use challenge.

II. Historical Background

The earliest subsidized mortgage properties were developed in the mid-1960s under the HUD Section 221(d)(3) Below-Market Interest Rate (BMIR) program, utilizing direct government loans. Later, interest subsidies were provided to private lenders under Section 236, with some projects insured by HUD and others financed directly by MassHousing. MassHousing also financed a number of properties under the state's Chapter 13A interest subsidy program.

Occupancy of these units was limited to low and moderate income families with initial incomes at or below 80% or 95% of area median (for 236/13A and BMIR projects, respectively). Rents were budget-based, including a fixed limited-dividend allowance. Many for-profit owners were permitted to prepay their 40-year subsidized mortgages "as of right" after 20 years. Others (including non-profits, certain owners who received HUD "flexible subsidy" rehab loans, and owners of MassHousing developments financed after August 1, 1973 or benefitting from subsequent mortgage increases) were subject to prepayment "lockouts" for the full mortgage term.

In the mid-1980s, the "expiring use restriction" (EUR) crisis began with a wave of mortgage prepayments, including a few in Massachusetts. Subsequently, the federal government imposed a prepayment moratorium and developed new preservation initiatives under Title II (ELIHPA) and Title VI (LIHPRHA). These programs provided fair market value incentives to existing owners and purchasers, in the form of increased Section 8 subsidies and HUD-insured second mortgage loans for acquisition, rehab, and equity takeout.[1] In exchange, affordability restrictions were extended: under Title VI, for the remaining useful life of property (or at least 50 years); but under Title II, only for the remaining term of the subsidized mortgage. Between 1987 and 1995, approximately 4,000 subsidized mortgage units in Massachusetts were permanently preserved under Title VI, while another 7,000 units were temporarily preserved under Title II.

In 1996, the federal government restored owners' prepayment rights and defunded the preservation programs. Instead, Enhanced Vouchers were provided to protect eligible low and (in some cases) moderate income tenants at the point of prepayment. Unlike regular vouchers, which are limited to the PHA's payment standard, Enhanced Vouchers are provided at the comparable market rent as long as the tenant chooses to remain in the housing. However, since the Enhanced Voucher moves with the tenant, upon turnover (absent other restrictions) the units are permanently lost from the affordable housing stock.

Since 1996, approximately 15,300 federally- and state-assisted units have been lost in Massachusetts, primarily due to subsidized mortgage prepayments.[2] An estimated 8,600 of these units have retained some degree of affordability--although generally not comparable to the original level--because the projects were sold or refinanced under programs requiring new affordability commitments. The balance of approximately 6,700 affordable units have been permanently lost as affordable housing.

At the same time, the creative use of new federal tools in combination with state and local resources has facilitated the preservation of many expiring use developments. The Section 8 Mark Up to Market program has encouraged the renewal of existing project-based rental subsidy contracts, while supporting new debt financing for acquisition and rehabilitation. For Section 236 projects, HUD's "decoupling" program has allowed the remaining interest subsidy stream to be redirected towards this new financing. In conjunction with these federal initiatives, the Commonwealth has provided Low Income Housing Tax Credits (9% and 4%), tax-exempt bond financing, and gap financing for preservation projects. In particular, the Capital Improvements Preservation Fund (CIPF) is targeted exclusively for the preservation of at-risk existing subsidized developments.

III. Maturing Subsidized Mortgages: New Challenges

[1] Alternatively, under Title VI many non-profit purchasers received direct capital grants.

[2] CEDAC, "Massachusetts Projects with Subsidized Mortgages or HUD Project-Based Rental Assistance," December 2008; updated by Emily Achtenberg.

While Massachusetts has had a strong track record historically in preserving at-risk subsidized housing, recent experience with maturing mortgage properties suggests that circumstances may be changing. Now that the oldest properties are reaching the end of their subsidized mortgage terms, affordable units (with both mortgage and rental subsidies) are being lost at a rate not seen since repeal of the prepayment moratorium in 1995. For example:

- *High Point Village, Camelot Court,* and *Brandywyne Village* are three mixed-income former BMIR developments located in strong market neighborhoods of Boston, that were formerly preserved under Title II. The properties provided a total of 1,084 affordable units, including: 66% very low income units (with project-based Section 8); 24% low income units, and 10% moderate income units. Upon mortgage maturity, the Section 8 contract was renewed only at Brandywyne (266 units). The balance of the Section 8 units (451), and all of the affordable low and moderate income units (367), were converted to market. While eligible tenants (excluding many at High Point who had already moved) received Enhanced Vouchers,[3] a total of 818 affordable units were permanently lost.

- *Bradford Apartments* is a 160-unit former BMIR development located in downtown Lawrence that was partially assisted with Section 8 (100 units). Upon mortgage maturity, the Section 8 contract was terminated and rents were increased to market. While eligible tenants (excluding many who had already moved) eventually received Enhanced Vouchers, all 160 units were lost as affordable housing.

  Subsequently, the property was offered as part of a portfolio sale through a national broker. The owner refused to accept offers from local CDC buyers. Fortunately, the successful bidder has received a commitment for tax-exempt bond financing and tax credits, although the financing has not yet closed. With the loss of rental subsidies, however, these units will be substantially less affordable than they were prior to mortgage maturity.

- *Brookline Coop* is a 115-unit former BMIR property in Brookline that was developed as an affordable limited-equity cooperative (with no Section 8 assistance). Upon mortgage maturity, the cooperative converted to condominium ownership with 32 units remaining affordable. Eighty-three affordable units were permanently lost.

Within the past year, several maturing mortgage properties have been offered for sale on a competitive basis through national brokers, similar to the process utilized for

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[3]Enhanced Vouchers were provided at these developments, and at Bradford Apartments, because the owners were eligible to (and did) prepay their subsidized mortgages prior to maturity; see below.

Bradford Apartments. Due to a combination of resource, timing, and regulatory constraints, it has been extremely difficult for local preservation buyers--especially community-based non-profits--to compete successfully in this market-driven system. Even if some units are ultimately preserved, the system encourages underestimation of property expenses and rehab needs and inflation of bid prices which is detrimental to the housing and increases the cost of preservation.

IV. Analysis of the At-Risk Maturing Subsidized Mortgage Inventory

A closer look at the maturing subsidized mortgage inventory reveals some of the characteristics of this housing that will make preservation (and tenant protection) extremely challenging, as well as the unique benefits that underscore the value of its preservation.

General Characteristics

The analysis is based on 130 projects, containing 16,800 BMIR, 236, and 13A units,[4] whose mortgages will expire by the end of 2020, placing their existing affordability at risk.[5] Two-thirds of the developments, containing 60% of the units, are financed by MassHousing. The remaining one-third, containing 40% of the units, are or were HUD-insured.

Sixty percent of the units are financed under Section 236, while 25% are 13A units and the remaining 15% are BMIR units. Twenty developments (containing 5,300 mortgage subsidy units) are Title II properties that were previously preserved but are again at risk.

Fifteen projects (containing 1,850 units) appear to be owned directly by non-profits. As demonstrated by the Brookline coop example above, non-profit owners are not immune from market or development pressures. Additionally, many non-profit projects suffer from disinvestment and require substantial recapitalization and renovations. Accordingly, this housing is also considered to be at-risk.

Only 44% (7,344) of the mortgage subsidy units are additionally assisted with project-based rental subsidy. Of these, two-thirds (4,899) are Section 8 and the balance

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[4]Another 1,660 market units in these developments, including some with project-based rental assistance, do not benefit from mortgage subsidy and are not considered in this analysis.

[5]Subsidized mortgage projects previously preserved (with new restrictions expiring after 2020) are not included. These are mostly Title VI preservation projects, Low Income Tax Credit projects with long-term restrictions (allocations made in 1990 or later), and projects receiving other types of state financing tied to extended affordability. Also not included are projects whose mortgage subsidies were previously lost through prepayment or maturity (regardless of whether some affordable units were retained by other means).

have rent supplement or RAP subsidies[6], which effectively terminate with the mortgage. Section 8 contracts (which can be renewed, extended, and, in many cases, "marked up to market") cover only 29% of the mortgage subsidy units, and are concentrated in 49 developments. Eighty-one of the 130 developments (62%) have no project-based Section 8 at all. Especially to the extent that non-Section 8 units are occupied by very low and lower income tenants (see below), this discrepancy poses a significant challenge for preservation of the housing and for tenant protection.

Rents/ Affordability/ Income Mix

Budget-Based Rents. While only a portion of the units are assisted with project-based rental subsidy, rents in the non-assisted units[7] generally appear to be quite affordable. This is a legacy of 40 years of budget-based rent regulation.

In 27 projects for which non-assisted unit rent data was readily available, the median/ average rent was 65% of FMR.[8] This rent level is generally affordable to households earning less than 50% of area median income, at 30% of income. Accordingly, the non-assisted units in many maturing mortgage properties appear to constitute a resource for serving very low income and lower income households without rental subsidy--a unique benefit offered by this historically regulated, non-speculative housing stock. Anecdotal evidence suggests that many of these units are occupied by tenants with even lower incomes, paying more than 30% of income for rent.

Tiered Rents. The 20 Title II projects have a "tiered" rent structure for unassisted units, based on their historical occupancy profiles, which is designed to preserve mixed affordability levels. In many Title II projects, the occupancy profile--which owners are required to maintain "to the extent practicable"--reflects substantial low/moderate income diversity. At the same time, owners are not precluded from serving additional lower income households and must accommodate tenants whose incomes decline by reallocating them to lower profile (and rent) subtiers. As indicated by the following example of a suburban Title II property within Greater Boston (which was recently offered for sale), unassisted units in these projects may be currently serving a lower income population than the historical profile suggests:

	Historical Profile	Current Profile

[6]These more limited forms of rental subsidy are typically found in developments financed by MassHousing. Most owners of HUD-insured projects were able to convert their rent supplement contracts to project-based Section 8 some years ago.

[7]Throughout this report, "non-assisted" or "unassisted" units refers to units with mortgage subsidy but without project-based rental assistance.

[8]In one development where rents exceed the FMR, all units are rent-assisted.

Very Low: <50% (S8)[9]	27%	27%
Very Low: <50% (non S8)	-	26%
Low 1: 51-60%	16%	8%
Low 2: 61-70%	18%	7%
Low 3: 71-80%	11%	9%
Mod 81-95%	27%	23%
Total	100%	100%

Vouchers. Finally, since the below-market rent structure in subsidized mortgage properties (both Title II and non-Title II) is typically well below the FMR/PHA voucher payment standard, very low income households with mobile vouchers are readily accommodated. Anecdotal evidence suggests that many of these developments have substantial occupancy by voucher-holders.

Location/ Community Context

Location. At-risk maturing mortgage properties are dispersed throughout the state, with more than 40% of the units located in cities and towns inside Greater Boston. Many projects appear to be situated in strong market areas, both suburban and urban (e.g. within the City of Boston, in the South End, Hyde Park/Roslindale, and Fenway neighborhoods), where they are a key source of economic and racial diversity and are vulnerable to market conversion pressures.

40B Compliance. Outside the major cities, many properties are located in cities and towns that barely meet, or fall below, the 10% affordable housing requirement under Chapter 40B. In these localities, maturing mortgage properties constitute a significant proportion of the 40B affordable housing stock (e.g. 42% in Brewster, 57% in Lincoln, 53% in Medford). The loss of these properties will make it much more difficult for the municipality to achieve or maintain 40B compliance.[10] In contrast to new 40B projects, which are often controversial, these existing developments have long been accepted as part of the neighborhood fabric.

A significant number of properties have Chapter 121A tax contracts which typically include low and moderate income use restrictions. However, since these contracts were executed when the projects were first developed and expire after 40 years, their relevance

[9] In Title II projects, all units occupied by very low income tenants at the time of preservation received project-based Section 8 subsidy.

[10] Under current 40B rules, 100% of the units in a rental development that is at least 25% affordable to households with incomes at or below 80% median are counted towards the 10% requirement. Termination of the affordability restrictions or subsidy contract generally causes the development to be removed from the 40B inventory, with some exceptions.

diminishes as mortgage maturity approaches. A few properties have zoning or existing 40B restrictions which may prove more useful.

At-Risk Dates

Mortgage Subsidies. In general, HUD BMIR and 236 mortgages are maturing now through 2014. MassHousing 236 and 13A projects, built later and with longer mortgage terms, will mature starting in 2012 through 2020.

Twenty-one projects containing 20% (3,500) of the mortgage subsidy units are at immediate risk. This category covers projects with mortgages maturing before the end of 2010, including several large Title II properties in and around Boston (e.g. Georgetown, Cummins Tower, Battles Farm). It also includes several prepayment-eligible (EUR) projects that are not subject to prepayment lockouts and can terminate their subsidized mortgages and restrictions *at any time* (e.g. Cambridge Court, Macarthur Terrace, Harborview Towers).[11]

Another 35 projects containing 30% (4,800) of the mortgage subsidy units have mortgages that will reach maturity through 2015. The remaining 74 projects, containing half (8,500) of the units will reach maturity through 2020. While these properties are not immediately at risk, they may present important opportunities for preservation (see below).

Rental Subsidies. Eighteen percent of the rental subsidies are at risk through 2010, 33% through 2015, and 48% through 2020. For Section 8 units, the at-risk dates generally track the mortgage expiration dates (except for EUR projects, where the Section 8 contract is at risk on its own expiration date, e.g. Harborview Towers). In projects subject to prepayment lockouts, if the Section 8 contract expires before the mortgage (e.g. Hope In Action), it is assumed not to be at risk since the owner has little incentive to opt out. This is consistent with the history of Section 8 optouts in Massachusetts to date, which (with some exceptions) have occurred in only conjunction with mortgage prepayments and maturities.

Rent supplement and RAP contracts expire after 40 years or at mortgage maturity/ prepayment, whichever occurs first. In some cases (e.g. Madison Park III), these subsidies will expire before the mortgage matures, creating an unanticipated affordability gap for very low income tenants.

Prepayment Lockouts. With respect to projects that are not immediately at risk due to prepayment lockouts, a critical public policy issue is whether they should be permitted to refinance prior to maturity, in exchange for extended affordability restrictions. This

[11]These EUR projects could have prepaid their mortgages up to 20 years ago but, for any combination of reasons, did not. Some (e.g. Cambridge Court) are clearly located in strong housing markets where there is a substantial incentive to prepay.

could facilitate more cost-effective preservation of the housing, since the value of the property during the lockout period is restricted.

For example, at one extremely valuable Section 236 property in the Greater Boston area which is eight years away from mortgage maturity, current rents for a 3BR townhouse at $1,300 are approximately 50% of market ($2,650). The owner is seeking to sell the property now, and does not intend to wait. The appraised value today (taking into account the remaining period of extended use) is half the projected value on the date of market conversion.

To purchase the property, a preservation buyer will need to prepay and refinance the existing mortgage with tax-exempt bond financing at lower interest rates, which will also generate Low Income Housing Tax Credits. By purchasing today, the buyer will be able to "decouple" and utilize the remaining Section 236 interest subsidy stream, a resource that diminishes each year as mortgage maturity approaches. Prepayment will also trigger Enhanced Vouchers for eligible tenants (see below). In the absence of a viable preservation option, there is a substantial risk that the property will be sold to a speculative buyer in anticipation of future market-rate conversion.

Tenant Protections/ Enhanced Vouchers

Relative to past expiring use situations, tenants in maturing mortgage properties are more vulnerable to displacement because Enhanced Vouchers are not guaranteed. While eligible tenants in any units subject to a Section 8 contract are entitled to Enhanced Vouchers if the owner opts out, the rules for non-Section 8 tenants--who occupy more than 70% of these units--are more complex.

Under current federal law, eligible non-Section 8 tenants can receive Enhanced Vouchers only if the owner is entitled to prepay the mortgage without HUD consent--and does in fact prepay prior to maturity. Projects that received Flexible Subsidy rehab loans may be approved for Enhanced Vouchers at HUD's discretion. HUD would also have to approve the provision of Enhanced Vouchers to Section 236 and Chapter 13A projects that are released by MassHousing from their historical prepayment locks. Certain types of projects, such as those owned by non-profits, require HUD consent to prepay and cannot receive enhanced vouchers.

In approximately 25% of the maturing mortgage subsidy units (located in 26 properties), eligible tenants could receive Enhanced Vouchers if the owner agreed to prepay. In another 62% of the units (located in 82 properties), Enhanced Vouchers could be available with HUD consent (and MassHousing prepayment approval, with respect to MassHousing projects). In the remaining 12% of the units (17 projects), Enhanced Vouchers cannot be provided under current law--either because the owner is a non-profit or the subsidized mortgage has already been prepaid.

V. Policy Implications

The challenges posed by maturing subsidized mortgages are occurring in the context of a profound economic and financial crisis when affordable housing resources in

Massachusetts (for both preservation and production of affordable housing) are extremely scarce. At the same time, the growing demand for affordable rental housing, fueled by rising unemployment and mortgage foreclosures, underscores the critical need to preserve existing subsidized housing resources. The Commonwealth's recent $4.5 million award from the MacArthur foundation provides an opportunity to refocus creative attention on preservation. The following proposed legislative, policy, and programmatic measures would greatly enhance opportunities for preservation.

1. Right to Purchase

State legislation is needed to provide, at a minimum, a Right of First Offer and a Right of First Refusal to DHCD or its designee, when a subsidized property is offered for sale. Adequate time frames, public notice provisions, and tenant protections should be included. This is an essential first step to facilitate opportunities for preservation purchases, which cannot be accomplished within the market-oriented national competitive bid system utilized by most sellers. A compromise bill negotiated among owners, advocates, and DHCD passed the Senate last year, has been reintroduced, and should be approved.

2. Preservation Financing

Tax exempt bond financing and associated 4% tax credits, which are currently in plentiful supply, should be made available for preservation transactions on a priority basis. State gap funding specifically targeted for preservation (including CIPF) should be expanded and awarded on a rolling basis, to accommodate the opportunistic nature of preservation transactions. The new Preservation Loan Fund, capitalized in part with MacArthur funding, should be aggressively utilized to facilitate the timely acquisition of at-risk properties pending the availability of permanent financing.

3. Non-Profit Purchasers

Additional measures are needed to allow qualified community-based non-profit purchasers, who are especially disadvantaged in the current financial crisis, to compete on a level playing field with private buyers (both market- and preservation-oriented). These include timely access to adequate predevelopment funds both prior to site control (to develop competitive offers) and after (to secure acquisition and permanent financing). There is also a critical need for a pooled guarantee fund to enable non-profit purchasers to meet investor reserve requirements and secure tax credit equity for preservation transactions in today's challenging market.

4. Prepayment Lockouts

MassHousing should permit the release of prepayment locks on subsidized mortgage properties in exchange for extended, long-term use and affordability restrictions, in order to facilitate cost-effective preservation. This is especially appropriate for properties at high risk of market conversion that are being offered for sale, or for properties requiring substantial rehabilitation. Recapitalizing owners and purchasers benefiting from the release of prepayment locks should be required to renew existing Section 8 contracts and to project-base Enhanced Vouchers, to the extent authorized by federal legislation (see

below). State preservation resources should be targeted to these projects on the same basis as projects which are at more immediate risk.

5. Enhanced Vouchers/ Project-Basing

Federal legislation (currently pending in Senate SEVRA) should be enacted to permit owners to project-base Enhanced Vouchers, subject to PHA approval, and with retroactive application to tenants in projects who have already received Enhanced Vouchers. Additionally, owners should have the option of exchanging their Enhanced Vouchers for HUD project-based Section 8 authority, as recently proposed by MassHousing. The scope of Enhanced Voucher eligibility should also be extended more generally to maturing subsidized mortgage projects with prepayment lockouts, in exchange for a requirement to project-base the vouchers. These measures are critical both for preservation and tenant protection.

Maturing Subsidized Mortgages at Risk Table