Section 515 Maturing Mortgages: What Tools RD Is Providing and Where They Fall Short

In my last article I introduced you to a growing problem with the Section 515 program, the natural maturation of its loan portfolio. It's a wave that was set in motion decades ago and few have been watching the horizon for the coming tsunami until very recently. The rural housing industry, and our residents, are now facing the potential loss of thousands of units of affordable rental housing in Rural America.

In my first article, I broke down the numbers based on raw data provided by RHS. If nothing is done, just this year, it is expected that the national portfolio will lose 3,061 units, including 1,415 units of Rental Assistance. By 2023, more than 10,000 units of affordable housing could escape the program eliminating some of the only affordable rental housing in some rural communities.

In Wisconsin, 48 units in 2 properties could be lost this year and over 500 units in 29 properties (320 of which have RA) could be lost over the next 10 years.

In April 2015, RHS officially recognized the problem and offered up a few solutions for properties that may be nearing maturity. In an Unnumbered Letter dated April 28, 2015, the Agency identified the problem, explained what "Paid Ahead" mortgages are and how they will be treated and offered up three tools available to owners and servicing officials to preserve properties with maturity dates through calendar year 2019.

RHS subsequently issued a replacement Unnumbered Letter on December 28, 2016 that remains effective through January 31, 2018. The two Unnumbered Letters are materially the same with the notable exceptions of 1) extending out the calendar requirements for notifying borrowers that their mortgages are maturing (from 25 to 36 months) and 2) adding language that encourages servicing officials to offer incentives to any borrower that doesn't take any of the first three mortgage extension tools offered. Let's take a look at all of these tools.

"Paid Ahead"

As RHS refers to them, "Paid Ahead" mortgages are loans that are on schedule to payoff **before** the maturity date in the Promissory Note. This would have occurred due to extra payments being applied to the balance. Several circumstances could have caused the balance and maturity date to get out of sync. They include 1) proceeds from partial sales of the property, 2) overage fees paid toward the loan balance over the years or 3) other surplus funds that may have been applied against the mortgage balance.

In the case of a project that has a projected payoff date sooner than the Promissory Note maturity date, RHS **will not permit** the last payment to be applied until the maturity date. If your project is on pace to make it's last payment in August 2017 but the maturity date in the

Promissory Note is April 2019, if you do nothing, the Agency will send back your last mortgage payment and not accept it until April 2019.

Re-am Lite

The Agency has introduced a streamlined version of the standard reamortization providing an exception for various conditions and required documentation of §3560.455(b). This exception and expedited reamortization is only available to properties with mortgages maturing through calendar year 2019.

For a Re-am Lite, no appraisal is needed, no change in the current year budget is required and the loan term can be extended for up to 20 years. No additional Restrictive Use Provisions (RUPs) will be added to these properties.

But, in the following year, the new budget must reflect the implications of the reamortization. This could result in a **rent decrease** and if the change in annual debt service is more than 50%, the borrower may have to get a Capital Needs Assessment (CNA) and the replacement reserve requirement could be resized.

There is one major problem facing almost any project considering this option: phantom income.

Any property maturing by 2019 is almost certainly to 1) have been fully depreciated and 2) have a relatively small remaining loan balance that results in a corresponding low new debt payment. These properties are likely already generating sizeable phantom income to the owner. If the reamortization results in lower rents and higher replacement reserve requirements, phantom income would go up while reducing NOI and the underlying property value.

The Re-am Lite tool does not provide for any increase in Return to Owner (RTO) or other method for an owner to extract the funds necessary to offset phantom income.

The Re-am Lite tool therefore has two major problems. First, there is **no real incentive** for most owners to take advantage of it. Second, and more importantly, there is a palpable disincentive by effectively **taxing owners and reducing the value of their property**.

The only types of borrower who may be incentivized to go through the Re-am Lite process are 1) mission based nonprofits that are exempt from taxes, 2) properties with Rental Assistance in a weak market where market rents are lower than the RA rent and 3) properties that are in financial freefall with no other options for recovery.

Owners with options have absolutely no incentive (and are disincentivized) to use Re-am Lite and should shy away from this tool.

Debt Deferral Under MPR

In the Maturing Mortgages Unnumbered Letter, RHS recommends to its servicing officials to encourage any borrower who passes on Re-am Lite to pursue debt deferral under the MPR program.

It’s unclear why any owner that decided Re-am Lite wasn’t for them would settle for a debt deferral. This would be even more catastrophic on phantom income and the property’s value.

In addition, the owner must go through the onerous MPR process with no incentive. Remember, like Re-am Lite, MPR debt deferral deals don’t allow for increased RTO or equity loans.

Again, this tool provides no incentive to owners with options and provides an exaggerated disincentive over the Re-am Lite option. The only types of owners that could benefit from debt deferral are those three types discussed earlier.

Prepayment

The Unnumbered Letter encourages servicing officials to recommend prepayment to borrowers who forgo Re-am Lite and MPR debt deferral.

Yes, you read that correctly. **RHS is actually encouraging prepayment**.

The Agency is encouraging this because if a property prepays, under the Statute, all the residents of that property may obtain a RD Voucher.

But, aside from knowing you helped your residents with a soft landing, there is no incentive to go this route. If the loan is paying off in the next 36 months anyway, and the owner doesn’t have to think about it or lift a finger, it’s asking a lot of them to go through the prepayment process without any compensation.

For this reason, it’s unlikely many properties maturing in the next 36 months will go the prepayment route.

Incentives

As an addition to the second version of the Unnumbered Letter issued in December 2016, RHS recommends servicing officials encourage the owner to apply for incentives to avert prepayment. These incentives include additional RA units, equity loans and/or an increase in Return to Owner (RTO). The Unnumbered Letter declares that “such action keeps the property in the RD portfolio.”

Finally, RHS is talking incentives. These incentives are laid out in the Statute and include equity loans, an increase of RTO, release of reserve funds to the owner and additional RA units.

Incentives are only available to properties with equity documented by an appraisal. This tool is what's needed to incentivize owners with options, but it will be costly. As Larry Anderson, former Assistant Deputy Administrator of RHS points out, "incentives become more expensive to the government the closer to mortgage maturity you get."

For example, to offer incentive RA to the nearly 3,677 non-RA units set to mature by 2019 would cost the government over $15.75 million. And then there are the incentives needed to preserve the other 2,300 units that already have RA. That's certainly many millions more of incentives required. It is unclear if RHS has set aside the funding required to fund these incentives.

Conclusion: An Empty Toolbox and A Bleak Outlook For Portfolio

My analysis is that the tools RHS has provided in the Unnumbered Letter are woefully inadequate to be even modestly successful in preserving mortgages that are about to mature. I'll go out on a limb and predict that of the 122 properties (3,061 units) scheduled to mature in calendar year 2017, only a small handful will be saved.

Discussing the number of properties that actually escaped the program in 2016 through mortgage maturity, Larry Anderson observed "Global warming has already hit us and the water level has already risen. RHS must take further action now before it's too late."

RHS should not sit still waiting for these inadequate tools to somehow magically start working. That isn't going to happen. RHS must act now.

It's important to note that Congress agrees with these sentiments. Senators Merkley (D-OR) and Moran (R-KS) of the Senate Agriculture Appropriations Subcommittee have expressed concern over the Agency's handling of the coming deluge of maturities. At their request, a GAO Report is underway to determine if the Agency's data is adequate to assess the problem and if the tools they have provided so far can solve the problem. The report is expected to be completed by the end of 2017.

On the data, I will note that RHS has now released three versions of the data, all of which have been quite different from the prior version. For example, the most recent data released in April 2017, the number of properties with maturing mortgages in 2017 increased by 33 properties and 822 units. We will continue to monitor data being released by RHS for these types of drastic shifts.

I have lots of ideas for tools that will actually work to preserve thousands of units and that will be the subject of my next article on this subject.