Mercy Housing, Inc.
MERCY HOUSING SYSTEM

Testimony of

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Senior Vice President
Mercy Housing, Inc.

Before the

Committee on Financial Services, Subcommittee on Housing and Community Opportunity

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Good morning Mr. Chairman. My name is Charles Wehrwein. I am a Senior Vice President of Mercy Housing and have also held posts overseeing multifamily housing programs at USDA's Rural Development and HUD. Mercy Housing has direct and significant experience with owning, acquiring and restructuring federally assisted properties, working within and using the Mark-to-Market program at HUD, using tools made available in the MAHRA legislation passed in 1997, and we led one of the largest rural portfolio acquisitions by a non-profit, know as the Cobble Knoll portfolio in Washington state. I appreciate the opportunity to offer my comments today on HR 5039.

Introduction: Mercy Housing

Mercy Housing is a non-profit affordable housing developer, owner and manager headquartered in Denver, CO, with real estate interests in many other regions throughout the nation. In our 25-year history, we have developed or preserved over 18,500 units of affordable housing serving more than 55,000 low-, very low- and extremely low-income Americans on any given day. Mercy Housing regards the preservation of affordable rental housing as essential to the stability and revitalization of communities and the residents who so desperately need this housing, both now and in the future. Mercy and others who work in the community development field remain deeply concerned about the future of preservation in general and the rural portfolio specifically. Mercy is a member of the Steward of Affordable Housing for the Future, or SAHF (say "SAFE"); whose members include some of the largest non-profit affordable housing developers and owners in the United States. The organization's policy agenda focuses exclusively on policy and marketplace barriers to the preservation and long-term ownership of affordable housing.

HR 5039

We would like to extend our appreciation to the bill's sponsors on recognizing the need to respond to the desperate preservation needs of the rural portfolio. The proposed bill is a very good start towards rectifying the issues spelled out in the November 2004 report titled "Rural Rental Housing – Comprehensive Property Assessment and Portfolio Analysis". We would like to offer some suggestions based upon our experience in preservation, and specifically the recent preservation of a large rural portfolio, about how the existing bill can be improved not only to respond to the existing situation, but also to serve as a proactive launching pad to spur preservation by organizations such as ours that intend to provide and extend quality affordable housing for the long term.

Given the brief time available today and the broad experience represented by the other panelists, our comments today will focus on elements of the proposed bill that effect the ease and likelihood of the transfer of these assets to owners who will sustain the housing as affordable for the long term. However, we remain concerned about the adequacy of funding levels, the impact of the proposals on residents and the permanent loss of the only decent affordable rental housing in some rural areas.

Case Study: Mercy Housing's Acquisition of the Cobble Knoll Rural Portfolio

Mercy Housing recently completed the purchase and is finalizing the rehabilitation of a 30 property, 926 unit rural portfolio located throughout Washington State, commonly known as the Cobble Knoll portfolio. Because of the large number of assets, Mercy developed and implemented a plan to acquire the portfolio in 2 phases during 2003 and 2004, in one group of 17 properties and a second group of 13 properties. In September 2003, Mercy acquired the first 17 properties (507 units), located in 12 communities, after 18 months and considerable upfront time and capital spent analyzing the financial and physical condition and arranging financing. Mercy decided to split the portfolio into 2 acquisition phases due to the large number of assets. The purchase price was approximately $31,000 per unit. We negotiated purchase prices and structured the financing in order to address the capital improvement needs, both immediate and over time, and to ensure the long term financial and physical viability of the housing.

The total development cost of the 30 properties will be about $42 million, including about $8,000 per unit in initial repairs and deposits to reserves. The Washington State Housing Finance Commission issued approximately $10.35 million in tax exempt 501©3 bonds. A major bank purchased the bonds, which have a 30 year term and a fixed rate of interest. Rural Development (RD) originated about $8.8 million in new Sec. 515 loans and subordinated the $20.7 million in existing Sec. 515 debt on all of the properties to the new bondholder. The State Department of CTED provided Housing Trust Funds to each property, which has made it possible for the properties to obtain property tax exemptions, and thus, reduce the operating costs to the government and the owner. Rural Development also provided additional units of Rental Assistance, approved significant increases in rent subsidy necessary to support additional debt and approved increases in annual deposits to replacement reserves in order to fund reserve contributions for future capital improvements. The sellers transferred all existing reserves and accounts belonging to the properties and made a charitable donation to Mercy to reduce the purchase prices.

Mercy Housing's goals in acquiring the Cobble Knoll portfolio were as follows:

- To preserve and strengthen these 926 units of deeply affordable housing for the poor rural seniors and families who depend on this resource;
- To test if rural preservation could be done a large and efficient scale;
- To attempt to structure the new ownership so that it was economically viable for a non-profit with a long-term ownership horizon; and
- To call out the tools that are useful in making rural preservation happen at scale, and the impediments in pursuing this strategy.

Our experiences, in summary are:

- A high-capacity not-for-profit can bring significant benefits to a large-scale transaction;
- Restructuring tools made available to the Department such as subordination, new debt, debt restructuring and in limited cases, debt forgiveness are key to creating

extended affordable use, as is the ability to reallocate rental assistance resources to raise some partially assisted properties to 100% assisted;

- Projects with 100% rental assistance, under either Sec. 8 or Sec. 521 are much more likely to be candidates for a successful restructuring and to be economically viable going forward;
- Project-based rental assistance is critical to achieve effective underwriting from market-sector lenders, with longer-terms providing more comfort and therefore more private-sector resources;
- Projects with partial or no rental assistance, especially those in remote or low cost areas, are extremely difficult to restructure using housing finance tools available today and will likely need debt forgiveness, new or transferred rental assistance and/or grants to be viable;
- The Rural Development field staff is made up of well trained generalists with a strong commitment to this housing and to rural communities in general. However, they have little experience with modern housing finance tools and strategies being used outside of the USDA today;
- The Department lacks expert restructuring agents; and
- The USDA's structure and culture is very decentralized, resulting in poor sharing of best practices, little capability or willingness of the national office to direct strategies based on best practices to the entire field, and a maddeningly variable application of rules from state to state, and even county to county.

As I noted earlier, Mercy Housing has preserved many other affordable homes in addition to the rural acquisition noted above. We have worked with HUD, specifically its offices of Multifamily Housing – OHAP and its predecessor, OMHAR in utilizing the tools commonly know as Mark-to-Market that were established under MAHRA. This experience is entirely relevant to the discussion today, and I would offer a few comments based upon our experiences:

- Creating and empowering a central unit to direct the implementation of preservation policy at HUD is a model of efficiency and good government.
- The team assembled first at OMHAR and now at its successor. OAHP are housing finance and restructuring professionals who delegate effectively to HUD field offices and to contractors (participating administrative entities, or PAEs).
- The policy and implementation of preservation and restructuring acquisitions with this approach have created a relatively smooth and consistent process with the appropriate amount of safeguards and incentives to foster long-term sustainability.
- These tools and their implementation have preserved scores of affordable homes and saved the taxpayers' money.
- I'd like to note that the tools used under MAHRA are about to expire on September 30, 2006, and we would also strongly encourage their extension.

The key tools used by HUD have been:

- Debt restructuring;
- The creation of and ability to assign junior cash flow notes to qualified non-profits; and

- The authority of the Secretary to provide for exception rents in a limited number of instances.

A final point I would like to make about the lessons learned from other preservation experiences is that not all owners share the goals of meeting property needs, assuring renewed and extended affordability, and engaging in long-term ownership. MAHRA specifically recognized the unique role of high capacity non-profit owners, Mercy Housing and others like us are in this for the long haul and our missions are congruent with the government's - to provide decent, safe and sanitary affordable homes for the long run. Promoting the transfer to and restructuring of these assets to qualified non-profits means that Congress will not have to come back to the table with new programs down the road to further extend the affordability of these homes.

Suggestions to enhance the effectiveness of Rural Preservation

With the foregoing experience in mind, we offer the following suggestions for improving this bill, so that this rare opportunity to change rural housing policy is maximized:

- Create or contract with a unit of expert housing restructuring staff such as exists in HUD's Office of Multifamily Housing – OAHP
- Empower this expert unit to promulgate policy, tools and best practices that will be used consistently across the country; for example, OAHP staff at HUD developed an Additional Funds policy that resulted in a significantly greater amount of rehab per unit.

- For any owner or purchaser seeking it, **require** the Secretary to provide a formal commitment as part of the long-term viability plan, failure to do so would leave the current or future owner uncertain of the Department's ability and commitment to carry through on the commitments and will chill their interest in engaging with the Department
- Provide for the ability to accelerate the replacement of systems that are due to be exhausted or obsolete within the next seven years in order to make better use of the state and local resources, to be consistent with state or local policy around rehabilitation, and to enhance the efficiency of the developer attempting to preserve these units.
- Provide the Secretary with the authority to split current USDA loans into multiple loans, some with fully amortizing terms, others with cash flow only terms, so that this debt might be preserved and used to increase tax credit basis, and therefore the amount of Low Income Housing Tax Credits (LIHTC) that can be attracted to these projects
- Eliminate the 75% rule under Sec 3(b)(6)(B) of the proposed legislation. It will not work with LIHTCs and essential debt products. We would be happy to assist the Committee with new wording that takes into consideration the complicated structure of today's multiple source financings
- Clarify that the 30% rents under Sec. 3(b)(7)(B) of the proposed legislation relates to how much a tenant contributes, not the level at which rents are to be set and that this limit on rental contributions applies only to rental assisted units. Failure

to do so would cause rents to be different for each tenant in all Sec. 515 financed properties.

- The notice of prepayment and sale is too short at 90 days and should be extended to six months to both help the tenants in finding replacement housing if needed, and to provide for more time for interested preservation buyers to become aware of and enter into negotiations with the seller
- Encourage transfer to high capacity not-for-profit owners by:
    - Mandating an Asset Management fee of the greater of $1,000/unit/year, or $15,000 per building/per year in the operating budget of the project. Currently, not-for-profit owners have all of the risks and responsibilities of ownership without being appropriately compensated for their internal costs of providing oversight of these assets and reporting to various lenders, governmental regulators and investors.
    - Following on the authority to create junior cash flow notes above, allow for the assignment of these notes to qualified not-for-profit purchasers/owners of Sec. 515 properties to encourage the transfer and long-term ownership of these properties to mission-driven stewards.

This concludes my testimony. We stand ready to assist the Committee, its staff and the Administration in any way possible to assure that the valuable affordable housing resources created over the years are enhanced and sustained, not lost. Thank you very much for your consideration.

Mercy Housing acquired 30 rural housing properties through a two phase acquisition in 2003 and 2004 totaling 926 units. 50% of the properties acquired served families while the remaining 50% served the elderly. The total development cost of the 30 properties was about $42 million, including about $8,000 per unit in initial repairs and deposits to reserves. The Washington State Housing Finance Commission issued approximately $10.35 million in tax exempt 501c3 bonds. Rural Development (RD) originated about $8.8 million in new Sec. 515 loans and subordinated the $20.7 million in existing Sec. 515 debt on all of the properties. The State Department of CTED provided Housing Trust Funds to each property, which has made it possible for the properties to obtain property tax exemptions, which reduced the operating costs. RD also provided 75% of the units with Rental Assistance or partial Rental Assistance with the remaining 25% receiving Section 8. RD monitors and approves the operating budget for all 30 properties.

In 2005, Mercy Housing was awarded a Neighborhood Initiative Grant for improvements to rural housing in Yakima, Washington. The grant amount totaled $297,600 and is planned to be utilized between 2 properties which Mercy Housing owns and manages in Yakima County.