# CHAPTER 5

# FINANCIAL INFEASIBILITY REQUESTS

The AHP properties were sold at a price discounted from market value to reflect the requirement that owners provide a portion of the units at restricted rents. Under most circumstances, that reduction in acquisition cost is expected to be sufficient for properties to remain economically viable for the compliance period. However, occasionally, market conditions may change over time, rendering a property unable to meet its Set-Aside obligations and remain economically viable.

Under the provisions of a property's LURA, monitoring agencies have the authority to <u>temporarily</u> reduce the occupancy requirements for Low and Very Low Income tenants in situations where it is no longer financially feasible for an owner to meet these requirements.

These waivers are not granted to relieve owners who failed to understand their Set-Aside obligations at purchase, or to relieve owners who have failed to make substantial efforts to market the set-aside units. Nor is the waiver a mechanism for owners to seek relief from self-induced financial distress, neglect, mismanagement, over-improvement or any other financial actions designed to create distress. The waivers provide temporary relief when market factors or other factors beyond the control of the owner render the project unable to maintain viability within Set-Aside requirements.

To obtain such a reduction, owners must submit an application to the monitoring agency requesting a temporary waiver of the property's occupancy requirements. This chapter describes guidelines monitoring agencies should use in reviewing owner requests for financial infeasibility waivers, including:

- ◊ the types of waivers agencies may issue;
- ◊ acceptable conditions for receiving a waiver;
- ◊ guidelines for reviewing waiver applications; and
- ◊ special procedures for monitoring properties with waivers.

## 5.1 FINANCIAL INFEASIBILITY WAIVERS

The purpose of giving owners a waiver of the property's occupancy requirements is to help prevent the loss of the property through default. A waiver enables an owner to increase income to the property by allowing the owner to temporarily rent some or all of the units set aside for VLI and LI households to tenants with higher incomes.

## A. Types of Troubled Properties

Financially troubled properties vary both in the nature and extent of the problems facing the owner. As noted in the introduction, not all properties experiencing financial problems should receive waivers. Properties where a waiver may be appropriate can be divided into two groups:

1. properties with insufficient income due to QU vacancies; and

2. properties with insufficient revenue to cover operating expenses.

Both conditions can leave the owner with insufficient income to cover operating expenses and debt service. Property owners may encounter other circumstances that weaken the financial position of the property, but agencies should carefully consider whether a waiver will enable the owner to address the problem.

### *Insufficient Income Due to Vacant Units*

Properties that experience unusually high and prolonged vacancies in QUs may be unable to meet their operating expenses and debt service due to revenue deficiencies. In addition to the evidence of financial distress, owners requesting this waiver must be able to document substantial efforts at targeted marketing to VLI or LI households, beyond traditional marketing. Owners must also be able to demonstrate that only reasonable screening and tenancy requirements are imposed on all applicants.

Where the owner has high vacancies among both QUs and unrestricted units resulting from general market problems, the property's income may not be sufficient to cover operating expenses and debt services. Because the marketability problem exists for unrestricted units as well, agencies should determine that waivers of QUs will enhance the viability of the property.

### *Insufficient Revenue to Cover Operating Expenses*

Over time, operating expenses for a property may rise faster than rents to the point where rental revenue is insufficient to cover costs. The AHP rent limits for QUs may prevent owners from increasing rents to cover operating expenses and debt service. These circumstances are likely to occur only in areas where the AHP rent limits are well below the rents for similar unrestricted units in the property, and median incomes (as the basis for rent limits) have not increased significantly over several years. Owners must be able to demonstrate reasonable operating expenses and debt service as part of the evidence of financial distress.

However, general market conditions may prevent owners from generating sufficient income, even if the owner could charge market rents for every unit in the property. In such cases, the property is no longer financially viable, a waiver will not address the problem, and a financial workout involving the lenders is necessary. The FDIC should be notified of such cases.

## B. Necessary Conditions for Granting Waivers

FDIC has established the following items as necessary conditions for receiving a financial infeasibility waiver. When evaluating requests for waivers, monitoring agencies should consider whether a property meets these conditions.

- **The Property Is In Financial Distress**. A property should be experiencing serious financial problems to receive a waiver. Properties where profits are lower than anticipated and those that encounter occasional monthly losses are not experiencing serious problems. One indicator of financial distress that monitoring agencies may use is the number of months a property has experienced negative cash flow.[13] FDIC has determined that when a property has experienced 24 months of negative cash flow, the property may be considered financially distressed. At least 3 years of property financial statements, preferably independently prepared, should be reviewed. Monitoring agencies may choose to use other indicators of financial distress they believe appropriate. Section 5.2.B provides further guidance on assessing financial distress.

- **The Conditions Are Beyond The Control of Owner**. The conditions leading to the property's financial problems should be beyond the owner's control. Agencies should avoid giving waivers where the problems are due to the owner's neglect, mismanagement or deliberate expansion of debt (for improvements or equity takeout). For example, if the owner discovers the presence of a toxic waste on the property and the expense of removing and disposing of the waste has seriously weakened the property's financial position, this is a condition beyond the owner's control. However, if the property is experiencing a sharp rise in maintenance costs because the owner failed to perform preventive maintenance on the major systems, the owner should not receive a waiver unless the owner performance issues are addressed.

- **A Waiver Enables The Owner to Address The Problem**. The waiver must clearly provide the increased income necessary to help preserve the

[13] A property is experiencing negative cash flow when income after expenses is less than the debt service for a property.

property. For example, in areas where the market rents are less than the AHP rent limits for the property, reducing the number of QUs will not help raise the property's income because the rents collected from unrestricted units would be the same as the rents for QUs.

♦ **The Owner Attempted to Strengthen The Property's Condition**. The owner must have taken all reasonable steps to address the problem and improve the property's financial condition. For example, if the problem is high vacancy rates, the owner must show that he or she actively marketed available units. If the problem is caused by a sharp rise in operating expenses, owners should have taken steps to control expenses, drawn on the property's reserves, and invested their own funds in efforts to address the problem. The owner also should have attempted to obtain other types of assistance for the property. For example, if some of the units need rehabilitation, the owner should have attempted to obtain public or private financing to make needed repairs.

♦ **A Waiver Is Compatible with Other Assistance to the Property**. It may not be possible to waive the occupancy requirements for a property if it also has Low Income Housing Tax Credits or tax exempt bond financing.

## C. Types of Waivers

There are two types of waivers agencies may consider giving an owner when financial infeasibility exists.

| TYPES OF INFEASIBILITY WAIVERS | |
|---|---|
| Type A: | Reduce the number of required VLI-QUs |
| Type B: | Reduce the number of required QUs (LI and VLI) |

The following limitations apply to waivers:

◊ While agencies may grant temporary waivers reducing the number of QUs, agencies may not issue a waiver to change the rent limits for remaining QUs.

◊ Waivers may only be granted on a year to year basis.

◊ A waiver may <u>not</u> be used to remove the QU designation from an eligible household. When the number of occupied QUs in the property exceeds the reduced number of QUs under a waiver, the owner may not raise the rent for occupied QUs may not be raised above the applicable rent limit until and unless a Qualifying Tenant moves out.

◊ A waiver does not relieve an owner of the obligation to correct a prior violation under which a QU was rented to an ineligible household.

***Type A: Reduce Required VLI-QUs***

In granting a Type A waiver, a monitoring agency is giving the owner a temporary reduction in the VLI Set-Aside, but not the total number of QUs. Under this type of waiver, only the portion of the Total Set-Aside that must be reserved for VLI households changes. For VLI units to which a Type A waiver applies, the LI occupancy and rent limits apply for the duration of the waiver.

For example, a Type A waiver might be granted to a property with a Total Set-Aside of 35 units and a VLI Set-Aside of 20 units to reduce temporarily the required number of VLI-QUs from 20 units to five units. However, the owner would still be required to maintain a total of 35 QUs.

***Type B: Reduce Required QUs***

When an owner receives a Type B waiver, the monitoring agency is reducing the total number of units designated for occupancy by VLI <u>and</u> LI households. Under this type of waiver, agencies will generally reduce both the Total Set-Aside and the VLI Set-Aside.

Using the same example presented above, an agency giving a Type B waiver might choose to reduce the required number of QUs from 35 units to 20 units and the required number of VLI-QUs from 20 units to 10 units.

## D. Determining the Size of the Waiver

Agencies must determine the type of waiver and the size of any reduction in the number of VLI-QUs or total QUs. In granting a waiver, the agency needs to decide whether a waiver will address the problem and restore viability, and what number of QUs are necessary to be covered by the waiver.

Agencies should avoid a complete waiver of the occupancy requirements wherever possible. FDIC strongly recommends that not all units in the Set-Aside be granted waivers, but that owners be required to continue to rent some units to VLI tenants.

Agencies should base the size of the reduction on the amount of additional income an owner needs to stabilize the property's financial position. Monitoring staff should decide on the number of units by comparing the additional income generated by waivers of different sizes to the amount of additional income needed by the owner. For example, if an owner needs an additional $1,000 per month to help pay off a short-term loan taken out to cover the cost of replacing the boiler for the building, the size of the reduction should reflect $1,000 additional income each month.

In some cases, a waiver alone will not be sufficient to address a property's financial problems. The FDIC should be notified of such cases where a broader financial workout is indicated.

## 5.2 REVIEWING APPLICATIONS FOR WAIVERS

### A. Basic Contents of Waiver Applications

Applications for waivers should provide sufficient information to enable the monitoring agency to evaluate the property's financial condition as well as a description of the relief the owner is requesting and how the relief will help strengthen the property's financial condition. Several years of property financial statements are recommended. The owner should also provide a narrative and supporting documentation to show what the owner has done to address the conditions contributing to the property's financial problems and the fee for processing the request.

Every application should contain the following items:

1) Description of the conditions that contributed to the financial distress

2) Property's financial statements for the past three years

3) Monthly income and expenses for the past year

4) Listing of other types of assistance received by property (e.g., tax credits, or bond financing)

5) Documentation showing market rate rents for the project area

6) Description of actions owner is taking to strengthen the property's financial position

7) Amount of additional monthly income needed to address problems and for what period of time

8) The type of relief the owner is requesting and a description of how it will be used to correct the problem

9) Processing fee of not more than $500, or as otherwise approved by FDIC[14]

If the owner indicates that **vacancies** are a significant problem contributing to the property's financial deterioration, the application should also provide the following information:

a) Documentation showing the property's vacancies over the past 12 month period;

b) Description of marketing efforts to attract LI and VLI tenants and documentation of these efforts; and

c) The total number of rental applications and the number of applications from potentially eligible tenants received during the past six months as well as an explanation of why potentially eligible applicants were turned down or decided not to accept units.

If the owner indicates that **increased expenses** are a significant problem contributing to the financial deterioration of the property, the application should also include the following information:

a) Evidence that the owner has taken steps to control operating expenses and has invested funds to correct the problem;

b) Sufficient documentation to show that the property's expenses do not include payments to the owner for non-essential services; and

c) Documentation showing that increased expenses are reasonable for the area or beyond the control of the owner.

Owners are responsible for submitting all materials necessary to support their request for a waiver. Agencies may make waiver determinations on the basis of the materials presented in the application. Applications with inadequate documentation may be denied on grounds of insufficient evidence.

## B. Reviewing Applications

Monitoring agencies should use the following procedures when reviewing applications to assess whether a waiver is warranted. Agencies should:

[14] This fee may be adjusted annually to reflect increased costs due to inflation. In making such adjustments, agencies must apply the same method used to adjust the annual monitoring fee.

◊ assess whether the property is receiving other types of assistance that preclude reducing the number of Low Income units;

◊ determine whether the property is financially distressed;

◊ assess the source of the property's financial problems (vacancies, increased operating expenses, etc.);

◊ determine whether the waiver requested will enable the owner to improve the property's financial position;

◊ evaluate whether the conditions causing the problem are beyond the control of the owner; and

◊ assess whether the owner has taken steps to strengthen the property's financial position.

Agencies should complete their review of an owner's request for a waiver within 60 days from the date of the application.

***Waiver Compatibility with Other Assistance***

Monitoring staff should examine the other forms of public assistance received by the property to determine if there are restrictions that preclude reducing the number of Low Income units. For example, if a property also receives Low Income Housing Tax Credits, a waiver of the AHP occupancy requirements may have no effect because the tax credit occupancy requirements would still apply. If the agency determines that a waiver is not compatible with the requirements of other programs, the owner's request for a waiver should be denied, unless compatible waivers are granted by the other regulatory entities.

***Presence of Financial Distress***

Next, monitoring staff should examine the financial information provided with the application to assess whether the property is experiencing serious financial problems.

In evaluating financial distress, staff should use commonly accepted indicators financial hardship. As discussed above, one indicator of financial distress is when a property has experienced an extended period of negative cash flow. If a property has experienced 24 months of negative cash flow, the agency may consider the property financially distressed. If the property has experienced large losses over a shorter period, the monitoring agency may determine that a property is in financial distress due to the severity of the negative cash flow.

Monitoring agencies may use other accepted indicators of financial distress in evaluating a waiver request. However, monitoring staff should document the method used to assess financial distress and show that it is an adequate indicator of distress.

***The Source of Financial Distress***

Monitoring staff also should examine the financial information to determine the source of the property's financial distress. As discussed in Section 5.1.A, monitoring staff need to evaluate whether the problem is due to:

◊ insufficient income due to QU vacancies;

◊ QU rents insufficient to meet operating expenses; or

◊ other conditions.

If the owner's application reports that QU vacancies is the problem causing the property's distress, monitoring staff must determine whether improving the property's occupancy rate would be sufficient to eliminate the financial distress. To make this determination, staff should compare the property's income[15] at an appropriate effective maximum occupancy level[16] (e.g., 95 percent) to operating expenses and debt service to see if the property generates sufficient income at full occupancy to cover its costs:[17]

◊ If the property's income at effective maximum occupancy is <u>sufficient</u> to create a positive cash flow, it is reasonable to conclude that the property has insufficient income due to QU vacancies.

◊ If a property's income at full occupancy is <u>insufficient</u> to cover operating expenses and debt service, the property's QU rent structure may be inadequate to meet the increased cost of operating the property. As discussed earlier, this condition can occur when operating expenses increase faster than the rents charged to tenants.

Monitoring staff should determine whether the property's negative cash flow could be remedied if the owner were allowed to charge market rents for 100 percent of the units. If the property still has a negative cash flow when the property's rents are left unrestricted, a waiver alone will not address the

[15] Calculate income with the property's set-asides and AHP rent limits in place.

[16] Effective maximum occupancy is defined as the maximum occupancy an owner is likely to obtain given the level of unit turnover in the local market.

[17] Monitoring staff should confirm that the rents for unrestricted units are comparable to the market rents for similar units. Staff can refer to the market rents provided by the owner in the application.

property's financial distress. In such a case the owner needs to obtain additional assistance from other sources to overcome the property's cash flow problem.

To determine if reducing the required number of QUs would enable the owner to overcome the property's negative cash flow, monitoring staff should compare the income the property would receive if the owner charges market rents for all units (95 percent occupancy) to the operating expenses and debt service for the property. If income to the property at effective maximum occupancy results in a positive cash flow to the property, then QU rents for the property may be determined to be insufficient to meet operating costs.

In determining the source of a property's financial distress, monitoring staff should assess whether other problems, such as vacancies among unrestricted units and/or inadequate control of expenses, are contributing to a property's negative cash flow. This information will be important in determining whether a waiver will enable an owner to remedy the property's financial difficulties.

***Can a Waiver Address the Problem?***

After determining the source of a property's financial distress, monitoring staff next should assess whether a waiver will increase income to the property and whether the additional income will enable the owner to stabilize its financial condition. For example, if an owner is experiencing vacancy problems among unrestricted units as well as restricted units in the property, it is not clear that reducing the required number of LI or VLI units will improve the owner's ability to obtain additional tenants. An owner's application must explain how the waiver will aid in leasing additional units. If the application does not provide convincing evidence that the waiver will improve the property's occupancy, the agency should deny the owner's request.

Monitoring staff also should consider whether the increased income produced by the waiver will provide is sufficient to address the property's financial problems. If the agency's analysis of the property's financial condition reveals that the owner would need almost a complete waiver of the occupancy requirements to generate a positive cash flow, a waiver alone may not be adequate to preserve the property. In such a case, the agency may want to require a condition of the waiver that the owner obtain additional financial assistance for the property. For example, the agency might inform the owner that a waiver could be granted if the owner worked with his or her lender to provide additional relief by restructuring the property's financing.

***Problem Conditions Beyond Owner's Control***

Next, monitoring staff should review the owner's description of the conditions that led to the property's financial deterioration to determine if the problem could have been avoided. As discussed above, FDIC has determined that if an owner could have prevented the property's decline, a waiver should not be given.

If the owner is experiencing high vacancies among QUs, the application must document the owner has actively marketed the units to LI and VLI households, including special outreach efforts. Agencies may consider failure to actively market the property to LI and VLI households as grounds to deny an owner's request for a waiver.

Applications also should include an explanation of why LI and VLI tenants have not responded to the marketing efforts. For example, an owner may have difficulty renting QU units if a nearby employer has moved and the property's neighborhood no longer provides sufficient employment opportunities. If the local rental market is soft, tenants may be able to find comparable units in other areas of the community more conveniently located to jobs and basic services such as public transportation.

If the property is experiencing financial distress because operating expenses have risen faster than rents, the owner's application should show that the increased expenses are beyond the owner's control. Sharp increases in property taxes or insurance are examples of conditions beyond an owner's control. However, if the property's expenses for maintenance and repair have risen sharply because the owner failed to perform preventive maintenance, the property's financial problems could have been prevented.

Agencies also should confirm that the increase in operating expenses is not the result of the owner taking payments from the property for non-essential services. Waivers should be given only when the property's income is insufficient to cover costs for <u>necessary</u> operating expenses and debt service. Agencies may consider payments for expenses other than reasonable management fees, maintenance and repair, taxes, utilities, and insurance, as unnecessary operating expenses.

***Owner Action to Address Financial Distress***

Finally, monitoring staff should review the materials in the application describing the actions the owner has taken to address the property's financial distress. To receive a waiver, owners should demonstrate that they have taken steps to slow the property's decline and attempted to obtain assistance from other sources.

◊ If the owner is having difficulty attracting LI and/or VLI tenants, the owner should have made special outreach efforts, such as contacting the local housing agency for referrals of Section 8 certificate holders as well as service agencies and other organizations serving the low income community.

◊ If a property's negative cash flow is due to increased operating expenses, the owner must demonstrate efforts to address or control rising costs, such as energy conservation to address rising utility costs or bidding out insurance to respond to rising insurance costs. Documentation of additional owner investments in the property is evidence of action to strengthen the property's financial position.

◊ If the property is in need of rehabilitation, applications for low interest rehabilitation loans from the city or state would also demonstrate owner action to address the property's financial problems.

## C. Granting Waivers

If an agency determines that a waiver should be granted, monitoring staff should inform the owner of the agency's decision and send a written notice describing the conditions of the waiver.

Agencies may establish conditions for receiving a waiver as needed to ensure that the owner makes a good-faith effort to restore the financial health of the property. Agencies may also require owners to submit monthly or quarterly compliance reports as a condition of the waiver to ensure the owner complies with the requirements that continue to apply to the property.

Waivers should be granted only for one year, subject to extensions upon determination by the monitoring agency that the conditions justifying the waiver still exist.

Monitoring agencies should send a copy of the notice granting the waiver to FDIC or its successor.

## D. Denying Waiver Requests

If the monitoring agency decides to deny an owner's request for a waiver, the monitoring agency should send the owner a written notice informing the owner that the application was denied and stating the reasons the waiver was not granted. This notice should be sent to the owner within 60 days of the date of application. A copy of the waiver denial should be sent to FDIC.

If the application failed to provide sufficient documentation to grant the waiver, the agency should indicate the areas where the owner did not provide adequate information.

Owners should also be informed that they may submit a revised application which addresses the deficiencies found in the original submission.

Owners may be required to pay another processing fee when submitting revised applications.

## 5.3 MONITORING PROPERTIES WITH WAIVERS

When an agency grants a waiver, the owner must continue to comply with all applicable provisions of the LURA. The agency's level of monitoring activity will vary depending on the extent of the waiver.

### A. Partial vs. Full Waivers

For properties where the waiver reduces, but does not completely waive, the occupancy requirements for the property, the owner must continue to comply with the occupancy requirements that remain in effect and all other applicable provisions of the LURA. Monitoring agencies must continue to monitor these properties to assure continued compliance by the owner and should supplement the applicable monitoring procedures presented in Chapter 3 with those described in the following sections.

In some cases, waiver of fees may be part of the response by the monitoring agency. However, because a partial waiver may contain conditions that require additional monitoring activities, agencies also may charge an additional administrative fee to cover the cost of this effort. The amount of the additional administrative fee for monitoring properties with waivers may not exceed the amount of the annual monitoring fee.

In cases where an agency grants an owner a full waiver of the occupancy requirements for the property, the agency need only monitor occupancy at the property as long as existing tenants continue to occupy QUs. Once the QUs have been replaced, the agency need only make annual assessments of the owner's ongoing need for the waiver and monitor any resale of the property.

### B. On-Site Reviews

Monitoring staff conducting on-site reviews of properties with partial waivers should follow the standard procedures (see Chapter 3). Agencies should continue to perform on-site reviews of properties with full waivers as long as tenants of QUs remain in their units. After all QUs have been vacated and rented as unrestricted units, the agency may discontinue on-site reviews, unless it is necessary to visit a property to assess the need to extend the waiver.

### C. Review of Owner Reports

If the conditions of the waiver established by the agency require the owner to submit compliance reports more than annually, monitoring staff should establish a schedule for receiving and reviewing these reports and inform the owner of this schedule.

Owners receiving a partial waiver must continue to submit an annual compliance report documenting compliance with requirements of the LURA that continue to apply to the property. Owners with a full waiver must also submit annual compliance reports as long as qualifying tenants continue to QUs.

Each year, at the time annual compliance reports are due, an owner with waivers must indicate to the agency whether there is a continuing need for the waiver, and submit materials documenting that the need still exists. If the owner fails to submit materials to the agency, the agency may terminate the waiver.

In reviewing an owner's submission, monitoring staff should assess whether all conditions of the waiver established by the agency have been met, and whether the property will experience a negative cash flow without the waiver.

- ◊ If the conditions of the waiver have been met and the property must have the waiver to maintain a positive cash flow, the agency may extend the waiver.
- ◊ If the documents show that the property's financial position has improved, the agency should consider reducing the size of the waiver and requiring the owner to restore some of the QUs.
- ◊ If the property's financial condition has not improved since the application or the previous waiver report, the agency may, if appropriate, require the owner to seek additional assistance to strengthen the property's financial position.
- ◊ If an owner has not met the conditions for receiving the waiver established by the monitoring agency, monitoring staff may discontinue the waiver.

### D. Failure to Comply with Waiver

If an agency's review of owner compliance reports or the results of an on-site visit reveal that an owner is out of compliance with the continuing requirements of the LURA, monitoring staff should follow the procedures in Chapter 4 to compel the owner to restore compliance.