

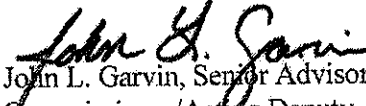


U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

FEB -1 2008

MEMORANDUM FOR: All Multifamily Hub Directors  
All Multifamily Program Center Directors  
All Multifamily Operations Officers  
All Directors of Project Management  
All Field Counsel

FROM:   
John L. Garvin, Senior Advisor to FHA  
Commissioner/Acting Deputy Assistant Secretary for  
Multifamily Housing Programs, HT

SUBJECT: Policy and Procedures on the Conversion of Efficiencies into  
One-Bedroom Units

**A. Purpose**

This Memorandum sets forth the Department's policy for owners seeking to convert efficiencies to one-bedroom units in certain types of HUD assisted and/or insured housing. The Hub and applicable Program Center (PC) are responsible to review requests to convert units pursuant to the requirements of this memorandum. The Hub will provide a recommendation on the conversion request to Headquarters (HQ) to approve, or to approve with conditions. HQ will issue a final approval or disapproval of the request. Hubs and PCs may reject conversion requests without seeking HQ's concurrence.

**B. Background**

The Department has received several requests from owners of assisted housing to convert efficiencies to one-bedroom units. Owners have indicated that such conversions will better serve resident needs, alleviate recurring vacancies, and provide the financial relief necessary to avoid default. The Department understands that conversions may be necessary to ensure that projects are preserved and resident needs are adequately met. As such, the Department has developed policy and procedures to permit the conversion of efficiencies to one-bedrooms provided it can be demonstrated that the conversion is warranted by local demands for affordable housing and results in the long-term financial and physical repositioning of the project.

### **C. Applicable Programs**

The requirements outlined in this Memorandum apply to the following assisted and/or insured projects:

- Section 202 Direct Loan with or without Rental Assistance
- Section 202 Capital Advance with Project Rental Assistance Contracts or Project Assistance Contracts (PRAC and PAC)
- Section 811 Capital Advance with Project Rental Assistance Contracts (PRAC)
- Section 236 insured and non-insured with or without Rental Assistance
- Section 221(d)(3) Below Market Interest Rate (BMIR) with or without Rental Assistance
- Section 8 Project-Based Rental Assistance with or without FHA insurance
- Rent Assistance Payment (RAP)
- Rent Supplement
- Properties subject to a HUD Use Agreement or Deed Restriction

### **D. Programmatic Requirements:**

Any owner submission for conversion must meet the following programmatic requirements:

1. The Owner must be in compliance with all business agreements with the Department. In the event of non-compliance that the Owner believes will be cured through a conversion, a description of how and when compliance will be achieved must be submitted. The Hub must concur that the conversion will cure any outstanding non-compliance. Any non-compliance that will limit the ability of HUD to analyze a conversion request must be cured prior to submission. For example, the required financial analysis cannot be completed if financial statements are not filed.
2. The proposed conversion must be warranted by local demands for affordable housing. The Owner must provide evidence of all efforts to market the units proposed for conversion and must provide evidence of demand within the geographic market area for the proposed post-conversion unit type.
3. The average vacancy in the efficiency units was at least 25 percent for at least 24 months of the preceding 36-month period.
4. Upon completion of the unit conversion, the project debt service coverage ratio must be 1.1 or greater.
5. The proposed conversion must only involve units of the same subsidy type. For example, a Section 236 project with a Section 8 contract covering 50% of the units may only convert Section 8 units to Section 8 units and 236 units to 236 units.

6. For any proposed conversion of units assisted by a project-based rental assistance contract, the proposal must establish that the conversion will not result in an increase in the amount of existing budget authority available to the project.
7. The proposed conversion must not result in any violation of Section 504 of the Rehabilitation Act of 1973 or HUD's implementing regulations at 24 CFR Part 8, including 24 CFR §8.23 (Alterations of Existing Housing Facilities).

Note: For the purposes of applying 24 CFR §8.23(b), conversion of two efficiencies into a one bedroom apartment constitutes an "alteration of a dwelling unit." For further guidance regarding Section 504 applicability and requirements, please refer to HUD Handbook 4350.3, REV-1.

**E. Programmatic Requirements Applicable to the Conversion of Units Assisted by Section 8, PRAC, PAC, Rent Supplement, Rent Assistance Program, and Section 236 Interest Reduction Payments**

**General Policy Applicable to all Subsidy Types**

The conversion of units must not result in an increase to the amount of existing budget authority available to the project.

The revised rent structure may not be effective until the rehabilitated units are ready for occupancy. HUD will inspect the project and establish the date of occupancy when construction is complete, except for minor items of delayed completion. If applicable, the owner must have received any required local approvals prior to HUD approving occupancy.

**Section 8**

The policies outlined in the Section 8 Renewal Policy Guide shall prevail unless inconsistent with the requirements of this memorandum, in which case the latter requirements will apply.

1. Post conversion unit rents must be established at the lesser of:
  - the current 1br unit rent;
  - the combined unit rents of the two converted efficiency units.

Future rent setting pursuant to MAHRA may be based on the converted unit type configuration.

2. The conversion may not combine units assisted under an original Section 8 HAP contract with units assisted under a Section 8 HAP contract that has undergone renewal pursuant to the Multifamily Housing Reform and Affordability Act (MAHRA).

3. Where the proposal concerns only units assisted under an original Section 8 HAP contract, the Multifamily Hub or PC may provide a letter to the Owner indicating that the Department will renew the existing contract, subject to the availability of sufficient appropriations, under the terms and conditions of the Section 8 renewal authority in place upon contract expiration/termination.
4. There is a cap on Section 8 rents in a Tax Credit Transaction. If tax credits are involved, rents may not exceed the lesser of use restricted rents or comparable market rents. For example, tax credit restricted rents set the upper limit for comparable market rents.
5. Nonprofit controlled ownership entities may not use Mark-Up-To-Market. They must use Mark Up To Budget under Chapter 15 of the Section 8 Renewal Policy Guide.
6. If the Owner will be prepaying the mortgage as part of the conversion process and the Section 8 contract is an "Old-Regulation" State Housing Finance Agency (HFA) form of HAP contract for New Construction or Substantial Rehabilitation projects, i.e., the November 1975 version of HUD-52645A ("1975 HAP Form"), it terminates automatically upon full prepayment of the original, permanent financing provided by a HFA. In such cases, the Owner is to be provided with the following three options:
  - a) Renew the project-based Section 8 contract under MAHRA under any option for which it is eligible;
  - b) Execute a HAP contract extension amendment, Attachment 1, which extends the contract to the natural maturity date of the original HFA mortgage; or
  - c) Opt out of the Section 8 contract.

These options apply only to HFA-administered November 1975 HAP contracts.

8. The Owner of a project that receives project based Section 8 rental assistance must agree to accept contract renewals as long as they are offered by the Department.
9. If a unit conversion is approved, the Owner must agree to amend the HAP contract to require compliance with the financial reporting and physical condition standards of 24 CFR Part 5.

#### **PRAC and PAC**

The proposed operating budget for the project should be reduced to reflect savings resulting from the unit conversion. If the new operating budget is not reduced, the Owner must explain why there is no adjustment and provide a justification for maintaining existing budget levels.

#### **Rent Supplement and Rent Assistance Payments**

Post conversion unit rents must be established at the lesser of the current one bedroom unit rent or the combined unit rents of the two converted efficiency units.

### **Section 236 Interest Reduction Payments**

If the conversion involves a refinancing of a Section 236 mortgage and a decoupling of the IRP, the Project Manager must calculate a new IRP to reflect any reduction of Section 236 IRP units. To calculate the new IRP, divide the current annual Interest Reduction Payment (IRP) by the total number of 236 units to obtain an annual IRP per unit. Multiply that per unit IRP amount by the number of Section 236 units being reduced. Subtract that total from the current annual IRP to arrive at the new annual IRP. Please note that the IRP may or may not be reduced depending upon the requirements of the original Section 236 mortgage. This document must be reviewed in order to determine whether or not an IRP reduction is required.

Please complete Attachment 2 to annotate changes made to the IRP as a result of the conversion. Please notate "other" in the Reason for Change section of the form and attach the recalculated IRP. Attachment 2 must be included with the HUB Director's recommendation of the conversion request to HQ.

### **F. Pre Submission**

The Owner must meet with HUD staff prior to submitting a unit conversion request in order to review project eligibility and submission requirements.

### **G. Owner Submission Requirements**

The Owner must submit an original and three copies of the conversion request to the local HUD office. The request must include the following documentation:

1. **\*Conversion Request Letter.** Letter signed by the Owner that includes the project name, project number, contract number, and a detailed description of the proposed conversion.
2. **\*Consent of the Lender.** The existing mortgagee of record must consent to the proposed unit conversion. The consent letter must be on the mortgagee's letterhead and signed by an officer or the individual authorized to execute documents on behalf of the mortgagee.
3. **Vacancy Information.** Documentation evidencing an average vacancy rate of at least 25% in efficiency units for 24 months over the preceding 36 month period.
4. **Marketing Efforts.** Documentation of the owner's leasing and marketing efforts during the two year period prior to the conversion request. The documentation must include a summary of those efforts and their results. At a minimum, the documentation must include the following: property traffic reports or other reports showing interest; advertising details; age or income waivers requested and final action of HUD; e.g., approved, approved with conditions, etc.; local community organizations contacted by the owner as part of the marketing effort, include name and address of organization and contacts; local housing

authority(s) wait list information for the prior two years; other affordable housing provider contacts made demonstrating there is minimal or no demand for the efficiency type units.

5. **Evidence of Need for Conversion.** A list of leased and un-leased units (assisted and unassisted) and tenant application and turnover documentation for the prior two year period.
6. **Rental Information.** Actual pre-conversion and projected post-conversion rent schedules including the unit type, unit rent, unit size, and unit square footage.
7. **Annual Operating Statement.** Actual pre-conversion and projected post-conversion operating statements formatted using the profit and loss reporting template in the Financial Assessment Subsystem. The post-conversion operating pro forma must demonstrate that the project will perform at a debt service coverage ratio of at least 1.10. For conversions involving a refinancing, a pre-conversion and post-conversion balance sheet must also be submitted.
8. **Sources and Uses of Funds Statement.** A detailed sources and uses identifying the estimated cost of the proposed conversion. The estimated cost must have been obtained within six months of the date of submission of the request. The Owner must also indicate the status of all funding commitments included in the sources and uses.
9. **Project Capital Needs Assessment (PCNA).** A PCNA prepared within six months of the submission of the conversion request. The PCNA must contain all of the information required by the MAP Guide, Chapter 5, Paragraph 5.26 and Appendix 5M.
10. **Proposed Rehabilitation.** A description of the proposed scope of work, including plans and specifications as required by local code. The design of the units proposed for conversion must be consistent in character with that of any project units that are not part of the proposed conversion and must be designed to meet current market demands and resident needs.
11. **Evidence of Notice to Tenants.** Notice to Tenants must be completed in accordance with the requirements of 24 CFR Part 245, as described in Paragraph H of this memorandum. The owner must complete the tenant notification procedure required by Paragraph H prior to the submission of a conversion request. The following documents must be included in the conversion submission to evidence compliance with these tenant notice procedures:
  - a) A copy of the Notice to Tenants;
  - b) Copies of all comments submitted by the residents and/or their representatives;
  - c) Owner's written evaluation of the comments; and
  - d) Owner's Certification of Compliance with 24 CFR Part 245, as required by this memorandum. Attachment 3.

12. **Displacement of Residents.** A certification that there will be no permanent displacement of residents. Attachment 4.
13. **Temporary Relocation Plan.** In the event that the conversion will involve the temporary relocation of tenants, a relocation plan must be submitted that identifies the affected units and tenants, estimates the relocation costs and provides a timetable for the relocation. The owner must also indicate what steps will be taken to minimize the temporary relocation of the tenants.
14. **Local Government Letter of Support.** Letter of support from the unit of local government authorized to certify on behalf of the community that the conversion is consistent with any applicable comprehensive housing affordability strategy and/or economic development plans.
15. **Tenant Selection Plan.** In the event that temporary relocation of tenants is required, the owner must amend their Tenant Selection Plan to give the right of first return to any tenant temporarily displaced by the unit conversion.
16. **\*Unit Conversion Agreement.** Copy of the proposed Unit Conversion Agreement. This agreement must be executed by the owner and the mortgagee of record. (Attachment 5)

Note to HUD staff: documents marked with \* should be sent to the Local Field Counsel for a legal sufficiency review.

#### **H. Tenant Notification Requirements**

1. At least 90 days, but not more than 120 days, before submitting a request to HUD for an approval to convert the efficiency units into one-bedroom units, the owner must serve notice of the proposed conversion in accordance with the posting requirements of 24 CFR Part 245.15.
2. The owner's notice must contain all information required by 24 CFR Part 245.410. In addition, the notice must inform the tenants that a meeting will be held within 5-7 days of the notice at which the owner will describe the proposed conversion. The location, date and time of the meeting must be suitable and convenient for the tenant population. Comments received by the owner at this meeting must be included in the owner's submission to HUD as required below.
3. The owner's notice must describe that the tenants have a right to participate as provided by 24 CFR Part 245.420. The tenants, and any legal or other representatives acting on behalf of tenants individually or as a group, must have the right to inspect and copy the materials the owner will submit to HUD with their conversion request. This information must include all of the items required by 24 CFR Part 245.419.

4. If the Owner makes any material change during the tenant comment period to the documents to be submitted to HUD, the Owner must notify the residents of the change in accordance with 24 CFR Part 245.420. The tenants must be provided 15 days from the date of service of this additional notice (or the balance of the applicable comment period, if longer) to inspect and/or copy the materials as changed and to submit any comments of the proposed action. If HUD's processing of the owner's conversion submission results in any material changes, the owner must provide another notice to tenants informing them of the changes and providing an additional 30 day comment period.
5. In accordance with 24 CFR Part 245.425, upon completion of the tenant comment period, the Owner must review the comments submitted by the tenants and/or their representatives and prepare a written evaluation. The owner must include the items listed in submission requirement #11 with their conversion request to HUD.

#### **I. Multifamily Housing Hub/Program Center Responsibilities**

The PC/Hub must review the submission to ensure that all programmatic requirements contained in this memorandum and the submission requirements identified in Paragraph G have been satisfied. This review must occur within fifteen business days of receipt of the submission. If the submission is incomplete or fails to satisfy any programmatic requirements of this memorandum, the Owner must be advised of the deficiencies in writing. It is strongly recommended that field office managers and supervisors impose a requirement that submissions be fully complete prior to beginning reviews. Additionally, incomplete requests and those that do not meet the threshold requirements shall be returned to the requester immediately, with the requester notified of the non-responsive part(s).

Upon receipt of an eligible project and complete proposal, the PC/Hub must review the request in accordance with the requirements of this memorandum. The PC/Hub must analyze the proposal and verify supporting documentation. The pro-forma operating statement should be compared against a sample of high performing comparable projects using OPTIS or REMS; sample verifications of third party data should be made to ensure currency and accuracy; proposal estimates and assumptions regarding post conversion debt service must be reasonable and supportable; etc. The PC/Hub must determine whether the proposed conversion will financially and physically reposition the property as affordable housing for the long term. The PC/Hub must determine what other actions are required of the owner to achieve the desired result. For example, if the long term viability requires changes in expense levels, those changes must be specified by the PC/Hub, accepted by the Owner, and accomplished concurrently with the conversion.

Architectural and Engineering (A&E) staff must determine the acceptability of the proposed scope of work and must approve the proposed architect and contractor. A&E staff must also monitor work progress and ensure compliance with Davis Bacon Wage Rates, if applicable.

The PC/Hub must perform an environmental review if required by 24 CFR Part 50. Certain rehabilitation and improvements of multifamily residential buildings may be categorically excluded from environmental review requirements, see 24 CFR 50.20(a)(2).



The PC/Hub must summarize their review and incorporate the findings of A&E and any other applicable technical disciplines using the attached Multifamily Unit Conversion Checklist (form HUD-92040), Attachment 6. The PC/Hub must complete their review within 60 days of a complete proposal submission. The Hub Director must prepare a memorandum to the Director of the Office of Asset Management in Headquarters. The memorandum must include a recommendation to approve, or to approve with conditions, the owner's request. If rental assistance is involved, a copy of this memorandum should be sent to the Director of the Office of Housing Assistance and Grant Administration. If a unit conversion is approved by HQ, the Owner must execute a Unit Conversion Agreement, revised Rental Schedule, and amendments to the Section 8 Contract. The PC/Hub should follow the steps outlined in Attachment 7 for implementing the reconfigured rents.

Attachments:

- 1-HAP Extension Amendment 1975 HAP form
- 2-Section 236 OCFO Change Control Form
- 3-Owner's Tenant Notice Certification
- 4-Owner's Relocation Certification
- 5-Unit Conversion Agreement
- 6-Multifamily Unit Conversion Checklist
- 7-Steps for Reconfiguring Section 8 Contracts in Unit Conversions