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DEPARTMENT OF AGRICULTURE

Rural Housing Service

7 CFR Part 3560

RIN 0575-AC66

Reserve Account

AGENCY: Rural Housing Service.

ACTION: Final Rule.

SUMMARY: Through this action, the Rural Housing Service (RHS) is amending its regulation to change the Reserve Account for new construction for the Sections 514/516 Farm Labor Housing (FLH) program and the Section 515 Rural Rental Housing (RRH) program. This action will not affect reserve accounts for existing portfolios.

EFFECTIVE DATE: This rule is effective [Insert date 60 days after publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Michael Steininger, Acting Director, Multi-Family Housing Preservation and Direct Loan Division, Rural Housing Service, U.S. Department of Agriculture, STOP 0781, 1400 Independence Avenue, SW,

Washington, D.C. 20250-0781. Telephone: 202-720-1610 (this is not a toll-free number); e-mail: michael.steininger@wdc.usda.gov.

SUPPLEMENTARY INFORMATION:

Classification

This final rule has been determined to be not significant and was reviewed by the Office of Management and Budget (OMB) under Executive Order 12866.

Civil Justice Reform

This final rule has been reviewed under E. O. 12988, Civil Justice Reform. If this final rule is adopted: (1) unless otherwise specifically provided, all State and local laws that are in conflict with this rule will be preempted; (2) no retroactive effect will be given to this rule except as specifically prescribed in the rule; and (3) administrative proceedings of the National Appeals Division of the Department of Agriculture (7 CFR part 11) must be exhausted before bringing suit.

Regulatory Flexibility Act

The final rule has been reviewed with regard to the requirements of the Regulatory Flexibility Act (5 U.S.C. 601-612). The undersigned has determined and certified by signature on this document that this rule will not have a significant economic impact on a substantial number of small entities. This rulemaking action does not involve a new or expanded program nor does it require any more action on the part of a small business than required of a large entity.

Paperwork Reduction Act

There are no new reporting and recordkeeping requirements associated with this rule.

E-Government Act Compliance

RHS is committed to complying with the E-Government Act, by promoting the use of the Internet and other information technologies in order to provide increased opportunities for citizen access to Government information, services, and other purposes.

Unfunded Mandate Reform Act (UMRA)

This rule contains no Federal mandates (under the regulatory provisions of Title II of the UMRA) for state, local and tribal governments or the private sector. Therefore, this rule is not subject to the requirements of Sections 202 and 205 of the UMRA.

Environmental Impact Statement

This document has been reviewed in accordance with 7 CFR part 1940, subpart G, “Environmental Program.” RHS determined that the proposed action does not constitute a major Federal action significantly affecting the quality of the environment. Therefore in accordance with the National Environmental Policy Act of 1969, Pub. L. 91-190, an Environmental Impact Statement is not required.

Programs Affected:

The programs affected by this regulation are listed in the Catalog of Federal Domestic Assistance under numbers 10.405 - Farm Labor Housing Loans and Grants; 10.415 - Rural Rental Housing Loans; and 10.427 - Rural Rental Assistance Payments.

Federalism:

For the reasons discussed above, this rule does not have significant Federalism implications that warrant the preparation of a Federalism assessment under Executive Order 13132.

Intergovernmental Consultation:

These loans are subject to the provisions of E.O. 12372 which require intergovernmental consultation with state and local officials. RHS conducts intergovernmental consultations for each loan in a manner delineated in 7 CFR part 1940, subpart J (available in any Rural Development office and on the Internet at <http://www.rurdev.usda.gov>).

Background Information:

In the past, Rural Development based its reserve account on a set percentage of a property's total development cost (TDC). With this final rule Rural Development will now base the reserve account amount on a life-cycle analysis or Capital Needs Assessment (CNA). Either reserve account analysis that meets Rural Development approval will be prepared by a third-party. The reserve account analysis will be used to determine the expected useful life of the building components and furnishings and to determine which building components or furnishings are the most cost efficient over the life of the building. The reserve account deposit level will be maintained through steady deposits to meet the needs of the project as they become due. The exact contribution amounts will be articulated in the borrower's loan agreement. Adjustments may be made at five or ten year intervals, either CNA or as part of the original analysis. Any adjustments that were not reflected in the original loan agreement will be reflected in an amendment to the loan agreement. The requirement for a reserve account analysis will be used for new construction rental housing funded under Sections 514/516 and Section 515 of the Housing Act of 1949. The new requirement is intended to assure quality construction as well as long term viability of the complexes. Reserve levels will be based on life cycle costs or capital needs in order to ensure necessary resources are available when needed to replace essential building components. Current agency regulations

require an annual minimum deposit of 1 percent of the TDC be put in a reserve account for FLH and RRH programs. The Agency has found over the years that the 1 percent requirement does not necessarily correlate to the long term needs of the property. This final regulatory change will ensure that reserve accounts properly sized to meet the capital needs anticipated at the time of construction. Due to the administrative burden involved, this change will only affect reserve account requirements of new construction rental housing funded under Sections 515 RRH or Sections 514/516 FLH.

Public Comments

The Agency received the following comments as a result of the publication as a Proposed Rule published in the Federal Register on April 5, 2007 (72 FR 16730-16731).

The Agency received eight responses to the proposed regulatory change. The commentators represented Rural Development employees who work with the Multi-Family Housing Direct Programs, a Multi-Family developer and rental property owner, and Interest Groups. The comments are summarized as follows:

1. *Defining the formula that will be used in the life cycle analysis.* A commenter suggested defining the formula to be used in the life cycle analysis as this could serve as a chart. Having the chart could alleviate people's resistance to calculating a full life cycle analysis for each component in the Multi Family Housing Direct Projects. Defining the formula could ease the concerns of Multi-Family Housing (MFH) borrowers regarding what basis was used to calculate the life cycle costs.

The Agency does not have a general formula that is used for the life cycle cost analysis. The life cycle cost analysis is a professional report that is performed by a third-party that primarily describes a detailed analysis and review of the

components and estimates the replacement cost in the future. The life cycle cost analysis is defined in 7 C.F.R. §3560.11. The Agency reviews the results of the life cycle cost analysis for its acceptability and compliance with the definition contained in 7 C.F.R. §3560.11. The Agency has made no changes in response to this comment.

2. *Increasing the Reserve Fund Requirement in excess of 1 percent, addressing the overcharging of gross rental incomes and the over-inflation of property taxes which are causes of underfunded reserve accounts.* Two commenters supported increasing the amount of contribution to the reserve account in excess of 1 percent as the commenters think the current system requiring this funding level is flawed and inadequate in regards to providing funding for improvements and/or renovations to existing properties. The comments suggested an increase in the amount of the contribution to the reserve account is a step in the right direction for newly built and rehabilitated properties in the future. Their comments also mentioned the gross overcharging of property management related costs that generally range from 20 percent to 30 percent of gross rental incomes. The private sector residential property management costs typically run less than 8 percent. Lastly, they discussed the over-inflation of property taxes which are causes of underfunded reserve accounts. Management companies and owners do not have a personal risk at stake with the Section 515 property and therefore fail to challenge their annual over-inflated tax bills and assessments. As a result, rent income funding that could be used to properly fund reserve accounts instead goes to the local Government. The Agency will not make a change to the regulation in response to these comments. The goal of the regulation is to move the reserve deposits off a percentage basis and base the reserve account amount on the facts of the CNA or life cycle cost analysis. The Agency agrees that the reserve accounts based on a percentage can be underfunded and the change to the reserve

account rule should help with that problem for new construction. While these comments related to operating expense are appreciated, the focus of this change will remain solely on properly sizing reserve accounts.

3. One commentator also agreed with the change to the reserve account requirements as the change would benefit MFH projects by linking reserve account amounts to anticipated needs for repair and replacement of building systems and components instead of the current 1 percent of TDC that are now set-aside in the reserve accounts.
4. Two commentators agreed with the change to the reserve account requirements, but cautioned the Agency that it might be cost prohibitive for smaller properties to review the CNA or life cycle cost analysis every 5 years. In response to this comment, the Agency has added a clause to the regulation that states contributions adjustments can be made every 5 or 10 years based on a revised CNA or as part of the original life cycle cost analysis. So a revised CNA will not be required in 5 years.
5. *Addressing the Reserve Requirements during ownership transfers and assumptions and/or subsequent loans.* One commenter suggested in addition to reserve requirements for new construction, the rule should address reserve requirements during ownership transfers and assumptions and/or subsequent loans. The Agency does not see a need to adopt this comment because the change to the regulation only addresses new construction and the regulations at 7 CFR 3560.406(d)(5) provide adequate guidance concerning reserve requirements meeting the capital needs of the property when there is an “ownership transfer or sale”. The change in the regulation only concerns new construction so it does not address the reserve requirements in the case of a subsequent loan, with an ownership transfer or sale and without an ownership transfer of sale. The Agency

does not plan on making a change to the regulation in response to this comment at this time.

6. *Changing the wording in Section 3560.65.* A commenter recommended changing the wording in Section 3560.65, as the analysis is really based upon the CNA or the Life Cycle Cost Analysis, prepared by a consultant or architect hired by the developer, not developed by Rural Development. We would note that the language “Acceptable to Rural Development” still allows for the CNA to be prepared by others but establish Rural Development as the final approval authority. The Agency agrees and will make the change to the regulation.
7. *Performing a CNA every 5 years, incurring the cost of the assessment and sharing the information.* Two commenters suggested that Rural Development perform a CNA every 5 years. The first of the two commenters suggested, if the cost of updating a CNA every 5 years is prohibitive for a specific project, it may be more appropriate to allow the Rural Development staff and the project management to conduct reviews, with a process for resolving disparities in their recommendations. The second of the two commenters suggested the Rural Development program incur the cost of the assessment and share the information and adjust the reserve requirements accordingly, as rents cannot be raised to an amount that will cover all current and future reserve expenses. Utilizing Rural Development staff and project management to update a CNA is a potentially beneficial practice, and the Agency understands that CNAs can be cost prohibitive. Therefore, a revision as to the regulation has been made to allow for contribution adjustments every 5 or 10 years rather than every 5 years. These updated CNAs must be paid for by the borrower and conducted by a third-party.
8. *Basing the reserve account deposits on a CNA or Life Cycle Cost Analysis.* A commentator agreed that the Agency should base the reserve account deposits on a CNA or life cycle cost analysis. By doing this, MFH projects would have better

project cash flow and improved long term performance which would benefit the low-income families residing in these units and provide sufficient reserves to maintain these projects in the long term, as well as the communities in which these projects are located. There is no need to change the rule for this comment.

List of Subjects in 7 CFR Part 3560

Accounting, Government Property Management, Grant programs - Housing and Community Development, Insurance, Loan Programs - Agriculture, Loan Programs - Housing and Community Development, Mortgage

Therefore, chapter XXXV, Title 7 of the Code of Federal Regulations, is amended as follows:

Part 3560 – Direct Multi-Family Housing Loans and Grants

1. The authority citation for Part 3560 continues to read as follows:

Authority: 42 U.S.C. 1480.

Subpart B – Direct Loan and Grant Origination

2. Section 3560.65 is revised to read as follows:

§ 3560.65 Reserve account.

- (a) For new construction, to meet major capital expenses of a housing project, applicants must establish and fund a reserve account that meets the requirements of § 3560.306. The applicant must agree to make monthly contributions to the reserve account pursuant to a reserve account analysis which sets forth how the

reserve account funds will meet the capital needs of the property over an acceptable 20-year period. The reserve account analysis is based on either a Capital Needs Assessment or life cycle cost analysis, provided and acceptable to Rural Development by the applicant. Adjustments may be made to the contribution amount at 5 or 10-year intervals, either through an updated Capital Needs Assessment or as part of the original life cycle cost analysis. The cost of conducting either a Capital Needs Assessment or life cycle cost analysis will be paid for by the applicant. The cost of the initial Capital Needs Assessment or life cycle cost analysis may be included in the loan financing.

- (b) For ownership transfers or sales, the requirements of § 3560.406 (d) (5) will be met.
- (c) For other existing properties, at a minimum the borrower must agree to make monthly contributions to the reserve account at the rate of 1 percent annually of the amount of total development cost until the reserve account equals 10 percent of the total development cost.

Tammye Treviño
Administrator
Rural Housing Service

May 29, 2012

Date

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