



REGULATORY INTERPRETATION 2002-RI-01

Date: February 13, 2002

Subject: Sponsors With Leasehold Interests in Affordable Housing Program Rental Project Buildings and Underlying Land

Request Summary:

A Federal Home Loan Bank (FHLBank) has asked whether sponsors' leasehold interests of 15 years or more in Affordable Housing Program (AHP) rental project buildings and the underlying land may be considered to be "ownership interests" of such sponsors, for purposes of satisfying the definition and related AHP contractual and other regulatory obligations of a rental project "sponsor" under the AHP regulation.

Conclusion:

Based on the unique circumstances of the 6 AHP projects at issue, as specifically described below, upon execution by the project sponsors of the Direct Subsidy Agreements and the 59-year leases in the project buildings and underlying land, the FHLBank may treat the project sponsors as project "owners" for purposes of satisfying the definition and related AHP contractual and other regulatory obligations of a rental project "sponsor" under the AHP regulation. However, the FHLBank should carefully review the 59-year leases and any other related documents to determine whether they contain any provisions that would affect the abilities of the FHLBank, members or project sponsors to meet the requirements of the AHP regulation and AHP application and, if so, the FHLBank may need to require execution of further assurances from the various parties in order to ensure compliance with the AHP requirements.

Background:

In 1998 and 1999, the FHLBank approved AHP direct subsidies totaling \$1,171,637 to entities identified as project "sponsors" in the AHP applications, for 6 proposed projects to be located on a former military base (Base). According to the FHLBank, the Base currently is owned by the United States, acting by and through the Department of the Navy. The Navy intends to transfer its fee ownership interest in the Base to a redevelopment agency created to administer the conversion of the Base to civilian use. Pending transfer of ownership of the Base to the redevelopment agency, the Navy entered into a ground lease with the redevelopment agency to

give it control of the Base, and the redevelopment agency entered into identical subleases with each AHP project sponsor to allow the use of the project property. Five of the projects have been completed, and the estimated completion date for the sixth project was January 2002. The projects received bridge loans from other sources in lieu of the AHP subsidies, which, once funded by the FHLBank, will be used to repay these loans.

The ground lease and subleases terminate on January 31, 2012. Upon transfer of the ownership interest in the Base to the redevelopment agency, on or before January 31, 2012, the redevelopment agency will enter into identical 59-year leases with each of the project sponsors covering both the AHP project buildings and the underlying land. The project sponsors then will request funding of the AHP subsidies. The members providing the AHP subsidies will take leasehold deeds of trust in the projects that will be recorded, enabling potential recapture of the AHP subsidy in the event of noncompliance with the requirements of the AHP regulation or AHP application.

Neither the Navy, as current fee owner, nor the redevelopment agency, as future fee owner, of the projects and underlying land, apparently is in a position to make the contractual, legal and administrative commitments required of rental project owners under the AHP regulation, and will effectively have no direct involvement in or control over the specific day-to-day operations of the AHP projects. The project sponsors control or will control the day-to-day activities of their respective projects, but will have no fee ownership interest in the projects. Accordingly, the FHLBank has entered or will enter into AHP Direct Subsidy Agreements with each member and project sponsor, under which, among other things, the sponsor has agreed or will agree to perform all of the AHP contractual and other regulatory obligations of a rental project owner, including project monitoring and repayment of AHP subsidy under certain circumstances, for the full 15-year retention period.

In anticipation of the requests from the project sponsors for funding of the AHP subsidies once the 59-year leases are executed, the FHLBank is requesting a Regulatory Interpretation that a sponsor's leasehold interest of 15 years or more in a rental project building and underlying land may be considered to be an "ownership interest" of such sponsor, for purposes of satisfying the definition and related AHP contractual and other regulatory obligations of a rental project "sponsor" under the AHP regulation.

Analysis and Discussion:

The AHP regulation defines a project "sponsor" for a rental project as an organization that has an "ownership interest (including any partnership interest)" in the project. See 12 C.F.R. § 951.1. The term "ownership interest" is not defined in the regulation.¹ The AHP regulation imposes

¹ In a previous interpretation, Finance Board staff stated generally that a project sponsor is considered to have an "ownership interest" in a project if the sponsor has a fee ownership interest in the project building and a leasehold interest in the underlying land. See Questions and Answers Regarding the Affordable Housing Program—Part 2 (Q&A Part 2), Q. 11, 64 Fed. Reg. 12079, 12083 (March 11, 1999). The interpretation did not state that a project sponsor's leasehold interest in a project is the "functional equivalent" of an ownership interest in the project. The Finance Board has not addressed the question of whether a project sponsor's long-term leasehold interests in both the project building and the underlying land, or a project sponsor's fee ownership interest in the underlying land and long-term leasehold interest in the project building, would qualify as an "ownership interest" for purposes of

certain contractual and other regulatory obligations on members and owners of rental projects during the 15-year retention period. For example, the owner of a rental project is required to repay to the member, and the member is required to recover from the owner, the amount of any AHP subsidy that, as a result of the owner's actions or omissions, is not used in compliance with the terms of the AHP application and the AHP regulation, unless the owner cures the noncompliance or modifies the terms of the application, with FHLBank approval, to eliminate the circumstances of noncompliance. *See* 12 C.F.R. §§ 951.12(a)(2) and (b) and § 951.13(b)(3)(ii)(B). The member is required to have in place an agreement with the owner specifying that the owner agrees to use the AHP subsidy in accordance with the terms of the AHP application and the AHP regulation, and that the owner agrees to repay the AHP subsidy in accordance with the requirements of section 951.12(b). *See* 12 C.F.R. § 951.13(b)(2)(ii) and (b)(3)(ii)(A). The agreement also must specify that the member shall ensure that the rental project is subject to a deed restriction or other legally enforceable retention agreement or mechanism requiring, among other things, that the project meets its AHP application income-eligibility and affordability commitments during the 15-year retention period, and, in the case of a sale or refinancing of the project during the 15-year retention period, that the full amount of the AHP subsidy is repaid to the FHLBank, unless the project continues to be subject to a retention agreement or mechanism incorporating the income-eligibility and affordability restrictions for the duration of the 15-year retention period. *See* 12 C.F.R. § 951.13(d)(2).

In addition, the project owner must satisfy certain initial monitoring requirements, including providing semiannual progress reports, certifying the project's compliance with AHP application commitments, and maintaining backup documentation, as well as certain long-term monitoring requirements, including certifying annually the project's compliance with AHP application commitments, and maintaining backup documentation, until the end of the 15-year retention period. *See* 12 C.F.R. §§ 951.10(a)(2) and 951.11(a)(3)(i). The member's agreement with the owner must specify that the owner agrees to comply with the monitoring requirements of sections 951.10(a)(2) and 951.11(a)(3)(i). *See* 12 C.F.R. § 951.13(b)(4)(iii).

For most AHP projects, the project sponsors have a fee ownership interest in the projects and control the day-to-day activities of the projects and, therefore, are in a position to assume the responsibilities of repaying AHP subsidy and monitoring the projects as provided under the AHP regulation. This is the reason why the AHP regulation places accountability for such responsibilities on sponsors with "ownership interests" in the projects. The six AHP projects on the Base are unique, however, because, as discussed above, neither the Navy nor the redevelopment agency apparently is in a position to make the contractual, legal and administrative commitments required of a rental project owner under the AHP regulation and, therefore, cannot act as project "sponsors" as that term is defined in the AHP regulation. The entities identified in the AHP applications as the project sponsors control or will control the day-to-day activities of their respective projects, but will not have fee ownership interests in their projects and, therefore, technically would not be subject to the contractual and other regulatory obligations of the AHP regulation. If no entity is accountable for carrying out these obligations under the AHP regulation, the FHLBank may not fund the projects with the AHP subsidies.

satisfying the project "sponsor" definition. These scenarios differ from the factual circumstances presented by the FHLBank in its request and, therefore, are not addressed in this Regulatory Interpretation.

The FHLBank cites examples, under federal and state law, where leasehold property interests of 30 and 35 years were treated as the “functional equivalent” of fee ownership interests in such property. The FHLBank argues that these examples provide sufficient support for the Finance Board to interpret sponsors’ leasehold interests of 15 years or more in AHP project buildings and the underlying land as the functional equivalent of “ownership interests” in the projects, for purposes of the AHP regulation. The FHLBank also argues that its requested interpretation is consistent with the policy objectives of the AHP regulation to place responsibility for AHP subsidy use and compliance on the entities that are in the best position to control how the subsidy is used and how the project is operated.

The Finance Board finds it unnecessary to decide the merits of the FHLBank’s functional equivalence argument.² Rather, the Finance Board’s view is that, based on the unique circumstances of the 6 AHP projects at issue, upon execution by the project sponsors of the Direct Subsidy Agreements and the 59-year leases in the project buildings and underlying land, the FHLBank may treat the project sponsors as project “owners” for purposes of satisfying the definition and related AHP contractual and other regulatory obligations of a rental project “sponsor” under the AHP regulation. These unique circumstances are: the apparent inability of the current or future project fee owners to make the contractual, legal and administrative commitments required of a rental project owner under the AHP regulation; the project sponsors’ day-to-day control of the projects; the project sponsors’ anticipated 59-year leasehold interests in the project buildings and underlying land, which will more than cover the full 15-year retention period required under the AHP regulation;³ the fact that the members will take leasehold deeds of trust in the projects that will be recorded, enabling potential recapture of the AHP subsidy in the event of noncompliance with the requirements of the AHP regulation or AHP application; and the project sponsors’ commitments in the Direct Subsidy Agreements to be bound by the contractual and other regulatory obligations of the AHP regulation for the full 15-year retention period.

However, as cautioned in Q&A Part 2, Q. 11, the FHLBank should carefully review the 59-year leases and any other related documents to determine whether they contain any provisions that would affect the abilities of the FHLBank, members or project sponsors to meet the requirements of the AHP regulation and AHP application and, if so, the FHLBank may need to require execution of further assurances from the various parties in order to ensure compliance with the AHP requirements.

A Regulatory Interpretation applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 C.F.R. §§ 907.1 and 907.5.

² We note, in passing, that the examples of functional equivalence treatment cited by the FHLBank involved different factual circumstances under laws serving different purposes than those at issue in the FHLBank’s request to the Finance Board. We also note that the 30- and 35-year leasehold interests cited by the FHLBank as receiving ownership interest treatment under a “functional equivalence” theory are significantly longer than the minimum 15-year leasehold interest for which the FHLBank specifically seeks ownership interest treatment in its request to the Finance Board.

³ A leasehold interest with a term of 15 years or more would suffice since the AHP regulation requires a 15-year retention period.

