United States General Accounting Office

GAO

Report to the Chairwoman, Subcommittee on Housing and Community Opportunity, Committee on Financial Services
House of Representatives

May 2002

MULTIFAMILY RURAL HOUSING

Prepayment Potential and Long-Term Rehabilitation Needs for Section 515 Properties

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United States General Accounting Office
Washington, DC 20548

May 10, 2002

The Honorable Marge Roukema
Chairwoman, Subcommittee on Housing
and Community Opportunity
Committee on Financial Services
House of Representatives

Dear Madam Chairwoman:

Nearly 450,000 elderly and other households depend on federal assistance to live in multifamily rural rental properties that were constructed with subsidized federal loans. With an average income of $8,105 in 2001, over 90 percent of these households are at or below 50 percent of the median income in the areas where they are located. Because the properties were built in areas when and where privately financed housing units, affordable by lower income households, were not considered economically feasible, the U.S. Department of Agriculture's (USDA) Rural Housing Service (RHS) has made direct loans with subsidized interest rates as low as 1 percent available to developers of affordable multifamily housing under its section 515 program.[1] The properties often receive project-based rental assistance in addition to the interest subsidies.[2] As of March 1, 2002, about 16,400 section 515 properties had an outstanding principal balance of $11.8 billion.

When the section 515 program began in the early 1960s, loans were generally made for 40 years, but borrowers were encouraged to refinance their properties as soon as they could obtain private credit. Refinancing the properties released the owners from the requirements in their loan contracts on admission and rents, allowing some to raise rents to market levels when they prepaid their section 515 loans. But prepayment of these loans also removed units that were affordable to low-income tenants from RHS's portfolio. Concerns about the loss of affordable units led Congress to enact legislation designed to keep section 515 properties in the portfolio for a longer time and to protect low-income tenants from being displaced.

[1]The program was authorized by a 1962 amendment to the Housing Act of 1949 (42 U.S.C. 1485).

[2]Under project-based assistance the subsidy is tied to the unit and the household can benefit from the subsidy only while living in the subsidized unit.

Congress ultimately enacted legislation that precluded prepayment for loans made on or after December 15, 1989. For loans made before that date, prepayment is restricted.

As agreed with your office, this report covers (1) the number of properties whose section 515 loans have been prepaid and the effect of prepayment on the section 515 portfolio; (2) the estimated impact on the number of properties in the portfolio by changing the legislation that restricted prepayment for loans made before December 15, 1989, and; (3) the long-term rehabilitation needs of the properties in the section 515 portfolio.

Our work is based on reviews of agency and published data; analyses of data from three RHS accounting systems; and discussions with industry representatives, Department of Housing and Urban Development (HUD) officials, and RHS headquarters and state officials. We were unable to survey property owners about their prepayment intentions because the RHS database is not designed to readily match owner and property location data. However, we were able to measure factors that RHS and industry representatives believe limit the potential for prepaying. We were also able to identify additional factors that are likely to impact prepayment, but we could not measure them without performing in-depth financial analyses of individual properties. We performed our work from June 2001 through March 2002 in accordance with generally accepted government auditing standards. Additional details on our scope and methodology are discussed in appendix I.

Results in Brief

Prepayment activity has been minimal and has removed a small percentage of properties from the section 515 portfolio. RHS has funded many more new properties than the portfolio has lost through prepayment. Since the program began, the number of new properties added to the portfolio exceeded the number that left the program after prepayment in every year except 2001. In that year, the balance changed because of a continued decline in funding rather than a significant increase in prepayment activity.

If the statutory requirement restricting prepayment for loans made before December 15, 1989, were changed to allow prepayment without restrictions after 20 years from the date of the loan, we estimate that prepayment could be an option for the owners of about 3,900, or about 24 percent, of all section 515 properties over the next 8 years. Owners of about 950 of these properties would immediately become eligible to prepay. This estimate is based on our analysis of economic factors that we

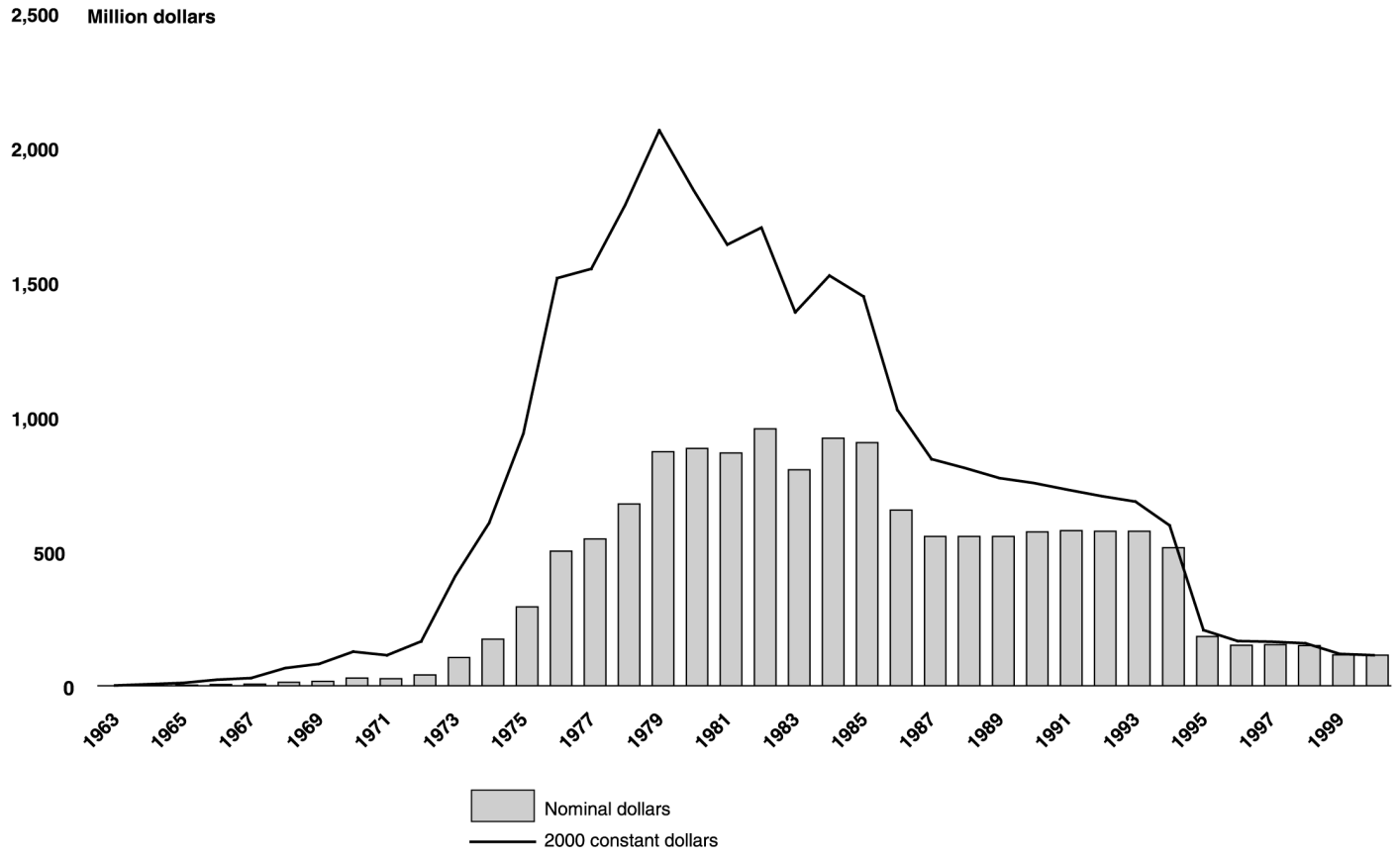
could measure and that RHS and industry representatives agree would limit the potential for prepayment and conversion to market-rate rents. However, several factors that we could not readily measure would likely reduce the potential for prepayment even further. To this end, individual properties must be able to operate without federal assistance, be in areas where high rental demand has raised market rents above RHS rents, have the funds or financing to meet future capital needs, and meet any tax requirements. Yet, despite these potential constraints on prepayment, RHS officials are concerned that owners who are dissatisfied with RHS's procedures and statutory restrictions could apply to leave the program if the opportunity to do so arose, even when economic factors would not make them likely to depart. RHS officials believe that planned enhancements to their management systems by the summer of 2002 will allow them to better measure some of these variables and more accurately predict prepayment potential.

While RHS is concerned with the capital replacement needs of a rapidly aging portfolio, routine inspections do not produce a cost estimate of the long-term rehabilitation needs of the properties in its portfolio. RHS field staff routinely inspect properties, complete and retain detailed descriptions of noted deficiencies, and transmit the summaries of the deficiencies identified to a centralized database. However, only current deficiencies are identified; therefore, the data are of limited value for determining the cost of long-term rehabilitation needs of the individual properties. Without a mechanism to prioritize the portfolio's long-term rehabilitation needs, RHS cannot be sure it is spending limited rehabilitation funds as effectively as possible and cannot tell Congress how much funding it will need in the future. RHS has been only able to provide a wide range of estimates on the amount of funding needed, ranging from $800 million to $3.2 billion. We are recommending that RHS undertake a comprehensive assessment of the section 515 portfolio's capital and rehabilitation needs, use the results to set priorities for the portfolio's immediate rehabilitation requirements, and provide Congress with an estimate of the portfolio's long-term rehabilitation needs. RHS officials agreed with the recommendation, acknowledging the need to focus on developing strategies to address the portfolio's rehabilitation needs. While noting that RHS knows the physical condition of individual properties, this information has not been consolidated into a national database that can be used to develop credible cost estimates of the portfolio's long-term needs.

Background

As shown in figure 1, expenditures for the section 515 program increased throughout the 1970s, peaked in 1979, and fell sharply after that. In recent years, the program has received about $115 million annually and has allocated $55 million for new construction, $55 million for rehabilitation, and $5 million for equity loans. The president's budget for fiscal year 2003 proposes to eliminate the new construction funding.

Figure 1: Section 515 Expenditures, 1963-2001



Source: GAO analysis of RHS data.

The number of units added to the portfolio each year has followed the funding curve. During the peak funding years, over 20,000 new units were added to the portfolio annually. Fewer than 5,000 new units have been produced annually since 1995.

In 1998, RHS created the Office of Rental Housing Preservation to administer the prepayment program. Mandated in the Housing and Community Development Act of 1992, the office's tasks include improving the effectiveness and integrity of the agency's prepayment and preservation processes.

As of fiscal year 2001, the average size of an RHS property was 27 units. About 8 percent of the properties, comprising about 5 percent of the units, were owned by small operators, often families, while most of the other properties had a more complex ownership structure—typically a managing partner, who owned 5 percent of the property, and many limited partners with smaller shares.

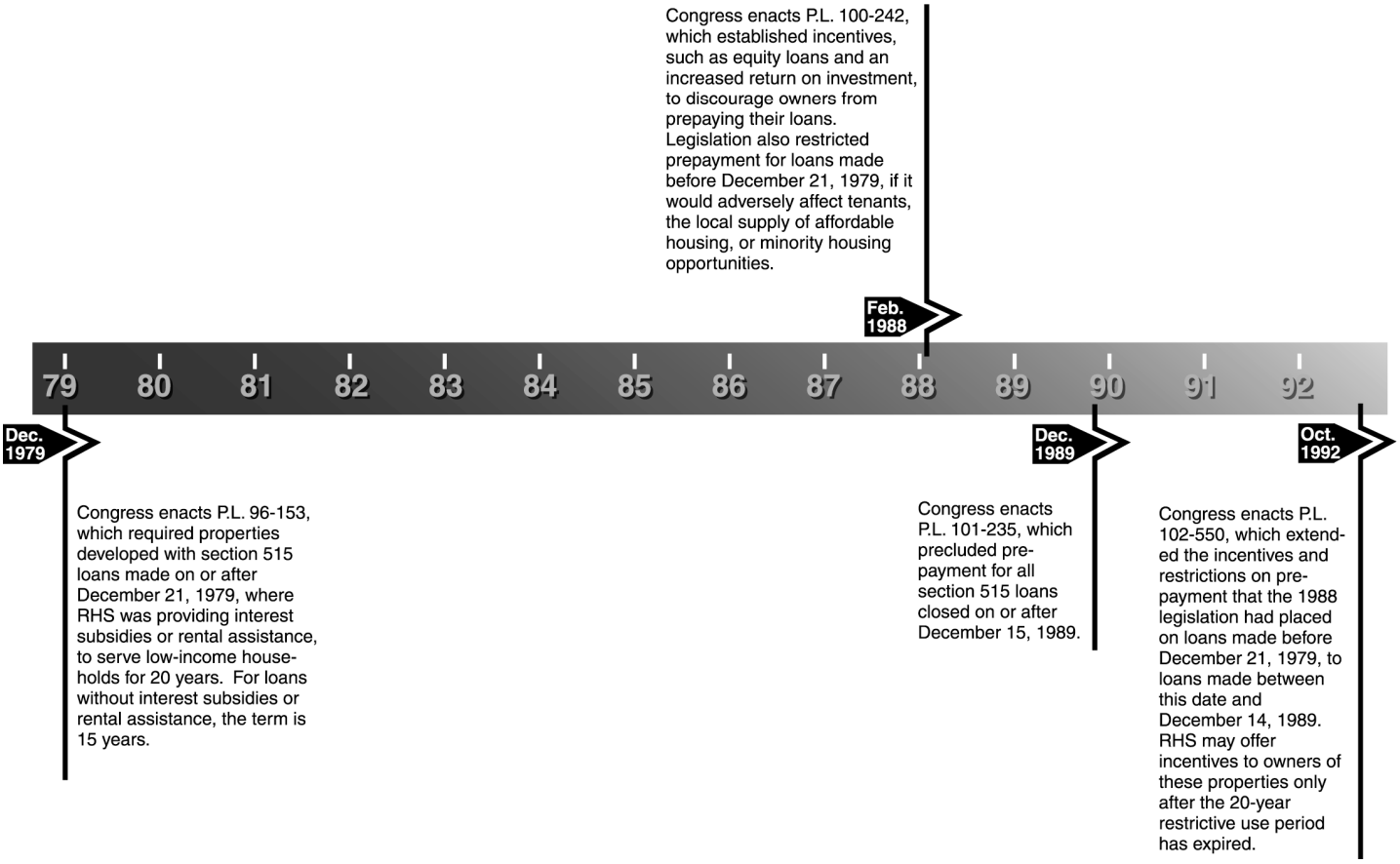
About half of the section 515 units receive RHS rental assistance, which makes up the difference between 30 percent of the assisted household's income and the unit's rent. About 14 percent of section 515 units have HUD project or tenant-based section 8 rental subsidies, which cover the difference between tenants' payments and fair-market rents, as determined by HUD on the basis of an annual survey of rents in over 2,700 market areas. Therefore, in those areas where fair-market rents are typically higher than the rents approved by RHS, section 515 properties with section 8 assistance usually generate more income for the owners. Both RHS and HUD provide project-based rental assistance, meaning that the assistance stays with the unit. HUD's section 8 voucher program provides tenant-based vouchers, meaning that the assistance stays with the tenant and is portable—households can use vouchers to rent any affordable units that meet HUD's housing quality standards.

In the program's early years, it was expected that the original loans, which are amortized over 40 or 50 years, would be refinanced before major rehabilitation was needed. However, with prepayment restrictions and limited rental assistance and rehabilitation funds, this original expectation has not been realized. To maintain the properties in good condition, RHS relies on owners to put aside funds in a reserve account. RHS requires borrowers to place 1 percent of the original cost of the properties into the reserve account each year for the first 10 years until 10 percent is held in reserve. The borrower must continue to make contributions to the reserve account to maintain it as withdrawals are made against the account to fund rehabilitation work. RHS is concerned about the adequacy of funding reserves at only 1 percent per year for 10 years and how to determine exactly what must be done on an ongoing basis to preserve each property. While owners are required to set aside a portion of their rent revenue in a reserve account to provide for modernization needs, these reserve

accounts have often not been large enough to adequately provide for major rehabilitation.

Concerns about the loss of affordable units led Congress to enact legislation designed to keep section 515 properties in the portfolio and to protect low-income tenants from being displaced. Figure 2 details the key legislation.

Figure 2: Key Prepayment Program Legislation



Source: GAO Analysis

The legislation restricting prepayment of section 515 loans has resulted in litigation.[3] Owners of section 515 properties who wished to prepay the loan pursuant to their original loan agreements and remove their properties from the section 515 program have sued the federal government. The owners claim that the federal government, with the enactment of the legislation and the subsequent refusal by RHS to accept unfettered prepayment, committed a breach of contract and an unconstitutional taking of their properties. The federal government maintains that no such breach occurred.

Prepayment Activity Has Not Adversely Affected the Section 515 Portfolio

To date, prepayment activity has been minimal. Over 4,550 new properties entered the portfolio since the 1988 prepayment restrictions went into effect. This number far exceeded the number of properties that left the portfolio after prepayment. For example, RHS data for fiscal years 1998 through 2001 show that fewer than 100 properties, on average have left the portfolio each year. Fiscal year 2001 is the only year when the number of prepayments exceeded the number of properties added to the portfolio. However, this exception reflects a decline in funding rather than an increase in prepayments. RHS officials noted that prepayment requests were particularly limited in 1995 after an RHS administrative notice, citing an application processing backlog and limited funding, resulted in discouraging owners from applying for prepayment.

Since 1988, the impact of prepayment has been minimized by a statutory restriction on owners who prepay by stipulating that, under certain circumstances, the rents for tenants not be increased for as long as they remain in the units. During fiscal years 1999 through 2001, the owners of 283 properties prepaid their loans. Following prepayment, 86, or about 30 percent, of these properties left the program without restrictions because RHS determined that these properties were not needed in the market area and their departure would not adversely affect housing opportunities for minority households. The loans for 197, or about 70 percent, of the properties were prepaid with restrictions on the rents of RHS-assisted households that would remain in effect as long as these households continued to reside in the properties. The owners of 88 other properties applied for prepayment but decided, instead, to accept RHS incentives to

[3] As of March 1, 2002, over 30 section 515 property owners were plaintiffs in lawsuits involving RHS prepayment issues.

stay in the program for 20 more years. Table 1 shows the prepayments by fiscal year.

Table 1: Recent Section 515 Program Prepayment Activity

Fiscal year	Owners accepted incentives in lieu of prepayment	Owners prepaid		
		Without restrictions	With restrictions	Total prepaid
1999	43	34	43	77
2000	21	21	90	111
2001	24	31	64	95
Total	**88**	**86**	**197**	**283**

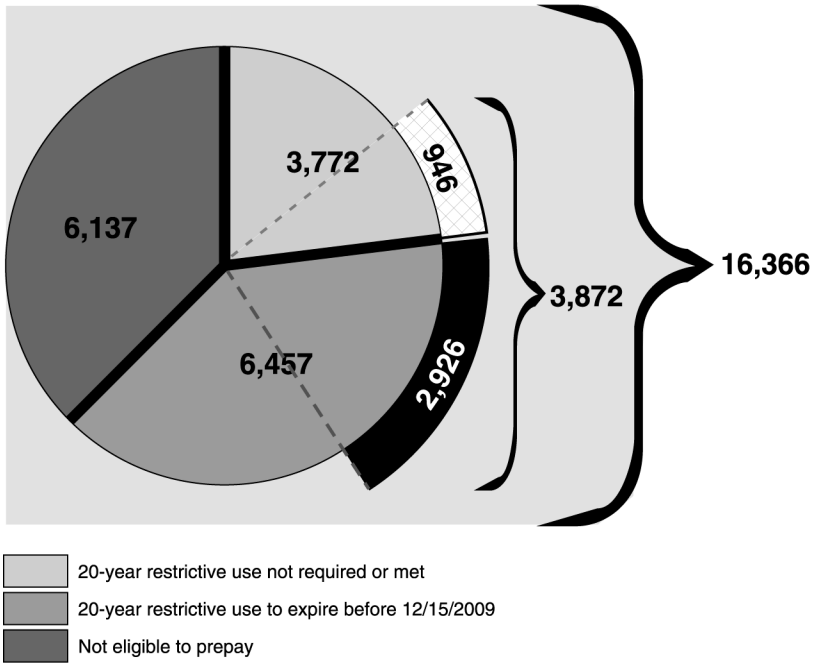
Source: RHS.

Prepayment Potential Limited by Series of Factors

If the statutory requirement covering loans made before December 15, 1989, were changed to allow prepayment without restriction after 20 years from the date of the loan, we estimate that prepayment could be an option for the owners of 3,872, or about 24 percent, of the 16,366 section 515 properties. This estimate is based on our analysis of three factors that we could measure and that RHS and industry representatives agree would limit the potential for prepayment and conversion to market-rate rents. However, a number of economic constraints on individual properties, which we could not readily measure, would be likely to limit the number of actual prepayments even further. Nevertheless, despite these potential constraints, RHS officials are concerned that owners who are dissatisfied with RHS's procedures and statutory requirements could apply to leave the program if the opportunity arose even if prepayment were not economically advantageous.

As shown in Figure 3, as of January 1, 2002, there were 3,772 section 515 properties that had served low-income households for 20 years or were financed before 1979 and were never subject to a 20-year low-income use restriction. In our analysis, we found that owners of 946 of these properties could consider applying for prepayment. The loans on another 6,457 properties were eligible for prepayment; however, the properties were still subject to a 20-year use restriction expiring between January 1, 2002, and December 15, 2009. We also found that over the next 8 years owners of 2,926 of these properties would be able to consider prepayment after they meet the 20-year restriction. The loans made on 6,137 properties on or after December 15, 1989, were not eligible for prepayment because the statute in effect when the loans were made precluded prepayment.

Figure 3: Prepayment Potential: Section 515 Properties by Restrictive Use Category As of January 2002



Note: We isolated 16,507 properties from RHS's databases but dropped 141 from our analysis because of inaccurate county code information, leaving a universe of 16,366 properties.

Source: GAO analysis of RHS data.

Our estimate of the number of properties whose owners could consider prepaying is based on three factors that RHS and industry representatives believe limit the potential for prepaying. These factors are as follows:

- Ownership by a nonprofit organization or public entity. Prepaying mortgages in an attempt to gain financially through converting to market-rate rents could conflict with these organizations' basic mission of providing high-quality, affordable housing for low-income families.
- Heavy dependence on RHS rental assistance that would cease upon prepayment. Industry experts and RHS officials in headquarters and the states we visited emphasized that, except in areas where growth has brought unexpected prosperity, high dependence on RHS rental assistance is a strong indicator that a property would have a difficult time maintaining adequate cash flow without such assistance.

- Location in a county where the population declined in the 1990s. Such properties most likely would not be able to obtain significantly higher rents in the private market than they are receiving under federal subsidies because the relative lack of population growth reduces demand for housing and keeps rents from rising.

After adjusting for these factors, we determined that the owners of 3,872 properties, or 24 percent of the total properties, could consider prepaying their loans. The number of loans that actually would be prepaid depends on several property-specific factors that we could not readily measure. Factors affecting prepayment potential include whether individual property owners (1) could operate without the subsidized direct loans, (2) had property located in areas where high rental demand has raised market rents above RHS rents, (3) had the funds or financing to meet future capital needs, and (4) could meet any tax requirements they would incur.

For example, in 1986, tax laws were changed to eliminate accelerated depreciation.[4] Owners who entered the program before the 1986 tax law change enjoyed the benefits of accelerated depreciation by annually writing off a larger portion of the original value of the property on their tax return than was permissible after the tax law change. In some cases, owners have fully depreciated their property, leaving them a zero cost basis, instead of the original value of the property, when determining their capital gains liability. While these owners enjoyed the write-off benefits associated with the tax savings, their current tax burden can significantly reduce the remaining proceeds. As a result, some owners are staying in the program to avoid the tax consequences.

On the other hand, RHS officials are concerned that owners who are dissatisfied with RHS's procedures and statutory requirements could apply to leave the program if prepayment were allowed, even if the costs exceeded the expected financial benefits. For example, the acting assistant deputy administrator for multifamily housing said he interprets the ongoing lawsuits and discussions he has had with owners who believe they were mistreated by the government as a strong indicator that psychological factors might override economic considerations if the law were changed covering loans made prior to December 15, 1989. Also, some owners want to get out of the program because of dissatisfaction with

[4]Accelerated depreciation encourages investment by letting entities recover the cost of assets more quickly with relatively greater depreciation deductions early in an asset's life.

RHS's oversight or because they had planned to use the proceeds from the sale of their properties to fund their retirements. RHS officials were unable to quantify the extent to which these views prevail or could affect the portfolio. RHS officials, however, believe that planned enhancements to its management systems, scheduled to be completed during the summer of 2002, will allow them to better identify property owners and determine the number of properties in the portfolio that are at risk. It should also help them better monitor replacement reserves and other property specific financial matters, which, in turn, could allow them to better predict prepayment potential.

Our estimate would also change if HUD tenant-based vouchers were made available or RHS were able to offer tenant-based vouchers. Owners with tenant-based vouchers could then prepay and exit the program but continue to receive federal subsidies for the units where RHS tenants chose to remain.

Cost of Long-Term Rehabilitation Needs of Section 515 Properties Unknown

In the program's early years, it was expected that the original loans would be refinanced before major rehabilitation was needed. However, with prepayment and funding restricted, this original expectation has not been realized, and RHS does not know the full cost of the long-term rehabilitation needs of the properties in its portfolio. RHS field staffs perform annual and triennial property inspections. However, the inspections identify current deficiencies rather than the long-term rehabilitation needs of the individual properties, and RHS does not know the extent to which reserve accounts will be able to cover long-term rehabilitation needs. Without a mechanism to prioritize the portfolio's rehabilitation needs, including a process for ensuring the adequacy of individual property reserve accounts, RHS cannot be sure it is spending limited rehabilitation funds as effectively as possible and cannot tell Congress how much funding it will need to deal with the portfolio's long-term rehabilitation needs.

RHS state personnel inspect the exterior condition of each section 515 property annually and conduct more detailed inspections of each property every 3 years. However, according to RHS inspection guidelines, the inspections are intended to identify current deficiencies, such as cracks in exterior walls or plumbing problems. Our review of selected inspection documents in state offices we visited confirmed that the inspections are limited to current deficiencies and RHS headquarters and state officials confirmed that the inspection process is not designed to determine and quantify the long-term rehabilitation needs of the individual properties.

RHS has not determined to what extent properties' reserve accounts will be adequate to meet long-term needs. According to RHS representatives, privately owned multifamily rental properties often turn over after just 7 to 12 years, and such a change in ownership usually results in rehabilitation by the new owner. However, with limited turnover and limited funding, RHS properties primarily rely on reserve accounts for their capital and rehabilitation needs, and RHS officials are concerned that the section 515 reserve accounts often are not adequate to fund the rehabilitation of the properties.

Without comprehensive information on the physical condition of all the properties in the portfolio, including the adequacy of the reserve accounts, RHS has only been able to provide a wide range of estimates on the amount of funding needed. An August 2000 RHS internal study estimates that without increased funding or policy changes, in 5 years, 25 percent of the section 515 properties will no longer be safe and sanitary. Further, a 1999 internal study estimated that it would take between $800 million and $3.2 billion to meet the properties' long-term rehabilitation needs.

A background paper by the Millennial Housing Commission on preserving affordable housing notes that a reserve account system, such as the one designed by RHS, would be adequate in the private market where greater turnover with higher cash flow is the norm.[5] However, the paper continues that such a system is not reasonable in the public housing market that, by design, does not have the equivalent ability to refinance and generate cash flow. In this regard, the paper noted that reserve systems like RHS's, are generally adequate to cover only between one-third and one-half of long-term capital needs.

RHS and industry representatives agree that the overriding issue for section 515 properties is how to deal with the long-term needs of an aging portfolio. Since 1999, RHS has allocated about $55 million in rehabilitation funds annually, but owners' requests for funds to meet safety and sanitary standards alone have totaled $130 million or more for each of the past few years.

[5]See "Background Paper: Preservation of Existing Affordable Housing," prepared for the Millennial Housing Commission Preservation Task Force, draft, revised September 2, 2001. Established as part of Public Law 106-74, the bipartisan Millennial Housing Commission's mission is to develop proposals to improve housing opportunities.

Over the past several years, RHS headquarters has encouraged its state offices to allow individual property owners to undertake capital needs assessments and has amended loan agreements to increase their rental assistance payments as necessary to cover the future capital and rehabilitation needs identified in the assessments. However, with varying emphasis by RHS state offices and limited funding for increased rental assistance, the assessments have proceeded on an ad hoc basis. As a result, RHS cannot be sure that it is spending these funds as cost-effectively as possible.

The August 2000 RHS study highlighting the scope of the long-term rehabilitation problem also recommended that the agency seek funding for a physical-needs-assessment study of the existing portfolio, but no funding was requested. USDA's fiscal year 2003 budget proposal requests funds for RHS to study its multifamily housing portfolio to determine how future construction could be provided at less cost to taxpayers. The proposal does not, however, request funds to obtain a comprehensive baseline of the existing portfolio's long-term capital needs.

Conclusion

With little new construction and limited prepayment, maintaining the long-term quality of aging portfolio has become the overriding issue. While RHS's practice of allocating its limited funds to properties with documented capital needs has helped properties on an ad hoc basis, RHS does not have a process to determine and quantify the portfolio's long-term rehabilitation needs. As a result, RHS cannot ensure that it is spending its limited funds as cost-effectively as possible and cannot provide Congress with a reliable or well supported estimate of the funding needed to deal with the portfolio's long-term rehabilitation needs.

Recommendation for Executive Action

To better ensure that limited funds are being spent as cost-effectively as possible, we recommend that the Secretary of Agriculture direct the RHS Administrator to undertake a comprehensive assessment of the section 515 portfolio's long-term capital and rehabilitation needs. Further, the results of the assessment should be used to set priorities for the portfolio's immediate rehabilitation needs and to develop an estimate for Congress on the amount and types of funding needed to deal with the portfolio's long-term rehabilitation needs.

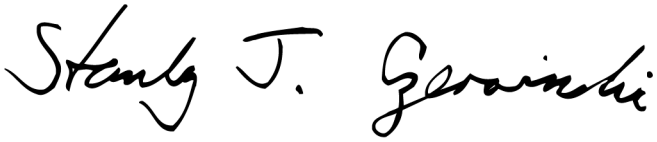
Agency Comments

We provided USDA with a draft of this report for their review and comment. RHS's acting deputy administrator for multifamily housing said that our report was thorough and balanced, and he supported the report's recommendation. He said that the agency is focusing on developing strategies to address the long-term needs of the portfolio, including building a national database. He said that, given the rapidly aging portfolio, the time is ripe to conduct a comprehensive effort to establish credible cost estimates for long-term capital needs.

The acting deputy administrator took issue with two points. First, he said that our draft gave the impression that RHS does not know the rehabilitation needs of the properties. He stated that RHS knows the physical condition of each property in the portfolio from its annual field staff reviews, but agrees that the data from the routine inspections are not compiled into a national database that would define long-term portfolio needs. We agree and have revised the report to clarify this point. Second, the acting deputy administrator said that he agrees that heavy dependence on rental assistance would limit prepayments from occurring. However, he said that the factor would be less of a deterrent to prepayment if vouchers were made available to prepaying properties. We added language in the report to clarify this point.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies of the report to interested congressional committees and members of Congress; the secretary of agriculture; the director, Office of Management and Budget; and other interested parties. We will also make copies available to others on request.

If you or your staff have any questions about this report, please contact me at (202) 512-7631. Key contributors to this report are Angela Davis, Bess Eisenstadt, Andy Finkel, Curtis Groves, Rich LaMore, John McDonough, and Tom Taydus.



Stanley J. Czerwinski
Director, Physical Infrastructure
Issues

Appendix I: Scope and Methodology

Our work was based on a review of published data; discussions with officials from the Rural Housing Service (RHS), the Department of Housing and Urban Development, the housing industry, and RHS property owners; and an in-depth analysis of RHS's prepayment and section 515 files. We also reviewed background papers prepared by the Millennial Housing Commission and attended a roundtable discussion on housing preservation issues sponsored by the Housing Assistance Council. Furthermore, we judgmentally selected and visited RHS offices in Massachusetts, New Hampshire, and Vermont, where we identified factors that could influence prepayment decisions by property owners.

As part of determining how many section 515 properties have been prepaid in recent years and the impact of their prepayment on the section 515 portfolio, we identified key laws and regulations affecting the implementation and operation of the prepayment program. Through discussions with agency officials and reviews of independent publications and legal documents, we identified key changes in the section 515 program, including legislative changes affecting prepayment. Where data was available, we determined the number of properties whose loans were prepaid. We also collected detailed funding and unit production information to document changes in the section 515 portfolio since the program began.

To estimate the impact of changing the legislation to allow prepayment without restrictions after 20 years, we planned to survey property owners about their prepayment intentions and obtain specific information from RHS on each property in the section 515 portfolio. However, RHS officials informed us that the information needed to survey the owners was not readily available because RHS's database did not identify specific owners. In addition, many of the properties are owned by large partnerships whose individual owners are not easily identifiable. While we interviewed a number of section 515 property owners on prepayment issues, we were unable to survey all property owners because the RHS database did not identify specific owners. Therefore we do not know the extent that the views of the owners we interviewed are representative of all section 515 owners.

RHS also informed us that specific information about individual properties was not readily available because the agency's accounting systems track loans rather than properties and most properties had more than one loan. However, RHS combined information from three separate accounting systems that helped us determine the likelihood of prepayment for each property. We were able to isolate 16,507 properties from RHS's database

by identifying loans with the same street addresses and county codes, but we had to drop 141 properties from our analysis because of inaccurate county code information.

We reviewed the case files for individual properties at the three RHS state offices we visited. From these reviews and discussions about the properties with the state RHS officials, we identified factors that could help determine the likelihood of prepayment. We also compared information from state office case files with information in RHS's database.

To determine the capital and rehabilitation requirements of the section 515 properties, we evaluated RHS reviews that identified the conditions of the properties and the estimated costs to meet the requirements. We obtained the views of RHS and industry representatives concerning the extent of the rehabilitation needs. We also documented RHS's inspection processes for identifying rehabilitation requirements at the properties.

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