AHIC
AFFORDABLE HOUSING
INVESTORS COUNCIL

April 23, 2009

Ms. Barbara J. Thompson
Executive Director
National Council of State Housing Agencies
444 North Capitol Street NW
Suite 438
Washington, DC 20001

Re: AHIC Comment for State Agency Implementation of ARRA Gap Funds and the LIHTC Exchange Funds

We have prepared these comments in the hopes that input from your partners, the investor community, will assist the state agencies in their effort to bring about an effective response to the current shortage of capital available for affordable housing development in the United States. We applaud your efforts as our industry grapples with unprecedented challenges.

Our comments cover the administration of ARRA Gap Funds, known as the Tax Credit Assistance Program (TCAP), and the exchange provision which enables state HFAs to exchange credits for cash.

Our comments are based on the perspective gained through our members' investment of billions of dollars in affordable housing through the purchase of federal and state low income housing tax credits and our interest in preserving and expanding investment in affordable housing. Importantly, we want you to know that AHIC is strongly supportive of the state agencies as they examine this new role, hopefully adhering to the fundamental parameters that have served the LIHTC program well to this point.

Shortage of Capital / Use of Substitute Grants

The current shortage of capital is a direct result of low levels of taxable corporate earnings, the inability of most corporate investors to plan for earnings over a 10 year investment horizon (the credit period), and an overall shortage of non-bank investors. The Community Reinvestment Act (CRA), which regulates and spurs investments in communities by banks, which have spearheaded investing in this product since its inception, also has an effect on the geographic location of housing investment. As a result of these conditions, affordable housing developers face several critical challenges:

1. Unfunded Developments: Developments that have not found an investor, whether through a lack of CRA fit, or through an inability to convince a non-CRA investor of the viability of the development. It is entirely possible that a strong affordable housing development may be located in an area that does not contain a profitable banking institution with an active LIHTC investment program. AHIC has members who are non-bank investors, yet there is a clear divergence between the CRA and non-CRA LIHTC market.

2. <u>Shortfall Developments</u>: Developments that can attract investor LIHTC purchase, but have a budgeted shortfall based on current tax credit pricing. At this writing, prices have fallen by 30% or more. Although viable, these transactions need a higher level of subsidy in order to proceed to development in 2009.

Unfunded Developments

We see several critical challenges in restoring capital to unfunded developments. First, we think that most housing agencies have relied on a certain amount of market discipline to "sort out" which developments go forward. As such, some state allocation plans naturally allow for numerous competing affordable developments in the same market geography. Funding a large number of similar deals in a single geography could easily lead to a failure by most of the properties. To address this, we urge the state agencies that are considering using exchange funds for unfunded developments to check the occupancy of LIHTC and other state funded developments and to prospectively look at anticipated additions to supply to make sure that demand will be sufficient to absorb the units. Independent market studies are helpful in this process, but ought to be updated to within 4-6 months of closing.

The second key challenge will be the absence of investor protections during the initial closing process and outside asset management over the long term compliance period. We would propose that an agency replicate much of the structure of a limited partnership agreement, but in the form of a control agreement for the funds being granted by the state. Borrowers, whether for-profit or not-for-profit, must have very substantial funds at risk if they fail to perform under such an agreement. These standards will protect the program from misuse or noncompliance with federal rules.

The levels of protection that need to be in place are:
1. Developer guaranties (construction loan, compliance, operating deficits, credit deficits)
2. Construction performance (bonding if appropriate, construction guaranties)
3. Contingencies and reserves at project level
4. Development fee hold back, full or partial, until critical events are met, including stabilization for a specified duration
5. Operating deficit reserves held for life of project
6. Fund level, or in the case of state agencies, program level reserves to address issues not covered by other protections
7. Reporting consistent with industry standards

Oversight that needs to be in place is for all of the above and:
1. Budget funding and title work on draws
2. Construction progress inspections by a qualified 3rd party engineer or architect hired by the state agency, keeping in mind the 15 year investment horizon
3. Schedule of placed-in-service tests and other key dates
4. Leasing status
5. Compliance with affordability restrictions and tenant lease reviews
6. Provision of all financial documents, financial statements and partnership audits
7. Long term project viability

State agencies will need a template for legal documentation and controls, and for the use of outside counsel and accountants. Ongoing compliance should be monitored, and penalties assessed for noncompliance.

Shortfall Developments

State agencies may find that the use of exchange funds to fill gaps on Shortfall Developments has the potential for the fastest solution and implementation and may limit the states' needs to develop the infrastructure described above. In a transaction where an outside tax credit investor is present, the following risks are underwritten and mitigations achieved:

Construction or Renovation Risk – The LIHTC program is designed to produce top-quality rental housing that will last for the full 15 year compliance period required under the program. Investors assess construction risk through up front underwriting of construction budgets, contractors, bonding, contingencies / reserves, and by initial plan and cost review. We rely on financial guaranties of completion by the developer and contractor. During construction, investors and tax credit fund managers monitor construction with regular inspections. Prior to funding a construction draw request, investors and syndicators check for budgets in balance, mechanics and materials liens, and adequate funds to complete.

- We would propose that exchange funds could be administered jointly with draws on investor funds and benefit from the same risk controls, assuming the exchange funds can be processed and funded monthly in an expeditious manner. If not, the exchange funds should come in upfront or be bridged by the construction lender. It is essential that construction costs be funded timely and monthly draws processed expeditiously.

Compliance and Recapture Risk – All participants in this program seek to ensure that the housing created serve as safe affordable living for the intended residents for the full compliance period. As you know, investors actively monitor compliance with IRS rules in order to prevent recapture of tax credits and the penalties that would come along with any recapture event. The chief tool in ensuring compliance is in withholding full developer fee payment until cost certification is complete, 8609s are issued and permanent financing has been closed. Similarly, provisions in our guaranties and partnership agreements allow us to enforce compliance over the longer term.

Budget and Conversion Risk - When investing in affordable housing, the underlying term debt needs to be well-supported by the cash flow of the property at restricted rent levels. If not well supported, foreclosure, with the loss of investment and threat of tax credit recapture, is a potential outcome. Term debt levels are sized at initial closing based on income projections. At property stabilization, there is a possibility of loan "resizing" based on sub-par income performance. Investors and lenders in this market regularly rely on their ability to use unpaid cash developer fee, those scheduled to be paid prior to or at conversion, to cover a loan resizing event.

- From the perspective of the state agencies, you would also be well served to look to as-yet unpaid cash developer fees as a tool to mitigate permanent loan issues. Similarly, developers should guaranty construction debt repayment and provide operating deficit guaranties on ongoing performance.

Operational Risk – As investors, we are holders of long term real estate risk in a property class that requires regular maintenance and attention. While we try to select development partners that carefully manage these assets, as investors, we also use internal asset management personnel and syndicator fund managers to monitor operational performance.

- Monitoring operational risk may be a function that state agencies view as needed to protect their interest. Ample resources for this exist in the industry and can be engaged by the agencies.

Other Considerations for the Future

In thinking about the investments state agencies will fund through ARRA and exchange programs, we also considered that states may see a need to sell or refinance these investments in the future. Certainly, proceeds from sale could provide new funds for the construction of additional affordable housing. With that possibility in mind, we suggest agencies consider that how states structure programs today will have a bearing on the salability of these assets in the future.

AHIC members share with you the mission of building affordable housing for America's low income residents. It is our hope that, as you implement the new powers granted to state agencies, our experience in this field can be a resource for the success of your programs. We would be pleased to help in any way.

Sincerely,

Patrick J. Nash

Patrick J. Nash
President
Affordable Housing Investors Council

cc: Susan J. Dewey
Garth B. Rieman