

MICHIGAN STATE HOUSING DEVELOPMENT AUTHORITY

RECOVERY ACT PROGRAM REVISIONS AND UPDATES

Background: Throughout its implementation of various provisions of the American Recovery and Reinvestment Act (ARRA), the Authority has recognized the difficult environment for affordable multifamily housing development and the need to be flexible and transparent in the ongoing implementation of its programs. The Authority has specifically indicated that it may make program changes and waivers as needed to ensure that the 9% Tax Credit Exchange Program is effectively implemented while continuing to be guided by the principles paid out in the Preliminary Implementation Plan.

As individual projects have been approved by the Authority Board and closings have begun to occur, a variety of issues previously announced in various program statements, question and answer items, and discussions with the industry have merited reconsideration or adjustment. This document is intended to outline several shifts and clarifications of Authority policy that will be incorporated into the 9% Tax Credit Exchange Program for transactions already approved and those that eventually are approved for funding.

This document is not intended to be exhaustive or cover all details of each issue area, so other program documents will be updated as appropriate over the next few weeks in an effort to spell out more nuanced or specific mechanical issues.

Developer Fee Pay-in Schedule: The Authority recognizes that the development community is under immense pressure from the disruption in the affordable multifamily housing production pipeline and that the last two years of dramatically reduced deal flow threatens the industry's ability to sustain hard-won capacity. At the same time, investor and syndicator shifts that tie developer fee pay-in schedules to successful and sustained development operations, while properly aligning developer incentives with good public policy, have exacerbated the pressure on developers.

In an effort to balance the short term need to support the development community with longer term shifts in policy that tie developer fees to sustained development operations, the Authority intends to modify its standard developer fee pay-in standards for 9% Tax Credit Exchange proposals without actual third-party LIHTC equity investment. Pay-in standards for projects with third-party LIHTC equity investment will not change; they will continue to rely on the schedule agreed between the developer and the investor.

The non-deferred developer fee will generally be paid in as follows:

- 25% of the developer fee paid at closing;
- 35% of the developer fee paid upon a) construction completion, b) approval by MSHDA to occupy, and c) submission of the contractor's cost certification;
- 30% of the developer fee paid upon a) attainment of qualified occupancy of 95% of units; b) receipt and approval of the mortgagor's cost certification; and c) evidence that any audit exceptions as determined by the Authority's Finance Division have been satisfied; and

- 10% of the developer fee paid upon the earlier of a) one full Authority-budget year at or above underwritten cash flow projections demonstrated by a certified annual audit (typically meaning that a development has met or exceeded the originally underwritten Debt Coverage Ratio) or b) two consecutive calendar years of cash-flow positive operations (or Operating Deficit Reserve draws at or below proforma levels) demonstrated by certified annual audits.

In all cases, release of developer fee will be contingent upon clearance of any compliance or default issues under the Authority loan documents and/or regulatory agreement(s), determinations that the development's sources and uses are in balance, and that all Authority required escrows and reserves are properly funded.

The Authority does not expect to negotiate individual pay-in schedules that release developer fees faster than noted above, and in certain limited cases with developments that pose special risks it may negotiate longer pay-in schedules. Mechanically, developers should note that in order to meet federal expenditure deadlines associated with ARRA funding, at construction completion the Authority anticipates disbursing the final portions of the non-deferred developer fee into a development specific escrow fund. Any interest earned on this escrow fund will be disbursed with the final developer fee payment.

Calculation of Developer Fees:¹ The Direct Lending Parameters only allow developer fees to be calculated with reference to a project's aggregate basis rather than to total development costs (in both cases less the developer fee itself), and as noted before ARRA funded transactions are subject to these parameters.

This shift in policy was an effort to coordinate several disparate calculations of developer fee allowances within various Authority programs that had evolved over time and to help establish clearer expectations moving forward as the Authority's soft funding has become more widely required to provide for sustainable development proposals. As specific transactions have begun to work through the closing process, the difference in the developer fee calculation across the various Authority programs has become more apparent to program participants causing further discussion.

The Authority recognizes:

- 1) Different approaches to calculate developer fee in the past—under many programs and without particular emphasis on consistency—have made it difficult to establish clear expectations for program participants or the Authority.
- 2) Developer fee calculations should encourage, rather than distract from, structuring economically sustainable properties and using limited subsidy resources efficiently.
- 3) Consistency across programs would, all else equal, improve the process, but a too-quick departure from admittedly unclear past practices could be unnecessarily disruptive.

¹ Unlike most other issues addressed herein that only apply to 9% Tax Credit Exchange Program developments, the temporary change in the calculation of maximum developer fees will also apply to the 9% Equity Support, 4% Equity Support, and Reinvestment and Innovation Programs.

Therefore, for 2009 only, the Authority has determined that the Authority required Operating Assurance Reserve (OAR) will be included in the calculation of the maximum allowable developer fee.² Other reserves and escrows will not be included in the calculation of the developer fee. This revision will not otherwise affect limits that restrict developer fees (such as per project fee limits), nor does the shift exempt a property from other program-specific limits on subsidy or funding amounts that may practically result in limits on the developer fee a given project may be able to support.

The inclusion of the OAR in developer fee calculations will apply to developments that have received or will receive funding allocations under the 2009 ARRA programs. This includes 2009 ARRA fund allocations awarded in 2010. Additionally, industry participants should be aware that the Authority intends to continue to evaluate and may adjust its developer fee policies moving forward. The temporary change in policy is intended only to minimize disruptive changes and better align with the industry's previous understanding of these programs.

Asset Management Fees: As previously noted, ARRA specifically requires the Authority to “perform asset management functions to ensure compliance with section 42 ... and the long-term viability of buildings funded by {the TCAP/Section 1602 Programs}.” The Authority has also noted that these expectations exceed standard compliance monitoring and require functions beyond those traditionally fulfilled by the Office of Asset Management. The Recovery Act specifically recognized that these additional responsibilities should be borne by property-level fees.

These shifts in federal policy, however, exposed other less obvious challenges for the affordable housing industry as a whole. For most syndicators and investors the cost of asset management was a loss leader supporting new originations; while new deal flow was strong, fund- and organization-level revenues obscured the actual cost of asset management.

Additionally, as previously expressed in various other forums, the cost of asset management on an ongoing basis is primarily a property-level cost rather than a per-unit cost structure. Like with other largely fixed-cost features of a development's operating budget (such as the cost of annual audits), this dynamic creates a disadvantage for smaller projects.

Simultaneously shifting asset management costs to the property and recognizing the true costs of this oversight has proven challenging, and this has been particularly of concern for sponsors of small properties.

As a result, the Authority has determined that it will support asset management costs imposed by the Recovery Act. In an effort to advance its mission of supporting affordable housing production, the Authority's asset management fees were initially set below its actual cost of overseeing these projects. In a further attempt to support the projects least able to spread these

² The Authority requires an OAR equal to four months of underwritten operating expenses, debt service, and reserve deposits. To the degree a project's investor requires a larger reserve—six months of operating expenses, debt service, and reserve deposits, for example—only the MSHDA required OAR will be included in the developer fee calculation.

costs over larger numbers of units, the Authority has now determined that ongoing asset management fees will follow a revised schedule as follows:

Development Size	9% Equity Support	9% Tax Credit Exchange/ Reinvestment Program³
Less than 50 units	\$2,500	\$5,000
50+ units	\$5,000	\$10,000

No change in the initial asset management fee is contemplated at this time, but program applicants should continue to be aware that, due to HUD requirements, TCAP funded projects must pay both initial and ongoing asset management fees with funds other than the TCAP award. On Section 1602 funded transactions, there are no “good cost/bad cost” distinctions, so Section 1602 funds can be used to pay the initial Asset Management fee.

Limited Dividend Calculations and Ownership of Development Reserves: As noted in the Preliminary Implementation Plan, one of the overarching goals of the Authority’s deployment of Recovery Act resources is to “improve the quality, sustainability, and long term impact of projects developed with ARRA resources. These one-time funds create a special opportunity to structure transactions that can weather the difficult economic headwinds currently facing Michigan and, in better times, will provide housing which is at once more affordable and of higher quality than the standing LIHTC program has traditionally produced.”

In the face of a growing recognition within the affordable housing industry that projects have been underwritten too narrowly and as a result were not adequately reserved against unexpected operating challenges or sustained periods of economic distress, the Authority has deliberately programmed higher reserves and more conservative underwriting. These additional costs to the project are largely if not entirely funded by the investment of public funds which the Authority is providing for the express purpose either a) to sustain a project through difficult times within the compliance period or more optimistically b) to provide an additional longer term benefit to the developments receiving ARRA funding.

In response to additional feedback, the Authority has eliminated the sustainability reserve requirement and intends to make several changes that should further clarify the intent of adequate reserve funding and the mechanics by which these reserves will operate.

Conceptually, reserves within 9% Tax Credit Exchange Projects can be seen as either a) “standard” reserves intended to sustain a project through its 15 year tax credit compliance period or b) “non-standard” reserves intended to protect against extraordinary challenges or to extend the life of a development into the extended use period. In that way, reserves are intended to either be available to the developer in the case of successful performance (the “standard” reserves) or to benefit the project further into the future (in the case of the “non-standard” reserves).

³ 9% Tax Credit Exchange and Reinvestment Program applicants that participate in the Authority’s Direct Lending Programs will continue to be exempt from annual asset management fees for as long as the Authority’s direct loan is outstanding.

To clarify the Authority's intent, upon disposition of 9% Tax Credit Exchange projects, whether immediately upon completion of the 15 year initial compliance period or during the extended use period, reserves will be treated as either belonging to the developer/owner or belonging to the project itself respectively. (Note that any "Operating Reserve Cash" balances in excess of allowable limited dividends will still, by function of the LDHA structure, not be available for distribution to the developer/owner; further discussion of these limits on return will follow below.)

The two levels will be treated differently by MSHDA:

- 1) "Standard" year 15 reserves may be withdrawn by the owner once the deal completes year 15, barring foreclosure, recapture, or similar sanction on the owner. Withdrawals need not happen as part of a sale or preservation transaction—they can be a simple withdrawal of funds. The Operating Assurance Reserve and the portion of the Operating Deficit Reserve intended to cover the first 15 years of development operations will be treated as "standard" reserves.
- 2) "Non-standard" post-year 15 reserves (including the portion of the Operating Deficit Reserve intended to provide for development needs beyond the 15th year and the Replacement Reserve) must stay with the project to ensure ongoing sustainability. MSHDA cannot redirect them away from the project, nor can an owner withdraw them as a distribution. This principle recognizes that the Post-Year 15 reserves were in large majority, if not entirely, created at MSHDA's discretion using public resources. Post Year-15 reserves may be accessed via a preservation transaction at any point during the project's extended use period but must stay with the property via capital improvements or reserves under the same restrictions.

At the same time, in lieu of a limited dividend defined as a percentage of annual cash flow, the Authority will include Section 1602 funds within the definition of "equity" and allow a return on equity of up to 12% per annum. The return will be fully cumulative.

However, the Authority will require that during the initial compliance period 50% of annual surplus cash available for distribution be deposited to the Operating Assurance Reserve. This will help ensure that projects funded under the 9% Tax Credit Exchange Program are protected against unexpected challenges and can continue to thrive throughout the 15 year initial compliance period. As noted above, subject to the Authority's existing OAR policies any unused balance in the OAR can be released toward accumulated limited dividends upon completion of the 15 year compliance period.

Authority staff is continuing to work through the modifications to the program documents necessary to reflect these principles, so further clarification on the mechanics, specific reserve names and classifications, and the like should be expected over the next several weeks.