Report of NCSHA's Working Group on Housing Credit Allocation and Underwriting Recommended Practices

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Executive Summary

The National Council of State Housing Agencies' (NCSHA) state housing agency members administer the Low Income Housing Tax Credit (Housing Credit) program in every state, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The Housing Credit is one of the most successful and longest-lived federal affordable rental housing production programs ever, responsible for the creation of 1.5 million apartments for America's low-income families since Congress enacted it in 1986. The Housing Credit produces high quality, well-designed, financially sound housing where it is most needed for low-income families, including the elderly and persons with special needs.

Key to the Housing Credit's success is strong and dynamic state administration. NCSHA's recommended practices in Housing Credit administration, developed over the life of the program by the state administrators themselves, have allowed states to achieve program excellence while maintaining the flexibility they need to best meet their unique and diverse affordable housing needs.

NCSHA and its member Housing Credit administrators last considered recommended practices in Housing Credit allocation and underwriting in 1998. Since then, the Housing Credit program has experienced significant change, including a 40 percent increase in annual state Credit authority and other changes in law and regulation. In addition, states have made advances in program administration and have, with each passing year, learned more about the long-term performance of Credit properties and the financial and physical challenges they confront over time.

To ensure NCSHA's recommended practices were still appropriate to today's Housing Credit program, the NCSHA Board of Directors in December 2002 approved the establishment of a state housing agency executive director Working Group to consider them. The Board asked the Working Group to review the practices and determine which, if any, needed refinement and what new practices, if any, were necessary.

This report is the product of the Working Group's effort. That effort was informed by all state Housing Credit Allocating Agencies and representatives of all sectors of the Housing Credit industry.

Background on Working Group's Effort

The Working Group consisted of 15 executive directors of state Housing Credit Allocating Agencies. Their agencies, representing large and small states from all regions of the country with a broad range of affordable housing needs and challenges, allocate half of all Housing Credits each year. A list of Working Group members is included at Appendix A.

The Working Group began its work in February 2003 by surveying all state Allocating Agencies and representatives of all sectors of the Housing Credit industry about the need to refine or expand the recommended practices. A list of industry representatives surveyed is included at Appendix B.

The Working Group met for the first time at NCSHA's May 2003 Spring Workshops to discuss the results of the survey and possible changes they suggested in the recommended practices. Members of the Working Group and NCSHA staff agreed to investigate further a number of questions the survey results raised to inform the Working Group's future deliberations.

The group convened again by conference call in August 2003 following NCSHA's 2003 Housing Credit Conference, where Housing Credit administrators from 49 states engaged in extensive discussion of the existing recommended practices with NCSHA staff, who used the information acquired there to inform further the Working Group's effort.

Following the August 2003 conference call, the Working Group produced a set of proposed practices for review and comment, which NCSHA sent in September 2003 to all Allocating Agencies and to those industry participants that responded to NCSHA's initial survey. In October 2003, the Working Group met in connection with NCSHA's Annual Conference to consider comments it received on the proposed practices. Thereafter, the Working Group finalized the recommendations, incorporating them in this report.

Background on Recommended Practices

Congress has delegated responsibility for administering the Housing Credit to the states, recognizing that each state is better able than the federal government to address the low-income housing needs unique to its citizens. This delegation of authority to the states to administer a major federal tax program is unique and unprecedented. In making it, Congress recognized the value of decentralized decision making concerning each state's low-income housing needs, but also imposed a uniform set of procedures each state must follow in determining the developments to which they allocate Housing Credits.

In the Housing Credit, Congress created a system for producing low-income apartments that relies significantly for its success on the market discipline of private sector developers, syndicators, lenders, and investors in those developments. Congress designed the system to provide adequate incentives to the private sector to achieve the objectives Congress intended and heavy tax penalties if it does not.

Congress made the states responsible for allocating all Housing Credits and underwriting all applications for them. The states take those responsibilities very seriously. Particularly in this era of more limited federal support for housing assistance and greater corporate accountability in general, states must strive to assure, to the extent they reasonably can, that housing financed with the Housing Credit remains quality affordable rental property for the full period it is set aside for low-income use. All states share an imperative to assure that housing financed by the Credit is prudently underwritten, in order to provide reasonable assurance, at the time such apartments are financed, that they can weather the stresses foreseeable during the 15 to 30 year period Housing Credit law requires them to be dedicated to low-income use.

To strengthen Housing Credit administration and continue to merit and maintain congressional confidence in it, states have developed through NCSHA recommended practices in Housing Credit allocation and underwriting. These practices—created by states for states—not only help states meet their responsibilities, but also preserve, to the maximum practical extent, the individual state flexibility that is at the heart of the Housing Credit program and its great success.

As Congress expected, during their 17 years of Housing Credit administration, the states have evolved a variety of allocating and underwriting practices appropriate to meet specific state low-income housing needs. At the same time, the states themselves have established recommended practices for each state to consider in its Housing Credit administration. The NCSHA Board of Directors has adopted two principal sets of recommended practices in Housing Credit allocation and underwriting for voluntary adoption by state Allocating Agencies—one in 1993 and one in 1998.

NCSHA developed the 1993 practices to strengthen state Housing Credit administration, demonstrate responsible and proactive state administration to Congress and the Treasury, and preempt through self-governance unworkable federal statutory and regulatory requirements. Congress made the Housing Credit permanent later that year.

The 1993 recommended practices and their implementation by most states were favorably cited numerous times by the General Accounting Office (GAO) in its 1997 report to Congress on the Housing Credit and in the House Ways and Means Oversight Subcommittee consideration of it. The recommended practices gave Congress confidence in state competence and conscientiousness in administering the Housing Credit and played a major part in averting the Ways and Means Committee-proposed sunset threat the Housing Credit faced in 1995-1997.

NCSHA developed the 1998 recommended practices following its successful campaign to defeat Housing Credit sunset. The practices responded to suggestions made by the Ways and Means Oversight Subcommittee in its review of the Credit and the Housing Credit industry. The 1998 recommended practices did not replace the 1993 practices, though some further refined 1993 practices. Most states have incorporated the recommended practices in their Housing Credit qualified allocation plans and underwriting guidelines.

The recommended practices set the minimum standards all states should meet on certain aspects of Housing Credit allocation and underwriting, regardless of other differences among them. They are not intended to suggest agencies reduce higher standards they judge better serve the low-income renters of their states.

The adoption of these standards for allocation and underwriting also does not imply any responsibility on the states to assume a greater monitoring responsibility than Congress and the Internal Revenue Service (IRS) have already required. The Housing Credit allocation and underwriting standards each state pursues, however, must be adequate to assure no development that receives Credits can reasonably be judged, when the Credits are allocated, likely to fail financially, thus potentially imperiling its condition or its devotion to low-income renters during the period the Housing Credit requires it be set aside for their use.

These baseline standards may be replaced by substantially equivalent standards, which individual states may adopt to achieve specific public policy objectives. To be substantially equivalent, an alternative standard needs to be based on sound underlying economics adequate to provide, under the particular circumstances of the state or development, the same long-term viability the standards recommended in this report are intended to help assure. A fundamental touchstone of state allocating and underwriting of the Housing Credit must be that allocating and underwriting standards producing unsound real estate cannot serve valid public policy objectives.

Finally, these recommended practices are intended to encourage sound real estate judgments in every Housing Credit development, regardless of its sponsorship. They do not intrude, however, on the discrete state housing policy objectives Congress left to each state in determining its own housing needs. Thus, for example, these recommended practices do not presume to judge the percentage allocation of Housing Credits between larger and smaller developers or between for profit and nonprofit entities—matters Congress, beyond a 10 percent minimum nonprofit set-aside, left to individual states to decide.

Summary of Working Group's Changes to the Recommended Practices

The Working Group determined NCSHA's recommended practices in Housing Credit allocation and underwriting did not require extensive revision. It found most of the recommendations as relevant and appropriate today as when NCSHA first adopted them.

However, based on its nine-month review of the practices informed by the expertise and experience of all state Allocating Agencies and Housing Credit industry participants, the Working Group made significant modifications to the following six recommended practices: debt coverage; developer fee limits; operating and replacement reserves; operating expenses; market analysis; and qualified allocation plan application to bond deals.

The Working Group determined the recommended minimum debt coverage ratio of 1.10 [1.05 for Rural Housing Service (RHS) developments] should be increased to provide greater assurance Housing Credit properties remain viable for the duration of their affordable use period. The new recommended practice calls for a minimum debt coverage ratio of 1.15 (1.10 for RHS properties) until initial stabilized occupancy. Furthermore, the practice specifies agencies should consider essential underwriting variables such as vacancy rates, ability to raise rents, and historic operating cost escalations customary in the marketplace, in determining debt coverage before and after initial stabilized occupancy.

Acknowledging a practice many states already follow, the Working Group revised the practice on developer fee and builder fee limits to recommend agencies evaluate the amount and duration of deferred developer fees to ensure cash-flow projections support the expectation of deferred fee payment within 15 years of a development's placed-in-service date. Payment within that timeframe is necessary for states to include such fees among those property costs eligible for Housing Credits.

The Working Group established new minimum replacement reserves of $250 per unit per year for new construction developments for seniors and $300 per unit per year for new construction developments for families and rehabilitation developments. This upward adjustment from the $200 per unit per year standard for new construction NCSHA established in 1998 recognizes the need for higher reserves to better position properties to withstand unforeseeable increases in expenses.

The revised operating expense practice calls for agencies to require itemized operating expense and vacancy rate projections, which should be supported by reasonable and credible evidence in the absence of adequate operating cost data. This requirement is designed to enhance the predictive quality of pro forma projections.

The Working Group revised the market analysis practice to conform to new requirements of law. The practice also includes two additional minimum criteria for market studies: capture rate analysis of target populations and a description of the proposed property's effect on the market area, including the impact on existing Housing Credit properties and other affordable rental housing. These criteria are intended to assure adequate demand for the property within the target population and to avoid saturating the market with rent comparable properties.

The new recommended practices call for agencies to underwrite bond-financed properties as rigorously as non bond-financed properties and apply substantially similar standards in evaluating and underwriting both development types. This change is designed to protect the program from Credit allocation to developments that have not undergone the thorough market and financial scrutiny agencies routinely apply to developments awarded Credits through the competitive process.

The Working Group also:

- Revised the minimum rehabilitation threshold practice to suggest agencies only consider "hard" rehabilitation costs in determining whether properties meet threshold requirements;
- Amended the capital needs assessment practice to suggest agencies encourage developers to undertake a Phase I environmental analysis;
- Modified the appraisals in acquisition/rehabilitation properties practice to recommend agencies limit the acquisition price on which Credits are allocated to the lesser of the sale price or the appraised value of the property; and
- Brought the recommended practice on verification of expenditures into conformance with current IRS regulations by requiring CPA cost audits for developments with 11 or more units.

The Working Group eliminated the recommended practice on state discretion in allocating Credit. Congress rendered this practice unnecessary in 2000 when it amended the Housing Credit law to require an Allocating Agency to provide written explanation to the general public for Credit allocations not made in accordance with the agency's established priorities and selection criteria.

The Working Group added a new recommended practice on Allocating Agency staff training. This practice acknowledges agencies' duty to ensure the thoroughness of their Housing Credit program staffs' knowledge of multifamily housing development and finance and the Housing Credit program.

The Working Group considered but decided not to establish recommended practices for dealing with properties reaching the end of their initial 15-year compliance period. The Working Group believes more state experience in this area is necessary to inform consideration of recommended practices. It suggests NCSHA revisit this issue in 2004.

NCSHA Recommended Practices in Housing Credit Allocation and Underwriting

1. Per Unit Cost Limits

Recommendation

In addition to carefully rationing the amount of Housing Credit allocated to eligible developments, as federal law requires, each Allocating Agency should develop a per unit cost limit standard. That standard should be based on total development costs, including costs not eligible for Housing Credit financing. The standard and the justification for it should be published in the Allocating Agency's qualified allocation plan or other Housing Credit allocation guidelines.

In developing its per unit cost standard, the Allocating Agency should thoroughly examine building construction and land costs in its state, including variations in such costs within the state. It should also examine certified cost data on existing Housing Credit developments and compare that data against the actual costs of other non-luxury multifamily housing located in the same geographic areas.

This process will produce a standard that either prescribes a single limit applicable to the entire state or limits for different areas that reflect differences in development costs. In many areas, the standard will be within the published dollar limits established for the HUD Section 221(d)(3) mortgage insurance program, including adjustments for multiple bedroom units, high-cost areas, and inflation that has occurred subsequent to the last adjustment of the limits.

In some areas of the country, the Section 221(d)(3) limits may not reflect the local market, because the Section 221(d)(3) program caps costs in certain high cost areas and does not reflect actual costs, which may be substantially higher. In other cases, actual development costs may be considerably lower than the 221(d)(3) limits allow. Where an Allocating Agency's process produces a standard above the 221(d)(3) limits in any geographic area of a state, all factors that contributed to the establishment of that standard, such as exceptionally high land costs, material costs, or special wage rates, should be disclosed and fully explained in the justification of the standard.

If an Allocating Agency receives an application for the award of Housing Credits to a development with per unit cost in excess of its established limit for the area in which the development is located, the agency should subject the development to a further level of scrutiny and review. Credits should be awarded to such developments only if that review reveals the additional costs are justifiable and reasonable under the circumstances; attributable to unique development characteristics (e.g., location in a difficult-to-develop area, limited commercial space, or tenant services or common areas essential to the character of the development) consistent with the housing needs and priorities identified in the agency's qualified allocation plan; and either permitted by Congress to be financed by Housing Credits or, if not, financed by other means.

The Allocating Agency should carefully limit and justify the total number of developments with per unit cost in excess of the state's established standard, as well as the total amount of Credit allocated to such developments. The agency should document the justification in each case, in light of the likely public and governmental scrutiny of the cost of such developments.

While encouraging cost efficient production with realistic per unit cost limits for Housing Credit developments, Allocating Agencies should not give preference solely for lowest development costs.

<u>Discussion</u>

In designing the Housing Credit program, Congress gave states the flexibility to respond to their unique and varied low-income housing needs and the responsibility to maximize the Housing Credit's use in producing significant numbers of low-income housing units. To that end, Congress carefully limited development costs that can be financed by Housing Credits. Congress recognized, however, that the cost of providing low-income housing:

- Is often highest in areas of greatest need, such as inner-city areas where development is frequently most expensive and difficult;

- May involve construction of facilities to support special services to low-income tenants;

- May sometimes reflect higher wage rates than other developments due to state or federal law; and

- In developments that include Housing Credit units, might also include market rate units not financed by the Credit.

Consequently, Congress did not limit either the total amount of Housing Credits that can be allocated to a single development or the total cost of any development, including costs ineligible to be financed by the Housing Credit that are financed by other sources.

Moreover, Congress required the states, in administering the Housing Credit, to give priority to developments that serve the lowest-income tenants and those that serve low-income tenants for the longest time, without regard to the higher amounts of Housing Credits that might be required to finance developments meeting these objectives. The cost of producing low-income housing, particularly special needs housing and housing located in difficult-to-develop areas, requires states to balance financing the maximum possible number of units that might be produced, if high-cost areas and developments were avoided, and serving areas and tenants of greatest need.

NCSHA recognizes preservation of the Housing Credit program depends on continued congressional and public support, and such support will be imperiled by developments, however meritorious, the cost of which exceeds an accepted standard of reasonableness. While higher costs will be justified in some developments where special tenant needs are served, there must be a standard against which even those costs are judged. At the same time, in minimizing costs, Allocating Agencies must be certain to adhere to sound underwriting practices, including assuring quality construction, if they are to achieve long-term property viability.

2. Developer Fee and Builder Fee Limits

Recommendation

Each Allocating Agency should include in its qualified allocation plan or other Housing Credit allocation guidelines a general developer fee limit, including overhead. The limit should not exceed 15 percent of total development cost, except for developments meeting specified criteria based upon the following factors:

- Development size - The smaller the development size, the higher the fee may be as a percentage of development costs.

- Development characteristics - Higher developer fees may be allowed as an incentive to produce hard-to-develop or socially desirable developments, such as homeless housing, single-room occupancy housing, and scattered-site developments.

- Development location - Higher developer fees may be allowed for developments produced in difficult-to-develop areas.

Allocating Agencies should encourage lower developer fees for the acquisition portion of acquisition/rehabilitation developments.

Allocating Agencies should evaluate the amount and duration of any developer fee deferral when underwriting a development and determining its Housing Credit allocation amount. Agencies should ensure a development's cash flow projections support the reasonable expectation that deferred fees can be paid within 15 years of the development's placed-in-service date.

To the extent Allocating Agencies incentivize lower fees in establishing realistic developer fee limits for Housing Credit developments, they should take special care to assure developments' long-term financial feasibility.

In addition to establishing developer fee limits, Allocating Agencies should include in their qualified allocation plan or other Housing Credit allocation guidelines limits on builder or general contractor charges. Generally, the standards set forth below should not be exceeded except for developments with characteristics, such as small size or location in difficult development areas, that may justify higher fees:

- Builder's profit - 6 percent of construction costs;

- Builder's overhead - 2 percent of construction costs; and

- General requirements - 6 percent of construction costs.

Allocating Agencies should require in their Housing Credit applications that developers identify the existence of an identity of interest with any other party to the development. Agencies should take such identity of interest into consideration in determining maximum fees.

<u>Discussion</u>

Developers typically earn a fee for their work in developing multifamily housing. In market rate developments, the developer also can expect some cash flow from the operation of the property—particularly over time as rents increase faster than operating expenses. Because Housing Credit property rents are restricted, significant operating cash flow in excess of debt service is generally not expected, generally limiting the developer's compensation for developing the housing to the developer fee.

A developer fee is an accepted cost of producing affordable housing under the Housing Credit and most other subsidized housing programs. The Housing Credit statute does not limit developer fees. However, it requires Allocating Agencies to limit Credit allocations to amounts necessary to assure the financial feasibility and viability of developments as qualified low-income housing throughout the Credit period. As part of this evaluation, agencies must consider the reasonableness of development and operating costs of the project, which include developer fees.

NCSHA first adopted a recommended developer fee practice in 1993, when there was little uniformity among Allocating Agencies in the definition of developer fee, agency procedures for establishing such fees, or application of the fees in underwriting Housing Credit developments. In the past decade, most agencies have incorporated developer fee limits into their Housing Credit underwriting guidelines.

Agencies should endeavor to set fees commensurate with the levels of work performed. For example, in acquisition/rehabilitation developments, lower fees for land acquisition services may be warranted depending on the difficulty of the transaction.

In applying developer fee limits, Allocating Agencies may reward lower developer fees. However, agencies should not reward sponsors with the lowest fees because unrealistically low fees provide less cushion against construction and lease-up risk and other unforeseen expenses.

Allocating Agencies may allow deferred payment of developer fees. However, the development's cash flow projections must support a reasonable expectation that the deferred fees can be paid within 15 years of the property's placed-in-service date if the developer fees are to be included in the property's eligible basis.

3. Consultant Fee Limits

Recommendation

Each Allocating Agency should adopt and apply a definition of consultant fees that:

- Identifies those professional fees (such as architectural, engineering, accounting, legal, environmental consulting, and construction management) reimbursable through the Housing Credit;
- Excludes costs properly allocated to and payable by the syndicator (such as SEC registration and sales commissions); and
- Requires consultant fees, other than the types of professional fees discussed above, be permitted only within the developer fee limit.

No distinctions between for-profit and nonprofit developers should be drawn for the purpose of determining the appropriate level of consultant fees.

Discussion

Work performed by consultants is often indistinguishable from that performed by developers. Particularly in the early years of the Housing Credit program, developers employed consultants to help them understand the requirements of the new program.

In 1993, NCSHA recommended developer fee limits to address in aggregate the work and risk involved in Housing Credit transactions. At that time, NCSHA recommended inclusion of consultant fees within developer fees, a practice most states have adopted.

4. Verification of Expenditures

Recommendation

Each Allocating Agency should establish a process for requiring and analyzing cost certifications for all developments as part of the final feasibility evaluation, prior to issuing an IRS Form 8609. As part of the analysis, the agency should judge the reasonableness of the cost components.

For developments of 11 or more units, the agency must require the sponsor to submit for the agency's review an independent third-party Certified Public Accountant (CPA) audit report as a part of the final feasibility evaluation.

Each Allocating Agency should establish a process for receiving and analyzing copies of federal cost certifications for RHS and FHA developments receiving Housing Credits.

Agencies should adopt the standardized 10 Percent Test and final audit reports developed by NCSHA.

Discussion

The Housing Credit law requires Allocating Agencies to limit Credit allocations to the amount necessary for financial feasibility and viability as a qualified low-income housing development throughout the Credit period. As part of their analysis, agencies must evaluate all sources and uses of funds and the reasonableness of development and operating costs. Agencies typically verify expenditures by requiring developers to submit a detailed cost certification.

NCSHA first adopted a recommended verification of expenditures practice in 1993, when little uniformity existed among Allocating Agencies in analyzing costs in Housing Credit developments. In the past decade, most agencies have incorporated a cost certification standard into their underwriting guidelines.

In January 2000, the IRS issued regulations requiring independent verification of sources and uses of funds in the form of a CPA audit report, based on an accountant's audit or examination of financial documents and certifications the development owner provides. IRS regulations exempt developments with 10 or fewer units from the requirement to obtain a CPA audit report.

Allocating Agencies require Housing Credit development owners to certify development costs for purposes of meeting the 10 Percent Test for a carryover allocation and again once the development is complete on a final cost certification. In 2000, to support the new IRS requirements, NCSHA developed standardized 10 Percent Test and final audit reports for agencies' use to create efficiency for and common understanding among developers and other Housing Credit industry professionals. NCSHA updates these reports as necessary to comply with changes in accounting practices.

While the practice recommends Allocating Agencies evaluate federal cost certifications for RHS and FHA developments receiving Housing Credits, agencies should note that certifiable RHS and FHA costs and fee limits may differ from those agencies permit under the Housing Credit program.

5. Operating and Replacement Reserves

Recommendation

Allocating Agencies should establish operating and replacement reserve standards that consider development location, site (single or scattered), construction type, population served, projected vacancies, duration of reserves, design features, and security.

- Minimum operating reserves should equal four to six months of projected operating expenses plus: i) debt service payments; and ii) annual replacement reserve payments.

- Minimum replacement reserves should equal $250 per unit per year for new construction developments for seniors and $300 per unit per year for new construction developments for families and developments involving rehabilitation. Exceptions may be made for certain developments intended for special needs populations that may suffer less wear and tear than other properties, and for rehabilitation developments in which a current capital needs assessment supports some other reserve level. In general, replacement reserve levels for all developments involving rehabilitation should be consistent with reserve levels suggested by a capital needs assessment. In projecting replacement reserve standards, agencies should take into account a realistic rate of inflation foreseeable at the time of underwriting.

In lieu of operating reserves, Allocating Agencies may accept developer guarantees, taking into account the developer's demonstrated financial capacity and liquidity, its track record, and other guarantees it has outstanding.

Discussion

Adequately funded operating and replacement reserves are essential to a rental development's long-term financial and physical viability. Operating reserves must be adequate to cover short-term operating income shortfalls. Replacement reserves must be sufficient to cover foreseeable capital expenditures.

Adequate reserves are particularly important in Housing Credit developments, because rents are restricted and may not keep pace with operating, maintenance, and replacement costs. Unexpected increases in utility costs, property taxes, and insurance rates in recent years underscore the need for reserves adequate to cover unforeseen expenses.

In evaluating the appropriateness of operating reserves, Allocating Agencies should assess what entity would be retaining the reserve accounts, whether reserve accounts could be reduced over time after achieving project benchmarks, and how such reserves would be funded.

6. Debt Coverage

Recommendation

Allocating Agencies should require a minimum debt service coverage ratio of 1.15 (1.10 in RHS properties) until initial stabilized occupancy for Housing Credit development debt financing that would foreseeably result in foreclosure if not repaid. For purposes of this standard, debt service coverage is defined as the ratio of a development's net operating income (rental income less operating expenses and reserve payments) to forecloseable, currently amortizing debt service obligations. In determining appropriate debt coverage up to and beyond the point of initial stabilized occupancy, agencies should consider other underwriting variables, such as vacancy rates, ability to raise rents, and historic operating cost escalations customary in the marketplace, to improve the development's ability to maintain viability for its period of low-income use.

Allocating Agencies should not reward developments with the lowest possible debt service coverage. Instead, agencies should ensure that rental income, any subsidies, and reserve funds are sufficient to cover the development's debt and operating expenses over the period of low-income use. Any alternative underwriting system should produce an equivalent outcome.

Discussion

Adequate debt coverage is essential to the long-term financial viability of Housing Credit developments. Excessive debt coverage ratios and property cash flows, however, subject the Housing Credit program to criticism that developers are becoming unduly enriched, rents are unnecessarily high, and lower income residents are not being served.

Allocating Agencies should require debt service coverage adequate to protect the financial viability of Housing Credit developments for the entire period they are set aside for low-income use, including periods of foreseeable economic downturn. Agencies should also take care to assure the Credits awarded are no greater than necessary to fill any actual financing gap and, for tax-exempt bond developments, do not result in minimizing the mortgage in an effort to provide implicit credit enhancement to the bonds. Except in RHS developments, where the RHS standard is 1.10, agencies should require minimum debt coverage of 1.15.

Allocating Agencies should not consider debt service coverage in a vacuum. Prudent underwriting requires agencies to consider several variables, including projected vacancy rates (which may require upward adjustment for small properties) and operating cost data, in conjunction with debt service coverage, in judging the long-term financial viability of properties.

7. Operating Expenses

Recommendation

Allocating Agencies should require realistic itemized operating expense and vacancy rate projections. In consultation with development sponsors, owners, property managers, syndicators, lenders, and investors, agencies should establish and maintain operating cost databases based on historic and current Housing Credit property experience and use them in their Housing Credit property underwriting. At minimum, the following operating expenses should be included in an agency's operating cost database:

- Management fees
- Administrative expenses
- Utilities
- Maintenance expenses
- Real estate taxes
- Property insurance
- Other operating expenses

In the absence of adequate operating cost data, an agency should require reasonable and credible evidence of the supportability of operating expense and vacancy rate projections.

Discussion

Housing Credit law requires Allocating Agencies to assess the reasonableness of all development and operating costs in evaluating the financial feasibility of Housing Credit properties. Inaccurate projection of operating expenses at underwriting, for example, by failing to consider historic experience in trending forward expenses compared to income, is a significant cause of financial underperformance of multifamily rental properties.

Comparing a property's projected operating costs against actual expenses of comparable properties is an effective way for Allocating Agencies to judge the adequacy of the property's operating budget. Establishing and maintaining a database of actual operating costs of Housing Credit developments is a useful way for agencies to access and analyze comparative property operating cost data.

8. Market Analysis

Recommendation

Allocating Agencies must obtain for each Housing Credit development a comprehensive market study of the housing needs of low-income individuals in the area to be served by the development before making an allocation of Credit. The study must be prepared by a party unaffiliated with the developer and approved by the Allocating Agency. The market study provider should have experience with multifamily rental housing.

Allocating Agencies should review each study to determine its implications for the financial viability of the property and whether it justifies the need for the number, size, and type (such as family, elderly, or other special needs housing) of rental housing proposed.

Allocating Agencies should specify in their qualified allocation plans or other Housing Credit allocation guidelines the time at which the market study must be provided to the agency (i.e., at Credit application or reservation) and the components and analysis required in the study. At a minimum, the market study should include:

- A statement of the competence of the market study provider;
- A description of the proposed site;
- Demographic analysis of the number of households in the market area that are income eligible and can afford to pay the rent;
- Geographic definition and analysis of the market area;
- Analysis of household sizes and types in the market area;
- A description of comparable developments in the market area, including any rental concessions these developments presently offer;
- A description of rent levels and vacancy rates of comparable properties in the market area;
- Analysis of practically available operating expenses and turnover rates of comparable properties in the market area;
- Projected operating funds and expenses, when available at the time of the study;
- Expected market absorption of the proposed rental housing, including capture rate analysis of target populations; and
- A description of the effect on the market area, including the impact on Housing Credit and other existing affordable rental housing.

Discussion

A market study is an indispensable tool for helping an Allocating Agency determine whether a particular development is appropriate in a particular market area. However, the usefulness of the market study depends on many variables, including the factors it considers, its adherence to generally accepted methodologies and techniques, and the independence of its provider.

Housing Credit law requires a comprehensive market study of the housing needs of low-income individuals in the area to be served by the Housing Credit property. The study must be conducted before the Credit allocation is made at the developer’s expense by a disinterested party approved by the Allocating Agency.

The Recommended Practice is consistent with the Housing Credit statutory requirement and exceeds it by specifying minimal market study components. Though it leaves the timing of the market study submission to be determined by the Allocating Agency, it makes clear the submission must precede Credit allocation.

9. Development and Management Experience

Recommendation

In allocating Housing Credits, Allocating Agencies should consider the capabilities and track record of the entire development team. They should take into account the team's record, financial capacity, and relevant experience in multifamily housing finance, development, management, and resident services. To the extent practical, agencies should develop and adopt a standardized prior participation form for use by Housing Credit applicants and development team members.

Discussion

The complexity of the Housing Credit program and multifamily housing development generally requires developers to possess a minimum level of development experience and financial strength. However, Allocating Agencies may deem broader access to the Housing Credit—a public resource—by new, less experienced developers a worthy public policy goal.

Evaluating the entire development team assures adequate development capacity without creating insurmountable barriers to program newcomers. It encourages partnering and joint ventures that often strengthen Housing Credit applicants.

To assist Allocating Agencies in evaluating development team experience, NCSHA is developing a standardized prior participation form for their use.

10. Minimum Rehabilitation Threshold

Recommendation

Allocating Agencies should establish a minimum rehabilitation threshold to assure meaningful, rather than simply cosmetic, rehabilitation of properties. Rehabilitation should be adequate to ensure the long-term physical viability of the property and supported by a capital needs assessment. Allocating Agencies should only consider “hard” rehabilitation costs in determining whether a property meets the minimum rehabilitation threshold.

The minimum rehabilitation threshold, and any exceptions to it, should be included in the qualified allocation plan or other Housing Credit allocation guidelines. Exceptions may be especially appropriate when the Credit is allocated in connection with state or federally assisted preservation efforts.

Discussion

In 1986, Congress established a minimum rehabilitation threshold of $2,000 per unit for a property to qualify for Housing Credits. Congress increased this amount in 1989 to the greater of $3,000 per unit or 10 percent of the building’s adjusted basis. Congress has not adjusted the threshold since, despite more than a decade of construction cost inflation. In many areas and for many properties today, the statutory minimum is insufficient to accomplish more than cosmetic improvements.

While limited rehabilitation may make a property temporarily more attractive, it often will not sustain the property's viability over a 15 to 30 or more year compliance period. An unrealistically low rehabilitation minimum also encourages ownership transfers by allowing use of the Credit for rehabilitating properties that simply need to address deferred maintenance.

11. Capital Needs Assessment

Recommendation

Allocating Agencies should require any award of Housing Credits for rehabilitation to be preceded by and take into account a capital needs assessment by a competent third party, such as a licensed architect or engineer. Alternatively, the Allocating Agency may perform the assessment if it has qualified construction analysts on staff. Such staff assessments may be particularly appropriate to avoid duplication of effort or when no other capable provider is available.

The assessment should include a site visit and physical inspection of the interior and exterior of units and structures, as well as an interview with available on-site property management and maintenance personnel to inquire about past repairs/improvements, pending repairs, and existing or chronic physical deficiencies. The assessment should consider the presence of environmental hazards, such as asbestos, lead paint, and mold, on the site. Alternatively, the Allocating Agency should encourage the developer to undertake a Phase I environmental study.

The assessment should include an opinion as to the proposed budget for recommended improvements and should identify critical building systems or components that have reached or exceeded their expected useful lives. The assessment should also include a projection of recurring probable expenditures for significant systems and components impacting use and tenancy, which are not considered operation or maintenance expenses, to determine the appropriate replacement reserve deposits on a per unit per year basis. The assessment should examine and analyze the following:

- Site, including topography, drainage, pavement, curbing, sidewalks, parking, landscaping, amenities, water, sewer, storm drainage, and gas and electric utilities and lines;
- Structural systems, both substructure and superstructure, including exterior walls and balconies, exterior doors and windows, roofing system, and drainage;
- Interiors, including unit and common area finishes (carpeting, tile, plaster walls, paint condition, etc.), unit kitchen finishes, cabinets and appliances, unit bathroom finishes and fixtures, and common area lobbies and corridors; and
- Mechanical systems, including plumbing and domestic hot water, HVAC, electrical, lighting fixtures, fire protection, and elevators.

Issues identified by the capital needs assessment should be addressed in the rehabilitation proposal and considered by the Allocating Agency in establishing operating and replacement reserve requirements.

Discussion

Housing Credit properties must provide a minimum of 15 years, and often 30 years or more, of affordable housing use. In rehabilitating properties, developers may encounter unforeseen issues that may delay, make more costly, or even halt rehabilitation.

To minimize the risk of unforeseen issues and to help ensure rehabilitation adequate to a property's needs, Allocating Agencies should require all allocations of Housing Credits for rehabilitation to be preceded by a capital needs assessment of the property by a competent party. A capital needs assessment is a qualified professional's opinion of a property's current physical condition. It identifies deferred maintenance, physical needs and deficiencies, and material building code violations that affect the property's use, structural and mechanical integrity, and future physical and financial needs.

12. Extended Use Agreements

Recommendation

Allocating Agencies should require extended low-income housing commitments to:

- Specify whether a development was allocated Credit under the nonprofit set-aside, to make clear that the current owner (and any new owner) during the compliance period must continue to qualify under that set-aside;

- Identify all requirements imposed on the development material to the award of Credit—including, for example, income restrictions, rent skewing, affordability period, reserve levels, amenities and services, and accessibility; and

- Require all mortgage liens on the property be subordinate to the low-income use restrictions, except in the event of foreclosure.

Discussion

Since Housing Credit developments often take as much as two years to complete, sponsors sometimes change a development's characteristics before its placement in service to respond to market or other changes. Sponsors also sometimes alter development characteristics after the placed-in-service date.

To assure the Allocating Agency's qualified allocation plan requirements and the conditions of its Housing Credit award are met, the agency should record in an extended use agreement any development characteristic that materially affected its allocation of Credit, so the agency has a means of enforcing it on the sponsor. Allocating Agencies should also require that all mortgage liens on a property be subordinate to the extended use agreement to ensure provisions of the agreement apply throughout the extended use period. This practice will ensure a property's extended use agreement complies with the statutory requirement that it be enforceable on all parties, including the lender, except in the event of foreclosure.

13. QAP Application to Bond Deals

Recommendation

Allocating Agencies' qualified allocation plans or other Housing Credit allocation guidelines should specify that agencies will evaluate and underwrite bond-financed Housing Credit properties as they do non bond-financed Housing Credit properties, considering, for example:

- The sources and uses of funds;
- The equity to be generated by the Credit;
- The reasonableness of the developmental and operational costs; and
- The housing needs of low-income individuals the development proposes to serve, as demonstrated by a market study.

In evaluating and underwriting bond-financed properties, Allocating Agencies should apply standards substantially similar to those they apply to non bond-financed developments and disclose those standards in their qualified allocation plans or other Housing Credit allocation guidelines. In the absence of an express exemption or variation, all evaluation and underwriting requirements applicable to non bond-financed properties should be applicable to bond-financed properties.

Discussion

The Housing Credit statute requires tax-exempt bond-financed developments to satisfy the Allocating Agency's qualified allocation plan. However, the statute entrusts the authority to evaluate tax-exempt bond-financed Housing Credit developments to the bond issuer, even if the issuer is not the Allocating Agency. Some bond issuers have little or no experience with multifamily housing development or the Housing Credit program.

This practice is designed to ensure that Allocating Agencies evaluate and underwrite bond-financed properties as rigorously as non bond-financed properties and apply substantially similar standards in evaluating and underwriting both development types. Allocating Agencies should publish in their qualified allocation plans or other Housing Credit allocation guidelines evaluation and underwriting standards applicable to bond-financed developments and assure the developments satisfy these standards.

14. Application Procedures

Recommendation

Allocating Agencies should endeavor, to the extent useful and practical, to streamline the application process for Housing Credit developments involving multiple subsidies by taking into account other sources of funding subject to different application and allocation schedules.

Discussion

Many Housing Credit developments, particularly those targeted to very low-income tenants, are financed with multiple federal, state, and local subsidies. Often these subsidies are administered by one or more agencies that the Allocating Agency does not control and in cycles other than those applicable to the Housing Credit.

The Allocating Agency should, to the extent practical, consider what it can do in its own program funding cycles to accommodate the timing of other funding sources. These efforts may include consolidating funding cycles for Housing Credits with HOME, CDBG, state trust funds, or other subsidies administered by the Allocating Agency, and coordinating Housing Credit funding cycles with those of other funding sources not controlled by the Allocating Agency.

15. Appraisals in Acquisition/Rehabilitation Properties

Recommendation

For acquisition/rehabilitation properties, states should limit the acquisition price on which Housing Credits are allocated to the lesser of the sale price or appraised value of the property.

Discussion

The Housing Credit law allows a four percent Credit for the acquisition cost of an existing property. To qualify for this Credit, the development sponsor must also substantially rehabilitate the property.

States have encountered situations in which the acquisition cost of a proposed development exceeds the appraised value of the property. In some cases, the acquisition cost may be inflated solely to increase the amount of acquisition Credit for which the property qualifies. States can prevent this practice by limiting Housing Credits to the lesser of the sale price or appraised value of the property.

16. Consistency Among Allocating Agencies

Recommendation

To the extent practical, Allocating Agencies should develop and adopt standardized administrative procedures and requirements (for example, standardized 10 Percent CPA reports, final CPA audit reports, and compliance reporting forms).

Discussion

The Housing Credit law provides Allocating Agencies broad administrative guidance, but does not specify administrative procedures. The House Committee on Ways and Means Oversight Subcommittee, in its 1997 Housing Credit report, called for standardization of reporting requirements where possible.

The Housing Credit program has benefited from standardization in some areas (for example, NCSHA's standardized CPA reports) and would benefit from further standardization. Consistency in some areas creates efficiency for and common understanding among developers and other Housing Credit professionals working in multiple states. In other areas, uniformity among Allocating Agencies may be impractical or inconsistent with states' need for flexibility to design programs that meet their unique needs and priorities.

17. Agency Staff Training

Recommendation

Allocating Agencies should provide Housing Credit program staff opportunities for continuing education and training.

Discussion

To assure compliance with statutory and regulatory requirements and encourage innovation, Allocating Agencies should provide Housing Credit program staff education and training opportunities to strengthen their multifamily housing development and finance and Housing Credit program knowledge and skills.

Appendix A

Members of NCSHA's Working Group on Housing Credit Allocation and Underwriting Recommended Practices

Alabama Housing Finance Authority	Bob Strickland
California Tax Credit Allocation Committee	Jeanne Peterson
Colorado Housing and Finance Authority	Roy Alexander *
Delaware State Housing Authority	Sandy Johnson
Indiana Housing Finance Authority	Kimberly Wize
Kentucky Housing Corporation	Lynn Luallen
Michigan State Housing Development Authority	Jim Logue
New Mexico Mortgage Finance Authority	Jim Stretz
New York State Division of Housing and Community Renewal	Judy Calogero
North Carolina Housing Finance Agency	Bob Kucab *
Ohio Housing Finance Agency	Dick Everhart
Pennsylvania Housing Finance Agency	William Bostic
Rhode Island Housing and Mortgage Finance Corporation	Richard Godfrey
Texas Department of Housing and Community Affairs	Edwina Carrington
Washington State Housing Finance Commission	Kim Herman

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Appendix B

Industry Participants

Affordable Housing Investors Council
Affordable Housing Tax Credit Coalition
Boston Capital Corporation
The Enterprise Foundation
Ernst & Young
Fannie Mae
Hawkins, Delafield & Wood
Housing Advisors
Lend Lease
Local Initiatives Support Corporation
National Association of Home Builders
National Association of State and Local Equity Funds
National Council of Affordable Housing Market Analysts
National Leased Housing Association
Novogradac & Company, LLP
The NRP Group LLC
Powell, Goldstein, Frazer & Murphy LLP
Red Capital Group
Reznick Fedder & Silverman, CPAs, P.C.
The Richman Group of Companies