Report of the National Council of State Housing Agencies' Housing Credit Task Force on

Recommended Practices in Housing Credit Allocation and Underwriting

As adopted by NCSHA's Board of Directors on December 6, 2010

NCSHA

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Table of Contents

Executive Summary

Background on Task Force Effort

Background on Recommended Practices

Summary of Changes to Recommended Practices

NCSHA Housing Credit Recommended Practices

1. Per Unit Cost Limits
2. Developer Fee and Builder Fee Limits
3. Consultant Fee Limits
4. Verification of Expenditures and Issuance of IRS Form 8609
5. Operating and Replacement Reserves
6. Operating Expense and Vacancy Rate Projections
7. Debt Coverage
8. Market Analysis
9. Development and Management Experience
10. Capital Needs Assessment
11. Minimum Rehabilitation Threshold
12. Extended Use Agreements
13. QAP Application to Bond Deals
14. Application Procedures
15. Appraisals in Acquisition/Rehabilitation Properties
16. Consistency Among Allocating Agencies
17. Agency Staff Training
18. State-Designated Basis Boost
19. Housing Credit Asset Management
20. Facilitating Rural Development with the Housing Credit
21. Use of the Housing Credit for Supportive Housing
22. Green Building and Sustainable Development
23. Housing Credit Developments at Year 15

Appendix A: Guiding Principles in TCAP and Exchange Program Administration
Appendix B: Industry Participants
Appendix C: Model Ten Percent and Final Cost Certification Letters

Report of NCSHA's Housing Credit Task Force on Recommended Practices in Housing Credit Allocation and Underwriting

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, New York City, 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 more than 2 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 2003. Since then the program has confronted significant challenges, including one of the largest economic downturns in recent times and the resulting significant disruption of the Housing Credit equity market. State administration of the program has experienced considerable change as well due to new statutory and regulatory requirements impacting the Allocating Agencies and ever-increasing affordable housing needs. Accordingly, the states have continued to make 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 are still appropriate to today's Housing Credit program, the NCSHA Board of Directors in March 2009 approved the establishment of a state housing agency executive director Task Force to consider them. The Board asked the Task Force to review the practices and determine which, if any, needed refinement and what new practices, if any, were necessary. The Board also asked the Task Force to develop recommended practices in the use of new Housing Credit authority and discretion provided to state Housing Credit allocators under recently enacted federal legislation, including the American Recovery and Reinvestment Act of 2009 (ARRA) and the Housing and Economic Recovery Act of 2008 (HERA).

This report is the product of the Task Force'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 Task Force Effort

The Task Force consisted of seven executive directors of Housing Credit Allocating Agencies. The Task Force's co-chairs were Bob Kucab (NC); Deborah VanAmerongen (NY DHCR), who served from 2009 until January 2010; and Doug Garver (OH), who served from February 2010 until now. Its members included Steve Auger (FL), Bruce Brensdal (MT), Marc Jahr (NYC), Sherry Seiwert (IN), and Valarie Williams (SC). Their agencies represent large and small states from all regions of the country with a broad range of affordable housing needs and challenges.

Given how quickly states were required to utilize ARRA Housing Credit gap-filling resources, the Task Force focused its efforts first on the development of principles and guidelines for states to follow in the allocation of those resources. Using information and feedback received from Congress, HUD, Treasury, Allocating Agencies, and Housing Credit industry experts, the Task Force developed a list of guiding principles in TCAP and Credit Exchange Program administration.

The Task Force met at NCSHA's June 2009 Housing Credit Conference in Los Angeles to discuss and adopt the guiding principles. A copy of these principles is included at Appendix A.

With the intense Allocating Agency focus on implementation of the TCAP and Credit Exchange Programs, the Task Force decided to defer review of all existing Housing Credit recommended practices to 2010. NCSHA began this work by convening virtually all Housing Credit Allocating Agencies at its January 2010 HFA Institute in Washington, DC. During this meeting, Housing Credit development staff discussed the existing NCSHA recommended practices and potential areas of refinement.

Using feedback collected during this meeting, the Task Force developed and distributed a survey to all Housing Credit Allocating Agencies in May 2010 to gather opinions about the need to refine existing recommended practices in Housing Credit allocation and underwriting or establish new ones.

The Task Force met at NCSHA's June 2010 Housing Credit Conference in Chicago to discuss the results of the survey and possible changes to the recommended practices. Following this meeting, NCSHA staff researched industry practices and other policies relevant to the existing recommended practices and contemplated possible changes to the recommendations.

In September 2010, the Task Force distributed a summary of proposed changes to the 17 existing recommended practices along with a description of six potential new recommendations to all Allocating Agencies and representatives of all sectors of the Housing Credit industry for review and comment. A list of industry representatives surveyed is included at Appendix B.

The Task Force met in October 2010 in connection with NCSHA's Annual Conference in Boston to consider Allocating Agency and industry comments received on the proposed changes. Thereafter, the Task Force 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 nearly 25 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. Though the 1998 recommended practices did not replace the 1993 practices, some further refined certain 1993 practices.

In 2000, NCSHA developed additional recommended practices on capital needs assessments, operating cost databases, and accountant opinion letters. Three years later, NCSHA convened a group of state agency executive directors to evaluate the efficacy of all existing Housing Credit recommended practices. As part of this exercise, NCSHA surveyed all Allocating Agencies and key industry representatives for suggestions on strengthening the existing recommended practices. While the group determined that the existing practices did not require extensive revision, it did refine some recommendations at that time. Most states have incorporated the recommended practices in their Housing Credit qualified allocation plans and underwriting guidelines.

In the seven years since NCSHA's last review of recommended practices, the Housing Credit has faced new challenges, including increasing affordable housing needs, the impact of one of the largest economic downturns in recent times, and the resulting severe disruption of the Housing Credit equity market.

The Congress made significant changes to the program during this time as well, most notably in the Housing and Economic Recovery Act of 2008 (HERA) and the American Recovery and Reinvestment Act of 2009 (ARRA). Among its many changes, HERA authorized Allocating Agencies to award a 30 percent basis boost to certain Housing Credit buildings and increased the minimum rehabilitation threshold limit. ARRA created two new programs—HUD's Tax Credit Assistance Program (TCAP) and Treasury's Section 1602 Credit Exchange Program—to work in conjunction with the Housing Credit and enhance feasibility of developments during a time of critical equity market turmoil. ARRA also imposed new asset management responsibilities on state Allocating Agencies for all developments assisted under TCAP and the Exchange Program.

In consideration of these significant program changes and to continue its proactive approach to state administration of the Credit, NCSHA's Board of Directors created a new Housing Credit Task Force in 2009. This group was charged with developing recommended practices in the use of new authority and resources provided state Housing Credit Allocating Agencies by HERA and ARRA and with reviewing NCSHA's existing Housing Credit recommended practices in the current environment. The results of this work are contained in this report.

The recommended practices that follow 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 Task Force Changes to the Recommended Practices

In the course of its work, the Task Force determined NCSHA's existing recommended practices in Housing Credit allocation and underwriting did not require extensive revision. Informed by the expertise and experience of Allocating Agencies and Housing Credit industry participants, however, the Task Force did make notable modifications to the following six recommended practices: per unit cost limits, verification of expenditures, operating expenses, market analysis, development and management experience, and application procedures.

The Task Force updated the per unit cost standard by deleting its reference to the HUD 221(d)(3) program limits as a cost benchmark and recommending agencies use their 25-year experience in allocating the Credit to judge the reasonableness of proposed development costs. NCSHA originally recommended the use of HUD's 221(d)(3) limits as a cost benchmark in 1993, just seven years after the Housing Credit program was created. Since that time, agencies have added a considerable number of Housing Credit developments to their portfolios and are especially expert in judging acceptable development costs for various types of development and geographic areas.

The verification of expenditures recommendation was expanded to encourage timely agency issuance of IRS Form 8609. In addition, the Task Force updated the model 10 percent test and final cost certification letters, revising them from an audit standard to an examination standard consistent with current accounting industry practice. A copy of the revised model accounting letters is included at Appendix C.

Acknowledging practices most states already follow, the Task Force amended the operating expense recommendation to specify use of a 7 percent vacancy rate projection and encourage agency consideration of operating expense data from the Housing Credit portfolio.

The Task Force refined the market analysis recommendation to incorporate current Allocating Agency and industry practices. The revised list of minimum market study components provides significantly more detail to reflect more than a decade of state and industry experience with Housing Credit market studies.

The revised development and management experience recommendation provides a definition of development team members, suggests agencies collect information on past experience of development team, encourages inexperienced sponsors to partner or joint venture with more experienced sponsors, and deletes reference to a standardized prior participation form.

Finally, the revised recommended practice on application procedures suggests agencies visit proposed development sites (or rely on third party site visit reports) at the application stage whenever possible.

The Task Force also:

- Revised the developer fee discussion to address allocation of developer fee between acquisition and rehabilitation and to acknowledge industry developer fee payout standards;
- Modified the operating and replacement reserve standard to suggest agencies consider historic portfolio reserve account usage and balances in determining appropriate initial reserve levels and the associated discussion to acknowledge current industry structuring of reserves and perspectives on developer guarantees in lieu of operating reserves;
- Encouraged agencies in the debt coverage recommendation to structure developments with incentives for quality long-term operations;
- Provided additional direction on the rehabilitation scope of work in the minimum rehabilitation threshold standard;
- Clarified in the extended use agreement recommendation that a foreclosing bank should have the right to elect to maintain affordability; and

- Amended the appraisals in acquisition/rehabilitation properties recommendation to suggest appraisals include an allocation of value between land and buildings and to acknowledge arms-length, negotiated purchase prices that exceed appraised value.

Finally, the Task Force developed six new recommended practices, encouraging Allocating Agencies to:

- Set standards for use of the state-designated 30 percent basis boost authorized by HERA;
- Establish procedures for asset management of ARRA-assisted Housing Credit developments;
- Analyze recent experience in developing rural housing with the Housing Credit and consider policies to ensure rural housing needs are adequately addressed;
- Study recent supportive housing development experience and consider Housing Credit policies to ensure such housing needs are adequately addressed;
- Assess Housing Credit policies encouraging green building and sustainable development and continue Allocating Agency innovations in this area; and
- Evaluate policies to determine impact on developments reaching the end of their initial 15-year compliance period.

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 in the state portfolio 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 cost limit applicable to the entire state or multiple limits that take into account disparities in costs due to project location, type of construction, population served, and potentially other project characteristics. In developing cost limits, agencies should balance the efficient use of scarce resources with the need to develop affordable rental housing that is durable, attractive, safe, energy efficient, and healthy.

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.

Discussion

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.

Discussion

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. Developer fee limits are now standard in agency 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. The proper allocation of developer fee between acquisition and development costs is typically defined in a development services agreement and addressed in the cost certification.

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.

While the NCSHA recommended practice does not dictate developer fee payout standards, Allocating Agencies should consider the payout schedule in evaluating the reasonableness of developer fees. Developers undertake significant risk in developing Housing Credit properties and have an interest in earning the developer fee as quickly as possible and limiting the amount of any deferred fees. In the current equity environment, Housing Credit investors strongly prefer holding back as much of the paid development fee as possible to mitigate risk and motivate the developer to reach certain important milestones (cost certification, stabilization, etc.)

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 and Issuance of IRS Form 8609

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. Agencies should issue Form 8609 in a timely manner after receiving all required documentation.

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 model 10 Percent Test and final cost certification letters 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. A cost certification practice is now standard in agency 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 cost certification letters 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.

The model letters were revised as part of the 2010 Housing Credit Task Force effort, changing both the 10 Percent determination and the final cost certification from an audit to an examination standard. While the level of opinion is the same, audit reporting creates concerns under professional accounting standards and an examination is better for certifying costs and eligible basis in accordance with Section 42. The revised draft model letters are attached to this document.

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.

Industry participants note a lack of consistency among Allocating Agency requirements for issuance of IRS Form 8609 and difficulty in implementing some agency requirements. Given the significant negative consequences involved with delays in receiving Form 8609s, agencies should evaluate their policies relating to this form and strive for timely issuance of it once the final cost certification and other necessary documentation is received. The Task Force encourages continued dialogue among the Allocating Agencies and the Housing Credit industry on this point.

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

- Minimum replacement reserves should generally 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 underwriting appropriate initial reserve levels, agencies should consider historic portfolio reserve account usage and balances. While use of operating and replacement reserves is project specific, analysis of trends in reserve balances may suggest higher reserve requirements than the above minimums for certain developments.

In limited circumstances, Allocating Agencies may accept developer guarantees in lieu of operating reserves, 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.

While the above recommended practice does not dictate length of time operating reserves should be held, Housing Credit investors prefer fully funded/capitalized operating reserves which: 1) stay in place for at least the duration of the 15-year investment hold period; 2) are maintained by the owner to fund future cash flow shortfalls; and 3) if used, are replenished prior to release of the operating deficit guarantee or distributions to the developer. In addition, most equity providers will not accept a developer guarantee in lieu of a fully capitalized operating reserve. In determining adequacy of reserves, agencies should balance the capital needs of developments with agency attempts to use the Credit as efficiently as possible.

6. Operating Expense and Vacancy Rate Projections

Recommendation

Allocating Agencies should promote long-term economic viability by requiring realistic and itemized anticipated operating expenses and using a 7 percent vacancy rate projection. In underwriting operating expenses, agencies should consider data from syndicators, investors, lenders, and their own portfolios.

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.

Allocating Agencies can support the long-term viability of the Housing Credit portfolio by underwriting and verifying realistic operating expenses and vacancy rate assumptions in consultation with equity providers, property managers, and, most importantly, with thorough analysis of operating data from their own portfolios.

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.

7. 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 foreclosable, 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. In addition, Allocating Agencies should structure developments such that there are incentives for quality long-term operations, including the potential for the sponsor to share in available project cash flow.

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. One crucial element in achieving long-term financial viability is structuring development incentives to encourage responsible and efficient operations. Some Housing Credit transactions are structured such that most cash flow remaining after must-pay debt service is used to repay subsidized financing. This practice creates program income for the agency to fund future loans, but can leave project sponsors heavily dependent on up-front fees, as opposed to compensation for responsible operation and management.

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.

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, detailing education and experience of primary author and including statement of non-interest;
- A description of the proposed site and neighborhood, including physical attributes of site, surrounding land uses, and proximity to community amenities or neighborhood features including shopping, healthcare, schools, and transportation;
- A map and photos of the subject site and surroundings showing location of community services;
- An overview of local economic conditions, including employment by sector, list of major employers, and labor force employment and unemployment trends over past 5-10 years;
- A description of the proposed development, detailing proposed unit mix (number of bedrooms, bathrooms, square footage, proposed rents, AMI level, utility allowances, and any utilities included in rent), proposed unit features and community amenities, and target population including age restrictions and/or special needs populations;
- Demographic analysis of the number of households in the market area that are part of the target market (i.e., family, senior, etc.), income-eligible, and can afford to pay the rent, including a projected household base at placed in service date;
- Geographic definition and analysis of the market area, including description of methodology used to define market area and map of market area including proposed site;
- Analysis of household sizes and types in the market area, including households by tenure, income, and persons per household;
- 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, segmented by property type (market rate, Housing Credit, deep subsidy) and with rents adjusted to account for utility differences and concessions or other incentives. Such description should include all existing Housing Credit developments in the primary market area and any planned additions to rental stock including recently approved Housing Credit developments;
- Expected market absorption of the proposed rental housing, including capture / penetration 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.

<u>Discussion</u>

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.

The original NCSHA market study recommended practice was adopted in 1998 prior to the statutory requirement and last refined in 2003. The minimum market study components outlined above were strengthened significantly in 2010 to reflect more than a decade of state and industry experience with Housing Credit market studies.

9. Development and Management Experience

Recommendation

In allocating Housing Credits, Allocating Agencies should consider the capabilities of the entire development team, including at minimum the project sponsor, developer, general contractor, architect, property manager, and key consultants. They should take into account the team's track record, financial capacity, and relevant experience in multifamily housing finance, development, management, and resident services. Agencies should require development team members to report past experience with affordable housing programs, including any removals as general partner, defaults under project documents, failures to receive IRS Form 8609, or project foreclosures.

Given the complexity of the Housing Credit program and greater industry emphasis on solid development and management experience, agencies should encourage program sponsors with no Housing Credit experience to partner or joint venture with a more experienced sponsor or developer.

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.

Requesting reports of past affordable housing experience helps Allocating Agencies judge the track record of the proposed development team and may prevent entities with negative past experience from jeopardizing the program's excellent track record.

10. 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.

11. 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.

The rehabilitation scope of work for a particular development must be sufficient to address the improvements identified as necessary in the capital needs assessment. The scope of work should address any design or structural problems that have caused or are likely to cause problems, reposition the property as necessary to achieve and maintain market viability, address all life/health/safety concerns, and make any required accessibility improvements. Whenever feasible and cost justified, the scope of work should incorporate environmentally sensitive design and materials or favorably impact operating costs.

Discussion

In 1986, Congress established a minimum rehabilitation threshold of $2,000 per unit for a property to qualify for Housing Credits. Congress has increased this amount twice since then, most recently in 2008 to the greater of $6,000 per unit or 20 percent of the building's adjusted basis. In many areas and for many properties today, the statutory minimum is insufficient to accomplish more than cosmetic improvements. Most allocating agencies require significantly more than the statutory minimum.

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.

12. Extended Use Agreements

<u>Recommendation</u>

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.

<u>Discussion</u>

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. A foreclosing bank should, however, have the right to elect to maintain affordability under the extended use agreement.

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.

In addition, agencies should visit proposed development sites (or hire a third party analyst to conduct a site visit) whenever possible at the application stage to assess the viability of the site and to check for nearby incompatible uses, physical barriers to development, or other important shortcomings.

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.

Conducting a site visit is essential to ensure Housing Credit properties are not located near land uses that are incompatible with residential occupancy. Checking the site also allows agencies to assess whether proposed development costs such as grading and infrastructure are reasonable. Due to the size of some states and/or personnel available, having staff conduct reviews simply is not possible for some agencies. In those cases, contracting with a third party is the best option.

15. Appraisals in Acquisition/Rehabilitation Properties

Recommendation

For acquisition/rehabilitation properties, Allocating Agencies should generally limit the acquisition price on which Housing Credits are allocated to the lesser of the sale price or appraised value of the property. Appraisals should include an allocation of value between land and buildings.

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. While agencies may consider an arms-length, negotiated purchase price that exceeds a current appraisal for purposes of approving the overall development budget, they should generally limit 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.

18. State Designated Basis Boost

Recommendation

Allocating Agencies should set standards in the qualified allocation plan for determining which areas and/or developments are eligible for the state designated 30 percent basis boost and should make the reasons for such determinations available to the public.

Discussion

The Housing and Economic Recovery Act of 2008 (HERA) authorized allocating agencies to award a 30 percent basis boost to Housing Credit buildings that states determine need the boost for financial feasibility.

In its General Explanation of the Act, the Joint Committee on Taxation (JCT) wrote, "It is expected that the State allocating agencies shall set standards for determining which areas shall be designated difficult development areas and which projects shall be allocated additional credits in such areas in the State allocating agency's allocation plan. It is also expected that the State allocating agency shall publicly express its reasons for such area designations and the basis for allocating additional credits to a project."

This provision offers significant discretion to state agencies and prudent use of the basis boost is critical to sound state administration of the program, particularly as Housing Credit equity pricing returns to customary levels.

While some states have chosen to apply the 30 percent boost on a statewide basis to any Housing Credit development based on financial feasibility, others have defined certain geographic areas, project types, or project characteristics that justify the boost. Examples include deep income targeting, developments with expensive land, location in areas affected by natural disasters, permanent supportive housing developments, projects exhibiting green building and sustainable development practices, location in rural or tribal areas, mixed-income and mixed-use developments, preservation initiatives, and transit-oriented developments.

19. Housing Credit Asset Management

Recommendation

Allocating Agencies should establish procedures for asset management of Housing Credit developments assisted under the American Recovery and Reinvestment Act of 2009 (ARRA). These procedures should detail typical asset management functions associated with the development, lease-up, and operations phases of a project. Agencies with established asset management history and experience may apply existing procedures to ARRA-assisted developments rather than establish separate procedures applicable solely to ARRA-assisted developments.

Discussion

To ensure program compliance and the long-term viability of developments, ARRA requires state Housing Credit agencies to perform asset management functions, or contract for such services, for all developments assisted under HUD's Tax Credit Assistance Program (TCAP) or Treasury's Section 1602 Credit Exchange program. The Act provides that such asset management will be funded at the owner's expense.

While many agencies have extensive experience conducting asset management for multifamily developments, this experience does not always include Housing Credit deals where asset management is typically a function of the investor and/or syndicator.

Since passage of ARRA, many states have contracted with outside firms to conduct asset management on this portfolio of developments. Other states have developed asset management guidelines for internal use. Developing a list of suggested asset management procedures will help to ensure effective implementation of this new requirement and to create consistency among the allocating agencies. Such procedures may include the following:

Development Phase:

- Review underwriting assumptions to ensure adequacy of debt service coverage, reserve levels, and other underwriting benchmarks.
- Review market studies for proposed developments to ensure reasonableness of assumptions and proposed capture rates.
- Review capital needs assessments for rehabilitation developments to ensure adequacy and reasonableness of assumptions.
- Monitor construction on a bi-weekly or monthly basis to ensure the development is progressing as scheduled.
- Monitor and approve construction draws and change orders to analyze actual development costs and compare to original budget.
- Conduct periodic construction inspections with development team.

- Establish and monitor project reserve accounts, including lease-up, operating, and replacement reserves.
- Confirm receipt of certificate of occupancy for development.

Lease-up Phase:

- Review and approve marketing plan for development.
- Monitor marketing and lease-up of development.
- Compare actual absorption rate, rental revenue, and lease up to original projections.
- Troubleshoot potential lease-up problems and resolve issues.
- Ensure proper documentation and completeness of first-year tenant files to ensure initial tenant qualification and proper documentation for each unit.
- Analyze stabilized occupancy to confirm minimum set-aside and affordability targets.
- Compare first-year Credit delivery to original projections.

Operations Phase:

- Conduct comprehensive on-site property inspections to assess ongoing property compliance consistent with IRS and state agency physical inspection standards.
- Conduct comprehensive tenant file reviews to ensure ongoing tenant compliance and proper documentation for tenant recertifications and new move-ins.
- Ensure prompt correction of any physical and tenant noncompliance.
- Review annual owner compliance certifications.
- Analyze project operations, including physical occupancy reports, annual operating budget, debt coverage, cash flow trends, and other financial information.
- Compare operating data against budget, prior year operations, and state averages.
- Manage operating reserves and replacement reserves, including approval of expenditures.
- Assess adequacy of property management.
- Analyze ongoing marketability and capital needs of developments.
- Recommend and implement workout strategies for any troubled projects.

20. Facilitating Rural Development with the Credit

<u>Recommendation</u>

Allocating Agencies should analyze recent state experience in using the Housing Credit in rural rental housing development and consider qualified allocation plan incentives or other policy initiatives to ensure rural housing needs are adequately addressed. Agencies should work with rural stakeholders and program investors to study current impediments to rural development and make appropriate changes to underwriting criteria or other policies to maximize investor interest in rural areas.

Discussion

The recent economic downturn and near collapse of the Housing Credit equity market had a devastating impact on the ability to attract investors and structure financially feasible Housing Credit developments in rural areas.

Some states have responded to this challenge with new QAP incentives for rural development including set-asides of Credit authority, additional points in the competitive scoring process, or use of the 30 percent basis boost in rural areas. Others have implemented changes in underwriting criteria for rural areas to recognize the current challenges in structuring and maximizing investor interest in such deals. Some states are prioritizing rural preservation projects by using the Credit to recapitalize the aging stock of USDA Section 515 developments, while others are allocating HOME funds to rural Housing Credit transactions to enhance financial feasibility.

The Task Force encourages continued dialogue among the Allocating Agencies and the Housing Credit industry to foster additional progress in this area.

21. Use of the Housing Credit for Supportive Housing

Recommendation

Allocating Agencies should analyze recent state experience in using the Housing Credit for supportive housing and consider qualified allocation plan incentives or other policy initiatives to ensure such housing needs are adequately addressed. Agencies should work with interested stakeholders and program investors to study current impediments to supportive housing development and make appropriate changes to underwriting criteria or other policies to maximize investor interest in these deals.

Discussion

The Housing Credit is a vital tool for developing supportive housing for various special needs populations. Recent Housing Credit equity market challenges, however, have greatly impacted the ability to attract investors and structure financially feasible supportive housing developments using the Credit. Such developments are critical to the state affordable housing mission and the loss of these deals is particularly problematic in the wake of one of the largest economic downturns in recent history.

Allocating Agencies have developed various strategies for overcoming current challenges in structuring and attracting investors to supportive housing deals. Some states have established or expanded set-asides of Credit authority for supportive housing, while others are offering additional points in the competitive scoring process. Some agencies are revising underwriting standards and using the 30 percent basis boost to enhance financial feasibility of supportive housing deals, while others are focusing on securing supportive service commitments and funding to enhance investor comfort with these deals.

The Task Force encourages continued dialogue among the Allocating Agencies and the Housing Credit industry to foster additional progress in this area.

22. Green Building and Sustainable Development

Recommendation

Allocating Agencies should evaluate current Housing Credit qualified allocation plan incentives or other policy initiatives designed to encourage green building and sustainable development and consider ways to continue fostering innovation in this rapidly evolving and increasingly important field.

Discussion

One of the biggest changes in Housing Credit qualified allocation plans since NCSHA last considered Housing Credit recommended practices is the intense focus of many states on encouraging sustainable development and green building practices with the Credit. Virtually every state now encourages these practices through a variety of policies addressing sustainable site selection, energy efficiency, resource conservation, indoor air quality, and other sustainable development practices. Current state approaches vary greatly from mandatory design requirements and threshold criteria to selection criteria incentives.

An increasing number of states are now adopting holistic approaches to sustainable development, some of which include reference to state green building mandates or industry green building standards such as the U.S. Green Building Council's Leadership in Energy and Environmental Design (LEED) criteria, Enterprise Community Partners' Green Communities program, the National Association of Home Builders' Green Building Standard, and others.

The Task Force encourages continued dialogue among the Allocating Agencies and collaboration with key sustainable development industry groups in this area to ensure the Housing Credit remains a model program for furthering sustainable development of affordable rental housing.

23. Housing Credit Developments at Year 15

Recommendation

Allocating Agencies should evaluate current Housing Credit qualified allocation plan incentives and other policy initiatives to determine any impact on developments reaching the end of their initial 15-year compliance period. While agencies should approach Year 15 projects with a goal of preserving the housing stock as a long-term affordable housing resource, the best course of action for each development is a project-specific determination that includes consideration of the project's current financial viability, its physical condition, and its relative competitiveness in the local market. As part of this determination, agencies should consider whether additional Housing Credits and recapitalization are necessary for each deal as part of an overall preservation strategy.

Discussion

As the Housing Credit portfolio ages, Allocating Agencies face significant policy decisions regarding the use of Housing Credits for recapitalization of developments that received a Credit allocation in the past. While Housing Credit developments with post-1989 allocations are subject to extended use restrictions that require an additional 15-year minimum low-income use, the physical condition and financial viability of certain developments suggest a need for recapitalization. Some Allocating Agencies encourage existing Housing Credit developments to apply for new Credits as part of a recapitalization strategy, while others prioritize Housing Credits to new development. Developments reaching the end of their initial 15-year compliance period present significant issues for Allocating Agency consideration, including preservation policies, enforcement of extended use agreements, qualified contract requests, and continued monitoring responsibilities.

The Task Force encourages continued dialogue among the Allocating Agencies and focused consultation with developers, equity providers, preservation advocates, tax advisors, and other Housing Credit industry professionals to study the scope of the Year 15 issue and identify potential additional work in this area.

Appendix A

NCSHA's Recommended Principles in State TCAP and Exchange Program Administration

Executive Summary

In March of 2009, NCSHA's Board of Directors created an HFA executive director Task Force to develop recommended practices in the use of new Low Income Housing Tax Credit (Housing Credit) authority and resources provided state Housing Credit allocating agencies under the American Recovery and Reinvestment Act of 2009 (ARRA) and the Housing and Economic Recovery Act of 2008 (HERA) and to review and update as necessary NCSHA's existing Housing Credit recommended practices. Throughout its work, the Task Force will also consider additional changes that NCSHA may wish to pursue in Housing Credit law and regulation to further strengthen the program and state administration of it.

The Task Force focused first on the development of principles to guide states in their allocation of Tax Credit Assistance Program (TCAP) and Housing Credit Exchange Program (Exchange Program) resources, given how quickly states must commit these ARRA-authorized Housing Credit gap-filling resources. Taking into account information and feedback received from state Housing Credit allocating agencies, Congress, HUD, Treasury, and Housing Credit industry experts, the Task Force developed and finalized the principles in June 2009. NCSHA's Executive Committee adopted them on July 8, 2009. The Executive Committee and Task Force urge all state Housing Credit allocating agencies to adhere to these principles in administering TCAP and the Exchange Program and to share their program results with their congressional delegations.

NCSHA and the Task Force will continue to work with HUD and Treasury to improve and expedite TCAP and Exchange Program guidance and to support state program administration. NCSHA and the Task Force will also continue to keep Congress, HUD, and Treasury informed of the programs' progress and results.

Recommended Principles in TCAP and Exchange Program Administration

State approaches to implementing TCAP and the Exchange Program vary significantly across the country, because states face different affordable housing challenges and access to Housing Credit equity. Nevertheless, quick and successful implementation of both programs is critical to enabling Housing Credit development to occur this year and next and also to the long-term viability of the Housing Credit program.

HUD and Treasury guidance appropriately provides state allocating agencies discretion in implementing these programs. The following principles are intended to help guide state decisions that are in keeping with not only with the letter but also with the spirit of the law and regulations and to inform Congress, federal agencies, and the affordable housing industry about what NCSHA and its allocating agency members believe is especially important in carrying out these new responsibilities.

Uphold the letter and spirit of all federal rules. Both TCAP funds and Exchange Program proceeds are subject to certain federal requirements. TCAP funds are subject to a number of cross-cutting federal rules, such as environmental review requirements and Davis-Bacon wage rates, which do not generally apply to the Housing Credit program. State allocating agencies should strive to fully understand and uphold these new requirements.

Tailor a response to the needs of the current development pipeline. Before using these new resources, state allocating agencies should conduct a thorough analysis of developments to which they have allocated Housing Credits and identify those with 2007 and 2008 carryover allocations that lack sufficient equity to complete construction. State agencies should also consider how provisions of its current qualified allocation plan may impact the financial feasibility of and investor interest in developments in the current equity market. State agencies should focus their resources on addressing Housing Credit equity gaps attributable to market conditions beyond the control of the developer.

Remember that state allocating agencies are responsible for these resources. Congress and the Administration have demonstrated their confidence in state allocating agencies once again by entrusting to them the administration of these new resources. Both TCAP and Exchange Program funds flow directly to state allocating agencies, which are accountable for their proper and effective use. Developments have no entitlement under the law to receive funds, even if they are currently holding a Credit allocation or if they return Credits. The amount of any assistance provided to developments under TCAP or the Exchange Program is determined by the Housing Credit allocating agency based on a financial feasibility determination and other appropriate state allocation criteria.

Retain Housing Credit equity investment in developments whenever possible. Both TCAP and the Exchange Program were designed as temporary measures to support production of affordable rental housing while the Housing Credit equity market is rebuilt. To the maximum extent possible, state allocating agencies should use these resources in ways that help to support, rather than replace, private equity. This approach preserves the public/private partnership benefits that are unique to the Housing Credit program. Achieving Housing Credit equity investment in a development also allows utilization of the effective Housing Credit compliance mechanisms, including IRS recapture of Credit, which have been critical to the program's long-term success and viability. However, state allocating agencies should discourage transactions that provide unreasonable gains for investors and avoid policies that pressure owners to accept too little equity for their Credits. In addition, state allocating agencies should strive to increase the investor base for the Housing Credit.

While striving for some amount of Housing Credit equity investment in each development is ideal, there may be particular deals that cannot attract private capital in today's equity market. To the extent such developments respond to the affordable housing needs and priorities of the state, state allocating agencies may allow them to proceed with no Credit or a nominal amount of Credit, using TCAP or Exchange Program funding to support their production. However, allocating agencies need to develop additional procedures to ensure their financial feasibility and program compliance.

Prioritize developments that can proceed quickly to construction and spend federal funds within the programs' prescribed timeframes. Congress responded quickly to Housing Credit equity market challenges, recognizing the dire need for affordable rental housing in the country and the critical importance of housing construction to the country's economic recovery. In allocating TCAP and Exchange Program funding, states should consider as part of their careful decision making processes each development's ability to proceed quickly to construction and to spend funds by prescribed program deadlines.

Limit awards based on financial feasibility analysis. Consistent with all Housing Credit allocations, states allocating agencies should provide developments only the amount of TCAP or Exchange Program funding necessary to ensure their financial feasibility and long-term viability as low-income housing, after maximizing all other available sources and uses of funds, including Housing Credit equity.

Maximize affordable housing production. To the extent possible, state allocating agencies should leverage TCAP and Exchange Program funding in order to maximize production and rehabilitation of much-needed affordable rental homes for low-income households.

Minimize additional procedural requirements. To assist in the rapid delivery of these new resources, state allocating agencies should minimize additional procedural requirements, establish transparency and clarity in the decision-making process, and ensure accountability for outcomes. Whenever possible, states should rely on existing due diligence and oversight expertise of the Housing Credit industry instead of creating new state requirements.

Appendix B

Housing Credit Task Force Industry Contacts

Associations

Affordable Housing Investors Council
Affordable Housing Tax Credit Coalition
Council for Affordable and Rural Housing
Housing Assistance Council
National Affordable Housing Management Association
National Association of Affordable Housing Lenders
National Association of Home Builders
National Association of State and Local Equity Funds
National Council of Affordable Housing Market Analysts
National Housing Conference
National Housing Trust
National Low Income Housing Coalition
National Multi Housing Council
National Rural Housing Coalition
Stewards of Affordable Housing for the Future
US Green Building Council

Firms and Other Organizations

Applegate and Thorne-Thomsen, PC
Baker Tilly Virchow Krause, LLP
Bank of America Merrill Lynch
Bank of America
Boston Capital Corporation
Boston Financial Investment Management
Bryan Cave
CAHEC
Cargill Investment, Ltd.
Centerline Capital Group
Citi Community Capital
Corporation for Supportive Housing
Enterprise Community Partners
Fannie Mae
First Sterling
Freddie Mac
Global Green
Gorman & Co., Inc.

Great Lakes Capital Fund
Holland & Knight
JP Morgan Capital Corporation
John Hancock Realty Advisors, Inc.
Local Initiatives Support Corporation
Mercy Housing
Michaels Development
Midwest Housing Equity Group
National Affordable Housing Trust
National Church Residences
National Equity Fund
Nixon Peabody LLP
Novogradac & Company, LLP
Ohio Capital Corporation for Housing
RBC Capital Markets
Raymond James Tax Credit Funds
Recap Real Estate Advisors
Reznick Group
The Richman Group of Companies
The Summit Group
Tax Credit Asset Management, LLC
Technical Assistance Collaborative
US Bancorp CDC
US Bank
Volunteers of America, Inc.
WNC & Associates, Inc.

Appendix C

MODEL TEN PERCENT LETTER

Independent Accountants' Report

Date: XXXX XX, 20__

To: Tax Credit Allocation Agency
Street
City, State Zip Code

and

XXXX (the "Owner")
Street
City, State Zip Code

Re: TCAA # XX-XXX

We have examined the accompanying Certification of Costs Incurred ("Exhibit XXX") of the Owner for XXXX (the "Project") as of XXXX, XX, 20__. Exhibit XXX is the responsibility of the Owner and the Owner's management. Our responsibility is to express an opinion on Exhibit XXX based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting Exhibit XXX and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The accompanying Exhibit XXX was prepared in conformity with the accounting practices prescribed by the Internal Revenue Service under the accrual method of accounting and by the Tax Credit Allocation Agency ("TCAA"), which is a comprehensive basis of accounting other than generally accepted accounting principles.

The 10% Test includes an estimate prepared by the Owner of total development costs and reasonably expected basis, as defined in Treasury Regulation Section 1.42-6. We have not examined or performed any procedures in connection with such estimated total development costs and reasonably expected basis and, accordingly, we do not express any opinion or any other form of assurance on such estimates. Furthermore, even if the Project is developed and completed there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

In our opinion, Exhibit XXX referred to above presents fairly, in all material respects, costs incurred for the Project as of XXXX XX, 20__, on the basis of accounting described above.

In addition to examining Exhibit XXX, we have, at your request, performed certain agreed-upon procedures, as enumerated below, with respect to the Project. These procedures, which were agreed to by the Owner and TCAA, were performed to assist you in determining whether the Project has met the 10% test in accordance with Internal Revenue Code Section 42(h)(1)(E) and Treasury Regulation Section 1.42-6. These agreed-upon procedures were performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representations regarding the sufficiency of the procedures below either for the purpose for which this report has been requested or for any other purpose.

We performed the following procedures:

- We calculated, based on estimates of total development costs provided by the Owner, the Project's total reasonably expected basis, as defined in Treasury Regulation Section 1.42-6, to be $XXXX as of XXXX XX, 20__.

- We calculated the reasonably expected basis incurred by the Owner as of XXXX XX, 20__ to be $XXXX.

- We calculated the percentage of the development fee incurred by the Owner as of XXXX to be XX% of the total development fee.

- We compared the reasonably expected basis incurred as of XXXX XX, 20__ to the total reasonably expected basis of the Project, and calculated that XX% had been incurred as of XXXX XX, 20__

- We determined that the Owner uses the accrual method of accounting, and has not included any construction costs in carryover allocation basis that have not been properly accrued.

- Based on the amount of total reasonably expected basis listed above, for the Owner to meet the 10% test in accordance with Internal Revenue Code Section 42(h)(1)(E) and Treasury Regulation Section 1.42-6, we calculated that the Project needed to incur at least $XXXX of costs prior to December 31, 20__. As of XXXX XX, 20__, costs of at least $XXXXX had been incurred, which is approximately XX.XX% of the total reasonably expected basis of the Project.

We were not engaged to, and did not, perform an audit of the Owner's financial statements or of the Project's total reasonably expected basis. Furthermore, even if the Project is developed and completed there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Owner and the Owner's management and for filing with TCAA and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.

City, State
XXXX XX, 20__

MODEL FINAL COST CERTIFICATION LETTER

Independent Accountants' Report

Owner's Name: XXXX

Project Name: XXXX

Project Number: TCAA # XX-XXX

We have examined the costs included in the accompanying Tax Credit Allocation Agency ("TCAA") Final Cost Certification (the "Final Cost Certification") of XXXX (the "Owner") for XXXX ("the Project") as of XXXX XX, 20__. The Final Cost Certification is the responsibility of the Owner and the Owner's management. Our responsibility is to express an opinion on the Final Cost Certification based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the Final Cost Certification and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

The accompanying Final Cost Certification was prepared in conformity with the accounting practices prescribed by the Internal Revenue Service, under the accrual method of accounting, and in conformity with the format and qualified allocation plan rules set by TCAA, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion the Final Cost Certification presents fairly, in all material respects, the actual costs of $XXXX and eligible basis of $XXXX of the Owner for the Project as of XXXX XX, 20__, on the basis of accounting described above.

This report is intended solely for the information and use of the Owner and the Owner's management and for filing with TCAA and should not be used for any other purpose.

We have no financial interest in the Project other than in the practice of our profession.

City, State
XXXX XX, 20__