For: National Council of State Housing Agencies
From: Novogradac & Company LLP
Date: September 27, 2010

RE: Potential Changes to NCSHA's Housing Credit Recommended Practices

We appreciate being given the opportunity to provide comments on the potential revisions to existing recommended practices dated September 10, 2010. Please find our comments detailed below:

1. Per Unit Cost Limits

We agree with the suggested change to eliminate reference to HUD Section 221(d)(3) limits as a per unit cost limit benchmark, as the 221(d)(3) cost limits do not accurately reflect costs in many markets. Given the large number of Housing Credit developments that have been placed in service by each respective HFA subsequent to the original NCSHA per unit cost limit benchmark set in 1993, it is reasonable to conclude that each HFA has garnered enough experience and is adept at determining a flexible, yet acceptable, threshold for development costs given the wide variety of market conditions that may exist within an HFA's domicile.

An alternative would be to keep the HUD Section 221(d)(3) limits in place as a general guideline, but provide for exceptions if a developer/sponsor can demonstrate that the limits are not reasonable.

2. Developer and Builder Fee Limits

We concur with the current provisions that encourage the use of a lower percentage limit of developer fees for the acquisition portion of an acquisition/rehabilitation development. However, we believe that the proper allocation of developer fee between acquisition and development costs is a federal income tax law matter, and should be based on the services provided as defined in a development services agreement. The proper allocation of the development fee should be addressed in the cost certification by the project owner and third party auditor.

Additionally, we recommend that HFAs adopt a revised allocation of the percentage limits on builder/general contractor charges. In lieu of 6-2-6 percentage limits of builder's profit, builder's overhead and general requirements, respectively, we recommend an overall percentage limit of 14%. This change would help simplify accounting for new construction/rehabilitation hard costs as the differences between what constitutes builder's profit, builder's overhead and general requirements is not clearly defined. In the alternative, we recommend an 8% limit for the combination of builder's profit and overhead and a 6% limit for general requirements.

3. Consultant Fee Limits: No comment.

4. Verification of Expenditures

We recommend that uniform policies and procedures be established in order to standardize and streamline the issuance process for Forms 8609. For example, there are a number of HFAs that require that Housing Credit developments have permanent financing in place before Forms 8609 are issued. However, many Housing Credit development investors will not contribute their final equity installment, which is needed for conversion to permanent financing, until the developer/sponsor receives the Forms 8609. This obviously poses an administrative problem that is not easily rectified. We recommend that the HFAs request a binding permanent loan commitment from the lender in lieu of requiring the permanent financing be funded. For underwriting purposes, the size of the permanent loan should be based on the terms of the binding permanent loan commitment and the loan amount that the project owner can reasonably demonstrate that the project can support.

5. Operating and Replacement Reserves

We recommend requiring that the operating reserve not be released until the project has achieved a minimum of five years of stabilized operations or two years of stabilized operations above a 1.20 debt service coverage ratio, whichever occurs first. Such limits would lessen the chances that a project will experience an operating shortfall that it does not have the resources to fund.

Regarding suggested change A, we disagree with the recommended consideration of historic portfolio reserve account usage in determining the appropriate initial reserve levels for individual Housing Credit developments. We do not believe it is appropriate to apply a portfolio-wide reserve usage history to an individual Housing Credit development. Each Housing Credit development will be exposed to unique conditions based on its geographic location, tenant population, level of tenant services and other factors. Also, any study of the recent history of a Housing Credit development's reserves will be skewed by the unprecedented real estate market conditions of the last few years.

Regarding suggested change B, the financial feasibility of increasing or decreasing required reserve deposits after a five-year review is questionable. A decrease in required reserve funding may unnecessarily expose a Housing Credit development to the risk of inadequate reserve levels to fund any operational shortfalls or major capital improvements in future years. Additionally, a required increase in reserve levels in year five may create a significant financing hurdle for the Housing Credit development and sponsor. This hurdle may inadvertently have negative consequences in the initial financial feasibility determination of a project as well as in year five of a project's operations. In the initial underwriting phase, underwriters will need to underwrite the ability of a project to resize such reserve fundings in year five, a difficult underwriting task. In year five, many Housing Credit developments may not have sufficient operating cash flow in order to provide any additional reserve funding. This could threaten a development's ability to continue as a going concern. It would be more prudent to structure the Housing Credit development with adequate reserves up-front.

6. Debt Coverage

We suggest that the existing recommended practices clearly distinguish that a minimum debt coverage ratio is an underwriting requirement and should be used to estimate the amount of projected permanent loan proceeds, but achieving the minimum debt coverage ratio should not be a prerequisite to the issuance of Forms 8609. Required debt service ratio targets may not be met by a Housing Credit development until stabilization of operations, which may not occur until well after a development is placed in service. Such a requirement unnecessarily delays the issuance of Forms 8609.

Additionally, we suggest that the existing recommended practices establish a minimum debt service coverage ratio of 1.20. Housing Credit developments tend to have a greater ratio of operating expenses relative to gross income as compared to market-rate developments. Any fluctuations in operating expenses may expose a Housing Credit development to greater risk of an operating shortfall. By sizing a Housing Credit development's debt to a 1.20 debt coverage ratio, a greater cushion is provided that will ensure that the Housing Credit development's operating cash flow will be sufficient for any given period. Even at a 1.20 debt service coverage ratio, the cash flow generated after debt service is a modest amount.

We recommend that in structuring housing credit transactions that HFAs ensure that there are financial incentives for effective ownership and operation of these transactions. Many Housing Credit transactions are structured such that most, if not all, available cash flow after payment of primary debt service is used for debt service on subordinate loans. This practice limits the economic incentives to developers/sponsors to the front-end in terms of developer fees, thereby leaving developers/sponsors unnecessarily dependent on such fees and not meaningfully compensated for responsible operation and management of the Housing Credit development over the long term. For Housing Credit developments that have subordinate loans repayable solely out of cash flow, we recommend that cash flow be shared by the subordinate lender and the developer/sponsor. By increasing the share of project cash flow to the developer/sponsor, the developer/sponsor will be further incentivized to operate a Housing Credit development at its optimal performance level (e.g., keeping the project in a financially healthy state, maintaining the physical condition and quality of the development structures, etc.). This will further align the goals of a developer/sponsor with a HFA's mission of providing high quality, affordable housing to low-income individuals and families over the long-term.

7. Operating Expenses

We encourage HFAs to consult with developers/sponsors, syndicators, investors and property management companies when underwriting operating expenses in order to forecast realistic operating expenses. In our experience, initial operating expense projections made by a HFA can at times be optimistically low.

8. Market Analysis: No comment.

9. Development and Management Experience

We recommend that HFAs require Housing Credit development developers/sponsors have prior, positive Housing Credit development experience and be substantially engaged in affordable multifamily development or management, involving the Internal Revenue Code Section 42 Low-Income Housing Tax Credit ("LIHTC") or other similarly complex programs (e.g., the U.S. Department of Housing and Urban Development Section 8 program). Developers/sponsors with neither LIHTC nor other acceptable rental housing experience should be considered only if the developer/sponsor joint ventures with an experienced LIHTC developer/sponsor or engages an experienced LIHTC consultant that materially participates in the Housing Credit development for the full 15-year LIHTC compliance period. If a developer/sponsor does not possess the above mentioned qualifications, we would recommend that HFAs take into consideration the portfolio history of the developer/sponsor as well as the experience of the entire development team (e.g., architects, attorneys, accountants, etc.).

10. Minimum Rehabilitation Threshold

We recommend that the scope of the rehabilitation work should be sufficient to address all major capital needs for, at a minimum, the initial 15-year LIHTC compliance period, as well any design or structural problems that may cause ongoing maintenance problems or threaten the market viability of a Housing Credit development.

11. Capital Needs Assessment

We recommend that a comprehensive capital needs assessment ("CNA") be prepared by an independent, qualified third party. The CNA should include a thorough inspection of the property, including inspection of at least 50% of residential units (representing all unit types and states of "wear-and-tear") and 100% of common areas.

12. Extended Use Agreements

We recommend that when a Housing Credit development's subsidized contract rents are near market-rate rents, but the project has deep-skewed rent restrictions, the HFA should insert language into the extended use agreement providing that in the event a subsidy contract is not renewed or is substantially reduced, the income limits and rent levels may be increased up to the 50% or 60% AMGI level. This exception should only apply so long as the subsidy non-renewal is not due to any action or inaction by the owner or its agents, the project has been in compliance with subsidy contract requirements and the owner has diligently pursued all renewal opportunities.

Also, the existing guidance states that extended use agreements should require all mortgage liens on the property be subordinate to the low-income use restrictions, except in the event of foreclosure. We suggest clarifying that a foreclosing bank should have the right to elect to continue to maintain the affordability under the use agreement.

13. QAP Application to Bond Deals: No comment.

14. Application Procedures: No comment.

15. Appraisals in Acquisition/Rehabilitation Projects

We recommend that HFAs require that third party appraisals accompanying Housing Credit applications include an allocation of acquisition costs between land and buildings. We note, however, that many purchase contracts have negotiated a neutral, arms-length allocation of the purchase price between land and buildings and that allocation might differ from the subsequent appraisal. The proper allocation is a federal income tax law matter and we believe that HFAs should look to project owners and their federal income tax advisors in determining the proper allocation. The proper allocation should also be part of the ultimate audit by the third party auditor of project costs.

16. Consistency Among Allocating Agencies

We recommend that some guidance be provided regarding universal report formats for 10% Tests and Final Cost Certifications. Certain states modify standard language to conflict with a CPA's Professional Standards. These states may also require auditors to opine on future events for which the outcome is unknown (i.e. receipts of future capital contributions, conversion of permanent financing, etc.). We recommend that the anticipated outcome of such future events be supported through representations by the Owner.

We recommend revising the language of the fifth bullet point on page two of the Model Ten Percent Letter to say the following: "We determined that the Owner uses the accrual method of accounting, and has included eligible costs in carryover allocation basis necessary to meet the 10% test and such costs have been properly accrued."

17. Agency Staff Training: No comment.

18. State Designated Basis Boost: No comment.

19. Housing Credit Asset Management: No comment.

20. Facilitating Rural Development with the Credit

In creating feasible LIHTC housing in many rural areas, we recommend that HFAs continue to carefully monitor market selection, the size of Housing Credit development relative to the market, the property management plan and the importance of retaining project-based rental subsidies (such as through RD). Additional incentives should be incorporated to attract investors to Housing Credit developments in rural areas. For example, HFAs can allow the state designated 30% basis boost to be applied for Housing Credit developments in rural areas.

21. Use of the Housing Credit for Supportive Housing: No comment.

22. Green Building and Sustainable Development: No comment.

23. Housing Credit Developments at Year 15: No comment.