An Introduction to

Affordable Housing Development

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Chapter 1.

Choosing to Develop Rental Housing

Rental housing serves a large portion of the low and moderate-income population, and is a very important part of a community's affordable housing stock. However, rental housing is perceived generally as being more complicated -- financially, operationally and politically -- than other types of affordable housing. True, rental housing requires deeper financial subsidies and often a mix of public resources that complicates financing. Long-term viability of projects is often a challenge as projects struggle to keep rents low while still providing adequate management and maintenance. In some communities rental housing is not favored, in part due to multi-family housing projects that have deteriorated and are viewed as negative factors in neighborhoods. <u>In other communities, rental housing is not favored due to density or design features that are inconsistent with community character or desires.</u> As a result, some communities and nonprofits are reluctant to make big investments in affordable rental housing.

Nevertheless, despite all these concerns and challenges, rental housing is a necessary element of a community's affordable housing supply, and preserving existing rental housing and producing additional affordable rental units should be part of any community's strategy to provide a range of affordable housing opportunities.

This guide is about the development of affordable rental housing. It is meant to help local government agencies and nonprofit developers make sound decisions about investments in affordable rental housing. The guide addresses many of the complicated elements of development, including:

- Choosing appropriate rental housing strategies for your community (Chapter 1);
- Assembling and managing the Development Team (Chapter 1);
- Conducting the Market Study (Chapter 2);
- Understanding Appraisals (Chapter 2);
- Creating realistic, complete Development and Operating Budgets (Chapter 3);
- How private lenders underwrite rental housing projects (Chapter 4); and
- How public agency lenders should underwrite affordable rental housing projects (Chapter 4).

Throughout the guide, some of the key requirements of the HOME and CDBG programs will be mentioned. While these are not the only sources of public funding for affordable rental development, they constitute the two key sources available to address rental housing needs.

A. Making Strategic Choices About Rental Housing

Every community has low and moderate income households who are homeless, living in substandard or overcrowded housing or paying an excessive amount of their income for housing. Affordable rental housing can serve many of these households in need. There are a range of possible responses to these community needs for rental housing, including:

- Assistance to the development of affordable rental housing projects -- including new construction, conversion of non-housing structures, and substantial rehabilitation of vacated structures;
- Preservation of existing affordable housing projects -- providing rehabilitation assistance and acquisition financing to housing that is currently designated for low and moderate income occupancy, many of which have received assistance previously through a Federal program, to help sustain the development and prevent it from losing its affordability restrictions;
- Rental rehabilitation programs -- establishing a program to provide rehabilitation funding to improve existing private rental housing and restore compliance with local codes and housing standards; and
- Tenant-based rental assistance -- establishing a program to provide assistance to low and moderate income households to enable them to pay for standard rental housing.

The option or options a community selects depends upon its existing rental housing stock, rental needs and the capacity of local developers and owners to deliver and maintain rental housing. The basic considerations of each of these strategic approaches are discussed below.

1. Rental Production

A rental production strategy is based on the recognition that additional affordable rental units must be produced to address a current or expected shortage. It can involve new construction, substantial rehabilitation of vacant or marginally occupied structures, conversion of non-residential structures, or expansion of existing developments.

Rental production tends to be a series of projects that are proposed by developers or solicited by the community. A community can take the approach of responding to each individual project proposal as it surfaces, or it can establish project guidelines or parameters that developers should follow. Some of the major policy issues are discussed below.

- ***Capacity and capacity-building*** -- Rental production programs and projects require experienced developers and operators of rental housing. Some communities prefer to work with nonprofits, if they are capable of doing rental housing, because nonprofits have a long-term commitment to affordability. Other communities prefer to work with for-profits due to either the absence of nonprofits or the perceived efficiency of for-profits and their access to private capital. In reality, a mix of both types of developers best serves a community. Communities should look objectively at both for-profit and nonprofit developers in the community and determine the most appropriate blend. Where capacity is deficient, communities should look at capacity-building strategies, including the use of HUD-funded TA under the HOME and CDBG programs.

- ***Targeting*** -- Targeting suggests that certain types or locations of rental housing should receive priority. What are the disproportionate needs and underserved areas as they pertain to rental housing? Should the community focus on certain neighborhoods? Should the housing target certain kinds of households: large-family versus elderly, special needs versus generic housing, etc?
- ***Method of soliciting*** -- Communities have options in how they solicit or accept proposals for funding. Some communities choose to concentrate proposals in a competitive process, while others try to keep an open door for projects as they evolve. Where funding is available, flexibility in the timing of applications for funding is very important to rental production. Rental housing projects are complicated, and they don't always come together at a specific time designated in an RFP. Some projects need early public commitments to enable them to chase other funding, while other projects need to move quickly to close when the public source is the last piece of the financing puzzle.
- ***Funding Parameters*** -- It is important to recognize that communities cannot be expected to fully fund rental housing, and that any guidelines established must be flexible to work with the requirements of other private and public lenders. A discussion of financial underwriting parameters occurs later in this guide (Chapter 4).

2. Preservation of Existing Rental Housing

Preservation takes center stage in communities that have stable or declining populations, and the need is to ensure that existing affordable housing remains available. However, it is also important in growing communities, because losses of units will offset production gains, and it is likely to be more costly to replace a lost unit than to preserve it.

The expiration of use restrictions on HUD and FHA rental developments can potentially mean the loss of hundreds of units to communities, as can the conversion and redevelopment of public housing under HOPE VI or other initiatives. In addition, preservation issues can flow from physical, financial and managerial distress in projects that are not escaping regulatory restrictions. The response to each type of challenge varies dramatically. Some of the opportunities are discussed below.

- ***Financial distress*** – Some existing rental projects may have been poorly capitalized at the beginning, or are experiencing cash flow problems due to changing market or project conditions. A community doesn't always know of the distress until default and foreclosure become public, and then it may be too late to intervene quickly and prevent loss of the project. It is important that the community establish a method for tracking or monitoring the status of existing affordable projects, and participating in workouts to avoid foreclosures. Regular contact with the public and private lenders as well as the owners and managers will keep the community abreast of the status, and also establish the community as a stakeholder in any workout or disposition.

- ***Physical distress*** -- Physical distress is usually more visible than financial distress. Communities can survey affordable projects through regular inspection and code enforcement programs, but also through contacts with owners and managers. Because rent revenue is usually limited by regulatory requirements, affordable housing projects can't always generate sufficient reserves to address repairs and capital improvements as they arise. Sometimes substantial rehabilitation funding is needed to stabilize properties and return them to full occupancy.
- ***Expiring use*** – A variety of Federal and state programs have created housing that is under fixed-term regulatory agreements to provide affordable housing. As these projects near the end of their compliance term (or approach an opportunity to prepay the public mortgage and eliminate the use restriction), the owner has important decisions to make about the future use of the property. Sometimes the commitment to continue to provide affordable housing is contingent upon commitment of funds for refinancing and rehabilitation. In other cases, the public financing might be focusing on assisting nonprofits to buy out the current owners and/or resident conversions to ownership. Tracking of the status of these projects is imperative, because early intervention is needed to identify and package such preservation projects before the units are lost to the affordable housing inventory. Contact with HUD, the state, and the Mark-to-Market Participating Administrative Entity (PAE) selected by HUD is critical.
- ***Redevelopment of public housing*** – Recent Acts of Congress and innovative HUD programs such as HOPE VI are charting a new course for public housing and the PHAs that operate public housing. High-density, low-income developments are being replaced by mixed income, mixed use projects of scale and proportion consistent with the community under the principles of new urbanism. This massive redevelopment and re-positioning of the public housing portfolio is drawing a mix of public funds, including funds controlled by local governments. Also, PHAs are now required to integrate their plans with the Consolidated Plan. As a result, PHAs and communities are partners in this process.

The need for preservation resources is enormous. Just one expiring use or public housing redevelopment project could absorb a significant portion of a jurisdiction's annual funding. Communities need to determine how and at what level they will participate in these large preservation and transformation efforts. Some communities have chosen to pre-determine the percentage of local funds that will be directed to preservation versus production of additional units.

3. Rental Rehabilitation Programs

While the large-scale project preservation efforts described above gain most of the attention, a large portion of the affordable rental inventory in many communities might be in small projects, including single family homes, duplexes and multi-plexes of less than a dozen units. In markets or neighborhoods where rents are low, the owners may not have the revenue to fully maintain and improve the rental units. This might contribute to neighborhood deterioration as well as loss of affordable rental units. Sometimes, the funding needed for these small projects is relatively minor, and attention to these properties is a necessary element of neighborhood revitalization. Moderate rehabilitation programs for small rental properties might be the most cost-effective strategy to preserve existing affordable housing.

Rental rehab programs may be the most efficient and acceptable method of addressing rental housing needs in small rural communities or in neighborhoods where there are many single-family or small multi-family affordable rental units. Strategies for moderate rehabilitation of rental units tend to take on more of a program focus than a project focus. Communities reserve a block of funds for a rental rehab program, and then commit to a series of small projects. In the past, some communities ran such successful programs funded through the HUD Rental Rehabilitation Program (RRP), but this program was replaced by HOME in 1992. The transition to HOME was not smooth, however, as HOME has a different set of requirements, including rent controls and long-term occupancy restrictions, which were not favored by the communities and the owners of small rental projects that traditionally participated in RRP. As a result, those communities that had rental rehab programs suspended taking new projects into their rental rehab programs and focused on the completion of existing RRP projects. Since the rental rehab program expired, few communities have considered new rental rehab programs.

Communities examining the role of moderate rental rehabilitation strategies, should consider the following key issues:

- ***Targeting & eligibility*** -- Should rental rehabilitation efforts be focused on particular neighborhood revitalization areas or more broadly available? Should project size be limited? Should project ownership types be limited?
- ***Rehabilitation standards*** -- Rehabilitation standards are important for establishing limits on what improvements can be done, and for ensuring fair and equal treatment of all projects. Should you address only code violations, or should broader (e.g., cosmetic) improvements be considered to ensure visible improvements and marketability of the units? Should there be a limit on the amount of rehabilitation per unit? The HOME Program Rule requires a written rehabilitation standard for any rehab program.
- ***Parameters of assistance*** -- These units tend to be privately owned, and owners need to maintain their equity investment as an incentive to maintain the property. What portion of the rehabilitation should public funds cover? What limits should be placed on funding per unit? What contributions should be required of the owner? What should be the terms of the public investment, including amortization and recapture?
- ***Underwriting guidelines*** -- What underwriting guidelines should be applied, such as loan-to-value ratios, cash flow requirements or limitations, equity requirements, borrower creditworthiness, and other standards discussed in Chapter 4?
- ***Administration*** -- Should the public agency administer the program itself or use a subrecipient to administer the program? Will in-house administration distract the agency from other activities? If targeted to a revitalization area, are there potential

subrecipients who might be better positioned to market the assistance and monitor its use? Do any potential subrecipients have the experience or capacity required?

- ***Marketing to owners of small rental properties*** -- How will the owners and managers of eligible properties be identified and reached? Are special or affirmative marketing efforts necessary?
- ***Relocation*** -- If most properties are occupied, what standards will be followed for interim and/or permanent relocation? Are lead paint and other hazardous elements indicating interim relocation? What about households that are over income? Are rent increases going to be permitted at the risk of economic displacement?
- ***Rent limits and compliance period*** -- Are rents to be limited? HOME imposes rent limits, while CDBG requires the community to determine affordability standards. How long must the low and moderate-income occupancy be maintained. HOME has minimum standards that a community can adopt or exceed.
- ***Rental assistance & protections to existing tenants*** -- In addition to rent limits, are there any other tenant protection elements available, such as rental assistance or processes for ensuring that rent increases are minimal?

4. Tenant-Based Rental Assistance

While the other three strategies focus on the production, preservation or rehabilitation of specific units as fixed affordable housing, the HOME Program also permits a local community to undertake tenant-based rental assistance (TBRA). Rental assistance generally is not a permissible activity under CDBG, except it may be used for emergency grant payments and to fund housing counseling and other such services in support of a HOME TBRA program.

Given the presence of Section 8 certificate and voucher programs funded by HUD in most communities, the use of HOME for TBRA is limited. Where it is used, the community has concluded that there is decent rental housing available for low income households and the temporary (two-year) rental assistance is sufficient to help the households until other assistance is available. Generally, the HOME TBRA programs are administered by PHAs or nonprofits as subrecipients in a manner similar to Section 8 Certificates or Vouchers.

This guide cannot address all of the required elements of using HOME for TBRA. Interested communities should obtain Tenant Based Rental Assistance: A HOME Program Model, available from the Community Connections Clearinghouse. Some of the basic issues confronting a community that wants to consider this strategy are highlighted below.

- ***Supply and demand*** -- What is the status of the Section 8 and Vouchers Programs, including the size of the waiting lists? What is the general supply of standard housing in the community, and how are market rents relative to FMRs?

- ***Goal*** -- What do you want to accomplish with the temporary (up to two years) assistance? Who do you want to serve? Households nearing the top of the Section 8 waiting list and waiting for a certificate? Families in self-sufficiency programs?

- ***Exit Strategy*** -- What is your exit strategy? What happens to families once the two-year assistance period expires?

- ***Basic Program Design*** -- Is the project going to fund monthly rental assistance, security deposits, or both? Is the structure of the program going to follow basic Section 8 Certificate or voucher rules? Are there key variations from these programs? Should there be income targeting? What preferences will be used? What payment standard will be used? Will there be other requirements on the households, e.g., self-sufficiency goals?

- ***Processing*** -- Will existing waiting lists be used or new ones created? What intake procedures will be used? How should HQS be handled? How will contracts and disbursement be managed?

- ***Administration*** -- Is a local PHA or nonprofit with experience in rental assistance administration available? If not, what would be required to establish the administration within a local agency?

- ***Marketing*** -- How should the program be marketed to ensure landlord participation? What affirmative marketing procedures should be used?

This strategy requires substantial up-front commitment to program design and the development of procedures. It is recommended that communities work with experienced rental assistance administrators if this strategy is chosen.

B. Building Partnerships and Capacity to Develop Rental Housing

Many communities that lack affordable rental housing also lack affordable housing developers capable of developing and managing rental housing. ***Partnerships*** are key to enhancing the capacity of the private market to deliver an expanded range of affordable housing opportunities. In Building Public-Private Partnerships to Develop Affordable Housing, HUD's report on an experiment with partnership building, benefits of partnerships were found to include increases in affordable housing production and "dramatic improvement" in the leverage of other funds.

Local public-private partnerships can exist in many different forms:

- ***Affordable housing task force*** -- groups that focus on galvanizing public attention to affordable housing, the design of public policy initiatives and the convening of discussions among industry actors;
- ***Operating support collaboratives*** -- groups of funders who come together to provide core operating support to nonprofits to enable them to enhance their capacity and focus on project delivery;

- ***Project-based developer partnerships*** -- partnerships that undertake direct development of projects;
- ***Program-based or financial intermediary partnerships*** -- partnerships to create pools of funds for use by affordable housing developers; and
- ***Public sector partnerships*** -- partnerships designed to facilitate relationships and cooperative efforts among existing public agencies at different levels of government.

Partnerships can be formal or informal, they can be project-specific or ongoing, depending upon the parties involved and the needs they choose to fill. In all cases, the goal is coordination and expansion of capacity.

According to the HUD-funded study of partnerships, six factors determine the likelihood of success:

1. Clear, identifiable need(s) that the partnership can address
2. Strong leaders and conveners
3. Diverse involvement
4. Access to funding
5. Doable programs
6. Effective mobilization of resources

Partnerships involve both public and private actors. Public agencies can play key roles in building each of the sectors, and the relationships between the sectors. Some of the key types of partners are discussed below, including what they bring to the partnership and what they require from the community to expand their capacity and produce more affordable housing.

1. Working with the Nonprofit Sector

Over the last couple of decades, nonprofits have been playing a rapidly expanding role in the production and operation of affordable housing and the delivery of services to low- and moderate-income families. They have taken over many service delivery functions formerly conducted by government, and they are increasingly active in the physical development of low-income neighborhoods and revitalizing areas.

Nonprofits bring many attributes to the partnership. They are organized specifically to undertake activities that benefit low- and moderate-income persons, and often involve low- and moderate-income persons directly in the organization through board, committee and membership structures. They attract dedicated staff to serving the low- and moderate-income population, and restrict their profits to charitable purposes. They have flexibility of structure and procedures that is not often available to public agencies. And their mission commits them to preserving affordable housing in the long run.

At the same time, many nonprofit organizations are long on commitment but short on funds. They have to seek operating support regularly, and this may divert attention or delay their ability to implement projects on a timely basis. Few have the capital to take on predevelopment costs and meet equity requirements. Well-intentioned and community-based boards and staff might lack some of the key skills needed for cost-effective implementation of projects and programs.

Most Federal programs accommodate and even encourage the use of nonprofits to undertake housing and community development functions. In the CDBG program, nonprofits can play roles as subrecipients, and Community-Based Development Organizations (CBDOs) have specific authority to undertake certain economic and housing development projects. In the National Affordable Housing Act of 1990 (NAHA), one of the purposes of the HOME Program is to "expand the capacity of nonprofit community housing development organizations to develop and manage decent, safe, sanitary and affordable housing." Nonprofits are eligible as subrecipient administrators of local programs, and certain nonprofits can qualify as Community Housing Development Organizations (CHDOs), gaining special access to 15% of the HOME Program funds for development projects, along with unique access to predevelopment loans, operating funds and technical assistance.[1]

What do nonprofits need from communities to be successful?

- Access to operating support;
- Access to seed money and predevelopment funds;
- Access to training and capacity building in housing development and management;
- Access to gap financing;
- Access to other lenders;
- The opportunity to earn reasonable developer fees; and
- Predictable pipelines of projects to sustain staffing.

What do communities need from nonprofits?

- Professional and sustained effort and timely project completion;
- Stability of staff and organization;
- Strong connections to the community and participation by the low- and moderate-income residents of the community; and
- Growth of capacity and the ability to carry expanding roles in community development.

2. Working with For-Profit Developers

[1] CBDOs and CHDOs are in some respects similar, but not identical. Both emphasize the community-based and nonprofit nature of the organization, but board composition and nonprofit status requirements are different. CHDOs qualify as CBDOs, but not all CBDOs will meet the CHDO requirements as specified in NAHA.

Private developers have built most of the affordable housing units in this country. They are the principal participants in FHA programs, the low-income housing tax credit program, tax-exempt mortgage financing and other public loans.

Private developers can bring important assets to the table. They have access to private equity and private loan capital. They offer fast and cost-effective production of housing, and the ability to manage complex projects.

What do developers need from the community?

- Efficient local approval process;
- Evidence of housing demand in markets that are not recognized as growing markets;
- Support for applications for public subsidies to projects;
- Assistance with site identification;
- Assistance in negotiating with neighbors who might be reluctant to support affordable housing projects;
- Assistance with M/WBE, Section 3, Davis-Bacon and other Federally-imposed construction requirements; and
- Access to infrastructure and infrastructure improvements.

What do communities need from private developers?

- Willingness to develop and operate housing that includes low- and moderate-income households;
- Access to equity for affordable housing projects;
- Access to private lending for affordable housing;
- Commitment to operate housing in full and ongoing compliance with regulations;
- Development cost control;
- Reasonable fees for developer services;
- Willingness to negotiate with the community to ensure long-term affordability; and
- Willingness to partner with nonprofits in development.

3. Working with the Lending Community

A basic premise of most housing programs, including CDBG and HOME, is that public funds should leverage private capital for housing and community development efforts. Indeed, a stated purpose of the HOME Program is “to increase the investment of private capital and the use of private sector resources in the provision of decent, safe, sanitary and affordable housing.”

Most lenders are willing participants, due to personal and corporate commitment to the community and the more pragmatic need to comply with the Community Reinvestment Act

(CRA). Lenders may be willing to stretch their usual underwriting parameters in order to accommodate the community's objectives. They also provide the discipline and oversight of projects to ensure completion.

Lenders are important partners not only for the direct funding of affordable housing projects sponsored by the community, but also for the broader role they play in overall investment in communities. Lenders that participate in partnerships can carry their knowledge and enthusiasm for the community into their other lending roles and relationships, and perhaps help to stimulate or support other private investments in the communities. They must be at the table, even if their money isn't on the table for every project.

At the same time, when lenders do invest in specific affordable housing projects, they might look to the community to absorb as much risk as possible to bring their investments within acceptable risk ranges. Sometimes their expectations for public risk-taking might exceed what is prudent for the community under public lending standards. Private and public lenders need to be able to communicate, understand the risk parameters of each other, and be able to work to reasonably accommodate the interests of both lenders. See the discussion of public underwriting in Chapter 4.

What do lenders need from communities?

- Opportunities to invest in CRA-eligible projects within reasonable risk limits;
- Subordination of the public investment to the private loans; and
- Assistance with understanding the requirements of public programs and the limits of public investments.

What do communities need from the lender?

- Inter-creditor agreements that reflect reasonable balance of the responsibilities and risks assumed by each party;
- Notice of debt service nonpayment on publicly-funded projects and reasonable time for the public agency to intervene and cure the delinquency or default prior to foreclosure to protect the public investment; and
- Commitment to the community and private investment beyond the specific public-private projects.

4. Working with Other Public Agencies

While the local government, perhaps through its Community Development Agency, may be at the hub of coordinating housing activities, there are many other local, State and Federal agencies that can participate in the partnerships and projects. Other local agencies might include the local public housing authority, redevelopment authority, health agencies involved in lead poisoning prevention and other healthy homes initiatives, police, fire, schools and other community agencies and institutions that provide services and facilities in the target areas.

These agencies are potential funders of affordable housing projects, but may also be funders of ancillary non-housing initiatives such as services and community improvements. Since the ultimate goal is viable and sustainable communities, the partnership should reach out to include agencies that can have a positive impact on the quality of life in the community.

States are important partners through Housing Finance Agencies and Community Development Agency programs, as well as Health agencies responsible for the regulation and administration of lead hazard reduction and other community quality of life initiatives.

While not all of these agencies can be at the table regularly like the local housing partners can, they are nonetheless important partners who need to be consulted and solicited regularly for the contributions they can make to local strategies.

What do the other public lenders need from the local community development agency?

- Coordination of underwriting efforts and project commitments across agencies to ensure adequate but not excessive subsidies to each project;
- Communication of regulatory requirements and willingness to negotiate and resolve differing requirements across programs;
- Willingness to negotiate priority of liens and subordination to ensure reasonable protection of all public funds;
- Coordination of compliance requirements and enforcement efforts; and
- Communication throughout the development process to ensure quick resolution of problems.

What do communities need from the other public lenders? The same things they need from the local community, plus:

- Inter-creditor agreements that reflect reasonable balance of the responsibilities and risks assumed by each party; and
- Recognition of the local community's unique role in understanding local needs and priorities, and providing local leadership.

An effective affordable housing delivery system depends upon partnerships and resources. The local community can play an important role by fostering partnerships and enhancing the capacity of organizations to deliver affordable housing. If this capacity is in place, affordable rental development will follow.

C. Assembling the Development Team

Any housing development has a "team" of professionals who will be included at various points and will have various roles to play. Some members may have multiple roles, but one person - the developer - must be the leader or manager who accepts ultimate responsibility for pulling the whole project together.

Developers are paid a fee: often between 5% and 15% of the project costs to manage the development process. Sometimes, however, nonprofits receive expenses in lieu of a developer's fee. The developer's percentage varies by the size and cost of a project. Smaller projects will require a larger percent. Architectural and engineering design fees are usually charged separately.

The **Developer** plays the role of team leader. This person or entity is most often the one who has the initial idea for the development and the experience and the commitment to take a risk.

The developer's responsibilities typically include:

- Defining the project scope
- Selecting and supervising the development team
- Obtaining local approvals and managing public relations
- Obtaining the financing commitments
- Managing the budget and schedule
- Overseeing marketing and occupancy

The developer role is extremely challenging, and requires a key person or team, who has a mix of skills, including real estate, political, management, negotiating, financial and marketing skills. The developer must possess these skills, or assemble a team with the required skills and have the capacity to manage that team. The development team may include the architect/engineer, contractor, marketing and/or occupancy manager and development consultants, as needed. The developer is also responsible for managing the other key relationships that must be maintained outside of the development team, including lender(s), the neighbors, and potential customers.

Sometimes the developer directly employs staff to play key roles in managing the day-to-day affairs of the development projects. These persons might be designated as:

- **Project Coordinator**, who provides day-to-day management of the development process, oversight of the entire process and tracking of progress and budgets; or

- **Construction Manager**, who assists the Developer by assuming direct responsibility for the oversight of the architect, engineer, and contractor until the project is complete.

When no such person or entity is designated, these functions remain the responsibility of the developer.

It is also important to recognize that the **Board of Directors** is a key element of the developer if the organization is a nonprofit. The Board will set the key direction and focus of the project, will approve all major financial commitments related to the project (including acquisition and borrowings) and will become involved in key decisions and problems along the way. It is important to recognize that the board should not be involved in the day-to-day decision-making needed to ensure timely implementation, but should provide regular oversight of project progress.

In addition to the Developer, the development project team typically includes a variety of actors. It might be useful to think in terms of:

1. A **core team** of professionals who are involved throughout the project design and implementation and have responsibility for most of the critical path activities;
2. **Supplementary professionals** who provide critical services to the team at key stages, but are not necessarily part of the core team; and
3. **Stakeholders and partners** who, while not part of the development team, are critical to many of the key decisions and with whom communication throughout the project is essential.

The core development team is likely to include the following actors:

- **Architect –** The Architect provides the blueprints and plans for the building, specification and oversight of the building process. The architect must be knowledgeable about local codes, be able to work with applicable program requirements (e.g., HQS under HOME) and be proficient in estimating construction cost impacts and doing cost effective design within reasonable time frames.

- **Project Engineer** – The Project Engineer is needed in new construction and substantial rehabilitation projects where structural condition is critical. The Engineer works usually as a subcontractor to the Architect to design, review and approve the structural elements of a design. The Engineer might also become involved in site and environmental problems and design issues that may occur before or during construction, and will also participate in budgeting.

- **Contractor/Builder –** Selection of the contractor early in the development process enables the contractor to work with the developer and architect in assuring that the project design can be constructed within the budgeted amount.

- **Management Agent -** This firm or individual should be selected early so their experience in managing poorly- and well-designed building can be considered in the planning stage. They can help focus attention on the design features that appeal to customers, and may also be skilled in marketing. Their review of designs can identify potential maintenance, security and management problems fostered by the design, and their input into operating budgets is essential. Quality management agents are important to lenders.

- **Attorney –** An Attorney is an essential member of the team for legal advice and consultation at all key stages of the process. The Attorney will be essential in creating ownership entities (such as joint ventures, partnerships and trusts) handling real estate transactions, coordinating loan closings and documents, and advising the developer in legal matters. Such advice will directly affect the shape of many projects. However, the Attorney need not be active at all team meetings and activities, and is consulted for legal advice rather than business or financial advice (unless so selected).

While these professionals form the core team, the developer may also add other professionals as needed to supplement the development team and provide it advice at key stages. Additional Development Team members might include:

- **Accountant** – An Accountant can play the role of ensuring that bills are paid in accordance with established policies for documentation of costs and provide cost certifications as may be required by certain lenders or investors. The Accountant's role is especially significant in tax credit projects, where cost certification is essential for establishing basis.

- **Appraiser** – Often, the appraiser is hired by the lender and is not a member of the development team so that the appraiser retains independence. However, sometimes appraisers are hired directly by the developer to establish acquisition price.

- **Market Study Professional** – Chapter 2 will address market studies. It is important that the study be conducted up front, so that the information can be used in shaping the project.

Finally, while it is not typical to think of the following as Development Team members, they are nonetheless important "stakeholders" and "partners" in the development and should be consulted throughout the process, and sometimes included in the deliberations and communications with the Development Team at key stages in the process:

- **Community/Neighborhood Representatives -** These persons reflect the community and can provide input and lend credibility that will help ensure support to the project. Neighbors and neighborhood associations can be a conduit for information to and from the community, and can help provide valuable input into the design, marketing and management of the project.

- **Local Government** – The local government is needed for project approvals and often project funding. Consultation should be done early to identify possible problems with approvals and funding.

- **Lenders** – Communication with lenders is critical throughout all stages of planning and implementation.

- **Customers** – Involving potential customers or groups that represent potential customers can help to provide a reality check on design decisions, as well as build word-of-mouth marketing for the project. Advocates and service providers for the tenant population you want to serve are essential in gaining professional input into many decisions.

It is the Developer's responsibility to select, assemble and consult with the team members at all three levels throughout the project. It is important to keep in mind that the selection of team members is likely to be subject to procurement rules imposed by public funding programs and lenders. Consultation with potential public lenders up front can avoid later re-bidding or rejection of team members.

D. Managing the Development Team and Process

There are several tools that a developer can use to maintain appropriate oversight and control of the implementation of the project:

- ***Market Study*** -- The market study defines the target audience, which should be a guiding beacon as the project evolves and changes. It is the constant reminder of who is to be served, and becomes the litmus test for whether the project is still on target as it evolves. This will be discussed in the next Chapter.
- ***Critical Path & Schedule*** -- To manage complex construction projects, contractors map out the sequencing of activities across a time line. Many activities are inter-linked and interdependent. If a critical activity falls behind, it can delay a whole variety of later activities. Delays put the project at risk of higher costs. Budget modifications often lead back to the public lender's door for increased funding. Make certain that the developer has scheduled the full development process using the critical path method or other scheduling process. Obtain a copy of the schedule and use it to monitor the project. When a project falls behind, the developer must take immediate corrective action.
- ***Development Budgets*** -- Budgets are estimates of the costs to complete the development, but they are dynamic and subject to constant revision. The developer must track the changes and do regular budget updates with actual costs and expected changes.
- ***Project Team Meetings*** -- Everyone on the development team is likely to be busy with multiple projects. Regular team meetings are necessary to keep all team members focused on the schedule, and to address problems that must be resolved with all parties present. Special team meetings beyond the regular meetings should occur at key stages when critical activities are occurring or a slowdown has occurred.
- ***Disbursements*** -- The golden rule of development is that "the person who has the gold rules!" The developer has the purse strings on the funds. When funds are disbursed before issues are resolved, the developer loses the leverage of the purse strings. Retention of funds and the strict supervision of all disbursements are essential to retaining control over the project. Then again, habitually slow disbursements or payment stops can slow down the project, so funds retention and payment stops must be used carefully.
- ***Lender Relations*** -- During the development process, silence is not golden as far as lenders are concerned. When a lender does not hear from a developer, the lender might become concerned that the project has slowed, or there is some problem that is being concealed. Developers should report in regularly.
- ***Neighbor Relations*** -- Some developers shy away from contacts with neighbors for fear of generating controversy, but concealment or avoidance can increase the mistrust and lead to stronger opposition to affordable housing projects in the future. The developer needs to accept the responsibility for meeting with

neighbors and addressing their concerns. The local public agency may be able to facilitate those meetings to ensure that opposing neighbors do not sidetrack the development. Ultimately, the developer and the neighborhood are in it together.

Together, these seven tools can be used to stay on top of the process and ensure progress. With these tools, development is a difficult process. Without sound management using these tools, development is an extremely high-risk process.

E. Negotiating Tips

The Developer will be involved constantly in negotiations -- with applicants, contractors, partners, lenders and attorneys. Negotiation skills are essential to timely and satisfactory conclusions to all projects and issues. Failure to negotiate successfully can result in excessive costs or risks to the developer, or even the demise of a project.

Inexperienced developers may feel over-matched when going to the negotiating table with experienced contractors, lenders and attorneys. While you may not have the training and skills to match the parties with whom you are negotiating, you should be able to achieve a satisfactory conclusion if you prepare properly and adhere to some basic guidance:

- **Prepare.** Get ready for the negotiation by listing the known or expected issues, the bottom line for your Agency on each issue, and the likely needs or concerns of the party with whom you are negotiating.
- **Listen**. Follow the well-known advice “seek first to understand, then to be understood.” If you don’t recognize all the concerns and issues of the other party, you will not be able to find a solution. If you don’t understand, ask again, or seek other advice.
- **Communicate clearly.** State concerns, issues and needs that you have. Be clear about regulatory and political constraints that restrict your ability to alter terms.
- **Seek win-win solutions.** Consider what’s important to you and what’s important to them. Can you achieve both? Focus on risk balancing: are the risks and rewards for each party in balance? If not, how can we change, reduce and balance the risks?
- **Get it in writing**. Document whatever has been discussed, agreed to, and unresolved from the meeting, and confirm it in writing.
- **Read it before you sign it**. If a document or agreement is produced as a result of the negotiation, don’t sign until you understand it. If you can’t understand it, find someone who can help you.

Chapter 2.

Project Selection

A. Selecting a Project Location and Site

Before a market study can be developed, the project site, or at least a general location, must be identified. You may have a specific parcel that you currently own or can acquire, or it might be one of the few vacant parcels or properties suitable for development within the proposed budget. However, before a lot of time and money is put into development, the principles discussed below should be considered.   Just because a site is owned, or can be purchased for next to nothing, that does not make it a bargain or suitable for affordable housing.

If a site has not been selected, focus these questions on general locations.   Pick neighborhoods, and then focus in on sub-neighborhood areas or perhaps several blocks.

- **The location must be suitable for the population it will serve.**

  The location has to be accessible and suitable for the intended population.   It may seem obvious, but consider transportation needs. Do prospective tenants have cars? If so, will the site accommodate sufficient parking spaces? If they do not have their own transportation, can public transportation be arranged?

  It must be accessible to places that provide for their needs. Is it close to a grocery store, discount department store, churches, social service agencies, schools and health care?

  Is it too close to notorious areas: busy, noisy bars; places with a high crime rate; reputed drug-dealers' territory?   Talk with neighborhood and customer groups. If they indicate the site is a problem, ask for their suggestions. If problems seem insurmountable, look for another site or property.

- **The location should not further concentrate poverty households and minorities.**

  Often, nonprofits and local governments focus on redevelopment of areas that already are significantly low-income in character, with concentrations of poverty and minorities.   If the location and project will only cause further concentration of poverty households and minorities, it is not promoting housing choice, which is the goal of fair housing and affirmative marketing.   Look more broadly at the market and opportunities to promote a diverse mix of housing opportunities throughout the market. If you are committed to revitalization of a low-income area, then focus on mixed-income strategies.

- **The site or existing property must be suitable for the proposed development size and type.**

  Is the proposed site appropriate for the development? Does it have the zoning needed, or is zoning approval readily available? Is the project use compatible with contiguous uses? Will the site support the density needed to make the project feasible?

- **When evaluating alternative properties, consider the acquisition price to include any infrastructure, site improvements or environmental remediation costs required to make the property suitable for development as the true total acquisition cost.**

  A particular site or building might be available at an affordable price because it is less than desirable. It may have water drainage problems that will be costly and problematic to solve; it may have environmental hazards; it may be too close to a busy commercial area; or the terrain may be rocky and difficult or costly to build or inhospitable for tenants.

  If it is an existing property, there may be lead-based paint or asbestos problems that make costs prohibitive. If an existing building is more than three stories high, you will need to deal with elevator installation or repairs. If the building was a school or commercial property, configuring units to meet the lender’s requirements and attract good tenants may be a problem. The type of property you want may not be a good match for what is currently available.

  An architect and/or engineer should be involved early on to spot these kinds of problems. The development team will need their services, and their skills could keep you from making a costly mistake. What are your options if they spot trouble? Redesign the building and landscaping or look for another site or property for sale? There is no such thing as a bargain if the development budget is broken by costs to “make it work.”

- **Neighbors may not welcome the development.**

  Both nonprofit and for-profit developers and local officials must be prepared to spend time marketing the concept to local residents. Have information readily available and deal with NIMBY-ism in its early stages. Seek out the local newspaper reporters and tell your story directly. Find allies in churches, social service providers, and organizations that serve the intended residents of the development.

  Nonprofit and for-profit developers should seek support from local officials before proceeding with even the early stages of a development. Politicians have been known to revoke building permits if public resistance is perceived as strong. Unfortunately, neighbors who express “market value” concerns may be expressing thinly veiled fear and prejudice about the likely tenants. Neighbors should be educated, but if resistance is strong, and the development proceeds in spite of it, the tenants may find the neighborhood a very unpleasant place to live and the occupancy rate (and rental income) may suffer.

Units of government should assist developers to understand the political and other considerations they may face given the scope and location of potential projects. This assistance goes beyond that provided regarding zoning and ordinances or other local requirements that will impact the development. Units of government that are uncertain of potential political or neighborhood considerations may wish to assist the developer to identify concerns and reassure neighborhood residents and politicians.

With these factors in mind, sort through possible locations and potential sites. If an irrevocable commitment to a single site has not already been made, the options should be left open and the market study should proceed. The market study, or subsequent budgeting, may indicate which site is the most appropriate and feasible for development.

B. The Market Study

The purpose of a market study is to help determine whether or not a market exists for a particular type of housing product under consideration for a particular location.

The market study is often contracted to a professional market study firm, particularly if the lenders require an independent market study. However, it is a mistake to think of this merely as a loan requirement that can be farmed out to a professional. Developers, including many nonprofit developers, often make two big mistakes that waste the resources devoted to a market study:

- ***Doing the Market Study Too Late*** – Sometimes, a market study is conducted as one of the last “loan application documents” assembled prior to submitting an application for funding. This is potentially a waste of the resources put toward the market study. Doing the market study at the end of the planning process is primarily an exercise of rationalizing what has already been decided. The information is needed at the beginning, not the end, of the planning process, when it can help guide decisions about site selection, project design, target audience, amenities required, pricing and other critical factors that affect the overall project plan.

- ***Leaving it to Market Professionals*** – Some developers are likely to farm out the study to a market study firm, without giving them real clear instructions on the target audience and the information needed, and not becoming involved in the study or knowledgeable of the results. As a result, they lose the ability to get targeted information from the study, often settling for warmed-over Census counts about the general low-income population rather than the specific customers for the project. In addition, many nonprofit developers have plenty of direct information on potential customers that would be of value to the market study professional, but they fail to provide it or incorporate it.

1. What Do You Want To Know?

Market studies are conducted to help predict the potential success of a project if it were developed as proposed. The study focuses on both supply and demand factors:

- Demand – Identify the target audience for a particular project and define what elements of the proposed project can enhance the demand for the project.
- Supply – Determine how competitive the project will be in attracting target households in consideration of the other opportunities available in the local market.

To analyze the supply and demand factors that pertain to a proposed project, we must rely on a mix of primary and secondary data.

	SUPPLY	**DEMAND**
Primary Sources	On-site visits to projects; windshield surveys Interviews with owners, managers, Public Housing Authorities, other housing providers, tenants' organizations, local officials, realtors, nonprofits	Interviews with prospective tenants, social service agencies, organizations whose members are prospective tenants, Public Housing Authorities, churches, surveys, Chambers of Commerce, employers Professionally-obtained market study, focus groups
Secondary Sources	Census data, local housing data Real estate boards and apartment owners' associations Universities and research centers	Census data, local housing needs data Real estate boards and apartment owners' associations Universities and research centers

2. Demand Analysis for Affordable Rental Housing Projects

One of the key tasks of market analysis is estimating the potential demand for the proposed housing units. It is typical for conventional lenders to require a market study, and sometimes this is useful for affordable housing as well. While professional market studies have a cost that is not insignificant, much of the analysis can be conducted by the developer or local government agencies.

Caution: demand is different from need. It is not sufficient to estimate the number of households that are eligible for a particular unit. Market studies that simply document the number of low and moderate-income households, without providing for further targeting, have not provided any useful service to the project or the public lender.

Analysis of demand typically relies upon a mix of primary and secondary data sources. Primary data is information directly available from or about the most likely customers, and is most instructive in shaping the kinds of housing, location, amenities and pricing for housing projects. Secondary data, such as Census data, is useful for supplementing the primary data and for estimating the overall size of the target pool of households.

Waiting lists, applications, surveys, focus groups, and other outreach techniques to potential customers are examples of primary market analysis. These sources give the best information because it comes directly from potential customers. Where affordable housing developers have the opportunity to have a direct relationship with low and moderate-income households, they should take advantage of it. Ask not-for-profits to analyze the interests of their clientele. Ask for-profit developers for copies of market studies and other information they may have about their clients, even though they may be of higher incomes.

Primary market analysis might address the following issues for potential customers:

- Interest in homeownership versus rental
- Amount of funds available for downpayment or move-in expenses
- Locations considered suitable or unacceptable for housing
- Accessibility priorities – e.g., relative importance of proximity to churches, schools, parks, shopping, jobs, etc.
- Safety factors -- perceptions of safety risks, safety measures required to create an acceptable level of safety
- Parking and other amenities required/desired on site
- Size of unit (bedroom) required
- Living spaces (other than bedrooms) desired
- Importance of air conditioning
- Acceptable price ranges and rent ranges
- Other factors affecting location decisions

These things can only really be analyzed by talking directly with customers or the providers that serve the potential customers.

On the other hand, demographic, or secondary analysis is used to supplement primary data collection and to help estimate how many total households might be in the target pool. Broadly speaking, all low and moderate income households comprise the total pool of eligible households for most Federal housing assistance. However, low and moderate-income households already in homeownership or assisted housing are unlikely to be primary candidates for newly assisted housing.

Not all of the households in that broader pool are within the target market for a particular housing development. Some projects might target low incomes. Unless project-based rental assistance is provided, the project is likely also to have an effective minimum income required to be able to afford the housing cost. In addition, housing built for large families won't be targeting elderly or single person households. These factors narrow the target pool for a particular development.

It is extremely valuable in understanding whether the proposed project provides what the customers are willing and able to pay for, and extensive primary data and waiting lists may reduce the need for the secondary market demand analysis described below. For example, when considering projects for homeless and special needs, the targeting is very focused. Special needs service providers may have a very defined client base or waiting list with detailed information about the actual clients. In these cases, the primary data is more important than the demographic analysis described below.

For most affordable rental housing projects, however, secondary demographic data analysis is useful. It starts with statistics from the Census and other sources to define the total pool of eligible households, which could be defined as total need. Then, need is translated into an estimate of demand by sorting and bisecting the total pool to identify the primary target households within the total pool. This demand estimate can be accomplished in the three steps described below.

1. Define the geographic <u>Market Area</u> from which customers are likely to be drawn. Market analysis usually focuses most on the "primary" market, which is the geographic area from which the project can expect to draw the <u>majority</u> of its customers. Market area is determined by how far people are likely to move. Market area is unlikely to be defined as your jurisdiction boundaries. The market area for a project could be a portion of a jurisdiction, or include adjoining communities or suburban and rural areas. Talk to housing operators and realtors in the community to get a sense of how big the geographic market is likely to be for affordable rental and homeownership projects.

2. Estimate the households in the <u>Eligible/Affordable Range</u>. What is the maximum income at which households are considered eligible. For CDBG and HOME, most assisted units must serve households at 80 percent of area median income or lower. However, not all households within the "eligibility range" can also afford the rents (or sales prices, in the case of homebuyer projects). For market study purposes, exclude households at the lower end of the income scale who cannot afford the rent or price, unless there is project-based rental assistance. This is what is referred to as the "Affordable Range."

3. Estimate the households in the key <u>Demographic Segments</u> targeted by the project. "Segmentation analysis" identifies the primary customers by key demographic characteristics. Most projects can identify typical customers -- for example single persons, small or large families, elderly, special needs or homeless. If data limitations prevent an estimate of the number of households in the targeted segments, eliminate households in key demographic segments that are not part of the pool. For rental or first-time homebuyer projects, eliminate existing homeowners from the pool. For a family project, eliminate elderly and single person households. If the project is targeting families with children, take out childless households. And so on, until the pool begins to resemble the more likely customers.

4. Affordable Rental Housing Supply & Competition Analysis

a. The Affordable Rental Housing Supply

The affordable rental housing supply consists of two major components:

- Public and assisted rental housing units; and
- Private unassisted rental units with affordable rents.

The inventory of public housing units and other assisted rental units in the community includes: units financed with Tax Credits, Section 202/811, FHA insured projects, existing HOME and CDBG assisted units, units assisted through the Federal Home Loan Bank Affordable Housing Program, RTC/FDIC Affordable Housing Program units, and state/local assisted units. Sources of information on the assisted housing inventory include: Community 2020 software, HUD, state and/or local housing agencies , state and local community development or housing agencies, Public Housing Authorities (PHAs), not-for-profit owners, and a variety of other agencies operating affordable housing programs such as the FDIC (which assumed responsibility for the RTC portfolio) and the Federal Home Loan Bank.

While contacting the various agencies, ask about occupancy or vacancy rates. Also ask about the number of units currently in the pipeline or under development.

After identifying the various programs and sources of affordable housing, the next challenge is to avoid the double counting of units, since some rental units have multiple sources of assistance (e.g., an HFA-financed, FHA-insured, Tax Credit project).

The number of private unassisted units is difficult to estimate with existing data sources. Surveys or samples of units currently available for rent would miss those units in long-term occupancy that are not available but have very low rents for long-standing tenants. One method is to use Census data to compute the number of low and moderate-income households that did not have rent burdens. From this, subtract the number of publicly assisted units to arrive at a net number of private rental units that are occupied and affordable to low and moderate-income households.

It would also be useful to further adjust the private inventory to exclude units that are substandard.

Some might consider adding tenant-based rental assistance to the estimate, such as Section 8 certificates, vouchers, HOME TBRA units, and any other State or local rental assistance programs available. However, this would result in over-counting because:

- Many certificates are being used in the publicly assisted units; and
- Tenants in private housing with rental assistance would have been included in the estimate above based on the absence of rent burden.

Analysis of the compiled inventory would incorporate the following issues:

- Utilization – What are the occupancy levels in the existing stock, and what portions of the stock are vacant or under-utilized?

- Trends – Is the overall inventory increasing, decreasing or stable? What are the anticipated changes?
- Vulnerability – What portions of the stock are vulnerable to:
  - Removal of restrictions as a result of Expiring Use, Mark-To-Market, public housing redevelopment and expiration of compliance periods;
  - Extensive physical deterioration as a result of deferred maintenance and inadequate management; and
  - Financial loss and foreclosure.

This information will provide guidance on rental priorities. For example, if the trends are for the loss of existing affordable housing, then preservation becomes a priority and a focus in the allocation of resources.

b. Competition Analysis

After the general supply has been quantified, the other element of market analysis is to evaluate the proposed project in comparison to the competition. Competing housing includes both assisted and private housing. Competing housing should be analyzed for issues such as:

<u>Assisted housing</u>

- What are the rents compared to the proposed project?
- Is rental assistance provided to this project or the competition to give one or the other an advantage in attracting customers?
- What are the locational and amenity advantages (and disadvantages) of the proposed project compared to the competition?
- What is their occupancy level? The size of their waiting lists?
- Will the proposed project be competing for the same customers?

<u>Private housing</u>

- What is the general vacancy level in the immediate area?
- What are the street rents in the immediate area and how do they compare to the proposed project?
- How do the proposed rents compare with typically available units?
- How do the unit sizes, location and amenities compare?

Regardless of whether the proposed project is for rental or homeownership housing, it is advisable to consider the availability and costs of both types of housing. Since renting is an alternative to owning, and vice versa, it is one of the choices households have when considering the proposed project.

5. Market Study Conclusions

In the final analysis, a market exists if there is a sufficient pool of targeted households to occupy the units and the project offers a unique or competitive product. Public agencies and others funding the project must have comfort that these conditions exist. If the developer does not provide primary and secondary data analysis, lenders and other partners will have to rely on their own analysis.

With the information generated by the demand and supply analyses discussed above, conclusions are then generated regarding the likelihood that the project as proposed will have an adequate demand to reach sustaining occupancy and remain viable over time. If a particular project has not yet been defined, the study will indicate some guidelines on what will make the project successful.

Market studies sometimes indicate a <u>Capture Rate</u> as the ratio of available housing units to the size of the target pool. There is no standard rule of thumb about how small or big that ratio needs to be. It varies by market. The larger the pool is in relation to the number of units, the more comfort you can have that there is an adequate market for the units. On the other hand, the more targeted or specific the market (e.g., a special needs market), the smaller the pool can be and you can still have comfort of an adequate market.

Market studies are also likely to address <u>Absorption rate</u>, which is the estimate of how long it will take to reach sustaining occupancy (the occupancy level that permits a project to break even). The size of the pool, the rate of rental unit turnover and growth of households in the marketplace, and the experience of comparable projects in achieving sustaining occupancy help determine this rate. The larger the pool (and the smaller the capture ratio), the more likely a faster absorption rate.

If the market study is completed at the end of project planning, then this information can only be used to justify what is proposed. However, if obtained early in the project, the analysis might point to changes in the targeting, marketing, sizing, amenity packaging and pricing of the products to increase the chances of project success.

If you are going to use valuable resources to complete a market study, do it early enough to make use of the information it generates. If you are going to use a professional vendor to conduct the study, be sure to provide as detailed guidance as you can about the target audience, and share any primary information you have, regarding potential customers. And, above all else, be sure to read it, understand it and use it to shape your project.

C. Uses of Appraisals In Affordable Housing

Many affordable housing developers obtain appraisals “because our lender insisted.” And many public lenders don’t look at them “because our loan amount is based on the gap rather than loan-to-value ratios.” When it is viewed simply as a conventional lender requirement, the full value of an appraisal will not be realized and some important information might be overlooked. As long as the project developer has to pay for it, why not get full use of the information it provides. This chapter is designed to suggest the ways that local governments and developers can make use of this required document.

Appraisals have many potential uses in the financing and development of affordable multi-family rental housing. The two most common are:

- ***Acquisition value*** --- The determination of a fair market value of the land and, if applicable, existing improvements is used to determine whether the acquisition cost proposed is reasonable and should be included in the costs eligible for funding.

- ***After-rehab/construction value*** -- The after-construction valuation is used for understanding the value of the collateral property for lending purposes.

Conventional lenders rely on appraisals as a primary basis for establishing one of the lender's major underwriting parameters: the loan-to-value ratio. Most rental housing lenders will lend only up to a certain percentage of the fair market value of a property, even if the project cash flow will support a higher loan amount. For example, a lender may establish the policy that it will not lend more than 70% of a project's value. The purposes of a loan-to-value standard are to ensure that (1) the borrower has a significant equity investment in the project, and (2) the value of the property will be sufficient to cover the loan amount in the event of foreclosure, even if property values decline.

Unlike conventional lending, however, the public lender doesn't tend to emphasize the collateral value of the property as a primary basis for determining amount of the public loan. Public lenders often are asked to lend for development costs in excess of what lenders are willing to lend, exceeding the conventional cap on loan-to-value, and in some cases project value. This is especially true in declining areas where values are depressed.

Nevertheless, appraisals can provide important information to public lenders and developers. Acquisition value can be a useful check on the reasonableness of the acquisition price being paid for the property. In addition, appraisals provide developers and public lenders with some other important information, including:

- ***Replacement cost*** -- One of the methods of valuation is the replacement cost method. While this is not often the primary basis for determining value, the estimated replacement cost of new construction projects can provide an important check against the cost estimates or bids received from contractors.

- ***Market rents*** -- One of the most significant conclusions of the appraiser is the total rent that a project is estimated to be able to collect, based on comparable projects in the marketplace. This provides an important market-based reality check of the assumptions of the developer, who might be maximizing rents to maximize borrowings or following rent limits of a particular public financing program even when the market cannot bear the full rents.

- ***Operating costs*** -- Similar to rent and construction prices, the appraiser estimates the operating costs of a proposed development based on operating costs generally applicable in the marketplace, providing a check against developer estimates.

As a result, the appraisal becomes a very useful source of information to both developers and public lenders, even when the primary purpose -- collateral valuation -- is not their primary interest.

If an appraisal is going to be required by the participating lenders in a project, try to get the appraisal done early (be sure to clear the appraiser with your lender), and use the information to help shape the project.

D. Three Basic Methods of Appraising the Value of Real Estate

Appraisers tend to rely on three valuation methods for valuing projects.

1. **The Market or Comparables Approach** – This method analyzes recent sales prices of comparable properties in the area, producing an estimate of the "market value" of the subject property, after adjusting for differences in housing location, size, quality, condition and amenities. The estimated value is the most probable price that an appraiser would expect the subject property would bring in an open, arm's-length sale between a willing buyer and a willing seller, both of whom are knowledgeable concerning the uses of the property.

2. **The Replacement Cost Approach** – This method produces an estimate of the "replacement cost," or the cost of re-creating the project on the basis of current prices and using current standards of material and design, and adjusting for depreciation and obsolescence to reflect building age. (When valuing land for acquisition value, the residual approach is used, subtracting the estimated construction cost from after-construction value to estimate what is left over and assignable to land value.)

3. **The Income Approach** – This method estimates the value based on the potential revenue stream of the project relative to the revenue streams of recently sold projects. This approach is the most commonly used one for market residential rental properties, but is less useful as a measure of value for low-income rental housing. Affordable rental housing typically is subject to rent restrictions, and thus the revenue is reduced. Using the revenue method with restricted rents will understate its market value if sold without restrictions. In addition, rental projects that have tax credits have additional value related to the tax benefits that are not reflected in cash flow.

Given that the valuation of rental properties relies heavily on the income approach, a basic understanding of the two primary techniques for valuing properties based on income – Direct Capitalization and the Gross Rent Multiplier – is helpful. The two should result in similar valuations, but are based on different calculations.

Under the **Direct Capitalization** method, the value of a property is estimated to be Stabilized Net Operating Income (NOI) divided by the Capitalization Rate.

- "Stabilized Net Operating Income (NOI)" is Effective Gross Income (EGI) adjusted for usual operating expenses and typical vacancies that can be expected over the long term once the project has achieved a stable level of occupancy. It represents a more reliable estimate of net operating income than the first year NOI, because the first-year rent-up schedule can distort revenue.

- The Capitalization Rate ("cap rate") is the yield or rate of return that an investor would consider necessary in order to justify an investment, considering both the investment capital as well as the cost of borrowing. It measures market attitudes about real estate as an investment and, within real estate, the desirability of a particular property as an investment.

  The estimate of the cap rate drives the entire valuation process. Given a certain NOI, the higher the cap rate, the lower the property value. Sources for the cap rate include published data provided by research firms and market comparables, by which the relationship of sales prices to cash flow indicates the effective cap rate. One source is Valuation Network Inc.'s national survey, published yearly in National Real Estate Investors magazine.

Under the ***Gross Rent Multiplier (GRM)*** method, cap rates and stabilized NOI are not used. Instead, Effective Gross Income (EGI) of the project is multiplied by a GRM that has been determined based on comparable property sales. Appraisers look at the EGI of several recent sales, and compare the sales price to the EGI to determine an average GRM.

This method should result in a similar valuation as the direct capitalization method. However, the GRM method assumes that operating expense ratios, amenities and quality of construction of the subject property are similar to the properties from which the GRM was derived.

E. Selecting an Appraiser

In most cases, the conventional lender will have a list of approved appraisers or have standards for an acceptable appraiser. Be sure to consult first with the lender.

In the absence of a conventional lender with specific appraiser requirements, affordable housing developers and public lenders should look for an appraiser with:

- adequate and recent experience in the appraisal of multi-family rental housing within the local market (at least five years of experience);
- current training (including course work) and certifications in multi-family appraisal from one of the nationally recognized appraisal associations; and
- demonstrable experience in appraising affordable housing projects.

An appraiser should be able to provide a list of references of clients for whom comparable work was done. Be sure to call the references, and check on the quality and timeliness of the work performed. References from the intended lender, or potential lenders, are a plus.

Appraisal agreements should be based on the requirements of the lender. The agreement should also state that the appraisal will be made available not only to the specific conventional lender but to public lenders as well.

Appraisers will not typically work on a contingency basis, i.e., being paid only if the project goes forward.   Their code of ethics prohibits this arrangement to avoid any appearance of a conflict of interest that the appraiser may have in the success of the project.

Chapter 3.

The Development and Operating Budgets

The Development Budget consists of all of the Sources and Uses of capital funds that are assembled for acquisition, rehabilitation, construction, and marketing of the property until it reaches a level of occupancy necessary for the project to sustain itself out of operating income. For a project to be considered feasible, sufficient sources must exist to cover all use of capital funds.

The Operating Budget is the estimate of Revenues and Expenditures that result from the operation of the housing development. It is also an essential part of the feasibility analysis. For the development to be self-sustaining, projected revenues must meet or exceed expenditures for the HOME period of affordability (up to 20 years) or longer if Tax Credits or other public sources are included. The Operating Budget is also the primary tool for analyzing whether or not the project operating costs will be affordable to the target low-income households.

The Development and Operating Budgets are both needed to fully assess feasibility. They are inter-related and inter-dependent. Decisions made regarding the Development Budget may affect operating costs (and the monthly charges needed to cover those costs), while operating cost decisions affect ability to carry debt. The determination that the project is both feasible and affordable cannot be made without both budgets.

A. The Development Budget

The development budget is the set of financial projections that is the basis for determining how much funding is needed, the uses to which it will be put, and the appropriate loan and credit products to use. The development budget includes all one-time costs to the project that will be covered by the overall financing package. It shows the sources and uses for the project:

- "**Sources**" refer to the financial resources, usually identified by their sources. The most typical Sources include equity, loans (debts) and public subsidies (which may be in the form of grants, soft loans or other forms of investment provided by public and charitable sources).

- "**Uses**" refer to the uses of the funds, or the development costs, which typically are organized under the following categories:

  – Acquisition cost
  – Site improvements (including environmental remediation)

- Construction or rehabilitation cost
- Soft costs -- so called to contrast them to the "hard" brick and mortar costs of construction
  - Architectural and engineering
  - Construction supervision
  - Construction period operating expenses
  - Financing fees and costs
  - Legal, accounting and other professional fees
  - Developer fees
- Operating and replacement reserves
- Working capital -- including office furnishing and set-up, one time equipment purchases and other expenditures needed to start up operations

1. Uses of Funds

Acquisition Costs. Land or property acquisition costs normally match the price paid to acquire property in order to undertake the project. If the land or building(s) were acquired earlier, the sponsor will have to decide whether to estimate the value of the land/building at the original acquisition cost, the current appraised value of the property, or some other amount. In any case, acquisition costs are the actual costs to be charged to the project.

Site Improvements. "Site improvements" refers to all of the costs necessary to make the site suitable and ready for development. Land improvements typically include: excavation for foundations or utilities; grading of the site; installing on-site utility lines; any on-site roads, walkways or parking areas; landscaping; outdoor lighting; or other permanent improvements to the land other than the buildings themselves. Other costs that might be incurred to prepare a site for construction or to put it in usable condition after construction might include: demolition of existing buildings; removal of large amounts of earth to an off-site location or moving earth from off-site for fill and grading; remediation of known environmental conditions on the site; and off-site utility or road extensions.

Even a rehabilitation project may have some land improvement costs to upgrade utility connections, remediate environmental problems, or correct for site conditions such as poor drainage.

Sometimes this category also includes the costs of surveys, environmental reviews, soil borings and other site-related testing.

Bear in mind that the costs of land improvements will typically be included in an overall construction contract, even though the actual work may be done by a sub-contractor. Accordingly, these costs should be based on a contractor's estimate.

Relocation. Relocation costs may be incurred when the property is occupied at the time that acquisition occurs. Relocation costs may occur in voluntary moves, involuntary displacement (such as for over-income occupants of a project that will have income limits), and economic displacement. When Federal funds are being used, legal occupants are entitled to the benefits afforded by the Uniform Relocation Act, and, if they are low income, the additional protections of Section 104(d) of the Housing and Community Development Act of 1974 (known as the "Barney Frank Amendment." These laws require the provision of notices, counseling, and financial assistance for moving expenses and incremental costs of their new residences for a period of time.   These costs need to be estimated, but can be done only after some information about tenants and tenant incomes become available.

Even if such protections are not afforded by law, the relocation of legal residents usually entails legal and other costs related to the termination of tenancy.

Demolition. This cost may be carried as a separate line or as part of the construction cost. It is listed separately when the work occurs in a pre-development phase, or there is other reason to separate it from the general construction.

Construction/Rehabilitation. This should include all costs included in a construction contract, except for the site work as noted above. In addition, the "hard" costs of materials and labor, which might incorporate the following components (although they may be listed as subheadings under this category): allowance for the contractor's project-related expenses or "general requirements" such as building permits, fencing around the site, temporary storage for materials; the contractor's overhead and profit; and the cost of performance/payment bonds or letters of credit provided by the contractor to insure that the project will be completed.

Probably the most realistic method of estimating construction costs is to obtain a preliminary cost estimate from a contractor, even if one has not been formally selected, or to purchase the services of a professional cost estimator. An alternative is to have an architect estimate the amount of the construction contract based on his or her experience with similar buildings. The skill of architects in doing reliable cost estimating varies dramatically, so be sure to check out the experience of the architect before relying on this estimate.

In some cases, an architect or contractor may only wish to estimate the cost of "bricks and mortar" for actual construction, without the other line items listed above. In this case, adjust the hard cost by adding: (a) 3 to 4% for "general requirements"; (b) the estimated cost of a performance bond or letter of credit, obtained from a bonding company or local lender; (c) an allowance of 4 to10% of the total of all preceding costs for the contractor's profit; and (d) builders risk insurance policy. Building permits may be listed as a construction cost if the contractor is paying these fees. Otherwise, they are listed below as Other Fees.

Construction budgets are merely estimates. There is the possibility that costs will vary for reasons that are not the responsibility of the contractor. That is the reason that most budgets include a construction contingency of 5 to15% of the construction budget to cover the unforeseen costs and changes in scope. The higher end of the range is for rehabilitation projects where not all of the structural and other issues will be fully exposed until demolition.

Architectural and Engineering Fees. Architectural fees should be based on an estimate from the architect or on an actual agreement with the architect. These fees may be based on a certain percentage of the construction contract amount, a fee per dwelling unit, a flat fee for services, or some other basis. Architects will specify one fee for the design of the building, and another fee for inspection and monitoring of the construction.

The design architect and the inspecting architect may or may not be the same. The amount of the fee will vary dramatically from market to market and by type of project.

Engineering work is needed in most new construction and substantial rehabilitation projects to address the structural integrity of the building. Most architects will include the engineering costs as a reimbursable line item under their contract, since they will need to supervise the engineer's work and incorporate it into the overall drawings.

The cost of an environmental survey and soil boring may be included under engineering fees because those costs are directly related to the design of the site plan and buildings and are often subcontracted by the architect to an engineer on behalf of the sponsor. The engineering fee estimate should also include any mechanical or structural engineering costs incurred as part of the design fee.

Other Fees. Other fees may include building permits, other municipal fees, appraisal, environmental and other surveys if not included above. In most cases, the legal and financing fees related to acquisition are incorporated below with other legal and financing costs, but might be listed here.

Legal Fees. Legal fees will be incurred for incorporation of any development or ownership entities, contract (contractor, architect, etc.) negotiations, property acquisition, loan closings and other assorted parts of the development process. Unless the project is highly unusual, and will require inordinate legal attention, it is possible to get a ballpark estimate of legal fees by looking at similar projects. An attorney may be willing to provide such an estimate.

In addition, this line item often includes the other costs of acquisition and financing, including title insurance, recording fees and other expenses.

Permanent Financing Fees and Expenses. Loan fees and points are part of the cost of capital. These are the one-time fees, a percentage of the total loan, which are paid to the lender. The lender bases the fees and loan points on the amount of the loan. Once you know how much money you have to borrow, your lender will tell you what fees and loan points will be charged. They can include application fees, commitment fees, appraisal, document preparation, legal and title work, credit reports and recording costs. These costs can be incurred more than once in a project -- for acquisition, for construction and for permanent lending, as applicable.

Construction Period Expenses. This line item collects the standard operating expenses that are incurred during the construction period when there is no project revenue to pay expenses such as: utility costs, insurance, taxes and construction interest.

While the contractor will carry builder's risk and liability insurance, the project sponsor will probably need to carry hazard insurance against damage to the building during construction. The project sponsor may also carry insurance against theft and liability for personal injury or property damage. The project sponsor should consult with an attorney and an insurance agent to determine what kind of insurance will best protect their interests during construction, and what the costs of carrying that insurance will be. Lenders for the project may have their own standards for the type of insurance needed during construction, so it is also wise to consult them before obtaining coverage.

Predevelopment and construction interest is a cost that the developer is accruing during the early part of the project. These costs should be included in the budget as part of the holding period costs.

Developer's Fee. The developer's fee is compensation to the developer for the time and risk involved in developing the project. It is not compensation for equity invested, which is paid out of project cash flow.

The services of a developer are often expressed as a percentage of total development cost, and most often the developer's fee falls within the range of 5% to 15%. The higher end of the range is usually reserved for tax credit projects and other complex projects. It also is appropriate for small projects. Keep in mind that many of the developer services are "fixed costs" rather than variable costs. A developer of a 100-unit project does not do 10 times the work of a developer of a 10-unit project (although there are obviously some higher risks associated with the larger project). Therefore, it is incorrect to assume that one standard developer's fee of, say, 10% is appropriate for all projects.

Some nonprofits still use a cost-based, rather than fee-based, method for being reimbursed for developer services. However, in a fee-based system, all developers are compensated in a comparable manner, so nonprofits have the opportunity to earn the same fees as for-profits, and thus have the potential to carry over those fees for future project development. In addition, a fee-based system rewards success and efficiency. Fees are earned when the services are delivered and completed, while cost reimbursement systems do not similarly withhold payment until success is achieved. And, the developer who finishes the project most expeditiously earns the greatest profit. The fee-based system will provide appropriate incentives for nonprofits to be more efficient and to complete projects on time.

Consulting fees may or may not be a cost to the project. If they are, consultants are doing some of the developer's functions, and the consulting fees should come out of the developer's fees and not be listed as a separate item in addition to a standard developer's fee.

Reserves. Reserves are funds set aside from the construction financing to take care of possible losses or shortfalls in the cash flow. The most typical reserves are the Rent-Up Reserve, Operating Reserve (and sometimes a Debt Service Reserve in addition to the Operating Reserve) and Replacement Reserve.

The Initial Operating Deficit or Rent-up Reserve sets aside funds to cover expenses as the project gradually rents up, until the time that the project achieves sustaining occupancy -- the level at which revenues cover all expenses. In general, expenses for a project approach full operational levels more quickly than gross rents, since the project will have to hire its staff and pay full interest, taxes, and other expenses immediately -- even if the project is not yet at full occupancy. Only a few things such as management fees are scaled to the level of project revenue.

Operating reserves may be capitalized to protect the project in the event of unforeseen operating expense jumps or drops in occupancy. Replacement reserves establish a fund for replacement of major building components that will occur over the life of the project.

Operating and replacement reserve contributions should also be a part of the Operating Budget, and the amount to capitalize out of the Development Budget is in part determined by the ability of the project to make such contributions out of project revenues.

Marketing. Marketing and management start-up costs are incurred between completion of construction and full occupancy. The development budget must cover these costs because total rental income will not be available until the housing is fully occupied. It would include advertising, staffing for application intake and reviews, credit checks and other costs related to processing applicants, fees paid to real estate agents for providing qualified applicants (if this method is used), and other related costs.

Other Expenses. This would include any miscellaneous expenses incurred by the sponsor that are not included in the rest of the budget. The expense items should always be accompanied by an explanatory note. An example is relocation costs connected with acquiring or rehabilitating an occupied building.

2. Sources: Development Financing

CDBG and HOME funds are available to qualified projects for a range of uses, including acquisition, construction, bridge and permanent loans. Such loans may include terms for deferment of principal and interest, and may be forgiven after the compliance period. The terms of the investment are determined by the jurisdiction.

Pre-development loans may be required by nonprofits and other agencies with limited capital to fund early development planning costs and costs related to site control. Both CDBG and HOME may be used for pre-development loans. Under HOME, all pre-development loans must produce HOME-assisted units or be repaid, except for pre-development loans provided to CHDO projects[2], which may be forgiven if the project is infeasible or does not go forward for reasons beyond the control of the CHDO.

It is common for CDBG and HOME funds to be used as gap funds in the project; that is, the funds cover the gap between the available equity and amortizable debt and the total project costs. As such, they often cover costs that exceed project value, so the traditional underwriting appraisal standards such as the loan-to-value ratio or gross rent multipliers are not useful to public lenders. Other financing criteria are more important to public lenders, especially the adequacy of equity and collateral commitments, firmness of other commitments, retainage and deferral of fees to guarantee completion, and reserves that help guarantee completion.

In addition, the rate and order of disbursements of funds is important because of the requirement that HOME funds be repaid if HOME-assisted units are not produced. Where other lenders request that public funds be disbursed first because these are the riskiest dollars, and developers want them in first because these funds are likely to have the lowest interest cost, public lenders must have assurances of project completion and

[2] Community Housing Development Organizations who have qualified as eligible organizations under the HOME regulations and are going to own, develop or sponsor a qualified development project.

are likely to required pro rata advances. Proration is particularly critical in mixed-income projects where HOME can only pay the HOME-assisted units portion of costs.

Inter-creditor issues with regard to default and foreclosure intervention were noted earlier. In addition to these concerns, the public lender or nonprofit partner should be concerned about the long-run affordability issues raised by balloon debt, partnership buyouts, & other long-term issues – even when they exceed the compliance period.

B. The Operating Budget

The operating budget, sometimes referred to as the “pro forma,” is used for two purposes:

(1) narrowly, to determine how much net operating income (NOI) the project will have available to make payments of principal and interest (debt service), and

(2) more broadly, to document the assumptions that are being made about the project and its feasibility. Estimates of project income and expenses should be reviewed to be sure that they are true reflections of the market and that the NOI is adequate to cover loan payments.

The budget is only a ***prediction*** of expected income and expenses, and that prediction is extended out for 10 to 15 years of project operation, depending upon the regulatory period or life of the proposed loan. Normally, a pro forma estimates the first 10 years of operation. However, when a developer uses the Low-Income Housing Tax Credit (LIHTC), for example, the pro forma reflects the first 15 years of operation, as this is the minimum term of the LIHTC rent and occupancy restrictions.

Sources of information used to compile the operating budget include:

- Rent Roll & Expense Statements for existing properties and comparable properties – The rent roll is the source document for information on units occupied and vacant, rents charged and collected, bad debt, move-in and move-out dates, and so on. Existing rents should be adjusted to account for limits placed by a funding source or for increases possible due to improvements in the property.

- Market Studies and Appraisals – Especially for newly constructed and substantially rehabilitated properties, these should provide estimates of rental rates for similar units in the surrounding area.

1. Operating Revenues

Gross Potential Revenue -- "Gross potential revenue" is the total annual amount collectable in rent, if all units were occupied continuously and all tenants paid their rent.

A common error (or deliberate exaggeration) in a pro forma is to assume that gross potential is the number of units times the proposed rent schedule. This error overstates gross potential because it ignores the fact that, aside from tenants renting month to month, rent schedules and increases take time to implement. This is a very important consideration when evaluating a new construction or substantial rehabilitation proposal, especially if the owner claims immediate results from the rent schedule or rent increases following construction. The lease-up period can take months, if not years for a larger project, and the implementation of rent increases requires up to a year if one-year leases are in place. In short, gross potential is not static, it changes each month as tenants move in and out. A miscalculation of the market leading to slow leasing will result in immediate and substantial cash demands on the owner.

Vacancy/Collection Loss. The allowance for vacancy and collection loss is a percentage of gross rent to allow for income lost while dwelling units are vacant due to turnover or from nonpayment of rent. It would also include “down time” for units under renovation.

Other Income. "Other income" includes any charges the sponsor realistically expects to make for use of the buildings or property, <u>other than</u> charges to the tenants for rent or services. Such income could be from a laundry room, charges for use of a community room as a meeting place by an outside organization, parking fees paid by residents or non-residents, and interest earned on the operating account.

Effective Gross Income. "Effective gross income" is the total income from the property less the vacancy factor.

2. Operating Expenses

Management. Management costs can be included as management fees paid to property management entity, or management staff and expenses when the staff are direct employees of the ownership. The "management fee" is an annual payment to a contracted management firm or agent for whatever scope of services is negotiated between the project sponsor and the management agent. Typically, the fee is set as a percentage of gross rent collected, most often ranging from 5% to 9%, but sometimes falling below that when management staff on site are budgeted separately. Other times, it is set at a certain amount per unit per month.

If the ownership entity directly employs management staff, personnel costs are shown here. If the same person spends time on both management and maintenance responsibilities, the costs associated with that person could be broken down on the basis of an estimated percentage of total working time in each activity. Payroll expenses include wages, fringe benefits and payroll taxes.

Professional Fees. Most typically there is an allowance for professional fees for legal and accounting/auditing services. Legal costs may be incurred in negotiating contracts with service providers, assisting the sponsor with legal disputes, and pursuing eviction. With many public lenders, an annual audit of the project accounts is a requirement and should be included in the budget.

Advertising. An amount should be budgeted for expenses in connection with advertising or other marketing efforts required to fill apartments or rooms that become vacant from time to time. This line item is to address unit turnover and ongoing maintenance of a waiting list. Expenses for initial marketing, when the project is first completed, are included in the development budget.

Administrative Office and Overhead. When the owner directly manages the property, the "overhead" costs to operate a management office, or to perform that function whether or not a physical space is devoted to it, should be estimated here. These costs are separate from the overhead of a management agency, if any, which should be included in the management fee.

Maintenance. Maintenance expense covers a broad category of interior, exterior and grounds items, including staff, materials and an array of possible third party contractors. Personnel costs for any project maintenance employees including wages, fringe benefits and withholding or other taxes should be included here.

Many of the project's mechanical systems might be covered by annual maintenance contracts with vendors, which should be reflected here. Examples are elevator maintenance and heating/cooling system annual maintenance.

A key influence on maintenance costs is *turnover,* or the number of units that are vacated and reoccupied in a given period. The higher the turnover, the higher the maintenance expenses for cleaning, painting, exterminating and other such preparation activities. (Turnover rates can be estimated based on the experience of other properties, and are sometimes disclosed in market studies. An existing property with an operating history can generate an estimate of turnover from the rent rolls for the prior year.) Property managers normally can quickly determine or estimate the average unit preparation cost, exclusive of replacing carpet or appliances. Typically, this cost is from $300 to $500.

Another element of the maintenance budget is the cost of general building cleaning and janitorial services and landscaping/grounds upkeep. These activities are generally handled by some combination of hired contractors and employed staff. In estimating these costs, consider special maintenance situations such as extensive grounds, swimming pools, flat roofs, poor drainage, stucco finish, and aluminum siding.

Utilities. Utility costs can be estimated by doing a utility comparison analysis with other buildings in the area of similar scope and design, or based on previous use levels. Be sure to take into account the type of utilities used in comparison buildings, and the level of energy efficiency of construction and appliances. Utility costs may also be estimated directly by the local utility company or by the local Public Housing Authority.

Sewer and water costs can be estimated by previous use levels, or if the building is new, by contacting the utility or public service provider for estimates. Properties with landlord-paid utilities (that is, heat, hot water, air or light) may need special attention. Efficient and environmentally sound operation demands that tenants' use of utilities be disciplined by costs, meaning utility users should pay utility bills. When feasible, conversion to tenant-paid utilities should be encouraged.

Taxes/Insurance. The estimated annual premium for hazard and liability insurance carried by the project owner should be included here. Policies should provide for rent loss protection and for restoration of the premises in the event of casualty.

Annual real estate taxes should be estimated by consulting with the local tax assessor about the value at which the housing will be assessed, and the likely tax rate. Since real estate taxes are a major component of operating costs, they should be carefully and realistically estimated. Nonprofit organizations should not automatically assume that the jurisdiction will waive all or part of the property taxes for the entire period of affordability. Instead, real estate taxes should be estimated for nonprofit-owned projects the same as for other ownership entities.

Contributions to Reserves. As noted above, projects typically have at least two reserves: for operating expenses and for replacement costs. The size of the contribution varies by project, and also depends upon whether the reserves were partially capitalized through the Development Budget.

An amount should be budgeted annually, and built into the budget to make regular contributions to reserves to pay major repairs or replacement of parts of the buildings or mechanical equipment and systems. The size of the annual contribution will vary with individual projects, and may be different for new construction as contrasted to rehabilitated buildings. Some lenders specify certain levels of contributions, other ask the owner to do an analysis of the useful life of building systems to determine what is needed to be escrowed for future replacements. Typically, annual Replacement Reserve contributions are set at 1% to 3% of total project value or replacement cost.

The operating reserve is created to provide funds to cover debt service and expenses when expenses rise faster than revenue or there is a temporary and significant loss of revenue. Many lenders look for build-up of reserves over time so that 3% to 6% of the Operating Budget is in reserve to deal with cash flow emergencies.

Net Operating Income. The net operating income (NOI) is the difference between the effective gross income and the total expenses -- before making payments on loans (referred to as debt service).

Debt Coverage Ratio (DCR). Debt coverage ratio is the ratio of NOI to the monthly mortgage payment. It is provided by the lender. The DCR must always be greater than 1, since NOI must be more than the mortgage payment in order for the project to be feasible. A typical minimum acceptable ratio is 1.2, or 120%. Some public lenders accept as low as 1.05, while some conventional lenders prefer 1.25 or 1.30.

Net Available for Debt Service. Once NOI is estimated and the Debt Service Coverage Ratio known, the net income available for debt service can be determined. This monthly or annual figure is then “capitalized” at the current lending rates to determine how much debt the project can afford to borrow.

3. The Ten-Year Operating Pro Forma

Most developers and public lenders use the ten-year pro forma to predict the long-term cash flows from the project. A picture of cash flow is especially useful for budgeting LIHTC deals, where the goal is to zero out the net cash flow in order to maximize tax losses.

The ten-year pro forma is based on assumptions of occupancy, rents and expenses. It is easiest to estimate a steady growth rate for rents, vacancies and expenses, and set fees as a consistent percentage of (effective) gross income.

Forecasting future income is where the most uncertainty will enter into calculations. Overly optimistic projections of future income aided and abetted the multifamily lending and building spree of the 1980's, with many of these same properties now struggling. Thus, constantly refreshed market knowledge is essential to sound judgement of income forecasts.

Projecting future income involves the following steps:

1. Choose a growth rate for rents, based on the market analysis but no greater than anticipated inflation or wage inflation, perhaps 2% - 3%.
2. Choose a growth rate for operating expenses, which may vary by line item in the budget. Typically, expenses are projected to rise at a rate at least 1% higher than wages.
3. Project any changes in the occupancy rate over time.
4. Apply the growth rate to gross potential rents, and adjust for the assumed occupancy rate.
5. Apply the growth rate to operating expenses. If the loans are not fixed, adjust debt service to reflect expected changes.
6. Compute the changes in cash flow over the ten-year period.

Your market projections should be based on sources for forecasts such as:

- Metropolitan newspapers and business periodicals (annually, if not quarterly);
- State and local colleges and universities, who often do business forecasting;
- Government forecasts, including the HUD area economist (EMAS);
- Realtors, although these projections may be less reliable; and
- Lender forecasts.

If projected rates of change in living costs and wages are comparable to past years and no dramatic local change in the economy, employment, housing supply or population is apparent, then apartment rents are likely to continue changing at rates established in prior years. Similarly, occupancy rates are likely to move proportionately.

Realism, not absolute accuracy, is the objective of projections. The temptation to help a deal work by "cooking the numbers" must be avoided!

Increases in expenses must be projected with the same care, using factors such as projected inflation rate and knowledge of the housing services and supply markets.

If government grants will be sought to finance part of the project, potential grantors should be contacted for guidelines to be used in projecting increases in rents and expenses.

C. Putting It All Together

Once the project's operating budget and development funding sources and uses have been determined, a statement of sources and uses of funds must be developed. The statement will serve as a guide for seeking sources of funding to match the development budget.

As potential funding sources are identified and funding commitments are secured, the sources and uses statement may change.

The mix of funding sources will determine the monthly principal and interest payments that must be made. The more equity funding the project has, the lower the monthly debt payment will be. When planning the sources of funds, the resulting total monthly debt payment must meet the debt-coverage ratio discussed on the previous pages.

Chapter 4.

Underwriting Affordable Rental Housing

Underwriting is the analysis that any lender, public or private, should undertake anytime that it wishes to invest, grant or lend funds to any venture. This section provides a broad overview of public underwriting as a guide to help nonprofit developers understand the lending decisions that will be made regarding their projects.

A. Elements of Underwriting Rental Housing

Underwriting is not about putting thumbs up or thumbs down on a project. Rather, it is the technical analysis that informs the funding. The important contribution of the underwriting analysis is identifying changes that can improve the project or make it an acceptable investment.

From the lender's perspective, underwriting is the practice of assessing and minimizing the risks associated with a project under consideration for funding. Underwriting is primarily a function of risk assessment, because it involves using current information to predict future performance of the borrower and proposed project. Although each underwriter has his or her own approach to the analysis, all underwriters – whether private or public – must consider risk issues in four categories: market risk, project risk, borrower risk and portfolio risk.

- **Market risk** considers the proposed housing type in the context of the overall housing market. It estimates whether there are a sufficient number of households who are likely to be candidates for the housing, how the project compares with the competition and whether the project is likely to be able to maintain sufficient market value to serve as collateral for the life of the loan. These are risk factors that are determined by the marketplace and are generally beyond the control of the project and its developer, yet they have a direct impact on whether the project should proceed.

- **Borrower risk** examines borrower characteristics to determine whether it is reasonable to believe that the borrower can undertake and deliver the project as proposed. It considers borrower equity and cash available to meet project obligations and contingencies, whether the borrower and the development team have the skills and capacity to accomplish the project, and whether the borrower can be expected to meet its debt obligations based on historical performance and character.

- **Project risk** addresses the specific characteristics of the proposed project and whether there are risks inherent in what is proposed. It evaluates the budgets to determine whether the project appears to be feasible and viable, and it looks at other factors that might affect the completion of the project and sustained occupancy. It also looks at whether the project has sufficient value to serve as the entire collateral for the loan.

- **Portfolio risk** is the examination of the proposed project as it fits with the lender's other activities and loans. The proposed project may be feasible and involve a reasonable level of risks, but the lender may already have too much exposure in its overall portfolio from this category of loans or geographic location. On the other hand, the portfolio may need this type of loan to maintain its balance. With respect to an affordable housing loan, the lender's Community Reinvestment Act performance and portfolio composition also factors in this analysis.

B. Financial Analysis

1. Development Budget Analysis

One of the key underwriting activities is the analysis of the Development Budget. The analysis focuses on the costs proposed, and addresses a range of questions pertaining to the feasibility of developing the project.

- ***Acquisition Costs*** -- Is the proposed acquisition cost reasonable? Is it supported by independent appraisal? Is the acquisition an arms-length transaction?

- ***Approvals*** -- Are the necessary local approvals (permits, zoning, etc.) in place or reasonably assured? Is a variance or other hearing process required? Is there community opposition or other impediments?

- ***Infrastructure*** -- Is a required infrastructure in place? Are any infrastructure costs required to be carried by the project?

- ***Site improvements*** -- Are there any unusual site, topographical or subsoil conditions that have the potential to increase costs?

- ***Construction Costs*** -- Are the plans and specifications of sufficient detail and quality to provide a detailed and accurate cost estimate? Are the costs reasonable in consideration of the level of work and the typical costs? Do the costs reflect labor standards, if applicable? Has the project been competitively bid? Is the construction contingency reasonable given the scope of work?

- ***Soft Costs*** -- Are all the expected soft costs included? Is the overall level of soft costs proposed reasonable?

- ***Fees*** -- Are the level of developer fees proposed reasonable given the scope of the project? Are there related parties earning multiple fees?

2. Operating Budget Analysis

Operating Budgets are predictions of expected income and expenses from a project. As such, they are heavily dependent upon assumptions regarding the performance of a property yet to be completed. Key assumptions that make the operating pro forma vulnerable are: occupancy date, rent-up period, vacancy/collection loss rates, taxes, utilities, and maintenance costs. Public underwriters will compare project estimates against data from similar projects to determine whether they are sufficient.

Rents are the key source of income to pay expenses. In the HOME Program, rents are restricted, so income will also be restricted. Under CDBG, rents have to be affordable, but are not subject to strict limits. It is imperative that the budgets contain both feasible rents and realistic operating expenses, because the ability to adjust for errors in estimation is restricted.

Key operating revenue issues include a review of the market information to assess the reasonableness of:

- The proposed rent-up period (absorption rate) and its impact on the operating cash flow and the need for an Initial Operating Deficit;
- The proposed rents compared to the competition and “street” rents
- The affordability of the rents to target households;
- The provision for utilities & utility allowances deductions from rent; and
- The margin for future rent increases under the HOME maximum rent system.

Under HOME, contract rents must reflect an allowance for tenant-paid utilities. Furthermore, the contract rents have to be realistic when compared to “street rents” -- those rents in the immediate area that reflect units of comparable amenities and condition. If HOME maximum rents are $500, but the street rents are closer to $350, then the project rents should be lowered to be competitive with other housing available.

Over time, operating budgets also become vulnerable to assumptions made regarding the rate of change in operating costs and rents. Under the HOME Program, rents are calculated annually by HUD and are based upon median income and Section 8 FMR changes, not project operating costs. Therefore, the project is vulnerable to regulatory limits on rent increases. HOME regulations hold developers/owners harmless from maximum rent decreases that occur subsequent to project commitment, and provide for a HUD appeals process for future rent adjustments needed to maintain project viability [92.252(d)]. However, the process and basis for such appeals is not clear at this time and is unlikely to be used extensively. For this reason, project developers are urged to create projects that (1) do not rely on maximum rents currently permissible (5 to 10 percent below the maximum rents is advised), and (2) to project no more than a 2 percent annual increase in maximum rents during the compliance period.

Operating expense analysis is also critical to public lending. Underwriters typical compute a number of ratios or other calculations as part of the expense analysis, including the following:

Net Operating Income (NOI) = Effective Gross Income - Operating Expenses

Cash Flow = NOI - debt service

Debt coverage ratio = NOI / debt service

Breakeven ratio = (Operating Expenses + Debt Service)/Gross Potential Income

Operating Expense Ratio = Operating Expenses/Effective Gross Income

Private lenders usually establish a minimum breakeven point of 80-85%, but in affordable deals the breakeven point if often closer to 90% due to the artificially restricted rents. The lender becomes concerned when the spread between the breakeven point and the projected occupancy rate is too close. For example, if an 8% vacancy/collection loss is projected, and the breakeven point is 90%, the project would only have to miss its vacancy target by another 2% before it would start to jeopardize its ability to pay operating expenses and debt service.

Developers should calculate these items and assess the concerns underwriters might have regarding the project's operating feasibility.

Beyond basic operating ratios, public lenders have to assess operating expenses to determine that the developer has anticipated all costs, and made provisions for operating reserves that will help the project endure cost changes. Public lenders are especially concerned about the vulnerability of the project to variable costs -- particularly utilities, taxes, and insurance -- which can change quickly and are beyond the control of the owner.

As will be noted below under the discussion of special needs, any operating costs with respect to services will be considered separate from the basic project operating budget.

The management plan is also a major concern in underwriting, because of the need to have competent management that is capable of administering the income qualification, rent regulation, and housing standards inspection compliance systems that are necessary for the compliance period. Managers with Section 8 experience are valuable additions to the team, and give the underwriter a level of assurance that income and housing quality rules will be understood and obeyed. In the absence of professional management with such experience, applicants should propose to address the need through training.

3. Underwriting Determinations

When all of the analyses have been completed, underwriting must bring together the findings into a conclusion and recommendation about the proposed public investment. Some of the key summary questions are:

- Market risk -- Is there sufficient demand among the target audience to ensure sale or rental of the proposed units within a reasonable period of time? How do the units compare with the competition in the local market?
- Borrower risk -- Is the proposed developer capable of implementing the project within the time frame proposed? Does the applicant have the

resources and capacity to meet all obligations? Is the applicant capable of adhering to the regulations?

- Project risk -- Are all proposed costs reasonable? Are the proposed fees and return on equity reasonable? Are private and other public sources leveraged to the extent possible? Do the public funds fill only the gap not fundable through non-public sources? Are the other sources firmly committed? Is the project financially feasible for at least the compliance period?

The analysis is then wrapped up into three important conclusions that comprise the underwriting recommendation:

1. What are the risks associated with the project in each of the categories, and are those risks within (or beyond) an acceptable range?
2. What changes to the project will mitigate the risks and bring them within acceptable ranges?
3. What is the appropriate level of lending given the lender's standards?

When assessing how much debt a development can prudently repay, lenders will be interested in two ratios - the loan-to-value ratio and the debt-coverage ratio. The maximum amount of debt financing will usually not exceed the maximum of either ratio. Once the maximum amount of debt financing is determined, the balance of the project costs will have to be covered by either equity investment or subsidies.

The *loan-to-value ratio (LTV)* compares the amount borrowed with the appraised value of the project. Most lenders will not lend more than 80 percent of the value. The developer will have to seek other financing to cover at least 20% of the property's value. (This is the "financing gap" that is often mentioned in public lending.)

The *debt-coverage ratio* is the amount of monthly net operating income (income minus expenses) divided by the amount of monthly debt service (principal and interest payments on the loan). When underwriting a loan, the bank must make sure that, after all operating expenses are paid, there is enough cash to pay monthly debt service, as well as a cushion for unforeseen circumstances. A commonly used debt-coverage ratio is 120 percent - paying 100 percent of the monthly debt service and an additional 20 percent.

C. Public Lender Underwriting Considerations

Public lenders have all of the same basic underwriting concerns and issues that conventional lenders have. However, public lenders take a slightly different approach to the basic underwriting risk categories of market, borrower, project and portfolio. In addition, public lenders have other concerns and requirements that must be met to invest public funds in a private venture. These are discussed below.

In addition to these basic risk categories, public lenders are responsible for making determinations of the following as part of the underwriting analysis:

- **Public purpose** --The project must meet the stated public purposes of the statute and regulations that govern the program in order to use public funds as a subsidy. For the CDBG program, this element is addressed when the unit of government makes a determination that the activity or activities meet one or more of the National Objectives. In addition, the determination of consistency with the Consolidated Plan is required for CDBG, HOME, and other HUD-funded projects.

- **Regulatory compliance** -- The project must meet all of the applicable regulatory requirements of the source program in order to be eligible for funding. This may impact the financial structure and feasibility of the project.

- **Affordability** -- While conventional underwriters are primarily concerned with whether there is sufficient demand for the project units at the proposed rents, public underwriters must also determine that the rents are affordable to the target population. Some programs such as HOME have rent regulations, but the affordability of the project to the target population remains an issue even in these circumstances since it may affect turnover and long-term viability.

- **Amount of Subsidy** -- The goal of public underwriting is to provide enough financing to make the deal feasible and affordable to the target population, but to not over-subsidize the project or unduly reward those who implement the project. When more than one public source of funds is provided to a HOME-assisted project, a layering analysis is required by HOME regulations. However, even when CDBG or HOME is the only source, the jurisdiction's underwriting should consider similar issues.

- **Long-term Compliance** -- Most federally assisted housing programs establish programmatic requirements that must be followed for a period of years. In the HOME Program, for example, HOME maximum rents and housing quality standards apply to rental projects for a period of 5 to 20 years. In CDBG, there are generally no minimum periods by regulation, but it is common practice for communities to impose periods of affordability, usually in conjunction with the term of the loan. Sometimes there are additional management responsibilities and risks associated with long-term regulatory requirements.

D. Regulatory Compliance

The source of the gap money will bring with it a set of statutory and regulatory requirements. If the project cannot meet those requirements, then that particular source cannot be used. This section outlines some of the key requirements when using CDBG and HOME in rental housing, and when they are combined with Tax Credits.

The CDBG and HOME Programs are two major Federal programs available to communities to use to assist the development and rehabilitation of affordable housing. CDBG and HOME may both be used broadly to assist rental housing in each of the models identified in Chapter 1, except that tenant-based rental assistance is limited to HOME. This section offers an introduction to the two programs for those who are new to community development.

1. Using CDBG for Rental Housing

Under CDBG, eligible activities listed below can be applied to the acquisition or rehabilitation of rental housing, provided that not less than 51% of the units (or one unit in a two unit project) in the structure (contiguous buildings under common ownership and management) will be occupied by low and moderate income households. In addition, the rents must be affordable to Low and Moderate Income households, according to a standard determined and published by the jurisdiction.

There are some exceptions to meeting the L/M Housing Benefit Standard of 51%:

- For new construction of non-elderly housing as permitted, not less than 20% of the units meet the L/M standard. If the percentage of CDBG funds exceeds 20%, then the percentage of units occupied by low/mod households must be proportionate to the percentage of CDBG funds.

- Removal of architectural barriers to elderly or severely disabled by rehabilitating the common areas of a multi-dwelling unit that does not qualify under the L/M Housing Standard;

- Repairs to properties must meet L/M Area Benefit or Slum/Blight objectives, per HCDA of 1992; and

- Housing activities for a single program year within a qualified Neighborhood Revitalization Strategy or Community Revitalization Strategy may be considered as a single structure for meeting the 51% requirement

New construction of non-elderly rental housing is permitted only for last resort housing and Special Activities by a Community Based Development Organization (CBDO) acting as a subrecipient in compliance with 570.204 to address the lack of affordable housing accessible to jobs. New construction of housing may also be determined to be eligible under the statutory waiver authority under Urgent Needs.

For other new construction projects, CDBG funds may be used to support such projects, as long as the CDBG funds are not used for the new construction. Eligible costs include acquisition, environmental remediation, site improvements to publicly owned land being prepared for housing, and disposition. Certain soft costs (surveys, site and utility plans, and application fees) may be paid, if HUD grants a waiver.

(Note that conversion of a non-residential structure to residential use may qualify as rehabilitation, unless the project involves construction beyond the existing building envelope.)

Some housing activities listed below may be qualified under other national objectives, such as Slum and Blight (including completion of Urban Renewal) and Urgent Needs.

2. Using HOME for Rental Housing

HOME funds may be used broadly to support the capital costs of acquisition, rehabilitation or new construction of low-income rental housing with only a few types of rental housing excepted. HOME funds may not be used for rehabilitation and operation of Federal low-rent public housing, certain FHA-insured expiring use properties, properties under compliance agreements in the Federal Rental Rehabilitation Program and shelters. In addition to the hard costs of acquisition and construction, soft costs that typically are incurred to support acquisition and construction may also be paid with HOME funds. This includes most typical professional fees, interim financing charges, interim operating costs, marketing costs, and developer fees. (See Section 92.206 of the HOME Program Rule.)

The use of HOME funds is limited to the eligible hard and soft costs associated only with any low-income housing units that will meet Program occupancy and affordability requirements. These units – called "HOME-assisted units" – are subject to a range of regulatory requirements, including those summarized below in the box.

Key HOME Rental Requirements

These requirements apply to any ***HOME-Assisted Units funded by the HOME Program*** *(HAUs) in a project, but do not apply to unassisted units.*

Income Limits:

- *All HAUs must be occupied by Low Income (80% of AMI)*
- *If 5+ HAUs in project, at least 20% of HAUs must be reserved for Very Low Income(below 50%)*
- *For PJ rental units overall, at least 90% of units (initially) must serve HHs below 60% of Median*

Maximum Rents: Two-tier rent structure published annually by HUD

- *Low HOME Rents: apply to 20% units reserved for VLI*
- *High HOME Rents: apply to all other HOME units*
- *HOME rents adjusted for PHA Utility Allowance Schedule*

Compliance Term:

Less than $15,000 HOME $/unit	*5 years*
Between $15,000 & $40,000 HOME $/unit	*10*
Greater than $40,000 HOME $/unit	*15*
New Construction	*20*

Compliance Period Requirements:

- *HUD calculates Max HOME Rents each year*
- *Tenant income recertified annually*
- *Units inspected for housing quality every 1 – 3 years*
- *If tenant over income, adjust rent, follow next available unit rules*

The costs allocable to non-housing uses and to housing units that are not low-income may not be funded with HOME funds, but may be combined with HOME-eligible units in mixed-use or mixed-income projects provided their costs are covered with other funds.

Combining HOME and CDBG in the Same Project

In some cases, both HOME and CDBG might be utilized for the same activity. In such cases both sets of rules apply to the project. The activities must be separately determined to be eligible under CDBG and meet the national objectives. The project must also meet all of the HOME rules.

HOME and CDBG are not incompatible, but in some cases the Programs apply rules differently. For example, Davis Bacon applies to CDBG-funded housing at 8 or more total units in the project, while it is applied to a HOME project with 12 or more HOME-assisted units in the project, not total units. When both programs are invested in a single project, both rules must be applied. Therefore, in the case of Davis Bacon, the more restrictive CDBG rule would require Davis Bacon to apply when there are 8 or more total units in the project.

3. Using CDBG & HOME with Tax Credits

The Low-Income Housing Tax Credits Program enables low-income housing developers to raise equity from investors to help pay for development costs and lower the monthly rents needed to repay that debt. To be eligible for Tax Credits, a project must comply with the program's rent and occupancy requirements.

Tax credits alone do not always provide a sufficient subsidy to allow developers to reduce monthly costs to the point where they can be paid by the rents allowed under the program guidelines. Often, developers must seek additional subsidized funding to make a low-income housing project financially feasible. CDBG and HOME are sources that are typically sought to help make Tax Credit projects viable.

In most localities, CDBG has been a regular source of subsidy to Tax Credit projects since 1989, when the Congress declared that CDBG funds are considered non-Federal for purposes of the Tax Credit Program. Thus, the use of CDBG funds does not disqualify a project from the larger 9% credit available to rehabilitation and construction projects that are not Federally funded. A smaller 4% credit available to Federally funded projects.

While it has been permissible to invest HOME funds in Tax Credit projects since the creation of the HOME Program, technical differences between the programs as well as the limitation on the credit value of Federal funds tended to discourage developers from utilizing HOME. The technical differences related to over-income situations on recertification, and the Housing and Community Development Act of 1992 reconciled these conflicts between the programs.

The second issue was addressed by the Omnibus Budget Reconciliation Act of 1993. Prior to this Act, developers faced the choices of excluding HOME funds from the eligible basis or borrowing the funds at a market rate of interest in order to qualify for the larger 9% credit available for non-Federal funds for improvements. OBRA changed this by declaring that a project is not considered federally subsidized solely because of the use of HOME funds. However, to receive the 9% credit rate for improvements, these projects must meet stricter requirements.

Consequently, there are now four ways to put HOME funds into a tax credit deal:

(a) Market rate loan -- If the HOME funds are provided at or above the applicable federal rate, these funds are not treated like a federal subsidy. The project qualifies for the 9% credit for eligible improvement costs and is eligible for the 130 percent basis for projects in qualified census tracts" or 'difficult development areas' (QCT/DDA).

(b) Below market rate loan with 9% credit -- If HOME funds are provided at an interest rate below the applicable federal rate, they may still be counted in the eligible basis and the project may receive a 9% credit if the project meets stricter occupancy requirements. Under OBRA, the project may receive the 9% credit if 40% of the residential rental units are occupied by households with incomes at or below 50% of the area median income. However, such projects are not eligible for the 130 percent basis for projects in 'qualified census tracts" or "difficult development areas'.

(c) Below market rate loan with 4% credit -- Some projects qualify only for a 4% credit, regardless of the way HOME funds are invested in the project. For example, a project with other Federal or tax-exempt mortgage revenue bond funds included in the basis is only eligible for a 4% credit under any circumstance, so HOME funds can be lent at any below market interest rate terms without consequence to the credit.

(d) Grant -- HOME funds may be provided in the form of a grant, but they may not be counted in the eligible basis for the project and do not contribute to the amount of credits for which the project is eligible. Therefore, a loan instrument is generally preferable to a grant. (Note that deferred payment loans are generally permissible provided the debt service accrues and there is a reasonable expectation that the loan can be repaid no later than when the loan matures.) In some cases, however, a grant of a small amount of HOME funds may be preferable to a below market interest rate loan, particularly if the project is eligible for the 130% QCT/DDA basis. Some experts have estimated that it could be more cost effective to provide a HOME investment of up to 20% of basis as a grant rather than a loan in such circumstances.

For any particular project and set of circumstances, the developer and public lender should analyze the use of HOME under all of these four options, and make a decision based on which option maximizes the credits and minimizes HOME (in consultation with the State Credit Agency).

4. Using CDBG and HOME with Other Sources

CDBG and HOME funds are intended to be leverage for other resources, both public and private. As noted in the underwriting section of this Chapter, rental projects are expected to carry private debt to the extent that cash flow permits. CDBG and HOME generally are invested at levels to cover gaps not covered by private and other public funds.

In rental housing, the pyramid of resources includes these levels:

- Primary loan -- typically comes from a private lender making a loan from its portfolio to increase its CRA performance, a private loan purchased by FNMA or FHLMC, a private loan with FHA insurance or GNMA backing, and/or HFA tax-exempt bond-backed mortgage;
- Secondary loans -- a mix of loans from other public, quasi-public or private lenders who provide favorable financing terms, but usually not total deferral, sometimes on an interim basis.
- Deferred loans -- CDBG, HOME or other local sources lent to the project, usually on deferred terms or cash-flow basis repayment;
- Owner's equity -- typically a significant source only in Tax Credit projects, but for-profit owners may be required to invest equity and/or real estate, and nonprofits sometimes can provide equity in terms of contributed real estate and grant funds.

Generally, CDBG and HOME are compatible with other sources. However, sometimes the requirements of these programs do not match. In such cases, the project must be able to meet the requirements of all programs from which funds are invested. Adherence to the strictest requirement usually will ensure compliance with lesser requirements in other programs. Where direct conflict arises, guidance or waivers should be obtained from the conflicting funding sources.

E. The Impact of Regulatory Requirements on Project Risk

The project risk analysis of the development and operating budgets presented in the previous chapter is expanded once the source of the gap money is known. The additional considerations are derived from regulatory requirements and their impact on the feasibility and viability of the project. The question that must be answered is: can the project meet the regulatory requirements and still remain feasible and viable? Some of these issues are outlined below for HOME and CDBG funded projects.

- ***Environmental issues*** -- Will the project pass the environmental review thresholds imposed by Federal regulations?[3]

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[3] CDBG and HOME projects must comply with 24 CFR Part 58. Local jurisdictions must submit to HUD for a Part 50 review under the Request for Release of funds.

- ***Housing Quality Standards*** -- Will the project meet local codes and any other housing quality standards on completion? Will project improvements increase the likelihood that compliance with housing standards can be maintained through the compliance period?

  The CDBG and HOME Programs are designed to fund modest housing for low and moderate-income families. HOME requires all units to meet Section 8 Housing Quality Standards or local codes (if higher), and energy standards if the project involves substantial rehabilitation or new construction [92.251]. While these are minimum standards for all HOME-funded housing, additional improvements may be necessary to make the housing marketable and durable.

- ***Match*** -- The HOME Program also requires match equal to 25 percent of HOME funds that can be met with a variety of non-Federal cash and in-kind contributions [92.2218-220]. Some of these match sources (in particular, the cash contributions) may be reflected in the development budget, but other in-kind contributions and fee and cost reductions might not be reflected. The match requirement applies to the jurisdiction's program, so it is not necessary that an individual project provide its pro-rata share of match; however, any match-eligible sources should be noted in the budget or elsewhere in the application. Developers should contact the HOME jurisdiction to determine match requirements that must be met by individual projects.

- ***Procurement*** -- Another development issue that affects underwriting is procurement. Project developers are subject to the procurement requirements of the program.[4] In addition, the program imposes EEO and affirmative hiring procedures that will ensure that Minority and Women Owned Businesses and local residents (under Section 3) will have access to the contracts and jobs created by the project.

- ***Davis-Bacon*** -- With respect to construction costs, Davis-Bacon prevailing wages may apply to construction where: 8 or more units are in a project for CDBG-funded construction; or 12 or more HOME-assisted units are in a HOME-funded. These requirements sometimes result in construction costs that are higher, and the public lender must ensure that costs are reasonable given the applicable procurement and wage requirements.

- ***Developer Fees*** -- Public lenders must be able to determine that the fees and profits earned by owner and the development team are reasonable. This consists of a general knowledge of the range of fees that developers typically earn, plus an analysis of total fees earned when there is an identity of interest between development team members. HUD regulations do not set maximum fees, deferring to the jurisdiction to make a determination of reasonableness.

- ***Capitalized Reserves*** -- Capitalized reserves are another issue. To ensure feasibility over the long term, especially when rent restrictions apply to HOME

[4] Participating jurisdictions are subject to 24 CFR Part 85 requirements. For most developers, this means that they will be subject to following a set of bidding procedures to ensure an open and fair competition. Where non-profits are acting as subrecipients, the requirements of Part 84 apply.

projects, assisted housing projects should have reserves that are either funded through cash flow or capitalized, or both. HOME funds may not be used to capitalize the reserves, except for an initial operating reserve.[5] The long-term operating and replacement reserves, if capitalized, must come from equity or other debt sources.

F. Determining the Amount of Subsidy

1. Gap Analysis

In most cases, public funds are used to cover the "gap" between development costs and the available debt and equity that the project income can support. Calculation of the amount of public funds required is referred to as Gap Analysis. The underwriter analyzes the operations of the project to determine the net income available for debt service, calculates the maximum conventional or other debt supported by the cash flow, and then computes the capital gap that must be funded with soft loans from HOME, CDBG or other sources.

The rent limits imposed by HOME were presented earlier in this chapter. The initial analysis of the operating budget presumes the highest rents permissible under the rent limits, and calculates the gap (and affordability issues) related to those rent levels. Then the analysis should examine the tradeoff of capital subsidy and rent levels. If rents are decreased to achieve greater affordability, what is the impact on the amount of subsidy required per unit.

The underwriter also needs to recommend any terms for the public investment, including repayment provisions. Just because the public investment is funding a gap does not mean that the funds must be granted or totally deferred. Projects may have cash flow related to debt service coverage required by public lenders, or might have cash flow in future years that can be made available to partially repay a loan. It is becoming increasingly common for public lenders to provide temporary loan deferrals, or what is called "cash flow" or "interest if earned" loans. These require payment of principal and/or interest on the public loan only if there is cash flow left over after meeting all other obligations and debt service. This generates program income and the ability to recycle the public funds to additional affordable projects.

2. Layering Analysis

A Layering Analysis is required for any project in which HOME funds are combined with at least one other public source, including CDBG. The HOME lender must analyze the project (and consult with the other public program agency) to determine the minimum total public subsidy required to achieve project feasibility. Although layering analysis requirements vary by HUD program, the analysis typically includes at least the following four elements:

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[5] HOME funds may be allocated to cover revenue shortfall for a period of up to 18 months while sustaining occupancy is reached. All funds reserved for this purpose must be expended or the funds expire; they are not available for long-term reserves.

a. Cost Analysis

- Is the acquisition cost reasonably related to market value and is it an arms-length transaction?
- Are development costs (construction and soft costs) reasonable?

b. Fee Analysis

- Is the Builder's Overhead and Profit reasonable?
- Are the Developer's Fee and all other non-arms-length-party fees (e.g., the developer or a subsidiary also receives a marketing fee) reasonable?
- If tax credits are involved, are the syndication costs and fees reasonable (this analysis is usually done by the tax credit agency)?

c. Equity Analysis

- Is the amount of equity committed reasonable (considering loan to value and Working Capital)?
- Is the Return on Equity or Return on Investment reasonable?
- Is the return reasonable after considering any tax benefits?
- Are there any restrictions on distribution of cash flow to the investors, and are reasonable reserves assured?

d. Gap Analysis

- Are the total sources of funding, including all public sources and equity, disclosed?
- Is the amount of public funding proposed reasonable in that it covers only the gap amount after adjustments required by the cost and fee analysis above?

Ultimately, layering analysis is essentially good underwriting fully informed of all public subsidies. The only aspect of layering analysis that might constitute an additional activity is that the public lender is expected to consult with other public funders to determine that its analysis is sufficient and inclusive of all other public subsidies committed.

G. Public Underwriting Issues for Complex Projects

This section addresses the unique underwriting issues that confront complex projects. Projects are considered complex if they:

- Have multiple public financing sources;
- Are occupied and may require relocation;
- Are mixed use or mixed income;
- Involve adaptive reuse of non-housing facilities for housing; and/or
- Serve a special needs population.

There is no particular bias against complex projects; rather, they have an additional level of proof that the borrower has the team and capabilities to manage all of the underwriting issues raised by the complex character of the project.

1. Special Considerations for Projects with Complex Financing

While any affordable rental housing project can be complex, those that have multiple public and private financing sources may present a unique set of underwriting issues:

- Readiness issue -- The presence of multiple funding sources is seen as raising the risk of all financing closing on time. Multiple funding sources mean multiple lenders who have to be able to meet similar deadlines in preparing their loans for closing. Timing is particularly important for the HOME Program, because of the Program deadlines for completion of expenditure of funds.

- Compliance issue -- Combination of funding sources can produce overlapping or conflicting requirements, some of which require time and negotiation to resolve. HOME has specific regulatory guidance for use of HOME with LIHC, but other programs may have different target populations, rent limits, or other requirements.

- Market issues -- Different income eligibility limits may narrow the target pool even more than a single program like CDBG or HOME does. In addition, indirect requirements such as the debt service coverage ratio of funding sources may decrease affordability and narrow the potential market.

Consequently, any developer proposing a project with multiple public funding sources should be able to demonstrate a thorough understanding and analysis of the regulatory requirements of all programs, including the proposed resolution of any conflicting regulations. In addition, the developer should demonstrate the ability to manage and coordinate the multiple sources.

2. Special Considerations for Occupied Properties

Occupied properties raise a whole set of issues pertaining to the rights and roles of the existing legal occupants when CDBG or HOME funds are used. Both the CDBG and HOME Program promote non-displacement of persons, including households and businesses. However, it may be necessary to relocate some legal occupants, either temporarily or permanently, to enable a CDBG or HOME project to proceed.

The provisions of the Uniform Relocation Act (and the regulations at 49 CFR Part 24) apply to projects funded by CDBG or HOME, as do the provisions of Section 104(d) of the Housing and Community Development Act of 1974 (and the implementing regulations at 24 CFR 570.606). Any legal occupants may be entitled to URA assistance if they are physically or economically displaced as a result of CDBG or HOME projects. Low-income residents may be entitled to additional benefits under 104(d), and affordable units that are removed or converted may need to be replaced with qualified affordable units.[6]

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[6] This Guide does not address specific requirements pertaining to relocation. HUD has provided for the development of HOME training courses and materials for relocation. Contact the American Communities Clearinghouse at 1-800-998-9999 to obtain copies of All the Right Moves and any relocation training courses that may be available to help you to understand your obligations with respect to relocation in HOME-funded projects.

CDBG and/or HOME funds may be used to pay relocation costs to any person (including businesses and other legal occupants) displaced by the activity, whether or not the person qualifies as a low and moderate income person under CDBG (or low income under HOME) guidelines. Jurisdictions must provide relocation assistance that is at least consistent with the URA and Section 104(d) requirements referenced above, but may also include optional or additional costs beyond the minimum requirements that the jurisdiction deems appropriate under the circumstances. Jurisdictions may also want to consider the use of HOME-funded or other tenant-based assistance to meeting the needs of tenants who are displaced, or to enable existing tenants to remain with affordable rents.

Relocation rules require the disclosure to occupants of planning for any rehabilitation activity that may result in displacement, and those requirements for notifying existing residents begin with the initial application for CDBG or HOME funds for the project. However, beyond these basic obligations of the participating jurisdiction to notify occupants, it is advisable to involve the existing residents early in planning the project to determine:

- How many residents are interested in remaining after the public investment;
- What unit size and configuration needs are of households interested in remaining;
- What items are in need of repair from the perspective of the tenants; and
- What changes may need to be made based on tenant experiences, such as security problems.

Where the residents show an interest in the project, it can be useful to involve them in a review of the rehabilitation plans and other aspects of the project. Though more time is required to involve the residents in these planning stages, it usually results in a better project with more tenant support and long-term satisfaction with the project.

3. Special Considerations for Mixed Income/Mixed Use Projects

CDBG funds may be provided to mixed-use or mixed-income housing that meets the national objectives and eligible activity requirements identified above. On the other hand, HOME funds may only be used for the capital costs associated with low-income housing units, but those HOME-assisted units may be included in a project that is mixed-use or mixed-income. HOME developers must certify that all HOME funds are used exclusively for costs associated with the low-income units, usually through cost estimation or cost allocation methods approved by the Participating Jurisdiction.

Beyond the basic funding eligibility issues, mixed-use and mixed-income projects present a challenge to public lenders, who must be concerned about the inter-dependency of the low-income housing operations with the other operations of the property. In some cases, the non-low-income operations may produce extra income that can help to subsidize the low-income housing; however, even when the low-income units appear to benefit by the excess cash flow from the non-low-income units, underwriting has to consider how vulnerable this dependency makes the low-income operations. For example, if the commercial space in a mixed-use property fails to rent, does the low-income housing revenue have to be used to carry the debt of the commercial space. For this reason, a separate operating analysis must be conducted of the commercial operations or the non-low-income housing operations, and underwriters typically create separate operating budgets for each component of the operations.

In addition, mixed-use projects create special property management requirements, so the proposed management plan needs to take into account the needs of all components of the project.

4. Special Considerations for Adaptive Reuse Projects

Included in the inventory of available properties for affordable housing are publicly held non-residential facilities such as schools, firehouses, hospitals, municipal offices and other community facilities. In some parts of the country, communities have sold their surplus schools to private developers for condominiums and elderly housing, or to nonprofits to convert the properties into low income and special needs housing.

Conversion of schools and other surplus facilities into housing can be appealing to a community for a variety of reasons. The buildings are often historic, solid buildings that have good locations within established neighborhoods, and a significant symbolic focus for the neighborhood. The prominence of the building makes it a high priority in a neighborhood revitalization strategy. The buildings can be controlled by the jurisdiction or one of its authorities, and may be available for no cost or low cost.

On the other hand, the schools and other community facilities were not originally built as housing, and the costs of conversion can be so high that rehabilitation costs approach or even exceed the costs of new construction. The properties are often old and uninsulated, and may contain large, inefficient windows that may be prohibitively expensive to replace due to historic preservation standards, or confront the residents with high heating bills. High ceilings add to heating costs, and large hallways and common space make it difficult to achieve an efficient layout for affordable housing, particularly when interior spaces are determined to have historic significance. Other historic preservation requirements also add to costs, and there also may be significant asbestos or lead paint removal costs or other environmental hazards associated with the prior use of the facilities.

Compounding the challenge may be a physical layout that may not be easily adaptable to residential use. For example, some buildings have a gymnasium or other performance space that cannot be converted to housing. They may continue to have some community use, but remember that the acquisition and rehabilitation of space that will be used for non-residential or community activities may not be paid with HOME funds, unless those spaces are exclusively for the use of the HOME project residents. Another issue may be the ownership of school grounds that contain public parks, playgrounds, and sports facilities that may continue to serve community purposes. In such cases, the title to such community use facilities may need to be separated from the housing and not included in the HOME project. CDBG funds may provide more flexibility in the improvement of these non-residential spaces.

5. Special Considerations for Special Needs Rental Projects

CDBG funds may be used to support the development or rehabilitation of housing for special needs populations. HOME can be used to produce permanent or transitional housing targeted to the homeless and special needs persons, but emergency housing and shelters are not eligible for HOME funds.

From the underwriting perspective, the service elements of the special needs or homeless housing must be considered separate from the real estate and the basic operations of a rental facility. A special needs project with separately committed services funding and staffing, and an experienced developer can be underwritten for project operating expense risks without regard to the service cost components (provided the service commitments are verified) and with consideration of special needs market risks and borrower capabilities. A publicly funded master lease project can be underwritten in a conventional manner, based on a guaranteed revenue stream covered by the lease and without any special needs market risk considerations. However, a special needs project (or component) without special provisions for these units or an experienced developer/operator requires careful examination of many issues, in particular the operating budget and service costs, manager capabilities, and the marketing plan.

Chapter 5.

Creating Affordable Housing for Homebuyers

A. Introduction

This chapter presents a framework for designing local homebuyer programs. The framework highlights key program considerations and suggests various production models and approaches to structure the public subsidy. In it you will see some of the key questions you need to ask, key issues you will need to address and strategies you will need to implement to solve the issues raised (see Framework for Local Homebuyer Program Design).

This chapter discusses several strategies in detail and includes when to use a specific strategy, alternative types of assistance, and how to use HUD's Community Development Block Grant (CDBG) and HOME programs to expand homeownership and leverage other resources. Many of the production models and subsidy approaches are complementary and can be combined to meet the unique needs of your community.

The following sections are included in this chapter:

- **Getting Started—A Homeownership Primer**. Before you can design a local program, you must be familiar with some concepts and principles that are common to all of the alternative production strategies. Topics include alternative types of homeownership, underwriting principles and trends, homebuyer counseling and education, maintaining long-term affordability, and other Federal requirements that are triggered when HOME and CDBG funds are used.

- **Strategy One—Purchase-Only Programs**. Purchase-only programs provide downpayment and/or closing cost assistance to lower income homebuyers who do not have the cash required to buy a home. In many cases, secondary financing (gap financing) is also made available for families that cannot qualify for a sufficient loan. These programs require fewer administrative resources and produce a relatively higher volume (in terms of units) than the other program design alternatives.

- **Strategy Two—Purchase-Rehabilitation Programs**. In addition to purchase assistance, purchase-rehabilitation programs provide rehabilitation assistance to housing that does not meet minimum construction standards. In many cases, the homebuyer purchases and rehabilitates the property with the assistance of the Community Development Agency. In other cases, nonprofits purchase and rehabilitate the property and subsequently sell it to a low-income household.

- **Strategy Three—Single-Family New Construction**. New construction programs use construction financing and other development subsidies that are needed to develop in-fill sites and/or new subdivisions. Direct purchase assistance to the eventual homebuyer is also included in many homebuyer developments.

- **Strategy Four—Lease Purchase Programs**. CDA are increasingly using lease/purchase programs as part of their homeownership strategies. Lease/purchase arrangements provide a transition period between renting and homeownership, which allows prospective homebuyers to accumulate cash for a downpayment and/or allows time for credit repair or the establishment of credit.

Each strategy requires varying amounts of administrative effort and costs. See the Exhibit below.

Various Homeownership Assistance Strategies and Corresponding Administrative Efforts

Strategy	Admin Effort / Unit	Sample Administrative Activities
Purchase only	Low to Moderate	Qualify purchaser and property Ensure the minimum and maximum subsidy limits are followed Undertake environmental review Provide homeownership education Establish and enforce long-term affordability standards
Purchase and Rehabilitation	Moderate to High	Qualify purchaser and property Perform layering analysis Ensure the minimum and maximum subsidy limits are followed Undertake environmental review Maintain relocation documentation file Select rehabilitation contractor Provide homeownership education Monitor rehabilitation Monitor Davis-Bacon Wage Rates Establish and enforce long-term affordability standards
Single-Family New Construction	High	Qualify purchaser and property Ensure the minimum and maximum subsidy limits are followed Undertake Environmental Review Prepare market study Assist in assembling land Assist in providing services Establish Relocation Documentation file Provide homeownership education Perform layering analysis Monitor construction Monitor Davis-Bacon Wage Rates Establish and enforce long-term affordability standards
Lease Purchase	Moderate to High	Qualify purchaser and property Ensure the minimum and maximum subsidy limits are followed Undertake Environmental Review Establish relocation documentation file Secure financing for the units during lease period Provide homeownership education during lease period Maintain the units during the lease period Establish and enforce long-term affordability standards

B. Getting Started–A Homeownership Primer

This section provides you with background information to address several fundamental questions that are common to all of the alternative production strategies. You will learn how to:

- Assess alternative forms of ownership.
- Better prepare homebuyers for the responsibilities of homeownership.
- Make sound investment decisions.
- Maintain long-term affordability.

1. Alternative Forms of Ownership

When most people think of homeownership, they envision a single-family home with a white picket fence to define the boundaries of ownership and control. Within the fence, the owner has total control. This is called "fee simple ownership."

Fee simple ownership, the most common form of ownership of single-family properties, consists of all the rights of homeownership, including the right to use, enjoy, and improve the property as the owner determines (subject to local laws), and to convey the property. In multifamily and shared forms of ownership, some or all of these rights are either shared with others or reserved by the governing body that protects the public interest in providing and maintaining affordable housing.

Other than fee simple ownership, common forms of ownership include cooperatives, condominiums, and community land trusts. Cooperative ownership is a hybrid form of ownership in which the members are partly owners and partly renters. It consists of (1) stock ownership or membership in a cooperation that owns and operates the property; (2) the right to occupy a unit under a long-term lease; and (3) the right to participate in the governance of the cooperative.

Cooperatives, or co-ops, are the most common form of ownership for projects that have been converted to low-income homeownership from other uses, such as commercial or market-rate rental projects, in large part because their corporate ownership structure makes it easier to restrict sale prices on units. These restrictions, commonly known as limited-equity provisions, are a well-tested method of ensuring that units remain affordable. In addition to limited-equity restrictions, the blanket mortgage on a cooperative reduces or eliminates the need for low-income residents to qualify individually for a mortgage.

Some limited equity coops are structured to ensure long-term affordability by placing formula price controls on the current and future maximum price of co-op stock. Such co-ops have provisions in the bylaws for limiting future stock prices to the original purchase price plus some formula adjustments that typically take in to account some or all of the following:

- Inflation, changes in the cost of living, or a rate of interest to be earned on a member's investment.
- Permanent physical improvements to the unit that are left behind for the future occupants.
- Mortgage principal amortized during a member's ownership of the stock and as a result of the member's monthly payments to debt service.
- The value of the member's contributions to reserves or special funds.

The factors are used to compute the maximum value of co-op stock. Members can sell their stock at any point in time. Members can sell their stock for no more than the maximum value. They can get back what they put into the co-op, with interest, but cannot speculate or make windfall profits. For low-income co-ops, the limited-equity formula ensures that the price of the stock will always stay affordable to future low-income buyers.

Condominium ownership more closely resembles single-family ownership than does cooperative ownership. It consists of (1) fee simple title to the living unit, with the physical boundaries consisting of the walls, floors, and ceilings of the unit; (2) shared, but undivided, interest in the underlying real estate, common areas, and other assets of the property; and (3) governance of common areas through a condominium association. In essence, the owner of the habitable unit has all of the rights of ownership with respect to his or her unit. However, what distinguishes a condominium from single-family ownership is that there are usually portions of the land and buildings that are owned by a type of corporation whose “shareholders” are limited to the unit owners.

Community Land Trusts separate the ownership of land from ownership of the building. The cost of land is a significant component of the budget for affordable housing. Land can account for 20 to 30 percent of a housing unit’s total development cost, particularly for single-family housing. In inflationary markets, speculation and increasing land prices tend to drive housing prices up faster than the cost of construction. A key factor in the success of land trusts is to obtain a long-term lease on the property; this is critical in order to ensure financing is received.

The increase in the housing cost over time can be moderated by removing the land from the speculative market. This is the primary reason land trusts are becoming an increasingly significant mechanism for developing and preserving affordable housing. Land trusts are entities, usually nonprofits, created to hold land for the community or individuals within the community. While the land trust owns the land, the occupant or user of the land owns the improvements on the land, such as a house. By separating out or eliminating the land cost, the capital requirements are reduced and the housing can be made more affordable.

2. Homebuyer Counseling and Education

Homeownership education and counseling are essential tools to increase and provide a foundation for long-term homeownership. For many potential first-time homebuyers, the frame of reference for housing expenses is a monthly rent check. The concepts and jargon of the homebuying process may be intimidating or confusing.

Homeowner education and counseling provide the following benefits to homebuyer programs:

- Education and counseling forge a critical link between first-time homebuyers and an increasingly complex housing industry.
- Education and counseling help families gain access to mortgage financing.
- Education and counseling prepare families for the long-term financial and maintenance responsibilities of homeownership.
- Education and counseling promote the success of homebuyer programs.

Homebuyers often require a combination of education and counseling assistance. Many potential homebuyers, particularly members of traditionally underserved populations, are unaware that homeownership is a possibility for them. Therefore, outreach is crucial to successful homeownership programs. Outreach focuses on informing the community about homeownership opportunities and available programs. Examples of outreach include homebuyer fairs, literature distributed at community centers, education programs in local churches, and adult education programs at schools.

There are three primary types of homeownership education and counseling:

- **Pre-purchase**. Pre-purchase education and counseling occur before the closing on a home and teach borrowers about the steps involved in purchasing a home and the ongoing responsibilities of homeownership. Topics include obtaining and managing credit, selecting a home, conducting a home inspection, choosing appropriate financing, calculating closing costs, monthly budgeting, and the importance of home maintenance and repair.

- **Post-purchase**. Post-purchase education and counseling provide contact and support after the home has been purchased. They help the homebuyer handle the ongoing responsibilities of homeownership, including assistance in managing a financial crisis and dealing with home maintenance problems.

- **Intervention**. Intervention counseling is conducted when a homebuyer has difficulty keeping up with scheduled mortgage payments. If notified well before default occurs, a qualified intervention counselor can often suggest a solution acceptable to both the homeowner and the lender.

Hundreds of homeownership programs are available nationwide to educate first-time homebuyers. Unfortunately, the quality of the materials varies widely and currently there are no industry standards for evaluating the quality of homeownership education programs. Below are some of the available resources for homeownership counseling.

Housing Counseling/Education Resources

HUD's Housing Counseling Clearinghouse
1–800–217–6970—General
1–800–569–4287—Counselor Referral
1–800–358–6216 TTD access
http://www.hud.gov/hsgcoun.html

American Homeowner Education and Counseling Institute
1156 15th Street NW, Suite 1220
Washington, DC 20005
1-800-AHECI-99
http://www.aheci.org

Neighborhood Reinvestment Corporation
1-800-438-5547

The National Foundation for Consumer Credit
1-800-388-2227

3. Making Sound Investment Decisions

a. The Private Lender's View

In almost all cases, a private lender will be making a first mortgage loan to your homebuyers. An understanding of the basics of mortgage credit is necessary so that you can design your local program to complement private-sector products as well as learn from the private sector's extensive experience in assessing borrower risk.

Private lenders will conduct extensive underwriting to assess the borrower's risk associated with the first mortgage loan. The specific criteria considered are generally referred to as the four C's of underwriting—**Capacity, Credit, Cash, and Collateral**.

Capacity. Can the homebuyer repay the debt? Look at employment information detailing how long the homebuyer has worked and how much he or she earns. Also look at the homebuyer's expenses, number of dependents, additional income, and other financial obligations.

Lenders typically apply two qualifying ratios to determine a borrower's ability to repay additional debt. The most restrictive ratio is used to determine the maximum mortgage amount that the borrower can afford.

Lender Ratios

- The maximum acceptable housing expense-to-income ratio (or front ratio) is generally expected to be in the range of 28-33 percent. The ratio is calculated by dividing the homebuyer's total housing expenses principal, interest, taxes, and insurance (PITI) by gross income.
- The total debt-to-income ratio (or back ratio) is also used by lenders to determine if homebuyers can handle a house payment in addition to all monthly recurring payments. The maximum ratio acceptable to the lender is generally in the range of 36-41 percent. This ratio is calculated by dividing all housing expenses plus other recurring monthly debt obligations by gross income.

Credit. Will the homebuyer repay the debt? Lenders closely scrutinize credit. The borrower's payment history on past obligations will be reviewed to determine whether a borrower is likely to meet mortgage payments in a timely manner. Many first-time homebuyers do not have traditional credit histories because they have not used credit in the past or do not have the type of credit history that would appear on a credit report. In these instances, lenders examine noncredit payment references such as history of rent, utility, or insurance payments.

Credit Scores: New Trends in Private Underwriting

The traditional approach to underwriting homeownership loans is changing. The current trend is to use credit scores. A credit score is a statistical way to predict the likelihood that a borrower will pay back a loan, such as a mortgage. The most commonly used credit score is known as a "FICO score," which was developed by Fair, Isaac and Co. It is a mathematical way to look at factors in an individual's credit record that may affect a borrower's ability and willingness to repay debt. These factors can include an individual's record of repaying loans (for example, student loans, car loans, and credit card bills); public records such as tax liens and bankruptcies; how often applications are made for installment loans and new credit cards; and the total amount of money that is owed.

Capital. Does the homebuyer have sufficient cash? PITI and other monthly expenses are not the only costs of homeownership. When a buyer purchases a home, he or she must provide a downpayment and cover the costs associated with closing a real estate transaction (often referred to as entry costs).

- Downpayment. Most lenders require that the homebuyer contribute an up-front payment toward the purchase price of the home. To make homeownership affordable to more people, most lenders now offer mortgages with a 3-percent downpayment.

- Closing costs. A number of costs are associated with the transfer of the property. They are called closing costs or settlement costs and are typically paid by the borrower (unless the seller has agreed to cover some of the costs as part of the purchase agreement). Closing costs usually range from 3 to 6 percent of the amount of the mortgage.

Collateral. Does the lender have adequate security? The evaluation of collateral is necessary to ensure that the lender can recoup its funds in the event of a foreclosure. A homeowner with a higher equity stake in the property will be more highly motivated to retain his or her home; therefore, the risk of foreclosure is reduced. Lenders will require property appraisals (to be performed by qualified and certified appraisers) to ensure that the value of the property adequately exceeds the loans on the property.

Lenders will use the loan to value (LTV) ratio to evaluate their risk. The LTV required by lenders is based on many factors. By charter, Freddie Mac and Fannie Mae are not permitted to buy mortgages with an LTV above 80 percent without additional credit enhancement. Mortgage insurance is often provided for loans in which the LTV is higher than 80 percent. If mortgage insurance is purchased, the lender will typically permit the homebuyer to have a maximum LTV of 95 to 97 percent.

b. The Public Lender's View

Public lenders must develop and implement procedures for reviewing funding requests that (1) ensure compliance with the applicable regulations associated with the funding source and (2) result in the prudent investment of public funds. The HOME and CDBG Program regulations contain specific eligibility requirements for homebuyers and properties. These eligibility requirements vary by funding source but typically include maximum income levels, property values, subsidy amounts, and property standards.

You should also carefully consider the implications of other Federal requirements, such as Davis-Bacon wage rates and the Uniform Relocation Act (URA), which may be triggered when using Federal funds such as HOME and CDBG.

On the other hand, neither the HOME nor CDBG Programs stipulate specific underwriting criteria. Instead, it is up to the agency to consider the underwriting options carefully and adopt well-defined written procedures. Depending on how you are structuring the public subsidy, you may be interested in the homebuyer's ability to repay the public subsidy. For instance, if the homebuyer is given a grant or deferred payment loan for assistance with the downpayment and closing costs, there is no requirement to assess the homebuyer's ability to repay because a monthly payment is not required. On the other hand, if secondary (gap) financing is provided as a below-market-rate loan that is fully amortizing, a review of the homebuyer's ability to repay the debt is expected.

The Exhibit below summarizes underwriting criteria for public lenders.

Public Lender Review Criteria—Suggested Guidance

Underwriting Criteria	Grants	Deferred Payment Loans	Amortizing Loans
►Capacity—Qualifying Ratios			4
►Credit—Credit History			4
►Capital—Availability of Cash	4	4	4
►Collateral—Loan to Value Ratio(s)		4	4
Eligibility Criteria (maximum income levels, property values, subsidy limits, property standards, and the like)	4	4	4
Other Federal Requirements	4	4	4

c. *Maintaining Long-Term Affordability*

Affordability is defined as a certain percentage of a homebuyer's household income. Many lenders assume that homebuyers can afford to spend 30 percent of their gross monthly income for housing expenses. Others use a higher percentage (30 to 40 percent) if the homebuyer has previously demonstrated the willingness and ability to spend a significant amount of his or her monthly income on housing (for example, a history of rental payments in the higher range). Neither the HOME nor CDBG programs define affordability; therefore, you have significant flexibility in defining it.

In certain real estate markets, it may also be beneficial to establish mechanisms to ensure the affordability of housing on resale. In fact, if the resale option is used under the HOME program, you must address the issue of long-term affordability. Common techniques used to promote long-term affordability include:

- Right of first refusal for the public agency to purchase the home if the initial homebuyer chooses to sell
- Limited-equity provisions that restrict the price of the unit on resale
- Restrictions on the income of subsequent purchasers
- Other means of ensuring continued use of the property for affordable housing

You should consider your local real estate market to determine if it is appropriate to impose restrictions on resale.

Long-Term Affordability and the HOME Program

Local programs should be designed to increase the supply of permanent affordable housing over an extended period of time within the Community Development Agency's local jurisdiction. The extended period of time (that is, the period of affordability in a HOME-assisted homebuyer program) is a period of not less than 5 years and not more than 15 years, depending on the level of HOME investment *(see 24 CFR 92.254).*

If the original homebuyer retains ownership of the property for the full period of affordability, no resale restrictions will apply. However, if there is a property transfer or the owner no longer occupies the property as a primary residence during the period of affordability, the CDA must ensure continued housing affordability in accordance with one of the following two options.

- **Recapture Option.** Under this option, the HOME subsidy must be returned to the HOME Program with certain exceptions. However, this option allows the seller to sell to any willing buyer at any willing price. Once the HOME funds are repaid, the property is no longer subject to any HOME restrictions. These funds may be used for any other HOME-eligible activity. *(see 24 CFR 92.254)*

- **Resale Option.** Using this option, an owner is obligated to resell the original home to another income-eligible homebuyer. The sale must be at a price that is affordable to the purchaser although the owner is also allowed a fair return on the sale. Under the HOME regulations, the CDA defines both the terms of affordability and fair return. Certain housing may be presumed to meet the resale restrictions during the period of affordability without the imposition of enforcement mechanisms by the CDA. The presumption must be based on a market analysis of the neighborhood in which the housing is located. The market analysis must be completed in accordance with the regulations. *(see CFR 24 92.254)*

C. Strategy 1—Purchase-Only Programs

If your community has existing housing that is available and in good condition, the best solution may be a purchase-only program in which the agency provides home purchasers with funds to enable them to buy a home. These programs address the common barriers of inadequate income, lack of cash, and/or poor or nonexistent credit. Depending on the specific barriers facing your homebuyers, you may incorporate any of the following types of assistance.

1. Types of Assistance

In determining which forms of assistance are applicable, the agency should consider the particular needs of the target beneficiaries. The options include:

- **Downpayment and closing-cost assistance**. For many potential homebuyers, the biggest barrier to homeownership is the downpayment and closing costs. While they may have a steady income that would allow them to make monthly payments, they do not have the means to save for the upfront costs of purchasing a home. In these cases, funds can be provided in the form of a grant or a deferred-payment loan.

- **Gap financing**. On the other hand, homebuyers may have a steady income that is insufficient to cover the total monthly payment. In this case, funds can be used to reduce monthly carrying costs by providing gap financing.

  The most efficient way to reduce the size of the monthly payment is to provide the homebuyer a grant or a loan (deferred-payment or below-market interest) to reduce the principal amount that he or she must borrow. You also may consider an "interest buydown"—providing funds directly to the lender to reduce the interest rate on the borrower's loan (see below).

  Gap financing, if provided as a loan, can be paid in small monthly installments (for a below-market-rate loan) or at the sale of the property (if a deferred-payment loan or DPL).

- **Direct mortgage loan**. In lieu of private first mortgage financing, provide direct mortgage loans at a below-market interest rate that requires repayment on a fully amortizing basis. These loans may be non-interest-bearing or may accrue interest at any rate that can be supported by the borrower. Often, very low interest rates are charged (that is, 1 to 3 percent) to make monthly payments more affordable than market rate loans. Although feasible, providing a direct mortgage loan is not an effective leveraging tool and results in fewer lower income homebuyers being assisted. In addition, direct mortgage loans require servicing of the loans, either with staff or with a contractor. In either case, the agency retains responsibility for the loan until it is repaid, sold, or written off.

- **Pre-paid interest subsidy**. A pre-paid interest subsidy, sometimes called an "interest buydown" or "interest writedown," is a payment of cash to a lender in exchange for a lower interest rate. The subsidy covers the difference between the market rate and the buydown rate. There are several variations to this approach. Generally, the agency makes a payment at closing equal to the present value of the interest write-down over the term of the loan. If the bank loan is paid off before the end of the loan term, the subsidy provider could receive a return of part of the original amount granted to the lender. Alternatively, the subsidy could be paid to the bank each month for the term of the loan, such as through an interest-bearing escrow account.

- **Loan guarantees**. See previous discussion of loan guarantees.

- **Discounted properties**. Many lenders and mortgage insurers hold title to foreclosed properties. Agencies may be able to obtain commitments for these properties at a discounted price. As a result, the overall cost of purchasing a home is reduced, thereby increasing the affordability for lower income homebuyers. Possible sources of these homes include property owned by the CDA, HUD, the U.S. Department of Veteran Affairs, Federal Deposit Insurance Corporation, Fannie Mae, Freddie Mac, the General Services Administration, the Internal Revenue Service, the Small Business Administration, the U.S. Army Corps of Engineers, and Federal surplus property listed in the Federal Register. Links to online searchable databases for many of these sources can be found at http://www.hud.gov/homesale.html.

Leveraging Effectiveness of Selected Types of Assistance					
	Agency Subsidy		***Local Lender Amount***		***Units Produced with $1 Million of Subsidy***
Gap Financing (DPL) with first mortgage at a rate of 8 percent	$17,300	25 percent	$77,682	75 percent	57 units
Interest Subsidies (buydown from 8 percent to 6 percent)	$17,300	N/A	$95,000	95 percent	57 units
Direct Loans at 6 percent	$95,000	95 percent	0	0 percent	10 units

Example assumes a house price of $100,000, 5 percent downpayment from the homebuyer, and $570 available for monthly repayment of principal and interest.

2. Funding for Purchase-Only Programs

a. CDBG

Eligible Activities [see 24 CRF 570.201(n)]

- Subsidize interest rates and mortgage principal amounts, including providing a grant to reduce the effective interest rate on the amount needed by the purchaser to an affordable level. (The funds granted would have to be applied toward the purchase price.) Alternatively, the grantee/subrecipient could make a subordinate loan for part of the purchase price, at little or no interest, for an amount of funds the payments on which, together with that required under the first mortgage, would be affordable to the purchaser.

- Finance the cost of acquiring property already occupied by the household at terms needed to make the purchase affordable.

- Pay all or part of the premium (on behalf of the purchaser) for mortgage insurance required upfront by a private mortgagee. (This would include the cost for private mortgage insurance.)

- Pay any or all of the reasonable closing costs on behalf of the purchaser.

- Pay up to 50 percent of the downpayment required by the mortgagee on behalf of the purchaser.

Homeownership assistance as a public service activity. Homeownership assistance may also be eligible under the category of public services [see 570.201(c).] In such cases, the activities are subject to the public services cap. However, homeownership assistance activities carried out as a public service do not have the same restrictions on the type of assistance that may be provided. For example, the CDBG contribution is not limited to 50 percent of the downpayment required by the mortgagee. In addition, assistance is not specifically limited by statute to low- and moderate-income persons.

Carefully assess the pros and cons of carrying out homeownership assistance activities under the public services category. The primary advantage is that an activity would be financed that would not otherwise be eligible if it were carried out as a homeownership assistance activity, such as paying more than 50 percent of the downpayment. The primary disadvantage is that the activity becomes subject to the 15 percent expenditures for public services.

Homeownership assistance as part of a neighborhood revitalization strategy. The Consolidated Plan regulations in Section 91.215(e)(2) describe an optional approach to community development called a neighborhood revitalization strategy (NRS). An NRS is a comprehensive strategy for revitalizing areas that are among communities' worst. If a community is considering creating an NRS, the CDA should consider making homeownership assistance activities part of that strategy.

NRS areas are often characterized by very low incomes and very high proportions of renters. It may be beneficial to include increasing the number of homeowners as part of the NRS. There are two advantages to this strategy:

All housing units assisted in an NRS area may be considered part of a single structure for the purpose of meeting the 51-percent occupancy requirement. In other words, families that are not LMI may be assisted if the number of such households does not exceed 40 percent of the assisted households. This factor alone can make a significant contribution to stabilizing a distressed neighborhood.

If the grantee elects to use a CBDO to deliver services in the strategy area, any services the CBDO provides (including homeownership assistance) would be exempt from the expenditures cap on public services. This would remove the main advantage of qualifying the assistance under the homeownership assistance category. The exemption from the public services cap is available, however, only if a CBDO administers the homeowner assistance program.

Eligible property types. Eligible property types include any property that serves as the purchaser's principal residence, including a single-family property (one unit), two- to four-unit property, condominium unit, cooperative unit or a unit in a mutual housing project (if recognized as homeownership by State law), or a manufactured home.

Purchase price. There is no maximum purchase price, but the housing must be affordable to LMI purchasers.

Property standards. Since there are no uniform property standards required by the CDBG program, grantees are advised to establish their own.

CASE STUDY—PURCHASE ONLY PROGRAM

Neighborhood Stabilization in Anyplace County Through Settlement Expense Loan Program

Since 1995, Anyplace County has used the Settlement Expense Loan Program (SELP) as the cornerstone of its efforts to stabilize some of its older neighborhoods. After a detailed analysis of demographic and economic trends in older suburban neighborhoods, Anyplace CDA staff identified neighborhoods where homeownership rates appeared to be declining.

Program Design

Those who are income eligible and interested in purchasing a home through SELP are required to attend at least one 2-hour homebuyer workshop and one individual homebuyer counseling session before their application will be accepted. The homebuyer workshop covers such topics as qualifying for a mortgage loan and the importance of housing inspections and housing maintenance. Counseling services for individual borrowers involve an analysis of credit reports, the borrower's finances, and the amount of money they will be able to devote to monthly housing payments. Post purchase counseling is also available through SELP.

Financing

Deferred payment loans of $1,000 to $5,000 are provided to LMI residents who purchase homes in community conservation areas. These loans are administered through a multilayered partnership of the CDA, a number of local private lenders, and local, nonprofit housing counseling agencies. In addition, the deferred repayment provisions of the loans do not affect whether buyers can afford a first mortgage.

As a result of SELP, there are 786 housing units in Anyplace County's older neighborhoods whose owners have a stake in their neighborhoods and the surrounding areas. The program's emphasis on pre-purchase counseling and education and its administration through community-based organizations have been singled out as two contributing factors to SELP's success.

b. HOME

Eligible Activities. Acquisition is an eligible activity under HOME. You can help eligible homebuyers purchase affordable homes by providing downpayment or closing cost assistance or by reducing the monthly carrying costs of a loan from a private lender. (You could also provide mortgages for home purchase, although few do this because it constricts the number of households that can receive assistance.) This approach to homeownership works best in areas in which an adequate supply of housing exists and if a grant or loan can make housing affordable to low-income households. Generally, for homebuyer assistance programs, the Participating Jurisdiction will use grants, deferred-payment loans, below-market-rate loans, and/or loan guarantees.

Eligible property types. Eligible property types include any property that will serve as the purchaser's principal residence, including a single-family property (one unit), two- to four-unit property, condominium unit, cooperative unit or a unit in a mutual housing project (if recognized as homeownership by State law), a combination of a manufactured home and lot, or a manufactured home (Section 92.254(a)(2)(iii).

Maximum purchase price. The purchase price of newly constructed housing or standard housing may not exceed 95 percent of the median purchase price for that type of single-family housing for the area, as published by HUD (http://www.hud.gov), or as determined locally through market analysis [see 24 CFR 92.254(a)(2)(iii)].

Property standards. Housing that is acquired as part of a purchase-only program must meet applicable State and local housing quality standards and code requirements. Many jurisdictions have a minimum housing code or standards that govern occupancy. If no such standards or codes apply, the property must meet HUD's Section 8 Housing Quality Standards (HQS). All assisted housing must meet the accessibility requirements of the Fair Housing Act and Section 504 of the Rehabilitation Act of 1973. Manufactured housing must meet the Manufactured Home Construction and Safety Standards, which preempt applicable State and local codes. [(See 24 CFR Part 3280.)]

Applicant/beneficiary requirements. To be eligible for HOME funds, the prospective purchaser must be low income, that is, have an annual (gross) income that does not exceed 80 percent of the median for the area, and occupy the property as a principal residence. Specifically, the purchasing household must be low income on the date of purchase.

c. Other Funding for Purchase-Only Programs

As with other affordable housing strategies, CDA can tap other partners and funding sources to leverage their limited CDBG and HOME dollars. Additional programs to assist lower income households to purchase a home include:

- Freddie Mac's Affordable Gold works to help meet the needs of more LMI borrowers by offering flexible ratios, affordable reserve requirements, and clear underwriting guidelines.

- Fannie Mae's Community Homebuyer's Program (CHBP) is available to homebuyers who earn no more than 100 percent of the area median household income. This 5-percent downpayment mortgage is a 15- to 30-year fixed-rate mortgage with 33/38 debt-to-income ratios. No cash reserves are required.

- Ginnie Mae, a wholly-owned government-sponsored enterprise (GSE) within HUD, helps expand homeownership opportunities for all Americans by purchasing Federal Housing Administration insured loans.

- State and local housing finance agencies sell tax-exempt mortgage revenue bonds to investors to raise funds for affordable housing. Funds are provided either to local primary lenders or directly to developers. The government agencies issuing the bonds pass the interest savings on through private lenders to lower income families for first mortgages; rehabilitation and energy-efficiency improvement of existing homes; and, for older homeowners, to use to tap their home equity for living costs.

- FHA offers several popular programs. The most popular purchase program is Mortgage Insurance for One-to Four-Family Homes (Section 203(b)). Through this program, FHA insures mortgages made by qualified lenders to people purchasing or refinancing a home of their own. Section 203(b) is the centerpiece of FHA's single-family insurance programs.

- Rural Development within U.S. Department of Agriculture, offers these homeownership programs:

    - Rural Housing Guaranteed Loans. Section 502 loans are primarily used to help low-income households purchase homes in rural areas. Funds can be used to build, repair, renovate, or relocate a home or to purchase and prepare sites, including providing water and sewage facilities. Applicants for loan guarantees may have an income of up to 115 percent of the median income for the area. Families must be without adequate housing, but be able to afford the mortgage payments, including taxes and insurance. These payments are typically 22 to 26 percent of an applicant's income. In addition, applicants must be unable to obtain credit elsewhere, yet have reasonable credit histories.

    - Rural Housing Direct Loans. Rural housing direct loans are directly funded by the government. These loans are available for low- and very low-income households to obtain homeownership. Very low income is defined as below 50 percent of the area median income (AMI); low income is between 50 and 80 percent of AMI; moderate income is 80 to 100 percent of AMI. Applicants may obtain 100-percent financing to purchase an existing dwelling, purchase a site and construct a dwelling, or purchase newly constructed dwellings located in rural areas. The purpose of this loan is to provide financing at reasonable rates and terms with no downpayment. Mortgage payments are based on the household's adjusted income. These loans are commonly referred to as Section 502 Direct Loans.

- The Federal Home Loan Bank (FHLB) System has operated two targeted housing assistance programs since 1990:

    - Affordable Housing Program (AHP) is a competitive program that may be used to finance the purchase, construction, and/or rehabilitation of housing.

    - The Community Investment Program (CIP) is a flexible, noncompetitive program that may be accessed by members of the FHLBank System on an ongoing, as-needed basis. Through CIP, FHLBanks make reduced rate advances, typically

20 to 35 basis points below the rate on a regular advance. These cost-of-funds savings can be passed on to the borrower as a lower mortgage interest rate.

- Community Development Financial Institutions (CDFIs), specialized private institutions, fill niches in the market that traditional financial institutions are not well positioned to serve. They provide a wide range of financial products and services to underserved communities and include such diverse institutions as community development banks, credit unions, loan funds, venture capital funds, and micro enterprise funds. The CDFI program invests in CDFIs in a variety of forms—equity investments, loans, grants, deposits, and credit union shares—depending on market needs and the ability of individual CDFIs to raise private matching funds.

D. Strategy 2—Purchase and Rehabilitation Programs

If your community has available housing, but it is in substandard condition, a purchase-rehabilitation program may be the best solution. “Purchase-Rehabilitation” addresses the need for rehabilitation as well as affordability issues—inadequate income, lack of cash, and/or poor or nonexistent credit.

Many programs use a combination of private (conventional) financing and public subsidies. More and more CDA are becoming involved in purchase-Rehabilitation programs. In fact, CDA have simplified the process by making it possible for homebuyers to combine purchase and rehabilitation financing in one package.

1. Program Structure

You can structure a purchase-rehabilitation program primarily in two ways: (1) a homebuyer purchases and rehabilitates the home; or (2) a CDA or nonprofit group purchases the home, fixes it up, and then sells the house to an eligible buyer.

a. Homebuyer Purchases and Rehabilitates

Typically, if the homebuyer purchases the property and is involved in the rehabilitation, he or she will obtain a loan from a lender for both the purchase amount and the cost of rehabilitation, minus any subsidies received. The lender will put the rehabilitation portion of the loan into an escrow account, where it will be “drawn down” as construction is completed.

In underwriting a purchase-rehabilitation loan, lenders consider the following factors in addition to the creditworthiness of the borrower:

- Whether the rehabilitation plans appear reasonable; and

- Whether the organization is able to complete rehabilitation on a timely basis, that is, whether the lender believes that the rehabilitation team is competent and that the borrower has the ability to monitor rehabilitation adequately.

Rehabilitation funds are usually not disbursed in a lump sum at the start of reconstruction; rather, the lender usually disburses loan proceeds during stages of the rehabilitation after obtaining evidence that the rehabilitation work for that stage is complete. Lenders often require that the borrower's architect, the affordable housing provider, and/or a third party professional, certify that the work is complete for that stage in rehabilitation. Lenders often allow borrowers to finance construction-related soft costs. These costs could include taxes, insurance and utility costs during the rehabilitation period, architectural and inspection expenses, consultant fees, and even the lender's construction loan interest.

Homebuyer Purchases and Rehabilitates A Property: An Example

A homebuyer wishes to purchase a home for $60,000. An estimated $25,000 is needed for rehabilitation. Suppose the homebuyer qualifies for only $70,000 in mortgage financing and will contribute $5,000 for a downpayment. In this scenario, the lender would issue a $70,000 mortgage. Ten thousand dollars would be placed in an escrow account and would be drawn as construction progresses. A local nonprofit contributes a $10,000 construction subsidy to complete the necessary financing.

b. Public/Nonprofit Agency Purchases, Rehabilitates, and Resells Property

In this approach, an affordable housing provider, local nonprofit organization, or the public agency purchases, rehabilitates, and resells the property to a qualified buyer. There are two ways that lenders may issue financing in this scenario:

- A one-time assumable permanent mortgage permits the financing of the acquisition and rehabilitation in the permanent mortgage. Under this type of financing, there is one long-term permanent mortgage that covers acquisition and rehabilitation. Rehabilitation funds are placed in an escrow account with the lender and paid out as work is completed. When the rehabilitation is completed and a qualified homeowner (the end-buyer) purchases the property from the housing provider, the homeowner has the option of assuming the permanent mortgage.

- A lender issues one purchase-rehabilitation loan to the affordable housing provider. Another loan is issued to the homebuyer at resale (either by the original lender or another lending institution).

The lender will underwrite the property and the affordable housing provider at the time the loan is originated, and will underwrite the end-buyer using affordable lending underwriting criteria at the time of the loan assumption or when the new mortgage is issued.

Criteria for Obtaining Interim Financing

√ Whether the affordable housing borrowers rehabilitation plans appear reasonable.

√ The agency's ability to complete rehabilitation on a timely basis, that is, whether the lender believes that the borrower's rehabilitation team is competent, and that the borrower has the ability to monitor construction adequately.

√ The likelihood that the affordable housing provider will be able to find a purchaser on a timely basis who will be able to obtain permanent financing.

√ The affordable housing provider's ability to continue payment on the loan if the home is not purchased or rented.

2. Types of Assistance

In determining forms of assistance, the agency should consider the particular needs of the target group. The following alternative approaches to structuring your subsidies in a purchase-rehabilitation program were discussed previously under purchase-only programs.

- Downpayment and closing cost assistance.
- Gap financing for purchase and rehabilitation.
- Direct mortgage loan.
- Prepaid interest subsidy.
- Discounted properties.
- Loan guarantee.

a. CDBG

Eligible Activities. For purchasing the property. Eligible CDBG funding for homebuying assistance is described earlier in this chapter. Eligible activities connected with the rehabilitation component of this program include [see 24 CFR 570.202]:

- Rehabilitation costs of labor, materials, supplies, and other expenses required for the rehabilitation of property.
- Water and sewer—Costs of connecting existing residential structures to water distribution lines or local sewer collection lines.
- Barrier removal—Cost to remove material and architectural barriers that restrict the mobility and accessibility of elderly and severely disabled persons.
- Landscaping, sidewalks, and driveways—The costs of installation or replacement of landscape materials, sidewalks, or driveways, when incidental to other rehabilitation of the property.
- Historic preservation—Cost of preserving or restoring properties of historical significance.

- Lead-based paint hazard evaluation and reduction—The costs of evaluating and treating lead-based paint.
- Other costs including insurance (initial homeowner's premium only), energy efficiency improvements, and security devices.

Ineligible Activities. Ineligible activities include installation of luxury items, equipment costs, furnishings or other personal property that are not an integral structural fixture, such as a window air conditioner or a washer or dryer. Labor costs for owners to rehabilitate their own properties are also ineligible. (24 CFR 570.207).

b. HOME

Eligible Activities. Acquisition and rehabilitation is an eligible activity under HOME. You can use HOME funds to fund either of the approaches outlined earlier—homebuyer purchases and rehabilitates or affordable housing provider purchases, rehabilitates, and resells. For example, the you might acquire and rehabilitate, or assist a developer to acquire and rehabilitate, substandard properties to be sold after rehabilitation to low-income purchasers. As an alternative, you might provide assistance directly to the homebuyer to perform the rehabilitation after the purchase. In such programs, you might offer rehabilitation loans in addition to, or instead of, the downpayment and closing-cost assistance discussed earlier in Strategy One—Purchase-Only Programs. You may also use a loan guarantee to minimize the lender's risk associated with the rehabilitation work.

Ineligible Activities. Ineligible activities include installation of luxury items, equipment costs, and furnishings or other personal property that are not an integral structural fixture, such as a window air conditioner or a washer or dryer. Labor costs for owners to rehabilitate their own properties are also ineligible.

Eligible Rehabilitation costs. The eligible costs include all reasonable costs necessary for the property to meet local codes and property standards, including energy-related improvements, improvements necessary to permit use by persons with disabilities, and abatement of lead-based paint hazards. (24 CFR 92.206 and 92.355)

Maximum purchase price. The after-rehabilitation value of the property may not exceed 95 percent of the median purchase price for that type of single-family housing for the area, as published by HUD (http://www.hud.gov), or as determined locally through market analysis [See 24 CFR 92.254(a)(2)(iii).]

Property standards. Housing that is being rehabilitated must meet applicable State and local codes, rehabilitation standards and ordinances, and zoning ordinances. If no such standards or codes apply, the local agency must use one of the Model Codes outlined in the regulations. You must also ensure that the property is free of health and safety defects before occupancy and no later than six months after property transfer. Also, you must ensure that the property meets all the standards outlined above within 2 years of property transfer to the owner. All assisted housing must meet the accessibility requirements of the Fair Housing Act and Section 504 of the Rehabilitation Act of 1973. Manufactured housing that is rehabilitated must meet all applicable local codes and ordinances governing manufactured housing (see 24 CFR 92.251).

Applicant/beneficiary requirements. To be eligible for HOME funds, the prospective purchaser must be low income, that is, have an annual (gross) income that does not exceed 80 percent of the median for the area, and occupy the property as a principal residence.

Specifically, the purchasing household must be low income at the time the agreement between the homebuyer and builder is signed.

c. Other Homebuyer Purchase-Rehabilitation Programs

- Government Sponsored Enterprises (GSEs) that provide secondary market financing, such as Freddie Mac and Fannie Mae, are introducing more flexible rehabilitation products that allow private lenders to make purchase-Rehabilitation loans. An example is Freddie Mac's HOME Works! Program that allows agencies to use their HOME funds to guarantee rehabilitation loans. In turn, Freddie Mac is willing to purchase the loan from your local lender before the rehabilitation is started. In this scenario, the majority of the risk is assumed by the HOME Program.

- Housing finance agencies sometimes have rehabilitation and purchase-rehabilitation loan programs.

- The Federal Housing Administration (FHA) offers several popular programs. The most popular for rehabilitation are the Section 203(k) Program for Purchase-Rehabilitation and the Title I Program.

    - Section 203(k) insurance enables homebuyers to finance both the acquisition and rehabilitation of a house through a single mortgage. Section 203(k) insured loans save borrowers time and money, and also protect lenders by allowing them to have the loan insured even before the condition and value of the property may offer adequate security.

    - The Title I Program insures loans to finance the light and moderate rehabilitation of properties. This program may be used to insure such loans for up to 20 years with a maximum loan amount of $25,000. The Title I insurance protects lenders against the risk of default for up to 90 percent of any single loan.

- Rural Development in the U.S. Department of Agriculture offers homeownership programs described previously in the Purchase-Only Section of this chapter, including guaranteed and direct loans.

    - Rural Housing Repair and Rehabilitation Loans. Rural housing repair and rehabilitation loans are funded directly by the government. These loans are available to very low-income rural residents who own and occupy a dwelling in need of repairs. Funds are available for repairs to improve or modernize a home or to remove health and safety hazards. This loan is a 1-percent loan that may be repaid over a 20-year period. To be eligible, homeowner-occupants must be unable to obtain affordable credit elsewhere, have very low incomes—defined as below 50 percent of the AMI, and must have a home in need of repairs and improvements to make the dwelling more safe and sanitary or to remove health and safety hazards. Grants are only available to homeowners who are 62 years old or older and cannot repay a Section 504 loan.

- Community Development Financial Institutions (CDFIs) wee discussed previously.

- The Federal Home Loan Bank (FHLB) System was discussed previously.

E. Strategy 3—New Construction

In areas in which there is an insufficient supply of appropriate housing, you may want to provide subsidies to stimulate the construction of new housing. An agency may develop housing itself or may work directly with housing developers, providing funds to other organizations or individuals to contract for the construction. Depending on the local needs, one or more of the following types of assistance may be provided to developers of new housing and/or the homebuyer directly.

1. Types of Assistance

In determining the forms of assistance, you should consider the particular needs of the target participants. The following outlines types of assistance that can be used in a new construction program. The Purchase-Only section gives a detailed description of the last five types of assistance.

- Development subsidy. One way to reduce the homebuyer's monthly housing cost is to subsidize the sales price of the house. If you provide a developer a subsidy, the developer can then offer the home at a lower sales price that presents a lesser burden to low-income homebuyers. The development subsidy is generally a grant to the developer.
- Downpayment and closing cost assistance
- Gap financing for purchase
- Direct mortgage loan
- Prepaid interest subsidy
- Discounted properties

a. Using CDBG for New Construction Programs

Eligible Activities. Under this category, CDBG funds may be used in certain specified circumstances to finance the construction of new permanent residential structures. The following identifies those limited circumstances:

- You may use CDBG funds in a housing construction project that has received funding through a Housing Development Action Grant (HODAG)–see 24 CFR 570.201(m).

- You may construct housing of last resort under 24 CFR Part 42, Subpart 1. (This is housing that must be constructed in order to provide suitable replacement housing for persons to be displaced by a contemplated CDBG project, subject to the URA, and if the project is prevented from proceeding because the required replacement housing is not available otherwise–see 24 CFR 570.207(b)(3).

- A recent HUD waiver (Sept 99) permits the use of CDBG funds for homeownership assistance, as long as the assistance is provided directly to the homebuyer. HUD has determined that downpayment assistance on a newly constructed home does not constitute an ineligible activity–by waiver. Supporting language from the letter stipulates, "…However, until a regulatory change is implemented, the use of CDBG funds for a homeownership program that would result in assisting the new construction of housing will require approval of a waiver of the CDBG regulations at 24 CFR 570.207(b)(3)."

- New housing construction is also eligible if carried out under the authority of the basic eligibility category of "Special Activities by CBDOs"–see 24 CFR 570.207(b)(3).

Conversion is another eligible activity. It should be noted that the cost of converting an existing nonresidential structure to residential is not generally considered to constitute new construction under the CDBG program and is thus covered under the basic eligibility category of rehabilitation. In some cases, however, the conversion may involve construction that goes beyond the envelope of the nonresidential structure. If this is the case, consult with the local HUD field office to ensure that the extent of such construction would not constitute new construction of housing and thus be ineligible for CDBG assistance. [Reference: 24 CFR 570.202]

It is important to note that several activities that support new housing may be carried out using CDBG funds, even though the actual housing construction costs are being supported by other resources. The following are examples of supportive activities:

- Acquisition of sites on which buildings will be constructed for use or resale as housing. [Reference: 24 CFR 570.201(a)]

- Clearance of toxic contaminants of property to be used for the new construction of housing. [Reference: 24 CFR 570.201(d)]

- Site improvements to publicly owned land to enable the property to be used for the new construction of housing, provided the improvements are undertaken while the property is still in public ownership. [Reference: 24 CFR 570.201 (c)]

- The cost of disposing of real property, acquired with CDBG funds, which will be used for new construction of housing. [Reference: 24 CFR 570.201 (b).]

- In addition, certain "soft costs" necessary for the new construction of housing that would otherwise be ineligible may be eligible if HUD waives the limitations of 24 CFR 570.206(g). Such soft costs include:
  - Surveys
  - Site and utility plans
  - Application processing fees

b. Using HOME for New Construction Programs

Eligible Activities. New construction is an eligible activity under HOME. You can provide development subsidies to developers as well as help eligible homebuyers purchase new homes by providing downpayment or closing cost assistance, or by reducing the monthly carrying costs of a loan from a private lender. (You could also provide mortgages for home purchase, although few do this because it limits the number of households that can receive assistance.)

Eligible property types. Eligible property types include any property that will serve as the purchaser's principal residence, including single-family property (one unit), two- to four-unit property, condominium unit, cooperative unit or unit in a mutual housing project (if recognized as homeownership by State law), or a manufactured home or lot, or manufactured home. For purposes of the HOME regulations, any property that is less than 1 year old is considered new construction.

Maximum purchase price. The purchase price of newly constructed housing or standard housing may not exceed 95 percent of the median purchase price for that type of single-family housing for the area, as published by HUD (http://www.site), or as determined locally through market analysis [(see 24 CFR 92.254(a)(2)(iii)].

Property standards. Housing that is acquired as part of a new construction program must meet applicable State and local housing quality standards and code requirements. Many jurisdictions have a minimum housing code or standards that govern occupancy. If no such standards or codes apply, the property must meet Section 8 HQS. All assisted housing must meet the accessibility requirements of the Fair Housing Act and Section 504 of the Rehabilitation Act of 1973. Newly constructed properties must also comply with the Model Energy Code.

Applicant/beneficiary requirements. To be eligible for HOME funds, the prospective purchaser must be low income, that is, have an annual (gross) income that does not exceed 80 percent of median for the area; and occupy the property as a principal residence. Specifically, the purchasing household must be low income at the time the agreement between the homebuyer and builder is signed.

Case Study-Loan Pool

Anytown USA's Housing Partnership created a loan pool funded by the local banks that will ease the way for residents to become homeowners. The loan pool program supplements the partnership's grant programs and helps program organizers lend money to a larger number of affordable housing developments, while increasing flexibility in leveraging grant funds. Interest rates, loan terms, and subsidy amounts vary with each new project. The partnership is efficiently run, and administrative costs are kept low because there are no salaried employees and Anytown provides meeting facilities.

Anytown's partnership overcame a shortage of funds for the construction of single- family homes by engaging banks, corporations, and foundations, which contributed $12 million. Each lender was reluctant to accept complete construction period risk but was willing to share the risk with a number of lenders. These private funding sources, combined with State and local funds, and HOME funds have assisted more than 1,800 families. The program offers a variety of assistance including underwriting construction costs, downpayment assistance, settlement assistance, and deferred second mortgages.

F. Strategy 4—Lease Purchase Programs

Affordable housing developers are increasingly using lease purchases as part of their homeownership strategy. In the past, a lease purchase was used when buyers had little cash for a downpayment. More recently, lease purchases have been used to address potential buyers' credit issues.

The reasons to consider a lease-purchase program include:

- High debt loads and previous unacceptable credit reports. Lease purchases provide time to reduce debts, clear up bad debts, and reestablish good credit.
- Demonstrate credit dependability. Borrowers with blemished credit records (and low credit scores) can prove their creditworthiness during the lease period.
- Inconsistent or unstable income. Lease purchase provides time to demonstrate steady employment.

- Affordability. Depending on lease and financing structuring, the escrow account can be used to provide a significant downpayment and reduce the size (and cost) of the eventual mortgage.
- Little available cash. In some instances, lease purchase provides time and an escrow account to accumulate cash.

Successful lease purchase programs have the following components:

- Lease with an option to buy. A clear option or sales contract is combined with a detailed leasing agreement or in some cases a right-of-occupancy agreement.
- Limited lease term. The HOME Program requires the CDA to establish a purchase deadline.
- Downpayment escrow account. As an option, part of the rent payment is used to accumulate cash for closing costs and downpayment.
- Maintenance responsibilities. Lease purchasers are required to maintain the home as if they were homeowners.
- Homeownership counseling. More extensive education and training is needed prior to leasing and during the leasing period. Training needs to include maintaining a home.
- Unique financing. The CDA must provide financing during the leasing period. The buyer must obtain financing to purchase the property at the conclusion of the lease period.
- Established financial sources. Financing sources designed to address the unique aspects of lease purchases must be sought. Very few lenders have established lease purchase products, so a local program must be developed. Look to secondary market entities for product help. In addition, use the HOME Program, CDBG, or other flexible resources.

1. Types of Assistance

a. Using CDBG for Lease-Purchase Programs

The CDBG program does not specifically address the use of CDBG funds during the rental phase of a lease purchase program as an eligible homeownership activity. However, once the homebuyer is prepared to purchase the property, CDBG funds can be used as outlined in Strategy One—Purchase-Only Programs. Costs associated with rehabilitation or construction as part of a lease purchase program also are eligible as described in Strategy Two—Purchase and Rehabilitation Programs, or Strategy Three—New Construction.

b. Using HOME for Lease-Purchase Programs

<u>Eligible Activity</u>. A lease-purchase option may be used in conjunction with the homebuyer program. However, ownership must be conveyed to an eligible homebuyer within 36 months of signing the lease purchase agreement. If at the end of the 36-month period, the household occupying the property is not able to purchase the unit, the CDA has an additional 6 months to identify an eligible homebuyer to purchase the unit. In all cases, if a homebuyer does not purchase the unit by the end of the 42-month period, the unit becomes a HOME rental unit subject to the HOME rental rules. Once the homebuyer is ready to purchase the unit, all of the activities outlined in the section on Purchase-Only Programs are eligible. (24 CFR 92.254 (a)(5)(ii)(A)(7)).

HOME-assisted rental units may be converted to homeownership units with or without the use of additional HOME funds by having the owner of the rental units sell, donate, or otherwise convey the units to the existing tenants.

- If additional HOME funds are used to help the tenants become homeowners, the minimum period of affordability is the affordability period required by the amount of direct homeownership assistance provided.
- If no additional HOME funds are used, the homeownership units are subject to a minimum period of affordability equal to the remaining affordability period that would apply if the units continued as rental units.

Maximum purchase price. The purchase price of newly constructed housing or standard housing may not exceed 95 percent of the median purchase price for that type of single-family housing for the area, as published by HUD or as determined locally through market analysis [(see Section 92.254(a)(2)(iii)]. In the case of property that does require rehabilitation, the after-rehabilitation value of the HOME property to be acquired by a homebuyer may not exceed 95 percent of the area median purchase price for that type of housing.

Property standards. Housing that is acquired as part of a lease purchase program must meet applicable State and local housing quality standards and code requirements. Many jurisdictions have a minimum housing code or standards that govern occupancy. If no such standards or codes apply, the property must meet Section 8 HQS. All assisted housing must meet the accessibility requirements of the Fair Housing Act and Section 504 of the Rehabilitation Act of 1973.

Applicant/beneficiary requirements. The homebuyer's household income must not exceed 80 percent of the median for the area at the time the lease purchase agreement is signed. It is not necessary that the homebuyer qualify again as a low-income purchaser at the time he or she actually purchases the property. The homebuyer also must occupy the property as a principal residence.

Case Study
Lease-Purchase Program

Anytown USA has initiated a lease purchase program that offers homeownership opportunities to income-eligible families who are unable to obtain a loan (from financial institutions) because of a lack of income stability, credit worthiness, or the ability to come up with downpayment and/or closing costs. This program offers qualified families a complete, individualized plan that corrects or resolves borrowing difficulties. In addition, lease payments are escrowed for a period of 2 years. After 2 years, the families can purchase the homes at half the appraised value. Escrowed funds, including interest, are used to cover the closing costs and downpayment requirements at this time. This program took approximately 2 years to develop and implement, which included the design and commitment from the financial institution, and the purchase and rehabilitation of the homes.

Anytown's lease purchase program allows all participants to correct all their credit deficiencies during their 2-year lease period and complete minor rehabilitation work as instructed by the housing department. To ensure success, all participants are required to attend financial counseling, and all units are inspected monthly to monitor the rehabilitation's progress. An integral part of the program's success was the public/private partnership created between the city and AnyBank. AnyBank is the fund manager and provides loan servicing, various free administrative services, and an interest rate that locks in for a 2-year lease period. Since the inception of the lease purchase program, approximately $220,000 in CDBG funds have been used to assist in the purchase and rehabilitation of four houses. These houses have been raffled to qualified participating families.

Other Federal Requirements when using HOME or CDBG for Homeownership

Other Federal Requirements	Apply to Homebuyer Programs?	Special Issues/ Considerations	Regulatory Citations and References
Non-Discrimination and Equal Access Rules			
Fair Housing and Equal Opportunity	Yes.	Participating Jurisdictions/grantees must affirmatively further Fair Housing. Particular attention should be paid to signs of discrimination in sale of properties.	91.225(a)(1); 91.225(b)(6) 92.350 HOME 570.601; 570.602 CDBG Title VI of Civil Rights Act of 1964 (42 U.S.C. 2000d et seq.) Fair Housing Act (42 U.S.C. 3601–3620) Executive Order 11063 (amended by Executive Order 12259) Age Discrimination Act of 1975, as amended (42 U.S.C. 6101) Sec 109 of the HCD Act of 1974, as amended
Affirmative Marketing	Yes, for all projects of five or more HOME-assisted units.	Participating Jurisdiction must adopt affirmative marketing requirements and procedures.	92.351 HOME
Accessibility for Persons with Disabilities	Yes.	New projects must be designed and constructed in accordance with applicable standards. Rehabilitated properties may require modifications.	570.602; 570.614 CDBG Section 504 of the Rehabilitation Act of 1973 (implemented at 24 CFR Part 8) For multifamily buildings only, 24 CFR 100.205 (implements the Fair Housing Act) Architectural Barriers Act (42 U.S.C. 4151–4157) Americans with Disabilities Act (42 U.S.C. 12131; 47 U.S.C. 155, 201, 218, and 225)
Employment and Contracting Rules			
Equal Opportunity Employment	Yes.	Contracts and subcontracts for more than $10,000 must include language prohibiting discrimination.	Executive Order 11246 (implemented at 41 CFR Part 60)

Other Federal Requirements	Apply to Homebuyer Programs?	Special Issues/ Considerations	Regulatory Citations and References
Section 3 Economic Opportunity	Yes, if amount of assistance exceeds $200,000 or contract or subcontract exceeds $100,000.	Include Section 3 clause in contracts and subcontracts.	91.225(a)(8) Section 3 of the Housing Urban Development Act of 1968 (implemented at 24 CFR Part 135) 570.607(b) CDBG
Minority/Women Employment	Yes.	Participating Jurisdiction must develop procedures and include in all contracts and subcontracts.	Executive Orders 11625, 12432, and 12138 24 CFR 85.36(e)
Davis Bacon	Yes, if construction contract includes 12 or more units that are HOME-assisted. Applies to CDBG only if rehabilitation involves eight or more units.	If applicable, requirements apply to the whole projects, not just the HOME-assisted units. Include language in contracts and subcontracts. Requirements do not apply to volunteers or sweat equity.	92.354 HOME 570.603 CDBG Davis-Bacon Act (40 U.S.C. 276a–276a–5) 24 CFR Part 70 (volunteers) Copeland Anti-Kickback Act (40 U.S.C. 276c)
Conflict of Interest	Yes.	Participating Jurisdictions should ensure compliance in-house and when using subrecipients.	92.356 HOME 24 CFR 85.36 24 CFR 84.42 570.611 CDBG
Debarred Contractors	Yes.	Participating Jurisdictions/grantees should check HUD list of debarred contractors.	24 CFR Part 5
Environmental Requirements			
Environmental Reviews	Yes.	Special attention should be paid to historic, noise, and flood plain requirements.	570.604 CDBG 92.352 HOME 24 CFR Part 58 National Environmental Policy Act (NEPA) of 1969
Flood Insurance	Yes.	If in a FEMA area, flood insurance must be obtained.	570.605 CDBG Section 202 of the Flood Disaster Protection Act of 1973 (42 U.S.C. 4106)
Lead-Based Paint	Yes.	Comprehensive revisions to lead-based paint regulations were published 9/15/99 to be effective 9/15/00.	91.225(b)(7) 92.355 HOME 570.608 CDBG 24 CFR Part 35

Other Federal Requirements	Apply to Homebuyer Programs?	Special Issues/ Considerations	Regulatory Citations and References
Relocation	Yes.	Required notifications to tenants. Required language in offers and contracts for acquisition of property.	91.255(a)(7) 92.353 570.606 Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970 (URA) (42 U.S.C. 4201–4655) 49 CFR Part 24 24 CFR Part 42 (subpart B) Section 104(d) “Barney Frank Amendments”

Glossary

“Cash flow” is the total amount of cash that a project receives, minus outgoing expenses and debt. For-profit investors will use this, along with tax credits they may receive, as their “bottom line” in deciding to whether or not to participate in affordable housing development, and they will compare this projected return against earnings their cash could make on other investments.

“CBDOs” are Community-Based Development Organizations (CBDO) as defined in the CDBG program regulations. These nonprofit agencies engage in community development activity within an identified geographic area. At least 51% of its governing body is: low income residents of the service area or their elected representatives, or owners or senior officers of private organizations in the service area; are not an agency or instrumentality of the grantee. CHDOs would generally meet the requirements to also be CBDOs. They may receive CDBG funds as an “eligible subrecipient” to develop new housing while other organizations or developers may not receive CDBG funds for this activity.

“**CHDOs”** are Community Housing Development Organizations as defined in the HOME program regulations. They are nonprofit agencies that have received their designation due to the Board composition meeting HOME requirements, their stated intentions in the bylaws to assist low-income residents through housing activities, and their demonstrated capacity to administer relevant housing activities. CHDOs are eligible for HOME set-aside funds to develop, sponsor, or manage affordable housing.

“Debt-Coverage Ratio” is the Net Operating Income divided by the monthly payments on loans to finance the project. Lenders look for a ratio that allows the owner to afford making all debt service payments and accumulate a cushion of funds for unexpected expenses.

A **“developer”** is the person or organization that plays the lead role from concept to construction completion. The developer may or may not own the property, but must have a contractual obligation to the owner to develop it. The responsibilities of the developer include:

- Obtaining necessary funds to buy or option land, finance construction, as well as long-term project funding
- Arranging pre-development activities
- Assembling the development team
- Overseeing construction through completion
- After construction completion, remaining in a management role, conveying ownership or management responsibilities to others, or selling the property to another entity.

The **"Development Budget"** includes costs to acquire the land and property, construction costs, and "soft costs" such as appraisals, permits, professional fees, insurance, legal fees, interest on the construction loan, utility hook-ups, contingencies and reserves.

"Equity investments" are financial contributions to the project made by investors in turn for a share of ownership. The most common way private sector equity is raised is through the sale of Low Income Housing Tax Credits to for-profit investors.

"Funding" versus "financing" are different concepts. "Funding" includes all money that goes to the development, including any grants or deferred loans, while "financing" usually refers only to the loans that must be repaid.

"Loan-to-Value Ratio" (LTV) is a calculation made by lenders that uses the appraised value of the property or sales price (whichever is lower) to assess the maximum amount of the loan that could be made. Many lenders use a 70% LTV as one of its ratios in underwriting a loan.

"Net Operating Income" for a housing project is the gross income received by the project (adjusted for vacancy loss) minus operating expenses and taxes.

The **"Operating Budget,"** commonly called a "Pro Forma," includes income from rental units -adjusted for anticipated vacancies and bad debts - and deducts the costs to operate the project: salaries or fees paid to a manager, maintenance, advertising, accounting, office expenses, insurance, property taxes, utilities, replacement reserve, and debt service. The Operating Budget will be different during the initial rent-up period (not expected to exceed eighteen months) and will include less income and more advertising expenses. This is why it is important to have an "operating deficit reserve" line item in the development budget.

"Pre-development" activities include project feasibility and market studies, appraisals, site control, preliminary architectural and engineering studies and plans, applying for funds, environmental and title clearance. CHDOs are eligible for pre-development loans prior to project approval, while other developers may reimburse these costs with permanent financing once their project is approved.

"Project sponsor" is a term used in the HOME program to define a CHDO-eligible role. To be a sponsor, the CHDO must solely or partially own the property to be developed and agree to convey ownership to a second nonprofit organization at a predetermined time. (This is in contrast to a CHDO acting as a developer, where ownership of the property is not required.) The transfer from the sponsor to the second nonprofit could occur prior to the beginning of construction, at the completion of construction, or prior to occupancy of the building.

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"Replacement Reserve" is an escrow account that is maintained to cover the anticipated cost of items that will require replacing over time, such as roofs or siding.

"Subrecipients" are public agencies or nonprofit organizations selected by a grantee to administer all or a portion of their CDBG or HOME-funded activities. A public agency or nonprofit that receives funds solely as a developer or owner of housing is not considered a subrecipient. Housing Authorities, Community Action Agencies and other nonprofits are commonly designated as subrecipients to administer housing rehabilitation activities on behalf of a county or city.

"Tax credits" are a vehicle for passing tax benefits to investors looking to reduce their tax liability. These credits reduce the amount of federal taxes that must be paid. This is in contrast to a "tax deduction" which does not result in a dollar-for-dollar reduction in taxes payable. Tax credits are sold at a discount based on the demand, the project's risk, and the developer's reputation. The tax credits are used over a ten-year period, receiving ten years of annual tax benefits. The IRS issues regulations governing their use and projects with tax credits must comply with rent controls and low-income benefit requirements for different periods.