2008 Development Seminar Series

Affordable Housing Development

Reference Manual

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Foreword

This reference manual was prepared by Franke Consulting Group as a companion to the 2008 Development Seminar Series conducted for nonprofit developers, communities intending to apply to the New York State Department of Housing & Community Renewal and the Housing Trust Fund Corporation for funding to develop affordable housing.

It is not intended to be a complete guide to development, but rather to provide supplemental information to the participants. It should only be used in combination with the lectures and materials provided to participants of the Seminar Series.

If you have questions about the Development Seminar Series or the contents of this manual please contact The DHCR Training Unit at (518) 473-3540.

Key Affordable Housing Acronyms

AMI	Area Median Income (as defined by HUD)
CBDO	Community-Based Development Organization
CDBG	Community Development Block Grant Program
CDTA	HUD Community Development Technical Assistance
CFR	Code of Federal Regulations
CHDO	Community Housing Development Organization
ConPlan	Consolidated Plan
CPD	HUD Office of Community Planning & Development
DHCR	New York State Division of Housing & Community Renewal
DSC	Debt Service Coverage factor
ELI	Extremely Low Income (30% of AMI)
EGI	Effective Gross Income
FHLB AHP	Federal Home Loan Bank Affordable Housing Program
FHA	Federal Housing Administration
GP	General Partner
GPR	Gross Potential Revenue (or Rents)
HCDA	Housing & Community Development Act
HOA	Home Owners Association
HOME	HOME Investment Partnerships Program
HQS	Section 8 Housing Quality Standards
HTFC	New York State Housing Trust Fund Corporation
HUD	US Department of Housing & Urban Development
IDIS	Integrated Disbursement & Information System
LI	Low Income (below 80% of AMI)
LIHC	Federal Low Income Housing Tax Credit Program
LP	Limited Partnership
LTV	Loan to Value ratio
MI&E	Monthly Income & Expenses
NADS	Net Available for Debt Service
NAHA	National Affordable Housing Act of 1990
NIMBY	Not In My Back Yard
NOI	Net Operating Income
OI	Over Income
PBA	Project Based rental Assistance

PITI	Principle Interest Taxes & Insurance
PJ	HOME Program Participating Jurisdiction
PUM	Per Unit Per Month (Expenses)
PUPA	Per Unit Per Annum (Expenses)
RD	US Department of Agriculture Rural Development
ROI	Return on Investment
SRO	Single Room Occupancy
TBRA	Tenant Based Rental Assistance
TDC	Total Development Cost
TLTV	Total Loan to Value ratio (all debt)
UPCS	HUD Uniform Property Condition Standards
URA	Uniform Relocation Act
V/CL	Vacancy & Collection Loss
VLI	Very Low Income

1. Housing Market Analysis

Housing development occurs in a marketplace where there is a housing supply and households that pay for the use of the housing. While housing needs analysis can help you to understand the range and extent of housing needs in your community, needs alone are not the basis for development decisions. Need is a “social” concept – our society defines housing needs based on a social goal of providing decent, safe, sanitary, affordable and accessible housing to all. However, housing is an economic activity. The economic concept is “demand” rather than need – that people not only need or want it, but are willing and able to pay for. Without the willingness or ability to pay, there is no housing transaction.

Consequently, market analysis is needed to support the use of limited public funds for specific housing projects. Applications submitted for DHCR/HTFC project funding must include an independent market study or a market analysis. Market studies are required for Tax Credit projects, but others can be supported by market information and analysis assembled by the developer.

The goal of this chapter is to help applicants understand requirements and make better use of the information provided by a market analysis or study, and also to avoid investing time and money on projects that do not have sufficient market support to be considered for funding.

1.1 What is Market Analysis?

With limited resources for the development of affordable housing, we need to make informed judgments about the types and locations of housing that are needed. We can’t predict the future of housing projects, but we can and must look at evidence in the housing marketplace that lends support to the demand for additional units of housing. While in most cases we don’t know the actual households that will occupy a proposed project, we can do research to:

- Explore and quantify the characteristics of the segments of the population that are the likely customers of a particular type of housing;
- Specify the type of housing that is most appropriate to serving the identified housing demand; and
- Analyze the competitiveness and likely success of the proposed housing in the current marketplace.

That is market analysis.

1.2 What Are the Market Analysis Requirements?

DHCR/HTFC requires market analysis for all projects, but the requirements vary depending upon the size of the project and funding source:

- **Market studies –** Market studies are formal presentations of market data, analysis and conclusions, typically by an independent professional, for a specific project or type of housing. Market studies are required by pre-qualified market analysts for projects requesting Low Income Housing Tax Credits (LIHC) from DHCR. (See http://www.dhcr.state.ny.us/ocd/forms/pdf/PreQual_Mkt_Analysts.pdf.)
- **Evidence of market support –** When DHCR/HTFC funding is requested without LIHC, independent market studies may not be required. However, market analysis is still an essential element of project planning and the application for funding. Independent market studies should be considered, although the analysis may be done in a less formal and comprehensive manner by in-house staff. The evidence of market support can include waiting lists, surveys or other customer information collected by the applicant, along with information from existing studies or report. See Chapter 5 of the Capital Projects Manual for guidance.

1.3 Why Is Market Analysis Important to Affordable Housing Development?

Like other housing, affordable housing is developed and sold or rented in a marketplace. Just because the conventional housing market does not, or cannot, deliver affordable housing does not mean that low-income housing escapes the influence of market forces. The success of an affordable housing project is determined by the supply and demand conditions in the market, although the market is more targeted or focused on low-income segments of the population. Since affordable housing resources are so limited, DHCR/HTFC cannot invest in housing that will not be quickly filled and remain full.

A basic misconception has long existed about affordable housing: **"If we build it, they will come."** Because we are confronted with enormous, almost overwhelming, needs for affordable housing, some developers assume that any affordable housing can be quickly filled. While this may appear true in extremely tight housing markets, nevertheless there are vacant affordable units in many locations – units that were built in the wrong locations, in unsuitable environments, at the wrong prices, offering the wrong unit types and amenities.

The problem is: we mistakenly confuse ***need*** with ***demand***. Need is a social concept; demand is an economic concept. While we can all agree that all low-income households need decent and affordable housing, each household still gets to choose how and what to spend on housing. If we don't deliver what they want and are willing and able to pay for (i.e., demand), they may exercise other choices.

While we may not agree with all of their choices, and their choices may be more limited than the choices enjoyed by households of higher income, low-income people nevertheless have choices. As we look to build affordable housing, we need to consider those choices or options that low-income households have, and make certain that we provide what they "demand", not just what we think they "need." That is why a market study or market analysis is so important to affordable housing.

So market studies or analyses are not just a funding application requirement. They are the source of critical information needed to inform our development funding decisions so we can be sure to deliver what low-income people want and are willing and able to pay for.

1.3.1 What Will I Find In a Market Study?

1.3.1.1 What Are the Contents of a Market Study?

The contents and quality of market studies have varied widely, particularly in recent years as the requirement for a market studies for LIHC applications caused a substantial increase in the number of market analysts. However, there has been recent movement toward enhancing the professionalism of the industry.

The National Council of Affordable Housing Market Analysts has developed a set of standards for rental housing market studies, as well as a checklist.[1] Although these standards are only advisory, a quality market study should contain all of the critical items listed, although the organization of the study report may vary.

1.3.1.2 What Are the Results or Conclusions of a Market Study or Analysis?

Market analysis and market studies evaluate historical trends and current conditions in housing supply, housing prices, and population to make professional predictions regarding:

- Whether there is sufficient demand among income and age qualified households in the market to support a project or type of housing under consideration; and
- Whether the project – its unit mix, amenities and rents – are competitive with the housing existing in the marketplace.

Market studies and analyses utilize a combination of data sources, including Census and Census updates, local economic and housing market information from a variety of sources, data from comparable projects, and any available information on potential applicants/occupants. When completed, the market analysis should address:

- The size, location and boundaries of the selected geographical target area known as the "primary market area";
- The depth and breadth of housing demand;

[1] Available at www.housingonline.com, link to "Market Studies/NCAHMA" and then to "Recommended Standards".

- The supply of competitive housing and how the proposed housing compares to the competition; and
- Conclusions about the marketability of the project, including capture rates, absorption rates and marketing challenges.

1.3.1.3 What Are the Key Sources of Information?

Good market studies rely on a mix of primary and secondary data to create this picture of the supply and demand characteristics of the local market. **Primary** sources of information include:

- Surveys, interviews, applications, waiting lists and other information obtained directly from or about potential consumers (demand); and
- Surveys or direct contact with rental agents, property managers, lenders and other professionals in the housing market about the competition (supply).

Secondary sources of information include:

- Census data
- Updates and projections of Census data by third party research firms
- Local housing office records
- Consolidated Plans
- Local comprehensive plans and other planning documents
- Real estate agencies (MLS & rental data)
- University and research centers
- City planners
- Appraisals and other market studies

Additional secondary sources that are specific to the affordability analysis for low and moderate income households (and available for most metropolitan areas, as well as some counties and smaller communities) include the following:

- HUD CHAS database: housing issues by key income levels (30%/50%/80% AMI): http://socds.huduser.org/scripts/odbic.exe/chas/index.htm
- NLIHC Out of Reach Database: analysis of required wages to afford housing costs: www.nlihc.org/oor/oor_current/
- National Housing Conference -- Center for Housing Policy – housing costs and workforce wages for 64 occupational categories: www.nhc.org/chp/p2p/

Whether you are doing in-house market analysis or hiring a market study analyst, make sure your analysts have compiled and analyzed data from ***primary*** sources where available, rather than simply relying on existing studies by others. If you have any primary information on the potential clients – from community group meetings, membership surveys, or other source – be sure to provide those to the analyst. While market study prices generally do not include original surveys of potential customers by analysts, the analysts should be able to incorporate any data you can make available. Analysts are expected to collect data directly from comparable projects.

While the Comprehensive Plan developed by your local or State government is a good source of information for your preliminary needs assessment, a professional analysis will include examination of the original census data itself and reach its own conclusions.

The Consolidated Plan needs assessment should support the market study, but not be the basis of the market conclusions. Also, the project that you ultimately decide to develop will have to be consistent with the priorities of the ConPlan in order to be eligible for Federal funding (HOME, CDBG, ESG and HOPWA).

1.3.2 When Should I Do the Market Study or Analysis?

The best time to do a market study is at the very beginning of the process – when you have just identified a potential project or parcel, and want to consider the best development options for the site. You want to do the market study before your plans are finalized, but you have some sense of the desired uses and likely funding sources (as these define the income band of affordability.)

However, keep in mind that market studies have to be current at the time of application submission. So, in order to get information upfront in the project planning process, while still have current conclusions at time of application (which might be many months or more than a year later), a two-step process is recommended:

1. Preliminary analysis – conduct the analysis of market trends, general demand analysis, and the inventory, analysis of supply, and (if the project location and type is known) the competitiveness analysis early in the planning process;
2. Confirmation and conclusions – Just before application submission, finalize, update and confirm as needed the analysis so that the analysis is current and fully addresses and supports the unit mix and rent levels that are to be in the proposal.

If you are further along in the planning of your project, you still should complete the market study as soon as possible, and be open to the results of the study, as they may point you toward important changes in the project plan.

If you complete the market study just before the funding applications are due, you have lost much of the utility of the market data. The study has become merely a costly application requirement – and you run the risk that its findings might undermine everything you have done to plan the project.

1.4 Interpreting Rental Market Study Results

If you are paying a market study professional for their analysis and judgment, you expect their analysis and professional judgment with regard to the following areas:

- Determination of the market area
- General market trends that may affect your development
- The size of the your target pool of customers
- How your project compares to the competition

If you are conducting the analysis yourself, you still need to be able to answer the same questions, although the burdens of data collection and analysis are somewhat less.

1.4.1 What Is the Market Area and How Is It Determined?

The analysis must include a delineation of the geographic market area. Market analysts define the **Primary Market Area** or **Effective Market Area** as the geographic area from which a *substantial majority* of the customers are expected to be drawn. In other words, what is the area from which you can expect to draw most, but not necessarily all, of your customers?

Market Areas are defined by expected patterns of consumer behavior, not political boundaries. The key determinant of market area is on how far typical consumers will move to take advantage of a particular housing opportunity.

Market areas don't necessarily correspond to jurisdiction or agency service area boundaries. Urban market areas are likely to be smaller than a city's boundaries for most generic housing opportunities. In rural areas, it might include multiple smaller communities, or even parts of proximate counties.

Market Areas generally are delineated by natural (e.g., rivers and mountains) and man-made (e.g., roadways, political, socio-economic and cultural) boundaries.

Consumer decisions often are influenced by identification with neighborhoods, church parishes and school districts, and proximity to jobs, services and amenities. The choices may also reflect familial, ethnic and cultural ties. These patterns are best determined by past behavior. One method is to look at the previous addresses of occupants in comparable properties. This should be analyzed for rehabilitation projects with an existing tenant base.

For affordable housing, the concentric circle approach typical of consumer market research is not the preferred method of delineating market area. Instead, due to the need to analyze

Census demographic data, the use of Census tract boundaries is more often the appropriate building block of Market Areas.[2]

For presentation purposes, a map clearly illustrating the Market Area should be included in the study report.

The delineation of the market area is critical to the market study and its conclusions. The pool of eligible customers cannot be determined until the boundaries of the market area are delineated. If the market area is under-defined, then it might not fully reflect the potential demand for your project. On the other hand, when the market area is defined to be larger than is reasonable given human behavior, market support might be indicated by study data, but the project is vulnerable to marketing problems and may ultimately fail. Some market studies done late in a project planning process may propose a larger-than-reasonable market area in order to justify or rationalize a development decision that has already been made. For example, a market study for an elderly development that includes a multi-community market area will be scrutinized carefully, because elderly households generally prefer to relocate within familiar community areas.

Your observations and experience in your local community are relevant to the market study. Notwithstanding this guidance and the professionalism of most market study analysts, the delineation of a market area is still somewhat subjective. When hiring a market analyst, be sure to share your perceptions and experience of how far people will move to live in the project area. If you already operate housing in the market area, examine the previous addresses of current tenants to gain some insight into consumer movement patterns, and share this with the analyst. And, when reviewing a market study, test it against observed patterns of movement, or ask potential customers living just within the fringes of the market area whether they would consider moving to the proposed project. If it seems highly questionable, then question it. You will not be served by faulty market delineation.

1.4.2 What General Market Trends May Affect Your Development?

The second key category of information provided by a market study is an analysis of the trends and conditions in your community that might affect the development. The general demand for real estate in an area, including housing, is usually recognized to be largely a function of three factors: employment, population (households) and income. The trends of growth (or decline) in these factors help to predict overall demand for housing, and create a context for analyzing vacancy rates and housing supply in the community.

There are four basic sources of demand for new rental housing units:

1. ***Movers within the market*** – Occupancy coming from normal unit turnover and households looking for better or more cost effective housing is the primary source of potential customers for a new or newly renovated project.

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[2] Census tract maps are available by county at: http://ftp2.census.gov/plmap/pl_trt/

2. ***Net household growth, formation or aging*** – Population growth may be a significant factor in some markets, but not in others. Even where population is not growing, the number of households may nevertheless be increasing because of the national trend toward smaller households. And for elderly housing, the aging of the population may be contributing to a significant growth in the number of elderly households even when the population overall is not growing. The burden is on you to demonstrate that growth is significant and will impact the size of the target pool of households during the development period.
3. ***Conversions from ownership*** – The entry into the housing market by households who sell owner-occupied homes is not considered a primary market factor for family rental units, but some conversions might occur within the elderly housing market from elderly households no longer wanting or able to maintain homeownership. Some studies suggest that this may be responsible for 10 – 20% of elderly rental housing demand. A safe harbor assumption is that up to 10% of existing elderly homeowners may be considered part of the potential pool.
4. ***In-migration*** – Again, some communities may be experiencing significant in-migration from other areas at a level, while others may not. In some communities, the in-migration is largely attributable to immigration. National trends suggest that that over one-third of the growth of households during this decade will be from immigration. If in-migration and immigration are significant factors, particularly where targeted subpopulations are moving into the market area, this may contribute to project demand.

Whenever any of these last three sources (household formation, conversion or in-migration) is included in the estimate of the customer pool as discussed in 1.4.3, adequate support should be provided of the significance of this factor in the local market area to justify the inclusion in the estimates.

1.4.2.1 Overall Population and Household Trends

Market analysts should examine overall population and household trends within the market area. Key data are:

- Population by Age (cohorts)
- Households by Age of Householder
- Households by Tenure (i.e., renters vs. owners)
- Renter Households by Age of Householder
- Renter Households by Household Size

Since the household is the economic unit purchasing housing, household trends are perhaps more significant in this analysis than population trends.

Typically, these data elements are noted for 1990 and 2000 (and perhaps a Census update to the current year and five-year projections) in table format. The percentage change between each date is to be noted as well.

Sources of data for this analysis tend to be:

- 1990 and 2000 Census data, supplemented by the CHAS data available from HUD which analyzes key HUD-eligible income levels (at 30/50/80% of Area Median Income.) (Please note that CHAS data books for 1990 and 2000 are available from HUD to analyze the changes in households by HUD income categories.)
- A nationally recognized demographic provider (e.g., Claritas and ESRI Business Information Solutions, etc.) for the current year estimates and 5-year projections.

As we get further and further from the 2000 Census, the need to update or project Census data becomes more critical. The projections should address the expected date of bringing the project into occupancy. A project proposed today may be entering the marketplace in one to two years. Projections, if used, should be defensible.

Consider key trends. Is population growing, static or declining? Is the population aging or are there significant numbers of households with children? Is the distribution of owners and renters changing?

Some of the key nationwide demographic trends that are projected for this decade include:

- Aging of the population, particularly among non-minority households;
- The increase in households being largely in single person households and households without children; and
- The increase in minority and immigrant households as the majority of household growth.

These national trends may or may not be reflected in your community. The analysis should identify whether these trends apply.

In some areas, significant in-migration can be considered as a distinct and separate factor contributing to overall demand, especially when that in-migration is significantly concentrated in the low-income range.

1.4.2.2 Household Income Trends

The distribution of Household Income within the Market Area is a very important part of the analysis, as most assisted programs have income eligibility limits. Growth in the number of low-income households is an important consideration, even when overall growth of the population might not be visible.

The distribution should be analyzed for 2000, and (where available from projections) for the current year and 5-year projections. The 2000 median household income among all households, owner households, and renter households should be noted.

For this analysis, income cohorts of no more than $5,000 should be used, when applicable and where available. Households with income over $50,000, or the applicable maximum eligible income, usually can be condensed into a single cohort for this analysis without impact.

Some key data sources include:

- 2000 Census data available from Census 2000 Summary File 3 (SF 3), Table HCT11.
- The ConPlan may be a useful source of information for this analysis, as estimates for the ELI/VLI/LI (30/50/80% AMI) populations are available for 2000 via the updated special tabulations of the CHAS Data (see http://socds.huduser.org/scripts/odbic.exe/chas/index.htm.)

Keep in mind that the indicated "income band of affordability" as will be discussed below very seldom is in round thousands of dollars, and so won't match up with the income cohorts. Interpolation must be done. Straight-line interpolation is the accepted practice, unless there is documented evidence for skewing. For example, if the income cohort is for $15,000 - $20,000, and the maximum income is calculated as $19,500, then 90% ($4,500/$5,000) of the households in that category should be included in the count.

1.4.2.3 Employment and Economic Trends

It is important for the market analysis to consider any prevailing economic and employment trends and major changes from year to year. Job opportunities and economic growth can directly affect housing markets. The lack of job opportunities and economic growth raises questions about the need for additional housing units. Relative economic strength and job growth usually lead to future higher incomes and greater demand for housing units. Stagnation and job loss would point to softening demand and ability to pay.

A market study should document the following:

- The major employers in the immediate area, the status of the employers in terms of growth and stability, the approximate salary range of the employees, and the approximate number of employees earning income within the appropriate income range for residency at the proposed development.
- The overall MSA/County distribution of (non-farm) employment by major industry classification (e.g., Mining – 9.5%, Construction – 24.5%, etc.).
- The average annual number of persons employed and unemployment rate (for the past five years), with particular focus on the number of persons employed and unemployment rates for the most recent month (because monthly data is not

seasonally adjusted, the study should note the number of persons employed as well as the unemployment rate for the corresponding month in the previous year.)

You will probably be confronted with a large volume of economic and job data. The important thing is to look at the overall conclusion of the analyst: do economic trends point toward a strengthening or weakening of demand for housing units for your market? These trends may be critical to the future viability of your housing development.

1.4.2.4 Overall Housing Market Trends

The market study should include an analysis of the overall housing market, and the general trends in housing supply, vacancy rates and pricing (rents). This analysis of overall housing market trends (and the underlying survey) should establish the basis for identifying and analyzing the competition, and determining how the proposed project will compete in the marketplace.

While Census data comprise the basis for analysis of the overall market, including numbers and types of units, much of the housing market data is time sensitive and must come from more current and regular real estate sources. This would include vacancy information, housing starts, rental and for-sale pricing and housing in the pipeline (i.e., in planning or development.)

Much of the data on the "competition" must come from a survey of the existing rental housing product within the Market Area.

The survey should include market-rate properties, plus all subsidized developments and Tax Credit developments in the market area. (A survey of available single-family rental homes within the Market Area should be included if the proposed development includes single-family rental homes.)

Survey data should be aggregated separately for: (1) market-rate and non-subsidized Tax Credit projects; and (2) government subsidized developments with rental assistance.

The market study should provide, in table format, the distribution of units, and vacancy rates by unit type (i.e., number of bedrooms). It should also include a distribution of market-rate and non-subsidized Tax Credit developments and units by year opened/substantially renovated.

The study should note the median rents by unit type for the market-rate and non-subsidized Tax Credit units. In determining the median rents, the collected rents at each property should be adjusted to a gross rent basis, using the local housing authority's Utility Allowance Worksheet (and included as an Addendum.)

In addition to the table summaries, the analysis should include a narrative summarizing the overall condition of the rental housing market within the Market Area, including:

- Absorption rates experienced at all properties opened within the past 3 years
- Waiting lists
- Rent concessions

- Vacancy rate and rental rate trends
- Seasonality of the market
- Under construction or planned rental housing development

The study should also identify any significant housing developments in the planning stages or under construction, or if there are none in the pipeline, provide a statement to that effect.

The actual survey is an Addendum to the Market Study. The effective date of the survey should be clearly noted.

A map (scaled for distance) illustrating the location of each property surveyed and the subject property should be included with the survey.

The conclusions of this survey and the housing supply analysis should be an indication of how the proposed project compares to existing units – a key indicator of the likely success or failure of the project.

As you review a market study, consider the projects included in the survey. Do they accurately represent the local rental market? Are they the most likely competition for your project? How does your project compare? What does their success in rents and occupancy levels predict for your project? Can both you and they succeed in the competition for tenants?

1.4.3 What Is The Size of the Pool of Potential Customers?

The next critical element of market analysis is the determination of the size of the pool of potential customers. The determination of the customer pool is one of the key pieces of data used in the determination of the capture rate – one of the major pieces of information used by DHCR/HTFC underwriting staff (see the discussion of conclusions below.)

1.4.3.1 The Market Area Household Base

In the previous section, the overall population, household count and growth trends were examined. In general, the household count is the critical data element for the analysis of the pool of potential customers, since the household is the economic unit purchasing housing. Each household should represent the purchase/rental of one housing unit in the market. The market study should attempt to provide the best estimate of the number of households that will exist in the market area at the time the project is ready for occupancy.

In markets without significant population growth, the impact of growth on the total number of households between now and the opening of the project is not likely to be a large number. Growth probably should not be considered the primary basis for development of additional units. The analysis should focus first and foremost on current population, and the 2000 Census data is presumed to be sufficient in a stable population environment.

However, there may be markets where it is reasonable to expect significant changes in the number of target households, and include the projected changes in households in the analysis, particularly when the housing is projected to be ready for occupancy more than a year from now:

- Elderly housing – in cases where the overall elderly population is expanding at a significantly greater rate than the population;
- Small household formation – in cases where new household formation is occurring at a rate that is significant;
- Growth areas – in suburban or urban areas experiencing documented growth patterns, including urban gentrification areas; and
- Declining populations – in urban markets where the trends point to significant declines in population and households.

In these cases, it is reasonable for the market study to project the change in target households from the time of the data base (2000 Census or updated Census projection) to the expected time of occupancy of the project. Otherwise, projections to the date of occupancy are not necessary.

1.4.3.2 Customer Profile(s) or Demographic Segments

The overall household base also needs to be reduced to reflect the characteristics of targeted customers, including age, tenure, family composition, and other demographic characteristics. This step in the analysis is sometimes referred to as "***demographic segmentation***."

Customers may be targeted in several different ways:

- ***Tenure*** – For a family rental project, the likely pool includes existing renters, but not owners, who are unlikely to give up ownership to enter the rental project. Some elderly homeowners may no longer be willing or able to maintain their own home. Generally, you should include no more than 10% of the age- and income-appropriate homeowners within the Market Area in the Senior Capture Rate analysis, and existing homeowners should <u>not</u> be included in the Family Capture Rate analysis.
- ***Family v. elderly*** – For a family development, even though age discrimination is prohibited, elderly households are unlikely to be considered a primary market. Age qualification in elderly assisted housing generally is permitted, and is not considered discrimination. Therefore, the analysis should exclude the age segment of the population not targeted by the development. The Senior Capture Rate Analysis must focus on the targeted age group (e.g., age 62+ in the case of federally subsidized units).
- ***Size of household*** – If the project consists of large family units, small households might not be considered the primary target, and vice versa. It is reasonable for the

primary market analysis to exclude the households that are disproportionately sized for the planned units.

- ***Special needs populations*** – Housing for special populations are permitted to be reserved or prioritized to the population without running afoul of discrimination laws (provided that the housing is open to all persons in the special population, not just the clients of a particular provider). It is appropriate in such cases to focus the analysis exclusively on the targeted special needs group. See the later discussion of special populations.

Look at the market study with your target population in mind. Did the study exclude the demographic segments of the market area population that are obviously outside of the target group? If not, the market analysis may overstate the size of the customer pool. However, if the study carefully focused in on the target group based on key demographic characteristics, then a higher capture rate still might be considered feasible.

1.4.3.3 The "income band of affordability"

Income obviously is a key determinant of the target pool for an affordable housing development. It narrows the pool in two ways:

- ***Maximum eligible and affordable incomes*** – Program income limits set a maximum income above which no household is eligible for occupancy. This is true of LIHC, HTF, HOME and most other public programs. However, if you are targeting the housing to the lowest possible incomes, you should focus on the top of the income band based on the proposed rents. *For example, determine the maximum income by multiplying the proposed rent (inclusive of tenant paid utility allowance) multiplied by 12 and divided by 0.30.*
- ***Minimum affordable incomes*** – While everyone below an eligible income limit might be eligible, the rents might not be affordable to some at the lowest income levels, unless project-based rental assistance is available. Underwriters cannot make assumptions about tenant-based rental assistance, as there is no guarantee that applicants will have certificates. Therefore, a minimum income requirement is used to establish the lower end of the income band. While we have 30% of income as the definition of affordable housing, many low-income families routinely pay 35%, 40%, 45% and even higher percentages of income for housing costs. *For example, you may want to establish the lower end of the band of affordability by multiplying the maximum rent (inclusive of tenant paid utility allowance) multiplied by 12 and divided by 0.45.*

Example: On an HTF project with a one bedroom renting at $325 per month and $25 in monthly tenant paid utilities, the upper income limit would be $14,000:

$325+$25 * 12months /.30 = $14,000

A lower income limit is established by the requirement that a household not spend more than 48% of their adjusted income towards housing costs or in this same case $ 8,750:

$$\$325 + \$25 * 12/.48 = \$8,750$$

The market study should focus on households with earnings between $8,750 and $14,000 as part of the potential pool.

However, not all households within the computed "income band" are appropriately sized to fit within the units. For example, it is inappropriate to consider large households in the customer pool when only 1BRs and 2BRs are being constructed. For an LIHC project, the applicable maximum eligible income limit is based on the program regulatory standards that population per household will equal 1.5 persons times the number of bedrooms.

For market-rate units that might be included in a mixed-income development, the market study must make some reasonable determination of a maximum income level beyond which a household will not likely be a participant in the rental market and this project. The study should note the assumptions used in determining the appropriate income range for the proposed market rate units.

When reviewing the market study results, consider the following:

- Did the analyst utilize an appropriate income band with minimum and maximum incomes?
- Did the analyst adjust the pool for minimum and maximum household sizes?
- Was the proposed rent adjusted to include tenant-paid utilities?
- If multiple rent levels are involved, did the market study note the appropriate income range for each targeted rent?

1.4.3.4 Considerations for Targeted Special Populations

For housing with predetermined client groups such as special populations, certain elements of the extended Market Analysis will not be necessary. If the proposed project is to serve people with special needs, the market analysis should focus on these residents, and rely on public or service provider data bases and analyses to specify the target population. General market study data is not as valuable as the primary data available from service providers and others working with the special population.

Market studies addressing a proposed development serving persons with disabilities are to include the 2000 distribution of Non-institutionalized Population with Disabilities by Type of Disability. This data is available from the Census 2000 Summary File 3 (SF 3), Table P41. The Consolidated Plan and the local Continuum of Care are possible sources of information on some special populations.

Alternatively, a project that establishes a contractual relationship with a service provider that guarantees a long-term demand for units in the development can rely upon identification of the exact customers to be served (with privacy protected) or an analysis of the client base of the provider substantiating the adequacy of the pool of clients to fill the project.

Market studies addressing a proposed development serving an age-restricted population should conduct the analysis only for those age cohorts applicable to the proposed development (e.g., age 62+).

1.4.4 How Does Your Project Compare to the Competition?

Market studies should include a survey of existing rental housing in the market area, and identify those properties considered most comparable. Comparable properties are those developments with similar financing, developments serving the same target population, developments offering similar amenity packages, and/or developments offering similar rents. Both assisted and unassisted units should be examined as part of this comparison.

As a rule, at least 3 market-rate properties should be included as Comparable Properties for establishing Comparable Market Rent. Otherwise, Section 8 Fair Market Rents (FMRs) will be used.

The study should include a table noting each income-restricted rental housing property in the market area, its current vacancy rate, and anticipated vacancy rate at the subject property's projected date of stabilized occupancy.

For each Comparable Property selected, the following information should be provided in a summary sheet format:

- Color photograph (of a representative residential building)
- Name, address, telephone number of the development
- Contact person, date of contact, and mode of contact (in-person or telephone)
- Year of opening and year of significant renovation (if applicable)
- Amenities (both unit- and project-related – see list below)
- Source of heat, water heating, and cooking (i.e., electric, natural gas, propane, etc.)
- Utility responsibility (i.e., tenant-paid or owner-paid)
- Number of units distributed by structure type (e.g., townhouse, garden-style, etc.) and unit type (i.e., number of bedrooms and baths within the unit)
- Net (heated) square footage of units
- Collected rents and estimated gross rents (including tenant-paid utilities based on the applicable Utility Allowance)
- Vacancy rates by unit type

- Public program participation (e.g., HUD Section 8, RD Section 515, Tax Credit, etc.), if any
- Tenant profile (e.g., family, elderly, persons with special needs, etc.)
- Waiting lists (the number of households or names on the list)
- Turnover rate
- Absorption rate (if the property is less than 3 years of age)
- Distance from the subject property (in miles based on travel distance)
- Proximity to Community Services & Site Detractions – see below

Typical amenities that should be included for consideration are listed below:

Unit Amenities		**Project Amenities**	
	Range		On-site management
	Refrigerator		Community bldg/room (__ net SF)
	Dishwasher		Laundry
	Disposal		Resident Business Center
	Washer & Dryer		Day care center
	Washer/Dryer Hookups		Exercise Room
	Carpeting		Swimming Pool
	Window Coverings		Playground
	Patio/Balcony		Tennis Court
	Basement		Basketball Court
	Carport/Garage		Racquetball Court
	Intercom system		Walking Trail
	Security system		Lake
	Other:		Other:

Access to jobs and services should take into account the following:

COMMUNITY SERVICES	NAME	TRAVEL DISTANCE* FROM SITE (IN MILES)
Major highways		
Public bus stop		
Major employers/employment centers		
Convenience Store		
Grocery		
Discount Department Store		
Shopping center/mall		
Schools: Elementary Middle/junior high High		
Hospital/medical center		
Police		
Fire		
Post office		
Bank		
Senior center		
Recreational facilities		
Other:		

Consideration of environmental negatives or detractions should include the following:

1.4.4.1.1.1.1.1 SITE AREA DETRACTIONS	DIRECT DISTANCE* FROM SITE (IN MILES)
Active Railroads	
Freeways	
Natural wash areas	
High tension power lines	
Landfill/garbage dumps	
Oil Refinery/Chemical Plant	
Power Plant	
Other:	

The market study should compare the proposed project to the Comparable Properties, and determine competitive advantages and disadvantages that might affect the marketability of the proposed project. Some of the key factors in the comparative analysis are:

- Rents – The analysis should determine the Comparable Market Rent(s) for the proposed units, and establish the proposed development's competitive rent advantage over comparable properties. The study should include the comparison tables used in the determination (e.g., HUD form 92273 or functional equivalent) and an explanation of the methodology used. Market-rate properties in the market area should be used in the Comparable Market Rent analysis.
- Unit Configuration – The bedroom, sizes and configurations of units (including accessibility by elevator, walkup or ground level) should be examined for comparative advantages and responsiveness to market demand.
- Amenities – The analysis should address the comparative attractiveness of the amenities package, both within the unit and the development overall, to identify any competitive advantages or disadvantages.
- Location – The analysis should look at location factors, including accessibility, and visibility, and the impact on marketability.
- Evidence of demand – The comparable projects should be examined to determine whether the demand is sufficient for those units and would indicate adequate demand for the proposed units.

In reviewing the results of the survey or comparison, you should consider the following questions:

- Did the analyst identify all of the most logical comparable projects in the area?
- Was the comparison inclusive of all facets: i.e., rents, unit configuration, amenities, location?
- How does our proposed project compare to the competition? Will we have a competitive advantage or be at a disadvantage?

1.5 Examining the Market Study Conclusions

Based on the analyses described above, the market study analyst should present conclusions about the proposed development's strengths and weaknesses to predict the project's success or define how the project can achieve market success.

1.5.1 Is there sufficient unmet demand?

The answer to this question is usually determined through capture ratio analysis, which is a core part of the underwriter's analysis.

The capture rate is determined by dividing the number of units in the proposed project by the number of households in the primary pool, after adjusting for the number of assisted units in the market area. A low capture ratio means that there are a large number of households from which to fill the proposed units, and the project is more likely to achieve success. High capture ratios mean the opposite, and raise the question about marketability in the near term and long term.

1.5.1.1 Adjusting for Existing Assisted Units

While the capture rate or ratio is based on the relationship of the proposed number of housing units to the total number of households that fit the income and demographic profile in the market area, the capture rate should not be computed until the target household pool is adjusted to reflect those in the income band that may already be in assisted housing.

It is recognized that many of the assisted units – such as public housing, Section 8 housing, Section 202/811 – have rent subsidies attached, and may serve households that are above or below the calculated income band. However, DHCR/HTFC uses the conservative assumption that all assisted units are available to the proposed income band, and adjusts the demand downward by the number of assisted units. If the study proposes an adjustment to reflect assisted units occupied by persons outside the income band, evidence must be provided.

This approach requires a detailed inventory of assisted units, usually assembled through discussions with the local government, state housing agencies, HUD, Rural Development and the local housing authorities. Sometimes the local government has assembled a good inventory for purposes of the Consolidated Plan.

1.5.1.2 Acceptable Capture Rates

There should be enough households in the target pool to ensure that the units will be able to be rented. There is no absolute capture rate or ratio that must be achieved by all projects. However, as a general observation, the smaller the percentage or ratio, the better it is for the project. Some projects succeed with capture ratios as high as 20% (or 1:5), particularly those with a well-defined target population. Others require capture rates of 10% or less, depending on the specific conditions. Some of the factors that are considered in these borderline cases are:

- The extent to which the market study narrowly targeted the customers through demographic segmentation analysis
- Overall stability or growth of households in the local market area
- Stability of jobs and economic opportunities in the market area
- Level of occupancy or vacancy, and the length of waiting lists at comparable projects

- Direct evidence of demand for this particular project, including current occupancy (for acquisition/rehab projects), waiting lists or survey information from potential customers
- Availability of project-based operating assistance or extremely favorable rent structures for this project relative to competing projects
- Level of improvements, amenities, unit configurations and other factors that give this project a competitive advantage over other projects in the market area

In other words, for borderline projects, the market area must have overall favorable conditions for stability and growth, and the project should have a distinct competitive advantage. Primary data support (i.e., information from and about the potential customers) is also important to making the case for borderline projects.

In reviewing the market study conclusion:

- Is the market area reasonably defined?
- Did the analyst correctly identify the income band of affordability as described earlier?
- Did the analyst adjust for household size and other demographic characteristics of the target households?
- Did the analyst adjust the gross demand for existing affordable units in the market area?
- Is the capture rate within DHCR/HTFC parameters?

1.5.2 What is the Predicted Market Success of the Project?

1.5.2.1 Rent Competitiveness

To determine if the project will be competitive, DHCR/HTFC examines the proposed rents relative to "street rents" in the market area. The market study is reviewed for its conclusions about the street rents for comparable unassisted housing units. The key determinant for this part of the analysis is that the proposed rents should be below comparable street rents. The proposed rents are also examined in relation to local Section 8 Fair Market Rents (FMRs).

In some cases, there may be justification for the proposed project rents to equal or be slightly higher than street rents, particularly when the comparable housing is substandard or lacking in the amenities of the proposed project. However, the evidence in such situations is examined closely.

1.5.2.2 Absorption Rates

Market studies usually project an absorption rate, and also estimate a stabilized occupancy rate (e.g., 95%, 93%, etc.) and turnover rate for the subject development as proposed (using proposed operating budgets, if available, or standard operating data.) The absorption rate or period is the estimate of how long it will take to achieve sustaining occupancy of the project upon completion of development. (The subject property's absorption period is considered to start as soon as its first unit is certified for occupancy.) It is based on the capture ratio analysis, along with an assessment of household mobility and growth in the market area. The resulting conclusions are expressed either as a number of units per month that are expected to be rented and occupied, or a total number of months to reach the sustaining occupancy level.

While DHCR/HTFC does not specify absorption as a required element of the market study, it is nevertheless essential to the developer because it helps the developer to estimate the initial operating deficit or rent-up reserve that is required in the development budget. It also helps the developer to address slow markets through more aggressive and early marketing.

Similarly, projected turnover rates for the subject development will help the developer to anticipate the level of ongoing marketing and size of waiting list that will be needed over time to maintain sustaining occupancy. It also may affect vacancy/collection loss projections in the operating budget.

If the anticipated absorption rate causes the proposed development's initial absorption period to extend beyond one year, "replacement absorption" (i.e., the need to re-rent vacated units due to tenant turnover) needs to be factored into the Analyst's projection.

For renovation projects, the study should take into consideration the anticipated number of existing (program-eligible) residents who will elect to remain at the property through its renovation, or return after rehabilitation. With respect to the anticipated absorption period of renovation projects, the study should offer the projection in two ways: (1) using the anticipated retention level; and (2) using the assumption that no residents will elect to remain at the property.

If an unusually slow absorption rate and/or unusually low stabilized occupancy rate is anticipated, the study should identify market-related or product-related issues that produce this conclusion, and include recommendations (if any) as to how the proposed development could be better structured to succeed within the market.

1.5.3 What will the impact be on existing affordable housing in the market area?

Market studies look at the competition primarily to determine how the proposed project will fare against the competition. Obviously, competition is an important concern.

However, newer projects sometimes can attract customers out of other affordable housing projects, and have a negative impact on those pre-existing projects. This is an important public lending issue, as limited public funds should be invested only where they can meet "unmet" or incremental housing needs. The public good is not served by funding new units that only drain older assisted units of their tenants, or two publicly assisted projects needing to compete for the same limited pool of customers. Such scenarios increase the viability risk of the proposed development or the pre-existing developments.

To estimate the impact of the proposed development on the existing market, the following should be considered:

- The amount of unmet demand for affordable housing in the market place relative to the existing supply of affordable housing and the proposed addition to supply (which is determined by reducing the target customer pool by the number of assisted units);
- Current affordable housing projects in the funding or development pipeline, and the timing of the absorption of those projects relative to the proposed project; and
- Overall market need for incremental or replacement units.

1.5.3.1 Impact on the Market Area: the Need for Incremental Housing Units

While the primary focus is on affordable, assisted units, DHCR/HTFC also has to consider whether additional units in the market area are indicated by the study data. In many upstate markets, stable or declining populations would discourage the need for additional housing units, but might support a strategy of rehabilitation or replacement of substandard units. The production of incremental assisted units in such an environment might cause additional vacant and abandoned structures, which would have a negative impact on the proposed project and the market area overall. The need for additional units in the market area is evaluated by considering:

- Number of boarded or abandoned housing units
- Number of substandard housing units
- The occupancy rate in the target area
- The type of housing demanded (as reflected in unmet demand)
- Financial constraints

It is reasonable to focus on new construction if factors (a) and (b) are low as compared to factor (c), and if the type of housing is not available in the existing housing stock. However, it may be advisable to focus on rehabilitation if factors (a), (b), and (c) are sufficiently high, and if the type of housing matches the existing housing stock in need of rehabilitation.

1.5.3.2 Impact on Projects in the Pipeline

The market study should also note income-restricted or affordable housing projects in the pipeline that are expected to come on line before or at the same time as the proposed project. This affects the absorption rate analysis, as noted below.

However, there is a larger concern for DHCR/HTFC that assisted projects not compete with one another for a limited pool of customers. If the creation of additional units through the proposed project, can be anticipated to have a direct, negative impact on the marketing of a project under development, or vice versa, then that cannot be considered a responsible investment of limited public funds for housing.

1.6 Market Analysis for Homebuyer Projects

The foregoing discussion has focused primarily on rental projects, where the market study takes on special importance because of the need for evidence of sustainable demand. Rental projects not only have to fill the project on completion, but maintain full occupancy over the life of the loans and restricted use periods.

Homebuyer programs or projects tend to be different in several key respects:

- Homebuyer programs/projects can more narrowly focus on the initial buyers, with less attention to resale or long-term demand than rental housing.
- Homebuyer programs/projects tend to have fewer units, and are typically multi-site projects (except for single building condominiums) that are able to be built in phases as demand dictates.
- Homebuyer programs/projects often proceed with construction with the buyers identified in advance, not only to ensure a ready purchaser, but also to permit the purchaser to be involved in the selection of finishes and final details.
- Because of counseling and downpayment requirements, sponsors often have a ready pipeline of buyers that have moved through the qualification process over several months or even years to become ready.
- Unlike rental, where LIHC, bond or other lending programs require market studies, homebuyer funding sources generally permit market analysis in lieu of third-party market studies.

If these factors apply, homebuyer markets studies or analysis can be focused on primary data from a pipeline, waiting list or counseling referral program. In such cases, the market analysis is used to:

- Define market or service area – Market areas for affordable homeownership projects tend to be larger than market areas for rental projects. Buyers tend to be willing to move further than renters in order to own. Depending on the availability of affordable homeownership opportunities and eligibility criteria, a homebuyer market area might be multiple neighborhoods, community wide, or even multiple communities.
- Establish basic program criteria – Homebuyer programs need to take into account primary mortgage underwriting criteria, so the income requirements and other qualification criteria can be different than rental. Credit scores and other mortgage

qualification factors need to be included in the analysis (and the understanding that many first time buyers need time to build credit and funds for downpayment/closing costs.) Also, public funding criteria might impose first-time buyer requirements.

- Segment the market – Again, the homebuyer market is narrower than the rental market. The focus needs to be on first-time buyers, even if the program doesn't restrict the program to this, as the first-timers are the largest portion of the pool. Segmenting first time buyers requires analysis of the renter pool. Also, the focus needs to be on household sizes in relation to the size of the unit.
- Analyze the competition – The competition is other entry-level homeownership opportunities, but it is also rental housing, which remains the primary alternative for most homebuyers. One of the key differences in other entry level homes is the condition of such properties. Usually, the homebuyer project is delivering new or rehabilitated properties, while entry level homes are often older with deferred maintenance and shorter useful life issues.

In the end, programs and projects with well established counseling programs, buyer clubs and waiting lists make it easy to demonstrate market support. Those without such access to ready clients and primary data will have to conduct a more careful analysis of the renters in the local market that might have the credit scores, liquidity and interest in becoming homebuyers.

1.7 Market Analysis for Special Populations

In almost all cases, market analysis for housing for special populations is a focused analysis rather than a broader market study. There is no relevance to looking at larger market pools when the special needs narrowly define the target population. Some of the key issues for the analysis are:

- Service area – While market studies tend to define market areas without regard to jurisdictional boundaries, the service areas of the public programs or service providers assisting a special population often become a practical limitation on market area.
- Defined client listings – Many special populations are served by public agencies or service agencies, so the pool of potential customers comes from a discrete list of clients of the various agencies serving the population. The knowledge of this population is finite and specific – often knowing exactly who needs the housing proposed. Therefore, analysis of these primary sources can be the principle focus of the demand analysis.
- Service needs and service providers – In many special housing environments, the goal is to establish a living environment where persons receive services that are needed to live successfully in that environment. From a fair housing perspective, housing cannot be limited to one service provider, but needs to be open to anyone

with the qualifying need or disability. The source of services cannot be restricted to one provider, but may obtain the needed services from any source. Therefore, it is important that the analysis be of all households with the targeted need in the service area, not just the primary provider.

- Privacy concerns – Because of fair housing and medical privacy concerns, access to some of this data may be limited, and users of this data should be careful to define and limit its use and disclosure.
- Competitive analysis – It is important to inventory all projects within the larger service area that provide housing and services to this population, but it is also important to try to analyze independent living arrangements where services can be delivered to the individual. How much of the client base lives independently with services accessed in the community rather than delivered in a service-enriched residential setting?

The decision to provide service-enriched housing to persons and households with special needs does not relieve the developer of the need to do market analysis. It just focuses the analysis on the specific population that is proposed to be served, and may open up more primary data that eliminates the need for broader market "pool" analysis as required for generic rental housing.

2. Project Selection

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. Then focus in on specific development opportunities. Don't jump at the first opportunity. Take time to compare the pros and cons of each site.

- **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 overwhelming, look for another site or property.

  Bottom line: The location should be suitable for housing – any kind of housing. If it is available for affordable housing only because it does not have other uses, are we at risk of placing units in an environment not suitable for our customers?

- **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.

See the discussion of hidden acquisition costs in the next section.

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

  Refer to the guidance provided below.

Sort the possible locations and potential sites according to these factors. 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.

2.1 Don't Let the Project Pick You!

A lot of projects are offered to nonprofits because someone or some agency in the community wants a project to happen, and they can't find anyone else to do it. The nonprofit becomes the "developer of last resort."

Well, there may be some good reasons that no one else wants to do it. For example, there might be some problems relating to the site or building, location or market that make the project a high risk or financially unattractive to other developers. Chances are that there are complications that make the project take longer and cost more.

Sure, there are a lot of good reasons to do a project that the community wants. But your first obligation is to your organization. Don't take on projects that could jeopardize your survival.

If someone offers you a project, ask yourself:

- Why me? Whose monkey is it? In other words, is someone trying to get the monkey off their back and shift it onto mine? Is someone trying to get me to take on their problem?
- Will it fit? Is it a match for my organization's capability? What's the probability of us being successful?
- What's it going to cost? How long is it likely to take? How much of my organization's resources will it require?
- What are my alternatives? What are the opportunity costs?

You may want to take a cue from for-profit developers, who look at multiple sites – 4, 5 or more – before picking one. They understand that not every site or project is a good project or a good fit for the developer. Why should you act differently?

Don't let the project pick you. Pick the project yourself to increase your chances of success.

2.2 Compare Acquisition Costs of Different Parcels

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."

The best way to analyze and compare the costs of alternative parcels for acquisition is to make certain that the sites are comparable. Some sites are "shovel-ready," while others require a certain amount of work and additional investment to make them ready for development. To be able to compare prices, all costs needed to make the site ready for development should be included in the overall cost of acquisition.

Key components of the total cost to acquire and make a site ready for construction are:

- **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.

  In addition, legal costs need to be considered. A property with an unusually complicated chain of title, a clouded title, or multiple sellers raises the effective costs of that parcel.

- **Environmental Remediation.** Some sites have environmental conditions that need to be remediated before development can occur. The costs of such remediation should be added in.

Keep in mind that environmental issues can also add significant time to the development process, and time is money in development.

- **Site Preparation.** Some sites have topographical and subsoil conditions that need to be addressed to make the site ready for construction. Leveling and compacting of sites that have excessive slopes, and the excavation or demolition of ledge conditions that prevent foundation work are two of the more typical conditions that are expensive to remediate.

- **Site Infrastructure and 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.

If you add in all these costs, you have a better estimate of what it will take to make the site ready for development, and it gives you a better basis for comparing different sites with differing levels of readiness.

2.3 Consider the Impact of NIMBYism

Opposition to affordable housing is quite common, and can add substantial cost and time to the development process. Sites should be evaluated for potential local opposition. Sites that require rezoning, zoning variances, subdivision or PUD approvals, or special use permits trigger public hearings and the opportunity for opposition to impact the process. Where possible, select project sites that can be developed “as of right.”

Where such development is not possible, and public input will be required, evaluate the NIMBY factor and its potential impact. Once potential opposition is recognized, deal with it directly, quickly and honestly. Consider the following guidance from organizations that have faced NIMBYism with success.

1. **Anticipate**: Consider the NIMBY response when selecting properties to develop. Strong NIMBY response may delay the approval or even result in disapproval. Ask yourself: am I willing and able to accept delay or even rejection of this site? Or is there an alternative site that will enable me to provide affordable housing without encountering such opposition? Do I really have to engage in this battle to win my war for more affordable housing?

2. **Be proactive**: Make sure the community hears about your project from you first. If you let the grapevine or rumor mill be the means of communication, you lose control of the message and the information is likely to be distorted. You end up not only defending your project for what it is, but also denying it isn’t. 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. Enlist their support before opposition can sway them.

3. **Put a face on it**: As you reach out to explain your project, use the strategy perfected by Ronald Reagan: convert the concept into a flesh and blood example. Identify the beneficiaries…by characteristic, if not by name. Preferably, identify

neighbors, people they can relate to. People have a harder time opposing something that will benefit real people that they know.

4. **Listen**: Remember the Stephen Covey principle: "Seek 1st to understand." If you aren't listening to them, then why should they listen to you? And, if they oppose your project out of the gates, don't take it personally. Chances are the feelings are long-standing based on previous projects and events. You just happen to be the next in line. Always remain polite, cordial, and respectful. And, above all, listen.

5. **Respond**: Validate their legitimate fears/concerns. Person have good reason to be concerned about future events and activities; we all feel a bit of loss of control of what is going around us. We aren't necessarily causing the problems they are concerned about, but we might be contributing to the growing problems and concerns, and we may be able to help the community address them. Don't proselytize. You don't need to convert them; you just have to gain their respect and tolerance. Think and talk community: you want to be perceived as a good & concerned neighbor. You want them to believe that you will be a responsive neighbor after occupancy, working with them to protect the neighborhood…as you should.

6. **Negotiate**: All of life is about compromise; so goes development. Borrowing another Covey principle, think "win-win." In the long run, we don't win when someone else loses. They will only be looking for ways to get even in the future…and we have to continue to be their neighbors. Seek the 3rd alternative – the one where everyone gets a bit of what they want. And negotiate in good faith. But don't promise what you can't deliver (see rule 7).

7. **Deliver**: Once you have completed negotiations, your life with the neighbors is only beginning. Make sure you deliver what you promise, or they will never trust you again. And, they will be stronger in their opposition to the next affordable housing project. If not for yourself, do it for us!

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.

2.4 Be Prepared to Walk Away

Development has a high opportunity cost. It diverts the organization's attention and resources from other activities. When you choose to undertake a project, it displaces some other nonprofit activities that can't be done at the same time. And, when you choose to do a certain development project, it may mean that other development projects cannot be done.

If you start working on a particular site, and it ends up being much more of a commitment of time and resources, or the feasibility of the project becomes questionable, you need to ask whether or not to invest more time and money in this project, or seek another project that will require less commitment or risk. A bad project may not be transformed into a good project by the investment of more resources. And, other projects may not happen while you divert resources to the risky and time-consuming project.

Another thing to remember is that bad projects that get built become a "brick and mortar" legacy of a bad decision. If the project can't be successful, if it will always look bad, then your reputation cannot afford it. The consequences of changing your mind are less lasting than the reputational damage of a bad project.

There is danger in the statement: "We've got too much invested to quit now." Are you sure you want this site and project to be your "bricks and mortar" legacy for all to see decades from now? The selection you make will make you proud…or haunt you.

3. Are You Ready to Be A Developer?

One of the fundamental questions is whether or not your nonprofit organization is ready to be a developer. A second fundamental question is whether or not the project in question is appropriate to your organization.

3.1 What Does It Take to Be a Successful Developer?

In part, success in development depends upon the developer being properly structured and having the necessary resources and capabilities available to support development. Some of the key organizational issues are:

- Organizational capacity – Development requires a range of skills, including project management, team management, financial packaging, physical planning and property management skills. The underlying expectation of the CHDO statute is that CHDOs will build these skills in staff over time. Does your organization currently have the staff skills, or are they adequately supplemented in the near term by board members, consultants and partners? And, is there a plan to develop those skills in house?
- Organizational structure – Is the organization structured so that the necessary focus can be given to development projects, and so that the other ventures and services of the organization can be separated from the high risks of development? Some organizations use development committees for focus, others use subsidiaries to achieve focus and risk insulation.
- Dedicated resources – Development requires money. Even if you are not going to be investing equity in your projects, in the near term you will need funds to pay bills until you can be reimbursed at a later closing. For example, you may need to get site control (options) and pay for architectural, engineering, environmental, legal and other consulting work needed to plan the project. Do you have funds available for capital advance, and is it dedicated to development?

Although the guide that follows goes into some detail, some of the key questions for any organization trying to assess its readiness to undertake a development project are:

1. Will development focus “displace” other activities? What are the “opportunity costs” of undertaking development?
2. Are you structured to insulate your other activities from the risks of development? Do you have a development subsidiary to separate the organization’s other assets and programs from the risks of development?
3. Do you have the liquidity to meet project needs? Do you have at least 5 - 10% of project total development costs (TDC) for upfront planning costs and ongoing capital advances prior to closing and draws?

4. Do you have the financial management procedures to safely manage this volume of cash?
5. If your key development person leaves, are your development projects "dead"? Is there anyone who can pick up the pieces? Have you done succession planning and are you training people to learn more than their current jobs?
6. Should you consider partners &/or consultants? That will be a question addressed in the next chapter.

These elements are discussed below, followed by a self-assessment guide.

3.1.1 Beyond the Dollars: The Opportunity Cost of Development

The issue of capacity is not merely one of whether you have staff and team members to do the development project, as discussed in Chapter 5. Certainly, development has its direct costs and risks, including the tremendous time and financial resources that are invested or placed at risk during a lengthy development process.

But it also has indirect costs. Development is so time and resource intensive that it can displace or limit other things that a nonprofit can do.

Economists call the displaced or foregone activities the "opportunity cost" of a decision. In housing development, an organization is required to invest a tremendous amount of time and resources to make a development project happen. But just as important are the things that the CHDO <u>can't do</u> as a result of making the choice to develop the housing project:

- Are there other non-development activities that will be undertaken or might suffer the loss of some of the staff and management time otherwise available to it?
- Are there other development projects that cannot be considered because of the one you have chosen?

Foregone opportunities need to be considered as much as the direct costs, because these choices affect what your organization can accomplish for the community. Is the development role the right choice for the skills, capacity and interests of your nonprofit?

3.1.2 Subsidiaries: Insulation from the Risks of Development

Many nonprofits assume that the simplest and quickest way to develop is to use their existing not-for-profit entity as the development vehicle. It may be convenient, but it also contains risks for the CHDO. Sometimes, a separate entity – perhaps a not-for-profit or for-profit subsidiary – is the more prudent approach.

Why should you consider a subsidiary or separate entity for development?

- ***Protect the parent from liability*** – Development has many risks associated with it, and failure of a project could drain financial resources from other assets and activities of the organization, putting the entire organization at risk. By creating a subsidiary, the risks of development generally can be contained to the assets of the subsidiary, without jeopardizing the other assets, programs and portfolio of the parent.

- ***Protect the parent's nonprofit status*** – Some development ventures have non-low-income components or are by nature are for-profit ventures. Undertaking these projects within the parent nonprofit could jeopardize it nonprofit tax status. Creation of a separate entity ensures no co-mingling of nonprofit and for-profit revenues.
- ***Funding requirement for a single-purpose entity*** – Some funding sources require an entity that exists only for that project, in order to eliminate any confusion or co-mingling of assets and liabilities of a particular development with the other assets and programs of the sponsor. It also is necessary when there are unique "partners" for a specific the project (e.g., LIHC).
- ***Board skills and focus*** – Nonprofit boards are often a mixture of people with different skills and interests to promote and oversee the broad range of public benefit activities that a nonprofit might undertake. Housing development requires specific skills and substantial financial risk, and some board members might not be comfortable with their ability to oversee development activities. Creation of a subsidiary with a smaller board that possesses specific development skills will facilitate development activities while allowing the parent board to focus on a broader range of charitable purposes and activities.
- ***Board composition*** – Another advantage of the subsidiary is the ability to create a new board that meets the CHDO statutory requirement rather than having to change or add board members to the existing parent corporation board. However, you have to be careful that the pursuit of one funding source doesn't distort the original purposes or structure of your nonprofit.

On the other hand, some of the potential costs or concerns of separate entities are:

- ***Control*** – Creation of a separate entity, even if it is a subsidiary, means the transfer of day-to-day control of CHDO activities to that entity's board, and a loss of control by the parent board.
- ***Incorporation & annual filing costs*** – It will require legal and filing costs to create a separate entity, and hundreds of dollars annually in accounting costs and filing fees, including annual tax returns
- ***Tax burden*** – For-profit activities can result in taxes due.
- ***Arms-length transactions*** – Transfers of funds, provision of office support, and staff assignments require accounting as formal third-party transactions.
- ***Overhead and operating costs*** – Separate entities may also require additional office, staffing, accounting and other overhead costs.

- ***Meetings*** – Separate entities generally have separate boards, meaning separate meetings, notices, records, etc.
- ***Lender treatment of separation*** – Some lenders do not permit a firewall between the single purpose entity and its parent or sponsor, sometimes requiring guarantees or cross-collaterization that transfers some of the development risk back to the parent corporation.

So there are costs to using subsidiaries, but also some potential benefits of risk management. If you are not going to create a subsidiary to oversee development and operation of projects, then you should at least consider the creation of a development committee within the organization to oversee development.

Additional information about subsidiaries and legal structure is in Chapter 5.

3.1.3 Creating the Liquidity Needed for Development

Generally, affordable housing projects do not require the investment of equity capital. Equity is invested where there is expectation of a positive net cash flow from property operations to pay a reasonable return. Affordable projects tend to be structured to yield little or no net cash flow (other than the minimum levels required by debt service coverage and other underwriting criteria), so there is little or no incentive to invest equity. Tax Credit projects are the exception, but the return on that investment comes from the Tax Credits, not cash flow.

Even though long-term equity investment is unlikely in affordable projects, short-term investment of capital (commonly called “capital advances”) is needed to meet the financial requirements of a project in advance of other funding sources becoming available. The heaviest capital advance requirements occur during the early planning stages, and become less significant after loan closings have occurred.

As a general rule, you should assume that these capital advances are going to approach 5 – 10 % of your project’s total development cost. Do you have that level of funds available to pay bills? And is it dedicated to development?

3.2 Self-Assessment Guide

Following is a guide to walk you through a self-assessment of your organization’s capacity to develop.

- Part 1 is an outline of a series of questions designed as a general assessment of your organization and its capacity to develop, divided into sections on:
    - Organizational structure,
    - Capacity to develop,

    - Project management, and
    - Financial management.
- Part 2 is a series of questions regarding how a possible project might impact an organization, to determine the compatibility of a particular project with your organization.

These should be used only as a guide for staff and board to discuss their readiness for development overall, and for a project in particular.

Part 1: Assessment of Organizational Readiness to Develop

1. Organizational Structure

	Yes	*No*	*Need to address*
Corporation Status:			
Is the organization incorporated & nonprofit status intact (if appl.)?			
Are you in good standing with state agencies?			
Have you made all required tax filings?			
If you are going to use a single-purpose entity or other new entity for development, has it been created?			
Corporate Planning:			
Do you have a strategic plan or mission that identifies housing development as a key activity?			
Membership:			
Is the membership active and in support of housing activities?			
Does the organization reach out to recruit low-income beneficiaries as members?			
To what extent has the organization made efforts to recruit members with relevant professional skills?			
Corporate management structure:			
Are the corporate lines of authority for development activities clear?			
Does management have the ability to manage additional activities?			
Are policies & procedures in place governing development activities?			
Are personnel policies and performance appraisal systems in place?			
Does the organization have a conflict of interest policy governing employees and development activities, particularly in procurement of contract services and the award of housing units for occupancy?			
Corporate Liability:			
Does the organization have adequate liability insurance, directors and officers insurance, and fidelity bonds for those who handle funds?			
Does the organizational structure separate housing development from other corporate activities – e.g., development subsidiary, independent development entities, separate portfolio management entity, or other legal firewalls?			

Rating: With regard to organizational structure, our organization rates:

5 We are fully ready to take on housing development
4 We are ready to take on many kinds of development
3 We can do limited development, but need to grow
2 We need to develop capacity in this area
1 We're not ready Score: ____________________

Comments/changes required:

2. Board, Staff & Development Team Capacity

	Yes	*No*	*Need to address*
Board Composition/Capacity:			
Do board members have professional skills directly relevant to housing development (e.g., real estate, legal, architecture, finance, management)? What efforts have been made to recruit such board members?			
Has there been stability/continuity of board members over the last several years?			
Does the board have a committee structure or other means of overseeing planning and implementation of development?			
Has the board demonstrated the ability to make timely decisions?			
Is there a good relationship between board and staff? Do they have shared goals for the organization?			
Staff skills: Do staff have adequate skills and training in the following areas:			
- management of housing development			
- fundraising/grantsmanship			
- oversight of design & construction			
- marketing & intake			
- oversight of property management (if rental housing)			
Training: Do you provide adequate opportunities and encouragement for staff to receive training and expand their development skills?			
Use of Consultants:			
Do you have access to experts beyond your staff in housing development?			
Do you have a policy/procedure for procuring consultants and development team members?			

Rating: With regard to capacity, our organization rates:

5 We are fully ready to take on housing development
4 We are ready to take on many kinds of development
3 We can do limited development, but need to grow
2 We need to develop capacity in this area
1 We're not ready Score: ____________________

Comments/changes required:

3. <u>Project Planning & Management</u>

	Yes	***No***	***Need to address***
Understanding of the market:			
Has the organization done any analyses of the local housing market and the housing needs of low income households?			
Has the organization analyzed the competition - both publicly assisted and private housing that serves low income?			
Project Selection:			
Do you have a process for carefully evaluating alternative projects and sites?			
Do you have a process for potential low-income beneficiaries of the housing to provide input?			
Project Planning:			
Does the organization have a process for regularly monitoring the progress of a project?			
Do you have a process for making timely decisions?			
Community Relations:			
Do you have positive relationships with your community/neighborhood? Are they likely to support additional housing development by you?			
Do you have positive relations with your local government, and can you count on them for support, approvals and funding?			
Property/Asset Management:			
Do you have property management operations established (occupancy mgt, fin mgt, maintenance)?			
Do you have procedures for overseeing the financial conditions of all property assets?			

Rating: With regard to project management, our organization rates:

5 We are fully ready to take on housing development
4 We are ready to take on many kinds of development
3 We can do limited development, but need to grow
2 We need to develop capacity in this area
1 We're not ready Score: ____________________

Comments/changes required:

4. Financial Management & Capacity

	Yes	*No*	*Need to address*
Financial management:			
Do you do an annual budget?			
Do you have a process for regularly tracking and monitoring expenditures against budget?			
Do you have adequate procedures in place to monitor cash flow (receipts and disbursements)?			
Do you have adequate internal controls to ensure separation of duties and safeguarding of assets?			
Do you make regular reports to the board updating financial positions?			
Audit:			
Do you have a regular and current audit?			
Is the most recent audit clean, or have all management or compliance findings been resolved?			
Do your financial management and accounting systems conform to OMB A-110 or 24 CFR Part 84?			
Financial stability:			
Does the organization have a diversified and stable funding base for operations?			
Are the revenues predictable year-to-year?			
Is the organization able to exist without developer fees?			
Are any programs or projects currently at risk?			
Are existing rental housing projects (if any) producing positive cash flow and paying management fees?			
Liquidity:			
Do you have adequate cash to pay bills most of the time?			
Do you have current assets that exceed current liabilities by at least 50%?			
Do you have enough liquid capital to make capital advances to a project (5–10% of project costs)?			
Do you have the capacity to quickly raise such capital for projects?			

Rating: With regard to financial management, our organization rates:

5 We are fully ready to take on housing development
4 We are ready to take on many kinds of development
3 We can do limited development, but need to grow
2 We need to develop capacity in this area
1 We're not ready

Score: ____________________

Comments/changes required:

5 Conclusions of the Organizational Assessment

Our organization is strongest in the following areas:

____

____

____

____

____

The following areas are where improvement is needed if the organization is to succeed at affordable housing development:

____

____

____

____

____

Part 2: Assessment of Project Impact on the Organization

Proposed Project Summary

Project Name ____

Description ____

____

____

Est. Total Capital Requirements (funds to be raised) ________________________

Est. Total Annual Operating Budget (non-revenue) ________________________

Time Frame for Development ________________________

Organizational Impacts/Considerations	
1.	Does the proposed project <u>directly</u> support the mission of the organization?
2.	How strong is the internal support of board, members, and staff for the project? Is there internal dissent? What is the potential impact of the dissent?
3.	Does the organization have the capacity to undertake another development project? Do we have the required staff and skills? Or can we create a partnership or venture to obtain the required capacity?
4.	Does the project use or build on organizational strengths (identified in the assessment)?
5.	Is it compatible with current organizational activities and our existing portfolio? Does it enhance other operations? Will there be economies of scale in the operation/management of the portfolio?

6.	What are the opportunity costs of the project: Other projects/activities that may not be able to occur due to diversion of management attention and corporate resources to this project? Diversion of capital from operational or portfolio needs?
Project Feasibility & Risks	
7.	Do we have evidence of a sufficient demand (not need) for this housing at affordable prices?
8.	Is there a financial plan or analysis demonstrating feasibility and long-term viability?
9.	How strong is the external support or opposition of the community, constituents, and the public sector? Will this affect the approvals of the project? Will it affect the project schedule?
10.	What are the other key completion risk factors?
11.	What are the total financial (capital advances & equity) requirements the project from CHDO funds: pre-development capital costs and advances ______________ project equity requirements ______________ organizational overhead costs during implementation ______________ initial operating deficits & capitalized reserves ______________ TOTAL EQUITY/CAPITAL ADVANCE REQUIREMENTS ______________
12.	Are the fees that can be earned reasonable and sufficient to cover the effort involved?
13.	To what extent could the risks/costs/impacts of any of the above be reduced by: a change in the type of project or clients served? A reduction in scale? A change in financing? A change in implementation schedule?

Long-Term Considerations	
14.	What contingent liabilities exist for the corporation if the project fails either before or after completion? Should the project be organizationally separate from other ventures?
15.	What other benefits result from the project: economic opportunities for customers? Physical improvement and other community benefits? Organizational benefits? Replicability?
16.	Overall, does the project provide reasonable benefits to our organization and our customers relative to the associated risks?

4. Partnering To Develop Affordable Housing

4.1 Partnerships and Capacity to Develop Housing

Many communities that lack affordable rental housing also lack affordable housing developers capable of developing and managing rental housing. ***Partnerships*** are essential 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 collaborative*** – 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 partnership*** – partnerships that undertake direct development of projects;
- ***Program-based or financial intermediary partnership*** – partnerships to create pools of funds for use by affordable housing developers; and
- ***Public sector partnership*** – partnerships designed to facilitate relationships and cooperative efforts among existing public agencies at different levels of government.

Partnerships can be formal or informal, and 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:

- Clear, identifiable need(s) that the partnership can address
- Strong leaders and conveners
- Diverse involvement
- Access to funding
- Doable programs
- 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.

4.2 Working with Various Partners

4.2.1 Partnering 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, 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.[3]

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?

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

4.2.2 Working with For-Profit Developers

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;

[3] 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 and 24 CFR 92.2.

- 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.

4.2.3 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. 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 6.

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.

4.2.4 Working with 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.

4.3 What to Look For In a Partner

What do you look for in a partner?

- Developer skills – Do they have project management skills that you don't have, or don't have in sufficient quantity to manage all of your current projects?
- Technical skills – Do they possess knowledge of specific project type or funding sources that will be needed for your project? For example, if you haven't done a Tax Credit project, working with an experienced partner who has placed Tax Credit deals and has contact with syndicators is important.
- Unique access to property/resources – Do they own the property you are interested in developing, or do they have access to the construction lenders or permanent conventional lenders that will facilitate your project?
- Experience working with nonprofits partners – Do they have prior successful experience in working with nonprofit partners? Do they understand what is unique about, and important to, nonprofits? Can they understand how nonprofits operate and make decisions?
- Trustworthiness – Can you count on them to meet their obligations, disclose any issues that affect you or your project, hold confidences that relate to you or your project, and take action to defend you or the project?

4.4 Establishing Joint Ventures

For many affordable housing, the demands of project financing, development and ongoing operation may be met best by a joint venture of a for-profit and nonprofit entity. For-profit developers bring project management skills, equity and access for private capital and loans. Nonprofits, on the other hand, may have better to community support and approvals, grant funding, marketing and outreach, and an interest in the long-term affordability of the project. Together, these two organizations may bring a better set of skills and resources that ensure long-term success – if a stable partnership or joint venture can be created.

The success of a joint venture depends upon a business relationship that is balanced. A balanced joint venture is not necessarily an equal partnership, but each partner has clear roles and responsibilities, and the risks and the rewards are commensurate with the role. In other words, each partner should earn fees in relation to the share of developers taken on, should contribute equity in relationship to their ownership and decision-making interest, and should not be put at risk beyond its ability to enjoy the rewards of development.

4.4.1 Tips for Negotiating Joint Ventures

As you prepare for negotiation of the joint venture with your partner, consider the following advice:

> **Negotiating Tip 1: Prepare by analyzing the differences and the shared interests.** How are we different? What can we each bring to table? What are our shared interests?
>
> **Negotiating Tip 2: Identify/disclose the "non-negotiables."** What are deal-killers for you? For example, do you absolutely need to serve certain income levels? Do you need to control the occupancy of the units? Do you require community participation? Are there certain financial issues (risks and rewards) that are essential for you to agree to participate? On the other hand, what are deal-killers for your partner?
>
> **Negotiating Tip 3: Seek the win-win, or the 3rd alternative.** You can't have a successful partnership with an unhappy partner, but you can't be unrealistic in your expectations either. Both sides have to give to get. Can we achieve a partnership deal that achieves both of our needs?
>
> **Negotiating Tip 4: Balance risk and rewards for all partners.** As discussed earlier, a successful partnership has to be a balanced partnership. What is the balance between control and the risks/liabilities assumed by each partner? What is the balance between responsibilities and the fees and other rewards allocated to each partner?
>
> **Negotiating Tip 5: Put the business deal in writing**. Trust your partner, but document the agreement! Document the business deal in a joint venture memorandum of understanding before turning it over to the lawyers for them to turn it into the legal deal. Don't sign till you understand!

4.4.2 Tips for Preparing the Joint Venture Agreement

A joint venture agreement is a combination of the "business deal" as well as the legal provisions and protections that each partner needs to enter into the joint venture relationship.

The business deal has to come first. A joint venture is constructed around a mutual agreement on the following points of the business deal:

1. **Scope of project** – A clear delineation of the project scope, including:
   - Number/mix of affordable units (& other uses)

- Targeted households
- Term of project
- Low income affordability/use restrictions
- Changes to scope:
- Non-negotiable v. desirable
- What changes of scope can be made & how changes will be decided?

2. **Ownership entity and interest** – The type of ownership entity, the split of ownership interest between the partners, and how this will be determined. Also, how change or sale of ownership interest occurs: how partners acquire interest from other partners, rights of 1st refusal by other partners, and succession in event of death/demise of partner.
3. **Decision-making** – How the partners will make decisions (voting, consensus, etc.) Voting rights are usually based on ownership interest, but some key decisions that must be made jointly or by consensus, such as incurring debt or financial obligations and significant changes in project scope. Also, what decisions individual partners can make in fulfilling developer obligations.
4. **Equity contributions and capital advances** – How and under what terms there will be calls to the partners for equity contributions or capital advances, and how the failure of a partner to make required contributions in a timely manner will be handled. How and when capital advances will be repaid How return on equity will be paid
5. **Division of responsibilities** – How the responsibilities of the developer will be split among the partners: management of the joint venture, acquisition, financing, design, local approvals, construction, marketing and occupancy. What rights exist to complete the project if a partner fails to fulfill its responsibilities?
6. **Split of developer fees** – How the developer fees will be split among the partners, presumably in proportion to the developer responsibilities; often this is established by a schedule of values for each responsibility.
7. **Guarantees** – Which partners are responsible for guarantees to lenders and limited partners, and the compensation associated with those guarantees.
8. **Dispute resolution** – How the parties will resolve situations when there is disagreement (mediation, arbitration, etc.)
9. **Termination** – How the partnership can be terminated, either before the project is completed or after all work has been completed. If a "handoff" from one partner to another is contemplated on completion, how that will occur.
10. **Buyout** – If applicable, the terms for one partner buying out the interests of another, either planned or as a result of an unresolved dispute. Elements of the nonprofit's strategy to buy out the other partner(s) may include:
    - Right of first refusal
    - Favorable formula for buyout "price"

- Management fees, incentive payments & distributions
- Maximized residual interest of nonprofit
- Public financing structured to minimize residual value to partners but assumable by nonprofit
- Grants/subsidies converted to nonprofit loans to projects (& accruing interest)
- Ground leases/land trusts to control land value
- Escrow portion of developer fees dedicated to buyout (sinking fund)

In some cases, a project involves a handoff of a completed project rather than a buyout. For example, a for-profit partner wants out after developing the project, or a service nonprofit takes over ownership and management of a special needs project after it is completed. In such cases, the joint venture agreement needs to specify:

- Standards for completion and acceptance of the project
- Warranty by the developer (including possible fee retention or guarantee)
- The process for the handoff, including lender/funder approvals

After you have negotiated the business deal as outlined above, create a joint venture memorandum between the partners to document the business deal. Then it can be turned over to the lawyers to create the full joint venture agreement with the appropriate set of legal protections. Some of the legal protections that your attorney will add to the joint venture agreement include the following:

- Joint approval in writing of major decisions
- Regular partner meetings
- The right to examine the books and records of the joint venture
- Receipt of monthly/annual reports from the managing partner
- Disclosure requirements
- Dual signatures on checks & documents
- Bonding
- Prohibition against self-dealing
- Arbitration/mediation

Together, the terms of the business deal and the legal protections constitute the full legal agreement of the joint venture. Make sure that your agreement contains both.

4.5 Final Thoughts on Partnering

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. Some final thoughts:

- If you need specific task/skill, hire a consultant; if you need resources, risk sharing &/or management, get a partner.
- Skills and resources aren't enough to justify selection of a partner. Seek a compatible partner(s) that you can trust.
- If you want to have control, you have to be able to put up equity or capital advances: Equity = ownership interest = control.
- Successful partnerships balance control, liability & rewards. Developer fees must reflect the split of work and responsibilities of the parties.
- Plan for the end(s) of the venture. Make provisions for the buyout or the handoff.
- Negotiate in good faith (with full disclosure of any "non-negotiables") and seek win-win arrangements.
- Document the business deal first in a joint venture memorandum; then let the lawyers turn it into a legal agreement with the appropriate legal protections.

5. Legal Structures of Development Entities & Ownership

5.1 Introduction

One of the major decisions during the planning stages of the development is the determining the entity that will assume ownership of the project during both development and occupancy. It's a key decision because it determines who will participate in the risks and rewards of the development.

Some of the key ownership decisions include:

- Whether you should assume **direct ownership** of the project, use a **subsidiary entity**, or use a **single-purpose** (or single-project) entity to assume or represent you in the project ownership.
- Whether the development project, and thus its ownership entity, need to be a **for-profit or a nonprofit**, and whether that nonprofit needs 501(c) (3) or 501(c) (4) designation from the IRS.
- Whether the **funding program or source mandates** certain ownership entities or designations, such as limited partnerships for Tax Credits, CHDO for HOME CHDO funding, CBDO for new housing construction with CDBG funding, or other program designations.
- Whether to do the project by yourself, or consider a **joint venture or partnership** to share the responsibilities, risks and rewards of development.

5.2 Subsidiary or Separate Entity

One of the first decisions is whether you should set up a separate entity to do the development project, either as an independent entity or as a subsidiary.

Why should you consider a subsidiary or separate entity for development?

- Protect parent from liability – Development has many risks associated with it. Failure of a project could negatively affect other projects and activities of the organization, and require the diversion of the staff and financial resources of the developer to cover the losses. Some organizations have become insolvent due to the failure of one development project. By creating a subsidiary, the risks of development generally can be contained to the assets of the subsidiary, without jeopardizing the assets, programs and portfolio of the parent.
- Protection of parent nonprofit status – Some development ventures have non-low-income components or are by nature for-profit ventures, including mixed income, mixed use and Tax Credit projects. If done within the parent nonprofit, these

activities could jeopardize the tax status of the parent organization. Creation of a separate entity ensures no co-mingling of nonprofit and for-profit revenues or dilution of the low-income focus of the parent.

- Requirement for a single-purpose entity – Some funders and funding sources require an entity that exists only for that project. This eliminates any confusion or co-mingling of assets and liabilities of a particular development with the other assets and programs of the sponsor. It also is necessary when there are unique "partners" for the project (e.g., LIHC).

Some of the potential negatives of separate entities are:

- Incorporation & annual filing costs – It will require legal and filing costs to create a separate entity, and perhaps hundreds of dollars annually in accounting costs and filing fees, including annual tax returns.
- Tax burden – For-profit activities can result in taxes due on the income from the profit-making venture (although this potentially true within the parent as well.)
- Arms-length transactions – Inter-entity transfers of funds, provision of office support and overhead, and staff allocations require accounting as formal third-party transactions.
- Overhead and operating costs – Separate entities may also prompt additional office, staffing, accounting and other overhead costs.
- Meetings – Separate entities generally have separate boards, meaning separate meetings, notices, records, etc.
- Lender treatment of new entity – Some lenders do not permit a clear firewall between the single purpose entity and its parent or sponsor, sometimes requiring guarantees or cross-collaterization.
- Control – Creation of a separate entity, even if a subsidiary means the transfer of some control to that entity's board.

Bottom line: while organizations do not want to propagate legal entities unnecessarily as there are costs associated, the potential risks and liabilities of the new development activities prompt nonprofit organizations to consider the creation of separate entities to insulate the nonprofit organization from the risks.

5.3 For-Profit or Non-Profit

If the decision is made to create a separate organization, a second decision is whether to create a for-profit entity or nonprofit entity for the venture.

As noted above, some development projects are by nature "profit-making" and may call for a for-profit. Mixed-use and mixed-income projects may have non-low-income aspects to the venture that necessitate the creation of a for-profit venture or risk undermining the continued eligibility of the nonprofit as a 501(c) organization. Consult IRS guidance on this matter.

In addition, Tax Credit projects are considered to be profit-making by the IRS or the project is ineligible for credits, so many attorneys counsel their nonprofit clients to create for-profit entities to participate in such ventures.

As a result, it is not uncommon for nonprofit entities to also have for-profit subsidiary entities to implement certain kinds of development.

If tax issues might cause you to think about which type of entity to create, consider some of the characteristics of for-profit entities or distinct advantages they may have over nonprofits:

- Quick formation – For-profit entities can be quickly formed with the filing of papers with the state government, and generally no special approvals are required by the state or IRS (other than requesting a Tax ID number).
- Unrestricted powers – Generally, for-profits are permitted to do anything (legal), and are not restricted as to the types of projects or the households served.
- No restriction on assets or profits – For-profits can direct their assets to any purpose, can distribute profits, and are not limited in the disposition of assets.
- Stock control – Stock can be distributed and transferred in most any manner without restriction.

On the other hand, for-profit entities do have some disadvantages:

- Taxable – All profits are subject to taxes.
- Subsidy sources limited – For-profits usually do not have access to certain public and foundation funding sources.

By contrast, note the following advantages and disadvantages of non-profits:

- Longer formation process – The applicant has to be recognized by the state as a corporation and as a nonprofit, and also file for recognition from the IRS, a process which can take many months and even in some cases more than a year.
- Restricted powers – Nonprofits are strictly limited to permissible activities consistent with state and Federal requirements and their mission. There are limitations on uses of profits and participation in profit-making activities, as well as restrictions on disposition of assets.
- Tax-exempt – Nonprofits enjoy exemption from most corporate taxes, and in some states are also eligible for real estate tax exemption.
- Subsidy sources – Nonprofits are eligible for most public and foundation sources of funding, which often are essential to filling the capital gap in affordable housing.

5.4 Special Program Requirements or Designations

Sometimes the type of development or ownership entity is determined or influenced by a critical funding source. Some of the key funding source requirements or designations are noted below:

- Low Income Housing Tax Credits – The Tax Credit program does not specify a particular type of entity or designation, but the almost universal form of ownership is the Limited Partnership, or in some cases a Limited Liability Partnership or Corporation. This is because the program ultimately pairs the active developer with passive investors. The two classes of owners are designated as General Partners and Limited Partners. The venture is considered a profit-making venture by the IRS.
- HOME CHDO (Community Housing Development Organization) funding – At least 15% of any Jurisdiction's annual HOME Program funding must be set aside for housing projects developed by nonprofits that meet certain requirements for board structure, IRS designation and low-income community input specified in 24 CFR 92.2. Sometimes these CHDO funds are more readily available than non-CHDO HOME funds, and there are also possible additional benefits to CHDOs, including operating expenses, pre-development loans and retention of project proceeds.
- Community Development Block Grant – The CDBG program has limitations on activities, including new construction of housing, which can only be done by organizations that qualify as Community Based Development Organizations (CBDOs.) In most cases, these are nonprofit organizations with some similarities to HOME CHDOs, but they are not identical or equivalent.
- Tax Exempt Bonds – Single-purpose entities are considered standard for mortgage revenue bond financed projects. In many cases, the tax-exempt bonds are paired with as-of-right 4% Tax Credits.

These are just some of the major programs that dictate or determine the type of development entity. Contact your funding sources to determine if their funds either require or influence the type of entity you will need to create.

5.5 Joint Ventures & Partnerships

For many affordable housing projects, the demands of project financing, development and ongoing operation may be met best by a joint venture of a for-profit and nonprofit entity, as discussed in Chapter 4.

Joint ventures require that an entity be created to reflect the partnership of the two entities. It is a legal entity that is sometimes a corporation, a limited liability partnership or general partnership. Usually, the entity is set up as a pass-through entity where all profits and tax liabilities are passed through to the venture partners rather than being a taxable entity itself.

6. Managing the Development Process

Managing the development process requires both an understanding of real estate development and skills in managing a team of professionals. The development process is a series of inter-related tasks being executed by a multi-disciplinary team of professionals. At the hub of the team and this complex process is the "developer", a person who assumes the responsibility for ensuring that all tasks are assigned and scheduled, and that the team performs on schedule.

The team and the responsibilities of the developer are described below.

6.1 Assembling the Development Team

Any housing development has a "team" of professionals who will be included at various points in the process and will have play specific roles. 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.

6.1.1 The Developer Role

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 or consultants 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.

Developers are paid a fee for the services they render: 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. When a developer chooses to hire consultants and staff to do the work of the developer, these consultant or staff costs are paid out of the developer fee.

6.1.2 The Role of the Board of Directors

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 are not part of the development team, but are critical to many of the key decisions and with whom communication throughout the project is essential.

6.1.3 The Development Team

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 participate in budget preparation for engineering-related costs.
- **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 included. 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 costs 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 1 addresses 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 team members and stakeholders 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.

6.2 Managing the Development Team and Process

A developer has the very challenging job of managing this inter-disciplinary team and coordinating the complex set of tasks. Below are some of the 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 update the budget throughout the process with actual costs to date 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 regular meetings should occur at times 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 a problem 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.

6.3 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 it until you understand it. If you can't understand it, find someone who can help you.

Additional general tips on negotiating are provided in Section 4.4.1.

7. Homebuyer Development Financing

Homebuyer projects have two inter-related stages: the development stage and the sales stage. The financing for the development stage, which is for the project, is directly impacted the financing for the sales stage, which is for the buyers. Understanding the inter-relationship of these two stages and budgets is a key to the successful development of a homebuyer project.

7.1 Two-Part Development Budget

Homebuyer development project budgets consist of two inter-related budgets – one focused on the development sources and uses and the second focused on the receipt and distribution of sales proceeds.

The development budget is focused on the unit and includes up-front, direct construction, and professional services costs such as:

- Market Analysis
- Acquisition
- Site improvements
- Legal and organizational
- Appraisals
- Title and Closing costs
- Loan and financing costs
- Direct construction
- Construction period insurance and taxes
- Builder Fees
- Architectural and Engineering Services
- Consulting Services
- Environmental Review
- Marketing and Advertising

This part of the budget is financed by equity, deferred developer's fees (deferred until receipt of sales proceeds), construction loans, and often public capital advances that fill the gap between the sources of funds and the uses of funds. Public capital advances are the funds provided by a government source to fill the gap between the available financing and equity and the cost to develop the unit.

Construction financing, usually a construction line of credit, is impacted by the number of units in each phase and the number of units under development and sold. Some soft costs are front loaded, including acquisition, approvals, infrastructure, design, construction financing. As units are sold, the net sales proceeds are rolled into the next phase or unit. The construction financing or line of credit may be temporarily paid down as units are sold and phases are completed.

The developer fee and sales costs are typically not included in the development budget because they are deferred until the units are sold. Consequently, Part II of the budget, which is focused on the buyer, includes these costs.

The timing of sales (Part II) directly impacts the amount that must be borrowed or contributed to the project during development (Part I). As units are sold, the proceeds from those sales are used to first pay any sales and closing costs, then to pay down the construction line of credit, then to reimburse public capital advances, and finally to pay the developer the fee they have earned and the investors their return on their investment.

<u>Development:</u>	<u>Sales:</u>
Sources:	Sources:
Equity	Buyer Funds: DP + 1^{st} Mort
Construction Loan	Minus: sales costs
Public Capital Advances	Equals: Net Sales Proceeds
Uses:	Use of Net Proceeds:
Acquisition/site	Construction loan payoff
Construction (hard costs)	Developer fee
Soft Costs	Public loan payoff

As illustrated above, at the time of sale the buyer's sources, which include the first mortgage and down-payment and are brought in to pay off construction financing. Because the permanent financing (sales proceeds) is phased with unit sales, the amount of construction financing needed by the project will not equal the total gap between development sources and uses.

7.2 Public Subsidy Funds

Given the two part budget there are two types of subsidies that need to be considered in a homebuyer project. The first subsidy is for the development part and is referred to as a public capital advance.

Public capital advances are generally allocated at closing in one of four ways:

- Buyer subsidy. A buyer subsidy is necessary when the fair market value of the property exceeds the amount of the buyer's down payment and first mortgage.
- Payment of Closing Costs. In addition to the sales price of the unit, which is generally sold at fair market value, the sales and closing costs must also be paid at closing. This payment impacts the amount of the buyer subsidy:

	Fair Market Value	$150,000
Plus:	Sales & Closing Costs	9,000
Less:	Buyer down payment	2,500
Less:	Buyer first mortgage	125,000
Equals:	Buyer Subsidy Needed	$ 31,500

- Developer fee. The developer fee is generally deferred until earned - when the unit is sold. In some projects, the developer fee will be paid upon the sale of each unit, in others it will not be paid until the entire project is complete or may be disbursed on a schedule. When the developer fee is paid upon the sale of each unit, it may be included in the buyer subsidy or may be written off by the public subsidy source. When the developer fee is paid upon completion of the entire project, it may be written off by the public subsidy source as an excess development cost or may be paid from proceeds.
- Public Capital Advance repayment. Repayment of the public capital advance may occur with each unit sales, upon completion of the entire project or not at all. The public capital advance may be converted to a buyer subsidy upon sale of a unit or may be written off as an excess development cost.

7.2.1 The Federal CDBG Program

The eligible activities for which purchase assistance using CDBG funds may be provided under this category are to:

- Subsidize interest rates and mortgage principal amounts, including making 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 towards the purchase price. Alternatively, the grantee or subgrantee 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 up-front by a private mortgagee. This would include the cost for private mortgage insurance.
- Pay any or all of the reasonable closing costs associated with the home purchase on behalf of the purchaser.
- Pay up to 50% of the down payment required by the mortgagee for the purchase on behalf of the purchaser.
- Note especially that the use of funds under this category is specifically limited to assisting low- and moderate-income households. 24 CFR §570.201 (n).

7.2.1.1 Eligible & Ineligible Activities

Rehabilitation. Eligible activities connected with the rehabilitation component of this type of program include. 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—Costs of installation or replacement of landscape materials, sidewalks, or driveways, when incidental to other rehabilitation of the property.
- Historic preservation—Costs to preserve properties of historical significance.
- Lead-based paint hazard evaluation and reduction—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 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. See 24 CFR §570.207.

New Construction. CDBG funds may be used in certain specified circumstances to finance the construction of new permanent residential structures. The following identifies those limited circumstances:

- 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. 24 CFR §570.207(b)(3).

- A HUD waiver (Sept 99) permitted the use of CDBG funds for homeownership assistance, as long as the assistance is provided directly to the homebuyer. HUD has determined that down payment 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)."
- Special Activities by CBDOs. 24 CFR §570.207(b)(3). Community-based Development Organizations may develop new housing using CDBG funds.

Conversion. Converting an existing nonresidential structure to residential is not generally considered to constitute new construction under the CDBG program and is considered 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. See 24 CFR §570.202.

Lease Purchase. 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 for purchase-only programs. Costs associated with rehabilitation or construction as part of a lease purchase program also are eligible.

7.2.1.2 Meeting a National Objective

Because the use of CDBG funds authorized under this category generally is limited to assisting low- and moderate-income households, any such use of funds would clearly qualify under the national objective of benefit to low- and moderate-income persons-housing activities. See §570.208(a)(3)

Homeownership assistance may also be eligible under the categories of Public Services or Special Activities by CBDOs. While these categories don't have the same restrictions on the type of assistance that may be provided, they do have to comply with the public services cap. However, under these provisions, assistance is not specifically limited by statute to L/M income persons. Therefore, a grantee should carefully consider its objectives against these factors and select the category that best fits those objectives in the context of its entire CDBG program.

7.2.1.3 Neighborhood Revitalization Strategy Area

If the community has an approved Neighborhood Revitalization Strategy (NRS) or Community Revitalization Strategy (CRS) and the grantee plans to provide homeownership assistance pursuant to that strategy, there are two further considerations:

1. If the grantee elects to use a CBDO to deliver services in the strategy area, any services provided by the CDBO (including homeownership assistance) would be exempt from the expenditure cap on Public Services. This would remove the main advantage of qualifying the assistance under the Homeownership Assistance category.
2. If the strategy involves assisting non-L/M income households to purchase houses in the area, CDBG assistance could not be provided under the Homeownership Assistance category (which is limited to assistance provided to L/M income households) unless a CBDO is used for this activity. CDBG funds provided to non L/M income households in a NRS/CRS area may still be considered to meet the L/M Income Benefit national objective because all housing units assisted in such an area may be considered to be part of a single structure for the purpose of meeting the 51%+ occupancy requirement.

7.2.2 The Federal HOME Program

The State of New York has elected to structure its program so that all resources are recaptured in the event the unit is sold during the recapture period.

HOME $$ INVESTED PER UNIT	MINIMUM RECAPTURE PERIOD
<$15,000	5 years
$15,000 - $40,000	10 years
>$40,000	15 years

Eligible Beneficiaries

- Must have a household income that does not exceed 80% of the area median adjusted by family size.
- Must use the property as their principal residence throughout the period of affordability.

Required Property Standards

- All properties must meet Section 8 HQS and local codes, zoning and ordinances at the time of initial occupancy.

Types of Investment

- Interest subsidies

- Down-payment assistance / Equity investments
- Closing-cost assistance

Terms of Assistance

- Below-market or no-interest deferred payment loan with a term equal to the recapture period, secured by a deed of trust naming the State or New York and/or State recipient as beneficiary.
- In the event the property is transferred during the recapture (loan) period, specific procedures must be followed to ensure the appropriate amount of HOME funds is recaptured.

Maximum property value

- The property value may not exceed the FHA 203(b) insuring limit for single-family properties

Minimum and Maximum HOME Investments

- The minimum per unit HOME investment is $1,000. Maximum per unit investments are updated annually by HUD.

Eligible HOME Program Costs

- Acquisition costs, including but not limited to down payment and closing costs;
- Acquisition of vacant land, when HOME funds have been committed for new construction;
- Hard construction costs;
- Rehabilitation costs, when rehabilitation of an acquired property is necessary to meet the required property standards;
- Housing Counseling
- Staff and overhead costs directly related to a project, such as work write-ups, inspections and housing

Eligible Property Types

- The property may be publicly or privately owned, existing or newly constructed, and be one of the following types of residences:
    - Single-family (one-unit structures)
    - Two-to-four unit structures - one unit must be owner-occupied, and remaining units are subject to HOME rental housing affordability requirements.
    - Condominium units
    - Cooperative units

- Manufactured housing, only if the unit:
  - is situated on a permanent foundation;
  - is connected to permanent utility hook-ups;
  - is located on land that is held in fee-simple title, land-trust, or long-term ground lease with a term at least equal to that of the affordability period;
  - meets the construction standards of 24 CFR 3280 if produced after June 15, 1976;
  - meets applicable local and/or state codes if produced prior to June 15, 1976;
  - meets all of the other requirements.

7.3 Estimating Sales Affordability

The market analysis for a project will help determine appropriate sales prices. In addition, there are buyer-based and unit-based factors that will impact not only the sales price but also the amount of public subsidy necessary for both the buyers and the development.

Buyer-based factors reflect the demographic and economic conditions of the potential purchasers of the units. These conditions include household income, access to financing and the terms of available financing, and other costs of ownership including mortgage insurance premiums, homeowner's association dues, taxes and insurance. When public funds are used program income limits and the amount of available subsidies also impact the sales price.

Unit-based factors reflect the cost of development in the market. When public subsidies are used mortgage insuring limits and maximum investment and construction cost limits also impact the sales price.

7.4 The Impact of the Lending Market on Sales

The process of making lending decisions has significantly evolved during recent years. As a result of the historical performance of hundreds of thousands of loans, the lending community is now able to better assess the major risks associated with making a loan to a homebuyer. This knowledge, coupled with improved technologies, has resulted in a more automated and objective underwriting process.

As a local project developer, it is important that you are aware of the basics of mortgage finance as well as the recent trends in the industry. This section will provide you with a foundation of knowledge in these important areas:

- Key Players – The key participants in the housing finance arena and how they work together to operate a highly successful and liquid mortgage system
- Popular Mortgage Products – A description of the most popular types of mortgages currently being originated
- Key Terms – A summary of the key terms necessary to understand how to review a homebuyer's loan application.
- Key Review Criteria – The 4 C's of Mortgage Credit—a discussion of the key criteria that lenders consider when making loan decisions.
- The Underwriting Decision – An up-to-date review of how lenders make lending decisions with a specific emphasis on the use of new technologies.

7.5 Buyer Financing

The key players in the housing finance industry are:

- Private Lenders
- Secondary Market Players
- Mortgage Insurance Industry
- Subsidy Providers

7.5.1 Private Lenders

Private lending institutions are playing an increasingly significant role in financing affordable homeownership initiatives. They are the principal originators of first mortgages and their involvement in affordable lending is critical. The private lending market is influenced by several factors, including the secondary market and the Community Reinvestment Act.

There are a number of reasons why lenders have become more engaged in affordable lending. The primary reasons are that as the industry becomes more competitive, lenders must continually seek new business opportunities. Many of these opportunities are found in serving traditionally underserved populations – minorities, immigrants and lower income families.

In addition, the Community Reinvestment Act (CRA), passed in 1977, requires lenders to serve low- and moderate-income neighborhoods. A lender's CRA performance directly affects its ability to merge with and buy out other banks. Thus, during the era of bank mergers that began in the early 1990s, lenders have stepped up their community lending efforts.

The Community Reinvestment Act was enacted by Congress in 1977 (12 U.S.C. 2901) and is implemented by Regulation BB (12 CFR 228). CRA is intended to encourage certain private lending institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods. CRA requires that each lender's record in helping meet the credit needs of its entire community be evaluated periodically. That record is released to the public and is taken into account in considering an institution's application to open new branches or engage in mergers and/or acquisitions. In 1995, CRA regulations were amended to place a greater emphasis on a lending institution's actual record of performance rather than the process by which the institution achieves that record.

Lenders are evaluated based on actual performance in their communities—loans and investments made as well as services provided. Large banks have a different test than do smaller banks. Lenders are given a rating of either "outstanding," "satisfactory," "needs improvement" or "substantial noncompliance."

CRA has spurred a dramatic increase in private investment in housing and economic development. Much of this investment has occurred in the 1990's, when consolidation and growth of large institutions prompted a wave of CRA-related products and investment. Still, many community-lending advocates argue that CRA reviews by Federal supervisory agencies are cursory and "toothless."

Lenders often sell the mortgages they issue on the secondary market to obtain additional funds to issue more loans. Federally insured loans are generally sold to Ginnie Mae, while conventional mortgages are frequently sold to Freddie Mac, Fannie Mae or other secondary market purchasers.

In order to sell loans to Freddie Mac and Fannie Mae, lenders must comply with underwriting guidelines set forth by these organizations. The good news is that both Freddie and Fannie have made great strides toward flexible underwriting standards, creating technology that greatly expands lenders' options and targeting non-traditional and lower-income borrowers.

In addition to these traditional secondary markets, some larger lenders bundle mortgage loans and sell their own mortgage-backed securities - receiving funds for additional loans much like they would by selling to the secondary market.

Lenders may choose not to sell mortgages on the secondary market. These loans are kept in the lender's portfolio. Some loans are kept in the lender's portfolio for the life of the mortgage. Others are kept for a short while until a payment record has been established, and then sold on the secondary market. These loans are called "seasoned" loans. Portfolio loans give lenders the opportunity to offer consumers some or all of the following benefits:

- Flexible underwriting criteria
- Reduced interest rates
- Reduced or waived fees
- Lower down payment requirements
- Waived mortgage insurance requirements, even with low down payments

7.5.2 The Secondary Market

The term “secondary market” refers to financial institutions that purchase mortgage loans originated by the lenders previously described. Lenders sell their loans on the secondary market to obtain more funds to originate new loans. Secondary market organizations then “bundle” loans and sell them to investors.

After origination, a majority of mortgage loans are immediately sold on the secondary market. Typically, the originating institution does not profit from the long-term interest on the loan. Instead, primary lenders make money on application and origination fees; servicing fees; and premiums paid by the secondary market when the loans are purchased.

There are three major secondary market players: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and, the Government National Mortgage Association (Ginnie Mae). Secondary mortgage market purchasers can also be large banks, life insurance companies and pension funds. Fannie Mae and Freddie Mac purchase the majority of loans sold to the secondary market.

Some key points about these two institutions include:

- Fannie and Freddie bundle the loans and sell mortgage-backed securities to investors.
- The money raised from the sale of mortgage-backed securities enables Fannie and Freddie to purchase more loans.
- Fannie and Freddie set forth criteria that the loans they purchase must meet.
- Most lenders adopt these criteria as their own so that they will be able to sell the loans they originate on the secondary market. (Loans that do not meet secondary market criteria must be held in the lender’s portfolio).
- In recent years, Fannie and Freddie have made their underwriting standards more flexible to make homeownership attainable for more households than ever before. The result has been an unprecedented number of creative new mortgage products and services offered by the private, public and nonprofit sectors.

7.5.3 Mortgage Insurance Industry

Mortgage insurance protects lenders from losses due to borrower default. Since mortgage lenders prefer to make loans with low loan-to-value (LTV) ratios - usually 80% or less, those loans with higher LTVs usually must have some type of mortgage insurance if it is to be sold on the secondary market.

Mortgage insurance allows lenders to issue loans on more flexible terms than they otherwise would. For this reason, homebuyers can secure a mortgage with a down payment as low as 5, 3 or even 0%.

7.5.3.1 Private Mortgage Insurance

Private mortgage insurance amounts to only a fraction of the total housing cost, typically about 7/10 of 1% of the loan amount per year. Borrowers usually pay premiums through their lenders as part of the overall financing of the home. Often the first premium is paid when a mortgage loan closes, and thereafter the premium may be a small part of the monthly mortgage payment.

7.5.3.2 The Federal Housing Administration (FHA)

The Federal Housing Administration (FHA) was established under the National Housing Act of 1934 to help revive and stabilize a housing market devastated by the Great Depression and the breakdown of the American banking system. In 1965, FHA was consolidated into the newly established Department of Housing and Urban Development (HUD). The overall goal of FHA's insurance programs is to help expand homeownership and affordable-housing opportunities for all Americans.

Over the years, two principal objectives have evolved for FHA programs:

- To serve homebuyers who are not adequately served by the private sector
- To be at the forefront in the development of innovative mortgage- financing techniques as needed due to changing market conditions

FHA insures private lenders against loss on mortgages/loans for:

- Single-family homes
- Multifamily projects
- Health facilities
- Property improvements
- Manufactured homes

Unlike private mortgage insurance, FHA insurance covers the full loan amount (100%). The FHA mortgage insurance allows a homebuyer to make a modest down payment and obtain a mortgage for the balance of the purchase price.
FHA's programs are financed from a Public Enterprise Revolving Fund, called the FHA Insurance Fund. The FHA Insurance Fund, supported through premium income, interest on investments, Congressional appropriations and other sources, is comprised of four sub-funds:

- The Mutual Mortgage Insurance (MMI) Fund supports FHA's basic single-family home ownership program—the Section 203(b) program. Historically this fund has been self-sustaining.
- The General Insurance (GI) Funds supports a variety of multifamily and single-family insured loan programs for rental apartments, cooperatives, condominiums,

housing for the elderly, nursing homes, hospitals, property improvement and manufactured housing (Title I) and disaster assistance.

- The Special Risk Insurance (SRI) Fund supports multifamily rental projects and loan to high-risk borrowers. In the past, many of these projects have been eligible for subsidized interest rates.
- The Cooperative Management Housing Insurance (CMHI) Fund supports insurance on market-rate cooperative apartment projects. This fund has historically been self-sustaining and is no longer active, except for refinancing.

7.5.4 Subsidy Providers

Private lenders and the secondary market go a long way toward meeting the mortgage lending needs of American homebuyers. Nonetheless, many individuals and families need additional assistance to purchase a home. Public subsidies can give these potential homeowners the opportunity to realize their dream of homeownership.
There are a number of barriers to homeownership. From the homebuyer's view, these barriers boil down to three basic barriers:
High monthly debt payments
Lack of cash for entry costs (down payment and closing costs)
Poor or nonexistent credit

Public subsidies can be used to address, directly or indirectly, many of these barriers. Typical program design approaches can include:

- Down payment/closing cost assistance
- Gap financing (principal reduction)
- Low-cost second mortgages for acquisition and rehabilitation
- Development assistance for developers
- Loan guarantees and/or credit enhancements
- Interest subsidies

A number of federal agencies and local governments provide public subsidies to finance homeownership. Key entities include:

- U.S. Department of Housing and Urban Development
- Department of Agriculture – Rural Housing Service
- Federal Home Loan Banks
- State and Local Housing Finance Agencies, and
- State and Local Governments

7.6 Common Types of Mortgages

In today's low interest-rate environment, many homebuyers are purchasing their first home. The most popular types of mortgages being originated include the following:

- **Fixed-Rate Mortgages**. A Standard Fixed-Rate Mortgage is generally for 15 to 30 years and is fully amortizing with a fixed interest rate for the entire term. Fixed-rate mortgages are simple to understand and have predictable payments. Because payments do not increase over time, homebuyers do not need to rely on increases in income to make future house payments. Fixed-rate mortgages are ideal for families that plan to live in their homes for a long period of time, or families that like the certainty of a fixed-rate loan.
- **Adjustable Rate Mortgages (ARMs)**. ARMs are generally for 15 to 30 years and have an interest rate that is adjusted periodically to reflect the value of money (interest rates). Three-, five-, seven-, and ten-year fixed-period ARMs can be tailor-made to the homebuyer's needs. An ARM offers a competitive rate plus an initial fixed rate to protect against rapid interest rate increases. Homeowners can enjoy from 3 to 10 years of fixed payments before the initial interest rate changes. Initial rate caps vary by product type, but subsequent annual adjustments are capped at 2%. The typical lifetime cap is 6%. Each product type generally encompasses a convertible and a non-convertible plan; convertible plans offer the option to convert to a fixed-rate mortgage after the initial fixed period.
- **Hybrid ARMs.** A hybrid ARM starts out as a fixed payment mortgage for several years, usually 3 to 10, and then converts to an ARM after that initial term to a full ARM for the remainder of the term. This gives the buyer stability during the early years along with a lower than fixed interest rate. However, there is a chance that the rates will be higher at the end of 7 years when the rate becomes adjustable, and there is adjustment risk for the remainder of the term. The assumption of this arrangement is that many owners move or refinance before the fixed payment term is up.
- **Bi-weekly Mortgages**. Biweekly Mortgages are another type of fixed-rate mortgage. Biweekly mortgages are just like traditional fixed-rate, level-payment, fully-amortized mortgages, except that the borrowers' payments are made every 14 days instead of once a month. Borrowers can qualify for a 30-year monthly payment amount, but get a loan that pays off approximately 22 years at current interest rates; at higher rates, the actual term declines. The borrowers' biweekly payment amount is equal to one-half of the monthly payment for a comparable monthly-pay mortgage. This results in 26, or sometimes 27, payments a year, the equivalent of 13 monthly payments or one extra monthly payment per year. Consequently, the biweekly mortgage will have a true amortization term that is shorter than the amortization term for a monthly-pay mortgage.

However, because housing is so expensive and lenders have become creative in the financing arrangements to make ownership more affordable, there are more than 40 types of mortgage products on the market. Some of the more exotic products including:

- Interest only mortgages;
- Negative amortization mortgages;
- Balloon mortgages (due or required to be refinanced prior to completion of the full amortization period); and
- Options ARMs – these mortgages allow the mortgagor to choose the monthly payment from among a minimum payment (which is really a negative amortization payment), an interest only payment, and a full amortization payment.

Such exotic mortgage products are extremely risky to lower income buyers and should be avoided, as the risks of owing more than a home is worth is much higher as is the risk of adjustments to mortgage payments that are unaffordable during the term.

Most counselors urge first time buyers to stay with fixed rate mortgages or long-term hybrids such as the 7 year or 10-year hybrid that allow the buyer to achieve some stability before facing adjustable terms or refinancing.

7.7 Buyer Underwriting

Before qualifying ratios can be evaluated, certain terminology should be explained. Without an understanding of the components of a mortgage payment and the types of debt and income, ratios cannot be determined.

- **Gross income** is the money you earn before taxes. Gross income also includes overtime, commissions, dividends and any other sources in addition to your regular income. As long as a steady history and documented proof of income can be shown, it can be counted by the lender.
- **Housing expense** includes Principal, Interest, Taxes and Insurance (PITI). If applicable, it also includes such fees as mortgage insurance premiums, homeowner's association fees, condo fees and second-trust principal and interest.
- **Principal** refers to the loan amount or the funds that were borrowed. A portion of each monthly mortgage payment is a principal payment, which reduces the overall outstanding loan balance. If the loan is fully amortizing and principal payments are made throughout the entire term of the mortgage, the loan will eventually be paid off in full at the end of the term.
- **Full amortization** means that both the principal and interest on the loan will be paid off at the end of a fixed period of time.
- **Interest** can be viewed as the cost of borrowing money and, in the early years of a loan, is a major portion of a homebuyer's monthly mortgage payment. The

interest rate charged can have a dramatic effect on the overall monthly payment for a homebuyer. The higher the interest rate, the higher monthly payments will be and the more interest the borrower will pay over the life of the loan. As time goes on, an increasing amount of the payment is for principal reduction. For instance, an $85,000 loan amortized over 30 years at 7.5% will have a constant monthly payment of $594.33 (principal and interest). While the monthly payment remains the same, the amount applied to principal and interest will change each month. At the beginning of the loan term, a much higher percentage of the payment will be applied to the interest payment compared with the amount paid near the end of the loan term for interest.

- The **Annual Percentage Rate (APR)** is the total yearly cost of a mortgage stated as a percentage of the loan amount. It includes the contract interest rate, mortgage insurance, and points. It is a better source of comparison than the interest rate alone.
- **Property Tax and Insurance**. The lender deposits the property tax and insurance portions of the borrower's payment into an escrow account. Mortgage insurance premiums and homeowner's association dues are also sometimes included.
- An **escrow** account is a special account held by the servicing agent used only for payment of taxes and insurance related to a specific property. When the yearly property tax and insurance bills are due, the servicing agent simply deducts the correct amount from the escrow account and pays the bill. Borrowers should carefully review the annual escrow analysis for accuracy. Example: If your property taxes are $600 each year, your lender will set aside approximately 1/12 of the $600 each month ($50) when you make your house payment. This way, as your payments are made, you accumulate enough money in your escrow account to cover the yearly tax bill.
- There are two types of **property insurance**: (1) hazard insurance protects the lender and homeowner in the event of fire or storm, and lenders require this coverage because the home serves as collateral for the debt; and (2) flood insurance is required if the home is located in a 100-year flood plain as determined by the Federal Emergency Management Agency (FEMA).
- **Mortgage insurance (MI)** is insurance designed to protect the lender from losses incurred when borrowers default and have less than 20% in a down payment or secondary financing. Mortgage default data shows that homebuyers who make small down payments, or have less invested, are more likely to default than those who put down at least 20% of the purchase price. Although an additional borrower cost, MI allows the homebuyer to purchase a home with a smaller down payment. The typical cost is approximately $250 to $300 per year for a loan of $50,000. Do not confuse MI with other types of insurance. A type of life insurance that is designed to pay off mortgage loans in the event of the borrower's death is often confused with MI. Once a homebuyer has accumulated equity totaling 20% of the market value of the home, mortgage insurance can be cancelled. In fact, federal law

now requires that mortgage insurance be eliminated, except in high-risk situations, after the loan-to-value ratio reaches 78%.

Lenders often speak of the four "C's" of credit:

- Capacity
- Credit
- Capital
- Collateral

These are explored below.

7.7.1.1 Capacity—Can the Homebuyer Repay the Debt?

Lenders typically apply two qualifying ratios to determine a borrower's ability to repay additional debt. The most restrictive ratio in any given case is used to determine the maximum mortgage amount. All ratios are applied to the borrower's total income. Consequently, the lender will first look at the sources and amounts of regular income available to the borrower.

The Housing Expense to Income Ratio (or "front ratio") is generally expected to be in the 28–33% range. The ratio is calculated by dividing the homebuyer's total housing expenses (PITI) by gross income. (Note: Freddie Mac does not require a "front ratio.")

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%. This ratio is calculated by dividing all housing expenses plus other recurring monthly debt obligations as described below by gross income.

Installment Accounts: Auto payments, furniture payments, and student-loan payments are called "installment" because they have the same payment each month. Often the lender will "discount" these payments or not use them if the number of payments remaining is less than 6-10 months.

Revolving Charge Accounts: Visa, MasterCard, and department store accounts are examples of revolving credit. The minimum payment on these accounts can go up or down depending on the outstanding balance. The lender will typically use the minimum monthly payment on your most recent statement for his calculations.

Other Monthly Payments: Child support payments, childcare expenses, alimony, and wage garnishments are also used by the lender to calculate the amount of your total monthly debt payments.

Exceptions to the Rule: Lenders do not include certain bills (for example, telephone and utility bills, auto and life insurance bills, retirement and savings contributions, and income and Social Security taxes).

7.7.1.2 Credit History—Will the Homebuyer Repay the Debt on Time?

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.

Historically, lenders have evaluated credit history by obtaining Mortgage Residential Credit Reports from national credit bureaus that collect records from businesses and financial institutions and, using a sophisticated computer system, compile records of individuals' credit histories. However, in recent years, the use of credit scores has become the predominant means of evaluating credit.

A **credit score** is a statistical way of predicting how likely it is that a borrower will pay back a loan, such as a mortgage, that might be made to the borrower. The most commonly used credit score today is known as a "FICO" score. The company named Fair, Isaac and Co. developed 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. FICO scores are used in more than 75% of mortgage loan originations and include four components:

- The most important factor the company uses is payment history, which accounts for 35% of the score. A couple of late payments are not an automatic "score-killer." An overall credit history will usually outweigh a few late payments. In looking at a consumer's payment history, Fair, Isaac looks at items such as the presence of adverse public records (bankruptcy, judgments, suits, liens, etc.) and the amount of credit a borrower owes.
- Next, Fair, Isaac looks at the amount of credit a consumer owes, which makes up 30% of the credit score. Having credit accounts and owing money doesn't make someone high-risk; instead owing a great deal of money on many accounts could indicate the person is over-extended and potentially high risk.
- Approximately 15% of the credit score takes into account the length of time credit has been established.
- The remaining 20% looks at whether the consumer is taking on new credit and if they have a "healthy mix" of loans.

The secondary market has found that borrowers with credit scores above 660 are likely to be acceptable credit risks. Underwriters can perform a basic review of these loan files. That means they review the mortgage for consistency and completeness, to confirm the borrower's willingness to repay as agreed.

The credit risk is less certain for borrowers with credit scores between 620 and 660, so it is recommended that underwriters perform a comprehensive review, which involves underwriting all aspects of the borrower's credit history. A borrower with a credit score in this range probably has a marginal credit reputation that should not be layered with other risks.

It is generally recommended that a very thorough review be made of any applicant if his or her credit score falls below 620, which indicates high-risk borrowers with usable credit scores in this range are likely to have poor credit reputation, so a cautious review is in order. If the information in the credit report is inaccurate or incomplete, or if there are less than three trade lines in the credit report, then the credit score may be considered invalid. Comprehensive counseling and credit enhancements may be necessary to assist these borrowers.

Credit scores are widely used today because they speed up the mortgage-approval process for most consumers, allowing mortgage lenders to work with consumers whose credit scores raise questions about their credit records. By using credits scores, mortgage lenders treat each person objectively because the same standards apply to everyone.

Credit scores assess each factor equally for every consumer debt, every time. They do not include race, religion, national origin, gender or marital status as factors. Credit scores are blind to demographic or cultural differences among people.

If there are errors in a homebuyer's credit report, a copy should be requested from each of the Big 3 reporting agencies. If one report is incorrect, there is a good chance that the others are also inaccurate.

The Fair Credit Reporting Act (FCRA) is a consumer protection law that sets up a procedure for correcting mistakes on credit reports. The FCRA says that credit bureaus must complete an investigation into a consumer's inquiry and get an answer back within a "reasonable period of time." In most cases, the answer is forthcoming within 30 days of the initial inquiry. Consumer Rights under the FCRA include:

- To learn the name and address of the consumer reporting agency whose report impaired the homebuyer's application in connection with a credit or job application.
- To discover on request the nature and substance of all information (except medical information that is privacy-protected) a credit agency has on file.
- To know the sources of such information, except investigative sources.
- To get the names of all people who have received reports within the previous six months or within the previous year if the report was furnished for employment reasons.

- To have all incomplete or incorrect information investigated, and if any information cannot be found or is found to be inaccurate, to have that information deleted from your file.
- To have a credit bureau notify all agencies of the credit bureau's mistake, at no cost to the consumer.
- To have the consumer's side of any controversy included in a creditor's report, if difference with that creditor cannot be resolved.
- To have no information sent out that is more than 7 years old (10 years if you have been bankrupt), with two exceptions: There are no time limits if the consumer is applying for insurance over specified limits, or if the consumer is applying for a job with a salary over specified limits.
- If an unresolved dispute exists with a creditor, the credit agency must include the homebuyer's explanation of the situation in future credit reports.

Many first-time homebuyers do not have traditional credit histories. They do not use credit or do not have the type of credit history that would appear on a credit report. In these instances, non-credit payment references, such as rent, utilities or insurance that requires payments at least quarterly may be used. At a minimum, there must be at least four non-credit payment references or a total of four trade lines and non-credit payment references. To be used to establish a minimum payment history, a non-credit payment reference must have existed for 12 months.

When verifying non-credit payment references, sufficient information must be obtained to establish:

- To whom the payments were made
- The nature of the obligations
- When the account was opened
- The amount of the payment required or made
- When payments are due
- A payment history
- Any outstanding balance
- The historical status of the account in a format indicating the number of times and duration of times past due

7.7.1.3 Capital—Does the Homebuyer have Sufficient Cash?

Principal, Interest, Taxes, and Insurance (PITI) and other monthly recurring costs are not the only costs of homeownership. When a buyer purchases a home, he or she must provide a down payment and cover the costs associated with closing a real estate transaction. These costs are often referred to as entry costs.

Most lenders require that the homebuyer contribute some cash up-front toward the purchase price of the home. This requirement ensures that the borrower has a vested financial interest in the property and is therefore less likely to "walk away." Down payments typically range from 3% to 20% of the purchase price of the home.

In the past, lenders required a minimum down payment of 20%. To make homeownership affordable to more people, most lenders now offer mortgages with only a 3% down payment. The down payment may be more or less, depending on the mortgage program used and the amount of cash the buyer has available. The greater the down payment, the greater the equity and the lower the monthly payment required.

There are a number of costs associated with the transfer of the property. These costs 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).
The amount of closing costs varies, but as a general rule, closing costs range from 3% to 6% of the amount of the mortgage. For instance, for a home with a $95,000 mortgage (a $100,000 home with a $5,000, 5% down payment) the closing costs will generally range from $2,850 to $5,700. Common closing costs include:

- Mortgage Origination Fee. This fee covers the administrative costs of processing the loan. It may be expressed as a percentage of the loan (for example, 1% of the mortgage amount).
- Credit Report Fee. This covers the cost of the credit report, which the lender used to determine creditworthiness. Like the appraisal fee, the credit report fee is generally paid when the borrower applies for the mortgage.
- Discount Points. "Points" charged by a lender to adjust the yield on the loan to market conditions. Each point equals 1% of the mortgage amount.
- Attorney or Escrow Agent's Fees. The buyer and /or seller may have attorneys or escrow agents involved during the process. The attorney is sometimes the settlement or closing agent and is responsible for preparing all documentation and organizing the closing.
- Land Survey. Lenders generally require a survey of the property before closing. A survey verifies property boundaries and confirms that the legal description of the property as stated in the sales contract is correct.
- Appraisal Fee. This pays for the appraisal, which the lender uses to determine whether the value of the property is sufficient to secure the loan. The borrower usually pays the appraisal fee when he or she applies for the mortgage.
- Inspection Fees. These are paid to property inspectors. Most borrowers receive a home inspection. Inspections may also be required to detect termites, radon, lead-based paint and other hazards.
- Title Search. A title search is done to ensure that the seller is the legal owner of the property and that he or she is free to sell it. The title search also checks the title records to make sure that there are no liens on the title.

- Title Insurance. Title insurance protects the lender and the homeowner in the event that a title defect is found and another party places a claim against the owner's title.
- Homeowner's Warranty. A homeowner's warranty is an insurance policy covering repair of the major systems during the first year of ownership. A homeowner's warranty is required for a new home and optional for an existing home. Longer-term warranties are available at an additional cost.
- Interest. At closing, borrowers generally have to pay the interest on the mortgage from settlement to the beginning of the period covered by the first monthly payment.
- Escrow Accounts or Reserves. Reserves are required if the lender will be paying property taxes, mortgage insurance and hazard insurance. State and local law and lenders' policies vary.
- Prepaid Insurance. The lender may require the first year's premium or a lump-sum premium on mortgage and hazard insurance at settlement.
- Recording and Transfer Fees. Most states impose a tax on the transfer of property and require payment of a fee for recording purchase documents.

7.7.1.4 Collateral—Will the Lender Have Adequate Security?

While the other factors – capacity, capital and credit – are used to minimize the likelihood of default and eventual foreclosure, the evaluation of collateral is necessary to ensure that the lender can recoup their funds in the event of a foreclosure. The primary concern is that the property the borrower is purchasing serve as sufficient security for the loan.

Homeowners with a higher equity stake in their property are more motivated to retain their home. As such, the risk of foreclosure is reduced. Lenders will require property appraisals to be performed by qualified, certified appraisers to ensure that the value of the property adequately exceeds the loans on the property.

Lenders use the Loan-to-Value (LTV) Ratio to evaluate their risk. The LTV is computed as follows: LTV = Loan Amount / Appraised Value of the Property.

Mortgage insurance is often provided for loans where the LTV is higher than 80%. If mortgage insurance is purchased, the lender will typically permit the homebuyer to have a maximum LTV of 95 to 97%.

7.7.1.5 The Underwriting Decision

Ultimately, the lender will review the 4 C's as discussed earlier in this section to determine if a loan can be made:

- The "Capacity" to repay the debt will be considered by analyzing qualifying ratios.
- The availability of "Capital" (cash) for a down payment and closing costs must also be reviewed.

- The homebuyer's "Credit History" will be reviewed using credit scores and a review of the credit history.
- The lender's "Collateral" will be analyzed by appraising the property and using a loan to value (LTV) ratio.

7.7.1.6 Traditional Underwriting

Once the components of a mortgage application have been analyzed, the lender must determine whether the risks associated with collateral, credit, capital and capacity combine to make an investment-quality mortgage.

Default probabilities will grow if multiple risk factors are present, which is known as layering of risks. Along with analyzing layers of risk, the need to identify strengths that offset those risks further complicates lending decisions. Yet this is the job the human underwriter is expected to perform!

Inevitably, different people make different decisions. The result is an uneven process whereby loan applicants are treated differently from case to case. Some families who are ready to become homebuyers get turned away. Others who are not yet ready for the financial responsibilities of homeownership may obtain mortgages, only to suffer foreclosure.

The cumulative effect of each of these mistakes weighs heaviest on households whose applications fall in the gray area between exceptions and denial.

7.7.1.7 Automated Underwriting

Like traditional underwriting, automated underwriting evaluates mortgage applications on the basis of the 4 C's: collateral, credit reputation, capital and capacity. However, automated underwriting represents a quantum leap forward in the ability to identify sound mortgage loans. Its unique strength lies in the ability to analyze a multitude of factors simultaneously.

Consider, for instance, the need to balance 10 or more elements in a loan application. The possible combinations of these factors alone can number in the thousands. Human underwriters cannot be expected to assess them accurately and consistently from application to application. In contrast, statistically-based automated underwriting systems are designed to handle risk combinations numbering in the millions. By consistently applying uniform standards of creditworthiness, automated underwriting provides the same objective treatment to all borrowers.

Automated underwriting delivers enormous benefits to consumers:

- Lower Costs – Automated underwriting reduces mortgage origination costs related to processing and underwriting, appraisals and lender warranties. As a result, more families are able to buy homes. Many automated underwriting systems can provide a lending decision in as little as four minutes. As a result, lending decisions can be made quickly and closings held within days instead of weeks or months. Today, Freddie Mac's Loan Prospector is lowering costs by $300 to $650 per loan, and the savings can be expected to grow. As these savings are passed through to consumers, they will help reduce one of the greatest obstacles to owning a home: up-front costs.

- Level Playing Field – Automated systems are blind to an applicant's race and ethnicity, promoting fair and consistent mortgage-lending decisions. Dispelling perceptions of unfair treatment and ensuring a level playing field will have a dramatic impact on the number of minority homeowners. Automated underwriting ignores any information that's not directly related to assessing a borrower's likelihood of default. Because of its statistical basis, automated underwriting is an accurate predictor of default, not just overall, but for borrowers across demographic and economic groups. The objectivity and consistency of automated underwriting gives every family applying for a loan a fair shake.
- Expanding Markets – Automated underwriting improves the accuracy of lending decisions, making it easier to serve families that do not fit the traditional borrower profile. Families who were once turned down for mortgages or relegated to the more expensive sub-prime market will be able to qualify for conventional loans.

7.8 Subprime Markets and Predatory Lending

Borrowers have a wide range of needs in terms of lending products. Some borrowers are considered an excellent risk and are considered an *"A" quality investment* while others are more risky and are considered *less than "A" quality.* Others are simply too risky from a lending perspective and are unable to get a loan.

When buying a home, most "A" quality borrowers obtain mortgage loans from the prime lending market. This is the conventional mortgage market, which is generally low-cost and stable, offering market-rate financing.

For borrowers with blemished credit that are considered less than "A" quality (that is, A-minus, B and C), mortgages are often available from the subprime lending market, often at higher cost or less favorable terms than loans available in the conventional prime market. These higher costs or less favorable terms offset the higher risk assumed by subprime lenders.

The readiness of subprime lenders to make higher risk loans can benefit borrowers that are not able to obtain conventional financing. Some borrowers with blemished credit histories turn to the subprime market because they feel they have no other alternative. With correct direction, a significant portion of the borrowers in the subprime market could obtain conventional financing.

To a large degree because of Freddie Mac and Fannie Mae's requirements, the mortgage markets are generally stable and efficient. In addition to reducing the overall level of mortgage costs, disparities that used to exist between different regions of the country have also been reduced. Today, conforming mortgage rates are essentially identical in all regions of the country, across all neighborhoods and across many lenders.

The home-buying process has also benefited from a great degree of standardization. Standard documents, standard disclosures, standard underwriting guidelines, standard protections—consumers in the prime lending market take these for granted, but they did not always exist.

According to the US Department of Housing and Urban Development, by providing loans to borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending can and does serve a critical role in the nation's economy. Through the subprime market, borrowers with blemished credit, insufficient credit history or non-traditional credit sources can buy a new home, improve their existing home or refinance their mortgage to increase their cash on hand.

The subprime market historically focused on refinances and second mortgages. Increasingly, purchase-money and first-lien mortgages are being originated in the subprime market. With a lack of competition, the lenders in the subprime market do not benefit from standardization and lower costs. Consequently, one lender's A-minus product may be another lender's C loan. Fees are high, loans repay quickly and many subprime lenders have experienced serious financial troubles in recent years.

The subprime segment of the market is neither stable nor efficient. Many financial industry leaders believe there is inadequate competition, poor information, almost no standardization and insufficient innovation.

There is also a disproportionate concentration of subprime lending in minority and low-income neighborhoods. During 2001, subprime lending accounted for 9.6% of all lending to low-income borrowers, 7.6% of the lending to moderate-income borrowers and 5.6% to high-income borrowers. Higher cost subprime lending accounted for 14.2 % of the loans to black borrowers compared with only 4.3 % to white borrowers.

In terms of neighborhoods, subprime lending constituted 12.5% of lending in low-income neighborhoods (where households have incomes of 80% or less of the area median) compared with 7.2% in moderate-income neighborhoods (households with 80 to 120% of area median income) and 5.2% in higher-income neighborhoods (households with incomes above 120% of the area median).

When a lender coerces a borrower into taking a loan that they cannot afford or makes a loan with terms (excessive fees and charges or unreasonable terms) that are less favorable than those for which the borrower is qualified, this is known as predatory lending.

While there is no one definition of predatory lending, a report by the Neighborhood Reinvestment Corporation and the Joint Center for Housing Studies of Harvard University considers that "loans become predatory when they:

- Target a particular population
- Take advantage of the borrower's inexperience and lack of information
- Manipulate a borrower into a loan the borrower cannot afford to pay, or
- Defraud the borrower or investor."

Predatory lenders target vulnerable populations. Much of the predatory lending takes place in relation to home-equity financing and targets borrowers that have built equity in their homes that can be used as security for loans. Other vulnerable populations often targeted by predatory lenders include minority, low- and moderate-income and elderly homeowners.

Credit life insurance can be used as an equity-stripping technique, such as when a borrower is given no choice but to finance the whole premium upfront. Since most borrowers cannot cover this expense, the cost is rolled into the loan balance, which increases their indebtedness, decreases equity and increases the risk of default. In some situations, heirs did not file a credit insurance claim because they did not know that their family member had purchased credit life—because the deceased borrower himself did not know he had bought it.

Prepayment penalties are broadly used in subprime lending because the rate of prepayment tends to be very high. Used correctly, prepayment penalty loans offer borrowers a lower rate in exchange for staying in the loan for a given period of time, which can be beneficial for some borrowers. Loan with prepayment penalties can be predatory when:

- Borrowers do not understand the terms of the loan
- Borrowers may not be offered a choice of an alternative product
- Borrowers do not get a lower rate
- Borrowers are locked into loans for extended periods or saddled with excessive prepayment penalties
- Borrowers are caught in a scheme where lenders deliberately "flip and strip" the loan by refinancing the loan and paying the penalty out of the proceeds

Timely, accessible and useful educational information is one of the best weapons with which to combat predatory lending. Public education/awareness campaigns to educate homeowners and homebuyers about inappropriate and/or abusive mortgage lending practices are critical. Outreach initiatives must be designed to educate consumers on the wise use of credit, to make them aware of their financial options and to help them avoid borrowing pitfalls.

7.9 Public Subsidies for Homeownership

Private lenders and the secondary market go a long way toward meeting the mortgage lending needs of American homebuyers. Nonetheless, many individuals and families need additional assistance to purchase a home. This section outlines the primary sources of public subsidies for homeownership and discusses popular approaches to structuring the subsidy, including:

- Principal Reduction Approaches
- Interest Subsidy Approach
- Loan Guarantees

There are many different ways to structure the subsidy. Sometimes local agencies get too "fancy," developing financing schemes that are expensive to administer and difficult to market to potential beneficiaries. The solution is to:

- Keep it simple
- Remain mindful of the local agency's "public purpose," the funding source, your customer's needs and your staff capacity

The financing approaches used by an agency may vary among program activities or even vary on a project-by-project basis. Selecting the appropriate form of subsidy depends on the program purpose, as well as:

- Source(s) of funds
- Client (customer) need
- Staff capacity

7.9.1 Principal Reduction

Principal reduction is a relatively simple form of leveraging, often referred to as "gap" financing. The subsidy provider would make a below-market-rate loan, deferred-payment loan or grant to the borrower to make up the difference between the financing the private lender will provide the borrower and what is needed for home purchase and/or rehabilitation.

If made in the form of a loan, the subsidy provider's mortgage will be subordinate to the first mortgage. Alternatively, the private lender can make one loan and give the subsidy provider "participation" in the one loan, and the subsidy provider would receive a monthly payment in proportion to the amount of the original principal contributed.

Advantages are:

- Simple to administer
- Creates high leverage

- Reduces loan-to-value problems, since the bank loan is for less than full purchase cost or purchase/rehabilitation costs
- Repayment of some or all of the subsidy is possible

Disadvantages are:

- Two liens (loans) are created, one for the lender's first mortgage and one for the government agency deferred loan.
- If borrower defaults on the loans, the government agency is second in line to recoup its loan.

There are many variations on repayment options under this approach, including:

- Grants
- Deferred payment and forgivable loans
- Equity sharing
- Amortizing below-market-rate loans

7.9.1.1 Grants

Grants are provided with no requirement or expectation of repayment. Thus, no liens are placed on the property or other household assets. The exception is "recoverable grants", which essentially are deferred forgivable loans. Grants are most commonly used for down payment/closing cost assistance or for rehabilitation costs in support of very low-income households.

Advantages are:

- Simple to administer (no credit reports, loan processing, etc.)
- Easy to explain (market) to recipients
- Often necessary for very low-income recipients

Disadvantages are:

- Expensive method of providing assistance
- No repayment is possible
- May create expectation of additional free assistance in future

7.9.1.2 Deferred Payment Loans

A deferred payment loan (DPL) typically means that all payments of principal and interest are deferred until some point into the future (e.g., resale of the property). DPLs, also referred to as soft seconds, provide no return on investment and are not amortized (i.e., repaid monthly). DPLs are provided with the property or some other collateral used as security for repayment. DPLs are being increasingly used to leverage private first mortgage financing in homeownership and rental housing projects.

While regular periodic installment payments are always deferred, DPLs can come in many variations. In fact, that is one of the attractive features of a deferred-payment loan. DPLs can accrue interest or be non-interest bearing, be paid back in full or be forgiven.
If the DPL is to be repaid, this could occur at sale or transfer of the property or at the end of a fixed period of time (e.g., the term of the first mortgage—to avoid a balloon payment).

If the DPL is to be forgiven, the forgiveness might be structured to occur at one point in time (e.g., end of 15 years of owning and maintaining the property) or forgiven incrementally each month or year over a period of time (e.g., reduce outstanding balance 1/120th each month for 10 years).

Advantages are:

- Simple to administer (no credit reports, very minimal processing)
- Easy to explain (market) to recipients
- Helpful for very low-income recipients (because no monthly payments required)
- A very flexible form of subsidy, which still allows for repayment at some future date
- Can help prevent windfall gains to recipient

Disadvantages are:

- Though repayment is possible in the future, no payments are received on a monthly basis
- If the property has low value, a DPL may not be a secure investment for the local government

7.9.1.3 Equity Sharing

Equity sharing allows the subsidy provider to get some repayment of its subsidy by sharing in the appreciation of house values with the homeowner. The conditions of the equity share as outlined in the loan documents are generally a percentage of the total appreciation recognized on resale. An equity share is more flexible and forgiving than accrued interest. Moreover, equity sharing can work in most types of markets. For example:

- In rising markets - Equity sharing allows the agency to invest in the community and share in any future market appreciation. If significant appreciation occurs, the return to the agency could be much greater than what charging interest would have yielded.
- In uncertain or declining markets – In this type of market, an equity share does not penalize the borrower. For example, a 20% equity share in a stagnant market means that no proceeds are due to the affordable housing provider. To charge mandatory

interest that accrues during the term of the deferred payment loan creates several significant problems. The homeowner's debt continues to rise as interest accrues, even though the property values are declining or stagnant. The secondary market will be reluctant to purchase mortgage loans where second mortgages include interest that accrues until the property is sold. A more appropriate approach in uncertain or declining markets is to charge zero interest and to establish an equity sharing arrangement. Accruing interest creates a disincentive to the borrower to maintain that the property or to continue payments of mortgage debt, since the borrower has negative equity in the property. Even when provisions for forgiveness of the accrued interest are incorporated, the interest provision becomes counterproductive.

7.9.1.4 Below Market Interest Rate (BMIR) Loan

A below-market-rate (BMR) loan is a loan with an attractive interest rate that requires repayment on a regular periodic basis—usually monthly—so that over a fixed period the entire principal (and interest, where applicable) is repaid. This type of loan is provided with the property or some other assets used as collateral.

Amortizing below-market-rate loans may be non-interest bearing (zero percent) or accrue interest at any rate that can be supported by the recipient. Often very low interest rates are charged (i.e., one to three percent) in order to make monthly payments more affordable. The terms can also be varied. For home purchase, a term of up to 30 years is common. For rehabilitation, typically a 10-to 15-year term is the longest that makes sense.

Advantages are:

- Provides immediate repayment to government agency
- Allows government agency to act as "banker"

Disadvantages are:

- More time consuming and staff-intensive to process loan requests
- Requires underwriting expertise
- Loans must be serviced after origination
- Compared to DPLs and grants, BMRs are an inefficient form of leverage

7.9.2 Interest Subsidies

A prepaid interest subsidy is a payment of cash to a lender in exchange for a lower interest rate. It is sometimes called an "interest buy-down" or "interest write-down." The subsidy covers the difference between the market rate and the buy-down rate.

There are several variations to this approach. Generally, the subsidy provider makes a payment at closing equal to the present value of the interest write-down over the term of the loan. This approach can be structured in such a way that if the bank loan is paid off early (i.e. before the end of the loan term), the subsidy provider would 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.

The subsidy to the lender is typically structured as a grant, but repayment could also be required when the property is sold (such as in a deferred payment principal reduction loan) or through an equity-sharing provision (also described above in relation to principal reduction loans). The grant to the lender achieves basically the same result as a zero-percent deferred-payment loan (used in the Principal Reduction Approach) but without the repayment potential. The level of subsidy will vary depending on the interest rate that the lender will charge, the loan term and the actual effective interest rate to the borrower that is sought.

Advantages are:

- Creates only one loan for ease of administration
- Easy to market and explain to borrowers
- Generates a high leverage

Disadvantages are:

- Banks must agree to make or "book" the "low-interest" loan (which is something hard to explain later to bank examiners).
- May have loan-to-value problems since the one mortgage loan is for total purchase financing needs (particularly where rehabilitation is involved).
- Tracking the loans and ensuring a refund upon prepayment can be difficult. Mistakes can be made.

7.9.3 Loan Guarantee

A loan guarantee is a credit enhancement or loan-loss reserve that is used to repay all or part of the loan if the borrower defaults. Loan guarantees are an inducement for private lenders to make affordable housing loans because they serve to lower the risk associated with the origination.

A loan guarantee is an adaptable tool that can increase lender flexibility (underwriting) or cover specific risks. The amount of the loan guarantee as a percentage of the loan amount may vary from loan to loan, or program to program. Another variation is that the loan guarantee may be held for a specified period of time, or reduced by a specific amount over time.

Advantages are:

- Results in high leverage and increased lender flexibility
- Facilitates greater productivity
- Simple to administer
- Guarantee funds often can earn interest for the Agency
- A well-conceived guarantee results in no loss of subsidy dollars

Potential disadvantages to the loan guarantee approach include:

- Poorly conceived or implemented loan guarantees can be expensive
- Can tie up funds for long periods of time
- Not a subsidy to the borrower since neither the amount of the financing nor the interest rate is reduced.

7.10 Foreclosure Prevention & Intervention

It may seem premature to worry about foreclosure prevention and intervention at the design stage. Yet foreclosures are a serious concern because:

- The assisted family may lose its equity, sweat equity and credit rating in a foreclosure, and be even further behind than when they became a homeowner.
- There is a potential loss of both the affordable unit and the public funds in the event of a foreclosure.
- If HOME funds are used under the "repayment" option, the HOME funds must be repaid in the event of foreclosure – whether or not the funds are recovered in the foreclosure.
- Each foreclosure is estimated to have a .9% impact on neighboring housing prices, so there is a neighborhood impact that reaches beyond the family, the house and the public subsidies.

To reduce the chances of loss in foreclosure, the following things should be considered while designing a homebuyer program:

- Underwriting for sustainability – To maximize the chances of assisted homebuyers avoiding future foreclosures, take into account the following during the underwriting:
    - Energy efficiency: Utilities affect affordability, and uncontrolled increases can impact the ability to pay the mortgage. Consider energy efficiency improvements in rehabilitation, and consider Energy Star and green building in the construction of new units.

  - Improvements: Homebuyers will have limited ability to pay for major repairs and improvements in the first several years after purchase, so plan to provide an adequate level of improvements so that the useful life of the structure and major systems will exceed the minimum affordability period if possible.
  - Pricing: Although program limits often permit pricing that serves the highest end of the low income range (at or near 80% of AMI), it will reduce foreclosure risk if pricing stays well below market prices and even program price limits (just be sure to structure legal documents for windfall profits recovery against early sales.)
  - Lending: A range of mortgage products exist today (even with a reduction of the subprime products in recent months.) Don't permit borrowers to utilize exotic or risky loan products that have teaser rates, balloon payments and other terms that might make the mortgage unaffordable. Where possible, require fixed mortgages or longer-term hybrid mortgages.
  - Marketing: As the market slows and inventory builds, be realistic about sales time for affordable units, and make certain the development budget has adequate funding for interim financing until closing.
  - Counseling: To remind buyers that assistance is available when they are getting into trouble, plan to provide post-purchase counseling, as discussed below.
  - Resale/recapture: Make sure that any resale or recapture mechanisms work in both up and down markets, and do not become an obstacle to resale.
  - Discount to Market & Market Monitoring: Because markets are cyclical, and market units are re-priced to reflect changing market conditions, developers of affordable housing need to track the market and adjust pricing to remain competitive in changing markets. At the underwriting stage, the extent of the "discount to market" is critical to evaluating the ability to remain competitive in changing markets.
- Loan servicing/monitoring – Many homebuyer assistance programs do not have a loan servicing procedures because subsidy loans are often deferred and due on sale, so there is no ongoing amortization or processing of payments. However, programs need to monitor the health of first mortgages and be ready to act on notice of delinquency or default.
- Resubordination policy – Resubordination is process of permitting an assisted owner to refinance the first mortgage or other mortgage senior to the public assistance. Refinancing has been so widespread that assisted owners assume that they have the right to refinance and access equity. It is essential that programs have a policy in place to ensure due disclosure and fair treatment as owners seek to refinance. Key decisions in the resubordination policy include:
  - Will you allow refinancing for better loan terms with no equity takeout?

  - Will you allow refinancing for equity takeout, and for what circumstances: Home improvements? Economic emergency (e.g., job loss) Medical emergencies? Education? Other debt consolidation? Foreclosure prevention?
  - If resubordination is permitted, what LTV/TLTV limits and other standards apply to the new loans?
  - Will you allow prepayment of the subsidy loan in the event resubordination policies do not accommodate the needs of the owner, and whether there are any prepayment prohibitions, whether prepayment counseling is required, and whether any use or resale restrictions will remain in place?
- Post-Purchase Counseling – Post-purchase counseling is not common, but is becoming more of a necessity. Post-purchase counseling is a relationship…not just an event. Buyers need to be reminded of the availability of the agency to assist in the event of financial trouble and mortgage default. Recent studies show a large number of delinquent buyers didn't think to contact counseling agencies – at all or until it was too late. Keep the relationship open through constant communication and reminders.
- Foreclosure Intervention – Program administrators should have a strategy for foreclosure intervention in the event that an assisted homebuyer can no longer maintain ownership. Program designs and legal documents should reflect the rights needed to intervene, including repurchase rights. Intervention strategies may include a designated interim buyer (e.g., a nonprofit or authority), funding for repurchase and repairs, and a pipeline of buyers ready to purchase. If HOME funds are used, the HOME rule permits additional investment to acquire, repair and resell properties to new eligible buyers, either through additional project dollars (subject to the maximum subsidy limits on a cumulative basis, or through administrative funds (committed or borrowed). Additional HOME funds may not be advanced to prevent foreclosure by assisting the existing owner.

7.11 Glossary of Mortgage Lending Terms

Adjustable Rate Mortgage (ARM) – A loan with an interest rate that fluctuates during the term based on a specified financial index.

Alt-A or A-minus mortgages – Two descriptions of loans that are below A-prime loans but above subprime loans. A-minus mortgages are for borrowers with a less than perfect credit history (below A level credit, but above B level) and/or questionable capacity. Alt-A is a way lenders have of grading or categorizing a loan that cannot meet all of the standards of an A class loan. For example, low-doc or no-doc mortgages are Alt-A. The two definitions have morphed together somewhat. In common usage, Alt-A has also come to mean loans with other "transgressions" such as not meeting standard underwriting guidelines for property type, debt ratio or loan-to-value ratio, as well as documentation requirements. Borrowers in this category will pay slightly higher interest rates and may have somewhat more stringent qualification criteria.

Balloon mortgage – A mortgage loan that requires the remaining principal balance be paid at a specific point in time. For example, a loan may be amortized as if it would be paid over a thirty year period, but requires that at the end of the tenth year the entire remaining balance must be paid. At that time, the owner will generally sell the property or refinance into a new mortgage.

Balloon Payment – A lump sum installment payment of a promissory note that is much larger than the regular installment payments.

Collateral – Assets pledged by a borrower to secure a loan or other credit, and subject to seizure in the event of default. Also called security. In a home loan, the property is the collateral. The borrower risks losing title to the property if the loan is not repaid according to the terms of the mortgage or deed of trust.

Conforming loans - Conventional loans may be conforming and non-conforming. Conforming loans have terms and conditions that follow the guidelines set forth by Fannie Mae and Freddie Mac, and are currently limited to $417,000 for a single family home.

Conventional loan – Any mortgage loan other than a government loan (e.g., FHA, VA, RD).

Cure – With respect to delinquent mortgage payments, all missed payments have been made and loan payments are current.

Deed-in-Lieu of Foreclosure (DIL or DILOF) – A process whereby an owner voluntarily conveys the title of the property to the mortgagee/beneficiary (lender) to avoid the negative credit consequences of a foreclosure. The title must be free and clear of any other encumbrances and the owners execute an affidavit acknowledging that they are acting volitionally, with informed consent.

Default – The failure to make loan payments in full and on time as agreed in the promissory note. The common usage of this term is when a mortgage is 60 - 120 days delinquent, and the lender can initiate foreclosure proceedings against the loan under the terms of the promissory note and mortgage. Lenders generally must record a notice of default to begin the foreclosure process.

Delinquency – Failure to make mortgage payments when mortgage payments are due. For most mortgages, payments are due on the first day of the month, and any late payment means the loan in delinquent. However, the more general use of this term is for mortgages that are more than 30 days delinquent. Then, most lenders report the late payment to one or more credit bureaus.

Federal Housing Administration (FHA) -- An agency of the U.S. Department of Housing and Urban Development (HUD), whose main activity is the insuring of residential mortgage loans made by private lenders.

Fixed-Rate Mortgage (FRM) – A mortgage in which the interest rate does not change during the entire term of the loan.

Flipper – An investor who purchases homes with the intention of fixing them up and selling them quickly for a profit when housing prices are appreciating.

Forbearance – A course of action in which a lender may agree to delay foreclosure or legal action against a delinquent borrower to give the borrower an opportunity to cure the delinquency. The lender may permit the temporary cessation of payments (principal and/or interest), allow an extension of time for making payments, or accept smaller payments than were previously scheduled. During forbearance, interest will accrue and it must be paid or it will be added to the loan principal, increasing the total amount of loan borrowed and the amount of interest that a borrower will pay.

Foreclosure – The legal proceeding by which a lender sells or takes ownership of a property on which the mortgagor has defaulted. The foreclosure procedure brings the rights of all parties to a conclusion and passes the title in the mortgaged property to either the holder of the mortgage or a third party who may purchase the realty at the foreclosure sale, free of all encumbrances affecting the property subsequent to the mortgage.

Foreclosure Filing – The start of the foreclosure process when the lender files the necessary legal documents to begin the foreclosure proceedings.

High Cost Loan – As defined by the HOME Mortgage Disclosure Act (HMDA) data, any loan with an interest rate more than 3% above the Treasury Bill rate. When using HMDA data for analysis, this becomes a surrogate for subprime loans.

Hybrid loans – Loans that combine elements of fixed and ARM loans. The most common is a loan that provides a fixed loan payment for several years, and then becomes an adjustable loan. A one-time adjustment is often referred to as a Two-Step Mortgage. Other versions start as ARMs and are convertible to fixed loans.

Interest Only Mortgage (I/O) – Loans that offer an interest-only payment or payment option, usually for a fixed period (three, five, seven or ten years). At the end of that period your loan becomes fully amortizing, thus resulting in greatly increased monthly payments.

Jumbo loans - Loans that are above the maximum loan amount established by Fannie Mae and Freddie Mac (currently $417,000 for single family) are known as 'jumbo' loans. Because jumbo loans are bought and sold on a much smaller scale, and cannot be purchased by Fannie Mae and Freddie Mac, they often have a little higher interest rate than conforming, but the spread between the two varies with the economy.

Loan-To-Value (LTV) – The ratio or percentage of the dollar amount of the loan to the estimated value of the property.

Loan Modification – Any change of the terms of the loan agreement by consent of the borrower and lender

Mortgage – A pledge of property that is put up as security for the repayment of a loan. The lender is the mortgagee and the property owner is the mortgagor. Some states, like New York, do not record mortgages. Instead, they record a deed of trust which is essentially the same thing.

Mortgage Payment – The regular installments (usually monthly) made towards paying back the principal and interest on a mortgage.

Negative amortization – Some types of loans offer payments below the amount required to pay the interest due on a loan. Others offer payment caps rather than interest rate caps, which limit the amount that monthly payments can increase, even if interest rate adjustments would require a higher payment amount. Any unpaid interest is added to the loan balance, so the loan balance increases.

No-doc/low-doc loan – A mortgage loan that requires less than full documentation of income, employment, and assets, usually within the Alt-A category of loans. The borrower still has to fill out an application, a credit report is pulled on the borrower, and an appraisal is done, but much of the documentation is reduced or eliminated. Also euphemistically referred to as a "liar loan." Types include: stated income loans (documentation of income not required), stated asset loans, no ratio loans, no income/no asset loans (also referred to as NINA loans), and no doc loans. These loans may have higher credit requirements, downpayments and interest rates to address the risk.

Option ARM – A loan that that doesn't require a set payment each month. Generally, borrowers have up to four payment options to choose from each month: (1) a minimum payment (which usually results in negative amortization), (2) interest-only payment, (3) 30-year amortized payment, or (4) 15-year amortized payment.

Promissory Note – A legally binding contract between a lender and a borrower. The promissory note contains the terms and conditions of the loan, including how and when the loan must be repaid.

RD or RHS loan – Rural Development, formerly referred to as the Rural Housing Service (RHS), of the U.S. Dept. of Agriculture guarantees loans for rural residents with minimal closing costs and no downpayment.

Real Estate Owned (REO) -- Real estate owned by a lender, usually as the result of a foreclosure or deed in lieu of a foreclosure.

Refinance -- The process of paying off one loan with the proceeds from a new loan using the same property as security.

Short sale – A sale of a house in which the proceeds fall short of what the owner owes on the mortgage. The lender agrees to accept the proceeds of a short sale and forgive the rest of what is owed on the mortgage. By accepting a short sale, the lender avoids a lengthy and costly foreclosure.

Subprime loan – A mortgage loan that is made to an individual with poor or bad credit. These loans do not meet the borrower credit requirements of Fannie Mae and Freddie Mac, and are also called 'B', 'C' and 'D' paper loans (vs. 'A' paper conforming loans.) Historically, such loans have been offered to borrowers that may have recently filed for bankruptcy, foreclosure, have had late payments on their credit reports, or don't have an established credit history. However, these loans have been used more broadly in recent years as more buyers have been unable to fit within traditional lending standards due to high prices. The interest rates and programs vary, based upon many factors of the borrower's financial situation and credit history.

VA loans – The U.S. Department of Veterans Affairs does not make loans, but guarantees loans made by lenders. The guaranty allows veterans and service persons to obtain home loans with favorable loan terms, usually without a down payment.

8. Underwriting & Financing Affordable Rental Housing

This overview is intended to help nonprofit developers understand the lending decisions that will be made regarding their project proposals. The better you understand how a public agency reviews your application, the more likely you will be able to create a project and application that qualifies for funding.

The financial and technical review of rental housing project proposals is also called "underwriting" or "risk assessment." In this guide, the terms are used interchangeably.

This chapter is on rental underwriting. Homebuyer underwriting issues are addressed in Chapter 7.

8.1 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 decision. The important contribution of the underwriting analysis to the funding decision is the identification of terms and conditions that can improve the project or make it an acceptable investment.

From the lender's perspective, <u>underwriting is the practice of assessing and minimizing the risks associated with a project</u> 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.

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. This requires a calculation of the "gap" between the equity and loan sources

available and the total amount of development costs. When more than one public source of funds is provided to a HOME-assisted project, a "layering analysis" is required by HOME regulations, which considers all public subsidies in combination. However, even when a layering analysis is not required, the jurisdiction's underwriting considers 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.

8.2 Market Analysis

Whether or not a market study has been conducted, the market risks must be evaluated. The site must be reviewed to determine the following:

- ***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-impacted 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. In fact, HOME Program regulations discourage the siting of new rental housing in such circumstances. Look more broadly at the market and opportunities to promote a diverse mix of housing opportunities throughout the market. If the applicant is committed to revitalization of a low-income area, then focus on mixed-income strategies.

- ***The site and surrounding environment must be suitable and compatible for the proposed development size and type*.**

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

- ***When evaluating the reasonableness of acquisition cost, 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.

  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 overrun 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, consider the location and site. The market study may indicate quite a bit about which site is the most appropriate and feasible for development.

8.2.1 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 content of market analysis or market studies was discussed in Chapter 1.

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:

- ***Don't do 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.
- ***Don't just leave 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.

Lenders are sensitive to proposals that do not appear to be supported by market analysis or appear to have not followed the information provided in a market study. At the same time, they are sensitive to market studies that appear to not be truly independent and appear to have been generated purely for purposes of supporting an application.

8.2.1.1 What Do Lenders 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

8.2.1.2 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 document the number of low and moderate-income households without providing for further targeting don't provide useful information 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 must be extremely focused. Special needs service providers may have a 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, as described in Chapter 2.

Make sure that your market analysis or study clearly defines the market area, the eligible/affordable income range of the buyer pool, and the demographic segments that comprise your pool.

8.2.1.3 Affordable Rental Housing Supply Analysis

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 any of the following circumstances?
    - 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
    - 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.

8.2.1.4 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:

Assisted housing:

- 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 location 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?

Private housing:

- 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.

8.2.1.5 Market Study Conclusions

In the final analysis, lenders interpret a market to exist 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 *capture rate* 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 *absorption rate*, 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 will occur.

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.

8.2.2 Property Value Analysis

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.

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

4. **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.

5. **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.)

6. **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, so the potential 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 will be. 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.

8.3 Financial Analysis

Financial analysis includes the review of the development and operating budgets to make a determination of how much public financing is needed to make the project feasible and viable.

8.3.1 Cost Principles

The OMB Circular A-87 (now in 2 CFR Part 225) addresses how costs should be analyzed, essentially noting the following key principles:

- Eligibility (or allocability) – the cost is one that is considered eligible under applicable funding program statutes and rules.
- Reasonableness – the estimated or proposed cost is within the range of costs in comparable projects, or based upon independent estimates.
- Necessary – the cost is essential to the project, and would have to be incurred to complete the project.
- Documentable – the costs can be documented.

These principles guide the review of costs in budget analysis below.

8.3.2 Development Budget Analysis

One of the key underwriting activities is the analysis of 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, equipment purchase, deposits and other expenditures needed to start up operations

8.3.2.1 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" refer to 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 skills of architects in doing reliable cost estimating vary dramatically, so you should be sure to check out the experience of your 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 Fee. The developer 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.

8.3.2.2 Sources of Development Funds

Generally, it is assumed that rental projects will first seek conventional financing or tax credit equity, and then seek the public sources of financing to fill the gap.

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[4], 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 are likely to require pro rata advances. Pro-ration 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.

8.3.2.3 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?

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4 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.

- ***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?

8.3.2.4 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.

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

- Narrowly, it can establish how much net operating income (NOI) the project will have available to make payments of principal and interest (debt service), and
- More broadly, it can 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 will estimate the first 10 years of operation. However, when a developer uses the Low-Income Housing Tax Credit (LIHC), for example, the pro forma reflects the first 15 years of operation, as this is the minimum term of the LIHC 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.

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, as well as the need for a Rent-Up Reserve or Initial Operating Deficit in the development budget;
- 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.

Operating Revenue Items include:

- **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, but rather 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, other than 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.

Operating Expense Items include:

- **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 onsite management staff costs are budgeted separately. Other times, it is set at a certain amount per unit per month. Generally, management fees range in the $25 – 40 per unit per month range.

  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 and operation may be included in the budget. 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.

Operating expense analysis is also critical to public lending. Key items in the analysis of revenues and expenses include:

- **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.

Underwriters typical compute a number of ratios or other calculations as part of the expense analysis, including the following "metrics":

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.

8.3.3 The Ten-Year Operating Pro Forma

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.

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 LIHC 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 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 judgment 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, 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.

8.3.4 Special 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.

8.3.4.1 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 some public 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.

8.3.4.2 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.[5]

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.

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[5] 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.

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.

8.3.4.3 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.

8.3.4.4 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.

8.3.4.5 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.

8.4 Regulatory Compliance Analysis

The project risk analysis of the development and operating budgets presented above depends upon the source of the gap money being known. The source of the gap money will bring with it a set of statutory and regulatory requirements. The question that must be answered is: can the project meet the regulatory requirements and still remain feasible and viable? 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. Some of the CDBG and/or HOME regulatory issues are:

- ***Environmental issues*** – Will the project pass the environmental review thresholds imposed by Federal regulations?[6]
- ***Property 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.

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[6] 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.

- ***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.[7] 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 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.[8] The long-term operating and replacement reserves, if capitalized, must come from equity or other debt sources.

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[7] Participating jurisdictions are subject to 24 CFR Part 85 requirements. Where non-profits are acting as subrecipients, the requirements of Part 84 apply. Developers are not subject to these rules, so procurement requirements for developers must established by the funding jurisdiction.

[8] 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.

8.4.1 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 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.

8.4.2 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 for Assisted 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*
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 <u>not</u> 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 are utilized for the same activity. In such cases both sets of rules apply to the project. The activities must be eligible under CDBG and the national objectives. The project must also meet all of the HOME rules.

HOME and CDBG are not incompatible, but in some cases the rules are different. For example, Davis Bacon applies to CDBG housing at 8 or more total units in a project, while it is triggered at 12 or more HOME-assisted units in the project, not total units. Therefore, the more restrictive CDBG rule would require Davis Bacon to apply when there are 8 or more total units in the project.

8.4.3 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 is 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, regulatory differences and the classification of HOME as Federal funds discourage developers from combining the two. 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:

1. <u>Market rate loan</u> – 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).

2. <u>Below market rate loan with 9% credit</u> – 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'.

3. <u>Below market rate loan with 4% credit</u> – 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.

4. <u>Grant</u> – 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).

8.4.4 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.

8.5 Determining the Amount of Subsidy

8.5.1 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.

8.5.2 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:

- 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?

- 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)?

- 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?

- 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 the only gap 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.

8.6 Underwriting Conclusions & Recommendations

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:

- What are the risks associated with the project in each of the categories, and are those risks within (or beyond) an acceptable range?
- What changes to the project will mitigate the risks and bring them within acceptable ranges?
- 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 (including MSHDA) 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 referred to.)

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 cast 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.

8.7 Glossary of Rental Underwriting & Financing Terms

"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, and 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 (known by the acronym LIHC) 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.

9. Construction Management

This chapter addresses some of the requirements for developers to be successful during the construction period, particularly in the defining of the scope of work and the hiring and oversight of the general contractor. Some of the key terms used in this chapter are defined below.

CONSTRUCTION/REHABILITATION MANAGEMENT TERMS

COMMONLY-USED TERMS:	***WHAT THEY MEAN:***
Deficiency or inspection report	A list of the deficiencies to be corrected in order for a property to achieve the standards set by the program.
Scope of work	A prioritized list of work items to be corrected based upon the Inspection Report.
Property standard or rehabilitation standard	Local, State or Federal standards or codes, such as the Section 8 HQS, or New York State Property Maintenance Code (see http://ecodes.iccsafe.org/iccf/gateway.dll?f=templates&fn=default.htm&vid=icc:ny). Used to assess the conditions of buildings and define what is required.
Program standard	Used to define what is eligible, and what is ineligible to be corrected in a specific rehabilitation program.
Technical specification ("Tech Spec" or "Spec" or Performance Standard)	A description of technical details concerning the quality, workmanship, durability, capacity and other characteristics of the rehabilitation work and materials. Often included by reference into work write-ups and contracts.
Work write-up, sometimes called the "Spec"	A specific description of what is to be done to the property by the contractor with detailed specifications of materials, quantities, and methods.
Cost estimating system	A local database that uses current information on the costs of both labor and materials (including overhead and profit) for work to be done based upon local prices and customary charges.

9.1 Applicable Codes & Property Standards

Many public funding programs have program standards that determine the quality and level of improvements that can be financed, including:

- Property condition or improvements
- Current occupancy & relocation
- Environmental review

All properties being assisted with HOME must meet the following standards:

- At a minimum, Section 8 Housing Quality Standards upon completion of assistance;
- Local housing codes that go beyond HQS, if more stringent apply; and
- **Newly constructed properties** receiving HOME assistance must meet the Model Energy Code. [9]

Housing Standards include rehabilitation standards, housing quality standards, livability standards, building codes and occupancy or housing codes all set forth standards for the condition of the properties to which they apply. They provide a guide for rehabilitation or construction of decent, safe and sanitary housing. They describe the desired end products of construction, and are used in housing programs to identify needed repairs and appropriate improvements. The HUD Section 8 Housing Quality Standards, the ICBO Uniform Housing Code, and the BOCA National Property Maintenance Code are examples of these types of codes.

Building Codes provide technical specifications, performance standards, and materials and methods standards for installation for each work item. In New York, the NY Residential Code applies (see http://ecodes.iccsafe.org/iccf/gateway.dll/NYRC2007_free?fn=document-frame.htm$f=templates$3.0). Be sure to investigate local requirements as they may require additional architectural work and associated costs that may affect program design.

In addition to the basic property standards, there are requirements for environmental hazards in the property:

- **Lead-based paint requirements:** All pre-1978 properties assisted with CDBG or HOME funds must comply with 24 CFR 35, the regulations implementing the Lead-Based Paint Poisoning Prevention Act. New rules took effect in 2000 that expanded the requirements of testing and treatment to all federally assisted rehabilitation. Developers should keep in mind the following:

[9] The Model Energy Code (MEC), published and maintained by the International Code Council (ICC) as the "International Energy Conservation Code" (IECC) as of 1998, contains energy efficiency criteria for new residential and commercial buildings. The MEC was first published in 1983, with subsequent full editions published in 1986, 1989, 1992, 1993, and 1995. The 1998 IECC is the successor to the 1995 MEC. The Energy Conservation Construction Code of NYS is base on and more stringent than the International Energy Conservation Code.

- Occupants (purchasers and tenants) of pre-1978 housing must be notified of the hazards of lead-based paint. The Environmental Protection Agency issued a brochure in 1995 entitled "Protect Your Family from Lead in Your Home" that should be used.
- Provisions must be included in all contracts for sale, management or rental to assure notification of all prospective tenants and purchasers.
- Contractors must use lead-safe work practices when abating or treating lead surfaces.

- **Asbestos requirements**: Licensed rehabilitation contractors, electricians, mechanical contractors, and residential building contractors are exempt from asbestos abatement licensing requirements when the asbestos they are removing is <u>incidental to their primary licensed trade and the project involves no more than 160 square feet or 260 linear feet of friable asbestos-containing materials.</u> For asbestos removal of a project larger than described in the preceding paragraph, prior notification to the state and licensing may required. Fines for the noncompliance with these regulations are up to $10,000 for each violation or each day that the violation continues. All contractors and electricians still must be trained to use the asbestos-safe work practices, governed by the OSHA asbestos standards, when they are performing asbestos abatement work.

What is a **Program Standard**? Program standards define what is eligible for treatment with funds from a certain program. For example, CDBG and HOME program standards would allow their funds to be used to treat a broader number of property deficiencies than DOE's Weatherization program would allow.

Program Standard v. Rehabilitation Standard

Sidewalks and Driveways

<u>Program Standard:</u>

Reconstruction of sidewalks and driveways is allowed only on private property and only if the existing conditions are a clear and imminent safety hazard. (Taken from a grantee's procedural manual.)

<u>Rehabilitation Standard:</u>

Sidewalks, driveways and similar areas shall be maintained free from hazardous conditions. (BOCA Property Maintenance Standard, 1993; PM 303.3)

Why are these Standards important?

- Participants need to know what is and what is not allowed.

- Participants need to be treated consistently and fairly.
- Contractors need broad definitions of what the limits are.
- Program staff need to set funding limits that are realistic.

What are **Technical Specifications**? (a.k.a. "Performance Standards" or "Specs")
Performance specifications describe the technical details concerning:

- **Quantity** - e.g., Replace Basement Stairs: Stairs shall be made with three (3) foot stringers, nominal 2" x 10" treads and open risers. Minimum width of treads shall be 2 feet. Stringers shall be securely fastened to open framing and rest on nominal 2" bottom bearing secured to basement floor. Rise shall not exceed 7 ½" and run shall not be less than 10" except as noted in UBC.
- **Capacity** - e.g., Install Gas Heating System: Furnish and install new properly sized natural gas/propane forced air heating system that is 81% AFUE (energy efficiency rating) minimum. Unit to be of proper size and output to meet heating code requirements. Install warm air runs to every room in living space with cold air returns of adequate size to meet heating code requirements. Install warm supply and return for basement. Install dampening grilles on all warm air outlets. Damper and balance heat runs. Include all necessary piping, controls, thermostats, wiring, connections and valves for a complete job to include removal of existing heating unit and abandoning excess gas piping. Specify size and brand name. Install per manufacturer's recommendations. Instruct owner on operation and leave all warranty and operation manuals. Dispose of old unit off-site.
- **Quality** - e.g., Install Combination Windows: Provide and install solid core combination wood, vinyl covered or aluminum-covered windows on existing openings. Units to be inside removable, two track and self-storing by Radford, Winterseal, Solar Seal or equal. Owner's choice of style and color. Triple track for porch enclosure.
- **Durability** - e.g., Floors - Linoleum: Installation shall include 1/4" AC fir plywood underlayment stapled in place. Install new Armstrong Sundial no wax linoleum or equal as per manufacturers' specifications. Material costs not to exceed $25.00 per yard. Style and color selection by owner. Installation shall include new vinyl or rubber base and all necessary metal accessories.
- **Other characteristics of the rehabilitation work** - e.g., Painting or Varnishing Interior Trim: Prime, paint or stain and varnish all new wood. New items shall have one coat primer or sealer and one coat enamel or one coat stain and one coat varnish. In door openings where only a new door and hardware are installed, contractor shall prime and enamel or stain and varnish door after fitting. Balance of the opening shall not be finished by the contractor unless specified in write-up. Material to be completely free of all lead and/or lead compounds.

What is the likely scope of improvements in rehabilitation? Generally, the improvements that are included within the scope of rehabilitation address the following:

- Substantially protect or improve the property to Section 8 Housing Quality Standards (HQS), local codes, or improve energy efficiency.
- Correct overcrowded conditions necessary to meet codes or HQS. This could include the addition of a living room, kitchen area with adequate storage and preparation space or a bedroom for every two persons. (The number of bedrooms in a unit should not require persons of the opposite sex other than husband and wife to occupy the same bedroom. Exceptions to this include infants and very young children.)
- Correct other livability conditions necessary to meet codes or HQS. For example, HQS requires that every home have a working oven, stove (or range) with top burners that work and a refrigerator with working freezer, adequate in size for the household. Therefore, funds may be used to purchase or repair these appliances. They need not be permanently affixed or built-in.
- Make other improvements that are considered typical for housing of modest means, are necessary to accommodate the household or make the unit competitive in the marketplace, and are not considered luxury items or of a quality above that normally required.

9.2 Occupied Properties and Relocation

The Uniform Relocation Act (URA) applies to the acquisition and rehabilitation of all real estate with Federal funds, including purchases made by an individual homebuyer or nonprofit organization. Purchases of property assisted with CDBG or HOME are subject to the Uniform Relocation Act. Low-income occupants may also be eligible for protections under Section 104(d) of the Housing and Community Development Act of 1974.

If federal funds are used toward the purchase of a residential property, any legal occupants displaced potentially are eligible for the protections, notices and benefits afforded by URA. However, when property is sold on a **voluntary basis**, the seller is ineligible for relocation benefits as a "displaced person," and the negotiations surrounding the sale are not covered by the acquisition requirements of the URA.

Therefore, while HOME and CDBG funds may be used to pay relocation costs, under most circumstances the local developer should purchase or fund the purchase only of ***vacant or owner-occupied properties***. For owner-occupants, developers must ensure that the proper notices are given as described below. If there are tenants in the property, consult with your funders before proceeding with any negotiations or commitments on the property.

With respect to owner-occupants, a "voluntary sale" is one in which:

- The purchaser does not have the power of eminent domain; or

- The purchaser (e.g., city of county) might have the power of eminent domain, but does not intend to acquire the property through condemnation.

What must a program developer do at this point in the process? (See the "Notification to Seller" and the "Occupancy/Vacancy Certification" forms that follow.)

- Inform the seller in writing that the purchase is assisted with federal funds.
- If the buyer has the power of eminent domain, inform the seller in writing that the buyer will not use its power of eminent domain to acquire the property if negotiations fail to result in a mutually-agreeable settlement. Buyers without eminent domain powers must state that this is a voluntary sale and that no eminent domain will be used.

The fair market value of the property must be revealed to the seller prior to entering into a sales contract, but if a lower sales price is negotiated, the buyer is not required to pay the full market value.

Both low income and non-low income tenants are covered by the Uniform Relocation Act, and involuntary displacement can occur due to increases in rent. Before proceeding with an occupied property, survey the tenants to determine if they are interested in remaining and what level of assistance might be required. Use this information to estimate a relocation budget. Mandatory notices must be sent to in-place tenants when the application is submitted and to any tenants moving in before project completion. Once the application has been approved, a Notice of Non-Displacement, tailored to the situation, must be sent.

Keep in mind that the recipient, rather than the owner, is responsible for making certain that the notice provisions are observed. The recipient should make certain that notice has been given to tenants upon application by the owner for financing.

Be aware that the State generally does not permit permanent displacement of tenants. This means that:

- Property owners must offer tenants who currently occupy units the opportunity to remain in the project after rehabilitation at an "affordable" rent.
- Tenants do not necessarily have to be offered the same unit they live in, but the offered unit must be suitable to the family's needs and size.
- "Affordable" rent means either: no rent increase from their current rent, or a rent increase that does not exceed 30% of their gross monthly income.
- Tenants can be temporarily relocated during the rehabilitation process, but either the owner or the program must pay their increased out-of-pocket expenses that result from the temporary move. This would include: moving expenses, utility hook-ups, a rent differential payment if the temporary rent is higher, and other costs that are reasonable and necessary.

- Owners may evict tenants who violate the lease, but they must follow Michigan's tenant-landlord laws in processing the eviction.

Since HOME funds cannot be used to rehabilitate units that will not be occupied by income-eligible tenants, developers should be careful about what units are designated "HOME-assisted." ***Tip:*** *Use the owner's contributed funds to rehab units that will be occupied by over-income families and designate the units that will be occupied by income-eligible families as "HOME-assisted" units.*

Low-income tenants must benefit from the rehabilitated units in order to support the federal requirements of CDBG and HOME. Whoever interviews in-place and incoming tenants must be familiar with the Section 8 definition of income and document files with sufficient information to document compliance. After-rehab rents must be within Section 8 Fair Market Rents (FMRs) in order to meet the CDBG National Objective and within HUD's High or Low HOME rents to be in compliance with program requirements. Therefore, developers must be aware of area FMRs and HOME rents for the area.

Refer to HUD Handbook 1378 and www.hud.gov/relocation/ for more information on the subject.

9.3 Environmental Review

Environmental regulations apply to any unit assisted with Federal funds. Under most circumstances, the activities for the local programs contemplated in this guide are categorically excluded from NEPA environmental assessments, but are still subject to environmental reviews at two stages in process: when the overall project area is being defined, and then when a specific property is identified for assistance. The state can provide assistance at both points to assure compliance with all applicable requirements.

After the program release of funds request is approved, a local program developer must review each property selected for the program for environmental considerations. For most local programs, environmental review requirements for individual properties will be limited. As a result of the changes to 24 CFR Part 58, the following activities are categorically excluded and consequently require only a non-NEPA checklist to be completed:

- single-family acquisition, rehabilitation, new construction (see 58.35(a)(7)
- multi-family rehabilitation (if no change in density or use & rehab cost less than 75% of new construction cost -- see 58.35(a)(4))

The following activities are categorically excluded and require <u>no</u> non-NEPA checklist (see 58.35(c)):

- tenant-based rental assistance
- homebuyer assistance for acquisition only of existing housing

All other activities require an environmental assessment under Part 58, plus a review of the non-NEPA requirements under 58.5 and 58.6.

Even if your activities are exempt or categorically excluded, you must maintain an **Environmental Review Record** containing all relevant documentation.

The non-NEPA checklist triggers a full review if a property is:

- located within designated coastal barriers;
- listed on, or eligible for, the National Register for Historic Places;
- located within a special flood hazard area;
- located near hazardous industrial operations (handling fuels or explosive/flammable chemicals);
- contaminated by toxic or radioactive materials; or
- located within airport clear and military accident potential zones.

Developers should incorporate these threshold criteria into screening of properties to avoid selecting any properties that are at risk of incurring substantial delays and/or mitigation costs. If an eligible property meets one or more of the threshold criteria and requires a full review and mitigating measures, consider the cost of the mitigating measures and the time required to complete, especially if these raise the cost of the property above the program limits and affordability standards. Where the time and cost impacts are significant, the recipient may wish to substitute other eligible properties.

The most time-consuming procedure is obtaining a determination by the State Historic Preservation Officer (SHPO) that the property is not a historic property under relevant threshold criteria. SHPO should be asked for a determination for an entire neighborhood, if possible, so that separate determinations are not required on each property. Also, efforts by the recipient to develop a working relationship with the SHPO to ensure timely receipt of SHPO determinations are encouraged. Funders will provide technical assistance to developers working with historically-significant properties.

Properties may be located in a floodplain or a protected area. State and Federal agencies have requirements about the use of public funds in these areas, and will assist developers in complying with these regulations.

9.4 Procurement

Procurement standards and procedures are necessary:

- **Maximize competition** – To the maximum extent practical, rehabilitation contracts must be awarded in an “open and free” competition.

- **Ensure project costs are reasonable** – In order to ensure "cost reasonableness" open competition should be maximized and all construction work must be within a reasonable range of an independent cost estimate.
- **Eliminate conflicts of interest** – No conflict of interest may exist between the entity performing the rehabilitation work and the development of work write-ups and cost estimates, the approval of progress and final draw requests, and the party responsible for dispute resolution
- **Select contractors that are responsive and responsible –** Ensure that contractors submitting bids are qualified to complete the work specified in their proposals, and are properly licensed and insured; and verify that contractors' proposals address all of the scope in sufficient detail so that the property will meet the program's housing standards upon completion

9.4.1 Conflict of Interest

Potential and actual conflicts of interest can arise from two events or circumstances:

- occupying a HOME-assisted affordable housing unit; and
- obtaining a financial interest or benefit from any contract, subcontract or agreement with respect to a HOME-assisted activity, or the proceeds there under, during their tenure or for one year thereafter.

Conflicts of interest occur when covered parties (see below) have:

- ***access to inside information*** with regard to the award of a contract or unit assistance; and/or
- ***undue influence*** on the policy or process by which a contract or unit occupancy is awarded.

Covered parties included officers, employees, agents or consultants of the jurisdiction, recipient or developer, including community housing development organization (CHDO) and their immediate family members or persons with whom they have business ties.

All potential and actual conflicts must be disclosed to your public funders in advance in writing, with the following information:

- full factual disclosure of the situation that gives rise to the potential conflict of interest, including the nature of the person's role and the financial benefit;
- the procedures that the recipient will establish to ensure that a fair process will be conducted with no inside information or undue influence to the party in question; and
- The basis for granting the exception under 92.356(e), if HOME funds are used.

It is HUD's intent to use these standards to enable related parties to continue to have access to the benefits of the HOME Program as they might otherwise be eligible, while ensuring that they do not gain an unfair advantage in gaining access to the benefits.

9.4.2 Procurement Methods

There are two primary ways in which contractors may be selected for particular construction and rehabilitation projects:

- Program staff selects the contractor (using a formal bidding process)
- Owner selects the contractor with program staff guidance (generally using a negotiated proposal process.)

9.4.2.1 Formal bidding - Program controls the selection of contractor(s)

Program staff publish an invitation for bids in a local newspaper that identifies the address of the property; where and when bid documents can be obtained; and the date, time and place for submission of the bid. After the bid opening, program staff meet with the property owner to make the final selection of a contractor. The owner is normally required to accept the lowest responsible bid unless he or she wishes to pay out of pocket the difference between the lowest bid and the bid of choice. Issue an Invitation for Bids (IFB) in a local newspaper that identifies:

- Address of the property,
- Where and when bid documents can be obtained, and
- The date, time and place for submission of the bid.

Make sure to issue the IFB early enough so that contractors have adequate time (perhaps 2 to 3 weeks) to prepare bids in response. Provide interested contractors with a package of informational materials that provides guidance specifying how, where, and when to submit bids. Evaluate proposals and select a contractor.

9.4.2.2 Competitive proposals - Developer selects contractor(s)

Program staff may provide the owner/developer with a list of approved contractors. With a deficiency list and rehabilitation specification manual or a detailed work write-up in hand, the owner requests that two or more contractors prepare a bid and proposal addressing the required work. The owner and program staff review the proposals for completeness, adequacy and reasonableness of cost. If the owner receives more than one acceptable proposal, staff may advise the owner on how to select the one that best meets the owner's needs. Typical procedures are as follows:

- The funding agency staff member may provide a package that is designed to assist the owner in obtaining an acceptable proposal from the contractor. Depending on the program, program staff may help the owner extensively during this process.

- Owner solicits proposals with the assistance of program staff. Typically, the owner must solicit at least two, and preferably three, proposals in order to obtain the best possible price for the work to be done.
- Contractors should be required to submit proposals to the owner within 10 working days of receiving the package and owners should complete the proposal solicitation process with 30 days.
- Review of proposal by owner and program staff. Owner should review the proposals and identify his or her first choice of contractor.
- The proposal is then reviewed and approved by the funding agency staff. Proposals/Bids must be reviewed and confirmed that:
    - The proposed price is within 10% of an initial cost estimate
    - All required work items have been identified in the proposal
    - The contractor has the required licenses, bonding and insurance
    - The proposed approach to the construction complies with the applicable rehabilitation standards, specifications and building codes

The competitive proposal process has several advantages over competitive bidding for most development of affordable housing by non-public agencies.

- It requires less staff time and therefore lower expenditures of program funds.
- It usually expands the number and range of contractors participating in local programs since the selection and review process is very similar to purely private transactions,
- Most importantly, it permits the owner to get involved in the process and to take responsibility for the choice of contractor. An involved owner is more likely to make sure that he or she can establish a decent rapport with the contractor that will help to minimize disputes. Should the owner become dissatisfied, he or she will be unable to point a finger at program staff and say "You made me accept this contractor. This is your problem, so fix it!"

9.4.2.3 Using In-House Construction Crews - "A Last Resort".

As a result of regulatory and policy concerns, public funders generally will not allow local agencies to use their own work crews for projects except as a **"last resort."** Individual projects will be reviewed on a **case-by-case basis** only after every reasonable attempt has been made to procure the services through an "open and free" competition. At a minimum, public funders consider answers to the following questions:

- **Why was a competitive bid/proposal process unsuccessful?** - A detailed description and evidence of the measures taken to secure bids/proposals
    - outreach methods used (e.g. advertisements, mailings, etc.)
    - timeframe of solicitations
    - number of contractors directly contacted

  - other outreach methods used

- **How will conflicts of interest be eliminated?** - A description of how independent third-party(ies) will be used to perform progress and final draw inspections, and resolve disputes between the homeowner, contractors, and/or local agency

9.4.3 Contractor Requirements & Marketing

The following outlines general policies and suggestions for recruiting and selecting contractors.

- **Contractor Solicitation.** Developers must solicit enough contractors to ensure a competitive environment, and especially must encourage female and minority contractor involvement. Minimum advertising or outreach may be required. Special affirmative outreach efforts may include mailings, telephone contacts, etc. A list of all contractors solicited (names and addresses) must be maintained in records by developers.
- **Licensing.** All contractors should be licensed by the State. Residential builders are licensed to build a house from the ground up and can do almost all type of repair, except for electrical, mechanical or plumbing work. Maintenance and alterations contractors can be licensed to do up to fourteen separate building activities. Electrical, mechanical, (heating and air conditioning) and plumbing contractors are also licensed. The developer should require a copy of the current license for all contractors who do work or bid for work financed with CDBG or HOME funds.
- **Contractor References.** Developers are encouraged to take additional steps to assure that each contractor does quality work by checking three references from local residents or businesses that have used the contractor recently. Also, check with the local Chamber of Commerce or licensing agent or Better Business Bureau to see if any complaints have been filed against the contractor.

9.4.3.1 Marketing to Contractors

The purpose of any marketing and outreach is to identify good contractors. You can do this through advertisements in newspapers or a reputation search. A "Contractor Application" process that enables your agency to identify those likely to bid so you can identify a pool of interested contractors and check references before bidding occurs. You can also initiate a reputation search through a variety of means:

- *Building Permits*: A review of your area's building permits issued over the past six months will give you an idea of the dollar amounts of rehab work going on in neighborhoods similar to the one in which your program operates and the types of repairs undertaken.
- *Local Trade Associations:* Local home builders' associations, home improvement councils, plumbers' councils, electrician's councils, etc., can provide information

concerning the number of their members involved in rehab work. This would indicate the demand for these contractors' services.

- *Neighborhood Residents:* Neighborhood residents are often a good source of information regarding the type of contractors working in the area and the general availability of qualified contractors.
- *Local lumber yards:* Local suppliers are often a good source and know who is active in the community.

If contractors are in short supply or your local market is overheated, outreach techniques must be more aggressive.

Providing Information to Potential Contractors. Once a preliminary list of contractors has been established, you will need to contact individual contractors to determine their level of interest and to check each firm's credentials. Most contractors will want to know the following information:

- how the program is funded
- how (and how frequently) contractor pay-outs are made
- amount of work available in the contractors' specialized field
- location of work
- program requirements
- contractor selection procedures

Outreach to Minority and Women-Owned Businesses. Public funders will provide developers with copies of the MBE/WBE directories or procedures to encourage the use of qualified minority and women-owned enterprises in connection with the local program. Developers are encouraged to provide information to MBE/WBE regarding contract opportunities and procurement procedures through solicitations, meetings, and seminars, and must keep records of efforts to reach MBE/WBE contractors.

9.4.3.2 Pre-qualifying Contractors.

When implementing any construction program, it is important to identify and attract qualified contractors who are interested in participating in affordable housing programs. The time to undertake this investigation and outreach is before you actually need to select a contractor for a particular project.

Collecting this information early permits the local agency to develop a list of potential bidders for their construction projects. Having a list of pre-qualified contractors hastens the process of soliciting and selecting a contractor for a particular project and helps to ensure that the contractor is well qualified. Typically, the list of pre-qualified contractors includes a contractor profile which, at a minimum, contains information on the status of the contractor's business, the contractor's business references, client references, suppliers, subcontractors, insurance and licensing status.

Depending upon the nature of the local agency's procurement process, it may either use the bidder's list for a request for proposals (RFP) or may share this information with owners who will select their own contractors.

9.5 Construction Management

Developers are responsible for making certain that the scope of work is properly implemented by the general contractor.

THREE KEYS TO GOOD CONSTRUCTION MANAGEMENT

1. Careful education of owners/developers and contractors who understand and "buy in" to what is expected of each other and the developer;

2. Complete plans, specifications or scope of work and a well-written construction contract; and

3. Developer and funder inspectors that keep on top of projects throughout construction with effective internal controls.

Construction Contract. Developers are still responsible for construction management and meeting program goals: both of which are critical to the success of the program.

Contracts should state the roles and responsibilities of all parties. A good contract will include:

- a construction schedule
- contract price
- provisions for inspections
- provisions for payments to the contractor for work completed
- provisions for a holdback of funds
- change order procedures
- procedures for resolving disputes
- references to any work which will be performed under warranty and the terms and conditions of such warranties
- all essential construction documents, such as the work write-up and technical specifications

- If federally funded, rehabilitation contracts should also include the provisions addressed in 24 CFR 85.36(I), such as termination for cause and convenience and, if applicable, compliance with Davis-Bacon requirements and Section 3 requirements in their rehabilitation contracts.

Pre-Construction Conferences. While not required in all cases, experienced developers routinely hold them for everyone. The following recommendations are based upon the "war stories" from the veterans of rehab programs in the past.

- If possible, hold the pre-construction conference on the project site. It allows a walk-through to go over the Work Write-up or Building Specification item by item and discuss what is to be done - and not done - with everyone involved present.
- Have a written agenda so you remember to cover all relevant information.
- Take notes and keep them in the project file. Like insurance, they'll be there if you need them.
- Discuss the owner and funder roles in monitoring progress and the contractor's obligation to let Rehab staff know when an inspection is appropriate.
- Review the fact that if work items are not on the approved work write-up, they will not be paid for with program funds. Cover the change order process. Discourage "side deals."
- Remind everyone that questions of interpretation of the work write-up are to be taken to the Rehab Specialist, and the owner is not supposed to try and interpret.
- Discuss payment requests and leave a supply of forms with the contractor.
- Discuss how disputes should be resolved: first, between the owner and contractor and then, only as a fall back, bring the Rehab staff into the conflict.
- Cover the closeout procedures - what each of the documents will be and what they mean.
- Finally, review the work schedule so all understand when work is expected to begin, how it will proceed, and when it is expected to be completed.
- The sample Pre-construction Conference Report is used by some programs to document who attended and what was covered.

Proceed Order. The contractor should not begin work on the project without a clear understanding or what items are to be corrected, how payment is to be made, and the role of the owner and the rehab staff. The date of the Proceed Order is an important date to be tracked so inspections can be scheduled at critical times.

Interim Inspections. Inspections also need to be conducted at every point in the contract when payment is requested by the contractor. The inspection must be done by someone qualified to make judgments about the quantity and quality of work completed.

• Tips from Veteran Inspectors •

Create a separate "field file" that staff uses during on-site inspections. It should contain a copy of the necessary documents - including the Work Write-up and the Owner-Contractor Contract - so disputes can be resolved and work can be accurately evaluated.

Staff should keep all active "field files" with them when they are out of the office. It is very time consuming to have to trek back to an office if a call comes in for an unexpected inspection.

Staff should make their notes as soon as they get back in their vehicle. It is amazing how quickly cases can blur together if staff counts on remembering what they saw and said on the site.

During the initial inspection the staff "read the client." Now they should plan the number and timing of interim inspections based upon that reading. There are essentially three factors to consider in deciding how often to inspect:

- The complexity of the job
- The capability of the owner
- The knowledge and experience of the contractor

There is more than one acceptable way to document inspections. Some use the actual specifications and note and initial each item as it is inspected. Some agencies use a Field Inspection Report as another way to document what the inspector found and it can serve as a "punch list" if items need to be corrected before completion.

Progress Payments. Certain documents that must support that draw on the account. Progress payments should only be made for completed work that has been inspected.

- Payment Request form signed by the Contractor, Owner and inspector working on the case;
- Lien waivers or sworn construction statements from the Contractor for the work covered by the payment request to protect the owner (and the rehab agency) from liability from suppliers and subcontractors who may have a dispute with the contractor.
- A Completion Certificate signed by the parties involved: the contractor, owner and staff person that documents the payments to date and the balance on the contract.

Change Orders. Nobody likes them. Experienced developers do everything possible to write the Scope of Work so they are unlikely to happen, but when a call comes from an owner or contractor, you need to have a policy to deal with them.

Some programs only allow them if unforeseen events occur: e.g., a wall collapsed, wood that appeared to be sound was actually rotten, materials became unavailable due to events beyond any reasonable person's control. Contractor error in estimating the project or doing the work is not typically allowed as a change order in increasing the cost of the job.

You should have a process that provides for:

- Review each Change Order so they are not perceived as "routine" by contractors;
- Required agreement by all parties in writing; and
- Adjustment of other records that are affected by the Change Orders, such as contract and repayment agreements or mortgages, as needed.

9.6 Recordkeeping

File maintenance is essential to documenting that the local program or project is meeting public loan program rules and statutory requirements. It is important that local developers maintain program and individual unit files so that funders can efficiently monitor for compliance.

Federal requirements are stated in the regulations. Recordkeeping requirements for HOME Program developers are outlined in 92.508(a)(2) - (3) and (a)(5) - (7). Recordkeeping requirements for CDBG Program developers are outlined in 570.506. Generally, all files should be maintained for at least five years, on a rolling basis for rental projects that have longer compliance periods.

General program files should include documentation of:

- Environmental Review Record
- Rehab Standards (if rehab is involved)
- Recipient Selection Procedures, including affirmative marketing
- Procurement Procedures
- Commitment Agreement with Property Owner(s)
- Program Income documentation
- Fair Housing complaints & resolution

Individual property files should be assembled for each individual project, unit or beneficiary that contains documentation (as applicable) for:

- Eligible property (ownership, value)

- Eligible homeowner/buyer (income, principal residence) or tenants (income)
- Procurement/contractor selection
- Contract supervision (incl. completion) & Inspections
- Project budget, financial records, disbursements
- Compliance documents (including resale restrictions (note/mortgage, etc.)

Disbursement records should be maintained for monitoring and audit purposes. Evidence that disbursements were made within 15 days of receipt of HOME funds is critical.

10. Marketing & Occupant Selection

Affordable housing projects need to be marketed. You want to reach your targeted audience in as efficient manner as possible, follow the marketing and occupancy requirements of your public funding program, make the application and selection process as painless as possible for all involved, and present the project in a positive light to the community.

If you are using Federal funds such as HOME or CDBG a series of five guides have been issued by the HUD HOME Program reviewing the requirements and limitations in fair housing, entitled Fair Housing for HOME Participants. These can be downloaded from the HOME Program web site.

Keep in mind that fair housing does not come into play just with regard to marketing and selection. It also applies to decisions that are made in:

- Project and site selection;
- Project design (for accessibility); and
- Overall program or project administration.

10.1 Fair Housing Non-Discrimination Requirements

All real estate professionals and property owners, regardless of whether or not the units are state or federally assisted, must ensure that they do not discriminate against possible tenants or buyers on the basis of race, color, religion, sex, disability, familial status, or national origin. Unlawful discriminatory actions include:

- Discrimination in the sale or rental of a dwelling;
- Discrimination in the terms and use of housing;
- Discriminatory conduct by members of the real estate industry;
- Discriminatory advertising; and
- Discrimination in residential real estate-related transactions.

With regard to the sale or rental of housing, discrimination in the sale or rental of a dwelling includes any refusal to sell or rent a dwelling based on the fact that the applicant is a member of a protected class. This includes:

- Refusing to negotiate for the sale or rental of a unit;
- Failing to accept or consider an offer;
- Refusing to sell or rent a unit;
- Failing to process an offer for sale/rental of a unit;

- Imposing different sales or rental prices;
- Using different qualification procedures or criteria; and
- Evicting or using different eviction criteria.

For operators of rental housing, discrimination in the provision of services or facilities in connection with the rental includes:

- Using different lease provisions or terms of agreement of sale, such as security deposits, down payment requirements, or closing requirements;
- Failing or delaying maintenance or repairs;
- Limiting use of privileges, services, or facilities; and
- Denying or limiting services in connection with sale or rental of a unit because a person failed to provide sexual favors.

In addition, developers and property owners are expected to do the following with regard to general advertising and selection:

- The Equal Opportunity logo or "EHO" must be displayed in the office and any advertisements for the project.
- The property owner must make available copies of the HUD publication, Fair Housing - It's Your Right.
- The owner must keep records of all applicants for vacant units.
- The owner must keep track of tenants' race, ethnicity, gender, income, family size, and rent and all new occupancies and vacancies.

10.1.1 Non-discrimination with Respect to Disabilities

Under the Fair Housing Act it is unlawful for a housing provider to inquire about:

- If an applicant for a dwelling has a disability or if a person intending to reside in a dwelling or anyone associated with an applicant or a resident has a disability, or
- The nature or severity of a disability of such persons.

Housing providers may make the following inquiries, provided these inquiries are made of all applicants, regardless of whether the applicant appears to have a disability or says he or she has a disability:

- An inquiry into an applicant's ability to meet the requirements of tenancy;
- An inquiry to determine if an applicant is a current, illegal drug abuser;
- An inquiry to determine if an applicant qualifies for a dwelling legally available only to persons with a disability or persons with a particular type of disability;
- An inquiry to determine if an applicant qualifies for housing that is legally available on a priority basis to persons with disabilities or to persons with a

particular disability. For example, a HOME housing provider may ask applicants if they need units with accessible features.

10.2 Affirmative Marketing

Federally-funded housing is subject to equal opportunity policies and protections. Affirmative marketing requirements are passed on to property owners when they have projects with five or more CDBG or HOME-assisted units.

While marketing is about getting the message out to all potential customers, affirmative marketing is about getting the word out to those "least likely to apply." From a HUD regulatory perspective, affirmative marketing focuses on the protected racial classes, and requires outreach specifically to those classes that are underrepresented in the immediate area of the proposed project. However, affirmative marketing efforts also can be extended beyond racial classes to other demographic groups that are underserved and unlikely to apply. Project developers can meet these requirements through the following activities:

- Examine the racial and ethnic composition of tenants living in the area of the assisted project and compare that to the racial and ethnic composition of the jurisdiction as a whole. (This information may be provided by the funding jurisdiction.) This is used to determine if all groups are fairly represented in the population in the project area, or if any groups are under-represented and therefore considered the "least likely to apply."
- Develop a tenant marketing & selection plan that includes steps to affirmatively market vacancies in buildings with five or more units rehabilitated or developed with CDBG or HOME funds.
- Maintain copies of advertisements and a list of contact dates with special outreach agencies to document good faith efforts to affirmatively market vacant units in compliance with the requirements.
- Cooperate with funding/monitoring agencies as they monitor your good faith efforts to comply with approved plans.

10.2.1 What should the affirmative marketing plan include?

An affirmative marketing plan should address the following:

- Methods for informing the general public about the availability of CDBG and HOME funds. At a minimum, this means placing an advertisement in a newspaper of general circulation **and** a publication reaching those persons least likely to apply.
- All advertising must contain the HUD-approved Equal Opportunity logo **and** slogan. All display advertising must contain the EO logo in a prominent position with the advertisement in letter size equal to or greater than the smallest letters in the ad.

- Additional outreach to organizations that service disabled persons should be made when a barrier-free unit(s) is part of the project.
- A summary of the plan must be available at the developer's office.

10.2.2 Suggestions for Special Marketing Efforts to Minorities

Some affirmative marketing suggestions are listed below:

- Advertise in, and send press releases to, minority newspapers and minority-focused radio stations.
- Advertise in projects for fund-raising events (i.e., charity dances or dinners) of minority organizations.
- Contact minority churches to see about placing announcements on bulletin boards or in newsletters.
- Post and leave brochures or flyers in community centers in minority neighborhoods.
- Post and leave brochures or flyers in adult education institutions with large minority enrollments -- especially trade or vocational education schools and community colleges.
- Post and leave brochures or flyers in government offices, libraries and recreation facilities located in minority neighborhoods, as well as in City Hall, the county office building, etc.
- Translate flyers, other announcements, and advertisements into minority languages. This is particularly advisable for projects aimed at neighborhoods with substantial numbers of foreign-language speaking residents.
- Identify active minority community groups and tap into their networks. Teach community leaders about the project. Their "buy in" will lend credibility to your project.

10.2.3 Affirmative Marketing for Special Needs Housing

Federal housing funds can be invested in a project(s) that serves targeted populations, in order to meet the special housing needs of certain groups of residents, such as persons with disabilities, large families, the elderly, farm workers, or participants in self-sufficiency programs. However, the jurisdiction must specifically articulate its plans to develop special needs housing in its Consolidated Plan in order to address a gap in benefits and services to those persons. However, access to this housing and/or assistance may not be denied on the basis of race, color, religion, gender, national origin, familial status, or age.

The assisted units in a special needs project must be affirmatively marketed to all persons with the special need. For housing that is developed for persons with disabilities, the housing must be marketed to all individuals with disabilities and cannot be restricted to persons with specific types of diagnoses or subclasses of persons with disabilities. Advertisements for this type of housing must clearly state that the housing is open to any person with a disability; however, the advertisement can identify the specific services that are to be provided to residents. Further, a good faith effort must be made to inform and solicit applications from all members of the special needs group throughout the market area.

10.3 Guidance on Developing a Marketing Strategy

So how do you attract the right applicants? Develop a marketing strategy that gets your message to the target audience in a variety of methods. Consider the following advice.

- **The role of press releases** – No doubt there has been a press release about the success of your application, and that generated some calls from the most alert and the most desperate. But the press release probably isn't enough to attract all the people that your project was designed to serve. Consider press releases to follow up that first success at critical steps in the process: when you sign the contract, when you line up lending partners, when you are ready to receive applications, and as you announce the first families to receive assistance.
- **Don't rely on existing waiting lists** – Even if you have a waiting list from other projects, they probably do not include the people this project was designed to serve. Furthermore, information is likely to be out-of-date and the families and landlords who were unaware of your earlier project deserve to have the benefit of your outreach efforts.
- **Capitalize on indirect marketing --** There's no advertisement like the sight of roofs, unsightly siding and deteriorated windows being fixed. Property owners know who their "competition" is, and they'll see what another owner is doing. Word-of-mouth is the best advertising. Encourage satisfied property owners and contractors to spread the word that this is a project that can work for them. If you treat applicants with respect and explain all the requirements early on, and if you deliver what you have promised, you will have pleased customers and the support from local politicians you need to operate your project.
- **Be realistic about the time it takes** -- Don't raise unrealistic expectations from the public. Things take time. Be clear about the time required to process applications.
- **Be clear about requirements** -- Rental owners need to be clear about public requirements to rent to low-income tenants, comply with rent control, and other such requirements so that they don't waste a lot of time processing ineligible tenants or tenants that can't afford the rent.
- **Use multiple marketing methods -** The following marketing tips were borrowed from other successful projects.
  - **Prepare a one-page description of your project in laymen's terms**. Just give the basics that will help eligible applicants realize that this is an

opportunity for them and will weed out those clearly ineligible. Set the stage for the "red tape" of income eligibility, crime-free housing, and other requirements but don't be too detailed or it will turn off the very people you want to attract.

- **Meet with civic groups and any landlord association and talk about the project.** These are the people who are committed to the community and will ask good, tough questions. They need to start seeing the project as an opportunity to improve the community and preserve neighborhoods. Most important, you need to start building ownership in the project so it is perceived as a partnership effort, not just <u>your</u> project.
- **Have the local newspaper run a feature article on the first building completed.** Provide color photographs and a detailed description of the amenities that are available. Even if your target tenants don't read the newspaper, someone they know probably does.
- **Consider all the places to put up posters and have a supply of brochures: banks, laundromats, hardware stores, grocery stores, churches.** Tenants frequent these places and frequently seeing information about your project will keep it foremost in their minds.
- **Ask for time on local radio stations and cable channels** to talk about the project, who you are trying to reach and what you are trying to accomplish.

10.4 Tenant Selection

An effective project design and targeted marketing project will result in a flood of inquiries from the public. These inquiries must be screened to identify families who the project was designed to serve and eliminate families who are ineligible or unlikely to stay in the project to completion. After pre-screening, families must complete applications for assistance and developers must verify statements made in applications.

10.4.1 Applicant Selection System

Generally, there are three methods that housing project administrators usually use to select among eligible applicants:

1. **First-Come, First-Served:** Applications from eligible families are received by a designated person in the developer/management agency and stamped with the time and date they were accepted for consideration. The developer must decide how "complete" an application must be before it is accepted into the system. It would be unfair to postpone acceptance until all verifications are returned from third-party sources, since the applicant family has no control over the response time. However, a developer could legitimately start the "clock" once an applicant has submitted all the items requested as part of the original application.

2. **Preference or Selection Criteria:** This method uses pre-established criteria to rank among qualified applicants. These criteria may consider housing needs, such as the condition of a family's current housing situation.

   For example, applicants currently living in substandard housing may be ranked higher if one of their basic systems presents a health or safety hazard. If this were the case, an otherwise equally qualified applicant whose furnace or roof needs immediate replacement or repair would be selected ahead of another applicant who does not have a similar need. Homeless families who qualify might be ranked ahead of other applicants.

3. **General Lottery:** If the demand for assistance is so great and it is infeasible to use other selection methods, a publicly-held lottery can be held. This method is usually not needed for rental projects unless rental assistance is available or for some other reason demand is expected to exceed the supply of units by a great margin.

Whichever method you use: first-come, first-served, ranking, or a lottery, take the following advice from veterans:

- ***Be clear*** in all written materials and conversations with applicants how the selection process will work. To reduce misunderstandings, describe the process in writing and have someone who knows nothing about the process read it to determine if it really is understandable.
- ***Be consistent*** in implementing your system.
- ***Be fair*** if you are using a first-come, first-serve system. Make certain that you have done a good marketing job to reach all households who would be eligible <u>before</u> you open the "window" for accepting applications. Don't use old waiting lists. The population you want to reach changes: people move in and out of the project area, they get poorer, richer, healthier, and frailer.
- ***Be discreet.*** If you are running a program and it uses a Committee to review applications, make certain that members are aware of Fair Housing and Data Privacy laws. Application information is not to be shared unless it is considered "public" under the Freedom of Information Act.

There are two major policy issues that must shape the design and implementation of the selection process: conflict of interest and confidentiality of information. These are discussed below.

10.4.2 Conflict of Interest

Potential and actual conflicts of interest can arise from two events or circumstances:

- occupying an assisted affordable housing unit; and
- obtaining a financial interest or benefit from any contract, subcontract or agreement with respect to an assisted activity, or the proceeds there under, during their tenure or for one year thereafter.

Conflicts of interest occur when covered parties (see below) have:

- ***access to inside information*** with regard to the award of a contract or unit assistance; and/or
- ***undue influence*** on the policy or process by which a contract or unit occupancy is awarded.

Covered parties included officers, employees, agents or consultants of the jurisdiction, recipient or developer, including community housing development organization (CHDO) and their immediate family members.

Disclosing an actual or potential conflict of interest in advance and in writing is the most important step in handling the conflict. The disclosure must include the following information:

- full factual disclosure of the situation that gives rise to the potential conflict of interest, including the nature of the person's role and the financial benefit;
- the procedures that the recipient will establish to ensure that a fair process will be conducted with no inside information or undue influence to the party in question; and
- the basis for granting the exception under the program rules (for HOME: 92.356(e)).

These are the standards used by HUD to allow related parties to continue to have access to the benefits of an assisted project as they might otherwise be eligible, while ensuring that they do not gain an unfair advantage in gaining access to the benefits.

10.4.3 Confidentiality of Information

The developer must protect the confidentiality of information provided to project administrators by applicants or beneficiaries. In general, there seems to be no good rationale for publicizing or making known specific applicant and/or recipient information to the general public.

Section 13 of the Freedom of Information Act provides that certain material is exempt from disclosure. The exemption that we are most likely to encounter is for information of a personal nature where the public disclosure of the information would constitute a clearly unwarranted invasion of the individual's privacy.

In **no case** would it ever be appropriate to release a recipient's source or amount of income, or any credit-related information.

10.4.4 Telephone Screening and Distribution of Applications

Telephone Screening. As telephone screening is the first opportunity for the public to ask detailed questions about your assistance, it is important that several things happen:

- The applicant is given accurate information and courteous treatment
- Follow-up action is timely and appropriate
- People who are clearly ineligible are told at the earliest point so their time (and the staff's time) is not wasted. It is common to talk with ten people on the telephone for every five applications sent out.

The Application Package. The person who does the telephone-screening interview is in the best position to send out application packages to callers. The package includes:

- **An application form**. The application should be pre-approved by your funder(s).
- **Releases for the applicant to sign** regarding the Government Data Practices Act and necessary verification requests.
- **A brief description of the project, including a definition of income.** It could be the applicable portion of your Policies and Procedures Guidelines if your marketing materials are too general for this step.

10.4.5 Application Processing

It is very important that administrators control all cases in the "pipeline" because:

- It is essential to keep cases moving from start to finish, controlling administrative costs, and managing staff workloads.
- Managers need to identify cases that drop out and identify problems in project design or administration if the pattern of a dropout becomes abnormal.

Tracking the Pipeline. It is important to make the verification process move as quickly as possible while also assuring that it is as "businesslike" as possible. Included in this step are examples of the following tracking devices:

- An application tracking system that follows the general progress of multiple cases;
- A status sheet that can be stapled to the outside of each file, enabling staff at different stages of the process to identify what has been done and what needs to be done;
- A completeness screening checklist; and
- A manager's monthly status report to track progress against goals.

Calculating Income. Each public funding project has procedures for verifying and determining gross annual household income. Be sure to obtain the guidelines from your public funding source.

11. Planning for Rental Property Management

The purposes of this chapter are to:

- Describe options for the management of affordable rental project, including smaller projects
- Discuss the 4 major components of rental property management – occupancy management, physical management, financial management and compliance management

11.1 Property Management Options

When a nonprofit or other organization is planning to undertake the development and operation of an affordable rental project, there are essentially three major options:

1. ***Hire a professional management firm*** – This is desirable when possible, because it increases the likelihood of long-term, quality management. However, many professional management firms have minimum size requirements - usually professional firms will not agree to manage projects with fewer than 25, 40 or even 50 units. In addition, the cost per unit relative to rents can be very high – often $40 - $50 per unit per month (PUM).
2. ***Hire management staff*** – Another option is for the developer to hire and train its own management staff, in essence creating its own little property management entity or division within the agency devoted to management. This ensures a high level of control while still creating an entity that focuses on management rather than development and services that are the broader mission of the agency, but it also raises several issues. First, the developer must have the portfolio and revenue to support one or more management positions. For many nonprofits, there must be 60 – 100 units under management before a management position is truly supported by property revenues. In addition, there is the challenge of training and retaining competent management staff. Management is not always an attractive profession, and management staff are constantly looking for better employment options, so turnover is a problem.
3. **Self management** – The third option is to try to manage the property within the existing organization or staff. This is often the only option for organizations with only one project or several small projects, as revenues cannot support property management on its own. However, it creates a competition for time and a potential conflict of objectives. Staff will be working on other development projects and delivering services to clients, while at the same time they will be challenged to give enough time to management and sometimes pursue the eviction of tenants who are also service clients. The two major questions with

self management are: Are you ready and able to provide management? Do you have the skills, the time, the inclination?

11.1.1 If You Are Hiring a Professional Property Management Firm

If you are able to hire a professional property management firm, consider the following:

- What is the list of management services provided by the firm? Will they provide all required services?
- Who are the actual staff to be assigned to the project? Are they acceptable? Does the firm provide background checks on all staff?
- Are their financial management systems sufficient to provide the information, reports and security you need? Are they able to ensure separate client accounts? Do they provide adequate budgeting & reporting? Do they have sufficient internal controls to secure your funds? Are they and their staff bonded?
- Do they have good property maintenance systems and procedures in place to ensure both ongoing planned/preventive maintenance services as well as work order response? Do they have 24-hour call capability to ensure that emergencies get appropriate response? Do they have inspection systems in place? Do they have good vendors in place to provide contracted services?
- Do they have volume purchasing in place to ensure that you get the best pricing on maintenance, janitorial and other supplies? Do they have procedures to avoid or disclose self-dealing?
- Do they have all appropriate insurances in force, including general liability, auto, workers comp, professional liability, fidelity bonds for handling of funds?
- Do they have professional accreditations for the key staff and the firm, indicating an ongoing commitment to professionalism and staff training?
- Do they have experience with public program compliance, particularly the programs funding your development? Do they have systems in place to do income certifications, file maintenance, property inspections, annual reporting on occupancy and rents, and other required compliance activities?
- Can they provide abundant current references? Are these references satisfied? Would they hire them again? In what areas of management is their performance not fully satisfactory?
- What is the fee structure? Is it a percentage of collections or a fixed amount per unit? What is covered by the base fee? What direct staff costs are charged in addition to the fee? What services require additional charges?

11.1.2 If You Are Hiring Management Staff

If you are going to hire property management staff, consider asking the following questions:

- What is your experience as a manager – how long? How many units/projects? What kinds of settings?
- Are you a people person? Can you get along with most people? Can you work with difficult people?
- Are you able to multi-task or keep track of many different activities at one time? How do you track multiple tasks?
- Are you familiar with building structures and mechanical systems? Do you have any knowledge or experience with the physical components of buildings and maintenance?
- Have you or can you develop & read a budget?
- Are you willing to evict a tenant? How would you pursue an eviction?
- Do you have experience supervising contractors and vendors?
- What are you looking for in the long run for your career? What do you expect in terms of a career ladder or growth?

11.1.3 If You Are Doing Self-Management

If circumstances require you to manage the property with your current staffing, consider the following challenges to whether or not you are ready:

- Do you have available staff time that can be dedicated to property management, even if it is a part-time person, or are they going to be managing "in their spare time"?
- Can you set up an on-site presence? Do you have the ability to provide 24-7 response?
- Do you have the accounting capacity to collect the rents, make deposits, track expenditures and report on property finances separately? Do you have the internal controls to handle cash (i.e., ability to have separation of duties)?
- Are you ready to enforce rules and evict tenants if necessary, even if this competes with your service objectives to help clients? Will it conflict with your other roles?
- What is the opportunity cost? What won't you and your staff be able to do because they are tied up with property management?

11.2 Occupancy Management

Some important reminders about occupancy management:

- Ensure fair and equal access to all applicants. It's the law, and it is the right thing to do.

- Seek good tenants. Go beyond eligibility and screen for the things that relate to good tenancy, but be sure to apply the standards equally to all.
- Focus on tenant communications
- Be ready to fill vacancies quickly. Vacant units mean lost revenue and potential difficulties in paying bills, including your management fees.
- Create a procedure manual as a way of training new staff and ensuring fair treatment to all.

11.2.1 Finding and Keeping Good Tenants

What are you looking for in a good tenant? One who is:

- Financially responsible
- Respects property
- Complies with rules
- Good neighbor
- Stable, long-term occupant
- Leaves unit in good condition

How do you find and keep a good tenant?

- Timely & effective communication so that the tenant always knows what is expected of them
- Respect for privacy
- Responsiveness to repair needs & maintenance of property
- Maintain safety & security
- Fair/consistent enforcement of house rules and dealing with problems
- Fair rents and reasonable rent increases

The objectives of intake are to provide equal access and fair treatment while identifying the most suitable tenants for the development. Intake and selection procedures include:

- Standard application form and assistance with completion of the form for persons with disabilities and language barriers
- Published priorities or preferences for certain kinds of tenants, as approved by your funding sources
- Maintenance of waiting lists to ensure that applicants are taken in order
- Income eligibility verification to ensure that tenants meet the required income limits
- Screening for appropriate tenant characteristics, including:

  - Financial screening for minimum income to afford the rent, cash to make deposits, and credit to meet financial obligations
  - Rental history: contact previous landlords to determine if the tenant met obligations of tenancy. Be on guard for current landlords not disclosing problems in order to get rid of a tenant. Ask previous landlords: would you rent to this person again?
  - Verify identity of all occupants. Federal programs require you to verify legal residency in this country.
- Reasonable accommodations & modifications – If you are dealing with a person with disabilities, you must be willing to make reasonable accommodations, and for higher cost modifications, permit the tenant to make them at their own expense.

11.2.2 Lease Execution

- Lease – have a standard lease form that meets state/Federal requirements.
- House rules – Publish a set of house rules that make clear expectations for occupancy and quiet enjoyment, including noise, pets, maintenance, access to management, etc.
- Unit walkthrough and inspection – Use a walk-through with the new tenant to document unit conditions, and brief them on the operation and maintenance of systems, appliances and other features.
- Disclosures – Are there any disclosures required, such as LBP?
- Lease renewals/re-certification – Set up a tickler system to make sure you start processing recertifications at least 60 days in advance of the lease renewal and recertification date.

11.2.3 Tenant Relations

- Welcome – Start things off on a positive note. Welcome the tenant. Provide a welcome letter or even small gift.
- Do timely repairs
- Communicate -- Take time to talk. Make contact when nothing is wrong, so they don't have to cringe any time they hear from you. Forewarn them of coming repairs and other activities that may affect them.
- Work out problems – Sit down and discuss them when possible rather than just the formal letter warning.
- Encourage tenant participation in planning some activities and improvements.
- Address security issues – Above everything else, you need to provide a safe environment, and tenants keeping watch and reporting things are part of the shared responsibility for security.

11.2.4 Occupancy Recordkeeping

- Maintain a current rent roll at all times.
- You should have a lease renewal "tickler" system that reminds you at least 60 days in advance of lease renewal to notify tenants of rent changes, begin recertifications and get the lease ready for renewal (unless self-renewing).
- Tenant files should include:
  - Application & verifications/certification
  - Move-in/move-out inspection checklist
  - Leases
  - Legal notices (LBP, etc.)
  - Work orders
  - Correspondence

11.3 Physical Management

The goals of property maintenance are to:

- Protect the physical asset
- Maximize occupant safety
- Minimize "emergency" repairs
- Control maintenance effort & cost

Physical management activities need a planned maintenance focus rather than simply responding to problems when they occur. ***Planned maintenance*** includes:

- Scheduled inspections, preventive maintenance & seasonal activities
- Service contracts
- Maintenance Activities
- Custodial maintenance
- Preventive maintenance
- Inspection program
- Seasonal bldg/system activities

In addition, you need a ***work order system*** that responds in a timely and professional manner to all tenant-initiated requests for maintenance. This includes:

- Response goals & tracking of response – usually the goal is to respond within 1 – 2 business days to any request, and to complete the repair within 2 – 3 days, subject to the ordering of materials and vendor scheduling.

- Emergency repairs – a 24-7 response system for handling emergency repair needs within hours.

The other major component of maintenance is the ***unit turnaround***. A vacant unit is lost revenue, so the goal is to turn around any unit for occupancy within a month. Most professional operations have a goal of 7 – 14 days to prep the unit and complete any repairs. This must be coordinated with occupancy management, so that the work crew gets notice when the departing tenant gives notice.

Turnaround activities include:

- Cleaning
- Systems and appliances testing/service/repair
- Painting
- Carpet/flooring cleaning

Some final thoughts on physical management:

- Think planned (preventive) maintenance – don't wait for things to break. It is more cost efficient, and maintenance costs are more predictable with planned maintenance.
- Do annual unit inspections, whether or not they are required by funders. Use them to identify needed repairs and tenant abuse.
- Develop an emergency response system that ensures prompt response but does not drain the management staff with round-the-clock calls.
- Plan for quick response to unit turnarounds. Empty units cost you revenue and use up your vacancy loss quickly. They also can be security problems.
- Create a maintenance procedures manual for training and ensuring consistent application of standards.

11.4 Financial Management

The goals of financial management are to:

- Safeguard cash
- Manage revenues & expenses
- Assess profitability & project future
- Pay the full cost of management

Financial management activities include:

- Budgeting
- Cash receipts & disbursements

- Accounting/recordkeeping
- Annual and monthly internal and external reporting
- Analysis, projections & planning

Some of the key recommendations for financial management are:

- Establish internal controls -- Separate key duties so that no one person controls any entire transaction. Separation ensures that accidental or intentional misapplication of funds must be done by more than one person.
- Monitor income and expenses monthly. Compare budget v. actual to identify trends and make adjustments.
- Pay reserves and management fees like 3rd party expenses. Don't just pay them if you have funds available – they'll never get paid.
- Maintain long-term financial projections to identify potential viability problems. Watch for the cross-over point when expenses catch revenues – if it is within five years, plan for rent increases and expense reductions as soon as possible.
- Plan reasonable regular rent increases. Tenants respond more positively to smaller, predictable increases than the occasional large increases.
- Document financial management procedures.

11.4.1 Budgeting

Budgets are usually prepared on a cash basis rather than accrual, and are used:

- To set rents
- To set benchmark for monitoring actual expenditures

11.4.2 Collections & Disbursements

- Rent collection procedures – published procedures for payment of rent (in-office, mail or drop box; cash, check or money order; etc.)
- Payment & enforcement – 7 day "notices to quit" and follow-up ending in eviction for non-payment if necessary.
- Cash handling, including internal controls to ensure separation of receipt, recording and deposit functions
- Expense controls – consistent with procurement policy (how decisions to purchase are made and what approvals are requirements; processing and payment of invoices to include adequate internal controls, i.e., separation of requisition & disbursement functions)

11.4.3 Management Fees

Avoid these habits:

- Not tracking all time devoted to management
- Paying yourself last
- Never collecting management fees

11.4.4 Financial Reports

- Monthly Income & Expense (MI&E) report
- Monthly budget v. actual
- Annual Income & Expense report
- Balance Sheet

11.4.5 Long-Term Operating Projection

It is recommended that you continue to project the long-term income and expenses of the property. Uses of this are to:

- Plan/implement rent increases so that they can be put in gradually rather than abruptly
- Anticipate the impact of major changes (e.g., changes in debt service)
- Identify in advance a "crossover point", when revenues no longer will cover expenses. If there is a crossover point within the next five years, immediate steps should be taken to reduce expenses, plan rent increases, refinance or other action to maintain financial viability.

Recommended trends (unless other evidence to the contrary) should be: 1–2% annual increase in rents, and 3–4% for expenses. Be sure to update for the current budget & actual expenses.

11.5 Compliance Management

The final area of affordable housing property management is compliance. Key compliance issues include:

- Occupancy mix – income levels of tenants
- Rent limits
- Occupant eligibility
- Enforcement of property standards
- Financial records and reporting, and financial viability (reserves, net income)

Maintaining compliance means have the appropriate files, completing the reports, and maintain relations with the compliance agency so that their monitoring activities can be accommodated.

To determine what compliance standards apply, talk with your public lenders or compliance agency, and refer to the appropriate legal documents and local requirements, such as:

- Written agreement
- Note/mortgage
- Deed covenant/restriction
- State and local codes and zoning ordinances

12. The Sustainability Imperative

You can't help anyone if both you and the project can't survive.

While this manual has focused on the planning and implementation of affordable housing projects, your success is not just defined by completing the project. Instead, your success in the long-run is based on the viability of the project.

In addition, you can only continue to develop and operate affordable housing if your organization remains viable. This chapter is about sustaining the project and your organization.

12.1 Sustainable Projects: Physical & Financial

12.1.1 Sustainable Design: Affordable Doesn't Have to Mean Cheap

It's tough to raise funds for affordable housing. Nonprofits are vulnerable to the temptation to minimize the "improvements" paid for up front in order to keep budgets down and gaps for public funding to a minimum. And we're only supposed to improve to the minimum property standards of the program, right?

Wrong! Although public funding programs may have minimum property standards and layering and underwriting criteria to prevent over-investment, this does not preclude a nonprofit developer from maximizing useful life , energy efficiency, and other capital improvements that keep the housing competitive, as long as they are within the range of improvements for housing of modest means. Luxury improvements are not permitted.

Since operating subsidies are rare, public agencies can only help one time – with upfront capital costs. Some programs, like the HOME Program, prohibit additional HOME funds during the affordability period either for operations or capital improvements. So, if you limit improvements too much, try to get by with aging systems and roofs, use cheap materials and finishes that won't hold up, ignore energy performance, and don't provide for adequate management and preventive maintenance, there is a high probability you will regret those decisions during occupancy as you encounter higher than anticipated operating costs. And public agencies may not be in a position to help.

Some guidelines for thinking about capital improvements:

- Hire architects who think efficient design and have experience with getting value out of limited affordable housing budgets. Keep in mind that efficient design is a combination of many factors, including:
    - Building shape

  - Building mass
  - Building orientation
  - Size & spaces
  - Insulation
  - Shading
  - Fenestration (windows)
  - Reflectivity
  - Ventilation
  - Materials
  - Mechanical systems & appliances
- Always try to include the most energy efficient appliance, windows, insulation and other building components affecting energy usage. Energy Star compliance should be an objective for all new construction.
- Try to ensure that the improvements to all building systems and structural components in the scope produce useful lives at least equal to the minimum affordability period, if possible. Cutting improvements now means repair and replacement problems during operations.
- Don't shortchange exterior improvements and sustainable landscaping. Curb appeal is incredibly important to marketing, and exterior use spaces are very inexpensive ways to extend the living area.
- Remember that design is only part of the battle. Proper specification, approvals and supervision of construction is needed to ensure that the design is implemented and avoid construction materials and methods that compromise efficiency, including:
  - Proper sealing of all holes, cracks, penetrations
  - Proper installation of insulation
  - Minimize/mitigate thermal bridging of structure
  - Mechanical and ventilation systems need to be balanced
- And fight for the appropriate amount of funding needed to get these improvements!

Sure, the enhanced scope of work will likely cost more, creating a bigger gap. But if you fail to fund the project for adequate improvements upfront, you are even less likely to be able to obtain help down the road.

Some web links for learning about different energy efficient methods and materials are listed below:

- http://www.eere.energy.gov/consumer/information_resources/index.cfm/mytopic=60001
- Energy Efficiency Information: http://www.energyfinder.org/sitepages/pid52.php
- Concept of a "Building Envelope" (for existing homes as well as new homes): http://www.aceee.org/consumerguide/envelope.htm
- Concept of "Building Envelope": http://www.eere.energy.gov/buildings/info/design/integratedbuilding/buildingenvelope.html
- Energy Efficiency with Residential Construction: http://peakstoprairies.org/topichub/subsection.cfm?hub=31&subsec=12&nav=12
- Green Building Introduction: http://www.warmtraining.org/green-building-manual.html
- Insulation and Air Sealing: http://www.eere.energy.gov/consumer/your_home/insulation_airsealing/index.cfm/mytopic=11220
- Insulation: Selecting insulation for new construction: http://www.eere.energy.gov/consumer/your_home/insulation_airsealing/index.cfm/mytopic=11370
- Insulation: Recommended levels according to your zip code: http://www.ornl.gov/~roofs/Zip/ZipHome.html
- Space Heating & Cooling: http://www.eere.energy.gov/consumer/your_home/space_heating_cooling/index.cfm/mytopic=12300
- Heating and Cooling Systems: http://www.eere.energy.gov/consumer/your_home/space_heating_cooling/index.cfm/mytopic=12340
- Appliances and Electronics: http://www.eere.energy.gov/consumer/your_home/appliances/index.cfm/mytopic=10020
- Energy Star qualified appliances: http://www.energystar.gov/index.cfm?fuseaction=find_a_product
- Water Heating: http://www.eere.energy.gov/consumer/your_home/water_heating/index.cfm/mytopic=12760
- Energy Star qualified home: http://www.energystar.gov/index.cfm?c=new_homes.hm_index
- Zero Energy Homes: http://www.eere.energy.gov/consumer/your_home/designing_remodeling/index.cfm/mytopic=10360
- Energy Savers Guide: http://www1.eere.energy.gov/consumer/tips/

- Geothermal: http://www.eere.energy.gov/consumer/your_home/space_heating_cooling/index.cfm/mytopic=12640
- Geothermal: http://earthcomfort.com/index.html
- Geothermal: http://geoheat.oit.edu/ghp/ghptable.htm
- Solar Energy: http://www.eere.energy.gov/consumer/renewable_energy/solar/index.cfm/mytopic=50011
- Neighborhoods: New Urbanism (compact neighborhoods with better access to local amenities requiring less transportation costs, more sustainable designs): http://www.newurbanism.org/newurbanism/principles.html

12.1.2 Rental Project Financial Sustainability

Adequate budgeting of capital improvements is only part of the upfront challenge: for rental projects, adequate budgeting of operations also impacts sustainability.

HUD's recent evaluation of HOME rental projects and lessons learned from HOME projects requiring workouts point to the need to be much more conservative in assumptions about operations. This section highlights the problems encountered in troubled rental projects that needed workouts.

1. **Too Much Hard Debt or Not Enough HOME Subsidy from Initial Underwriting**. Many troubled properties suffer from excessive debt service in relation to attainable net operating income (NOI). Debt on these properties either accumulates unpaid (risking foreclosure) or the owners seek other sources of funds for debt payment (such as deferred maintenance or owner loans to the property). Since most public funding is for upfront capital subsidies and not for ongoing operations, it is essential to have enough subsidy to reduce the amortizing mortgages to a sustainable level.
2. **Under-funded Capital Needs**. Financial pressures at initial development sometimes result in under-funding improvements and under-capitalizing replacement reserves. As properties age, repair and replacement needs can outpace available reserves, property conditions can deteriorate, and compliance and sustainability can be at risk.
3. **HOME Compliance Problems**. Some of the projects reviewed for the HUD TA were not in compliance with the HOME rules regarding rents, low-income occupancy, or unit quality. In limited cases, these projects were never in compliance because the owner did not understand its HOME responsibilities. In other cases, the owner decided to charge a higher rent in order to avoid foreclosure.
4. **Inadequate Coordination Among Funders**. In some projects – especially those where HOME and Low Income Housing Tax Credits were combined – it

appeared that the requirements and benefits of those other programs were the primary guiding force in selecting and underwriting the projects. For example, some projects were underwritten using the LIHC rents (LIHC rents are tied to median incomes whereas HOME rents are often capped by the FMR). In addition, it appears that some projects were sited in locations that were advantageous for boosting credit basis but that did not fully take into account other market factors such as local vacancy rates or competing nearby low-income housing.

5. **Market Weakness or Lack of Demand**. In some of the projects, there was an insufficient demand for the HOME units because the community had competing private units available for rent or because the community was very small and thus had only limited primary demand for rental units. In some cases, the competing units may not have been as new or as nice as the HOME units, but households made the decision to rent elsewhere due to a lower rent. In other cases, the market for the HOME units changed during the affordability period when local economic conditions deteriorated.
6. **Need to Consider the Entire Portfolio of Projects**. This issue is related to the market concerns raised above but addresses the PJ's overall portfolio of HOME projects. With some projects, there did not appear to be a good strategy for considering the location and financial health of existing assisted properties when determining where to locate new properties. For example, one PJ built a new LIHC development down the street from an existing troubled HOME project, siphoning off some of the HOME tenants or causing the achievable rents at the HOME project to go down even further.
7. **Ownership or Management Problems**. Poor quality property management or inexperienced ownership caused some of the projects to become troubled. In these cases the property manager may not have been familiar with the HOME requirements or may simply have been inexperienced in the difficult job of effectively managing assisted rental units.
8. **Design or Construction Problems**. Some of the projects reviewed in the TA faced difficult financial issues due the poor quality of their construction. This poor initial quality meant that replacement or repair was needed sooner and more frequently than might have been planned and was a contributing factor in the growing capital needs gap for some projects.
9. **Lack of Recorded Legal Covenants to Foreclosure-Proof a Project**. Because it is the PJ that is ultimately responsible for repaying funds to HUD if affordability is lost, it is important that the PJ have binding means of ensuring owner commitment and on-going affordability. Typically this is done through both legal agreements with the owner (and with the mortgage lender) and encumbrances on the land. Usually, the best option for protecting HOME affordability against foreclosure risk is to structure the HOME affordability commitment recorded as a "covenant running with the land" to which the mortgage debt is subject.

10. **Lack of Monitoring or Early Warning Systems**. In general, the sooner a problem is detected, the easier (and less expensive) it is to fix. In order to detect a problem early on, developers and funders need to develop reports and systems that inform it of each property's status. For example, some PJs require periodic reporting of key project financial and occupancy data, such as vacancy rate, move-ins, bad debt, balance in reserves, etc.

As you plan your rental project, you can help to ensure long-term viability by considering the following:

- The rent decision is one of the most important decisions you will make. Don't plan to start with rents at the maximum rents permitted by your funding program(s). If you start out with rents at the maximum, you will have no room to move if program rent limit increases don't cover increased operating costs. Also, no matter what the rent limits are, never structure rents higher than "street" rents. Rents higher than the competition can increase vacancies, reduce overall revenue, and put the project at risk.
- 5% vacancy & collection loss might be an industry rule of thumb, but it is risky for affordable housing and may substantially understate the experience in your market. Be realistic: 7 - 10% might be a better starting point.
- Budget for full property management and preventive maintenance costs from Day 1. Don't cut management costs because you are planning to self-manage. Don't eliminate maintenance just because components are new.
- Don't create your baseline maintenance budget on a new project and typical first-year operations where few things go wrong (and many things are under warranty.) Benchmark the property to operations in projects that are at least 5 years old.
- Minimum debt service coverage might not be enough cash flow for a project. Other benchmarks to consider: annual cash flow should also be greater than 8% of operating expenses or 3% of Gross Potential Rent (GPR).
- Replacement reserve contributions are likely to need to be more than the standard rule of thumb of $300+ per unit per annum.
- If you are doing an enriched housing model with supportive services, separate the real estate operating budget from the services budget, so that it is clear what is needed to adequately fund operations.

Remember that you have to live with the consequences of your budget decisions for decades. Don't rely on overly optimistic assumptions or an attitude that "we'll just have to get by." You will regret it for years to come.

12.1.3 Homebuyer Project Financial Sustainability

While homebuyer projects do not require the creation of reasonable operating budgets, there are still several things that developers can do to enhance the long-term viability of the homeownership opportunity:

- Establish property standards that emphasize reasonable useful life and energy efficiency, not just minimum functionality.
- Seek buyer financing with reasonable lending ratios – Aggressive lenders are increasing both front-end and back-end ratios in lending, but may do so to the point where buyers get over-extended.
- Discourage risky exotic financing – Lenders are offering a range of exotic loans that put buyers at risk of having no equity in the property in the near-term, especially if real estate prices stop increasing – interest only mortgages, mortgages with negative amortization, loans at greater than 100% LTV. Even some shorter-term ARMs are risky in an environment when interest rates are trending upward.
- Leave some cash in the buyer's pocket at closing – Most buyers leave the closing table with no cash, and run up debt to move and furnish the new house. Any near-term emergency repairs or needs could leave them unable to sustain ownership. Consider a standard of some buyer cash left at closing, and encourage emergency reserves through counseling/training.
- Provide post-purchase counseling/training – Provide post-purchase counseling that addresses maintenance, budgeting, and refinancing traps (predatory lending).
- Provide education and advice to avoid predatory lending – Provide community-wide education about predatory lending traps, and offer counseling.
- Set reasonable resubordination policies & procedures – Although the tendency is to deny resubordination of public subsidy mortgages on refinancing that involves equity takeout, this may only result in decisions to prepay in order to access equity. Set a reasonable policy that allows buyers to tap some equity without jeopardizing the security of the subsidy mortgage (perhaps impose an LTV cap of 95 – 100%). And require counseling prior to acceptance of prepayment.

See section 7.10 for a discussion of how these issues help to prevent foreclosure.

12.2 Organizational Sustainability

12.2.1 What Are the Keys to Long-Term Organizational Success?

Below are some imperatives for building the long-term success of your organization as a developer.

- You must build a pipeline of projects, not just a single project.
- You must make certain that past projects are not a future burden, and contribute to your ability to do projects in the future.
- You must set aside funds for capital advances to new development projects.
- You must avoid conflict of interest situations.

- You must focus on asset management.
- You must plan for succession and turnover.

Each of these imperatives is discussed below.

12.2.2 Build a Pipeline of Projects

Developers have to survive in large part by earning fees. The fees from one project don't sustain you for very long. To be successful as a developer, you have to have a pipeline of projects.

This recommendation is not meant to discourage the nonprofit that occasionally develops a project to supplement its services to its clients. However, long-term success as a nonprofit development requires you not only to be focusing on your current development project, but also thinking about the next one as well – or, perhaps, more than one because not every project goes forward. The question is: when you finish this project, what are you going to do next?

12.2.3 Build a Working Capital Fund for Development

As noted several places in this manual, you need liquidity to be able to meet the upfront costs of selecting and planning projects, or you will be slowed down.

Some of the capital for the next project may be earned through the profits or fees on your current job, and the tendency is to use the funds as they come in to pay other organizational bills. Try to avoid this tendency, or at least put aside some of the earnings for the next project.

Also, some public funders and foundations are willing to provide money as equity for current or future projects. Again, if you are reimbursed out of project financing, and are able to retain these funds, try to set them aside to revolve them into the next project.

One rule of thumb is to have working capital equal to 5 – 10% of the Total Development Costs of your typical development project.

12.2.4 Build a Portfolio of Properties & Mortgages

Organizations that develop rental housing are creating a portfolio of projects. The goal should be for the projects individually, and the portfolio as a whole, to be self-sustaining, and even produce cash flow and asset value that build the organization's balance sheet and ability to borrow. Projects that have cash flow shortages, that cannot pay the organization's management fees, and require organizational cash to make emergency repairs are a drain on that organization and prevent it from accomplishing new projects.

Organizations that produce homeownership opportunities are not creating a portfolio of projects, but are potentially creating a portfolio of mortgages. These mortgages might produce cash flow from amortization payments, but even mortgages that are deferred and due on sale will eventually produce revenue for the organization. Assisting homebuyers should be viewed as temporary assistance, and homeowners should be expected to “ass it on” to future buyers over time. To forgive these mortgages and not require repayment limits both the organization and future buyers.

12.2.5 Protect Your Reputation: Avoid Conflict of Interest Situations

One of the fastest ways to ruin the reputation of your organization is to get into a conflict of interest situation. Potential and actual conflicts of interest can arise from two events or circumstances:

- Occupancy of a HOME-assisted affordable housing unit; and
- Receipt of (or financial interest in) a contract, subcontract or agreement with respect to a HOME-assisted activity, or the proceeds there under.

As a provider of publicly funded units, you must make certain that the potential benefits are available to all who might be eligible.

Whenever someone associated with your organization gains a benefit from your publicly funded activities, some outsiders might be concerned that the person received the benefit because they had:

- **Access to inside information** with regard to the award of a contract or unit assistance; and/or
- **Undue influence** on the policy or process by which a contract or unit occupancy is awarded.

And make no mistake about it – it is about the appearance or perception of conflict that matters, whether or not actual conflict of interest exists.

When such suspicions or accusations arise, there must be an objective method of establishing whether or not the potential conflict of interest is real, or whether the procedures followed ensured fair access.

The Federal HOME and CDBG Program rules defines a presumption of a conflict of interest for anyone associated with the entity distributing the assistance, but the rules permit an “exception” if the PJ has determined in advance that there is no real conflict and the process is fair.

The intent is not to prohibit your board, staff and members from enjoying the benefits of HOME-assisted units, but to make certain that your PJ first determines that these persons have no unfair advantage over other applicants. Why require this determination in advance? Because an accusation requires an immediate response, and there is no easy way to correct such problems "after the fact."

All potential and actual conflicts must be disclosed to your public funders in advance in writing, with the following information:

- Full factual disclosure of the situation that gives rise to the potential conflict of interest, including the nature of the person's role and the potential financial benefit;
- The procedures that the CHDO will establish to ensure that a fair process will be conducted with no inside information or undue influence to the party in question; and
- The basis for requesting an exception.

These standards are intended to enable related parties to continue to have access to the benefits of Federal programs as they might otherwise be eligible, while ensuring that they do not gain an unfair advantage in access to the benefits. It may seem a bit restrictive, but it is for your protection.

Furthermore, please note that Federal rules currently do not extend to the award of contracts by nonprofit developers. However, many public agencies and nonprofits have adopted more stringent conflict of interest policies that also extend to the award of contracts, not just unit benefits. That would prohibit the award of contracts to, say, an architect, realtor, lawyer or contractor on your board without prior review and exception granted by your PJ. One sample is provided below.

12.2.6 Beyond Compliance is Asset Management

As we deal with our PJ and HUD on matters of compliance and documentation, it is easy to become distracted from the true long-term challenge and obligation – to sustain the project for long-term affordability and decent housing. Because of the repayment obligation as well as your desire to provide affordable housing for as long as possible, it is important to exercise prudent management of HOME projects.

If you have a rental portfolio, consider these matters of advice:

- Practice planned and preventive maintenance – Don't wait for things to break. It will cost you more in the long run, create unpredictability in budgeting, and cause a strain on maintenance staff.
- Raise rents regularly – Do annual increases in small, regular increments (like you probably budgeted in your funding applications) to stay ahead of costs and to keep rent increases modest. Don't wait until you absolutely need it, and have to raise rents by an amount that causes people to leave.
- Manage occupancy aggressively – a vacant unit is a problem. Have a goal of no more than one month for unit turnaround: have applicants ready when vacancies occur; get the unit turnaround crew in immediately; coordinate the re-occupancy.

- Make reserve contributions – These are not optional, these are not "if you have money left over" payments. In the long run, they are as important as any other line item in the budget.

Remember that your projects are your "bricks and mortar" legacy. Failure to take care of the assets will be a very tangible reflection on your organization. It's not about getting it built; it's about making it last.

12.2.7 Plan for Long-Term Success by Doing Succession Planning

You might be capable right now of doing affordable housing development. You might have a knowledgeable board, capable development staff, skilled property management staff and other skills for implementing affordable housing development.

And then something happens. Your property manager gets a job offer, your project manager has to move for family reasons, a key board member leaves, or you decide to move on. As that person goes out the door, what key skills are lost to the organization? Can your organization continue down the developer path?

You need to consider "succession" planning – you must create an organization that can survive the loss of any one person. You need to consider:

- **Make sure there is adequate oversight** – Set up a board committee or senior staff to keep track of the project and ensure that adequate understanding of the project exists beyond the key person.
- **Apprentice each key role – Select someone to be the backup person for each key role. Have them follow** the process enough to be able to step in at any point if needed. For junior staff, this is OJT – on the job training.
- **Create career growth opportunities** – As the organization succeeds and grows, try to create job growth opportunities for staff.
- **Establish training as a core organizational value** – Be sure to seek out opportunities to train staff in development skills, funding sources, management functions and other related skill areas. You may think you can't afford the time or resources for training…but can you afford not to? Training is essential to long-term organizational succession and survival, and it is a personal development activity that helps staff to stay engaged and grow in your organization. You owe it to them as much as yourself.
- **Create the paper trail** – Files aren't just there to satisfy government funders. They are also the project history. Make sure the key documentation is not just in the "head" of a key person. If that person leaves abruptly, is there enough of a paper trail for you to pick up the pieces? Have they set up files, created meeting notes, implemented tracking tools and taken other steps to document progress and unresolved items?

12.3 The Final Word: Top 10 Survival Tips

This guide has communicated the dimensions of the challenge to survive and thrive in a performance-based world.

The New York Department of Housing and Community Renewal is looking for good affordable housing developers and projects. DHCR/HTFC funding is a great opportunity, but it doesn't guarantee success. It only provides some financial tools to help qualified nonprofits become capable developers.

If you don't understand what it takes to be a developer, you may not be ready to be a developer. If you do, there are some great opportunities for you in this program. Some final thoughts and tips for survival:

Top 10 Affordable Housing Developer Tips

1. You haven't helped anyone until you deliver a completed and occupied unit.
2. You can't help anyone if you can't survive. Make sure that development also takes care of your organization's needs, not just community needs.
3. Affordable housing may not always require developer equity, but it always requires liquidity – cash the developer can advance to pay bills until reimbursed. Lack of liquidity slows development.
4. The opportunity cost of development – the things your organization cannot do because you have committed your time and resources to development – may be as important as the direct costs.
5. Pick the project that's right for you. Don't let the project pick you. Beware of free property – the true cost of a property is the total cost to make it "shovel ready."
6. In development, time is money. Get it done! There are many excuses why development doesn't move forward, but only one person to blame – you, the developer!
7. It's not enough to get it built; you need to build it to last. Design and build for viability/sustainability.
8. Protect your reputation. Avoid the appearance of conflicts of interest.
9. Plan for success by planning for succession. Always think about developing staff capacity and growth.
10. Always be thinking: What's next? A developer has to be thinking about the "project pipeline."

We hope this guide (and the training that this guide supplements) will help you to become successful as an affordable housing developer. We wish you success.