HTF: The Housing Trust Fund

Housing Trust Fund Developer Advisory Group

Options and Considerations Related to the HTF Operating Assistance and Operating Assistance Reserves

The national HTF Developers Advisory Group (http://bit.ly/1Sj1uOp) created an Operating Assistance Work Group to discuss how states, advocates and developers could and should consider employing the operating assistance (OA) and OA reserves that are allowable under the national Housing Trust Fund regulations. The workgroup consisted of Jim Yates, Liz Stewart, and Ann O'Hara from the Technical Assistance Collaborative; Brian D'Andrea from Century Housing; Kevin McCormack from McCormack Baron Salazar; Ginger Segel from Community Frameworks; Dora Leong Gallo from A Community of Friends; Shannon Nazworth from Ability Housing; Patrick Sheridan from Volunteers of America; and NLIHC staff. Scott Hoekman from Enterprise Community Partners also provided input.

This document is the result of that workgroup's efforts. The first section of this paper provides an overview of the HTF regulations related to operating assistance and operating assistance reserves written by NLIHC Senior Advisor Ed Gramlich. The second part is a summary of the options and considerations for HTF advocates, developers and HTF state administering agencies offered by the HTF Operating Assistance Workgroup.

1. What HUD Regulations State about the HTF Operating Assistance and OA Reserve:

The interim HTF regulations are at 24 CFR part 93: No more than one-third of a state's annual HTF allocation may be used for operating cost assistance and/or an operating cost assistance reserve. [Section 200(a)(1)]

Operating cost assistance and/or an operating cost assistance reserve may be provided only to rental housing acquired, rehabilitated, reconstructed, or newly constructed with HTF funds. [Section 200(a)(1)]

> The preamble to the interim rule regarding the one-third cap on operating cost assistance and operating cost assistance reserve (*Federal Register*, Vol. 80, No. 20, Friday, January 30, 2015 page 5210): "Within this cap, each fiscal year the grantee will have discretion in how it awards operating cost assistance to projects. The grantee may apply the one-third limit to all projects or adjust it accordingly, as long as no more than one-third of each annual grant is used for operating cost assistance and for operating cost reserves."

Eligible activities are at Section 201: Eligible use of HTF for operating cost assistance and operating cost assistance reserve are at Section 201(e).

Regarding operating cost assistance, Section 201(e)(1) reads:

"(1) Operating costs are costs for insurance, utilities, real property taxes, and maintenance and scheduled payments to a reserve for replacement of major systems (provided that the payments must be based on the useful life of each major system and expected replacement cost) of an HTF-assisted unit.

"The eligible amount of HTF funds per unit for operating cost assistance is determined based on the deficit remaining after the monthly rent payment for the HTF-assisted unit is applied to the HTF-assisted unit's share of monthly operating costs.

"The maximum amount of the operating cost assistance to be provided to an HTF-assisted rental project must be based on the underwriting of the project and must be specified in a written agreement between the grantee and the recipient. The written agreement may commit, from a fiscal year HTF grant, funds for operating cost assistance for a multiyear period provided that the grantee is able meet its expenditure deadline in § 93.400(d) [that is - expend the funds within five years – Ed].

"The grantee may renew operating cost assistance with future fiscal year HTF grants during the affordability period [Section 302(d)(1) establishes a 30-year minimum affordability period] and the amount must be based on the need for the operating cost assistance at the time the assistance is renewed."

> The preamble to the interim rule regarding operating cost assistance (*Federal Register*, Vol. 80, No. 20, Friday, January 30, 2015 page 5210): "This interim rule establishes that a grantee may provide operating cost assistance to a project during the entire period of the affordability for the project. The written agreement between the grantee and the owner that commits funds from an HTF grant received in a single fiscal year may provide operating cost assistance over a period for multiple years as long as the grantee [sic] to meet its five-year expenditure deadline in § 93.400(d)…
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> "HUD will recapture funds not expended by the five-year deadline…
> "The grantee may renew operating cost assistance for HTF-assisted units during the affordability period by executing written agreements after future fiscal year HTF grants are awarded."

Regarding operating cost assistance reserve, Section 201(e)(2) reads (in part):

"(2) An operating cost assistance reserve may be funded by the grantee for HTF-assisted units in a project where the grantee determines in its underwriting of the project the reserve is necessary to ensure the project's financial feasibility. . . If the operating cost assistance reserve is funded with non-appropriated HTF funds [such as the dedicated sources coming from Fannie and Freddie], the reserve may be funded for the period of affordability."

The preamble to the interim rule regarding operating cost assistance reserve (*Federal Register*, Vol. 80, No. 20, Friday, January 30, 2015 page 5210-11):

> "HUD understands the need for both capital (replacement) and operating reserves in housing projects. When grantees provide HTF funding for a project, the need for annual or monthly contributions to these reserves are determined through the underwriting process.

"Funding for capital or operating reserves "up front" for the present value of the entire amount needed over the required period of affordability (30 years) is not possible if the HTF funds are appropriated, as Federal funds cannot be drawn in that manner, years in advance of need. However, funding for the HTF may come from non-appropriated sources, i.e., the proceeds from GSEs as described in section 1337 of the Act. Therefore, in the interim rule HUD establishes separate requirements for operating cost reserves funded by appropriated and non-appropriated funds.

"If the operating cost assistance reserve is funded with non-appropriated HTF funds, the amount necessary to fund the reserve must be calculated using the same methodology [The grantee must demonstrate the necessity of the reserve amount based on an analysis of potential deficits remaining after the expected rent payments for the HTF-assisted unit are applied to the HTF-assisted unit's expected share of operating costs.]; however, the reserve may be funded for the amount estimated to be necessary for the entire period of affordability up front, or if this amount would exceed the cap (one-third of each annual grant), could be funded in phases from future grants determined to be suitable and necessary to secure advantageous financing. HUD will provide guidance and training to states about underwriting standards for investment of HTF funds and establishing replacement reserves to provide necessary rehabilitation during the period of affordability in their HTF program guidelines."

Some other eligible uses of HTF money: Section 201(g) Costs relating to payment of loans: "If the HTF funds are not used to directly pay a cost specified in this section, but are used to pay off a construction loan, bridge financing loan, or guaranteed loan, the payment of principal and interest for such loan is an eligible cost only if:

(1) The loan was used for eligible costs specified in this section, and

(2) The HTF assistance is part of the original financing for the project and the project meets the requirements of this part."

Section 201(d) Related soft costs*: "*Other reasonable and necessary costs incurred by the owner or grantee and associated with the financing, or development (or both) of new construction, rehabilitation or acquisition of housing assisted with HTF funds. These costs include, but are not limited to:

"(2) Costs to process and settle the financing for a project, such as private lender origination fees, credit reports, fees for title evidence, fees for recordation and filing of legal documents, building permits, attorneys' fees, private appraisal fees and fees for an independent cost estimate, and builders' or developers' fees.

"(5) For new construction or rehabilitation, the cost of funding an initial operating deficit reserve, which is a reserve to meet any shortfall in project income during the period of project rent-up (not to exceed 18 months) and which may only be used to pay project operating expenses, scheduled payments to a replacement reserve, and debt service. Any HTF funds placed in an operating deficit reserve that remains unexpended after the period of project rent-up may be retained for project reserves if permitted by the grantee."

2. Options/Considerations from the HTF Operating Assistance Workgroup

Some recommendations and considerations from the OA Work Group about the HTF operating assistance and operating assistance reserve follow:

Using cross-subsidization in mixed-income projects supported by multiple funding streams will generally be necessary to achieve the deep targeting that most advocates and mission-oriented developers will strive to serve – e.g., extremely low income (ELI) households with incomes below 30% of area median incomes (AMI). Cross-subsidizing refers to combining ELI units with units affordable to higher income households where the rents paid by higher income households help offset the lower rents from ELI households to meet the operating costs of the housing project.

The work group thought households receiving Supplemental Security Income (SSI) benefits are a worthy proxy for targeting, which are generally those with incomes at 15-20% of AMI. Developers are encouraged to cross-subsidize rental units for ELI households using rent payments by households using project-based vouchers and by households paying higher than 30% of AMI in Low Income Housing Tax Credit (LIHTC), HOME, Federal Home Loan Bank AHP, and perhaps some market-rate units in the same project.

Options for Operating Assistance and Operating Assistance Reserves:

a. <u>Centrally Managed Operating Assistance Approach</u>: The work group discussed the possibility of having states retain and manage the 33% operating assistance, which they would then allocate to projects based on the incomes of households who actually occupy the HTF units, bridging the gap between resident's ability to pay and per-unit operating costs. One work group member noted that this could operate like a HUD 202 Supportive Housing for the Elderly Project Rental Assistance Contract (PRAC) subsidy administered by the state Housing Finance Agency (HFA). Those that are project-based Section 8 or voucher administrators for HUD already would not find this too great a stretch for them. Some work group members expressed concerns that many states would not have the capacity or interest in managing such a fund, noting the difficulty in operationalizing such a program. The group cautioned that state agencies that do not have experience rental subsidy administration should probably not pursue this option.

   In addition, if a state HTF program administrator (e.g., HFA) maintains and manages an operating assistance fund, they must consider the HTF regulatory requirement that HTF funds must be "spent" within five years of the original grant award from HUD. This model may also limit the amount of HTF available for future projects (both capital and operating) as existing projects will likely need renewed operating assistance past the initial five years.

   Many in the work group thought that up-front project capitalization of a operating reserve (see below) is preferred so that lenders, investors and other potential funders know the total dollars that are in the deals from the start and so that developers have greater flexibility in structuring the projects' financing. As in the other options, consideration must be given to the requirement that HTF units must be affordable for at least 30 years.

b. Project-Level Operating Reserve Approach: Allow developers to capitalize a reserve at the project level as part of the development budget. The reserve would be funded through NHT funds which would be categorized as an operating assistance reserve. This reserve will increase the ability to leverage other resources. In this situation, developers can create an escrow account or other form of funding disbursement agreement to manage funds appropriately to ensure affordability. It was noted that most nonprofit developers are very familiar with creating and operating transitional reserves (reserves meant to mitigate subsidy loss risk) so there is already an existing framework for establishing operating reserves. The consensus of the work group was that a "flat subsidy" approach be established where rents are underwritten to a specific AMI threshold –e.g., 15% of AMI – rather than it being subsidized to 30% of a household's income because: a) that is much easier to administer and involves less compliance cost and b) it is hard to predict how long an operating subsidy reserve will last if the project is paying the difference between a scheduled rent and 30% of income. Advocates, state administering agencies and developers are encouraged, however, to be sure to set those rents as low as possible to ensure that those occupying the new units are not rent-burdened (i.e. paying over 30% of their income towards rent).

   The work group noted that all forms of rental subsidy (Section 8, HTF as operating assistance or HTF operating assistance reserves) are going to either have a contract term or are going to be a fixed amount (so they will be projected to last a certain amount of time). Even if you get a 15-year contract (in the case of Section 8) or structure an operating assistance reserve to last 15 years, thereby satisfying LIHTC investors, you will need to think about and plan for what happens after that timeframe expires. Very long-term/permanent affordability with very deep targeting is the challenge. It should be noted that non-appropriated HTF funds can be used to capitalize an operating reserve to cover the 30-year affordability period but this may result in hitting the 33% cap quickly. As one work group member noted: "If each ELI unit needs $3K per year in operating subsidy, a five-year commitment is only $15K – far less than 33% of the capital cost for this unit. But if you set aside enough for the full 30 years, it would be $90K – far more than 33% of the capital cost for that unit."

   Another consideration for grantees providing capitalized operating reserves is how the reserve is structured as part of the development budget and its impact on the total development costs per unit (e.g. TDC will increase). Separating these costs from the budget or in their own budget line item will provide necessary distinction from other hard and soft costs. HUD recently made it clear that operating reserves will not be included in the HTF subsidy limits established by the grantee.

c. Using HTF for Project Capitalization. Another option is to use HTF resources as "deeper" project capitalization up-front to allow the developer to reduce the size of hard debt and structure their financing to keep units deeply affordable for ELI households over a 30-year mortgage term. This project capitalization would be in the form of a grant or, if used in a LIHTC-property, a no-interest loan with a maturity date that is later than other debt on the property - not a source of regular cash-flow. A straight capital contribution allows developers to structure their individual deals, to attract lenders and other funders with a stronger equity position, to deploy flexible tax credits, and to use equity as a future resource for operating reserve needs. As part of this discussion, the HTF capitalization approach could be pursued in two primary ways either by (1) cross subsidization lowering the need for first mortgage debt allowing ELI affordability to be carried over a specified term or (2) establishing a project-based operating subsidy reserve funded directly from LIHTC equity or an increased developer's fee (a practice used by the Pennsylvania Housing Finance Agency, among others) to cover the difference between the LIHTC rent levels (typically 50-60% AMI) to deeply affordable rents at 20-30% AMI over a specified term of between 15 and 30 years.

Note: Advocates are encouraged to consult with a member of the HTF Developer Advisory Group or another mission-focused developer who has strong knowledge and experience with LIHTC if HTF funds will be used as part of a LIHTC project.

States should consider how strong the affordable rental market is when identifying the best strategy for their market. For example, the cross-subsidization approach will be more successful in higher cost rental markets with very high demand where a rental project could carry non-LIHTC, market rate rental units at 60-80% AMI that could assist in supporting the ELI units. Correspondingly, the operating reserve approach may be more successful in areas where the fair market rents and the 60% AMI/LIHTC rent levels are similar.

Other Considerations:

- Setting rents at some level – e.g., 15% or 20% of 30% of AMI – is helpful for underwriting purposes. See "b" above.
- Rent payments at 30% of 30% or 35% of AMI are considered break-even levels in some markets, but not everywhere.
- Explore commitments to other state and local sources of gap financing (e.g., bonds and transaction/document recording fees) as source of additional subsidy (e.g., through creation of a state housing trust fund).
- Special needs providers prefer a simple model – e.g., allocate the 33% operating assistance and see how many families you can serve for how long.
- Be careful about "forward committing" HTF operating assistance. If operating assistance forward commitments are made counting on future HTF resources, there would be less of that assistance available for new HTF projects.
- Consider various factors when deciding whether a specific approach will be successful (e.g. the state's Qualification Allocation Plans, HFA capacity, developer capacity, market forces, etc.)
- Seek out guidance in setting up reserves. States need to understand the particulars of what should be in escrow/funding agreements (entity managing fund, eligible costs, excess funds, HFA oversight).

Conclusion:

What is contained in these pages is just a brief overview of options and considerations related to HTF operating assistance and operating assistance reserves. If you would like to dig deeper into what's contained in this document or get other advice on this topic or other issues about developing and managing HTF projects for extremely low income individuals and families, you can reach out directly to members of the HTF Developers Advisory Group, all of whom are experienced mission-driven affordable housing developers who have agreed to serve as a resource. You can find a list of HTF Developers Advisory Group members and their contact information at http://bit.ly/1Sj1uOp.