WASHINGTON STATE
HOUSING FINANCE
COMMISSION

Memorandum

To: 9% Tax Credit Program Stakeholders

From: Steve Walker

Date: September 20, 2013

Re: Proposed 9% Housing Credit Policy for 2014 Program Year

Dear Stakeholders,

Please join us at the following stakeholder meetings to discuss the policy proposals in this draft.

Metro Stakeholders: September 23, 10 am – 12 pm, Commission Training Room

Non-Metro Stakeholders: September 24, 10 am – 12 pm, Commission Training Room

King County Stakeholders: September 25, 10 am – 12 pm, Commission Board Room

We look forward to your input! If you are unable to attend the stakeholder meetings and would like to provide written input, please send it to Leslie Brinson Price at leslie.price@wshfc.org as soon as you can but please no later than Friday, October 4, 2013. Our intention is to publish our final recommendations by October 14th and to take those policy recommendations to the Board on October 24, 2013. Please note, input received prior to the publishing of the Final Recommendations to the Commission is not considered as 'formal written comment' for purpose of the Public Hearing.

Rehab/Preservation Priority – Metro and Non-Metro

In an effort to balance the recapitalization of an aging affordable housing portfolio and the production of new units, we are proposing the following changes to the way in which the program prioritizes projects within the rehabilitation/preservation spectrum:

Create Preservation and Recapitalization Set-Asides

The Metro and Non-Metro Credit Pools will be divided into two parts – Preservation and Recapitalization Set-Aside (P&R Set-Aside) and New Production. Projects that consist of units already in the Affordable Housing Portfolio will compete among themselves in the P&R Set-Aside within their geographic credit pool.

New Production is defined as new construction, projects that create new affordable units through adaptive re-use, or projects that convert existing market rate units to use-restricted affordable units. New Production Projects will compete among themselves within the New Production portion of their Geographic Pool.

The Allocation Criteria Points associated with Rehabilitation Projects and At Risk Properties will be eliminated from the Metro and Non-Metro Pools.

Metro: 25% of the credit available to the Metro Credit Pool will be set-aside to fund Preservation and Recapitalization projects as outlined below.

Non-Metro: 25% of the credit available to the Metro Credit Pool will be set-aside to fund Preservation and Recapitalization projects as outlined below.

The P&R Set-Asides will be "soft" set-asides of credit within each of the Metro and Non-Metro Credit Pools. If the remaining portion of the of the credit in a P&R Set-Aside is equal to at least 75% of the Geographic Pool's next highest ranked P&R project's credit request, the full amount of credit requested will be made available to that project, through forward commitment if necessary. Should a P&R Set-aside go undersubscribed, any remaining credit will flow into the New Production portion of that Geographic Credit Pool.

Eligibility Criteria for Participation in Preservation and Recapitalization Set-Aside

- **Project Age:** Project must have last placed in service 20 years before the year of Application for the P&R Set-aside. Placed in Service is defined as the date of the original Certificates of Occupancy or the date the last substantial rehabilitation was completed.
- **Project Sponsor** must be in good standing with all Commission programs and policies.
- **Project Financing:**
    - Projects that are feasible as a 4% Tax Credit/Bond Deal will not be funded under the P&R Set-Aside. The Applicant must submit financing plans that show the project structured as both a 9% project and as a 4% tax credit/bond project. The financing plans must demonstrate the quantitative and qualitative differences between the two scenarios. For example, what changes would be required to the scope of rehab or the income set-asides to make the project work as a 4% Tax Credit/Bond deal. A statement that the project has a funding gap as a bond project alone is not acceptable. The determination that a project is not feasible as a 4% Tax Credit/Bond Deal is at the sole discretion of the Commission.

    - Projects originally financed with 4% tax credits and tax-exempt bonds are not eligible for recapitalization in the 9% program unless it receives preapproval in advance of the Application.
- **Minimum Rehabilitation Threshold:** A project applying to the 9% Program is expected to use the recapitalization opportunity to extend the life of the project by at least 20 years. A minimum of $40,000 in hard construction costs per unit must be included in the development budget and supported by a Capital Needs Assessment.
- **Additional Low-Income Housing Commitment** will be determined by comparing the Weighted Average of the low-income set-asides in the existing Regulatory Agreement to the available set-aside options under Allocation Criteria 6.1.
    - If the weighted average of the existing low-income set-asides is *less* than 40% AMI in Higher Income Counties or 42% AMI in Lower Income Counties (the weighted average of the 60 point options), the project will be allowed to choose less restrictive set-asides on the new Regulatory Agreement, to be filled through attrition.
    - If the weighted average of the low-income set-asides in the existing Regulatory Agreement is *greater* than 40% AMI in Higher Income Counties or 42% AMI in Lower Income Counties, the Applicant may choose equivalent or more restrictive set-asides under Allocation Criteria 6.1
    - The weighted average of each of the low-income set-aside options will be added to Additional Low-Income Set-Aside Menu in the policies for Applicant convenience.
- **Related Party Transactions (Tier 2 and Tier 3 as defined below)**
    - The Project Sponsor must be able to demonstrate strong asset management performance on the project.
    - The Sponsor is expected to contribute equity to the Project based on reasonably expected Replacement Reserve levels over time of $250 per unit per year less documented draws on reserve accounts for capital expenses.
        - For example, $250 x 50 units x 20 years = $250,000 less $100,000 documented reserve draws = $150,000 owner equity contribution.
    - It is expected that any equity or appreciation in value in the project realized by the Project Sponsor will remain in the project as a contribution (e.g. as seller financing).
    - The allowable Developer Fee will be restricted. Developer fee will not be generated on the acquisition cost of the land and the building as represented in the budget. The fee will be based on the Total Project Costs less acquisition costs, capitalized reserves, intermediary costs, and donation.

Ranking of Projects within the Preservation and Rehabilitation Set-Aside

Projects competing within each P&R Set-Aside will be prioritized based on the following categories. Projects in Tier 1 will be funded before those in Tier 2; projects in Tier 2 will be funded before those in Tier 3. Within each tier, projects will be ranked according to the number of Allocation Criteria points they have selected.

<u>Tier 1 - Preservation of Rental Assistance:</u> The top priority within a P&R set-aside will be projects that are at imminent risk of loss to the affordable portfolio. These projects include HUD and RD properties with Rental Assistance and expiring use agreements where the current ownership is looking to sell the property. This category requires a change of ownership to an unrelated party. The expectation in this category is that the seller is looking to exit the affordable housing business and that if sold, the residents would be displaced.

Minimum Threshold Requirements for Tier 1 Status:

- Projects must have one or more Federally Assisted Buildings.
- Projects must have a minimum of 75% of its units operated with expiring project-based rental assistance.
- The Federal Agency regulating the low-income use must certify that the owner may be released from all low-income use restrictions within three years of the date of the Purchase and Sale Agreement.
- The Purchase and Sale Agreement must document a change in ownership to an unrelated party.
- The project's location must qualify for Job Center points.
- The Applicant must demonstrate that a market exists for the project to be converted to market rate housing and that the existing residents are likely to be displaced should the project not be purchased by the Sponsor.
  - A market study or at least 3 market rate comparables for each bedroom size must be provided to indicate the market rents that might be achievable at the property without the federal assistance restriction.
  - The Applicant must supply the rent rolls that show the incomes of the residents being served by the rental assistance to demonstrate that the population living in the units is unable to afford market rate rents in the same market area.

Preapproval of Tier 1 Status Required: Tier 1 projects must seek preapproval of their Tier 1 status at the time the Purchase and Sale Agreement for the property is being negotiated. Projects that are already under a Purchase and Sale contract at the time this policy is passed, may seek preapproval of Tier 1 status as part of the 2014 Preapprovals Requests due on November 7, 2013.

Preapproval will be based on the Minimum Threshold Requirements stated above. The Commission must concur that the project is "at-risk," that a true threat for conversion of the property to market rate housing exists, and that the displacement of the existing residents is imminent.

Once preapproval of Tier 1 status has been granted, it is valid for up to three years. The acquisition price in the Tax Credit Application must be supported by a current appraisal. Preapproval of Tier 1 status is not a guaranteed allocation of Credit. The project must compete for credit in the round in which it applies.

Projects originally granted rental assistance through HUD's Legacy Programs (Section 8 Moderate Rehab, Rent Supplement [Rent Sup], and Rental Assistance Payment [RAP]) may qualify for Tier 1 if the Rental Assistance is being preserved through the Rental Assistance Demonstration Program (RAD). Projects converting Public Housing subsidy into project based Section 8 through the RAD program are not eligible for Tier 1; those projects must compete under Tier 3.

Tier 2 - Preservation of Physical Asset: The second priority within the P&R set-aside will be projects that have expiring use agreements and rental assistance but where there is not a desired change in ownership.

Minimum Threshold Requirements for Tier 2 Status (preapproval is not required):

- Projects must have one or more Federally Assisted Buildings.
- Projects must have a minimum of 75% of its units operated with expiring project-based rental assistance.
- The Federal Agency regulating the low-income use must certify that the owner may be released from all low-income use restrictions within three years of the date of the Purchase and Sale Agreement.
- The Applicant must demonstrate that a market exists for the project to be converted to market rate housing and that the existing residents are likely to be displaced should the project not be purchased by the Sponsor.
    - A market study OR at least 3 market rate comparables for each bedroom size must be provided to indicate the market rents that might be achievable at the property without the federal assistance restriction.
    - The Applicant must supply the rent rolls that show the incomes of the residents being served by the rental assistance to demonstrate that the population living in the units is unable to afford market rate rents in the same market area.
- The current owner should remain as the sponsor of the project and the General Partner/Managing Member of the tax credit ownership entity once funded with tax credits unless approved by the Commission.
- The project must have significant and immediate capital needs evidenced by a required 3rd party Capital Needs Assessment.

Tier 3 - Recapitalization: The third priority is projects with existing use restrictions that are not expiring but need recapitalization evidenced by a required 3rd party Capital Needs Assessment. All Recapitalization projects that meet the Eligibility Criteria outlined above are eligible to compete in Tier 3. Projects will be ranked according to the number of Allocation Criteria points they have selected.

Proposed Changes to Metro & Non-Metro Allocation Criteria as a result of the P&R Set-Asides

1. Eliminate the 5 Allocation Criteria points associated with Rehabilitation Projects.
2. The Historic Buildings Allocation Criteria worth 5 points will remain, but these points will only be available to projects that are considered "New Production" per the definition above.

3. Eliminate the 10 points associated with At Risk Properties.

Preservation and Recapitalization in King County

The imbalance of new construction and rehab has been less of an issue in King County because of the coordinated efforts of the public funders. Instead of a P&R Set-Aside in this credit pool, preservation and recapitalization projects will compete with new construction projects with the following revisions to the Allocation Criteria point categories:

1. Eliminate the 5 Allocation Criteria points associated with Rehabilitation Projects.
2. Redefine "At Risk Properties" to match the definition above for Tier 1 Projects with the following exceptions: Projects are not required to be eligible for Job Center points. Preapproval of Tier 1 Status is not required. At Risk Properties will be worth 7 points.
3. The Historic Buildings Allocation Criteria worth 5 points will remain, but these points will only be available to projects that are considered "New Production" per the definition above.

Cost Containment Policies

Total Development Cost (TDC) Limits

We have updated our development cost database with project costs from 2012 and 2013 applications and final cost certs received between January 2011 and June 2013. This update adds roughly 140 projects to the data considered in the development of the TDC limits in 2011. We have also examined construction cost trends since the limits were in place.

King County

In the 2011 dataset used to determine the 2012-2013 TDC Limits, the average unit costs in King County were roughly 3-5% *below* the limits established. Using the 2013 dataset, King County's average unit costs are now 2-5% *over* the limits, demonstrating a 5-10% increase in costs. In those same 3 years, the ENR Construction Cost Index (CCI) for Seattle increased by 9.7% and the Building Cost Index (BCI) increased by 1.5%. Stakeholders have reported a spike in the King County construction market due to the competition for sub-contractors. The 9.7% increase in the CCI, which is influenced more heavily by the labor market, supports the stakeholders' experience.

Based on the escalation of construction costs that we have seen in our data confirmed by our research of the construction market, we propose the following increases to the King County Limits:

	Studio	One Bedroom	Two Bedroom	Three Bedroom	Four+ Bedroom
2012-13 Limits	$195,000	$220,000	$260,000	$315,000	$347,000
2014 Limits	$204,750	$231,000	$273,000	$315,000	$347,000
% Increase**	5%	5%	5%	0%	0%

Metro

The dataset used to develop the 2012-2013 TDC Limits lacked sufficient project data to specifically analyze construction costs in the urban counties outside of King County. In analyzing the 2013 dataset, we have found that it is a combination of an urban location mixed with an urban project type that causes Metro County projects to exceed the Balance of State TDC Limits.

Projects located in Metro Counties of Urban Project Type will be subject to the King County TDC Limits and the King County Cost Containment Incentive points. Urban Projects are defined as those that have two or more of the following:

- More than 4 stories
- An elevator
- Required structured parking
- Located on an urban infill site

Supportive Housing in Metro Counties is already subject to the King County TDC Limits per the existing TDC Policy.

Projects located in Metro Counties that do not meet the above Urban Project Type qualifications and are not Supportive Housing are subject to the Balance of State Limits outlined below.

Balance of State

In the 2011 dataset used to determine the 2012-2013 TDC Limits, the average unit costs in Non-Metro counties were roughly 4-13% *below* the limits established. Using the 2013 dataset, the Non-Metro Counties' average unit costs have increased roughly 11% and are now between 2% below to 7% *over* the limits. We do not have the same level of detail for increases in the rural construction market. However, the national statistics show that the cost of construction has increased roughly 4-5% since 2011.

Additionally, the 2012-2013 Balance of State TDC limits underestimated the cost of studio and one bedroom units. At that time, we did not have many projects outside of King County with studio or one bedroom units in our dataset. Projects subject to the Balance of State limits that are made up of primarily one bedroom units have been at a disadvantage under our TDC Limit policy and many have had to apply for waivers of the Limits.

	Studio	One Bedroom	Two Bedroom	Three Bedroom	Four+ Bedroom
2012-2013 Limits	$135,000	$152,000	$184,000	$239,000	$263,000
2014 Limits	$148,500	$167,200	$189,520	$246,170	$270,890
% Increase**	10%	10%	3%	3%	3%

**While construction costs do not impact unit sizes differently, we are also working to calibrate the costs among the unit sizes appropriately. For that reason, not all unit limits have been increased by the same percentage.

Cost Containment Incentive

In an environment of constrained resources, staff has been directed by the Commission to reward projects that are able to develop quality housing in a cost efficient manner. Staff is proposing the addition of an Allocation Criteria that ranks projects in a round against each other and awards points to the ones that are able to develop housing for less.

When Applications are received, the Residential Cost per Square Foot (Cost/SF) of each project will be calculated per the following definitions:

- Residential Project Square Footage is defined as the gross square footage of the buildings to be constructed or rehabilitated. Commercial space that is to be owned under a separate legal entity and whose costs are not included in the Residential Project Budget is not allowed to be included in the total project square footage.
- Total Development Cost is defined in the same way as it is under the existing TDC Limit Policy: Total Residential Project Cost minus the cost of land and minus capitalized reserves.
- Cost per Square Foot is determined by dividing the Total Development Cost by the project's Residential Project Square Footage.

Projects competing in the same allocation round that are subject to the King County TDC Limits (i.e. those located in King County, Supportive Housing, and Urban Type Projects in Metro Counties) will be grouped together to determine the median King County Cost/SF for the round. Those projects will then be ranked against that median.

The same approach will be used to develop the median Balance of State Cost/SF. Projects competing in the same allocation round that are located in the Metro and Non-Metro Counties and subject to the Balance of State Limits will be grouped together to determine the median Balance of State Cost/SF for the round. Those projects will then be ranked against that median.

- A Project whose Cost/SF is more than 5% above the applicable median Cost/SF will receive 0 points.
- A Project whose Cost/SF is 5% above to 5% below the applicable median will receive 2 points.
- A Project whose Cost/SF is more than 5% below the applicable median will receive 3 points.

If at the time of Final Cost Certification, a project has failed to maintain its Cost/SF in the range for which it was awarded points, an equal number of points will be deducted from the Project Sponsor's next 9% tax credit application.

NOTE: As a result of this new Cost Containment Incentive allocation criterion, the Efficient Use of Credit allocation criterion will be eliminated.

10% Credit per Project Limit – King County Only

Our analysis shows that our 10% Credit per Project Limit artificially constrains the scale of projects in King County to approximately 75 units per project. There is substantial anecdotal evidence that sites in King County are not being developed to their full capacity because of this limit or that projects are being unnecessarily developed in phases. We are proposing a policy that allows for a competitive demonstration of the efficiencies that may be gained by developing at scale greater than 75 units per project. Projects funded through this demonstration will remain subject the 15% Credit per Sponsor limit; so in effect, the maximum credit per project under this policy is 15% of the Available Annual Authority. Projects also remain subject to the Credit per Low-Income Unit policy.

We are proposing this policy would apply to projects seeking an allocation of Credit in the 2015 credit round. In order to coordinate with the public funding process, the MHFC Director would approve one project to use more than 10% of the credit through a competitive process held in the spring of 2014. At that time, applicants would submit a conceptual overview of their proposed project that demonstrates how it meets the following selection on the criteria:

- The Total Development Cost of the Project is less than its Total Development Cost Limit.
- The project is more than 100 units.
- The project is able to demonstrate the efficiency of developing a larger scale project in a single phase; including evidence that splitting the project into two allocation cycles or into a split financed transaction (9% project co-developed with a 4%/bond project) is either inefficient or infeasible.

Once approved, the selected project can proceed through the public funding cycle (if applicable) and apply for an allocation of Credit out of the King County Credit Pool in the 2015 round. Approval of a project to exceed the Credit per Project Limit is not a guaranteed allocation of Credit. The project must compete for credit in the round in which it applies.

Veterans

After analysis and receiving input from stakeholders, we have determined that veterans are well served by the Program through the existing policies. We will not be implementing any changes regarding veterans at this time.