Allocation Costs in the HOME Program

HOME Webinar Transcript
Tuesday, December 13, 2016

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Finally, as with all recorded events, the information presented may not remain current over time as HUD guidance and/or regulations are updated. If in doubt, PJs should always contact their HUD Field Office for clarification.

Steve Lathom: Apparently, the Web streaming audio is not working, so hopefully everybody has gotten the message to use the dial-in. Two quick things to note, the plan is to record this and post it, and we also have plans with HUD to hold a repeat of this session on a to-be-determined date after the first of the year. We apologize for that, but sometimes these technical issues happen.

(Slide 1) What I'm going to do is switch over to the right slide deck and welcome you to today's webinar on allocating costs in the HOME program. For the next hour and a half or two hours, we're going to be talking about that, which is all based on CPD notice 16-15.

(Slide 2) Since we are talking about the HOME program, it comes as no surprise that the webinar is sponsored today by HUD's Office of Affordable Housing programs, which is the home of the HOME program. I'm Steve Lathom from TDA Consulting. I'm happy to be joined today by Monte Franke, whom many of you know well from the Franke Consulting Group. We're happy to be with you today and hope that, despite the challenges with addressing this somewhat technical issue in a webinar, that you'll find the discussion helpful.

(Slide 3) Before we get started, I want to make sure everyone knows about some additional resources that are available. Of course, the notice itself, CPD 16-15 on cost allocation, is available on the HUD exchange. Embedded within that are some process charts for each of the different cost allocation methods that we'll be touching on today. If you haven't already pulled that down and read it, we would strongly encourage you to do so, of course not at the same time that we're doing the webinar. We also developed an Excel workbook called the HOME Cost Allocation Tool. This contains a series of spreadsheets that PJs can use to complete the cost allocation process. It includes specific spreadsheets for each of the different methods of cost allocation that we'll talk about today, the standard method, the proration method, and the hybrid method, as well as including a sheet that helps guide you as to which method to use based on whether or not your units are comparable and what your starting input is. We'll talk more about those issues later.

All of these are available on the HUD exchange and if you were to go back to the HUD exchange training listing, and you went to today's webinar, you're going to see the slides. You're going to see the cost allocation tool. There's also a link to the notice. Those are all available to you and will continue to be available to you via the Web.

(Slide 4) Again, it will be important for those of you that haven't, to go back and read the full notice because as anyone who's been on one of these webinars before knows, we can't fully cover every nuance in the time available to us today. As a roadmap of where we're going, we're going to start with an overview of cost allocation, when and why it's required, and how it's linked to the broader requirement for project underwriting. As we'll see, cost allocation is really a sub-routine within the larger underwriting process.

From there, we'll talk about the process for cost allocation itself. While it can look a little intimidating, the process can actually be broken down into five relatively straightforward steps. Most of them are the same, no matter which of the potential three methods are available to us. Finally, we're going to talk through various implementation requirements. As we sometimes joke when we deal with federal programs, if it isn't documented it didn't happen. A fair amount of this section will be related to how we take the results of the cost allocation analysis and make sure that it feeds through to the project underwriting, to our written agreement with the project owner, and its impact on how we disperse funds, as well as the need to recheck everything if and when things change prior to project completion.

(Slide 5) Before we go any further, what I'd like to do is run a quick poll to help us gauge the audience today. I'm going to ask Sandy to go ahead and turn that poll on. It should show up on the right hand side of your WebEx window, toward the bottom. We've got four questions for you, just to give us a better sense of where you're coming from and so you can get a sense of who else is on the webinar with you today. The first question relates to your role in the program. Are you a PJ, a state, or a sub-recipient? Are you a developer, which could be a CHDO? Are you HUD staff? Are you from some other role in the process?

Our second question is more about your relationship to cost allocation. Are you in a role that's more of a general policy and program oversight? Are you one of those deal jockeys that runs the numbers and actually does the work of doing the cost allocation review? We're also interested in whether or not you've read the notice in advance. Finally, can you let us know how long you've worked with the program? Are you one of those new folks with less than a year of experience? Have you been working with HOME for one to five years? Six to ten? Are you a grizzled veteran with more than a decade of experience?

We're going to give another minute or so for folks to answer those questions. Then we'll ask Sandy to go ahead and close the poll, as well as publish the results so that we can see them. That just takes a second to do, so we may have just a slight amount of dead air time. As we wait for that, Monte, do you have anything you want to say to folks?

Monte Franke: Hi Steve. I thought I'd just take a moment to say hello to everybody. I looked through the list and we rounded up a lot of the usual suspects, I see. I wanted to say Happy Holidays to you and welcome you. I'm surprised you could take the time, given the time of year when we're so busy with year-end, holiday parties, shopping, and things like that. I hope we can make today useful for you.

Steve Lathom: I think the poll has gone ahead and finished. We'll ask Sandy to go ahead and get that published. We'll talk through the results, and then we will move on.

[Silence Until 00:06:36]

Steve Lathom: Looking at the results, which I think most of you see in the right hand side of your screen, it looks like better than half of you that are on the call today are from PJs, which is very much to be expected. We've still got some folks that are state recipients or sub-recipients. We have a handful of developers. We have quite a few HUD staff. We have various others. Some of those may be TA providers, lawyers, who knows what. Some of you didn't answer and that's fine.

It looks like, of the people that responded to the second question, we've got about twice as many of you that are more in a general program or policy oversight role relative to cost allocation, as we do those that run the numbers. It looks like about half and half, roughly, have read and haven't read the notice. Again, those of you that haven't read the notice, we would encourage you to go back and print that off. Read it in greater detail later. We've got a nice mix of a fair number of new folks, a lot of folks in the middle with one to five or six to ten years of experience, and then at least 20% of you that are those grizzled veterans with more than a decade.

This just helps us have a sense of who's on. Let's go ahead and move forward. I'm going to hand it over to Monte now, to talk through the first section. I will hand you the presentation ball, Monte.

(Slide 6) Monte Franke: Thanks Steve. Hello again, everybody. Let' dig into it. I wanted to start with a little bit of regulatory context and background. Those of you who are new, and there are some of you according to the poll who haven't had a lot of experience with HOME, will have an understanding of where cost allocation fits in. HOME has a very important flexibility in that it can assist specific units within larger projects. That gives us the ability to do mixed use, mixed income, and other types of properties. HOME funds can be allocated to the cost of specific units or a mix of units within larger projects, allowing for those units to be HOME assisted and be subject to HOME rules, while any other units or spaces can be funded with other funds and not be subject to HOME rules.

This process for allocating HOME funds to specific units or unit mixes is called cost allocation. There are three regulatory cornerstones to this that set up our cost allocation process. The first one, as you see, is in 92.205 of the HOME Final Rule, that tells us that we can only pay for the eligible development costs of assisted units with HOME funds, and that we have to determine this space on a method of cost allocation.

The second is that we also have to apply a maximum subsidy limit. That's in 92.250(a). That is the maximum amount of HOME funds that can be provided to any HOME unit. Your limits vary by participating jurisdictions. You should see the notice that's listed there, and also online at the HUD Exchange HOME program page, what the limits are. It will tell you how to go about determining it. If you have any questions about what the maximum per unit subsidy limits should be for your particular jurisdiction, consult with your field office to get additional guidance.

The third corner of this cost allocation process is the requirement to underwrite. As many of you know, the underwriting requirements were updated significantly in the 2013 Final Rule. The core determination in underwriting is for a PJ to invest no more funds than are necessary to provide quality affordable housing that's financially viable. It is important that the PJ, as part of this underwriting, determines how much money is absolutely needed to make the project not only feasible from the standpoint of implementation, but also viable for the affordability.

(Slide 7) These three then form the basis for limiting HOME funds, the underwriting gap that is determined through underwriting. The gap is what the difference is between the reasonable cost of the project and the loans and other funds that are available to the project other than HOME. In addition, we have put by the eligible cost limits on the project and we have to apply the maximum per unit subsidy limits. These two additional items come into the cost allocation process. Together with that and the underwriting, we form a decision about the HOME assistance to a project.

(Slide 8) So when does cost allocation apply? Cost allocation is required when a HOME project has units that are not HOME assisted or non-residential spaces that are not eligible. That means that it would apply when we have mixed income projects that include HOME units, as well as non-HOME units that might not be HOME eligible, might be unrestricted, or might be covered by another public source of funds. It must be used when we have mixed use, when we have non-residential spaces such as commercial or public use spaces that are not eligible for HOME funding. It applies to mixed tenure properties, such as an owner occupied two-family or three to four-family with rental units. A decision has to be made as to which units are assisted in that project. It must also be applied when there's mixed financing that prevents us from putting HOME funds into all of the units. The example you see on the screen is public housing, where we are prohibited from assisting certain types of federal low-rent public housing units that are funded with the capital fund or operating assistance. In all those cases, we need to make a decision about which units are HOME assisted and what the eligible costs are toward those units.

When it is not required? Technically, if all the units in a project are HOME assisted, we're not allocating cost to individual units. That would come up in cases of single family home ownership or single family rentals, or 100% of a multi-family project being HOME assisted. However, let me be clear. Even in these 100% HOME unit circumstances, the underwriting requirements of HOME, the eligible cost limits, and the subsidy limits still apply. It is just that the costs don't have to be allocated among individual units or unit types. They can be considered for the project as a whole.

(Slide 9) What is cost allocation? Cost allocation is a methodology that HUD has designed for assigning actual costs to individual HOME assisted units. The methodology helps PJs to determine the balance between HOME funds in assisted units for any given HOME investment. It can help the PJ to determine either the minimum type and number of HOME assisted units for a given amount of HOME investment proposed to by the applicant and supported by underwriting, or it can help the PJ to determine the maximum HOME investment that's permissible for a proposed mix of HOME assisted units.

(Slide 10) Cost allocation can be used in two different ways, either to get from a proposed dollar investment to the minimum assisted units required to make the investment eligible, this is what we tend to call dollars to units, or to get from a proposed unit mix to the maximum permissible HOME investment in those units. This is what we call units to dollars. Let's start with a simple example of dollars to units.

Let's say a developer has submitted a proposal for, and initial underwriting has confirmed the need for, a certain amount of HOME funding, let's say $300,000. If the eligible cost and subsidy limits associated with that one unit are $120,000, then one assisted unit would not be sufficient to allocate the required HOME funds.

(Slide 11) However, if three units of the same or different sizes together total $300,000 or more in eligible HOME costs, and assuming that this is also in line with the maximum subsidy limit, then that would achieve the balance of dollars to units needed to permit the investment of the $300,000 in HOME funds.

(Slide 12) Let's consider the units to dollars approach. Say the developer's proposed to provide you with three units HOME assisted within a larger project and you need to determine the maximum assistance you could provide given those three HOME assisted units that are proposed.

(Slide 13) Through cost allocation, you would calculate the eligible costs for those three units along with the maximum subsidy limits, and determine the maximum amount of HOME funds that could be invested, given the three assisted units to achieve the balance. Of course, underwriting will ultimately determine the needed amount of HOME assistance, but it would have to make certain that it did not exceed the amount of assistance determined through cost allocation.

(Slide 14) These examples begin to suggest the relationship that cost allocation has to underwriting. Cost allocation is nested within the overall underwriting process, almost as what I like to call a sub-routine. Initial underwriting produces the preliminary estimates, either of the gap in the HOME funds potentially necessary for the project, and/or the initial designation of the units, number of units, or mix of units that are proposed to be designated as HOME assisted. Cost allocation then examines the eligible costs by unit type and the maximum subsidy limits that would apply to the project, and either determines the unit mix required for the proposed HOME investment or the maximum HOME investment permitted by the proposed unit mix. In other words, either dollars to units or units to dollars.

The cost allocation results then are reapplied to the underwriting to test that the HOME investment and the unit mix determined through cost allocation work. In other words, by works, I mean that the underwriter determines that the project is still financially viable given the cost allocation determination and the assistance amount is appropriate.

Think for a moment about the potential impact of the cost allocation. The designation of a certain number and mix of assisted units is going to affect the rents that can be charged, and therefore the revenue to the project. This might, in turn, affect the gap that needs to be funded and the amount of HOME assistance that's needed. Consequently, cost allocation might need to be an iterative process, where you have to go back and test a different unit mix or a different assistance amount to determine that you're still complying with all the rules. This may take a couple of different turns between the cost allocation and final underwriting to get to that final amount.

Keep in mind that cost allocation only provides what I will call limits, the minimum number of HOME units or the maximum HOME dollars. The PJ can always determine to require more than the minimum HOME assisted units or provide fewer than the maximum permissible dollars based upon the final underwriting determination.

(Slide 15) Now that you know about where cost allocation fits in, and the product of cost allocation, let's begin to talk about the methodology. To start, we need to recognize the notice that Steve referenced identifies three distinct methods that are permissible under various circumstances. The first method is called the standard method. This method can be used in all project circumstances, and as such should be considered the default method. However, there are some projects that have units that are comparable. We'll define that in just a moment. HUD has determined that in those comparable situations, the PJ may be able to use one of two slightly simplified methods that are known as the proration method and the hybrid method. We'll talk more about those different methods in a few minutes.

(Slide 16) Let me first address what comparable means. When are units comparable? For the purpose of the cost allocation, units are considered comparable if they are similar in most respects and likely to have a similar market value. Comparable units have similar configurations, such as number of bedrooms, bathrooms, and total rooms. They are similar size in terms of square footage. There are similar amenities, features, fixtures, and finishes. They have a similar market value for rent, not taking into account any program restrictions that limit this.

Comparability does not require that all units within a project be the same. For example, a project does not have to have all two-bedroom, two-bathroom, 700 square foot units. Comparability can exist within unit types and there can be several unit types within the project. With any unit type, all units in that category must be comparable. Please note, units don't have to be identical to be considered comparable. Units with minor layout differences or square footage variations that do not impact the unit or its market value might still be able to be considered comparable and part of the same unit type.

The notice outlines the three methods and Steve will be describing them further in a few minutes. However, let me just offer this personal observation. The options are offered to you for flexibility. However, sometimes options can add complexity or lead to confusion. In my view, you can keep this process simpler and more likely to be in full compliance by using the standard method for all projects. That's the safe way to go. HUD permits the alternative methods in projects where units are comparable, but as a PJ you've got to be aware that you could risk a serious error in applying an alternative method incorrectly to a non-comparable situation. Just be careful when you select those other methods.

(Slide 17) With that, let's pause and see if there are any questions. I'll turn it back to Steve. Steve, do we have any questions?

Steve Lathom: Yeah, we had a couple of questions. I think in some ways they both kind of came up at about the same time when you talked about mixed finance. The first is this. If there's another funding source used as match, does that require cost allocation? The other one is very similar. Are matched funds considered mixed finances, if they're the only non-HOME funds going into the project? I think the response there, in essence is this.

Mixed finance is a term that we use often with public housing. The issue is that cost allocation is required any time a project includes both HOME assisted and non-HOME assisted units. If those non-HOME assisted units happen to be public housing units or happen to be market rate units, cost allocation is required. Let's not get tripped up over the term mixed finance. I think the other point is that when we do the cost allocation, we're looking at the HOME funds and not necessarily the matched dollars per se. It's not that we add the HOME and the match together to do the cost allocation. That's not referenced in any way within the notice.

This is the other question that just came in Monte, and I'll let you handle it, is this. Can a project that has one, two, and three-bedroom units be comparable if the unit types for the one-bedrooms are the same, the unit types for the two-bedrooms are the same, and the three-bedroom unit types are the same, and if all amenities are the same for all units?

Monte Franke: I think you're going to be getting into that a little bit more as we go along. The answer generally is yes, you can have different unit types within a project, but within each type the units must be comparable. How you distribute the HOME units determines whether or not you can use proration or the hybrid method. I think you'll be covering that more Steve, as you go into step three.

Steve Lathom: We will. We'll get into that a little bit deeper. I see another question that came in. I want to defer it because we'll cover that in the next section. It talks about this. For policy reasons, the PJ shows they have greater demand or greater need for larger units than necessarily the smaller units in a development. We'll talk about the options for that. The short answer in the preview is that when you use the standard method, you can pick the units. When you're using one of the other methods, in general, HOME will have a roughly equal proportion of each unit type.

This is another question that came in, that we kind of anticipated. Is there a defined amount of variance permitted within the square footage within a set of units, for example, the two-bedroom units, in order to determine that they're comparable? The questioner proposed a 10% square footage variance. HUD deliberately did not set a variance in terms of saying plus or minus X% from the average. I think that's something that PJs have to set. HUD's language in the notice said a small variance. PJs, within their policies and procedures, need to take that into account. I do think that a 10% difference may be getting to be a pretty big swing when you consider that 10% smaller than the average and 10% bigger than the average leaves quite a big range. HUD did not set a specific number, so I think PJs need to set that for themselves, looking at the general guidance of that being relatively small.

The big issue that we're looking at in comparability is that fundamentally, the differences should be insignificant enough that it really doesn't matter to me whether I've got Unit A, Unit B, or Unit C. They're fundamentally close enough that over time things are going to be about the same. If the size difference is meaningful, then suddenly the product that HOME is being given from time to time is not interchangeable and is not the same thing. Let me just look here at some of the additional questions that have come in.

This is another question about negotiating with the developer to take a larger number of the three-bedroom units versus the two-bedroom units. We'll talk more about that, but again, if you want to pick specific units for a specific reason, you're going to need to go with the standard method and use fixed units. If we're using floating units, we really want roughly the same share of each unit type. Let me see.

This is one other question. If we have floating units instead of fixed, does that give us comparability? In fact, it really goes the other way. Comparability tells us whether or not we can use floating units. The starting point would be that we're probably going to use fixed units and use the standard method. If we determine that units are comparable, that opens us up to allowing our HOME units to float. It really goes the other way. Comparability determines whether or not you can use floating or fixed units.

I think we've probably covered most of the questions. There are a couple we're going to end up hitting on in terms of walking through the different details.

(Slide 18) I'm going to go ahead and move on in the presentation. We'll come back. We've got two other spots for questions and answers, so we're going to keep moving on right now. This is not your last bite of the apple, as it were. Keep those questions coming. Monte will track those as we go. We'll do more.

At this point, my unenviable job is to try to help everyone make sense of the details of the cost allocation process. I know that sounds like a little bit of a tall order when you heard Monte talk about there being two different entry points, starting with dollars and moving toward units or starting with units and calculating dollars. We've got three different methods. It sounds really complicated, but in practice we're trying to simplify it and recognize that it is a lot simpler than it sounds initially. I want to start with an overview of the process.

What you see on the slide right now is that the cost allocation process really follows the same basic logic, no matter which of the different methods we're using. The variation between methods is really just in the third step. Once we've determined that cost allocation is required, that is, we have a multi-unit project where some units are HOME assisted and some aren't, the first thing we need to do is to determine whether or not those units are comparable using the framework that Monte talked about earlier. That determination informs our decision about which cost allocation method we're going to use.

If the units are not comparable, our only option is that we must use the standard method. If the units are comparable, we can still the use the standard method, but we also have the option of using either the proration or hybrid method, potentially. First, determine comparability and figure out which method we're going to use.

Next, we have to determine what our starting input is. Are we starting from the initial or proposed HOME investment? Maybe that's the amount of money the developer requested. Maybe that's the amount that you as the PJ have initially decided you're willing to invest based on your underwriting of the project, or even because that's the maximum that you'll award to a project, for example. In practical terms, this is the most common starting point. It really is the best way to approach things, since as a PJ you're always going to have to underwrite your project anyway, to make sure that the HOME award is reasonable and necessary, and sized to the actual gap in the project.

In some cases, we still may be starting from that set of proposed HOME units and trying to determine how much could be awarded from the project. As Monte mentioned, we kind of talk about this as the units to dollars approach.

The third step is where we see the variation. Depending on which method we're using and what the starting point is, dollars or units, then we have these different options. We're going to dig into those more in a couple of minutes. The basic idea of the third step in the process is that the end of the process will be determining the actual cost of those units, and designating enough units as HOME assisted to equal or exceed the proposed HOME investment. Once we've determined what the actual cost of those HOME units is, we're really on the downslope of the process.

We next need to determine, in the fourth step, the maximum project subsidy, which is just based on the maximum per unit subsidy added together for each of the units that we've designated as HOME units. The fifth step is to compare and take the lesser of the proposed investment or the gap in the project, the actual cost of the HOME units, or the maximum subsidy. PJs can't give more funds than are needed. We can't give more than the units that are being designated as HOME actually cost. We can never give more than the maximum subsidy. When you layer those three things together, it's the smallest of the three that comes out the other end.

Finally, as Monte mentioned earlier, we have to go back to the broader underwriting process and make sure everything is still balanced. If the proposed HOME investment required more units with HOME rent restrictions than we originally anticipated, it's possible the project's revenue is now lower, which could lead to a reduced mortgage and a higher gap. In other cases, the number of HOME units might be bigger than we thought and might trigger additional requirements like Davis-Bacon, and then that can affect the cost.

The point is that once we do cost allocation, if that changes anything about the underwriting, we may have to run through the process again in an iterative fashion until everything achieves this level of balance and stability in the numbers.

(Slide 19) Let's go ahead and walk through these steps in greater detail.

The first step is to determine whether or not the units in the project are comparable. As Monte covered before we did the Q&A, that doesn't mean that units need to be identical. The concept of comparability is that the differences are minor enough that we're willing to substitute units one for another over time. We're looking at the configuration and the number of rooms, the overall square footage, the level of amenities and finishes, and at the end of the day, we're kind of looking at whether or not some of these units command a premium in the unassisted market. If the developer says that if this isn't HOME assisted this is a $1,000-a-month unit and this one is an $800-a-month unit, there's probably something different about those making them not comparable. That's our ultimate gut check in determining comparability.

Additionally, as Monte covered and we've touched on a couple of different times, HUD recognizes that in many projects, if not most projects, comparability is going to be determined within groupings of tranches of units. It's not that all units are comparable. Instead, we might determine that all of the one-bedroom units in the project are comparable to each other, all of the two-bedrooms are comparable to each other, etc. In other cases, we might even have a further level of breakdown that we need to do. Perhaps there's a project that has a group of comparable two-bedroom townhome units that are comparable to each other, but the other two-bedroom units are flats and those are comparable to each other. Ultimately, to make these determinations about comparability PJs are going to need to review detailed plans for the project that show the layout and the square footage of the different units, as well as the specifications, which would help us demonstrate whether or not some units are getting different amenities and higher level finishes than others.

The determination at the end of this as to whether or not projects are comparable in turn guides our choice about which cost allocation method to use. If you do access the cost allocation tool, what you'll notice is that the first page is instructions, but the first substantive page helps you walk through the determination of which method may be used based on comparability. Again, any time the units aren't comparable, you have to use the standard method and you have to use fixed HOME units. Even if they're comparable, you can always choose to use the standard method and designate fixed units. It's only when units are comparable that we have the option of using the proration or the hybrid methods, which we'll talk more about later, in designating floating units. In the Excel workbook the first spreadsheet helps walk through the decision about comparability and then helps you select which method of cost allocation is most appropriate to your project.

(Slide 20) Once we've determined the comparability, our next step is to complete the initial underwriting. We need to determine what our starting input is. As we kind of talked about at a couple of other points, most of the time our starting input is a proposed HOME investment. We're using cost allocation to determine how many units we have to designate as HOME assisted. Our developer asks for and our initial underwriting suggested that we need to give this project $1 million in HOME. Are we going to designate fixed units as HOME? Are we going to designate eight units as HOME? Does that require 15? Cost allocation helps us answer that question.

In other cases, we might work in the other direction. For example, we know that seven units are going to meet the HOME income and rent restrictions. We're trying to figure out how much of a HOME investment those units can justify. Remember that if you're working in that other direction, starting from the units and moving toward the dollars, in every case the PJ ultimately still has to underwrite the project in its entirety and make sure the HOME funds provided are no more than what's needed to be viable, usually what we talk about as the funding gap. For that reason, that's why the most common path through this overall process is to start from the dollars and determine the unit designations.

(Slide 21) The third step in our process is where things start to get more confusing. Hopefully, we'll be able to de-mystify some of this. To start out, what I want to point out is that there are two primary methods, the standard method and the proration method. At a high level, they go through the same basic path. Both work to get to the point of what we refer to as the base cost per square foot. From there, using that base cost per square foot, we can determine the cost of each unit in the project. The key difference is that in the standard method, we're going to be looking at the cost of a specific unit. For example, we might determine that the cost attributable to Unit 101 is $117,312, to pick a random number.

The proration and the hybrid methods are going to look at an average or typical unit within this tranche of comparable units. In that case, what we might find is that the typical one-bedroom unit has a cost of $120,500. That's kind of where we're headed. In both cases, what we do is designate HOME units until the sum of the cost for those HOME assisted units equals or exceeds the HOME investment, the kind of scale balancing graphic that Monte used earlier. Step three is where these different paths have the most detail. We're going to go through them a little bit more specifically. To do that, we're going to focus initially on the standard method and then we'll talk a little bit more about the proration and hybrid methods later.

Monte Franke: Hey Steve?

Steve Lathom: Yeah.

Monte Franke: Sorry to interrupt, but we did get a question in about what you meant by base cost on that last slide. Could you just clarify that while we're still there?

(Slide 22) Steve Lathom: Sure. This next slide explains what we're talking about with the term we use about base project cost. In both cases, whether we're using the standard method, proration, or hybrid method, the first part of step three is to calculate the base project cost. The way we do that is to take the total development cost of the project, all of the different uses of funds, and from that we first remove any costs that are not eligible to be reimbursed for HOME, HOME-ineligible or not HOME-eligible costs. This includes things like most of the capitalized reserves, organizational or syndication costs, and off-site infrastructure. Some of the other usual suspects of cost that have to be removed as HOME-ineligible are things like freestanding non-residential structures. That's just a quirk in the way the program works and the way the statute is written.

We can't use HOME to pay for a detached garage or carport, or in a multi-family project if you have a freestanding leasing office or community building that is not physically connected to residential units, those freestanding non-residential structures have to be removed. In a mixed use project, we would take out the cost associated with the commercial portions of the project. Maybe we've got a project that has the first floor as retail and the upper stories are residential. You're going to remove those ineligible costs.

In the standard method, we could be dealing with units that aren't comparable. If the reason they're not comparable is because some units have upgrades that others don't have, maybe some higher end units that have hardwood floors, fireplaces, and premium finishes, while others are a little bit more builder grade, in that example what we would need to do is figure out what the cost of those non-standard upgrades are and remove them as well. This step in the proration or hybrid methods is moot. It doesn't need to take place because we've got comparable units. There is no unit specific upgrade to remove.

The other option that we have to look at is how we're going to treat uniform relocation or URA related relocation costs. As everybody knows, in federally funded projects including HOME, if the project results in the temporary relocation of or the permanent displacement of existing occupants or tenants of an occupied building, those folks are entitled to certain protections and benefits. For projects that include these URA required relocation costs, HUD gives PJs two different options about how you can treat them.

First, what you can do is simply treat those relocation costs as a common cost of the project. What that does is basically distribute those costs evenly across the project as a whole. If that's what you choose to do from a policy standpoint, you do simplify what you're doing with cost allocation. There's nothing special to do here. On the other hand, HUD lets a PJ choose to assign those relocation costs exclusively to the HOME units. Essentially, it's kind of like saying but for the use of the federal money, we wouldn't have incurred this cost at all, so we're going to charge this specific cost and only this cost entirely to the HOME program. If a PJ wants to go that route, then within this calculation we're going to temporarily remove those relocation costs and add them back in later.

To get to the base project cost, we started from the total development cost. We removed the HOME-ineligible costs. We took out any costs that are associated with non-standard unit upgrades. If we're charging URA exclusively to the HOME units, we temporarily remove those. That gives us a number that we call the base project cost. We then divide that by the total residential square footage in the project to get to a base cost per square foot. When we're talking about that residential square footage, that's the sum of the interior space of all the units added together. We don't include the square footage of common areas like hallways, laundry rooms, etc. That's how we get to that base cost per square foot that I mentioned on the previous slide.

This logical part of the process really is the same whether we're talking about the standard method, the proration method, or the hybrid method. It's only those unit specific upgrades that would only happen in the standard method. With the other two methods, because there's no substantive difference between the units, there are no upgrades to remove.

(Monte Franke: Steve, can you clarify URA and what actually means?

Steve Lathom: URA is the Uniform Relocation Act.

(Slide 23) We worked our way down to the base project cost. That now lets us determine the individual cost of each unit in the project. We do that by multiplying the base cost per square foot by a specific unit square footage. Right now we're in the standard method. Just to make the math really easy, let's assume that we've determined the base cost is $100 per square foot. Clearly, that's less than a lot of our construction projects, but it's easy math. If I look at the plans and determine that Unit 101 has 700 square feet, then to determine the cost, the actual cost of Unit 101, its $100 per square foot multiplied by 700 square feet, which is $70,000. We get to the individual unit cost.

(Slide 24) Next, to determine the actual cost of the HOME units in the project, we simply add together the individual cost of each HOME designated unit. This is where we come back to the Uniform Relocation Act or URA costs. If our approach was to assign those costs exclusively to the HOME units, then we would take the sum of the individual costs of the HOME units and add the URA back in, to get to the actual cost of this group of HOME units. On the other hand, if we had decided to just let the URA costs be treated as a common cost of the project, then this step is even simpler because that cost is already embedded within the base cost and would just be in that sum of individual unit costs.

If I'm working from dollars to units, the most common approach, what I would need to do if I know how many dollars I'm giving to the project is keep designating additional HOME units until the sum of those individual unit costs equal or exceed the HOME investment in the project. If we're going to the other way, we have a list of units and we just calculate the cost of each of those individual units and add it together. What we end up with at the end of this portion of the process is the actual cost of the HOME units. We have a list of units that are HOME designated and we have a number that says this is the actual cost of these units.

(Slide 25) So far, we've been talking about the standard method. That's not just because we have to start somewhere, but because as Monte pointed out, we can use the standard method in all cases. Let's talk briefly about the proration method now, but at a little bit more of a conceptual level instead of doing every bit of the calculation. Remember, proration is only available if we have comparable units. That's the key to understanding the difference. Whether we're talking about starting with the HOME investment and calculating the units or starting from the units and trying to figure out their cost, the fundamental difference is that the standard method assigns cost to a specific unit, whereas the proration and hybrid methods are going to assign cost based on a typical unit of a given type.

For example, if we used the standard method, we might have been able to determine that Unit 101 costs $125,000 and Unit 201 costs $127,000. Because we're using fixed units, we add those specific costs together. The proration method works more from the idea that the average one-bedroom unit might cost $126,000 dollars. When we assign our units and calculate the cost, we're just looking at a typical unit, rather than a specific unit.

In most cases, as we've established cost allocation starts with the proposed HOME investment and then determines the number of units that are needed. When we do that using the proration method, we calculate what we refer to and what the notice refers to as the HOME share ratio. Ultimately, this is just a fancy way of saying what percentage of a project's HOME-eligible costs are we proposing to fund with HOME funding. Because in the real world that almost never works out to a nice round number, let's say its 15.7%, then we take that ratio and we apply it to each unit type in the project. We need at least 15.7% of the two-bedroom units, at least 15.7% of the three-bedroom units, and so on. Within each tranche or each grouping of units, when we do the math we also need to round up to the nearest whole number. You can't designate 3.3 units, so you would need to round up to a whole number and designate four units of that type.

If you're going the other way and you're starting from a set of units and trying to determine what share of the project they represent, math can kind of create some limitations for us here. To use the proration method in that manner, going from units to dollars, there are some limits. Either all of the units in the project need to be comparable and are all of the same type, or the breakdown of the types needs to allow for the exact same ratio of each unit type to be HOME assisted. Bear with me here, because I know some of us get twitchy when we try to do too much math. Let's use a simplified example to kind of illustrate this.

Let's imagine we have a project with 30 units. That's ten units each of one-bedrooms, two-bedrooms, and three-bedrooms. We've determined that within each of these groups the units are comparable. If the developer says he'll give us three units, one of each type, in this case I can use the proration method because the ratio of HOME units to total units is the same. I've got 10% of the one-bedrooms, 10% of the two-bedrooms, and 10% of the three-bedrooms.

What if a project has a different configuration? Imagine that it had nine one-bedroom, ten two-bedrooms, and 11 three-bedrooms. I still have 30 total units, but if I only have three HOME units, they're not in the same proportion across each unit type. The other example is if we had the same starting configuration, ten of each unit type, but the developer is saying he's only going to give us five HOME units. I can't take those five and assign them in the same proportion across each unit type. I might get two units each of the one and two-bedrooms, so I have 20% of those tranches. That's only one more unit of the three-bedrooms, so the ratios aren't the same.

The point that we're trying to illustrate is that when we're going from units to dollars using the proration method, we can only do that when the HOME units can be assigned in exactly the same ratio within each unit type.

(Slide 26) That is where the hybrid method comes in. I know some of you might be starting to zone out a little bit because as we get into the weeds with all of the different variations, which methods, and which starting points. Let me point out that the hybrid method actually has pretty limited applicability. It's only for projects where units are comparable, where we're going from units to dollars as opposed to starting with the proposed HOME investment, and where the designation of HOME units is such that we can't assign them in the exact or precisely same percentage across each unit type.

I do want to note that HUD does expect that HOME units be assigned proportionately across the various unit types when we're doing floating units, and when we're using either the proration or the hybrid methods. The issue is that sometimes the math doesn't work perfectly, so even in the hybrid method we need to be allocating our units in roughly the same proportion, acknowledging that the math just doesn't work for the proportion to be exactly the same.

What you'll see in the example that's provided as part of the notice, and a portion of its repeated here on the screen, is that ultimately what we're trying to determine is the HOME cost of each set or grouping of HOME assisted units. In this example, we're designating two one-bedroom units as HOME assisted. We're going to multiply the number of units, the two units, by the average square footage of a unit of that type. In the one-bedrooms, we're talking about two units at an average of 900 square feet apiece. Then we would multiply that by the base cost per square foot. Since the units are comparable and we're letting them float, I'm not really concerned that at any given point over time I might have one unit that's the HOME unit that's a little bit smaller, versus one that's a little bit bigger. Things are going to average out over time.

For those of you that are getting overwhelmed with all of the different iterations, I want to point out that PJs can make policy choices that really simplify things for them. Just starting and saying our process will always be to underwrite first and establish a proposed HOME investment, going from dollars to units, will simplify the set of choices that you need to make. Deciding from a program design on the front end that you're always going to treat URA relocation costs as a common cost of the project rather than trying to assign those costs explicitly and exclusively to the HOME units also simplifies the math that you need to do. While the notice has to describe the whole range of options available to you in the program, the point is that many of you can actually simplify your focus and only have to implement one or two of the different paths that we've talked about based on how you choose to do your program design.

Again, at the end of step three, no matter which method we're using or where we started, the point is that we have a list of HOME designated units and we've calculated what the actual cost of those HOME units is. That's the result of this third step in the process.

(Slide 27) Now we move onto the fourth step in the overall process. That is to calculate the maximum project subsidy limit, which should really just be a derivation of the maximum per unit subsidy limit that's imposed by Section 92.250 of the rule. If you've been with the program a while, you know that we used to calculate those per unit subsidies based on the FHA 221(d)(3) program. When that program was eliminated, HUD began calculating the HOME maximum per unit subsidy using the FHA Section 234 program. If you need more detail on this, I'd encourage you to go back and look at CPD Notice 15-003, that talks through all of it. As a PJ, the thing that you need to know is that you actually get this number from your local HUD field office. They are responsible for calculating the subsidy limits from or indexed against the {Section} 234 limit, but it's not the {Section} 234 limit itself. HUD updates these numbers each year and at the end of the day, as a PJ, you should be able to get from your field office the actual per unit subsidy limit number, which varies based on the number of bedrooms in the unit. They're going to give you a number that says for a two-bedroom unit, this is the most that can be invested.

To determine the project subsidy limit, all we're doing is adding together the per unit subsidy limit associated with each of the HOME designated units. In the example here, you see we have two one-bedroom HOME units, which we multiplied by the limit of $125,000 per unit. We take that $250,000 and add that to the two-bedroom subsidy limit, multiplied by the three HOME two-bedroom units we have of another $450,000. The maximum subsidy limit is then $700,000. Again, step four is the same. This portion of the cost allocation process is the same, no matter which of the various methods that we're using. The variation is all in step three.

(Slide 28) Step five is to go back – again it's the same for all cases – is to go back through and make sure we're comparing. No matter what, as a PJ I can never give a project more than what I've determined it needs, the gap based on my underwriting. As we talked about, that's usually our starting input. No matter which method I use, step three told me what the actual cost of the HOME designated units is. Usually that's going to be a little bit bigger. We can never pay more than those units actually cost. Finally, our program can never invest more than the maximum subsidy limit, even if the gap is bigger or the actual cost is bigger. As a PJ, I couldn't give more than the maximum project subsidy limit we just calculated in step four.

If you look at the example that's posted as part of the notice in Example Two, what you would see is that the gap is $800,000. That was the underwritten amount. We determined the actual cost of the HOME units was $938,646. The maximum subsidy limit was $1.155 million. The smallest of those three numbers was the underwritten gap. That's the most that I can give the project. Here, I will make a brief note that if you download the new Excel spreadsheets and put that same example in, there's a very minor difference in how it calculates the actual cost of the units that's simply based on the level of rounding that gets done. It's explained in that spreadsheet, but there are some small differences there based on how many digits we round out to.

(Slide 29) At this point we've talked about cost allocation implicitly, mostly in the context of multi-family rental projects. Of course, that's because that's the type of project that's most likely to include both HOME and non-HOME units in a single project, which in turn is what triggers the requirement for cost allocation. There are a couple of special applications that we want to touch on and are all talked about in greater detail in the notice.

Remember that HUD defines single-family housing as having one to four units. While it's not particularly common, we may have some homeownership projects out there and structures that have two, three, or four units. For example, maybe we're helping a buyer to purchase a duplex. They're going to live in one side and use the other side as a rental unit. In a case like that, we still have to go through cost allocation. We have to use the standard method. Depending on the results of that cost allocation, we might find that our HOME funds could be entirely allocated to the owner's unit. In that case, that unit is subject to the homeownership requirements of 92.254. The buyer has to be low income. We have to use the resale or recapture requirements. In that case, the rental unit is unassisted and doesn't have to be subject to any HOME requirements.

On the other hand, we might do the cost allocation and determine that the HOME investment could be entirely allocated to the rental unit. If that's the case, the rental unit in that duplex has to be subject to the rules of 92.252 that govern rental. The owner's unit wouldn't have to be HOME assisted. Theoretically, we could even help an over-income buyer in this scenario, since what we're doing is producing a HOME assisted rental unit.

In other cases, what you might find is that both units have to be HOME designated because the HOME investment ends up having to split across the units. There, you end up applying home ownership requirements to the owner's unit and rental requirements to the rental unit. There's more detail on this in the notice. We wanted to touch on it. It's not a super-common program design.

Another special issue to note is the treatment of managers' units. In a multi-family project, it's perfectly acceptable to include a manager's unit when you plan the project that way from the beginning. The manager's unit is really treated as a common cost of the project and the cost allocation process proceeds normally based on the number of units that are actually available for rent. For example, you might have a building that you look at and say physically there are 50 units, but really there are only 49 units because that 50^{th} unit is the manager's unit. It's not actually for rent. When you do cost allocation including determining the gross residential square footage that would be used to calculate the base cost per square foot, you're going to treat that manager's unit as a common cost, almost like it's a laundry room or a hallway. In effect, the cost of that manager's unit gets spread across the 49 units that are actually available for rent.

The 2013 HOME final rule introduced a new provision in 92.205(d)(2) that talks about managers' units. What it allows is, in limited circumstances, a PJ could retroactively convert a HOME rental unit into a manager's unit for a project that didn't originally have one. This is only allowed if the project was initially structured so that all units in the project were designated as HOME assisted. Remember, cost allocation tells us the minimum number of HOME units that must be designated, but a PJ can always over-designate those units. If we have a project where all HOME units were initially designated, all units were initially called HOME units, the PJ in consultation with the owner has now decided that converting one of those units to a manager's unit will improve the sustainability of viability of the project, a PJ can go to their HUD field office and seek approval to convert that unit.

To get the approval, what you need to do is basically rerun the cost allocation for the project and ensure that the total investment is still within the maximum project subsidy that would have been in place when the project was first funded. Basically, we have to make sure in the example I used a minute ago of a 50-unit project that the HOME funds awarded would have been within the amount that was appropriate, had we been looking at that as a 49-unit project to begin with.

As we talked about briefly earlier, another special case is projects involving both HOME and public housing. As we know, HOME cannot be used to assist public housing units, but that doesn't mean HOME can't be involved in a project that involves both public housing units and non-public housing units. Again, we often talk about these as mixed finance projects, where there are both public housing units that receive ongoing operating subsidies from Public and Indian Housing at HUD, and non-public housing units. In projects like this, HOME can be used to assist the non-public housing units. Of course, cost allocation will be required to make sure HOME funds are being dedicated only to the non-public housing units that are HOME designated.

In such a case, there are two special points to keep in mind. First, you must use the standard method and you must designate fixed HOME units. We're going to be calculating the cost of the specifically identified units, not a typical or average cost of a given unit type, even if the units are otherwise comparable. You have to use the standard method. Second, if any of the common areas in the project are not exclusively for that project, but are used more broadly by the PHA, then those common costs have to be treated as HOME-ineligible. They get removed from the base project costs.

Let's say the project involves a leasing office that's inside an apartment building. Normally, that's a part of your overall cost and its fine. If that leasing office is not just for this project, but is used broadly for applicants to apply to live in any of the Public Housing Authority's broader portfolio, then we have to treat the cost associated with that space as HOME-ineligible. It's the same thing if we're talking about community rooms, storage, or maintenance spaces, etc. If they're used by the broader PHA portfolio and not just for the residents of the specific project, those are not HOME eligible. In one sense, it's almost like we were dealing with a mixed use project and taking out the commercial space. It's not part of the residential project.

(Slide 30) I'm going to make one more point here and then turn it back over to Monte for a few minutes, for some questions. As we've touched on at a couple of points, cost allocation is deeply and closely related to underwriting. From a systems standpoint, it's a sub-routine within the overall financial and underwriting evaluation of a project. The input, when we start the cost allocation project, came from the initial underwriting of the project. Usually it's that proposed gap that we're going to fund with HOME, or in some cases it's the units. When we come out the other side of cost allocation, we have both a maximum HOME investment and a list of units that are going to be HOME designated and HOME restricted.

Most of the time this works just fine. It fits into the initial underwriting and we just proceed forward. Sometimes the results of this cost allocation impacts the original financial analysis of the project, making the process more reflexive or circular instead of linear. Maybe the development cost changes. The plan didn't originally account for Davis-Bacon prevailing wages, but it turns out we need to designate 13 units as HOME assisted when we thought we were only going to have eight. This leads to a cost increase, which in turn increases the gap, and increases the proposed HOME investment. We have to go back through the cost allocation process and now maybe it shows that we need 15 units.

In other cases, it's possible that we had to designate more HOME units that we first thought and then applying the HOME rent restrictions to those units reduced the revenue, decreased the mortgage, and increased the gap. If we're going to fill that with HOME, we now have to run through the cost allocation process again to make sure that everything balances out. The point is that we may go through this process a couple of times until everything balances, where the HOME investment and the unit designation works within the evaluation of the project's overall financial viability.

With that point made, what I want to do is go ahead and go back to Monte for a minute for some additional questions. Then we'll move into the next section.

(Slide 31-Questions) Monte Franke: Okay Steve, thanks. Take a breath, you're the one that needs to relax a moment after that explanation. A number of questions did come up. I think some of them might be too specific for us to answer without knowing additional details. We'll do our best here. This is one of the questions that came up when you raised the issue of eligible costs and taking out ineligible costs. They asked if there is a finite list of ineligible costs. Project legible costs are listed in the 92.206. There are some ineligible costs listed in 92.214.

The most common things are, since we're not looking at operating costs and only development costs, funding of reserves or working capital items that are really operating costs. Therefore, they are ineligible. There are also some organizational costs that may come out, things like syndication and other types of ownership entities having to be created. I would urge you to go to the 92.206 list and start there. That lays out what is eligible under the HOME program. You'd have to take out those ineligible costs that otherwise might be associated with the units since we can't pay for them with HOME.

Steve, are there other things that you would point out as being ineligible?

Steve Lathom: Yeah. I think the things you touched on and that we touched on earlier are the most common, the usual suspects. I think when HUD wrote the notice, if you go back into the notice there is a deeper discussion of costs that are not eligible and need to be removed for that purpose. I think part of their effort there was to identify the ones that come up most frequently and are sometimes most frequently misunderstood.

Monte Franke: Okay. This is another question on the eligible cost issue. Somebody asked, "If we have a deferred developer fee as part of the cost, is that considered an eligible cost even though it won't be paid with HOME funds, but with later proceeds?"

Steve Lathom: Yeah. Typically, what's happening in that kind of a situation is that you've got an overall developer fee. Let's use easy numbers. You've got a developer fee of $1 million. Of that $1 million, $200,000 is deferred. On the uses section of your overall pro forma of your sources and uses statement, you show a use of $1 million for developer fee. On the sources end of the pro forma, what happens is that you show a

$200,000 source. It's kind of a paper source for the deferred fee, but in essence what's happening is that the developer is making a loan to the project that will get paid back out of cash flow over time. They sort of balance each other out. You would still show the overall developer fee that's been determined to be necessary and reasonable according to the PJ's policies and procedures, as well as the cost reasonableness review. The deferral is really a separate source of financing in terms of the permanent financing of the project. I think you still show the overall developer fee.

Monte Franke: Okay. Now we've got a couple of questions that touch on the issue of comparability and deciding, as a result, which method to use. This is an interesting question. If we have two units that are the same size, but one is ADA compliant and one is accessible, can we consider that comparable?

Steve Lathom: Let me expand on that a little bit. I think if you've got two units that are otherwise comparable and the difference is that one is accessible and one is not, then I don't think there's any problem with treating those as both part of the same group. There's nothing that was intended here to say that one of the groupings of units always has to be the accessible units. That would end up having some weird implications. In fact, in talking through the detail of some of this with some PJs, we've had some PJs that have said, 'When I make the determination about whether or not units are comparable to one another, when I'm looking at an accessible unit,' – this goes back to the question earlier about how much square footage variation is acceptable. HUD did not specify a percentage and PJs need to do that for themselves – I think there are PJs that are looking and saying that the accessible units can actually have a little bit more of a range on the plus side, recognizing that in order to make them accessible often that drives just a little bit more square footage. You need a wider hallway or a little bit more square footage in the bathroom, or even in the kitchen. There's nothing here that was intended to take those accessible units out of the otherwise comparable groupings. I hope that answers it.

Monte Franke: Now there are a couple of questions that run into choice of method. I think you addressed this, but I will give you another chance to. As a PJ, I get projects that are typically mixes of ones, twos, and threes. The units are comparable within the unit types, but number of HOME units varies across unit types. Which method do I use? I assume that the way you had explained it shows that the standard method should be used in those cases.

Steve Lathom: Part of it depends on whether or not we're going from dollars to units or units to dollars. If we're going from dollars to units, I know that I'm planning to give this development $1 million, I'm trying to say how many units I need from each type. When you look at the spreadsheets that we've provided, there are actually two proration versions, one that goes units to dollars and one that goes dollars to units. In the dollars to units example, I've determined that the $1 million leads to a HOME share of 10%. I want 10% of each unit type. Then I round up to a whole unit. If I had 15 one-bedroom units and I want 10% of those, I can't designate 1.5 units. I round up to two. Now the HOME program is getting two out of 15, which is a little bit more than 10%.

Let's say that I have 20 two-bedroom units and my ratio was 10%. I'm getting two of those units. The ratio ends up being a liter bit different because of the rounding up, but I could use proration. As Monte points out, we can always use the standard method. The standard method is acceptable in every case.

Monte Franke: In fact, I'd go one step further as I did earlier Steve. If you're listening folks, the standard method is always permissible. It's the safe approach. If you have doubts about whether you can achieve comparability, don't worry about using proration or hybrid because the standard method works. If you have questions about a specific project, you may need to consult with your field office. The standard method is safe.

The other question that came up was this. When you mentioned unit upgrades and taking out unit upgrades in the adjustment, you were referring to unit upgrades that would be in market rate or non-HOME units, adjusting for that. You weren't talking about upgrades within the HOME units themselves, were you?

Steve Lathom: Right. Generally, when we're talking about upgrades we're talking about feature that are sort of not only non-standard but "luxury." If you remember, HOME is about paying for modest housing. We shouldn't be paying for luxury upgrades.

Monte Franke: This is another one. This question came up about a mixed income home ownership and whether proration can be used. I'm assuming that if we're talking about a scattered site home ownership project, we would be doing the cost about the individual units that are going to be designated as low income, because we're not in a situation to trade off those units.

Steve Lathom: Yeah. I would agree. In most cases, when you're doing a multi-unit home ownership project, it's quite likely that in fact those units are not truly comparable. There are meaningful differences between them, even if they're subtle. In most cases, there are other reasons that PJs don't set up a lot of multi-unit home ownership projects anymore, given the way that the financing works, the way the deadlines work, and the way these things really end up kind of standing alone. In most cases, I think it would be unlikely that a multi-unit home ownership project could qualify to use the proration method. There, what you're going to want to look at is the actual cost of each individual site.

Monte Franke: Okay. In terms of another question that just came up about contingencies and contingencies in development budgets, including them or not including them in the cost allocation, what happen if they're not used? That would be something we'd adjust at the end, right, when we do a final one? We have several questions that have come in that are about when we recheck the underwriting and when we recheck the cost allocation. If there's any change that occurs in the amount of HOME funds or the overall project costs and eligible costs, we need to revisit it and recheck it. This would be one of those cases, right?

Steve Lathom: Right. I think there are two practical approaches to that. The first one is that cost allocation, just like underwriting, is not truly a one-shot deal. Almost all of our projects have numbers that move over the course of their implementation. By the time we get to project completion, we've got a bunch of things that moved a little bit and we need to rerun and recheck certain things, including the cost allocation.

On the other hand, from a practical standpoint in some cases working with local PJs, what I've done is in the initial cost allocation, we kind of assume that the contingency is not actually there. It's almost like we take it out for purposes of doing the initial cost allocation. In designating the units, if in doubt we marginally over-designate the units. We're unlikely to have to come back and say, "I told you initially that it was seven HOME units, and now I need an eighth." Deep in the weeds there's a way to kind of err on the side of taking cost out, which will marginally lead to a small over-designation of units and reduce the chances of the kind of, "What happens if I have to do more," at the end.

Monte Franke: We've got a couple of questions that come about the floating units and change over time. I'll defer those until the next segment. There is one question that was posted about the standard method being the default method. The question was really about the other methods and when they are an advantage, as well as how they are an advantage.

Steve Lathom: The advantage of the proration or hybrid method, to some degree, is providing some flexibility, particularly to use the floating units and to look at the average cost. A lot of times, developers do like and PJs do like to allow the flexibility of having the HOME units float over time, so that Unit 201 is not always the HOME unit. In many cases, that's the way people have approached this, saying they want HOME to have its fair share percentage of each unit type, and allow those to then float within the tranches. That becomes the reason that a lot of people do this.

Monte Franke: There are number of more questions that run into more detailed things. I'm not sure we can address them right now. It might make sense for us, Steve, to move onto the next section and then you can look through and look back at some of these. Some of them will be hit in the next segment.

Steve Lathom: Sure, absolutely. Let me move the presenter ball back to Monte so he can advance the slides and we'll go into the next section. For some of the questions that we don't necessarily get to today, for everybody's benefit, we do have a transcript of the questions that have come in. We always go back through those with HUD. In some cases, we're able to later publish FAQs that get at some of those when we identify common issues. In other cases, we are going to plan to repeat this live version of this webinar sometime after the first of the year, on a to-be-determined date. Some of those questions that don't get answered might inform some things we can say the next time around.

There are going to be other products that HUD is going to be promoting vis-à-vis the cost allocation process. We've got better than 500 of you on the line. If we can't get to every individual question, know that there's still value in asking them. Hopefully we'll get those answers back to you. I think you've got the controller Monte, and you can move on.

Monte Franke: I have one last one that came up as I'm looking at this. If we have a project with largely comparable units with the exception of one or two oddballs, I like that word, are we allowed to pull those units out and still use proration for the remainder, and then only allow units to float in those blocks? Does comparability have to be achieved across the board to use those other methods?

Steve Lathom: I think that's one, in talking to HUD about that, that their expectation is that the HOME units be designated across all of the different unit types in roughly the same proportion. If you've got a situation where you almost want to ignore a certain unit type because it's nominal within the project, I think you need to go and talk to your field office. The notice really doesn't accommodate that. I think HUD is willing to look at project specific circumstances and problem solve if there's some sort of weird unintended consequence. Remember, you always have the option to use the standard method and designate fixed units. There, you can choose which types of units in the project you want.

(Slide 31-Commitment/Written Agreement)) Monte Franke: Okay, great. With that we'll move on, and if there are any additional questions we'll have another chance in just a couple of minutes.

What I want to do is step back from the details of the process that Steve took you through, the six steps, and put cost allocation back into the overview of where it fits in with committing and disbursing HOME funds. Maybe I'll address a few of the implementation issues related to cost allocation.

First, it's important to recognize that cost allocation, when it's integrated into the underwriting analysis, helps to produce some of the key requirements that are central to the terms of project commitment. Cost allocation can produce the minimum mix of HOME assisted units, the number of assisted units by unit type, the number of low HOME versus high HOME, and whether the units can be fixed or floating. Cost allocation also correlates that unit mix to the total amount of HOME funds that are eligible, given the review of eligible costs and maximum subsidy.

Of course, you've got to keep in mind what I mentioned earlier. Cost allocation establishes limits, minimum HOME units and maximum HOME dollars, and underwriting determines the final dollars and units within the limits established by cost allocation, and possibly through a repetitive process until we get to the right number that works in both underwriting and cost allocation.

(Slide 32) Cost allocation helps to determine the total amount of HOME assistance that can be provided to a project. The cost allocation process does not dictate the specifics of disbursing HOME funds. It doesn't limit the disbursement of funds only for cost of the HOME assisted units, nor does it create a fair share percentage of any particular eligible line item that can be paid with HOME funds. HOME funds may only be disbursed against an approved budget with specific HOME-eligible line items identified for HOME disbursement. Within those parameters, HOME can pay the entire cost of a HOME-eligible line item without regard to the portion of units that are HOME assisted. For example, the approved cost of acquisition can be paid entirely with HOME, even when not all units are going to be HOME assisted.

Cost allocation only caps the total amount of HOME assistance. However, I want you to keep in mind that PJs are responsible for disbursing HOME funds only for HOME-eligible costs. You need to make certain that you have an approved budget that comes out of the underwriting process.

(Slide 33) In addition, during project implementation and this has come up in some of the questions that were asked at this last break, there might be changes that are needed to the budget to accommodate unforeseen costs or, as was mentioned in one question, a contingency that wasn't used, or even the need to modify one of the other sources. Any changes in budget, both sources and uses, might affect the total amount of HOME funds that are needed or are eligible, and may ultimately affect the number, type, and distribution of HOME assisted units.

If any such budget changes need to be made after commitment, at any time during commitment either during development or before completion and closeout, the PJ will have to update the cost allocation to the final project costs and the HOME investment. If it's indicated by the updated cost allocation analysis, they must modify the unit designations as needed so that completion accurately reflects total HOME investment and the necessary number and mix of assisted units. Upon completion, PJs need to make sure that the cost allocation is updated to support the final HOME dollars and units that are designated for the project.

(Slide 34) Steve already gave you a caution earlier, reminding you that documentation is a critical last step in the administration of federal programs. We'd be remiss if we didn't remind you again to document your cost allocation. It's a regulatory requirement to document the eligibility of the HOME investment. Failure to document could result in repayment of the HOME funds invested. I assume most or all of you have seen the integrity bulletin released earlier this month from the HUD Office of Inspector General that reminds us that full documentation must be the final step in your process.

Among the key items of the analysis that we urge you to document are your determination of the unit types, the classification of the unit types in the project to establish comparability, that you determined both eligible costs and the maximum subsidy limits, how you allocated the costs and determined the assisted units, and that the assisted units and HOME funds determined by cost allocation are reflected in the written agreements and the legal documents.

I'll also mention this, since it's come up a couple of times in the questions, that cost allocation does affect the ability to float units. The rule permits floating in 92.205 with multi-unit projects. It permits you to have floating units, but it says that the floating units are to be comparable units. You need to make certain that the floating of units remains within the comparable units and the unit typology that you came up with in cost allocation. We did have one question that asked whether we could float up. In other words, if we were owed a one-bedroom could we substitute temporarily or permanently a two-bedroom. Generally, the HUD approach has been to permit you to go upward, but not downward in terms of the allocation. The allotment of units across unit types that are designated in the agreement is what needs to be maintained.

Obviously, the risk in trading down units would put you at a lower cost unit that might not meet the HOME investment requirements. Be very careful about doing anything other than substituting comparable units as they float over time.

(Slide 35) I'd also like to remind you that, as Steve has mentioned, the cost allocation tool, an Excel spreadsheet of multiple sheets, has been placed up on the HUD exchange website, at the webinar page, the same place where you downloaded the slides. You're welcome to download and use this. Its structured in such a way that it has a general instruction in the first page, and then as you go through the tabs you'll see a second one is a selection of method worksheet to help you document unit types and summarize your conclusions about whether the units within each type are comparable or not, as well as the cost allocation method you will use. There are separate worksheets for each of the methods, standard, proration, and hybrid. This tool is available to you on the HUD exchange on the webinar page.

(Slide 36) With that Steve, I guess we can open up to another set of questions. Have you had a chance to catch your breath and take a look at the questions that have been posted? Steve?

Steve Lathom: Sorry, I started talking without taking myself off of Mute. It's a common problem with these sorts of technologies. In any event, to be clear there are some questions we're probably not going to be able to get to, or some that are unrelated to the topic. Let me start to deal with some of these.

One that just came in is asking if this applies to the National Housing Trust Fund. I think HUD is going to be talking about that in greater detail at the NCSHA conference in January. For those of you that are states that are managing the Housing Trust Fund, the short answer, is that the same process applies. Be sure to listen for more from HUD. There's really not much of a difference there.

Let's see, there's a question about this. If you're doing a single-family homeowner project that's only one unit, the project itself is only one unit, do cost allocation requirements apply? The short answer is no, they don't. Cost allocation is only required when you have assisted and unassisted units. Remember that you also always have to make sure that you're not providing more than the maximum per unit subsidy. In that case, it's just a one-unit project.

Monte Franke: I think I mentioned that in an earlier slide, to remind them that even though cost allocation isn't triggered because they don't have to allocate costs, they still have to underwrite the project. They still have to make sure they're only paying for eligible costs within the maximum subsidy.

Steve Lathom: Right. Here's a question about the start date for projects needing cost allocation documented. It says the CPD notice was published in late August and the guidance is just now available.

In one sense, cost allocation has always been required and it's always been a requirement that you document in your file these determinations. The original notice on cost allocation was back in 1998. The new notice just provides more specificity and clarity, as well as a lot more detail on how to do this, in part because what we found was that this was not necessarily a well understood issue. This is something that's sort of always been there and always should have been documented. In general, HUD is pretty reasonable in working with PJs to try to get everybody on the same page. If there's a minor technical error that you made in good faith, I'd just talk to your field office about it. For the most part, given that if you were following the requirements of the old notice prior to the publication of the new one, you would have been fine. Let me mark that.

Monte Franke: The other thing I would add, to remind PJs, is that because cost allocation sets limits rounding up from the minimum number of units or staying below the maximum permissible dollars, it helps them to avoid a problem when there was a slight miscalculation.

Steve Lathom: Right. I would go one step further with that point too. You're almost never going to have the math work out exactly, that these three units equal exactly the amount of HOME funds that were provided for the deal. It's just like saying how many times you go to the grocery store and the total bill is exactly $100 even. It doesn't happen that much in the real world. Usually, the actual cost of the HOME units that have been designated is in fact a little bit higher than what's being awarded. That does give us some wiggle room when it comes time to have to reevaluate those numbers at the end if things have moved a little bit. Generally, unless things have moved dramatically, often that implicit marginal over-designation that works in this process tends to make it so things are going to work out okay.

There was a question here about a rehab project where some units require more repairs than others. Does that change the process? It really doesn't because what we've concluded is this. Let's say you've got this big apartment building and for whatever reason Unit 101 needed more work than Unit 201. At the end of the day, the point is that both of those ended up, particularly if we're talking about a project where the units are comparable, in roughly the same end condition. If you really wanted to chase yourself down the rabbit hole of trying to analyze that, then theoretically Unit 101's acquisition price, because it was in worse condition, might have been smaller.

HUD doesn't require that we go through those crazy machinations. In essence, what we're doing is taking the eligible costs and distributing them over the project as a whole, really on that square footage basis. We don't have to sit there and get too worried in a multi-unit project – particularly, a lot of these preservation projects, where there are marginal differences because we're dealing with units that are 30 years old and have had different things done over time. Let's say some of the units need the appliances replaced right now and some of them had them replaced three years ago. We don't have to chase that level of detail.

Monte Franke: I think that a clarification on the word, when we say actual cost, is that we are really talking about average unit cost and not the actual cost of each specific unit separately priced out.

Steve Lathom: Yeah. There's a question here about a project with both rehab and new construction. We're really not making a distinction there about the new versus the old units. What's likely to happen is that in fact you're going to end up with those being determined to be not comparable. The new ones probably just end up being a different type than the rehabbed ones.

Let's see. There's a question here about the percentage of HOME units that triggers Davis-Bacon. Is it still eight or more? In HOME there's no change. Davis-Bacon is triggered at the point that you have more than 11 units. Once you hit a 12th HOME assisted unit in a project, then the Davis-Bacon is going to kick in. The eight standard is related to CDBG. They're just different programs. More than 11 HOME assisted units in a project will trigger Davis-Bacon. Let's see.

Monte Franke: Steve, I see one of the questions came up that's asking about Low-HOME units. We talked about using cost allocation to determine the total units overall. That helps us discover how many Low-HOME units there are. We don't need to use cost allocation to actually identify specific Low-HOME units within the overall mix.

Steve Lathom: That is correct Monte. In discussing this with HUD, what we've determined is that this tells us how many units must be HOME assisted. The Low and the High-HOME designations can actually float within those units. The unit that today is a Low-HOME next year might be a High-HOME. With the percentage in a project that triggers the project rule where there are five or more HOME assisted units, you have to make sure you're always at the 20% or greater. Some PJs do, in their written agreements, get more restrictive and specify wanting Low-HOME units to be this many of Type A and this many of Type B, as well as this many of Type C. You're not required by cost allocation to chase it all the way down to which ones are the Low and the High.

We have a question that just came in that says the PJ has an annual NOFA. The developer wants funding for half of the project by unit count that are special needs one-bedroom units. The other half of the project are two and three-bedroom units that are not receiving funding. Can the developer designate only the one-bedroom units? In this case, because you're designating units that are not comparable and you're not getting a share of each unit type, you can do that. You need to use the standard method and you need to use fixed units. Anytime you're going to do floating, HUD still expects that you're getting a roughly proportionate share of each unit type. If you want just one-bedroom units, you need to go fixed units. Once you're doing fixed units, you should just do the standard method.

There are a couple of folks asking about the Excel file. You can go download that from the HUD Exchange if you find the link to today's webinar. I think some folks said they're having some trouble finding that link. I can't 100% promise, but we will make an effort. I think Sandy can work this out for me, to find the email addresses of everybody who logged on today. We'll just send you that link. That's not that big of a deal.

Monte Franke: Steve, I just went to the link to the webinar. I hit the register and that takes you to another page that tells you that registration is closed. The links are on that page.

Steve Lathom: Yeah, there they are. I think this is a follow-up to the Davis-Bacon point we just made. A project has both HOME and CDBG funding. Would the HOME Davis-Bacon trigger of 11 supersede CDBG?

In essence, no. The answer you're going to have to use is this. You're going to have to look at it from both a HOME standpoint and a CDBG. If either triggers Davis-Bacon, then Davis-Bacon is going to apply. If you've got both sources in a deal, you have to basically apply the standard independently. If either one of them triggers it, it's going to apply.

There's a question about the new HUD secretary that I am not touching with a ten-foot pole.

Monte Franke: Steve, I was leaving that one for you.

Steve Lathom: Yeah, I know. We can provide technical, not political, advice. My political advice with $5 will get you a Starbucks coffee, depending on what market you're in.

Here's a question. A project costs $1 million. I'm assuming that's the total cost. There's a HOME loan of $200,000 to fill the gap. If the project costs came in below budget at $975,000, would we need to cut back the HOME?

All else being equal, the answer to that is yes. If the other sources stayed the same and the costs came in lower, then in essence your gap is now lower. HOME should be a gap funding source. It's not appropriate at the end of a project to have $1 million in sources and only $975,000 in uses. Somewhere one of the public subsidy sources in the transaction would need to be reduced. In the real world, there are often other costs. It's much more common to find the costs have gone up rather than gone down. There can be other moving pieces. To simplify, if the costs come in lower, then we should in fact generally be reducing the amount of HOME investment.

Monte Franke: There's a whole separate discussion based on the interim final rule on commitments. When they have to reduce HOME funds that have been allocated to a project and they're beyond the commitment deadline. I would urge everybody to read that notice and pay attention to that. I should say read the rule.

Steve Lathom: Yeah. There are a couple of questions here about good standard development agreement language. Unfortunately, that's not something that we can provide very easily in a webinar. With some of our direct local work, what we often see are agreements that call for the opportunity for some sort of a cost certification at the end at project completion, and a requirement that if the PJ determines that the costs were already disbursed and are now greater than what was necessary, they need to be returned and/or if the numbers change, there's a sort of reservation of the opportunity by the PJ to designate additional HOME units to balance out the cost allocation requirements. That's the type of language that I would look to, that requires that at the end there's a reevaluation of these things. If the developer has to preemptively agree, they'll work with you to make additional unit designations. In practice, another way to help address some of those issues is to give yourself, as a PJ, control over approval of change orders and approval of any use of the contingency, not to try to hold anything up, but to make sure that over the course of the project you see things as they're changing, if things are not moving in with the budget. There are a couple of thoughts there for you.

Let's see. I think somebody else just noted that there is a really important interim rule that was just published a few days ago or a week ago, about the way commitments work in the HOME program. This makes some substantial changes. It's well beyond what we're prepared to talk about today. There are two things. Please go back and read that. Start to understand, because it's published as an interim rule. That means it takes effect before there has been comment. Know that HUD will be hosting a webinar early next year to try to address as many of those questions as possible.

On a similar note, I would mention that there was also recently some guidance relative to final implementation from a regulatory standpoint of VAWA, the Violence Against Women Act provisions, that addresses HOME requirements. I would encourage you to go and look at that as well. That is taking effect here shortly. PJs that are on the call that haven't heard of either of those issues, please go ahead and take a look. I also see that we've just gotten a message from HUD that we will send out an announcement to the whole list, rather than following up with the folks on the webinar specifically, with the link to the cost allocation spreadsheets. If you're not able to get those, just give us a couple days to get that message back out.

Do you see anything else in the questions that we want to handle right now Monte? I see one that asks how we handle restoration of historic buildings. The costs and reserves on those projects sometime are higher, but may be necessary. HOME really doesn't change anything from a cost allocation standpoint. HOME can participate in those projects, but you have to go through the same process. Often, what happens in those projects is that they may in fact be more costly. Those are sometimes the ones where the actual costs are more apt to run up against the subsidy limits. Fundamentally, in terms of the analysis process, there's nothing different that you do. It's just that those are in fact often more costly and more complex projects.

Do you see anything else Monte, that we should cover. There's a question here about average base costs for rental projects on a per square foot of construction. That's not something that we have access to. Of course, in terms of evaluating hard costs of construction, there are a variety of ways of doing that in addition to looking at comparable projects that you, as a PJ, have done in the past. There are a variety. I think the most common is the RS Means Cost Index that provides regional cost data. We don't have access to data like that, that would allow us to answer that question relative to the HOME program.

There's a similar question about limits on replacement reserves for a project. There's no specific limit on replacement reserves. Let's talk about two things. Again, most capitalized reserves, including the replacement reserve, is a cost that is not a HOME-eligible cost. It doesn't mean that this should not be included in a project. In fact, it should be from an underwriting standpoint. It's just that we can't pay for that specifically with HOME. When we do cost allocation, we conceptually remove that cost to get down to the base project cost.

Every cost in the project, whether we're paying for it with HOME funds or not, in your underwriting is subject to an evaluation of whether that cost is necessary and reasonable. While there's no specific limit where HOME says you can never put aside more than X-dollars in replacement reserves, as a PJ you should always be evaluating whether or not those costs are reasonable and necessary within the thrust of trying to get to a project that is viable without being overfunded. Replacement reserves are critical. We can't pay for them directly with HOME. You always have to make sure that they're reasonable.

There's one other thing to note. I think we're still getting a few questions here and there about the cost allocation tool itself, the Excel spreadsheet. We do plan to produce some prerecorded Web-based tutorials on using that. We're not really prepared to answer detailed functionality questions today. The webinar is probably not the best way to do that. We're coming up on the end of the time. Watch for additional information on that tool.

I do note that we're at the scheduled 3:00 end time. Monte, do you have any additional questions that you see, that you want us to cover?

Monte Franke: No, I think we've covered most of them. There are a few that can't be answered on this webinar.

(Slide 37) Steve Lathom: Okay. With that, we're going to go ahead and wrap up here in just a second. I would very much like to thank everybody for taking the time today. Again, we apologize for some of the technical hiccups that happened at the beginning, with having to have people move exclusively over to the phone line. Unfortunately, the more reliant on technology we become, the more we run into those things here and there. We know this topic is not particularly exciting. It is an important and critical aspect of the program. Hopefully, we've helped de-mystify some of that. We tried to focus on those broader concepts. When the webinar closes, you will be pushed to an evaluation through SurveyMonkey. It looks very much like the evaluations that you've done in every other HUD training that you've participated in. That should automatically open. If you want to come back and review anything… *{Recording stopped a few seconds early. Speaker noted that materials were available on the web and again thanked people for participating.}*