HOME Underwriting & Subsidy Layering Guidelines  
HUD Notice CPD-15-11  
Q&A, 7-28-16

Kris Richmond: Great. All right. So I've been answering some questions as we go along. But I do have a couple that I think would be helpful for everybody to hear and perhaps you could give us some answers.

The first one underneath the homebuyer activity; so they want to know if a homebuyer unit converts to rental after the 9-month period and you're in the rental phase can the developers sell the unit to the tenant or a subsequent homebuyer during that affordability period?

Les Warner: Yeah. That's a good question. So when we have a homebuyer unit that fails to meet the time requirements it will have to be converted to rental. It does get set up within IDIS as a rental unit and then all of the rental requirements do apply. So HOME does allow for a home rental unit to be sold to that existing tenant. And we could sell that outright if it was going to be affordable for them or we could actually provide them homebuyer assistance and of course then we would do appropriate underwriting as part of that.

Now keep in mind -- that does not mean that -- let's say when the Smiths move out of their unit that I decide that, you know, I really never wanted to have this as a rental unit; I'm going to put a for sale sign in the front yard. HOME allows you to sell it to that existing tenant not to simply market vacant units for sale. So it's not a way to simply get past that deadline and then go right back to what you were trying to do originally.

Kris Richmond: Great. Thank you. The next one is if the buyer -- again, we're still under homebuyer -- if the buyer falls out of the purchase contract after the 9 months does the project automatically convert to rental. The answer to that is yes. Because they want to know; is there time to enter a new purchase contract with somebody else?

Les Warner: So my understanding of compliance on this deadline would be that within that 9-month period it has to either be sold or be documented as being in a binding sales agreement. So if I made -- let's say I built 10 units; 9 of them were sold and one was -- I met my deadline because one of them was under a binding sales agreement and for some reason or another they're not able to complete that transaction.

I think you're going to have to work with HUD to determine the compliance on that. I would think -- my guess -- is that it's going to have to convert to a rental unit. But I'm not sure about ongoing testing once you may have met that initial compliance on that. I think that's a question we can try to route up on our end but I would also suggest that you talk to your local field office and ask that same question.

Kris Richmond: The next one is, "Can you give guidance on how to deal with homebuyers getting bank approval with housing payments greater than 30 percent of income; does the PJ have to provide additional subsidy to eliminate the cost burden?"
Les Warner: So you as the PJ have underwriting standards; and you have determined what consider to be affordable. So let's say I as the PJ have set 30 percent for principal, interest, taxes, and insurance. And we oftentimes will have banks that will say I'm happy to approve this person for a mortgage that is 35 percent of their household income. That violates your standards. And so in that case you would be saying we don't consider -- so let's say the bank was offering them $100,000 mortgage and it was going to be at 35 percent and your standard is 30 [percent]. You're going to need to calculate what is the maximum mortgage that that household can afford.

And you would be providing -- you would be working with the bank to say no, under our program we will only approve this if they are carrying no more than a particular amount. You would be offering them the appropriate amount of assistance to make that unit affordable. Because we want to make sure that if there's illness, there's temporary job loss, there's some kind of maintenance, that they really can afford this unit and it won't be lost later.

Kris Richmond: Great. Thank you. Another question -- this is under commitment -- "Is it possible to pre-award expenditures before having all of their financing secured?"

Les Warner: So you can't commit your funds until you know what the real numbers are. Because you can't identify what the gap is, you can't identify what their needs are, whether they're going to be sustainable or not. So you can give someone some kind of a preliminary approval but you will not be able to commit these funds, finalize that written agreement until you actually have verification on all of those numbers.

Kris Richmond: Great. Thank you. The next couple questions are under cost reasonableness. They're looking for some guidance on what documentation should be reviewed to determine cost reasonableness for when a developer owns a property and is getting reimbursed for acquisition costs with the HOME funds. They're wondering if they should use a third party to assist them --

Les Warner: Well, if I was going to reimburse I certainly would use a third party. But I oftentimes would be questioning, shouldn't the developer be bringing that as part of their equity in this project and be paid back over time out of the proceeds of that project. I think you have some options here. But I certainly would say that you need a third party estimate on the current value of what they are contributing to that project.

Kris Richmond: All right. The next one, again, is under cost reasonableness. "Do we judge reasonable cost home investment or the total cost?"

Les Warner: Well, you're really looking at the total. Because you're filling a gap or subsidizing a project based on needed funds and if they've sort of overstated what this should cost you might be essentially funding as sort of an artificial gap on this. So you're really evaluating the overall project.

Kris Richmond: All right. The next one was when we were talking about developer capacity and they wanted to know. "How do you document adequate financial management systems and practices?" I think that was something you mentioned when you were talking about developer
capacity. And they wanted to know, "How do you document adequate financial management systems and practices? Is it okay if the developer doesn't have audited financial statements?"

Les Warner: I think that probably is but I think you need to have the standards within your guidelines about what you need to see from them. And so it might be a cash statement; it might be what their other obligations and lines of credit would be. I think you need to -- in the absence of them being able to provide an audit what statements would be appropriate and how they would be certified.

Kris Richmond: Okay. And those were all the ones I had gotten in before; there's been a number that have come in since I started asking the questions. So they won't be grouped as nicely as the first ones I gave you; we'll just go down the line here.

So the next one is on a single-family sales if the home is under contract within 9 months -- I think we answered that one already. Okay, sorry. Let's see. They want to know if we can clarify slide 16; it was noted that HOME funds may not trigger federal procurement.

Les Warner: Yes. So federal procurement applies to you as the PJ and the subrecipient. But let's say I am a developer or as a CHODO, I don't trigger federal procurement unless you as the PJ have required that.

So for instance if I was funding -- well, when I worked as a developer, as a nonprofit we worked with a particular builder who helped us develop our application. So we would work with them on putting together the design and all of the construction numbers. So I as a nonprofit was not required to go out and bid out my project to at least three builders and try to get the lowest responsible responsive bid on that.

So at the state -- or whoever the PJ is -- when that application comes in I don't have that bidding process to help me make an evaluation on that. And so that's where I have to have some kind of a system to be able to compare some kind of methodology to look at those costs and evaluate them.

But you could as the PJ -- say I expect, I require each of my projects to go through a bidding process. But there are many compelling reasons why you might not want to do that. In the case I worked in we had identified a builder who we trusted who we worked with on an ongoing basis who did quality work. And so there are some decisions that you as the PJ would need to make on that.

Kris Richmond: Okay. The next one; they are asking about the timelines and just wondering how those would be tracked. So they're saying, "The deadlines -- construction in 12-18 months, the rent, 9 months the sale -- how are those being tracked? Are they being tracked by IDIS?"

Les Warner: They're really not -- I mean, a few of these are. So your commitment will be set up in IDIS and so that project completion would be something that could be tracked within IDIS.
The 18-month occupancy requirement -- once you've completed construction, met your property standards, you've drawn your HOME money, you are to go in to IDIS and mark that project as complete. So that does start within IDIS, that time tracking of that 18-month occupancy period. I mean, frankly, you as the PJ need to have some systems in -- you don't want to be notified by HUD that you have just missed that deadline.

And I really think that you need all those systems in place -- not only for those specific deadlines but if you're going to meet project completion -- let's say within the 4-year time period -- and you have a production schedule that was provided as part of your evaluation on this project I'd want that as part of my written agreement and I would be tracking that as part of my due diligence on that project.

So if let's say a milestone was that the acquisition would be completed by a particular date and foundations would be in by a particular time -- whatever that would be -- I would, as staff, be looking at those for my projects and either through reporting or monitoring or contacts I would want to know, tell me what the current status of your project is versus what the timeline was so that well in advance of missing one of those deadlines you would recognize, you know, they should have been way ahead of where they are so based on that we could now be in trouble. And you want to figure that out as early as possible so that you can work with them to try to figure out how do we get them back on track.

So yes; some things can be tracked through IDIS but I think you need a broader system that looks at a number of milestones on these projects and is able to essentially anticipate before you get into trouble with some of those other deadlines.

Kris Richmond: All right. So somebody -- they want to know if they use an assumption that operating costs would increase 3 percent per year and rents would increase 2 percent, do you have any recommendations for safeguarding the long-term operating plan from suffering because rent limits do not rise 2 percent per year.

Les Warner: Well, the first safeguard is to try to look at your portfolio and kind of look at what you think is really a reasonable projection. When I first started doing this I think that was about what we had -- I think we had projected maybe rents at 2 percent and I think expenses at 3 percent -- but that didn't happen -- rents are based on incomes. And if you're in an area where incomes have been somewhat stagnant you're going to see rents not go up -- in some cases we've seen home rents go down. So that obviously really messes with those numbers.

So I think you have to do your best on trying to figure out what do we think the best number that reflects this current market and maybe be slightly conservative on that to make sure -- and then of course having adequate reserves in place. So operating reserves in place to make sure that if those numbers were a little too rosy based on our projections that there's something to fall back on during those time periods when things are kind of tight.

Kris Richmond: Great. We do want to remind everybody that another new notice will be coming out of HUD in the near future about homebuyer underwriting and it will also be talking about
homebuyer policies and procedures. So it will go into detail about underwriting, specifically for homebuyer projects. So I wanted to let everybody know about that.

Another question came in about Habitat-type projects, perhaps you can answer this. "What's the best way to deal with sales proceeds and project sources in the development budget when there's no cash at closing with Habitat mortgages. Do you have any guidance on that?"

Les Warner: Well, again, you're putting in an investment to that project and there is going to be a return to the owner of that project -- or the developer in this case -- over time. So you are having to look at your investment versus their investment and what is a reasonable rate of return for them on that project. I would think in a lot of cases your investment in that project is probably minimal compared to what might be the total cost for that project. And so it might be completely reasonable that they're receiving all of those proceeds in that case. That's part of your sort of determination of are they being overcompensated on that.

And then also taking into consideration there's some risk on their part about over time going to receive back those payments.

Kris Richmond: Great. Thank you. Another question came in. "Does the maximum per-unit subsidy include only the development or does it also include the direct homebuyer assistance from a DPA program?"

Les Warner: You may be doing this in a couple of different ways; in some projects you are underwriting this for development and then having some proceeds or some value essentially roll to the buyer.

So let's say I put in $100,000 per unit. It might be that $10,000 of that is going to remain as like a secondary soft second loan and reduce the cost of the inaffordability subsidy. So there's no double-counting because there's only one chunk of money, essentially, in the project for both development and for the affordability.

For the per unit subsidy I believe it would be just the development. I don't know that I've ever been asked that question before. I think we need to double-check that and we can see about posting a frequently asked questions on the Exchange with this. I want to make sure that you have the correct answer on that.

Kris Richmond: Great. And just to let some people know; there are some very detailed questions that have come in that we're not going to be able to answer in this forum. It really requires a lot more back and forth of asking more additional questions. So if we don't answer your question it's not that we're ignoring it it's just this is not really the appropriate forum for us to go into trying to answer some of those. So I'm going to start to try to highlight the ones that we can answer.

This one I think is really interesting; Doug is asking about -- he's reviewing the home costs and he's aware of what his maximum amount of HOME funds he can pay out and what's the minimum number of HOME units but he's wondering if he can just decide on what to pay for --
can he just pay on a couple of construction budget items instead of spreading out all the costs out across; is he able to pick and choose like that?

Les Warner: Well, yes. So you have two steps here. One, you're looking at that cost per unit overall at the project level -- eligibility costs -- and doing your cost allocation process. But you also can designate where your money is going. And so many folks will say I don't want to put my money -- maybe I don't want to put my money in acquisition up front; I want to be in the construction phase and maybe I want to pay at the end on a proportional with the other sources on this project.

You always have to make sure that where the HOME money is actually being used is for an eligible expense. So you're always going to want to designate in a line item budget where the HOME funds are actually to be used. And so yes, you certainly can -- the cost allocation and the maximum subsidy is determined how many HOME units based on your investment need to be set aside for long-term affordability. But you can designate where your funds are actually going to be used within that project.

Kris Richmond: All right. Thank you. Here's a question that comes up -- it was a homebuyer project and it was developed by a CHODO and so they were saying if a sale doesn't happen in 9 months and it converts to a rental project what happens to the holding costs of the CHODO until the unit is rent? Can it be charged to the program or does the CHODO have to eat those costs? I guess they were looking to have some funds returned to them when a mortgage would come in and replace some of those costs.

Les Warner: I don't see it as being something that they're eligible for reimbursement because based on their agreement their compensation was going to come through sales proceeds. I would presume that under that -- now that we're becoming a rental project that that would be something that would be paid out out of cash flow on that project. I think that's probably a question to route to HUD but I guess -- I'm not sure that they can be compensated at that point. Of course our main goal here is to make sure that if I fund something as homebuyer that I actually can sell it and I don't have to deal with how do I make this work in a conversion.

Kris Richmond: Well, I don't have any other questions in the queue right now; do we want to wait a minute or two to see if anymore come in?

Les Warner: Sure.

Kris Richmond: All right. And remember, this is about underwriting, subsidy layering, guidance -- those are the kinds of questions we're looking for right now.

Les, do you want to remind people where this will be afterwards?

Les Warner: So this will be posted on the HUD Exchange. We already have the slides that have been posted on the HUD Exchange -- I believe if you were to look under trainings this webinar would show up and the slides are already posted there from the prior session. And we will then have transcripts that will be posted for this also.
Kris Richmond: Great. Thanks. Well, I don't have any other questions that have -- oh wait, here's one. "Are there any sources you can recommend for evaluating factors such as rate of returns for developers, increasing costs, rent amount increases?"

Les Warner: Well, on things like trends in expenses and rates that should be in place -- I'll try to address those first because those are, frankly, the easiest ones. Again, I think you need to look at your own portfolio and look to see what you're seeing in your existing projects. And I think that's not a one-time thing that probably you need to think about how do I have some kind of a sort of rolling evaluation that I'm doing to make sure that my underwriting assumptions and my standards remain current and appropriate as part of that. And I think also part of that then is thinking; oh, how am I going to collect that information?

So as part of your financial monitoring of these projects I would want to see what did we project originally versus how did this actually turn out and use some of that backend information to keep sort of tweaking the front end.

I sometimes say to people who sort of are trying to build a system for the first time to look to see as sort of a starting point -- if I was a local PJ I might look to someone like the state housing finance agency with their tax credit program -- and look to see what standards they have in place. But it's not that you can just adopt what they have -- that's a starting point for you then to make a policy decision about; do I think that these make sense with my own portfolio and with the projects that I'm working with? But I do think that may be a starting point.

On the return to the developer and what's appropriate I also again think it really has to do with their investment, with the risk in that project. If I were a developer -- let's say building and selling homebuyer units in maybe a little more difficult, challenging of a market I may have more carrying costs, I may have more risks involved in this project in complexity than if I were doing a rental project that was pretty standard in a market where I've got a huge waiting list on these things.

So I think you have to think about the project itself -- the scale of that project -- and kind of make that evaluation. There are -- you don't want these things to be so close that the developer over time -- if there is some kind of a shortfall -- the owner doesn't have an ability to make those corrections on that project but obviously we want to make sure that we're not leaving them with more money.

I did mention -- and I don't know how many projects actually use these -- I have done projects where we chose to do a cash flow loan so that we were able to evaluate over time on an annual basis there was a reporting on what the actual net operating income was on that property and then we took a share of that cash flow so that we could be sure over time that we weren't leaving that developer with too high of a rate of return but we weren't -- that allowed us to actually work with actual numbers as opposed to sort of those long-term projections. But I do think that's one of the tricky parts of this.
Kris Richmond: Thank you. That's very helpful. Another question that's come in is how often do you have to update your underwriting and subsidy layering review standards and if things change do you have to re-review everything?

Les Warner: So what I'm saying is it can be a bit of a moving target. And so I'm suggesting that you as the PJ adopt some kind of process, whether that's you collect a certain number of factors out of your existing portfolio maybe on an annual basis and you look at those and then make decisions whether it's sort of a rolling sort of thing where at one point you look at vacancies versus expenses or whatever that would be.

But I think you have to have something as a plan to kind of trigger to think about I need these from time to time; I just need to reevaluate them to determine do I think these are still current. And I think where we sometimes see problems is depending on how large you are in your operations, how they're laid out -- in some cases we have the folks that would have more interaction with the existing portfolio during their affordability periods -- they may have very little contact with the folks who were upfront doing the underwriting. And it could be very helpful to, at some point or another, have some way of kind of pulling them together and kind of comparing, even when you think about on sustainability.

If I did my underwriting and I had an initial pro forma and let's say that I showed that my cash flow was going to be declining steadily after maybe the first 10 years or something but that it didn't go negative until let's say year 23 and so we had decided this is a sustainable project. If I was looking at that project during its affordability period and I then saw that instead of where we projected that project would have I don't know; let's say $10,000 in cash flow -- and they actually are at $2,000; that may mean that they are way ahead of the curve on these declines. I'd want to know what's happening with this project.

And if it's that our assumptions aren't good not only do I need to try to step in with this project and try to figure out how do we keep it from getting into trouble before the end of its affordability period but I would then be having to question does this tell me something about what I ought to be doing on my underwriting for current projects. And at least that conversation needs to be held and thought about.

So I don't know that there's some hard and fast how often frequency on this. But I think it needs to be somehow built into your process but we need some way to get -- what are we going to use to make that evaluation of whether our standards and our process is adequate? I think anytime you have a project that gets into any kind of trouble I would be looking back at my original underwriting and my sort of oversight process and try to think is there any way that I could have anticipated this? Is there something that I failed to take into consideration on the front end here? And also, what does this tell me? Is this just project-specific or might there be something that I need to be concerned about with a whole number of other projects based on what I'm seeing on this one to kind of warn me early on some of these things?

Kris Richmond: Great. Another question is under homebuyer assistance. "Can you talk about when it necessitates a need for the gap for homebuyer assistance? Maybe talk a little bit about ratios?"
Les Warner: Yeah. So as part of your standards what you're trying to look at is what's going to be affordable for this household. And so typically we're seeing that folks would use a front-end ratio which would be looking at -- what we typically see is looking at what their principal interest taxes and insurance would be. So these are sort of their fixed housing costs. And then having a percentage of their income. And we kind of standardly see maybe 30 percent use for that number. Some people have a tiered system that would say if you're under a certain income level we want that to be a little bit smaller percentage of your income that we consider to be acceptable. So that's a front-end ratio that we typically see.

A back-end ratio then would be when we're looking at not only housing costs but what all their other debt is, so credit cards, car payments, whatever that would be. And then usually that percentage is something higher -- maybe it's 40 percent or something.

So as part of our underwriting process we would be determining what's the actual income for this household and then looking at what percentage of this are they actually paying out towards housing costs or if we're looking at that back-end ratio how much of their money is designated just to get through the month in paying all of their fixed expenses? And we don't want to have this so tight that if the car breaks down and they have to spend some money to get that fixed that they suddenly can't make -- they're choosing between house payment and groceries or whatever that would be.

So that's where your standards come into play. And there was a question earlier about the bank might be comfortable with this household having a much higher percentage of their income going towards housing costs but you as their program will set what you consider to be affordable and then you are going to base your subsidy based on making that affordable.

So if you determine they can only afford a $80,000 mortgage and the bank is willing to loan them $100,000; we don't want them to be that cost burdened. We're going to be willing to put in -- if it's within our program guidelines -- we're going to be willing to put in more money for that particular household to make that affordable for them. And our standards are going to tell us what is affordable for that household and we're going to compare that to what's been proposed and decide; do they need our assistance or do they not?

And frankly, that standard might be applied in the inverse. You might have someone, particularly in a lower-cost market, who might come to you and they are asking for down payment assistance from you and based on your underwriting they might be only projected to use let's say I don't know 19 percent of their monthly income towards housing costs. And so if you followed that projection you might be over-subsidizing them. We want households to take responsibility as they can afford to cover their expenses; we don't want to over-subsidize or under-subsidize.

Kris Richmond: Great. Thanks. I don't have any other questions that have come in the queue; I've asked you all the ones that have come in since then.

Les Warner: I think we'll be here for a few minutes if there are any additional questions that come in but I think we can thank folks for your attendance.

~~~ Noble Transcription Services - 714.335.1645 ~~~
Make sure that you go back over the notice; read through it, familiarize yourself, and then think about and evaluate the systems you have in place, the guidelines you have in place, making sure that you have documentation in how your following up is going to be captured within your files that your staff understands what your process is going to be.

And then do think about over time how do I evaluate this from time to time and tweak this to make sure that it continues to be appropriate.

Thanks, everybody.

(END)