HOME Underwriting and Subsidy Layering Guidelines
HUD Notice CPD-15-11
• Speaker

Les Warner, ICF International
Agenda

• Purpose and Applicability
• Related HOME Requirements
• Underwriting Policies and Procedures
• Market Assessment
• Developer Capacity Assessment
• Project Review
• Establishing the Level of HOME Subsidy
• Self-Sustaining Investment
• Document Compliance
Purpose of Underwriting and Subsidy Layering

- HOME underwriting is the analysis of project assumptions and risks to ensure the project will meet affordability requirements.
- Subsidy Layering is completed to determine the level of HOME assistance is necessary and reasonable.
- Analysis of Market assessment and Developer Capacity ensure viable and sustainable projects.
Applicability

• Applies to all rental and homebuyer development projects, direct homebuyer assistance, and homeowner rehabilitation assistance loans for which funds are committed on or after August 23, 2013.

• Applies to projects funded in part or in whole with HOME funds

• CPD Notice 15-11 HOME Underwriting and Subsidy Layering Guidelines published on December 22, 2015
Applicability: Direct Homebuyer Assistance §92.254(a)

- For direct homebuyer assistance that is not part of a development project:
  - Market analysis is not required
  - Evaluation of developer capacity is not required
  - A PJ must underwrite the buyer per §92.254(f)(1) for projects with commitments on or after January 24, 2014
Applicability: Homeowner Rehabilitation §92.254(b)

• Underwriting and subsidy layering is only required if assistance is provided as an amortized loan
• Market analysis is not required
• Evaluation of developer capacity is not required
Regulatory Requirements

• §92.250(b) requires a PJ to adopt and evaluate HOME projects according to written underwriting and subsidy layering guidelines

• §92.254(f) requires a PJ to adopt and follow written underwriting standards for assistance to homebuyers
Related HOME Requirements

- Maximum per unit subsidy limits
- Cost Allocation
- Written Agreements
- Commitment
- Home Deadlines
- Property Standards
- Rents/utility allowance
- Affordability period
Cost Allocation

• HOME funds may only be used to pay eligible costs for HOME-assisted units
• A PJ must perform cost allocation for a project where less than 100% of the units are HOME-assisted.
• Cost allocation dictates:
  – The maximum amount of HOME funding (capped by subsidy limits), or
  – The minimum number of HOME units
Commitment of HOME funds

• PJs may not commit HOME funds to a project until:
  – A project is identified
  – Environmental review requirements are met
  – A budget and production schedule is established
  – All necessary financing is secured
  – Underwriting and subsidy layering is complete (including assessment of market and developer capacity)
  – Construction is expected to start within 12 months

• Reference CPD-15-09: Requirements for Committing HOME Funds
HOME Deadlines

PJs must comply with several key deadlines:

- 2 years to commit funds to activities, including CHDO projects
- 5-year expenditure for all HOME funds, including CHDO funds
- Construction must be expected to start within 12 months after acquisition/demolition
HOME Deadlines (cont.)

• 4-year project completion deadline
• 18-month lease-up in rental housing projects
• 9 months for a ratified sale contract or the PJ must convert the project to rental

Projects must remain compliant for entire period of affordability
Underwriting and Subsidy Layering Guidelines

• A PJ must have written HOME underwriting & subsidy layering guidelines that describe PJ’s process for:
  – Assessment of market demand for the project
  – Review of developer experience & financial capacity
  – Examining cost reasonableness
  – Ensuring HOME funds invested are no more than necessary to provide quality, financially viable affordable housing
  – Determining reasonable level of profit/return to owner/developer for size, type, complexity of project
  – Ensuring financial viability for the entire affordability period
  – Verifying financial commitments are firm
Coordination with Other Funders

- A PJ must evaluate a project against its HOME underwriting standards and cannot simply accept underwriting done for LIHTC or other lenders.
- A PJ can review other lenders’ underwriting but the PJ must make and document its own determination that the project meets HOME requirements.
- The PJ must certify in IDIS to the use of its underwriting guidelines.
Developing Guidelines

• Written guidelines should describe how PJ will collect & review:
  – Market studies
  – Development budgets
  – Sources and uses statements
  – Pro forma operating expense statements

• Guidelines should include:
  – Underwriting criteria such as key ratios and dollar limits
  – Guidance on reviewing cost reasonableness
  – How underwriting and financing decisions will be made by PJ
    o Including level of HOME subsidy and terms

• Acceptable forms of documentation
Market Assessment

• Develop policies and procedures to assess and document current neighborhood market demand for projects before entering into legally binding agreement
• Assessment scaled to the project size
  – Type of assessment based on project type
• Three options for market assessment:
  – PJ does own using knowledgeable, experienced staff
  – PJ contracts for market assessment
  – PJ requires owner to do professional assessment and PJ review
Market Assessment Topics

• Demographic trends
• Market area
  – Project area/neighborhood
  – Metropolitan wide
  – County wide
  – Other broad market area
• Housing demand & cost
• Housing supply
• Construction trends
• Vacancy rates
Market Assessment Questions

• Do you agree with the market study assumptions?
• Has a demand for the type and number of housing units been convincingly demonstrated?
• Does the unit configuration, location, amenities and affordability match the market demand?
• How do the proposed rents compare to market rents?
• Is it likely the proposed units will be “absorbed” within program deadlines? Is there a clear marketing plan?
• Will the development adversely impact existing affordable housing developments?
Evaluating Developer Experience

• Areas to assess:
  – Recent, relevant experience & skills of the organization and of the staff
  – Strength: financial and organizational

• Key questions in assessing developers:
  – Assessment varies by project size, scope, complexity
  – Type of development entity (CHDO, nonprofit, for-profit)
  – New entities v. established developers
  – Current workload
Evaluating Developer Financial Capacity

• Must assess team’s financial ability to complete project development and support project operations

• Available capital
  – Request current financial statements with current valuation
  – Need sufficient reserves/LOC to complete project
    o Depends upon other obligations
    o Depends upon size/risk factors of project

• Ensure stability for this project through period of affordability (rental) or sales (homebuyer)
Assessing CHDO Capacity

• CHDOs are covered by the requirement to assess developer capacity

• Each time it commits funds to a specific CHDO project, PJ must certify that the nonprofit:
  – Meets CHDO definition (including the staff capacity requirement)
  – Has capacity to fulfill specific role (owner or developer/sponsor) it will assume for the project
Project Review

• At a minimum, collect and review:
  – Sources and uses statement
  – Development budget
  – Operating pro-forma or homebuyer sales plan

• Compare projects against standards in PJ’s underwriting guidelines, which take into account:
  – Market (as previously discussed)
  – Targeting: geography and project type
  – Targeting: income levels/mixed-income
  – Trade off between volume and quality
  – PJ tolerance for risk (more later)

• Build sustainability into PJ’s guidelines
Reviewing Sources and Uses Statements

• PJs must obtain Sources and Uses statement
  – All funds and costs to complete the project
  – Sources = public and private funds, including timing and availability
  – Uses = all costs associated with project development
  – Supporting documentation

• Review Sources & Uses from several perspectives:
  – Are all sources firmly committed?
  – Are all uses verified?
  – Do sources and uses match up over time?
  – Do sources match up with eligible costs?
  – Are start up operating costs are included?
  – Has developer maximized available resources? Review LTV calculation to assess level of project debt
  – Has the owner invested a reasonable amount of equity?
Reviewing Development Budgets

• PJs must determine all project costs are **eligible, customary and reasonable**
• PJs must require the submission of a detailed development budget
• Consider: total cost, per unit cost, and line item percentages
  – Ensure all HOME costs eligible per 92.206
  – Ensure HOME investment does not exceed max per unit subsidy limits
  – Review cost allocation to be sure costs correctly allocated to HOME units
Reviewing Pro-Formas

• PJ guidelines must require an operating budget and affordability period pro-forma

• At minimum, the pro-forma should cover:
  – Projected income and vacancies
  – Operating expenses
  – Contributions to reserves
  – Debt service
  – Cash flow and payments of deferred fees

• PJ should establish standard format
In its review, a PJ must ensure that:

- Adequate cash flow each year
- Income is sufficient to cover expenses and debt service for entire period of affordability
- Margin of safety
  - Assumptions allow for “bumps in the road”
  - Use DCR and NOI as good metrics
- Are rent assumptions realistic?
- Are rents in compliance with HOME limits?
- Are expense assumptions realistic?

Plan in place for balloon payments

Reserves are adequate over life of affordability period
Sales Plan for Homebuyer Projects

• PJ must request a sales plan from the developer outlining their efforts to market and sell the units
• Sales plan should include cash flow and timing of when and how units will be sold
• PJ’s evaluation:
  – Is cash flow from sales needed to complete the project?
  – Are timelines achievable given the market?
Returns to Developers and Owners

• Analysis includes profit from operating cash flow, sales proceeds, and/or any other professional fees.
• Compare returns to other, similar projects and investments
  – Returns will vary with complexity and risk of project
• PJ must establish standards for reasonable rate of return
  – LIHTC QAP may include a standard on ROI
  – Most common method is cash on cash calculation
  – Can also look at tax benefits, appreciation, IRR
Project Selection & Subsidy Layering

• PJ should select projects & establish level of HOME subsidy based on:
  1. PJ review of project as compared to its standards;
  2. Analysis of financing gap;
  3. Reasonable return to owner;
  4. PJ assessment of project risk.

• PJ assessment of project risks, such as:
  – HOME Compliance Risk
  – Revenue Risk
  – Operating Expense Risk
  – Capital Needs Risk
  – Cash Flow Risk
• Other risks:
  – Risk of Inadequate Sources
  – Risk of Additional Uses
  – Construction Risk
  – Lease-Up Risk

• If the requested HOME assistance is not necessary and reasonable, the PJ should:
  – Reduce the HOME assistance
  – Increase the number of HOME units or target to lower incomes
  – Impose loan terms to decrease rate of return
Self-Sustaining Projects

- HUD encourages PJs to employ underwriting principles that promote Long-term financial viability
- Underwriting covers the HOME affordability period at a minimum
- Tools such as the Capital Needs Assessment are utilized to project needed reserves
- Project should be able to survive moderate losses or revenue or increased costs
Documenting Compliance

- PJ must develop and follow procedures to document all elements of underwriting and subsidy analysis.
- File must identify who submitted documentation and when it was submitted.
- PJ must document its review and approval following standards and procedures.
- Changes made during development will require updated review and written agreement provisions.
Questions?