INITIAL STATEMENT OF REASONS

**Uniform Multifamily Regulations**

**California Code of Regulations, Title 25, Division 1, Chapter 7, Subchapter 19**

**Commencing with Section 8300**

**Proposed Amendments to:**

**Sections 8300, 8301, 8302, 8303, 8305, 8308, 8309, 8310, 8312, 8313, 8314, 8315, and 8316**

**INTRODUCTION**

This Initial Statement of Reasons (ISOR) has been prepared by the California Department of Housing and Community Development (“the Department”) regarding amendments to regulations currently in effect governing certain aspects of multiple housing finance programs administered by the Department. These regulations were initially adopted in 2003 to bring uniformity to the Department’s rules on multifamily rental loan underwriting, tenant selection, and similar matters. At that time, they applied to the Multifamily Housing Program, the HOME Investment Partnerships Program, and the Joe Serna Junior Farmworker Grant Program. Since then, and by reference, they have been made applicable in whole or in part to the TOD Housing Program, the AB 1699 HCD Loan Restructuring Program, the Affordable Housing and Sustainable Communities Program, and the Veterans Housing and Homelessness Prevention Program. In 2010, there was a narrow amendment to Section 8315, regarding subordination to other lenders.

Some of the proposed amendments simply adjust numerical limits to account for inflation since 2003. Others reflect changes in requirements for other funding sources used in conjunction with HCD loans, including private bank loans. A third set of amendments addresses specific issues that have arisen in the dozen years since the regulations were first adopted.

**DISCUSSION OF PROPOSED AMENDMENTS**

**Section: 8300. Purpose and Scope**

Subsection (b)

Purpose: The proposed amendments update the list of Department programs to which these regulations apply, to include programs that came into existence after the regulations were initially adopted. They also clarify that the list is not necessarily exhaustive, to account for programs that will use these regulations in the future, and correct the name of one program.

Problem: The list of programs in this subsection is not up to date, and the wording suggests that it is an exhaustive list.

Rationale and Benefits: This change is being proposed only for purposes of clarity and completeness. It does not modify the substance of the regulations.

Alternatives Considered: This subsection has resulted in limited confusion to date, so it probably could be left unmodified. However, since other changes are being proposed, this seems like the appropriate time for minor clarifications.

Subsections (c), (d) and (e)

Purpose: The proposed amendments specify which projects are subject to the amendments.

Problem: These regulations govern projects that have been completed and occupied, as well as those at several stages of the development process. There needs to be clarity regarding which ones are subject to the amendments.

Rationale and Benefits: The proposed regulation seeks to apply the amendments in a manner that avoids adverse impacts from midstream rule changes while giving sponsors of existing projects the opportunity to benefit from certain provisions that make sense to be applied to them.

The proposal is to make the complete set of amendments applicable to three groups of projects. The first group is those who start the application process – which begins with the issuance of a funding announcement -- after the amendments become effective. This group will have clear notice of what the new rules will be, from the beginning of the period during which they can consider applying for them, so it is fair to apply the new rules to them.

The second group consists of projects that were initially funded under previous versions of the regulations, but are undergoing a major restructuring of their financing. In this case the Department expects most sponsors will welcome switching to most of the new rules. In return for allowing them to take advantage of the provisions they find advantageous, the Department expects them to accept those they find less advantageous, at a time when it is possible to structure project financing in a manner that is consistent with the new rules.

The third group subject to the complete set of amendments consists of projects that are in the process of preparing an application or who have received an award but not yet closed their Department loan, where the sponsor elects to be governed by the new rules. This gives sponsors a choice, at a point in the process where requiring adherence to the new rules could potentially be difficult.

The proposed subdivisions (e) and (f) give sponsors of existing projects, and those in process, the option of applying selected provisions of the amended regulations, one regarding asset management and partnership management fees and a second regarding supportive services costs treated as project operating expenses. Both of these provisions increase the limits on these expense items. The rationale for the increased limits is detailed in Section 8314 of this document. The reason these limits are proposed to apply to existing projects is that they benefit equally from having adequate resources available for asset management and supportive services, and because other resources available for this purpose are scarce.

The last paragraph of subsection (e) specifies the steps sponsors must take in order to avail themselves of the increased limits. Consents from other funding sources will often be required because amendments in question will potentially reduce payments on the Department’s loans, thus arguably impacting the interest of other funders, and junior lienholders in particular. Since the existing limits are typically specified in the Department’s loan documents, these documents will require amendment to effectuate a change.

Subsection (e) requires sponsors to accept standard form documents if they want to take advantage of the increased limits on asset management / partnership management fees and supportive services costs. This provision is intended to avoid the substantial time and expense involved with negotiating individual documentation for hundreds of projects.

For clarity, subdivision (g) specifies that sponsors cannot choose to apply selected provisions of the amendments, except for situations described in subsections (e) and (f). To keep its monitoring costs to a reasonable level, the Department needs to avoid ending up with a portfolio where each individual project is subject to unique requirements.

Alternatives Considered: The most straightforward approach would be to apply the amendments only prospectively, to projects that receive awards under funding announcements released after the effective date of the amendments. This approach would give certainty to those planning application before the regulations were finalized, and be simplest to administer. However, the Department believes that its proposal is fairer to applicants, and would encourage better asset management and supportive services.

**Section: 8301. Definitions**

Subsection (e)

Purpose: Clarify treatment of required payments into an operating deficit reserve, when evaluating Debt Service Coverage Ratio.

Problem: Questions have been raised about whether operating income required to be deposited into a reserve account to defray projected future deficits should be counted in the calculation of Debt Service Coverage Ratio.

Rationale and Benefits: The first sentence of this definition provides that required reserve deposits be subtracted from Operating Income, when making this calculation, so this point is arguably already covered. Since some readers seem unsure about it, however, the proposal is to add a specific exclusion, for clarity.

Alternatives Considered: The existing text could be left unaltered. The proposed addition is only being added for clarity.

Subsection (j)

Purpose: Define Native American Lands.

Problem: Programs covered by these regulations have not been used on Native American Indian reservations or similar land subject to federal restrictions designed to protect Native Americans. One of the reasons for this situation is that federal rules, and rules established by individual tribes, sometimes are inconsistent with the rules governing Department programs, including these regulations.

Rationale and Benefits: This definition is used in other parts of these regulations to describe situations under which modifications of otherwise applicable requirement can be made to accommodate conflicting federal and tribal rules. It is the same definition used for this purpose by the California Tax Credit Allocation Committee (TCAC) and the California Debt Limitation Allocation Committee (CDLAC).

Alternatives Considered: Other sources describe these lands using other terms, but this one was chosen to be consistent with the other state housing agencies.

Subsection (k)

Purpose: The proposed amendment adds case management and services amenities required by TCAC to the list of project operating expense cost categories.

Problem: Chronically homeless individuals and other very high need households typically need intense individualized assistance with obtaining and coordinating supportive services and benefits – case management – along with arranging services to be made available to groups of tenant -- services coordination.

It is also generally recognized that other very low income households benefit significantly from services tied to their specific needs and offered on-site, such as after-school programs and classes in English as a second language.

In recognition of the benefit provided by services, some housing funding agencies require or strongly encourage them. In California, the most notable example is TCAC, which labels the services they encourage through their application scoring system as “service amenities.”

Rationale and Benefits: Funding from external sources for case management and direct services is sharply limited, so owners have increasingly turned to project sources for this purpose. The proposed amendment, coupled with the addition of 8314(e), would allow use of project operating income for case management, on a priority basis. Where required by TCAC, it would also allow direct services to be paid for on the same basis. This change will reduce the risk that the most vulnerable tenants will not receive the services they need, and encourage developers to take on the challenge of serving this population.

Alternatives Considered: Historically, the Department has held the position that supportive services, including case management, should be funded by services programs, and not divert resources from housing programs, which this change effectively allows. A reasonable alternative would be to maintain this position. However, in the present environment, with services funding so limited, and an increasing emphasis on housing tenants who need intensive services, this does not seem to be in the best interest of the most needy tenants assisted by Department programs.

Another alternative would be allow priority use of cash flow for direct services in all projects, and not just those where these services are required by TCAC. This alternative is not being proposed due to the difficulty of monitoring the provision of services over time. Where TCAC has the requirement, they will be monitoring this as well as HCD, and there is less of a risk of abuse.

Subsection (p)

Purpose: Provide more specific guidance on what constitutes an acceptable scattered site project, and eliminate unnecessary barriers to projects of this type.

Problem: The existing definition of “Rental Housing Development” specifies what types of scattered site projects are acceptable. However, it has proven to be too imprecise, and subject to numerous interpretations. It also does not represent current Department policy.

Rationale and Benefits: Many potential development sites are too small to efficiently finance and operate as stand-alone projects, but would be viable if combined with other sites. The Department sees no reason to discourage these types of projects, as long as they meet all program requirements (including program-specific regulations and statutes) and do not create significant practical administrative problems. The proposed amendment to Section 8303 attempts to define what is acceptable in this area with more precision than the text proposed for deletion from Section 8301.

Alternatives Considered: See discussion of Section 8303.

**Section: 8302. Restrictions on Demolition**

Subsection (a)

Purpose: Make this subsection consistent with amendments proposed to subsection 8300(p), the definition of Rental Housing Development, and subsection 8303(b), regarding scattered site projects.

Problem: This subsection includes the reference to “common ownership, financing and management” proposed for deletion from the definition of Rental Housing Development. Because it includes this reference, it is also inconsistent with subsection 8303(b), for scattered site projects.

Rationale and Benefits: The rationale for the deletion is provided in the discussion of subsection 8300(p) above and 8303(b) below.

Alternatives Considered: None.

Subsection (b)

Purpose: Allow for exceptions to the general rule barring a reduction in the number of bedrooms when existing housing is demolished to make way for new units.

Problem: The Department has encountered some situations where it believes the existing rule is not in the best interest of project tenants.

Rationale and Benefits: The chief situation that has come up relates to single room occupancy hotels, where a unit is often a small room without kitchen or bathing facilities. The proposed amendment would allow the Department to approve demolition of these types of units, and replacing them with larger, more livable units.

Alternatives Considered: None.

**Section: 8303. Site Control Requirements**

This section is proposed to be retitled and renumbered, to reflect the addition of two subsections on scattered site projects.

Subsection (a)

Purpose: Clarify that fee title may be evidenced by non-traditional means, on tribal trust land.

Problem: Preliminary title reports are the standard method of evidencing fee title in California. These reports are not available for tribal trust land.

Rationale and Benefits: Title status reports and attorney opinion letters are accepted by other public agencies as evidence of fee title on tribal trust land.

Alternatives Considered: Since the existing regulation does not mandate use of title reports, this amendment may not be essential. However, since not being able to obtain a title report is so unusual, the Department believes a clarifying change provides helpful guidance to sponsors and staff.

Subsection (b)

Purpose: Define requirements for projects on non-contiguous sites.

Problem: As discussed above, the provisions of Section 8301 that relate to this subject have proven too vague and restrictive.

Rationale and Benefits: The proposed amendment is identical in substance to the provision on this subject included in the AB 1699 loan restructuring guidelines adopted by the Department in 2014, except for one provision regarding pre-existing local public agency loans. (Outside of the AB 1699 context, projects rarely will have loans of this type.) It aims to allow for the efficiencies associated with larger projects, while avoiding burdensome administrative difficulties and ensuring sufficient commonality to reasonably be characterized as one project.

The introductory paragraph of subdivision (b) makes it clear that any pertinent statutory requirements associated with individual Department programs must be satisfied, in addition to the requirements of the regulations.

Subsection (b)(1) requires scattered sites to have a single owner and property manager, so that there is a single responsible party and one entity to work with on property management issues.

Subsection (b)(2) requires senior debt to be the same on all sites, to avoid the complications of dealing with multiple senior lenders in an enforcement action.

Subsection (b)(3) requires a unified audit and unified annual report, to avoid the time and expense of dealing with multiple items of this nature.

Subsection (b)(4) specifies that the Department loan be secured by all sites, with priority with respect to local public agencies determined in accordance with the tried and true formula in Section 8315. These provisions are intended to provide adequate security for the Department’s loans, and head off arguments about lien priority and the division of cash flow available for residual receipts loan payments.

Subsection (b)(5) clarifies that the Department expects to covered by hazard and liability insurance policies for all sites. This is a logical corollary to the requirement for security on all sites.

Alternatives Considered: Consideration was given to requiring that all sites be located in the same jurisdiction, within a certain distance of each other, and with identical junior financing as well as senior debt. These alternatives are not being proposed because they were deemed unnecessary to achieve any particular Department policy objective, to avoid an unacceptable administrative burden, or to ensure sufficient commonality to be conceptualized as one project.

**Section: 8305. Tenant Selection**

Subsection (a)(1)

Purpose:  Clarify that sponsors may use local coordinated entry process to select tenants.

Problem:  Coordinated entry, (also known as centralized or coordinated assessment) is a new way of selecting tenants for affordable housing. The federal Department of Housing and Urban Development (HUD) requires its use for housing developed under the two primary federal programs serving persons experiencing homelessness, and encourages its use more broadly.  Coordinated entry involves a standardized assessment of need and allocation of available housing based on need, rather than time of application or other traditional method.  HUD’s primary goals for coordinated entry are that housing and services assistance be allocated as effectively as possible and that it be easily accessible no matter where or how people present. Continuum of Care entities (groups that coordinate a number of local activities aimed at reducing homelessness) are currently creating standard assessment processes and community agreement on referrals based on HUD guidance and requirements. Because this approach is new, and deviates from the standard selection process, this provision will clarify for owners and the community its acceptability for projects subject to these regulations.

Rationale and Benefits:  Vacancies in affordable housing have historically been filled by individual owners based on date of application or through a lottery.  In developments targeting the homeless and other special needs groups, this has often led to limited access and a small proportion of units being occupied by those with very high needs, who typically have most to gain from the housing and supportive services offered along with it. The traditional method of tenant selection often means those with the longest histories of homelessness or those who are the most vulnerable do not receive assistance – they do not hear about vacancies, are not able to navigate the application process, face long waiting times, or they are screened out.

To ensure the use of HUD-sanctioned and community-driven coordinated entry processes, the proposed amendment requires that any coordinated entry process follow the rules established by HUD for these systems.  These rules include oversight by the local Continuum of Care, strong encouragement for use of written standards, standardized assessment tools, privacy protection, person-centered, cultural competence, and uniform record keeping. See <https://www.hudexchange.info/resources/documents/Coordinated-Entry-Policy-Brief.pdf> and <https://www.hudexchange.info/resource/3897/notice-cpd-14-012-prioritizing-persons-experiencing-chronic-homelessness-in-psh-and-recordkeeping-requirements/> for additional information.

Alternatives Considered: One alternative would be to remain silent on coordinated assessment, as it arguably involves use of the “reasonable criteria” required by the current regulation.   However, this approach would necessitate either a sponsor or Department determination of reasonability on a case-by-case basis. The amendment is being proposed to align the Department’s programs with HUD’s goals and local community processes and in the interest of clarity to Sponsors.

Subsection (a)(4)(A)

Purpose: Prohibit requiring prospective tenants to stand in line to be considered for vacant units.

Problem: It has come to the Department’s attention that sponsors occasionally take applications for units in new developments using a process that requires tenants to stand in line, sometimes for hours on end. This system creates a hardship for those who work during the period they would need to be in line, or who have physical limitations that makes waiting in line difficult.

Rationale and Benefits: Making applicants wait in line is unnecessary. Many sponsors accept applications during a window of time, and then use a lottery to determine which ones will be considered first. Other methods are available as well. Because of the negative impacts on applicants, and the availability of alternatives, the Department believes it is appropriate to prohibit systems that require standing in physical lines.

Alternatives Considered: The Department currently has adequate authority to disallow the practice that is the subject of this proposed amendment, so an alternative would be to leave the existing language alone. However, putting the prohibition in the regulation would assist sponsors by making explicit the Department’s requirements, and would reduce the chances that it is not overlooked.

Subsection (b)

Purpose: Reduce the need for sponsors to request exemptions to normal minimum occupancy requirements, by specifying situations under which these exemptions are clearly acceptable.

Problem: The existing regulations allow for “reasonable” exemptions to the normal requirements, but do not provide guidance on how to determine reasonableness.

Rationale and Benefits: The additions are an attempt to specify situations where allowing fewer occupants than the standard specifies would clearly be reasonable, in the eyes of the Department. They were derived from the standards used by various California housing authorities, when using federal funding. The housing authority standards examined vary widely; some are very strict (e.g. requiring grandmothers to share bedrooms with grandchildren), and some are quite liberal. The proposed standards attempt to strike a middle ground. To avoid conflicts with housing authority rules, they also explicitly specify that housing authority rules prevail, when Department funding is used on projects that receive rental assistance administered by them.

Alternatives Considered: Reasonable arguments could be made for variations on this theme. As noted above, the proposal attempts to specify situations where the Department is clearly comfortable with an exception, and does not preclude sponsors requesting exemptions for other situations.

**Section: 8308. Operating Reserves**

Subsection (e)

Purpose: Allow the Department to defer to the operating reserve requirements of HUD’s Native American Housing Assistance and Self Determination Act (NAHASDA) funds.

Problem: Parties interested in using Department funds subject to these regulations on tribal trust land have identified the current lack of authority to defer to various provisions of NAHASDA as an obstacle to combining the two resources.

Rationale and Benefits: The Department recognizes that Native Americans face significant unmet housing needs, and desires to remove barriers to using Department program resources to meet these needs. It has not at this point conclusively determined that the requirements of NAHASDA are inconsistent with maintenance of an operating reserve in accordance with the requirements of this section, but believes this is likely. Accordingly, the Department seeks authority to defer to NAHASDA , should this prove necessary.

Alternatives Considered: None.

**Section: 8309. Replacement Reserves**

Subsection (b)(1)

Purpose: Add clarity to the specification of minimum replacement reserve deposit amounts for new construction, and add an inflation adjustment to reflect projected construction cost increases.

Problem: The Department’s has consistently approved reserve deposit amounts that are less than the 0,6% of estimated constructions specified in the regulations, based on other indicators of the need for reserve funds, including that the potential for obtaining rehabilitation funding through new tax credits after a number of years of operation. It has also rarely approved deposit amounts of less than $600 per unit per year. As a result, the existing regulations do not provide clear guidance to sponsors regarding the Department’s requirements.

Rationale and Benefits: Sponsors would benefit from having the Department’s requirement clearly spelled out in the regulation. To adequately account for inflation, this amount should be increased over time, for projects receiving new commitments of Department funds.

The $600 per unit amount was established a number of years ago based on information available at the time, including an analysis of the replacement needs of older HUD projects, an estimate developed by the National Association of Home Builders, and the United State Department of Agriculture’s Rural Housing Services (USDA). It was reduced below the levels suggested by these sources due to the fact that it exceeded the amounts required by most other funding sources.

To evaluate the current reasonableness of the $600 figure, the Department recently consulted with the California office of USDA, which sets replacement reserve requirements for both new construction and rehabilitation projects based on an individualized physical needs assessment covering a 20 year period. USDA projects are limited to rural areas, and for this reason should have, lower replacement costs than is typical for Department projects, which tend increasingly to be concentrated in higher cost areas and to be built with higher densities. For new construction projects evaluated in 2014, USDA reported that their requirement averaged $657 per unit. This suggests that the $600 figure is reasonable, and not excessive.

The Department’s goal is to ensure that reserves are sufficient to cover capital needs for at least the initial 20 years of the projects it funds. It recognizes that most projects will need an infusion of new funding, typically from tax credits, to address their physical need over the remainder of the term of their Department loan. For this reason, it proposes to replace the existing reference to sizing the reserve deposits based on need over the term of the loan with a requirement to cover the initial 20 years It also recognizes that the data it has on what these needs actually are is limited, and invites submission of any data that could assist with refining its analysis.

Alternatives Considered: One alternative considered was increasing the $600 amount, to account for inflation since the studies referenced above were conducted. This alternative is not being proposed because, as discussed above, the Department recognizes that external resources are sometimes available to cover replacement costs, including tax credit equity and government funding programs, and in acknowledgement of the fact that this would reduce borrowing capacity and thereby reduce the amount of development sources available for other uses.

A second alternative would be to count on new tax credit equity infusions as the primary source of funding for rehabilitation, at year 15 and every 15 years thereafter. The Department is reluctant to rely on this approach, as it has not observed it to be a fully satisfactory solution to physical problems in its own aging portfolio. For a variety of reasons, new tax credits are not always available at the time they are needed to address problems, and the tax credit equity generated through a 4% transaction is not always sufficient to cover the cost of needed improvements.

Subsection (b)(2)

Purpose: For rehabilitation projects, provide better guidance on the replacement reserve deposit amount to be used in initial underwriting.

Problem: Under the regulations, replacement reserve amounts for rehabilitation projects are set based on an individualized, third-party analysis of replacement needs over time. However, this analysis is rarely completed at the time the Department completes its initial underwriting. In the absence of better information, and out of necessity, the Department uses a preliminary estimate for the initial underwriting. To provide clearer guidance to sponsors, the Department believes it desirable to include the estimated amount in regulation.

Rationale and Benefits: The $600 figure proposed to be used at initial underwriting is reasonably consistent with the $760 average reported by USDA for rehabilitation projects in California that it has assisted in the past few years. (Similar to USDA’s approach to new construction, the $760 is based on an analysis of projects as they were actually completed, and with a 20-year time horizon).

As for new construction, rehabilitation costs rise with inflation, so it seems prudent to index the initial underwriting amount to inflation.

Alternatives Considered: Based on its experience, the Department expects that the individualized analysis for rehabilitation projects will frequently result in deposit amounts exceeding $600. To reduce the incidence of problems occurring late in the process as a result of the reserve requirement being increased, the Department considered requiring use of a higher amount at underwriting, in the $800 to $1,000 range. However, recognizing that this would adversely impact projects that do not end up needing these higher amounts, it is not currently proposing to do so, but invites comments on which is the better approach.

Subsection (b)(4)

Purpose: Allow the Department to defer to the replacement reserve requirements of HUD’s Native American Housing Assistance and Self Determination Act (NAHASDA) funds.

Problem: Parties interested in using Department funds subject to these regulations on tribal trust land have identified the current lack of authority to defer to various provisions of NAHASDA as an obstacle to combining the two resources.

Rationale and Benefits: The Department recognizes that Native Americans face significant unmet housing needs, and desires to remove barriers to using Department program resources to meet these needs. It has not yet fully researched the requirements of NAHASDA to confirm that it is inconsistent with maintenance of a replacement reserve in accordance with the requirements of this section, but believes this is likely Accordingly, the Department seeks authority to defer to NAHASDA, should this prove necessary.

Alternatives Considered: None.

**Section: 8310. Underwriting Standards**

Subsection (b)

Purpose: Allow an exception to the normal 50% commercial space vacancy assumption, under limited conditions.

Problem: Developers have pointed out that a 50% vacancy rate assumption is quite conservative in some market areas. This conservatism results in projects borrowing less from private lenders than might otherwise be the case, and increases the need for subsidy.

Rationale and Benefits: The Department adopted the 50% standard long ago, due to problems it and other affordable housing lenders were having with over-estimation of rental income from ground floor commercial space. At that time, it was unusual to see an affordable project located on a site that commercial tenants would find particularly attractive. Now, with the increasing emphasis on urban infill, affordable projects are more frequently being located on sites that are highly desirable for commercial tenants, in strong markets like San Francisco. In some especially clear cases, the Department believes it would not be imprudent to base its underwriting on a less conservative vacancy assumption.

The proposed amendment would allow a deviation from the 50% standard under either of two conditions. The first involves an evaluation of the local market, using vacancy rate and the presence of other commercial space as indicators of market strength, and of the competiveness of the space itself, based on its specific location, configuration and projected rental rate. The second requires the space to be pre-leased to a financially strong tenant.

If one of these conditions is satisfied, the proposed amendment would allow the Department to use a 25% vacancy assumption, instead of the current 50%. The Department is aware that some other funding sources are willing to underwrite some projects using a lower vacancy rate assumption. The Department is hesitant to do this, due both to inherently high risk of commercial markets and the Department’s lack of expertise in evaluating them. Based on past experience with under-performing commercial space, it is reluctant to defer to the judgments of commercial lenders, and is also reluctant to assume that financially strong owners will remain strong over many decades. Finally, sponsors always have the option of separating ownership of the commercial space, through a condominium structure. Where ownership is separate, commercial vacancies do not threaten the financial health of the Department-funded residential units, and the Department does not underwrite commercial income at all.

Alternatives Considered: It would be possible to take a less conservative approach, and allow use of a vacancy rate assumption lower than 25%. However, for the reasons described above the Department does not believe the extra risk associated with a less conservative approach would be offset by the potential gains.

Subsection (e)

Purpose: Improve readability, allow but not require projects to be structured to project a positive cash flow for 20 years, as opposed to the 15 year period currently used, and broaden the exemption from the general rule available to HUD Section 811 and 202 projects.

Problem: This subsection is not always read accurately. In addition, projections for projects that comply with its requirements sometimes show negative cash flow shortly after the standard 15 year analysis period, which does not bode well for long-term financial feasibility. Finally, the provision allowing modification of normal requirements for certain federal programs is outdated.

Rationale and Benefits: The proposed revisions in the first part of this subsection, prior to subsection (e)(2)(D), are intended solely to improve readability.

The proposed new subsection (e)(2)(D) is prompted by the Department’s concern with projects that have operating expenses consuming a large proportion of rental income. Using standard trending assumptions, projections for these projects reasonably often show a negative cash flow in the outlying years, sometimes soon after the end of the standard 15 year analysis period. The proposed revision would allow first year Debt Service Coverage Ratio to exceed the normal limit, 1.20, as necessary to allow positive cash flow to be projected for 20 years. This would allow some projects, typically those with low rents, to operate with a higher margin, and reduce the odds that they will face financial challenges as they age, should they have sufficient subsidies to do so.

The proposed revision to the final paragraph would broaden the exemption that now exists for the HUD Section 811 and 202 programs to any program that is structured with the same type of operating or rental subsidy as these HUD programs. When these regulations were first adopted, the 811 and 202 programs were the only known programs that provided a subsidy to ensure breakeven operation. Since that time, other programs have been introduced that have this same feature, including the Veterans Housing and Homelessness Prevention Program administered by the Department.

Alternatives Considered: The simplest way to address the concern about inadequate cash flow over time would be to allow or to require a higher debt service coverage ratio. This would be consistent with the increase in the minimum ratios required by many private lenders since the time these regulations were initially adopted. However, increasing the allowable ratio would not assist many of the projects of concern, because they typically already exceed the current 1.20 limit, and are constrained by the 15 year projection period. Similarly, there is a set of projects, typically with higher rents, that if underwritten using the 1.20 standard show ample and increasing cash flow over time. Increasing the allowable ratio for these projects would allow them to justify higher subsidies, with little benefit in terms of increasing sustainability.

Another option would be to increase the period of time during which positive cash flow must be projected – to make penciling over 20 years a requirement rather than an allowable situation. This would be a logical approach if it was thought that the projections were a highly accurate indicator of future performance; it does not make sense to allow projects to cease to be financially viable after 15 years if the goal is to have the housing available over a much longer time period. However, there is not the evidence to suggest that the projections are truly accurate enough predictors of the future to go this route, which could substantially increase subsidy needs and render many projects infeasible.

Subsection (f)

Purpose: Open up limited exemptions to the current prohibition on senior debt with balloon payments.

Problem: The Department has received many requests to allow senior loans with balloon payments, which are easier to obtain than long-term fully amortized loans and typically have lower interest rates, lower fees and lack burdensome prepayment charges. It would like to accommodate these requests, to the extent they do not jeopardize feasibility.

The Department has also observed that existing projects often have greater than normal difficulty obtaining new senior loans meeting current Department requirements, where the Department is not providing additional funding. It would also like to encourage rehabilitation of its existing projects with resources other than Department funding programs.

Rationale and Benefits: The proposed amendment would allow the Department to approve balloon payment loan structures for existing projects where the Department is not providing new funding, as a way to encourage the rehabilitation of existing projects without tapping into new Department funding. The Department continues to believe that balloon payment loans pose substantial risk. It is willing to take this risk for existing projects in part because it has good information on their operating history, and is better able to assess their ability to handle the balloon payment, and in part because it believes the volume of these transactions will be comparatively low, so the risk to the overall portfolio is limited.

The amendment would also allow senior lender balloons where the Department’s regulatory agreement – but not necessarily its deed of trust – is recorded senior to the lender’s documents. This would ensure that the Department’s regulatory restrictions survived a foreclosure sale resulting from the inability to pay off a balloon payment. Although it could result in substantial financial losses, having the regulatory agreement in senior position would protect the tenants, and minimize the risk that the Department’s fundamental policy objective ended up being sacrificed for marginally superior senior lender loan terms.

The last paragraph of subsection (f) specify the basic test the Department would use to evaluate proposals for balloon payments for projects meeting the requirements of either (f)(1) or (f)(2). It requires projected project operating income, along with the proceeds of new financing, to be sufficient to cover the balloon payment. This is the standard analysis done by lenders to evaluate situations like this.

Alternatives Considered:

The Department is aware that its general prohibition on balloon payment loans deviates from standard industry practice, at least after the 15 year initial tax credit compliance period. It is also aware that there are costs associated with this prohibition, including higher interest rates and substantial yield maintenance / prepayment penalties. Due to these considerations, it was considering moving away from its historic position in a more fundamental manner, and allowing balloon payments more generally, provided that it could become comfortable with the analysis methodology it assumed was used by lenders who offered products with balloon payments.

The Department retreated from its initial thinking about the appropriate scope of change in this area for two reasons. One was an examination of a sample of senior loans on Department-financed projects, and a realization that the terms of a number of them appeared quite satisfactory -- that the costs and potential costs associated with the prohibition were not as high as expected. Some did indeed have very large penalties for repayment prior to the end of their terms, which could be result in substantial costs if refinancing was necessary prior to this date. Others, however, had only modest penalties, at least after the initial years of the loan, during which it would be unlikely that there would be a need to refinance. Interest rates also seemed acceptable.

The second reason for a change of heart was the absence of a response to repeated requests for specific information on the analysis senior lenders perform to become comfortable with balloon payments. This lack of a response was perceived by the Department to be an indicator that the industry was largely operating based on considerations other than ones the Department could use itself.

Subsection (g)

Purpose: Increase readability.

Problem: The existing regulation treats the subjects of senior and junior debt in one sentence. With the changes proposed regarding senior debt, combining these two together would be confusing

Rationale and Benefits: For readability only, the proposal is to split off the language on junior loan balloon payments into a separate subsection.

Alternatives Considered: None.

Subsection (i)

Purpose: Prevent senior lender yield maintenance / prepayment charges from significantly increasing the cost of any necessary refinancing of senior debt, on newly funded projects.

Problem: Some Department projects have senior debt with extremely high charges for prepayment. This has significantly increased the cost of some refinancings.

Rationale and Benefits: As noted above, there appears to be considerable variation in the marketplace regarding yield maintenance / prepayment provisions in senior lender loan documents. Most lenders seem to have high charges in the initial 15 years. After this period, there is substantial variability. Some promissory notes provide for modest charges, others continue the high charges for a very long period,

The formulas used to calculate the high charges often assume that repaid funds will be re-invested in very low risk investment products, which overstates the cost to lenders associated with having their loans repaid early.

It is unlikely that projects will need to refinance during their initial 15 years to cover rehabilitation costs, so significant charges during that period are not cause for great concern. After this period, however, these charges could constitute significant barriers to needed rehabilitation. Given that there are loan products available without high charges after year 15, and that there does not appear to be a compelling reason for the high charges, the Department proposes to prohibit them on Department-financed properties.

The proposed amendment does allow a one-percent yield maintenance charge or prepayment penalty after year 15. This is intended to be in line with the practice of lenders who currently have the types of provisions in this area that the Department wishes to encourage.

Alternatives Considered: None.

Subsection (k)

Purpose: Minimize the risk that sponsors will need to come up with cash to buy out limited partners at the end of the initial 15 year tax credit compliance period, and protect project reserves and other cash assets.

Problem: Under the terms of many existing partnership agreements, there is a significant possibility that sponsors will need to come up with cash to purchase all of the partnership assets, spend down reserves and other cash assets prematurely to avoid the need to pay for them, or do both. This either causes hardship for the sponsor, or results in less than optimal use of project cash assets.

Rationale and Benefits: One of problems with some partnership agreements is that they do not give the sponsor the right to buy project reserves and other cash assets at an appropriate price. Accordingly, the proposed amendment requires that the cash assets be included in the agreement, and specifies that the purchase price for all of the assets of the owner must minimize the risk that a cash outlay will be necessary to effect the sale. It also suggests a price that is intended to be consistent with IRS requirements and, due to the typically high amount of accrued debt on Department projects, and relatively low market values, to minimize the risk that the purchase transaction will require an infusion of cash.

Alternatives Considered: The Department could let sponsors address this issue on their own, and use its control over reserves to prevent spending them down prematurely, where sponsor efforts were inadequate. However, it believes that it would be better for both projects and sponsors if there was a more consistent approach.

**Section: 8312. Developer Fee**

Subsection (a)

Purpose: Make this subsection consistent with subsection (b).

Problem: In subsection (b), The Department is proposing to make fundamental changes in the way developer fee is limited for tax credit projects, eliminating any connection with the rules set forth in subsection (a). The text of subsection (a) needs revision to make this clear.

Rationale and Benefits: The formula in the proposed amendment to subsection (b) would be difficult to apply to projects without tax credits, where a calculation of eligible basis is unlikely to be readily available. For this reason, the existing formula is being retained for projects without credits.

Alternatives Considered: None.

Subsections (b), (c) and (d)

Purpose: For tax credit projects, increase developer fee limits, and make them consistent with TCAC’s limits on the amount allowed in basis for 9% credit projects, plus the amount TCAC allows for non-residential space. Also, increase the amount of tax credit equity generated in 4% projects, by allowing additional deferred fee, above the amount that could be included in basis if the project was using 9% credits.

Problem: Current regulations cap developer fee payable from development sources at $1,200,000. This figure has not been adjusted since it was first adopted in 2003, and quite possibly does not fully cover the costs developers incur when they develop the medium to large urban infill or supportive housing projects that are increasingly typical in the Department’s portfolio.

Rationale and Benefits: Developer fee is a necessary expense, but it reduces the amount available for other purposes, such as construction, and increases public subsidy requirements. From the Department’s perspective, developer fees should be set at the minimum level required to keep developers solvent and to induce them to submit enough quality funding applications to use available Department resources.

With its current limit, and in spite of the loss of other significant project funding sources, the Department has not observed problems with either developer solvency or demand for its funding. That said, it acknowledges that inflation will eventually create issues in those areas, and that the tax credit program provides the most commonly accepted standard in this area. For this reason, it is proposing that tax credit projects be subject to the lowest limits set by the state’s tax credit allocation entity, which currently top out at $1,400,000, plus the extra amount TCAC allows in project costs for commercial space.

Where consistent with TCAC rules, the Department is also proposing to allow the basic limit to be exceeded, to the extent that the excess is offset by general partner capital basis contributions and deferred developer fee. This provision is intended to increase the amount of tax credits available, without increasing state or local subsidies.

Along with these substantive changes, the proposed amendment makes a number of editorial changes, designed to improve readability and reduce confusion.

Alternatives Considered: One alternative would be to increase the current cap based on inflation, which would achieve roughly the same result. However, this alternative would not align with the tax credit system.

Another alternative would be to defer to a different, higher TCAC limit. For the 9% program TCAC allows other funding sources to augment the amount of developer fee that it uses in its calculations of tax credit amounts, up to a limit that is currently set at $2,000,000. If the Department allowed this higher fee, it would be increasing the state or local subsidy required, without leveraging any additional tax credits. As a result, fewer units could be built. In the absence of developer solvency or funding program demand issues, the Department does not believe that this would be a good outcome.

For 4% projects, TCAC currently allows a fee as high as a $2,500,000 all of which is adds to the equity raised. If the Department adopted this limit for this type of project, a portion of the extra cost would hence be offset by the additional equity. However, a significant portion would need to come from other sources – state or local subsidies, and the result would be fewer units built.

**Section: 8313. Reserved**

The proposed amendment would rename this currently unused section, and add new provisions that do not logically fit under other categories, as described below.

Subsection (a)

Purpose: Allow variations from normal program rules to facilitate federal funding of Department projects.

Problem: Federal programs tend to have many and often inflexible rules. To give Department-funded projects access to federal funding sources, it is occasionally helpful to be able to deviate slightly from state rules.

Rationale and Benefits: Under Section 7306 of the Multifamily Housing Program regulations, the Department currently has authority to make exceptions to these regulations to ensure compatibility with federal funding programs. This provision has been useful in helping to blend the two funding sources, without sacrificing fundamental objectives of Department programs. For example, it has allowed Department-funded projects to access rental subsidies under HUD’s 811 program, which greatly enhanced their ability serve disabled extremely low income tenants. The Department believes that there could be advantages to having this authority for other programs as well.

The proposed amendment excludes federal loan guarantee programs, because these programs typically add little value to Department projects, and often involve entities with less public purpose motivation than the federal government itself.

Alternatives Considered: None, except for treating federal loan guarantee programs the same as direct federal assistance.

Subsection (b)

Purpose: Establish clear guidance for apportioning cost saving occurring during construction.

Problem: In the absence of clear regulatory guidance, this subject sometimes prompts arguments at the permanent loan closing stage, and results in needless closing delays.

Rationale and Benefits: The proposed amendment specifies that the Department will share in cost savings in proportion to its share of public funding. This leaves local agencies the choice of claiming a share of the savings with developers, or retaining this share for themselves.

The Department believes that this is an equitable arrangement, and is similar to its widely accepted rules on the division of operating cash flow available for residual receipt loan payments.

The Department’s proposal does not preclude the use of savings in one cost area for a legitimate cost in another. It also applies only to savings that reduce the development budget below what it was at construction loan closing, so that it would not prevent another public lender from being repaid for additional funds advanced to cover a projected overrun that emerged during the course of construction.

The amendment exempts 9% tax credit projects from the requirement to pass on savings in the form of a reduced Department loan amount. The reason for this is that the 9% program regulations prohibit the reduction in committed public subsidies, to prevent gaming of this program’s competitive point system, which heavily weights these subsidies. To prevent creating a windfall resulting from cost savings in a 9% project, the amendment further specifies that these saving will be applied towards some use benefitting tenants.

Alternatives Considered: This could be left to case-by-case negotiations, but the Department believes it would be more efficient to have a standard rule.

Subsection (c)

Purpose: Establish clear rules on permissible borrower organizational structures.

Problem: The identity of the project sponsor plays a key role in the Department’s funding decisions and underwriting. Accordingly, the Department reviews organizational documents carefully, to ensure that the identified sponsor truly controls the entity that owns the project, which is typically a limited partnership or a limited liability company. Sometimes this review is complicated and time consuming, due to complicated organizational structures.

Rationale and Benefits: The proposed regulation reflects current Department practice, with one key difference: it allows two corporate entities between the sponsor and the borrowing entity, rather than one.

Subdivision (c)(1) specifies that sponsors must remain liable for specific performance (but not financially) under the program documents. This is to ensure that sponsors will not attempt to distance themselves from troubled projects, and will provide adequate resources for and oversight of legal entities created to participate in project ownership. For some programs, the mechanism traditionally used by the Department to establish liability has been guarantee provided by sponsor regarding project operations. For others, it involves having the sponsor be a party to a state contract (Standard Agreement).

Subdivision (c)(2) specifies that sponsors may not use the structure or existence of the special purpose entity in any manner that would limit in part or whole or limit procedurally, the Department’s right and ability to legally pursue the sponsor for performance of the duties owed by the sponsor under the Standard Agreement and Department loan documents*.*

Subdivision (c)(3) is the provision limiting the number of intermediary entities between the sponsor and borrower to two. Based on numerous discussions with developers, the Department understands that this rule would allow the organizational structures that are most common in the industry. Its intent is to rule out needlessly complicated structures, and hence to reduce review time and the risk that a deficient structure will erroneously be approved.

Alternatives Considered: The Department has traditionally required that that there be at most one entity between the project sponsor and the borrowing entity. This structure minimizes the time required for review of organizational documents and the risk that flaws in these documents will lead to lack of control by the sponsor. Based on conversations with borrower counsels, there also does not appear to be any legal impediment to adhering to it. However, the Department recognizes that the current rule is inconsistent with common industry practice and a significant inconvenience for sponsors. It now believes that these considerations outweigh the extra workload associated with an additional organizational layer, and that the risk is manageable.

**Section: 8314. Use of Operating Cash Flow**

Subsection (a)(1)(B)

Purpose: Update the limit on asset management, partnership management, and similar fees.

Problem: The existing limit is dated, does not take into account the fees that investors increasingly take for their asset management functions, and unfairly distinguishes between projects located in jurisdictions with different levels of willingness to assert that they have local policies on this subject.

Rationale and Benefits: The proposed amendment increases allowable annual fees from $12,000 to $30,000, ends exemptions to the limit in jurisdictions with more liberal policies, and provides for an inflation adjustment. A related provision, in subsection (c) allows a limited accrual of unpaid fees.

The Department believes that asset management is an important function, and acknowledges the need for resources to handle partnership management and to pay investors the asset management fees they demand. Based on the reports of developers and others about the cost of these activities, It believes $30,000 is sufficient to cover them adequately.

Alternatives Considered: One alternative, urged by some developers, would be to break out fees paid to investors, so that sponsors would be assured of an adequate payment. Based on its understanding of the amounts typically required by investors, the Department believes $30,000 is adequate to cover both amounts. Having a single limit covering both sets of fees is simpler, and avoids the need to determine whether fees are appropriately classified.

Subsection (a)(2)(A)

Purpose: Increase fairness of formula for sharing residual receipt loan payments with local government.

Problem: The current regulation counts local assistance only if it is structured as a loan. Land donations and land leased at below market rates do not factor into the equation, leading in some cases to under-valuation of local assistance.

At the same time, the current regulation overstates the value of local assistance in other cases by failing to take into account required payments on local loans.

Rationale and Benefits: Local public agency assistance provided as donated land or as a below market land lease is equally as valuable as a direct loan; all three have the same impact on project feasibility and the need for additional subsidy. Similarly, the value to the project of local agency loans are reduced to the extent that payments are required on these loans, as the required payment reduces the amount of private debt financing the project can support.

To properly reflect the value of donated land and below market land leases, and to adjust the value of loans with required payments, the proposed regulation provides that they be accounted for in this section the same way they are accounted for in Section 8315, which addresses the similar issue of lien priority.

Alternatives Considered: To discourage local loans with large required payments, an alternative would be to not count them at all in this section. However, this would not recognize the value they do bring to the project, even if this value is limited by the payment requirement. The Department believes adjusting the value rather than not recognizing it at all is the fairest approach.

Subsection (c)

Purpose: Allow accrual of unpaid asset management, partnership management and similar fees, on a limited basis. (The deleted text is moved to the following subsection, without revision.)

Problem: Asset management work and partnership expenses are ongoing. Project cash flows , however, vary from year to year. In some years there may be insufficient cash flow to pay allowable fees, while in other years there may be a surplus.

Rationale and Benefits: To encourage the full funding of sponsor asset management activities, and the benefits they bring to the project, the proposed amendment would allow fees not paid in a given year due to inadequate cash flow to be paid out of cash flow in the following three years, should funds be available during that period.

Alternatives Considered: Since for most projects the amount of the allowable annual fee is proposed for a substantial increase, the need for having fees accrue to support a strong asset management function is being reduced. Accordingly, one option would be to continue current rules, which do not allow any accrual. This would be administratively simpler.

Another option would be to allow accrual indefinitely. However, this approach runs counter to the goal of ensuring a steady flow of resources to cover necessary expenses. Based on the Department’s experience with monitoring deferred developer fee over time, it would also likely lead to time consuming efforts to revisit long periods of history if and when projects started doing well.

Subsection (d)

Purpose: Reconcile this section with other provisions of these regulations, and with Department practice. (The added text was moved from subdivision (c)).

Problem: The existing subsection (d) provides that distributions attributed to commercial space not flow through the cash flow waterfall established by this section. However, this provision is arguably inconsistent with the definition of “Operating Income” in Section 8301, and with the way this term is used in other sections of the regulations. It is also inconsistent with current Department practice.

Rationale and Benefits: Ideally, commercial space should stand on its own, and not be subsidized by monies meant to produce housing, including Department funds, low income housing tax credits, and local housing funds. However, there are often good reasons for incorporating commercial space into affordable housing projects, and this space does not always produce the revenue sufficient to finance it entirely from sources other than housing subsidies, such as private bank loans. For this reason, and to reduce administrative burden, the Department has for several years been interpreting existing regulations consistent with the definition of Operating Income, and not as the existing subsection (d) seems to provide.

Alternatives Considered: This amendment amounts to a clarification, and is not essential. One option would be to not include it. However, the Department believes that it is a useful clarification.

Subsection (e)

Purpose: Encourage the provision of a reasonable level of resident and supportive services in Department-financed projects, by establishing clear rules for use of project cash flow to cover a portion of the cost of these services.

Problem: As noted in the above discussion of proposed amendments to Section 8300, proposed changes to the definition of “Operating Expenses” would expand this term to include direct services required by TCAC, as well as case management. This subsection (e) establishes limits on cash flow used for this purpose, and specifies allowable cost categories.

The current definition of “Operating Expenses” does include supportive service coordination, but does not specify allowable cost categories, or provide guidance on reasonable amounts. This has led to varying interpretations, and relatively low limits for projects serving the homeless, in comparison to the cost of providing the intensive services needed by this population.

Rationale and Benefits: There is a general consensus in the affordable housing industry that residents of family and senior projects benefit significantly from some level of organized resident services (after school care, ESL classes, referral to community senior services, bingo night), and that these types of projects should be served by staff who both assist with organizing these services and with providing limited assistance to individual tenants to connect them with other community services that meet their particular needs. This function is often called “services coordination.”

For projects that target individuals and families experiencing homelessness, and particularly those targeting the chronically homeless, there is also a consensus that housing should be linked with a variety of services addressing the particular issues common among this population, such as mental health and substance abuse, and that trained staff connected to the project should be available to provide substantial assistance with accessing these services, obtaining benefits, and otherwise assisting tenants in meeting their individual needs. The work these staff performs is generally described as “case management.”

More affordable housing could be built if funding for services coordination and case management was reliably available from sources other than project operating income

Unfortunately, this is not always the case. To ensure a consistent stream of revenue for these activities, sponsors often build some funding for them into their operating budgets. This subsection establishes limits on this funding, with the aim of allowing amounts sufficient to provide an at least minimally adequate level of service while encouraging sponsors to pursue sources external to the project.

The specific limits applicable to homeless populations, in subsections (e)(1) and (e)(2), were modeled after the rules used for a similar purpose by the City of Los Angeles’s housing department (attached hereto), and based on a calculation of the rough cost of maintaining a certain tenant to case manager ratio. The $4,080 per unit applicable to units for the chronic homeless is consistent with a 15:1 ratio, assuming staff costs of approximately $60,000 per year. The $3,060 per unit for units serving other homeless persons is consistent with a 20:1 ratio. These ratios are benchmarks used by various public agency programs focused on homeless persons, including the Department’s Multifamily Housing Program and the State’s Veterans Housing and Homelessness Prevention Program.

The proposed limits in (e)(3) and (e)(4), applicable to units with a more general population targeting, work out to a tenant to staff ratio of about 40:1 and 50:1, based on a $40,000 assumed annual service coordinator cost. These amounts are roughly consistent with what the Department has observed in budgets it has approved under existing rules (although these amounts vary widely). Based on a sample of 39 projects applying under the first round of the 2015 9% tax credit competition, they are well above the $355 per unit per year average for these projects.

Finally, the last sentence of this subsection provided that the proposed limits will increase by two percent each year, to account for inflation.

Alternatives Considered: One alternative would be to revise the eligible cost categories, but not set fixed limits on them, and to evaluate requests on a case-by case basis. However, there is a wide variety of opinion on what constitutes reasonable amounts, and no clear way to evaluate them, without some sort of formulaic rule.

Another alternative would be to not set limits for the allowable cost categories. One problem with this approach is that it would reduce the incentive to seek funding and in-kind services available from other sources. Another is that it would encourage use of the services line item as a way to siphon off cash flow without providing full value to the tenants. Setting a ceiling on this amount as least limits the potential for this to occur.

A third alternative would be to allow the funding of direct services (beyond case management and service coordination), where these services are not required by TCAC. The main reason for not doing this is the difficulty of monitoring the provision of services, where the Department is the only monitoring entity. Where the Department and TCAC are both involved, effective monitoring will be easier.

Subsection (f)

Purpose: For supportive housing, allow sponsors to use operating cash flow and development sources to fund a reserve to cover short-term gaps in services funding.

Problem: Funding for supportive services is often provided on a year-to-year basis, and is not necessarily stable over time.

Rationale and Benefits: With Department approval, this amendment would allow sponsors of supportive housing projects --- those where services are most critical -- to establish reserves intended to cover short-term gaps in the core functions of services coordination and case management. It is intended to reduce the likelihood that these functions will be suspended due to shifting priorities of services funding agencies or variations in project cash flow.

Alternatives Considered: There is an argument for funding services reserves for projects beyond supportive housing, and for allowing this reserve to cover gaps in direct services as well as services coordination / case management. Other project types face the challenge of unstable services funding, and funding for direct services is unstable too. However, the Department is concerned about the impact on housing production levels if too much housing subsidy is converted to services funding through mechanisms such as this one, and believes that a more limited approach is warranted.

Subsection (g)

Purpose: Clarify the type of services and cost categories eligible for funding as “resident services coordination” and “case management.”

Problem: There have been different interpretations of current rules regarding what specific cost categories are eligible as “on-site supportive services coordination,” which is the term used in the current regulations to describe this general cost category. Department staff and project sponsors would benefit from clearer guidance on this subject.

Rationale and Benefits: There are a variety of costs associated with the resident services coordination and case management functions, and these services can either be provided by project employees or under a contract with a third party. Different services are needed by different tenant populations, and by individuals within these populations. The Department is not aware of a good reason for excluding any of services or cost categories listed in the proposed amendment. It is somewhat concerned that allowing costs provided under a contract could increase the difficulty of determining whether the services being provided are commensurate with their cost, but believes this concern could be addressed by requiring the contract to include appropriate budget details (e.g. charges for administrative overhead).

Alternatives Considered: The current rule has sometimes been interpreted to exclude contract costs, and to prohibit use of project funds for resident events that are more aimed at building community than at the provision of identifiable services, including refreshments at tenant meetings. The Department’s current thinking is that contracted services can be effective, and do not inherently lead to abuse, so there is no compelling reason to not allow them. Similarly, it believes that the community building benefits of activities like tenant meetings outweigh minor expenditures intended to make them more attractive.

**Section: 8315. Subordination Policy**

Subsection (a)(1)

Purpose: Correct typographical error.

Problem: The word “to” is missing from the phrase “including but not limited [to]”.

Rationale and Benefits: This corrects a typographical error only.

Alternatives Considered: None.

Subsection (c)(3)

Purpose: For purposes of determining lien priority, discount public agency loans to reflect required payments.

Problem: Subsection (b) specifies that the Department may subordinate its lien to a local public agency that provides assistance valued at more than twice the amount of the Department’s assistance. Subsection (c)(3) specifies how local assistance is calculated.

The Department has observed that a handful of local jurisdictions seem to be requiring significant payments on their loans, which reduces their value to the project.

Rationale and Benefits: The current regulation does not provide for an adjustment to local loan amounts to reflect their reduced value, when they require large payments. The proposed amendment would do this, where the payment was significant, defined as being more than the amount the Department requires for several of its own loan programs, 0.42%.The method for making the adjustment – basing it on a net present value calculation, is standard in the financial industry.

Alternatives Considered: None.

Subsection (d)

Purpose: Limit the risk posed by having the Department’s lien be “sandwiched” between a senior lender and a part-owner of the project that is affiliated with the senior lender.

Problem: Many projects subject to these regulations have a senior lender that is affiliated with an investor who has an interest in the project owner. These ownership interests are not structured to give the investors managerial control over project operations, but the Department has observed that in some cases investors seem to exercise this control, on a practical basis. It is possible that an investor affiliated with a senior lender could intentionally default on the terms of the senior loan, in order to give the lender an excuse to foreclose and wipe out the Department’s interest.

Rationale and Benefits: The Department believes that few lenders affiliated with investors would risk the potential damage to their reputation that would result from an intentional default. Those that might be possibly tempted include lenders that are not motivated to remain active in the affordable housing industry based on regulatory requirements under the Community Reinvestment Act, especially in California, and those with finances weak enough to prompt them to take unusual risks. Accordingly, the proposed amendment would prohibit affiliations involving lenders with a less than stellar Community Reinvestment Act rating, or with a low credit rating.

Alternatives Considered: The clearest way to eliminate “sandwich loan” risk would be to require that there be no affiliation between senior lenders and investors. The drawback of this approach is that it would eliminate a number of the active lenders and investors who are most active in the California market. These lenders and investors often offer attractive terms, in part because they operate both as equity investor and lender. The Department believes that the cost of eliminating this option is greater than the slight risk reduction resulting from a complete prohibition on affiliations between lenders and investors.

**Section: 8316. Leasehold Security**

Subsection (a)(2)

Purpose: Clarify conditions under which Department loan documents may be recorded against a leasehold rather than fee interest.

Problem: The Department prefers to record against the fee, as this provides the greatest security for its loan, and eliminates the risk that its interest will be wiped out as the result of a default under a ground lease. However, it recognizes that sometimes it is not possible for any party to record regulatory or security documents against the fee, and, under these circumstances, is willing to consider recording against the leasehold. This subsection was intended to reflect this intent.

The problem that has arisen is that some legal counsels have argued that regulatory agreements or other similar documents recorded against the fee do not trigger this provision, as they are not “mortgages.”

Rationale and Benefits: A clearer statement of Department policy on this issue will reduce legal costs for both the Department and those represented by counsel who would otherwise be inclined to argue about this point.

Alternatives Considered: None.

Subsection (b)

Purpose: Clarify conditions under which Department loan documents may be recorded against a leasehold rather than fee interest.

Problem: The issue is essentially the same as with subsection (a). The existing regulations do not state Department policy, as articulated in the above problem statement for subdivision (a), as clearly as it could, leading to arguments.

Rationale and Benefits: A clearer statement of Department policy on this issue will reduce legal costs for both the Department and those represented by counsel who would otherwise be inclined to argue about this point.

Alternatives Considered: None.

Subsection (d)

Purpose: Allow exceptions to the general policy on leasehold security for projects located on Native American Lands, where consistent with other legal requirements.

Problem: Native American Lands are often subject to special restrictions that preclude compliance with all of the requirements of this section. In some cases, for example, they cannot be leased for a term of more than 50 years, under federal law. The existing regulation would address this situation if the land was owned by a public agency, but not in other cases.

This amendment would allow exceptions for Native American Lands, regardless of the nature of the owner, where the exemption is consistent with other legal requirements applicable to the Department program.

Rationale and Benefits: The restrictions governing some Native American Lands make it difficult to secure loans and to structure enforceable regulatory restrictions. The Department has been advised that land leases provide a workable mechanism for achieving these ends, and desires to eliminate impediments to using this mechanism.

It should be noted that a number of Department programs do have other legal requirements that would currently preclude use of this exemption. The Department is looking into options for modifying these other legal requirements.

Alternatives Considered: None.

**ECONOMIC IMPACT ASSESSMENT**

 The proposed regulation amendments would revise uniform standards and program rules applicable to multifamily rental housing developments assisted by the Department of Housing and Community Development under a number of different statutorily authorized programs.

 The proposed changes update numerical limits, reflect changes in requirements for other funding sources used in conjunction with Department programs, and address specific issues that have arisen since the regulations were originally adopted in 2003.

Creation or Elimination of Jobs within the State of California

 The affected programs are currently being administered by existing Department staff. No additional funding for administration is being requested. Participation in these programs is voluntary. The proposed amendments will increase revenues received from project operations by developers, and encourage expansion of social service programs offered in conjunction with assisted housing developments. The increased revenues will likely result in the creation of a small number of private sector jobs. The Department’s estimate is that five jobs will be created.

Creation of New or Elimination of Existing Businesses Within the State of California

 The affected programs are currently being administered by existing Department staff. No additional funding for administration is being requested. Participation in these programs is voluntary. Developers can decide not to apply for or accept program funds. The proposed amendments will enhance revenues for existing businesses, but the magnitude of this revenue increase is unlikely to be sufficient to result in the creation of new businesses. Nothing in the proposals would result in the elimination of existing businesses.

Expansion of Businesses or Elimination of Existing Businesses Within the State of California

 The affected programs are currently being administered by existing Department staff. No additional funding for administration is being requested. Participation in these programs is voluntary. Developers can decide not to apply for or accept program funds, The proposed amendments will enhance revenues for existing businesses, which will likely allow them to expand.

Benefits of the Regulations

 The proposed changes update outdated numerical limits, reflect changes in requirements for other funding sources used in conjunction with Department programs, and address specific issues that have arisen since the regulations were originally adopted in 2003. In general, they improve the overall operation of these programs.

 The proposed changes will benefit the health and welfare of California residents by improving that ability of Department-funded projects to assist low-income occupants of Department-funded projects. It will also benefit for-profit, non-profit organization and local government agencies that receive funds through the affected programs, and the communities they serve. Participation in these programs is voluntary. Developers can decide not to apply for or accept program funds, For these reasons, the Department has determined that this regulatory proposal will not have will not have a significant adverse statewide impact on the health and welfare of California residents, worker safety, or the state's environment.

**EVIDENCE SUPPORTING NO SIGNIFICANT ADVERSE ECONOMIC IMPACT ON BUSINESSES**

Participation in these programs is voluntary. Developers can decide not to apply for or accept program funds. If they do decide to participate, the long-term financial benefits to them will almost always outweigh the nominal cost of application preparation. For these reasons, the Department has determined that this regulatory proposal will not have an adverse economic impact on businesses.

**OTHER DOCUMENTS RELIED UPON:**

As discussed in regard to Subsection 8314(e), attached is an excerpt from a City of Los Angeles document that influenced the proposed rules on supportive services costs payout out of project cash flow.

**EFFECT ON SMALL BUSINESS**

The Department estimates that 50% of all businesses impacted by the proposed amendments qualify as small businesses. The amendments will enhance the revenues of these businesses, and the magnitude of this enhancement will be far greater than the costs of application preparation.