



TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS

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**RE:** An Internal Audit of the Real Estate Analysis Division

**To:** Chairman J. Paul Oxer and the Board Members of the Texas Department of Housing and Community Affairs

Dear Chairman Oxer and Board Members,

This report presents the results of the internal audit of the Texas Department of Housing and Community Affairs Real Estate Analysis Division (REA or Division).

### Executive Summary

The Office of Internal Audit (OIA) evaluated the underwriting process performed by REA. Based on the fieldwork performed between March 1, 2016 and April 4, 2016, OIA concludes that the underwriting process is generally performed accurately and according to applicable rules, however, the following opportunities for improvement were identified:

1. REA should complete the underwriting reports and ensure the reports are available to stakeholders including the TDHCA Governing Board before the allocation and funding decisions are made.
2. REA should comply with the *Underwriting and Loan Policy* rules in the Texas Administrative Code (Title 10, Part 1, Chapter 10, Subchapter D). If the rules or portions thereof, are no longer relevant or applicable, the rules should be revised accordingly.

During the course of this audit, OIA noted an inherent risk that exists related to the current process for obtaining market analyses from analysts that are engaged and compensated by the applicant.

OIA would like to recognize REA's development of a tool that may enhance the presentation of multifamily activity application information by summarizing key components on a two page form.

### Objective, Scope and Methodology

The audit of the REA was identified in the Fiscal Year 2016 Annual Audit Plan. Based on an assessment of risks and controls, the following audit objectives were developed:

- to examine and assess the Department's underwriting process and
- to determine if the underwriting is performed according to applicable rules and completed in a timely manner.



The audit scope included underwriting reports and underlying analysis performed by REA for HOME Multifamily applications, Competitive Housing Tax Credit Applications and 4% Housing Tax Credit Applications during calendar year 2015.

The audit methodology included gaining an understanding of the Division, its activities and the underwriting process by interviewing employees and reviewing documentation. OIA performed a risk assessment of the critical points in the process to develop the audit objectives and focus audit resources. OIA interviewed employees and reviewed documentation. OIA identified relevant criteria for evaluating the underwriting process. OIA tested a judgmental sample of underwriting reports and the underlying analysis to evaluate whether the underwriting process was performed accurately, completely and in a timely manner.

### **Real Estate Analysis Overview**

The Real Estate Analysis Division provides the TDHCA Governing Board and staff with comprehensive analytical reports necessary to make well informed decisions for funding of affordable housing developments.

The Division is responsible for analyzing feasibility of proposed multifamily housing activities and preparing a credit underwriting analysis report that will be used by the TDHCA Governing Board in decision making with the goal of assisting as many Texans as possible by providing no more financing than necessary based on an independent analysis of the development feasibility.

### **The Underwriting Process**

Applications for allocations of low income housing tax credits (LIHTC) or multifamily funding awards are submitted to the Department for consideration. The applications submitted for review and evaluation may include requests for:

- Competitive 9% Low Income Housing Tax Credits
- 4% Low Income Housing Tax Credits
- Multifamily HOME only funding
- Combination of Competitive Tax Credit Allocation and HOME funding

The applications are reviewed by the respective multifamily program area, for example 9% LIHTC, 4% LIHTC, Multifamily HOME. Not all applications received by the Department are submitted to REA for review. Only the highest scoring LIHTC applications are forwarded to REA. Multifamily HOME applications that have passed the 1<sup>st</sup> and 2<sup>nd</sup> level program reviews are transferred to REA for review.

REA is notified by the respective program area when an application is ready to be reviewed and evaluated by REA. REA leadership assigns the application to a real estate analyst. Assignments are made based on work load. Management tries to assign deals from the same developer to the same underwriter to gain efficiencies.

***Underwriting can mean different things to people in various industries. For purposes of this report, the term underwriting is defined as analyzing the feasibility of proposed multifamily housing activities.***

The comprehensive review performed by the REA analyst includes evaluation of the affordable housing activity using the established guidelines published in the *Underwriting and Loan Policy Rules* and other relevant requirements which could include the qualified allocation plan (QAP) or HOME rules and regulations depending on the type of award or funding requested. Factors evaluated by the real estate analyst include:

- Operating feasibility
- Income (rents and miscellaneous incomes adjusted for vacancy and collection losses)
- Expenses (general and administrative expense, management fees, payroll expense, repairs and maintenance, utility expense, et cetera).
- Net Operating Income
- Debt Coverage Ratio
- Total Housing Development Costs
- Development Team Capacity
- Other Underwriting Considerations

In addition, the analyst will review the environmental site assessment, market analysis and property condition assessment as applicable.

One of the tools used for the evaluation is the underwriting analysis workbook, commonly referred to as the template and sometimes referred to as the underwriting report. The underwriting analysis workbook is a standardized template that has been developed by REA management and staff to include the key information and facilitate evaluation of financial factors and market demand to assess the feasibility of the proposed deal.

The actual underwriting report is created using the underwriting analysis workbook. Once the real estate analyst performs their review and evaluation of the application, it is submitted to REA-leadership for review. Once the review is complete, the underwriting report, in portable document format (pdf), is posted to the Department's public web page.

The posted report includes the recommended award of funds or housing credit allocation amount. Of course, the report may recommend that no award be made or that the amount of the award or the credit allocation be reduced. A recommendation for a reduced allocation could occur because the Internal Revenue Code requires that tax credits allocated to a development not exceed the amount necessary to assure feasibility.

In addition to the underwriting performed by REA on the original application packet, REA may review the feasibility of the project at other key milestones. For example, REA may perform an in-depth review of the development data when the carryover documentation is submitted to the Department or when the 10% Test documentation is submitted to the Department. A review by REA may be performed to ensure specific conditions required during the initial underwriting are satisfied by the applicant. Another review by REA may be necessary if changes to the original proposal are made.

### **Evaluation of the Underwriting Process**

OIA judgmentally selected a sample of 10 underwriting reports from the population of 97 applications transferred to REA for review. A sample size of 10 represents 10.3% of the population. Because the population of applications includes multiple program types (4% LIHTC, 9% LIHTC and HOME) and multiple activity types (new construction or acquisition and rehabilitation), the sample was selected to include a proportionate representation of each type of program and activity. Additionally, the sample was selected with care to include applications reviewed by each of the Division's real estate analysts.

The sample items were tested to determine if the reports were prepared accurately, completely and in a timely manner. The testing results indicate that the underwriting reports are prepared accurately and completely and are generally prepared in compliance with applicable rules and requirements.

However, the underwriting reports are not always available in a timely manner. More specifically, of the ten sample items tested, seven items were for the 9% Competitive Housing Tax Credit Program. According to the 2015 Program Calendar for the Competitive LIHTC, the final awards would be made in July. Of the seven

competitive applications reviewed, four of the reports (57%) were not completed and posted in time for the July 30, 2015 Governing Board Meeting. Therefore tax credit allocation awards were made without the benefit of the comprehensive analysis performed by REA.

It is important to note that the recommendations for award allocations made at the July 30 meeting were conditioned upon the completion of underwriting, the imposing of all conditions of underwriting, the imposing of the conditions recommended by Executive Award and Review Committee (EARAC).

Of the reports that were posted after the 7/30/2015 board meeting, the smallest number of business days lapsed was 32. The largest number of business days from the award date to the report completion date was 69. In this case, the completed underwriting report was posted on 11/3/2015, which is one day after the carryover documentation delivery deadline.

**Finding** – Underwriting reports are not always completed and posted prior to the decision deadline for the Competitive 9% LIHTC Award Allocation. As a result, the Governing Board and other stakeholders do not have the benefit of the comprehensive analytical reports when making their decision regarding affordable housing developments.

**Auditor recommendation** - REA should complete the underwriting reports and ensure the reports are available to stakeholders including the TDHCA Governing Board before the allocation and funding decisions are made.

#### **Management Response**

The Real Estate Analysis Division ("REA") agrees that underwriting reports relating to awards should be published prior to TDHCA Governing Board consideration of allocation and funding decisions. Management will undertake the following to implement this recommendation:

1. Changes already made in the creation of the 2016 Qualified Allocation Plan with respect to the timing and scoring of applications will help reduce the number of total applications that must undergo by REA analysis, only to find that changes in scoring priority require REA to drop them and analyze other applications. Fewer applications will be de-prioritized by the program area as scores should not change as dramatically as in prior years. No specific action required as this has already occurred and is in place for the 2016 application round.
2. Management will continue to aggressively manage the pipeline of all applications, including bond transactions, re-evaluations, and amendments such that the current year 9% applications are prioritized quickly and with the best possible information. This is already occurring in weekly meetings with Executive, Multifamily, Asset Management, Legal, and External Affairs. We will continue to find ways to improve processes that will save time without compromising the analysis. This is an ongoing action.
3. Full implementation of the Real Estate Analysis Application Summary will allow TDHCA Governing Board and stakeholders to have timely underwriting information without the full underwriting report being finalized and posted. It should be noted that in the past even where an original underwriting report has not been published on applications where underwriting has commenced, REA has generally performed sufficient analysis to conclude that the proposed development is feasible.

#### **Target Completion Date**

July 30, 2016

**Responsible Individuals and Title**

Brent Stewart, Director of Real Estate Analysis  
Tom Cavanagh, Manager of Real Estate Analysis

During the evaluation of the underwriting process, OIA noted REA deviated from the *Underwriting and Loan Policy Rules* related to:

- Presenting applications to EARAC when a significant confluence of concerns was identified
- Review and evaluation of personal credit reports when evaluating the overall capacity of the development team

Auditors noted that one (10%) of the ten underwriting reports tested was not presented to the EARAC as required when the underwriter identifies a significant confluence of concerns. In this instance, the applicant was made aware that the application would not be recommended for award because of the concerns. The applicant informed REA that it would not appeal the recommendation. According to REA leadership, the applicant was effectively withdrawing their application by not appealing REA's decision. Therefore, there was no action needed by EARAC and the deal was not presented to EARAC.

Underwriters do not review and evaluate personal credit reports as part of their evaluation of the development team capacity. The underwriting rules state that underwriters will review and evaluate the personal credit reports for development sponsors, developer fee recipients and those individuals anticipated to provide guarantees. It is not currently REA's practice to review personal credit reports when the applications are underwritten in REA.

**Finding** - REA deviated from the *Underwriting and Loan Policy Rules* related to:

- Presenting applications to EARAC when a significant confluence of concerns was identified
- Review and evaluation of personal credit reports when evaluating the overall capacity of the development team

**Auditor recommendation** - REA should comply with the *Underwriting and Loan Policy* rules in the Texas Administrative Code. If the rules or portions thereof are no longer relevant or applicable, the rules should be revised accordingly.

**Management Response**

Management agrees that REA should adhere to its rules and, if the rules need revision, pursue revision. The Planned Action consists of developing and proposing revisions to the rules to reflect current practice and procedure relating to these items. With respect to presenting applications to EARAC when a significant confluence of concerns is identified, a revision will be proposed to make that presentation optional by the Director of Real Estate Analysis based on the specific circumstances of the application. With respect to review and evaluation of personal credit reports, a revision will be proposed to make that language permissive in the rare cases that a personal credit report might be warranted.

**Target Completion Date**

During the annual rulemaking process in which the 2017 rules will be developed.

**Responsible Individuals and Title**

Brent Stewart, Director of Real Estate Analysis  
Tom Cavanagh, Manager of Real Estate Analysis

**Market Analyses**

OIA noted the inherent risk that exists related to the current process for obtaining a market analysis, also referred to as market study, on a proposed multifamily development. Currently, the applicant engages and compensates the market analyst to provide the market study to TDHCA.

The Internal Revenue Code [26 U.S.C. § 42: US Code – Section 42 (m)] indicates that a comprehensive market study of the housing needs in the area to be served by the project is to be conducted before the credit allocation is made at the developer's expense by a disinterested party approved by the housing credit agency. The REA public webpage includes a list of approved market analysts, a document that provides the necessary qualifications for being included on TDHCA's approved market analyst list, a form (with instructions) for documenting the rental rate adjustments to include with the submitted market analysis and contact information for anyone that needs further information regarding market analysis.

The Texas Administrative Code, Title 10, Part 1, Chapter 10, Subchapter D, § 10.303 contains the Market Analysis Rules and Guidelines. In general, the market analysis prepared for the Department must evaluate the need for decent, safe, and sanitary housing at rental rates or sales prices that eligible tenants can afford. The market analysis must determine the feasibility of the subject property rental rates or sales price and state conclusions as to the impact of the property with respect to the determined housing needs. The market analysis must be prepared and certified by a qualified market analyst approved by the Department. 10 TAC Chapter 10.303 (d) itemizes the required market analysis contents. If it is found that a market analyst has not conformed to the Department's rules and guidelines, the analyst will be notified of the discrepancies in the analysis and be removed from the list of approved qualified analysts.

Currently, the applicant submits a market analysis to the Department. One of the real estate analysts prepares an independent market study which is compared to the market study submitted to the Department by the applicant. Discrepancies noted between the two studies by the real estate analyst will be documented in the underwriting report. Discrepancies between the studies could occur because the market analyst used a different data source or applied different assumptions when performing the analysis than the real estate analyst.

Because the market analyst is engaged and compensated by the applicant, it could be argued that they are not a "disinterested party". There is an inherent risk that the analyst may not be entirely objective. The market analyst may feel pressure to publish a market study that is favorable to the applicant although there may be evidence to the contrary. This type of pressure, even when unintended, subconscious or imagined, could have an impact on recommendations presented in the final market analysis. As a result the usefulness of the report could be diminished.

OIA reviewed the results of a survey conducted by the National Housing and Rehabilitation Association. According to the survey results, published in the June 2014 issue of *Tax Credit Advisor*, other states may follow a different approach regarding market studies. In some states, the state housing credit agency commissions the market study from a contractor. Another state has contracted underwriters order third party market studies.

Evaluating the cost and benefit of the current approach in comparison of other methods is outside the scope of this engagement. However, OIA recognizes the inherent risk that exists in the Department's practice.

### New Application Summary

The REA Division developed an "Application Summary" to present select information of the proposed multifamily activity application in an easy to digest format. The new form is a two page summary document that presents the key components of the deal including: property description, key principals/sponsors, unit distribution, income distribution, proforma feasibility indicators, market feasibility indicators, development cost summary, photos or illustrations, site plan, debt, cash flow, equity, risk profile, conditions and recommendation. The summary uses colors and icons to convey when the indicators are within the acceptable range and when there is a potential risk. The new form was demonstrated at the March 21, 2016 EARAC meeting. The new form was well received by the attendees. REA plans to further enhance the summary form and share it with other stakeholders.

OIA extends our sincere appreciation to management and staff of the Real Estate Analysis Division for their cooperation and assistance during the course of this audit.

Sincerely,



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Director of Internal Audit

MES/mbs

cc:

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