

The Texas Department of Housing and Community Affairs (the "Department") proposes to amend 10 TAC Chapter 10 §§10.302 (c)(2), 10.302 (d)(3), 10.302 (d)(4)(D), 10.302 (e)(9), 10.302 (e)(11), 10.302(e)(12) and 10.302 (i)(4) concerning Underwriting and Loan Policy. The purpose of the proposed amendments is to implement changes that will improve the underwriting that occurs at the time of cost certification for the Housing Tax Credit Program. The amended sections propose changes related to gap method analysis, reserves, acceptable debt coverage ratio, additional amenities, feasibility criteria and the underwriting process at cost certification.

**REQUEST FOR PUBLIC COMMENT.** The public comment period will be held March 27, 2015 to April 27, 2015 to receive input only on the proposed amendments to the subsections listed above. Written comments may be submitted to the Texas Department of Housing and Community Affairs, P.O. Box 13941, Austin, Texas 78711-3941, ATTN: Pam Cloyde, or by email to [pcloyde@tdhca.state.tx.us](mailto:pcloyde@tdhca.state.tx.us), or by FAX to (512) 475-4420. ALL COMMENTS MUST BE RECEIVED BY 5:00 PM on April 27, 2015.

### **§10.301. General Provisions.**

(a) **Purpose.** This subchapter applies to the underwriting, Market Analysis, appraisal, Environmental Site Assessment, Property Condition Assessment, and Direct Loan standards employed by the Department. This subchapter provides rules for the underwriting review of an affordable housing Development's financial feasibility and economic viability that ensures the most efficient allocation of resources while promoting and preserving the public interest in ensuring the long-term health of the Department's portfolio. In addition, this chapter guides staff in making recommendations to the Executive Award and Review Advisory Committee (the "Committee"), Executive Director, and the Board to help ensure procedural consistency in the determination of Development feasibility (Texas Government Code, §§2306.081(c), 2306.185, and 2306.6710(d)). Due to the unique characteristics of each Development the interpretation of the rules and guidelines described in this subchapter is subject to the discretion of the Department and final determination by the Board.

(b) **Appeals.** Certain programs contain express appeal options. Where not indicated, §10.902 of this chapter (relating to Appeals Process (§2306.0321; §2306.6715)) includes general appeal procedures. In addition, the Department encourages the use of Alternative Dispute Resolution ("ADR") methods, as outlined in §10.904 of this chapter (relating to Alternative Dispute Resolution (ADR) Policy).

### **§10.302. Underwriting Rules and Guidelines.**

(a) **General Provisions.** Pursuant to Texas Government Code, §2306.148 and §2306.185(b), the Board is authorized to adopt underwriting standards as set forth in this section. Furthermore, for Housing Credit Allocation, §42(m)(2) of the Internal Revenue Code (the "Code"), requires the tax credits allocated to a Development not to exceed the amount necessary to assure feasibility. The rules adopted pursuant to the Texas Government Code and the Code are developed to result in a Credit Underwriting Analysis

Report used by the 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 Development feasibility. The Report generated in no way guarantees or purports to warrant the actual performance, feasibility, or viability of the Development.

(b) **Report Contents.** The Report provides a synopsis and reconciliation of the Application information submitted by the Applicant. The Report contents will be based solely upon information that is provided in accordance with and within the timeframes set forth in the current Qualified Allocation Plan ("QAP") or Notice of Funds Availability ("NOFA"), as applicable.

(c) **Recommendations in the Report.** The conclusion of the Report includes a recommended award of funds or Housing Credit Allocation Amount based on the lesser amount calculated by the program limit method, if applicable, gap/debt coverage ratio ("DCR") method, or the amount requested by the Applicant as further described in paragraphs (1) - (3) of this subsection, and states any feasibility conditions to be placed on the award.

- (1) **Program Limit Method.** For Applicants requesting a Housing Credit Allocation, this method is based upon calculation of Eligible Basis after applying all cost verification measures and program limits as described in this section. The Applicable Percentage used is as defined in §10.3 of this chapter (relating to Definitions). For Applicants requesting funding through a Department program other than Housing Tax Credits, this method is based upon calculation of the funding limit based on the current program rules or NOFA at the time of underwriting.
- (2) **Gap/DCR Method.** This method evaluates the amount of funds needed to fill the gap created by Total Housing Development Cost less total non-Department-sourced funds or Housing Tax Credits. In making this determination, the Underwriter resizes any anticipated deferred developer fee ~~downward (but not less than)~~ to-zero before reducing the amount of Department funds or Housing Tax Credits. In the case of Housing Tax Credits, the syndication proceeds needed to fill the gap in permanent funds are divided by the syndication rate to determine the amount of Housing Tax Credits. In making this determination and based upon specific conditions set forth in the Report, the Underwriter may assume adjustments to the financing structure (including treatment of cash flow loans as if fully amortizing over its term) or make adjustments to any Department financing, such that the cumulative DCR conforms to the standards described in this section. For Housing Tax Credit Developments at cost certification, timing adjusters may be considered as a reduction to equity proceeds for this purpose. Timing adjusters must be consistent with and documented in the original partnership agreement (at admission of the equity partner) but relating to causes outside of the Developer's or Owner's control. The equity partner must provide a calculation of the amount of the adjuster to be used by the Underwriter.
- (3) **The Amount Requested.** The amount of funds that is requested by the Applicant as reflected in the original Application documentation.

**(d) Operating Feasibility.** The operating financial feasibility of developments funded by the Department is tested by subtracting operating expenses, including replacement reserves and taxes, from income to determine Net Operating Income. The annual Net Operating Income is divided by the cumulative annual debt service required to be paid to determine the Debt Coverage Ratio ("DCR"). The Underwriter characterizes a Development as infeasible from an operational standpoint when the DCR does not meet the minimum standard set forth in paragraph (4)(D) of this subsection. The Underwriter may model adjustments to the financing structure, which could result in a re-characterization of the Development as feasible based upon specific conditions set forth in the Report.

**(1) Income.** In determining the first year stabilized pro forma, the Underwriter evaluates the reasonableness of the Applicant's income estimate by determining the appropriate rental rate per unit based on contract, program, and market factors. Miscellaneous income, vacancy and collection loss limits as set forth in subparagraphs (B) and (C) of this paragraph, respectively, are applied unless well-documented support is provided.

**(A) Rental Income.** The Underwriter will independently calculate the Pro Forma Rent for comparison to the Applicant's estimate in the Application.

(i) **Market Rents.** The Underwriter will use the Market Analyst's conclusion of Market Rent if reasonably justified and supported by the attribute adjustment matrix of Comparable Units as described in §10.303 of this chapter (relating to Market Analysis Rules and Guidelines). Independently determined Market Rents by the Underwriter may be used based on rent information gained from direct contact with comparable properties, whether or not used by the Market Analyst, and other market data sources.

(ii) **Net Program Rents.** The Underwriter reviews the Applicant's proposed rent schedule and determines if it is consistent with the representations made in the remainder of the Application. The Underwriter uses the Gross Program Rents for the year that is most current at the time the underwriting begins and uses the most current utility information available. When underwriting for a simultaneously funded competitive round, all Applications are underwritten with the Gross Program Rents for the same year. If Gross Program Rents are adjusted by the Department after the close of the Application Acceptance Period, but prior to publication of the Report, the Underwriter may adjust the EGI to account for any increase or decrease in Gross Program Rents for the purposes of determining the reasonableness of the Applicant's EGI.

- (I) Units must be individually metered for all utility costs to be paid by the tenant.
- (II) Gas utilities are verified on the building plans and elsewhere in the Application when applicable.
- (III) Trash allowances paid by the tenant are rare and only considered when the building plans allow for individual exterior receptacles.
- (IV) Refrigerator and range allowances are not considered part of the tenant-paid utilities unless the tenant is expected to provide their

own appliances, and no eligible appliance costs are included in the Total Housing Development Cost schedule.

- (iii) Contract Rents. The Underwriter reviews rental assistance contracts to determine the Contract Rents currently applicable to the Development. Documentation supporting the likelihood of continued rental assistance is also reviewed. The Underwriter will take into consideration the Applicant's intent to request a Contract Rent increase. At the discretion of the Underwriter, the Applicant's proposed rents may be used as the Pro Forma Rent, with the recommendations of the Report conditioned upon receipt of final approval of such increase.
- (B) **Miscellaneous Income.** All ancillary fees and miscellaneous secondary income, including, but not limited to late fees, storage fees, laundry income, interest on deposits, carport rent, washer and dryer rent, telecommunications fees, and other miscellaneous income, are anticipated to be included in a \$5 to \$20 per Unit per month range. Exceptions may be made at the discretion of the Underwriter for garage income, pass-through utility payments, pass-through water, sewer and trash payments, cable fees, congregate care/assisted living/elderly facilities, and child care facilities.
  - (i) Exceptions must be justified by operating history of existing comparable properties.
  - (ii) The Applicant must show that the tenant will not be required to pay the additional fee or charge as a condition of renting a Unit and must show that the tenant has a reasonable alternative.
  - (iii) The Applicant's operating expense schedule should reflect an itemized offsetting cost associated with income derived from pass-through utility payments, pass-through water, sewer and trash payments, and cable fees.
  - (iv) Collection rates of exceptional fee items will generally be heavily discounted.
  - (v) If an additional fee is charged for the use of an amenity, any cost associated with the construction, acquisition, or development of the hard assets needed to produce the additional fee for such amenity must be excluded from Eligible Basis.
- (C) **Vacancy and Collection Loss.** The Underwriter generally uses a vacancy rate of 7.5 percent (5 percent vacancy plus 2.5 percent for collection loss). The Underwriter may use other assumptions based on conditions in the immediate market area. Qualified Elderly Developments and 100 percent project-based rental subsidy developments and other well documented cases may be underwritten at a combined 5 percent at the discretion of the Underwriter if the historical performance reflected in the Market Analysis is consistently higher than a 95 percent occupancy rate.
- (D) **Effective Gross Income ("EGI").** The Underwriter independently calculates EGI. If the EGI estimate provided by the Applicant is within 5 percent of the EGI calculated by the Underwriter, the Applicant's EGI is characterized as reasonable in the Report; however, for purposes of calculating DCR the Underwriter's pro forma will be used unless the Applicant's pro forma meets the requirements of paragraph (3) of this subsection.

(2) **Expenses.** In determining the first year stabilized pro forma, the Underwriter evaluates the reasonableness of the Applicant's expense estimate by line item comparisons based upon the specifics of each transaction, including the Development type, the size of the Units, and the Applicant's expectations as reflected in their pro forma. Historical stabilized certified financial statements of the Development or Third Party quotes specific to the Development will reflect the strongest data points to predict future performance. The Department's Database of properties in the same location or region as the proposed Development also provides heavily relied upon data points; expense data from the Department's Database is available on the Department's website. Data from the Institute of Real Estate Management's ("IREM") most recent Conventional Apartments-Income/Expense Analysis book for the proposed Development's property type and specific location or region may be referenced. In some cases local or project-specific data such as Public Housing Authority ("PHA") Utility Allowances and property tax rates are also given significant weight in determining the appropriate line item expense estimate. Estimates of utility savings from green building components, including on-site renewable energy, must be documented by an unrelated contractor or component vendor. Well documented information provided in the Market Analysis, Appraisal, the Application, and other sources may be considered.

- (A) **General and Administrative Expense** ("G&A")--Expense for operational accounting fees, legal fees, advertising and marketing expenses, office operation, supplies, and equipment expenses. G&A does not include partnership related expenses such as asset management, accounting or audit fees. Costs of tenant services are not included in G&A.
- (B) **Management Fee.** Fee paid to the property management company to oversee the operation of the Property and is most often based upon a percentage of Effective Gross Income as documented in a property management agreement. Typically, 5 percent of the Effective Gross Income is used, though higher percentages for rural transactions may be used. Percentages as low as 3 percent may be used if well documented.
- (C) **Payroll Expense.** Expense for direct on-site staff payroll, insurance benefits, and payroll taxes including payroll expenses for repairs and maintenance typical of a comparable development. It does not, however, include direct security payroll or additional tenant services payroll.
- (D) **Repairs and Maintenance Expense.** Expense for repairs and maintenance, Third-Party maintenance contracts and supplies. It should not include capitalized expenses that would result from major replacements or renovations. Direct payroll for repairs and maintenance activities are included in payroll expense.
- (E) **Utilities Expense.** Utilities expense includes all gas and electric energy expenses paid by the Development.
- (F) **Water, Sewer, and Trash Expense** ("WST"). Includes all water, sewer and trash expenses paid by the Development.
- (G) **Insurance Expense.** Insurance expense includes any insurance for the buildings, contents, and general liability, but not health or workman's compensation insurance.

- (H) **Property Tax.** Includes real property and personal property taxes but not payroll taxes.
- (i) An assessed value will be calculated based on the capitalization rate published by the county taxing authority. If the county taxing authority does not publish a capitalization rate, a capitalization rate of 10 percent or a comparable assessed value may be used.
  - (ii) Property tax exemptions or a Proposed Payment In Lieu Of Tax ("PILOT") agreement must be documented as being reasonably achievable. At the discretion of the Underwriter, a property tax exemption that meets known federal, state and local laws may be applied based on the tax-exempt status of the Development Owner and its Affiliates.
- (I) **Reserves.** An annual reserve for replacements of future capital expenses and any ongoing operating reserve requirements. The Underwriter includes minimum reserves of \$250 per Unit for New Construction and Reconstruction Developments and \$300 per Unit for all other Developments. The Underwriter may require an amount above \$300 for the Development based on information provided in the Property Condition Assessment ("PCA"). The Applicant's assumption for reserves may be adjusted by the Underwriter if the amount provided by the Applicant is insufficient to fund capital needs as documented by the PCA during the first fifteen (15) years of the long term pro forma. Higher reserves may be used if documented by a primary lender or syndicator.
- (J) **Other Expenses.** The Underwriter will include other reasonable and documented expenses. These include audit fees, tenant services, security expense and compliance fees. This category does not include depreciation, interest expense, lender or syndicator's asset management fees, or other ongoing partnership fees. The most common other expenses are described in more detail in clauses (i) - (iv) of this subparagraph.
- (i) **Tenant Services.** Cost to the Development of any non-traditional tenant benefit such as payroll for instruction or activities personnel and associated operating expenses. Tenant services expenses are considered in calculating the DCR.
  - (ii) **Security Expense.** Contract or direct payroll expense for policing the premises of the Development.
  - (iii) **Compliance Fees.** Include only compliance fees charged by the Department and are considered in calculating the DCR.
  - (iv) **Cable Television Expense.** Includes fees charged directly to the Development Owner to provide cable services to all Units. The expense will be considered only if a contract for such services with terms is provided and income derived from cable television fees is included in the projected EGI. Cost of providing cable television in only the community building should be included in G&A as described in subparagraph (A) of this paragraph.
- (K) The Underwriter may request additional documentation supporting some, none or all expense line items. If a rationale acceptable to the Underwriter for the difference is not provided, the discrepancy is documented in the Report. If the Applicant's total expense estimate is within 5 percent of the final total expense

figure calculated by the Underwriter, the Applicant's figure is characterized as reasonable in the Report; however, for purposes of calculating DCR, the Underwriter's independent calculation will be used unless the Applicant's first year stabilized pro forma meets the requirements of paragraph (3) of this subsection.

- (3) **Net Operating Income ("NOI").** The difference between the EGI and total operating expenses. If the first year stabilized NOI figure provided by the Applicant is within 5 percent of the NOI calculated by the Underwriter, the Applicant's figure is characterized as reasonable in the Report; however, for purposes of calculating the first year stabilized pro forma DCR, the Underwriter will maintain and use his independent calculation of NOI, unless the Applicant's first year stabilized EGI, total expenses, and NOI are each within 5 percent of the Underwriter's estimates. For Housing Tax Credit Developments at cost certification, actual NOI will be used as adjusted for stabilization of rents and extraordinary lease-up expenses. Permanent lender and equity partner stabilization requirements documented in the loan and partnership agreements will be considered in determining the appropriate adjustments and the NOI used by the Underwriter.
- (4) **Debt Coverage Ratio.** DCR is calculated by dividing NOI by the sum of scheduled loan principal and interest payments for all permanent sources of funds. Loan principal and interest payments are calculated based on the terms indicated in the term sheet(s) for financing submitted in the Application. Unusual or non-traditional financing structures may also be considered.
- (A) **Interest Rate.** The rate documented in the term sheet(s) will be used for debt service calculations. Term sheets indicating a variable interest rate must provide a breakdown of the rate index and component rates comprising an all-in interest rate. The term sheet(s) must state the lender's underwriting interest rate, or the Applicant must submit a separate statement from the lender with an estimate of the interest rate as of the date of such statement. The Underwriter may adjust the underwritten interest rate based on data collected on similarly structured transactions or rate index history.
- (B) **Amortization Period.** The Department generally requires an amortization of not less than thirty (30) years, and not more than forty (40) years (fifty (50) years for federally sourced loans), or an adjustment to the amortization is made for the purposes of the analysis and recommendations. In non-Housing Tax Credit transactions a lesser amortization period may be used if the Department's funds are fully amortized over the same period.
- (C) **Repayment Period.** For purposes of projecting the DCR over a 30-year period for developments with permanent financing structures with balloon payments in less than thirty (30) years, the Underwriter will carry forward debt service based on a full amortization at the interest rate stated in the term sheet(s).
- (D) **Acceptable Debt Coverage Ratio Range.** Except as set forth in clauses (i) or (ii) of this subparagraph, the acceptable first year stabilized pro forma DCR for all priority or foreclosable lien financing plus the Department's proposed financing must be between a minimum of 1.15 and a maximum of 1.35 (maximum of 1.45 for Housing Tax Credit Developments at cost certification).

- (i) For Developments other than HOPE VI and USDA transactions, if the DCR is less than the minimum, the recommendations of the Report may be based on an assumed reduction to debt service and the Underwriter will make adjustments to the assumed financing structure in the order presented in subclauses (I) - (III) of this clause:
  - (I) a reduction of the interest rate or an increase in the amortization period for Direct Loans;
  - (II) a reclassification of Direct Loans to reflect grants, if permitted by program rules;
  - (III) a reduction in the permanent loan amount for non-Department funded loans based upon the rates and terms in the permanent loan term sheet(s) as long as they are within the ranges in subparagraphs (A) and (B) of this paragraph.
- (ii) If the DCR is greater than the maximum, the recommendations of the Report may be based on an assumed increase to debt service and the Underwriter will make adjustments to the assumed financing structure in the order presented in subclauses (I) - (III) of this clause:
  - (I) reclassification of Department funded grants to reflect loans, if permitted by program rules;
  - (II) an increase in the interest rate or a decrease in the amortization period for Direct Loans;
  - (III) an increase in the permanent loan amount for non-Department funded loans based upon the rates and terms in the permanent loan term sheet as long as they are within the ranges in subparagraphs (A) and (B) of this paragraph.
- (iii) For Housing Tax Credit Developments, a reduction in the recommended Housing Credit Allocation Amount may be made based on the gap/DCR method described in subsection (c)(2) of this section.
- (iv) Although adjustments in debt service may become a condition of the Report, future changes in income, expenses, and financing terms could allow for an acceptable DCR.

- (5) **Long Term Pro forma.** The Underwriter will create a 30-year operating pro forma.
- (A) The Underwriter's first year stabilized pro forma is utilized unless the Applicant's first year stabilized EGI, operating expenses, and NOI are each within 5 percent of the Underwriter's estimates.
  - (B) A 2 percent annual growth factor is utilized for income and a 3 percent annual growth factor is utilized for expenses.
  - (C) Adjustments may be made to the long term pro forma if satisfactory support documentation is provided by the Applicant or as determined by the Underwriter.

**(e) Total Housing Development Costs.** The Development's need for permanent funds and, when applicable, the Development's Eligible Basis is based upon the projected Total Housing Development Cost. The Department's estimate of the Total Housing Development Cost will be based on the Applicant's development cost schedule to the extent that it can be verified to a reasonable degree of certainty with documentation from the Applicant and

tools available to the Underwriter. For New Construction Developments, the Underwriter's total cost estimate will be used unless the Applicant's Total Housing Development Cost is within 5 percent of the Underwriter's estimate. The Department's estimate of the Total Housing Development Cost for acquisition/Rehabilitation will be based in accordance with the PCA's estimated cost for the scope of work as defined by the Applicant and §10.306(a)(5) of this chapter (relating to PCA Guidelines). If the Applicant's is utilized and the Applicant's line item costs are inconsistent with documentation provided in the Application or program rules, the Underwriter may make adjustments to the Applicant's Total Housing Development Cost.

- (1) **Acquisition Costs.** The underwritten acquisition cost is verified with Site Control document(s) for the Property.
  - (A) **Excess Land Acquisition.** In cases where more land is to be acquired (by the Applicant or a Related Party) than will be utilized as the Development Site and the remainder acreage is not accessible for use by tenants or dedicated as permanent and maintained green space, the value ascribed to the proposed Development Site will be prorated based on acreage from the total cost reflected in the Site Control document(s). An appraisal containing segregated values for the total acreage, the acreage for the Development Site and the remainder acreage, or tax assessment value may be used by the Underwriter in making a proration determination based on relative value; however, the Underwriter will not utilize a prorated value greater than the total amount in the Site Control document(s).
  - (B) **Identity of Interest Acquisitions.**
    - (i) An acquisition will be considered an identity of interest transaction when the seller is an Affiliate of, a Related Party to, any owner at any level of the Development Team or a Related Party lender; and
      - (I) is the current owner in whole or in part of the Property; or
      - (II) has or had within the prior 36 months, legal or beneficial ownership of the property or any portion thereof or interest therein prior to the first day of the Application Acceptance Period.
    - (ii) In all identity of interest transactions the Applicant is required to provide:
      - (I) the original acquisition cost evidenced by an executed settlement statement or, if a settlement statement is not available, the original asset value listed in the most current financial statement for the identity of interest owner; and
      - (II) if the original acquisition cost evidenced by subclause (I) of this clause is less than the acquisition cost stated in the application:
        - (-a-) an appraisal that meets the requirements of §10.304 of this chapter (relating to Appraisal Rules and Guidelines); and
        - (-b-) any other verifiable costs of owning, holding, or improving the Property, excluding seller financing, that when added to the value from subclause (I) of this clause justifies the Applicant's proposed acquisition amount.

acquisition date may include property taxes, interest expense to unrelated Third Party lender(s), capitalized costs of any physical improvements, the cost of zoning, platting, and any off-site costs to provide utilities or improve access to the Property. All allowable holding and improvement costs must directly benefit the proposed Development by a reduction to hard or soft costs. Additionally, an annual return of 10 percent may be applied to the original capital investment and documented holding and improvement costs; this return will be applied from the date the applicable cost is incurred until the date of the Department's Board meeting at which the Grant, Direct Loan and/or Housing Credit Allocation will be considered.

- (-2-) For transactions which include existing buildings that will be rehabilitated or otherwise retained as part of the Development, documentation of owning, holding, or improving costs since the original acquisition date may include capitalized costs of improvements to the Property, and in the case of USDA financed Developments the cost of exit taxes not to exceed an amount necessary to allow the sellers to be made whole in the original and subsequent investment in the Property and avoid foreclosure. Additionally, an annual return of 10 percent may be applied to the original capital investment and documented holding and improvement costs; this return will be applied from the date the applicable cost was incurred until the date of the Department's Board meeting at which the Grant, Direct Loan and/or Housing Credit Allocation will be considered. For any period of time during which the existing buildings are occupied or otherwise producing revenue, holding costs may not include capitalized costs, operating expenses, including, but not limited to, property taxes and interest expense.
- (iii) In no instance will the acquisition cost utilized by the Underwriter exceed the lesser of the original acquisition cost evidenced by clause (ii)(I) of this subparagraph plus costs identified in clause (ii)(II)(-b-) of this subparagraph, or if applicable the "as-is" value conclusion evidenced by clause (ii)(II)(-a-) of this subparagraph. Acquisition cost is limited to appraised land value for transactions which include existing buildings that will be demolished. The resulting acquisition cost will be referred to as the "Adjusted Acquisition Cost."

- (C) **Eligible Basis on Acquisition of Buildings.** Building acquisition cost will be included in the underwritten Eligible Basis if the Applicant provided an appraisal that meets the Department's Appraisal Rules and Guidelines as described in §10.304 of this chapter. The underwritten eligible building cost will be the lowest of the values determined based on clauses (i) - (iii) of this subparagraph:
- (i) the Applicant's stated eligible building acquisition cost;
  - (ii) the total acquisition cost reflected in the Site Control document(s), or the Adjusted Acquisition Cost (as defined in subparagraph (B)(iii) of this paragraph), prorated using the relative land and building values indicated by the applicable appraised value;
  - (iii) total acquisition cost reflected in the Site Control document(s), or the Adjusted Acquisition Cost (as defined in subparagraph (B)(iii) of this paragraph), less the appraised "as-vacant" land value; or
  - (iv) the Underwriter will use the value that best corresponds to the circumstances presently affecting the Development and that will continue to affect the Development after transfer to the new owner in determining the building value. Any value of existing favorable financing will be attributed prorata to the land and buildings.
- (2) **Off-Site Costs.** The Underwriter will only consider costs of Off-Site Construction that are well documented and certified to by a Third Party engineer on the required Application forms and supporting documentation.
- (3) **Site Work Costs.** The Underwriter will only consider costs of Site Work that are well documented and certified to by a Third Party engineer on the required Application forms and supporting documentation.
- (4) **Building Costs.**
- (A) **New Construction and Reconstruction.** The Underwriter will use the Marshall and Swift Residential Cost Handbook, other comparable published Third-Party cost estimating data sources, historical final cost certifications of previous Housing Tax Credit developments and other acceptable cost data available to the Underwriter to estimate Building Cost. Generally, the "Average Quality" multiple, townhouse, or single family costs, as appropriate, from the Marshall and Swift Residential Cost Handbook or other comparable published Third-Party data source, will be used based upon details provided in the Application and particularly building plans and elevations. The Underwriter will consider amenities, specifications and development types not included in the Average Quality standard.
- (B) **Rehabilitation and Adaptive Reuse.**
- (i) The Applicant must provide a detailed narrative description of the scope of work for the proposed rehabilitation.
  - (ii) The Underwriter will use cost data provided by the PCA. In the case where the PCA is inconsistent with the Applicant's estimate as proposed in the Total Housing Development Cost schedule and/or the Applicant's scope of work, the Underwriter may request a supplement executed by the PCA provider reconciling the Applicant's estimate and detailing the difference in costs. If the Underwriter determines that the reasons for the initial

difference in costs are not well-documented, the Underwriter utilizes the initial PCA estimations.

- (5) **Contingency.** All contingencies identified in the Applicant's project cost schedule, including any soft cost contingency, will be limited to a maximum of 7 percent of Building Cost plus Site Work and off-sites for New Construction and Reconstruction Developments, and 10 percent of Building Cost plus Site Work and off-sites for Rehabilitation and Adaptive Reuse Developments. For Housing Tax Credit Developments, the percentage is applied to the sum of the eligible Building Cost, eligible Site Work costs and eligible off-site costs in calculating the eligible contingency cost. The Applicant's estimate is used by the Underwriter if less than the 7 percent or 10 percent limit, as applicable, but in no instance less than 5 percent.
- (6) **Contractor Fee.** Contractor fees include general requirements, contractor overhead, and contractor profit. General requirements include, but are not limited to, on-site supervision or construction management, off-site supervision and overhead, jobsite security, equipment rental, storage, temporary utilities, and other indirect costs. Contractor fees are limited to a total of 14 percent on Developments with Hard Costs of \$3 million or greater, the lesser of \$420,000 or 16 percent on Developments with Hard Costs less than \$3 million and greater than \$2 million, and the lesser of \$320,000 or 18 percent on Developments with Hard Costs at \$2 million or less. For tax credit Developments, the percentages are applied to the sum of the Eligible Hard Costs in calculating the eligible contractor fees. For Developments also receiving financing from USDA, the combination of builder's general requirements, builder's overhead, and builder's profit should not exceed the lower of TDHCA or USDA requirements. Additional fees for ineligible costs will be limited to the same percentage of ineligible Hard Costs but will not be included in Eligible Basis.
- (7) **Developer Fee.**
  - (A) For Housing Tax Credit Developments, the Developer fees and Development Consultant fees included in Eligible Basis cannot exceed 15 percent of the project's eligible costs, less Developer fees, for Developments proposing fifty (50) Units or more and 20 percent of the project's eligible costs, less Developer fees, for Developments proposing forty-nine (49) Units or less.
  - (B) Any additional Developer fee claimed for ineligible costs will be limited to the same percentage but applied only to ineligible Hard Costs (15 percent for Developments with fifty (50) or more Units, or 20 percent for Developments with forty-nine (49) or fewer Units). Any Developer fee above this limit will be excluded from Total Housing Development Costs. All fees to Affiliates and/or Related Parties for work or guarantees determined by the Underwriter to be typically completed or provided by the Developer or Principal(s) of the Developer will be considered part of Developer fee.
  - (C) In the case of a transaction requesting acquisition Housing Tax Credits:
    - (i) the allocation of eligible Developer fee in calculating Rehabilitation/New Construction Housing Tax Credits will not exceed 15 percent of the Rehabilitation/New Construction eligible costs less Developer fees for Developments proposing fifty (50) Units or more and 20 percent of the Rehabilitation/New Construction eligible costs less Developer fees for Developments proposing forty-nine (49) Units or less; and

- (ii) no Developer fee attributable to an identity of interest acquisition of the Development will be included.
- (D) Eligible Developer fee is multiplied by the appropriate Applicable Percentage depending whether it is attributable to acquisition or rehabilitation basis.
- (E) For non-Housing Tax Credit developments, the percentage can be up to 15 percent, but is based upon Total Housing Development Cost less the sum of the fee itself, land costs, the costs of permanent financing, excessive construction period financing described in paragraph (8) of this subsection, reserves, and any identity of interest acquisition cost.
- (8) **Financing Costs.** Eligible construction period interest is limited to the lesser of actual eligible construction period interest, or the interest on one (1) year's fully drawn construction period loan funds at the construction period interest rate indicated in the term sheet(s). Any excess over this amount will not be included in Eligible Basis. Construction period interest on Related Party construction loans is not included in Eligible Basis.
- (9) **Reserves.** Except for the underwriting of a Housing Tax Credit Development at cost certification, The the Underwriter will utilize the amount described in the Applicant's project cost schedule if it is within the range of two (2) to six (6) months of stabilized operating expenses plus debt service. Alternatively, the Underwriter may consider a greater amount proposed by the first lien lender or syndicator if the detail for such greater amount is found by the Underwriter to be both reasonable and well documented. Reserves do not include capitalized asset management fees, guaranty reserves, or other similar costs. Lease up reserves, exclusive of initial start-up costs, funding of other reserves and interim interest, may be considered with documentation showing assumptions acceptable to the Underwriter. In no instance will total reserves exceed twelve (12) months of stabilized operating expenses plus debt service (including transferred replacement reserves for USDA or HUD financed rehabilitation transactions). Pursuant to §10.404(c) and for the underwriting of a Housing Tax Credit Development at cost certification, operating reserves that will be maintained for a minimum period of five years and documented in the Owner's partnership agreement and/or the permanent lender's loan documents will be included as a development cost.
- (10) **Other Soft Costs.** For Housing Tax Credit Developments, all other soft costs are divided into eligible and ineligible costs. Eligible costs are defined by the Code, but generally are costs that can be capitalized in the basis of the Development for tax purposes. Ineligible costs are those that tend to fund future operating activities and operating reserves. The Underwriter will evaluate and apply the allocation of these soft costs in accordance with the Department's prevailing interpretation of the Code. If the Underwriter questions the amount or eligibility of any soft costs, the Applicant will be given an opportunity to clarify and address the concern prior to completion of the Report.
- (11) Additional Tenant Amenities.** For Housing Tax Credit Developments and after submission of the cost certification package, the Underwriter may consider costs of additional building and site amenities (suitable for the tenant population being served) proposed by the Owner in an amount not to exceed 1.5% of the originally underwritten Hard Costs. The additional amenities may be included in the LURA.

**(12) Special Reserve Account.** For Housing Tax Credit Developments at cost certification, the Underwriter may include a deposit of up to \$2,500 per Unit into a Special Reserve Account (pursuant to §10.404(d)) as a Development Cost.

**(f) Development Team Capacity and Development Plan.**

- (1) The Underwriter will evaluate and report on the overall capacity of the Development Team by reviewing aspects, including but not limited to those identified in subparagraphs (A) - (D) of this paragraph:
  - (A) personal credit reports for development sponsors, Developer fee recipients and those individuals anticipated to provide guarantee(s). The Underwriter will evaluate the credit report and identify any bankruptcy, state or federal tax liens or other relevant credit risks for compliance with eligibility and debarment requirements in this chapter;
  - (B) quality of construction, Rehabilitation, and ongoing maintenance of previously awarded housing developments by review of construction inspection reports, compliance on-site visits, findings of UPCS violations and other information available to the Underwriter;
  - (C) for Housing Tax Credit Developments, repeated or ongoing failure to timely submit cost certifications, requests for and clearance of final inspections, and timely response to deficiencies in the cost certification process;
  - (D) adherence to obligations on existing or prior Department funded developments with respect to program rules and documentation.
- (2) While all components of the development plan may technically meet the other individual requirements of this section, a confluence of serious concerns and unmitigated risks identified during the underwriting process will result in an Application being referred to the Committee. The Committee will review any recommendation made under this subsection to deny an Application for a Grant, Direct Loan and/or Housing Credit Allocation prior to completion of the Report and posting to the Department's website.

**(g) Other Underwriting Considerations.** The Underwriter will evaluate additional feasibility elements as described in paragraphs (1) - (3) of this subsection.

- (1) **Floodplains.** The Underwriter evaluates the site plan, floodplain map, survey and other information provided to determine if any of the buildings, drives, or parking areas reside within the 100-year floodplain. If such a determination is made by the Underwriter, the Report will include a condition that:
  - (A) the Applicant must pursue and receive a Letter of Map Amendment ("LOMA") or Letter of Map Revision ("LOMR-F"); or
  - (B) the Applicant must identify the cost of flood insurance for the buildings and for the tenant's contents for buildings within the 100-year floodplain and certify that the flood insurance will be obtained; and
  - (C) the Development must be designed to comply with the QAP, as proposed.
- (2) **Proximity to Other Developments.** The Underwriter will identify in the Report any developments funded or known and anticipated to be eligible for funding within one

linear mile of the subject. Distance is measured in a straight line from nearest boundary point to nearest boundary point.

- (3) **Supportive Housing.** The unique development and operating characteristics of Supportive Housing Developments may require special consideration in these areas:
- (A) **Operating Income.** The extremely-low-income tenant population typically targeted by a Supportive Housing Development may include deep-skewing of rents to well below the 50 percent AMGI level or other maximum rent limits established by the Department. The Underwriter should utilize the Applicant's proposed rents in the Report as long as such rents are at or below the maximum rent limit proposed for the units and equal to any project based rental subsidy rent to be utilized for the Development;
  - (B) **Operating Expenses.** A Supportive Housing Development may have significantly higher expenses for payroll, management fee, security, resident support services, or other items than typical affordable housing developments. The Underwriter will rely heavily upon the historical operating expenses of other Supportive Housing Developments provided by the Applicant or otherwise available to the Underwriter;
  - (C) **DCR and Long Term Feasibility.** Supportive Housing Developments may be exempted from the DCR requirements of subsection (d)(4)(D) of this section if the Development is anticipated to operate without conventional or "must-pay" debt. Applicants must provide evidence of sufficient financial resources to offset any projected 15-year cumulative negative Cash Flow. Such evidence will be evaluated by the Underwriter on a case-by-case basis to satisfy the Department's long term feasibility requirements and may take the form of one or a combination of: executed subsidy commitment(s); set-aside of Applicant's financial resources to be substantiated by current financial statements evidencing sufficient resources; and/or proof of annual fundraising success sufficient to fill anticipated operating losses. If either a set aside of financial resources or annual fundraising are used to evidence the long term feasibility of a Supportive Housing Development, a resolution from the Applicant's governing board must be provided confirming their irrevocable commitment to the provision of these funds and activities; and/or
  - (D) **Total Housing Development Costs.** For Supportive Housing Developments designed with only Efficiency Units, the Underwriter may use "Average Quality" dormitory costs, or costs of other appropriate design styles from the Marshall & Swift Valuation Service, with adjustments for amenities and/or quality as evidenced in the Application, as a base cost in evaluating the reasonableness of the Applicant's Building Cost estimate for New Construction Developments.

- (h) **Work Out Development.** Developments that are underwritten subsequent to Board approval in order to refinance or gain relief from restrictions may be considered infeasible based on the guidelines in this section, but may be characterized as "the best available option" or "acceptable available option" depending on the circumstances and subject to the discretion of the Underwriter as long as the option analyzed and recommended is more likely to achieve a better financial outcome for the property and the Department than the status quo.

(i) **Feasibility Conclusion.** An infeasible Development will not be recommended for a Grant, Direct Loan or Housing Credit Allocation unless the Underwriter can determine an alternative structure and/or conditions the recommendations of the Report upon receipt of documentation supporting an alternative structure. A Development will be characterized as infeasible if paragraph (1) or (2) of this subsection applies. The Development will be characterized as infeasible if one or more of paragraphs (3) - (5) of this subsection applies unless paragraph (6)(B) of this subsection also applies.

- (1) **Gross Capture Rate.** The method for determining the Gross Capture Rate for a Development is defined in §10.303(d)(11)(F) of this chapter. The Underwriter will independently verify all components and conclusions of the Gross Capture Rate and may, at their discretion, use independently acquired demographic data to calculate demand and may make a determination of the effective Gross Capture Rate based upon an analysis of the Sub-market. The Development:
  - (A) is characterized as a Qualified Elderly Development and the Gross Capture Rate exceeds 10 percent for the total proposed Units; or
  - (B) is outside a Rural Area and targets the general population, and the Gross Capture Rate exceeds 10 percent for the total proposed Units; or
  - (C) is in a Rural Area and targets the general population, and the Gross Capture Rate exceeds 30 percent; or
  - (D) is Supportive Housing and the Gross Capture Rate exceeds 30 percent.
  - (E) Developments meeting the requirements of subparagraph (A), (B), (C), or (D) of this paragraph may avoid being characterized as infeasible if clause (i) or (ii) of this subparagraph apply.
    - (i) Replacement Housing. The proposed Development is comprised of affordable housing which replaces previously existing affordable housing within the Primary Market Area as defined in §10.303 of this chapter on a Unit for Unit basis, and gives the displaced tenants of the previously existing affordable housing a leasing preference.
    - (ii) Existing Housing. The proposed Development is comprised of existing affordable housing which is at least 50 percent occupied and gives displaced existing tenants a leasing preference as stated in a relocation plan.
- (2) **Deferred Developer Fee.** Applicants requesting an allocation of tax credits where the estimated deferred Developer Fee, based on the Underwriter's recommended financing structure, is not repayable from Cash Flow within the first fifteen (15) years of the long term pro forma as described in subsection (d)(5) of this section.
- (3) **Pro Forma Rent.** The Pro Forma Rent for Units with rents restricted at 60 percent of AMGI is less than the Net Program Rent for Units with rents restricted at or below 50 percent of AMGI unless the Applicant accepts the Underwriter's recommendation, if any, that all restricted units have rents and incomes restricted at or below the 50 percent of AMGI level.
- (4) **Initial Feasibility.**
  - (A) Except when underwritten at cost certification, the The first year stabilized pro forma operating expense divided by the first year stabilized pro forma Effective

Gross Income is greater than 68 percent for Rural Developments 36 Units or less and 65 percent for all other Developments.

(B) The first year DCR is below 1.15

- (5) **Long Term Feasibility.** The Long Term Pro forma, as defined in subsection (d)(5) of this section, reflects a Debt Coverage Ratio below 1.15 or negative cash flow at any time during years two through fifteen.
- (6) **Exceptions.** The infeasibility conclusions may be excepted where either of the criteria apply.
- (A) The requirements in this subsection may be waived by the Executive Director of the Department or by the Committee if documentation is submitted by the Applicant to support unique circumstances that would provide mitigation.
  - (B) Developments not meeting the requirements of one or more of paragraphs (3), (4)(A) or (5) of this subsection will be re-characterized as feasible if one or more of clauses (i) - (v) of this subparagraph apply.
    - (i) The Development will receive Project-based Section 8 Rental Assistance for at least 50 percent of the Units and a firm commitment, with terms including Contract Rent and number of Units, is submitted at Application.
    - (ii) The Development will receive rental assistance for at least 50 percent of the Units in association with USDA financing.
    - (iii) The Development will be characterized as public housing as defined by HUD for at least 50 percent of the Units or HOPE VI financed transactions.
    - (iv) The Development will be characterized as Supportive Housing for at least 50 percent of the Units and evidence of adequate financial support for the long term viability of the Development is provided.
    - (v) The Development has other long term project based restrictions on rents for at least 50 percent of the Units that allow rents to increase based upon expenses and the Applicant's proposed rents are at least 10 percent lower than both the Net Program Rent and Market Rent.