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MSHDA 2009 Qualified Allocation Plan: Preamble

Using this document

MSHDA is issuing this Preamble to enable all stakeholders to better understand the draft 2009 Qualified Allocation Plan ("QAP"). This preamble is intended as a guide to the draft QAP being issued simultaneously herewith, and as such it should be read alongside the QAP. However:

- This Preamble is not the QAP and is qualified in its entirety by reference to the QAP.
- This Preamble has no legal force and in no way modifies, amends, or contradicts the QAP.
- Participants should neither rely upon nor use this Preamble when preparing applications.

The QAP and the accompanying policy bulletins and other guidance are the sole authoritative source for the LIHTC allocation process in Michigan.

1. Introduction

1. A. LIHTC market correction

The LIHTC market is undergoing the single biggest correction since the creation of the program. Macroeconomic and program-specific factors have converged to create this disruption:

- *Global credit crisis*, as banks and other providers of liquidity reassess risk.
- *Recession*, which began in December of 2007.
- *Shrinkage of LIHTC investor interest*, due to consolidation in the banking sector, federal takeover of Fannie Mae and Freddie Mac, and overall reduction in buyers anticipating tax burdens.

The result is falling credit prices. Credit prices that were once $0.90 per dollar of credit are now closer to $0.70 in areas of high investor demand, and even lower in less attractive markets. The

LIHTC and affordable housing world in 2009 will be vastly different than the equilibrium which prevailed through the end of 2007. We do not know when the market will reach a new equilibrium, nor at what price.

1. B. Allocation in disequilibrium

MSHDA is committed to making full use of its federal allocation of LIHTC, even during this disruption. That means making sure all of Michigan's LIHTC is both allocated to sustainable projects and sold to investors. To do otherwise would be to waste a valuable federal stimulus in the midst of a recession.

For many years, LIHTC enjoyed a rising market. Investor demand appeared endless, creating an expectation that every viable project would, eventually, get done. As credit prices rose, LIHTC allocating agencies could gradually increase requirements, relying on competition among investors to drive credit prices up and provide subsidy to absorb required costs.

Now, we are abruptly shifting to a LIHTC market where the controlling feature is equity investment. Properties are chasing equity rather than equity chasing properties, and the market has yet to clear. Prices will eventually settle, but certainly at a lower level than previously, and likely with greater price differentiation around location, sponsor capability, financing complexity, and asset quality.

Lower tax credit prices means each dollar of credit allocated provides less subsidy for housing. Therefore, more resources will be needed for each property. Some of this can be made up through soft debt and similar gap-filler resources, but these are finite and in many ways already stretched thin. Some of the credit ceiling may now be exchanged for direct gap-filler resources, under authority newly granted under the American Recovery and Reinvestment Act of 2009 (as yet unimplemented). More credits can be allocated per property, particularly with the discretionary 30% basis boost, but this too has its limits. In the end, fewer properties and units will be produced.

MSHDA has designed this QAP to address this disequilibrium directly. Our aim is to make Michigan a desirable state for equity investors and to award credits to projects in which those investors prefer to invest.

1. C. Guiding principles

The QAP and the allocation round are guided by a few principles:

- **Fully utilize Michigan's federal LIHTC allocation**, either through credit allocations or awards of gap-filler from exchanged LIHTC funds, particularly during this economic recession.

- **Make Michigan desirable for equity investors**, in terms of process and asset strength.

- **Support Michigan's overall policy long-term policy goals.** Among the concerns that motivate the distribution of LIHTC are:

    - Supporting MSHDA's work under its Consolidated Plan to expand the supply of affordable rental housing, improve neighborhoods, aid the homeless, and expand economic opportunity.

- o Providing a common vision and voice for affordable housing through Michigan's 5-Year Affordable Housing Community Action Plan.
- o Maintaining consistency with MSHDA's Public Housing Agency and Administrative Plans.
- o Observing Michigan's Land Use Leadership Council Ten Growth Tenets.
- o Encouraging the development of Michigan's Economy and Vibrant Communities.
- o Supporting Michigan's Campaign to End Homelessness.
- o Ameliorating poverty in Michigan.
- o Preserving affordable housing in Michigan.
- o Fulfilling the requirements of the federal statutes for the LIHTC program.

- **Provide a process that is easier for participants**. Now that participants have experienced one round under this approach, new applications should be even easier to prepare.

- **Rely on competitive scoring** as the ultimate basis for allocation. MSHDA will allocate credits to the properties that best meet the stated goals. This is deliberate. Competitive scoring encourages program participants to find ways to fulfill the social objectives articulated in the QAP, which results in better social outcomes.

- **Encourage investment in Detroit-Hamtramck-Highland Park** via a priority scoring Target Percentage. (Within DHHP, the Next Detroit Neighborhoods are also advantaged.)

- **Maintain Permanent Supportive Housing as a central objective, but not a property cost.** Continue Michigan's commitment to serving those who need supportive services as a permanent part of their housing. Particularly in the PSH units created as a threshold requirement, make it clear that services must have a dedicated funding source separate from the property, and that a safety valve exists to protect the property if service funding is unavailable.

2. Mechanisms to encourage equity investment

With this QAP, MSHDA has proposed several changes designed specifically to address the equity bottleneck by encouraging projects that appeal to equity investors. Allocations to projects that cannot attract investment have potentially negative value to the state of Michigan. Such credits will, eventually, be returned, and if unused, will be used by other states via the national pool. Therefore, the changes to the allocation mechanisms seek to specifically advantage projects that can demonstrably and quickly close on equity investments.

2. A. Points for hard equity commitment

The single largest point items—100 points—in the Scoring Summary is for a hard equity commitment. Requirements to earn the points are quite high:

- At application, a binding commitment (which can be conditioned on receiving an award of LIHTC) identifying both syndicator and investor, documentation of the price, and commitment to a closing within 60 days of award.
- Within 60 days of award, updated documentation of the equity commitment including a signed partnership agreement.

These requirements are intentionally stringent. Projects that can show a hard equity commitment will score much higher and be extremely likely to receive an allocation. Only those projects that really do have a hard equity commitment should, in effect, move to the front of the line. Projects that claim a hard equity commitment and receive an award based on that must then fulfill their commitment quickly, or else forfeit their award, lose nonrefundable fees, and risk negative points in future rounds.

2. B. Additional LIHTC to aid existing allocations

In this environment of falling credit prices, properties with allocations from past rounds are struggling to close. Affordability resources will need to concentrate in fewer properties to ensure that those properties succeed. MSHDA is therefore providing additional LIHTC to projects that have received an allocation of tax credit from previous rounds. Properties applying for additional credit that have a hard equity commitment will receive consideration for funding before all other projects.

Again, the key element is a hard equity commitment. It is an effective use of additional LIHTC to make sure a previous allocation closes on equity investment and does so quickly.

2. C. Capabilities of development and management team

It has become clear that in this environment, the strength of a property's developer and manager are even more critical both to the property's operational success and its attractiveness to equity investment. We have therefore:

- doubled the points available for Sponsor and Management Agent Characteristics, and
- allowed multiple properties to count toward the total points.

Applicants who have successfully developed multiple properties and managed them successfully for several years can earn up to 40 points.

2. D. Basis boost

The federal Housing and Economic Recovery Act of 2008 granted states the ability to apply a 30% basis boost (equivalent to being located in a DDA) to ensure financial feasibility. MSHDA has determined the following criteria, any one of which is sufficient for properties eligible for the 30% basis boost:

1. High Cost Areas – Projects where the eligible basis (without the boost) would be a low percentage of the total development costs due to either high land costs or the necessity of extensive site preparation and/or off-site costs.
2. Permanent Supportive Housing – Projects receiving allocations under the set-aside.
3. Financial Feasibility – Projects that demonstrate, to the Authority's satisfaction, that they are financially infeasible without a boost, based on such factors as: market conditions that make it difficult in obtaining debt financing and equity commitments, income and expense expectations affected by economic conditions, and other subsidy resources already committed to the project.
4. Historic tax credits – Projects receiving an award of federal or state historic tax credits.
5. Green Community/New Urbanism – Projects that achieve a score of 10 points or greater in the category.

6. Deep income targeting – Projects serving very low income tenants (50% AMGI or less).
7. Preservation projects – Projects meeting the threshold requirements for preservation.

2. E. Underwriting changes

Evaluating the feasibility of applications in a declining economic environment requires adjustment of underwriting parameters. For properties to be sustainable long term (and therefore of interest to equity investment), they will require sufficient cushion to withstand negative economic events. Therefore, we have changed:

- Debt service coverage ratio: 1.25 for all projects, unless circumstances warrant the use of an alternative standard (e.g. RHS-financed projects).
- Vacancy rate: 8%

By necessity, this will require greater concentration of subsidy resources, thereby reducing the total number of units produced. This is a necessary tradeoff to ensure that allocations made are used successfully in sustainable properties.

2. F. Points for historic properties/historic credits

Historic tax credits are in some ways more attractive to investors than the LIHTC. Historic credits are available up front, properties have a shorter compliance period, and compliance is more easily verifiable. Properties combining both LIHTC and historic credits are particularly attractive to investors. Furthermore, the federal Housing and Economic Recovery Act of 2008 requires that QAPs address the historic character of properties. Therefore, we have allowed historic projects to earn 10 points if they also use state or federal historic credits.

We recognize that there may be properties of historic character that do not have an award of historic credits. However, to establish objective criteria and focus allocations on properties attractive to equity, we have chosen to rely on a parallel award of state or federal historic credits to implement this criterion.

2. G. Credits reserved for post-round rolling allocations

MSHDA recognizes that the process of assembling the many elements of a successful project are even more difficult in this disrupted equity environment. To encourage stronger equity commitments to emerge even after the initial round, MSHDA is reserving approximately 25% of its allocation ceiling to be awarded on a rolling basis to projects that have a hard equity commitment, meet threshold requirements, and a minimum score.

The process is designed to be simple but flexible, so applicants need not worry about how or when to apply. The sooner an application with hard equity comes in, the better. The mechanism, described in detail in the QAP, follows these principles:

- ***Single track process***. Applications received before the May 1 deadline will be considered for the competitive round, as described. Applications received after May 1 and until September 30 with a hard equity commitment may receive allocations on a rolling basis, provided they meet a minimum score.
- ***Hard equity gets quick response***. Those that apply to the initial round with a hard equity commitment will receive all of the advantages described above and may well be awarded credits very early in the initial round. Applications with hard equity that arrive later will be addressed first-come, first-served.

- ***Rolling process is only for hard equity.*** MSHDA is specifically reserving credits to encourage applications with equity commitments even after the initial funding round ends. As with the points for hard equity in the competitive round, applying with hard equity brings with it requirements for nonrefundable fees, requirement for quick closing, and risk of penalties for failing to fulfill.

3. PSH is priority, not a property cost

At the highest levels of government, Michigan has declared its desire to serve one of the neediest populations in the state—those who need supportive services as a permanent part of their housing. LIHTC is a powerful resource that can provide permanent supportive housing (PSH) to aid individuals with different levels of need, as long as the LIHTC resource is coupled with funded service providers in a well-defined set of relationships.

Particularly in this difficult LIHTC marketplace, we should be clear that PSH obligations are not a property cost. Properties providing PSH are obligated to provide housing and accept services, but funding for those services must be provided separately.

3. A. Two types of PSH: deconcentrated and service-enriched

Some PSH residents will benefit from integration into a mainstream community via deconcentrated housing interspersed with market apartments. Other PSH residents require a comprehensive service environment and function best in a community that is predominantly service-enriched, which in turn implies a property that has a concentration of such residents to allow common facilities.

Therefore, Michigan has chosen two mechanisms to create permanent supportive housing:

1. Broad-based inclusion of 10% PSH units as a threshold requirement for *every* (non-elderly) LIHTC development, with appropriate roles, responsibilities, and operational safety valves.
2. A set-aside for higher-density PSH developments.

For each, the QAP draws on Michigan's examples of successful PSH development, which has produced over 1,300 units of PSH housing, as well as North Carolina's model for PSH, which has functioned well for several years.

3. B. Roles, responsibilities, and operational safety valves

Roles and responsibilities. Core to making PSH work is a proper allocation of the 'new' roles (to a rental apartment) of the servicer provider and referring agency.

- Owners and managers must hold PSH units available for PSH applicants sent to them by servicer providers. (Details are provided below.)
- All PSH tenants must pay the same rent and abide by the same conditions of occupancy as other tenants. Subsidy, if not attached to the apartment and necessary for the resident to afford the apartment, must accompany the PSH tenant.
- Service provision (and funding for such services) is not the owner or manager's responsibility, it is that of the servicer provider.

These roles require collaboration documented in a Memorandum of Understanding (MOU) among the applicant, management agent and service organization detailing the services that will be provided. Owners and management agents will partner with service organizations skilled in servicing Supportive Housing Tenants. MSHDA will coordinate and assist applicants in identifying quality service organizations and will also facilitate the execution of the MOU.

This threshold requirement was new in 2008, which means that property managers and service providers are still developing working relationships to deliver services and subsidy resources to tenants within properties that serve a market beyond just supportive housing tenants. Developing those relationships and the ways of doing business is ongoing, and participants are learning from experience and from each other as they are developed.

MSHDA has the authority to extend the deadlines for MOU between service providers and property owners, if extensions are needed to make the process work.

Availability, rental, and re-rental. Allowing PSH units to remain vacant other than for normal turnover is not an acceptable result; hence the PSH threshold requirement is predicated on the service provider and referring agency providing qualified rental applicants. To protect operational viability, the 2008 QAP includes a safety valve for supportive housing units:

- Properties must make PSH units available to PSH tenants supplied by the service provider.
- If a lease-qualified PSH tenant is not available within a normal rental interval, the property may rent the unit to a non-PSH tenant under the property's other applicable use restrictions.
- If at any time the property has fewer PSH tenants than its threshold, the next-available-vacancy must be made available to a PSH tenant.

Overall impact of the safety valve. This safety valve works for all participants:

- Properties will receive rent for units, either occupied by PSH tenants or other low-income tenants, and thus will remain financially viable.
- Tenants will have access to PSH units throughout the property's affordability commitment.
- Service providers will have time to assemble resources and deliver services, but also an incentive to do so quickly, as the sooner qualified tenants can be delivered, the sooner PSH tenants can be assisted.

Rent levels, income targeting, and subsidy. To enable MSHDA's LIHTC to serve the maximum number of households, PSH units do not have intrinsic separate or lower income ceilings. Rents for PSH units are thus to be set by sponsors in the normal fashion. This is a deliberate choice designed to use complementary resources as they were designed, because:

- The LIHTC subsidy does not efficiently reach deep enough to target below 50% AMI; deeper income targeting requires income assistance such as Section 8.
- Even at very low income ceilings (e.g. 30% of Area Median Income), many PSH applicants cannot afford such rents without income subsidy.
- Tying deep income targeting to the LIHTC subsidy risks confusion about appropriate rent levels when subsidies overlap.

Deep income targeting is not an intrinsic function of the LIHTC award for PSH units, but can be achieved through additional subsidy such as income supplement (e.g. Section 8 or Housing Choice Vouchers), or sinking funds established by additional local sources. MSHDA encourages applicants to seek awards of project-based vouchers to support PSH units.

4. Safety valve for deep income targeting

Particularly in a recession, providing affordable housing to very low-income residents of Michigan is a priority for State of Michigan. Properties that commit to deep income targeting are advantaged in the scoring. However, we also recognize that imposing unfunded additional costs on properties already under severe financial stress can undermine the sustainability of properties and deter equity investors. The QAP therefore continues its commitment to deep income targeting while ensuring that the property-level commitments have a safety valve to protect financial sustainability.

In most markets, rents affordable to residents at 30% of AMI are equivalent to zero net operating income—barely sufficient to pay operating costs even with no debt service. In weaker rental markets with slower income and rent growth, the zero-NOI level can be even higher. To operate sustainably properties with deep income targeting need rental subsidy, such as project-based Section 8, in addition to capital subsidy, such as LIHTC.

Project-based rental subsidy makes properties more sustainable, but it also adds a level of risk to which equity investors and lenders are sensitive. For instance, project-based Section 8 contracts are subject to annual appropriations risk—if Congress does not appropriate sufficient funds, subsidy can be cut. This has never happened, but it is possible under the subsidy contracts. Were it to happen, equity investors and lenders are rightly concerned that a property could be required under a use agreement to target very low income tenants without the expected subsidy.

The 2009 QAP therefore incorporates a safety valve for projects that commit to deep income targeting and choose to rely on project-based rental assistance to achieve financial feasibility. If the project-based rental assistance ends due to events outside the owner’s control, the rent and income restrictions revert to the 50% or 60% level as selected by the owner. This preserves the ongoing sustainability of the property to serve low-income tenants even if the rental subsidy that allows deep income targeting ends.

5. Preservation is a priority

In general, the challenges facing Michigan require not more housing units in total, but higher-quality housing and the reinvestment in Michigan's cities. This QAP therefore encourages preservation in the general competition. It also clarifies that redevelopment of public housing is an eligible preservation transaction, regardless of whether it occurs through the HOPE VI program.

6. Green Communities/New Urbanism remain point options

Although energy conservation, green initiatives, and new urbanist design are important priorities for use of public investment capital, they are still relatively new to Michigan—2008 was their first introduction in Michigan. The initial experience with 2008 awards suggest many of the Green Communities/New Urbanism add value to properties without much, if any, added cost.

Program participants who have remaining concerns about these streamlined green requirements are particularly invited to submit specific comments on particular elements, together with recommended alternatives. Based on comments in the previous round and MSHDA's own observations, we have modified the list of requirements for this round. Further comments will be useful for this and subsequent rounds of LIHTC allocation.

7. No penalty for returning credits

Because of the disruption in equity markets, some 2007 allocations and many 2008 allocations have yet to close. Developers should make a realistic assessment of their ability to close and consider returning credits that cannot be used in a timely fashion. It is of paramount importance that Michigan put its LIHTC to work quickly.

There is no penalty for voluntarily returning credits. Developers who do so will be doing a service to the state, as it helps no one to hold on to allocations that could be used in other, ready projects. Applications can be resubmitted in later rounds, when the project is more ready to proceed. Doing so would be much better than having an allocation rescinded by MSHDA for failure to close, which could result in a penalty to the developer.

8. Credit exchange should provide additional gap-filler

New federal legislation signed just days before this QAP was issued provides an innovative new tool: MSHDA can exchange a portion of its LIHTC allocation ceiling for gap-filler funds to be allocated to LIHTC properties. MSHDA will move quickly to implement the LIHTC exchange and use the resources provided to support sustainable affordable housing preservation and development in Michigan. Because the program is still emerging, specific guidelines will come in a policy bulletin, guided by the following principles:

- ***LIHTC exchange funds are gap-fillers to create more sustainable properties***. The LIHTC exchange provides a much-needed mechanism for concentrating subsidy into a necessarily smaller number of more sustainable properties.
- ***Allocations of exchange funds carry LIHTC compliance requirements***. They may also create additional asset management requirements for MSHDA to fulfill, which may require property-level fees. Much will depend on specific implementation.
- ***Allocations will be competitive***, just like LIHTC. Even with this new mechanism, Michigan has finite resources that are over-subscribed. Competitive allocation directs those resources to where they can best serve the state's affordable housing needs. Just because a property has an existing (but unsold) allocation of LIHTC does not mean it will automatically qualify for exchange funds.
- ***Michigan will maximize the value of its federal resource***. That means balancing the likely higher per-credit dollar price obtainable via the exchange against the demonstrated efficiencies of syndicated LIHTC, all in the context of a disrupted syndication market. As market conditions shift, so too will the value of various options.

9. Conclusion: drawing equity investment to Michigan

This QAP is, as before, an exercise in practicality, seeking mechanisms to attract equity investment to Michigan in service to the state's policy goals. MSDHA invites stakeholders to provide comments in the same spirit, focusing on rapid, full utilization of MSHDA's scarce and valuable resource.

As part of improving the 2009 QAP, MSHDA intends that:

1. ***MSHDA will be a leader in cooperative efforts to fully utilize Michigan's LIHTC allocation.*** Resources are finite and in this difficult environment all parties to a transaction must contribute to make the property succeed. MSHDA will use its available resources, pioneer new mechanisms such as the LIHTC exchange, be flexible in its policies, and encourage all other parties to cooperate in fully utilizing the tax credit resource.
2. ***Allocation will be transparent.*** MSHDA will make all scores and the methodology for making awards public.
3. ***The process will adapt.*** The market is moving faster than annually-reviewed policies can react. As those shifts continue, MSHDA will use all the tools available to it to encourage the full use of the LIHTC resource and the development of affordable housing in Michigan. This will likely mean more waivers, quicker implementation, policy bulletins guiding new mechanisms, and an overall more flexible process focused on the end goal of creating sustainable affordable housing properties.
4. ***Improvements will be made in 2010 and thereafter.*** MSHDA anticipates an ongoing review and revision of the QAP to keep the LIHTC program in step with changing economic conditions and policy priorities. Active participation by stakeholders is essential to that process.