August 18, 2010

MSHDA 2011 Qualified Allocation Plan: Preamble

Using this document

MSHDA is issuing this Preamble to enable all stakeholders to better understand the draft 2011 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

In late 2008 and throughout 2009, the LIHTC market experienced the single biggest correction since the creation of the program. The macroeconomic and financial market conditions that converged to create the crisis have largely faded, but credit prices remain significantly lower. 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. Distinguishing features remain:

- sponsor capitalization and track record
- competition from CRA-motivated investors with overlapping footprints
- strength of local real estate market

Properties that benefit from two or more of these features typically can sustain above-average pricing. Properties without any of them have great difficulty attracting investors.

1. B. Allocation continues to adjust

MSHDA is committed to making full and efficient use of its federal allocation of LIHTC, even during this disruption. In 2009-10, we made substantial changes to the QAP to support that goal. The results have been positive:

- New and existing investors are supporting LIHTC in Michigan.
- The Reinvestment and Innovation Program, using LIHTC Exchange resources, is preserving properties in the existing portfolio, including renovations for energy efficiency and sustainability.
- A combination of a competitive round and a rolling round gave developers and investors flexibility to bring deals together.
- More than half of the 2009 allocations were made to properties that had hard equity commitments at time of application.

The controlling feature of the pipeline remains equity investment. Properties are chasing equity rather than equity chasing properties, and the market is only beginning to clear. Prices are settling, but certainly at a lower level than previously.

The market for LIHTC equity appears bifurcated: properties with strong sponsors, in stable real estate markets, and in the CRA footprint of one or more major investors draw much attention, but properties without these features draw little or none. The Exchange program (proposed for extension into 2010) remains a wild card contributing to the bifurcation in the market, as the less-attractive properties hold out for Exchange grant funding.

MSHDA has designed the 2011 QAP based on the successful 2009-10 QAP to continue to adjust allocation to the disrupted market. 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 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.
    - Providing a common vision and voice for affordable housing through Michigan's 5-Year Affordable Housing Community Action Plan.
    - Maintaining consistency with MSHDA's Public Housing Agency and Administrative Plans.
    - Observing Michigan's Land Use Leadership Council Ten Growth Tenets.
    - Encouraging the development of Michigan's Economy and Vibrant Communities.

- Supporting Michigan's Campaign to End Homelessness.
- Ameliorating poverty in Michigan.
- Preserving affordable housing in Michigan.
- Fulfilling the requirements of the federal statutes for the LIHTC program.

- **Provide a process that is easier for participants**. We continue to improve the process, drawing in part on the help of stakeholders who have participated in policy discussions and focus groups.

- **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. Rolling round changes

In the 2009-10 allocation cycles, the rolling round proved to be an effective complement to the general competitive round. The rolling format provides a mechanism for applicants to assemble the many complex elements of a successful development—in particular, a committed equity investor—outside of the schedule of a competitive round as long as the property meets a minimum threshold score. Credits are made available on a first-come, first-served basis.

MSHDA has therefore chosen to slightly increase the amount of annual credit available under the rolling round from 25% to 30%. This increase reflects the proven utility of the rolling round format in the disrupted LIHTC market, but also the serious tradeoffs against mission objectives and Michigan's legal obligations:

- **Rolling format privileges speed and completeness over other mission features.** The competitive round distinguishes properties by a host of criteria, but the rolling format focuses specifically on awarding to the first complete application at a minimum threshold score. This reduces the competitive pressure to serve affordable housing policy goals.

- **Michigan law requires fulfillment of statutory set-asides.** The rolling format does not provide the necessary administrative flexibility to ensure that MSHDA meets the required statutory set-asides for nonprofits, elderly housing, rural housing, and eligible distressed areas. MSHDA has deliberately scheduled the rolling format first so that the competitive round can efficiently meet the set-asides relying in part on the rolling round results. However, the rolling round simply cannot expand very much further.

MSHDA has also added a provision to allow it to reallocate credit between the rolling and competitive rounds and to reopen a rolling round after the competitive round, should such be needed to ensure full use of the available LIHTC.

2. B. Improvements to hard equity incentives

An application that brings with it a hard equity commitment earns advantages under the QAP. In the rolling round, a hard equity commitment is a minimum threshold requirement. In the competitive round, it is a 125-point (up from 100 in 2010) scoring item that can move an application much higher in priority. In the 2011 QAP, we have clarified and strengthened the requirements for a hard equity commitment. Specifically, we require:

- ***Completion of basic due diligence***. Absent such, a commitment is not credible.
- ***Commitment to purchase the equity***. This may be conditioned on an award of credit, but it must be a commitment to act, not simply an expression of interest.
- ***A cash deposit*** (unchanged from 2010).
- ***Evidence of a committed investor*** (not simply the syndicator or fund entity). This is an essential check that there is a committed investor to fund the project. This may be satisfied by indentifying the investor, or by providing alternative evidence acceptable to MSHDA that there is an investor committed to providing equity financing to the project, including, but not limited to, a certification by a certified public accountant or attorney with knowledge of the transaction.

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.

We have extended the closing deadline to 75 days (up from 60) to adapt to the processing timeline of the investment community. Investor committees generally need at least two meetings to reach a conclusion on a project. Because these meetings typically take place monthly, an increase to 75 days should safely allow for these committees to have two cycles to review a project.

2. C. Removed equity letter threshold requirement

To further distinguish hard equity requirements from the past practices of a soft investor letter, we have removed the requirement for the soft letter entirely. This recognizes that the soft letter brought little distinguishing value and imposed costs on syndicators and developers. Projects may still apply and win credit without an equity commitment, of course, and applicants should still seek to assemble developments that will appeal to investors, even if not bringing a hard commitment at time of application.

2. D. Capabilities of development and management team

The investor community remains unanimous that the strength of a property's developer and manager are ever more critical both to the property's operational success and its attractiveness to equity investment. In recognition of the need to get credit to those who will be able to sell it, the 2011 QAP increases the total points available for Sponsor and Management Agent Characteristics to 30 points each (up from 20 in 2010). Applicants who have successfully developed multiple properties and managed them successfully for several years can earn up to 60 points. To achieve maximum points, a developer or manager must have experience specifically in Michigan, although large portfolios outside of Michigan can still achieve quite high scores. We have also rescaled the scoring to better differentiate based on length and breadth of experience. Properties of 6 units or more can count toward these point areas.

2. E. Readiness to proceed

In the current market, the true indicators of a project's readiness to proceed are its ability to secure debt and equity. Taking this into account, the 2011 QAP includes the complete Readiness to Proceed points as part of the Hard Equity Commitment points. Projects that do not have a Hard Equity Commitment will still be able to get some points for their ability to proceed (for local approval items), but will not be able to get the full Readiness to Proceed points. Doing this also puts more stringent requirements on projects that have indicated they have a Hard Equity Commitment because they will now also have to close on the property and disburse funds within 120 days of award.

3. Income targeting focused on sustainability

Particularly in a recession, providing affordable housing to very low-income residents of Michigan is a priority for the State of Michigan. Properties that commit to deep income targeting are advantaged in the 2011 QAP scoring, but in a new way that focuses on long-term sustainability of affordability commitments.

The previous approach, which encouraged complex tiered commitments of units at various AMI levels was designed to encourage maximum commitment to mission goals. Over time, however, it encouraged applicants to impose too-strict requirements in pursuit of points. It also represented a false precision—income tiering is neither as precise or sustainable as such commitments imply.

As the recession has deepened, this problem has become apparent, as property owners are applying to MSHDA for flexibility on their income and rent targeting. It also reflects the basic constraint that rents targeted below 40% of AMI in most cases cannot support a property's operating cost, much less the capital needed initially. Cross-subsidy from higher-rent units to deep-targeted units is inherently unstable, particularly in markets like Michigan where market rents are below LIHTC caps. MSHDA wishes to ensure that the developments created by the 2011 LIHTC allocations are sustainable long term.

The revised low-income targeting scoring operates on a few key principles:

- Project-based rental assistance is the most sustainable means for achieving long-term affordability
- Unassisted low income targeting should be limited, to avoid encouraging unsustainable commitments to cross-subsidy.
- Underwriting should be realistic, to avoid false precision in income tiering.

Thus, the 2011 QAP allows maximum points for low income targeting only to projects that have project-based rental assistance. Projects without rental assistance can and should earn points for income targeting, but the QAP deliberately does not encourage them to commit to unsustainable levels. Applicants should choose an income mix that provides for long-term sustainability.

The 2011 QAP also maintains the safety valve (added in 2009), so that a commitment to deep income targeting is conditioned upon receipt of rental subsidy. To receive points for deep income targeting, the owner must commit to rent restrictions and obtain project-based rental assistance. If the project-based rental ends due to events outside the owner's control, the rent restriction reverts 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.

4. Allocation process improvements

MSHDA has made several improvements to the allocation process based on our own observations and concerns raised by stakeholders.

4. A. Milestones

The allocation process should recognize that even carefully chosen allocations may not be able to attract equity interest—markets move faster than allocation decisions and development plans. To encourage developers to assess realistically the likelihood of their project being able to move forward and adjust accordingly, MSHDA has added two new milestones to the allocation process for 2011:

- Return option. Recipients may voluntarily return the credit and receive refund of their fee, as long as they do so voluntarily before a 75-day deadline.
- Equity closing deadline. Even projects that did not claim a hard equity commitment should move expeditiously toward closing. In addition to submitting the needed items for a commitment within 120 days (i.e., the reservation period), projects that did not claim a hard equity commitment will need to demonstrate that they have closed on their equity within 180 days after receiving an award. This requirement is designed to create a decision point for projects that did not initially have an investor to have closed on their deal or, if the deal cannot move forward, to have the credit returned to MSHDA so that it can be used on another project.

4. B. Developer fee

Developer fee limits and policies have not changed for many years, even as costs have risen and markets have moved. To adapt to the many changes, MSHDA has changed two aspects of the developer fee policy:

- ***Raised the cap to $1,800,000 for 9% LIHTC, $2,500,00 for 4% LIHTC.*** The previous cap of $1,000,000 for 9% credits ($2,000,000 for 4% LIHTC) had been in place for many years. Over time, it came to affect more and more projects. To ensure fair compensation for developers and to support developer's ability to sustain their properties, Michigan has increased the cap.

- ***Required reserves included in the calculation.*** To the extent that project reserves are required by MSHDA, the lender, or the investor for the project, these project reserves will be counted towards the calculation of the developer fee.
- ***Increased Developer Fee factor for larger Acquisition/Rehabilitation Developments.*** The revised version of the QAP being presented in August calculates fees based on 15% of all costs (acquisition and rehabilitation) regardless of project size. This is an increase from the 2009 QAP which limited the fee to 10% of acquisition costs for projects of 50 units or greater.

4. C. Title insurance requirement

In an effort to minimize some of the upfront costs to a developer for putting together an application, the requirement to supply title insurance has been moved so that it is now required prior to an award of credit, except for scattered site projects. This means that only those projects that actually receive an award of credit will need to incur this cost. Scattered site projects are the only exception to this change, clear title being such an important element of the project feasibility.

4. D. Unified scoring

Historically, the scoring for projects applying under the Permanent Supportive Housing (PSH) set-aside had been separate from what was available to projects applying in the general pool. This created a "Which line do I get in?" problem for developers. In an effort to eliminate this problem, PSH projects will now compete in the same pool with all of the other, non-PSH project applications. PSH projects still have the same 25% set-aside, and will have some points available to them that non-PSH projects will not have, but they will now not have to make a decision about which area to compete in. MSHDA does not expect this change to affect which projects receive awards—it will serve only to simplify the process for all concerned.

As part of the unification of scoring, points for visitability of new construction units have been added, available to all projects. This should encourage developers to create more units and community spaces that are navigable by wheelchairs without imposing undue costs.

5. 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. Initial results from the 2008-10 cycles are encouraging, and MSHDA continues this approach in 2011.

5. 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.

5. 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. Residents are, of course, free to choose other service providers and as much or as little service as they desire.
- 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 2011 QAP continues the policy of offering 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.

6. 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 and the rolling round. This maintains a long-standing commitment to the preservation of existing affordable housing.

7. 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. 2009-10 awards appear to be continuing this trend, though many are still in the early stages.

MSHDA recognizes that the affordable housing industry has yet to settle on national standards for green affordable housing. Various options are in their early stages: Enterprise Green Communities, LEED, and various local and regional standards, among many. MSHDA has formed a working group to investigate these standards and their applicability to this state's development needs. The goal is to find a national standard that would allow clear, consistent understanding of requirements while still fitting Michigan's needs.

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. Further comments will be useful for this and subsequent rounds of LIHTC allocation.

8. 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 2011 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. 2009 and 2010 cycles have demonstrated this commitment already.
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 2012 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.