

OPERATING ASSURANCE RESERVE (OAR) POLICY

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Purpose of Operating Assurance Reserve

The OAR helps ensure the stability of a development. During the first years of operation, the reserve can be used for operating shortfalls. The OAR may also help with RR Needs or other underfunded escrows and obligations to the Authority near the middle of the development’s mortgage term.

Originally called the Operating Assurance Escrow (OAE), the OAE name changed to Operating Assurance Reserve (OAR) around February 1999. This policy uses the “OAR” title, but the policy applies to either the escrow or the reserve.

Contributions to the OAR

When required, Mortgagors establish an OAR with the Authority at or prior to the initial disbursement of the loan proceeds. The OAR deposit requirement equals four months estimated development operating expenses, including debt service payments, deposits to escrows, and any other anticipated development expenses. In previous years, OAE accounts were generally funded by deferring developer fees until the development demonstrated successful operations while OAR accounts since the 1999 conversion have been funded with Mortgage proceeds.

If any funds are disbursed prior to Final Closing to assist with operating shortfalls, the

Mortgagor must restore the OAR to the original Regulatory Agreement balance at Final Close. The reserve must be funded with at least 50% cash after the Mortgage Cut-off Date. Any portion of the reserve not funded by cash must be funded with an irrevocable letter of credit. The letter of credit's annual fee must be paid by the owner and not from development operations. Interest earned, if any, shall become part of the OAR and shall be treated and disbursed in the same way as other OAR funds unless otherwise stated in the Regulatory Agreement.

OAR Structures

The amount and any special terms governing the OAR are described in the development's Regulatory Agreement and the Mortgage Loan Commitment report. **Review these documents carefully to obtain the complete OAR processing parameters for specific transactions.** During any part of the Authority funded loan term, OAR funds are available for eligible operating deficits. If an Operating Deficit Reserve (ODR) exists, the OAR becomes a secondary source for funding operating deficits.

After a 12 or 24-month successful operating period, the OAR funds may become eligible for a reduction in the balance of funds maintained in the OAR account. Refer to the Criteria for OAR Reduction section of this policy for more details about the successful operations requirements. This may result in either a reduction of the Letter of Credit amount required to be held by the Authority or a reduction of the OAR funds. Generally, four different OAR structures have been used in the regulatory agreement language within the MSHDA-financed portfolio. The OAR structures identify four different eligibility dates and parameters as follows:

Type 1

OAE accounts prior to February 1999 are eligible for reduction, if requested by the owner, **beginning** one year from the final closing or mortgage cut-off date. Funds are eligible to be reduced in thirds over a period of years as designated in the Regulatory Agreement. After each successful 12-month operational period the following reductions may be approved:

- 1st successful period allows a 33% reduction in the OAR balance.
- 2nd successful period allows a 50% reduction in the remaining OAR balance.
- 3rd successful period allows a 100% reduction in the remaining OAR balance.

Type 2

OAR accounts on developments closed since February 1999 are eligible for a reduction **beginning** in the 10th and 15th years after the mortgage cut-off date. In the 10th and 15th year, the OAR is used to fund any underfunded escrows, including replacement reserve needs identified in the most recent CNA or as a result of annual deposit(s) that have been underfunded. After the escrows have been fully funded and the development achieves 12-months of successful operations, then in the:

- 10th year – the OAR balance may be reduced by 50%.
- 15th year – the OAR balance may be reduced by 100%.

If the development has a TCAP loan, released funds are first applied against the TCAP Loan prior to being transferred to the development's Operating Reserve Cash (ORC) account.

After the 15th year of operation if any funds remain in the OAR, the funds will be transferred to the development's Replacement Reserve account, unless otherwise stated in the Regulatory Agreement, and used in accordance with the Replacement Reserve policy.

Type 3

OAR accounts on preservation Developments since February 1999 are eligible for a reduction **beginning** in the 6th and 12th years after the mortgage cut-off date. In the 6th and 12th year, the Authority uses the OAR to fund any underfunded escrows including replacement reserve needs identified in the most recent CNA or as a result of annual deposit(s) that have been underfunded. After the escrows have been fully funded and the development achieves 12-months of successful operations, then in the:

- 6th year – the OAR balance may be reduced by 50%.
- 12th year – the OAR balance may be reduced by 100%.

Additionally, 50% of any funds released may be required to be applied to the Preservation Fund Loan prior to being transferred to the development's ORC account. Review the Regulatory Agreement to confirm the specific requirements that apply to that development.

Type 4

OAR accounts on Section 8 preservation developments may not use the OAR until the original HAP contract expires. The Section 8 preservation developments become eligible for a reduction *beginning in the later of* the year the HAP contract expires or the 12th year after the mortgage cut-off date.

- The funds can be reduced by 100% at the designated date, if 24-months of successful operations have been achieved. Funds released may be required to be applied to the TCAP Loan prior to being transferred to the development's ORC account. Review the Regulatory Agreement to confirm the specific requirements that apply.

Eligible Expenses

OAR funds may be used to pay for development operating expenses based on the priority set forth in the Management Agreement under Section 5 – Expense Management. Eligible expenses include:

- Payments to maintain the fiscal integrity of the development.

- Expenses or payables projected to come due without operating funds being available in the next 30 days.

The OAR **cannot** be used to pay Identity of Interest vendors.

Requests for OAR Disbursements

The Owner may submit a written request for either an OAR disbursement or reduction in the OAR balance to the assigned Asset Manager. If the request is submitted by the Management Agent, written approval from the owner **MUST** be included. All reserve disbursements require a review of the development's on-site cash position and operating cash funds available to cover expenses prior to the disbursement and use of the OAR funds.

Disbursements - If an operating deficit requires an OAR disbursement, the request must include the following:

- Owner's approval of the requested disbursement.
- Completed Operating Assurance Reserve Draw/Reduction Request (MSHDA Mgmt. 504A).
- Completed OAR Draw/Reduction Worksheet (MSHDA Mgmt. 504B).
- An explanation of the intended use of the funds.
- An explanation for using OAR funds versus another available reserve, if one exists.
- The amount of the request, which must exceed \$1000.

Requests for OAR Balance Reduction

Once the OAR account becomes eligible for a reduction, as identified in the Regulatory Agreement, the Owner may request a reduction of OAR Funds. The request for reduction must include:

- The amount of the reduction being requested.
- Completed Operating Assurance Reserve Draw/Reduction Request (MSHDA Mgmt. 504A).
- Completed OAR Draw/Reduction Worksheet (MSHDA Mgmt. 504B).
- If another agency, such as HUD or RD holds the development's replacement reserve, submit confirmation from the administering agency regarding the funding level of the replacement reserve.

- OR -

Once the OAR becomes eligible for a reduction, if an operating deficit occurred and the owner opts to pay for the deficit with cash, the OAR letter of credit balance may be

reduced by the amount of the owner's cash advance (or contribution) toward the deficit. For this request include:

- The amount of the reduction to the letter of credit being requested.
- Evidence of the owner's cash advance to the development.

Criteria for OAR Reductions

Upon receipt of a reduction request from an owner, the AM will also review the operational success of the development for the past 12 or 24 months, depending on the OAR structure Type. This review will evaluate the following performance items:

- a. *Liquidity* – Review the entire period to be evaluated for any trends in the development's operation. If the trends are different from the development's condition at the time of review, an explanation should be included with the recommendation.
 1. *All developments, except Section 8 Preservation*: For the past 12 months preceding the review, the operating liquidity position (excluding owner contributions) has remained at or above one month's gross rent potential - **and** - the average physical vacancy equals 5% or less.
 2. *Section 8 Preservation Development*: For the past 24 months, the operating liquidity position (excluding owner contributions) has remained at or above one month's gross rent potential - **and** - the average physical vacancy equals 5% or less.
- b. *Mortgage Delinquency* – No mortgage delinquencies exist, and payments have been current during the preceding 12 months through the date of the potential pending reduction of the OAR.
- c. *Escrow Funding* – All escrow accounts, for example the tax, insurance, and replacement reserve are fully funded. Consideration should be given to the **projected** funding levels for the replacement reserve for the life of all outstanding loans due to the Authority.
- d. *Operating Deficit Reserve (ODR)* – In the 12-months prior to a potential reduction of the OAR balance, ODR withdrawals have **NOT** exceeded the allowable operating deficits established in the development's Regulatory Agreement and cash flow analysis. If ODR withdrawals have exceeded the allowable disbursements, they must be reimbursed before becoming eligible for any reduction of OAR funds.
- e. *Non-101 Payables* – All non-Identity of Interest undisputed payables are less than 60 days old.

- f. *IoI Payables* – No Identity of Interest vendors have been paid when there is any non-Identity of Interest accounts payables over 90 days unless an “Accounts Payable Action Plan” is approved by the Authority.
- g. *Deferred Maintenance* – All deferred maintenance items listed on the most recent inspection or re-inspection report have been responded to appropriately.
- h. *Fidelity Bond* – The Employee Dishonesty or Crime Coverage Policy is current.
- i. *Annual Audit* – The annual certified audit has been reviewed, approved, and indicates that no material weaknesses exist in the operation that could jeopardize the development.
- j. *Legal Liabilities* – No pending or threatened claims against the mortgagor or disputed payables exist that would materially affect the financial condition of the development as reported in the most recent monthly operating statement.
- k. *Management Fee* – For the last 12 months preceding the evaluation date, the development has paid a management fee equal to or less than the maximum basic management fee allowed by the Authority – **or** - liquidity (excluding owner contributions) is greater than or equal to the **approved** management fee less the management fee actually paid.
- l. *Satisfy Financial and Physical Obligations* – All financial (e.g. funding of Replacement Reserve Needs and other escrows and reserves, timely submission of budgets and audits) and physical obligations to the Authority and Federal Government have been met (e.g., under all regulations, guidebooks and written agreements binding the owner or the development, such as loan documents, regulatory or use agreement(s), management agreement, subsidy contracts, etc.).

Mortgage Loan Prepayment

Upon payment in full of the Mortgage Loan, the disbursement of excess funds is governed by legal documents and applicable law.

Forms and Attachments

504A – Operating Assurance Reserve Draw/Reduction Request

504B – OAR Draw/Reduction Worksheet