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HUD Publishes Updated Administrative Guidelines for Project-Based Voucher Subsidy Layering Reviews

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On February 28, 2020, HUD published updated Administrative Guidelines ("**New Guidelines**") governing subsidy layering reviews ("**SLRs**") for Project-Based Vouchers ("**PBV**s"). Effective immediately, the New Guidelines update prior SLR guidelines issued by HUD on September 26, 2014 (79 Fed. Reg. 57955) ("**Prior Guidelines**"), to:

1. Include new PBV Housing Assistance Payments ("**HAP**") contract terms in accordance with the Housing Opportunity Through Modernization Act of 2016 ("**HOTMA**");
2. Provide SLR guidelines for Mixed-Finance projects; and
3. Clarify cash flow, debt coverage ratios, net operating income, and operating expense trending requirements.

Purpose and Applicability:

SLRs for PBV assistance are required by statute whenever PBVs are proposed for new construction and rehabilitation projects that will be used in connection with other governmental assistance. The purpose of the SLR is to ensure that HUD is providing no more assistance than is necessary to make a PBV project feasible. SLRs are performed by HUD or, in certain cases when LIHTC is involved, Housing Credit Agencies. SLRs are not applicable to:

1. PBV awards to existing housing projects—including projects that already have PBVs and undergo refinancing with LIHTCs.
2. PBV awards to new construction or rehabilitation housing projects with no other forms of governmental assistance.[1]

Notable provisions of the New Guidelines include the following:

[1] The definition of "governmental assistance" is broad, including "any loan, grant, guarantee, insurance, payment, rebate, subsidy, tax credit, tax benefit, or any other form of direct or indirect assistance from the federal government, a state, or a unit of general local government, or any agency or instrumentality thereof.

<u>Development Standards:</u>

- ***General Contractor Fee***: HUD continues to permit a "maximum allowable combined contractor fee" of 14% of total hard construction costs that includes 6% for General Conditions, 2% for Overhead, and 6% for Builder's Profit.

- ***Developer Fees***: The safe harbor standard is a maximum 15% of total development cost for profit and overhead, replacing the former safe harbor of 12% with a 15% ceiling.[2]

<u>Operating Standards</u>: HUD requires an operating pro forma that covers each year of the HAP contract initial term (i.e., up to 20 years) in order to conduct the operating analysis. The New Guidelines maintain the same overall targets for debt coverage ratio ("**DCR**") (between 1.10-1.45) and cash flow (maximum of 10 percent of operating expenses), but with clarifications that we believe were intended to be helpful, although they still contain some maddening imprecision:

- ***Debt Coverage Ratio Test***

    - *Need for Hard Debt.* The DCR test applies only to a project "with debt". We suspect that this provision was intended to avoid a situation that occurred in the past when HUD insisted on apply its DCR test to projects without hard debt, but unfortunate drafting ambiguities cloud this conclusion. The New Guidelines include a definition of "debt service" that provides that debt service "does not include forgivable/soft loans, nonrepayable grants, non-repayable federal, state or local assistance, deferred developer fees, financing fees, partnership fees, management fees, capital contributions, tax concessions, or tax credits." It is unclear whether HUD intends to exempt from the DCR test a project that has only soft (cash flow only) debt (and thus has debt, but not "debt service", and would have a DCR of infinity based on NOI divided by a debt service of zero). This unclarity is compounded by the apparent requirement that debt be forgivable to be disregarded in the debt service definition.

    - *Temporary deviations from guidelines may be justified.* HUD allows for DCRs that are within range overall but deviate in an individual year to be justified by the owner and PHA. Here, HUD has recognized that projects may have higher or lower cash flows and debt service across the trending period that may cause some departure from the overall target.

    - *Updated trending Assumptions*:
        - Operating Expenses should be trended at a consistent fixed rate between 1% and 3% per year for the first 5 years and 3% thereafter (the Prior Guidelines allowed trending at 1 to 3 percent). Justification is required for increases above 3%.

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[2] There are separate safe harbors for mixed-finance projects: 9% without justification; 9-12% with justification; above 12% only if the PHA receives the amount over 12% and use of the fee is restricted for projects costs or future phases.

        - Rent Increases should be trended yearly at a consistent fixed rate between 2% and 3% per year (the Prior Guidelines were 1% - 3% for the first three years, 3% thereafter). Justification is required for increases outside this range.
        - Vacancy Rates must not exceed 7% (note: this is a new requirement).

- ***Cash Flow Test***

    - *Permitted Adjustments.* Cash flow is defined as "net operating income minus all required debt service"; however, the New Guidelines now permit further deductions of (a) contributions to operating and replacement reserves, and (b) the "face value amount of the deferred developer fee (i.e., no interest earned)."
        - The treatment of deferred developer fee ("**DDF**") was not addressed in the Prior Guidelines and had been an area of confusion among those submitting and reviewing SLRs, so this clarification is welcome.
        - It remains to be seen how HUD will process deals in which tax or other considerations require interest on DDF; the New Guidelines do not bar that, but simply exclude such interest from the exclusion.
        - The cash flow test will continue to pose problems for deals in which generous cash flow is required in order to pay DDF, causing the 10% limit to be suddenly exceeded when DDF is paid. HUD seems to be warning against increasing reserve contributions at that point, by permitting only consistent annual adjustments.

    - *Temporary deviations from guidelines may be justified.* The New Guidelines treat cash flow as excessive "if in any given year the annual cash-flow is greater than 10% of annual operating expenses and it remains above 10%." This may mean that, as with DCR, a temporary noncompliance can be justified to HUD.

Mixed-Income Finance Projects: The New Guidelines provide that SLRs for mixed-finance projects with PBVs will be conducted by HUD as part of the mixed finance review and without separate PBV SLR review process. Mixed-finance projects are subject to same SLR standards as other projects, as well as provisions of 24 CFR 905, Subpart F and other applicable guidance.

Timing of Environmental Reviews: HUD now requires a PHA to show that a Part 50 review has been submitted to the field office or a Part 58 review has been submitted to the responsible entity at the time of initial submission of the SLR request. An AHAP may not be executed until both the SLR and environmental review approval are complete.

Submission Requirements: Appendix A of the New Guidelines provides an updated list of required elements for the SLR submission.

The New Guidelines are available here. Should you have any questions about this KH Housing Alert or require any further information, please contact Meredith Barnett (mbarnett@kleinhornig.com) or Adam Norlander (anorlander@kleinhornig.com).