State of California

Department of Housing and Community Development

Asset Management & Compliance Branch

Title 25, California Code of Regulations

Proposed Portfolio Restructuring Guidelines

Sections 100 through 115

Initial Statement of Reasons

INTRODUCTION

This Initial Statement of Reasons (ISOR) has been prepared by the California Department of Housing and Community Development (hereinafter "the Department") to describe guidelines that the Department is adopting, as required by Health and Safety Code Section 50560(h). These guidelines implement and interpret the provisions of AB 1699, which gives the Department the authority, under specified loan programs, to extend the term of existing multifamily housing loans, subordinate a Department loan to new debt, and authorize an investment of tax credit equity in developments with Department loans. The Restructuring of the Department's loans is intended to preserve affordable housing units that would have been lost to termination of the regulatory provisions restricting rents and occupancy, to address physical deterioration of the property and/or to improve project fiscal integrity. Defined terms (such as "Restructuring") are capitalized; the definitions for defined terms are in the text of the guidelines or in the Uniform Multifamily Regulations (UMRs) or Multifamily Housing Program (MHP) regulations.

These guidelines will apply to all Restructurings of projects originally funded under the following Department programs:

1) the Rental Housing Construction Program Original (RHCP-O) established by Chapter 9 (commencing with Section 50735);
2) the Special User Housing Rehabilitation Program (SUHRP) established by Section 50670;
3) the Deferred Payment Rehabilitation Loan Program (DPRLP) established by Chapter 6.5 (commencing with Section 50660);
4) the rental component of the California Natural Disaster Assistance Program (CALDAP) established by Section 50671;
5) the State Earthquake Rehabilitation Assistance Program (SERA), established by Section 50671;
6) the rental component of the California Housing Rehabilitation Program (CHRP-R) established by Section 50668.5;
7) the component of the Rental Housing Construction Program funded with bond proceeds, (RHCP-B) pursuant to Section 50771.1;
8) the Family Housing Demonstration Program (FHDP) established with Section 50880; and
9) the Families Moving to Work Program (FMTW) established by Section 50880.

Upon adoption of the final AB 1699 guidelines and completion of the Restructuring, the original statutes, regulations, guidelines, standard agreements, regulatory agreements and other loan documents for these programs will no longer apply to the projects. Instead, the projects will be subject to the provisions of the AB 1699 guidelines which, with certain exceptions, are similar to the provisions of the Department's Multifamily Housing Program ("MHP") and the Uniform Multifamily Regulations ("UMR").

For Department-administered programs, these guidelines, when adopted, will supersede and replace the guidelines for the Housing Loan Conversion Program (SB 707, Statutes of 2007) for any project restructuring that was not completed as of the date of adoption.

PURPOSE AND RATIONALE OF EACH PROPOSED SECTION

The specific purpose of each adoption, and the rationale for the determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed, together with a description of the public problem, administrative requirement, or other condition or circumstance that each adoption is intended to address, is as follows:

Proposed Section 100

Section 100 sets forth the statute and regulations that the guidelines implement, and the relationship of existing Department regulations to these guidelines. The proposed guidelines explain the context in which Chapter 3.9 was created, the purpose of Chapter 3.9, and lists the Department's programs which are covered by it. The proposed guidelines also provide instruction on the fact that the portion of SB707 that pertains to the Department's loan programs will terminate once these guidelines are effective, and list the specific programs covered by Chapter 3.9.

Proposed Section 101

Section 101 sets forth the defined terms used in Section 50560, 50561 and 50562 of the Health & Safety Code which are also contained in this section. Some defined terms are incorporated by reference from the UMRs and the MHP Regulations. Defined terms are capitalized. It is the intent of the legislation to establish consistent and updated rules for the Restructuring of Projects under the Department's legacy loan programs. Therefore, the definition of "Household Income" is different than the Original Program definition. "Household Income" was calculated differently in the Original Programs than is required for the MHP Program, which the statute sets forth as the model for the Restructured Projects. Therefore, the definition of "Household Income" is different than it was under the Original Program rules. Also, the definition of "Rent" has been modified from the definition used in the "Original Program" requirements.

The definition of "Sponsor" is included because the definition in the UMRs doesn't clearly state that a borrower may not include more than three layers of ownership, so that the Sponsor is not separated from the Borrower by more than one entity. The reason that the Department does not permit Borrower organizations with more than three layers of ownership is the intense workload required to review each entity to make sure it complies with the Department's requirements, was organized legally, and that the proper authorized signators sign the Department's loan documents. In addition, the Department does not believe that more than three layers of ownership are needed to refinance and resyndicate the Projects in the Department's loan portfolio.

The term "Unit" is defined here because it is a different definition than is stated in the UMRs, which allows for a "Unit" to be used as Transitional Housing. Due to the long-term restrictions on Rent for Existing Households in a Project being Restructured, the Projects cannot be converted to Transitional Housing.

The term "Existing Household/Tenant" is important in these guidelines because Chapter 3.9 requires that Existing Households/Tenants be protected from high Rent increases.

Therefore, there must be a list of these Existing Households/Tenants so that the specific Tenants whose Rents are restricted can be tracked from year to year. The Department decided to consider the Existing Tenants to be defined as all of those tenants who are listed in the rent roll that is submitted as part of the application for Restructuring. This timeframe is appropriate because the Department requires the list of Existing Tenants and their current Household Incomes in order to determine and approve the amount of Special Rent Increases, which is required to be set forth in the new Regulatory Agreement that will be executed by the Department and the Borrower. Tenants who moved out of the Project before the application is submitted to the Department are not considered Existing Households/Tenants.

The term "Fiscal Integrity" is defined here simply for ease of understanding the Guidelines. The definition is the same definition as is stated in the MHP Regulations.

Proposed Section 102

Section 102 sets forth specific requirements of Chapter 3.9, with the exception of subsection (c), which includes a requirement that the Sponsor and Borrower must be in compliance with all of their Department contracts, not just in compliance for the Project being Restructured. This is a standard requirement of the Department in its program operations. The Department views requests for special transactions, such as a Restructuring, as an opportunity to achieve Sponsor compliance if there are any areas of noncompliance in the Sponsor's operations of Projects assisted by the Department. "Remaining Useful Life", as stated in subsection (b), means the period during which the physical characteristics of the Project are projected to comply with habitability standards applicable to the low-income housing tax credit program, as based on a third party physical needs assessment.

Proposed Section 103

Section 103 sets forth requirements for Projects that only request an extension of the Department's loan. Subsection (a) limits the term of allowable extensions to the 10 to 55 years allowed by Chapter 3.9 for projects without tax credits.

Subsection (b) implements the provision of Chapter 3.9 that allows Special Rent Increases only where rehabilitation is being performed. In subsection (c), "Fiscal Integrity", which is defined in the MHP Regulations, means that the Project is anticipated to have at least an amount of income equal to the expenses generated, including mandatory debt service, operating expenses and replacement reserve deposits. The Department recognizes that some Projects will not be able to meet this requirement. Under certain conditions, the Department has the authority to enter into work-out agreements with project sponsors that allow its loan to remain in place. Subsection (d) allows for the operating reserve to diverge from the otherwise applicable UMR requirements for a capitalized operating reserve, due to the fact that there is no new source of funds to the Project. Therefore, the operating reserve requirement will continue as under the Original Program regulatory agreement until the reserve balance reaches the level required under the UMRs.

Proposed Section 104

Section 104 subsection (a) addresses the fact that the Original Program was governed by different rules than those required by Chapter 3.9 for the Restructured Projects. To resolve any conflicts between Chapter 3.9 and the Original Program rules, these Original Program rules no longer apply once the Project has been Restructured, except for the third party beneficiary rights that were granted to tenants living in assisted units in the Project, which is discussed in subsection (c). The regulatory agreements for a significant number of Projects funded under the Original Programs, including those funded under the "Bond" component of the Rental Housing Construction Program, the California Housing Rehabilitation Program, and the Family Housing Demonstration made tenants a party to the regulatory agreements. These "third party beneficiary rights" are contractual rights that cannot be removed from Existing Tenants without their consent. Therefore, the new regulatory agreements will preserve the third party beneficiary of Existing Tenants. New tenants who move in after the closing of the Restructured loan shall no longer have these third party beneficiary rights. Subsection (b) sets forth the requirement that Projects will be required to comply with the UMRs and the MHP Regulations after Restructuring, and therefore, new loan documents containing these requirements must be executed and recorded. Subsection (d) further expands on the requirement that the new loan documents must be agreed to by all other lenders and third parties, to ensure that the new legal documents are enforceable.

Proposed Section 105

Section 105 sets forth the requirements imposed by Chapter 3.9 for Projects that are being refinanced, to ensure that they comply with the UMRs and the MHP regulations. Subsections (a) and (b) reference the requirements set forth in earlier sections of the guidelines. Subsection (c) derives from a requirement in the UMRs and MHP regulations for Projects to demonstrate through a multiyear pro forma that there will be no negative cash flow for at least the first 15 years, so that the Department's security is not jeopardized through obtaining the new senior lien. Subsection (d) sets forth the requirement that the Original Program loan may not have matured before an extension is granted. This is because once the Department's loan matures, the Department no longer has authority to extend the loan. General contract principles preclude extending a contract once the contract has expired. A loan matures based on its own terms and is considered expired upon maturation. All rights and obligations within the contract are discharged except for those rights or obligations related to a breach. For example, if the loan is unpaid, the contract right to repayment results in a breach of the contract, and the right to repayment will survive the expiration of the contract. No other contract right will survive, such as the right to extend the contract. Subsection (d) also reiterates Chapter 3.9's limitation on the length of extensions: no fewer than 10 years and no more than 55 years or 58 years with only projects receiving a new allocation of tax credits eligible for the 58 year extension, and only as needed to comply with tax credit requirements.

Subsection (e) reiterates the statutory requirement for compliance with the UMRs and MHP regulations, specifically as it concerns loans from senior lenders, which may not have terms or provisions that would jeopardize the Department's security. Subsection (f) requires compliance with the Rent and income requirements of the statute, referring to the detailed requirements set forth in Section 108. Subsection (g) references the requirements on relocation of Existing Households, as set forth in Section 110. Subsection (h) reiterates the Chapter 3.9 requirement for the underwriting requirements of the UMRs to be adhered to, further specified in Section 112. Subsection (i) sets forth the requirement for a complete application form, including all required documents, to be submitted together, so that the Department can begin review of the Restructuring request.

Proposed Section 106

Section 106 reiterates the requirement in Chapter 3.9 that the Department will subordinate its loan only if necessary to increase the Project's financial health, which means that the debt service is being reduced or that the Project is being improved through needed rehabilitation being performed. The Department's security is not permitted to be reduced through subordinating the Department's loan to a higher amount of senior debt unless the higher amount of debt is needed due to the Project being rehabilitated, improving its value. Even in situations where the Project is being rehabilitated, the rehabilitation is required to be limited to those improvements which are shown in a third party physical needs assessment as being needed within the next five years, and the improvements must be modest, so that the Department's security isn't reduced unnecessarily. Energy efficiency improvements are permitted.

The proposed guidelines allow for reimbursement of certain expenses incurred by the Sponsor as long as the amount of senior debt isn't increased over the current loan balance. The allowable expenses include: 1) those incurred by the Sponsor for capital improvements made in the 12-month period before Sponsor submits the application for Restructuring, subject to documentation that payments were made to unaffiliated businesses; 2) those operating expenses that were paid by Sponsor due to insufficient income and reserves in the 12-month period before Sponsor submits the application for Restructuring, subject to documentation in a third party audit.

Proposed Section 107

Section 107(a) sets a general standard for evaluating senior lender loan payment terms, including required balloon payments. It is intended to permit the Department to revise its standards on this subject based on changing market conditions. Subsections (b) through (f) set forth the Department's customary requirements for senior loans, which are deemed prudent requirements to protect the Department's security. In addition to the Department's prohibition on senior lenders having the potential to call their loans prior to maturity, which is unrelated to any default by the borrower potentially jeopardizing the Department's security, the Department also does not permit senior loans to have an option requiring bonds to be remarketed prior to the loan maturity. The Department requires all required fees and payments to be disclosed in the Department's underwriting documents, and requires an interest rate cap on any loan that does not have a fixed interest rate for the full term of the loan. The Department underwrites the Project using the cap, and requires that the Project will maintain Fiscal Integrity throughout the entire loan term. The Department does not permit senior loans in which a Sponsor is required to requalify for an interest rate reset or renewal or an extension of a letter of credit. If a senior loan is subject to a swap agreement, a collar, rate cap, letter of credit, credit enhancement, hedge or facility provider agreement, the Department requires all such agreements to extend for the full term of the senior loan, without need for extension or renewal. All of these requirements are for the purposes of protecting the Department's security.

Proposed Section 108

Section 108(a) sets forth the limitations on Special Rent Increases, which are defined as Rent increases that exceed the increases that were permitted under the Original Program Regulatory Agreement. With a couple of exceptions, this section restates clear statutory provisions, which limit the extent to which it could be modified.

The reason for the limitation on Rent increases is the negative impact that sudden and significant Rent increases would have on the Existing Tenants in the Projects, and due to the loss of Units with very low Rents in the community. Therefore, Special Rent

Increases are not permitted unless the Project is being rehabilitated at a fairly substantial level (the level required to receive tax credits under the low-income housing tax credit program) and only if the rehabilitation is truly needed, as defined in Section 106(b). The Special Rent Increase is limited to the lowest amount that is truly needed to support the new financing that the Project needs to be able to perform the rehabilitation. The first such Special Rent Increase is not permitted until after the closing of the Restructured loan. There is one exception to this rule: Some Projects have Rents that are so low that even when the Special Rent Increases are permitted to occur, there will still be insufficient rental income to comply with lender and/or investor underwriting requirements. Therefore, Projects that need more than a year or two of Special Rent Increases before there will be sufficient rental income to comply with lender and/or investor underwriting requirements will be eligible to apply for early Special Rent Increases. To make certain that only the Projects that need these early Special Rent Increases take advantage of them, the Department will require all of the additional rental income to be placed in a reserve until the Restructuring takes place, which is required to be within three years of the date of the new Regulatory Agreement that is executed. In addition, the Department will require significant documentation to demonstrate that the Project requires the early Special Rent Increases, including the scope of work, a physical needs assessment prepared by a third party, a construction cost estimate prepared by a general contractor, a development budget, a sources and uses of funds, a preliminary title report, a multi-year pro forma, a proposed operating budget, a complete report showing all existing tenants by unit number, unit size, household incomes as reported in an income recertification performed in accordance with the requirements of the low-income housing tax credit program within the past three months, household size, current rent and subsidies and utility allowance, and date of annual rent increase. Subsection 108(a)(4)(vi) addresses the requirements to be met if the anticipated Restructuring fails to occur within three years of the date of the execution of the new Regulatory Agreement. If the Restructuring doesn't occur within that period of time, the Rents shall be reduced back to the levels that would have been reached, including the adjustments that would have been permitted under the Original Program Regulatory Agreement, and the funds on deposit in the reserve created for this purpose shall be used as the Department determines to be the most essential use. Among the potential uses are critical repairs and replacement and provision of Rent subsidies for tenants.

In addition, all Special Rent Increases must comply with the notice requirements set forth in the Statute and in Section 108(b).

Subsection 108(a)(5) relates to the fact that, as noted in Subsection 104(c), the tenants of Projects assisted under some programs covered by these Guidelines have third-party beneficiary rights under the existing regulatory agreements. Therefore, Borrowers are required to certify that any necessary consent(s) from third-party beneficiaries have been obtained. The Department will look to Borrowers to determine when these consents are necessary.

Section 108 (b) states the precise limits on Special Rent Increases imposed on Existing Tenants in Projects originally funded under the RHCP-B and FHDP programs. The Legislature is concerned about the negative impact of sudden and significant Rent increases on the Existing Tenants of the Projects that are being Restructured. Therefore, the limits on Rent increases that can be charged to Existing Tenants are stringent and are intended to result in gradual increases over a number of years. The Legislature was also concerned about these Special Rent Increases creating a large Rent burden on the low-income Households living in the Projects. For that reason, there is a limit on Rent as a percentage of the Existing Households' income—the projected Rent increases cannot result in a Rent that exceeds 50 percent of the Existing Tenant's Household Income, measured using the certified Household Income in the Schedule of Rental Income submitted as part of the Restructuring application.

For Existing Tenants with Household Incomes that do not exceed 35 percent of area median income, no more than a 5 percent increase in Rent is permitted each year until the Rent reaches the level stated in the Unit Mix of the Regulatory Agreement. For Existing Tenants with Household Incomes above 35 percent of area median income, no more than a 10 percent increase in rent is permitted each year until the Rent reaches the level stated in the Regulatory Agreement. These provide for gradual increases in rental income to the project, to allow for the Project to obtain financing for rehabilitation and low-income housing tax credits, while not harming the Existing Tenants. It should be noted that State relocation law restricts Rent increases that can be imposed on Existing Households if State relocation law is triggered by a government agency. It is the Department's opinion that the rewrite of our loans under Chapter 3.9 triggers State relocation law. Therefore, Special Rent Increases imposed on Existing Tenants by the Sponsor may require Relocation benefits be provided to those tenants in the form of a Rent subsidy, and the Department will expect to see a line item providing that Rent subsidy to the tenants in the development budget and the operating budget.

To provide sufficient notice to the Existing Tenants concerning these Special Rent Increases, the Statute requires six months' notice of the approximate amount of the Rent increase and requires 90 days' notice of the exact amount of the Rent increase.

Section 108 (b)(1)(B): As discussed earlier, in order to make it feasible for Projects to be rehabilitated, which generally requires greater rental income, the Statute allows for the Unit Rents to be adjusted in amounts that exceed the Original Program Rent limitations. For Units that are vacant at the time of submission of the application for Restructuring, or become vacant after the Restructuring documents are executed, the Department will determine, through underwriting, what Rent is needed to assure that the Project complies with the underwriting requirements of Section 112 and achieves positive cash flow for at least 20 years, and the Department will only approve Rents at these levels, and no higher. This is to prevent the loss of the low-rent housing stock, when the only rationale for the loss of the low Rent units would be to provide generous cash flow to the Borrower.

The maximum Rent levels and income limits for vacant Units are based on the Original Program Regulatory Agreement Unit designation. For Units that were designated “very low-income” in the Original Regulatory Agreement, the Rent limit is 30 percent of 35 percent of area median income, as published in the MHP Rent & Income Limits table, and the income limit is 35 percent of area median income. For units that were designated “low-income”, the Rent limit is 30 percent of 60 percent of area median income, as published in the MHP Rent & Income limits table, and the income limit is 60 percent of area median income. However, it should not be assumed that the Rents and income limits approved by the Department will actually be as high as 60 percent of area median income. The Department will only approve Rents at the area median income level needed to assure that the Project complies with the underwriting requirements of Section 112 and achieves positive cash flow for at least 20 years.

Section 108(b)(2) states the precise limits on Special Rent Increases imposed on Existing Tenants in Projects originally funded under the RHCP-O, SUHRP, DPRLP, CHRP-R, CALDAP, SERA, and FMTW programs. As mentioned earlier, the Legislature is concerned about the negative impact of sudden and significant Rent increases on the Existing Tenants of the Projects that are being Restructured. Therefore, the limits on Rent increases that can be charged to Existing Tenants are stringent and are intended to result in gradual increases over a number of years. The Legislature is also concerned about these Special Rent Increases creating a large Rent burden on the low-income Households living in the Projects. For that reason, there is a limit on Rent as a percentage of the Existing Household’s income—the projected Rent increases cannot result in a Rent that exceeds 50 percent of the Existing Tenant’s Household Income, measured using the certified Household Income in the Schedule of Rental Income submitted as part of the Restructuring application.

For Existing Tenants with Household Incomes that do not exceed 35 percent of area median income, no more than a 5 percent increase in Rent is permitted each year until the Rent reaches the level stated in the Unit Mix of the Regulatory Agreement. For Existing Tenants with Household Incomes above 35 percent of area median income, no more than a 10 percent increase in rent is permitted each year until the Rent reaches the level stated in the Regulatory Agreement. These provide for gradual increases in rental income to the project, to allow for the Project to obtain financing for rehabilitation and low-income housing tax credits, while not harming the Existing Tenants. It should be noted that State relocation law restricts Rent increases that can be imposed on Existing Households if State relocation law is triggered by a government agency. It is the Department's opinion that the rewrite of our loans under Chapter 3.9 triggers State relocation law. Therefore, Special Rent Increases imposed on Existing Tenants by the Sponsor may require Relocation benefits be provided to those tenants in the form of a Rent subsidy, and the Department will expect to see a line item providing that Rent subsidy to the tenants in the development budget and the operating budget.

To provide sufficient notice to the Existing Tenants concerning these Special Rent Increases, the Statute requires six months' notice of the approximate amount of the Rent increase and requires 90 days' notice of the exact amount of the Rent increase.

Section 108 (b)(2)(B) sets forth the limits on Rent increases in vacant units in projects originally funded by the RHCP-O, SUHRP, DPRLP, CHRP-R, CALDAP, SERA, and FMTW programs. For Units that are vacant at the time of submission of the application for Restructuring, or become vacant after the Restructuring documents are executed, the Department will determine, through underwriting, the Rent needed to assure that the Project complies with the underwriting requirements of Section 112 and achieves positive cash flow for at least 20 years, and the Department will only approve Rents at these levels and no higher. This is to prevent the loss of the low-rent housing stock, when the only rationale for the loss of the low Rent units would be to provide generous cash flow to the Borrower.

The maximum Rent levels and income limits for vacant Units, and the overall Rent restrictions for the Projects funded under the RHCP-O, SUHRP, DPRLP, CHRP-R, CALDAP, SERA, and FMTW programs, are different than is required for Projects funded under the RHCP-B and FHDP Programs. At least thirty-five percent of the Assisted Units are required to have Rent limits that do not exceed the mid-level target of MHP, commonly called the MHP-B Rent limit. This limit is based on 30 percent of 30 percent of State median income in counties where the area median income is 110 percent or less of the State median income. The limit is 30 percent of 35 percent of State median income in counties where the area median income is more than 110 percent of State median income. In the event that the Original Program Regulatory Agreement required more than 35 percent of the Assisted Units to be restricted to the mid-level target of MHP, this restriction must be met by having higher than 35 percent of the Assisted Units. It is important to note that this restriction might result in some Units' Rents being required to be reduced to the required level. The MHP-B Rent limits are published annually in the MHP Rent & Income Limits table. The income limits for these MHP-B units are required to match the Rent limits (for example, if the MHP-B level in County A is 35 percent of State median income, the income limit and the rent limit will be 35 percent of State median income). For the remaining Assisted Units in these Projects, the Rent limit is 30 percent of 60 percent of area median income, as published in the MHP Rent & Income limits table, and the income limit is 60 percent of area median income. However, it should not be assumed that the Rents and income limits approved by the Department will actually be as high as 60 percent of area median income. The Department will only approve Rents at the area median income level needed to assure that the Project complies with the underwriting requirements of Section 112 and achieves positive cash flow for at least 20 years.

Section 108(c) explains how Rent increases will be limited in Restructured Projects that do not require or which aren't eligible for Special Rent Increases. Due to the fact that the Original Program rules and regulations are terminated for Projects after they are Restructured, the original Consumer Price Index-based formula for Rent increases is also terminated and a new methodology for Rent increases is needed. The Department is particularly interested in feedback on which methodology should be used in this type of situation. The Department understands that few Housing Programs now use a CPI-based Rent increase formula, and thus it proposes that Restructured Projects begin using the MHP rules, which are the same as the low-income housing tax credit rules. However, the MHP rules cannot be used in totality, as the Units in these Projects do not have specific, numeric area median income levels. As a result, the Department proposes to derive the rate of change in the Rent for a two-bedroom Unit at the 50 percent of area median income level for the county, as published in the MHP Rent and Income limits, and to use this percentage change for all Assisted Units in the Project. Based on recent experience with the MHP Rent limits, this could result in $0 increase in Rent in a particular year. However, this methodology would utilize the federal "Hold Harmless" rules adopted for the low-income housing tax credit program, which eliminate the potential for rents dropping over time, even if area median incomes decline. For example, if a Sponsor was calculating the allowable Rent increase for the calendar year 2013, the Sponsor would review the 2013 MHP published Rent limits, and assess whether the Rents increased from the 2012 published Rents, or decreased or remained the same. If the Rents decreased from 2012, then the Project would be eligible for the

“Hold Harmless” rule to keep Rents at the same level, rather than to decrease. If the published Rents increased from 2012, then the rate of increase in the two-bedroom Unit at 50 percent of area median income would be applied to all Unit Rents to derive the percentage used to set the Rent increases for 2013. The other possibility the Department is considering for Rent increase limitations would be to reinstate the CPI-based increase only for those Projects that are not receiving a Special Rent increase. This isn’t the Department’s preferred methodology, as it continues the current labor intensive processes involved in setting the Rent increases and requires Department review and approval, rather than following the Chapter 3.9 direction to use the MHP rules as the model for Projects that have been Restructured. The Department would appreciate feedback on which of these Rent increase methodologies to use.

Proposed Section 109

Section 109 addresses the fact that the RHCP-O annuity fund is limited and may be depleted prior to the expiration of some of the existing contracts. Therefore, the statute terminates payment of the annuity to Projects upon the date of the maturity of the Original Program Regulatory Agreement. However, the annuity fund might be depleted before the end of the Original Regulatory Agreement and therefore, the annuity might end sooner than the maturity date of the Original Program Regulatory Agreement. The goal is to stretch the annuity fund out for the longest possible time and to provide tenant protection for the Existing Households in these Projects. Therefore the annuity will only be continued for low-income and very low-income Existing Households who occupy Assisted Units at the time that the Restructuring application is submitted, and only up to the maturity of the Original Program Regulatory Agreement. In addition, as part of every Restructuring, the formula for determining the Rent required to be paid by Existing Tenants will increase to 30 percent of Household Income from the current 25 percent of Household Income. Thirty percent of Household Income allocated to Rent is the current standard among housing programs.

Proposed Section 110

Section 110 differentiates between State relocation law as set forth in the Government Code and the special requirements of Chapter 3.9 to protect Existing Tenants through maintaining very low Rents. The goal is to make certain that the Existing Tenants benefit from the stringent Rent restrictions that the legislation imposes on Units occupied by Existing Tenants. Therefore, the Legislature requires that Existing Tenants who are relocated off the Project site in order for the rehabilitation to take place, be provided a first priority in moving back to the Project after rehabilitation is completed. However, if the rehabilitation is projected to take six months or more, relocation law requires that the tenants be provided with permanent relocation benefits. The permanent relocation benefits do not provide the same level of tenant protection as does Chapter 3.9, which provides very low Rents to the Existing Tenants for as long as they chose to remain in the Project. For this reason, the Department is requiring Sponsors to provide a special notice to the Existing Tenants detailing information about the tenant protections, Rent increase limitations of Chapter 3.9, having the right to return to the Project into a comparable unit upon completion of the rehabilitation, and the amount of the Rent that will be charged upon reoccupancy. This Notice is particularly important because, as subsection (c) states, if an Existing Tenant accepts the permanent relocation benefits offered to them, they are no longer considered an Existing Tenant, and they lose the very low Rent tenant protections of Chapter 3.9. Subsection (e) points out that there is one exception to the requirement for Existing Households to have the right to return to the Project. This exception is invoked if there is a special federal or State program that is funding the Project, which requires that all tenants comply with certain age requirements, disability requirements or that all tenants must be homeless. This would be the case if the Project obtained funding from the HUD Section 811 program, which requires all tenants to be disabled.

Proposed Section 111

Section 111 sets forth the application process and procedure for the Department to be able to process the Restructuring request. The documents listed in subsection (a) are not all-inclusive. The documentation requirements will vary, depending on the type of Restructuring that is being requested. If the Sponsor is only requesting an extension of the Project loan, there will be fewer requirements. For a complex refinancing, resyndication, and rehabilitation, there will be quite a number of documents required, all of which have to be reviewed and approved by the Department before the new Department loan documents can even be drafted. All required documents must be submitted before the Department can evaluate compliance with the requirements of Chapter 3.9. Sponsors are urged to submit all the required documents as early as possible, especially since many Projects have the exact same deadlines imposed by other funding sources, such as the tax credit deadlines. The Department needs to impose a “first-come, first-served” policy concerning which Projects receive review of their documents first, in the event that two or more Projects have deadlines at the same time. Since the number of requests the Department may receive for Restructuring is difficult to predict sufficiently to have processing times set forth in these guidelines, the Department will set minimum processing times on its website, so that Sponsors are aware of how much time they need to allow for the Department to review and approve the Restructuring.

Subsection (c) requests that applications be submitted six months prior to the maturity date of the Department's loan in order to be completed prior to the maturity date. However, if applications are not submitted six months prior to the maturity date, this will not prevent the Department from processing the Restructuring, although it may not be completed prior to the maturity date. <u>The Department is not barred from processing applications after the maturity date of the Department's loan.</u>

Subsection (e) notes that the Department will use documents previously submitted concerning the Project's operations, such as previous annual reports and schedules of rental income, in evaluating the request.

<u>Proposed Section 112</u>

Section 112(a) is necessary because the statutory requirement represents a departure from the Uniform Multifamily Regulations, which require replacement reserve deposits to be based on 55 years of replacement costs.

Section 112 (b) and (c) of the proposed guidelines note a difference from the Uniform Multifamily Regulations. Given that the Department has had a long history with the Projects that are being Restructured, and has a great deal of data concerning these Projects, including the actual commercial income and actual operating expenses, the Department will require the projected operating expenses to be based on the actual past operating costs. Due to the fact that the Projects are being improved and made more water and energy efficient, the Department will expect that certain operating expenses will be lower.

Section 112(d) sets forth the Department's acknowledgement that there are no new funds being contributed by the Department to Projects being Restructured. Thus, if there are no Special Rent Increases, there is no reason to restrict the debt service coverage ratio to the ratios that are applicable to new loans being made by the Department. If there are Special Rent Increases, however, the Department will limit the debt service coverage ratio to 1.20 to prevent enrichment by the Sponsor at the expense of higher rents to be charged to the very low-income tenants.

Section 112(e) clarifies that in the event of loss of project-based rental assistance, such as Section 8, the limitations on Rents contained in Chapter 3.9 will be waived, but only to the extent necessary for the Project to have income equal to the costs for operating, required debt service and reserve deposits, and in no event are the Rents permitted to exceed 30 percent of 50 percent of area median income.

Section 112(f) represents another departure from the Uniform Multifamily Regulations because Chapter 3.9 allows a higher developer fee. As long as Special Rent Increases are not requested, there is no limit on the developer fee by the Department. If there are Special Rent Increases, the developer fee permitted under Chapter 3.9 may be equal to the amount that the low-income housing tax credit program allows to be included in basis under the 9 percent tax credit rules. The developer fee is limited in Projects requesting Special Rent Increases so that the Rents are not increased in part to pay the developer fee.

Section 112(g) represents another departure from the UMRs, because Chapter 3.9 does not prohibit balloon payments on other lender loans. For Projects Restructured through Chapter 3.9, balloon payments may be permitted if the Project demonstrates that it has sufficient operating income, including through refinancing, to be able to support all required loan payments, which includes the ultimate balloon payment. This is intended to address the variability of the financial markets, and the fact that some Projects require such a small permanent loan that many lenders do not provide a 30-year, fully-amortizing loan product for such small principal amounts.

Proposed Section 113

Section 113 sets forth the fees to be charged by the Department for processing the Restructuring request and for the monitoring work required for the additional period of the extension of the Department loan and the staff work required to review the documents required for the Department to provide approval of the Restructuring transaction. The monitoring fee set forth in subsection (b) is based on an analysis of the current costs the Department incurs in providing asset management services for each Project in the Department's portfolio. The Legislature and the Department recognize that not all Projects have sufficient operating income to be able to pay this fee, and therefore the fee will be reduced or waived for Projects that are unable to pay, as stipulated in subsection (e). Due to reducing or waiving the monitoring fee for some Projects, the Department will need to charge a premium for Projects that can afford to pay the monitoring fee. The Department has determined that a 30 percent premium is necessary, as it anticipates that 30 percent of the Projects in its portfolio will not be able to pay the fee. The monitoring fee, which represents current costs, will not actually be charged until the maturity date of the original loan, which in many Projects is 30 years in the future. Due to the very long period of time that the fee will be collected, the monitoring fee will be inflated by 3 percent per year so that it keeps up with inflation.

The Department will permit the monitoring fee to be capitalized and paid up front, which may be preferable for Projects that are being resyndicated and have sufficient development sources to pay the fee at one time in advance. For those Projects, the Department will calculate the one-time fee using a discount rate of 2.18 percent, which is the average rate earned by the State Money Investment Fund ("SMIF") for the 10 year period from 2002 to 2012. This rate is the actual, average rate earned by the State for its funds in reserve, and is the most realistic and reasonable calculation of the required amount of a one-time fee in order to be the equivalent to an annual fee. As rates are likely to change over the years, the Department will reevaluate the average 10 year SMIF rate every five years to determine whether adjustments are required.

The Department will waive or allow reduced monitoring fees if there would be a negative impact on the extremely low-income households who occupy a particular Project. Among the types of Projects for which the Department will waive or reduce the monitoring fee are Group Homes, which are typically very small and are occupied by extremely low-income disabled households; Projects that are more than 50 percent occupied by Households with extremely low income Households; and Projects for which the Department's projections indicate there will be insufficient operating income to pay all required expenses for the next 15 years of the extended loan term.

The Department will charge a transaction fee of $40,000 for Projects that are being refinanced or resyndicated, plus an additional $10,000 for Projects that request an early Special Rent Increase. The Department will charge a lower transaction fee ($5,000) for Projects that are solely requesting an extension of the Department's loan. One thousand dollars of this amount is required to be paid at the time an application is submitted, and the remainder is required to be paid at the closing of the Department's loan. The reason for these amounts is that they reflect the actual costs for staff to process these different types of transaction requests. The reason for requiring a small portion of the fee to be paid at the time of application is to make sure applications are well planned and prepared so that they can be completed efficiently.

Proposed Section 114

Section 114 sets forth the requirements of Chapter 3.9, which states that after Restructuring, Projects will be required to comply with the Uniform Multifamily Regulations' and the MHP Regulations' requirements for use of cash flow, except as it pertains to payments that were received by local government lenders prior to the

Restructuring. The Department will evaluate the amount of payments made on the Project's local public agency loans the year prior to the Restructuring to avoid the local public agency suffering a loss of loan payments simply due to the change in the Department's loan terms. The proposed guideline also makes clear that commercial income is required to be included with the residential income, and that the residential income includes all units, including non-assisted units, for the purpose of calculating the total cash flow and the consequent required residual receipts payment on the Department's loan.

Proposed Section 115

Section 115 sets forth specific sections of the UMRs and the MHP Regulations that Restructured Projects are required to comply with after Restructuring The guidelines also reiterate the requirement of Chapter 3.9 section 50561(i) for Sponsors to submit a report listing tenant Household Incomes and Rents in Projects that are approved for Restructuring.