

**DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT  
DIVISION OF STATE FINANCIAL ASSISTANCE**

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**DATE:** January 3, 2023 (Amended August 8, 2023)

**MEMORANDUM FOR:** Interested Parties

**FROM:** Jennifer Seeger, Deputy Director  
Division of State Financial Assistance

Handwritten signature of Jennifer Seeger in blue ink.

Sasha Hauswald, Deputy Director  
Division of Federal Financial Assistance

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**SUBJECT:** Pooled Transition Reserve Policy

**ADMINISTRATIVE NOTICE NO. 23-01**

This Administrative Notice establishes a formal written notification of administrative guidelines and policies that affect the operation of the California Department of Housing and Community Development's ("HCD" or "Department") financing programs. This format is used to identify, clarify, and record administrative guidelines and interpretations of public interest.

**This Administrative Notice ("Notice") sets forth and establishes the California Department of Housing and Community Development's (HCD/Department) Pooled Transition Reserve Policy ("Transition Reserve Policy" or "Policy") applicable to all HCD state and federal multifamily loan programs, except in cases where this Policy conflicts with federal requirements.** This Notice implements and interprets statutory provisions made by SB 948 (Chapter 667, Statutes 2002) as codified by Health and Safety Code Section 50468 and constitutes guidelines. Health and Safety Code Section 50468 gave the Department authority to implement this statute by utilizing guidelines. Pursuant to Subdivision (f) of Section 50468, those guidelines are not subject to the requirements of Government Code Part 1, Division 3, Title 2, Chapter 3.5 (commencing with Section 11340). The matters set forth herein are regulatory mandates and are adopted in accordance with the authorities set forth below: "Quasi-legislative regulations ... have the dignity of statutes ... [and]... delegation of legislative authority includes the power to elaborate the meaning of key statutory terms..." Ramirez v. Yosemite Water Co., 20 Cal. 4th 785, 800 (1999).

This Notice applies to all HCD-awarded rental housing Projects which have federally originated rental assistance or operating subsidies, or rental subsidies operated by the City and County of San Francisco and the City or County of Los Angeles<sup>1</sup> which closed or will close permanent financing on or after January 1, 2023. This Notice also applies to HCD-awarded rental housing Projects that currently have a Project-Specific Transition Reserve (PSTR) that was funded for a

<sup>1</sup> HCD is including the rental housing subsidy program operated by the County of Los Angeles using its statutory authority under Health and Safety Code 50468(d)(3) to include "other means of rental assistance or operating subsidy identified by the department" as a qualified project rental or operating subsidy.

Project that closed permanent financing prior to January 1, 2023. This Notice does not apply to HCD-funded Capitalized Operating Subsidy Reserves.

This Notice takes effect as of January 1, 2023 and amends any active program guidelines and Notices of Funding Availability. After January 1, 2023, HCD will change the underwriting assumptions used for applications at the application review, construction loan closing, and permanent loan closing stages to comport with the Notice. The Department will update program guidelines consistent with this Notice. Such clarifying guideline amendments are forthcoming. A list of applicable programs, which may be amended from time to time as new programs are designed and implemented, is included as Appendix A.

## **Background**

Senate Bill No. 948 (Chapter 667, Statutes of 2022), codified as Health & Safety Code section 50468 (“Pooled Transition Reserve Fund Bill”), provided for the creation and administration of the Pooled Transition Reserve Fund to mitigate the impacts on tenant rents from the loss or exhaustion of a qualified project rental or an operating subsidy. In accordance with the requirements of the Pooled Transition Reserve Fund Bill, HCD has established this Transition Reserve Policy.

HCD’s rental housing programs encourage the development of Projects with rents that are affordable to low and extremely low-income residents. To ensure financial feasibility, these Projects often rely on project-based rental assistance such as HUD Section 8, VASH or similar programs. HCD’s previous policy has been to require each Project with such assistance to fund a transition reserve which is held for the term of the HCD loan. As an example, in Round 4 of the Multifamily Housing Program (“MHP”), PSTRs ranged from \$143,000 to \$800,000 and averaged \$300,000 per subsidized Project, for a total of \$5.8 million in reserves. Requiring each Project to fund a transition reserve increases the need for state funding, while mitigating an historically very low risk of termination or non-renewal of project-based subsidies. The creation of the Pooled Transition Reserve Fund will free up significant resources that can be used instead to increase production of affordable housing or cover the financing gap associated with construction cost and interest rate increases. At the same time, a pooled transition reserve will provide an effective mechanism to mitigate the impacts on tenant rents for a period of time if subsidies are lost.

By eliminating project-funded transition reserves, these funds will be available to further the state’s goal of increasing the availability of multifamily housing for low and extremely low-income residents. It will also eliminate the requirement to hold these reserves, which are rarely drawn upon, for the term of the HCD loan, which sidelines millions of dollars for several decades.

## **The Policy**

As of the date of this Notice, the Department’s Transition Reserve Policy will be as follows:

1. This Policy applies to all permanent loan closings that occurred or will occur on or after January 1, 2023.

2. HCD shall not require a Project-Specific Transition Reserve (PSTR) for any unit which has federally originated rental assistance or operating subsidies, or rental or operating subsidies operated by the City and County of San Francisco and the City or County of Los Angeles.
3. The Pooled Transition Reserve Fund will be held by HCD and is initially capitalized at \$5 million from the Housing Rehabilitation Loan Fund.
4. Projects that do not pay the Transition Reserve Fee and contribute to the Pooled Transition Reserve (PT-R) shall not be permitted to access funds from the PT-R.
5. Projects with operating subsidy from the City and County of San Francisco's Local Operating Subsidy Program ("LOSP") may opt out of the PT-R provided that the City and County of San Francisco continues to fund a LOSP Transition Reserve of at least 10 percent of the total annual LOSP contract encumbrance and continues to provide priority access to the LOSP Transition Reserve to Projects with capital from HCD programs that are governed by the Uniform Multifamily Regulations ("UMRs").
6. Projects with project-based rental assistance from federal sources or from a local rental housing subsidy program operated by the City or County of Los Angeles, Projects with operating subsidy from the City and County of San Francisco's LOSP that do not opt out of the PT-R, and Projects receiving rental or operating assistance from any other local rental housing subsidy program operated by the City and County of San Francisco shall pay a one-time Transition Reserve Fee at permanent loan closing which is deposited to the Pooled Transition Reserve Fund. Projects that only receive HCD funding through the Portfolio Reinvestment Program shall not be required to pay the Transition Reserve Fee.

For Projects where the assistance is structured as an annual subsidy, the fee is 15 percent (15%) of the first year's maximum subsidy amount.<sup>2</sup> The calculation and an example are as follows:

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<sup>2</sup> Based on an analysis of Projects funded through Round 4 of the Multifamily Housing Program (MHP), Round 4 of the No Place Like Home program (NPLH), Round 6 of the Veterans Housing and Homelessness Prevention program (VHHP) and Round 6 of the Affordable Housing and Sustainable Communities program (AHSC), the annual revenue from a Transition Reserve Fee of 15 percent of one year of subsidy on each Project would be sufficient to cover a situation where the 5 percent of subsidized Projects with the highest annual rental or operating subsidy lost their subsidies in the same year, and also to cover HCD's costs to implement the Pooled Transition Reserve (as required by statute).

While historically fewer than 5 percent of subsidized Projects have lost their subsidy each year, the overall number of Projects that HCD is funding and the percentage of funded Projects that receive rental or operating assistance have both increased significantly in the last few years. This in turn increases the likelihood that one or more Projects will lose their subsidy in any given year. Indeed, HCD has seen an uptick in Projects losing their subsidy in the past few years.

In addition, the Pooled Transition Reserve Fund also covers Projects that receive local operating subsidies from the City and County of San Francisco and the City or County Los Angeles, where there is less certainty about whether funding will be appropriated annually and whether the short-term (roughly 15 year) operating subsidies will be renewed. In fact, the Los Angeles program is so new that no Project has yet to apply for renewed operating subsidies, so there is no track record

First year's maximum rental subsidy:	\$1,053,460
X percentage of rental subsidy	<u>15%</u>
=Transition Reserve Fee amount	\$158,019
Original capitalized transition reserve:	\$801,956
Less Transition Reserve Fee	<u>\$158,019</u>
Savings realized by this change:	\$739,906

For Projects where the assistance is structured as a total subsidy to be apportioned over a number of years, the fee is 15 percent (15%) of one year's worth of the total operating subsidy. The calculation and an example are as follows:

Total operating subsidy amount:	\$8,500,000
/ number of years of operating subsidy	15
= One year's worth of operating subsidy	\$566,667
X percentage of one year's subsidy	<u>15%</u>
= Transition Reserve Fee amount	\$85,000

7. If a third-party investor or lender requires a PSTR, HCD has the right, at its sole discretion, to waive the requirement for the Project to pay the Transition Reserve Fee if the terms of the third party's PSTR are acceptable to HCD. If HCD waives the requirement for a Project to pay the Transition Reserve Fee, any withdrawal from the PSTR shall be subject to HCD approval. If the fee is not waived, Project Sponsors must pay the Transition Reserve Fee as per this Transition Reserve Policy.
8. For Projects that have federally originated rental assistance or operating subsidies or funding from the local rental housing subsidy programs operated by the City and County of San Francisco and the City or County of Los Angeles, with loans that were underwritten prior to January 1, 2023 but will close permanent financing on or after January 1, 2023:
  - a. If the loan was underwritten with a PSTR, Project Sponsors have two options:
    - i. Option 1: The Project Sponsor may request to continue with the Project as previously underwritten (with the PSTR); HCD may grant or refuse that request at its sole discretion. HCD will grant requests in cases where a third-party investor or lender requires a PSTR, or in cases where the amount of the Transition Reserve Fee would be greater than the amount of the PSTR.
    - ii. Option 2: The Project Sponsor may opt to pay the Transition Reserve Fee rather than capitalizing the PSTR.

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of those subsidies being renewed.

This analysis included only half of the Projects funded in AHSC Round 6 because two years of revenue went out in one NOFA and the goal of the analysis was to approximate one year's worth of awards.

- iii. If the Project Sponsor opts to pay the Transition Reserve Fee, or if HCD refuses a Project Sponsor's request to continue with the Project as previously written and requires the Sponsor to pay the Transition Reserve Fee, the Sponsor may use any excess funds (the difference between the previously underwritten PSTR and the Transition Reserve Fee) for eligible Project costs or for supportive services. Sponsors should apply any excess funds to direct Project costs before applying them to the developer fee. If any excess funds remain after all eligible Project costs have been met, they will be treated as cost savings, with loan amounts reduced accordingly.
  - b. In the unlikely case that the loan was not underwritten with a PSTR because the calculation under the prior transition reserve requirements indicated that a PSTR was not required, Project Sponsors have two options:
    - i. Option 1: Participate in the PT-R by paying the Transition Reserve Fee as per this Transition Reserve Policy. To the greatest extent possible, the fee shall be paid out of the development budget. Any remaining fee which cannot be paid out of the development budget may be paid out of cash flow. The entire fee must be paid within five years.
    - ii. Option 2: Not pay the Transition Reserve Fee and therefore not be permitted to access funds from the Pooled Transition Reserve Fund.
9. Requests to close under the previous HCD transition reserve requirements will be considered on a case-by-case basis.
10. HCD will periodically review the financial state of the Pooled Transition Reserve Fund to determine whether the Transition Reserve Fee should be increased or decreased for future Projects.

### **Accessing the Pooled Transition Reserve**

Projects that contributed to the P-TR whose qualifying subsidy is terminated or exhausted and not renewed may withdraw and use funds from the P-TR subject to the following conditions:

1. The per-Project maximum limit for total P-TR withdrawals is the amount of one year's worth of subsidy as of the year the subsidy is terminated or exhausted and not renewed.
  - a. If the annual subsidy amount is higher at the end of its term than at the start of its term, the Project's limit will be the most current subsidy year total amount.
  - b. If the subsidy that is ending is a static amount, the total of one year's subsidy amount is the limit, regardless of inflation or increased expenses over time.
  - c. Future escalations of the terminated subsidy assistance and unrealized escalations, regardless of applicability or eligibility, of the terminated subsidy assistance will not be recognized in calculating a Project's maximum total draw amount from the P-TR.
2. The maximum draw amount attributable to a single operating year is equal to the total operating deficit for that year from all Project units resulting from approved Operating Expenses, mandatory debt service, and reserve deposits exceeding Operating Income.

3. If the full per-Project maximum limit is not drawn in one request, additional withdrawal requests may be made annually until the full amount has been withdrawn. Withdrawals may be requested no more than once every 12 months.
4. Draw requests must be submitted on the Reserve Withdrawal Request Form available on the Department's website and accompanied by the following documentation:
  - a. The Project's certified financial statement ("Audit") if available
  - b. The most recent Project budget
  - c. Schedule of Rental Income ("SRI")
  - d. Cost analysis for justification of withdrawal
  - e. Documentation of the loss of subsidy (termination, denial of extension, or exhaustion of funds) from the source entity that had provided the subsidy, including contact information at the source entity that had provided the subsidy for the Department's independent verification
  - f. Any other documentation required by the Department
5. In the event an Audit is not recent or available, the Department may still issue a disbursement of funds from the P-TR to the Project under the following conditions:
  - a. All other documentation noted above must still be submitted.
  - b. The next subsequent Audit submitted by the Project must document the revenue shortfall that created the need for the P-TR funds, as well as the use of the funds.
  - c. The Department will review the Audit and other documentation to confirm the need for and use of the funds. If the disbursement of funds to the Project is determined to have been more than needed by the Project for eligible uses, the Sponsor shall be notified and shall promptly repay to the Department the excess funds disbursed.
6. Upon receipt of a withdrawal request, the Department will review the requested documentation for the Project to determine the need for funds. A response will be sent to the Sponsor to communicate the Department's decision. The Department will endeavor to approve requests within 30 days from documented receipt of the request. If the request for funds is approved, regardless of the amount, the Department will request the funds from the State Controller's Office ("SCO"), which retains the immediate control of the funds. SCO will send a check to the Sponsor. The Department is not able to control the timeframe for SCO procedures.
7. The receipt and subsequent use of all funds from the P-TR should be noted in the following fiscal year's Audit submitted annually by the Project. If the Audit verifies that more funds were disbursed by the Department from the P-TR to the Project than needed by the Project, the Project must return the excess funds to the Department. The Department may, at its sole discretion, reconcile the amount disbursed with the Project's continued need for P-TR funding in the next fiscal year, up to the total amount of funds the Project is eligible to receive. The Project must acknowledge this requirement as part of the withdrawal request.
8. The Project shall include information in the following fiscal year's SRI indicating the efforts to maintain affordable rents and mitigate increases to the rents for the units that had been eligible for subsidy. Increases in rent above the permitted rents for the previously approved

Area Median Income (“AMI”) levels (which may be referred to as “float-up provisions”) will not be permitted until the P-TR funds for those units are exhausted, and then changes in AMI levels may only be permitted to the extent necessary to achieve fiscal integrity as determined by the Department in accordance with the HCD regulatory agreement and/or other funding source requirements.

### **Opting Into the Pooled Transition Reserve**

Beginning January 1, 2024, Projects that currently have a PSTR that was funded for a Project that closed permanent financing prior to January 1, 2023, shall be eligible to opt into the Pooled Transition Reserve (P-TR).

1. A Project will only be eligible to opt into the P-TR under the following conditions:
  - a. the Project has never drawn funds out of their PSTR; and
  - b. the Project Sponsor has no outstanding compliance issues with the Department.
2. A Project that opts into the P-TR will be permitted to access the P-TR starting twelve (12) months after the opt-in is approved in writing by HCD. HCD may waive this requirement at its sole discretion.
3. Sponsors of a Project wishing to opt into the P-TR must submit a request to HCD (in a manner prescribed on a form(s) provided by the Department, and disseminated on the HCD website, as may be amended from time to time) and receive HCD’s prior written approval. Please submit your request to your Project’s Asset Management and Compliance Fiscal Representative and to [AMCBranch@hcd.ca.gov](mailto:AMCBranch@hcd.ca.gov) no less than 90 days before you need to use the excess funds liquidated from the PSTR.
4. Opting into the P-TR will liquidate the PSTR. The Project Borrower, Sponsor and all entities in the ownership structure of the Borrower, as well as all junior or senior lienholders on the Project, must certify that such liquidation is being allowed by their respective authorized signers (Resolutions will be required), and will not jeopardize the fiscal integrity and financial feasibility of the Project (as defined in the Project’s Regulatory Agreement and the UMRs) nor any federal or state tax credits associated with the Project.
5. All requests to access funds liquidated from the PSTR (for use in paying the Transition Reserve Fee and for transferring to the Project’s replacement and/or operating reserve accounts) must be submitted to and approved by HCD, using the Reserve Withdrawal Request Form.
6. After payment of the Transition Reserve Fee, all remaining funds from the PSTR must be transferred to (accounted for as part of) the Project’s operating reserve and/or replacement reserve, and proof thereof submitted to HCD. All such funds shall remain with the Project to be used for eligible Project costs.
7. Under no circumstances may funds liquidated from the PSTR be used for or in connection with a limited partner buyout, substitution, or assignment of ownership interest, neither during an operating (fiscal) year nor at any potential restructure or resyndication transaction.

## Appendix A

### Transition Reserve Policy Listing of Applicable Programs

The Pooled Transition Reserve Policy applies to all multifamily loan programs administered by the Department, and includes, but is not limited to, the list below. For programs that provide funding in the form of both loans and grants, the policy applies only to loans.

- Affordable Housing and Sustainable Communities Program (“AHSC”)
- Multifamily Housing Program (“MHP”)
- Housing for a Healthy California Program (“HHC”)
- Veterans Housing and Homelessness Prevention Program (“VHHP”)
- Joe Serna, Jr. Farmworker Housing Grant Program (“FWHG” or “Serna”)
- No Place Like Home Program (“NPLH”) – HCD administered competitive and non-competitive allocations
- Transit-Oriented Housing Development Program (“TOD”)
- California Housing Accelerator Program (“ACC”)
- Community Development Block Grant – Disaster Recovery (“CDBG-DR”)
- Home Investment Partnerships Program (“HOME”) – non-entitlement HCD-administered program only
- HOME - American Rescue Plan (“ARP”) – non-entitlement HCD-administered program only
- National Housing Trust Fund Program (“NHTF”)
- Portfolio Reinvestment Program (“PRP”)\*

\* Projects that only receive HCD funding through the Portfolio Reinvestment Program shall not be required to pay the Transition Reserve Fee.