December 27, 2022

MEMORANDUM FOR: Interested Parties

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

ADMINISTRATIVE NOTICE: Notice Number: 22-08

SUBJECT: Transition Reserve Policy

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 Department’s Pooled Transition Reserve Fund 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 statutory changes made under SB 948 (Chapter 667, Statutes of 2002) applicable to Health and Safety Code Section 60468. 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 of Los Angeles which will close permanent financing on or after 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. Amendments of program guidelines to remove project-funded transition reserve requirements and additional guidance on how much funding projects that contribute to the Pooled Transition Reserve Fund will be eligible to request to withdraw from the Pooled Transition Reserve Fund and under what circumstances will follow. 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”), project-specific transition reserves 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 occur on or after January 1, 2023.

2. HCD shall not require a project-specific transition reserve for any unit which has federally originated rental assistance or operating subsidies, or rental subsidies operated by the City and County of San Francisco and the City of Los Angeles.

3. The Pooled Transition Reserve Fund will be held by HCD and is initially capitalized at $5 million dollars from the Housing Rehabilitation Loan Fund.

4. Projects that do not pay the Transition Reserve Fee and contribute to the Pooled Transition Reserve Fund shall not be permitted to access funds from the Pooled Transition Reserve Fund.

5. Projects with operating subsidy from the City and County of San Francisco’s Local Operating Subsidy Program (LOSP) may opt out of the Pooled Transition Reserve Fund 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 of Los Angeles, projects with operating subsidy from the City and County of San Francisco’s LOSP that do not opt out of the Pooled Transition Reserve Fund, 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.

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.\(^1\) The calculation and an example are as follows:

\[
\begin{align*}
\text{First year’s maximum rental subsidy} & : \quad 1,053,460 \\
\times \text{percentage of rental subsidy} & : \quad 15\% \\
= \text{Transition Reserve Fee amount} & : \quad 158,019
\end{align*}
\]

\[
\begin{align*}
\text{Original capitalized transition reserve} : & \quad 801,956 \\
\text{Less Transition Reserve Fee} : & \quad 158,019 \\
\text{Savings realized by this change} : & \quad 739,906
\end{align*}
\]

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:

\[
\begin{align*}
\text{Total operating subsidy amount} : & \quad 8,500,000 \\
/ \text{number of years of operating subsidy} : & \quad 15 \\
= \text{One year’s worth of operating subsidy} & : \quad 566,667 \\
\times \text{percentage of one year’s subsidy} & : \quad 15\% \\
= \text{Transition Reserve Fee amount} & : \quad 85,000
\end{align*}
\]

7. If a third-party investor or lender requires a project-specific transition reserve, 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 project-specific transition reserve are acceptable

\(^1\) 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 Pooled 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 cities of San Francisco and 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 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.
to HCD. If HCD waives the requirement for a project to pay the Transition Reserve Fee, any withdrawal from the project-specific reserve fund 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 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 project-specific transition reserve, project sponsors have two options:

   i. Option 1: The project sponsor may request to continue with the project as previously underwritten (with the project-specific transition reserve); HCD may grant or refuse that request at its sole discretion; or

   ii. Option 2: The project sponsor may opt to pay the Transition Reserve Fee rather than capitalizing the project-specific transition reserve.

   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 project-specific transition reserve 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 project-specific transition reserve because the calculation under the prior transition reserve requirements indicated that a project-specific transition reserve was not required, project sponsors must pay 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.

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.

Attachment

- Appendix A
Appendix A
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”)
- National Housing Trust Fund Program (“NHTF”)
- Portfolio Reinvestment Program (“PRP”)