Cost Control and Safe Harbor Standards

for Section 8 Projects under Choice Neighborhoods Program

November 2015

In order to expedite the review process and control costs for Section 8 projects that also involve Choice Neighborhoods funding, HUD is instituting safe harbor and maximum fee ranges for a number of costs, similar to the standards that have been in effect for mixed-finance public housing development since 2003. In addition, HUD has provided guidance on several development issues. Unless otherwise noted, the Cost Controls and Safe Harbors Standards (Cost Controls) apply only to Choice Neighborhoods replacement units developed as part of specific projects and project phases for existing and future Choice projects involving Section 8, both Project Based Rental Assistance (PBRA) and Project Based Vouchers (PBV) for which a term sheet has not been submitted as of the date of this document. These guidelines do not address requirements under the Rental Assistance Demonstration (RAD).

These policies were developed in consultation with Choice Neighborhoods grantees, HUD staff, and industry representatives. Where program areas each have standards, the Choice standard or the more stringent standard shall apply, unless otherwise noted here. HUD will continue to review these policies, based on experiences reported by grantees and other program participants, and may make revisions to the standards in the future. Any such future revisions would become effective at time of amendment.

HUD's Cost Controls are contained in the following chart. The chart provides a brief definition of each term, lists the safe harbor and maximum allowable fees, and briefly describes the risk factors or circumstances that may result in a fee above the safe harbor standards. These guidelines should be used by grantees, developers, and consultants when negotiating terms and drafting documents for HUD review.

If a project item, as presented in the below text table, is at or below a safe harbor standard, no further review will be required by HUD. If a project is above a safe harbor standard, additional review by HUD will be necessary. In order to approve terms above the safe harbor, the Choice Neighborhoods grantee must demonstrate to HUD in writing that the negotiated terms are appropriate for the level of risk involved in the project, the scope of work, any specific circumstances of the development, and the local or national market for the services provided.

Cost Control and Safe Harbor Standards

Item	Defining Criteria	Safe Harbor	Maximum
Net Developer Fee for Rental Section 8 Choice Neighborhoods Developments **(Developer Fee and Overhead**)	The safe harbor and maximum standards apply to the net developer fee, i.e., the portion of the developer fee received by the developer to cover overhead and profit. Net developer fee is expressed as a percentage of the total development/ project costs. Project costs are defined as all hard and soft costs of constructing a particular component with the **exclusion** of the following: • Third-party costs paid by the grantee under contracts entered into directly by grantee and third parties, which will not be reimbursed to grantee at a mixed-finance closing (e.g., where the grantee contracts separately for demolition services); • The developer fee itself; • All costs related to family self-sufficiency and resident relocation activities; and, • All reserve accounts regardless of how characterized, including start-up reserves, operating deficit reserves, capital improvement reserves, initial operating period reserve, Reserve for Replacement and Initial Deposit to Replacement Reserve, etc. Payments to developers such as "deferred developer fee" are considered part of the fee/overhead amount. Developers may receive up to a 1% additional fee (within the original cap of 12% developer fee) if cost savings are realized. This 1% incentive fee must be paid from non-Choice Neighborhoods and non-HUD funds.	The lesser of the state allowed maximum or 9% or less of the total development/project costs (profit and overhead); projects that do not have both LIHTC and Choice financing should have fees well below 9%.	12% of the total development/project costs (profit and overhead). Fees above 12% will be considered only if allowed by the State Housing Finance Agency **and** with significant justification from the grantee and developer demonstrating the increased risk.

* The safe harbor and maximum guidelines assume the net developer fee excludes any portion of the fee received by the developer or co-developer (including a grantee) that is returned to the project to fund operating reserves or to cover project costs.

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Item	Defining Criteria	Safe Harbor	Maximum
	Developers with fees above the safe harbor standard should meet most or all of the following risk factors: • Developer guarantees are for large dollar amounts in proportion to project size and/or long terms; • Developer independently obtains financing, including tax credits (fee increases with both amount of financing and number of sources); • Developer obtains site control from an entity other than grantee (fee increases with number of sites); • Project is small (i.e., total of 50 units or less); • Project is complex (e.g., in financial, legal, environmental, and/or political terms); • Project contains units without operating subsidy (i.e., market-rate or LIHTC-only units); • Developer bears more than 25% of the predevelopment costs (until reimbursement at closing); and/or • The Developer Fee is deferred (paid out of positive cash flow). All criteria apply to both for-profit and non-profit developers.		

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Item	Defining Criteria	Safe Harbor	Maximum
Pay-Out Schedule for Developer Fee/Overhead	Neither Choice Neighborhoods funds, Section 8 funds nor other public housing funds may be used for payment of developer fee/overhead. The financing plan must demonstrate both that all sources of funding are committed, and that the uses meet program requirements. HUD recommends the following limit on the pay-out schedule, to the extent that non-HUD funds are available, by phase: • Closing: Not to exceed 50% of the fee/overhead amount. • Construction Completion: 25% of the fee/overhead amount. • Stabilized Occupancy: 25% of the fee/overhead amount. Where there are state pay-out requirements, HUD will evaluate to ensure that the pay-out schedule meets the above program requirements. Any differences will be addressed on a case-by-case basis. A portion of the fee can be further deferred. On a case-by-case basis, HUD will consider advancing the developer funds where there is an extended predevelopment period caused by such external factors as environmental remediation, consent orders, etc. If HUD determines such an advance is warranted, HUD will advance up to 15% of the total developer fee/overhead amount to the developer prior to closing using Choice Neighborhoods or other HUD funds.	Within recommended pay-out schedule.	Payments of greater than 50% at closing or less than 25% at stabilized occupancy will be closely scrutinized.
Contractor Fee	• Percentages are based on hard construction cost. • General Conditions include the bond premium.	Overhead: 2% Profit: 6% General Conditions: 6%	14% is the maximum for these combined costs provided that the grantee justifies why the 2/6/6 percentages for the individual costs cannot be met.

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Item	Defining Criteria	Safe Harbor	Maximum
Grantee Administrative/ Consultant Costs	• Costs should reflect only actual documented expenditure of time and overhead cost (supplies, equipment, telephone, etc.) • Such costs include both in-house staff time and outside consultants (program manager, development advisors, relocation specialists, etc.), but **exclude** outside legal and community and supportive services costs. On the HUD budgets, these costs may be captured under multiple BLIs. • This cap applies to Choice Neighborhoods grantees. HUD will continue to evaluate whether this cap is reasonable and does not hamper the grantee's ability to implement the grant. • If grantee is also developer, then safe harbor and maximum standards shall be as stated here.	3% of the total project budget (basis includes all hard and soft development costs excluding Supportive Services/People and Critical Community Improvements expenses). If grantee is also developer, then safe harbor standard shall be 2% of the total project budget.	6% of the total project budget (basis includes all hard and soft development costs excluding Supportive Services/People and Critical Community Improvement expenses). If grantee is also developer, then maximum standard shall be 4% of the total project budget.
Sharing of Third-party Pre-development Costs	HUD recommends the following cost-sharing schedule: • Grantee and Developer split third-party costs 75/25. • Developer's share of third-party costs (25%) will be reimbursed at closing out of available sources. Costs to be shared are all third-party costs under the developer's scope of work (e.g., A/E, market study, financing fees, etc.) incurred during the predevelopment period. HUD funds may not be used to reimburse developer legal counsel prior to closing, and developer legal costs do not contribute to the developer's share of third-party costs. Exceptions to the schedule may be made for small, local, non-profit, and/or minority/disadvantaged firms on a case-by-case basis.	Costs are shared up to 75% by the grantee and at least 25% by the Developer.	N/A

Cost Control and Safe Harbor Standards

Item	Defining Criteria	Safe Harbor	Maximum
Equity Raise and Pay-In Schedule	For equity pay-ins for LIHTC transactions that involve FHA, the Multi-Family Accelerated Processing (MAP) guidelines for minimum equity pay-in apply. For other projects, HUD will not adopt a safe harbor equity raise or standard pay-in schedule, as these are highly competitive, market-driven numbers.	Market conditions, except as noted.	N/A
Identity of Interest Parties	• Identity of interest parties are those that share an ownership or financial interest. Identity of interest relationships are most common between a developer/owner and construction management, general contractor (GC), private management firm, and/or investor. • Grantees are required to ensure cost competitiveness through existing procurement policies/practices. • Where a developer and GC have an identity of interest, HUD will approve use of the GC in conjunction with the project's approval. • While the use of related or preferred entities as investors is permitted, HUD recommends that grantees document that the yield is competitive through market analysis and pricing comparisons among alternative service providers.	N/A	N/A

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Item	Defining Criteria	Safe Harbor	Maximum
Property Management Fees	• Can be defined on a percentage of gross income or per-unit per month (PUM) basis. • If using the PUM basis for fee, fees should drop for vacant units. • Fees may increase with higher-risk projects, such as small projects.	a) 6% effective gross income or, b) a flat PUM fee for occupied units that is supported by the local project-based Section 8 program in the area (use Field Office guidelines) or, c) 6% of imputed tax credit rent for public housing units that are tax credit units.	Proposals above the safe harbor will be closely scrutinized; higher fees will require significant justification.

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Item	Defining Criteria	Safe Harbor	Maximum
Legal Fees	• Largely independent of the size of the phase. • Attorneys should be used for legal functions. • Legal fees should be tied to a scope of work, which should be monitored. HUD will review grantee legal costs when reviewing Choice Neighborhoods development budgets. • In order to reduce costs and provide an incentive to reach closing, HUD funds may not be used to pay developer legal costs prior to closing. The procurement regulations state that for any RFP, the grantee must undertake a cost or price analysis prior to receipt of proposals.	No express limit; HUD funds may not be used to reimburse developer legal counsel prior to closing. All legal costs will be reviewed by HUD.	N/A
Reserves	• HUD is not establishing maximum or minimum levels of reserves to be maintained, as appropriate reserve levels depend upon the specific project and investor requirements. • Choice Neighborhood funds and other public housing funds may not be used to initially fund reserve accounts, with the exception of establishment of an Initial Operating Subsidy Reserve. • Choice Neighborhood funds and other public housing funds may not be used to fund an Exit Tax Reserve. • Choice Neighborhood funds, public housing and Section 8 funds in all reserve accounts must be tracked separately. • Choice Neighborhood funds, public housing and Section 8 funds in all reserve accounts must remain with the project if sold/ transferred or returned to a public entity grantee. • MAP guidelines for FHA insured projects require a Working Capital Deposit of 4% of the loan amount and an Operating Deficit equal to the greater of 3% of the loan amount or 4 months debt service.	N/A	N/A

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Item	Defining Criteria	Safe Harbor	Maximum
Maximum Amount of Choice Grant funds per Unit	Limit on Choice grant funds per unit will be determined as follows: Maximum grant = Total development cost (TDC) minus supportable debt, where Supportable Debt = lesser of Fair Market Rent (FMR) or local tax credit limits for 60% AMI, less a 5% vacancy factor, minus per unit operating cost per HUD Multi-Family Aggregate Report equals net operating income, divided by minimum debt coverage ratio, then divided by mortgage constant. Costs based upon the TDC for the bedroom mix (1 bedroom, 2 bedrooms, etc.) of the project/phase. Debt service based upon prevailing FHA 221(d)(4) loan terms, plus 300 basis points (currently 40 year term/amortization; 3.95% plus 300 basis points) equals 4.25% interest. See accompanying appendix for sample calculation.	As stated here.	In extraordinary circumstances, amount above safe harbor can be considered, in HUD's discretion, and with supporting documentation.
Debt Coverage Ratio (DCR)	The minimum DCR will be the FHA debt coverage ratio, which is currently: 1.11 DCR for projects with 90% or greater rental assistance 1.15 DCR for projects that meet the attached MAP guidelines definition of qualifying housing	The safe harbor shall equal the FHA standard, which is currently as stated.	The maximum DCR, per subsidy layering requirements, is 1.45. Any alternatives to this DCR standard shall be considered on a case-by-case basis.

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Appendix
Glossary of Selected Terms

MAP Guidelines:
Multifamily Accelerated Processing (MAP) is designed to establish national standards for approved lenders to prepare, process and submit loan applications for Federal Housing Administration (FHA) multifamily mortgage insurance. The MAP Guide provides - in one volume with appendices – guidance for HUD staff, lenders, third party consultants, borrowers, and other industry partners. Topics include mortgage insurance program descriptions, borrower and lender eligibility requirements, application requirements, underwriting standards for all technical disciplines and construction loan administration requirements. The MAP Guide only applies to FHA multifamily mortgage insurance programs.

MAP Guidelines Debt Coverage Ratio (DCR) Qualifying Housing Definition:
For purposes of MAP DCR guidelines, qualifying housing is defined as projects meeting both of the following requirements:

(a) projects that have a recorded Regulatory Agreement with rent and occupancy restrictions or a Project-Based Section 8 contract for 90% of the units, that will be in effect for at least 15 years after Final Endorsement, and

(b) projects that meet at least the minimum LIHTC restrictions of 20% of units at 50% of area median income (AMI), or 40% of units at 60% of AMI, with economic rents (i.e. the portion paid by the residents) on those units no greater than LIHTC rents.

Projects (for example mixed income properties or properties with subsidies other than Project-Based Section 8) need not use LIHTCs to qualify for affordable underwriting so long as they have, and are in compliance with, a recorded Regulatory Agreement imposing the minimum low income occupancy and restricted rent tests above, with a term of at least 15 years after Final Endorsement. The recorded Regulatory Agreement must be imposed, monitored and enforced by a governmental agency.

Total Development Cost (TDC):
Total Development Cost (TDC) refers to the use of HUD public housing funds as applied toward the cost of developing a public housing project (or the public housing units in a mixed finance project), including costs associated with administration, professional services, relocation, demolition and abatement, infrastructure improvements, as well as the actual cost of construction of improvements to the property.

"TDC Limit" refers to the maximum amount of such funding that HUD will approve for development of specific public housing units in a given location. Note, however, that because the TDC limit applies only to the costs of development of public housing that are paid directly with HUD public housing funds, a PHA may exceed the TDC limit using non-public housing funds such as CDBG, HOME, low-income housing tax credit equity, private donations, and private financing. TDC limits for new construction are published regularly by HUD for various building types and unit sizes (by number of bedrooms) in specific market areas. Determination of the TDC limit for a project is made by multiplying the HUD-published TDC limit applicable to each type and size public housing unit in the project, by the number of such units in the project. Non-public housing units are excluded from the calculation of TDC limits. Rehabilitation costs paid directly from HUD public housing sources are calculated using 90 percent of the published TDC limits for new construction, based on the number of public housing units after rehabilitation and reconfiguration.

Hypothetical example: Maximum Amount of Choice Grant Funds per Unit

As an illustration, below is a sample calculation of the maximum Choice grant award for a two-bedroom unit in a hypothetical PHA.

Maximum grant = Total Development Cost (TDC) minus supportable debt

Supportable debt =net operating income, divided by minimum debt coverage ratio (DCR), divided by mortgage constant

Net operating income = lesser of Fair Market Rent (FMR) or local tax credit limits for 60% Area Median Income (AMI), less a 5% vacancy factor, minus operating costs

Assumptions:

Total Development Cost (TDC)	$212,579
Fair Market Rent (FMR)	$1,415
60% Tax Credit Rents	$1,210
Vacancy allowance (5%)	$60.50
Operating Expense	$655
Loan Terms:	
Term	40 years
Interest rate: FHA 221(d)(4) rate	3.95%
plus 300 basis points	0.30%
Loan interest rate	4.25%
Mortgage constant	0.05203

Calculation:

Net Operating Income (NOI)	$1210-$60.50-$655=$495
Net Cash Flow for Debt	$495/1.11=$445
Supportable Debt	$445*12/0.05203 = $102,747
Choice grant limit	$212,579-$102,747 = $109,832

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Data Sources:

TDC	HUD published data
Tax credit rents	Published sources
Operating Expense	HUD Multi-Family data
Debt Coverage Ratio	FHA guidelines
Interest Rate and Term	221(d)(4) rate/term
Mortgage Constant	Published sources