



# Rental Assistance Demonstration Conversion Guide for Public Housing Agencies

This RAD Conversion Guide (Guide) is intended to assist public housing agencies (PHAs) as they prepare to apply for conversion of assistance under the Rental Assistance Demonstration (RAD) pursuant to PIH Notice 2012-32 (Notice).<sup>1</sup> Accompanying the Guide is an Excel-based RAD Inventory Assessment Tool (Tool) available on the RAD website to help PHAs conduct first-level assessments of which properties in their inventory might prove to be viable candidates for conversion of assistance under RAD. The Guide and Tool are intended only as planning aids for PHAs. In the event of any discrepancy among the Guide or Tool and the RAD Final Program Notice, the provisions of the Notice govern. For more complete information and supporting materials on RAD, visit the RAD website at [www.hud.gov/rad](http://www.hud.gov/rad).

The Guide is organized in five phases:

- (1) Planning;
- (2) Identifying RAD projects: Building a preliminary Operating Budget and a preliminary Development Budget;
- (3) Resident Protections and Choice Mobility;
- (4) Assembling Your Development Team; and
- (5) Confirming Financing Partners.

The companion Tool will be most useful in Phase 2. The process of preparing to apply for RAD is likely to be an iterative one, wherein initial judgments are later reshaped or superseded as information about a potential project develops. For example, a lender's underwriting process may result in a different loan size or terms than was projected in initial discussions with the lender. This is fairly common in developing affordable housing, and may result in rethinking the financial structure of a project, or rejecting it in favor of another more viable project.

## **PHASE 1: PLANNING**

### **Become Familiar with the Notice**

PHAs should note the basic limitations on applications per PHA and the measures intended to ensure that RAD attracts applications from all regions and sizes of PHAs. While there is no cap on the number of projects for which a PHA can apply for under RAD, and no fee for applying for multiple projects (or for withdrawing applications), PHAs should consider the following in developing applications:

- All applications must evidence financial feasibility, i.e., the PHA must reasonably identify all of the financing to meet a project's indicated needs.

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<sup>1</sup> Check the RAD website for updates on the status of the RAD Application.



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- No PHA may be awarded more than 1,000 units of authority to convert assistance under RAD (with the exception of up to 4,000 units accorded the New York City Housing Authority due to its size).
- If a PHA has only a few projects in its public housing inventory, it may want to consider applying to convert assistance for all projects so that, if awarded, it could consolidate programs.
- If a PHA is submitting multiple applications, it can identify a “priority project.” Small PHAs, defined as having fewer than 250 public housing units may designate all projects as “priority” projects.
- PHAs will compete only with other PHAs of similar size and in the same geographic region. As a result, HUD expects that a wide variety of PHAs will be competitive for RAD awards.
- Applications that are submitted during the Initial Application Period will be reviewed and selected before any applications submitted during the Ongoing Application Period are considered. If complete applications that are submitted during the Initial Application Period exceed the 60,000 units HUD is authorized to convert, it is possible that no projects submitted during the Ongoing Application Period will be selected.

### Schedule Planning Meetings & Other Long Lead-Time Items

Applications under the Initial 30-Day Application Period are due October 24, 2012. At a minimum, PHA staff should plan now to schedule and conduct an agency Board meeting prior to then, as the Board is required to approve the submission of the RAD application. Such a meeting also provides an opportunity for the staff and Board to address all matters related to a potential application. PHAs should note that if selected for award, they will have 60 days following the award to submit a Significant Amendment to its Annual/5-Year Plan.

Other events that potential applicants should consider early in the application process include:

- **Identification of Potential Lenders or Investors.** For any source of debt or equity, other than contributions from the public housing agency itself, a PHA will be required to provide a Letter of Interest/Intent from the sources in the Application. PHA staff or consultants should begin now to identify and meet with potential lenders/investors to satisfy this requirement.
- **Resident Meetings.** Prior to submitting an Application, a PHA must hold two resident meetings at the proposed project(s) and then summarize the comments received and responses provided. While a PHA might not know which project(s) it will apply for at this stage, staff should plan now for the associated logistics.
- **Physical Conditions Assessment (PCA).** For purposes of the application, a PHA is not required to have completed a RAD-compliant PCA. It can use its best estimate of capital



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needs. However, if awarded an initial commitment—or Commitment to enter into a Housing Assistance Payment (CHAP)—a PHA will have 90 days to submit the PCA. Accordingly, staff should plan early on for selecting an appropriate PCA provider.

### Determine if Properties Have Existing Debt

Most public housing properties are debt-free. However, some may have incurred debt, likely as a result of the following:

- Financing utility conservation measures (often through Energy Service Companies, or ESCOS);
- Participating in public housing’s Capital Fund Financing Program (CFFP), wherein the PHA may have pledged up to one-third of its future Capital Fund to support rehabilitation at a specific property or properties;
- Participating in a public housing Mixed-Finance transaction, including older HOPE VI projects (PHAs should note that only HOPE VI projects that had a Date of Funding Availability or DOFA prior to October 1, 2002 are eligible to apply under RAD).

Under RAD, a PHA is not released from any prior debt obligation. Consequently, PHAs should keep in mind that a new conventional mortgage lender is likely to require that any existing debt be subordinated to a new first mortgage loan that it may offer. At the same time, an existing lender or investor is unlikely to allow a new first-mortgage lien to be placed in a superior position to its existing lien(s). The best resolution to this situation may be for the PHA to pre-pay all existing property-level debts. This can likely be incorporated into the RAD financing structure and paid at the time assistance is converted under RAD and related financing is closed. However, this action will require negotiation with the existing lender, which is advisable to start as soon as possible.

### **PHASE 2: IDENTIFYING RAD PROJECTS — BUILDING PRELIMINARY OPERATING & DEVELOPMENT BUDGETS**

This is the Phase in which the Tool should prove helpful. Included with the Tool is information on “current funding” for each public housing project, based on 2012 subsidy levels, as well as estimated RAD contract rents.<sup>2</sup> The Tool includes complete instructions on its use.

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<sup>2</sup> In certain circumstances, a PHA may desire to convert a portion of a project. For example, assume that a PHA has a 150-unit project consisting of 100 units within an elderly high-rise building and 50 units of scattered-site family housing located in the surrounding neighborhood. The PHA might seek to convert only the scattered site properties (or, conversely, only the elderly high rise). Any such partial conversion must make sound business and real estate development sense (for example, a PHA would not be able to convert only the bottom two floors of the high rise). If a PHA is considering a partial conversion, it will need to indicate its plans in the RAD application. If



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Users are advised that the Tool is not intended to be a complete financial feasibility analysis. Rather, it can be used to provide a first-year snap shot of income and expenses for each PHA property or defined project in a PHA's inventory, and with that, an initial estimate of net operating income available to service debt. With this scan, PHA staff or consultants should be able to identify a project or projects that may lend themselves to a possible conversion of assistance under RAD. If identified in this way, PHAs should undertake a more complete, standard feasibility analysis of each such project prior to submitting an application. Applicants are not required to use the Tool, and it is intended only to identify potential properties for further analysis.

Important factors for PHAs to consider when building Operating and Development budgets for possible RAD transactions are outlined below. Additional information and standard underwriting terms are further described in each of the three Attachments to this Guide.

### **The Operating Budget: Income & Expenses**

#### ***RAD Rent Levels & Property Income***

Under the "current funding" premise of RAD, a public housing property's current income stream—as determined by its Operating Fund and Capital Fund subsidies and a recently-defined level of tenant rent contributions—are used in determining RAD contract rents. The RAD rent level will be set in a new long-term Section 8 Housing Assistance Payment (HAP) contract for any project selected for conversion of assistance under RAD, and the contract rent typically constitutes the bulk of a property's operating income.

One of the decisions a PHA needs to make in considering a RAD conversion of assistance is to choose between the two forms of Section 8 assistance offered under RAD: either (1) Project-Based Rental Assistance (PBRA), administered by HUD's Office of Multifamily Programs; or (2) Project-Based Vouchers (PBVs), which the PHA itself, or a partnering PHA, can administer. While a PHA must indicate in its application whether it plans to convert assistance to PBV or PBRA for a given project, if awarded a CHAP, it has until 60 days following CHAP issuance to change the decision. This flexibility allows a PHA's development team to discuss both options with prospective lenders and/or investors.

Some important considerations that can inform the choice of Section 8 assistance are summarized in Attachment A: Evaluating Income and Operating Expenses. PHAs should note that they will be required in the RAD Application to provide a "reasonable rent" determination to establish the applicability of rent caps for either PBV or PBRA. A Rent Comparability Study

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awarded, the PHA will then remove the affected units from the PHA's inventory (through PIC) at the time of conversion.



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(or, RCS) is not required for the Application. But PHAs may want to conduct an informal survey of nearby properties, especially those with unrestricted or market rents

PHAs will also want to consider their historical experience in estimating vacancy rates due to either physical vacancy or bad debt. This estimate should also take into account whether these factors might change with the conversion to RAD and a HAP contract. Finally, PHAs will want to consider whether, when the RAD rehabilitation/construction is completed, there will be any additional sources of income—such as laundry or vending income (see Attachment A).

### ***RAD Operating Expenses***

PHAs should thoroughly assess whether a property's current Operating Expenses will change significantly under a RAD conversion of assistance and associated improvements. Some factors to carefully consider, which are outlined in more detail in Attachment A, are whether:

- A project's historical operating expenses may have included some capital items, which will be addressed in construction budget or replacement reserves under a RAD conversion;
- Capital repairs, especially replacement of major systems or appliance, is likely to yield efficiency improvements in utility consumptions;
- A project's existing Payments in Lieu of Taxes (PILOT), although a condition of receiving assistance under an annual contributions contract with a PHA, is a matter that is otherwise governed by state and local law and must be determined on a property-by-property basis. Although HUD believes that in most cases PILOT provisions will continue to apply, the PHA is responsible for demonstrating if this is the case or not in its RAD Financing Plan. PHAs should consult local legal counsel to determine whether their PILOT agreement will continue to apply;
- PHA property management fees are paid as operating expenses under both PBV and PBRA similar to the way such fees are accorded under a Section 8 contract. Asset management fees and other fees (such as those allowed under PIH Asset Management as "add-ons") can be paid as operating expenses in PBV or out of cash flow in either PBRA or PBV.

PHAs are reminded that the Replacement Reserve called for in a RAD conversion of assistance, which is paid from project income, must be sized appropriately to address anticipated long-term modernization and improvement costs, i.e., projected costs that are not immediate, but will need to be addressed longer term. As a result, the RAD Replacement Reserves will typically be larger than a standard replacement reserve (often estimated at \$250/unit/year). PHAs should adjust the replacement reserve estimate up or down relative to the anticipated longer-term physical needs of a project.

Once properly estimated relative to a potential RAD conversion of assistance, a project's operating expenses should be subtracted from its RAD-established rental income (and any



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other incidental project income) to determine the Net Operating Income (NOI) available for debt service on a conventional mortgage.

### The Development Budget: Sources & Uses of Funds

By using the Tool, a PHA can begin to assess a project's potential sources of funds that will be required for a successful conversion of assistance under RAD. As indicated above, the Tool only provides a preliminary estimate of the amount of debt that potentially can be borrowed to address a project's rehab or construction needs based on the assumptions made about interest rate, Mortgage Insurance Premium and Debt Service Coverage Ratio. (For additional information on financing terms that lenders and investors will consider, see Attachment B: Considerations in Choosing a Lender & Standard Lender Terms). The estimate of debt that can be carried is merely a starting point in developing a standard Sources and Uses or Development Budget. This step typically begins with defining all the anticipated uses of funds for a project.

### *Uses*

- **Construction Costs.** The most critical calculation in estimating a project's Uses of Funds is the level of rehab or construction required. A PHA will likely have a rough estimate of a project's capital needs from its required 5-Year Physical Needs Assessment. This estimate will need to be verified by a Physical Conditions Assessment (PCA) to be submitted to HUD 90 days following the issuance of a CHAP. Immediate capital needs should be addressed up front and longer-term modernization or capital replacement needs should be funded through a larger-than-standard Replacement Reserve (see discussion above on sizing the RAD Replacement Reserve). Contractor general requirements, overhead, and profit (which often run 6%, 2%, and 6% respectively) should be included in the rehabilitation/construction estimate. In addition, lenders typically require a 7-10% contingency on rehab construction costs.
- **Acquisition Costs.** Generally acquisition costs are only included if the financing structure includes Low Income Housing Tax Credits (LIHTCs).
- **Professional Fees.** This estimate should be large enough to cover the cost of the PCA, survey, title work and any market studies required by the lender as well as legal fees.
- **Loan Fees & Costs.** PHAs should talk with their lenders about loan fees and any required third-party reports in addition to those listed in "Professional Fees" above. The lender can assist the PHA with calculating the interest cost during construction, which will depend on current rates and the length of the rehabilitation or construction period.
- **Reserves.** Projects will commonly require an initial deposit into the replacement reserve when capital repairs are anticipated in the short-term that will not be addressed immediately. Also, if planning to use an FHA insurance product, there is no operating reserve requirement. However, private lenders will typically require some form of an operating reserve, which a PHA should inquire about in initial discussions.



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- **Developer Fee.** Under RAD, HUD allows a developer fee of up to 10% of total development costs (minus acquisition, reserves, and developer fee). If using LIHTCs, PHAs may earn a developer fee payable from the tax credit equity subject to the LIHTC issuing agency's limitations on developer fees, and in no case to exceed 15% of total development costs.
- **Relocation Costs.** If temporary relocation is required to accommodate rehabilitation/construction, the cost for such relocation should be included in the Uses of Funds.

Once estimates of the Uses have been made based on the best information then available, the total Uses of Funds must be reconciled against the initial Sources of Funds. As indicated above, in most affordable housing development budgets—including conversions of assistance under RAD—the initial Sources will likely need to be augmented with additional financing resources.

### ***Additional Sources: PHA-Supplied & Other Common Options***

Additional potential sources of funding that a PHA might consider in augmenting a conventional first-mortgage loan for a particular project include:

- **PHA Sources**
  - **Operating Funds, Capital Funds, Replacement Housing Factor Funds.** Under RAD, a PHA can contribute any of these sources of funds as available to the financing structure to address a project's capital needs, which can be in the form of a direct grant (contribution) or loan to the project.
  - **Deferred Developer Fee.** If needed to balance the Sources and Uses, the PHA can lend or contribute a portion of its developer fee back to the project, to be repaid from available cash flow.
- **Other Financing Sources**
  - **HOME/CDBG.** Both of these sources can be used in a project's development budget, but they often pose additional program restrictions that a PHA should carefully consider.
  - **Affordable Housing Program of the Federal Home Loan Bank (FHLB).** Each of the FHLB regions administers its own Affordable Housing Program, which is well described on regional FHLB websites. Applications are typically taken once or twice a year and timing varies by region. These funds can be either loans or grants, depending on the program. Loan size is often capped at \$1 million.
  - **Local or State Housing Trust Funds.** Localities often administer public funds that are intended to support the development and preservation of affordable housing. Public housing preservation often meets and exceeds such requirements for income targeting, leverage, etc.



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- **Green Energy Programs.** As noted in Attachment A: Evaluating Income & Operating Expenses, PHAs should consider the potential operating savings generated when energy-saving measures are included in the project rehabilitation, which reduces operating expenses, and in turn, increases NOI. A first mortgage lender should be willing to increase its loan size relative to the additional NOI. PHAs can also seek specialized funding programs for conservation. Many such options are described at the U.S. Department of Energy's Database of State Incentives for Renewables & Efficiency: [www.dsireusa.org](http://www.dsireusa.org).

### ***Additional Sources: 4 % or 9% LIHTCs***

As indicated above, many potential projects with high capital needs will require additional, non-debt sources of funding to balance against indicated uses. A proven and well-established equity source for meeting such needs in affordable housing development is the 4% or 9% federal Low Income Housing Tax Credits (LIHTCs). Especially if a project is located in a Qualified Census Tract (QCT) or Difficult Development Area (DDA)<sup>3</sup> that affords a 130% boost to the qualified basis of a LIHTC transaction, a PHA should consider applying for an award of 4% LIHTCs coupled with tax-exempt bonds, or 9% LIHTC from a local or state issuing agency.

*In considering using LIHTCs, PHAs are strongly encouraged to consult with an experienced tax credit advisor early in the process of assembling an application under RAD.*

In order to help PHAs determine a preliminary “ball park” estimate of what LIHTCs may be able to generate in the form of investor equity for a particular project, the Tool offers a “LIHTC Estimator.” The estimator provides a projection of LIHTC equity that potentially can be generated from investors, minus LIHTC-related transaction costs. The following adjustments to the Development Budget are typical in an LIHTC transaction prior to calculating the amount of equity proceeds:

- **Sources**

- **Seller Take-Back Financing.** The value of the apartment units conveyed to Limited Liability Corporation, or LLC, which is the ownership structure required for LIHTC partnerships, can be included in the calculation of 4% LIHTC Acquisition Credits. The PHA will typically lend this value to the LLC in the form of a note, often referred to as Seller Take-Back Financing, which is subordinated to any first-mortgage financing. Accordingly, the amount of this note should be included in the Sources and Uses budget (see discussion of estimating Acquisition costs below). Under RAD, such subordinated debt can be repaid out of project cash flow as available, or as necessary, portions or all

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<sup>3</sup> For a list of current QCTs and DDAs, see [www.huduser.org/portal/datasets/qct.html](http://www.huduser.org/portal/datasets/qct.html).



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of its debt service can be deferred and repaid upon likely refinancing of the project when indicated.

- **Uses**

- **Acquisition Costs.** A PHA should estimate the value of the existing apartment units (typically exclusive of the value of the underlying land, which cannot be included in tax credit basis) that is to be conveyed to the LLC. This is typically best done by providing a recent appraisal or by having one conducted if necessary. (The determined value will typically be the same as the amount of the Seller Take-Back financing described above, but LIHTC tax counsel should be consulted on structuring). Note that for LIHTC transactions under RAD, the PHA must maintain an interest in the property as described in the Notice.
- **Construction Costs.** In structuring a LIHTC transaction, a tax credit advisor will likely urge maximizing the amount of rehab or construction in the construction cost estimate for a given project—rather than just immediate capital needs. This is because all construction costs can be included in LIHTC basis and maximizing such costs will increase the amount of credits generated, and correspondingly, increase the amount of equity investors are willing to contribute to the project. If maximizing tax credit basis for a project, a PHA may also be able to reduce the Replacement Reserves amount, which will increase the supportable mortgage amount for the project.
- **Operating Reserves.** LIHTC investors typically require 6 months of operating expenses and debt service on the first mortgage to be placed in an operating reserve to address project contingencies.
- **Developer Fee:** In LIHTC projects, the developer fee may be up to 15% as permitted by the applicable state or local issuing agency as stated in its Qualified Allocation Plan (QAP).

After adjustments to sources and uses are made to comply with a LIHTC structure, a PHA will need to determine whether a 4% credit with tax-exempt bonds or a 9% credit best meets the project's capital requirements. Note that there is significantly less competition for the award of 4% LIHTCs than 9% LIHTCs. If a PHA opts to apply for 4% credits, there are a series of specific requirements and issues (e.g., bond proceeds covering 50% of qualified costs, etc.) that must be addressed by experienced legal and tax counsel. If a PHA chooses to apply for 9% credits, it will need to show evidence in the RAD Application that it has consulted the state or local tax credit issuing agency and demonstrate that the submitted project will score competitively against stated QAP factors.

Also note that many variables impact the exact amount of a LIHTC award, including the requirements of each agency's QAP, the amount of infrastructure that may not be basis-



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eligible, the size of reserves, owner guarantees, and current market pricing paid by investors per tax credit award dollar. In addition, many states offer state affordable housing tax credits, which can be combined with federal LIHTCs.

At the end of the process of building a Sources and Uses or Development budget for a project or set of projects, a PHA should be able to see if a specific project or projects in its portfolio would potentially make for a viable application for converting assistance under RAD. Having identified those projects, the PHA should begin preparing the complete RAD Application, which requires continuing discussions with potential lenders and investors to obtain the necessary letters of interest; holding the required meetings with residents of the proposed RAD developments; obtaining required PHA Board approvals; and addressing other requirements of the Application package.

### **PHASE 3: RESIDENT PROCESSES**

One of the major goals of RAD is to provide additional housing choices to public housing residents. The RAD Final Notice describes all of the processes and requirements for providing such “choice-mobility” options when converting assistance under RAD, which PHAs should carefully review. Some important considerations to address in preparing a RAD Application include:

- **Communications.** PHAs should keep residents informed throughout the process. As soon as it has preliminarily identified potential RAD projects, a PHA should hold the first of two required meetings with the residents of the proposed projects. All questions must be responded to in writing and a summary of the meeting and written responses must be provided as part of the Application materials.
- **Rights & Requirements.** All residents in a project undergoing a conversion of assistance under RAD have the right to return to the rehabilitated project or any project that is replaced as part of the process. No additional screening or requirements of current residents is permitted. Temporary relocation due to constructions should be minimized and if needed, PHAs are responsible for determining the applicable provisions of the Uniform Relocation Act. If relocation is necessary, a Relocation Plan specifying how relocation costs will be addressed must be included with the RAD Application.
- **Different Provisions under PBVs & PBRA.** Choice-Mobility provisions vary by the form of Section 8 assistance chosen by the PHA:
  - If a PHA elects to convert to PBVs, the normal resident choice rules under the PBV program apply, e.g., after one year of residency, at a household’s request the PHA must offer the household the first available Housing Choice Voucher (HCVs) to use at a private property of his/her choosing.



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- Recognizing that non-RAD forms of PBRA do not require a “choice” component for public housing residents, the Choice-Mobility provisions for PBRA are different from similar provisions for PBVs. A resident may opt to exercise a Choice-Mobility option under RAD PBRA the later of: (a) 24 months from date of execution of the HAP (the RAD “closing”); or (b) 24 months after the move-in date. A PHA converting to PBRA is not required, in any year, to provide more than one-third of its turnover vouchers to the residents of covered projects; the PHA may also limit the number of moves to 15% of the assisted units in the project converted under RAD. Additionally, a PHA may apply for a good-cause exemption if the PHA itself does not operate a voucher program or if the PHA operates a voucher program and more than one-third of its voucher turnover typically is awarded to the homeless or Veterans.
- PHAs should note that additional scoring points are awarded under the Ranking Factors in the Application for collaborations between those PHAs who do not operate an HCV program (or who have one-third of their voucher turnover committed to veterans or to homeless populations) and are converting to PBRA, and those PHAs who are willing to provide a portion of their own HCV turn-over vouchers to these projects converting to PBRA under RAD.

### **PHASE 4: ASSEMBLING THE DEVELOPMENT TEAM**

Once a PHA has conducted a preliminary review of its inventory, taking financing considerations and resident processes into account, it should consider whether to add any development partners to its team.

PHAs with recent successful development experience with Mixed Finance or comparable projects involving multiple sources of financing may likely have internal capacity to successfully plan and carry out a RAD conversion. However, PHAs lacking such experience may want to engage development consultants and/or partners. As assembling a development team takes time, PHAs should make such a judgment early in the process of preparing a RAD Application. While there are no scoring factors related to development capacity, HUD will nonetheless review the capacity of the PHA relative to the complexity of a proposed project 30 days after issuance of the CHAP and again in approving RAD Financing Plans. In any event, an experienced team is nonetheless essential for project success.

As underscored above, if a PHA is considering applying for 4% or 9% LIHTCs as part of a RAD transaction, and it does not have any experience with securing and administering LIHTC-supported projects, it is strongly recommended that it consider enlisting a partner to co-develop the project and/or engaging a tax credit advisor.



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A further consideration in this regard is that a partner(s) may be able assist the PHA meet certain requirements that it may have difficulty doing so on its own. For example, LIHTC investors typically require that construction completion and operating deficit guarantees be pledged over relevant development or operating periods. An investor may be open to allowing the PHA to pledge its developer fee to help collateralize those guarantees. However, if the PHA's balance sheet will not support such guarantees, or if its Board is uncomfortable with that level of risk, the PHA should strongly consider enlisting a co-developer.

Finally, PHAs may use up to \$100,000 in public housing funds for RAD pre-development expenses without prior approval from HUD. If a PHA is planning to engage one or more development consultants to assist with this effort, in most cases it will be possible to use public housing's Small Purchase Procedures to acquire these services. (However, a PHA may have additional state and/or Board requirements governing such procurement).

### **PHASE 5: CONFIRMING FINANCIAL PARTNERS**

Once a PHA has identified a potential project or set of projects, and initiated the associated financial projections, it should begin conversations with possible lenders—ideally with any enlisted consultants or development partners. If pursuing 4% LIHTCs and tax-exempt bonds, a PHA should begin to talk with providers of bond financing as well as investors as soon as possible. If pursuing 9% LIHTCs, a PHA should carefully review its state or local tax credit issuing agency's QAP, as it must obtain a letter from it indicating that a proposed project will score well in its competitive process. If a PHA is unable to obtain such a letter, it will need to provide a self-scoring sheet for the submitted project and evidence of efforts to communicate with the issuing agency as part of its RAD application materials.

While there is no requirement for a PHA to have secured a lender or investor prior to submitting a RAD application, the PHA will need to provide a non-binding Financing Letter of Interest/Intent. If selected and awarded a CHAP in the RAD competitive process, the PHA should move quickly in securing a lender and investor to satisfy the milestones outlined in the RAD Final Notice. PHAs should consider the factors outlined in Appendix B—Considerations in Choosing a Lender & Lender Terms, when selecting a lender or investor and/or when selecting a particular loan product.<sup>4</sup>

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<sup>4</sup> As indicated in the Notice, HUD will be releasing separate guidance detailing how HUD will modify the policy and processing of FHA insurance program to accommodate RAD conversions and minimize duplicative requirements.



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## ATTACHMENT A: EVALUATING INCOME & OPERATING EXPENSES

### Income

In the RAD Application, the PHA will need to identify whether it is proposing to convert to PBRA or PBVs. Although PHAs can change that selection prior to the submission of the RAD Financing Plan, it will be helpful to make that decision early in the process as it affects not only the Choice-Mobility options (which would be of importance to residents in the required resident meetings) but also possibly the contract rent levels. If a PHA chooses PBV, and it does not operate a Housing Choice Voucher program, it will need to identify a voucher agency that is willing to administer the PBVs (unless you are applying for a good-cause exemption, as outlined below).

A PHA should consider the following list of factors in choosing between PBRA and PBV:

- **Rent caps.** For conversions to PBVs, rents may not exceed the “reasonable” (i.e., market) rent.<sup>5</sup> Thus, if current funding is \$700 per unit monthly (PUM), but the reasonable rent is \$650 PUM, rents will be capped at the latter. For PBRA conversions, where current funding is higher than market, rents are capped at 120% of FMR; if current funding is below market, rents are capped at 150% of FMR.
- **Contract Administration.** For conversions to PBVs, the contract administrator is the agency that administers the voucher contract (which in many cases will be the same PHA that owns the project). PHAs that do not operate a Housing Choice Voucher program will need to find a voucher agency that is willing to administer the vouchers. If the PHA cannot secure a participating voucher agency, the PHA can opt to convert to PBRA. For conversions to PBRA, the project will be overseen by HUD’s Office of Multifamily Housing Programs.
- **Initial Contract Term.** For PBVs, the initial contract term must be for a minimum of 15 years, but can be extended to 20 years at the consent of the PHA administering the voucher contract. For conversions to PBRA, the initial term will be 20 years. Both types of conversions, however, require that the project be offered a renewal contract and that the PHA accept that renewal contract.
- **Lender Familiarity.** Because of the relatively limited size of the PBV program, and because of the historically more-limited contract length, lenders tend to be more familiar with the PBRA program.
- **Cap on Number of Assisted Units.** Under RAD, only 50% of the units in a PBV project can be assisted, with exceptions for elderly, disabled, and family units receiving supportive services, or for units in single-family buildings. There is no cap on PBRA projects.

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<sup>5</sup> Annual rent adjustments, after initial rent determination, cannot result in rents lower than those initial rents.



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- **Choice-Mobility.** Under the PBV program, residents are eligible to move with the first available Housing Choice Voucher after one year of residency. For conversions to PBRA, RAD establishes an alternative Choice-Mobility requirement that limits the number of Choice-Mobility moves from a given project and the number of vouchers a PHA is obligated to commit in any one year.
- **Reasonable (Market) Rents.** PHAs will need to make a “reasonable rent” determination to complete the RAD Application (primarily for the purpose of determining the applicability of standard rent caps when assistance is converted to PBVs or PBRA). For purposes of the Application, there is no requirement to complete a formal “rent comparability study” (RCS) to determine reasonable rents in your local market. However, if your agency operates a Housing Choice Voucher program, it can be a ready source of data on market rents. An informal survey of nearby properties, especially those with unrestricted or market rents, might also prove helpful. (To make a final financing commitment, a lender is likely to require that an appraiser or other qualified third party determine the comparable market rents in the local area). Such an estimate of reasonable rents will be useful if including any market or unassisted units as complementary part of a development proposing to convert assistance under RAD.
- **Rent Loss (Vacancy-and Collection Loss / Bad Debt Loss).** A PHA should consider both the vacancy and any bad debt loss that the property has experienced historically with other projects in its portfolio. It should also take into account that improvements made under a RAD conversion of assistance is likely to improve the property’s marketability. As result, post-RAD rent loss may be lower than that prior to conversion. Damage charges and late fees may also be less after conversion.
- **Other Income.** A PHA should consider whether improvements made under a RAD conversion of assistance will afford new revenue opportunities, e.g., laundry or vending income.

### Operating Expenses

Similarly, a PHA should consider how a RAD conversion of assistance may improve a property’s marketability and reduce future maintenance and utility costs. Compared to public housing, the regulatory environment is generally considered less burdensome, and more stable under Section 8, which may also affect a project’s operating expenses. Moreover, properties converting assistance to Section 8 will be benchmarked against other similar Section 8 properties in the local market, including the level of operating, maintenance, and property management expenses. PHAs should carefully consider such changes and realities in developing a line-by-line estimate of post-conversion operating expenses.



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- **Capital Items in Historical Operating Expenses.** PHAs should consider that a property's current operating expenses likely include a significant level of maintenance expense that when converting assistance to Section 8 under RAD will be absorbed into a standard Replacement Reserve line item in the operating budget—or may no longer be necessary due to the improvements made to the property. RAD requires that the Replacement Reserve be sized to meet 100% of anticipated 20-year capital needs.<sup>6</sup> Accordingly, PHAs should eliminate reserve-eligible items from the historical operating expenses of the property when estimating post-RAD maintenance expenses.
- **Real Estate Taxes.** A PHA should determine whether its current payment in lieu of taxes (PILOT) agreement with a local jurisdiction as determined by state law will apply after a conversion of assistance under RAD. As converted properties will continue to operate as publicly-owned or controlled affordable housing consistent with a PHAs mission, it is anticipated that most if not all converted properties will continue to be eligible for PILOT provisions. However, PHAs are advised to carefully review applicable local and state law requirements and plan accordingly. In the event that an existing PILOT agreement cannot be extended to a converted property, the PHA should attempt to negotiate a PILOT agreement specific to the converted property by pointing to the demonstration purpose of RAD.
- **Resident Participation Funding.** The RAD Notice specifies that the current public housing requirement of \$25 per unit per year in funding for resident participation funding to continue after a conversion of assistance under RAD, of which \$15 per unit must go to the legitimately recognized resident council, and the remainder of which can be used by the PHA to support resident participation activities.
- **Asset Management Fee.** PHA property management fees are paid as operating expenses under both PBV and PBRA similar to the way such fees are accorded under a Section 8 contract. Asset management fees and other fees (such as those allowed under PIH Asset Management as “add-ons”) can be paid as operating expenses in PBV or out of cash flow in either PBRA or PBV.
- **Replacement Reserve Funding.** RAD requires that the replacement reserve (via initial funding, ongoing funding, and interest earnings) be capable of funding 100% of the estimated 20-year capital needs as determined in the PCA. PHAs should note that this requirement may call for a higher level of Reserve funding than is typical for new market-rate or LIHTC properties (depending on the level of initial repairs vs. out-year replacements of aging systems and components).
- **Income & Expense Trending.** If a project plans to apply for FHA mortgage insurance, FHA focuses primarily on the first year (post conversion) of operating income and expenses. In contrast, LIHTC investors, as well as many non-FHA lenders, will require a 15-year operating pro-forma to see how the property operates over time. These

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<sup>6</sup> Other than capital needs funded in the initial rehab.



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lenders/investors will also provide direction on what inflation factors to use for trending income and expenses. (The Tool allows the user to examine the impact of these different inflation factors on out-year debt-coverage ratios).



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### ATTACHMENT B: CONSIDERATIONS IN CHOOSING A LENDER & STANDARD LENDER TERMS

- **Lender Familiarity with RAD.** All else being equal, a lender/investor that is familiar with and interested in RAD will be a better choice, with improved chances for a smooth financing process. A well-prepared lender/investor will help the PHA anticipate potential issues and solve them well in advance. A less well-prepared lender/investor may end up delivering unpleasant surprises late in the financing process. In particular, lenders and investors need to be very familiar with the following RAD features: initial rent setting, annual rent adjustments by OCAF, term of the HAP contract, restrictions on future ownership (including restrictions affecting foreclosure), and the RAD Use Agreement (which is structured to survive foreclosure). In order to optimize underwriting resources, ensure that the lender's chief underwriter has approved pursuing financing of RAD projects as a business line objective before investing any significant time in this process. Share the RAD timeline with potential lenders and investors and make sure that the lender or investor is prepared to meet the timeline.
- **Selection of Loan Product.** There are a variety of loan types that would be suitable for financing RAD conversions. A lender that can offer a variety of loan products will be a better financing partner and will be in a better position to advise the PHA on which loan product will be the best fit for a particular property. If seeking both a loan and LIHTC equity for a particular project, be sure that the investor approves the choice of loan product.
- **Transaction Costs.** Multifamily financing involves a wide array of financing costs. PHAs should have a very early conversation with each potential lender to understand the full range of costs that are likely to be incurred. Also, keep in mind that transaction costs may vary depending on which loan product is selected. Be sure to fully understand all "third-party reports" (e.g., environmental reviews) that will be required by the lender, when they will have to be ordered and paid for, and what they will cost.
- **Required RAD Physical Condition Assessment.** Discuss the use of the PCA scope of work described above with your lender/investor to ensure that the lender's or investor's PCA meets the RAD standards.
- **RAD Milestones.** Begin working with lenders/investors early in the process and begin planning for the Financing Plan since it will require significant due diligence. Selected projects will have 12 months to complete conversion actions, starting with issuance of the CHAP and ending with execution of the Section 8 HAP contract (and the closing of any new financing). Within 30 days after issuance of the CHAP, the PHA's selected lender must issue, and the PHA must accept, a lender engagement letter. Within 180 days after issuance of the CHAP, the PHA must submit the Financing Plan for HUD review and approval.



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- **Processing Time.** Obtain from the lender and investor a sense of the processing time. Loan products with shorter processing times make it easier for the PHA to comply with the RAD timelines and milestones.
- **Certainty of Execution.** Before selecting a loan product, be sure to understand the lender’s underwriting and approval processes, the factors that will determine the approvable loan amount, whether the loan will be approved, and those that will determine whether an approved loan will actually close.
- **Debt Service Coverage.** Most loan products are subject to a requirement that the property’s NOI be materially larger than the total mortgage payment (principal, interest, and mortgage insurance or other “credit enhancement”) or project “debt service.” If, for example, the NOI must be at least 125% of the debt service, a 1.25 debt service coverage (DSC) is required. Have an early discussion with potential lenders to understand the DSC requirement for each loan product being considered.
- **Loan-to-Value.** Most loan products are subject to a requirement that the loan amount is not to exceed a certain percentage of the market value of the property—or the “Loan-to-Value” or LTV requirement. Because appraisers do not have experience valuing RAD-converted properties, it is important to have an early discussion with potential lenders regarding LTV requirements and how the lender will work with appraisers to determine a fair and accurate market value. PHAs should also be aware that, in low interest rate environments such as we have today, the LTV requirement is commonly more important to lenders than the DSC requirement. Accordingly, it is not unusual for approved loans to have a relatively high DSC (well above the minimum DSC required for that loan product).<sup>7</sup>
- **Overhang Risk.** Lenders use the term “overhang risk” to refer to risk associated with Section 8 rents that exceed market levels, and often lenders impose special underwriting requirements for properties that have overhang risk. Accordingly, PHAs should discuss this issue with potential lenders if, under a conversion to PBRA, a PHA’s current funding exceeds market rents (projects converting to PBVs are prohibited from having rents that exceed a locally-determined “reasonable” rent standard). In order to address potential overhang risk issues, it may be helpful to undertake a Rent Comparability Study or similar market appraisal mechanism.

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<sup>7</sup> For example, suppose that a project is expected to produce \$800,000 of net operating income (NOI) annually, and that the lender’s minimum debt service coverage requirement is a 1.20:1 debt service coverage ratio; the lender would allow the property to spend up to \$666,666 ( $\$800,000 \div 1.20$ ) annually for debt service payments. At a 4% interest rate and 30-year amortization, \$666,666 annually would support a loan amount of \$11,636,700. If, however, the property appraises for \$13,000,000, and the lender limits the loan amount to 80% of value, the loan would actually be limited to \$10,400,000. The debt service on a \$10,400,000 loan at 4%/30 years would be \$595,814, and the actual debt service coverage would be  $\$800,000 \div \$595,814 = 1.34$ .



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### ATTACHMENT C: GENERAL CONSIDERATIONS IN ESTIMATING THE LEVEL OF REHAB

In preparing a RAD application, PHAs should consider the following in determining the level of rehab:

- **System Replacement.** RAD requires replacement (either before closing or in rehab) of any item that is not functioning at the time of the PCA site inspection.
- **Planning for Utility Efficiency.** The PCA tool that will be used for RAD will provide PHAs with useful information on initial costs and utility savings for all utility-consuming components such as appliances and HVAC systems. RAD also requires that any utility-consuming systems that are at or past estimated useful life be replaced with the most financially-efficient replacement component, taking into account initial cost and utility savings. PHAs will frequently find that a more expensive but more efficient component will quickly pay for itself.
- **Accessibility.** Any alterations of converted projects must meet the accessibility requirements of Section 504 of the Rehabilitation Act of 1973 (24 CFR § 8.23) and any other applicable design and construction standards including the Fair Housing Act, where applicable.
- **Environmental Review.** Under Federal Environmental Review Requirements, the provision of a new contract for PBRA or PBVs is subject to environmental review. If applying for FHA Insurance, HUD will conduct the review for the PHA; for all others, a state or unit of general local government will complete the environmental review. Issues to consider in an environmental review include lead-based paint, asbestos-containing materials, flood insurance, flood preparedness (if improvements are within the 500-year flood plain), and fuel storage tanks. PHAs should also note that within 90 days of CHAP issuance, the PHA must submit a completed Environmental Review.
- **Competitiveness.** Consider whether improvements (such as adding air conditioning) are needed in order for a property to be competitive in its local rental market.
- **Davis Bacon and Section 3.** The RAD Final Notice provides that any initial rehab undertaken at the time of the RAD conversion that constitutes “construction” or “rehabilitation” will be subject to Davis-Bacon prevailing wage and Section 3 requirements.
- **General Contractor.** Although some PHAs use in-house capacity to perform construction work (“force account”), most lenders will require use of a third-party contractor as a condition of a loan.
- **Developer Fee.** RAD allows a Developer Fee of 10% of total development costs (less acquisition costs, reserves, and developer fee), except in cases where LIHTCs are part of the financing structure, when it may be up to 15% as determined by the state or local issuing agency.



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- **Initial Operating Deficit Escrow.** If the property's revenue stream will be reduced during rehab, and if that revenue stream is not sufficient to cover the operating expenses (which have also likely been reduced during construction), the development budget will likely need to include funding to cover this initial operating deficit. Commonly lenders will require an Initial Operating Deficit Escrow for this purpose.
- **Temporary Tenant Relocation.** The PHA must include a relocation plan for the rehabilitation or new construction, including a relocation budget and a certification that the relocation plan complies with all applicable HUD requirements, including Uniform Relocation Act requirements. Temporary relocation plans must be disclosed in the RAD Application and the PHA must show that relocation is fully funded in the RAD Financing Plan. Note that under RAD, all current tenants have a right to return to a rehabilitated or replacement property.