Guidance on Operating Deficit Reserves, Overhead Expenses, and Combined Loan to Value Ratios – July 30, 2012

Operating Deficit Reserves

Several organizations involved in the Neighborhood Stabilization Program (NSP) have requested that HUD allow the establishment of reserves for operating deficits for rental housing developments. These reserves support the cash flow of new developments during lease-up and later may be used when expenses exceed revenues, to avoid default. HUD has not generally allowed such reserves in CDBG based on longstanding interpretation of the Housing and Community Development Act.

Operating deficit reserves have only been allowed when required by a third party lender, based on the language in 24 CFR 570.202(b) that allows “other means” of carrying out the rehabilitation. Not all NSP projects have private lenders, so this provision does not address every situation. NSP grantees have been advised that replacement reserves may be generated from excess cash flow, but not capitalized initially with NSP grant funds.

Given the current strain on financing affordable housing and the downward pressure on property values, HUD has determined that creating operating deficit reserves for NSP multifamily projects is important to the sustainability of these projects, as required by the Housing and Economic Recovery Act of 2008. The Public Housing and HOME programs both allow operating reserves to be established.

Therefore, CPD finds that allowing such reserves is appropriate for NSP grantees. To enable this to occur, the Department will consider grantee requests for exceptions to the eligibility provisions of the HCD Act, at 42 USC Section 5305(a). Exceptions may be approved by the local field office.

The basis for granting an exception shall be that project underwriting demonstrates to the field office that an operating deficit reserve is necessary for project viability in the target market. Grantees may request a one-time allocation to an initial operating deficit reserve fund for an amount justified by project underwriting. Such amounts should not exceed a value equal to eighteen months of principal and interest payments. Reserves must be maintained by an independent trustee and may be used for both lease-up and operating deficits.

A grantee considering an exception request is advised to review the HOME program policy on initial operating deficit reserves at 24 CFR 92.206(d)(5) for guidance. Technical assistance with underwriting rental developments is available through the NSP Resource Exchange at no cost to the grantee.
**Overhead Expenses**

Developer fees consist of profit and overhead. While subrecipients, consortium members and public non-profits may not act as developers and receive profits, they may benefit from a Public Housing practice of allowing a fee of 3% in lieu of a cost allocation structure (PIH Notice 2007-15.) Many smaller non-profits have been discouraged by the difficulty of developing and receiving approval for indirect cost allocation plans, although they regularly incur such expenses.

In its mixed-finance projects, Public Housing provides a safe harbor level of 3 percent of total development costs which is deemed a “reasonable fee” to cover indirect costs or overhead. According to the Office of Public and Indian Housing, this structure is permitted under OMB Circular A-87, Attachment A, Section (A)(2)(b) as an alternative to reduce the administrative burden of establishing overhead rates.

CPD supports the application of this policy in NSP projects. This “reasonable fee” acknowledges the existence of indirect costs and provides modest reimbursement with little administrative burden. NSP grantees may use this method beginning immediately. Any grantee using this method must document its choice in the applicable activity records. Any indirect cost or overhead charge above this level still requires a cost allocation plan.

**Mortgages Exceeding 100% Combined Loan to Value**

HUD has cautioned NSP grantees to underwrite loans to home buyers carefully, taking care not to over-subsidize or over-burden low-, moderate-, or middle-income buyers. Many conventional lenders allow closing costs to be included in the mortgage amount; conventional loans are bank mortgages not insured by a government agency. This practice can result in Combined Loan to Value (CLTV) ratios over 100%. HUD policy previously discouraged this course of action.

NSP grantees, subrecipients and developers should have access to the same financing as any other developers. Because NSP grantees generally offer soft second mortgages, with deferred or forgivable payments, this practice is being permitted when there is a conventional first mortgage on the property.