



**NATIONAL ASSOCIATION OF STATE AND LOCAL  
EQUITY FUNDS**

**“BEST PRACTICES” FOR**

**ASSET MANAGEMENT OF LIHTC INVESTMENTS**

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**INTRODUCTION**

As a leader in the low-income housing tax credit industry, the National Association of State and Local Equity Funds (NASLEF) has developed the following “Best Practices” for member syndicators in performing asset management and compliance monitoring of portfolios invested in affordable housing financed partly by federal tax credits. Adherence to the “Best Practices” will lead to better quality tax credit projects, preserve and protect the interests of investors, and assure compliance with Section 42 of the Internal Revenue Code. This document sets forth guidelines and is not intended as a set of mandates. NASLEF recognizes that there may be circumstances where the guidelines need to be modified by individual syndicators to meet their needs.

NASLEF is a professional, nonprofit association formed in 1994 to promote the efficient management of state and local equity funds. Collectively through 2010, its 14 member funds operating in 32 states and Washington, D.C. have created or rehabilitated 111,000 units of affordable housing and have raised over \$7.4 billion in equity capital for rental housing developments throughout the United States.

This document describes the multiple roles of syndicators as organizers and General Partners of investment funds (so-called upper tier partnerships) or direct investment vehicles which hold an equity stake in single-purpose entities (lower tier partnerships) which develop, own and operate affordable multi-family rental housing. The typical business model of NASLEF syndicators is to aggregate on an annual basis the combined performance, tax benefits and investment return of these lower tier partnerships into investment funds, which comprise the bulk of their managed portfolios. Tax benefits and investment returns are passed through annually by the syndicators to passive upper tier or direct investors.

The document is intended to summarize the **key responsibilities** or **functions of asset management staff** and their primary cross-departmental interactions within syndicator companies, but it is not meant to convey the detailed policies and procedures followed by asset management to achieve those goals. The guidelines also include **standard deliverables** and **industry benchmarks** for assessing investment performance. So the focus is more on what tax credit asset managers do, not how. Internal practices may be unique to every business and are far more detailed than can be summarized efficiently.

Syndicators act as:

- a. limited partners with Developers who are the General Partners in lower tier entities,

- b. fiduciaries on behalf of investors who subscribe to upper tier partnerships and are the ultimate recipients of income, losses and tax benefits produced by the lower tier Limited Partners,
- c. asset managers for the upper tier investment funds or direct investors.

The key responsibilities broadly included under asset management of Low Income Housing Tax Credit investments are summarized below and discussed further within this document. In general, the practices described are to be followed by asset management staff in oversight of operating partnerships (also known as lower tier investments) although certain functions may be performed by other corporate departments, such as Acquisitions or Fund Accounting with asset managers in a supporting role.

1. Underwriting & Due Diligence
2. Construction & Lease-up
3. Capital Contributions & Distributions
4. Stabilized Operations: Lower Tier Reporting & Analysis
5. Contractual Compliance
6. Regulatory Compliance
7. Information Management Technology
8. Investor Reporting
9. Document Retention
10. Risk Ratings & Watch List
11. Workouts
12. Dispositions
13. Upper Tier Risk Analysis
14. Training

## **DUE DILIGENCE AND CLOSING**

Asset Management collaborates with Acquisitions staff in the analysis of potential investments during the due diligence and underwriting process. The goal is to structure partnerships that have a high likelihood of performing in accordance with projected operating budgets, achieving occupancy goals, and delivering projected tax benefits.

Typically a syndicator's Acquisitions staff coordinates with its counsel to address minimum standards in partnership documents for issues impacting the proposed transaction as both a real estate investment and a tax strategy. Asset Management assumes the responsibility to monitor (1) the developer's compliance with contractual requirements, (2) long-term performance of the real estate, and (3) realizing the targeted investment return.

### **Deliverables**

- Participate in a due diligence site inspection.
- Review the proposed development's physical aspects and financial structure, assess its suitability and competitive strengths/weaknesses related to long-term marketability and management of the property.
- Review market studies and projected operating budgets, compare proforma rents and operating expenses with market knowledge and historic portfolio trends, evaluate any significant plan and budget to provide tenant services, and assess the adequacy of proposed rent-up, operating and replacement reserves.

- Evaluate qualifications of proposed property managers and accountants with regard to their real estate operations, affordable housing finance and Section 42 experience. Review and approve proposed management contracts and management plans.
- Review investment partnership legal documents to ensure that updated asset management and compliance monitoring requirements and standards are incorporated. Confirm that the Developer/General Partner's contractual role and obligations are clearly defined, as well as events of default and Syndicator/Investor Partner's remedies. Documents should contemplate Investor Partner's authority over potential encumbrance, sale and disposition of part or all of partnership assets. Assess scope and terms of Developer guaranties given risk factors of proposed investment.

### **Underwriting Standards**

- **Capital Contributions:** A percentage of equity as well as some or all of developer's fees should be withheld prior to reaching certain milestones such as construction completion, final cost certification, receipt of 8609's, the closing of permanent financing, verification of qualified initial occupancy, and achievement of stabilized occupancy and/or break-even operations for a specified period of time. Capital contribution schedules should provide for credit adjusters for those projects not delivering tax credits as projected.
- **Operating Reserve:** Minimum Operating Reserve should be capitalized by closing of permanent financing equal to a percentage of annual projected operating expenses plus "must pay" debt service payments plus deposits to Replacement Reserve. Factors to be considered in setting initial reserve levels include project location, competitive advantages or disadvantages in the market, design specifics, security, projected vacancies, potential for reductions in expected rent subsidies, and expectations for erosion in operating margins over time.
- **Rent-up Reserve:** A reserve should be funded by permanent closing to cover likely operating shortfalls during the initial leasing period prior to stabilized operations. Factors to be considered include the development's market study, population to be served, availability of rent subsidy or other partnership funding sources, and the mix of market and LIHTC units.
- **Replacement Reserve:** Also capitalized at permanent closing, but with subsequent periodic deposits for the intended investment holding period, a Replacement Reserve will be restricted to pay for replacement of capital items. A minimum deposit equal to \$250 to \$400 per unit should be established at closing for new construction, with potentially a higher amount, based upon a capital needs study if possible, for rehabilitation projects. That initial capitalized amount should be increased annually by a fixed inflation factor and should be considered part of the development's annual operating expenses.
- **Uses of Restricted Reserves:** Expenditures of funds from the reserve accounts should be monitored. The syndicator may control disbursements of any amount or only for defined thresholds, depending on several factors including the prior performance and experience of the developer and property manager, and any unique risk factors. Syndicators may also require the General Partner to fund any deficits during the rent-up period if the Rent-up Reserve is depleted, thereby preserving the Operating Reserve until certain occupancy and debt coverage benchmarks have been achieved. Furthermore, syndicators may mandate advances by General Partners to pay affiliated property management fees during deficit operations.

- **Insurance Requirements:** This discussion of types of insurance serves as a general guideline. Standard coverage limits tend to change over time, so consultation with the project's or syndicator's insurance agents may be prudent. Where appropriate, syndicators should incorporate the insurance requirements of a project's lender(s). Additional types and different amounts of coverage may be required in some cases. Asset management should routinely verify the types and amounts of insurance coverage in force, develop a tracking system to ensure renewal of policies and respond to any lapses, and confirm that commercial space located in the project is separately and appropriately insured. In addition, property managers should provide evidence of insurance covering Multiple Peril, Liability, Fidelity Bond, and Errors and Omissions (if feasible).
- **Investment Partnerships** should provide evidence of the following types of insurance protection, in accordance with Operating Agreements. Insurance companies should have minimum AM Best ratings of A+. General Liability Insurance is suggested in a minimum amount of \$2,000,000 per occurrence. Coverage by All Risk Casualty (or during construction, Builder's All Risk) Insurance should equal the replacement value of all improvements (review for hazardous materials and soft costs). Following are additional aspects of routine coverage that should be considered:
  1. Inflation guard endorsement.
  2. Title Insurance Flood Insurance, if a project is located in a flood plain.
  3. Earthquake insurance if located in identified areas of risk based on earthquake analysis results.
  4. Rental Interruption Insurance: amount of coverage should equal six to twelve months gross rental income.
  5. Equipment Breakdown (formerly known as Boiler & Machinery) Insurance on a comprehensive form, including repair and replacement for mechanical and electrical systems, where appropriate.
  6. Loss of historic tax credits (federal/state) if partnership is to receive same.
  7. Investor Limited Partner(s) to be named as Additional Insured. Other additional insured parties may include Operating Entity and Management Agent, with Permanent Lender as Loss Payee.
- **Reporting Requirements:** Syndicators should establish specific project reporting requirements, which should be incorporated in project Operating Agreements. More detailed standards for these requirements are discussed under the Operations section below.
- **Minimum requirements for Property Managers and Accountants:** Asset managers should establish written criteria for approval of property managers and accountants to be engaged by lower tier partnerships.

## **CONSTRUCTION**

Once a partnership investment is closed and construction begins, the role of Asset Management expands as it assumes responsibility for monitoring construction, lease-up and in many cases, release of equity funds. Typically, the Acquisitions department hands off oversight responsibility at this point, although they may retain a first line of communication with the developer until closing of permanent financing. Even so, Asset Management staff perform most of the functions from this point, whether in conjunction with other departments or independently.

### **Deliverables**

Syndicators may rely on staff or outside independent construction inspectors to ensure that projects are built in accordance with plans and specifications and they are constructed in a workmanlike manner. Syndicators should require independent certification of total construction costs by approved certified public accountants to properly account for use of funds during the development phase.

- Plans, specifications and the construction budget should be reviewed by syndicator staff or the construction inspector, if any, prior to starting construction.
- Construction Monitoring: Ideally, a qualified independent construction inspector or inspecting architect/engineer should inspect projects and review construction draw requests on a monthly basis during the construction period. Sometimes it is acceptable for syndicators to rely on third party reports generated on behalf of the construction lender or the state housing finance agency.
- Asset Management should review all construction progress reports and regularly updated development budget information, as well as all documentation provided by any third party professionals engaged to oversee construction.
- Asset Management should review change orders and approve significant changes in construction specifications. The developer, consultant or other agent should provide monthly updates to the total development budget, reporting variances in actual to projected data and estimating total sources and uses of funds through completion. Asset Management's analysis of such financial data allows early identification and resolution of brewing problems.
- Capital Contributions: Asset Management should review all requests for capital once a project is under construction and recommend the syndicator's response. In some companies, authority over capital contributions may rest with Acquisitions or Fund Accounting, but asset managers should retain responsibility for collection and analysis of all relevant information.
- Requests for disbursements of equity during construction should be accompanied by adequate documentation including AIA Form G703, completion progress to date, cost overruns or change orders, construction inspector's reports, and developer's certification regarding use of funds and the absence or disclosure of any liens.
- If construction is delayed past 60 days, the developer should submit a revised construction and leasing schedule.
- Syndicators may hold back a portion of equity until the property has undergone its one-year warranty inspection. .

### **Benchmarks**

- Certificates of Occupancy for all units and buildings after completion: In many LIHTC projects, the CO date represents Placed in Service Date per IRS Section 42, starting the compliance period.
- Project Accountant's Cost Certification: resolve any unfavorable variance with regard to expected award of tax credits.
- Completed IRS Form 8609: dated and signed by the state housing finance agency. Verify total credits awarded versus initial investment projections.

- Total Development Budget Sources & Uses of Funds: assess gaps, initiate corrective action if needed in consultation with Acquisitions.
- Construction Loan Conversion: goal is to timely pay off construction lender and close permanent financing, with no unresolved unfunded liabilities of investment partnership.
- Developer's Guaranty: assess for completion of construction, no unexpected claims on partnership assets.

### **LEASE-UP & INITIAL TENANT FILE REVIEW**

Asset Management's primary role in this phase is to monitor the pace of initial leasing, confirm compliance with Section 42 rules regarding tenant eligibility, and estimate delivery of resulting tax credits. The ultimate goals are to track and facilitate the project's performance in order to meet requirements under the operating agreement and to quantify and mitigate any non-performance or shortfalls. Asset managers identify problems such as slow leasing, ineligible tenants and potential deferral of credits. They intervene to the reasonable extent feasible in order to minimize or resolve shortfalls and delays in investment benefits, and they assess financial penalties (credit adjusters, guaranty advances) if warranted.

Syndicators may rely on staff or external compliance consultants to evaluate Section 42 eligibility of all households which take initial occupancy of restricted units. Every tenant file must be confirmed to be complete and compliant with IRS regulations. If noncompliance is found, it must be resolved to the syndicator's satisfaction, which may entail eviction of ineligible tenants and replacement with qualified tenants. Asset managers oversee the execution of lease-up and Section 42 compliance by the partnership's property manager. Asset management may also monitor the project's compliance with other relevant regulations or requirements imposed by public funding or subsidy sources, including:

- HUD loan programs.
- Section 8 rent subsidy.
- Rural Housing rent subsidy.
- Federal HOME, HOPE, AHP and CDBG programs.
- State and local subsidy and loan programs.

Asset managers develop relationships and work closely with property managers engaged by developers to operate investment properties, starting largely in the lease-up phase and continuing through the entire IRS compliance period. Since staff of state housing finance agencies (HFAs) may replicate some or all of the initial regulatory compliance evaluation, it is desirable for syndicators to coordinate with all involved parties to maximize productivity by property managers and minimize disruption to tenants.

### **Deliverables**

- Pre-occupancy meeting organized by syndicator, ideally convening all stakeholders including developer, property manager, state HFA, compliance monitor, other capital sources. Pre-occupancy meeting is valuable to introduce parties, share information, confirm that property manager has relevant partnership documents and requirements, and update projections for leasing and operations.

- Dissemination to developer partners and property managers applicable reference materials, such as closing binders, reporting formats, standard policies, syndicator's website access and guidance about access to external consultants.
- Monthly occupancy reports which define leasing status of restricted and unrestricted units.
- Developer's certification of attainment and date of 100% qualified occupancy, as well as adequate summary roster of qualifying tenants. Complete rent roll showing all units and tenants.
- Syndicators may hold back a portion of equity until the asset manager has reviewed all initial tenant files for compliance.
- Complete copies of all initial lease files for all restricted units, may be hard copy or electronic media.
- Compliance monitor's confirmation that all restricted units are occupied by eligible households.
- Project Accountant's certification of first year tax credits, based on developer's lease-up reports (number, square footage and dates occupied of restricted units).
- Confirmation that Minimum Set-Aside per IRS Section 42 is met by relevant deadline.
- Estimate any permanent shortfall in future annual tax credits and any deferral of credits due to leasing delays. Calculate any applicable credit adjusters, and coordinate with Acquisitions or Fund Accounting to collect any adjuster payments from developer.
- Revised operating budget from property manager or developer for current leasing year and first full year of operations.

## **OPERATIONS & REPORTING**

Achievement of 100% initial qualified occupancy is a major milestone, but projects are considered to remain in "start-up" mode through the first partial year of operations and typically are closely evaluated during this period. Commencing with the first full year of operations after completing initial lease-up, projects have reached the "stabilized" phase and are subject to routine monitoring and reporting requirements. Broadly, much of Asset Management's focus from this point is on two aspects: (1) performance and condition of the real estate, and (2) delivery of investment return in line with original projections. Therefore, much of the flow of information from developers and property managers to syndicators, and from syndicators to investors, deals with a wide variety of reporting and analysis related to these fundamental aspects.

Data from stabilized operations can be compared to syndicator projections and annual budgets, and aggregated into portfolio performance measures. Timely submission by developers or property managers of complete and accurate partnership and property reports is crucial to adequate evaluation by syndicators of investment performance. Project Operating Agreements may provide for financial penalties incurred by developers who fail to comply with these provisions.

Thus, comprehensive and efficient reporting procedures and systems must be established to ensure that syndicators obtain required information throughout the investment holding period. Syndicators may consider providing a standardized reporting template to each developer partner. When feasible, reporting formats and documents should be consistent with those of annual audited financials by partnership accountants and of HFAs. When allowed by the HFA, syndicators should be included on mailing lists for any default notices or IRS forms 8823 generated by the State about the syndicator's projects.

Syndicators are expected by institutional tax credit investors to provide an increasing scope and variety of information about both upper and lower tier performance. Availability of current and accurate operating data on operating properties is the foundation for much of this information flow. Syndicators must be able to collect, store, extract, analyze, and aggregate data on both an individual investment partnership level and at a collection of investments, whether for specific upper tier funds or an entire investment portfolio.

Technology implications will be discussed in a subsequent section of this document. The focus here is on collection and analysis of lower tier information from developers and property managers to Asset Management.

### **Deliverables**

- Site inspection and compliance review of initial tenant files within 90 days of full occupancy. Syndicators or their agent may inspect a representative portion or all units for satisfaction of HUD housing quality standards or laws concerning accessibility by the disabled. Particular care should be taken to affirm qualified tenant eligibility before December 31<sup>st</sup> of the year of lease-up, so that corrective action may be taken if necessary, prior to relevant Section 42 deadlines.
- Occupancy Reports: monthly and quarterly physical and economic vacancies, complete rent rolls quarterly, and unit turnover analysis if possible.
- Annual Operating Budgets: review and approval by Asset Management of annual operating budget typically serves as basis for comparison to future actual results and monitoring of property performance, including early warning of potential problems.
- Quarterly Interim Financial Statements: income and expense statement, balance sheet, aged accounts payable and receivable, and reserve account balances and period activity (deposits and withdrawals). Reports should include explanations of significant variances in actual revenues and expenses versus budget, and any use of restricted reserves.
- General Partner's quarterly certification of compliance with all partnership contractual requirements and affirmation that no violations exist.
- Periodic copies of documents required to be provided by the developer to the HFA, the IRS or any other government or financial authority. Included in this category are annual certifications and tenant activity reports, as well as ad hoc items such as HUD management reviews and REAC scores, any default notices, and any IRS Forms 8823.
- Annual tax returns and audited financial statements: drafts and final copies should be reviewed and approved. Errors or inconsistencies are to be resolved prior to final submission. Relevant data from these key reports are incorporated in portfolio

databases regarding lower tier performance and upper tier financial models regarding delivery of investment benefits. In many companies, these responsibilities may be allocated among Fund Accounting and Asset Management.

- Payment of deferred Developer Fee and Cash Flow Distributions: in accordance with partnership operating agreements, should be monitored annually through review of the financial audits. Asset Management confirms amounts owed, priority of payment per contractual terms, and collects amounts owed as fees to syndicator or capital return to investors.
- Confirm at least annually (and preferably quarterly) that activity in restricted reserves (deposits and disbursements) conforms to contractual requirements. Take corrective action as needed to cure any defaults.
- Ongoing monitoring to ensure that property taxes and insurance premiums remain current. Take corrective action for any delinquencies or lapses in coverage.
- Collect capital needs assessments as regularly updated. Syndicators may monitor spending from replacement reserves in context with capital needs assessments.

## **Benchmarks**

- Debt coverage ratio (DCR) calculated as the ratio of net operating income including deposits to restricted reserve but excluding payment for hard debt service, divided by hard debt service payments. Industry standards for minimum target DCR historically have ranged from 1.15 to 1.20, with reduction to as low as 1.00 in certain cases, such as for projects with budget-based operating subsidies. Industry watch list and risk rating criteria depend on DCR, among other performance indicators.
- Occupancy rates generally are targeted from 93% to 97%, depending on existence of project-based rental assistance.
- Typically syndicators defer payment of a portion of equity capital, conditioned on property performance as measured by DCR and sustained occupancy rates, among other factors. Such thresholds for capital pay-in are intended to confirm that investment properties can meet or exceed original performance projections.
- Net cash flow per unit may be analyzed, but the value of such data can be minimal given wide variety in size, types and locations of tax credit projects. However, industry professionals and investors may seek to collect such historic information.

## **CONTRACTUAL & REGULATORY COMPLIANCE**

A fundamental role of Asset Management is risk reduction, in an effort to promote realization of target investment return. Thus, asset managers play a major role in monitoring compliance. Two aspects of compliance are contractual and regulatory. Contractual compliance refers to all documents by which the investment partnership or developer is bound, with special emphasis on the syndicator's operating (or lower tier partnership) agreement and related documents. However, contractual compliance by extension also refers to legal agreements (such as land use restrictions and mortgage

documents) with external stakeholders including HFAs, lenders and professionals. Asset managers must understand all relevant contractual agreements and enforce terms pertinent to the operating agreement and other partnership documents.

Regulatory compliance refers primarily to conformity by the investment partnership / property owner with all affordable housing requirements imposed by any applicable programs, with special emphasis on IRS Section 42, since receipt of expected tax credits represents such a significant element of investor return. Thus, asset managers must be knowledgeable and certified in Section 42 compliance. Syndicators may use industry compliance experts to supplement staff or to entirely outsource regulatory compliance reviews.

### **Deliverables**

- Annual compliance review consisting of site visit and HQS evaluation or to applicable housing code of some (typically 20%) of units and review of tenant lease files (typically 20%) for compliance with Section 42 and other applicable regulatory restrictions. File reviews often are “desktop” conducted offsite via electronic copies. Compliance Monitor creates written report of findings and follows up to resolve any issues cited.
- Increased frequency or scope of physical inspections or file reviews may be warranted for troubled assets. Similarly, scrutiny may be reduced for lower risk investments, perhaps as measured by size of equity investment, historic performance or other factors.
- Collect and review annual compliance reports required to be sent by developer to the HFA, including certification of program compliance and tenant activity summary for past year.
- Collect and review all management and compliance review reports produced by State HFA.
- Solicit any 8823s generated by State HFA, whether from developer, property manager or HFA.
- Solicit at least annually developer’s certification of compliance and affirmation that no violations have occurred.
- Confirm that property management firm has met any professional education requirements which may be imposed by State HFA or syndicator.
- Some syndicators retain the services of compliance professionals to provide ongoing technical assistance in Section 42 and other regulatory matters. Typically such service is free to partners and managers connected to investment properties in which syndicator holds interests. Such resources encourage avoidance of compliance problems and reinforce education for property operators.

Systems and procedures to regularly and thoroughly conduct compliance monitoring cover scheduling, communications with developers and property managers, reports on findings, corrective action and documentation of resolution of any problems identified. Asset managers and compliance specialists routinely work with property managers to promote understanding of reporting requirements and compliance issues.

Syndicators should consider requiring in the partnership documents immediate self-disclosure by developers of any notice of:

1. Default from lenders or other contractual parties.
2. Violation of law or local building/housing codes.
3. Non-payment of real estate taxes.
4. Filing of Fair Housing complaint.
5. Litigation or initiation of bankruptcy proceedings which involve the General Partner or guarantor or investment partnership.
6. Negative reports from State HFAs or the IRS regarding non-compliance findings, including issuance of any forms 8823 and any notices of audit or recapture from IRS.

## **INFORMATION TECHNOLOGY**

Syndicators are huge consumers and producers of data, and they rely on integrated, well functioning information management systems to conduct their business. Clearly the size of invested portfolios and staff impact the scope of data technology systems, but it is unlikely that Asset Management can be productive without an adequate database and local area network, as well as speedy internet access. Industry resources to manage information needs vary from simple proprietary systems to complex third party administered ones. Reporting by lower tier relationships and dissemination of upper tier results may be web-based and heavily automated.

A trend to paperless reporting continues, even as a partial guiding principle. The cost for ongoing upgrades to Asset Management systems should be factored into any long-term budgets by syndicators. Other syndicators, especially NASLEF affiliates, can provide recommendations and referrals, as well as share internal forms and protocols.

Information technology serves as a tool to provide key information. IT systems must incorporate procedures for utilizing this data in support of the deliverables outlined in this document.

## **DOCUMENT RETENTION**

Various documents are standard and critical to compliance oversight. Certain duplicate project records may be required in the event of IRS proceedings, such as an audit. Asset Management must have adequate procedures and systems to ensure long-term retention of key documents for 21 years from the start of the compliance period, *i.e.*, through the 15-year holding period and expected disposition in year 16, plus 5 additional years for IRS statutory compliance.

- All legal documents including partnership agreements and related documents
- All permanent loan agreements and other closing documents.
- Qualified Allocation Plan.
- Tax credit application.
- Reservation letter from tax credit allocating agency.
- 10% carryover cost certification, if applicable.
- Carryover allocation letter from the tax credit allocation agency, if applicable.
- Final cost certification.

- Extended Use Agreement.
- Certificate(s) of Occupancy.
- First year IRS Forms 8609, with Part II completed indicating owner's irrevocable elections.
- Rent roll reporting every restricted unit, initial eligible tenant and date each was initially qualified.
- Complete lease files for all initial qualifying tenants.
- Tenant selection plan.
- All annual partnership tax returns, particularly K-1s.
- All partnership audited financials.
- Annual reports to State HFA.
- Annual income limits and rent increase documentation.
- Annual utility allowance documentation.
- Record of unit transfers.
- Any 8823s or other notices of noncompliance and documentation of corrections, if applicable.

## **RISK ANALYSIS & WORKOUTS**

The tax credit industry has evolved to use sophisticated tools to monitor and assess risk, and to communicate internally and with investors about potential or real problems. Syndicators must have comprehensive systems and well defined procedures to ensure consistency in risk analysis and reporting. Within the tax credit industry, certain standards for risk analysis and reporting are influenced by major institutional investors or their trade associations, such as the Affordable Housing Investors Council (AHIC). Many syndicators seek to integrate such standards to the degree that they are relevant, feasible and productive for syndicators to implement. Most syndicators prefer to use one integrated system for risk ratings and watch lists, but standardization of risk assessment does not currently exist among major investors. Hence, it is likely that some syndicators will continue to be challenged by the costs and inefficiency of maintaining multiple risk evaluation and reporting tools.

### **Risk Ratings**

It is common practice to assign ratings to all lower tier partnerships, meant to synthesize quantitative and qualitative evaluation of investment risk at many levels appropriate to tax credit operating partnerships. Multiple categories are assessed, such as financial, sponsorship, physical, market, and ultimately aggregated into one overall rating. Similarly, ratings of individual assets can be analyzed to determine collective portfolio risk. Typically, syndicators start the rating process at the closing of a new investment and regularly update the ratings thereafter. During construction and lease-up, as well as for stabilized projects which fall short of projections, it is common for risk ratings to be conducted at least quarterly. Ratings for stable investments may be updated annually.

There are several templates in the tax credit industry used by syndicators and investors to assign risk ratings. Sources include the investors cited above, as well as other NASLEF and national syndicators. AHIC revised its rating guidelines in 2010, which may be posted to the AHIC website cited below. Typically there are unique ratings templates for each of the development and stabilized phases. The calculation of risk ratings requires inputs from analysis of the multiple aspects of investment partnerships, much of which have been previously discussed:

- Pace and budget of construction completion.
- Lease-up progress.
- Occupancy statistics.
- Financial results, both interim and annual audited statements.
- Tax returns.
- Physical inspections.
- Major casualty events.
- Compliance reviews.
- State HFA certifications & findings.
- Breach of contractual obligations.

### **Watch Lists**

Just as syndicators maintain risk ratings systems, they also generate regular periodic watch lists, typically on a quarterly schedule, to report on under-performing assets. Many follow or adapt their watch list criteria in conformity with AHIC standards. It should be noted that some investors ascribe to a policy of identifying all tax credit partnerships which in some way fall short of original or updated financial and performance projections, intending to have early warning of potential problems and avoid any “surprises”. On the other hand, investors frequently want to focus only on those investments most likely to deliver impaired investment return, particularly due to reduced tax credits or real estate failure. Syndicators must balance the desire of investors for inclusive “transparency” with the efficacy of narrowing attention to assets likely to lose investment benefits. Syndicators should follow consistent guidelines to categorize watch listed assets as effectively benign, chronic or of serious concern. Please see the AHIC website for its watch list criteria: [Welcome to AHIC.org](http://www.ahic.org)

### **Deliverables**

- Risk rating criteria which reflect current industry priorities.
- Development phase rating template.
- Stabilized Operations phase template.
- Updated ratings output – quarterly or annually.
- Summary analysis report of portfolio ratings.
- Watch list criteria.
- Watch list report quarterly.
- Classification of watch list by defined levels of investment impairment.

### **Workouts**

Syndicators must allocate experienced staff and have clear procedures to identify and resolve problem investments. Although threatened or actual impairment of investment return is the common trigger to most workouts, the nature of troubled assets can be complicated and unique. However, some common threads to successful resolution require advance procedural planning by syndicators and may include any of the following:

- Syndicator’s decision-making authority.
- Collaboration with external stakeholders having an interest in the asset.
- Collaboration with internal departments, such as Fund Accounting (upper tier impact).
- Professional guidance, particularly legal counsel and accounting.
- Property management consulting or engagement.

- Organizational subsidiary to act as replacement General Partner.
- Loan restructuring.
- Bankruptcy protection.
- Investor reporting.

### **Upper Tier Risk Analysis**

It is common for executive staff, internal boards of directors and large tax credit investors to seek periodic analytical output from syndicators to assess the stability and long-term viability of their business operations, particularly in the absence of future development or acquisitions activities. Such “sustainability analysis” consists of financial projections typically over a rolling 15-year period to forecast corporate revenues and expenses to maintain Asset Management and Fund Accounting operations. Several templates for such analysis are in use by syndicators and AHIC makes available a suggested format.

Related to fund level risk evaluation is the assessment of availability and adequacy of upper tier reserves, capitalized by syndicators from fees earned upon the subscription and closing of new investment pools or funds (upper tier partnerships). Such reserves are usually intended to be held over the investing horizon of the fund, to be used for various purposes in conducting upper tier business. Acceptable uses of upper tier reserves at the syndicator’s discretion may include routine professional fees (such as annual audits) incurred by the syndicator, asset management fees to the syndicator, costs of workouts incurred by lower tier partnerships, and fund disposition expenses. The upper tier partnership documents typically specify expected creation and use of such reserves.

### **DISPOSITIONS**

The maturity of the tax credit industry has increased awareness of the disposition or liquidation phase of lower tier investments. Upon completion of the 15-year traditional expected holding period, syndicators play a pivotal role in divesting lower tier partnerships and ultimately closing out upper tier funds. A host of technical and analytic skills are required, and large firms may have specialized staff or use outsourced professionals to execute. Many industry trainings are conducted by various experts to build required skills.

Syndicators must coordinate with lower tier general partners, accountants, State HFAs and internal staff responsible for upper tier benefits analysis. Asset Management may handle the lower tier disposition function, or play a supporting role with Fund Accounting or Acquisitions, or oversee engagement and performance by external professionals. Certainly asset managers are responsible for reporting and analysis needed to prepare for and complete dispositions. To that end, following is a list of basic information required.

### **Deliverables**

- Portfolio runs of scheduled Year 15 dates.
- Fund target return and current updated projections.
- Lower tier projected return and total benefits through disposition date.
- Quantify any exit taxes likely.
- Review partnership document for relevant terms, including buy-out option of developer, minimum return or total benefits standards, ROFR, allocation of capital proceeds.
- Confirm investment partnership is in good standing or identify any breach.
- Verify terms of existing land use and capital program restrictions.
- Estimate real estate value, factoring in all relevant land use restrictions.

- Obtain capital needs assessment, if feasible.
- Determine goals, resources and needs of developer.
- Evaluate alternative financing prospects, including re-syndication for tax credits, if applicable.
- Draft sources & uses of disposition funds, if any.
- Determine investors' authority or reporting requirements over lower-tier disposition.
- Obtain required investor approvals, if any, for proposed transaction.
- Communicate to developer investor partner's rights and goals, collaborate on potential disposition action plan.
- Confirm rights and goals of other stakeholders, such as lenders and State HFA.
- Facilitate communication and decision-making by other stakeholders, particularly State HFA.
- Engage professionals as needed to represent upper tier investor partner, specifically accounting and legal.
- Close disposition transaction, account for impact at upper tier, provide applicable tax and financial reports.

## **TRAINING**

Training specific to the development and operations of affordable housing is important to developers, syndicators, property managers, compliance specialists and asset managers. Some State HFAs and syndicators may require annual continuing education by property operators. Curricula vary in relevance, with the following priorities for different target audiences:

- **Developers:** topics broadly aimed at housing tax credit financing, deal structuring and impact of different subsidy programs; other credit financing such as new markets and historic; design and construction issues; energy efficiency.
- **Property managers, asset managers and compliance specialists:** certification by nationally recognized Section 42 program compliance trainers; integration of program restrictions imposed by other affordable housing subsidy programs, such as HOME, Rural Development, HUD loans and rent assistance; certified occupancy specialist; HUD Housing Quality Standards (HQS) and applicable state and local housing codes; rental property and financial operations; fair housing and rental marketing.

Training programs have proliferated and include sources which focus on:

- nationally recognized Section 42 compliance certification, such as Spectrum Seminars and A.J. Johnson Consulting Services
- asset and property management, such as Consortium for Housing and Asset Management (CHAM) and Institute of Real Estate Management (IREM)
- project financing and subsidy programs, such as Institute for Professional and Executive Development (IPED)
- broad affordable housing policy and operations, provided by many trade groups and mission-oriented organizations including NASLEF
- local priorities, such as State HFAs, property manager trade groups and syndicators