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(letter from SCANPH)

January 20, 2009

William J. Pavao
Executive Director
California Tax Credit Allocation Committee
915 Capital Mall, Suite 485
Sacramento, CA 95814

Dear Bill:

The Southern California Association of Non-Profit Housing has convened a working group of developers and consultants with extensive experience developing below market-rate housing to consider the Tax Credit Allocation Committee's proposals to revise its regulations. After reviewing the posted revisions, our discussions focused on the proposed changes to Leveraging scoring and the Third Tie Breaker. SCANPH has adopted the unanimous consensus of the working group that 1) we strongly oppose the proposed changes to scoring Leveraging, and 2) the proposed changes to the Third Tie Breaker are a significant improvement to the current process.

Leveraging Scoring

We strongly oppose the proposal to change the competitive Leveraging scoring, allowing a maximum of 15 points for cost efficiency, 15 points for public funds and 5 points for credit reduction (maximum 30 points in total).

- In the past, applicants have manipulated cost basis in order to improve their chances of winning an allocation. This proposed change magnifies the effect of such manipulation while eliminating the alternative of using public funds to fully offset cost efficiency points.
- Encouraging applicants to develop projects with costs that are significantly below the threshold basis limits will tend to diminish the quality of the housing produced by the program, thus eroding public confidence in subsidized housing and the long-term durability of many projects.
- Certain development types—many of which are SCANPH priorities and state housing policy priorities (e.g. supportive housing, transit-oriented housing, and mixed use developments)—are higher cost by nature. Urban infill projects will likely receive few if any cost efficiency points and so their point total in this category will likely be limited to 15. Projects that are less costly to build, generally those in suburban or rural areas, on the other hand, will tend to receive all of the cost efficiency points plus some public funds points, thus having a higher overall leveraging score. We must not advantage cost efficiency over other measures of project quality; nor should we encourage sprawl and contradict smart growth initiatives by disadvantaging urban infill projects.

- Los Angeles County’s basis limits are significantly lower than other parts of the state under the new system of basis limits published last year. Because of these low limits it is much more difficult to score cost efficiency points in Los Angeles than in other areas. Therefore, by making it necessary to score cost efficiency points, the new proposal puts LA projects at a disadvantage when competing for the set asides, which comprise a significant portion of the overall funds.
- Alternatively, public funds should receive more points than cost efficiency. In addition, assuming that a project would need both types of points to win under the proposed leveraging point system, projects which meet more public goals could be disadvantaged, because they tend to be more expensive. For example, redevelopment/publicly inspired projects often involve relocation subject to full relocation benefits, and/or they may take on difficult sites with toxic clean up, extensive shoring, difficult staging issues, etc, and/or they are subject to additional design requirements, and/or they are subject to prevailing wage requirements. These projects, therefore, may score well over 15 points in the public funding section, but nothing for cost efficiency, while a moderately well publicly funded project with simple construction in a suburban location might score 15 points in both categories. In addition, this section as proposed probably favors rehabilitation over new construction for the same reasons.
- It is clear that TCAC intends to reduce credits if a project’s tie-breaker is worse at placed-in-service than at application. But does the same apply to the leveraging section points? If so, what happens when a project suffers some cost increases during development (which is a pretty normal occurrence)? Cost increases could result in lower points in both cost efficiency and local funding. Losing credits because of cost increases is a disaster that will affect a large number of projects. This is not a big concern under the existing point system, because you could compensate for points lost in cost efficiency by adding points in some combination of the other two leveraging sections.
- If TCAC does not intend to enforce any consequences if a project’s points change due to cost overruns, then it is relatively easy to artificially increase a project’s score by underestimating its costs or basis. We understood that a major impetus for the proposal to change the tie-breaker was that some developers were manipulating the system by showing artificial financing, then after getting an award of credits “extorting” money out of local agencies to make up the gap created by taking away the artificial financing. The proposed point system lends itself to the same game.
- It seems that the requirements imposed on augmenting and substituting local funding are intended to reduce this points game. However, the proposal to require TCAC approval of any new public financing is cause for concern. It adds one more risk and a potential time delay to an already risky situation—at a time when investors are already skittish. What would be the criterion for disapproving an additional public source?

Third Tie-Breaker

We strongly support the proposed change to the third tie-breaker, using the highest ratio of public funds to total development cost. The current third tie-breaker seems to be vulnerable to a manipulation of costs and hence does not serve the policy objective of choosing the best projects for the allocation of tax credits.

- Utilizing the highest ratio of public funds will link allocations to local planning, thus promoting quality projects in local high priority locations, such as transit-oriented developments.
- The proposed new tie-breaker should also result in deeper income targeting, since projects that are less able to service conventional debt, due to their lower rent levels, will have a higher ratio of public subsidy. Use of the highest ratio of public funds to total project costs as a tie-breaker should therefore serve to promote greater affordability in TCAC allocations.

- There is wide-spread agreement that the proposed new tie-breaker will diminish unfair manipulation of the application process.
- We are very concerned with one aspect of the third tie breaker as proposed, and are suggesting a way to fix it. It is far too easy for a developer who submitted everything honestly to end up with a lower tie breaker at placed in service as compared to application stage. Often costs come in higher than anticipated at initial application. If costs are even \$100 over, the tie breaker will be lower and the developer will be subject to future negative points and possible reduction of credits. If shortfalls are filled by additional public subsidy, then it probably improves the tie breaker. However, shortfalls are usually at least partially filled by other means, such as deferring more developer fee, increasing the private mortgage—if interest rates went down or rents went up over the construction period—getting some Project Based Vouchers, securing a higher pay in, etc. Using any of these methods decreases the tie breaker, and using these fixes should not be penalized. We suggest: First, a possible reduction in credits may scare off investors, so this penalty should be eliminated. Getting negative points is a severe enough penalty to deter bad behavior. Second, a reasonable safe harbor by which the tie breaker can change without causing negative points would be appropriate, to include an override by TCAC for extraordinary circumstances. We are aware that these safeguards make it easier to manipulate the system, but the incentive in this tie breaker is to understate the need for credits, so it should contain its own limits to manipulation.

Thank you for the opportunity to comment on these proposed regulation changes. Although such changes are subject to debate, we feel that a substantial case has been made for not following through with the proposed changes to the way Leveraging is scored. Likewise, it is time to revise the Third Tie-Breaker in a way that favors local priorities, discourages manipulation, but includes a safe harbor that protects good projects from unintended consequences.

Sincerely,

Paul Zimmerman
Executive Director

Cc: State Treasurer Bill Lockyer
State Controller John Chiang