NATIONAL DEVELOPMENT COUNCIL
AUGUST 27, 2015
RECOMMENDED REVISIONS TO RDA'S LOAN POLICIES AND PROCEDURES

Background. The RDA currently lists six different loan programs; New Construction, Renovation, High Performance Building Construction, High Performance Building Renovation, Environmental Assessment & Remediation and Housing Acquisition. Currently these six programs carry different interest rates (0%, 3%, and 5%) and varying loan underwriting criteria. In practice, however, only the first two programs are currently active. The staff reports a loan volume of approximately five to seven loans for new construction or renovation considered and closed each year, and an outstanding loan balance of just under $15 million as of 6/30/15, comprising 31 individual loans. Currently the RDA Board is the final arbiter of all loan requests over $500,000 or when any non-standard loan terms are proposed.

The RDA Board has requested an examination of lending policies, including the possibility of shifting loan approvals to the Redevelopment Advisory Committee, or the RDA Loan Committee. This is more typical of a public lending program; with the Board making the public policy decisions that will guide the program's design upfront, followed by adoption of a loan program designed to support those policies. The individual lending decisions are then left to the staff and a loan committee, within the structure of the loan program guidelines.

Task #1 - Review the loan products currently offered. Identify appropriate rate, term and amortization adjustments that could be made to remain competitive in the market, while continuing to encourage mission-oriented development.

Recommendation. Combine the programs into one set of loan policies and procedures. This program can uniformly cover all types of development encouraged by the RDA in their project areas, including new construction, building acquisition and rehabilitation, and energy efficient upgrades. The Environmental Assessment & Remediation program may be restructured as a grant program, so will not be discussed as part of this report.

The loan rate, size and other favorable loan terms are an important way for the RDA to effect the City's policies and objectives in the Redevelopment Project Areas. Setting rates or terms so that the resulting debt service payment amounts are below market can encourage developers and businesses to look to the RDA as a desirable funding source. These financial benefits can allow the RDA to negotiate additional development standards or encourage the specific development types the City wants to see in the Project Areas. If the lending terms are structured to be desirable enough to bring potential borrowers to the RDA, it can result in the type of developments the RDA feels will best serve the needs of the City's residents; sparking additional improvements, and providing additional public benefits.

If the terms are not sufficiently attractive, developers and business owners will seek other less-restrictive sources (like private capital), or decline to develop in the Project Areas. On the other hand, if the RDA's terms are too attractive, the City risks overspending valuable public resources for the same projects they might see happening otherwise, or unduly enriching a private developer at public expense. It's a balancing act that requires frequent fine-tuning, so simply setting interest rates at a fixed amount and leaving that rate stagnant as conventional lending rates rise and fall may not accomplish the City's purposes. This is the current policy, which the RDA staff and Board have recognized as insufficient to make a positive impact on the RDA's Project Areas.

Recommended Rate. The interest rate for all loans should be based on a widely-available index that can be easily accessed by RDA staff, board and potential borrowers. The Treasury Rates, or "Daily Treasury Yield Curve Rates," are posted each Friday on the government website, Treasury.gov at http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield, which meets the requirement of being widely available. The site publishes rates which differentiate between 5, 7 and 10 year (or longer) borrowing.

The RDA can add a standard "spread" to that index, resulting in a loan interest rate that is designed to be attractive, but still generally parallels rates offered by the private sector as economic conditions change.

For example, a project qualifies for a standard spread of 200 basis points on the 5-year index, for a 5-year fixed rate loan. The chart below shows the Treasury rates for the week of August 3 – 7, 2015. The above policy would result in a borrowing rate of 3.59% (1.59% index + 2.00% spread) for a loan closed within the week after August 7, 2015.

DAILY TREASURY YIELD CURVE RATES FOR THE WEEK OF AUGUST 3, 2015

Date	1 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
08/03/15	0.03	0.08	0.17	0.33	0.68	0.99	1.52	1.89	2.16	2.55	2.86
08/04/15	0.05	0.08	0.18	0.37	0.74	1.08	1.60	1.97	2.23	2.59	2.90
08/05/15	0.05	0.08	0.19	0.38	0.73	1.10	1.65	2.02	2.28	2.64	2.94
08/06/15	0.04	0.04	0.20	0.35	0.71	1.08	1.62	1.98	2.23	2.59	2.90
08/07/15	0.03	0.06	0.23	0.38	0.73	1.08	1.59	1.93	2.18	2.52	2.83

Friday Aug 7, 2015

This would be a very attractive rate for a typical development project, and should be well below what most projects will be able to secure from the private sector. Just how much lower the RDA's standard rate should be set is a policy decision, but something in the area of 200 to 300 bp above the Treasury rate should attract interest in the loan program. Higher spreads (say 400-500 basis points) would result in a loan rates that are pretty close to what an experienced developer or well-run business can probably find elsewhere so may not accomplish the RDA's purpose.

Since the RDA doesn't rely on the interest rate spread to support its general operations, the spread to a particular project could be reduced further, depending on the degree to which the project meets public goals. The standard spread of 200 basis points (bp) could be decreased in 50 bp increments for projects that meet other RDA goals, such as being LEED-certified, or providing public open space, or to encourage a specific project that is deemed critical to the overall success of the RDA's efforts in a Project Area. If the RDA desires to have more flexibility to incentivize particular project characteristics, the rate can be reduced in return for committed benefits all the way to zero, if that is the desire of the Board.

Amortization Schedule. Currently, the RDA allows a maximum amortization period of 20 years on their loans. For many of the projects the RDA will be asked to finance, the economics of the project are likely to be somewhat thin in the early years of the project. The RDA can assist in reducing a project's risks in those early years by allowing a longer amortization period than those typically offered by conventional lenders (typically 20 to 25 years for commercial development, and 30 years for a residential project). Since the RDA primarily finances real estate; either acquisition, construction or rehabilitation costs, the amortization period could be as long as 30 or 35 years for new construction projects, and for as long as the appraiser's estimate of remaining useful life for rehabilitation projects. Another structure that can assist projects with higher risk during lease up, is to extend the interest-only period up to a maximum of three years, allowing for full occupancy by the time principal payments begin.

Loan Term. The RDA staff articulated a desire to have the RDA loan funds recirculate more rapidly, if possible. Generally, a project should be able to stabilize its operations and qualify for conventional financing after establishing a track record of stable operations for 3-5 years. If overall redevelopment efforts have been successful, the project should be able to raise rents as the desirability of the surrounding area increases, allowing the project to potentially refinance to a higher loan amount if the developer desires.

For these reasons, the RDA should initially offer fixed rate loan terms for periods of 5 years, with a longer amortization period, say 25 – 30 years. If the project warrants it, an additional 5 year option could be allowed, extending the overall term to 10 years. Additionally, the loan's interest rate could adjust at that point, with the rate stepping up by an additional 200 basis points above the corresponding Treasury index five years after the initial loan closing. This will provide some incentive for the developer to evaluate refinancing the RDA's loan if they are in a position to qualify for conventional financing at that time, but will allow them to have the certainty of an additional period of public financing if economic conditions are not favorable at that time.

Exception. The RDA may want to consider an exception to the above policy when making loans to affordable housing with restricted rents. In that case, the ability of the project to support an increasing amount of debt five or ten years later will be limited by the rent restrictions on the affordable units. In addition, loans to projects with equity from Low Income Housing Tax Credits (LIHTC) will require an initial loan term longer than the 15 year initial compliance period. Whether or not a project uses the LIHTC program, projects with a significant percentage of affordable units (for instance >25%), the RDA should consider offering a loan term that provides a fixed interest rate for the length of the rent restrictions. This policy could provide added incentive for the inclusion of rent restricted units within a market rate project, when coupled with other housing funding programs.

Task #2 - Review the current loan underwriting guidelines and processes being used to insure that proposed projects are financially feasible and that RDA financing provided is necessary and appropriate to the development. Provide metrics for RDA staff and loan committee to employ in making these evaluations.

While the current loan programs provide some basic underwriting guidelines for the staff to follow in sizing proposed loans, currently the amount of funds the RDA will provide to a project is essentially limited only by the project costs (up to 100% of the hard costs for new construction and up to 50% of the cost of building renovation). Within those parameters the loan amount requested is left almost entirely up to the borrower, and the staff and board have little additional guidance to determine whether that amount is appropriate. Though the current program states that the RDA funds are intended to be a "gap" sources and a "lender of last resort," in fact, the lending policies do not support that policy.

Since for the most part, the terms of the RDA loans allow a higher debt amount (lower interest rate, higher Loan to Value (LTV) ratio, lower Debt Coverage ratio (DCR)) than those offered by conventional lending sources, the policy creates an incentive for borrowers to claim that they cannot get private financing (without specifying the terms of that financing), thus requiring a higher loan amount from the RDA. Salt Lake City is a relatively capital-rich area, so a viable real estate project developed by a competent development team should be able to attract some amount of private debt, and if it can't, that may indicate problems with either the project or the development team, and should alert the RDA of the need for greater caution if they choose to proceed in funding the project.

In addition, a policy that primarily bases the available loan amount on cost, rather than value, puts the RDA at risk of not having sufficient collateral in the event of a foreclosure.

For these reasons, NDC recommends several important modifications to the above policy:

1. **Maximize Private Debt.** The RDA should require projects to secure a loan commitment (evidenced by a Letter of Interest and Term Sheet) from a private lending source at the best possible rate and terms and in the maximum size available, given the economics of the project. Standard metrics used by the conventional lenders may be a Debt Coverage Ratio (DCR) of 1.25:1 and a Loan to Value (LTV) of 75%, but the lender may also make other modifications to the developer's model, based on their comfort level with the project and its developer (for instance, reducing rents or increasing the vacancy rate).

Regardless of the specific methods used, this will often result in a loan amount below the total financing needed to cover the project costs, since the project's location in a redevelopment project area and additional RDA requirements may result in either higher costs than typical, or lower rents, or a combination of the two.

Note that most lenders should find the RDA's willingness to lend to the project in a subordinate position to be positive, providing additional security for their loan. It may be helpful to prospective borrowers if the RDA maintains a list of the lenders who have been willing to do such lending in the Project Areas. However, the pool of interested lenders may vary greatly, depending on the project, loan size and developer experience, so shouldn't be used or viewed as a "recommended lenders" list.

2. **Size the RDA Loan to Fill the Lending Gap**. The RDA's loan would then be sized to cover the remaining financing needed to meet the lower of the RDA's DCR of 1.1:1 using the standard interest rate, a Loan to Value (LTV) of 95%, or a Loan to Cost (LTC) of 95%. Developer/owner's equity (which could be equity from tax credits or grants in the case of a nonprofit developer) would make up the balance of funds needed. This equity amount could range from a fairly small number if the appraised value turns out to be close to the cost, to a significant amount if the total development costs exceed the market value of the project. The latter situation is actually quite common in cases where market rents are still relatively low, or the costs are somewhat high due to additional features required by the RDA. The Loan to Cost (LTC) ceiling results in all developers having some skin in the project, ensuring less risk to the RDA.

3. **Consider Rate Reduction if Equity Return is Unreasonably Low.** For projects with a high degree of public benefit, a reduction of the interest rate should be considered if the resultant developer's return on equity appears unrealistically low. This is not an exact science, and it does require that the RDA staff and loan committee have access to a financial model that provides sufficient information to feel comfortable making that judgement.

4. **Make Loan Approvals Subject to Appraisal**. A current appraisal does not need to be part of the loan application package. After conditional loan approval, the appraisal should be ordered by the primary lender and shared with the RDA, or vice-versa. Most lenders will prefer to order the appraisal themselves. If the appraisal does not support the underwritten rents and the overall as-completed value for the approved loan size, the loan should be reduced to a level that does. The appraisal can also confirm that project expenses are reasonable and not inflated to increase the lending gap or exaggerate the need for additional rate reduction.

5. **Exceptions**. The RDA may want to consider an exception to the gap financing approach for very small projects, for example a total project size of $500,000 or less, or a project where the supportable private debt is below $250,000. In this case it is unlikely that having two separate loans would be cost-effective, due to the need for duplicate legal counsel, and it is unlikely that a private lender would find the work required for such a small loan to be worth their trouble. However, if the RDA does consider being the sole lending source, they should implement a more conservative DCR requirement for those loans, since a 10% cushion on the expected Net Operating Income on a project of that size will be a very small amount. A more conventional DCR of 1.20 might be more appropriate for those loans.

Recommended Metrics. One of the beauties of this shared lending approach for the RDA is that to some extent the RDA can piggyback on the analysis done by the private lender in underwriting the deal and the developer. The RDA can require that it receives the same pro forma and assumptions from the developer that the private lender has reviewed to prevent the RDA from acting on different assumptions than the private lender. Ideally, the RDA staff should then be able to do an analysis of the appropriate RDA loan size themselves with the appropriate assumptions. The model should include an income and expense pro forma that covers the length of the loan term to make sure the RDA's debt coverage ratio is maintained, as well as calculating the cash-on-cash or internal rate of return that the developer is projected to realize on the project. This is not overly complicated or technical, and NDC is willing to provide a customized spreadsheet tool along with training on the use of that tool for staff, as a follow-up activity.

Task #3 - Make recommendations on information required from borrowers at application and post-closing regarding public benefits to be provided by RDA funded developments, including at a minimum, construction and permanent jobs created and/or retained, commercial space renovated and/or constructed, increased development density, open space, housing units created/renovated and other requested design or amenity enhancements. Provide recommendations for specific metrics for RDA staff and loan committee to employ in making this evaluation.

Some threshold criteria is appropriate for a project to qualify for RDA financing in the first place. Currently the primary filter is that projects must be located within an RDA Project Area, contribute to the goals of that Project Area, and conform to the neighborhood's Master Plan. A further justification for the RDA's below-market loan rates is the requirement for design review. While this review is essential to determining if a proposed project meets the RDA's goals, it can be viewed as a disincentive by developers, with the lower rate helping ease the pain.

As previously mentioned, the ability of the RDA to provide loans at rates well below market can be a very powerful tool to help achieve the Agency's goals. Therefore, it makes sense to have projects proposed for RDA's standard loans rates (200 - 300 bp above the index) be based on meeting all threshold criteria, then further flexibility could be allowed for that interest rate to be reduced if the project both meets a higher level of Project Area Priorities, <u>and</u> can demonstrate a greater need because of the cost of the additional public benefits. To reward projects with lower rates based <u>only</u> on need may encourage marginal development, and is probably not the best public policy.

Threshold Criteria to Receive Standard RDA Loan Pricing:

- Is in an RDA Project Area, or is an affordable housing project; and
- Meets two or more of the Project Area Objectives from the Area's Strategic Plan; and
- Has a letter of interest and term sheet from a private lender and a demonstrated remaining financing gap.

Potential Project Characteristics Warranting Additional Rate Reduction:

- Meets one or more of the Implementation Program Priorities of the Project Area's Strategic Plan; or
- High Performance (pursuing at least LEED Silver, Energy Star or Equivalent); or
- Provides showers and lockers for employee use; or
- Provides permanent new jobs at or above living wage (or some other standard for quality jobs); or
- Provides affordable housing with restricted rents affordable to households at <60% ami, or sales prices affordable to households at <100% ami households; or
- Contains permanent design features or other amenities that provide documentable public benefits, or will seed additional positive economic activity and investment in the Project Area; or
- Other proposed characteristics as set by the RDA Board

NOTE: The above are only samples of the types of project characteristics that could qualify for interest rate reductions. The types of project characteristics and the rate incentives appropriate for these characteristics should be discussed and approved by the RDA Board and can be modified as goals and circumstances changes.

Rate Reduction. The RDA could reduce the standard interest rate by 50 bp per "benefit" provided, up to a maximum of 200 or 300 bps discount from the standard rate. It is important to note that the policy will be less prone to political interference the more the interest rate reduction items can be made quantitative vs. qualitative in nature, which requires making the public policy decisions upfront.

Compliance. Borrowers will be required to describe and commit to the benefits provided in their loan application, and would also be required to report on the actual benefits realized by the project. Some of these benefits will be documented through a one-time report that is completed after construction completion and stabilized occupancy, (for instance the High

Performance requirements, or the construction of a public plaza) but other benefits will need to be reported on annually (job creation or affordable housing) for the term of the RDA loan. In addition, some of the benefits will come from the project's tenants, rather than from the developer, so a mechanism to pass along the requirement for tenant compliance will likely need to be included in the developer's lease agreements with the tenants.

See attached sample compliance reporting form which can be tailored to fit the RDA's needs and desires. If necessary for compliance, the RDA could implement a policy that requires the interest rate be increased back up to the standard rate if any benefit fails to be realized (or if the annual reports are not completed) after some kind of "cure" period, or they could simply deny future funding or loan extensions to developers whose projects failed to achieve the promised benefits.

Task #4 – Review servicing procedures to identify improvements in process and operations, and advise RDA staff on options/alternatives for back-of-house administrative support.

To date, the RDA has relied on their Project Area staff to market their loan program in the Project Areas, field requests for loans, work with potential borrowers to complete the application, underwrite and produce the loan report for the Advisory Committee and Board ($500K+), oversee loan closing, and provide loan servicing. This is all on top of their regular job responsibilities. The staff has identified loan servicing as an area they could potentially outsource.

NDC discussed this prospect with a major local bank and two non-profit lenders (one local, the other national). Since the total portfolio is quite small, and the borrowers fairly diverse in terms of sophistication, servicing by a nonprofit organization, or a smaller lending institution may be a better fit for the portfolio. Potential servicers include nonprofit organizations like the Mercy Loan Fund, Utah Community Reinvestment Corporation, or Zions Bank or some other local lender.

Mercy Loan Fund is a national provider of loans for affordable housing and community health clinics, based in Denver, Colorado. They have a portfolio of over $40MM in loans with an average term of five years (which is similar to the RDA's portfolio average), and an average loan size of $860,000. They have two fulltime staff working in their servicing department.

Utah Community Reinvestment Corporation (UCRC) is a member-based consortium lender with an office in the southern part of the Salt Lake Valley, lending in a five state area. They have an outstanding loan balance of over $140MM, and are currently servicing over 100 loans with a three member servicing team. The majority of their loans are permanent loans for affordable housing, with 15+ year loan terms.

Both organizations expressed interest in providing servicing for the RDA's portfolio, but would require additional information on the scope of work needed and portfolio details before being able to provide a definitive quote. NDC can arrange a meeting with either of these lenders should the RDA wish to continue to explore this option.

Zions Bank was also open to additional discussion on the subject, but as the key person was on vacation, we were unable to have a discussion during the timeframe prior to this report. We can follow up with them and any other local banks or credit unions to get more details.

From my conversations, it appears that the straightforward servicing of the loans, (once they reach stabilized occupancy and start making amortizing payments) could be relatively easily outsourced. The services could include payment tracking and monthly collection, making required annual payments of property taxes and insurance, document storage, and generation of monthly, quarterly and annual reports. All these services would be feasible for either of the two nonprofits interviewed to perform, and each ball-parked a fee of around 50 basis points annually. This would include promptly notifying the RDA in the event of missed or late payments, but any workouts would remain the responsibility of the RDA staff.

One concern with third party servicing is in the timely reporting of late payments and the responsibility for following up on missed payments. Without timely information, it is very easy for a borrower to rapidly move from one late payment to 90 day default, requiring action by RDA.

Another option the RDA staff wants to explore is whether a third party loan servicer could additionally provide loan closing services. This is an option that was discussed with all of the lenders interviewed, but none felt they could provide the cost of that service without more information about the types, sizes and other specifics about the likely loans. It may make more sense to view this as a second phase, once new policies and procedures are fully in place and servicing of the current portfolio is running smoothly with a third party servicer.

Finally, it might be worthwhile for the City to instead consider combining the servicing operations of other City lending programs; specifically the affordable housing loans from HAND, and the small business loans from the Economic Development Department. Combined, there might be enough volume to make in-house servicing by a small staff dedicated to that purpose a more economical option than third party servicing.

Additional Items for Consideration. Several additional closing and servicing issues were uncovered during the review that warrant consideration. The first is the RDA practice of accruing interest on approved loans during the construction period, and then adding that interest to the loan balance once the project is completed. This would appear to result in an actual loan balance that exceeds the approved loan amount. That could be averted by doing what most construction lenders do, which is to require monthly interest only payments, budgeted into the project's budget, and paid through draws from the loan itself.

The RDA may also want to explore alternatives to the blanket requirement for performance and payment bonds from the general contractors involved in their projects. This may be a firm requirement of the private lender, and if that is the case, there may not be any reason to pursue an alternative. But for loans where the RDA is a sole lender, or where the primary lender is amenable, they may want to explore other options. For instance, NDC has engaged a national third party firm who provides the following services:

- Document and Cost Review
- Contractor Evaluation
- Construction Progress Monitoring
- Funds Disbursement
- Construction Completion Commitment

If the firm is engaged for the first four services, they will provide the Construction Completion Commitment for an additional one-time fee, which is based on the loan size. The overall cost of this package of services appears to be substantially less than the cost of performance and payment bonds for the general contractor, particularly for smaller projects with a smaller-sized contractor who may not qualify for the best bonding rates.

Task #5 - NDC was asked to provide assistance in recruiting and vetting candidate(s) with specific underwriting expertise to the RAC and loan committee.

Once the RDA adopts and consistently follows the underwriting guidelines and lending policies described above, the level of specific lending expertise required for members of the committee should be fairly minimal. While it may be helpful for the committee to include one or more members with additional lending familiarity, the purpose of the RAC or loan committee should primarily be to represent the public's interest in deciding which projects deserve public resources.

It should be the staff's responsibility to underwrite the project and to present to the committee a loan that is structured for a high probability of success. The reports the staff provides to the committee should outline where the proposed loan departs from the standard policy, along with the rational for that departure, and the potential associated risks. If the rationale is based on the project's projected public benefits, the lending decision should be made based primarily on the extent to which the committee feels the proposed project will meet those goals. The committee shouldn't be asked to make underwriting decisions at their meetings. Once there are firm guidelines in place for underwriting the projects, the committee should be focused on determining whether any exceptions to the guidelines or standard pricing are warranted for a specific project, based on the public benefits that the project is expected to bring.

Several recent experiences with the RAC indicates that, armed with a detailed and complete staff report based on reasonable assumptions, the current members of the loan committee can do a good job of getting to the relevant issues. They will clearly benefit from having a more complete financial model of the project to review, especially if they are going to be asked to decide on exceptions to standard terms, since this will allow them to see the impacts of any proposed exceptions. We recommend that they be given a Sources and Uses and an Operating Pro Forma with revenue, expenses and cash flow projected for the life of the RDA's loan.

In NDC's opinion, the RDA runs the risk that someone recruited to the committee specifically for their lending expertise may feel they need to bring the perspective of a private lender (minimize risk/maximize return) to that committee, without being sensitive to the primary purpose of the RDA's involvement in a project. Since a career lender will be skilled in lending lingo, it can also be intimidating for the non-lender committee members to feel their participation and perspective is equally valuable Both of these potential issues can be overcome by careful candidate selection, combined with sufficient orientation and training.

In addition to the staff training mentioned above, NDC would recommend that less intensive training be made available to members of the loan committee to help them understand basic lending terminology and procedures, the RDA's underwriting guidelines, as well as their general responsibilities. This will help provide a more equal knowledge base to all committee members. If additional assistance was needed for either the staff or the loan committee on specific loan requests, NDC would be willing to discuss providing that service on an ongoing basis for the RDA.

Finally, it is important to maintain a healthy balance of perspectives on the advisory committee or loan committee. We have seen loan committees made up of several commercial loan officers where each lender works to outdo the others in identifying weaknesses, and the resulting loan becomes more restrictive than a conventional loan! The RDA is in the business of turning around distressed neighborhoods, a task that is not accomplished using conventional financing metrics. It is crucial that Board, staff and committee members keep the public purpose mission foremost as they work to improve the RDA loan program.