

OPERATING RESERVES MAINTENANCE, ELIGIBILITY AND DISBURSEMENT GUIDELINES

Maryland Department of Housing and Community Development

Sections

1. Purpose and Background
2. Scope and Applicability
3. OR Requirements
 - A. Approval of Distribution of OR Funds
 - B. Minimum OR Balance
 - C. Eligible and Ineligible Uses and Requests
 - D. Unauthorized and Limited Disbursements
4. Process and Procedure for Requesting OR Disbursements
 - A. Timing and Frequency of OR Requests
 - B. Preparation of Complete OR Package
 - C. Submission, Processing, Approval of OR Requests
 - D. Waivers and Modifications

1. Purpose and Background

The purpose of these Guidelines is to provide project borrowers/owners and management agents (collectively “**Owners**”) of rental projects with loans or grants made by the Department of Housing and Community Development (“**DHCD**”) and the Community Development Administration (“**CDA**” and, together with DHCD, the “**Department**”) with criteria for determining eligible expenses and evaluating, preparing and submitting Operating Reserve (“**OR**”) withdrawal requests.

An OR is a set aside pool of funds, which are typically required to be held by either the senior lender or CDA. The funds are intended to hedge against the short-term liquidity risks when an otherwise healthy project does not generate sufficient operating cash flow to meet current operating expenses. The OR is generally not intended to be a long-term reserve and is expected to be released as soon as practicable after a Project reaches and maintains sustainability/break even operations for a short period of time. The OR also serves as additional collateral for repayment of debt owed to the Department.

The Department has interests in this subject due to its role as an affordable housing and housing finance lender, with a vested interest in the Project's operations and its collateral security interest in project property, reserves, and escrow accounts.

The Department's purposes and expectations related to ORs can vary greatly from one project and loan to the next and may be impacted by a variety of factors leading up to and following the closing of the Department loan(s).

These Guidelines are subject to change and the Department reserves the right to impose such additional requirements and conditions as it determines in its sole discretion.

2. Scope and Applicability

The Division of Credit Assurance (“**DCA**”) of the Department is responsible for all asset management activities relating to Department funded loans, including:

1. monitoring the sufficiency of OR accounts; and
2. evaluation, processing, and approval of all OR disbursement requests.

This policy applies to **all requests for disbursements from OR** that require the approval of the Department.

The Department's loan documents, regulatory agreements, and other agreements executed in connection with loan funding (collectively, the "**Loan Documents**") typically provide minimum requirements relating to the establishment, maintenance and release of OR accounts and disbursement of funds from OR accounts. Disbursements from an OR, whether it is held by the Department or another lender, typically require the prior written approval of the Department.

These Guidelines are meant to supplement and provide clarity and consistency around Department's decisions regarding OR accounts not specifically dictated by the Loan Documents. In the event that the Department's Loan Documents directly conflict with the requirements of these Guidelines, the Department will apply the terms of its agreements in a way that, in the discretion of the Department, most closely parallels these Guidelines.

Unless otherwise provided in the Department's Loan Documents, Owners must obtain written approval from DCA for any disbursements from the OR. Owners may also be required to obtain consent of additional parties (e.g. HUD, other lenders, investors, partners, etc.) prior to receiving or using OR funds. These parties may have different requirements or may require the Owner to submit additional or different information and documents. These Guidelines contain solely the requirements of the Department.

Prior to considering submitting an OR request, Owners should review these Guidelines, their Loan Documents, partnership or operating agreement, management agreement, budget, financials, and the Project's capital improvement schedule and most recent capital needs analysis. Owners should carefully assess requests in the context of the property's operations, capital improvement schedule, current reserve balance, and the long-term needs of the Project.

For projects where the Department holds the OR account and/or serves as a senior lender and/or servicer of record, the Department will have greater authority and responsibility for managing OR. For projects where the Department does not hold the OR and serves as subordinate lender only, or where CDA is a bond issuer for a senior loan that is not serviced by the Department, the guidelines applicable to OR or other similar reserves may also be subject to the requirements of senior lenders and servicers. However, even in circumstances where the Department is not holding the OR or is not the seniormost lender, in most cases, Owners must also seek the Department's consent prior to seeking a disbursement of OR funds.

3. OR Requirements

Unlike a Reserve for Replacement or other reserve specifically intended for use to fund certain types of projects and expenditures, the OR is a general reserve to be used to fund

operating deficits due to unforeseen, short-term operating cash flow issues - either due to increased operating costs and expenses or insufficient income or revenues.¹ Accordingly, the Department exercises wide discretion in determining what purposes and requirements (if any) to impose upon the use of OR funds.

A. Approval of Distribution of OR Funds

Department Loan Documents typically provide the Department with authority to approve distributions of OR funds during the period in which the project is becoming operationally stable (the “**Stabilization Period**”). The Stabilization Period is typically completed following economic break-even, meeting debt service coverage ratio for a set period of time, or some other set of milestones provided for by the Loan Documents (“**Stabilization**”).

Following Stabilization, the Department’s expectation is that the OR is no longer needed and will be distributed and applied towards repayment of outstanding Deferred Developer Fee, payment of the Department’s soft or surplus cash debt, or other project uses required or allowed by the Department or the Loan Documents.

The Department reviews OR balances periodically to determine whether a Project has reached Stabilization and whether to require distribution or release of OR funds to be applied towards repayments and/or to fund additional reserves. To the extent that funds remain in the OR following the Stabilization Period and are not required to be applied towards repayments or to fund additional reserves, such funds may be approved for distribution to the Project, at the discretion of the Department, to address operating shortfalls.

Expedited Disbursements

Provided the Project is not in default or out of compliance with its obligations under the Loan Documents, the Department will allow an initial, expedited disbursement (an “**Expedited Disbursement**”) upon submission of a completed request in the following amounts:

- **During the Stabilization Period** - Up to 20% of the originally budgeted OR amount required by the terms of the Loan Documents to be released to a Project upon request per fiscal year to address temporary and unexpected liquidity shortfalls.
- **Following the Stabilization Period** - Up to 10% of the originally budgeted OR amount required by the terms of the Loan Documents.

¹ An *operating deficit reserve* is distinct from an OR in that it is traditionally funded with an anticipated (and underwritten) expectation of losses to be sustained through the use of the operating deficit reserve for a specific period of time.

Following an Expedited Disbursement, the Owner will be required to provide the Department with additional information and documentation explaining the cause of the operating deficit and the plan to return/get the project to economic break even and Stabilization.

Supplemental and Additional Disbursements

Any requested OR disbursement(s) that exceed the Expedited Disbursement amount, or any supplemental disbursements that exceed the Expedited Disbursement amount, will be conditioned or denied based on the Department’s review and consideration of the Project’s plan of action to address the existing and any future operating shortfalls, and the Project Owner’s performance in carrying out the plan of action.

To the extent that the plan of action requires an owner or affiliates to contribute additional funds or capital to the project to address operating shortfalls, the Department may consider allowing OR disbursements to be distributed to reimburse such contributions following the Project reaching Stabilization.

B. Minimum OR Balance

The required amount to be maintained in the OR (the “**Minimum OR Balance**”) is:

1. **During the Stabilization Period** - The lesser of:
 - a. The minimum amount required to be maintained by the terms of the Loan Documents (typically between 3 and 6 months of underwritten operating expenses); and
 - b. The amount determined by the Department that, together with anticipated project operating revenues and deposits to the OR required by the Loan Documents (if any), will be sufficient to pay for all anticipated operating expenses, debt service payments, and required deposits to other reserves over the next 3 years;
2. **After Stabilization is Achieved** - Unless the OR has been terminated, or the Department requires the OR to be disbursed from the OR as provided for by the Loan Documents following Stabilization, the Minimum OR Balance shall be the amount determined by the Department that, together with anticipated project operating revenues and deposits to the OR required by the Loan Documents (if any), will be sufficient to pay for all anticipated operating expenses, debt service payments, and required deposits to other reserves to return the Project to Stabilization.

C. Eligible and Ineligible Uses and Requests

DRAFT – FOR PUBLIC COMMENT

Generally, the following are not considered eligible uses for OR funds, either directly or if the Project made payments from operating cash for such uses that contributed to the operating shortfalls -

1. Payment/reimbursement for Capital Items that are or would have been eligible for payment from Reserve for Replacement, regardless of availability of funding in the Project's RfR account;
2. Distributions to members, partners or investors in the Owner, or their affiliates. The term "distributions" does not include payments of bona fide Project operating expenses incurred and allowed by the Loan Documents;
3. Any other payments prohibited by the Loan Documents that were made without the Department's prior written consent.

Prior to approving an OR request, the Owner must certify that the operating losses are not due, in whole or in part, to payment of ineligible expenses.

D. Unauthorized and Limited Disbursements

Requests Resulting in Distributions That Would Lower OR Below the Minimum OR Balance and Expedited Disbursement Thresholds

The Department will deny or limit the amount of any OR disbursement request that would take the balance of the OR account below the Minimum OR Balance and/or that seeks an amount more than the Expedited Disbursement, unless:

1. The Owner agrees to a temporary or permanent increase in the annual OR deposit amount to an amount required by the Department to replenish disbursements, together with a feasible plan for funding the increased deposit amounts and return the OR account to the Minimum OR Balance; and/or
2. the Owner and/or an affiliate of the Owner acceptable to the Department enters into an agreement to replenish the OR account to the Minimum OR Balance within a period required by the Department.

Property Condition and Capital Needs Shortfalls

The Department may limit or deny disbursements from the OR to Projects that:

1. have not obtained and submitted current CNA (if required to do so); and/or

2. have reserves for replacement accounts that are not adequately funded to meet ongoing capital needs.

Requests for Advances from OR

The Department will not approve requests for advance payments from the OR based on anticipated operating shortfalls.

Defaulted or Delinquent Projects

Projects that are in default or delinquent in payments required under the Loan Documents are not eligible for OR disbursements other than those made by the Department as protective advances pursuant to the terms of the Loan Documents, in the Department's discretion, or through a written workout or forbearance agreement.

4. Process and Procedure for Requesting OR Disbursements

A. Timing and Frequency of OR Requests

Owners are limited to one (1) OR request per fiscal year.

Owners may not submit a request within 180 days of having received an OR disbursement; provided that more frequent disbursements may be made as part of an agreed upon plan of action to return the Property to Stabilization.

B. Preparation of Complete OR Package

An OR request and all supporting documentation must be complete and prepared in compliance with these Guidelines to be eligible for review by the Department.

Step 1 - Review Guidelines and Agreements

DRAFT – FOR PUBLIC COMMENT

Review these Guidelines and the Loan Documents, as well as any third-party agreements impacting the availability or use of OR funds, to ensure that the request is eligible and does not exceed the amounts allowed under the Guidelines, the Loan Documents, and any third-party agreements (e.g. other lender's loan documents, partnership or operating agreement) impacting the availability and use of OR funds and the Owner has requested approval from all required entities. Department approval may be held pending confirmation of such entities' approvals.

Step 2 - Complete OR Request Form and Worksheet

1. Request Form
 - a. Project Information
 - b. Request Date
 - c. Amount Requested
 - d. Current OR Information (Balance, Monthly Deposit Amount, Required Minimum Account Balance)
 - e. Last Approved Request Date
 - f. Last Approved Request Amount
 - g. Stabilization date (if project has already reached Stabilization)
 - h. List of all entities required to approve disbursement from OR and status of request(s);
 - i. Payee Information
 - j. Routing/Wire Instructions
2. Supporting Documents/Explanation
 - a. Most recent month-end aged A/R (30/60/90+) report;
 - b. Most recent month-end aged A/P (30/60/90+) report;
 - c. Complete list of uses of funds requested from OR;
 - d. Sources (and uses) for any gap between OR disbursement and A/P balance;
 - e. If the Department is the entity holding/dispersing the OR funds - written approval from all entities (investors, lenders, etc.) with approval authority over distributions from OR
3. Confirmation and Certification

Step 3 - Post-Disbursement Supporting Documentation Following Expedited Disbursement²

1. Narrative/explanation

² Additional documentation and information may be required by the Department for any additional disbursements beyond an Expedited Disbursement based on the analysis of the Post-Disbursement Supporting Documentation and Project Owner's resolution of underlying issues/weaknesses that resulted in the need/request for OR funds.

DRAFT – FOR PUBLIC COMMENT

- a. Cause(s) of operating deficits/losses;
 - b. Gap between anticipated operating deficit, including A/P balance, at fiscal year end and amount of funds requested from the OR; and
 - c. Actions taken by owner/manager to address operating deficits/losses to date;
 - d. Plan of Action to reduce/eliminate operating deficit and reach economic breakeven/Stabilization, along with timeline and milestones (not less than 3-, 6-, 12- and 36-month periods);
2. Financial documentation
- a. Current (as of most recent month-end) financial statements comparing budgeted vs. actual performance for the past 12 months;
 - b. Updated month-end aged A/R (30/60/90+) report;
 - c. Updated month-end aged A/P (30/60/90+) report;
 - d. Total Approved Developer Fee
 - e. Total Deferred Developer Fee
 - f. Outstanding Deferred Developer Fee
 - g. List of all expenses for Capital Items paid by the Project over the past 2 years and whether such expenses were reimbursed or paid from RfR or other reserve account;
 - h. List of all owner/equity contributions to the Project following cost certification, including loans and advances from owners and affiliates;
 - i. List of all advances made by the Project's management company to cover operating costs and deficiencies;
 - j. Projected operating revenues/losses for the remainder of the fiscal year and the following 2 fiscal years;

C. Submission, Processing, Approval and Distribution from OR

All OR disbursement requests must be submitted, in writing, to the Project's Procurement Workcenter, along with all required documents and information - **03 Standard Requests_01 Reserve, Escrow and Impound Disbursements/Approvals_02 Operating Reserve Disbursements**.

DCA will review and respond to all requests for the release of OR funds within 15 days of receipt of the request and strive to have all Expedited Disbursement OR requests processed within 30 days of submission of a complete package - including, if approved, providing consent or disbursing funds. Requests for amounts more than the Expedited Disbursement amount, or that do not comply with the requirements of this Policy, will take additional time to review and process.

If the OR disbursement request does not contain all required documents and information, it will be returned to the Owner with a request for missing documents and information needed to process the request. review and response period will begin upon submission of the missing documents and information.

Once approved, the Department will (a) notify the Owner and its servicer of the approval and instruct the servicer to process payment in accordance with the payment instructions provided and approved, or (b) provide the Owner with written approval.

D. Waivers and Modifications

Projects may request temporary waivers from these Guidelines based upon undue hardship or other special circumstances as determined by the Department. The Department reserves the right to approve or reject any waiver requests in its sole and absolute discretion. Any waivers or exceptions must be documented in writing and approved by the Director of DCA.

The Department reserves the right, in its sole and absolute discretion, to modify the requirements and process set forth in these Guidelines, or to waive or require different requirements, in accordance with its rights under the Loan Documents and at law; provided that such modifications and changes will not be applied retroactively to approvals and disbursements already completed and the Department will seek to provide reasonable notice of any material changes to these Guidelines in advance of enacting them.