Combining FHA Insured Loans with LIHTC

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Federal Housing Programs – What’s Ahead

• Boost per-capita allocations to the LIHTC
• Set floors to 9% and 4% credit
• National Housing Trust Fund - 2016
• GAO suggests IRS/HUD jointly administer LIHTC Program
Recent Enhancements to Align FHA with LIHTC

- HUD ongoing efforts to boosts volumes of FHA – insured loans supporting LIHTC
- New policy adjustments and organizational streamlining – Multifamily Accelerated Processing (MAP) Guidelines
- LIHTC projects using FHA – insured debt can seek lender underwriting of their developer fees to 15% of TDC
- LIHTC Pilot expanding from just the 223(f) to also include 221(d)(4)
- Consistent practice of allowing bridge debt
- Streamlined underwriting of LIHTC projects
Increased Production of FHA insured loans combined with LIHTC
Tax Credit projects account for 25% of Total commitments

FHA LIHTC Loan Volume (Firm Commitments Issued)
Billions

Source: Housing & Urban Development
FHA Pilot Pipeline Status as Sept. 2015

- Active MAP Lenders: 28 of 52
- States with Projects: 34
- Pipeline Projects: 144
- Housing Units Affected: 16,700
- Firm Approvals Issued: 73
- Projects Closed: 61
- Project Types: Family 72%, Elderly 28%
- Average Days to Close: 101 (well below 120 Day Goal)
New FHA policy adjustments and organizational streamlining

• **Single Underwriter Model.** The single underwriter model tested in the LIHTC pilot is being rolled out nationwide as part of HUD’s “Multifamily for Tomorrow” initiative with specialists in each HUD region focused on tax credit transactions;

• **Dedicated Rental Assistance Demonstration (RAD) Teams.** There will be dedicated teams of FHA/RAD underwriters in four hubs and regional centers around the country. The new teams are trained to meet the unique timelines and complexities of RAD and LIHTC.

• **Expansion of Pilot to 221(d)(4).** HUD is currently testing expansion of the pilot program to include FHA Section 221(d)(4) mortgage insurance.
  – Single Underwriter model (prior to full adoption in all offices in 2016 through the Transformation);
  – Faster processing times;
  – Straight to Firm commitment underwriting; and
  – Streamlined processing through reduced forms.
Rental Assistance
Demonstration (RAD)

• RAD allows public housing agencies to leverage public and private debt and equity in order to reinvest in the public housing stock. This is critical given the 25.6 billion dollar backlog of public housing capital improvements.
  – 2014 cap – 60,000 units
  – 2015 cap – 185,000 units

• PHA’s exchange public housing vouchers for long term Section 8 contracts
  – New application deadline of 9/30/2018 for First Component

• Section 223 (f) or Section 221 (d) 4
• 4% LIHTC’s and TEB’s used with FHA Debt
• Bridge loans for LIHTC equity to increase pricing
Combining Tax Exempt, Short Term Bonds with Taxable GNMAs for 4% LIHTC Apartment Financing
Structuring 4% LIHTC Transaction with HUD 221(d)4 Taxable GNMA Financing

Background
• Since 2008 Taxable U.S. T-Bonds began to significantly outperform Tax Exempt Municipal Bonds
Challenges with 4% LIHTC Bond Transactions

1. Borrower cannot borrow all funds from the taxable market because borrower is required to finance 50% of the Project’s land and depreciable cost basis with tax exempt bonds and keep the bonds outstanding until Project is placed in service.

2. Traditional 4% LIHTC Bond transactions required the Bond to be fully funded at closing which generates significant negative arbitrage.

3. Complex Structure with high 3rd party cost
The short-term cash backed bond structure

- Allows developers to secure an allocation of 4 percent LIHTCs and lock in the long-term rate available in the credit markets using a taxable FHA Loan.

- Developer submits a private activity bond allocation request while processing the FHA loan request at the same time as the bond allocation request.

- The short-term bond proceeds are deposited in an escrow held by a trustee. This escrow is security for the tax-exempt bonds and, if structured properly, will result in an AA+ Standard & Poor’s rating.

- As the developer requests funds to construct, buy or renovate the property, proceeds are withdrawn from the bond-funded escrow to pay the costs and a like amount of FHA loan proceeds are deposited into the escrow.

- The development uses bond proceeds, thereby satisfying the 50 percent test, and the short-term bondholders are always 100 percent cash collateralized.

- After the development is completed and placed in service, the short-term bonds are retired and the taxable loan remains outstanding.
# Benefits of Structure

1. Lower borrowing cost
2. 150 bps lower effective borrowing rate
3. Significantly lower negative arbitrage
4. Larger debt service constrained loan

<table>
<thead>
<tr>
<th>$13 Million Project</th>
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<tr>
<td>$600k NOI</td>
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<table>
<thead>
<tr>
<th>Traditional Long-Term Tax-Exempt GNMA Backed Bonds</th>
<th>Short-Term Cash Collateralized Bonds with Taxable GNMA Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>FHA Loan Amount</td>
<td></td>
</tr>
<tr>
<td>$8,000,000</td>
<td>$9,000,000</td>
</tr>
<tr>
<td>FHA Loan Term/ Tax-Exempt Bond Term</td>
<td></td>
</tr>
<tr>
<td>40/40 Years</td>
<td>40/2 Years</td>
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</tbody>
</table>

**Mortgage Loan Interest Rate**

<table>
<thead>
<tr>
<th></th>
<th>Bonds</th>
<th>FHA Rate</th>
<th>3rd Party Fees</th>
<th>3rd Party Fees</th>
<th>Serviceing &amp; GNMA Fee</th>
<th>Serviceing &amp; GNMA Fee</th>
<th>MIP</th>
<th>MIP</th>
<th>Total Borrowing Rate</th>
<th>Total Borrowing Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5.00%</td>
<td>3.85</td>
<td>0.35% est</td>
<td>N/A</td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.45%</td>
<td>0.45%</td>
<td>6.05%</td>
<td>4.55%</td>
</tr>
</tbody>
</table>

**Estimated Negative Arbitrage Savings for New Construction/ Substantial Rehabilitation Projects**

<table>
<thead>
<tr>
<th></th>
<th>4.65 % X $8,000,000 X 2 years</th>
<th>0.75% X $7,000,000 X 2 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negative Arbitrage (Deposit)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$800,000 ( 10% of ML)</td>
<td>$105,000 (1.17% of ML)</td>
<td></td>
</tr>
</tbody>
</table>

| | $400,000 ( 5% of ML) | $52,500 ( 0.58% of ML) |
FHA Section 223(f) & LIHTC Pilot Program

**PURPOSE:** Permanent financing for existing (at least three years old) multifamily and seniors rental properties. Commercial space ≤ 20% of total SF or 20% of gross income.

**Loan Term Amortization:** The lesser of 35 years or 75 percent of the remaining economic life of the property as determined by the appraiser.

**Note Rate:** Taxable, low-interest GNMA mortgage-backed securities for permanent loans or may serve as credit enhancement for tax-exempt bonds. The interest rate is typically locked once a firm commitment issued by HUD is accepted by the borrower.

**Loan Amount:** No maximum mortgage limitations for market rate properties other than those imposed by the underwriting standards. Maximum mortgage is $25m for loan processed under pilot program.

**Underwriting:** With 90% or greater Rental Assistance = min. DSCR 1.15; and “affordable”= min. 1.176 (and market rate 1.20).

LTV= max. 87% and 85% (and market rate 90%) respectively.

Davis Bacon Wages are typically not required for rehab or repairs (as long as the project isn’t RAD).
LIHTC Pilot Program continued

Affordable multifamily rental apartments with 4% or 9% percent Low Income Housing Tax Credits (LIHTCs) including projects with Section 8 HAP contracts.

Purpose:
1. Permanent financing processed under waiver of three year rule for newly constructed or stabilized properties with low income housing tax credits.
2. Permanent financing with moderate rehabilitation for re-syndicated tax credit projects.
3. Permanent financing for acquisition and/or refinance with moderate rehabilitation for affordable apartment buildings with 90 percent of units with project-based rental assistance and tax credits.

Timing:
60-90 days from application to firm commitment. 30 days to close. Pilot applications receive priority over other applications in federal office and there is a FHA Designated Underwriter.

Other Program Differences:
- Up to $40,000/unit in rehab
- Plans and specs may be required based on proposed work scope
- General contractor not required for some transactions
- Davis Bacon wages not required unless required by Issuer
- Construction period may exceed 12 months
- New 20 year HAP contract if currently Section 8
223(f) Pilot 120 day Processing Overview

1. The concept meeting and application phase is when HUD’s designated underwriter (DU) determines if the project is eligible for the pilot program.

2. The next phase then begins, the preliminary review of the firm application, which begins immediately upon receipt of the application and takes only five days to complete.

3. Underwriting Phase, this is estimated at 45 days. The truncated timeframe is accomplished by the Designated Underwriter performing a majority of the review process and only consulting with technical disciplines when determined necessary.

4. The next step consists of the DU obtaining approvals for a firm commitment. This usually takes about 10 days and the firm commitment letter is issued by the DU within five days of the committee approval.

5. The closing process is expected to take 30 to 60 days and largely mirrors the procedures of the FHA Sec. 223(f) program.
Combining LIHTC with FHA 223(f)

Benefits

• Non-recourse
• Fully Amortizing 35 yr. loan
• Lower mortgage constants
• Larger loan proceeds
• Up to $40,000 unit in rehab
• Potentially less need for deferred development fee

Challenges

• Subordination Agreements
• Timing
• Asset Management
• As-is Valuation
• Compliance
• Limited Distributions to Partnership
Recent Underwriting Improvements to the 223(f) pilot program

• Developer fees can be included as a mortgagable cost in the pilot program (not to exceed 15%).

• The allowable tenant relocation period has been increased from two weeks to 30 days.

• Assisted projects (90% + Section 8 HAP contract) can now utilize the band of investment approach when determining cap rate for valuation.

• There is a requirement to fund 100% of the repair escrow at closing. The additional 20% completion assurance has been reduced to 10% and can be deferred on a case-by-case basis.

• Rental Assistance Demonstration (RAD) can be eligible for the pilot, as long as 90% of a project’s units are assisted.

• Tax credit or bond cap allocation no longer required with submission of firm application.
FHA Section 221(d)(4)

PURPOSE: Construction and permanent financing for new construction or substantial rehabilitation for multifamily and senior (without services) properties. Commercial space is permitted but may not exceed 10 percent of total square footage or 15 percent of gross income.

Loan Term Amortization: Construction period plus a 40-year fully amortizing permanent loan.

Non-recourse including construction period

Note Rate: Low rates as a result of a AAA rated credit, fixed at construction loan closing for life of the loan, based on market conditions. The interest rate is typically locked once a firm commitment issued by HUD is accepted by the borrower.

Loan Amount: No maximum mortgage Limitations other than those imposed by the underwriting standards. Loans Greater than $25m have higher developer experience requirements

Underwriting: min. DSCR 1.11 With 90% or greater Rental Assistance; min. .1.15 for “affordable”; (and market rate 1.20)

LTV= max. 90% and 87% (and 83.3%) respectively

Davis Bacon wages are required

Operating deficit escrow (LOC or cash)

4% working capital escrow (LOC or cash), half of which is a construction contingency to cover cost overruns and approved change orders
## 221(d)(4) comparison to conventional lending for LIHTC

### FHA
- Fixed rate locked prior to closing
- Can opt for 15% developer fee or BSPRA to increase mortgage proceeds
- Lower permanent mortgage constant
- Reserves are set formulaically maxed at $500/unit
- No contingency in loan
- No personal guarantees from non-profit borrower.
- Timing: At least 6 months
- Plans & Spec need to be materially complete

### Conventional
- Low construction rate higher take-out permanent rates
- Typically lower loan amount requiring more equity or differed development fee
- $300 to $350 per unit per year in reserves
- Contingency usually allowed
- Personal Recourse
- Timing 4 months
- Status of Plans and Specs Vary
Advantages of Using HUD 221(d)4 Financing for LIHTC Projects Compared to Market Rate Projects

<table>
<thead>
<tr>
<th>LIHTC Transactions</th>
<th>Market Rate Transactions</th>
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<tbody>
<tr>
<td>• 1 stage “Straight to Firm” processing</td>
<td>• 2 stage Pre-Application and Firm Application processing</td>
</tr>
<tr>
<td>• DSCR of 1.15 &amp; 1.11</td>
<td>• DSCR of 1.20</td>
</tr>
<tr>
<td>• Mortgage Insurance Premium of .45%</td>
<td>• Mortgage Insurance Premium of .65%</td>
</tr>
<tr>
<td>• Plans and Specs do not have to be fully complete at time of Firm Submission</td>
<td>• Plans and Specs do have to be fully complete at time of Firm Submission</td>
</tr>
<tr>
<td>• Timing Implications: 5-7 months to Initial Endorsement</td>
<td>• Timing Implications: 10-12 months to Initial Endorsement</td>
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Accounting Considerations

- Important Benchmarks – LIHTC/FHA
- HUD cost certification
- Cash accounts, distributions and HUD Surplus Cash
- Annual reporting
Important Benchmarks – LIHTC/FHA

- Carryover allocation to CHFA
- Tax exempt bonds – 50% test
- LIHTC cost certification to CHFA
- HUD cost certification (if required)
- FHA Final Endorsement date
- CHFA final tax credit allocation (8609s)
- First year credit delivery
HUD Cost Certification

- If determined at the time of Firm Commitment issuance that the ratio of loan proceeds to the actual cost of such project is less than 80 percent, the mortgagor may not be required to certify actual costs to HUD
- If required:
  - Final completion is date of HUD trip report
  - Option to capture costs up to 60 days after cutoff date
  - Cost certification is due 45 days after the cutoff date
- May require a contractors’ cost certification
  - Required if contractor has identity of interest or cost plus contract
Cash Accounts

- HUD requires the project have the following accounts:
  - Regular operating account
  - Replacement reserve (held by mortgagee)
  - Tenant security deposit account
- CHFA has specific requirements for operating and replacement reserve accounts
- Owners should also consider the reserve account requirements in the partnership/operating agreements
Cash Distributions

• Consider all of the following prior to making cash distributions:
  – HUD Regulatory Agreement
  – Partnership Agreement
  – CHFA rules/approval process
HUD Surplus Cash

• Surplus Cash
  – Defined as the cash remaining after all necessary and reasonable expenses of the Project have been paid or fund shave been set-aside for such payment
  – Depending on the HUD Regulatory Agreement, HUD allows semi-annual and annual distributions from Surplus Cash
HUD Surplus Cash

• “Project” vs. “Entity” Expenses
  – HUD’s regulatory authority is at the Project level
    • Project income and expenses
    • Project cash flows
• Project expenses are expenses incurred in conjunction with the operation of the property
• Entity expenses are expenses attributable solely to the entity
• Entity Expenses can only be paid when the Project has Surplus Cash
• For financial reporting purposes, HUD requires that “Project expenses” be segregated from “Entity expenses”
Annual Reporting

• Submission of audited financial statements to HUD REAC
  – Due 90 days after year-end
  – Depending on the Project’s cutoff date, the initial year audit requirement may be waived by HUD

• Investor audit and tax return requirements
  – See partnership agreement
Questions?

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