Financing Mechanisms for Affordable Housing

The financing of affordable housing is a highly complex field. Few if any industry experts grasp every facet of it.

A complicating factor is the multiplicity of government assistance programs. HUD alone administers over 100 separate housing programs. A half dozen other federal agencies offer some form of financial help for affordable housing and homeless shelters. Over 1,000 state and local government agencies operate thousands of separate funding programs, which funnel through federal funds, provide locally-generated revenues, or both.

Another factor is the enormous scope of our housing problems. Over a third of all households in the United States—37 million out of 108 million—pay over 30% of their incomes for housing while only 6.4 million households live in government-assisted rental housing, according to the “American Housing Survey – 2005,” published by the Census Bureau and the U.S. Dept. of Housing and Urban Development (HUD).

A third factor is that these households have widely varying situations and needs. They are renters and homeowners, rural and urban, individuals and families. They reside in single-family homes, garden apartments, high rises, mobile homes, homeless shelters, group homes and on the streets. Some can afford to pay no rent or mortgage payments. Some need transitional housing and special supportive services.

All of these variables multiply the kinds of financing mechanisms that are required to address specific needs. Often, the mechanisms are mixed and matched—for example in rental projects that use federal tax credits, federal grants and have project-based rent subsidies.

While employing specific financing mechanisms alone or in combination is a complex and technical business, it is important to understand that their purpose is to achieve a few simple goals. Following are the five principal ways that housing is made more affordable, and only three of them (numbers 3, 4, and 5) involve financing.
1. **Reducing the costs of real estate development.** Reductions of out-of-pocket costs—acquisition, construction or "soft" costs (fees, interest, etc.)—are equally effective. When the initial costs are reduced, a homeowner or rental property owner carries less debt, and the carrying costs for occupants are thereby reduced. The most effective methods of reducing costs are to build or renovate housing modestly but intelligently, to achieve reasonable economies of scale, and to aggressively control hard and soft costs. Donated land, materials and labor are effective but less prevalent ways of reducing development costs. It is important to note that a grant or public funding to offset land and infrastructure costs is not a cost reduction—it is a subsidy as described in item 4 below.

2. **Reducing routine operating costs.** For rental properties, this may be as mundane as haggling over insurance rates and tax assessments, and keeping staff costs as low as possible. And for almost all types of housing, increased affordability can result from reducing energy and water consumption and maintenance costs. The highest efficiencies can reduce monthly user costs substantially.

3. **Providing direct subsidies for rents or operating costs.** These may apply to new, rehabilitated or existing housing. Federally-funded and locally-funded rent subsidy programs are the most widely used mechanisms. Public housing operating subsidies help several million low-income renter households. Many local governments provide housing vouchers or housing allowances through public assistance programs. For very low-income homeowners, fuel assistance grants are another form of operating subsidy.

4. **Providing direct financing for real estate.** In the affordable housing arena, this includes loans and equity investments—usually on non-conventional terms—as well as grants. Seven direct financing mechanisms are described in this document—two of the most common being below-market-rate loans and deferred payment loans.

5. **Providing inducements to financing.** These include public or private mortgage insurance, loan guarantees, tax-exempt lending provisions, interest subsidies, tax credits, and a number of other devices designed to make direct financing easier or less expensive. Unlike direct financing mechanisms, they are not "money on the table" for a real estate development project—rather, they induce or make possible other, more direct investments such as loans or equity investments.
Affordable Housing Financing Mechanisms
This document focuses on the third, fourth and fifth categories—financing mechanisms—which can be defined as the generic techniques by which: (1) renters or rental projects receive on-going subsidies, (2) affordable housing is directly financed (at below-market or market rates), or (3) affordable financing is induced.

What defines these mechanisms is the fact that standard procedures and legal instruments for all of them are generally accepted throughout the United States. For example, a first mortgage loan, a mortgage deed (sometimes called a deed of trust) and the accompanying promissory note represent a financing mechanism—namely a real estate loan—that is universally accepted and understood in the real estate industry.

Following is a list of financing mechanisms that are commonly or occasionally used to finance affordable housing—whether in a real estate development project, a home purchase or home improvement project (all of these have separate descriptions listed in this database):

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Some of these mechanisms can be called **conventional** because they are commonly used in market-rate real estate development—for example loans, loan guarantees, mortgage insurance and equity. But many are used primarily or only in the fields of low-income housing and economic development, where cash flows from projects typically cannot support conventional financing or risks to investors are unacceptably high.

The **non-conventional** mechanisms are typically employed by the government agencies and nonprofits, using such "non-market" resources as federal grants, tax revenues, the credit-worthiness of a government agency, various housing trust fund devices and charitable grants.

**Understanding the Terminology**

The terminology used to describe financing mechanisms can be misleading. In casual conversation, inducements to financing may be discussed as if they were financing. For example, a developer might say, "I'm financing that project with tax credits and loan guarantee from the City," when in fact the project is being financed with equity investments (induced by federal tax credits) and a bank mortgage (induced by the guarantee).

There is an easy way to distinguish direct financing from indirect forms of financial support: direct financing always shows up as line-item amounts on the **sources-and-uses budget** or settlement sheet for a project. Mortgage insurance, interest subsidies or loan guarantee may be critically important to obtaining financing a project, but they are not shown in a budget except perhaps as a footnote.

Then, too, **sources** of funding are sometimes confused with **financing mechanisms**. For example, the federal HOME program and Community Development Block Grants are not financing mechanisms per se—these are relatively flexible sources of financing that government housing agencies can deploy using various mechanisms of their choice—such as grants, low-cost loans and rent subsidies.

Similarly, housing trust funds and land trusts are sometimes referred to as financing mechanisms, but they are not. Trust funds are **pools** of capital that are typically used to make loans, but sometimes used for funding grants and technical assistance. Land trusts (in their purest form) are ownership mechanisms used by nonprofit organizations that own land and lease it to homeowners, who own only the buildings. Financing of the land and buildings is done through other mechanisms—typically grants and low-cost loans.
How the Mechanisms Are Used for Real Estate Financing

Conventional and non-conventional financing mechanisms are used as real estate financing primarily for two purposes: (1) home purchases or repairs by individual low-income homeowners (usually assisted by a public or nonprofit agency) and (2) real estate development projects carried out by public, nonprofit or for-profit entities.

Depending on where they live, individual low-income homeowners might use between two and a half-dozen financing mechanisms. Conventional loans are ubiquitous, and low-interest loans funded by tax-exempt bonds are widely available from state or local housing finance agencies.

In real estate development projects, virtually all of the mechanisms listed are possibilities, but their availability locally depends on the willingness and capacities of local governments, state agencies or grant-makers. Some local programs will fund deferred payment loans and some make only grants. Some mechanisms make sense with one type of homeowner or developer, but not another.

In any case, the available project financing mechanisms are employed in four ways:

1. **Pre-development financing** - Grants and low-cost loans frequently fund early, high-risk expenses such as option fees or site engineering—particularly for nonprofit sponsors that do not have their own pools of venture capital.

2. **Construction financing** - Low-cost construction loans can reduce interest costs by hundreds or thousands of dollars per unit. In syndicated rental projects, typically one-third of the equity is advanced for construction, further reducing interest carry costs. Grant financing is less common—used mainly for construction of public housing, housing for the elderly and homeless or home repairs for the poor.

3. **Permanent financing** - All of the financing mechanisms can come into play, except for rent subsidies and operating subsidies, which have only indirect effects on permanent financing. Non-conventional permanent financing generally has the effect of reducing or, more rarely, totally eliminating debt service on the project. Grants for down payment assistance and closing costs have a different purpose—helping cash-poor home buyers qualify for conventional financing.

4. **Rent subsidies and operating subsidies** - These mechanisms increase the income stream to a project, or make it possible for occupants to live more affordably. Examples include federal rent subsidies, public housing operating subsidies, locally-paid housing stipends and heating fuel assistance payments.

At each stage of the development of affordable housing projects, two, three, four or more financing mechanisms are typically used in combination—so that there
are literally thousands of possible tailored approaches to financing affordable housing—most of them outside the mainstream of real estate financing.

These financial complexities are not widely known outside the affordable housing industry. If they were, many a Wall Street wizard would scratch his or her head and be thankful for the relative simplicity of stock market index options or derivatives.

The Role of "Inducements"
There is little question that direct financing mechanisms such as grants, low-interest loans and equity investments are among the most important tools that are available to create affordable housing. However, there are barriers to financing affordable housing that even grants, low-interest loans and other direct subsidies cannot solve:

For example:

• A developer may have planned an excellent apartment construction project, but still be denied a loan because the neighborhood is perceived as a high-crime area that may not attract renters. Some extra inducements may be necessary to get equity investments and a conventional loan.
• Deferred payment loans for partial financing of home purchases can’t help low-income buyers if conventional lenders have 20 percent down payment requirements or other underwriting criteria that screen out most low-income applicants.

This section describes a number of financing mechanisms that do not directly provide low-cost financing, but which can overcome financing barriers such as these.

Some of these inducements are termed credit enhancements, because they enhance the credit-worthiness of the person or entity seeking financing—by reducing or eliminating some identified risk. For example, loan guarantees and mortgage insurance are credit enhancements that reduce or eliminate risks of loss if a default occurs. In contrast, another credit enhancement, the interest subsidy, reduces the risk that a default will ever occur, by making loan payments more affordable.

Some inducements are not considered credit enhancements—for example, loan purchases by secondary markets, non-conventional underwriting, tax credits and tax-exempt financing. Yet each mechanism in its own way can make financing of affordable housing more feasible.
Rent Subsidies

Over 2.3 million low-income tenants in privately-owned housing receive federal rent subsidies—making this the single largest form of federal housing assistance. Public housing programs run a distant second with over 1.25 million tenants.

In most federally-funded rent subsidy programs, “affordable housing costs” are calculated at 30 percent of household income for rent and utilities, as in this example:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenant's annual income</td>
<td>$10,000</td>
</tr>
<tr>
<td>Tenant's monthly income</td>
<td>$833</td>
</tr>
<tr>
<td>30% of monthly income (affordable rent amount)</td>
<td>$250</td>
</tr>
<tr>
<td>Market rent for tenant’s rental unit (or similar unit)</td>
<td>$600</td>
</tr>
<tr>
<td>Estimated cost of utilities paid by tenant</td>
<td>$90</td>
</tr>
<tr>
<td>Total housing cost</td>
<td>$690</td>
</tr>
<tr>
<td>Subtract: Tenant contribution</td>
<td>($250)</td>
</tr>
<tr>
<td>Equals: Section 8/Voucher contribution</td>
<td>$440</td>
</tr>
</tbody>
</table>

There are two distinct kinds of rent subsidies:

1. **Tenant-based assistance**, by which the subsidies "float" with the tenant, who is free to move at the end of each one-year lease period.
2. **Project-based assistance**, which are intentionally "attached" to specific affordable housing projects for periods of 10 to 20 years. The subsidy allows a market-rate rent to be charged and thereby increases the amount of financing that can be raised for a rental project.

Project-based rent subsidies are effective incentive for construction or preservation of affordable housing. Because rent subsidies increase the income stream of a project, they also increase the debt-carrying capacity. Across the nation, approximately 1 million privately owned rental units have attached rent subsidies, most of which were built or preserved in the early 1980s under the Section 8 New Construction, Substantial Rehabilitation and Moderate Rehabilitation programs. Over the years, HUD has become more liberal in allowing local housing authorities—the administrators of HUD rent subsidies—to attach rental vouchers to affordable housing projects. These are not new
subsidies that are additive to the affordable housing supply; housing authorities can earmark up to 20 percent of their supply of rent subsidies for this purpose.

Other examples of **project-based rent subsidies** include:

- The HUD Section 202 and Section 811 programs for the elderly and disabled—which also involve grants to build the projects.
- The Rural Housing and Community Development Service’s Section 515 rental housing program—in which rent subsidies are typically approved in tandem with low-interest permanent loans.

In contrast, tenant-based assistance is structured to benefit individual households, not projects, because these programs always require that the subsidy be portable—that is, transferable to another rental unit when the lease term is up. Tenants benefit by paying more affordable rents, and landlords benefit from a more dependable (and sometimes higher) stream of income than they could otherwise expect from a very low-income tenant.

**Tenant-based subsidies** include:

- The HUD Section 8 Existing Certificate and Housing Choice Voucher programs.
- A similar but short-term (2-year) program that can be funded with HUD's HOME program.
- Rental assistance paid by local welfare departments.

**Operating Subsidies**

Subsidies operations and maintenance of public housing account for approximately 20% of HUD's budget.

Tenant rent contributions in public housing are calculated in nearly the same way as in the Section 8 program—at 30 percent of income. But tenant incomes in public housing tend to be extremely low—in some surveys averaging around $8,000 cash income. Therefore the tenant contributions of about $150 to $200 a month are insufficient to operate the housing properly, even though no debt service is involved.

As a result, operating and maintenance subsidies are the life blood of public housing. Operating subsidies are not limited to public housing. HUD's Flexible Subsidy program provides about operating subsidies to older, privately owned rental properties financed with federal money.

Occasionally, governmental housing finance agencies or private foundations offer very limited operating subsidies to affordable housing development projects—usually only to see them through the rent-up stage.
Market-Rate Loans

Market-rate loans need little explanation. These are loans offered by banks, thrift institutions and mortgage companies to homebuyers and investors in rental property. Insurance companies and public pension funds also make direct real estate loans, but rarely with affordable housing projects, because the transactions are typically too small to be profitable.

There is no set "market rate" of interest for housing loans—rather, a range of rates, which are determined by market factors. These rates are primarily functions of three variables: (1) the perceived risk of the investment, (2) the costs of doing the transaction and (3) supply/demand factors in the money markets.

One determinant of market interest rates are the secondary markets for loans—those institutions such as Fannie Mae and Freddie Mac that buy loans from banks. Mortgage lenders who plan to originate loans and sell them naturally set their interest rates in line with the benchmark rates of their secondary market sources. However, many other factors affect loan rates.

As of this writing (in 2007), interest rates for fixed-rate 30-year home purchase loans averaged 6.4%, while rates for 15-year loans averaged 6.09%, because lenders and their secondary markets perceived less "rate risk"—that is, the risk that costs of money would rise during the period of the loan. For loans involving fewer "points" (i.e., upfront fees for making the loan), lenders asked a higher rate of interest, since their transaction costs for making the loan had to be recouped primarily through interest payments over time.

Adjustable rate 30-year mortgages (ARMs) were being made for an average of 6.15 percent—also less than fixed-rate loans, reflecting the fact that lenders were taking less rate risk, because ARM rates are adjusted periodically to prevailing market interest rates.

Again, as of this writing, multifamily loans were typically being offered at rates ranging from 7% to 9%, reflects the fact that lenders and secondary markets perceive higher risk in making these loans.

While market-rate loans do nothing per se to make housing affordable, they are widely used in affordable housing development projects and home purchase programs in tandem with subsidy financing such as below-market-rate loans, deferred payment loans and grants. It is the availability of this financing that is most important, and for low-income homebuyers and developers of affordable housing, liberal underwriting guidelines are often crucial (see section below with that title).
Below-Market-Rate Loans

A below-market-rate loan can be defined as any loan with an interest rate that is clearly lower than prevailing market rates, taking into account the market factors just described and the particular benefits and risks of the transaction in question.

There are eight common sources of below-market-rate loans:

1. Direct low-interest loans from federal agencies - Once this was more common. Until recently, the Farmer's Home Administration offered direct low-interest loans for rural housing, but it is now transitioning to loan guarantees. HUD abandoned the last of its direct loan programs years ago.

2. Lending using federal sources - HUD's HOME and CDBG grants to local and state governments are used to make low-interest loans.

3. The proceeds of selling tax-exempt bonds - In this case, investors in bonds issued with the approval of local and state governments have traded lower interest rates for tax shelter—creating a pool of low-interest loan money.

4. Credit-enhanced investments - These are characterized by lenders offering slightly lower interest rates in exchange for more certainty of repayment—for example, through a third-party guarantee.

5. Housing finance agency reserves - Many state and local housing finance agencies have cash surpluses far beyond their required reserves. These can be lent out at low rates—or for that matter granted, though this is rarely done.

6. Community Reinvestment Act (CRA) motivated loans - The federal CRA encourages lender involvement in lending that assists low-income individuals or communities. It does not mandate below-market-rate lending, but some has resulted.

7. An investment pool that mixes market-rate funds with grants - This is not a common source. An example: Neighborhood Housing Services of America (NHSA) borrows money in the investment markets and blend it with grants to create a national pool of below-market-rate loan funds.

8. Other innovative sources of capital - These include benevolent loan funds that use capital invested at below market rates, and housing trust funds, which typically use some source of dedicated revenue.

To give some examples, let's look at the fictional town of Pleasantville in 2007, when rates for conventional home purchase loans averaged 6.5 percent. On the same day, that city's housing finance agency was offering home purchase loans at 6.1 percent—funded by the proceeds of tax-exempt bonds.
Also in Pleasantville, three affordable housing projects got financing commitments:

- One sponsored by a Native American organization got a 6 percent rate because a federal loan guarantee was in place.
- Still another involved a direct loan from the local government housing office at 1 percent interest using Community Development Block Grant funds.
- And in the third project, some new homes built by a nonprofit organization had a commitment of 6.2 percent financing from a local bank, which was offering a concessionary rate to improve its performance rating for compliance with the Community Reinvestment Act.

Some novices in the field or arm-chair advisors have a tendency to look for gimmickry or "creative financing" that creates below-market-rate financing out of thin air, so to speak. But as there is a law of conservation of matter, there is similar law involving below-market-rate financing: *For below-market interest rates to exist, somebody had to give something in return.*

U.S. taxpayers were indirectly paying for three of the four financings in Pleasantville:

- First, taxpayers will eventually pay for the tax-exempt financing through making up the lost federal tax revenues (if they don't, consumers will pay through increased inflation resulting from increased government debt).
- Second, taxpayers also underwrite the federal loan guarantees, accepting the risks and costs of future defaults.
- Third, the local government loan was funded with taxpayers' money at a rate of return far below other possible investments.
- The stockholders of the bank paid in lost a minor amount of profit in the fourth example—the concessionary loan—but gained CRA credit and benefits to the community.

**Project-Based Grants**

Project-based grants are used for the acquisition, construction or renovation of affordable housing. These are distinguished from other types of grants that might, for example, be used to pay rent subsidies, capitalize a loan pool or underwrite the operating expenses of a nonprofit housing organization.

Project-based grants from federal and private sources are used for a number of purposes in the affordable housing industry. Significant examples include:

- A HUD grant to a housing authority under one of the “HOPE” programs to rebuild low-rent public housing as a mixed-income community.
- A HUD grant to a nonprofit organization to build:
- A Homeless shelter.
- "Section 202" apartments for the elderly.
- "Section 811" housing for the disabled.
- Grants to low-income families to renovate their homes—typically made by local governments using the HUD HOME program or CDBG programs.
- Weatherization grants to low-income families or their landlords—using funds from the Department of Energy and other sources.
- Grants to low-income home buyers for down payment assistance—often made with funds from HUD's HOME program, the Community Development Block Grant Program or local housing trust funds.

The sources of grants (principally public housing funding and entitlement programs like HOME and Community Development Block Grants) are in high demand and a shrinking resource. Therefore, there is a tendency for project-based grants to be used very strategically, in the following situations:

1. The clients in the housing are very poor and cannot bear (though rents or mortgage payments) any added debt service.
2. The grant recipient is a housing authority or other nonprofit agency which charges exceptionally low rents.
3. Some forms of assistance are so small and the clients so poor, that a loan with small monthly payments would be possible but not really efficient. Examples are weatherization, home repair and down payment assistance grants in the range of $500 to $5,000.

Federal policies and practices regarding project-based grants have varied over the years. In the mid-1980s HUD stopped funding public housing with low-interest loans and started making grants, because, inefficiently, HUD operating subsidies were previously used to pay the debt service to HUD—a holdover from bygone days when public housing could actually afford to pay debt service.

Apart from public housing and various programs for the homeless, most federal grants for housing have been passed through local government programs as home repair grants for low-income homeowners living in substandard housing. In the early 1980s, HUD began encouraging local rehab programs to move away from grants and into loan making—as a way to recycle scarce subsidy dollars.

One result of this movement toward efficiency is a financing mechanism that in some ways acts like a grant, but in others is most certainly a loan—the deferred payment loan.

**Deferred Payment Loans**

In conventional lending, loan principal payments are often deferred during the development phase of a project—perhaps a year or two at most—until the project
can generate cash flow. Interest payments are rarely deferred for more than a month or two.

In the affordable housing industry, "deferred payment second mortgage loan" typically means that all payments of principal and interest are deferred until resale of the property or conversion to another use. Such loans are also called "soft seconds" or DPLs. They typically generate no return on the original principal invested (unless there are also shared appreciation provisions), are not amortized (repaid monthly) and are made with non-conventional sources of investment capital, usually federal sources such as HOME and CDBG or local trust fund monies.

Sometimes such loans are even forgiven (written off) over a period of years—for example, one-twentieth of the loan principal a year over 20 years. In other words, it is a grant with recapture provisions. However, most deferred loans have provisions for full repayment of the principal, even if no interest is charged. But in either case, this is partially or completely "free money" when viewed in conventional lending terms.

The source of a deferred payment loan is almost always a grant or the lender's own cash surpluses rather than borrowed money—simply because the time of repayment is so uncertain. The home buyer might sell in a year and repay the loan, or wait 30 years.

The most common sources of funds for these types of loans are: (1) HUD's HOME program, (2) HUD's Community Development Block Grant program and (3) local and state housing trust funds.

No particular federal or private program has required deferred payment loans. But it is one of many mechanisms allowed in locally-designed housing programs that use federal funds.

Deferred payment loans are generally used in three ways:

- Down payment assistance for low-income homebuyers—typically amounting to $2,000 to $10,000—in tandem with conventional financing.
- Major subsidies—gap financing—to rental project developers or home buyers, typically on the order of $10,000 to $50,000 per dwelling unit.
- Rehabilitation loans to low-income homeowners or landlords who cannot afford additional debt service—typically in the range of $5,000 to $50,000 per dwelling unit.

Increasingly, deferred payment second mortgage loans are being used to leverage conventional first mortgage financing, as the following example illustrates:
**Home Purchase with Deferred Payment Subsidy Loan:**

- **Buyer annual income:** $24,000
- **Assumed maximum monthly payment (principal & interest) per lender underwriter:** $500
- **Assumed home purchase price and market value:** $100,000

**Subtract:**

- **a. Maximum affordable down payment (buyer cash available):** ($4,000)
- **b. Maximum affordable first mortgage at 6.5%, 30 years with $500 payment:** ($79,000)

**Equals:**

- **Required deferred payment second mortgage:** $17,000

In this case, the deferred payment loan made it possible for the lender to participate without violating its normal underwriting standards regarding the maximum affordable monthly payment. That would not only be risky business for the bank, but would place an unaffordable financial burden on the borrower. In addition, since the buyer and other funders are providing over 20% of the financing required—through mechanisms approved by most lenders—the buyer can completely avoid paying monthly mortgage insurance premiums to protect the lender against possible default (see below for a description of mortgage insurance).

When deferred payment second mortgages first came into use, conventional lenders were hesitant because of their natural resistance to including other debt obligations in a financing package.

Today, many conventional lenders are pleased to have deferred payment loans made in tandem with their loans—for example financing a home purchase for a low-income family. The conventional loan helps the lender meet Community Reinvestment Act (CRA) requirements. And the deferred payment loan improves the **loan-to-value ratio** (LTV)—all important to a lender.

No lender likes to advance a loan for 100 percent of the value of a property. In this example, the loan-to-value ratio is 78 percent—two percentage points under the 80 percent maximum LTV that is standard for a conventional home loan.

This subsidy mechanism can also be used to make rental projects affordable, as the following example illustrates.
Rental Project with Deferred Payment Loan:
Target monthly rent: $450
Mortgage amount needed per apartment: $90,000

Subtract:
Maximum market-rate loan amount that can be supported by rent: ($45,000)

Equals:
Required subsidy per unit (could be a deferred payment loan): $45,000

While this example appears to have a large subsidy per apartment, it is not uncommon for affordable rental projects to have 100 percent subsidy financing. Particularly in New York, San Francisco and other expensive markets, the per-unit subsidies in a rental project can easily exceed $250,000—with rents covering only bare operating expenses, and thus making the property owner unable to repay a loan.

In such instances, deferred payment loans from several sources are often combined with equity raised from the Low Income Housing Tax Credit. Projects helping the homeless and disabled typically follow this 100 percent subsidy model, since affordable rents may be as low as a few hundred dollars, not even sufficient to cover bare operating expenses such as maintenance, insurance and utilities, let alone repayment of debt. In projects with extremely low-income tenants, operating subsidies are often required for basic building operations as well as supportive services.

Owner Equity and Equity Syndication Proceeds
Owner equity can be defined as cash or something else of value provided by the owner to a real estate transaction that involves acquisition, construction or refinancing. For example, a homebuyer's down payment is equity. An investor's cash paid into a deal is equity. The market value of land or buildings provided to a deal is equity.

With rehabilitation of a property for an existing owner, the owner's equity is usually valued as the difference between the market value of the property and debt on the property.

In the real estate industry, all financing is grouped into two generic categories: debt and equity. All financing—at least all sensible financing—follows these two related formulas, by which equity must make up the gap between total project costs and the amount of loan money that can be raised:

- Equity + debt = total financing
• Total financing = total development cost

Just as lenders expect a return on their investment (ROI) through interest payments, most investors expect an ROI on their equity. Homeowners may or may not expect a return on their equity, over and above their enjoyment of their home. But investors in rental housing typically expect a 10 to 20 percent return on equity from net rental income, plus possible appreciation, and tax benefits.

Early investors in the high-risk phase of a development project may expect a 20 to 30 percent return on equity through sales of land or homes.

In real estate development projects—for example rental projects—conventional lenders will typically lend up to a maximum of only 60 to 70 percent of the project's market value. The remainder of the financing in conventional projects is made up with equity or higher-risk (and higher rate) debt investments.

Whether developing a conventional or affordable housing project, many project sponsors do not have sufficient equity, so they form partnerships or corporations with two, twenty or even hundreds of investors.

In ordinary partnerships, all partners share income and risks in proportion to their investments. If the project goes sour, every partner could lose their original investment, or in the worst case, may even have to make up further losses.

In a special kind of partnership called a syndication, a general partner (usually the developer) plans and oversees the project and is fully liable for all financial obligations. Limited partners buy shares of a project's ownership much as stock certificates are sold. As with stocks, the investor's liability is limited to the amount of the investment (thus the term "limited" partnership). But unlike stocks, syndications pass through tax losses and tax credits to the investors.

Syndication proceeds are the sum total of limited partners' investments, less legal, accounting and sales expenses. Regarding low-income housing, there are several tax credits, which are commonly used with syndications. These tax credits are described elsewhere in this document.

Lease-Purchase Loans

A few major national and regional banks have offered financing for lease-purchase programs. Fannie Mae and Freddie Mac, the leading national buyers of home loans, have both offered special financing products.

In a typical program, a local government agency or nonprofit group arranges financing for a group of homes—whether homes to be built, rehabbed or simply bought in the open market. The program sponsor sells the homes to low-income
families who do not currently qualify for conventional financing—usually by failing to meet down payment requirements. A slight surcharge on the monthly payment builds up a reserve account for the down payment.

The loan to the program sponsor is essentially a multifamily housing loan that converts to a single-family home purchase loan in a year or two, when the lessee buys the home. In most programs, a maximum interest rate is guaranteed upon conversion. This mechanism is unique in two respects: (1) the ability to convert and (2) the extremely long forward commitment to a maximum mortgage rate (60 to 90 days is usually the maximum for single-family loans).

Some in the industry have called into question the benefit of this approach. With mortgage insurance or other special funding described herein, most home purchase programs can reduce down payment requirements to as low as 3 percent—which amounts to $2,400 on an $80,000 home—or even $0 in some instances. Some operators of special financing programs argue that not having a home provides an incentive for families to repair their credit ratings and save up these minimal down payments.

**Alternative Mortgage Instruments**

The suitability of alternative mortgage instruments as tools for affordable housing programs has been the subject of some controversy. There are four principal types of alternative mortgage instruments: (1) adjustable rate mortgages (ARMs), (2) graduated payment mortgages, (3) reverse mortgages, and (4) shared appreciation mortgages.

The first three mechanisms are little used in the affordable housing industry, but sometimes described as potential affordable housing tools. In contrast, the shared appreciation mortgage is an important (if only occasionally used) mechanism to recapture windfall profits from sales of homes in high-priced markets.

**Adjustable-Rate Mortgages**

Interest rates for ARMs can be adjusted from time to time after the loan is made in line with the changes in a benchmark interest rate. As a result, an ARM presents a lender with less risk than a fixed rate loan, thus enabling the lender to price interest rates somewhat lower under typical market conditions. Benchmarks that are commonly used are the one-year or six-month U.S. Treasury bill rate or LIBOR (London InterBank Offer Rate), a global inter-bank lending rate.

There is one drawback, which is significant for low-income borrowers. ARMs offer only limited protection against future increase in interest rates.
For example, if ARM rates increase substantially in a short time or “reset” from teaser rates—as occurred in 2006 and 2007 with dire results for some homeowners—the payment on a home loan can increase by hundreds of dollars a month. This might be an acceptable risk for a middle-income borrower, but it could lead to a default by a financially strapped low-income borrower.

**Graduated-Payment Mortgages (GPMs)**

With this type of mortgage, which has never been widely used, the starting interest rate is pegged below conventional fixed-rate mortgages, but is stepped up by specified amounts over a period of years. The assumption is that borrowers’ incomes will increase with inflation while the loan payment will be fixed.

While incomes of young professional households might be expected to increase, the real incomes of most low-income households have declined since the early 1970s. As a result of these economic realities, most home purchase programs assisting low-income borrowers have adopted neither ARMs nor graduated payment mortgages. HUD’s Section 245 program provides mortgage insurance for GPMs as an inducement to lenders to offer this type of mortgage.

**Reverse Mortgages**

This type of mortgage never creates affordable housing—it can only extend the time during which a household (usually headed by an elderly or disabled person) can live in its home.

With a reverse mortgage, a homeowner borrows against his or her home equity to create a monthly living stipend. HUD offers a mortgage insurance program for reverse mortgages, and many lenders offer their own products.

**Shared Appreciation Mortgages (SAMs)**

In conventional financing of home purchases, this device aroused a brief flurry of interest during the periods of high interest rates in the 1980s. Where SAMs were used at all, banks would charge a below-market interest rate in exchange for a share of the home’s appreciation upon resale. The terms of these mortgages were typically for ten years—forcing a sale or refinancing at the end of that time. SAMs in this form were almost never used in affordable housing programs.

However, in recent years, a different type of SAM has been used by governmental or nonprofit housing agencies that sell more suburban-type homes to low-income households in expensive and rapidly appreciating markets. This SAM is not a money-making venture by the lender—rather a way to recapture subsidies put into the home and recycle profits for the benefit of another low-income homebuyer in the event of a resale. Following is an example of this kind of SAM:
Example of Shared Appreciation Mortgage Used to Recapture Windfall Profits

**Scenario: Nonprofit sells new home to low-income family**

Home cost: $200,000  
Price affordable to buyer: $140,000  
Monthly payment on SAM: (due only on resale) $0  
Estimated resale value in 5 years: $250,000  
Assumed gross profit from resale: $50,000  
Assumed sales costs, at resale: $15,000  
Assumed net profit from resale: $35,000

**Financing package:**  
Down payment $20,000  
Bank first mortgage $120,000  
Deferred payment SAM $60,000  
Total financing: $200,000

**Proration of net profits upon resale:**  
To SAM provider: 30% ($60,000 SAM as a percentage of $200,000 total financing).  
To homeowner: 70%

**Homeowner's share of proceeds from resale:**  
70% of $35,000 net profit: $24,500  
Equity from down payment and principal paydown: $24,000  
Total: $48,500

**SAM provider's proceeds of resale:**  
30% of $35,000 net profit: $10,400  
Repayment of original SAM principal: $60,000  
Total: $70,400

It should be pointed out that the shared appreciation requirements, in and of themselves, do nothing to generate the capital for the initial deferred payment SAM, although over time SAMs can generate new revenues to make additional loans. Typically governmental or private grant funds are used to fund these loans. Used in the way just described, the SAM’s only purpose is in recapturing and recycling subsidies for an ongoing housing subsidy program.

**Loan Guarantees**

A loan guarantee is a promise by a person or entity to make good on a loan if it goes into default. The guarantor may be the borrower, but more commonly is a government agency.
Currently, the major guarantor of housing loans in the United States is the Government National Mortgage Association (GNMA—or Ginnie Mae), a quasi-public agency headquartered with HUD. Ginnie Mae guarantees pools of mortgages that are the "backing" of mortgage-backed securities. The securities (usually bonds) are paid off with the revenue from monthly mortgage payments. With Ginnie Mae's guarantee, the securities are seen as eminently safe, and thus easy to sell. The deep-pocket federal guarantee also results in a cost of capital that is lower than would otherwise be obtained, and helps keep mortgage rates nationally as low as possible.

Ginnie Mae's guarantee is not an affordable housing program per se—its guarantees are available to all securities issuers that have pools of mortgages acceptable to Ginnie Mae. However, loan guarantees in other forms are important tools for affordable housing programs.

Other examples of federal government loan guarantees are the HUD Section 184 Indian Home Loan Guarantee Program and a variant of the Dept. of Agriculture Section 502 program which provides affordable home purchase financing in small cities, towns and rural areas. In these programs, the homebuyer pays a guarantee fee, which currently ranges from 0.5 percent to 1 percent of the loan amount.

Providing such guarantees is not necessarily a profit-generating activity when provided by the public sector. In the case of the two programs mentioned, the federal agencies from time to time have to make good on some defaults.

Occasionally in profit-motivated real estate deals—such as a rental housing development—individually-tailored loan guarantees are provided for a price. For example, a lender may want a construction loan guaranteed, but the borrower does not have enough liquid assets to make good on the guarantee. In this case, the borrower might buy a guarantee by paying a high net-worth individual or corporation to co-sign the promissory note. The cost of such a guarantee will vary depending on how the guarantor perceives the risk of loan default and how much effort it takes to analyze a deal. More often, the owner/developer of the project provides guarantees to the lender, which may require bringing in new principals to the deal who have the net worth to back up such a guarantee.

Some local governments and charitable foundations have provided loan guarantees for nonprofit housing developers (most of which have both low net worth and few liquid assets). Often, these are partial guarantees. For example, the City of Tampa for many years reserved a specified amount of funds to guarantee home repair loans made by local banks. The fund amounts to only a small fraction of the loans outstanding, but defaults have been so infrequent that this partial guarantee is a powerful inducement to lending.
Loan guarantees not only induce lenders to make loans, they can result in lower-than-normal interest rates (as with the Ginnie Mae guarantee) because investments in federally guaranteed mortgages are considered one of the lowest risk investments that can be made—almost on a par with savings bonds and Treasury bills.

**Mortgage Insurance**

From the lender's point of view, mortgage insurance is very similar to a loan guarantee. With mortgage insurance, a private or public agency agrees to make good on a loan if it defaults. But these are several differences from loan guarantees: (1) mortgage insurance is almost never individually tailored (as a guarantee may be), (2) the risks to the guarantor are more limited, and (3) it is generally a money-making business, even for government insurers such as FHA and VA.

HUD provides mortgage insurance through an array of programs designed as inducements for the financing of affordable and moderate-priced housing. The resulting loans are generally called HUD-insurance mortgages or FHA insured mortgages, since the Federal Housing Administration is the division of HUD that manages these insurance programs. The Veteran's Administration (VA) provides mortgage insurance to veterans under similar terms for home purchases.

Profit-motivated companies also provide mortgage insurance, which is often referred to as PMI.

HUD/FHA focuses its efforts on what might be called "public purpose" markets such as inner cities, lower-income home buyers, and rental housing developers. Private companies gravitate to more mainstream markets. But increasingly, private insurers overlap much of HUD’s targeted single-family markets and charge similar insurance premiums.

Unlike benevolent loan guarantees, mortgage insurance is not free of charge. The insurer may charge both an up-front fee and continuing monthly fees. Because of this, mortgage insurance is typically only used by borrowers who are perceived as above-average risks for one reason or another.

For example, conventional lenders for home purchases do not like to lend more than 80 percent of the value of a home without having mortgage insurance to cover the risk of default. Without mortgage insurance, requiring the owner to have 20 percent equity in the home gives the lender a margin of safety if the home has to be foreclosed on and sold by negotiation or through an auction. If the home's value is nearly equal to its cost (as in most purchases), the borrower must come up with a 20 percent down payment.
However, if the borrower can obtain mortgage insurance, most lenders will loan up to 97 percent of the value of the home and sometimes even up to 100 percent. The higher the percentage, the higher the premium for mortgage insurance.

The most commonly used HUD single-family mortgage insurance programs are Section 203(b), used with purchases of new or existing one- to four-family homes, and 203(k), which insures loans for home repairs and improvements.

In the late 1960s through the 1970s, mortgage insurance was one of HUD's major inducements for developers to build and operate affordable apartments, and for lenders to finance these projects. Hundreds of thousands of rental units were built using HUD insurance programs such as Section 221(d)(d) and Section 236, which were usually coupled with interest subsidies.

These programs and other HUD multifamily insurance are still used by developers, since they help reduce mortgage rates and overcome lenders' high equity requirements—but much less so than decades ago when significant interest subsidies were attached to these programs.

HUD Section 232 mortgage insurance is widely used for construction of nursing homes, and the Section 234 program is widely used to finance condominium sales.

**Mortgage Purchase Programs (Secondary Markets)**

Some people buying a home for the first time have the impression that local banks have money stored that is used for making home loans. This is typically not the case.

Many lenders make a loan and immediately sell it to a national secondary market institution such as Fannie Mae or Freddie Mac. The originator may still collect monthly payments (called *servicing* the loan) under contract to the new owner of the mortgage.

In such a sale, the originating lender typically holds the loan only for a month or two. As a result, interest income to the originator is negligible. The originator makes its money in one or more of these ways: (1) on application and origination fees (the latter being called *points*), (2) on servicing fees (a percentage of the monthly payment) and (3) on any premium paid by the secondary market (which occurs when the loan was originated at a higher rate than the "buy" rate).

Some loans are "packaged" for banks and mortgage companies by mortgage brokers, who make sure the borrower is qualified and prepare the paperwork. But the broker is not the lender.
The ultimate sources of most housing loan capital in the U.S. are large financial institutions such as Fannie Mae and Freddie Mac, who buy loans from banks, thrift institutions and mortgage companies. These buyers are collectively called **secondary mortgage markets**. The secondary markets, in turn, sell mortgage-backed securities (MBS – typically bonds) to institutional and other private investors to raise the capital to buy more mortgages.

Sometimes, banks hold on to their mortgage loans. These are called **portfolio loans**, since the lender keeps the loans in its portfolio of investments. For these loans, credit requirements have sometimes been varied in such a way that the secondary market won’t buy them—the loans don’t meet their underwriting criteria. Often such loans are "seasoned”—kept in portfolio a few years to establish a steady payment record or overcome a negative credit factor—and then sold. Holding loans in portfolio is more common with community banks that have large amounts of deposits to invest and/or want to participate in affordable housing programs that benefit the community.

Because most home purchase and refinancing loans (along with many multifamily loans) are ultimately sold off, major **secondary market** players such as Fannie Mae and Freddie Mac have a powerful influence on the financing of affordable housing. For example, “Fannie” and “Freddie” may buy home purchase loans that were piggybacked with a deferred payment mortgage and forego their usual cash down payment and mortgage insurance requirements, so long as homebuyer training is provided and the second mortgage program is examined and meets the standards of one or both of these mortgage institutions.

### Interest Subsidies

While a below-market-rate loan is one with an inherently low rate of interest, an interest subsidy is a payment of cash to a lender in exchange for a lower interest rate. These subsidies are sometimes called "write-downs" or "buy-downs" of the loan, as in this illustration:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-Year loan amount</td>
<td>$100,000</td>
</tr>
<tr>
<td>Monthly payment at 6.5% (market rate)</td>
<td>$632</td>
</tr>
<tr>
<td>Buy-down or interest subsidy required to achieve 3% loan</td>
<td>$33,000</td>
</tr>
<tr>
<td>Monthly payment at 3%, after subsidy</td>
<td>$422</td>
</tr>
</tbody>
</table>

In this example the subsidy is, in effect, prepaid interest paid at the time the loan is made. An interest subsidy may also be a deposit in an interest-bearing account, from which monthly subsidies are drawn and paid to the lender along with the regular monthly payment.

In the affordable housing industry, an interest subsidy might involve a third party—for example a government agency—making a one-time payment to a
conventional lender in order to reduce monthly loan payments for a low-income home owner, a nonprofit housing developer or a profit-motivated developer of affordable rental housing. Up-front interest subsidies are intended to equal the present value of interest that will not be paid in the future—or in other words discounted for inflation. However, it is possible for a lender and a subsidy provider to disagree on the precise formula and assumptions to be employed.

Mortgage interest subsidies were widely used in connection with HUD/FHA housing development programs from the 1960s through the early 1980s, but now are little used in any context.

Several other financing mechanisms can achieve the same results as an interest subsidy, much more simply. The most prevalent alternative today is a zero percent interest deferred payment loan, due only on resale of the financed property. A deferred payment loan made in tandem with a conventional first mortgage loan seems at first glance very different from an interest subsidy. However, using equivalent amounts of funds, a deferred payment loan and an interest subsidy both result in very similar, if not identical, reductions of the monthly payment of the corresponding conventional loan.

The most prevalent use of interest subsidies today is in conjunction with tax-exempt bond programs. Typically, a housing finance agency will use some of its surplus cash to "write down" the interest rate on part of the proceeds of a bond issue.

For example, a $10 million bond issue might yield mortgage money at 6% interest. On 20 percent of the issue, agency cash might be used to subsidize the interest rate down to 4 percent for homebuyers with incomes below a certain threshold, for example, under a certain income threshold that is lower than their normal target market.

Compensating Balances

Very occasionally, loan interest rates are subsidized by a method other than a cash payment made in exchange for the reduced income. Instead, a government agency or socially-motivated investor deposits funds with the lender at no interest or a low interest rate. The terms of the deposit are designed to compensate for the lender's loss of interest income from making a low-interest loan.

For example, the Pleasantville city government wants to help Nonprofit Housing Corp. build 10 low-rent apartments. The project works only with a 5 percent interest rate. The Pleasantville bank is willing to make the loan, but its current rates are higher. The city doesn't want to pay out interest subsidies and never get them back, so it gets the bank to agree to a compensating balance arrangement, which looks like this:
Current bank interest rate for multifamily projects: 8%
Monthly payment affordable to project: $6060
Interest rate corresponding to that monthly payment: 5%
Reduction in interest rate needed: 3%
Compensating balance arrangement:
  Bank loan at 5%, 20 yrs. $1,000,000
  City deposit at 0%, 20 yrs. $500,000

The city pledged to keep its deposit in the bank at that rate for as long as the loan is outstanding. Every year, a portion of deposit may be withdrawn—but only equal to the amount of loan principal paid down. However, if the borrower defaults, the deposit is not forfeited as if it were a guarantee. Its only purpose is to subsidize the interest rate.

The theory behind the compensating balance is this: Pleasantville Bank will use the non-interest-bearing deposit to fund market-rate loans or other high-yielding investments. Thus, extra income is generated for the bank to offset the below-market loan made to Nonprofit Housing Corp.

But there are several factors that make this a seldom-used financing mechanism for affordable housing. First, compared to an interest subsidy or a deferred payment mortgage, it ties up a great deal more capital for a long period of time. Second, the actual future yield on the deposit is typically determined by using a conservative benchmark, such as Treasury bills or notes that run for the same length of time. The provider of the compensating balance might well have achieved a higher rate of return through another investment vehicle.

This arrangement is not as clear-cut as if the city, for example, had simply given a deferred payment second mortgage of $275,000, which would reduce the monthly mortgage payment by the same amount: to $6060.

From the standpoint of current dollars available, the city could fund roughly twice as many affordable apartments with current dollars by using interest subsidies or deferred payment loans instead of a compensating balance. Of course the original principal is preserved with the compensating balance mechanism, but any accountant will tell you that depositing money for 20 years with no return is tantamount to giving away something like half or two-thirds of the original capital, because inflation will diminish its value.

Aside from compensating balances, other indirect capital investments such as these can be used to induce lending for community development and economic development projects. The terminology involved—compensating balances, linked deposits and matched funding—becomes confusing. For our purposes, the terms are defined as follows:
• Compensating balances are below-market-rate and non-conventional investments (such as federal block grants) used to induce lenders to make below-market-rate loans.

• Linked deposits are low yielding but conventional investments (such as pension fund money) which are deposited to induce lenders to make loans at rates which are slightly below market.

• Matched funding is a market-rate investment (such as from the Federal Home Loan Bank Board’s Community Investment Program—CIP) that simply eliminates lenders' risks of future increases in market rates of interest.

The techniques are similar and best remembered as a continuum. Compensating balances are intended to create an interest rate subsidy. Linked deposits generally offer a little discount from conventional rates. Matched funding offers no real subsidy.

Linked Deposits
Because the nature and magnitude of their portfolios, pension funds have been used creatively to induce lending for affordable housing projects. The portfolios are typically a mix of short-term, middle-term and long-term investments. In some cases, the long-term investments are conservative ones with yields similar to 30-year treasury notes (around 5 percent at this writing).

Some pension funds have made agreements with public and private lenders to create linked deposit programs with community development objectives. The pension funds agree to make long-term investments at their normal (but relatively conservative) rates, and the investments are linked to certain loans made at rates two or three percentage points higher.

Similar to a depositor of a compensating balance, the pension fund investment is not at risk if the loan defaults.

Matched Funding
The nation's best-known and largest matched funding program used to finance affordable housing is the Federal Home Loan Bank's Community Investment Program. The program’s technique is best explained by an example:

Let's assume you are a developer with a plan to buy and renovate 100 apartments. You want to use the federal Low-Income Housing Tax Credit, which requires that rents be below a certain level. To achieve these rents, you need 25-year debt financing at an interest rate of 8 percent or less. But let's say for sake of an example that the current market rate for this type of loan is at least 9 percent.
You approach a lending institution that is a member of the Federal Home Loan Bank System (FHLB), which entitles it to use the CIP program. Under CIP, the FHLB branch borrows money in the major capital markets, often at relatively low rates compared to conventional mortgage rates. At this writing CIP rates are around 6.5%. These funds are then passed through to the local lender and deposited.

The funds are not literally used to make your loan. They become co-mingled with other funds and used for loans or other investments. In essence, the funds are a hedge against market interest rates rising. With this in mind, the lending institution would normally make a loan for about 50 or 200 basis points over its cost of the matched CIP funding—or something like 7 percent to 8.5 percent. The lower end of that spread—50 basis points, or half of one percent—would typically represent a major concession on the part of the lender, because this is below any normal benchmark for covering costs of lending and risks of default. For multifamily loans, many lenders require a higher spread to compensate for their work in underwriting and servicing the loan, as well as the perceived risk of default. But at least the CIP funding eliminates the risk of future market interest rate increases—called “rate risk.” The nature of the risk is this: if market interest rates rise, loans made at lower rates experience a corresponding reduction in their market value on the books of the lending institution—the same as with owning bonds.

As with compensating balances and linked deposits, CIP funds are not a loan guarantee. If a borrower defaults on a loan, the lender must still pay back the funds borrowed from the Home Loan Bank. Matched funding does not remove all risks of making a loan—only the risk that market interest rates will increase.

Liberal Underwriting Guidelines
The other lending-related “inducements” discussed in this set of documents have one common characteristic—a third party (such as a government agency) has made a financial concession to induce a private lender to make a loan, usually at a low interest rate.

With liberal underwriting, the private lender makes the concession. Liberal underwriting guidelines allow a lender to make a loan to an applicant who would not otherwise be qualified. The most common motive is a desire to comply with the Community Reinvestment Act (CRA).

In single-family lending, liberal underwriting can vary from conventional underwriting one or more of these ways:

- Loan-to-value ratios are liberalized without requiring mortgage insurance.
- Down payment requirements are reduced.
- "Debt ratios" applied to borrowers' incomes are liberalized.
• Credit reports showing more payment problems are accepted.
• Lower-than-normal credit scores are accepted.
• More irregular employment histories are accepted.
• Alternate forms of income (like food stamps) are accepted.
• Liquidity standards for borrowers (conventionally, cash in the bank for two months’ mortgage payments) are lowered.

A little over a decade ago, concessions such as these were considered extraordinary. However, with the growth of “Alt-A” and subprime lending, more flexible underwriting standards such as these became commonplace. And all too often, standards of some mortgage companies were loose and/or irresponsibly applied. As a result, at this writing, the pendulum is swinging back toward somewhat less flexible underwriting in the face of widespread defaults and foreclosures.

However, the experience of many affordable home purchase assistance programs has indicated that flexibility in underwriting is critically important to low-income families, and that foreclosures can be minimized by providing effective pre-purchase counseling and training and additional financing such as down payment assistance.

In multifamily lending, similar concessions might be made, including:

• Reduced requirements for equity invested in the project
• Higher loan-to-value ratios
• Higher debt service ratios
• Reduced net worth requirements for borrowers
• Reduced requirements for project reserves and guarantees
• Offering fixed rates when variable rates are standards
• Increasing amortization periods—for example from 15 to 30 years.

With multifamily projects, concessions are usually made on a deal-by-deal basis. Loan-to-value ratios are sometimes liberalized from the conventional 70 percent to 80 or 90 percent. Debt service ratios (the ratio of project cash flow after expenses to the debt service) are relaxed from the typical 1.20 to 1.10 or even less—allowing the amount of the loan to be higher.

As with concessions on single-family loans, relaxed standards for multifamily lending naturally create tensions. Risks are increased so that social benefits can be achieved.

However, multifamily loans can run in the millions of dollars, so more is at stake. And history shows that multifamily lending has been more risky than single-family lending. As a result, significant concessions are less frequently found in multifamily lending.
Tax Credits
As a result of certain provisions in the federal tax code, tax credits are available for investors in low-income rental properties. These tax credits greatly increase the return on equity for certain investors, so much so in some instances that cash returns on the investment are of little or no importance. The three most relevant federal tax credits for producing affordable housing are:

- The Low-Income Housing Tax Credit program, which allows the project owner tax credits of 40 to 90 percent of the value of a residential rental property over ten years if the owner agrees to keep rents and tenant incomes below certain levels. This is by far the most potent of the three credits described here in terms of its ability to reduce the cost of housing substantially below market rates.
- A 20 percent federal historic tax credit for rehabilitating a certified historic structure.
- The New Markets Tax Credit, a 39 percent tax credit over 7 years for qualified community development investments. While primarily aimed at commercial real estate development and business investment, it can also be used to lower the cost of development capital for single-family home construction.

The Low-Income Housing Tax Credit is much more widely used in affordable housing projects, and in fact has become the nation’s single biggest indirect subsidy program for affordable housing.

Tax credits are available only after a building has been put into service, so they cannot be used for up-front financing. However, they are converted to up-front project capital through the formation of limited partnerships, commonly called syndications, which were described in the previous section.

With the Low-Income Housing Tax Credit, syndication proceeds paid into a qualified project can amount to as much as 80 percent or 90 percent of the cost of building the project. This reduces the amount of the mortgage loan needed and the amount paid for monthly debt service—or can eliminate debt service altogether in some instances. Therefore, rent levels can be pegged considerably lower than market rates.

About 10 state governments also offer tax credits for cash and in-kind corporate gifts to affordable housing projects and other public-purpose activities. However, these credits only partly offset the cost of the gift—they have nothing to do with conventional investments.
Tax-Exempt Lending Provisions

Internal Revenue Code allows the interest from many types of investments to be exempt from federal taxes—if defined public purposes are being served by the investment.

The list of available tax-free investments is long. Individuals can create their own tax shelters by investing in approved retirement accounts, or they may take advantage of the home mortgage interest deduction. These tax exemptions are allowed by the government because comfortable retirements and homeownership are seen as socially beneficial.

In the affordable housing industry, most tax-exempt lending is accomplished through issuance of tax-exempt bonds. Bonds are security instruments like stocks, mortgages or certificates of deposit. Given in exchange for an investment, a bond is a written pledge by the issuer to repay the money by a specified date in the future—usually 30 years later for housing bonds. In the interim, interest is paid to the bondholders.

There are two major types of tax-exempt bonds: (1) revenue bonds and (2) general obligation bonds. Revenue bonds are normally used to make one loan or a group of loans, and are paid back with the loan repayments. General obligation bonds are generally paid back out of future years' tax dollars.

The federal government authorizes only certain entities to issue tax-exempt revenue bonds—usually called "finance agencies" or "finance authorities." These quasi-public entities are chartered by state and local governments, which typically appoint their boards of directors. Housing finance agencies, economic development authorities and student loan authorities are examples of revenue bond-issuing agencies.

General obligation bonds can be issued only by state and local governments. These can have much broader purposes and more flexible uses—for example, road building, financing water and sewer systems, school construction, floating public debt, or construction of public facilities. Occasionally, the proceeds of so-called "G.O." bonds are used in connection with affordable housing programs—most commonly for infrastructure. Occasionally, G.O. bonds have been used to finance housing trust funds or loan funds.

Using tax exempt revenue bonds to raise capital for housing loans was pioneered in the 1960s and has become commonplace since then. Tax-exempt single-family mortgage revenue bonds are the bread-and-butter business of state housing finance agencies.

Tax-exempt bond financing has these key benefits:
• It reduces the mortgage interest rate for home purchase loans typically by 50 to 100 basis points (half to one percent), as compared to conventional mortgage loans.
• Tax-exempt financing can be used by rental housing developers, as well as income-qualified individuals who are buying homes.
• Its widest use is as permanent financing, although it is sometimes used for construction financing of rental projects.
• Bond financing can be used very flexibly—for acquisition of existing housing, financing of new housing and even some types of renovations.
• Tax-exempt financing can be combined with deeper forms of housing subsidies—such as "soft" second mortgages from federal HOME funds, CDBG funds or other sources. Increasingly, it is being used with the Low-Income Housing Tax Credit, although this reduces the total amount of tax credit eligibility.

However, tax-exempt financing is not without its detractors—who claim that tax-exempt bonds are an inefficient subsidy that cost the U.S. government billions of dollars a year. Only part of this tax loss ends up benefiting public purposes—while the rest pays middleman costs and benefits wealthier taxpayers.

Despite these legitimate issues, tax-exempt bond financing is the single largest source of below-market mortgage financing for affordable housing.

**Mortgage Credit Certificates**

Federal rules allow a simple alternative to the expensive and complex business of issuing and selling bonds to raise tax-exempt investments for housing loans. The device is called a **mortgage credit certificate**, which entitles a qualified borrower a federal income tax credit for a portion of the interest on a qualified mortgage.

In a sense, the tax credit is used to repay the mortgage. In underwriting a loan with a mortgage credit certificate, a conventional lender calculates a monthly pro-rata- tion of this tax credit. This amount should be added to the borrower's maximum spending capacity for PITI (principal, interest, taxes and insurance). This, in term, qualifies the borrower for a bigger loan, just as if the interest rate on the mortgage were a percentage point or so lower.

At this writing, the annual credit per individual cannot exceed $2,000 per year of the life of the mortgage, which adds about $26,000 in borrowing power at current interest rates. However availability is limited. Certificates are allocated by housing finance agencies—the same agencies that provide tax exempt single-family mortgages.