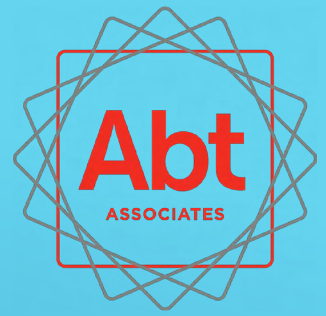


# FILLING FUNDING GAPS:

## HOW STATE AGENCIES ARE MOVING TO MEET A GROWING THREAT TO AFFORDABLE HOUSING

PREPARED FOR:

# Introduction

## Motivation for This Study

Sharp increases in construction material and labor costs since the beginning of the COVID-19 pandemic have left a growing number of pending Low-Income Housing Tax Credit (LIHTC) developments with significant shortfalls that jeopardize project completion. This dynamic, unprecedented in both its depth and breadth, is jeopardizing desperately needed affordable housing developments that have been approved by state and local agencies. Further, it is putting pressure on state agencies to fund project cost gaps with other sources of funds, depleting current and future resources envisioned for additional new affordable housing.

Substantially higher-than-expected construction costs, along with higher interest rates and supply chain disruptions, have triggered a need for additional resources in both 4 percent and 9 percent LIHTC deals. They have also caused many tax-exempt, bond-financed projects to risk falling short of the requirement that tax-exempt bonds finance at least half of the project's costs.

There is an urgent need to identify and implement creative solutions to ensure that approved affordable housing developments can be completed notwithstanding these cost increases. State agencies are at the forefront of efforts to respond to this escalating challenge. Most of the responsibility has fallen on state housing finance agencies (HFAs), which administer the LIHTC in every state but California and Massachusetts, where the program is administered by another state entity. These agencies collectively are the primary sources of financing for affordable rental housing through the LIHTC and other federal and state resources (see box 1, The Low Income Housing Tax Credit).

State legislatures and local governments are also stepping forward with solutions, as are many affordable housing developers. The federal government is increasingly focused on the challenge and exploration of how existing federal authorities can unlock additional resources.

## Approach

To help document these challenges and the different ways in which HFAs and others are responding to them, the National Council of State Housing Agencies (NCSHA) commissioned Abt Associates and the Tingerthal Group (study team) to examine the experiences of 11 state agencies. The study team compiled information on the severity and extent of these shortfalls and the strategies the state agencies are using to address them.

In June and July 2022, the study team interviewed individuals at each agency as well as 11 practitioners with experience working through these challenges, including developers, accountants, and attorneys. A list of the 11 agencies and the organizations with which the other interviewees are affiliated is in the appendix.

# Key Themes

State agencies' strategies for helping developers close unexpected funding gaps include reducing costs through administrative flexibility, allocating future-year LIHTCs, increasing financing from tax-exempt bonds, using Coronavirus State and Local Fiscal Recovery Funds (recovery funds), and working with developers to identify project cost savings.

During the study team's research and interviews, several key themes emerged:

- Nearly all deals that were awarded LIHTCs from 2019 to the present have faced significant, unexpected cost increases after being awarded credits. As a result, many—if not most—projects have had to seek additional credits, soft funding, or other resources from HFAs and other sources to close unexpected funding gaps.

- The stakeholders interviewed consistently reported cost increases of around 30 percent. Some developments face even larger gaps.

- It is essential to find solutions and keep deals moving toward closing and completion, especially given rising interest rates. The longer a deal is delayed while HFAs, developers, and others look for the resources to close remaining gaps, the more likely it is that problems will compound and become even more difficult to solve.

- Developers, HFAs and other allocating agencies, investors, syndicators, and other industry participants have demonstrated flexibility and creativity in responding to rapidly increasing costs with a limited set of tools.

- The options available to state HFAs and other allocating agencies vary depending on their particular ecosystem of housing resources. Some agencies are better resourced and equipped to move quickly to fill funding gaps than others. States that had been experiencing high demand for bond financing before the pandemic may be especially challenged.

- Closing the gaps on specific projects often means engaging all parties that have housing resources—local and state governments, tax credit and bond allocating agencies, and developers.

- Even when these strategies have filled funding gaps and enabled projects to proceed, they have often come at the expense of the current and future production of affordable housing. Longer-term and more comprehensive solutions are needed to avoid significant reductions in affordable housing production and preservation in the coming years.

- In late July (after the study team's interviews), the U.S. Treasury Department announced guidance that provides states and cities additional flexibility to use recovery funds to fill cost gaps for affordable housing development. This guidance will provide many states a significant new tool to address recent challenges.

## Caveats

The landscape for affordable housing development is changing rapidly. Perhaps most important, recent interest rate increases (together with the potential for further increases in the near future) are likely to have a significant effect on financing costs. At the same time, the rising interest rates may slow the rate of single-family and other market-rate development, which could put a certain amount of downward pressure on the cost of labor and materials. This downward pressure may be offset by the supply chain disruptions, such as shipping congestion and labor shortages, that first emerged during the initial peak of the COVID-19 pandemic and remain unresolved. Recent increases in the price of fuel also continue to put upward pressure on the cost of many goods and materials.

On the positive side, there is bipartisan recognition of the problems posed by rapid increases in housing costs generally and affordable housing costs specifically. That recognition could potentially translate to support for some of the regulatory and legislative solutions needed to avoid the longer-term consequences of the recent dramatic cost increases.

In the longer run, the trends driving the dramatic cost increases in construction materials and labor will not go away soon. More permanent solutions are needed.

### The Low-Income Housing Tax Credit

The following is a description of the Low-Income Housing Tax Credit:

> The Low-Income Housing Tax Credit (Housing Credit) is a federal tax credit created by the Tax Reform Act of 1986 and designed to encourage private-sector investment in the new construction, acquisition, and rehabilitation of rental housing affordable to low-income households. Since its creation, the Housing Credit has become the most successful affordable rental housing production program in history.
>
> The Housing Credit offers a dollar-for-dollar reduction in a taxpayer's income tax liability in return for making a long-term investment in affordable rental housing. State agencies award Housing Credits to developers, who engage private investors in the property's ownership partnership. The investors provide upfront equity capital to fund the construction and rehabilitation of affordable housing, allowing developers to borrow less money and pass through the savings in lower rents for low-income tenants. Investors, in turn, receive a 10-year stream of tax credits based on the cost of constructing or rehabilitating apartments that must be rented to low-income households.…
>
> The Housing Credit program has two components: the *9 percent* Credit and the *4 percent* Credit. The annual amount of 9 percent Housing Credit authority in each state is limited by a volume cap based on the state's population.…
>
> The 4 percent component of the program can be triggered only by the use of tax-exempt private activity multifamily Housing Bonds. Housing Bonds and the 4 percent Housing Credit finance a growing proportion of Housing Credit rental homes every year. In 2020, rental homes financed with 4 percent Credits and Bonds made up nearly 60 percent of Housing Credit homes financed that year. Because multifamily Housing Bonds are limited by the Private Activity Bond volume cap, the 4 percent Credit is not subject to the Housing Credit volume cap. Not only do Housing Bonds make possible the production of substantial numbers of new Housing Credit properties, they are essential to state efforts to preserve affordable housing.

*Source: Housing Credit 2022 FAQs, National Council of State Housing Agencies.*

# The Funding Gap Problem

## Most LIHTC Projects Experienced Unexpected Cost Increases

According to the study team's interviews with individuals who work on LIHTC deals around the United States, nearly all deals awarded LIHTCs from 2019 to the present have faced significant unexpected cost increases that led to a need for additional resources; this is true for both 4 percent and 9 percent LIHTC deals and for both new construction and acquisition and rehab projects. The range of cost increases is broad, and stakeholders reported their projects' unexpected funding gaps vary greatly. Every stakeholder interviewed reported a funding gap on virtually every project.

For example, one HFA reported that 39 of 42 projects awarded 9 percent credits in 2020 requested additional funding, with requests ranging from $145,000 to $5.7 million, to help cover unexpected cost increases. This HFA also reported that while pre-COVID-19 costs averaged $150,000 per unit, costs have risen to over $200,000 per unit (a 33 percent increase).

Funding gaps owing to unexpected cost increases continue to be a challenge among projects that were awarded tax credits very recently. Another allocating agency reported that none of the projects awarded 9 percent credits in 2021 has closed without experiencing unexpected funding gaps, and half of those projects were still delayed in closing a year after receiving the award. The agency expects every project recently awarded a 9 percent credit will also have a funding gap.

Among the 11 state agencies examined, 8 of them—Georgia, Massachusetts, Minnesota, North Carolina, Ohio, Pennsylvania, Virginia, and Washington—reported that nearly all of their LIHTC projects since the beginning of the COVID-19 pandemic have experienced significant funding gaps. The three California housing agencies examined by the study team reported that many of their projects are experiencing unexpected funding gaps. They have been flexible with developers by extending deadlines for issuing bonds; nonetheless, they expect many recent bond projects to need a supplemental allocation.

Projects are experiencing funding gaps in all regions of the country, in both rural and urban locations. Developers who work in a range of jurisdictions across the country did not report any variation in funding gaps by geography. Additionally, both for-profit and nonprofit developer stakeholders reported they are experiencing funding gaps on nearly all projects.

Although it is not unusual for affordable housing developments to experience funding gaps as they approach construction, the problem's current depth—with stakeholders reporting an average gap of 30 percent and a number of projects with even larger ones—and nearly universal breadth are unprecedented across the board in the interviewees' experience.

# Factors That Contribute to Funding Gaps

## Overview

The funding gaps are due to sharp increases in recent years in the costs of labor, materials, and borrowing. For example, the price of lumber increased sharply in 2020 and the first part of 2021; since then, it has fluctuated widely, decreasing in mid-2021 before rising sharply again and then falling in March through June 2022. Fuel costs have increased substantially as well. Labor shortages and increased costs for labor have also contributed to funding shortfalls, as have project delays related to supply chain and other issues. These challenges are some of the most common, but stakeholders cited several additional factors as also contributing to funding gaps, such as rising insurance premiums. Often, projects are affected by a combination of several factors. (See box 2, Ability to Manage Funding Gaps Varies among Developers.)

## Increases in Demand for Construction Workers

A number of factors have increased demand for construction workers, leading to labor shortages and associated increases in labor costs. For example, the pandemic and its accompanying social isolation, a transition to remote work for many office workers, and federal stimulus payments prompted increased demand for housing and home renovation. Interest rates—which until recently the Federal Reserve had kept at historic lows to stimulate the economy in the wake of the pandemic—also played an important role in encouraging new construction.

These factors combined to increase the amount of construction activity, especially in the residential sector. As a result of this increased demand, stakeholders reported seeing more overbooked general contractors and subcontractors and fewer bids on projects. Some stakeholders said that labor shortages have hit rural parts of the country the hardest; these areas were the most likely to experience construction labor shortages even before the COVID-19 pandemic.

At the same time, stakeholders said that workers' having to isolate from exposure to COVID-19 or recover from COVID-19 has also left projects insufficiently staffed. Some of the current labor shortages have their roots in the sharp reductions in construction activity associated with the housing market downturn that started in 2008; once contractors left the industry and found other employment, it became harder to regrow the workforce.

## Rising Materials Costs

The cost of construction materials has also been increasing (see figure 1). Spikes in the price of lumber, especially early in the pandemic, have been well publicized, but prices of other building materials have also

been affected and have only very recently shown signs of leveling off. For example, Fannie Mae reported that the costs of most construction materials rose significantly from 2020 Q3 to 2021 Q3.[1] Steel and aluminum were up 22 percent, and electrical and lighting were up 12 percent. While lumber was down 2 percent during this period, it experienced extreme volatility, including steep rises in 2020; despite reductions in 2022, lumber costs are still elevated compared with 2019 prices. More generally, increases in the cost of fuel have added not only to the cost of many materials, but also to shipping costs.

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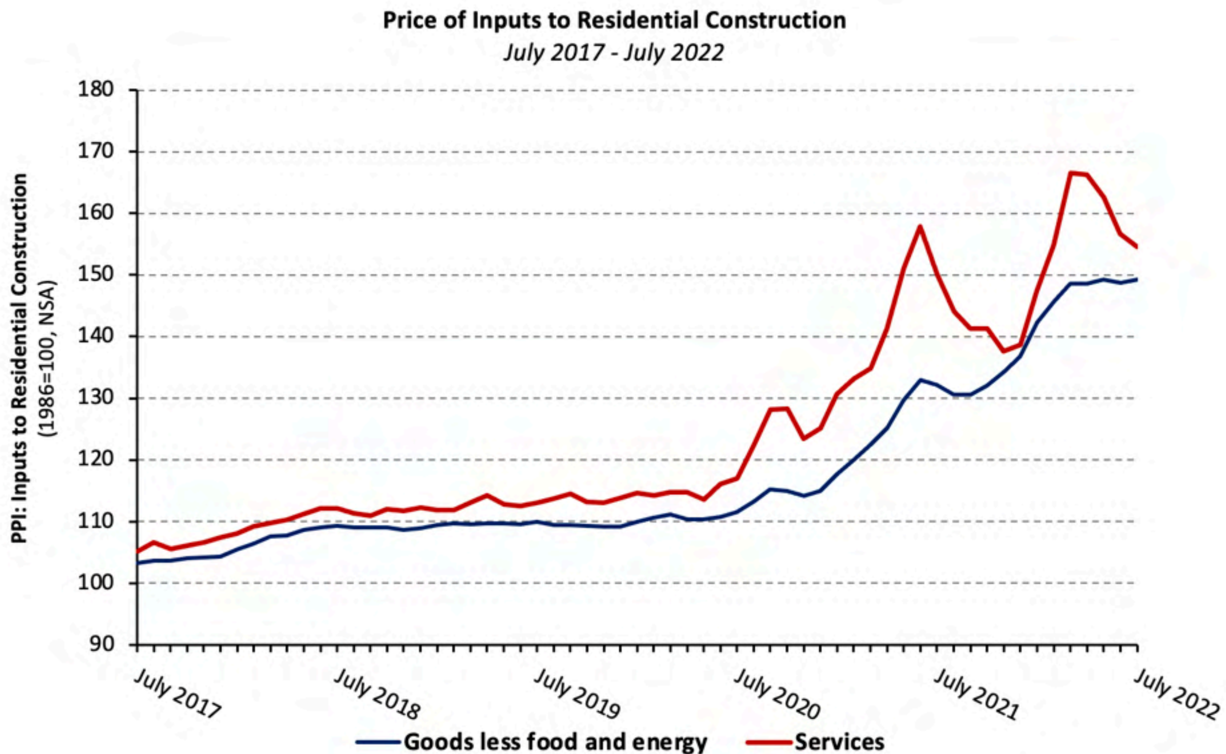
**Figure 1. Rising Construction Costs**




*Source: Testimony of Jerry Konter on Behalf of the National Association of Home Builders, Hearing on the Role of Tax Incentives in Affordable Housing, Senate Committee on Finance, 117th Congress, July 20, 2022, page 5.*

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## Project Delays

Stakeholders reported that project delays are widespread, contributing significantly to funding gaps as construction costs continue to rise while projects are stalled. They said several factors have caused these delays, including staffing shortages across participants in the affordable housing production process (allocating agencies, local governments, contractors, and others); slower-than-usual development approval processes at the local level; and slower underwriting and approval processes for financing partners, such as HFAs and other agencies, the Federal Housing Administration, and syndicators. In addition, competition for labor means that subcontractors are often booked for months in advance, forcing developers to wait for labor to become available.

[1] Francisco Nicco-Annan, "COVID-19 and Multifamily Construction Costs," *Multifamily Market Commentary*, Fannie Mae, May 19, 2022.

Supply chain disruptions, including shipping delays, have also caused project delays. For example, projects have stalled while contractors wait for essential parts and supplies (such as appliances, cabinets, and junction boxes). Lead times for ordering critical components like doors and windows have been much longer than usual and have caused delays in project start times.

## Increases in Price Volatility

Variability in the cost and availability of materials and labor has led many general contractors to shorten time frames for firm price quotes on bids from 90 days to 30 days. Developers have seen significant increases in bids once quotes expire. Additional funding sources or cost-cutting measures must be identified for projects with higher-than-expected bids or cost increases from the general contractor. While developers are searching for additional funding or redesigning projects to reduce costs, overall project costs can sometimes increase even further.

Stakeholders reported that, in general, unpredictability in the price of labor, prices and availability of materials, and processing time frames creates risks of higher-than-expected costs. Guaranteed maximum price (GMP) contracts, which specify that a contractor is compensated for actual costs plus a fixed fee up to a maximum price, are often used in the construction industry, meaning that much of this risk is borne by general contractors and subcontractors. In response, many contractors are including cost-escalation clauses in their bids to protect themselves against this risk. This approach both further contributes to price increases and introduces uncertainty.

Developers and underwriters sometimes struggle to identify exactly what line items are driving cost increases, meaning that budgets need even more careful scrutiny than under normal conditions. In some cases, materials estimates may be based on a high-water mark that is no longer justified. For example, a budget may include high lumber prices that no longer match market prices.

## Interest Rate Increases

Most recently, increases in interest rates are contributing to project expenses. Stakeholders reported that, in particular, the increases in interest rates for construction loans mean that delays in the construction process add direct costs (relatively high rates paid over a longer period of time) and, indirectly, can mean higher mortgage costs, because some organizations' rates on permanent loans cannot be locked in until the construction loan closes.

Some stakeholders are concerned that interest rate increases may cause project investors to re-underwrite deals and reduce their equity bids because more cash flow will be needed for debt service. Project delays may also prompt re-underwriting because of the reduced value of tax credits to investors, who will start receiving tax credits later than expected.

One developer described the combined effects of project delays, price volatility, and interest rate increases this way: "In a normal tax credit deal, you might have 20 transaction parties—the appraiser, environmental review, legal, permitting, [etc.]. If everyone is one week delayed, that's 20 weeks added to your schedule. That four or five months can make or break a deal. You bake … that much more volatility into [general contractor] bids and the interest rate volatility right now. Interest rates have doubled over [the] last 4 months. That 20 weeks alone creates huge new funding gaps. Time is the enemy of all of these gaps."

## Local Factors

Various local factors have also contributed to cost increases. More than one allocating agency said insurance costs have risen rapidly and are contributing to funding gaps; a developer working in multiple states reported that insurance requirements vary by allocating agency and can be much higher in some states than in others. Some states are requiring builder's risk insurance and construction completion guarantees; allocating agencies are more likely to require these if they are providing loans or other funds in addition to providing tax credits.

Additionally, some regions of the country have experienced unique supply chain issues. In King County, Washington, for example, a labor dispute led to a concrete delivery drivers' strike, meaning that some projects had little or no access to concrete.

Stakeholders reported that projects in places that did not classify construction as an essential service during early COVID-19 shutdowns and placed a moratorium on construction faced more significant funding gaps owing to delays and the costs of restarting projects once construction was allowed again. For example, one stakeholder said building moratoria in Boston and Cambridge, Massachusetts, caused significant funding gaps for several LIHTC projects once construction could resume.

### Ability to Manage Funding Gaps Varies Among Developers

Although unexpected cost increases are widespread and affect all regions of the country, both for-profit and nonprofit developers, and urban and rural areas, stakeholders did report that some projects are more able to absorb cost increases and resolve funding gaps than others. Given the information gathered in the stakeholder interviews, a project's ability to close unexpected funding gaps and move forward to completion seems to vary according to the developer's size and experience, as well as the income level of the neighborhood around the project site. Projects serving neighborhoods with a lower area median income, whether urban or rural, may be least able to raise rents to close funding gaps. Additionally, some stakeholders highlighted specific examples of less-well-established developers, including some developers of color and tribal developers, that have the fewest resources to close funding gaps.

For example, one allocating agency has an allocation pool dedicated to the projects of emerging developers of color. Several projects in that category were among those experiencing problems, partly because these developers have smaller portfolios, less access to capital, and less ability to defer developer fees. This same agency also recently had a tribal project return its bond allocation because the construction bids for its project were too high; even with more bonds, the project could not move forward. Another agency had two tribal deals from 2019 still stalled as of mid-2022.

Stakeholders report that larger, better-established for-profit and nonprofit developers have generally been better equipped to manage funding gaps and delays. One stakeholder said these developers are better able to absorb cost increases and negotiate better terms because they have more leverage with contractors than do new or smaller developers. Another stakeholder said developers with deeper pockets are the most likely to get projects across the finish line because smaller developers' investors are backing out when projects' rebids come in millions over initial estimates.

One large developer reported that it has its own lumber company, which provides some insulation against price volatility. Others have the financial resources and established relationships with suppliers to order supplies well before a deal is funded and then swap out those supplies for other projects if needed, helping the developers reduce construction delays stemming from difficulties obtaining materials.

Larger developers may also be better able to defer more of the developer fee, which is a source of funding for the project, or to access their own resources to fill gaps. For example, one large nonprofit developer was awarded Capital Magnet Funds from the Community Development Financial Institutions Fund, which it is using to fill gaps. Until recently, the developer had internal policies related to how to distribute such funds, which included a cap on this source of funding for each project. The developer has found that to close gaps, it has had to relax that cap. The amount of Capital Magnet Funds allocated to each project to fill gaps is now determined on a project-by-project basis.

# State Agency Approaches to Closing Funding Gaps

## Overview

State HFAs and other state housing agencies are taking a variety of approaches to help fill gaps in LIHTC deals. These approaches depend in part on local factors, including whether states have allocated recovery funds to housing; whether the same agency allocates both housing credits and multifamily housing bonds; and whether state-specific resources, such as a state tax credit or state housing trust fund, are available. State agencies' strategies for helping developers close unexpected funding gaps in projects fall into five major (not necessarily mutually exclusive) categories: (a) providing flexibility along a variety of dimensions, (b) allocating additional bonds or LIHTCs, (c) using recovery funds, (d) using state-available sources of soft funding, and (e) asking developers to make efforts to close funding gaps (described in the next section).

## Providing Administrative Flexibility

All the allocating agencies examined are working collaboratively with developers, offering flexibility in a credit award and execution process that is necessarily quite rigid (due to the competitive nature of 9 percent LIHTCs in all jurisdictions and of private activity bond authority in an increasing number of states). Examples of flexibilities given to developers include allowing timeline extensions; waiving penalties for returning unused credits; and allowing changes to some aspects of the project, such as the number of units, amenities, and community space.

Allocators must balance the need for flexibility to allow a project to move forward with the need for fairness. To the extent that some projects were awarded credits for reduction or elimination of features, interviewees at some HFAs expressed concern that developers who were not awarded tax credits for their projects may have reason to protest.

Interviewees at several agencies mentioned that their ability to be flexible is often constrained by state statutes, the terms of their Qualified Allocation Plans (QAPs), or other guidelines and regulations that govern the programs they administer. Some agencies have been able to take action through their governing board, while others have required legislative changes to address the issues raised by funding gaps. Each jurisdiction requires a unique set of solutions, often involving more than one state agency and multiple programs.

Going forward, some allocating agencies also plan to take flexible approaches. For example, one state reported that it is allowing flexibility in underwriting, such as higher debt–service coverage ratios, particularly for small developers. As another example, some allocating agencies plan to use 4 percent and 9 percent credits in the same project. Connecticut reported that its QAP limits 9 percent credits, so it provides developers with access to 4 percent credits to cover the excess basis in the deal.

Another HFA reported that it is allowing higher contingencies to be carried by the construction manager or the owner in some cases. This HFA also sometimes waives the rule that GMP savings (when a project is delivered for less than the GMP) be returned to the project, instead allowing for shared savings between the construction manager and the project to compensate for the greater risk to the construction manager.

## Allocating Future-Year LIHTCs

Most of the states the study team examined are considering the allocation of additional 9 percent LIHTCs as a source of funds for projects that already have 9 percent allocations and have funding gaps. The approach to additional allocations and the amount of the allocation varies widely.

Some states routinely "forward allocate" some or all of their 9 percent LIHTCs, meaning that the agency draws credits from a future allocation round for current projects. This practice allows developers an extra year to meet statutory deadlines for placing units in service. The strategy is also used to prevent a scenario in which credits are returned to the state agency because a project is unexpectedly unable to close by the deadline.

Recent unexpected cost increases are prompting allocating agencies to forward allocate 9 percent credits for a different purpose—as an additional source of funding to close project financial gaps. More than one stakeholder interviewed by the study team described this strategy as a short-term one; it essentially "robs Peter to pay Paul"

because future credits allocated to current deals are then not available for future funding rounds. For example, Georgia reported that this approach has reduced the total amount of available credits for 2022 by about one-third.

States are taking different approaches to the conditions under which they will allocate additional 9 percent credits to projects. Some states are discouraging developers from requesting additional credits by incorporating a penalty. For example, Georgia, Ohio, and South Carolina are reducing a developer's maximum future tax credit by 1.5 times the amount of additional tax credits requested for a current project.

Other states, such as Massachusetts and Virginia, have allocated additional credits with no penalty, although they have typically instituted a cap or restrictions on the use of additional credits. For example, Massachusetts has allocated up to $100,000 of additional credits per project. In Virginia, where nearly every project awarded credits in 2021 requested an additional allocation, the cap was $150,000 per project, and the use of additional credits was restricted to cost increases. At one agency that did *not* assign penalties for requesting additional allocations, the interviewee noted—in retrospect—a penalty probably should have been implemented. Going forward, in similar circumstances, the agency would likely incorporate, at a minimum, a rule limiting requests to those that are absolutely essential.

At the extreme, forward allocating future 9 percent credits could mean that few credits would remain available for new affordable housing projects in a future year. One HFA staffer told the study team that public funders in her state discussed the possibility of not having a 9 percent tax credit allocation round at all in 2023. She said, "What's the point if we can't get the deals we have off the ground? We could see a halt [in affordable housing production], because we keep borrowing from the future anyway." She and other stakeholders expressed concern about the effect of canceling or reducing the size of future 9 percent tax credit allocation rounds both on future affordable housing production and on developers, who depend on a steady flow of work to produce income to sustain operations.

She further said, "There is a timeline and pipeline of predevelopment [for developers]. These deals don't just pop up. Is that the next potential impact—that our public funding resources go to fill these gaps? And then if we took a break, what would that mean to the whole development cycle?" She was concerned about the way a break in HFA funding support would affect the whole affordable housing construction industry in her state, especially developers that already have potential projects in the works.

Additionally, some agencies are allowing developers to do a credit swap, for example, return the 9 percent credits they originally received, then receive credits from the next credit allocation year; such a swap gives developers more time to meet their placed-in-service deadline. This approach helps reduce the likelihood that delays lead to the loss of credits. Virginia and Washington are both using this strategy.

## Increasing Financing from Tax-Exempt Bonds

Another issue for projects using tax-exempt bonds and 4 percent tax credits is the so-called 50 percent test. For a project to qualify for 4 percent credits, at least 50 percent of the costs of the project must be financed with tax-exempt bonds. Increases in project costs can cause the share of costs financed with tax-exempt bonds to fall below 50 percent. States routinely allocate slightly more than 50 percent of project costs in the form of tax-exempt bonds to avoid the possibility that projects will fail this test as a result of unforeseen cost increases. Allocations of 51 percent, 52 percent, and even up to 55 percent of project costs are not uncommon.

Until very recently, this approach was a sensible way to make efficient use of the limited tax-exempt volume cap, preserving some of the cap for other uses while also providing a small cushion for the 4 percent projects. The recent unexpected increases in production costs for affordable housing have gone well beyond built-in cushions, causing many projects to run the risk of failing the 50 percent test.

In many states, the solution to the problems of funding gaps and the 50 percent test on 4 percent projects is relatively straightforward: allocate additional tax-exempt bonds to the project to reach the 50 percent level. The additional tax-exempt bonds trigger an increase in 4 percent credits, which allows properties to raise additional equity, helping close a significant portion of funding gaps on 4 percent tax credit projects.

A number of states have not reached their tax-exempt bond volume cap; in these states, issuing additional tax-exempt bonds is a relatively straightforward (although expensive) solution. When interest rates are such that tax-exempt bonds are not a particularly efficient form of financing, developers use them for financing anyway to qualify for the 4 percent credits. In these circumstances, developers repay the bonds within a few years after the project is placed in service, using financing with more favorable terms, such as a Department of Housing and Urban Development–insured multifamily mortgage or a Department of Agriculture loan.

In contrast, many states have reached their tax-exempt bond volume cap (see figure 2). In these states, the award of additional tax-exempt bonds to already-funded properties will have the effect of reducing the number of affordable housing properties that can be developed with 4 percent credits.

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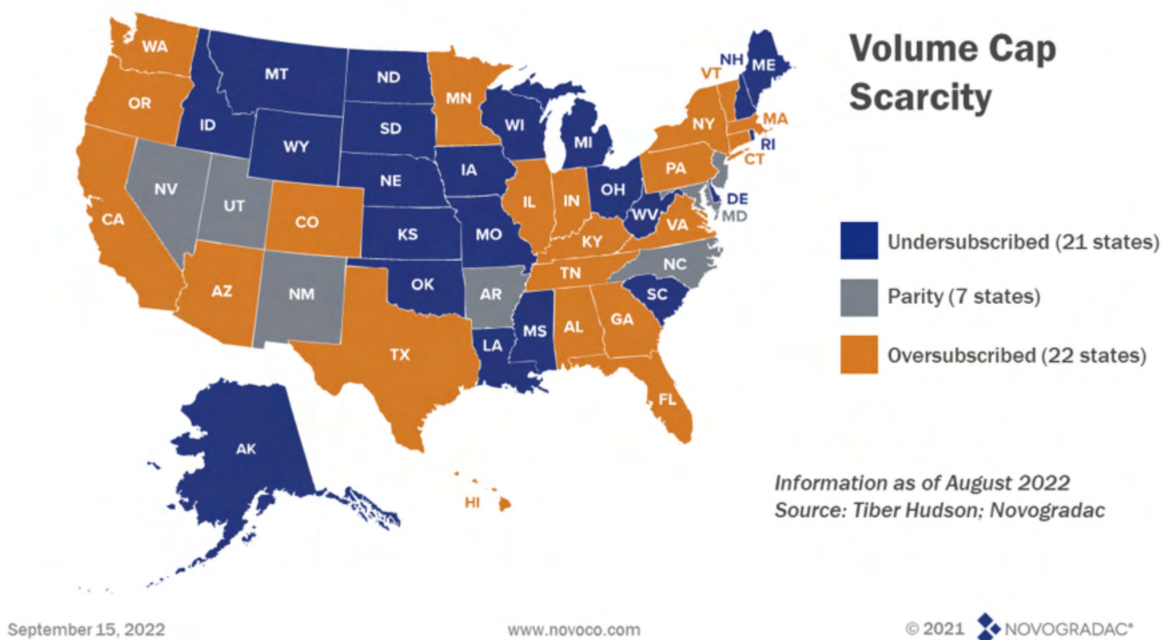
**Figure 2. Private Activity Bond Volume Cap Demand**

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Agencies in Georgia and Ohio are using additional tax-exempt bonds as their primary strategy for closing funding gaps on existing projects that use 4 percent tax credits, while North Carolina had several 4 percent deals request additional bond authority to meet the statutory 50 percent test due to increased costs. Georgia is an example of a state that until recently had bond volume to spare; with increasing developer interest in 4 percent credits, however, Georgia is joining the lengthening list of states now awarding 4 percent credits on a competitive basis.

For the growing list of states whose tax-exempt bond volume is fully subscribed, the issues of closing funding gaps for projects with 4 percent credits and avoiding the problem of projects failing the 50 percent test are more challenging. Going forward, states will likely have to allocate more bonds to each project to provide enough of a cushion to guard against failing the 50 percent test.

Some developers, HFAs, and others are coming up with creative workarounds for the 50 percent test. For example, if land can be excluded from total project costs, a property that previously failed the 50 percent test may now pass it. A developer may be able to exclude the costs of purchasing land from total project costs by using a long-term lease.

States are taking a range of other approaches as well. For example, Washington reported that tax-exempt bonds that have been allocated by other issuers, such as housing authorities, sometimes become available as projects fail to materialize. These can be allocated for supplemental bond issuances for 4 percent tax credit projects.

As another example, California's recent state budgets have appropriated a total of $2.1 billion to fund the California Housing Accelerator using recovery funds. The California Department of Housing and Community Development (HCD) noted that in 2021, most of the 4 percent projects in California were stalled because the state had reached the limit of its tax-exempt bond authority; these are among the projects being targeted for additional funding. Specifically, the funds are being used to fill funding gaps in shovel-ready projects that have received funding under other HCD programs and have been unable to access LIHTCs. HCD described this as a "synthetic" tax credit program in which state money is used to replace tax credits. Note that HCD does not have statutory authority to award additional funds to deals that have previously received funding. To help projects that have been awarded LIHTCs close funding gaps and meet the 50 percent test, the state is working to establish a supplemental allocation of tax-exempt bonds from the California Debt Limit Allocation Committee.

One industry observer noted that because tax-exempt bond authority is used for multiple purposes in each state, one option could be for states to shift bonding authority to multifamily housing from another purpose, such as single-family mortgages. Because this approach reduces resources for single-family housing, it could be controversial. None of the HFAs examined reported they are currently taking this approach.

States may also be able to commit a future year's allocation of bonds to a project to cover higher-than-expected costs. The ability of a state bond allocating agency to over-commit or forward commit tax-exempt bonds to projects depends on the terms of the statute that governs the allocation of tax-exempt bonds in that state. HFAs are adding soft funds, such as Home Investment Partnerships Program (HOME) funds, to help close gaps in 4 percent deals. Developers are identifying ways to help close gaps in 4 percent projects as well, such as obtaining fee waivers from local jurisdictions, deferring or reducing their developer fees, taking on more debt, and applying for additional sources of soft funding. Assembling additional resources can significantly delay projects, so HFAs, including those in California, are extending deadlines to give developers enough time to find resources to move projects forward.

## Using Federal Fiscal Recovery Funds

Congress authorized the Coronavirus State and Local Fiscal Recovery Funds (recovery funds) program in the American Rescue Plan Act in March 2021, providing a total of $350 billion to government entities to support their response to the COVID-19 pandemic. A final rule issued in January 2022 clarified that funds could be used for affordable housing, but only under specific circumstances. As of June 30, 29 states had allocated nearly $9 billion in recovery funds to a range of affordable housing purposes, according to an NCSHA survey (see figure 3). Various other sources suggest local governments have committed an additional $5 billion of recovery funds similarly.

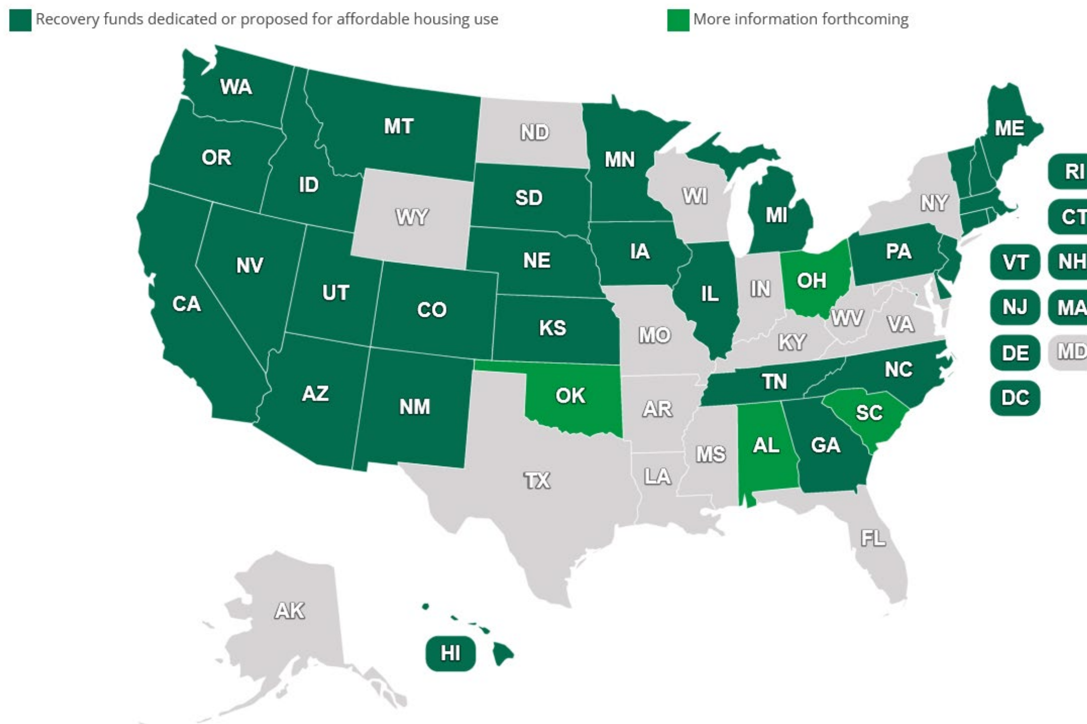
Most states and many cities plan to use recovery funds to fill funding gaps in LIHTC and other affordable housing developments. Although Treasury's original rules created complexities and limitations in using recovery funds for this purpose, several states have found ways to manage it.

For example, North Carolina allocated $170 million of recovery funds to the Workforce Housing Loan Program, which is a state-funded nonrecurring gap lending program. Projects previously awarded tax credits can get additional resources to close funding gaps as long as they can be traced back to pandemic-related cost increases.

Similarly, Pennsylvania is using recovery funds appropriated through the legislature as a grant to the Commonwealth Cornerstone Group (a designated Community Development Entity). Because the funds are appropriated, they are considered expended, and the Commonwealth Cornerstone Group can structure loans to LIHTC projects to close funding gaps. The program—the Construction Cost Relief Program—received $50 million in appropriations for LIHTC projects in 2021, all of which was deployed for 2019 and 2020 deals.

The Pennsylvania HFA executive director reported that funding gaps addressed through the program were related to increases in the costs of construction materials and labor and to reductions in LIHTC equity commitments. The legislature appropriated another $150 million in July 2022 for cost overruns associated with 2021 and 2022 LIHTC projects. The executive director noted that without the additional funding, projects receiving LIHTC from 2021 and 2022 would be unable to proceed. "This is as urgent as it gets," she said.

### Figure 3. States Devoting Fiscal Recovery Funds to Affordable Housing




*Source: States Are Using Fiscal Recovery Funds for Affordable Housing, National Council of State Housing Agencies, July 19, 2022.*

In late July, Treasury made significant changes to the rules for using recovery funds to expand the affordable housing supply, including by filling funding gaps. NCSHA noted after the announcement, "Treasury's announcement will quickly unlock significant amounts of financing, encourage states and cities to invest additional funds, and establish new sources of long-term capital for affordable construction around the country."

While the new recovery fund rules should benefit many transactions, they will not solve the funding gap problem, for several reasons. First, even states that have allocated recovery funds to this purpose may not have enough funding to sufficiently serve all the deals that need it. Second, a number of states have not yet allocated any recovery funds to affordable housing.

## Dedicating State Sources of Soft Funding

Several HFAs reported that state sources of soft funding have been critical to closing funding gaps since the beginning of the pandemic. These sources are being used both to fill past funding gaps and to offer developers more resources to avoid gaps for current projects. For example, in Ohio, the HFA used housing development loans on top of additional credits to close gaps owing to increases in hard costs for projects awarded credits in

2019 and 2020. For the 2022 round, the agency was able to write its QAP to give higher priority to projects where urban and suburban areas committed funds from HOME and the National Housing Trust Fund, in addition to providing resources from the Ohio Housing Trust Fund. In Iowa, one developer cited the Workforce Housing Credit as having been a helpful source of funding.

As another example, Massachusetts has a state housing tax credit that has been helpful in closing funding gaps. Minnesota has several state-funded resources, all of which have been used, to the extent they are available, to help close funding gaps.

# Developer Efforts to Help Close Funding Gaps

## Overview

Both HFAs and developers generally are making efforts to close LIHTC projects' funding gaps. Indeed, many HFAs ask developers to try to address their gaps before coming back to the HFA. Developers are trying to address their problems in a variety of ways.

## Deferring Developer Fees

One key strategy is for developers to defer more of their developer fee than initially budgeted. A developer fee compensates the developer for the time and effort of planning and developing a project. By deferring large portions of their fee, developers run the risk of having insufficient revenue to continue putting LIHTC deals together, raising concerns among some stakeholders about the health of the development industry. Those stakeholders did not see fee deferral as a long-term solution.

Furthermore, this strategy can be particularly challenging for nonprofit developers focused on projects with greater affordability; those deals tend to have less ongoing cash flow that could be used to repay the developers for the deferred fees. By contrast, large for-profit developers doing 4 percent deals that do not target very low-income households tend to structure their deals with less reliance on upfront developer fees; they rely more on property cash flow to achieve the revenue they need to sustain their operations.

## Advocating for More Funds from Local Government

Developers are taking other approaches as well. As described previously, developers are applying to cities for soft resources, fee waivers, property tax exemptions, or an agreement for payment in lieu of taxes. In addition, in California, some developers are lobbying state senators for an allocation of funds through the state budgetary process.

One developer described a city that agreed to waive impact fees to help close funding gaps. (In other cases, cities have offered property tax exemptions or soft funding, such as HOME funds.) This developer said he has successfully closed gaps on some projects using a combination of soft resources from local jurisdictions and additional debt. While local funding has been extremely important for helping these projects get to the finish line, the developer noted that obtaining and satisfying requirements of soft funding can further delay projects. He said, "There are not a ton of programs that are quick. And we're doing 200- to 300-unit projects. So, getting a $250k HOME loan is nice, but it's barely chipping away at the problem. And it has another layer of regulatory compliance and income targeting that creates costs down the line."

## Value Engineering

Another way to address funding gaps is through value engineering, the process of analyzing a building's design to determine how to provide the essential functions at the lowest cost while maintaining safety, reliability, and quality. Developers may also reduce projects' square footage and cut units and amenities to the extent they can while still meeting the HFA's minimum standards. Most developers look for additional funding sources before redesigning, a process that is costly and causes more delays. Design changes require new approval, so these projects' timelines are further drawn out, stalling affordable housing production. Stakeholders from allocating agencies in Massachusetts, Minnesota, North Carolina, Ohio, and Virginia said they have allowed developers to implement small design changes or have been flexible in allowing cost-saving measures, such as changes in materials from brick to a lower-cost exterior. In North Carolina, the agency allowed design changes and value engineering as long as the project continued to meet the minimum design standards outlined in the QAP.

In contrast, the HFAs examined by the study team are holding the line and generally refusing to make changes that would reduce energy efficiency or omit other features required in their QAPs. For example, the Massachusetts tax credit allocating agency described its design requirements for approving an LIHTC deal—including those for energy efficiency, sustainable design, and elevators in senior housing—as "stringent." The Massachusetts Department of Housing and Community Development is allowing developers to do some amount of value engineering but not to materially change the design or quality of the building.

### Increasing Debt Financing

Some developers are increasing project debt as a strategy to close funding gaps in cases where they have the flexibility (and are willing) to raise rents to support higher debt levels. North Carolina reported that most of the developers the state works with have chosen this option, although the developers are required to maintain the same targeting/unit mix as at the time of award. The ability to raise rents depends on a number of factors, including whether a project was meant to serve households below the maximum income limits and whether there has been an increase in the area median income, which determines the maximum rent. In addition, many states provide points in their QAPs for projects that target households with very low or extremely low incomes; projects that received these points generally do not have the option of increasing rents to support more debt, unless the developers can still comply with the criteria used to award the points even after modestly raising rents.

### Integrating Vertically

Some larger developers are using vertical integration to address the challenges of accessing construction materials. For example, one developer interviewed said it owns its own lumber company to keep costs down. Another stakeholder said that it knew a developer whose projects were being delayed by a wait for electrical junction boxes, so the developer used 3D printing to create its own boxes.

### Advance Purchases

As noted earlier, some developers are also purchasing materials even before their LIHTC deals are selected for funding so that they are ready to start construction as soon as the funding comes through. This approach can be risky, but larger developers can manage it by repurposing the materials for other projects in the event their project is not selected for funding.

## Consequences of Funding Gaps for LIHTC Projects

Stakeholders mentioned several consequences of recent project cost increases, such as canceled projects, affordable projects converted to market-rate properties, and potentially fewer resources available for future affordable housing developments—all of which ultimately result in less affordable housing. Additionally, some stakeholders expressed concerns about long-term adverse effects on developers' capacity because of deferred fees and less predictable project pipelines. These issues raise questions about whether states should try to help smaller developers increase capacity to better withstand these kinds of cost overages and delays or instead try to prioritize larger developers that are better able to manage these issues.

One allocating agency expects to do fewer deals moving forward and to possibly have fewer resources to assist single-family homebuyers because of the state's decision to prioritize support for multifamily housing through tax-exempt bonds. This year, another agency reported being able to fund fewer than half its typical number of projects, and another agency saw slightly fewer units or smaller units in projects (e.g., one-bedroom units reduced to studios) and expected that trend to continue. One developer said it had to switch seven recent projects with financing gap issues from affordable properties to market-rate properties, forgoing credits entirely. The same developer dropped four projects entirely, representing a loss of over 1,000 units.

One stakeholder said it believes recent development barriers will "thin out the players in the field" because deals will be more expensive and profit margins will be thinner. Several stakeholders mentioned concerns with developers' needing to continuously defer developer fees, because it reduces their ability to pay for overhead and acquisitions, resulting in under-capitalized developers.

In addition, states, developers, and syndicators are all having to make difficult decisions about which deals to prioritize. Most stakeholders interviewed described a triage approach to managing the near-universal funding gaps across LIHTC projects. Some stakeholders are prioritizing older deals (some of which have made second requests to HFAs for additional funding); others are prioritizing deals that were more recently awarded credits but are already facing gaps and making the difficult decision to ask developers to return credits for older deals that have still not closed after 18 months.

Finally, state agencies' responsibilities to do what they can to fill cost gaps caused by extraordinary conditions further complicate their long-running efforts (and statutory responsibility under the LIHTC enabling legislation) to tightly control project development costs. Industry stakeholders made several suggestions on ways to reduce the costs of affordable housing production in the long term:

- Some states are considering adjusting some of the add-ons they incentivize through the QAP, such as community space, solar panels, energy-efficient construction, and deeper income targeting, at least temporarily.

- Some HFAs are experiencing staff shortages, and where these are causing delays (and thus project cost increases), industry stakeholders have suggested that HFAs consider outsourcing certain functions or raising fees (which are included in the basis) to fund the hiring of additional staff.

- Developers may be able to reduce costs by adopting new, more efficient construction approaches—such as panelized or modular construction—or smart construction techniques that reduce utility costs and lower operating expenses.

- Some developers have begun vertically integrating to increase their access to and reduce the price volatility of portions of the supply chain of construction materials, such as lumber.

# A Long-Term Challenge

This report is not a postmortem on a temporary crisis that is now safely in the rearview mirror. According to stakeholders, funding gaps are very much an ongoing issue, and one they are less equipped to deal with compared to one or two years ago.

Although some stakeholders speculate that prices for construction materials may stabilize, inflation generally continues unabated, and most stakeholders find it hard to predict what will happen to costs going forward. Anecdotal reports of subcontractors with openings in their schedules and reports of single-family projects being canceled are signs that the construction frenzy may be subsiding.

The costs of financing are more predictable, and it is all but certain that the additional increases in interest rates announced by the Federal Reserve will raise the costs of financing for affordable housing developers. Even projects with little or no permanent financing typically need construction financing, and, recently, these costs have risen sharply.

Stakeholders are also aware that state HFAs and other allocating agencies, having forward allocated 9 percent credits in many places to close funding gaps for recent or current projects, will have fewer credits available for future allocation rounds. One industry expert suggested that allocating agencies make the practice of forward allocation permanent, setting the 2019–2022 period of unusual forward allocation as the new baseline. This approach could allow them to continue to fund new projects without the reductions that would be needed if an agency wanted to stop forward-allocating credits. One issue with this approach is that forward allocation is a one-time solution: if HFAs reset a new forward allocation baseline, this option will not be available as a strategy to cover any future funding shortfalls.

The problems caused by the 50 percent test in a world of cost increases and the excess applications for private activity bonds for housing (which is a new condition in many states) must also be addressed. Some states may need to reevaluate their current processes and policies for allocating private activity bonds as they encounter

oversubscription for the first time. Regardless, the affordable housing industry is likely to face disruption as allocating agencies adjust.

## Legislative and Regulatory Action Needed

Stakeholders described several steps the federal government could take to help resolve the declines in affordable housing production—which will otherwise follow from ongoing volatility and rapid cost increases. The steps fall into two major categories: (a) fixes to or increased resources for 4 percent and 9 percent credits, and (b) changes to recovery funds to facilitate the use of these funds for LIHTC projects.

Stakeholders suggested several federal actions that could increase resources for affordable housing produced using 4 percent and 9 percent tax credits:

- *Restore and make permanent the temporary 12.5 percent increase in 9 percent tax credits that expired in 2021.* Higher construction costs mean that the same amount of LIHTCs is producing fewer units. Making the 12.5 percent increase in LIHTCs permanent would help restore the units otherwise lost to inflation.

- *Increase the volume cap for private activity bonds for each state.* The number of states reaching the maximum authority to issue private activity bonds is currently at 22 and growing rapidly. These are some of the largest states with the greatest needs for affordable housing. Fixing the rate of the 4 percent credit increased its popularity, and developers have created strategies to use these credits effectively. Increasing the volume cap for private activity bonds would give states room to allocate more bond volume to each project as a cushion against unexpected cost increases, preventing the problem of projects failing the 50 percent test.

- *Alternatively, reduce to 25 percent the share of adjusted basis that needs to be covered by bond costs to qualify for 4 percent credits.* As an alternative approach to increasing the bond volume cap, changes to rules about the amount of basis that must be financed using tax-exempt bonds would stretch the existing state bond volume cap to cover more projects.

- *Allow recycled multifamily bonds to be used for single-family housing.* This approach is another way to allow states to make better use of the existing bond cap, and it would allow states to increase the proportion of the bond cap allocated to multifamily bonds without undermining their ability to support their single-family homeownership programs. Multifamily bonds that are paid off before their stated term can be used to finance additional multifamily housing, but they are generally not used for this purpose because recycled bonds do not bring an additional allocation of 4 percent tax credits. Allowing recycled multifamily bonds to be used to finance single-family mortgages could enable agencies to fully use their bonding authority for the entire allowed term rather than having it go unused because the developer can use an alternative form of long-term financing when multifamily bonds are repaid early.

In terms of regulatory action, NCSHA is urging the Internal Revenue Service to extend certain regulatory deadlines that affect Housing Credit financings. Delays and complications caused by the factors discussed in this report are preventing developments from meeting their placed-in-service deadlines, jeopardizing their credit funding. Existing properties requiring repairs to fix noncompliance or for general maintenance and those that require more significant restoration after a casualty loss are facing the supply chain disruption challenges and are unable to meet other similar deadlines.

## Conclusion

State HFAs and developers are taking a variety of short-term approaches to close unexpected funding gaps. Other industry stakeholders, including cities, syndicators, and investors, are also participating in solutions. Recent cost increases are occurring in the context of long-running concerns about the per-unit cost of LIHTC projects and are reinforcing the importance of discussions about longer-term solutions for reducing per-unit costs. All these responses are happening in an environment in which project costs are unusually volatile, leading

HFAs, developers, investors, and others to seek greater safety margins to increase the chances that projects reach completion. These safety margins, while necessary, further contribute to cost increases.

In the current environment, characterized by unpredictability and rapidly increasing costs, developers need more resources to produce the same number of units. Most projects are no longer viable with the resources available, so industry stakeholders are having to prioritize which projects will get the scarce additional resources needed to restore viability. Some projects are falling through and being abandoned or converted to market-rate housing. Without an increase in resources, fewer affordable housing units are being produced.

Several stakeholders said that, having used all available resources (and then some, via forward allocations) to cover gaps for existing projects, they expect they will need to reduce the number of projects they fund in the coming years.

Some states, including California and Pennsylvania, are hoping for additional future allocations of recovery funds from their state legislatures. Others, such as Minnesota, Ohio, and Virginia, are delivering a strong message to developers up front, warning that although recent projects have been allocated additional credits, they cannot expect those resources for current and future projects.

The affordable housing industry has reacted to the current crisis with speed, creativity, and flexibility, but stakeholders noted that options are dwindling. Many expressed concern that without action from the federal government, annual affordable housing production will drop significantly. The recent guidance from Treasury will make it easier to use recovery funds to support LIHTC projects experiencing cost overruns in some states. However, additional support and flexibility will likely be needed for states to ensure that they will continue to be able to robustly support the production and preservation of affordable multifamily housing.

## Appendix: Organizations Interviewed

- The Annex Group
- California Department of Housing and Community Development
- California Housing Finance Agency
- California Tax Credit Allocation Committee
- CohnReznick LLP
- Dominium
- Enterprise Housing Credit Investments
- Georgia Department of Community Affairs
- Lincoln Avenue Capital
- Massachusetts Department of Housing and Community Development
- Minnesota Housing
- National Housing & Rehabilitation Association
- North Carolina Housing Finance Agency
- Novogradac
- Ohio Capital Corporation for Housing
- Ohio Housing Finance Agency
- Pennsylvania Housing Finance Agency
- U.S. Bank
- U.S. Department of Treasury
- Virginia Housing
- Volunteers of America
- Washington State Housing Finance Commission