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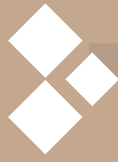

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The Low-Income Housing Tax Credits *Issue*

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High Interest Rates Are Driving More Developers to HUD-Insured Loans

MICHAEL J. NOVOGRADAC, CPA

High interest rates are driving more real estate developers to apply for loans insured by the U.S. Department of Housing and Urban Development (HUD) to finance affordable housing, and such financing is often combined with low-income housing tax credits (LIHTCs) and private-activity bonds.

HUD Section 221(d)(4)- and Section 223(f)-insured loans generally offer slightly lower interest rates than many conventional mortgages, as well as a longer amortization period. That combination generally allows developers to borrow more money through a HUD-insured mortgage for the same monthly payment as a conventional loan, making the HUD-backed offerings attractive.

Basics

Two major HUD-insured loan programs are available to multifamily developers:

Section 221(d)(4): This program insures mortgage loans that facilitate new construction or substantial rehabilitation of multifamily rental or cooperative housing projects with five or more units. HUD Section 221(d)(4)-insured loans offer a fixed-rate of interest and an amortization of 40 years (with the option of an additional interest-only three-year construction period).

Section 223(f): This program insures mortgage loans to facilitate the purchase or refinancing of existing multifamily properties. The developments must have at least five units and have been completed or substantially rehabilitated for at least three years before the date of the application for mortgage insurance. The mortgage term is up to the lesser of 35 years or 75% of the estimated remaining life of the improvements.

In short, HUD 221(d)(4) loans are for construction and substantial rehabilitation and HUD 223(f) loans are for acquisition and refinancing.

Lower Rate, Longer Amortization: Bigger Mortgage

During the period of historically low interest rates over the past decade, HUD-backed mortgages did not generally offer notably better terms than conventional mortgages, but that has changed: As of early April, HUD-insured loans were in the range of 5.2% to 6.0%, while conventional mortgages were at an average of 6.75%. A delta of 0.75 to 1.5% has a notable impact on the amount of borrowings a given amount of cash flow can generate. By way of example, a difference of 1% in the overall interest rate generates a difference in loan proceeds of about 10%. This means even a small gap in the interest rate between HUD-insured mortgages and conventional mortgages can mean a significant amount of money.

Combine the lower rate with the fact that the HUD-insured mortgages are amortized over 35 or 40 years, rather than the 30-year conventional loan period, and it means a borrower can secure an even larger loan amount through a HUD-backed loan.

One consideration for those considering a HUD-backed loan: It's not unusual for a HUD-insured loan to take a year from the start to finish, a longer period than usually required for conventional loans. The longer time period is caused by the fact that it often takes up to six months to compile the requisite paperwork for the application and another six months or more to get approval. For developers used to working with a conventional loan, this is a major delay.

Additional Requirements, Davis-Bacon Standards

HUD-insured loans do come with additional, and generally more burdensome, requirements than a conventional loan. Those include an annual financial audit with additional HUD-required elements (that must be submitted to the HUD Real Estate Assessment Center (REAC), HUD physical inspections and periodically a management-occupancy review to confirm compliance with HUD rules and regulations. A replacement reserve must be maintained, with initial funding at loan closing, followed by mandatory additional monthly deposits. HUD approval must be received before making any withdrawals from the replacement reserve.

Another requirement for Section 221(d)(4) loans is that work financed by them complies with the Davis-Bacon Act, which means paying labor what's commonly called "prevailing wages." For some developments, that translates into a sizable additional cost, which is a factor in weighing the benefits of a Section 221(d)(4) financing. Developers must determine how much higher payroll costs will be and whether the increased labor costs are worth the additional loan amount.

In assessing the effect of complying with Davis-Bacon rules on project costs, developers should note that developments that meet Davis-Bacon standards are able to realize a considerably larger Internal Revenue Code Section 45L tax credit for energy-efficient homes.

The Inflation Reduction Act of 2022 included a provision to extend and expand the Section 45L credit, which jumps as high as $2,500 per unit for affordable multifamily properties that meet the Energy Star Residential New Construction Program requirements and $5,000 per unit on affordable multifamily properties that meets the Zero Energy Ready Home requirements.

Already Popular Programs

Historically, in spite of the additional HUD requirements and Davis-Bacon standards, plenty of borrowers have used the Section 221(d)(4) and Section 223(f) programs. In 2019, 876 HUD-insured loans closed. Following the 2019 release of a pilot program to accelerate processing of HUD loan applications including LIHTC, by 2021, the number of closings more than doubled to 1,812. In 2022, those amounts dipped down to 1,181, which was likely caused by the various derivative effects of sustained high inflation.

HUD loan closings are widely expected to grow in 2023, as developers find solutions to developing in high inflation times, and as long as conventional mortgage rates are notably less attractive than HUD-insured loan rates.

Goldilocks Zone for HUD-insured Loans

The ability to borrow more money for the same monthly payment makes the HUD-insured loans attractive, but there are specific types of affordable housing and geographical areas where the loans are particularly attractive:

- Tax-exempt bond and 4% LIHTC-financed properties are the most obvious target, due to the larger amount of debt required compared to 9% LIHTC properties. With a larger debt, the difference from a HUD-insured mortgage is amplified.

- Properties in metropolitan areas are also more likely to show an interest in HUD-insured mortgages due to the likelihood that they are already paying Davis-Bacon Act wages (or at least close). That contrasts with rural properties where labor prices may be below Davis-Bacon wage limits and the economics of labor costs may be a determinative factor.

Considering HUD-Insured Loans

While the scope of this article is on affordable housing, market-rate housing is also eligible for HUD-insured mortgages, although affordable properties (or those with rental assistance) benefit from more favorable loan-to-value and debt service coverage ratios.

In short, while a HUD-insured loan likely takes more time and includes more oversight by HUD, the primary benefit is tangible: HUD-insured loans often allow a developer to borrow more money. The additional debt proceeds close financial gaps and help make a property more financially feasible. For real estate developers and owners, particularly with respect to affordable housing properties, HUD-insured mortgages are worth a thorough investigation. ❖

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