New Sources of Leverage Loans in a Constrained Market:

Making Use of FHA Loans in a NMTC Transaction

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The New Markets Tax Credit ("NMTC") program has had a significant impact on low-income communities nationally with more than $18 billion in qualified equity investments made in more than 15,000 businesses over the past decade. Central to the program's success has been the use of the leverage loan structure through which NMTCs are leveraged using debt, public subsidies or other sources of capital that are already part of the project's financing structure. This leveraged model has allowed borrowers to maximize the amount of NMTCs in their projects, making the difference between a project moving forward and a project stalling due to financing gaps.

In today's marketplace, however, with continued tight credit markets, there is little appetite in the financial community for unsecured debt which has made it increasingly difficult to finance NMTC transactions. While a combination of debt and equity in an investment fund is still the primary mode of structuring NMTC transactions, the number of organizations willing to act as a leveraged lender has decreased.

Federal Housing Administration ("FHA") insured debt has the potential to be a new source of leverage loans for the NMTC program. FHA programs such as the Section 221(d)(4), the Section 220 mixed-use program and the Section 242 hospital finance program can be a good match with the NMTC program requirements. Borrowers already taking advantage of HUD financing for their real estate project now have the potential to leverage NMTCs using the existing construction and permanent debt on their project.

FHA Insured Debt as a Leverage Loan

Building America CDE, Inc. ("BACDE") has developed a structure which allows FHA/GNMA secured debt to be part of a NMTC transaction while meeting the program's rules and regulations. Under this structure, there is a leverage loan made to the CDE Investor as in most NMTC transactions. The CDE Investor uses these funds to make an equity investment in the CDE. The CDE then uses these proceeds to purchase from an FHA Lender a participation in a specific FHA insured loan backed by a Ginnie Mae security. This purchase is treated as a qualified loan (QLICI) made by a CDE under an advance purchase agreement. The proceeds from the sale of this FHA insured loan are used by the FHA Lender to finance the specific project. Under this structure, a borrower can either leverage the entire amount of their HUD-insured loan, or just a portion of the loan depending on the amount of NMTC allocation that the CDE will use for the project.

During the seven year compliance period, a CDE would have legal title to the MBS. The leverage lender would have a loan agreement with the Investment Fund under which the lender would receive interest during this period and the equity investor would pledge 100% of its interest in the Investment Fund to the leverage lender. At the end of the seven-year compliance period, instead of the leverage lender receiving full repayment of the outstanding principal on its leverage loan, the leverage lender would receive the MBS as repayment. If the transaction contemplated only leveraging part of the MBS then this MBS could be re-combined with the remaining part of the MBS on the project and/or it could be sold separately in the marketplace.

This proposed structure allows the use of FHA-insured loans and Ginnie Mae MBS debt in an NMTC transaction while complying with Revenue Ruling 2003-20. NMTC practitioners read this ruling as requiring that a leverage loan cannot be secured by the assets of the CDE or the qualified low-income community business ("QALICB") that receives financing for its project. This means that leverage lenders are not able to get a mortgage on the underlying property from the project borrower. BACDE's proposed structure is designed to meet both the NMTC program requirements and the demands of the marketplace.

Benefits of FHA Financing when used with an NMTC Leverage Loan and Equity

Three of the FHA's financing programs are particularly well-suited to be combined with NMTC equity. FHA's Section 221(d)(4) program allows for up to 25 percent of a project's operating income to come from retail or other components and the Section 220 program allows up to 30 percent, both of which exceed the 20 percent minimum required under the NMTC Regulations while promoting the creation of mixed-use developments. The FHA Section 242 program is used to finance hospital and healthcare facilities which can be located in low-income or medically underserved areas consistent with the NMTC objectives. Some of the features of these programs should be of particular interest to the QALICB as well as to the leverage lender in choosing to integrate FHA debt with NMTC equity. These include:

- *Financing of mixed-use projects and health care/hospital facilities.* These projects bring a range of community benefits to low-income communities including providing housing, construction and permanent employment opportunities, and the provision of needed healthcare services. This comprehensive approach to community development is beneficial to the low-income communities the NMTC program was designed to serve.
- *Long Amortization Period.* FHA provides competitive debt pricing and offers up to a 40-year amortization period, reducing the amount of annual income required to meet the project's debt service. In addition, project debt does not have to be refinanced at the end of the seven year compliance period.
- *Higher loan-to-value.* FHA allows for higher loan-to-value ratios than conventional bank financing. FHA LTV ratios range from 75 to 90 percent. Higher LTVs combined with NMTC equity can maximize the amount of private capital available to the project in order to close any potential financing gap in the project.

- *Non-recourse Financing.* FHA financing is 100% non-recourse to the borrower which results in lower borrower reserve requirements and collateral exposure for the QALICB. This is a feature unique to FHA insured financing which can make financing more accessible to a broader range of borrowers while allowing for improved project underwriting.

Policy Solutions

While the structure set forth in this article allows FHA financing to be part of NMTC real estate transactions, further guidance from the Treasury Department explicitly allowing leverage lenders to receive a pledge of the borrower's assets securing the CDE's loans would allow the leverage lender to hold the MBS directly and would simplify such transactions. This guidance would increase the private capital flowing into NMTC transactions going forward, resulting in increased access to capital for businesses in low-income communities especially during these difficult economic times.

Conclusion

Utilizing FHA debt in a NMTC transaction will allow more projects to move forward, leverage greater amounts of NMTC equity and promote the development of mixed-use affordable housing and hospital and health care facilities in low-income neighborhoods throughout the country. This structure has the potential to be replicated and to break new ground in the NMTC program by unlocking new sources of capital for eligible projects—allowing purchasers of mortgage-backed securities to act as leverage lenders. It brings into the NMTC program untapped new sources of capital for leverage loans which are critical given today's market conditions.

Building America CDE is currently reviewing transactions which it hopes to finance utilizing the structure set forth above in order to promote the creation of mixed-use development and healthcare facilities in low-income neighborhoods. For more information on Building America CDE or this structure please contact Eric Price, Chief Executive Officer, Building America CDE, Inc. at eprice@aflcio-hit.com or 202.331.8055.