Guide to Using Interim Financing for NSP Activities

About this Tool

Description:

The purpose of this tool is to provide Neighborhood Stabilization Program (NSP) grantees and affiliates carrying out NSP-funded activities with information about interim financing. Interim financing can be a valuable technique for leveraging NSP resources, in turn allowing grantees and their affiliates to accelerate, expand, sustain, or otherwise enhance their impact. This tool describes interim financing, discusses the advantages and disadvantages of incorporating interim financing into a grantee's local neighborhood stabilization program, helps grantees to assess whether interim financing is a good fit for their activities, reviews key steps to implementing interim financing, and provides information on how interim financing can be obtained.

Disclaimer:

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This resource is part of the NSP Toolkits. Additional toolkit resources may be found at www.hud.gov/nspta

Guide to Using Interim Financing for Neighborhood Stabilization Program Activities

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Interim Financing for Neighborhood Stabilization Programs

1. Overview of Interim Financing

Interim financing is the deployment of capital, typically accessed through a private lender, for short-term development such as the acquisition and renovation of single-family properties. It is generally repaid with long-term financing, such as a 30-year fully amortizing permanent mortgage. By leveraging their NSP funds with interim financing, grantees can use their public funds more efficiently and enhance their impact on their communities.

The health of our communities depends on securing sufficient financial resources for neighborhood stabilization activities. NSP funds alone are often not enough: they are available for only a specified period of time, and only in limited amounts. By complementing their NSP funds with interim financing, grantees can build local neighborhood stabilization programs that are stronger, more efficient, and that can be sustained even once NSP subsidies expire or are spent. For grantees seeking to maximize their impact on their communities, interim financing can be a valuable resource.

NSP grantees are mostly governmental entities that are constrained in their ability to borrow and therefore may be unable to access interim financing directly. Such grantees can still benefit from interim financing by coordinating with non-profit or quasi-governmental entities and other housing providers that are not subject to the same restrictions. Throughout this tool, the term "grantee" is used as a reference not only to NSP grantees, but also to those housing providers or affiliates of the grantee that are participating in an NSP grantee's neighborhood stabilization activities.

2. Advantages of Interim Financing

Grantees can benefit from interim financing by improving the *timing* of the availability of their funds, and/or by increasing the total *amount* of available funds. With interim financing, a grantee may be able to:

- *Access funds earlier in the development cycle.* This can be especially valuable for grantees seeking to intervene in targeted neighborhoods on an expedited basis, before a cycle of disinvestment and neighborhood decline becomes established.

- *Increase the total amount of funds available for its neighborhood stabilization activities.* With more resources, grantees can acquire and rehabilitate more properties, broadening the impact of their local stabilization programs.

- *Continue neighborhood stabilization activities even after its NSP funds have been exhausted.* For grantees seeking to continue their neighborhood stabilization activities without NSP funds, interim financing can provide alternative funds.

The benefits that interim financing can provide to grantees can vary depending on several factors, including the unique needs of the grantee and the way in which the delivery mechanism for the interim financing—the “credit facility”—is structured. Grantees’ current action plans may also affect which interim financing structures are available to them. Grantees should consult with their local HUD office to review any potential compliance issues that may be triggered by deploying NSP funding for this purpose.

The charts below illustrate how interim financing can enhance grantees' local stabilization programs. The examples presented below show grantees benefiting from interim financing as a gap-filler and as a substitute or additional source of funds. In each case, interim financing helps the grantee to redevelop more units than would have been possible otherwise.

Chart 1 – Making More Projects Feasible. *Grantees can use interim financing as a source for paying a portion of the development costs of a project. By doing so, grantees can make projects feasible that would otherwise be infeasible due to a shortfall in available sources for paying development costs. For example, if the acquisition and rehabilitation of a property costs $150,000, but the only sources the developer has available with which to pay for the project are $50,000 in NSP subsidy and $30,000 in equity, then the project is infeasible because the developer faces a development budget "gap" of $70,000. Interim financing could provide the $70,000 needed for the project to become feasible. The chart below compares a project development budget that shows a gap with a project development budget where the gap has been filled with interim financing.*

Project Development Budget - Program without Interim Financing	
Interim Sources	***Amount***
Subsidy	50,000
Developer's Equity	30,000
Interim Financing	0
Total Sources	**80,000**
Total Uses	**150,000**
Development Budget Gap	**70,000**
Feasibility of Property Acq/Rehab	**Not Feasible**

Project Development Budget - Program with Interim Financing	
Interim Sources	***Amount***
Subsidy	50,000
Developer's Equity	30,000
Interim Financing	70,000
Total Sources	**150,000**
Total Uses	**150,000**
Development Budget Gap	**0**
Feasibility of Property Acq/Rehab	**Feasible**

Chart 2 – Getting to Scale. *Financing can also help to reduce the amount of subsidy or equity that is needed for each property. Instead of using only subsidy or equity to acquire, rehabilitate, and hold properties, grantees can use interim financing to bridge permanent financing, and use subsidy or equity to cover only the balance of costs. Freeing up subsidy and equity can provide grantees with the funds they need to simultaneously "start" —that is, commence acquisition, rehabilitation, or maintenance activities—on more properties. The chart below compares an all-subsidy and equity program structure with a program structure that incorporates interim financing. In this example, the number of simultaneous property starts possible for the grantee more than doubles with interim financing.*

Project Budget - All-Subsidy Program		
Sources	***Development Phase Amount***	***Permanent Phase Amount***
Subsidy	120,000	50,000
Developer's Equity	30,000	0
Interim Financing	0	0
Homebuyer's First Mortgage	0	100,000
Total Sources	**150,000**	**150,000**
Total Uses	**150,000**	**150,000**
Financing Gap	**0**	**0**
Number of Simultaneous Property Starts per $500,000 in Subsidy		**4.17**

Project Budget - Program with Interim Financing		
Sources	***Development Phase Amount***	***Permanent Phase Amount***
Subsidy	50,000	50,000
Developer's Equity	30,000	0
Interim Financing	70,000	0
Homebuyer's First Mortgage	0	100,000
Total Sources	**150,000**	**150,000**
Total Uses	**150,000**	**150,000**
Financing Gap	**0**	**0**
Number of Simultaneous Property Starts per $500,000 in Subsidy		**10**

Chart 3 – Using a Credit Enhancement. *In another alternative, by allocating a portion of their unexpended NSP funds to a loan loss reserve—a common credit enhancement for financing structures—and in exchange securing a line of credit from a lender, grantees can increase the total resources they have available for their neighborhood stabilization activities. Loan loss reserves are typically structured so that the lender can draw on the loan loss reserve if the grantee fails to pay any amount it owes to the lender. Because of the protection from losses that they provide, loan loss reserves and other credit enhancements can be a powerful inducement for lenders to make available interim financing to grantees. Since the amount of interim financing provided by the lender typically exceeds the amount of funds that the grantee has to deposit into the loan loss reserve (as shown in the chart below) or allocate in another form to credit enhancement, the result is a net increase in the total amount of resources available to the grantee for its neighborhood stabilization activities.*

Program without Interim Financing	
Grantee Resources	**Amount**
Available NSP Funding	3,000,000
Loan Loss Reserve Funded with Portion of Available NSP Funding	N/A
Line of Credit	0
Total Grantee Resources	**3,000,000**

Program with Interim Financing	
Grantee Resources	**Amount**
Available NSP Funding	3,000,000
Loan Loss Reserve Funded with Portion of Available NSP Funding	(500,000)
Line of Credit	2,000,000
Total Grantee Resources	**4,500,000**

3. The Pros and Cons of Interim Financing

The advantages that interim financing can bring to NSP grantees are compelling. Accelerating, expanding, sustaining, or otherwise enhancing the impact of a grantee's local neighborhood stabilization program by bringing additional resources to the table or smoothing the funding process can be a critical difference-maker in helping the grantee to meet its neighborhood stabilization goals.

Interim financing does, however, have potential disadvantages. It can add an additional layer of complexity to grantees' operations in the form of additional processes and requirements imposed by the lender. Further, interim financing is not free, and if not used and managed properly, can drain a grantee's resources without providing an offsetting benefit.

4. Costs of Using Interim Financing

The difference between interim financing that is worthwhile for a grantee, and interim financing that is not, is a matter of whether the credit facility's utility, or usefulness, to the grantee outweighs its cost. *Costs* can include fees, staff time and other grantee resources that must be expended to implement and manage the facility. *Utility* is measured by improvements to the effectiveness or breadth of the grantee's neighborhood stabilization activities that can be attributed to the credit facility.

Typical costs a grantee may encounter include:

- *Allocation of staff.* Staff will need to be assigned to prepare an application for interim financing, interfacing with the lender during and after the application process, and managing the credit facility on an ongoing basis.

- *Upfront fees.* Charged by the lender before interim financing is made available to the grantee, these fees may include an application fee, an origination fee, and/or legal fees. Some lenders permit upfront fees to be paid from loan proceeds at the closing of the credit facility.

- *Ongoing fees.* For so long as the credit facility remains outstanding, the lender may charge a servicing fee, a draw fee, and/or a non-use fee (on any funds the lender commits to the grantee but are undrawn).

- *Interest payments.* The lender may require periodic payments of interest. Some lenders permit interest to be capitalized into the loan—that is, added to the outstanding principal balance of the loan, rather than paid out-of-pocket by the grantee on an ongoing basis.

- *Credit enhancement.* The lender may require the grantee to allocate some funds, typically a percentage of the amount of the interim financing provided by the lender to the grantee, to a loan loss reserve or other credit enhancement mechanism.

- *Covenants.* Though not "costs" in the strict sense of the word, financial and/or operating constraints (or "covenants") imposed on the grantee by the lender may require the grantee to maintain certain levels of liquidity, abstain from seeking financing from other sources while the credit facility is outstanding, or otherwise restrict the grantee.

Grantees vary widely in their financing needs and their tolerance for certain costs. To help assess whether the advantages of interim financing are likely to exceed the disadvantages, grantees should

start by considering their organizational capacity and their availability of funds, as discussed in the following section.

5. Assessing Whether Interim Financing Is a Good Fit

The utility of interim financing to a grantee is a function of several factors, including:

- *Alignment of credit facility with grantee needs.* Any credit facility should be structured to provide the grantee with funds in a manner and amount that complements the other resources available to the grantee and helps the grantee to achieve its program goals.

- *Ability of grantee to effectively use the credit facility.* Grantees should have the capacity to fully utilize any interim financing they secure. Underutilized credit facilities can saddle grantees with many of the same costs as fully utilized credit facilities, but for less of a benefit in return.

To assess whether interim financing is a good fit, grantees should first consider their organizational capacity and their availability of funds. Grantees with strong organizational capacity, but facing program constraints due to limited funds, are the best fit for interim financing. In contrast, grantees with limited organizational capacity that are also facing challenges programming the resources already available to them are a poor fit. In general, grantees with strained organizational capacity should prioritize strengthening their organizational capacity before seeking interim financing from a lender, as lenders will review organizational capacity in the course of their underwriting.

For grantees seeking to improve their organizational capacity, there are various technical assistance providers that can help. NSP Technical Assistance (NSP TA) can be accessed via HUD's NSP Resource Exchange at http://hudnsphelp.info/index.cfm or by contacting one of HUD's regional or field offices.

In addition to organizational capacity and the availability of funds, organizational financials are also an important consideration. Lenders look for strong organizational financials, and may be unwilling to finance organizations with considerable financial weaknesses—or may only provide financing on more restrictive terms. NSP TA may also be available for grantees seeking to develop strategies for strengthening their financial condition.

6. Aligning Interim Financing with Grantee Goals

To ensure any interim financing is aligned with grantee goals, grantees should take several steps before, during, and after submitting an application for interim financing.

- ❑ *Before applying—Identify the financing need.* Local stabilization programs are often complex, with many moving parts, numerous sources of funds, and competing priorities. Before applying for financing, grantees should carefully consider how financing will complement their existing activities. Is the goal to acquire and rehabilitate more houses? To accelerate the availability of funds? Grantees should have a clear sense of what goals interim financing will help them to achieve before they approach a lender.

- ❑ *While applying—Communicate the goals.* Throughout the application process, grantees should focus on ensuring that the terms of any interim financing proposed by the lender are consistent with their goals. As the structure of the credit facility takes shape, grantees should monitor the impact of any changes on the interim financing's overall cost and utility.

- *After applying—Ongoing credit facility management.* Once the credit facility is finalized, grantees should focus on effectively deploying their newly available funds. Grantees should manage funds to ensure they are deployed in coordination with other resources and in compliance with all applicable requirements imposed by the lender.

7. Examples of NSP Grantees Using Interim Financing

The varied ways in which grantees around the country have targeted their NSP funds and utilized interim financing reflect the unique challenges faced by every grantee in building a successful neighborhood stabilization program that is responsive to local needs and harnesses local relationships.

The first two sample programs presented below incorporate several forms of credit enhancements, including loan loss reserves, reservation agreements, and refundable loan guarantee fees, that are designed to protect private lenders from losses and thereby encourage them to provide interim financing. The third sample program highlights how one grantee was able to incentivize builders to secure their own interim financing for neighborhood stabilization activities. In all cases, financing has helped these grantees to achieve a significantly greater impact on their target areas.

- *New York City Department of Housing Preservation and Development (HPD).* After successfully deploying interim financing for its Asset Control Area (ACA) Program, the City of New York, via HPD, used the same model for its NSP financing. In 2006, the City of New York established a credit facility to facilitate the acquisition, rehabilitation, and sale to homebuyers of distressed properties in HUD's Asset Control Area Program. The credit facility combined $45 million in private debt with $15 million in credit enhancement funds contributed by the City, of which a portion was used to capitalize a loan loss reserve. Restored Homes HDFC, a City-established non-profit, borrowed under the credit facility to effectuate the redevelopment of over 100 homes.

  In 2010, the Department of Housing Preservation and Development and the New York State Housing Finance Authority contributed $17.6 million and $1.9 million in NSP1 funds, respectively, to credit enhance a $32 million line of credit provided by a group of lenders. A new non-profit, Restoring Urban Neighborhoods, LLC (RUN LLC), was established to borrow under the credit facility. With funds drawn down from the credit facility, RUN LLC acquires and rehabilitates REO properties, selling them on completion to qualified homebuyers. The new credit facility has accelerated the City's stabilization program, allowing it to more quickly redevelop more properties. The City estimates that, with the credit facility, it will successfully redevelop 90 properties; without the credit facility, its volume would have been half that.

- *Neighborhood Lending Partners (NLP), Pasco County and Pinellas County.* NLP, Pasco County and Pinellas County were jointly awarded $50 million in NSP2 funds. Several creative financing mechanisms implemented by the consortium have used NSP2 funds to unlock interim financing, helping to improve the speed, scale, and sustainability of the consortium's neighborhood stabilization activities.

  In one financing mechanism, NLP enters into "reservation agreements" with local lenders. The reservation agreements are contracts pursuant to which lenders agree to make loans for up to 50 percent of value to developers. In exchange, NLP reserves some of its NSP funds to be accessed by the lender in the event of a loss. The mechanism has several benefits, as it not only brings private capital to the table, but also results in a smooth funding process for developers

and increases the involvement of local lenders in the community. NLP estimates that, by deploying this mechanism, it has increased the volume of units generated by about a third.

To facilitate interim financing, other NSP consortium members can utilize NLP's leveraging programs by using "loan guarantee fees" to secure a loan from NLP's member banks. These fees are typically equal to 50 percent to 70 percent of the amount of the loan made to a developer by the member banks. Once the loan is repaid, the fee is fully refunded to the grantee and can be used to secure financing for additional properties. In the event of a loan loss, however, the lenders can keep a portion of the fee equal to the amount of the loss. These fees, like the reservation agreements, have helped to stretch NSP funds across more units. As properties are completed, remaining NSP funds can be recycled, helping to sustain the consortium's stabilization activities for the long term.

- *Sacramento Housing and Redevelopment Agency (SHRA).* SHRA is the redevelopment agency, housing authority and housing department for the City and County of Sacramento. SHRA received $32 million of NSP1 funds, which it invested across several programs, in each case complementing its NSP1 funds with other resources—such as redevelopment funds, Community Development Block Grants and affordable housing funds—it had available.

  Through its Vacant Properties Program, SHRA provides no-interest, partially forgivable rehabilitation loans to builders acquiring vacant, foreclosed upon homes. Builders are responsible for securing conventional financing from a private lender or other resources with which to acquire their properties. Once the rehabilitation and resale of the property to a homeowner is completed, SHRA pays the developer an incentive fee. Funded with $9.5 million in NSP1 funds, the Vacant Properties Program has leveraged over $10 million in non-NSP resources, including other funds available to SHRA and conventional loans from private lenders.

  Most of SHRA's single family NSP activity has been accomplished through this program. In fact, some individual builders participating in the program have completed more than 40 properties. To build on its success to date, SHRA has allocated a portion of its NSP3 grant to continuing the program.

8. How to Obtain Interim Financing

Grantees that decide interim financing would be a valuable complement to their neighborhood stabilization activities have several options. A good place to start is with any lender with which the grantee has a preexisting relationship. Alternatively, grantees can elect to start exploring financing options with:

- *Community Development Financial Institutions (CDFIs).* CDFIs are certified by the CDFI Fund, which is operated by the U.S. Department of the Treasury. They are specialized financial institutions with expertise in serving distressed communities. Many CDFIs are actively engaged in providing interim financing to organizations in communities hard-hit by the foreclosure crisis.

- *Local Community Development Banks (CDBs).* CDBs are commercial banks specifically serving low- and moderate-income communities. Many CDBs are also CDFIs.

- *Other local banking relationships.* Commercial banks are often interested in helping to stabilize communities in which they are active, especially if they are lending to organizations with which they have a preexisting relationship.

- *The Stabilization Trust REO Capital Fund.* Established by many of the nation's leading housing nonprofits, and seeded with an investment from the Ford Foundation, the REO Capital Fund was specially designed in the wake of the foreclosure crisis to support CDFIs and other lending operations providing interim financing to organizations working to stabilize communities. Interim financing from the REO Capital Fund is accessed through participating CDFIs and lending operations.

- *Foundations*. Many foundations provide program related investments, mission related investments, grants, or other financing to organizations whose activities are consistent with philanthropic objectives. Although foundations are unlikely to provide interim financing per se, they may be able to provide capital that can improve grantees' ability to secure interim financing from another source.

Resources are available online for grantees seeking to identify potential sources of interim financing. The CDFI Fund publishes a list of certified CDFIs on its website, http://www.cdfifund.gov/. The REO Capital Fund's participating CDFIs and lending operations are listed at http://www.stabilizationtrust.com/.

9. The Application Process

Grantees should be prepared to meet all lender application and underwriting requirements. Items the grantee may have to submit include:

- *Financial statements.* Lenders typically require three years' audited financial statements, plus the applicant's most recent quarterly internal financial statements.

- *Organizational background.* Required items may include a narrative describing the applicant's current and past activities, a description of the applicant's governance and organizational structure, and resumes of key staff.

- *Proposed activities.* The applicant will have to describe to the lender the activities that it proposes to support with interim financing.

- *Project pro forma.* The applicant's pro forma should show anticipated sources and uses for the project across all its stages of development. The source of repayment for the interim financing should be clearly identified.

- *Appraisals and market information.* Particularly when considering lending to applicants whose proposed activities are focused in distressed neighborhoods, lenders will want to review any available property appraisals or other market information. To the extent the applicant has a pipeline of prequalified or preapproved buyers for its properties, the applicant should be prepared to provide this information to the lender as well.

The application process can involve significant back and forth discussions between the lender and the applicant. Lenders often request follow-up items or clarification on submitted materials. To help the process move as quickly as possible, grantees should aim to be as responsive as possible. Preliminary conversations with prospective lenders can be a good start to exploring requirements, beginning to assemble materials, and gauging lender interest.

10. Looking Ahead

Although interim financing can be a challenge to secure and implement, its benefits to grantees and their target areas are potentially vast. With interim financing, grantees can significantly expand the breadth and depth of their impact, helping neighborhoods to recover from the foreclosure crisis more quickly and completely than would otherwise be possible.

As the first rounds of the Neighborhood Stabilization Program draw to a close, interim financing will only become a more significant component of grantees' continuing efforts to revitalize their communities. With subsidies dwindling, grantees will have to identify alternative funding sources. Interim financing will, for many grantees, become critical. For grantees looking ahead, interim financing can be the key to securing a sustainable stabilization program for the future.