Gap Financing: a Barrier to Affordable Housing

By Gary Bennett and Hugh Gordon, members, Frederick County Affordable Housing Council.

It is true that most developers are not hurting for money. No news there. But it is equally undeniable they provide great community value, particularly when working to provide affordable housing.

Unfortunately, there's a huge barrier affordable housing developers must overcome: the ability to fully fund development and pre-development costs without the promise of market-rate revenues. As one developer put it: "Providing housing at rents low- and moderate-income folks can afford and still cover our costs is like trying to solve a Rubik's cube."

Think of it this way: To build any development, a developer must pay for land, materials and labor, not to mention taxes and myriad permitting and other government fees. During the last two decades these costs have skyrocketed while renter and homeowner salaries have stagnated. Therefore, rents that low- and moderate-income households can afford are often too low to cover the full costs of building, owning and managing an affordable property. Add to this the seemingly never-ending delays in the governmental approval process, and you have a recipe for possibly abandoning a project.

When development and pre-development costs can't be met by traditional methods such as taxable and tax-exempt bonds, local bank loan funds, General Partner (GP) capital, or Federal Home Loan Banks (FHLBs), developers must turn to other methods to fill the gap.

Hence the need for what is known in the affordable housing world as "gap financing."

Gap financing, also known as bridge or interim financing, is a short-term loan that can help affordable housing developers fill the gap between the cost of a project and the funds available. To fill the gap, developers usually need help in the form of subsidies. Those subsidies most often come from local, state or federal governments, but can also come from other sources.

The sources include tax credits in various forms, mortgages with below-market interest rates, tax-exempt bonds, federal grants or loans from programs like the HOME Investment Partnerships Program, local grants, land donations, contributions from charitable foundations and deferred developer fees.

Almost all affordable housing projects begin with tax credits awarded by the state. The most common of these is the Low-Income Housing Tax Credit (or LIHTC, pronounced LIE-TECH.) It finances about 90% of all affordable housing developments nationwide. This U.S. Department of Housing and Urban Development (HUD) program was enabled by Congress in the 1990s, was an undisputed bipartisan success and is operated by each state's housing agency including Maryland's Department of Housing and Community Development (DHCH).

Tax credits are greatly needed to make the books work, but the problem is that LIHTC is ultra-competitive and extremely limited. In Maryland, DHCD establishes its affordable housing priorities and then developers compete for the tax credits based on how well their project satisfies those priorities. Developers receiving an award use the tax credits to raise capital from investors. Only a handful of Frederick projects have won these tax credits in recent years.

Because a project is not feasible unless it covers 100% of its funding gap, every source of funding matters. A relatively modest local contribution can be the critical investment that makes a project work and allows the community to benefit from a large amount of federal subsidy that would otherwise flow to a different community.

That is why Frederick County and the State of Maryland try to be aggressive when helping affordable housing developers. The county and state often step in with funding options such as waivers or deferrals of impact of fees charged to buyers that meet income requirements for affordable housing purchases from a developer.