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HUD Section 108 Loan Guarantee a Valuable Development Tool

By William F. Griffin Jr. and Henry Longmire

RECENT MASSACHUSETTS BUDGET CUTS HAVE resulted in a contraction in state and local government resources available for housing and community development. In this new era of scarce resources, the creative use of available federal funds becomes even more important. One very valuable federal program is the HUD Section 108 Loan Guarantee Assistance program, which enables communities to leverage their federal block grants to accomplish housing and community development projects.

For example, the city of North Adams and the Massachusetts Department of Housing and Community Development recently closed a $3.8 million long-term loan to the Massachusetts Museum of Contemporary Art under the Section 108 program for the rehabilitation of two buildings on the museum's campus. One of the buildings will be leased to the commonwealth for a new Northern Berkshire District Court and the other to a local law firm. The lease revenues generated will be used to pay debt service on the loan and provide additional operating funds for the museum's activities.

Other economic development projects funded by Section 108 loans include the New Boston Seafood Center in South Boston and the proposed $40 million investment fund for new hotel development in Boston. The proposed refinancing of the Malden Mills facility is also reported to include a HUD Section 108 loan from the cities of Lawrence and Methuen, with the assistance of the commonwealth. Nationwide, HUD has recently funded $340 million in Section 108 loans through a public offering of debt securities in August 2003.

Under Section 108 of the Housing and Community Development Act of 1974, as amended, HUD guarantees notes issued by local municipalities or other public entities. These notes, also secured by pledges of future HUD grants, and usually by other collateral provided by third-party borrowers, are pooled and sold to investors. Because the securities are backed by the full faith and credit of the U.S. government via the HUD guarantee, they bear interest at rates only slightly higher than Treasury securities. For example, the recent public offering of 20-year Section 108 securities in August carried interest rates varying from 1.21 percent to 5.69 percent, depending on maturities.

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The Section 108 program is a part of the federal Community Development Block Grant, or CDBG, program, which entitles qualified communities to receive "block grants" on an annual basis in accordance with a pre-determined formula. The CDBG program, instituted in 1974, replaced prior programs requiring communities to compete for grant funds. In general, annual block grants are made directly to municipalities with populations of more than 50,000 – called "entitlement communities" – and indirectly to other communities – termed "non-entitlement communities." Grants for non-entitlement communities are administered in Massachusetts by the commonwealth's Department of Housing and Community Development.

Advantages and Objectives

The Section 108 program permits communities to borrow against future CDBG grants for a variety of activities, including acquisition or rehabilitation of real estate, related relocation, demolition, site clearance and preparation costs, payment of interest and financing costs, providing a debt service reserve, housing rehabilitation and economic development. The maximum loan amount is five times an entitlement community's annual CDBG allocation. The most common use of Section 108 funds is for economic development activities involving loans to private businesses for the creation or retention of jobs.

The principal advantages of the Section 108 program are as follows:

- The program allows municipalities to effectively accelerate the receipt of CDBG funds, thus enabling them to undertake larger and longer-term projects;
- The program allows municipalities to spread out loan repayments over a term of up to 20 years;
- Section 108 loans which are re-loaned to private businesses provide significant financial leverage, since the Section 108 loan

continued on page 2

can be repaid from the third-party borrower without ever using the community's future CDBG grants;

• Section 108 loans are not general obligations of the municipality and thus do not involve limitations and restrictions on municipal borrowing;

• Section 108 loans have low fixed interest rates substantially below the non-investment-grade rates on private borrowings otherwise available to third-party borrowers; and;

• Section 108 loans can reflect a flexible repayment schedule proposed by the municipality.

The Section 108 application process can be time-consuming. This process involves the development and negotiation of the project itself, the preparation of a comprehensive application, public participation and hearings, and HUD review and approval. Section 108 loan documents follow a standard format, but third-party loan documents usually require individualized negotiation and documentation with the assistance of outside counsel.

The Section 108 program has the same statutory and regulatory requirements as the CDBG program, which require compliance with HUD's "national objectives" of benefit to low- and moderate-income persons, elimination of slum or blight, or (rarely) meeting urgent community needs. Since municipalities must expend at least 70 percent of all CDBG funds (including Section 108 loan disbursements) for projects that benefit low- to moderate-income persons, an entitlement community must be careful to allocate an appropriate portion of its Section 108 funds among the three national objectives. For this reason, most Section 108 loans qualify for the low- to moderate-income benefit objective.

Section 108 loan recipients must also comply with other CDBG program requirements, including environmental assessments, Davis-Bacon Act wage standards, historic preservation, and fair housing and nondiscrimination requirements. Loans to private businesses must also have an "appropriate" public benefit and be financially feasible. Applicants must also demonstrate that the project is consistent with the local goals and objectives of the municipality's (or the state's) community development plan or comprehensive housing strategy and certify that alternative sources of funds are not available and the loan guarantee is necessary. Long-term Section 108 projects must typically meet an 80 percent loan-to-value ratio documented by an appraisal.

Section 108 loans may not be prepaid, but may be "defeased" by the deposit of U.S. government securities sufficient to pay the future principal and interest payments on the Section 108 notes. Defeasance can be costly in an environment of falling interest rates; municipalities customarily shift this risk by contract to the third-party borrower.

In an era of scarce municipal and state resources, the Section 108 program can be a valuable tool for creating affordable housing and promoting economic development. ■