Local Lending for Affordable Workforce Housing[1]

October 25, 2022

The mission of LION – the Local Investing Opportunities Network of East Jefferson County, WA – is "to build prosperous local businesses, keep investing money in our community, and help build a more resilient and sustainable economy in East Jefferson County, Washington." LION is a network which connects local investors with local businesses and non-profits that need financing. LION is not an investment group, and each member makes their own investment decisions.

Increasingly, the lack of affordable housing for the local workforce has become a barrier for local businesses, non-profits, and public agencies. Many of them identify the lack of affordable housing for their workforce as their biggest barrier. LION has decided to start new track directed towards LION members providing loans to local homeowners for improvements or additions to their real property to create affordable housing units for the local workforce.

Part I – Regulatory Considerations

Current LION processes for supporting investment in local businesses are aligned with the Security and Exchange Commission and the WA Department of Financial Institutions (DFI) securities regulations related to private offerings. A business or non-profit can only make a private offering to a party with which they have a "significant pre-existing relationship." LION processes are structured to enable businesses to develop relationships with local investors.

From our research we have learned that private lending, or third-party lending, to private individuals for real property improvements do not fall under securities regulations. According to a securities lawyer they fall under regulations for consumer lending:

> *"Overall, if the lender is calling the shots (underwriting by their own process, setting terms, etc.), it looks like a bank loan and is not considered a security. It's a consumer loan."*

There is a significant difference between who is protected by securities regulations and who is protected by consumer lending regulations. Securities regulations were established to protect investors from unscrupulous business owners. *Complying with the regulations is the responsibility of the business*. Consumer lending regulations were established to protect consumers from predatory lenders. *Complying with the regulations is the responsibility of the lender*. These differences can influence LION processes for these different types of financing.

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[1] These notes were compiled with input from the National Coalition for Community Capital and a discussion with the WA Department of Financial Institutions (DFI). This document is not endorsed or approved by DFI. Further, DFI cannot give legal or financial advice and does not endorse or recommend any person, product, or institution.

The Consumer Loan Act (CLA)[2] regulates the lending of money or extension of credit for family, personal, or household use, including the financing of residential mortgages and secured or unsecured consumer loans. Licensing under the CLA is required for lenders (individuals or entities), unless exempt. A mortgage loan originator license may also be required for individuals who meet the definition of "mortgage loan originator." There are exemptions from licensing, however, some of which are summarized in the DFI publication Residential Seller Financing and Third-Party Lending.

Federal consumer loan regulations stem from the Truth in Lending Act and are implemented by Regulation Z. Regulation Z specifies disclosures that creditors are required to make to establish transparency to the lending process. Disclosures include items like annual percentage rate, total cost of credit, prepayment penalties, late fees, etc. The coverage of Regulation Z "applies to each individual or business that offers or extends credit… when four conditions are met," one of which is "The offering or extension of credit is done regularly." The regulation further specifies "A person regularly extends consumer credit only if it extended credit … more than 25 times (or more than 5 times for transactions secured by a dwelling) in the preceding calendar year. ..." Local lenders are limited by state regulations to five or fewer consumer loans in a calendar year, and therefore would not qualify as creditors under the definitions of Regulation Z. Regulation Z does not appear to apply to LION members making loans for affordable housing.

LION Member Lending and Consumer Lending Regulations

LION processes and the actions of individual LION members for financing affordable housing need to align with applicable federal and state consumer lending regulations. As discussed above, a license is required for lenders, unless exempt or eligible for a waiver, and may also be required for individuals who meet the definition of mortgage loan originators. We have learned that:

- Private parties making loans for real property may apply for a waiver for five or fewer unsecured and five or fewer secured loans in a calendar year.[3]
- Interest cannot exceed the usury rate limit, which is currently 12% in WA.

Unsecured Promissory Notes

The WA DFI publication states: "If you are lending money that will not be secured by residential real property, you are not a mortgage loan originator"[3] and therefore are exempt from licensing as one. Additionally, if you make five or fewer unsecured loans during a calendar year you do not have to obtain a lender license. However, you must apply for a Third-Party Consumer Lending License Waiver using an application form[4] available on the DFI website before engaging in the activity. It is very likely that the waiver would be granted if properly submitted. LION members would not meet the criteria of regular creditors by Regulation Z and therefore the Regulation Z disclosures would not be required.

> *LION members lending for real property improvements would be exempt from state consumer lending regulations, other than usury rate limit and a limit of five or fewer loans in a year, if loans are not secured by residential real property, and a Third-Party lending waiver has been granted by DFI. LION members do not qualify as creditors under Regulation Z.*

Promissory Notes Secured by Real Property

Lenders who secure their loan with real property may require a lending license and a mortgage loan originator license. However, these lenders may apply for a Third-Party Residential Lending License

[2] Chapter 31.04 RCW and 208-620 WAC.
[3] https://dfi.wa.gov/residential-seller-financing
[4] https://dfi.wa.gov/sites/default/files/documents/seller-financing/third-party-consumer-lending-waiver.pdf

Waiver from state regulations using an application form available on the above DFI website. It is very likely that the waiver would be granted if properly submitted. LION members would need this waiver to record the lien on the property. The LION member would also need to provide the borrower with a Residential Disclosure Summary (fixed rate or variable rate version). The waiver only applies to state regulations. Additionally, the LION member must follow Washington law if they pursue a foreclosure. LION members would not meet the criteria of regular creditors by Regulation Z and therefore the Regulation Z disclosures would not be required. It is recommended that LION members making secured loans seek legal advice.

- *LION members who wish to secure their loans with real property should seek advice from an attorney. They would need to comply with several state regulations; would be limited to five or fewer real estate related loans in a calendar year; and interest rates cannot exceed the usury rate limit, currently 12% in WA. LION members do not qualify as creditors under Regulation Z.*

As to LION processes, a new Affordable Workforce Housing Opportunity Submission Form containing relevant loan information should be developed. Unlike the Business Opportunity Submission form, the Affordable Housing Form should include financial information, such as the estimated cost of construction. Information requested should be restricted to what is needed for underwriting the loan and no information should be requested related to protected classes (race, religion, gender, etc.).

City and County Permitting
Separate from consumer lending regulations, both the City of Port Townsend and Jefferson County have regulations related to building codes. The homeowner is responsible for complying with such regulations. LION members should be aware if the project does or does not conform to local regulations.

WA Taxes
The homeowner should be aware of their potential tax obligations. A publication of the WA Department of Revenue Rental vs. license to use real estate states “Leases or rentals of real estate are not subject to B&O tax or retail sales tax.” One of the five conditions that must be met for an “activity to be an exempt rental of real estate” is that the rental period must be 30 days or longer.[5] WAC 458-20-101(2) states “…every person who is engaged in any business activity for which the department [of revenue] is responsible for administering and/or collecting a tax or fee, must apply for and obtain a tax registration endorsement with the department.” A landlord satisfying the five criteria is not subject to taxes collected by the WA Department of Revenue, and therefore does not need to obtain a tax registration endorsement (aka a UBI). That is, renting properties for 30 days or longer is not considered to be a business.

Part II – The Challenge of Affordable Workforce Housing

The new LION track targets local lending for creating affordable housing for the local workforce. A widely accepted guideline is that a household should not spend more than 30% of its gross income on

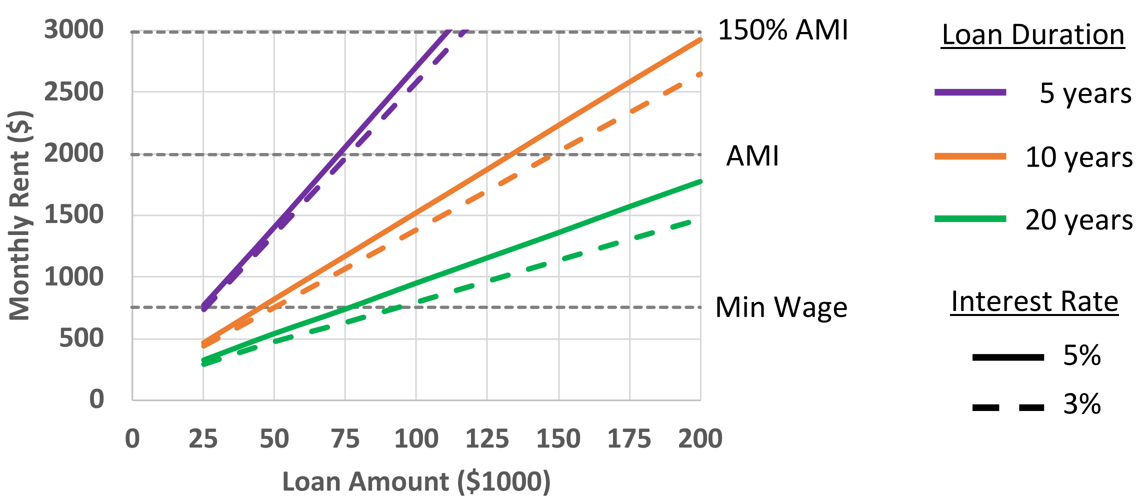
[5] The other four are:

- There must be a landlord/tenant relationship.
- The lessee must have exclusive use of the rented space.
- The lessee must have the exclusive right of continuous possession.
- The lessee must have dominion and control of the rented space.

housing (for renters this includes rent and utilities). The Area Median Income (AMI) for families in Jefferson County in 2022 as published by HUD is $79,600. A household earning the AMI should not pay more than $1990 for monthly housing costs. Although the workforce spans a wide range of household incomes, affordable housing efforts are generally targeted at AMIs less than 150%. A household with a minimum wage earner working full time would have an annual income of $30,255 (52% of the AMI). Taking the minimum wage earner for the lower limit and 150% of the AMI as an upper limit, affordable monthly housing costs would range from $756 to $2985 for the local workforce.

Consider a loan to enable creation of a rental unit for a member of the local workforce. The borrowing homeowner might want to have the rental income pay for the monthly payments plus cover the operating costs of the unit. And the homeowner might also like to realize some income. Not surprisingly, it is a "penciling out" challenge to make all this balance out for a monthly rental that is affordable for the workforce.

The below chart illustrates the monthly rent required to pay for operational costs[6] of the rental unit and service a loan from $25K to $200K. Also shown are the monthly rents corresponding to 30% of gross income for the range of AMIs listed above.



For illustration, let's consider the example of a household earning the Area Median Income whose housing costs should not exceed $1990 per month. If the homeowner needs to borrow $50K and secures a 5-year loan at 5% interest, after paying their monthly costs of $1410 they would net $580 of income. They could also consider renting the unit for $1500 and foregoing any income until the loan is paid off. However, if their project cost $75K the $1990 rent would cover the costs but not generate income until the loan was paid off when they would start earning about $1400 per month.

If the homeowner needs to borrow $125K and intends to rent the unit to a household earning the AMI, the numbers won't work with a 5-year loan. But a 10-year loan @5% would work.

The sensitivity to interest rates of the monthly rent needed to service the loan increase with loan duration. For the AMI example being considered, for a 5-year loan for $75K, the monthly rent decreases

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[6] Operational costs include allowances for property tax, utilities, maintenance, and income tax and assume the unit is vacant one month a year.

by only $95 for a 3% loan, while for a 20-year loan for $175K, the monthly rent would decrease by $265. At the time of this writing, interest rates are increasing which will make the challenge of affordable workforce housing even greater.

Part III – LION Lenders as Part of the Financing Ecosystem

LION lenders are only one source of financing. The many sources of capital for financing housing include personal and family resources; home equity loan; home equity line of credit; refinancing first mortgages; construction loans; and renovation loans. A short summary about each of these is included in the Housing Solution Network's The *ABCs and 123s of ADUs.*[7] Borrowers should explore the above sources of financing before turning to LION. The cumulative capacity of LION lenders is tiny compared to the cumulative capacity of these other sources. LION lenders pair best with borrowers who cannot yet qualify for traditional financing, or for whom bridge lending may be needed as a step towards traditional financing. LION lenders will likely have more flexible terms than traditional lenders, but also may want shorter duration loans.

A Snapshot of Lending by LION Members

From 2008 – 2020 LION members invested at least $10.5M through 313 deals in local businesses, non-profits, and real estate. 71% of the loans were unsecured promissory notes. The average loan duration was 5.37 years, and the average loan interest rate was 5.4%. 72.5% of the loans were for $25K or less. Over 40% of the business opportunities had more than one investor participating. This profile can be helpful in considering how LION members can contribute to affordable workforce housing.

Some Possible Examples of LION financing.

Loans under $75,000 with a 5-year repayment – Referencing the above chart, such loans could enable affordable housing for households earning up to the AMI. Five-year loans at 5% interest fall within the average range of past investment by LION members. In keeping with past and current LION members deals, several LION members could team up to provide loans within this range. Some examples of affordable housing projects that could fall in this bracket include:

- Interior remodeling to create one or more rooms for rent.
- Interior remodeling to convert a single-family residence to home sharing for 3-5 renters.
- Interior remodeling to create a 400-500 sf Attached ADU from an unused garage, basement, or rec room. An example of one such conversion is attached.
- Remodeling an existing external structure (garage, workshop) into a 400-500 sf Detached ADU.
- Purchase of material for a Do-It-Yourself homeowner to build an ADU or a tiny home.
- Bridge lending for a new homeowner to make a down payment on a single-family middle-income house.
- Funding for a larger project when the homeowner can also contribute assets.

Loans from $75,000 to $150,000 with repayment up to 10 years – Loans longer than five years have lower monthly payments and therefore could enable more expensive projects and perhaps housing for family units. However, there may be fewer LION members willing to make longer duration loans, and/or it may require more LION members participate in a particular lending opportunity for the larger loan amounts. Examples of projects falling in this bracket include:

- Building a Detached ADU of 400-600 sf. An example is attached.

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[7] https://drive.google.com/file/d/1nf2drP1jFg96L5DeKMDl3yqWIrk0zt9_/view

- Adding a small wing to an existing residence for an Attached ADU.
- Remodeling an interior space of 1000-1250 sf to create a large Attached ADU sized for a family.
- Purchase of materials for a small single family Do-It-Yourself residence.
- Funding for a larger project when the homeowner can also contribute assets.

Loans greater than $150,000 – Such loans would require repayment periods longer than 10 years to keep monthly payments affordable, a duration beyond the interest of most LION members. However, LION members could provide bridge loans for the construction and initial rental period of an ADU or other housing unit. After the initial rental period, the homeowner could refinance their primary residence or take out a home equity loan and repay the LION lenders. Local lenders can provide flexible terms during construction, which could be more difficult for conventional lenders. Several conventional lenders now allow ADU rental income to be used for loan qualification. The match of local lenders financing the initial phases of a project and conventional lenders financing the long duration loan could be a good fit. An example of how this might work is:

- During construction, the borrower draws on the LION Lender(s) loan as needed to meet construction expenses, and only pays interest on the balance borrowed.
- Once the unit is built and rental income starts:
    - The loan is repaid on a 20-year amortization schedule to keep monthly payments low. After a period when rental income has been proven, the owner refinances with a conventional lender and pays off the balance of the LION lender(s) loan.
      Or
    - The owner continues to make interest only payments and uses the excess rental income to build a contingency fund for the property. After a period when rental income has been proven, the owner refinances with a conventional lender and pays off the full principal of the LION lender(s) loan.

Another example that falls into this category are bridge loans for low- or middle-income households to purchase a home they can afford until they are able to refinance. The recent real estate market that has required cash offers has excluded people who need to make an offer contingent on receiving financing, even if they would qualify. Although the amounts of money needed to finance a cash offer may be beyond the capacity of many LION members, a few who do have that capacity could make a difference.

Potential Risks and Mitigation Strategies

Lending money for affordable housing has different risks than lending to businesses. Some potential risks to consider and possible mitigation strategies include:

- Project costs exceeding the initial estimate might be mitigated by careful planning and by including a contingency in the project budget.
- A homeowner pivoting to a market rate rental can be mitigated by carefully vetting applicants to determine their commitment to affordability and including a clause in promissory note that the loan is contingent upon keeping the unit affordable.
- Fire or other damage during construction could be mitigated by requiring construction property insurance as a condition of the loan.
- Escalating operating costs could be mitigated by including a contingency fund in operating budget or by increasing the rent.
- A homeowner not qualifying for financing to repay bridge loan can be mitigated by having them explore qualification before making the bridge loan.
- An extended period of vacancy is a risk, but an unlikely one in the current rental market.

Creating a Basement ADU

A contractor who was installing a half bathroom in the basement level of a retired couple's uptown home suggested the basement space could be converted into a rentable apartment unit. He said he would be happy to do the work which he estimated would cost about $40K. Over the next 6 months the couple thought about his suggestion. As they aged, it could be a place for a live-in caregiver. And as they read about the community's need for affordable rentals, they realized it could serve that role until the time came. Financially, they could afford the project, and would be happy if the rent could just repay the costs. The space was below their kitchen and dining room (rarely used) and they would need to be conscious of making noise in the kitchen. They were concerned about how to locate a tenant, and if it would work out having someone living in their home. Balancing concerns with opportunities, they decided to proceed.

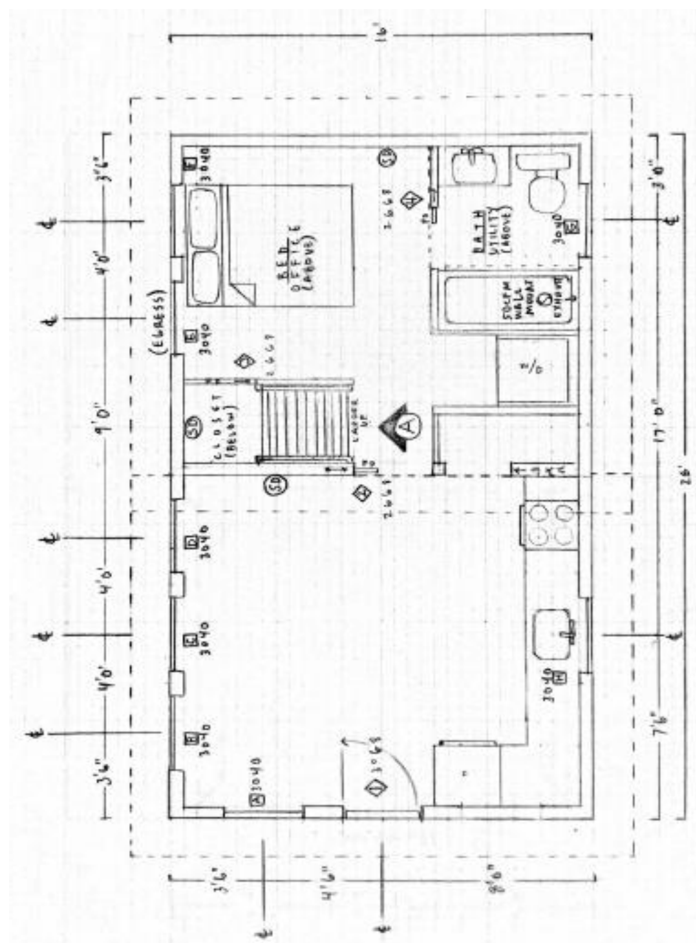
The contractor was fabulous to work with, did a fine job, but worked at his own pace so the project took eight months. He did the design and all the construction except electrical which was subcontracted. The unit is about 400 square feet with an entrance door that opens onto a parking area that the owners do not use. It has a full kitchen, ¾ bath, access to washer/dryer & storage, and screened off bedroom area which the contractor created with a dresser and armoire. The owners decided to fully furnish the unit to avoid damage with furniture moving in and out. Extra insulation was added as a noise buffer between the apartment and the main living area.

The total cost of the project was $45-$50K including all appliances and furniture. After asking people about affordable rental rates, the owners decided to charge $1200 per month including all utilities, WI-FI, and TV. With help from a lawyer, they drew up an agreement that requires an initial rental period of 3 months, followed by month-to-month rent. A damage deposit equal to one month's rent, and a post rental cleaning fee are required. Once they have some history on utility costs, they may lower the rent.

The owner's original goal was to make the unit available to visiting or newly arriving workers at Jefferson Healthcare. After finding little need for that at the time of rental, an advertisement on Craig's list drew many inquiries. They showed the apartment to four people. Most prospective tenants felt the rental rate was reasonable. Their first tenant was in a life transition and spent only a few months. The second tenant has become a long-term renter and has also become quite involved in the community. Concerns about noise and privacy have not materialized and the owners are very pleased with the whole experience.

Creating an ADU with Help from Local Lenders

A couple with a young daughter wanted to create a rental unit on their five-acre property located in unincorporated Jefferson County. Having struggled with finding affordable housing before they became homeowners, the couple wanted to "give back." They envisioned a small living unit that could also be used for parents when not having a tenant. Being capable Do-It-Yourselfers, they bought materials when they had spare cash and started building a small, detached unit. And then through word of mouth, they learned about HSN and LION. During the next year the homeowners and the HSN/LION team converged on a plan to build a fully permitted ADU with a 448sf, 1BR ground floor and a 126sf loft designed and built by Wayland Constructive[8]. The homeowners refinanced their primary residence to cover a portion of the cost, and three LION lenders provided the remaining funds with terms that enabled an affordable rental rate. The time from first engagement of the team to ADU rental was about twenty months. The total project cost was about $120,000 and the unit is rented for $900 per month which covers loan payments and maintenance reserve.



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