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A Primer on Affordable Housing Finance

Note: This Primer on Affordable Housing Finance is a vast simplification of very complex programs that are subject to many laws and regulations that may change without notice and involve the management of very large sums of public funds, mortgages for low and moderate income families and affordable apartments. This document is intended to provide general information and individual government agencies may have significantly different approaches and results. Individual agencies should seek the best possible financial and legal guidance before undertaking any housing finance transaction.

I. Overview

America's Housing Finance Agencies (HFAs) are government entities created by the states to finance affordable housing for their residents. Although HFAs vary widely in their governance structures and scopes of service, most are independent entities that operate and administer a wide range of affordable housing and community development programs under a chief executive who reports to a board of directors or, in a few instances, directly to the Governor. Collectively, HFAs have helped more than 2.6 million families buy their first homes with mortgages financed under the Mortgage Revenue Bond program. Using tools that include federal tax-exempt bonds and Housing Credits, HFAs have also financed over 2.9 million low and moderate income apartments. Unsummed other American individuals and families have received housing assistance from additional HFA programs such as those that have reduced homelessness, provided down payment assistance and saved homes from foreclosure.

Based on 2014 financial information, state HFAs collectively had nearly $130 billion in assets, more than $92 billion in outstanding debt and about $28 billion in net worth. This is a huge amount of housing resources to be prudently managed to best meet the affordable housing needs of the individual states and protect the financial interests of their residents.

II. Affordable Housing Finance

Affordable housing is an often used but frequently misunderstood term. In its broadest sense, affordable housing helps young families to buy their first home, low and moderate income families to rent a healthy apartment, individuals and families to avoid homelessness and allows senior citizens to live in safe homes that meet their needs and that they can afford. Affordable housing programs include public housing that are sometimes called "projects" but far more often means programs like the FHA and VA mortgage insurance programs that have been in place since World War II and propelled the American Dream forward. Today's affordable housing financing is generally targeted to working families who earn average incomes. Very little financing is available today for our lowest income individuals and minimum wage workers.

III. HFA Financing

HFAs were created, beginning in the 1960's, for states to directly support the construction of affordable apartments and assist first-time homebuyers through the issuance of tax-exempt bonds. Over the decades the HFA mission has greatly expanded and many additional tools are available to them in this effort. Subsidies for the financing of affordable homes can come from state, federal, local or private sources and can usually be classified as:

> **Capital subsidies** which reduce the cost of buying, repairing, developing or rehabilitating homes; or
> **Rent, Operating and Supportive Service subsidies** which sustain the property over time, cover rents that exceed the tenant's ability to pay or provide services that will allow the individual or family to live independently.

TBA (the "to be announced" market) is not a financing system unique to HFAs. In this regard HFAs are like other secondary market intermediaries that package mortgages into pools and sell them; often engaging third party vendors to undertake many of the functions. The advantage that HFAs have over other secondary market intermediaries is their ability, under current consumer finance protection regulations, to offer down payment assistance that essentially allows homebuyers to obtain 100+% financing even in the face of FHA and Fannie Mae requirements that require some borrower funds in the transaction.

While TBA financing programs are easy for HFAs to administer and require no bond volume cap, the financial return to HFAs is usually significantly less than available under mortgage revenue bond programs. There is typically no interest rate advantage for a borrower under an HFA/TBA program and rates are frequently above market rates to cover the amortization of the down payment assistance and third party fees. TBA funding generally involves an upfront, one-time payment to the HFA but does not generate the long-term income, flexibility and financial strength that so many HFAs need to fund a wide range of other housing assistance programs to the residents of their states. Therefore, many HFAs who have volume cap available and want to comprehensively address the affordable housing needs of their respective states do so by issuing and managing portfolios of loans or mortgage backed securities financed by mortgage revenue bonds.

A. Capital Subsidies. Capital subsidies make homes more affordable by directly covering some of the development costs or lowering the interest rate on the debt - most commonly through the issuance of tax-exempt bonds. Some capital subsidies come in over an extended period but the amount is usually quite predictable. Capital subsidies can include grants, interest rate subsidies and/or tax credits. Tax incentives have become the primary form of capital subsidies because they don't require annual appropriations from legislative bodies, are less visible and are more politically acceptable as they can be construed as "tax cuts". Tax incentives are easier to sustain year after year because, rather than needing re-affirmation each budget year, they usually require an affirmative act of the legislative body to eliminate them. The low-income housing tax credit program has been the major federal rental housing production program since about 1990. The tax deduction available to the general population for mortgage interest on owner occupied homes is the largest form of capital subsidy for housing and carries about a $200 billion annual cost to the federal government.

Federal capital subsidy programs funded by appropriations including the HOME program and several smaller specific purpose programs are being significantly reduced. The Housing Trust Fund is a new federal housing program that is expected to be used mostly as a capital subsidy. Sometimes state governments issue state General Obligation bonds, authorize annual appropriations or dedicate user fees such as recording fees to support affordable home construction. Some states provide a state tax credit.

Traditionally most state housing finance agencies subsidized affordable housing through capital subsidies in the form of lower interest rates by exploiting the advantage that tax-exempt debt normally enjoys over taxable debt. In today's interest rate environment, this advantage is smaller and is further undermined because tax-exempt debt cannot be used in the same transaction as 9% housing credits (See below). HFAs can raise funds by issuing bonds or selling mortgages. HFAs may also use their own net worth to make deferred payment or no interest loans for capital costs that cannot be amortized. When HFAs do issue debt to make multi-family loans, usually the loan-to-value (LTV) is low because of other capital subsidies and the severe tax consequences that accompany defaults on LIHTC transactions protect against early losses. However, beyond year ten, tax credit properties can experience cash flow stress and the often-accompanying operating challenges.

Capital subsidies, including the Housing Credit, are the most predictable cost subsidies available from the perspective of the provider. However, capital subsidies alone generally only allow housing to be made affordable to households earning between 50% and 60% of median income because the rents must still cover operating costs including management, repairs, insurance and taxes. Capital subsidies include:

> **1. Private Activity Bonds (PABs)**. This is a sub-set of tax exempt revenue bonds that government agencies can issue that differ from general obligation bonds in that they are used for private purposes and are repaid from private revenue streams rather than general tax revenues. Private activity bonds include mortgage revenue bonds (single-family) and residential housing bonds (multi-family) as well as bonds for airports, industrial development and public transportation. Each state is limited by the tax code to a fixed amount of PAB's that can be issued in any year. The state allocates the volume cap among issuers. Housing is the one of the major users of volume cap that can carry it forward for up to 3 years. So, generally, any state volume cap remaining at the end of the year goes to housing. Sometimes HFAs issue taxable bonds to finance affordable homes when no volume cap is available, 9% housing credits are used or to satisfy specific investors.
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> **2. Low income Housing Tax Credits ("Housing Credits" or "LIHTC")).** Housing Credits are currently the primary federal subsidy program for the creation of new

affordable rental housing in America. Each state receives an annual amount, based on the state's population, of 9% Housing Credits that it can allocate. Many states receive a small state minimum of about $2.7 million per year however, because these credits can be taken at a rate of approximately 9% of the "basis" in a property for 10 years, the actual amount of development that can be funded by the tax credits is about 10 times the allocation amount or about $27 million a year for a small state (the actual amount varies based on several factors.) Therefore, Housing Credits are extremely valuable and must be carefully allocated by the HFA pursuant to a qualified allocation plan (QAP). Of course, as a tax-code propelled program, the financial and legal complexities of Housing Credit transactions are enormous; with lawyers, accountants and consultants being well paid for sorting through the complexities. The large amount of fees associated with Housing Credit transactions imposes feasibility limits on the minimum deal size.

A smaller Housing Credit subsidy is available when affordable housing is financed with tax exempt bonds. This is known as the 4% credit and correspondingly is worth about 4/9 as much as 9% credits. Although 4% credits must theoretically be administered in the same manner as 9% credits, there is no limit on the amount of 4% credits that can be allocated except as limited by PAB volume cap. Interestingly, while 4% credits are automatically available with tax-exempt bonds, tax-exempt bonds cannot be used with 9% credits.

3. Deferred Payment Loans (DPLs). Many HFAs make deferred payment loans to help homebuyers with items such as down payments and closing costs and/or help apartment developers to fill financing gaps that are left after factoring in amortizable debt, equity and tax credit equity. DPL can be funded with state and federal funds, agency funds or the excess parity within bond indentures. While the repayment risk accompanying, DPL may be higher, it is real debt. Therefore, it can be considered when valuing development basis for Housing Credit purposes. The likelihood of repayment of DPL varies with the purpose of the loan and the location of the property. Many single-family DPLs are repaid on sale or refinancing of the property. DPL for multi-family can be repaid if properties are in areas where market rents justify the conversion of the property from low income targeting or when an alternative subsidy source becomes available. DPLs are especially valuable to agencies when the source of funds is from an outside entity or from bond or loan sale premium payments. DPLs are carried as assets by an agency with a corresponding offset by a loan loss reserve that reflects the payment period and risk associated with the loan.

4. Grants. From a developer's perspective, it may seem like grants would be preferable to DPLs. However, because loans can be taken into basis, DPLs allow more Housing Credit income to be generated. For this reason and because funders and HFAs hope to be able to recover the funds sometime in the future, grants are rarely used. Another argument against outright grants is that funders want to be assured that the original public and charitable purpose will be maintained. Sometimes, recoverable grants are used to recapture funds if the public/charitable purpose ends but DPLs are the more common method.

B. Rent, Operating and Supportive Service Subsidies. To serve individuals and families with incomes lower than 50% of median, some form of operating support is usually needed in addition to the capital subsidies. For certain populations, additional subsidies are needed to cover the cost of supportive services. With operating subsidies, the costs are frequently harder to predict because they depend on many uncontrollable factors and run for many years. Moreover, with each additional unit subsidized, the annual cost to government increases cumulatively. With capital subsidies, new units can be produced each year for approximately the same amount as in prior years.

Many federal housing programs began with capital grants and then had to add rent subsidies when operating costs skyrocketed or tenants had so little income that they couldn't even afford rents with a zero-debt-service component. Capital cost subsidy programs often attract a population that is drawn to the affordability when the apartments are new and operating costs are relatively low. Over time however, residents' income often does not increase at a rate comparable to those of operating costs. Therefore, both landlords and tenants are squeezed. Many federal subsidy programs, such as the Section 8 New Construction program, are legacies of more generous federal times and today we are seeing the number of rent-subsidized apartments shrink as operating costs increase. This is especially true with older buildings, including public housing, that need significant or substantial rehabilitation. HFAs work very hard to preserve these deeply subsidized units but in doing so, use resources that are also needed to create new affordable housing, increase housing opportunity and break down past patterns of discrimination and concentrations of poverty.

Voucher programs are a way to make existing housing affordable and, if paired with capital programs, create good quality affordable housing. Voucher programs are also perceived as increasing economic opportunity. However, they only work when there is an adequate supply of good quality housing that is available without discrimination and at a below market price. This severely limits their utility in high economic opportunity areas and in an era when, in many places, it is virtually impossible to create decent low-cost homes without capital subsidies.

Note: MF and SF Underwriting Differences. For multi-family financing, project underwriting with prudent long-term trending of rents and operating costs is critical. HFAs can reduce their risk exposure with FHA insurance, risk-sharing or a guarantee from a federal agency. For single-family financing, the collateral consists of thousands of relatively small mortgages; many of which are insured or guaranteed. Therefore, the underwriting of each individual loan becomes less important but prudent overall procedures are more so. Interest rate subsidies can help more families buy homes but, in times of low rates and small differences between conventional and tax-exempt interest rates, capital subsidies such as down payment and closing cost assistance may be bigger factors. Some private sector lenders may object to HFAs providing financing for moderate income homebuyers but HFAs often need this income diversity to strengthen its loan pools. Pools made up of a high percentage of geographically concentrated loans to only low income borrowers are obviously more risky and costly than balanced pools. Because HFA loans are geographically targeted to a single state, to be more risk-resistant, HFAs need to reach the broadest possible population within the state.

In their early days, most HFAs held vast amounts of individual loans. Today, however, most HFAs reduce their risk by selling pools of loans in exchange for federally guaranteed mortgage backed securities (MBS). In doing so they must pay a guarantee fee and comply with the guarantor's underwriting standards but, once satisfied, have no further risk of loss. Some agencies have residual pools of "whole loans" in their portfolios. Others may choose to develop mortgage programs that do not conform to the federal requirements to better serve a specific need in their state.

III. Issues Related to Private Activity/Tax-exempt Bonds

A. Tax Code Restrictions. The IRS significantly restricts the amount that HFAs can earn on loans made with tax-exempt debt, requires regular reporting and the return of any excess yield. For multi-family financing the maximum allowable spread (the difference between the bond yield and mortgage yield is known as ***arbitrage***) is 150 basis points (1.5%) and for single-family financing the maximum spread is 112.5 basis points (1.125%). From this spread, the HFA must cover all its costs and generate extra income to cover their non-income generating programs. Revenue streams from single family mortgage pools are constantly changing as local and national job, real estate and interest-rate markets move up and down. This distinguishes them from government bonds used for other purposes in which the cash flow and arbitrage calculations are relatively predictable. However, pools of multi-family mortgage loans also experience some losses that can be offset with gains in other areas. Therefore, mortgage and bond yield calculations for housing bonds become complex and challenging with precise modeling needed for both program and financial optimization and IRS compliance.

B. General Obligations, Special Obligations, Moral Obligation, Conduit Debt. These terms have specific meanings within municipal bond law, but are often confused by policy makers and commentators. Therefore a few brief definitions may be helpful about HFA debt.

1. **General Obligation Debt**. These bonds are backed by the full faith and credit of the issuing entity and most of its assets are pledged to their payment. While HFAs sometimes issue GO debt and some HFAs have an issuer credit rating (ICR), the term GO Bond is most commonly used to describe bonds backed by the parent state, require voter approval and are supported by general state revenues and assets.

2. **Special Obligation Debt**. Most HFAs issue special obligations backed by specifically identified revenues and assets. Usually these special obligations are backed by pools of mortgages. Some agencies have multiple pools and others just have one or two. These pools of mortgages are governed by bond indentures (i.e. contracts with bond-holders) and the rights of the parties are clearly spelled out in both a broad general resolution and individual series' resolutions. While there is no legal obligation for either the HFA or the parent state to come to the rescue of special obligation bond-holders, if revenues are insufficient to meet the debt service, reputational damage could impact their ability to issue future debt at reasonable interest rates. The special obligations issued by HFAs are subject to rigorous stress tests by rating agencies and survived the housing collapse very well; even as major banks and federal housing agencies were failing.
3. **Moral Obligation Debt.** This term is sometimes misconstrued by applying it to the reputational risk that parent government entities wish to avoid in conjunction with special obligation debt. However, its legal meaning generally denotes a requirement for the executive officer of the parent state to request an appropriation to refill a debt service reserve fund. Because most legislative bodies cannot be bound to pay long-term debt without voter approval, there is no legal requirement for them to refill the reserve fund. However, the reputational damage of failing to do so is even more severe than with special obligation debt.
4. **Conduit Debt**. This debt is the most loosely tied to both the issuer and the parent state and the failure by either entity to rescue the bond-holders holds much lower reputational risk within the financial markets. Generally, this debt is associated with a single private borrower such as an affordable housing developer, hospital or private university. The name of the borrower is prominently featured on the offering documents and generally no other assets of the issuer are pledged to the investor nor is there a general expectation that the issuer will step in. However, defaults on conduit debt, or even scandal surrounding the use of funds without a default, can do reputational and political damage to the issuer, its board and parent entity. Therefore, while financial risk may be minimal, conduit transactions should be carefully screened.

C. Rating Agency Requirements. To effectively sell their bonds, HFAs need to have their debt rated. Because housing debt has experienced boom and bust cycles, the rating agencies have extensive stress tests that must be modeled before a rating is given or affirmed. With more accurate information on individual portfolios, rating agencies have more confidence that agency portfolios will perform as expected.

D. Variable Rate Debt. Using variable rate debt as part of a bond financed program is a significant way for HFAs to lower the interest rate that they can charge borrowers or generate additional income with which to fund other housing assistance. Just as most prudent investors have a mixed investment portfolio that includes some fixed rate and some variable return products, laddered time horizons and corresponding risk levels including stocks, bonds, CD's and money market funds; it may be prudent for HFAs to include a mixture of debt types within their debt portfolio. While most HFAs try to have serialized debt maturities to match anticipated mortgage payments and pre-payments, they may not have a mix of fixed and variable (hedged and un-hedged) interest rates and repayment priorities.

Prior to the market crash of 2007 – 2008, swaps lacked a great deal of regulation and transparency. Just as important, the benefits of using swapped variable rate debt might only have meant a small decrease in the overall interest rate. Therefore, many HFAs wisely avoided variable rate debt altogether or used internal variable rate investments as natural hedges. However, post-recovery, the transparency and regulation surrounding swaps and the entire municipal bond sector has increased along with the benefits of using swaps and other products. Some agencies have substantially reduced their borrowing cost by including a calculated amount of swapped variable rate debt within their bond issues. In addition to the prudent use of swaps, a certain amount of internally hedged variable rate debt can be a powerful tool in reducing borrowing costs and balancing risk.

IV. Optimizing Affordable Housing Finance.

A. Mission Allocation. HFAs were created to help states meet the affordable housing needs of their residents without the need for state appropriations. Some states choose to augment HFA funding with annual appropriations but, in most states the HFA itself is the primary provider of housing funds. When housing funds come from non-HFA sources, the outside funders get to decide the way the funds will be used. However, when HFAs generate their own funds, they get to decide where and how they should be applied. States face many affordable needs including young working families, senior citizens and individuals with multiple challenges. The smaller the subsidy that is needed for each household, the more households that can be served. Conversely, the larger the subsidy needed, the smaller the numbers served. HFAs can often create more income for their programs by taking on more risk. Therefore, while Board members may want to avoid day-to-day involvement in agency work, it is certainly advisable that they collectively set policy guidelines within which to balance these competing interests.

B. Mission Expansion. As mentioned above, most HFAs were first created as bond issuing entities. Over time, the mission of many agencies has been expanded to include administration of state and federal housing programs, addressing homelessness, allocating tax credits and preventing foreclosures. While sometimes there are administrative fees associated with these extra activities, in many cases the agencies themselves must cover the shortfalls in operational and program costs. In such situations, the HFAs need the income generated from bond financing programs to be sustainable. Therefore, bond financing programs function as profit-generating activities as well as mission driven activities. The inherent tension between mission and financial sustainability within HFAs is perpetual and can be best resolved with excellent financial management and the best possible knowledge of costs and benefits.

C. Quantitative analysis. Quantitative analysis allows HFAs to most effectively balance the competing forces and generate the most income, within program goals and risk tolerances, to fulfill their housing mission. Excellence in quantitative analysis can assure that HFAs:

1. earn the optimum amount of program funds;
2. charge an interest rate that is optimally balanced between agency mission and financial sustainability;
3. meet all the required rating agency stress tests;
4. adhere to agency policies and bond covenants; and
5. comply with all applicable IRS rules.