AFFORDABLE HOUSING FINANCE

House's Private-Activity Bond Repeal Harms Housing Production

Attorney Wade Norris breaks down what's at risk.

By Wade Norris, as posted on November 27, 2017 on the Affordable Housing Finance website.

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According to a recent Novogradac & Co. study, private-activity bonds (PABs) and the associated 4% low-income housing tax credits (LIHTCs) accounted for 75,000 to 80,000 affordable housing units in 2016. In addition, the United States produced about 50,000 to 60,000 units from 9% LIHTCs. This amounts to a total of about 125,000 to 135,000 affordable apartment units last year through the LIHTC program.

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Recent analyses by Harvard University's Joint Center for Housing Studies (JCHS) and Freddie Mac have shown that the United States produces about 400,000 new apartment units annually. By eliminating tax-exempt multifamily housing bonds and 4% LIHTCs, the Tax Cuts and Jobs Act recently adopted by the House of Representatives would instantly kill roughly 60% to 65% of the annual production of affordable multifamily rental housing in the United States and almost 30% of the annual production of rental apartments. This would occur in the midst of a severe and growing rental housing crisis. It is critical that the position in the pending Senate bill, preserving this vital program, prevail in any version of tax reform that might become law.

What PABS are used for

Some testimony in the House Ways and Means Committee deliberations suggests that the House's elimination of all forms of PABs may reflect a misperception that the bonds primarily finance professional sports stadiums, office buildings, golf courses, industrial development bonds, or other facilities that have a limited public purpose. This is far from reality. According to one highly reputable industry source, almost 90% of the $87 billion of PABs issued in 2016 (20% of all municipal bonds) and still outstanding financed:

Nonprofit hospitals	38%
Affordable housing (multifamily, 8%; single-family, 10%; student, 2%)	20%
Nonprofit colleges and universities	14%
Nonprofit senior housing	6%
Nonprofit and other charter schools	3%
Airports	6%
Total	**87%**

The vast majority of these facilities is owned by nonprofit organizations and/or serve vital public purposes. Industrial development and uses other than those listed above represent only about 10% of all PABs. Tax-exempt municipal bonds may only be issued for facilities such as sports stadiums, office buildings, and golf courses if those facilities are publicly owned. Those bonds are not PABs, and their issuance would not be prohibited by either pending bill.

The House's Tax Cuts and Jobs Act would eliminate PABs and 4% LIHTCs. It is extremely difficult to reconcile this result with the fact that the bipartisan Tiberi-Neal Affordable Housing Credit Improvement Act, H.R. 1661, which would dramatically expand the value and use of 4% LIHTCs, is supported by over a quarter of the House of Representatives and two-thirds of the House Ways and Means Committee. How could the House that overwhelmingly supported this legislation knowingly and rationally vote to abolish the very program that the Tiberi-Neal bill would so dramatically expand?

A growing rental housing crisis: Three major trends collide

Single-family homeownership in the United States has fallen from over 69% before the 2008 financial crisis to about 63.9% today. This reflects a net shift of about 700,000 households per year converting from owners to renters.

The post-World War II baby boom echo generation has completed its education and is entering the workforce. By some estimates, this has added about 4 million units, or 400,000 units per year, to this surge in rental housing demand over the past 10 years.

Finally, between 2012 and 2015, net immigration into the United States rose from about 1,060,000 to just under 1,300,000—an almost 23% increase in only four years. Immigrants rent for eight to 10 years before they buy.

The State of the Nation's Housing, 2015 by Harvard's JCHS summarized these trends as follows:

- From 2005 to 2015, the nation saw the largest increase in rental households in any 10-year period on record—9 million, or 900,000 households, per year.
- Compare this with a current production rate of 400,000 rental apartments per year, with a loss of 100,000 units per year due to deterioration and obsolescence, for a net addition of 300,000 units per year. This means that U.S. apartment demand has been more than three times greater than the net new supply for the past three to five years. Moreover, from 2012 to 2016, U.S. per capita disposable income has grown at a rate of 2.8% per year compared with a 6.5% growth rate for U.S. apartment rents.
- According to the 2016 Harvard JCHS study, the number of American families who are severely rent burdened—paying over 50% of their income for housing—grew by 23% from 9.2 million to 11.4 million from 2008 to 2014. The U.S. affordable housing crisis is critical and is accelerating.

PABs + 4% LIHTCs: A powerful double-barreled subsidy

On most tax-exempt bond/4% LIHTC financings, the tax-exempt debt funds 60% to 65% of total development cost and the 4% LIHTC funds 25% to 35%. Some leading tax-exempt debt providers estimate that the tax-exemption on the debt side of the financings lowers mortgage rates by 1% to 1.25%. On a debt-service constrained loan at today's interest rates, this produces an additional 15% of loan proceeds, or an amount equal to 8% to 10% of total development cost. The 4% LIHTC can be syndicated to fund 25% to 35% or more of total development cost. Without these two vital federal subsidies (for projects without 9% LIHTCs), there would be no affordable housing projects.

Linking the 4% LIHTC to the issuance of PABs also ensures that these projects receive a thorough, local vetting and approval of public purpose and that they will address local needs of the community where the project is located. Last year in California, where $4.6 billion of PABs were issued for multifamily, almost 95% of the issuance was through cities or counties or joint power authorities set up by cities and counties. This vital role of cities and counties as tax-exempt PAB issuers working with developers ensures that projects will be located where they are most wanted and needed by the local community.

A time-tested public/private partnership

The use of low-rate PABs with 4% LIHTCs has been a brilliant public/private partnership.

1. States and local municipalities are involved in the allocation and issuance process and determine where these powerful federal subsidies will be directed.

2. The projects are almost entirely financed by private debt and equity capital investment.

The developer must locate two private sources of investment capital willing to put their money at risk in the project:

1. **4% LIHTC investor**. A 4% LIHTC investor (or syndication firm acting on behalf of such investor) who will invest an amount equal to 25% to 35% of total development cost in the first two years to obtain a stream of 4% federal LIHTCs over the next 10 years. These credits, as they are earned over a 10-year period, are:

- Subject to recapture by the U.S. Treasury if the developer defaults on provisions of a tax credit regulatory agreement setting forth income and rent limits and other operational requirements imposed by the tax code; and
- Will be lost to the extent not yet realized if the project is lost through foreclosure or deed in lieu of foreclosure following an economic default (the remaining tax credits "go with the land" to the next owner).

As a result, tax credit investors and syndicators whose equity funding is at risk impose stringent underwriting standards and post-closing compliance monitoring, and partnership agreements give the limited partners the right to remove the general partner/developer if various types of defaults occur.

2. **Tax-exempt debt investor or credit enhancer**. Similarly, large bond credit-enhancers, such as the Federal Housing Administration, Fannie Mae, Freddie Mac and/or banks and other institutions who purchase the tax-exempt bonds and provide the other 60% to 75% of total funding on the debt side of the deal, are at risk of loss if regulatory requirements are not followed (the bonds may become taxable and the loss of tax credits can trigger a bond default). This sophisticated debt side provider of capital will pursue a *separate* rigorous underwriting of the developer and the project and, together with the bond issuer, impose post-closing compliance requirements.

Three decades of exemplary results

This public/private combination has produced an efficient, disciplined, effective allocation of federal support for a vital societal need.

- **Largely scandal-free**. A Government Accountability Office audit of almost 100 projects after the program had been up and running for over a decade or so found only two relatively minor violations of regulatory requirements, which were quickly corrected following their discovery.
- **Extremely low rate of economic defaults**. It is general knowledge in the industry that the rate of default on tax-exempt bonds and loans is far less than 1%--one of the lowest in any type of real estate investment class and lower than the default rate on all but the strongest corporate and governmental credits.

Conclusion

In short, this is a brilliantly designed federal program that has withstood the test of time for over three decades,providing, together with 9% LIHTCs, nearly 3 million units of affordable rental housing to approximately 6.7 million families—or almost 5% of U.S. households, according to the Affordable Rental Housing A.C.T.I.O.N. Campaign.

Over the past 10 to 15 years, industry leaders have made a laudable widespread effort to show their representatives and senators projects in their communities that these two vital programs have produced. These congressmen and congresswomen are often shocked to discover that these are safe, clean, attractive, well-managed apartment buildings in which they would be glad to see a parent or child or other loved one reside and which are invaluable *assets* to their community.

Abandoning what may be one of the nation’s most successful, essential societal programs providing two-thirds of the nation’s affordable apartments at a time of increasingly desperate need by millions of America’s most vulnerable families would be a tragic policy choice indeed. Congress should

move quickly and decisively to remove any threat to the continuation of the tax exemption under Sec. 142(d) for tax-exempt multifamily housing bonds combined with 4% LIHTCs.

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