Talking Heads

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The ABCs of Multifamily Housing Bonds

By Darryl Hicks

Since this issue focuses on Tax-Exempt Multifamily Housing Bonds (TEBs) and includes case studies and technical details of how they are used, we thought it would be beneficial to begin with a basic introduction. So we sat down with attorney Wade Norris, founding partner with the Washington, DC law firm of Norris George & Ostrow PLLC, whose paper, "Introduction to Tax Exempt Multifamily Housing Bonds," is widely regarded as the leading resource for bond novices.

Over the past four decades, Norris has participated in over 3,500 bond transactions and played a major role in developing the country's largest tax-exempt bond and loan bank private placement program; short-term, cash-backed tax-exempt bonds used with FHA, Rural Development and other low-rate taxable loans; the Freddie Tax-Exempt Loan or "TEL" structure; and Fannie Mae's M.TEBs tax-exempt monthly MBS pass-through structure.

***Tax Credit Advisor:* What is a Multifamily Housing Bond?**

Wade Norris: It is debt issued by a state or a political subdivision of a state, like a city, county, housing authority or redevelopment agency, the proceeds of which are loaned to a borrower who uses them to build or acquire and rehabilitate an affordable rental housing complex, or a rental housing complex for the elderly or the physically challenged.

***TCA:* What are the advantages of Multifamily Housing Bonds? Who typically are the investors?**

Norris: The interest income on these bonds is exempt from federal and often state income taxation. The debt traditionally bears a lower rate of interest, which can be passed through to the borrower as a larger loan, greater cash flow and/or lower rents. Historically, most Multifamily Housing Bonds were rated and publicly sold to high-income individuals or mutual fund companies that bought the bonds and sold shares to high-income individuals and, in some cases, banks and insurance companies that wanted tax-exempt income. Beginning in the late 1990s, banks and other sponsors created their own private placement programs that eliminated the time and expense of going through a rating agency or public offering, or having a credit enhancement placed on the bonds. These banks are big sophisticated institutions that can do the real estate underwriting themselves and assume the risk. It was considered a more streamlined, efficient process that could be done more quickly and with lower upfront issuance costs. This approach became a model and today represents about three-quarters of all tax-exempt Multifamily Housing Bond deals. The other quarter are publicly-rated, public-offered, credit-enhanced deals.

Wade Norris

***TCA:* What rules must be followed when using Multifamily Housing Bonds?**

Norris: There are three types of Multifamily Housing Bonds, but 90 to 95 percent are tax-exempt private activity bonds issued under Section 142(d) of the Internal Revenue Code, so I will just speak about them. There are basic income targeting requirements that must be followed for a minimum period of 15 years after 50 percent occupancy has been achieved. You must either set-aside 20 percent of the units for a family of four making 50 percent or less of area median income or 40 percent of the units set aside for a family of four making 60 percent of AMI. This is a test on the income level of the

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people living in the units, not a rent test. The income levels are adjusted up or down for families of different sizes. In addition, the housing must be rental. It cannot be condos or housing that's privately owned by the tenants. Lastly, you must demonstrate to the state or municipality that your project has a certain degree of public merit. If you follow these steps, you become entitled to syndicate four percent Low Income Housing Tax Credits, which covers another 30 to 40 percent of your total development costs. It's a powerful incentive and one of the main reasons why for-profit developers use tax-exempt Multifamily Housing Bonds.

***TCA:* Does the addition of four percent credits create more rules?**

Norris: To maximize the value of the four percent credits, most developers set aside 40 percent of the housing units at 60 percent AMI to meet the income test under Section 142(d), but then make 100 percent of the units affordable at 60 percent AMI. That way, they qualify for tax credits on all of the units. They pick up a new set of regulations under Section 42 of the Internal Revenue Code that governs the LIHTC program. They now have a cap on the rents that can be charged to the tenants. That test is 30 percent of the applicable income limit. For example, if I have a family of three living in a unit whose income is equal to 42 percent of AMI, I cannot charge that tenant more than 30 percent of 42 percent of AMI in my aggregate rents. But syndicating the four percent tax credits more than offsets this.

***TCA:* Why is there a cap on the amount of Multifamily Housing Bonds that states can issue? How is the cap calculated? Does it fluctuate from year to year?**

Norris: Municipal bonds create a drain on the U.S. Treasury, because the investors who buy them don't pay federal taxes on the interest that they earn. The Treasury estimates that it loses about 29 percent of the interest that is paid on these bonds each year if they were taxable. In 1986, the IRS agreed to allow states and municipalities to continue issuing tax exempt private activity bonds if they followed certain rules and were issued for quasi-public purposes, such as single-family housing for first-time homebuyers and multifamily affordable housing, but there would be a limit on the amount of such bonds that could be issued annually. That volume gets indexed for inflation each year and today equals the greater of $105 per person or $311 million. California, the most populous state, can issue $4.2 billion in private activity bonds, whereas less populated states, like Wyoming, can issue $311 million. Each state then decides how much in private activity bonds will be issued for housing, industrial development or other public purposes. Some states, like California, have a very high percentage of their private activity bond allocation dedicated to multifamily affordable housing.

***TCA:* Is it a highly competitive process to obtain bond financing, much like it is with nine percent LIHTCs?**

Norris: In almost every state, it's much less competitive than getting a nine percent allocation and that's because the nine percent LITHC is a more powerful federal subsidy. In Massachusetts, New York, New Jersey, Connecticut, Minnesota, Utah, Washington state, Arizona, Tennessee, Virginia and Texas, private activity bond volume is very limited for single-family and multifamily housing, and developers are asking those states to allocate more toward affordable housing. But if you're in a state that is not oversubscribed, then it's not a problem.

***TCA:* Do the application and compliance rules for multifamily housing bonds vary from state to state or is the application process fairly consistent?**

Norris: They are all over the map. Some states add additional requirements. California has three or four allocation rounds per year and it's not yet a volume-starved state, so developers have a great deal of flexibility on timing. Once you get an allocation, generally you must use it within 90 to 120 days or lose it and then you need to reapply. Other states have one or two windows a year and it may take you as much as five or six months from application to the awarding of the bond allocation. In Texas, you may apply in January or February, but it may be July or August before you get the allocation and can close the deal.

***TCA:* What costs are associated with issuing Multifamily Housing Bonds?**

Norris: There's the upfront cost of issuance and then there are ongoing costs. Upfront costs depend on the size of the bond issuance. The median bond issuance is around $15 to $20 million, based on a $30 million deal. Upfront issuance costs run about three percent of total project costs and include underwriting, legal and issuer fees and the lender's origination fee. In terms of ongoing costs, bond issuers charge a fee each year—ranging from seven to 12 to 15 basis points for local issuers and 25 to 40 to 50 basis points for state issuers—and there are also often trustee's fees and rebate fees of four to five basis points.

TCA: What are the ideal circumstances for using Multifamily Housing Bonds?

Norris: If you want to develop an affordable housing project and you cannot get an allocation of nine percent tax credits, this is your only viable alternative. If you can't get a private activity bond allocation and trigger the four percent tax credit equity, in all likelihood you'll do a conventional apartment loan and it will not be an affordable deal.

TCA: Most states don't issue the full amount of bonds that they are allowed to. Why is that? Are there drawbacks that make them less appealing compared to other financing sources?

Norris: In states where they don't use all of their private activity bond volume, there isn't enough economic growth and enough demand for new single-family homes or new multifamily rental housing, or the other types of activities that tax-exempt bonds help finance. It's the states with large urban areas and vibrant economies where we see demand outstripping supply. There are states where market-rate rents aren't that much higher compared to subsidized housing. In these cases, a developer is better off getting a conventional loan to finance construction or rehabilitation costs, rather than having to meet the regulatory hurdles or incur the upfront expenses associated with tax-exempt Multifamily Housing Bonds.

TCA: Do you have any advice on how state housing finance agencies and local jurisdictions can generate more tax-exempt bond activity?

Norris: Be as user-friendly as possible. Don't impose any substantial eligibility requirements for this type of financing over and above what federal law requires. If you impose artificial rent caps, limitations on developer fees and other requirements, you will restrict this type of activity that would otherwise occur in your state, and you will throw away a huge federal subsidy for a critical local need.

TCA: What are the more popular financial executions you are seeing in the bond world today?

Norris: There are two executions that comprise 65 to 75 percent of all multifamily private activity bond deals: bank draw-down private placements and the Freddie Tax-Exempt Loan or "TEL" structure. Most, by far, are draw-down bank private placements. The Freddie TEL structure is fundamentally the same thing as a bank or other sponsor draw-down private placement, except you have two different lenders. Another 25 to 30 percent of executions comprise Fannie Mae's M.TEB program, which is now over $1 billion and growing rapidly. M.TEB uses a combination of a taxable draw-down bank loan for the pre-conversion phase financing with a publicly offered Fannie Mae MBS tax-exempt, highly rated monthly pay bond for the permanent phase financing. The other portion would be combining FHA insurance on the debt side of the deal under its 223(f) program for refinance acquisition/rehabilitation projects and 221(d)(4) program for new construction and short-term cash-back bonds that we developed to satisfy the 50 percent test.

TCA: Under current law, the four percent credit rate floats and is worth considerably less due to low interest rates. If Congress should establish a minimum four percent tax credit rate—which is a possibility if lawmakers pass a smaller tax bill before the new Congress is sworn in—what impact would that have?

Norris: Passage of that provision would be a phenomenal benefit. It would increase the dollars flowing into these projects by 20 percent, if you adjust the current level of 3.2 percent up to four percent. Over the past year, we've seen higher interest rates and a decrease in tax credit equity pricing due to the tax law changes. This change would restore those losses and then almost double it. On a recent webinar, one of the affordable housing industry's top lobbyists said there was a fair chance this provision could get attached if another bill is passed before Congress adjourns. If that doesn't happen, he was optimistic that with the Democrats taking control of the House, something could be achieved in 2019. TCA

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