

Four Percent LIHTC Developments Take Advantage of Unusually Low Taxable Mortgage Rates

By Richard Gerwitz, Citi Community Capital

During the past two years, low-income housing tax credit (LIHTC) developers have been increasing their use of a new financing structure that marries a taxable conventional loan with equity from 4 percent LIHTCs. Although at least 50 percent of a 4 percent LIHTC development's aggregate basis needs to be financed with tax-exempt private activity bonds for the developer to secure the LIHTCs, compelling taxable mortgage rates have made taxable conventional loan financing an attractive alternative to traditional tax-exempt bond financing. This financing structure meets the 50 percent test by issuing short-term cash-backed tax-exempt bonds, initially secured by the cash proceeds of the bonds themselves. Conventional loan proceeds replace these funds as the tax-exempt bond funds are advanced to the property. Once the development is placed in service, the short-term bonds are redeemed and the development is left with the conventional permanent loan.

A unique confluence of events has contributed to the rising popularity of this structure: high grade taxable rates have been lower than comparable tax-exempt multifamily rates; GNMA's bonds have traded extremely tight to Treasury bonds; the Federal Housing Administration (FHA), the most frequently used taxable permanent loan provider, has streamlined its approval process for certain loans; and Freddie Mac and Fannie Mae have been aggressively looking to finance low-income developments.

What Has Happened to Interest Rates?

Historically, tax-exempt interest rates trade anywhere from 70 percent to 85 percent of comparable maturity taxable rates, generally because taxable interest income is included

in adjusted gross income for tax purposes. General concerns about municipal credit quality, however, along with other technical factors, have resulted in a significant outflow of funds from the tax-exempt market in recent months and driven the tax-exempt to taxable yield ratio as high as 120 percent. While some buyers have returned to the market, the ratio remains close to 110 percent. This relationship has made taxable loans more attractive relative to tax-exempt funded loans.

Another factor influencing taxable rates for taxable FHA multifamily loans is the increased demand for the purchase of GNMA's. FHA 221(d)(4) and 223(f) loans result in the delivery of a GNMA mortgage-backed security, which is sold into the market. The price that buyers will pay for these securities is a large part of what determines the mortgage rate. Real estate mortgage investment conduits (REMICs) have constituted a large part of the GNMA market. These buyers take portfolios of GNMA's and issue pass-through certificates for broader investor distribution. REMICs were especially aggressive buyers from late 2012 through early 2013, as they found the increased yield available in GNMA's compared to Treasuries particularly attractive in the very low interest rate environment. While GNMA rates have climbed since the end of 2012, they still produce taxable FHA/GNMA loans that are below loans funded in the long-term FHA enhanced tax-exempt market.

Conventional FHA and Agency Lending Programs

FHA lending programs have always been an attractive alternative for the long-term financing of affordable rental housing properties. Lower debt service coverage

continued on page 2

continued from page 1

requirements and longer amortization periods result in greater proceeds than can be found in other structures. The fact that they are non-recourse is also highly attractive. What has been less attractive is that their use requires that a development adhere to federal Davis-Bacon Act wage requirements, and the relatively long FHA loan processing time. Many developers will accept the additional cost of Davis-Bacon wages, particularly on an acquisition/rehabilitation property, but developers may have a hard time waiting for approvals because of allocation deadlines, seller impatience and fear of missing a favorable interest rate. To address these issues, the U.S. Department of Housing and Urban Development (HUD) in February 2012 started a pilot program that reduced the processing time for most 223(f) loans and increased from \$15,000 to \$40,000 per unit the amount of rehabilitation that developers can perform on a property to use the 223(f) program rather than the 221(d)(4) program, which has a longer timeframe. HUD expanded the pilot program to the entire country late last year. Affordable housing developers are using both these programs on a taxable basis more frequently with 4 percent LIHTCs.

Initially the hybrid structure was used only in connection with conventional FHA/GNMA loans. However, pricing improvement at Freddie Mac and Fannie Mae has resulted in taxable loans from both agencies being combined with the short-term cash-backed bond financing structure. It only works effectively, however, with the agencies immediate funding programs, not their forward loan programs. Of particular note is that Freddie Mac initiated a program earlier this year to increase the number of Very Low-Income (VLI) units they finance. VLI units target families and individuals whose income is less than 50 percent of area median income. Freddie Mac, therefore, is trying to finance many of the same developments that are, or were, financed with 4 percent LIHTCs. To achieve its goals, particularly in markets with a large number of Community Reinvestment Act-motivated financial institutions, Freddie Mac has provided attractive taxable financing options to affordable housing developers.

The Short-Term Cash Backed Bond Structure

The short-term cash backed bond structure allows developers to secure an allocation of 4 percent LIHTCs and lock in the long-term rate available in the credit markets using either the FHA, Freddie Mac or Fannie Mae conventional loan alternative. This is accomplished by the developer submitting a private activity bond allocation request and the agencies processing the conventional loan request at the same time as the bond allocation request. Once allocation and issuer approvals are received and the loan is approved, the lender will lock the permanent loan interest rate and a bond underwriter will concurrently sell short-term tax-exempt bonds in the market or a financial institution will buy

continued on page 3

Novogradac Journal of Tax Credits Editorial Board

PUBLISHER

Michael J. Novogradac, CPA

EDITORIAL DIRECTOR

Alex Ruiz

TECHNICAL EDITORS

Robert S. Thesman, CPA
James R. Kroger, CPA
Owen P. Gray, CPA
Thomas Boccia, CPA
Daniel J. Smith, CPA

ASSOCIATE EDITOR

Jennifer Dockery

STAFF WRITERS

Teresa Garcia
Mark O'Meara

EDITORIAL ASSISTANT

Elizabeth Orfin

CONTRIBUTING WRITERS

Peter Lawrence	Jillian Toole
Jana Cohen Barbe	Rodney Sommers
Scot Keller	Brent R. Parker
Richard Gerwitz	Forrest Milder
Brandi Day	John M. Tess
Jim Kroger	

CARTOGRAPHER

David R. Grubman

PRODUCTION

Alexandra Louie
Jesse Barredo
James Matuszak

Novogradac Journal of Tax Credits Information

Correspondence and editorial submissions:
Alex Ruiz / 415.356.8088

Inquiries regarding advertising opportunities:
Emil Bagalso / 415.356.8037

Editorial material in this publication is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding the low-income housing tax credit or any other material covered in this publication can only be obtained from your tax advisor.



**NOVOGRADAC
& COMPANY** LLP®

CERTIFIED PUBLIC ACCOUNTANTS

© Novogradac & Company LLP
2013 All rights reserved.
ISSN 2152-646X

Reproduction of this publication in whole or in part in any form without written permission from the publisher is prohibited by law.

Novogradac Journal of Tax Credits Advisory Board

LOW-INCOME HOUSING TAX CREDITS

Bud Clarke	BOSTON FINANCIAL INVESTMENT MANAGEMENT
Jana Cohen Barbe	SNR DENTON
Tom Dixon	BOSTON CAPITAL
Rick Edson	HOUSING CAPITAL ADVISORS INC.
Richard Gerwitz	CITI COMMUNITY CAPITAL
Rochelle Lento	DYKEMA GOSSETT PLLC
John Lisella	U.S. BANCORP COMMUNITY DEV. CORP.
Phillip Melton	CENTERLINE CAPITAL GROUP
Thomas Morton	PILLSBURY WINTHROP SHAW PITTMAN LLP
Mary Tingerthal	MINNESOTA HOUSING FINANCE AGENCY
Rob Wasserman	U.S. BANCORP COMMUNITY DEV. CORP.

PROPERTY COMPLIANCE

Michael Kotin	KAY KAY REALTY
Michael Snowden	MCA HOUSING PARTNERS\
Kimberly Taylor	HOUSING DEVELOPMENT CENTER

HOUSING AND URBAN DEVELOPMENT

Flynnan Janice	RAINBOW HOUSING
Ray Landry	DAVIS-PENN MORTGAGE CO.
Denise Muha	NATIONAL LEASED HOUSING ASSOCIATION
Monica Sussman	NIXON PEABODY LLP

NEW MARKETS TAX CREDITS

Frank Altman	COMMUNITY REINVESTMENT FUND
Merrill Hoopengardner	ADVANTAGE CAPITAL
Scott Lindquist	SNR DENTON
Matthew Philpott	U.S. BANCORP COMMUNITY DEV. CORP.
Matthew Reilein	JPMORGAN CHASE BANK NA
Ruth Sparrow	FUTURES UNLIMITED LAW PC
Elaine DiPietro	ENTERPRISE COMMUNITY INVESTMENT INC.

HISTORIC TAX CREDITS

Jason Korb	CAPSTONE COMMUNITIES
John Leith-Tetrault	NATIONAL TRUST COMM. INVESTMENT CORP.
Bill MacRostie	MACROSTIE HISTORIC ADVISORS LLC
John Tess	HERITAGE CONSULTING GROUP

RENEWABLE ENERGY TAX CREDITS

Bill Bush	BORREGO SOLAR
Ben Cook	SOLARCITY CORPORATION
Jim Howard	DUDLEY VENTURES
Forrest Milder	NIXON PEABODY LLP
John Pimentel	FOUNDATION WINDPOWER

continued from page 2

the bonds privately. The short-term bond proceeds are deposited in an escrow held by a trustee and they can only be invested in Treasury bonds or other similarly rated short-term instruments. This escrow is security for the tax-exempt bonds and, if structured properly, will result in an AA+ Standard & Poor's rating.

As the developer requests funds to construct, buy or renovate the property, proceeds are withdrawn from the bond-funded escrow to pay the costs and a like amount of conventional loan proceeds are deposited into the escrow. In this manner, the development uses bond proceeds, thereby satisfying the 50 percent test, and the short-term bondholders are always 100 percent cash collateralized. After the development is completed and placed in service, the short-term bonds are retired and the taxable loan remains outstanding.

While traditional tax-exempt multifamily bond structures are still most prevalent, this hybrid financing structure has become more popular during the past 18 months. The pace of activity has accelerated from the beginning of the year, even as rates have increased. When rates were lowest, conventional FHA/GNMA 35-year mortgage rates, including the mortgage insurance premium, were 2.75 percent to 3.00 percent. While rates are now nearing 5 percent, they remain substantially below an FHA tax-exempt bond execution, and taxable Freddie and Fannie rates are at or below the most aggressive bank tax-exempt permanent loan rates in many regions. Because of this, the structure remains a viable and attractive alternative for financing 4 percent LIHTC developments. ❖

Richard Gerwitz has more than 30 years of experience in the tax-exempt securities and real estate markets. Mr. Gerwitz has financed new construction and acquisition/rehabilitation projects all across the country using a variety of financing and capital structures, including credit enhanced and non-credit enhanced private placements.

This article first appeared in the November 2013 issue of the Novogradac Journal of Tax Credits.

© Novogradac & Company LLP 2013 - All Rights Reserved

Notice pursuant to IRS regulations: Any U.S. federal tax advice contained in this article is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties under the Internal Revenue Code; nor is any such advice intended to be used to support the promotion or marketing of a transaction. Any advice expressed in this article is limited to the federal tax issues addressed in it. Additional issues

continued on page 4

continued from page 3

may exist outside the limited scope of any advice provided – any such advice does not consider or provide a conclusion with respect to any additional issues. Taxpayers contemplating undertaking a transaction should seek advice based on their particular circumstances.

This editorial material is for informational purposes only and should not be construed otherwise. Advice and interpretation regarding property compliance or any other material covered in this article can only be obtained from your tax advisor. For further information visit www.novoco.com.