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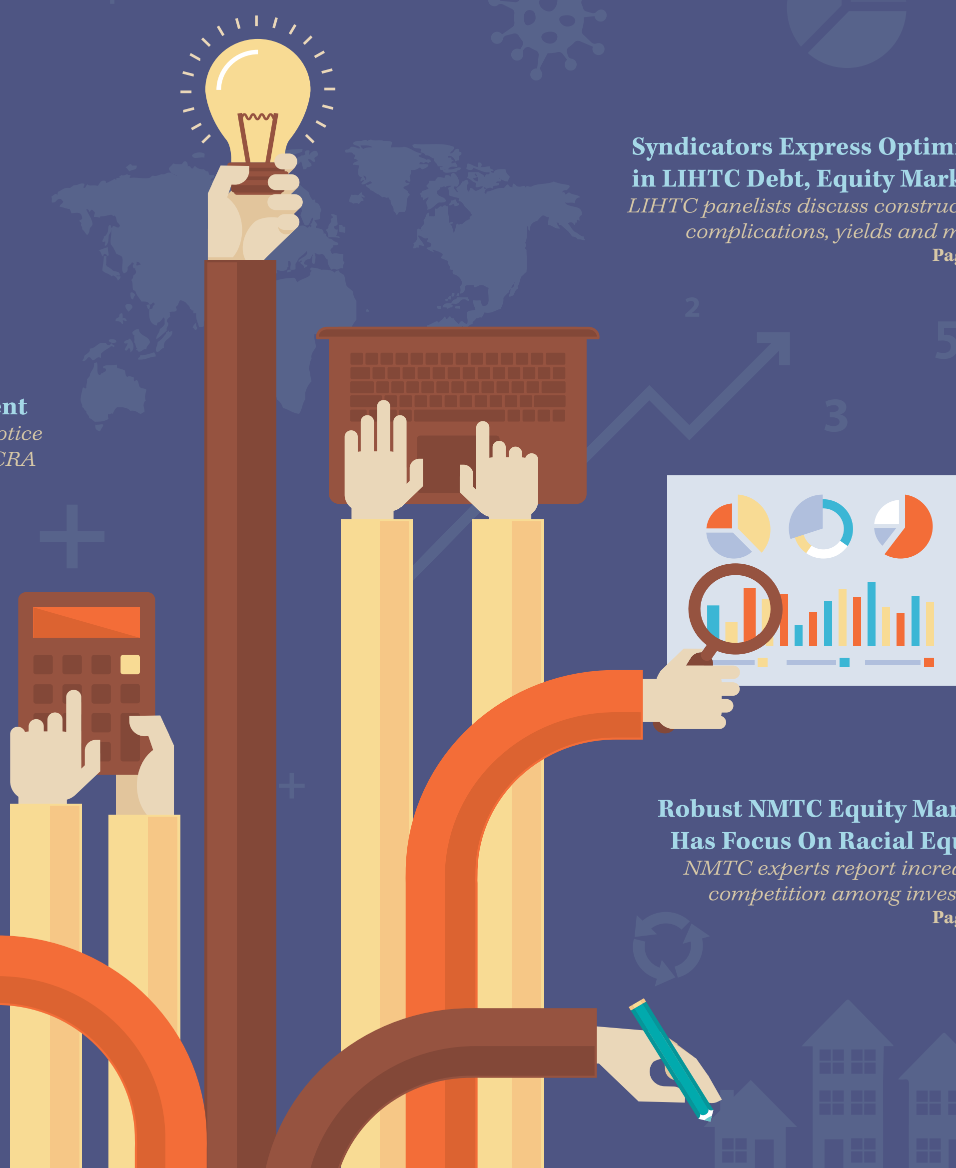
Debt and Equity Market Updates



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Decrease in 50% Test Could Boost Production, but Include Unintended Consequences for Pricing

RICHARD GERWITZ, CITI COMMUNITY CAPITAL

With an overwhelming need in so many neighborhoods for more affordable housing, reducing the threshold for receiving an allocation of private activity bonds (PABs) and the related 4% low-income housing tax credits (LIHTCs) from a 50% test to a 25% test is a welcome and eagerly anticipated prospect in the multifamily affordable housing market. But not surprisingly, there may be some unanticipated consequences that could mitigate some of the potential benefit.

The change has the potential to double the supply of 4% LIHTCs in states taking full advantage of the reduction, an increase in volume that might arguably lower the price per credit that investors are willing to pay while also increasing debt costs, making it more expensive for affordable housing developers to build and preserve housing.

Since the Great Recession, which was a relative low point in the use of PABs and the associated LIHTCs, the number of projects and units produced under the incentive has steadily increased. New York was the first state to use all of the bond cap it had available for multifamily housing, followed by California and then a host of others, including Washington, Oregon, Texas, Georgia, North Carolina, South Carolina, Colorado, Utah and Minnesota. Some of the states that have used all of their bond cap, or that portion of the bond cap dedicated to multifamily housing, have tried to spread the available capacity as widely as possible by eliminating allocations for "80/20s," focusing almost exclusively on new construction and limiting the amount of allocation provided to any one project to no more than the amount needed to pass the 50% test.

Still, even with those limitations in place, more than $3 billion of project allocation applications were submitted to California's allocating agency in March for the $1.5 billion the agency has available in the first of two allocation rounds it will conduct this year.

The proposed reduction in the 50% test was one of several provisions the affordable housing industry was able to have included in the House version of the Build Back Better Act. While the package will not be passed in its earlier form, the reduction of the 50% test is still considered to have a good chance of being enacted, either as part of a scaled-back reconciliation bill or a year-end tax-extender bill.

If the test were to be reduced to 25%, it could double the number of 4% LIHTCs available in those states that take advantage of the opportunity. Recently, the industry has had some experience with the impact a substantial increase in the volume of tax credits can have on pricing. While there is nothing conclusive and it would not be easy to separate all the factors that impact pricing, the experience suggests that a modest to significant decrease in the price of the credits may occur in certain markets.

Financial institutions have been the primary, if not exclusive, investors in LIHTCs, as they are an efficient way for banks to make community investments as part of their obligation to satisfy the lending and investment tests under the Community Reinvestment Act (CRA). They have become so active in the market that they have driven down returns and disincentivized economic buyers. There can be a wide divergence in the price per credit based on geography. Concentrations of banks and a limited amount of tax credits, for example, have driven pricing substantially higher in high-need CRA markets such as New York, San Francisco and Miami versus other parts of the country. A number of market participants believe that the most significant price reductions will be in smaller markets, where there are fewer CRA-influenced investors. Tangentially, there does already seem to be some reduced interest in high-need CRA markets where larger project sizes and single project tax credit totals serve to limit the number of interested buyers.

Of course, corporate tax rates also affect tax credit pricing. After a period of uncertainty following the 2016 elections when tax credit investors pulled back from the market, the reduction of the corporate tax rate from 35% to 21% in 2018 caused average equity pricing to fall about 10 cents per dollar credit. Additional pressure from the increase in the amount of 9% credits available and the fixing of the 4% tax credit rate seem to have had a less dramatic, but noticeable, impact on pricing.

Another notable consequence of reducing the 50% test would be that a project's capital stack may include more taxable debt, which can be up to 50 basis points more expensive than comparable tax-exempt debt. As a result, projects that have blended tax-exempt and taxable debt will incur increased interest costs during construction and may find that they qualify for a smaller permanent loan amount if some of the taxable debt needs to remain outstanding during the permanent period. The combination of lower tax credit pricing and higher interest costs will also mean there will be a need for an increased subsidy for each project and an increase in the overall amount of subsidy needed given the larger number of projects able to secure an allocation of bonds and credits.

Regardless of the downside of lower tax credit pricing, higher interest rates and the need for more subsidy, lowering the 50% test will still enable more projects to be built and preserved. The industry has proven to be thoughtful and creative in adapting to changes in policy, markets and local conditions over the years. The key to the increases in available resources, however, will be to make sure PAB allocations are spread wisely and in a manner that increase affordable housing stock without driving up the overall cost of doing so.

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