Capital Markets for Affordable Housing

*Cynthia Bast and Rick Morrow**

The authors review recent affordable housing developments, including a court decision that could have state housing finance agencies all over the country reviewing their policies for allocating low income housing tax credits to rental developments and the locations of those developments.

The Great Recession emphasized the need for affordable rental housing in our communities. Yet, the collapse of the credit market made it impossible for developers to obtain the private financing necessary to build and preserve affordable housing. The low income housing tax credit ("LIHTC"), which has been the nation's primary affordable housing finance tool for almost 25 years, failed to generate equity capital, and lenders were reluctant to provide debt. A backlog of proposed projects grew until the American Recovery and Reinvestment Act ("ARRA") provided critical stimulus funds. Developers used the ARRA Tax Credit Assistance Program and the Tax Credit Exchange Program to replace private equity funds that had been lost and to fill financing gaps; billions of dollars worth of funding closed in 2010. During the hiatus, the capital markets for affordable rental housing retooled themselves. With the ARRA funds expiring (although renewal of the Tax Credit Exchange Program remains on the table, which would provide an additional source of funds), we are expecting the LIHTC investors and lenders to be providing financing again in 2011.

Equity derived from LIHTCs should be more plentiful in 2011. LIHTC syndicators have attracted new investors. Some of these investors, such as Google, are not driven by the Community Reinvestment Act ("CRA"), unlike the financial institutions that have historically dominated the market. This should make it easier for developers to find equity financing in secondary and rural markets that CRA investors traditionally avoid. Furthermore, new LIHTC syndication firms have formed. With a significant amount of equity capital entering the market, LIHTC prices have increased while rates of return have decreased below double digits. Pricing is somewhat volatile; a wide range of pricing can be found, depending on the location of the development and the strength and experience of the developer. Underwriting will be more stringent, emphasizing longer and stronger guaranty requirements and developers with positive track records. The National Association of Home Builders estimates that 55,000 residential units will be produced us-

*Cynthia Bast, a partner with the national law firm of Locke Lord Bissell & Liddell, heads the firm's Affordable Housing section and works out of the firm's office in Austin, TX. Rick Morrow, also a partner with the firm in its Austin office, represents for-profit and non-profit developers in connection with the acquisition, development, financing and management of affordable housing. The authors can be reached at cbast@lockelord.com and rmorrow@lockelord.com, respectively.

ing LIHTCs in 2011, a 17% increase from 2010.

There are positive factors for debt financing in 2011 as the yield on 10-Year Treasury Notes remains historically low. However, CRA will continue to be a factor in connection with providing construction debt for affordable housing. Although not as readily available in secondary and rural markets, banks should continue to lend for urban transactions in order to satisfy CRA requirements.

For permanent financing, Fannie Mae and Freddie Mac have worked to implement constructive changes. When sizing loans, Freddie Mac is permitting the use of above-market Section 8 rents for properties with long term Section 8 contracts and loan terms of at least 10 years. Moreover, Freddie Mac should be able to provide lower rates on preservation deals as it continues to offer immediate fundings through its securitized Capital Markets Execution Program. In an effort to increase efficiency and nation-wide consistency, including underwriting, Fannie Mae has taken steps to centralize its operations. FHA continues to be an attractive alternative.

In addition to changing its underwriting criteria in the 221(d)(4) and 223(f) Programs to make them more favorable to affordable transactions, FHA is expanding the 223(f) Program to provide greater rehabilitation dollars per unit. A small uptick in tax-exempt bond financing was seen near the end of 2010, and bond financing may grow in 2011. Under the New Issue Bond Program, state and local housing finance agencies are able to offer low rate debt on fixed-rate bond transactions, creating financing opportunities that were not available in recent years. Of course much could change if the federal government acts on any of the proposals offered by the Administration related to the possible phasing out of Fannie Mae and Freddie Mac.

Underwriting standards, which tightened substantially over the past few years, will likely continue to favor established developers. Conventional lenders have indicated that they are not only placing increased value on the past performance of their prospective developer clients, but also on the projected future strength of their existing developments in a sometimes volatile market. In order to gain additional comfort, more and more lenders are requiring the inclusion of liquidity standards that have not been seen in past years. In addition, it has been projected that interest rate floors for construction loans, and higher rates on forward commitments, will likely continue, requiring an increased dependence of gap financing. Some sources of gap financing are Community Development Block Grants, HOME Loans, other local sources, like housing trust funds, and tax abatements and exemptions.

With an increased availability of capital for affordable housing in 2011, we are looking for a "new" normal. We hope this looks a lot like the "old" normal, but with stricter underwriting standards. At the same time, we must look beyond 2011 to assure the long term stability of private financing for affordable housing, including the LIHTC. The recently published Report of the National Commission on Fiscal Responsibility and Reform recommends a dramatic overhaul of the federal income tax system, which would eliminate LIHTCs. Although the report failed to achieve the super majority vote required to make it a recommendation to Congress, it has received some bipartisan support and sparked national dialogue. Current thought from Washington, D.C. is that tax reform may not take a front burner until 2012. Until then, the affordable housing industry must continue educating the public to preserve and protect this important funding source.

LIHTC Allocation and Fair Housing

A recent court decision in Texas could have state housing finance agencies all over the country reviewing their policies for allocating low income housing tax credits to rental developments and the locations of those developments. In *Inclusive Communities Project, Inc. v. Texas Department of Housing and Community Affairs,*[1] the court found that the plaintiff had established prima facie evidence that the defendant had allocated tax credits in the Dallas area in such a way as to have a discriminatory impact.

The plaintiff in this case is a non-profit organization that works with African-American families who have rental subsidy vouchers to find housing in suburban areas that are predominantly Caucasian. The plaintiff showed that it is easier to place these families in properties financed with low income housing tax credits than in other kinds of properties. Yet, Inclusive Communities claimed that there were few tax credit units available in suburban areas and charged that the Texas Department of Housing and Community Affairs ("TDHCA") had allocated tax credits to properties in mostly minority areas, in violation of the Fair Housing Act and the Equal Protection Clause of the 14th Amendment.

As the allocating agency for housing tax credits, TDHCA administers the allocation of the credits to developers who have selected the sites and proposed the details of the development. TDHCA is required by federal law (I.R.C. § 42) to establish a qualified allocation plan (a QAP), which outlines the procedures and priorities by which tax credits will be awarded. The QAP must include a preference for allocating tax credits to properties that serve the lowest income tenants and are located in census tracts with higher poverty rates. Under Texas state law, the QAP is required to include additional preferences.

Inclusive Communities showed the court that, between 1999 and 2008, TDHCA awarded tax credits in the Dallas area such that 70.2% of the tax credits for properties designated for elderly tenants went to census tracts that were more than 90% Caucasian, while only 34.7% of the tax credits for properties designated for families went to census tracts that were more than 90% Caucasian. Considering motions for summary judgment, burdens of proof, and other procedural matters, the court held that these statistics were sufficient prima facie evidence that TDHCA's allocation of tax credits during that timeframe had a discriminatory effect.

This case makes a significant statement as to the obligations of a state housing finance agency when allocating tax credits. It indicates that a state housing finance agency should balance its responsibility under federal law to serve the most impoverished areas with its responsibility under the Fair Housing Act and the Equal Protection Clause to ensure that the award of tax credits does not have a discriminatory effect. The case is far from over—with motions for summary judgment decided, the litigation heads to trial on certain key questions. However, it has garnered significant attention and could have all state housing finance agencies and state legislatures reviewing their tax credit allocation policies and results in 2011.

National Housing Trust Fund and Proposed Rules

A $1 billion appropriation authorized by the Housing and Economic Recovery Act of 2008 is currently pending in Congress that would establish the National Housing Trust Fund ("NHTF"), providing deeply rent skewed affordable housing with a critical layer of capital financing. HUD recently published the proposed rules that would implement NHTF, setting forth a "menu of production programs" that would become a part of and share many of the same rules as the existing HOME Program.

In an effort to address the problems inherent in deeply skewed transactions, the proposed NHTF rules require the allocation of 80% of the funds to rental housing, which can be in the form of a grant, a loan or an equity investment, with an emphasis on extremely low income families. At least 75% of the funds must benefit families with extremely low incomes below 30% of the area median ("ELI"), and the remaining funds must benefit families with very low incomes below 50% of the median area income ("VLI"); however, in the first year of the NHTF Program, 100% of the funds must be allocated to ELI families.

Other key elements of the proposed program include:

- Affordability restrictions must be in effect for at least 30 years, although the applicable granting jurisdiction may establish a longer period;

- Eligible costs (each with some limitations) include acquisition, relocation and operating costs; development hard costs; financing and development soft costs; and costs of refinancing existing debt that is coupled with rehabilitation;

- No more than 10% of a jurisdiction's annual grant may be used for homeownership activities;

- A project may have HTF-assisted units and non-HTF-assisted units and/or public housing units, provided HTF funds are only used for the HTF units; and

- The NHTF dollars must be committed within 24 months to subgrantees that will begin construction or rehabilitation within 12 months.

Those are but a few of the provisions of the still evolving proposed rules. Once finalized, the challenge will be to move the bill through Appropriations in a Congress that looks much different in 2011 than it did in 2010, and which might not give affordable housing the priority it has received in the past.

NOTES:

[1] *Inclusive Communities Project, Inc. v. Texas Dept. of Housing and Community Affairs*, 2010 WL 3766714 (N.D. Tex. 2010).