FINANCE

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AFFORDABLE HOUSING FINANCE

More States Feel the Squeeze for Bonds

Developers face increasing competition for bonds in several states.

By Donna Kimura

In a growing number of states, the demand for critical private-activity bonds (PABs) is outpacing supply. This is quickly becoming a serious issue for developers who rely on these tax-exempt bonds to help finance the construction or preservation of affordable housing. Nationally, the issuance of multifamily bonds has more than doubled from about $7 billion in 2015 to over $14 billion in 2018, creating a more competitive arena, according to the Council of Development Finance Agencies.

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The number of states hitting their caps could rise from the seven to eight seen in recent years past to 10 to 15 in 2020, estimates Wade Norris, a multifamily housing bond attorney at the Washington, D.C.–based firm of Norris George & Ostrow.

Demand for PAB volume has exceeded supply in Connecticut, Massachusetts, Minnesota, New York, and Washington state for a number of years. California, Colorado, Georgia, Hawaii, Nevada, Oregon, Tennessee, Texas, and D.C. are some of the jurisdictions where demand is surpassing or nearing the limits, according to bond experts.

This troubling trend is new territory for affordable housing developers and many state housing finance agencies that oversee PABs.

"Since 2001, there's been more than enough volume in most states," Norris says. "Most states were getting more volume than they were using."

And, if a state does not utilize all of its bond volume, it can carry the volume forward for three years. This allows states to stockpile their unused bond volume to use in the future. "Until recently, the vast majority of states had plenty of annual volume and carryforward volume, so volume has not been an issue," Norris says.

Now, more states have begun to eat through their carryforward, becoming volume limited.

"Unless we have a big recession or another event that cuts demand, I would anticipate that an increasing number of states will become competitive this year and in 2021 and 2022, because these are long-term trends, especially in the high-growth areas that are continuing to put pressure and create more demand than there is supply," Norris says.

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It's come full circle, according to housing bond attorney Kent Neumann, a partner of the Tiber Hudson law firm. He notes that some developers had transitioned their businesses from 9% LIHTC deals, which are extremely limited and competitive, to tax-exempt bond and 4% LIHTC deals to ensure more certainty. Now, it's getting tougher to get bonds—and therefore qualify for the 4% tax credits in many states.

For developers, it's going to mean weighing different options and financing strategies, according to bond attorney Allison King, another partner at Tiber Hudson. Many have deals that are under contract or are looking to put projects under contract with a set time to close. Developers will have to consider what happens if they aren't able to secure tax-exempt bonds in a particular year, according to King. This relatively new uncertainty adds to the many other factors developers in the affordable housing space will need to account for going forward.

Changes in California and Georgia

Each state's PAB volume is the greater of the state population multiplied by $105 or a minimum of $321,775,000 this year. California will receive $4.15 billion of PAB volume in 2020 and has been allocating 85% to 90% of available volume to multifamily housing in recent years. The state has shifted from having excess bond volume to using it all in 2019, and is now about 2-to-1 oversubscribed, according to Norris.

"It has gone from being not an issue in a year-and-a-half to being a very serious issue," he says. "The first questions that a developer in California has to ask now are the following: Is my project [the right] type? (New construction versus acquisition/rehab is presently favored due to state subsidies tied to new construction.) And can I score high enough to get an allocation of PAB volume if I want to do an affordable rental housing project."

For the first time in years, there's far more demand for bon allocation than there is supply, requiring the California Debt Limit Allocation Committee (CDLAC), chaired by state Treasurer Fiona Ma, to use its competitive scoring system to award allocations, said the Treasurer's Office.

"A demand survey from last year found there is demand for $10.5 billion in tax-exempt bonds, while the cap is $4.148 billion," said the office, noting the reasons for this include Ma's focus on financing low-income housing and an additional $500 million in state housing tax credits allocated for low-income housing this year, which will be paired with 4% credits.

At its Jan. 15 meeting, the CDLAC board made preliminary allocations of 84% of the total 2020 cap to multifamily housing, which amounts to $3.48 billion. It also added $207 million of "on hold" cap, raising the total to $3.687 billion.

The agency is considering several changes, including increasing the per unit bond allocation cap and updating scoring categories to support state initiatives to increase affordable housing.

In February, the Georgia Department of Community Affairs (DCA) announced that the current 4% bond pre-applications in the underwriting pipeline exceed its 2020 bond cap. The agency's cap has become fully subscribed for the first time in at least 20 years. By the end of 2019, the DCA had received 67 pre-applications for 4% credits, most of which were under review and had not booked their bond allocations.

A strong economy, low interest rates, increased demand for Rental Assistance Demonstration conversions, and favorable LIHTC prices have increased 4% LIHTC applications, according to the agency.

As a result of the recent crunch, the DCA said it is closing future bond application submissions and will be working with the development community to form strategies for 2021.

It's key to watch the rate at which a state uses its PAB volume versus its annual allocation, Norris says, explaining that once the utilization begins to exceed the annual volume, states can quickly exhaust their carryforward and become volume limited.

What's Next

PAB volume allocators, issuers, and others are looking at different strategies to try to address this growing problem. Many states often direct a large portion of their bond volume to multifamily housing, but they also use the bonds for single-family housing and select other uses. There's a possibility that such a state can direct more of its total PAB volume toward multifamily rental housing and away from other uses, Norris says, adding that developers should also be alert to other competing uses that could divert bond volume away from multifamily housing.

For example, in California, a recent proposal emerged for $1.25 billion of bond volume (30% of the 2020 allocation) to fund a desalinization plant, which, at least for now, has been delayed.

The tax code requires that at least 50% of aggregate basis in the project be financed with tax-exempt PABs to qualify for 4% LIHTCs. This is known as the 50% test. In some cases, especially in high-cost markets, developers may be using more volume cap than needed to meet this requirement. A number of states facing a volume shortage have begun to limit the PAB volume allocated to a project to between 53% and 55% of tax credit basis—in other words, enough to qualify for the 4% LIHTC and leave a little cushion. "One doesn't want to cut it down to 50% and come up short of 50% if cost increases raise tax credit basis, thus coming in at less than 50% and then lose the credits," Norris says.

If permanent debt is above the tax-exempt allocation, a portion of the bond issue, often not more than 10% to 15%, may be issued as taxable bonds. These "taxable tails" will reduce the amount of tax-exempt bonds needed but still allow the project to be feasible.

On large mixed-income projects in urban areas (most often deals where 20% of the units are affordable at 50% of the area median income, and the balance are market-rate units), some volume-starved states like New York have begun requiring developers to treat the affordable units as a separate 100% affordable project and will allocate PABs only for those units, according to Norris.

Using condo or master-lease structures on mixed-income deals to bifurcate the affordable units from the market units, thereby reducing the amount of volume cap needed to meet the 50% test on the affordable project, is one strategy, King agrees. Others include ensuring any unused volume cap is carried forward for following years (up to three years maximum) and forward allocating volume cap into the following calendar year. Some states have also started a scoring or merit-based award program for tax-exempt bond volume cap—similar to what is used for 9% tax credit deals.

One example where several of the above ideas were implemented was on a mixed-income deal, which King and Neumann worked on, that was initially submitted to the District of Columbia Housing Finance Agency (DCHFA) requesting over $100 million in new PAB volume cap. After collaborating with DCHFA and the various finance partners, a structure was created to set up two separate air-rights assessment and taxation lots —one for affordable units and the other for market-rate units—which reduced eligible basis for the affordable component and resulted in an allocation of less than $20 million in new volume cap (which was carried over from a prior year). The developer was still able to get favorable underwriting terms on the market-rate component with very limited impact to the overall cost of the financing, King says.

A partial solution in some states is a bond volume recycling program. Massachusetts, New York, Colorado, and Washington state have established a bond volume recycling program, where bonds that have been paid off before maturity can be used for other projects. California and other states are developing such a program. Unfortunately, a recycling program is complicated to set up and administer, and there are substantial limitations under current law.

The Affordable Housing Credit Improvement Act of 2019, which has good bipartisan support but has not yet been passed, includes provisions to greatly expand the opportunities for recycling bonds. The biggest one is to allow multifamily housing bond volume to be recycled for single-family housing projects, which would then free up new PAB volume for multifamily housing.

The bill also calls for locking in the 4% LIHTC credit rate, which would increase the value of the credit by about 20%. That will help plug financing gaps in affordable housing deals, but it could also increase the use and demand for PABs.

The increasing scarcity of PAB volume has also led industry leaders to begin looking at the possibility of reducing the 50% test to a lower amount, possibly 30% or 40%, to help spread the bonds and 4% LIHTCs to more projects. "This change," says Norris, "would have the largest positive impact on providing more units but can only be made through legislation at the federal level."

It may be one of the most promising ideas, but it could thus take the longest to put in place, he says.

Affordable housing development has always been one of the more complex areas of the real estate industry with many moving parts to which developers have become accustomed. “This relatively new phenomenon of limited tax-exempt volume cap is likely to become the norm under the current market conditions, so it is also important for developers to add this potential variable to their list of due diligence and stay informed about what’s happening in their states and stay in touch with bond professionals who have their ears to the ground and understand the lay of the land,” Neumann says.

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