UPDATE:

THE STATE OF PUBLIC HOUSING FINANCING

BY ROD SOLOMON

Increasingly, public housing authorities (PHAs) are turning to capital markets to finance public housing improvements. If they are to fulfill their mission of offering decent conditions to public housing families, many PHAs have little choice. A consultant study published by HUD in 2000 reported a $21.6 billion unfunded backlog of public housing capital as of 1998, and about $2 billion annually resulting from the depreciation of the 1.2 million-unit public housing stock. Last year's annual appropriation for public housing capital needs was under $3 billion, enough only to cover ongoing needs and make the smallest dent in the backlog. Capital financing is a way to address this problem.

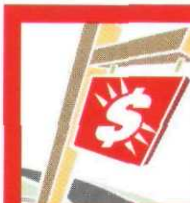
In last year's September/October issue of the *Journal,* I reviewed the history of public housing capital financing. The Quality Housing and Work Responsibility Act of 1998 (QHWRA) specifically authorized the use of public housing capital funds for such financings. By the summer of 2003, HUD had approved approximately $600 million in bonds and loans financed with this funding source. PHAs typically pledge their capital funds for up to 20 years to repay the bonds or loans. Because the only source of repayment is the capital fund, and annual capital fund amounts are subject to appropriations, the bond rating agencies and individual lenders generally have insisted on debt service coverage ratios of at least 3 to 1. In other words, if a PHA's annual capital fund grant were $3 million, it could not pledge more than $1 million annually to repay the bonds or loans. Depending on market interest rates and other variables, such a pledged amount might raise about $13 million.

Events of the Past Year

The capital fund effort has continued and expanded. By the end of May 2004, HUD had approved over $1.5 billion in the loans for the Capital Fund Financing Program (CFFP), its new HUD name. The $900 million in additional approvals since June 2003, however, were concentrated in three transactions: New Orleans ($86 million); Puerto Rico ($693 million); and a five-PHA Maryland pool ($90 million). HUD also approved five other transactions, for far smaller amounts, during that time period.

Each of the large transactions represents important innovations. The Puerto Rico transaction is so large that it is a substantial public housing initiative in itself. In recognition of this and manage-ment problems during prior administrations at the PHA, HUD required the PHA to obtain separate financing from another government entity (the Puerto Rico Government Development Bank) for any work not completed on time and on budget. The Maryland pool is the first approved transaction in which the state housing finance agency (HFA) is the bond issuer and lends the bond proceeds to individual PHAs. This will allow small PHAs, for which financing otherwise would be inefficient because of transaction costs, to participate in the bond market. The New Orleans transaction featured the use of 4% tax credits to raise additional funding for the PHA's needs, following a model used by the Philadelphia PHA a year earlier. This was accomplished through a loan of the capital fund proceeds to a limited partnership that invested both loan proceeds and the tax credit equity in the public housing. The PHA had obtained tax-exempt bond volume cap and thus the ability to issue "private activity bonds," which can generate 4% tax credits. (Note, however, that the use of bonds and 4% tax credits requires a mixed-finance structure, under which the PHA gives up some degree of ownership and control to private sector participants. As such, it may not be suitable for all PHAs and all developments.)

The list of transactions yet to be approved also reflects interesting trends. Some of the pooled transactions are sponsored by state HFAs; others use an alternative model in which PHAs market a bond issue either acting through a non-profit created to administer the issue or through a lead PHA. The alternative model was pioneered last year, by a 37-member Alabama pool. In addition, some large financial institutions are becoming involved



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directly in making or purchasing loans, including Bank of America (which participated in the very first capital fund loan to the Washington, D.C. PHA), Fannie Mae (which also participated in the Washington, D.C. loan and is intending to offer direct loans to PHAs) and Wachovia Bank (which is involved in an individual bank loan). These entities and others are developing means of bringing the program economically to small PHAs.

The HUD approval process is still evolving. Currently, three program staff members - one of whom has substantial other responsibilities - are devoted to the approval effort. Two attorneys also service the program on a part-time basis. There are also no applicable regulations, though QHWRA was enacted almost six years ago. This year, HUD created a helpful "term sheet" that it provides to prospective CFFP participants - this sheet is, however, "subject to change without notice." More substantively, HUD has continued or added various requirements, including an independent management assessment of the PHA, a "fairness opinion" indicating that the terms and conditions of the bonds or loans and related fees are reasonable, and in some insistences a "physical needs assessment" designed to indicate that the use of capital funds for debt service is reasonable in view of other capital needs of a PHA that would not be addressed by the borrowing. These requirements, coupled with inherent transactional expenses such as the need for a legal opinion that the bonds or loans are tax-exempt, as well as the process of obtaining HUD approval, can require considerable effort and expense, especially for small PHAs.

Alternatives to CFFP

The CFFP is a powerful financing tool, but it differs from all other real estate borrowing in an important respect: it does not take advantage of the underlying value of the property. Real estate borrowings are typically secured by a mortgage on the property and underwritten based on projected rents. This approach depends upon a predictable rent/cash flow stream to support the debt, and exposes a property to foreclosure if the development fails. But it can also result in borrowings almost twice as large as CFFP borrowings relative to the annual capital funding available to a property. This can occur because the pledge of the property results in a dramatic reduction in required debt service coverage. For a small PHA whose CFFP borrowing is very restrained by its small annual capital grant, or for a relatively small PHA with an extensive capital backlog and the capability to address it, this difference could be very important. Property-based financings, including the mortgaging of the property, also demand much more management accountability, in order to ensure that the property's management expenses over time (including a capital replacement reserve) will result in the continuing success of the development with use of available funds.

In recognition of such advantages, in its fiscal 2003 and 2004, the administration proposed the Public Housing Reinvestment Initiative (PHRI). PHRI would allow PHAs to convert public housing operating and capital subsidies to project-based vouchers and then borrow against the property like other Section 8 owners with project-based contracts on a voluntary, development-by-development basis. The initiative would also include a partial federal loan guarantee, in order to facilitate lending. While this is a very promising approach, both for leveraging additional capital and provision of built-in management discipline, the

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administration is unfortunately not pursuing the PHRI in its proposed fiscal 2005 budget.

HUD could achieve some of the advantages of PHRI through its ability to approve mortgaging of public housing under current law (Section 30 of the United States Housing Act). This approach would not have some of the advantages of PHRI, including lender familiarity with Section 8 and other funding and regulatory advantages, but it would capitalize on underlying property values. Despite the strong advocacy for this approach by the Assistant Secretary for Public and Indian Housing, however, HUD has approved only two such transactions. To make such an initiative effective, HUD would need to issue guidelines explaining how to use public housing subsidies in this manner and enabling them to operate like Section 8 to support debt service; provide regulatory clarifications, and make the policy determination of the circumstances under which HUD will allow property no longer to be used as public housing if a foreclosure is necessary.

Prospects for the Future

The CFFP has shown itself to be a valuable means of enabling PHAs to access additional capital for public housing. The refinements developing over the past year, including use of 4% tax credits and bond pools as well as direct loans that can reach smaller PHAs, promise to increase CFFP's usefulness. HUD should address the processing bottleneck by some combination of a reconsideration of some of its requirements, delegation of aspects of the approvals to other entities with appropriate means of addressing the risks of such delegations, and/or additional staffing or contracting assistance.

Property-based financing has great potential, and a move in this direction would be consistent with changes coming in the administration of the public housing operating fund that will emphasize property-based management. But a number of steps are needed to get from here to there. These should include the enactment of the PHRI, as well as HUD-issued guidelines targeted toward making this property-based borrowing a workable option in the public housing program. Recently, a diverse group including several PHAs, an HFA, the National Housing Conference and the Bank of America wrote a letter to the agency, encouraging consideration of some of these changes.

The further improvement of CFFP and the development of such alternatives should be a high priority. Progress on these fronts will result directly in improved housing for more public housing-eligible families. ■