

HOUSING BOND REPORT

A MONTHLY PUBLICATION ON THE LOW-INCOME HOUSING TAX-EXEMPT BOND INDUSTRY

May 2002, Volume V, Issue V, Published By Novogradac & Company LLP

Tax Credit Investors Face Shrinking Surety Bond Market

By Alex Ruiz, Staff Writer, Novogradac & Company LLP

Following the economic downturn, terrorist attacks and collapse of Enron in 2001, the surety bond market – an already unfamiliar and tricky topic for many – is shrinking, and poses even more challenges for tax credit investors.

Surety Bond Basics

Surety bonds are tools that investors and syndicators can use when faced with recapture triggered by a transfer or sale of low-income housing tax credits (LIHCs). Under section 42(j)(6) of the Internal Revenue Code, taxpayers who dispose of a qualified low-income building or interest can avoid recapture by posting bonds or treasuries for the remainder of the property's compliance period, plus 58 months.

In Revenue Rulings 90-60 and 90-67, the Internal Revenue Service (IRS) provides guidance to taxpayers for posting security bonds, including the use of monthly bond factor amounts, which are published quarterly by the IRS. Bond factor amounts are used to calculate the size of the bond that taxpayers are required to post, depending on when the property came in to service and when it was sold.

Based on that amount, taxpayers must post a bond securing their liability for the credit recapture. IRC section 42(j)(6) requires that the taxpayer's obligation be secured by surety, which acts like a guarantor for the bond.

One-Third Is Never Enough

A common misconception, according to Rosemary Byrne, president of BHI Brokerage Services Inc., is that taxpayers are only obligated for one-third of the total credit amount when posting a surety. In fact, the amount of the bond equals one-third of the credits plus interest.

"It's never just a just a third, sometimes it's more than 100 percent," Byrne says. "As interest rates fall, the factor is less, but it is sometimes a very big number."

This reality often surprises smaller investors, who are largely unfamiliar with the process. "It's a ripple in the process that no one really knows about

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BRIEFS & RESOURCES

Moody's Investors Service last month assigned a rating of A1 to the \$89 million Massachusetts Housing Finance Agency's Housing Project Revenue Bonds 2002 Series A. The Housing Project Revenue Bond Program is secured primarily by the U.S. Department of Housing and Urban Development's (HUD) Section 8 and 236 subsidies, as well as a subsidy provided by the Commonwealth of Massachusetts.

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until it comes around and smacks them in the face because it's a part of the business that you are never otherwise involved in," she says.

Market Trends – Fewer, Smaller, Shorter

The surety bond market is currently undergoing considerable change, due to several factors not related to Section 42 issues. Some of the resulting changes, however, have potential to have a significant effect on LIHC investors.

First, the market is shrinking. Billions of dollars worth of exposure following the September 11 terrorist attacks and collapse of Enron have caused the market contraction. In general, Byrne says, sureties are writing fewer and smaller bonds and prices are rising.

Second, sureties are considering ways to minimize their existing exposure by examining the size of the bonds they've issued, the amount of exposure to one particular company or interest and the length of their commitments. This last criterion – the length of commitment – is often the most significant challenge for tax credit investors.

What That Means For LIHC Investors

The trend to minimize exposure poses complications primarily because the IRS requires that tax credit surety bonds must be issued for the remainder of a property's compliance period plus 58 months, a relatively long time in the surety market. "Fifteen years, and the volatility you can find in that time is a very difficult thing to underwrite. Sureties realize that is very long exposure; they don't want to be on the hook for that long," Byrne says.

As sureties reassess their exposure, they may ask clients to provide collateral for bonds that have been issued already, or to find another surety to secure part or all of a bond. In some cases, buyers have been allowed to provide backup credit, and act as a kind of co-signer, Byrne says. This may provide some relief for smaller investors, those that don't have a reputable balance sheet or those that are not a rated corporation.

The IRS is not prepared to deal with the difficult situation that taxpayers, particularly smaller investors, face in today's surety market. Rather, says Byrne, "The IRS is encouraging sureties to be more involved with Section 42 bonds because they consider it virtually risk-free, they think it's easy money," she says. Sureties however, are less and less willing to take on the long-term risk involved with LIHCs.

Because of this conflict, BHI Brokerage Services Inc. encourages sureties to widen their scope when evaluating a Section 42 surety bond issue. "We're trying to convince them to not just look at the credit worthiness of the

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ISSN 1536-6847

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taxpayer, but to look at the deal," she says. "What's the likelihood that there will ever be a recapture event? The credit risk of the seller may be a jumping off point, but the great equalizer is the strength of the deal and the risk of recapture. We encourage sureties to look at the buyer, since their interest is aligned with the surety's interest: to avoid recapture."