

COMMENTARY**State of Affordable Housing Debt Markets**

By Timothy R. Leonhard, MMA Financial

The capital markets have seen tremendous turmoil in a relatively short period of time. Between August of 2007 and December 2007 a variety of events occurred leading to this turmoil; primarily the implosion of the sub-prime market paved the way to a severe shortage of liquidity and significant tightening of credit standards throughout the financial industry. The liquidity shortage and tightening of credit standards led to a crash in the auction rate, municipal bond, and CMBS markets and a dramatic widening of spreads throughout the financial industry. This “perfect storm” led to a variety of liquidity challenges throughout the financial industry, which affected the affordable housing arena in a negative way.

Since 1998 and throughout the first half of 2007, a wide variety of debt financing tools existed that could be used to finance the two major types of affordable housing: 9 percent low-income housing tax credit (LIHTC) transactions and tax-exempt bond financed assets utilizing 4 percent LIHTCs. Government sponsored entities (GSEs) Freddie Mac and Fannie Mae, which had always been at the forefront of financing affordable housing, faced fierce competition from both national and regional banks, publicly held financial institutions, life companies and conduits, and state housing finance agencies (HFA) that implemented their own proprietary lending programs.

In August of 2007, the sub-prime meltdown created a liquidity shortage that resulted in the tightening of credit standards. This trend not only continued but worsened in 2008. Some financial experts fear that we have yet to see the bottom. This shortage of liquidity has led to a dramatic increase in the cost of capital throughout the finance industry. Faced with this dilemma, many participants exited the affordable housing industry, including the majority of

regional banks, life companies, private placement bond purchasers and conduits. In addition, a significant number of national banks have either left the industry or increased their spreads significantly. Freddie Mac and Fannie Mae have maintained their commitment to affordable housing but have been forced to increase their spreads rather dramatically as is outlined in the following chart.

Although the above spreads have increased substantially, there was some positive activity in the interest rate market from July of 2007 through July of 2008. For example, on a newly constructed 9 percent LIHTC transaction, the spreads increased in excess of 1.2 percent but the corresponding 10-year Treasury rate decreased by approximately 1.3 percent, keeping the effective net rate basically the same at 6.9 percent. This rate represents a 30-month forward with an 18-year term and 35-year amortization.

On tax-exempt bond financed assets the picture is slightly different. The liquidity shortage has caused virtually all private placement lenders to either exit the market or at a minimum increase rates by 100 to 125 basis points. The market for credit enhanced fixed-rate bonds has seen a similar increase in rates. The prevailing rate for a private placement bond or credit enhanced fixed-rate bond with 18-year terms with a 35- to 40-year amortization period is in the 6 percent to 6.5 percent range. Currently, the most effective way to execute a tax-exempt bond financed transaction is through the issuance of credit enhanced variable rate bonds with an interest rate swap enhanced through a GSE execution or alternate credit enhancement. The all-in interest rate savings is in excess of 125 basis points on an 18-year term swap as compared to a private placement or fixed-rate bond execution. This reduction in the all-in rate provides substantially higher loan proceeds and improved

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deal feasibility. Given the significant reduction that occurred in the pricing of low-income housing tax credits, every dollar counts when structuring affordable housing debt transactions.

The current outlook for the affordable housing debt market appears to be fairly stable, albeit with fewer participants, primarily the GSEs and CRA-motivated banks that continue their commitment to affordable housing finance. I would anticipate that the market remains stable for the remainder of 2008 and throughout 2009, with additional participants re-entering the market in 2010 and beyond once the liquidity and credit crisis improves.

Unfortunately, the affordable housing industry in general remains unstable due to instability in the depth of the market and pricing for LIHTC, which threatens the

viability of numerous affordable housing developments. A variety of factors will have to materialize in order to stabilize the LIHTC market including legislative changes in Washington, an upward adjustment in LIHTC investment yields to attract new investors to the market, and a variety of fixes at the HFA, local and state levels, including an increase in the amount of tax credits allocated to an individual project and the availability of subordinate financing and other types of housing subsidies. ❖

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