

Housing Finance Agencies: Current Appraisal And Future Prospects

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State governments have recently been increasing their efforts in the housing field in response to both the serious shortage of housing for low income families, and the mounting construction costs that threaten to price even the more affluent families out of the housing market. The major expression of such state concern has been the creation of housing finance agencies (HFA's) — state agencies charged with the responsibility to increase the supply of low and moderate income housing within their respective states. The purpose of this article is to examine the functions of HFA's, evaluate their performance and appraise their future potential.

The Functions of Housing Finance Agencies

Although the goal of all HFA's is to increase the supply of affordable housing, there is a great deal of variation in the scope and methods states have chosen to accomplish this goal. In this re-

gard, we can isolate three distinct functions of HFA's:

Direct Finance

Most housing finance agencies make temporary, short-term construction loans and permanent financing directly available to non-profit and limited profit developers through the sale of HFA bonds and notes. Because these securities are exempt from federal income taxation, HFA's hope to improve housing's competitive position in the long term financial markets by attracting funds from both institutional and individual investors who deal primarily in tax exempt issues, but not in residential mortgages (Stegman, 1974). Such funding obtained at below-market rates of interest can then be loaned to finance housing construction at less than prevailing market rates on short-term construction loans and long-term mortgages, a savings which can be passed on to the home buyer and tenant. The bondholders, in turn, are paid from the repayment of mortgage loans placed by the agency. Thirty-nine states are currently authorized to underwrite such direct mortgage lending operations (Lincoln, 1974; Blew, Poorvu and Stevenson, 1977).

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Secondary Mortgage Market Operations

Although mortgage lending is the core function of HFA's, this is not their sole function. Many state housing agencies are also authorized to engage in secondary mortgage market operations. These programs are intended to encourage the construction of additional housing for families of moderate means through the purchase of outstanding mortgage paper originated by institutional lenders, thereby releasing funds for additional loans. Generally, such mortgage paper is purchased by HFA's with the stipulation that the proceeds be reloaned to finance state-approved housing projects. These operations are comparable on a smaller scale to the secondary market activities of such federal and quasi-governmental agencies as the Government National Mortgage Association and the Federal National Mortgage Association, which use the proceeds from the sale of long-term bonds to purchase outstanding mortgage loans. Private lenders are encouraged to participate in these state programs because of the increased liquidity afforded their loan portfolios by an active secondary market.

A variation to this approach is the "loan to lenders" program, whereby HFAs use the funds obtained from the sale of state agency securities to make direct loans to private institutional lenders. These lenders, in turn, agree to make loans for single and multi-family housing in low and moderate income neighborhoods under state agency supervision and usually at preferential interest rates (Alexander, 1975).

Finance Ancillary Services

Less ambitious, but possibly just as important, many state HFA's have been designed and initiated to supplement the various federally sponsored housing and urban development projects. To finance ancillary services such as planning and architectural design, land use studies, and start up costs of developers, HFA's have established revolving funds. These are separate accounts into which are deposited the proceeds from the sale of

revenue bonds and the payments to principal and interest from mortgage loans placed by the agency. In general, these accounts are capitalized by the issuance of short term notes, grants and/or specific state appropriations. The funds deposited into these accounts can then be used to provide seed money to sponsors and developers, as well as for loans to eligible low income families who lack the downpayment for federally subsidized homes and dwelling units (Stegman, 1974; Lincoln, 1974).

Performance and Evaluation

Since their inception in 1960, state housing finance agencies have raised more than \$7.5 billion in the tax exempt bond market, and financed over 285,000 low and moderate income housing units (Hance, 1976; Moody's Bond Survey, January, 1977). Although the latter figure represents only a small fraction of the number of housing units built in the last few years, when it is considered that more than half of these agencies have only been in operation since 1974, this is not an altogether unimpressive track record. The short operational history of HFAs, however, does make it difficult to evaluate the success of these agencies in increasing the stock of adequate housing or forecast their long run effectiveness. In addition, the structure and financial characteristics of individual HFAs exhibit significant variation and these differences can have a bearing on how effectively such agencies perform their stated objectives. With these reservations in mind, however, a number of generalizations and observations can be put forward.

Borrowing Limits

State authorized housing finance agencies should not be expected to substitute for or take the place of federally sponsored and subsidized housing programs. Most states simply do not have the financial, economic, or manpower resources to single-handedly solve their respective housing

problems. Accordingly, they have designed their agencies to supplement and tap into on-going federal housing programs. Most states have set maximum ceilings on HFA indebtedness, with borrowing limits ranging from \$50 million in Maine to over \$5 billion in New York (Stegman, 1975; Alexander, 1975). Typically, the majority of HFAs are constrained to between \$200 million and \$600 million as the upper limits on the amount of indebtedness housing finance agencies are permitted. Although construction costs will vary by location, such funding translates into approximately 2,000 to 2,500 single family housing units for each \$100 million in mortgage lending. (Wall Street Journal, June 13, 1977).

Bond Security

While no state housing agencies may issue general obligation revenue bonds, backed by the full faith and credit of the state, most states have established capital reserve requirements to secure their bonds. The provision of an adequate reserve fund is considered necessary not only to insure marketability, but also to keep borrowing costs at a minimum. In addition, many of the state enabling acts which created HFAs contain moral obligation clauses which commit their respective legislatures to at least consider (authorized but not required) replenishing capital reserve accounts should they fall below specified levels. Although the moral obligation clause does not constitute a binding commitment on the part of the state to replenish reserve accounts should they prove deficient, it has enabled HFAs to market their securities at interest rates below unsecured revenue bonds (Lincoln, 1974). HFAs that provide neither a reserve fund or a moral obligation clause have, typically, experienced greater difficulty in marketing securities and must limit their long term lending to FHA insured and VA guaranteed mortgages in order to maintain investor confidence in their housing bonds. In this case, bondholders are protected from project insolvency and debt default by the cash payment from the

FHA or VA. With the loan to lenders programs, debt security is provided by the recipients of agency loans, who are required to put up FHA or VA mortgages as collateral. In some cases, the collateral requirement can be as high as 120 percent of the loan (Alexander, 1975).

HFAs Must be Self-Supporting

The major factor limiting the ability of HFAs to finance low income housing is the requirement, typical of most states, that HFAs must be self-supporting. For the most part, operating revenues are obtained from loan initiation fees and user charges paid by developers and sponsors, whose projects have been financed by agency funds. Because these agencies must be fiscally solvent, they must, of necessity also be concerned with the soundness and default potential of the projects they underwrite. Consequently, most of the initial projects funded by HFA have been directed at moderate income, suburban housing developments which have proven to be the least susceptible to default. These projects can be adequately financed by HFAs alone, since their below-market rate of interest on HFA mortgages is usually sufficient to put adequate housing within the financial grasp of moderate income families. (Blew, Poorvu, and Stevenson, 1977).

In addition to the benefits derived from the tax exempt status of agency obligations, low income families generally require additional subsidization in order to afford HFA financed housing (Lincoln, 1974). Therefore, many agencies have sought to piggy-back state subsidy programs with federal interest subsidy and rent supplement programs. For example, by contracting directly with HUD for Section 235 single family and Section 236 multi-family interest subsidies under the 1968 Housing Act, HFAs were able to provide mortgage loans at effective interest rates as low as one percent. The sizeable reduction in annual housing costs this combined subsidy program generated permitted families with incomes as low as \$6,600 to obtain HFA-financed housing (Blew, Poorvu

and Stevenson, 1977). With the impounding of housing assistance funds by the 1973 moratorium, however, many HFAs were forced into less satisfactory and often more costly indirect assistance programs to support the housing market, programs which usually provided too shallow a subsidy to effectively reach low income families (Petersen, 1976). Fortunately, the recently increased allocations of Section 8 subsidy funds to HFAs in 1976 may help fill the program void created by the cessation of Section 235 and 236 monies (Petersen, 1976; Blew, Poorvu and Stevenson, 1977).

The Effects of Changing Market Conditions

Aside from the changes taking place in federal housing assistance programs, a topic discussed at greater length in the next section of this paper, HFAs must rely upon the private capital markets for their primary source of funding. Given the recent unstable state and municipal credit situation, caused in part by the continuing New York City financial crisis, the temporary default of New York's Urban Development Corporation and the threatened default of the Pennsylvania Housing Finance Agency in 1975, the marketing of housing agency obligations has become more difficult. In conjunction with growing investor concern over the non-binding nature of the moral obligation clause that secures agency bonds and the increased supply of such obligations that reached the market in the early 1970s, yields on HFA offerings rose dramatically in 1975, approaching 10 percent in some cases (White, 1975). As a consequence, a number of agencies had to cancel, postpone, or reduce the size of their bond issues (Petersen, 1976). Unfortunately, at the same time, the market situation was aggravated by the withdrawal of commercial banks from the tax exempt market. The pull out of commercial banks, the major institutional purchaser of long term state and municipal securities, reflected both growing concern over the quality and liquidity of their investment portfolio and increased availabil-

ity of other tax sheltered investments, such as direct leasing operations and the creation of foreign subsidiaries and branch banks (Renshaw, 1975; Peterson, 1976). To compensate for slack commercial bank demand, HFAs had to offer higher yields in order to attract mutual funds and the more numerous, lower tax bracket, individual investors, buyers who typically are more interested in the higher yielding, taxable corporate and U.S. Government obligations. As a result, not only did HFA interest costs increase, but so did the windfall profits of institutional investors that normally hold tax exempt bonds, even at lower rates of interest.

Although, by 1977, interest rates had fallen and HFA regained access to the capital markets, borrowing costs remained relatively high for many state housing agencies, due in part to greater investor selectivity (Blew, Poorvu and Stevenson, 1977; Moody's Bond Survey, 1977). Whereas, in the past, investors and underwriters relied on the credit ratings of the sponsoring state when evaluating an HFA debt offering, greater attention is now placed upon the long run economic prospects and feasibility of HFA financed projects (Blew, Poorvu and Stevenson, 1977). HFAs engaged in direct mortgage lending, especially for low income, multi-family housing projects, typically face higher interest rates than other agencies involved in indirect assistance programs, such as "loans to lenders," which are perceived as inherently less risky by investors. Perhaps of more long range concern is the growing use of tax exempt bonds for pollution abatement programs, hospital finance, athletic stadiums, and other privately operated facilities. Although the capital market is dynamic and constantly changing, the increased competition for funds will, at least in the near term, prevent interest rates from falling much below current levels. Unless HFAs can keep their borrowing costs to a minimum, however, it is unlikely that these agencies can, through the sale of tax exempt bonds alone, provide a subsidy large enough to encourage construction of affordable housing even for middle income families.

Prospects for the Future

In large measure, the long run viability of housing finance agencies may rest with two provisions of the 1974 Housing and Community Development Act; Section 8, the housing assistance program, and Section 802, the taxable bond option.

Section 8: Housing Assistance Program

The Section 8 program, which became fully operational in 1976, is designed to encourage new construction and subsidize existing housing (Halperin and Brenner, 1976). Unlike the Section 236 program, which Section 8 replaces, subsidy payments are made directly to the tenant, with HUD paying the entire difference between the housing units' operating and financing costs (HUD-determined "fair market rent") and the tenant's rental payment, which can vary from 15 to 25 percent of tenant income (Halperin and Brenner, 1976; Blew, Poorvu and Stevenson, 1977). Under the Section 236 program, although interest costs were subsidized, increased operating costs had to be passed on to tenants, rent increases which, in many cases, low income families were unable to meet, thereby jeopardizing an entire housing project and the bond issue that financed it.

Although Section 8 projects can be financed by conventional mortgage lenders, local housing authorities and FHA insured loans, state housing finance agencies will probably become the major delivery system for Section 8 funds. Not only can FHAs obtain 40-year commitments for housing assistance payments (twice as long as for private sponsors), but HUD has set aside specific grant allocations for HFAs, fund allocations that are expected to increase during President Carter's term in office. The longer term commitment of funds and HFAs lower lending rates should provide developers, sponsors and investors a satisfactory return over the life of an HFA financed housing project, even in the face of inflation and rising operating costs (Halperin and Brenner, 1976). The only qualification to the above assess-

ment is the possibility that if construction and operating expenses continue to increase faster than tenant income, the cost of the Section 8 program could become so great that future fund commitments may be slowed (Blew, Poorvu and Stevenson, 1977).

The Taxable Bond Option

Section 802 of the 1974 Housing Act authorizes federal grants for up to 33.3 percent of the interest payable on housing finance agency bonds which are made subject to federal income taxation. Finally funded in August, 1976, a total grant of \$600 million has been appropriated, and a number of states have already received commitments for part of the \$15 million annual allocation (Federal Register, August 16, 1976). Although the new taxable agency obligations have yet to reach the market because some details of the application procedures have not been finalized, we can, at least to some degree, anticipate the impact of this program on the market and assess its implications for HFAs.

The primary purpose of the taxable bond alternative is to lower the borrowing costs of housing finance agencies by reducing the net effective interest cost of their bonds. We can illustrate how this can be accomplished with a simple numerical example. Assume HFAs were confronted with a bond market in which they could sell taxable bonds for 10 percent and comparable tax exempt obligations for 8 percent. If HFAs were permitted a 33 percent interest subsidy for taxable securities, they would elect to issue taxable bonds, since the net interest cost would only be 6.7 percent of the taxable yield, or 6.7 percent, a savings of more than 1 percent in interest costs.

A second likely result is that interest rates on tax exempt bonds would decline. The reduction in the supply of tax exempt issues, and the consequent lessening of competition for buyers in this segment of the market, would tend to drive down the yields on such securities toward the net effective cost of the taxable bonds; 6.7 percent in the

present example. In the absence of the taxable bond option, there is virtually no limit to the narrowness of the spread between taxable and tax exempt yields (Morris, 1976). With a taxable bond option, however, the subsidy ratio would limit the spread to the point where state agencies would never pay more on a tax exempt issue than the net cost of taxable interest subsidized obligations. Whenever tax exempt obligations could not be absorbed by the market without driving up yields, HFAs could sell taxable securities.

The third effect of the taxable bond option is that it would broaden the market for HFA bonds, a market which is currently closed to many types of institutional investors. Organizations such as retirement and pension funds, charitable, religious and educational institutions and other non-profit investors, although interested in long term investments, are primarily attracted to the higher yielding taxable securities because their income is tax exempt. Taxable HFA bonds with higher yields, however, would be attractive investments for such organizations because of their relatively low risk, and the opportunity they would provide for diversification of investment portfolios (Joint Committee on Internal Revenue Taxation, 1976). This broader investor base would help stabilize the market for HFA securities and reduce rate fluctuations during periods of monetary constraint.

One final consequence of the taxable bond alternative concerns the equity and efficiency of the current method of state and local debt finance. In periods of credit restriction, or when the volume of tax exempt offerings increase and interest rates are rising, the major beneficiaries of the tax exemption, ostensibly designed to reduce borrowing costs of state and municipal governments, are high income investors. A taxable bond option, by reducing both the quantity of and yields on tax exempt obligations, would also reduce the windfall profits of such investors and a larger portion of the tax subsidy would accrue to state and local governments, the intended beneficiary of the tax exemption. Not only would the equity of the fed-

eral income tax be improved, but, in addition, part of the program cost would be recaptured from the taxes paid on that portion of HFA bonds made subject to federal income taxation.

On the opposite side of the ledger, it does not appear that any undesirable market adjustments will result from the taxable bond option. The major objection that has been voiced against such proposals in the past is the fear that the resulting increase in taxable securities would be so sizable that interest costs of the Treasury and corporate borrowers would be driven up. This development is unlikely to occur for two reasons. First, only housing finance and development agencies are presently entitled to issue taxable, interest subsidized bonds. Second, it is quite probable that at least a portion of the taxable HFA bonds will be purchased with funds that would otherwise have gone into the tax exempt segment of the market (Morris, 1976).

Although a detailed appraisal of the taxable bond option and its effects on housing finance agencies is not possible, the scenario depicted above should prove fairly indicative of the market adjustments likely to occur when the program becomes fully operational. Whether and to what extent all of the potential benefits just described will be realized by housing finance agencies, however, is largely dependent upon the final structure of the taxable bond option. In particular, the precise method of grant allocation, the size of the interest subsidy, whether it is to be fixed or variable, and the type of housing projects that can be financed by taxable agency obligations are provisions yet to be finalized, and are still subject to change.

From the standpoint of housing finance agencies, the taxable bond alternative would prove most efficacious if the subsidy ratio is a fixed and determinate figure, rather than variable and subject to frequent change of program administrators. Frequent changes in the size of the subsidy could have a destabilizing effect on the financial market, and may inhibit effective, long range financial and developmental planning by housing

finance agencies. Furthermore, the grant allocation procedure should encourage the widest possible program participation and not produce unwarranted competition among HFAs for funding. Such competition could be counterproductive if it worked to bid down subsidy ratios and consequently make taxable agency bonds too expensive to issue. Lastly, eligibility criteria should be broad enough to insure that legitimate agency financed housing projects receive satisfactory subsidization.

Certainly, whatever the final program format, the concept of a taxable bond option is a sound one, and offers housing finance agencies not only lower borrowing costs, but also a wider, more stable capital market for agency obligations. Together with the federal government's already ongoing housing programs, and supported by a viable taxable bond option, housing finance agencies can be useful and effective adjuncts to a comprehensive intergovernmental housing policy, one that can be national in scope and yet tailored to individual state and local housing needs.

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