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The Guru Is In

Financial Shock Absorbers Needed Now

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Pop quiz, hotshot: You're mountain-biking down a virgin trail making great time, when it abruptly turns much steeper and much rockier. Trying to stop now will just launch you headfirst over the handlebars. What do you do?

This problem now confronts Low Income Housing Tax Credit (LIHTC) developers and their allocating agencies, as the disruption of global transoceanic supply chains spikes construction materials prices – lumber up 40 percent, overall residential build costs up 12 to 13 percent year-to-date. Such spikes will bust anybody's underwriting, possibly tossing us back into turmoil not seen since those happy fun times of 2008-9.

Back then, the preceding decade and a half of rising prices and falling rates had lulled developers and allocators into a smug sense of mutual superiority. The sudden implosion of Fannie Mae and Freddie Mac and the ensuing 20 percent LIHTC price drop threw our volatility-fragile industry into a tizzy. What ensued was a liquidity-injection bailout embedded in late 2008's American Recovery and Reinvestment Act, with the novel Tax Credit Exchange Program (TCEP) by which developers could turn back their future credits for 85¢ cash on the allocated dollar.

Today, TCEP's gone, LIHTC prices aren't rising any time soon, and the cash portion of development fee is unlikely to be enough. Nor is re-underwriting appealing now.

Any increase in uses means a wider funding gap, reapplication and return to the funding queue, and renegotiation or extension of the existing soft loan commitments. To avoid that teeth-rattling, knee-skinning wipeout, LIHTC mountain bikers barreling downhill need new shock absorbers – quick.

There is a way. It's within the HFAs' control if they cast their minds back to a time before LIHTC.

In 1979, when newly appointed Federal Reserve chairman Paul Volcker decided to break the back of inflation, which would peak at 14 percent in 1980, he did so by tightening the screws on credit. As interest rates shot up, The Department of Housing and Urban Development (HUD) could no longer afford to originate new Section 221(d)④ loans at the theretofore sacrosanct 7.5 percent interest rate. Instead, HUD boosted the interest rate on new loans to 9.75 percent and offered borrowers a subsidy-funded rent boost, the Financing Adjustment Factor (FAF), to cover the increased debt service.

As things turned out, FAF solved HUD's 1981 problem much better than TCEP solved LIHTC's 2009 problem: it was programmed to go down when interest rates did, savings being split 50/50 between HUD and the HFAs. With TCEP, some lucky developers wound up with fully financed properties with no investors. A year later, some allocating agencies awarded 2010 credits based on the depressed 2009 prices instead of the bounce-back 2010 prices, resulting in "windfall" profits and creative developer strategies to camouflage them.

Today's HFAs can improve on the 1981 FAF experience with a new HFA loan product, drawing from these principles:

- *Act quickly to plug the funding gap*, so that deals with firm allocations sign construction contracts, lock materials prices and availability and get going.
- *Avoid reopening the previous underwriting*, which would stall the property, add cost and risk construction costs rising still further.
- *Let each state decide on its own* so that state-level decision-makers can speedily take state-level action.
- *Allow variable loan sizing*, because materials price increases will vary dramatically from state to state, depending on what is home-grown and what is imported from where.
- *Align incentives between developer and allocator,* with both incentivized to ask for a reasonable loan, and both motivated repay it out of operations as quickly as possible.

Let's call it Construction Cost Adjustment Loan Financing (CALF), with these terms:

1. Eligible developer (pending application or committed allocation that have not started construction) chooses whether to apply for a CALF loan.
2. CALF loans equal no more than 110 percent of the documented increase in construction costs as verified by binding general contractor or subcontractor bids/prices.
3. HFAs fund CALF loans on their own balance sheet and hold them in portfolio.
4. CALF loan bears interest at a reasonable rate (say, the state's five-year bond rate) and resets every five years.
5. CALF loan is junior to the hard debt, senior to everything else.
6. Interest and principal is paid from 50 percent of (a) any excess proceeds at cost certification, or (b) available annual cash flow, with the other 50 percent available to pay any Deferred Development Fee.
7. CALF loan matures at Year 15, payable in full – at the HFA's discretion rolled over into a new loan upon an HFA-approved recapitalization.

To developers who say it's a bad idea for them I say, *then don't apply*; and to HFAs who think it's a bad idea for them I say, *remember 2009?*

What do you do, hotshot? As they teach you up front about mountain biking, keep your eyes firmly on the trail ahead, and get your butt off the seat.