NAAHL | National Association of Affordable Housing Lenders

August 15, 2017

Stress Testing Public Welfare Investments

Under the Comprehensive Capital Analysis and Review's (CCAR) severely adverse scenario for banks subject to global trading shock, most public welfare investments (PWIs) in real estate (including affordable rental housing) are assumed to lose 62.9% of their value, except for a 2% loss rate for most tax credit investments.[1] While this loss rate may be appropriate for luxury apartment investments, affordable housing and other PWIs have performed much better through the financial crisis. A 62.9% loss rate is both unwarranted and strongly discourages PWIs that generate economic returns instead of tax credits, effectively thwarting Congressional intent in authorizing PWIs and the Federal Reserve Board's (Board's) support for affordable housing and community development. The Board should assign to PWIs a much lower assumed loss rate. For example, under Basel III risk-based capital standards, PWIs receive a 100% risk weight, whereas other non-publicly traded equity exposures receive a 400% risk weight.

1. The scope of the policy is significant. The six global trading shock banks[2] collectively account for $5.9 trillion in domestic assets, or about 44% of all U.S. large bank domestic assets.[3] Moreover, the loss rates prescribed for global trading shock banks could have an even broader negative impact because they could become the *de facto* benchmark for other banks developing their own CCAR risk models.

2. Affordable housing and other PWIs do not fit the apparent framework underlying CCAR's private equity loss assumptions. Given that banks themselves are generally prohibited from making private equity investments (except for PWIs), it appears that the CCAR framework is designed for bank holding companies with private equity interests in luxury apartments and commercial real estate, which may lose much of their value in severe stress scenarios. In contrast, multifamily affordable rental housing properties have demonstrated stability relative to market rate/luxury (and other) property types during expanding and contracting economic environments given low vacancy rates, supply shortage, and underwriting at lower rent levels. (See paragraph 3c regarding cap rates.)

3. Affordable multifamily properties present less risk than the luxury multifamily properties that typically attract private equity, especially in severely adverse market conditions.

    a. The affordable multifamily market is larger, less geographically concentrated, and more robust than luxury housing rental market. Affordable properties have tended to have lower turnover and vacancy rates than luxury properties, especially during the

[1] Including Low Income Housing Tax Credits and New Markets Tax Credits.
[2] Bank of America, Citi, Goldman Sachs, J.P. Morgan Chase, Morgan Stanley, and Wells Fargo.
[3] https://www.federalreserve.gov/releases/lbr/current/default.htm

recent recession, when moderate-income families suffering from reduced incomes and home foreclosures sought affordable rentals and home purchase demand declined. In addition, while demand for affordable rentals is very broad and is expected to grow for the foreseeable future, the supply remains constrained because affordable rents cannot support the cost of new construction without public subsidies that are both limited and modest relative to need. In contrast, the luxury rental market is thinner and more vulnerable to over-building and tenant turnover (overbuilding is now driving up luxury rental vacancies); and homeownership is a more realistic alternative for higher-income tenants in luxury apartments.

b. Affordable properties generally performed well during the crisis. For example, a CohnReznick study of Low Income Housing Tax Credit (LIHTC) property performance found that: "The financial crisis that occurred during 2008−2009 appears to have had almost no adverse impact on the overall health of the housing tax credit inventory, which marks a striking difference compared to the impact of the recession on conventional multifamily housing."[4] An earlier CohnReznick report explained: "Notwithstanding the national recession and sharp increase in unemployment, median occupancy in housing credit properties was 96.4%, 96.3% and 96.6% in 2008, 2009 and 2010, respectively. As previously noted, high occupancy rates are another indicator of the tremendous imbalance between the increasing demand and short supply of affordable housing properties. Many survey respondents we interviewed following publication of our August 2011 report noted that unfavorable economic conditions led to enlarged tenant bases across properties in their affordable housing portfolios."[5]

c. While the federal banking agencies have expressed concerns about current low capitalization rates for multifamily housing,[6] cap rates for affordable multifamily properties generally remain above 6% (vs. ~4% for high-end properties). Because low cap rates tend to reflect speculative expectations of rising values for luxury properties, affordable properties with higher cap rates are less vulnerable to devaluation in times of market stress. It is especially relevant for CCAR that cap rates were much less volatile over the financial cycle for affordable multifamily housing than for luxury housing. Over the course of the recent economic crisis, cap rates for affordable properties rose gradually from 6.3% in 2007Q1 to 8.1% in 2010Q3 before

---

[4] CohnReznick LLP, *The Low-Income Housing Tax Credit at Year 30: Recent Investment Performance (2013-2014)*, December 2015, p. 38. https://issuu.com/cohnreznick/docs/cr_lihtc_dec2015

[5] CohnReznick LLP *The Low-Income Housing Tax Credit Program at Year 25: An Expanded Look at Its Performance*, December 2012, p.9. https://www.cohnreznick.com/sites/default/files/2012lihtc/cohnreznick-lihtc-2012-fullreport.pdf

[6] Federal Reserve Board of Governors, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Statement on Prudent Risk Management for Commercial Real Estate Lending," December 18, 2015 https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20151218a1.pdf

drifting down to 7.7% in 2012Q1. In contrast, cap rates for luxury multifamily properties jumped from 5.4% in 2007Q1 to 8.6% in 2009Q1 and fell to 4.7% 2012Q1.[7]

d. According to Harvard University's Joint Center for Housing Studies, "The total number of units renting for less than $800 declined by over 260,000 from 2005 to 2015, a time when the overall rental stock increased by over 6.7 million units. The shift in the rental stock toward the high end is also clear from the 32 percent rise in real median asking rents since 2000. . . . The result is a worsening mismatch of demand and supply, with the number of low-income renters far outstripping the number of available units at the lowest end of the market."[8]

4. <u>Economic-return equity investment in affordable housing is modest in scale but it is growing and is strategically important</u>. It has become apparent that LIHTCs, while critically important, are insufficient to address the nation's severe and growing affordable housing investment needs. This recognition has led to the formation of several economic-return affordable housing investment funds, as the Urban Land Institute's Terwilliger Center for Housing and NeighborWorks America have documented.[9] These funds typically finance one or a combination of three types of affordable rental housing:

   a. Properties previously financed with LIHTC but which have exited their 15-year recapture periods. Under CCAR, an investment in a property while tax credits are generated is assigned a 2% loss rate but an economic investment to preserve the same property is assigned a 62.9% loss rate.

   b. Properties with other public subsidies, such as project-based Section 8 rental assistance, but not with active LIHTC financing.

   c. Naturally occurring affordable housing (NOAH), where market rents are affordable. Most affordable rentals are naturally occurring, rather than subsidized.

5. <u>PWIs are an appropriate investment class for more favorable CCAR treatment</u>.

   a. Congress has specifically authorized banks to make PWIs, defined as investments "designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as by providing housing, services, or jobs), to the extent permissible under State law." (12 U.S. Code § 338a)

   b. Favorable consideration of PWIs is consistent with broader Board policy. In general, "The Federal Reserve System and its national partner organizations support efforts to

---

[7] Source: CoStar.

[8] Joint Center for Housing Studies of Harvard University, *The State Of The Nation's Housing 2017*, p. 28.

[9] Urban Land Institute and NeighborWorks America, *Preserving Multifamily Workforce and Affordable Housing: New Approaches for Investing in a Vital National Asset, 2015,* http://uli.org/wp-content/uploads/ULI-Documents/Preserving-Multifamily-Workforce-and-Affordable-Housing.pdf

transform how community investments are made to stabilize communities."[10] More specifically, "a bank holding company may … engage in 'making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas.' The Board included that activity among those the Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto, in order to permit bank holding companies to fulfill their civic responsibilities. As indicated hereinafter in this interpretation, the Board intends §225.25(b)(6) to enable bank holding companies to take an active role in the quest for solutions to the Nation's social problems. Although the interpretation primarily focuses on low- and moderate-income housing, it is not intended to limit projects under §225.25(b)(6) to that area."[11]

c. This CCAR policy is inconsistent with more broadly favorable treatment of PWIs under Basel III risk-based capital rules[12] and the Volcker Rule.[13] Under the Basel III advanced and standardized risk-based capital requirements, all PWIs (except those in Small Business Investment Companies) receive the more favorable 100% risk weighting instead of the higher 400% risk weighting ascribed to much other private equity. The Volcker Rule excludes all PWIs from the definition of "covered fund."

d. PWI authority is sufficiently circumscribed to minimize undue risks to banks, bank holding companies, and the banking system. A bank's aggregate PWIs may not exceed 5% of its paid-in capital and surplus without prior regulatory approval. A PWI may not expose a bank to unlimited liability. Moreover, as noted above, PWIs are limited to activities, such as affordable housing, that demonstrate a clear public policy purpose as defined by Congress that differentiates them from more traditional private equity investments.

[10] https://www.federalreserve.gov/consumerscommunities/neighborhood-revitalization.htm
[11] 12 CFR § 225.127(a)
[12] *Federal Register*, Vol. 78, No. 198, October 11, 2013, p. 62017 ff.
[13] *Federal Register*, Vol. 79, No. 21, January 31, 2014, p. 5697 ff.