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Commentary

Public Housing Authority Capital Securitization Criteria

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Legislative changes put into effect in 1998 laid the groundwork for public housing authorities (PHAs) to accelerate the modernization and repair of their housing stock with U.S. Department of Housing and Urban Development (HUD) funding. Since that time, HUD has been working with PHAs to determine the best financing structure for securitizations of HUD funds, which are directly applied to pay debt service on PHA modernization financings. Standard & Poor's has determined that PHA debt backed solely by the annually appropriated HUD Capital Fund program can be rated in the investment grade category based on the following critical factors:

- Strong and extensive history of the federal government's support for public housing programs;
- Significant ongoing need for affordable rental housing for the lowest income segment of the rental population;
- Predictable mechanisms for allocating Capital Funds to individual housing authorities;
- Potential for strong support by HUD; and
- Bond structures that provide adequate reserves, additional bonds tests, and segregation of Capital Funds needed to support bond debt service.

The main factors that affect where the rating will fall within the spectrum of low to high investment grade are:

- The level of debt service coverage on the bonds, stressed under a variety of scenarios, evidenced both by revenue projections and the coverage provided by the additional bonds test. All investment grade structures should include a maximum annual debt service reserve fund;
- PHA's track record of HUD funding and creation of mechanisms to enhance predictability of funding levels;
- Evaluation of PHA's capital improvement plan, including ongoing Capital Fund leveraging as well as management's ability to undertake the scope of work;
- HUD support for the PHA's financing plan including prior approval both of the plan of development and bond structure;
- How well the financing insulates bondholders from recapture or withholding of the Capital Funds for any reasons, including HUD sanctions due to performance, prior liens which may be placed on the funding, or flow of funds problems at the PHA level;
- Strength of legal structure; and
- Availability of a diversified stream of revenues, especially important at higher rating levels.

The greatest risk to bondholders investing in PHA debt secured by Capital Funds is the risk that funds will not be appropriated by the federal government in amounts sufficient to pay debt service. This risk cannot be eliminated by the federal government except through direct support of debt service through some form of full-faith-and-credit pledge. The risk can be offset, as discussed below, through reserves and debt service coverage that anticipate funding cuts. But in order to arrive at an acceptable level of support for rating purposes, the risk has to be understood through a thorough review of federal funding history, practices, and factors that have affected and can continue to affect funding.

Public Housing Reform

With the latest estimates of the backlog of modernization needs exceeding \$20 billion, and the average wait for a public housing unit at 11 months, Congress needed to launch new methods of funding the upgrade of the public housing stock and system. In a variety of new programs culminating in the Quality Housing and Work Responsibility Act of 1998 (QHWRA), Congress set the stage for public housing reform in several important ways. It focused on the four critical elements of public housing—the condition and configuration of the housing stock, PHA management, social aspects of the system, and monitoring and oversight of the program.

Public housing reform, expressed in programs and legislation such as HOPE VI, the Moving to Work Demonstration Program, and, ultimately, QHWRA, promotes the concept of mixed finance and mixed income housing aimed at creating more socially and economically integrated communities and establishes programs to break the mold of public housing as housing of last resort programmatically designed to attract and retain the poorest of the poor. Financial flexibility granted under public housing reform laid the groundwork for PHAs to turn around their aging, outdated, and dilapidated housing stock with the help of the capital markets principally by allowing HUD funding to be applied to pay debt service. More than anything else, this opened the door for securitization of the public housing Capital Fund, a significant new development in the financing of affordable housing and a major breakthrough for PHAs in the acceleration of the modernization of their housing stock. Through securitizations, PHAs can achieve large-scale modernization efforts on a timetable that meets the needs of their development plan, free from the constraints of year-to-year funding.

QHWRA aims as well to improve the industry by examining methods of evaluating PHAs and other affordable housing providers and requiring annual and five-year plans aimed at encouraging PHAs to plan effectively to carry out the new Federal mission for public housing. Through public housing reform, the Federal government hopes to preserve its \$90 billion investment in public housing by introducing more flexibility, accountability, and self-sufficiency into the system. In doing so, it has taken a giant step forward in improving the creditworthiness of public housing funding.

Essentiality, Longevity, and Predictability

In evaluating the history of public housing, three elements are clear contributors to the potential creditworthiness of capital funding:

- The essentiality of housing for low and very low-income people;
- The long track record of funding for public housing by the federal government; and
- Increasing predictability of funding levels for individual public housing authorities.

Essentiality.

The need for the public housing program is at the heart of gauging the federal government's continuing commitment to the program. A review of the demand for public housing, the general dearth of affordable rental housing, and the likely continuation of the undersupply indicates a high degree of likelihood that public housing will continue to be the centerpiece of the nation's supply of housing for those in greatest need. Public housing is a significant part of the federal government's \$31 billion annual expenditure in HUD-assisted housing, with the important distinction of being the sole government-owned housing program. The demand for affordable rental housing has been well-established for years by government surveys and waiting lists for publicly and privately owned subsidized housing. The 1999 American Housing Survey indicated that almost 14 million households have critical housing needs—defined as paying more than 50% of income for housing or living in substandard housing. In 1997, subsidized housing programs served just over 3 million of that population. Public housing accounts for roughly one-third of that number and has waiting lists averaging almost one year, with some cities, such as Los Angeles, having waiting lists as long as ten years.

There are many reasons why we can expect the need for deeply affordable rental housing to continue. The federal government is no longer in the business of developing deeply subsidized publicly and privately owned housing and has moved toward a paradigm of mixed-finance, mixed-income housing that can sustain affordability by renting to higher-income tenants. The number of existing deeply subsidized federally assisted units is expected to decrease due to the federal government's ban on new conventional public housing and the conversion of privately owned subsidized housing properties to market rate status upon expiration of subsidy contracts. Major production programs, such as the Low Income Housing Tax Credit program, although affordable, are targeted at higher-income tenants. Some segments of public housing tenancy, such as the elderly, who make up 32% of public housing tenants, are expected to increase significantly in coming years.

Federal funding history.

The public housing system was originally authorized in the National Housing Act of 1937. The program was envisioned by the Act to be of permanent standing with no sunset provisions. The history of federal funding for public housing spans six decades and 12 presidential administrations, and is as much an evolution of the federal government's reaction to the plight of American individuals and families in need of decent, affordable housing as it is an attempt to address the needs of the public housing system it created.

In the early post-Depression years, the goal of the public housing program was the eradication of slums, creation of employment opportunities, and provision of decent affordable rental housing. The federal government's investment in public housing, reported to be \$90 billion, funded the development of over 1.3 million apartments in 13,000 developments. Because of federally imposed rent restrictions, the federal government has funded an increasingly larger and larger operating subsidy for PHAs to make up the difference in operating costs and the extremely low, and sometimes nonexistent, rents that most public housing tenants can afford to pay. The funding has increased to over \$3 billion in 2001 since its inception in 1969.

Whereas, under QHWRA, both operating and Capital Funds could potentially be pledged to pay debt service, at present the criteria for public housing securitizations only addresses debt where the primary support is a PHA's Capital Fund allocation. To properly assess a pledge of operating funds, it would be necessary to evaluate the history of the operating fund in the same way we have evaluated the history of the Capital Funds and perform an in-depth evaluation of the entire operations of the PHA involved.

While the above helps to establish the commitment of the federal government to the public housing program, examination of modernization funding is the main focus in understanding Capital Fund securitizations. Because development funding for public housing did not include ongoing reserves for improvements, by 1968 Congress needed to address the severe deterioration in the housing stock through a modernization funding program. That early program has grown from initial appropriation to fund specific modernization needs of \$35 million in 1977 to the Capital Fund program of today, which was funded at almost \$3 billion in 2001 (*see chart*). Since 1977, Congress has appropriated almost \$46 billion for public housing modernization. The history of modernization funding shows an upward trend in funding with some large increases and decreases as the government developed its policy regarding modernization, with a maximum decrease of 38% in 1984.

Because of the severe modernization needs of public housing, the long history of increasing funding, and the importance of the program to the federal government, it is reasonable to assume that funding will continue for many years. However, as the history shows, Congress has taken bites out of modernization funding when needed on a year-to-year basis. As the public housing inventory undergoes modernization, the need for Capital Funds may decrease over time. Therefore, prudent leveraging and reserve sufficiency should be a critical component of all investment grade PHA Capital Fund securitizations.

Predictability of PHA funding levels.

As part of analyzing appropriation risk, Standard & Poor's has carefully considered the methodology for allocation of Capital Funds to the individual housing authority. Positive changes have taken place since the 1980s when PHAs had to compete for modernization funds. Formula funding was introduced for larger PHAs in 1988. Further changes in the Capital Fund allocations effected under QHWRA greatly enhance the predictability and stability of allocations to the individual PHAs by:

- Merging the funding of modernization programs (the Comprehensive Improvement Assistance Program and the Comprehensive Grant Program) into one fund, the Capital Fund, which eliminates any PHA competition for modernization funds except for a small performance reward factor;
- Establishing a formula for the Capital Fund arrived at through negotiating rulemaking, which helps to ensure consistency of methodology over the years; Increasing predictability of the formula through clarification of factors that can affect funding; and
- Allowing for a replacement housing factor which allows PHAs to receive funds over a period of time for units that have been demolished.

Although there are many factors that could change a PHA's funding level, such as ongoing and backlogged needs, impact of unit reduction, and performance reward factors, projecting increases in PHA funding would not be consistent with investment grade ratings. What is consistent with investment grade ratings is the development of a worst case funding level. In addition to appropriation risk, Standard & Poor's will stress anticipated Capital Fund receipts through adjustments for potential reductions in units, unit mix, and the effect of the performance reward mechanism. Another significant factor that can affect PHA funding levels are sanctions that HUD is within its right to employ based upon PHA performance, discussed later under "The Importance of HUD Approvals".

For each PHA transaction, Standard & Poor's will develop assumptions for funding levels based upon the PHA's actual Capital Fund allocation over time. In cases where the PHA has obtained a funding agreement, such as under the Moving to Work demonstration, Standard & Poor's will assume that the PHA will receive the funding level identified in the agreement for the term of the agreement recognizing it may still be subject to appropriation risk. HUD should clearly state that performance issues cannot affect the level of funding while the agreement is in effect.

Assessing the PHA Redevelopment Plan

As part of the rating process, Standard & Poor's will review the PHA's redevelopment plan including scope of work, financial plan, integration with the PHA's other development and redevelopment plans, relocation planning and resident communications, integration with the surrounding community, and strategy to ensure completion of work in a timely fashion. Communication with HUD and timely submission of one- and five-year plans are critical. The depth of the review depends to a great extent on HUD's willingness to waive its right to sanction the PHA. If the PHA's performance in completing its redevelopment plan or submitting additional one and five-year plans is an issue, a full evaluation of the PHA's capacity and an in-depth review of the development plan would likely be needed.

Debt Service Coverage

Although there is a long and positive track record overall for public housing authority funding, there is the potential for reductions in program funding, especially on a year-to-year basis. There are two levels of appropriation risk that must be considered. The first level is that the federal government will reduce the amount of capital funding to PHAs as a whole. The second level is that the individual PHA will suffer reduced funding as a result of issues directly associated with PHA performance or the method of allocating funds to the PHA. The key ingredient to offsetting these risks is to provide for adequate debt service coverage in the transaction to take into account these potential decreases. In this instance, debt service coverage means the amount of annual Capital Funds available to cover annual debt service on the bonds. In determining the appropriate stresses for rated debt, Standard & Poor's considers the following factors:

- Historical federal funding levels, taking into account largest decreases in funding;
- Method of allocating PHA share, accounting for key aspects of the formula funding such as the impact of unit reduction; and
- PHA risk and performance issues as well as track record in funding receipt.

For investment-grade ratings, coverage levels assume that Capital Funds go directly to the bond trustee and that HUD has provided legal covenants that funding will not be withheld due to poor PHA performance (see "The Importance of HUD Approvals" below).

In analyzing the appropriate coverage level for individual transactions, Standard & Poor's will analyze the actual coverage as well as the coverage required in the bond documents to issue additional bonds in conjunction with the level of capital needs and likely leveraging. The higher the coverage levels, the greater stress the revenue stream can withstand without jeopardizing debt service. Coverage levels are meant as general guidelines for rated transactions, and can be adjusted for specific transactions due to factors such as:

- A HUD agreement for the life of the transaction that sets PHA funding;
- A diversified revenue stream beyond Capital Fund, such as a backup pledge from a rated entity;
- Closed bond resolutions; and
- Shorter bond maturities.

The Importance of HUD Approvals

HUD is the administrator of PHA funding. For that reason alone, HUD approvals play a very important role in PHA securitizations and may account for rating differences depending on HUD approvals each PHA is able to secure. In addition, HUD has indicated its willingness to provide legal assurances that go a long way toward removing PHA performance risk from the transactions, as well as provide set funding for some period of time, subject to federal appropriation. PHAs that take advantage of these options will greatly enhance their ability to secure higher ratings.

In all investment grade transactions, Standard & Poor's expects that the PHA will secure HUD approval of the development plan and the bond transaction upfront. Although seldom used in the past, HUD does have the right to apply sanctions for poor PHA performance that could affect funding levels. Therefore, reducing the risk of sanctions or other actions that could interrupt funds flow is a critical component of investment grade transactions if they can be supplied in a legally valid document such as the Annual Contributions Contract. It is unlikely that HUD will legally give up all rights to sanction PHAs; however, clear statements that funds will always be available to pay debt service, albeit, subject to appropriations, will be viewed positively.

HUD agreements, such as the Moving to Work agreement, can provide important assurances as well, especially regarding funding levels and evidence of the federal government's recognition and support of these financings. Congressional appropriation risk has not been removed from these transactions thus far, so it is important to remember that funding is still subject to Congressional appropriation.

Standard & Poor's views HUD's agreement to provide these and other assurances outlined in "Key Legal Features" below in a positive light. Without the support of HUD and without HUD's willingness to consent to key legal provisions that remove critical risks in this type of PHA financing, it would be difficult, if not impossible, for PHAs to achieve investment grade ratings.

The Role of Reserves

Reserves are necessary to ensure that no bond payments are missed due to government shutdowns, resulting late appropriations, and/or temporary severe reductions in appropriations. All investment grade transactions should include a debt service reserve fund (DSRF) sized at maximum annual debt service on the bonds. The reserve fund can be funded from bond proceeds, should be funded upfront, and, if invaded, should be replenished in the flow of flows before any Capital Funds can be released to the PHA.

The DSRF can also serve to protect against any administrative delays in the receipts of Capital Funds by PHAs. Typically, the funds appropriated by Congress for Capital Fund become available in the October/November of the year following the beginning of the federal fiscal year (Oct. 1). The careful timing of debt service payment dates, coupled with the DSRF, can provide a significant cushion to bondholders and insulate them against the risk of late budgets or other delays impacting debt service.

Also viewed favorably will be representations from HUD that protect debt service against any delays caused by the process whereby PHAs requisition and receive approval for their allocation of Capital Fund. This occurs as part of the PHA's annual plan submission to HUD, which could be subject to delays either at HUD or the PHA.

Key Legal Features

Investment grade transactions should include certain legal provisions. To achieve an investment-grade rating, issuers and their advisors may wish to consider incorporating the following features in their transaction documents:

- The PHA should grant the indenture trustee or collateral agent on behalf of the bondholders a perfected security interest in the Capital Fund program moneys to be received by the PHA;
- Debt service payments should be legally separate from all other Capital Funds received from HUD. Debt service payments and any replenishment of reserve funds should be clearly delineated and have a priority of payment only to bondholders, if possible before any remaining funds are released to the PHA;
- Capital Fund monies should flow directly from HUD to the indenture trustee or collateral agent to pay debt service without passing through the PHA;
- Capital Fund monies to be used for debt service should be held under the indenture or deed of trust and should not be commingled with any other funds of the PHA;
- The pledge to bondholders should include not only Capital Fund monies but also the PHA's contract rights pursuant to which the Capital Fund monies are paid as well as the PHA's rights under any successor program;
- An "additional bonds" test should establish the required coverage ratios for any future debt; and
- HUD should stipulate contractually that (1) use of Capital Funds for debt service payments is a permissible use of funds, (2) no subsequent change in the permitted use of Capital Fund monies will affect HUD's obligation to pay the Capital Fund monies, (3) amounts pledged to the payment of debt service shall not be available for any other purpose, and (4) amounts payable to the indenture trustee or collateral agent are not subject to recapture for any reason whatsoever.

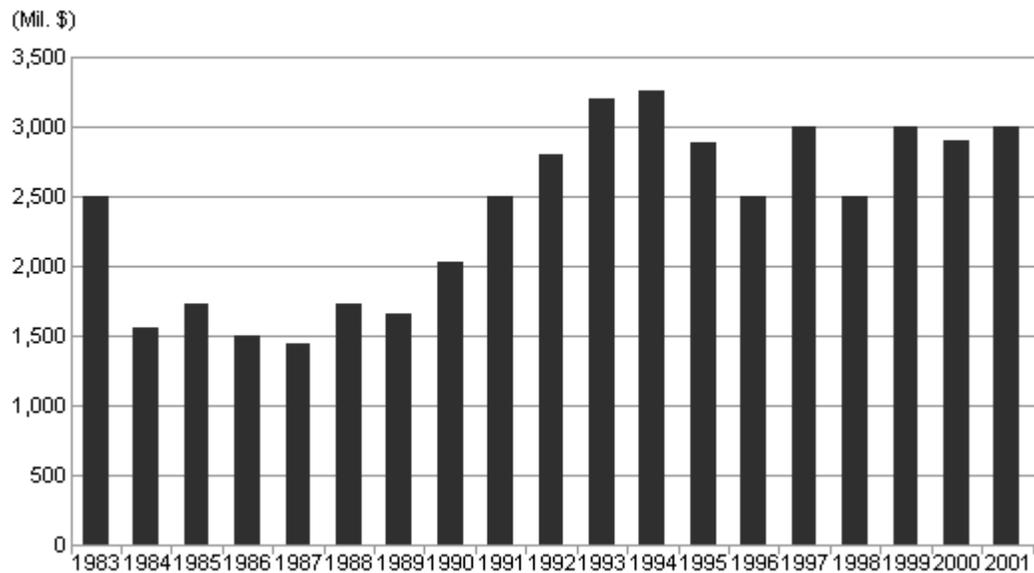
Standard & Poor's will also review the legal covenants made by the PHA and indenture trustee or collateral agent to ensure compliance with the letter and spirit of the Capital Fund program. For example, the PHA should notify the indenture trustee or collateral agent immediately upon being notified by HUD of the availability of the annual Capital Fund allocation. The indenture trustee or collateral agent should then, in turn, proceed to requisition the Capital Funds immediately from HUD and hold these funds in appropriately rated investments until paid to bondholders.

It is anticipated that, at least initially, Standard & Poor's may request legal comfort as to the perfection and priority of the security interest granted by the PHA in (or as to the nature of absolute assignment by the PHA of) all collateral held by the indenture trustee or collateral agent, the status under the U.S. Bankruptcy Code of the PHA, and the effectiveness of the grant by HUD of all representations, warranties, covenants, approvals, permits, and waivers necessary to effect the transaction.

Surveillance

Standard & Poor's will review these ratings annually as part of our secondary market review process. The review will consist of two parts: First, an ongoing review of the federal appropriations process to determine whether there is any evidence of a weakening commitment to public housing in general, or the Capital Fund program in particular. Second, a review of the PHA's progress in meeting their redevelopment plan objectives. To the extent the PHA is able to meet plan goals and objectives in a timely fashion, the likelihood that there will be any reductions in Capital Fund receipts will be reduced. Also, to the extent the PHA's portfolio composition shifts away from what was outlined in its plan documents, the funds received from the Capital Fund formula is subject to change, which could have an impact in the coverage provided to bondholders.

Chart 1
HUD Modernization Funding Levels 1983-2001



Political Factors

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There are a number of factors at the federal level that could affect funding and support for public housing--positively or negatively. While the state and local levels of government can be factors, the federal level is the most relevant since funding and program design at that level drive the way PHAs operate today. Even with greater flexibility, PHAs will continue to be impacted by decisions of the federal government.

Both the executive branch and the legislative branch are key to public housing programs. Each year the President submits to the Congress a budget that includes a funding request for public housing programs. But beyond the important budget area, the executive branch is responsible for implementing legislation through HUD. HUD regulations can help or hinder programs. Funding formulas may be workable or tie the PHA's hands. Regulations providing specific direction on how PHAs operate can help or hinder smooth delivery of service.

The first key factor is authorization legislation. It is the authorizing legislation that directs the overall program. Congress originally established the public housing program in 1937. While a permanent authorization is in place, that legislation has been amended many times over the years. Amendments to the authorizing legislation have brought significant changes to the program and need to be recognized.

Another factor at the federal level is appropriation. Public housing programs are funded on an annual basis as part of the HUD budget that is included in the larger federal discretionary funding. Each February the president sends his budget requests for the next fiscal year to Congress. Congress then determines final levels in its annual budget resolution. These levels serve as a guide for the appropriations committees. Authority for funding is included in the authorization legislation. QHWRA authorized public housing operating and capital funds for a five-year time horizon, currently through FY 2003. At the end of the five years, Congress must extend the authority for new monies to flow to PHAs. Providing multi-year authority for programs is a standard budget-related procedure for the federal government.

Timing of appropriations is also a factor. The federal fiscal year begins on Oct. 1. Only twice since 1989 have all 13 appropriations bills been in place by that date. During those years when appropriations are not completed by Oct. 1, Congress usually provides for agencies to function on the prior year's amounts through continuing resolutions. But it can create some uncertainty. Since 1990, post-Oct. 1 deliberations lasted as few as five calendar days in 1993 to as many as 208 days in 1996.

A third major factor at the federal level is HUD. HUD is the executive branch department responsible for implementing legislation and monitoring the use of funds by PHAs. Programs created by authorizing legislation are converted to regulations that can help or hinder the work of the PHA. HUD also establishes the process for delivery of funds to PHAs and monitors the use of those funds.

While there are numerous factors that can affect the public housing programs positively and negatively, the 65-year old program continues with support from the federal government each year. In addition to funding and programs, this long history offers a wealth of data for analysis of funding and program evolution.

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