

Executive summary

Ernst & Young LLP has been engaged by Enterprise Community Partners, Inc. and Local Initiatives Support Corporation to help understand the current market environment for low-income housing tax credit ('housing credit') investments, investor motivations and investor responses to potential legislative enhancements to rules that govern these transactions. As part of this engagement, we surveyed current, former and potential institutional investors, as well as syndicators and brokers active in the housing credit industry. This report was jointly undertaken by Ernst & Young's Tax Credit Investment Advisory Services group and its Quantitative Economics and Statistics group.

Our findings are summarized below:

- ▶ The composition of the housing tax credit equity market has evolved significantly since the earliest years of the program, from an individual investor base to institutional investors drawn from a range of industries, and finally to the current investor base dominated by very large financial services corporations. As the capital market for housing credits began to mature and become increasingly efficient with increased demand from the late 1990s onward, housing credit prices had reached historic highs, and yields reached corresponding lows, by 2006. Unfortunately, this narrowed investor base, heavily dependent on the GSEs and major banks, left the market for housing tax credits highly vulnerable to the credit crunch observed among financial services companies beginning in 2008. These companies had a precipitous decline in their profitability, one consequence of which was a dramatic decrease in their need for tax shelters including housing credits.
- ▶ In 2008, housing credit investment levels fell dramatically from 2007 levels due both to the broader economic conditions, and dislocation in the financial services investor base. Since affordable rental housing development depends on the reliability of capital raised from the syndication of housing credits, the data we have compiled shows that a nationwide inventory of slowed or stalled development has begun to accumulate.
- ▶ Based on the data we received, we have no reason to believe that this equity gap can be quickly closed absent legislation designed to stimulate new investment activity. The decline in investment activity is expected to continue absent stimulus for the equity market. Survey respondents predicted a total 2009 equity volume of \$4.5 billion absent additional housing credit stimulus legislation, representing a 22.4% decrease from respondents' 2008 levels, which itself represents a 14.8% decrease from 2007. Our estimates of the overall market size based on data compiled from various sources reflect even more significant declines of 34.5% from 2007 to 2008, compared to the 22.4% reduction reported by the survey respondents. The variance between the industry's investment volume estimate and survey responses is partially due to the fact that active investors are more likely to respond compared to investors that have permanently exited the market.
- ▶ As a sub-set of the total market, tax-exempt bond financed investments have been more adversely affected than those financed with allocated credits, as a majority of the investment decline among survey respondents from 2007 to 2008 appears to have been associated with tax-exempt bond transactions. Survey respondents indicated a 44.4% decline (from \$1.575 billion to \$876 million) in tax-exempt bond financed investments from 2007 to 2008, which is much more dramatic than the decline in allocated credit investments during the same period.

- ▶ Among the proposed legislative changes they were asked to evaluate, respondents indicated that having the ability to carryback their housing credits for up to five years (instead of one, as provided under present law) would be their preferred alternative:
- ▶ It was the alternative most likely to increase either the likelihood of their becoming investors, or for current investors, the likelihood that they might increase their current level of investment.
- ▶ When we aggregated the replies received concerning the likely impact of the proposed legislation on their own investments, respondents indicated they would invest \$5 billion more than they currently plan through 2011 if the five-year carry-back proposal is enacted. Specifically, they would invest 14% more (\$5.1 billion vs. \$4.4 billion) in 2009, 49% more in 2010 (\$6.6 billion vs. \$4.4 billion) and 47% more (\$7.1 billion vs. \$4.8 billion) in 2011. In addition, since not all market participants responded to the survey, the total market investment amount would be higher.
- ▶ Respondents also indicated a preference that their housing credit investments be comprised either entirely of allocated credits, or that, if there were a blend of the two, no more than 25% of their investment go to 4% credit projects financed with tax-exempt bonds. Respondents consistently cite the negative impact of higher loss levels on their financial statements as the basis for their preference.
- ▶ While current and prospective investors indicated that higher yields were the first factor they considered, it was obviously not the only one driving their investment decisions. Since market yields have more than doubled since hitting historic lows in 2006 (10% versus 4.25%), and equity demand remains anemic, it is clear that these other factors are important, and may even be more important than yield to some. Among these issues, respondents indicated that:
 - ▶ Corporations are reluctant to commit to investing in a program that requires a reliable ten years of consistently positive tax liability. This is consistent with their stated preference for the five-year carryback alternative noted above.