More Than Coincidence

New Study Documents Correlation Between CRA and Housing Credit Pricing

By CohnReznick Tax Credit Investment Services

A new study by CohnReznick LLP confirms that the federal Community Reinvestment Act (CRA) has been responsible for substantial levels of banking investment in low-income housing tax credit (LIHTC) properties. The study also concludes that the methodology for setting CRA investment goals has inadvertently led to a two-tier pricing market for housing credits, with major urban areas coming out as the clear winners and less populated markets and rural areas not as fortunate.

The CohnReznick study confirmed that CRA has been a great engine of capital formation for the development of affordable rental housing in the U.S. As investors and regulators have become increasingly confident in the financial performance of LIHTC properties as an asset class, housing credit investments have become a highly favored CRA-qualified investment for banks. As a result, the LIHTC program has become highly reliant on equity investments from banks.

According to CohnReznick, approximately $10 billion in total LIHTC equity was raised in 2012. Of this amount, the banking sector accounted for approximately 85%. Moreover, of the bank-supplied equity investment, CohnReznick estimates that 60% came from the top five U.S. commercial banks alone.

Study Methodology

CohnReznick compiled bank branch location information for the top 20 U.S. commercial banks from the Federal Deposit Insurance Corporation, to create a database of 35,479 branch locations. CohnReznick mapped each bank branch's address by zip code to identify and rank the "CRA investment test value" of an investment in that area based on the number of bank branches located in each zip code. The CRA investment test value of a given project begins with determining whether it is located within the CRA assessment area of one or more top 20 banks. Areas with more than ten bank branches maintained by the nation's top 20 U.S. banks were deemed to have the highest level of CRA value for investment test purposes.

CohnReznick then overlaid more than 17,000 properties, and their corresponding tax credit pricing information, on to the map of bank branch locations. The surveyed properties in the report account for nearly two-thirds of all the housing tax credit properties that have been placed in service since the inception of the program, and that are still in their 15-year compliance period.

Real World vs. Theory

In theory, a dollar of housing tax credit should be worth a dollar to investors, whether the housing tax credit is generated by a property located in Martinsville, W.Va. or a project located in downtown San Francisco, Calif.

Investors typically acquire housing tax credits at a discount to achieve a certain level of return on their equity investment, or yield. The higher the discount is, the higher the investment's yield will be. The magnitude of the discount is a function of several factors that ultimately determine the "cost" of housing credit equity. The study concludes, however, that the market pays a premium for projects located in "CRA Hot" areas. The size of the premium can affect investor yield by 200 basis points or more.

Following are some of the major observations from the study *(The Community Reinvestment Act and Its Effect on Housing Tax Credit Pricing)*:

- The single largest variable in housing tax credit pricing is based on the CRA Investment Test value of a given property's location. The collected data shows large spreads in credit pricing (as much as 35 cents per dollar of tax credit) at the extreme ends of the pricing spectrum, between what CohnReznick calls "CRA Hot" areas – typically major urban market areas such as New York City and San Francisco – and "CRA Not" locations, which can be smaller, more rural communities or more populated areas that do not fall within the CRA "footprint" of one of

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the major commercial banks. These gaps cannot be explained sufficiently by factors other than CRA.

- There is a clear mismatch between the factors that determine CRA investment test objectives and the way in which the tax credits are distributed. State housing agencies allocate their housing credits to projects according to their annual qualified allocation plan, which is principally driven by the agency's assessment of the state's most critical housing needs. Demand by banks for LIHTC investments, on the other hand, is largely tied to the CRA regulations, which disproportionately focus on areas where bank branch locations and bank deposits – and consequently, investment test requirements – are the highest.

- Consolidation among the major banks has made the largest banks as national players competing against each other in the same markets. As a result, CRA assessment areas overlap in major metro areas and deposits are concentrated in a fashion that does not reflect population levels. This tends to cause the investment test to funnel capital to areas that have a disproportionately small number of new LIHTC investment opportunities. As a result of this imbalance in supply and demand, LIHTC projects in center city locations command significantly higher prices. CohnReznick reports that this imbalance pushes up pricing in these markets to levels as high as $1.25 per $1 of housing tax credit.

- Between 2005 and 2007, when LIHTC equity volume peaked, housing credits traded more or less at par ($1 per $1 of tax credit) in many locations. During this period, when equity demand was at peak levels and Fannie Mae and Freddie Mac were still in the market, the spread in median tax credit pricing between states with the highest level of CRA demand and states with the lowest level of CRA demand was $0.14. By contrast, during 2008 and 2009 when the GSEs exited the LIHTC market and equity demand nose dived, the price for housing credits in CRA Hot locations were highly resistant to lower tax credit pricing. The study found that during this period the spread between tax credit prices in CRA Hot versus CRA Not locations more than doubled.

CRA: *The Basics*

The Community Reinvestment Act (CRA) requires federally regulated banks and thrifts to meet the needs, including for credit, of the communities in which they have branches that take deposits – so-called assessment areas.

CRA is administered by the federal banking regulators (Federal Reserve, Office of Comptroller of the Currency, Federal Deposit Insurance Corporation), which review and rate the CRA performance of each institution under their supervision periodically. For regulated financial institutions subject to CRA, this is generally once every three to five years.

Regulators evaluate each bank for its CRA performance based on numerous factors, with the specific criteria determined by whether the institution is large, intermediate, or small. Large banks are evaluated for their activities in each assessment period under a three-pronged test: a lending test, accounting for 50% of the bank's CRA performance rating; an investment test, 25%; and a service test, 25%.

Each institution is evaluated on its performance under each of the tests in each of its assessment areas, based on the regulator's review of facts and data supplied by the bank and of submitted public comments. Taking all of this into account, the regulator then gives the bank a "rating" for its overall CRA performance: Outstanding; Satisfactory; Needs to Improve; or Substantial Noncompliance. TCA

More Flexibility Needed

The "partnership" between CRA investment objectives and the housing credit program has been a great success. But CohnReznick believes that federal banking regulators should adopt a methodology for granting positive CRA consideration for LIHTC investments by banks that is more flexible in its application. Thus, for example, CohnReznick believes that banking institutions should be given CRA credit for investments that help to meet the affordable housing needs in wider statewide or regional areas beyond their assessment areas.

(The study, The Community Reinvestment Act and Its Effect on Housing Tax Credit Pricing, *can be found at www.cohnreznick.com/cra-study. For more information, contact TCIS@cohnreznick.com)* TCA