THE MORTGAGE SUBSIDY BOND TAX ACT OF 1980: EXPERIENCE UNDER THE PERMANENT RULES

The Congress of the United States
Congressional Budget Office

PREFACE

In the Mortgage Subsidy Bond Tax Act of 1980, the Congress sharply restricted the issuance of tax-exempt bonds for housing. Because a large number of bond issues was marketed under these restrictions in November and December 1981, the Congressional Budget Office (CBO) has been able to prepare this preliminary assessment of experience under the act. This paper, prepared at the request of Charles Rangel, Chairman of the Oversight Subcommittee of the House Committee on Ways and Means, examines these bond issues and describes the experience to date under the act. It also discusses the liberalizations of some of the act's provisions adopted December 16, 1981 by the Senate in the Miscellaneous Tax Bill (H.R. 4717).

Cynthia Francis Gensheimer of the CBO's Tax Analysis Division prepared the report, with the assistance of Martha J. Smith and under the direction of James M. Verdier. Bruce Davie of the Committee on Ways and Means reviewed and provided suggestions on the report. Patricia H. Johnston edited the manuscript and Linda B. Brockman typed it for publication.

Dozens of investment bankers, lawyers, housing agency officials, and rating agency and insurance company personnel gave generously of their time in relating their experiences with the act's provisions and providing information to CBO. A preliminary list of the bond issues discussed in this report was provided by The Bond Buyer in mid-December.

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SUMMARY

In December 1980, the Congress sharply limited the use of tax-exempt bonds for housing in response to a surge in the issuance of these bonds and in an attempt to target the assistance more efficiently. A year later, enough bonds have been issued under the new rules to enable the Congressional Budget Office to make a preliminary assessment of the effects of the act and to discuss the potential effects of some less restrictive amendments adopted by the Senate in the Miscellaneous Tax Bill.

BACKGROUND

Tax-exempt bonds have been issued for housing since just after World War I, but not until the early 1970s were the bonds issued in any great quantity. At that time, many state housing agencies started to issue tax-exempt bonds for mortgages on apartment buildings and on owner-occupied houses, and in 1978 local governments began to issue bonds for mortgages on owner-occupied houses.

State and local governments issue bonds at relatively low, tax-exempt interest rates and relend the proceeds at slightly higher rates for mortgages. In the case of bonds issued for owner-occupied housing, people apply for the mortgages at private lending institutions that are hired by the bond issuers to process the mortgage applications to check both for general creditworthiness and to ensure that borrowers meet all restrictions imposed by federal and state law and by the issuer.

The federal government subsidizes the bond issues because interest on the bonds is exempt from federal income tax. Most of the subsidy is passed on to homeowners who get below-market-rate mortgages and to bondholders who do not have to pay tax on their investment income (they pay a lower, implicit tax, however, in that the bonds carry a lower interest rate than taxable bonds do). Some of the subsidy also goes to the various intermediaries in the process.

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The use of tax-exempt bonds for owner-occupied housing increased dramatically in the late 1970s. In 1976, according to the Department of Housing and Urban Development, a total of $1.3 billion in these bonds was issued, compared to $12 billion in 1980.

During this expansionary period, federal law imposed basically no restrictions on these bonds, as long as they were issued under the auspices of a state or local government. The Congress was concerned both about the large federal revenue losses associated with the growing bond volume and about the possibility that the volume of housing bonds would push up interest rates on tax-exempt bonds issued for more traditional public purposes. Moreover, the Congress wanted to target the assistance as efficiently as possible.

THE MORTGAGE SUBSIDY BOND TAX ACT OF 1980

In response to these concerns, the Congress enacted the Mortgage Subsidy Bond Tax Act of 1980. This act sharply limits tax-exempt bonds for owner-occupied housing and denies tax-exemption on nearly all bonds for owner-occupied housing issued after December 31, 1983. It also restricts somewhat tax-exempt bonds for rental housing.

In order to limit the dollar amount of bonds issued for owner-occupied housing, the act imposes limits on the amount of bonds that each state may issue. The act imposes several restrictions to target the assistance: issuers can charge homebuyers interest rates no more than 1 percentage point above the interest rate on the bonds; all borrowers must be first-time homebuyers; price limits are imposed on bond-financed houses; and a portion of each bond issue is reserved for mortgages in targeted areas. Bonds can be issued for rental housing only if at least 20 percent of apartment units (15 percent in targeted areas) are rented to low- or moderate-income tenants.

EXPERIENCE UNDER THE ACT

Lenient transitional rules exempted bond issues in the pipeline from the act's restrictions. Therefore, most of the bonds subject to the permanent rules of the legislation were not issued until the last two months of 1981, after workable temporary regulations were published. Thirty-eight bond issues for mortgages on owner-occupied housing were issued under the new restrictions in 1981, totaling \$1.68 billion. Eight bond issues for home-improvement loans were issued under the permanent rules in 1981, totaling \$155 million. A total of \$1.1 billion in bonds for rental housing was issued in 1981, only a small portion of which was affected by the act's restrictions, because most of these bonds have traditionally financed apartments in which all tenants are low income.

Adverse Market Conditions

While the act's restrictions created difficulties for bond issuers in late 1981, mortgage revenue bonds faced other problems unrelated to the act. Tax-exempt interest rates reached their highest historical levels in late 1981, both in absolute terms and as a percentage of comparable taxable rates. Consequently, since high interest rates on bonds necessitate high interest rates on the mortgages financed with bond proceeds, the mortgage interest rates offered by these programs had to be higher than those previously charged. Only a small group of borrowers both could (or would) pay the higher rates and had incomes high enough to meet the lenders' qualifications for the high-rate mortgages but low enough to meet the programs' income limits.

In response to the high interest rates on long-term, tax-exempt bonds, many issuers devised ways to shorten bond maturities and thereby achieve lower bond interest rates that enabled them to set lower mortgage interest rates. Usually this was done by shortening the maturities on the mortgages. Some programs offer level-payment mortgages that will be paid off at the end of 20 or 25 years instead of the usual 30 years or mortgages in which the monthly payments increase each year, so that the entire mortgage is paid fully at the end of about 16 years.

Arbitrage Rules

Federal law generally prohibits the issuance of tax-exempt bonds at low interest rates if the bond proceeds are invested at much higher rates. Without these so-called "arbitrage" rules, state and local governments could profit from tax-exempt bonds. As part of the Mortgage Subsidy Bond Tax Act of 1980, the Congress tightened the arbitrage rules for tax-exempt bonds for owner-occupied housing in order to channel most of the subsidy provided by the tax exemption to homeowners rather than to issuers and financial intermediaries. To this end, the act requires that mortgage interest rates be no more than 1 percentage point above bond interest rates and that any profit earned on nonmortgage investments be rebated to the homeowners or to the federal government.

The act so limits the yield on investments made with bond proceeds that the yields are not high enough to cover interest due on the bonds and other expenses and still leave a cushion for unexpected contingencies. In effect, therefore, the act implicitly requires state and local governments to subsidize tax-exempt bonds for owner-occupied housing. The Administration has just proposed explicitly requiring state or local subsidization for all tax-exempt bonds issued for private purposes.

For the most part, subsidies on housing bonds were provided by cash contributions from state housing agencies or state or local governments. The yield on investments made with these cash contributions was then available, along with the yield on investments made with bond proceeds, to cover expenses and debt payments on the bonds and to provide additional security for the issue. The amount of cash conributions varied widely from issue to issue but was about 8.7 percent of the total amount of bonds issued for mortgages on owner-occupied houses in 1981.

The ability and willingness of state and local governments to subsidize bond issues also varies widely. Some state housing agencies have large net worths and were able to contribute to issues., but others have smaller net worths or funds that are committed to other purposes. If surplus funds remain after all bonds have been retired and expenses met, they usually revert to the housing agencies' general funds. A portion of the agencies' contributions, therefore, might be thought of as loans, rather than grants, although the amount of funds returned could be small and not recovered for many years.

Some issues did not receive cash contributions but were issued as housing agencies' general obligations or were backed by other agency assets in addition to the bond proceeds. Several issues were self-supporting, however. These included bonds of which at least a portion were unrated and privately placed with investors rather than publicly marketed. Investors who purchased these bonds probably were willing to accept a level of risk unacceptable to the rating agencies.

Under another approach, homebuyers were charged interest rates exceeding those normally allowed, on the assumption that large amounts of their mortgage debt would be forgiven once all bonds are retired. This later forgiveness would reduce the effective interest rate. Compliance with the arbitrage rules requires only that the issuer demonstrate, under reasonable assumptions, that it expects to forgive a large amount of indebtedness. If events turn out otherwise, no violation of the rules would occur, but homeowners would pay higher interest rates than the Congress intended in the 1980 act.

As discussed above, the intent of the new arbitrage rules was to channel as much of the subsidy as possible to homebuyers and thereby offer them the lowest possible interest rate on their mortgages. The success of the rules in achieving low mortgage interest rates is uncertain, for no one knows what the interest rates would have been in the absence of the rules.

The lower are the costs of a bond program--bond interest and fees to financial intermediaries--the lower are the mortgage interest rates that need be charged. In the aggregate, fees for financial services have probably decreased a little or stayed the same, even though the act increased the responsibilities of many financial intermediaries. Because the act's yield restrictions reduce the security of the bonds (even with sizable cash contributions), bond interest rates may be somewhat higher than they otherwise would be, however. The net effect of the act, therefore, may have been to increase mortgage rates somewhat.

The act requires that any profit on nonmortgage investments made with bond proceeds be rebated to the homeowners or to the federal government. By design many of the issuers do not expect to rebate much, if any, money. Their reserves are either funded wholly with outside cash contributions, or invested pursuant to long-term contracts with banks at interest rates below the rates on the bonds.

Volume Limits

The act limits the annual volume of bonds that can be issued in any state to $200 million or to 9 percent of the state's annual mortgage originations averaged over the past three years, whichever is greater. The formula favors sparsely populated states; in 1981, bonding authority per capita was $500 in Alaska but only $24 in New York State. The volume limits imposed by the act were not a constraint in 1981, however, since only two states issued their full allotments in that year.

Targeted Area Provisions

The targeted area provisions of the act require that at least 20 percent of mortgage funds be reserved for targeted areas, designate certain census tracts automatically as targeted areas, and allow states to nominate other areas for designation. Less than the full 20 percent can be reserved if the jurisdiction contains no targeted areas, if the targeted areas are sparsely populated, or if they are areas in which few mortgages have been made in the past. Because of these exceptions, the majority of 1981 issuers set aside little or no funds for mortgages in targeted areas.

Although federal law offers incentives to set aside funds for targeted areas by allowing the purchase of higher priced houses and purchase by other than first-time homebuyers in those areas, the value of these incentives is small compared to the added costs of setting aside funds for mortgages in targeted areas. The market, therefore, places at a disadvantage issuers that are required by law to set aside the full 20 percent of funds for targeted areas, namely those with many qualified census tracts.

First-Time Homebuyer and Purchase Price Provisions

With a few exceptions, the act requires potential purchasers to be first-time homebuyers. Because many state and local governments had previously imposed low-income limits on borrowers under their tax-exempt bond programs, a majority of the borrowers has always been first-time homebuyers. Many of the issuers have not been much affected by this provision, therefore, other than to be faced with the additional administrative burden of demonstrating compliance. Although not bound to do so by federal law, nearly all issuers impose income limits on borrowers.

The act limits the purchase prices of bond-financed houses to 90 percent of the area median purchase price (110 percent in targeted areas). The limits vary widely according to area, ranging from $33,000 for existing houses in northeast Pennsylvania to $144,000 for existing houses in San Jose, California.

Registration Requirement

All tax-exempt bonds for housing must be issued in registered form after January 1, 1982, meaning that names of all bondholders must be on file with the trustee bank. This requirement was imposed so that the Internal Revenue Service (IRS) could locate bondholders to collect gift and estate taxes and tax on bond interest if the bonds were found to violate any of the act's requirements. Housing bonds are currently the only major group of tax-exempt bonds that must be issued in registered form. Many investment analysts fear that this requirement has narrowed the market for the bonds and that interest rates on them may initially rise by at least one-fourth of a percentage point as a consequence.

Bonds for Veterans' Housing

Bonds for veterans' housing may be issued free of nearly all of the act's requirements, as long as the bonds are general obligations of the state. California and Oregon were the only states that issued general obligation bonds for veterans' housing in 1981, but these bonds totaled 20 percent of the tax-exempt bonds issued for owner-occupied housing in that year.

Bonds for Home-Improvement Loans

Eight issues of bonds for home-improvement loans were marketed in 1981 under the act's permanent rules. Bond proceeds may be used for home-improvement loans up to $15,000 each. In 1981 most of these bonds financed Title 1 home-improvement loans insured by the Federal Housing Administration. Title 1 loans can be used for general home improvements and repairs, but not for recreational facilities, such as swimming pools.

The home-improvement loan bonds were more heavily subsidized with cash contributions (often with Community Development Block Grant funds) than were the bonds for mortgages on owner-occupied houses. In several cases, interest rates were set lower on loans for low-income people or for people buying houses in designated neighborhoods than for other borrowers.

Bonds for Rental Housing

The act allows tax-exempt bonds to finance rental housing only if at least 20 percent of the units (15 percent in targeted areas) are rented to low- or moderate-income tenants for at least 20 years. Since most apartments financed with tax-exempt bonds have been 100 percent low-income projects, this requirement only affects a small share of the rental-housing bonds.

At the high interest rates now prevailing in the tax-exempt bond market, most developers do not find rental housing projects profitable, even without the requirement that 20 percent of the units be reserved for low-income tenants. The targeting requirement probably worsens the profit outlook somewhat, but is not the primary factor impeding bond issuance.

Enforcement of the targeting requirement could prove to be a problem, since many of the bonds are being issued with maturities shorter than 20 years. Bond counsels have required that the 20-year targeting requirement be filed as a deed restriction or covenant running with the land, so that it binds current and future owners of the project. If abrogated, low-income tenants, or the bond issuing agencies, would possibly sue for enforcement of the restriction.

Very little is known about the quality of the units that have been set aside for low- or moderate-income tenants (whether they are less desirable than or separated from the other units, for instance).

PROPOSED AMENDMENTS TO THE ACT

The Miscellaneous Tax Bill (H.R. 4717) passed by the Senate on December 16, 1981, contains provisions easing the restrictions on bonds for owner-occupied and rental housing. The House bill contains no provisions dealing with housing bonds.

The Senate version of the bill would allow slightly higher yields on mortgages financed with bond proceeds. Most issuers feel that these higher yields would enable them to issue bonds with smaller cash contributions, but that some contribution would probably still be needed in most cases. The Senate bill would also shorten the length of time during which the targeting requirement for rental housing bonds would be in effect. The Joint Committee on Taxation estimates that the federal revenue loss of the amendments would be $4 million in fiscal year 1983 and $22 million in fiscal year 1986, for a total revenue loss over 1983-1986 of $50 million.

CHAPTER I. INTRODUCTION AND BACKGROUND

The volume of state and local tax-exempt bonds for owner-occupied housing rose sharply in the late 1970s, from a total (including bonds for veterans' housing) of about $1.3 billion in 1976 to about $12 billion in 1980.[1] The latter amount constituted 21 percent of the total long-term, tax-exempt bonds issued in that year.[2] Much of the growth was caused by the entry of local governments into the tax-exempt housing bond market for the first time.

This large increase and shift in the use of tax-exempt bonds prompted several concerns in the Congress. It was feared that the growth in housing bond volume would generate large federal revenue losses and push up interest rates on bonds issued for traditional municipal projects, such as schools and roads. In addition, the Congress was concerned about the allocation of the federal subsidy created by the bonds' tax-exempt status. To improve the bonds' efficiency, the Congress wanted to channel as much of the subsidy as possible to homebuyers and to target the subsidy on deteriorated neighborhoods and first-time homebuyers.[3] In response to these concerns, the Congress enacted restrictions on the use of tax-exempt bonds for housing in the Mortgage Subsidy Bond Tax Act of 1980.[4]

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1. Figures are from Fred Thompson, Department of Housing and Urban Development.

2. Based on CBO total for tax-exempt bonds, which includes large amounts of industrial development bonds not compiled elsewhere.

3. See The Mortgage Subsidy Bond Tax Act of 1979, Report on H.R. 5741, House Committee on Ways and Means, 96th Cong., 1st sess. (1979).

4. The Mortgage Subsidy Bond Tax Act of 1980 was part of the Omnibus Reconciliation Act of 1980 (Public Law 96-449) and was amended on December 24, 1980 by Public Law 96-595.

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BACKGROUND

Bonds for Owner-Occupied Housing[5]

The first tax-exempt bonds for owner-occupied housing were issued by California after World War I and by Oregon shortly after World War II to provide below-market-rate mortgages for veterans. In the early 1970s, state housing agencies started issuing bonds to finance mortgages on single-family housing for all state residents of low- or moderate-income. In 1978 cities and counties began to issue the bonds; at about the same time, state agencies shifted their efforts sharply from rental housing toward owner-occupied housing, much of it in the suburbs and aimed at middle-income families.

Each bond program is slightly different. Some state and local housing agencies have large staffs that play an active role in the month-to-month administration of their programs, while other issuers have no staffs and consist of boards of local citizens who meet only to approve the bond issues. The basic mechanics of the issues are all the same, however. Bond proceeds are used to purchase mortgages made by private lending institutions according to rules laid out by the issuer. The private lenders process the loan applications, automatically accepting those that meet the issuer's eligibility requirements and the lenders' creditworthiness standards. The selected homeowners send their monthly mortgage payments to the lenders, who forward the money to another financial institution, which pays the bondholders. Because the bonds are generally not backed by the issuer's full faith and credit, the bondholders and mortgage insurers assume any risks of a bad mortgage portfolio.

Because interest on the bonds is tax exempt, bondholders are willing to accept a lower interest rate on them than on comparable taxable securities. This enables a below-market interest rate to be offered to homebuyers on their mortgages. The federal government subsidizes the issues in that it loses the taxes that would otherwise be paid on bond interest. The subsidy mainly is divided between the bondholders and homebuyers, with some portion also going to the various intermediaries in the process.

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5. See Congressional Budget Office, Tax-Exempt Bonds for Single-Family Housing (April 1979).

Bonds for Rental Housing

Although the first tax-exempt bonds for rental housing were issued in 1955 by New York State, it was only in the early 1970s that large numbers of state housing agencies began to issue bonds for rental housing.[6] In the mid-1970s, state housing agencies became heavily involved with the then new Section 8 housing program, under which the federal government pays private project owners a large portion of rent on behalf of low-income tenants. The housing agencies issue tax-exempt bonds to provide construction and permanent financing for these privately owned Section 8 apartment buildings.

Section 11(b) of the Housing Act of 1937, as amended in 1974, provided a new authority to issue tax-exempt bonds for Section 8 projects to local housing agencies, nonprofit organizations, and individuals designated as public instrumentalities. In 1978, $800 million in tax-exempt bonds was issued by these local public agencies and their instrumentalities for Section 8 housing.[7] In the late 1970s and early 1980s, most tax-exempt bonds issued by state housing agencies for rental housing financed Section 8 projects, although some state bonds financed market-rate rental projects, and local governments frequently issued bonds for market-rate apartment buildings. Very often the mortgages on the market-rate projects are insured by the Federal Housing Administration.

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6. For a brief history of the development of tax-exempt bonds for housing, see Council of State Housing Agencies, The History of Tax-Exempt Financing for Housing Development (1981).

7. Ibid, p. 3. The Department of Housing and Urban Development (HUD) issues tax-exempt, federally guaranteed notes to finance the construction, modernization, and acquisition of public housing agency apartment projects. In 1981, HUD issued $20.1 billion of these notes, with maturities of between three months and one year. (Weekly Bond Buyer, February 16, 1982.) As of March 1, 1982, $10.4 billion of these notes was outstanding. HUD also issues tax-exempt notes for urban renewal projects. On March 1, 1982, $130 million of these urban renewal notes for housing was outstanding. In 1981, $1.5 billion in other interim construction financing and short-term notes was issued by state and local housing agencies (Fred Thompson, HUD).

THE MORTGAGE SUBSIDY BOND TAX ACT OF 1980

Restrictions of the Act

The 1980 act imposed many restrictions on the issuance of tax-exempt bonds for owner-occupied housing and eliminated the tax exemption on all bonds (except those for veterans' housing) issued after December 31, 1983. The major restrictions of the legislation are:

- Special provisions (called "arbitrage" provisions) restricting the yield on mortgages and invested reserves funded with bond proceeds (the yield on these investments is usually higher than the yield on the bonds);
- State-by-state annual limits on aggregate bond volume;
- Rules requiring nearly all homebuyers to be first-time homebuyers;
- Limits on the prices of houses to be purchased;
- A requirement that 20 percent of lendable proceeds be set aside for mortgages in designated "targeted areas"; and
- A requirement that all bonds be issued in registered form after January 1, 1982. (Registration requires that the name of the current bondholder be recorded with the trustee bank.)

Bonds issued to finance mortgages for veterans are exempted from all of the requirements, including the sunset provision, provided that the bonds are general obligation bonds, backed by the full faith and credit of the state and issued in registered form. The act does forbid the use of veterans' bond proceeds to replace or acquire existing mortgages.

The act also restricts the use of tax-exempt bonds to finance home-improvement loans. Home-improvement bonds are subject to all of the restrictions listed above, except for the rules requiring loan recipients to be first-time homebuyers and the rules limiting the prices of houses to be financed with bond proceeds. Home improvement loans cannot exceed $15,000.

To target the subsidy of tax-exempt bonds for rental housing, the act requires that at least 20 percent of the units (15 percent in targeted areas) in apartments financed with tax-exempt bonds be rented to tenants of low- or moderate-income for at least 20 years, and that all of these bonds be issued in registered form after January 1, 1982. (The Senate version of the Miscellaneous Tax Bill, H.R. 4717, would shorten the length of time during which the low- and moderate-income tenant requirement is in force.)

Effects of Act

Few bonds were issued under the new restrictions until November 1981, mostly because lenient transitional rules allowed many bond issues in the pipeline to be issued free of the restrictions. Issuances were also delayed because temporary regulations establishing workable administrative compliance procedures were not set forth until November 5, 1981.[8]

Publication of the temporary regulations, coupled with a slight drop in interest rates, led to a large number of issues in the last two months of 1981. Issuers were anxious to market bonds before 1982 in order not to have to use part of their 1982 bond allocation total and to avoid the registration requirement that went into effect on January 1, 1982. All told, 38 issues of bonds for mortgages on owner-occupied houses (other than general obligation bonds for veterans' houses) were issued under the permanent rules of the act in 1981, for a total of $1.68 billion. Eight issues of home-improvement bonds were issued in 1981 totaling $155 million, bringing the total of bonds issued under the permanent rules to 53 percent of all bonds for owner-occupied housing (other than veterans' housing) issued in 1981. Roughly $1.1 billion in tax-exempt bonds for rental housing was issued in 1981, although

8. The Internal Revenue Service issued temporary and proposed regulations on the provisions dealing with mortgage revenue bonds on July 1, 1981 in the Federal Register (46 Fed. Reg. 34311 and 34348), which were amended by a notice of proposed rule making released on November 5, 1981. The thrust of the amendments had been announced by John Chapoton, Assistant Secretary of the Treasury Department, on October 15, 1981.

only several hundred million dollars of rental housing bonds were affected by the act.[9]

Nearly all of the bonds for owner-occupied housing were subsidized by an appropriation of a state or local government or a contribution of a housing agency from previously accumulated surpluses. These contributions were needed because of provisions in the act that place strict limits on the yields on investments made with bond proceeds. As another amendment to the Miscellaneous Tax Bill (H.R. 4717), the Senate passed a provision that would allow a slightly larger spread between the yield on mortgages and the yield on the bonds. The total revenue loss from this amendment and the one shortening the duration of the targeting requirement for rental bonds would be $4 million in fiscal year 1983, increasing to $22 million in fiscal year 1986.[10] The corresponding House bill contained no reference to mortgage subsidy bonds.

PLAN OF THE PAPER

The purpose of this study is to present data gathered on the bonds issued under the permanent rules of the act. Detailed information on each bond issue is presented in Appendixes A, B, and C, and an overall summary of the workings of the major provisions is presented in the body of the report, with emphasis on the provisions discussed in the conference on the Miscellaneous Tax Bill.

The bulk of the study is devoted to analyzing bonds for owner-occupied housing, since these bonds are most affected by the act. Chapter II describes the effects of adverse market conditions--very high interest rates--and the ways in which state and local govern-

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9. Figures for totals of owner-occupied and rental housing bonds are from Fred Thompson, Department of Housing and Urban Development. Nearly all of the rental housing bonds would have met the requirements of the act even had no legislation been passed. Some of the rental housing bonds were issued under Section 11(b) of the Housing Act of 1937, as amended, and are therefore not subject to the restrictions imposed by the 1980 act.

10. Joint Committee on Taxation, pamphlet summarizing H.R. 4717, Miscellaneous Tax Bill, as amended and passed by the Senate (February 12, 1982).

ments have reacted. Chapter III is devoted to the arbitrage provisions of the act. It describes the new rules and the difficulties they pose for the issuance of self-supporting bond issues, the forms and uses of subsidization funding, the techniques for structuring self-supporting issues, and the net effect of the rules and whether they are accomplishing their intended goals. Chapter IV summarizes the effects of the act's other provisions on bonds for owner-occupied housing and home-improvement loans. Chapter V describes bonds issued for rental housing.

Appendix A is in the form of a table providing the following information on each issue of bonds for mortgages on owner-occupied housing: date and size of issue; net interest cost and mortgage interest rate; type of bond obligation and type of mortgage; bond ratings; percentage application of funds for mortgages, reserves, costs of issuance, and bond discount; amount of funds from sources other than bond proceeds; designated recipient of excess arbitrage earnings; percent of lendable funds set aside for targeted areas; ranges of purchase price and income limits; and issuer's other bonds outstanding and fund balance. The footnotes to the table describe each issue briefly, the source and use of any contributed funds, the fees imposed on various participants, the number of lending institutions involved, and the names of the underwriters. Appendix B is a comparable table containing information on the bonds issued for home-improvement loans, and Appendix C is a table containing data on a sample of bonds for rental housing.

Data for the tables were derived from each issue's official statement. The body of the study summarizes that data and relies heavily on information from telephone conversations with lawyers, investment bankers, state housing agency officials, and insurance company and rating agency personnel.[11]

11. The study does not cover technical legal issues, but these issues are addressed in "Regulations on Mortgage Subsidy Bonds," by Dale Collinson and the Tax Section of the New York State Bar Association (December 30, 1981).

CHAPTER II. IMPACT OF ADVERSE MARKET CONDITIONS

Even had no restricting legislation been enacted, states and local governments would have had trouble issuing mortgage revenue bonds in late 1981. Demand by investors for tax-exempt bonds had dropped off significantly, particularly for those like housing bonds that typically have long maturities. Individual investors found tax-exempt bonds less attractive an investment with the reduction in the top marginal tax rate to 50 percent and with the enactment of new tax-preferred savings incentives--expanded individual retirement accounts and Keough accounts and tax-free all savers' certificates.[1] In addition, the demand for tax-exempt bonds by traditional institutional investors--commercial banks and casualty insurance companies--had almost dried up.

HIGH INTEREST RATES

As a result of the conditions discussed above, the level of interest rates on long-term tax-exempt bonds rose sharply to about 85 percent of the rates on comparable taxable bonds, compared to the 70 percent ratio that characterized the relationship throughout the 1970s.[2] With taxable interest rates extremely high, tax-exempt interest rates reached all-time highs.

The high level of interest rates on tax-exempt bonds, both in absolute terms and relative to rates on taxable bonds, posed serious problems for mortgage revenue bond issuers. Since the interest rate charged on the mortgages has to be high enough to defray the interest expense on the bonds, high bond interest rates lead necessarily to high interest rates on mortgages financed with bond proceeds. But if tax-exempt interest rates are high relative

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1. These were all provisions of the Economic Recovery Tax Act of 1981 (Public Law 97-34).

2. The ratio of yields on Aaa-rated, 20-year general obligation tax-exempt bonds to yields on 20-year U.S. government bonds ranged between 77 and 91 percent and averaged about 85 percent in November and December 1981 (Department of HUD).

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to taxable rates, the interest savings on mortgages financed with tax-exempt bonds may not be very large, and there may not be sufficient demand for these mortgages. This would be particularly true if homebuyers associated mortgage revenue bond programs with burdensome red tape or other restrictions. Under many of the programs, for instance, homebuyers are charged loan origination fees of several percentage points, which make these mortgages less attractive for many first-time homebuyers who plan to pay off their mortgages within a few years. In addition, under the act, the pool of potential mortgagors is limited explicitly to first-time homebuyers and to those buying moderately priced houses, which automatically restricts the potential market for the mortgages.

Tax-exempt bond rates that are high in absolute terms result in mortgage interest rates that are high in absolute terms, which also limits the market for the mortgages. At very high interest rates, the number of people interested in buying houses is limited, and those who are interested in buying may find it difficult to qualify for mortgages. This is especially true of first-time homebuyers who, as a group, tend to have relatively low incomes and of all homebuyers in programs with low-income limits.[3]

In order to reduce interest rates on bond-financed mortgages, several states have "bought them down." Alaska, Tennessee, and Wisconsin made cash contributions to their mortgage bond issues to reduce the interest rates charged on mortgages.

An additional problem caused by market conditions generally occurs when tax-exempt rates are high relative to taxable rates, especially under the new arbitrage rules. In late 1981, issuers were unable to invest bond proceeds at rates as high as rates on the bonds. Since it can take up to a year and a half to make all of the mortgages, bond proceeds are invested until then in short-term securities. To the extent that the yield on those securities is below the interest cost of the bonds, it may be more difficult to demonstrate that the bonds are creditworthy.

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3. See the footnotes to the Riverside, California issue in Appendix A. A market demand study found that only 11 percent of the county's population has income below $34,344 (enabling them to fall below the program's income limit) and above $28,413, the minimum income to qualify for a mortgage on the houses being constructed under the program.

RESPONSES TO ADVERSE MARKET CONDITIONS

Several bond issues that had been planned for late 1981 were scaled back, postponed, or cancelled.[4] As mentioned above, in a few instances states contributed funds to reduce interest rates on the mortgage loans. In other cases, the maturities on the mortgage loans were reduced, enabling the issuer to shorten maturities on the bonds and thereby issue bonds at lower interest rates than rates prevailing on long-term bonds.

Mortgage maturities have been shortened in several ways. Some programs (Kentucky; Oklahoma; and central, east, and southeast Texas) offer level-payment mortgages that amortize over terms shorter than 30 years--usually 20 or 25 years. Growing equity mortgages (GEMs) are being offered in Hawaii, Michigan, and Florida. Interest rates on GEMs are fixed for the life of the mortgage, and the payments in the first year are the same as payments on a 30-year, level-payment mortgage at the same interest rate. At specified intervals thereafter (usually once each year), monthly mortgage payments are increased (usually by 3 percent each year), with the entire increase used to pay off principal more quickly than under the standard 30-year mortgage. As a result, the entire mortgage is paid off quite early--at the end of 16 or 17 years.[5]

Average bond maturity has also been shortened by structuring the bonds on the assumption that mortgagors will prepay their mortgages at the same rate as experienced historically by the Federal Housing Administration (FHA) for the region of issuance. Since structuring the bonds on the assumption that prepayments will occur is now considered somewhat risky, this kind of structuring is coupled with a letter of credit from a bank. Under this agreement,

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4. These include, among others, issues in Indiana, Maryland, Montana, West Virginia, and Benton County, Arkansas. Adverse market conditions were probably not the only factor causing difficulties for these issues, however.

5. At least one issuer is planning to offer mortgages in which monthly payments would be the same as those on a 30-year, level-payment mortgage but whose principal balance would be due at the end of fifteen years. A private lender would agree to refinance these "balloon mortgages" at the market interest rate prevailing at the end of the fifteen years.