Tax-Exempt Single-Family Mortgage Bonds

By Peggy Brockschmidt

The sale of tax-exempt bonds to finance housing programs has risen rapidly in recent years. Sales of these bonds, most of which were used to finance single-family housing, rose from less than $1 billion in 1974 to $12 billion in 1979. As a result, these bonds accounted for more than a fourth of all tax-exempt issues in 1979. The rapid increase in the issuance of single-family mortgage bonds has generated concern about their effects on local and national mortgage markets, on tax-exempt securities markets, and on monetary and fiscal policy. Reflecting this concern, recent efforts have been made in the U.S. Congress to curb the issuance of these securities, and the future of the securities remains uncertain.

This article discusses the development and the effects of single-family mortgage bonds. The first section of the article reviews the activities of state and local housing finance agencies. The second section examines single-family mortgage revenue bonds issued by local governments. Next, the local and national effects of single-family tax-exempt bonds are discussed; and then the future of tax-exempt bonds for housing is considered.

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HOUSING FINANCE AGENCIES

A housing finance agency (HFA) is an instrumentality of a state or local government with the power to finance housing primarily for low- and moderate-income families through the sale of notes and bonds in the municipal securities market, which is composed of securities issued by state and local governments and their agencies. Since interest on securities issued in the municipal market are fully exempt from Federal income taxes, the market is also referred to as the tax-exempt market.

Background

Most HFA's were formed in the late 1960s or early 1970s, except for the New York State Housing Finance Agency which was founded in 1960. The major impetus for their formation was the Revenue Adjustment Act of 1968. The act delineated "quasi-public" purposes for which tax-exempt funds could be raised, even though they would benefit private companies or individuals, including "residential real property for family units." A further spur to the development of HFA's was the temporary moratorium on direct Federal subsidies for housing imposed in 1973 by the Nixon Administration. Currently 40 states, the District of Columbia, and Puerto Rico have one or more HFA's.

Housing finance agencies are set up by state law and have limits on their total bond issuance and on the kinds of housing activities they are permitted. The proceeds of a bond issue are used to finance mortgages and to set up reserves for debt service. If mortgage payments are insufficient to meet debt service payments, money is drawn from the reserves. Since housing finance agencies have no taxing power, payments on the bonds are made primarily through the repayment of the mortgage loans securing the bonds and by interest income on available funds in the various reserves.

Single- vs. Multi-Family Housing

In the early years of the HFA's, nearly all the funds raised in the tax-exempt market were used to provide multi-family housing, which was an extension of programs existing since the 1930s in which state and local governments borrowed funds to construct public housing. In recent years, however, a greater portion of the funds have been channeled into single-family housing.

Multi-family housing programs are often, though not always, related to a specific Federal subsidy program targeted toward low- and middle-income families.[1] Prior to 1973, the Section 236 program of the Department of Housing and Urban Development (HUD) supported the activities of HFA's. In recent years, HUD's Section 8 program has been used by HFA's in the multi-family housing programs. Over the 1970-79 period, about 5 per cent of the dollar value of all multi-family mortgages made was financed by state housing finance agencies. In addition, as shown in Table 1, at the end of 1979 they held 12.1 per cent of all outstanding construction loans and 6.8 per cent of all permanent mortgages for multi-family properties.

Single-family housing programs have grown rapidly of late. From 1970 to 1979, the proportion of single-family loan originations and purchases by HFA's to the total originations and purchases by HFA's rose from less than one-third to over 80 per cent. In part, this growth reflects the developments of HFA's in the South and West, where multi-family housing is less common than in the Northeast, and the establishment of programs to provide single-family housing for veterans. Primarily, however, this growth reflects the popularity of programs meant to reduce the costs of home ownership for low- and moderate-income families. Other programs for single-family mortgages have been set up by HFA's to stimulate lending when mortgage money is less available and to revitalize depressed urban areas.

Programs

HFA's have taken various approaches in providing mortgage money to their areas. The programs fall into four major categories: developer loans, loans-to-lenders programs, mortgage purchase plans, and direct mortgage loans.[2]

Developer Loans. The major vehicle for financing multi-family housing for low- and moderate-income families has been the direct loan to a developer for construction of multi-family housing. These loans are below market rates because funds have been obtained in the tax-exempt market at rates about 25 per cent

[1] See Peggy Brockschmidt, "Multi-Family Housing in the 1970s," *Economic Review,* Federal Reserve Bank of Kansas City, July-August 1978, for a description of Federal multi-family housing programs.

[2] This discussion is taken in part from George E. Peterson, *Tax-Exempt Financing of Housing Investment* (The Urban Institute: Washington, D.C., 1979), pp. 13-18.

lower than in taxable markets. The lower cost of capital to the developer results in lower housing costs when the reduced costs are passed along to the renter in the form of lower rents. Loans can be either short term to finance construction of a project (the more common approach) or long term to provide permanent financing. Developer loans can also be made to finance single-family housing. However, use of programs that subsidize the homeowner directly are more common.

Loans-to-Lenders Programs. A common arrangement for supplying subsidies for single-family mortgages is a program to lend funds to financial institutions, which in turn relend the funds to qualified homebuyers. The HFA will usually specify the interest rate charged on the loans, and it is the reduced interest rate (and hence the lower monthly payments) that provides the subsidy to the homeowner. Within the income guidelines and the geographical and other limits imposed by the HFA, lenders follow their usual lending criteria.

Mortgage Purchase Program. In some programs, the HFA operates as a secondary market purchaser of single-family mortgages. The agency may either purchase existing mortgages or make a commitment to purchase in the future mortgages originated by financial institutions. Buyers of particular types of housing or sizes of mortgages or those meeting

Table 1
MORTGAGE ACTIVITY OF STATE HOUSING FINANCE AGENCIES

	1970		1979	
	Millions of Dollars	Per Cent of Total Market	Millions of Dollars	Per Cent of Total Market
Single Family				
Originations	139	0.4	1,877	1.0
Purchases	14	0.1	1,740	2.5
Outstandings	1,884	0.7	10,704	1.4
Construction Outstandings	–	–	18	–
Multi Family				
Originations	316	3.6	607	4.0
Purchases	4	0.4	159	3.1
Outstandings	1,917	4.2	7,254	6.8
Construction Outstandings	243	3.9	1,480	12.1

	Single Family as a Per Cent of Total	
	1970	1979
Originations and Purchases	32.3	82.5
Outstandings	49.6	59.6

SOURCE: Department of Housing and Urban Development. Includes data from New York City housing finance agencies.

established criteria thus have available more funds than would otherwise be the case. This plan is similar in many respects to the purchase program operated at the Federal level by the Federal National Mortgage Corporation (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC).

Direct Loan Program. In a few cases, HFA's have chosen to make loans directly to homebuyers rather than through financial institutions. While administratively more complex, this approach allows the agency tighter control over the distribution of the benefits of the subsidy.

LOCAL GOVERNMENT SINGLE-FAMILY MORTGAGE BONDS

The increased activities of state and local housing finance agencies in supplying single-family housing credit were a precursor to the issuance of mortgage bonds directly by local governments. Tax-exempt bonds are used by the municipality to make single-family mortgage loans. These bonds were rare prior to 1978.[3] The first program to receive public attention was introduced by the city of Chicago, which in June 1978 issued $100 million of single-family mortgage revenue bonds. The total amount issued by local governments rose from $550 million in 1978 to approximately $6 billion in 1979.

These city and county programs of mortgage-backed bonds for single-family housing are similar in many respects to the HFA programs. Typically, they follow the loans-to-lenders or mortgage purchase approach and work through financial institutions in the community. The issues will usually restrict the location of the home to the geographical boundaries of the local government and will, in addition, often have limits on the income of prospective homebuyers or on the value of the house to be purchased with tax-exempt funds.

The income and mortgage limits placed on local government single-family mortgage revenue bonds have typically been less restrictive than those imposed by state HFA's. The program limits have often been much above median incomes in the community and thus include the majority of families in the area. In the 50 programs listed in a Congressional Budget Office study of tax-exempt bonds used to finance single-family housing,[4] nine had no income restrictions. The median income limit of the remaining 41 programs was $30,000, with a range of $18,000 to $60,000. In half of these plans, the maximum income level was more than twice the median income of the community. Twenty-eight of the 50 bond issues had no mortgage limits. In the remainder, the median mortgage limit was $60,000, with a range of $44,500 to $100,000. While restrictions on the total assets of borrowers are frequently found in state HFA programs, none of the local government plans had asset limits.

Another difference between local single-family bonds and HFA issues is the degree of risk to the bondholders. HFA issues are commonly backed by the obligation of the agency, that is, the HFA will draw upon its own revenue sources to meet the debt repayment obligations of its bonds. The bonds are also often backed by the "moral obligation" of the municipality or state sponsoring the agency.

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[3] In 1974, Minneapolis issued $10 million of general obligation bonds to finance a city housing rehabilitation loan and grant program. Since then, the city has raised tax-exempt funds for both rehabilitation and new construction through a variety of sources.

[4] *Tax-Exempt Bonds for Single-Family Housing,* a study prepared by the Congressional Budget Office for the Subcommittee on the City of the Committee on Banking, Finance, and Urban Affairs, House of Representatives, 96th Cong., 1st sess., April 1979, pp. 11-14.

Local issues, on the other hand, are normally revenue bonds, that is, only the revenues from the mortgage pool can be used to repay bondholders. It is for this reason that many issues carry private mortgage insurance covering a portion of the entire pool or mortgages and providing an extra layer of protection for bondholders. This insurance is in addition to the private mortgage insurance which is generally used for mortgages in which the loan-to-value ratio exceeds 80 per cent.

EFFECTS OF SINGLE-FAMILY MORTGAGE BONDS

The increase in the supply of mortgage money and the associated increase in tax-exempt debt implied by the issuance of single-family mortgage bonds has both positive and negative impacts. Short-run impacts include the displacement of regular mortgage lenders. Long-run effects include the impacts on borrowing costs of state and local governments and on Federal revenues, which will depend heavily on the future growth of single-family mortgage bonds. This section discusses some of the effects on both the local and national level of the financial innovation of funding single-family mortgages through the tax-exempt market.

Local Effects

The rapid growth of the use of tax-exempt bonds to finance single-family housing has led to discussion of the effect of the bonds on the welfare of individuals, neighborhoods, and cities. In addition, the impact of the bonds on the local mortgage market is a topic of particular concern to long-time mortgage lenders such as savings and loan associations and mortgage companies.

Individuals. The major beneficiary of single-family mortgage bonds is the individual homebuyer who obtains a mortgage at a rate that is, on the average, 20 per cent less than conventional mortgage rates.[5] The lower rate will enable the homebuyer to make lower mortgage payments than would otherwise have been the case or, alternatively, the homebuyer can buy a more expensive house for the same payment level. An additional beneficiary may be the seller of the house, assuming the buyer's access to cheaper money induces the buyer to pay a higher price for the house.

Neighborhoods. Some single-family mortgage bond issues have limited the location of the homes eligible for purchase under the program to central city areas. Others have set aside a portion of the funds for rehabilitation loans to substantially improve older homes. In these cases, the cities felt that state HFA's were not meeting urban redevelopment needs and used the tax-exempt market as a new source of funds for aiding older urban areas. However, the social goals of improving the quality of the neighborhood and bringing middle-class homeowners back to central city areas are thought by some to have undesirable side effects. The major source of concern is that "gentrification"—as the introduction of middle-class homeowners into a neighborhood is called—will result in displacement of lower-income renters, who are often members of ethnic minorities.

Another implication of mortgage bonds is the upward pressure placed on housing prices in a neighborhood because of the increased demand resulting from greater availability of mortgage funds. In cases where the funds supplied amount to one-third to one-half the average volume of mortgage loans made in an area, this impact can be particularly severe. The effect may possibly be mitigated by provisions that

5 Peterson, *Tax-Exempt Financing of Housing Investment*, pp. 37-38.

loans be used to finance new or rehabilitated homes rather than existing homes, assuming that resources are available to meet the increase in housing demand.

Cities. Local communities can experience several benefits because of their issuance of single-family tax-exempt bonds. First, the total supply of both new and rehabilitated houses in the city can be increased. Next, employment in construction and related industries may increase, resulting in a higher tax base and a higher level of employment, leading in turn to increased property, income, and sales tax revenues for the local government.

The benefits accruing to local communities can be offset if nearby communities issue tax-exempt mortgage bonds. For example, after the Chicago single-family mortgage bond was issued, several Chicago suburbs also floated bond issues to increase the supply of mortgage money to their communities, which diluted the impact of increasing the supply of housing money to attract new families into the central city.

Local Mortgage Markets. The money raised by single-family mortgage bonds can temporarily increase the supply of funds in local mortgage markets. In cases where state usury ceilings have restricted lending by normal mortgage originators, tax-exempt bonds may be a significant source of funds to the local mortgage market.[6] The lending institutions in the community then function as mortgage bankers and use the capital raised in the tax-exempt market to originate new mortgages. They can profit through the retention of servicing and originating fees without having to supply capital.

The extent to which other loan demand at mortgage lending institutions is affected by the issuance of single-family tax-exempt issues will depend primarily on the degree to which subsidized homeowners resemble unsubsidized homeowners. If the two groups are very similar, i.e., if income and mortgage ceilings are nonexistent or ineffective, local mortgage lenders may find that their mortgage demand has declined. No increase in housing supply or in the proportion of the population owning homes will occur; subsidized families will simply replace unsubsidized ones. Regular lenders may then adjust to the reduction in local mortgage demand by reducing their mortgage rates to stimulate demand, or by reducing their secondary market sales of mortgages, buying mortgages in the secondary market, or supplying other types of credit.

National Effects

Besides the effects on individual localities, single-family mortgage bonds can affect tax-exempt securities markets, Federal revenue, and monetary policy.

Tax-exempt Securities Market. The volume of bonds issued in the tax-exempt market has doubled since 1974. Table 2 shows, however, that during the 1974-79 period the issuance of general obligation bonds, i.e., bonds backed by the full faith, credit, and taxing power of the state or local government, has remained relatively unchanged. The increase has occurred in revenue bonds, that is, bonds whose repayment is expected to be made from the stream of revenue generated by the projects financed by the bond proceeds. Such projects include hospitals, pollution control projects, industrial parks, and sports arenas, as well as single- and multi-family housing. But housing has been the major area of growth in 1978 and 1979. As Table 2 indicates, the level of housing revenue bonds issued grew fivefold from 1977

[6] Federal legislation preempted state mortgage usury ceilings beginning January 1, 1980. The preemption would be removed if the state adopts a new usury ceiling.

Table 2
GROSS NEW TAX-EXEMPT BOND ISSUANCE
(Billions of Dollars)

	Total	General Obligation	Revenue Total	Revenue Housing	Revenue Other
1974	22.8	13.0	9.8	0.7	9.1
1975	29.3	15.0	14.3	0.6	13.7
1976	33.8	16.9	16.9	1.5	15.4
1977	45.1	17.9	27.2	2.4	24.8
1978	46.2	17.9	28.3	5.6	22.7
1979	41.9	12.6	29.3	11.9	17.4

SOURCE: Salomon Brothers **Bond Market Roundup**, February 1, 1980.

to 1979, while other revenue bonds declined.

The growth in housing-related bonds has raised concern about the effects that the increased supply of bonds will have on tax-exempt interest rates. The spread between taxable and tax-exempt rates depends on the income tax bracket of the marginal purchasers of tax-exempt issues, since as the amount of tax-exempt issues increases, other things equal, buyers with lower tax rates will have to be drawn into the market. To equate the taxable and tax-exempt rates for the marginal investor, the tax-exempt rate will rise. This may cause an increase in tax-exempt rates in general and reduce the spread between tax-exempt and taxable rates. The increase in all tax-exempt rates relative to taxable rates may pass on a portion of the costs of housing bond programs to all taxpayers, not just to those located in areas financing housing through tax-exempt bond sales. Also, higher tax-exempt bond rates may lead to postponement or cancellation of bond sales to finance traditional public programs.

The greater issuance of housing bonds may also increase the spread between rates on housing bonds and other tax-exempt revenue and general obligation bonds. Furthermore, at some point, because of single-family housing bond issuance, borrowing costs for multi-family housing projects as well as other revenue projects may be pushed so high that they will become difficult to offer.

Quantifying the impact of the increased supply on tax-exempt rates is no simple matter. Estimates of the impact depend heavily on assumptions about the characteristics of investors in tax-exempt securities and the range of securities and other alternative investments available. Two major studies analyzing the effect of single-family mortgage bonds on tax-exempt rates have been done. The first, by George Peterson for the Department of Housing and Urban Development, concluded that rates would be increased 4 to 7 basis points per $1 billion of tax-exempt mortgage bonds, while the second, by Roger Kormendi and Thomas Nagle for the Public Securities Association, concluded that the impact would be much smaller.[7]

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[7] See Peterson, pp. 103-18, and Roger C. Kormendi and Thomas T. Nagle, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds," Working Paper, University of Chicago, January 1980.

Peterson analyzed the tax-exempt market by using a model in which demand for these securities by institutional investors is dependent on net cash flow and any securities not taken by those sectors of the economy are purchased

Federal Revenues. A second issue closely related to the effect on tax-exempt bond markets is the effect on Federal revenue of an increased volume of tax-exempt issues and the accompanying increase in tax-exempt interest income. To the extent that investors shift from taxable investments such as stocks, corporate bonds, and other investments, Federal income tax revenues will be reduced. This revenue loss will have to be offset by increased payments by taxpayers in general or by an increase in the deficit, which will increase inflationary pressures in the economy. Projections of expected Federal revenue loss depend primarily on assumptions about the marginal tax rate of those buying the additional tax-exempt securities and the tax rates on alternative investments.

These revenue losses will be partly offset by a reduction in mortgage interest deductions on Federal tax returns since the interest payment on the tax-exempt mortgages is less than on conventionally financed mortgages.

Estimates of net Federal revenue losses were $31.5 million for every year the bonds are outstanding for each $1 billion in tax-exempt housing bonds in the Peterson study and only $10-11 million in the Kormendi-Nagle study.[8] Neither study incorporated the effect of the increased income of investment bankers, mortgage pool insurers, and mortgage servicers on increasing Federal revenues.

Monetary Policy. Typically, the housing sector has felt the greatest impact of monetary restraint, since it is closely dependent on the availability of credit and the level of interest rates.[9] The desirability of reducing the sensitivity of housing to monetary policy is a debated subject. Some would view the response of housing to a restrictive monetary policy as harmful to the economy. They contend that housing should be no more severly affected than other sectors, and that the strong cyclical movements in housing production drive homebuilders out of the industry and ultimately make home ownership more expensive. Opponents of this view contend that housing is the only sector of the economy sufficiently responsive to interest rate changes and therefore is a natural area for stabilization.

Some observers have argued that policy decisions of the Federal government have reduced the effectiveness of high interest rates in reducing mortgage demand. They also contend that more recent actions, such as the

by individuals. The rate on tax-exempt securities depends on the change in individuals' holdings relative to the change in their holdings of all assets. It adjusts relative to the taxable interest rate to attract enough buyers into the tax-exempt market to absorb the total supply. It should be noted that the supply of other types of securities and the rates on these securities do not affect the demand for tax-exempt securities in this model. The study concluded that each $1 billion in tax-exempt mortgage bonds would push up tax-exempt rates by 4 to 7 basis points.

Kormendi and Nagle attempted to incorporate additional factors into this basic analysis. Including other types of investment in the model and enlarging the sample period led them to conclude that Peterson had over-estimated the impact of an increase in issuance of tax-exempt bonds on the rate of such securities. Their analysis indicated that the initial rate impact would be only 0.9 basis points per $1 billion and the long-run effect only 0.33 basis points.

8 In all cases, the revenue loss exceeds the subsidy to housing, since the taxes avoided by high-bracket holders of mortgage bonds exceed the difference between the interest payments on tax-exempt and taxable financing. The larger yield required by taxpayers in the marginal tax bracket to equate tax-exempt and taxable yields is paid to all bondholders, even though those taxpayers in tax brackets higher than the marginal bracket would have been willing to accept lower rates. The greater income received on these securities by higher bracket investors makes the Federal revenue loss exceed the gain to state and local governments of the tax-exempt privilege.

9 William E. Gibson, "Protecting Homebuilding from Restrictive Credit Conditions," *Brooking Papers on Economic Activity,* 1973:3, pp. 647-91.

introduction of money market certificates and the relaxation of usury ceilings, may have served to further reduce the effects of monetary policy. Any similar measure which allows the effects of high interest rates to be diluted, then, would further reduce the linkages between the level of interest rates, monetary policy, and the growth of economic activity. To the extent that these observers are correct, and if single-family mortgage bonds are issued in a countercyclical fashion, and thus increase in volume when interest rates are rising, monetary policy will be less effective.

THE FUTURE OF SINGLE-FAMILY MORTGAGE BONDS

The single-family housing bonds issued by HFA's and by local communities increase the access of single-family housing to capital markets. However, a range of credit instruments and financing devices is available to single-family housing through the Federal government. These arrangements have led some observers to conclude that single-family housing has sufficient access to capital markets and that the single-family mortgage bond is unnecessary. Also, they contend that the revenue loss to the Federal government from single-family mortgage bonds is unduly high.

The Federal government has encouraged single-family home ownership by both indirect support of housing markets and direct subsidy. Total "tax expenditures" by the Federal government to subsidize single-family housing have been estimated by the Congressional Budget Office (CBO) to be more than $16 billion in fiscal 1980.[10] The Federal government also supports housing through various subsidized loan programs and through special agencies which support the secondary market for home mortgages.[11]

Because of the existing support of single-family housing through Federal housing policy and the large revenue losses implied by the continued issuance of single-family tax-exempt bonds, several bills have been introduced in Congress to make the interest on single-family tax-exempt mortgage bonds subject to Federal income taxes. The bills were intended to prohibit the further use of tax-exempt state and local bonds to provide funds for owner-occupied housing, but to allow continued issuance of tax-exempt bonds to finance rental housing projects for low- and moderate-income families and to finance veterans housing.

In March 1980, the House approved the Mortgage Subsidy Bond Tax Act, which would limit single-family mortgage bonds to 5 per cent of the mortgage market in each state. The bill required that the subsidy be limited to low- and moderate-income individuals who have not been homeowners in the previous three years. It also specifies low down payments and limits the purchase price of the home to 80 per cent of the average purchase price in the area. More liberal provisions were established for areas with high unemployment. After two years, all single-family mortgage bonds would be banned.

Thus far, no legislation has been passed by the Senate to deal with such issues. It seems likely, however, that when the housing, construction, and mortgage markets recover from their current weakness, the issuance of tax-exempt mortgage bonds for single-family housing could be limited in some way.

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10 *Tax-Exempt Bonds for Single-Family Housing*, pp. 67-77.

11 Peggy Brockschmidt, "The Secondary Market for Home Mortgages," *Monthly Review*, Federal Reserve Bank of Kansas City, September-October 1977.

SUMMARY

The use of tax-exempt funds to supply mortgage money for single-family housing has raised a number of important social issues. Many of the effects of such bonds are beneficial to local communities by providing new sources of mortgage funds at times when other sources may be reduced. However, the positive effects at the local level may be insufficient to outweigh the negative impacts of single-family tax-exempt bonds on tax-exempt interest rates, Federal revenues, and other Federal taxes. In addition, the effectiveness of monetary policy is weakened by the greater access of homeowners to capital markets and by the higher level of interest rates required to dampen economic activity. For these reasons, many have proposed curbs on such instruments. Until Federal legislation is passed, discussions on the utility of tax-exempt single-family mortgage bonds is likely to continue.