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Essential Function Bonds: An Emerging Tool For Affordable Housing Finance

William Apgar and Emily J. Whiting

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Joint Center for Housing Studies
Harvard University

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I. INTRODUCTION

This report summarizes the findings of a Joint Center for Housing Studies survey of the use and performance of Essential Function Bonds. The report was sponsored by the National Association of Local Housing Finance Agencies (NALHFA), and completed with the cooperation of the National Association of Housing Redevelopment Officials (NAHRO) and the Kitsap County Consolidated Housing Authority. Additional support was provided by McDonald Investment: A Key Corp Company. The Joint Center Survey builds on a previous 1995 survey of Essential Function Bond Activity by researchers at the Graduate School of Public Affairs at the University of Washington (hereafter called the 1995 Survey).

Essential Function Bonds (or EFBs) are issued to finance the construction and substantial rehabilitation of affordable housing or other community facilities owned by state and local housing finance agencies. Although some state agencies issue EFBs as part of their efforts to expand affordable housing opportunities, local housing authorities (or LHAs) have pioneered the use of this tool. While traditionally LHAs have devoted most of their attention to operating the federally funded Public Housing and Section 8 programs, most LHAs have the legal authority needed to become involved in a wide range of housing, community and economic development activities including the construction and financing of low- and moderate-income housing. EFBs represent a promising way to access the capital needed to better serve low- and moderate-income people and communities.

Recognizing the continuing need for affordable housing, a growing number of state and local housing finance agencies have issued EFBs since the 1995 Survey. The Joint Center Survey found that as of July 2002 some 64 agencies have issued a total of $2,119 million in EFBs (Exhibit 1). Of these, there were 221 EFB bond issues outstanding totaling $1,749 million, more than double the estimate of $740 million obtained by the 1995 Survey. In addition to the increasing dollar volume, the number of state and local housing finance agencies reporting EFB use increased from 36 to 64, the number of outstanding EFB issues increased from 114 to 221 while the aggregate number of housing units financed more than doubled from 16,063 to 41,615.

As part of a broader effort to reform public housing, the Quality Housing and Work Responsibility Act of 1998 authorized new ways to leverage capital and operating funds and stimulated interest in bond financing mechanisms. Several recent transactions – including a $291 million issue by Chicago Housing Authority in 2001 and an $85 million issue by the Philadelphia Housing Authority in 2002 – demonstrate the potential of these new approaches to finance public housing capital improvements.

Following this introduction, the report is divided into five sections. The first section briefly summarizes the nation's continuing affordable housing challenges and the efforts made by local housing agencies to expand production and rehabilitation of affordable housing. Section two briefly summarizes the survey methodology and describes the growing utilization of EFBs. The third section documents the growing acceptance of these bonds by the municipal bond market, spurred in large measure by the growing sophistication of credit enhancement tools, and the fact that to date there have been no instances of EFB defaults. Section four presents a series of case studies illustrative of the range of local housing initiatives now being financed by EFBs. The final section briefly describes some of the policy challenges facing local housing agencies as they seek to meet the continuing housing and community development needs.

Exhibit 1: Summary Results

Agencies Reporting EFB Activity:	1993 Survey	1995 Survey	2002 Survey
Total Number of Agencies	27	36	64
Total Issues to Date	unknown	140	298
Original Value of All Issues (in millions of dollars)	unknown	$872	$2,119
Number of Bond Issues Outstanding	76	114	221
Original Value of Outstanding Issues (in millions of dollars)	$479.1	$740	$1,749
Number of Units	9,658	16,063	41,615

Source: Joint Center for Housing Studies tabulations of 2002 EFB Survey, and University of Washington tabulation of the 1995 Surveys.

II. BACKGROUND

Before turning to the survey results, this section briefly describes the pressing housing needs facing low-income families, and the efforts being made by local housing agencies to expand production and rehabilitation of affordable housing.

Housing Problems Reach Working Poor

According to information from the 1999 American Housing Survey, at the close of the 1990s, over 14 million households – about one in eight – spent more than 50 percent of their income for housing. In addition, two million households lived in homes with serious structural problems. Nearly one-fourth of these households also had high cost burdens. Housing problems are highly concentrated among extremely low-income households. In fact, almost nine million households – or two in three – of all those with incomes less than 30 percent of the area median paid more than 50 percent of their income for housing (Joint Center for Housing Studies, 2002).

Despite widespread housing needs, only about one third of all very low-income renters with incomes less than 50 percent of the area median receive housing assistance. Joint Center estimates suggest that the federal government provides rental assistance to 4.6 million very low-income renters, including 1.3 million tenants in public housing, 1.9 million living in privately owned buildings with subsidies tied to their buildings, and 1.4 million with vouchers to rent private market units that meet federal requirements. Unfortunately, this leaves almost twice as many (9.7 million) very low-income renter households to fend for themselves on the private rental market without federal assistance. (Joint Center for Housing Studies, 2002).

The lack of affordable rental options poses particular problems for those families attempting to make the transition from welfare to work. For those coming off welfare and working at minimum wage, paying for housing and having enough money left for other necessities remains a struggle. Tightening housing markets are also putting pressure on even moderate-income households (earning between 80 and 120 percent of the area median). Overall, the Joint Center for Housing Studies estimates that some 3.9 million families with earnings at least equivalent to a full-time minimum wage salary spend more than half of their income on housing.

Affordable Housing Production Lags

Recent efforts to expand the affordable housing supply have been made primarily through the Low Income Housing Tax Credit Program. Since they began in 1987, tax credits have resulted in the production or substantial rehabilitation of one million rental units affordable to people with incomes up to 60 percent of the area median. While some tax-credit units have rental prices below this level, many are still unaffordable to the nation's lowest-income households.

At the same time that the tax credit program was adding new supply, thousands of units of older subsidized units were lost from the affordable housing inventory. As owners "opted out" of programs or prepaid their FHA mortgage insurance, about 120,000 assisted units have been converted to market-rate housing. In addition, while the U.S. Department of Housing and Urban Development (HUD) made significant progress in replacing badly deteriorated public housing units in the 1990s, the supply of public housing has continued to shrink. With the stock of assisted units falling short of the number of families with severe housing cost burdens, the waiting lists for public housing have grown to about one million households. As a 1999 HUD report notes, in some large cities families must wait ten or more years for an available unit (U.S. HUD, 1999).

Public Housing Response

Local public housing agencies have long had the authority to issue tax-exempt bonds, and in recent years many have used this authority to raise capital for non-profit and other public agencies, as well as private, for-profit developers. In contrast with these efforts, some agencies have issued tax-exempt bonds for purposes of financing low-income and mixed income housing owned by the agency or for other activities linked to the "essential functions" of these entities. Under federal tax law, the proceeds of these bonds are subject only to the same general restrictions as other government purpose bonds. Perhaps most significantly, these Essential Function Bonds (or EFBs) are not subject to the federally imposed statewide bond caps, and hence are readily available in those states that permit local housing finance agencies to issue bonds on their own behalf.

The Quality Housing and Work Responsibility Act of 1998 handed housing authorities a powerful new tool to address an estimated $24 billion backlog of modernization needs (U.S. HUD, 2000). Of course HOPE VI was created to address this backlog, but HOPE VI appropriations only fund only about 1 out of every 4 grant applications. Moreover, for many housing agencies, annual federal Capital Fund allocations barely cover annual maintenance requirements. The 1998 Legislation enabled local housing authorities to pledge future allocations from the Public Housing Capital Fund to secure private loan or bond financing. By tapping existing annual federal allocations to leverage additional capital, a LHA can secure sufficient funds to undertake comprehensive modernization activities, rather than stand by and see more public housing units continue to deteriorate.

In a recent HUD funded study of public housing operating costs, Harvard's Graduate School of Design documented several approaches to utilize the new financing tools authorized by the 1998 reform legislation (Harvard University, Graduate School of Design, 2002). Under the so-called "Bank Loan Model," a private bank makes a loan to the LHA, citing the LHA's pledge of future Capital Fund allocations as security for the loan. The bank may require a variety of credit enhancements, including placing some limitations on the amount of Capital Funds that the LHA can obligate for other borrowings. Depending on these details, the bank and LHA negotiate a rate consistent with market trends and perceived risk of the loan.

Alternatively, in the "Bond Model," bonds are issued by or on the behalf of a LHA and the proceeds are used for Capital Fund eligible activities. As is true with other bond funded activities, the terms of these bonds vary with the amount and term of the bond issue, as well as other project specific risks. LHAs also may undergo additional scrutiny, especially those who seek to have their bonds rated by outside rating agencies In combination the with a growing investor belief that future capital fund appropriations are a reasonably secure source of funding, investment grade bond ratings have substantially enhanced the marketability of this new type of financial instrument.

III. BOND UTILIZATION

The Joint Center survey of Essential Function Bonds builds on a previous 1995 Survey by researchers at the Graduate School of Public Affairs at the University of Washington. This section briefly describes the survey methodology and then presents a summary of survey findings.

Survey Methodology

The methodology used in this report builds on the previous 1995 Survey. Working in cooperation with the National Association of Local Housing Finance Agencies (NALHFA) and the National Association of Housing and Redevelopment Officials (NAHRO), as well as housing finance experts, Joint Center researchers assembled a list of those agencies identified as having issued, or as having considered issuing EFBs. An initial survey was mailed to each of these agencies (see Appendix A for a copy of the survey materials). To insure complete coverage, surveys were also sent to each of the nation's 400 largest local housing authorities not on the initial list. In all, over 600 surveys were sent. To enhance survey response, one month after the initial mailing, a second mailing was sent on NALHFA letterhead urging participation of its members. Additional follow up, including telephone calls to the housing agency Executive Director and/or Director of Finance, focused on those agencies known to have issued EFBs. These "targeted agencies" included the agencies identified as using EFBs in the previous University of Washington EFB survey, agencies identified by NALHFA as EFB issuers, as well as agencies identified by housing finance experts and those familiar with bond financed public housing development.

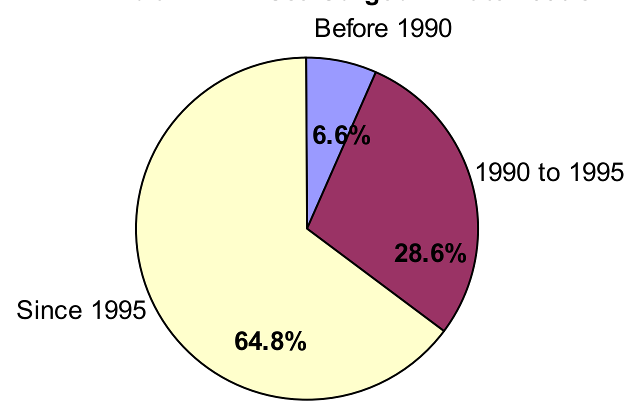
Although the agencies surveyed represented only 17 percent of the nation's nearly 3,400 housing agencies, survey agencies accounted for over half of the nation's approximately 1.3 million units of public housing. Overall, some 171 agencies responded to the survey, with 64 agencies indicating that they had in fact used the EFB financing tool (See Appendix B for a list of agencies indicating that they had issued EFBs).

In interpreting the results of the study, it is important to note that not all local agencies issuing housing bonds make use of the EFB option. Indeed several agencies responding to the Joint Center survey indicated that they had issued housing bonds, but their bonds did not fit into the EFB category. The most commonly sited alternative included locally issued tax-exempt multi-family revenue bonds, or bonds issued by the LHA on behalf of nonprofit organizations, or so-called “conduit bonds.”

Essential Function Bond Use Up Sharply Since 1995

In response to the continuing need for affordable housing opportunities and increased competition for scarce federal housing resources, EFB use surged in the 1990s. The Joint Center survey reveals that as of July 2002 there were 221 EFB bond issues outstanding totaling $1,749 million. Including bonds that have matured or been redeemed, the survey gathered information on 298 bonds totaling $2,119 million. As indicated in Figure 2, of this total approximately two thirds (or $1,372 million) of all issues have occurred since 1995, with two very large EFB issues ($291 million by Chicago Housing Authority in 2001 and $85 million by the Philadelphia Housing Authority in 2002) accounting for almost one third of that total.

Exhibit 2: EFB Use Surged In Late 1990's



Total Issues = $2.1 Billion

Source: Joint Center for Housing Studies tabulation of 2002 EFB Survey

Despite the fact that both the 1995 and 2002 Surveys used the same survey instrument and similar methods to identify agencies using the EFB tool, care should be exercised in comparing the results of the two efforts. Although the detailed data on individual EFB issues obtained in the 1995 Survey are no longer available, detailed analysis of the 2002 data suggests several areas of concern. Most obviously, 8 of the 36 agencies included in the 1995 Survey have yet to respond to the 2002 survey, despite repeated efforts to contact these agencies. Indeed, several of these non-respondents insist that their agency had never issued EFBs, despite the fact that they reported EFB activity in the 1995 Survey.

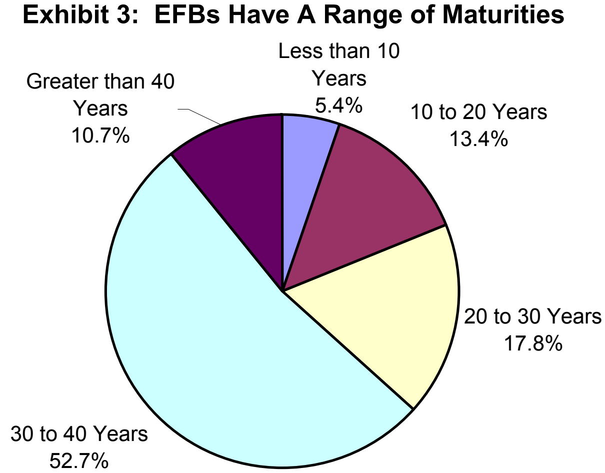
Moreover, review of the 2002 Survey identified several agencies not included in the 1995 Survey had in fact issued EFBs before 1995. Similarly other agencies included in both the 1995 and 2002 Surveys apparently failed to completely report on EFBs that reached maturity, were refinanced, or otherwise redeemed or restructured over the 1996 to 2002 period. Unfortunately, absent retrieving detailed data on the 114 issues identified in the 1995 Survey, it is impossible to measure the overall impact of these differences, although undoubtedly they imply that the 2002 figures represent an underestimate of total EFB activity. Even so, the available data portray a picture of the growing use of EFBs by agencies in an increasing number of states and localities.

EFBs Differ in Characteristics and End Use

Although EFBs are being used to finance a wide range of housing and community development activities, the vast majority of EFBs finance housing activities. Of the 221 outstanding EFBs, 203 financed construction or substantial rehabilitation of some 41,615 housing units. These bonds currently account for $1,666 million of the $1,749 million of outstanding EFBs. Other uses include financing the development of community and social service centers, urban infrastructure, energy systems upgrades, or construction of office space used by the housing agency. For example, Nashville Housing Authority used EFBs to finance energy system upgrades for their older housing stock, while the City of Colorado Springs Housing Authority issued an EFB to finance development of new office space.

Consistent with their use for financing long-lived assets, EFBs are typically long term bonds with maturities ranging from 20 to over 40 years (Exhibit 3). Though shorter term bonds were less common, they can play a useful role in financing the development and construction of single family homes. In this instance, shorter-term bonds are retired once units are sold off to eligible homeowners.

Exhibit 3: EFBs Have A Range of Maturities



Total Issues = 298

Source: Joint Center for Housing Studies tabulation of 2002 EFB Survey

Lower Interest Rates Prompt Redemption of Older EFBs

The 64 agencies included in the 2002 Survey reported originating a total of 298 EFBs totaling $2,119 million. Recognizing the emerging nature of this source of funding along with the typically long term of these bonds, some 205 (75 percent) of these issues remain outstanding. Exhibit 4 presents information on both total and currently outstanding bonds organized by date of issue, with dollar figures reported in terms of the initial amount issued. As indicated, only about one third of all EFBs issued before 1990 are still outstanding, while virtually all bonds issued since 1998 remain outstanding.

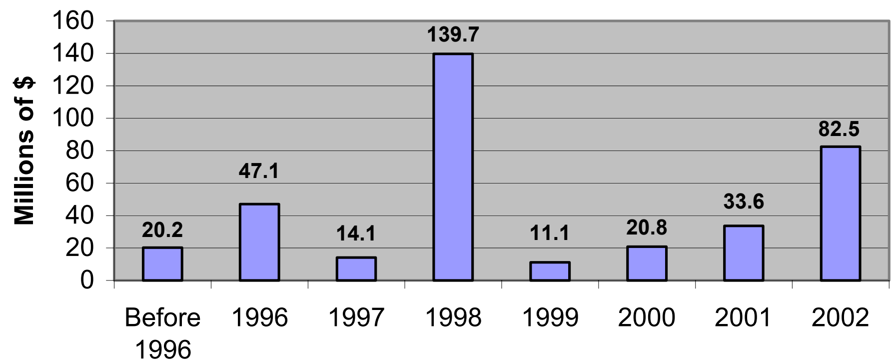
Exhibit 4: Essential Function Bonds by Year of Issue

Date Originated	Total Originated	Current Outstanding	Percent Outstanding
Pre 1990	$139,638	$42,060	30.1%
1990	$54,148	$42,113	77.8%
1991	$110,885	$21,350	19.3%
1992	$115,174	$63,189	54.9%
1993	$94,808	$79,803	84.2%
1994	$81,396	$32,506	39.9%
1995	$150,170	$128,245	85.4%
1996	$117,601	$114,646	97.5%
1997	$115,719	$92,426	79.9%
1998	$325,592	$325,592	100.0%
1999	$121,550	$118,550	97.5%
2000	$104,631	$101,786	97.3%
2001	$451,768	$451,768	100.0%
2002*	$135,455	$135,455	100.0%
TOTAL	**$2,118,535**	**$1,749,489**	**82.6%**

Note: 2002 data are for year to date from January 1 to July 1.
Source: Joint Center for Housing Studies tabulations of 2002 EFB Survey

Both the number of new issues and redemption of older issues grew in recent years. Attractive refinancing options available in the later portion of the 1990s and the expansion of new bond activity to fund construction or substantial rehabilitation of affordable housing units combined to spur EFB activity. Survey respondents provided detailed information on 77 retired EFBs totaling $369 million (i.e. issues that were redeemed or otherwise no longer outstanding). As rates trended down in the late 1990s, refinancing emerged as the primary reason for redemption. As indicated in Exhibit 5, redemptions totaled $139.7 million in 1998 and over $100 million for the 18 month period from January 2001 through June of 2002. Although the initial provisions of EFBs often limit the capacity of an agency to take advantage of the recent favorable rate environment, those able to refinance EFBs realized significant interest rate savings.

Exhibit 5: Falling Interest Rates Have Promoted Substantial Refinancing of Outstanding EFB's



Source: Joint Center for Housing Studies tabulation of 2002 EFB Survey

Several States Dominate EFB Activity

Overall, 62 agencies in 27 states reported 221 EFB issues outstanding in 2002, while two agencies reported having used EFBs in the past, but had no EFBs outstanding at the time of the survey. While housing agencies across the country utilize EFBs to fund needed affordable housing, six states with outstanding EFBs in excess of $100 million dominate. Collectively, Washington, Illinois, Oregon, Maryland and Minnesota account for $1,226 million (or 77.4) of the total, while the top ten states bring the total to $1,518 million (86.8 percent). In contrast, the Joint Center Survey revealed that collectively, the 17 other states included in the survey had on average less than $14 million each in EFBs outstanding.

Exhibit 6: Suvery Response By State

State	Agencies	EFBs Outstanding	Dollar Value *($ millions)*	Number of Units
Washington	10	52	362.7	7,291
Illinois	1	1	291.0	12,252
Oregon	4	26	163.7	3,517
Maryland	1	16	162.4	1,883
Minnesota	4	21	132.5	2,284
California	9	28	113.4	1,395
Pennsylvania	2	2	86.2	807
Florida	3	5	83.9	1,626
Texas	3	7	61.1	2,736
Colorado	3	24	59.5	2,362
Top Ten States	40	182	$1,516.4	36,153
Other States	22	39	231.1	5,462
Total	62	221	$1,747.5	41,615

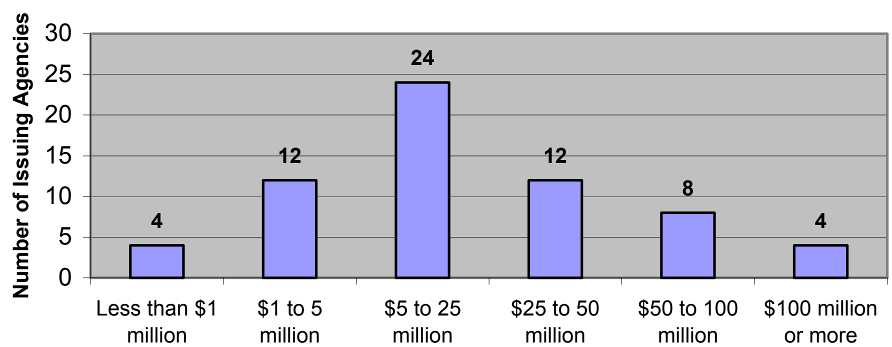
Source: Joint Center for Housing Studies tabulation of 2002 EFB Survey

As noted earlier, since 1995 local agencies have initiated $1,372 million in EFBs. Agencies in the state of Washington alone issued $259 million over this same period, while those in Oregon (with $138 million), Maryland (with $88.1 million), Minnesota (with $69 million), and California (with $61 million) also had significant activity. Of course, since agencies in these states started the period with a relatively large share of total outstanding issues, they had greater opportunity to take advantage of the favorable rate environment when opportunities presented themselves. Indeed, agencies in these states collectively accounted for $246 million (or 77 percent) of total redemptions of over $318 million that occurred over the 1996 to 2002 period.

In addition to large issues in Illinois (Chicago) and Pennsylvania (Philadelphia), agencies in Colorado, Florida, and Texas also contributed to the nationwide growth of EFB activity. While Chicago's $291 million recent EFB issue was a major contributor to overall EFB growth, among all survey respondents only the

Montgomery County Maryland, Portland Oregon and King County Washington agencies issued over $100 million in EFBs. In contrast, the largest share of EFB activity consists of relatively small issues. For example, excluding Chicago, the other 297 EFB issues reported by respondents (including both outstanding and retired bonds) have an average size of only $6.2 million. Moreover, as indicated in Exhibit 7, some 40 of the 64 agencies reporting EFB activity have issued less than $25 million in EFBs, while only 12 have issued more than $50 million.

Exhibit 7: Most Agencies Have Issued Less than $25 Million of EFBs



Source: Joint Center for Housing Studies tabulation of 2002 EFB Survey

IV. BOND PERFORMANCE

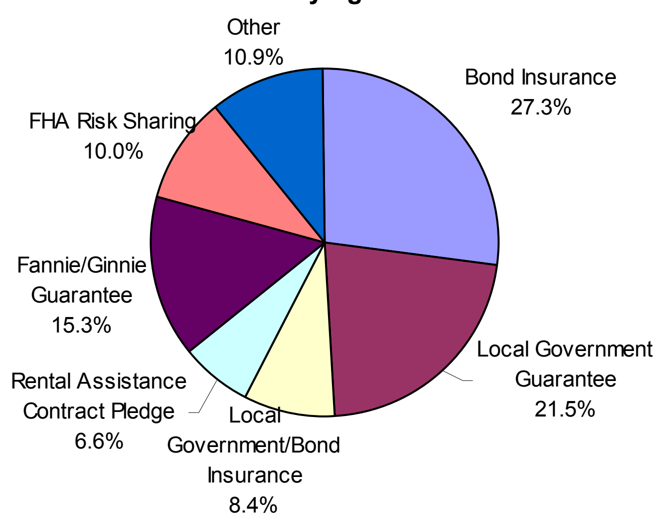
Despite the often troubled past of many multifamily housing assistance programs, there is a growing body of literature that suggests that subsidized low- and moderate-income housing developments have a significantly better track record in terms of defaults, relative to the rest of the multifamily industry. Indeed, building on efforts to reform local housing agencies by enhancing their ability to manage the development, construction, and financing of multifamily housing, EFBs are developing a positive track record among investors.

Credit Enhancement

Credit enhancements offer housing agencies the opportunity to improve the credit worthiness of their EFBs and significantly lower their cost of capital. At the same time, adding credit enhancements can increase the complexity and cost of bond issues, and in doing so offset some of the interest rate advantage, an especially important concern for smaller EFB issues. Of the 221 outstanding EFB issues included in the Joint Center study, only 102 reported some form of credit enhancement. As result, some $939 million or 53.7 percent of the total $1,749 outstanding EFBs have no credit enhancement. The fact that a large share of EFBs lack special credit enhancement, reflects the underlying credit worthiness of the housing and related activities funded by EFBs. Indeed, it is not uncommon for EFBs with no credit enhancement to secure investment grade credit ratings from Standard and Poor's or other rating agencies.

Credit enhancements for EFBs include such options as bond insurance and local government guarantees, as well as bank letters of credit and guarantees backed by secondary market entities Fannie Mae and Ginnie Mae. As indicated in Exhibit 8, bond insurance represents the most common form of EFB credit enhancement, accounting for 27.3 percent (or $221 million) of the $810 million EFBs reporting use of some type of credit enhancement. Some 21.5 percent (or $174 million) of all credit enhanced bonds are backed by local governments including special tax pledges or other pledges that make payments a general obligation of the city, county or state government. Another 8.4 percent (or $68 million) combine bond insurance with a general city or county obligation. In addition to these forms of credit enhancements, 15.3 percent are backed by a Fannie Mae or Ginnie Mae guarantee, 10.0 percent are part of the FHA Risk Sharing Program, backed by the pledge of a Section 8 or other housing assistance payment contracts, and 10.9 percent are backed by a bank letter of credit or other forms of credit enhancement.

Exhibit 8: EFBs Utilize Varying Credit Enhancements



Source: Joint Center for Housing Studies tabulation of 2002 EFB Survey

Defaults

The Joint Center survey identified no cases of default of an EFB out of the 275 bonds reviewed. This is consistent with the 1995 Survey, which also reported a "zero" default rate for EFBs. The University of Washington did report what it believed to be a "technical default" of a $2.6 million bond issued in 1990 by the Portland Housing Authority to fund a 96 unit project named "CTC." The "technical default" occurred when the first debt service coverage (DSC) certificate was not filed because of problems encountered with the rehabilitation of the project. Creation of an Amended Trust Indenture that extended the time for filing the DSC certificate quickly resolved the matter. Since this initial "technical default," there have apparently been no subsequent problems with the project.

The consistent performance of EFBs is gradually gaining the attention of investors, and rating agencies are now active in this area. This growing interest was enhanced by the announcement in the summer of 2001 that S& P would rate EFBs backed by future Capital Fund appropriations. As noted earlier, in the past EFBs both with and without various forms of credit enhancement have received investment grade ratings. Against the impressive performance history of EFBs, the new capacity of local public housing agencies to leverage annual federal support should promote expanded use of the EFB tool in the years ahead.

V. CASE STUDIES OF EFB USE

The broad summary statistics mask the substantial variation in utilization of EFBs by state and local housing finance agencies across the country. For example, recent EFBs issued by the Chicago and Philadelphia Housing Authorities portend exciting new possibilities. In Chicago, a $291 million in bond financing in 2001 will enable the housing authority to substantially rehabilitate their portfolio of 12,252 seniors housing units. In Philadelphia, a recent $85 million EFB is a critical element in the redevelopment of Tasker Homes, a large multifamily complex. Both represent a new and aggressive use of the EFB tool that promises expanded utilization in the years ahead. At the same time, there are a growing number of smaller agencies that regularly utilize their bond authority to issue smaller scale EFBs. This section presents four case studies that illustrate some of the challenges confronting agency use of the EFB tool, as well as the potential for expanded use in the future.

Dakota County, Minnesota

Dakota County lies in the southern portion of the Minneapolis/St Paul metropolitan area. In 1989, the Dakota County Community Development Agency (DCCDA) became the first public housing authority in the state of Minnesota to make use of essential function bonds (EFBs) as a means of financing affordable housing. In addition to Dakota County, several other authorities in Minnesota have a history of active essential function bond use including Washington County, Carver County, and the cities of Faribault and Virginia.

Since 1989 Dakota County has issued some $66 million in EFBs, at interest rates ranging from 3.4 to 5.6 percent, with terms averaging 21.6 years. By backing the bonds by the "full faith and credit" of Dakota County, the DCCDA was able to benefit from the County's AA+ bond rating. Moreover, by working with the County, DCCDA was able to reduce the costs of issuing the bonds. A state law that waives sales tax on building material for sites financed by EFBs also enabled DCCDA to achieve cost savings on the project.

The DCCDA used EFBs to address a growing need for housing for senior citizens. In total, DCCDA has constructed 711 units of housing for people over the age of sixty-five, with plans for continued construction. At present, 7.4 percent of the county's 363,866 inhabitants are seniors, and this number is expected to triple between 2000 and 2020. In light of recent rapid rent increases in the County, the projects have greatly expanded affordable rental opportunities to this growing population. Rental revenues are pooled to pay for the expenses and debt service for all buildings. DCCDA also obtained an annual tax levy pledge from the County, enabling them to charge rents well below market rents. In all but one property, the cost of renting a 1-bedroom unit is limited to the greater of $305 or 30 percent of gross household income, not to exceed $575. For two-bedroom units, the figures are $455 and $725, respectively. Since the projects have performed well, the EFB program is now generating additional revenue to support other DCCDA initiatives.

Main Street Manor and Cortland Square were completed in 2001. Main Street Manor, a 51 unit complex, is a mixed income development with market rate units as well as units for affordable to low-income and very low-income households with Section 8 vouchers. Approximately two-thirds of Main Street Manor's total project cost of $4.5 million was financed by a $3.2 million credit enhanced EFB as a general obligation of Dakota County. The property is located in the heart of downtown Lakeville, and a senior center and post office, along with various grocery stores, banks, and restaurants are all within walking distance of the complex which currently has a waiting list of 109 people.

Cortland Square, a 60 unit complex is inhabited by residents of an income mix comparable to Main Street Manor. Cortland Square is located in a mixed use neighborhood within walking distance of a bus station. Within a two-mile radius, residents have access to a 24-hour health clinic, pharmacy, grocery stores, a movie theater, restaurants and retail shopping. Cortland Square's waiting list is 255 people long. Seventy three percent of its total project cost was financed by an EFB of $3.1 million.

The City of Santa Barbara, California

The Housing Authority of the City of Santa Barbara (HACSB) has developed a system to finance housing that relies more on simple notes than bonds. Using this system to fund new construction and acquisition, the housing authority finds little need for credit enhancement. The notes are secured by a first trust deed and often are linked to a secondary residual receipts loan held by either the City of Santa Barbara or the City's Redevelopment Agency. Recently, projects that required credit enhancements included a refinance of a 122 unit HUD insured 221(d) (3) property, as well as another group of properties owned by a non-profit and sold to a traditional investor that required a reserve account for the project. Other deals were sold to local investors in the market for tax-exempt debt.

Overall HACSB has $15 million in outstanding bonds that finance 300 units. Over the course of its history with Essential Function Bonds, this housing authority has retired a total of $3 million in bonds. Projects executed by the Housing Authority of the City of Santa Barbara typically utilize 30-year bonds with rate adjustments occurring in years 11 and 21. In recent years the Authority has benefited from declining rates and refinancing opportunities. In addition, it was able to reduce costs by keeping deals small, by avoiding underwriting and rating of the paper, by marketing and negotiating their own deals with debt purchasers, and by using in house counsel to prepare the note and deed of trust and associated legal documents.

In recent years, rents and home prices have moved up sharply in Santa Barbara, a situation that is common throughout California. Santa Barbara's strong rental market is both a blessing and a curse. On the positive side, the rental affordability squeeze makes it relatively easy for HACSB to keep their properties operating at or near full occupancy. This in turn helps reduce investor concerns about the capacity of HACSB owned housing developments to meet financial targets needed to support required EFB payments. At the same time, the strong rental market encourages private owners – when contractually able to do so – to "opt out" of continued participation in housing subsidy programs. This not only shrinks the city's available supply of affordable rental units, but also limits the ability of many low-income families and seniors to remain in the city.

EFBs have emerged as an important tool to preserve the city's stock of affordable housing. In 2000, HACSB used a $5.2 million EFB to purchase Villa La Cumbre, a senior development with 60 one-bedroom units and a recreational building. Located in the upper State Street Area and built in 1989, this development was a privately owned publicly assisted affordable housing development. Due to its expiring affordability controls, the private owners threatened to "opt out" of the program before HACSB stepped in to purchase the property in April of 2000. HACSB ownership will ensure the property remains affordable for low-income seniors in perpetuity.

Kitsap County, Washington

Essential Function Bonds have been a popular affordable housing financing mechanism in the state of Washington. Kitsap County Consolidated Housing Authority (KCCHA) located in Silverdale, Washington has an extensive history of using them for the construction of multi-family housing. Over the years, KCCHA has issued almost $70 million in bonds. Taking advantage of declining interest rates, in 1998, KCCHA secured new EFB funding to refinance 6 earlier issues and, in doing so, helped reduce their costs of providing affordable housing to county residents. In total, KCCHA has $40.4 million in outstanding EFBs, including a $5 million bond issued in 2001 to fund construction of 134 units of housing. This most recent EFB was issued without associated credit enhancement. Indeed, with one exception, KCCHA bonds typically do not include credit enhancements.

The KCCHA EFB portfolio includes a wide range of affordable housing developments. For example, KCCHA issued a 30-year, $2.2 million EFB in 1992 for the construction of the Kingston Ridge development, a 43 unit complex with a recreation center that features a computer center for resident use. This bond was refinanced in 1998, a move that substantially enhanced the ability of KCCHA to maintain the affordability of these units. Tree Tops Apartments is a larger 270 unit development that was initially financed in 1992 and then refinanced in 1998. Tree Tops features an affiliated community center that was also financed with EFBs. Including a fitness center, a computer center, a basketball court and indoor gym, the center not only enhances the quality of community life at Tree Tops, it also enhances the ability of police and various social service agencies to assist residents of the development. Finally, KCCHA is also active in expanding homeownership opportunities. In this instance, EFBs are issued to finance the cost of land acquisition and construction. As units are sold to income-eligible homeowners, the bonds are prepaid.

Like other housing authorities in Washington, KCCHA benefits from state legislation that provide them a broad range of finance powers, including the ability to finance their own projects, to sell housing to low-income people, and to make loans to low-income people and to finance loans to private nonprofit or for-profit entities to promote development of housing affordable to low- and moderate-income families and individuals. Of particular interest is the capacity of housing authorities in Washington to finance a broad range of development activities including recreational facilities, and buildings to house social services or commercial activities that provide public benefits to the communities they serve. Also of note, local housing authorities in Washington have the express power to sell housing, including sales at less than fair market value in order to expand homeownership opportunities of low-income persons. In combination, this extensive array of state granted powers have enabled KCCHA and other Washington housing authorities to emerge as leaders in the creative utilization of the EFB financing tool.

Chicago, Illinois

EFBs are playing a major role in the plans of the Chicago Housing Authority (CHA) to transform its public housing inventory. In December 2001 the CHA issued $291 million in EFBs, the first bonds to be secured by annual Public Housing Capital Grants. The bonds carry a Double-A rating from Standard and Poor's, mature in 2019, and will play a major role in the CHA's plan to rehabilitate 9,480 units of housing for the elderly and 2,686 scattered site housing. Though primarily targeted for these purposes, the bond proceeds can also be used for any HUD approved work on any housing authority properties that are part of the CHA revitalization plan.

S&P was careful to clearly articulate those project features that justified their Double-A rating of the first bonds secured by annual Public Housing Capital Fund grants. In particular, S& P noted that a debt service reserve fund equal to the annual debt service substantially reduced risk, as did the CHA's important and highly visible role as the nation's third largest housing authority. In that regard, the S&P noted the Moving to Work (MTW) agreement that the CHA signed with HUD in February 2000. This MTW agreement not only established annual capital funding of $139 million through 2009, assuming level Congressional appropriations, but also included numerous program waivers that the CHA needed to implement the overall transformation plan. To S & P, HUD's demonstrated support for this transaction limited the risk associated of any sanctions or other unfavorable regulatory rulings that could jeopardize the flow of funds to bondholders.

As one of the first transactions of its type, the Chicago transaction will undoubtedly pave the way for other transactions to follow. Since future agreements will also carry whatever risk is associated with the possibility that Congress will not appropriate funds for HUD's Public Housing Capital Fund, each of these future deals will require both careful financial structuring and a host of HUD approvals. Unfortunately, to date HUD has yet to issue final regulations covering use of Public Housing Capital Fund for bond financing. As a result, securing needed HUD approvals is currently a time consuming process. For example, following nearly a year of intensive negotiations, in August 2002, the Philadelphia Public Housing Authority (PPHA) issued an $85 million EFB secured by annual Public Housing Capital Funds. This EFB was a critical element of a larger effort to revitalize 1040 unit Tasker Homes using Tax Credits, Private Activity Bonds and other public resources linked to Philadelphia's "Neighborhood Transformation Initiative." Once again, securing needed HUD approvals proved to be a key element in establishing the marketability of the EFBs. Overall, negotiations between HUD and PPHA extended for nearly a year, before the needed approvals were obtained and the bonds were issued.

VI. CONCLUSION

Essential Function Bonds are an important tool for financing the construction and substantial rehabilitation of housing and other community facilities owned by local housing finance agencies. Using EFBs local housing agencies can expand their activities beyond operating the federally funded Public Housing and Section 8 Programs. The Quality Housing and Work Reform Act of 1998 authorized new ways to leverage federal capital funds and stimulated expanded interest in EFBs. Yet to fully realize this potential, as well as build on more traditional approaches to EFB financing, LHAs need to expand and improve their managerial and administrative capacity.

Moreover, at the Federal Level, HUD and Congress can play a major role in increasing LPA capacity and access to capital markets. Expanding HUD systems to incorporate best practices of housing finance and real estate asset management is essential to the continued expansion of LHAs as capital market participants and producers of affordable housing. While the Quality Housing and Work Responsibility Act of 1998 paved the way for LHAs to leverage annual Capital Fund Appropriations, lack of certainty concerning HUD's regulations of this initiative has limited utilization of this potentially exciting tool, as have continued concerns over willingness of Congress to fully fund the Capital Fund program. Any steps that HUD or Congress can take to remove the unpredictability concerning the availability of Capital Funds will clearly serve to increase investor acceptance of Capital Fund bonds and increase the number of LHAs using this tool.

States also have a role to play. In particular, states can clarify – and in some instances expand – the powers granted to LHAs. As case studies from Minnesota and Washington make clear, supportive state policy is essential to the effective and widespread utilization of EFBs as a financing tool. As they assume greater responsibility in meeting the affordable housing needs of low- and moderate-income families, states would be wise to do everything in their power to enlist the support and cooperation of the increasingly sophisticated network of local housing finance agencies.

Appendix A:

ESSENTIAL FUNCTION BOND SURVEY

*The Joint Center for Housing Studies at Harvard University is undertaking a study of the financial history of **ESSENTIAL FUNCTION BONDS** issued by loal housing authorities. As defined for this study, Essential Function Bonds are **tax exempt revenue bonds issued directly by a housing authority to finance properties owned by the authority.** This survey form asks for information about these bonds.*

The reults of this study will be made available to all local housing authorities, bond counsel firms and other interested parties who have participated in this study free of charge. Certain participants in this study also intend to make summaries of this information available to rating agencies and credit enhancers as documentation of the performance of local housing authorities as owners of multi-family projects.

Please answer each question as accurately as possible and attach any additional pages and information as necessary. If you have any questions about this form please contact the Joint Center for Housing Studies at Harvard University.

I. BASIC INFORMATION

Name of Housing Authority: ______________________

Address: ______________________

City: ______________ State: __________ Zip: ______

Telephone: ______________ FAX: ______________

Contact Person and Title: ______________________

____

What date was the Authority first established? ______________

Bond Counsel: ______________ Phone: ______________

Bond Counsel Firm Name: ______________________

____

Would your authority like to receive a copy of the results of this survey?

YES ______ NO ______

Joint Center for Housing Studies, Harvard University
1033 Massachusetts Avenue, 5th Floor, Cambridge, MA 02138
(617) 495-7908 FAX: (617) 496-9957

II. ESSENTIAL FUNCTION BONDS OUTSTANDING

In this section we are asking for information about ESSENTIAL FUNCTION BONDS that were issued by the Authority and are ***still outstanding.*** *If any current bonds are refundings or previous issues, please use Section III to summarize the previous issue. Please complete each item as thoroughly as possible and attach additional sheets if needed.*

Please attach a copy of the original bond summary page if it is available.

(1) Bond Issue Amount($)	(2) Bond Issue Date	(3) Maturity Date	(4) Interest Rate	(5) Type of bond Insurance	(6) Other Credit Enhancements	(7) Type of Mortgage Insurance	(8) Project Name and Size (units)	(9) Project Ever Default? (Y/N)	(10) Bond Ever Default? (Y/N)

Please explain any credit enhancements listed above: ______________________

Please explain any instances of default: ______________________

Please attach additional sheets if necessary.

III. HISTORICAL INFORMATION

In this section, we are asking for information about ESSENTIAL FUNCTION BONDS which were issued by the Authority, but are ***no longer outstanding.*** *If this section does not apply, please skip it.*

Please attach a copy of the original bond summary page if it is available.

(1) Bond Issue Amount($)	(2) Bond Issue Date	(3) Original Maturity	(4) Interest Rate	(5) Use of Bond Funds	(6) Redemption Date	(7) Reason for Redemption	(8) Bond Default (Y/N)	(9) Special Comments

Please explain if there was a default on any of the bonds listed above: ______________________

Please add any additional information: ______________________

Please attach additional sheets if necessary.

This is the end of the survey. Thank you for participating!

Appendix B: Housing Authorities Reporting Essential Function Bond Use

City of Los Angeles	CA
City of Alameda	CA
City of Santa Barbara	CA
County of Monterey	CA
County of Santa Barbara	CA
County of Stanislaus	CA
Fresno	CA
Oxnard	CA
San Joaquin	CA
Yolo County	CA
Adams County	CO
Colorado Housing and Finance Authority	CO
Colorado Springs	CO
City of Danbury	CT
Norwalk	CT
Clearwater	FL
Miami Beach	FL
Pinellas County	FL
DeKalb County	GA
Boise/Ada County	ID
Chicago	IL
Kentucky Housing Corporation	KY
Shreveport	LA
Montgomery County	MD
Dakota County	MN
Virginia County	MN
Washington County	MN
Greensboro	NC
City of Grand Forks	ND
Lincoln	NE
Omaha	NE
New Hampshire Housing Finance Authority	NH
Bernalillo County	NM
New York City	NY
Syracuse	NY
Akron	OH
Portage	OH
Zanesville	OH
Tulsa	OK
Central Oregon Regional	OR
Portland	OR
Yamhill County	OR
Allentown	PA
Philadelphia	PA
DeSmet	SD
Madison	SD
Volga	SD
Nashville	TN
City of Dallas	TX

City of El Paso	TX
San Antonio	TX
Salt Lake City	UT
Norfolk	VA
Bellingham/Whatcom	WA
Kitsap County	WA
Longview	WA
Seattle	WA
Snohomish County	WA
Spokane	WA
Tacoma	WA
Vancouver	WA
Cheyenne	WY