



Low-Income Housing Tax Credit Investment Survey

Prepared for:

Enterprise Community Partners, Inc.
Local Initiatives Support Corporation

8 October 2009





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Contents

Limiting conditions	2
Executive summary	3
Background and investment history	5
Current market conditions	9
Investor motivations	11
Legislative proposals	14
Legislative proposal 1: five-year carry-back	16
Legislative proposal 2: accelerated credit period	18
Legislative proposal 3: liberalization of passive loss rule	19
Legislative proposal 4: extension of the credit exchange program	21
Conclusions	22
Appendix A: Other syndicated tax credits	24
Appendix B: Methodology	30

Limiting conditions

This study was undertaken solely to assist Enterprise Community Partners, Inc. and Local Initiatives Support Corporation ('the Clients') in better understanding the low-income housing tax credit investment market, its investment history, current market conditions and investor motivations, and analyzing potential investor responses to certain legislative proposals designed to stimulate investment activity. The specific terms of our engagement are memorialized in Statements of Work executed by the Clients. The sufficiency of these procedures is the responsibility of the Clients. Consequently, Ernst & Young LLP ('EY' or 'we') makes no representation regarding the sufficiency of the procedures, either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to, and thus did not perform, an audit or examination, the objective of which would have been the expression of an opinion on any financial information. Accordingly, we do not express an opinion with respect to such accompanying financial information. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. We have no responsibility to update this report for events or circumstances occurring after the date of this report.

The tax advice contained herein was not intended or written by EY to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed on the recipient.



Executive summary

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

Our findings are summarized below:

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

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

Background and investment history

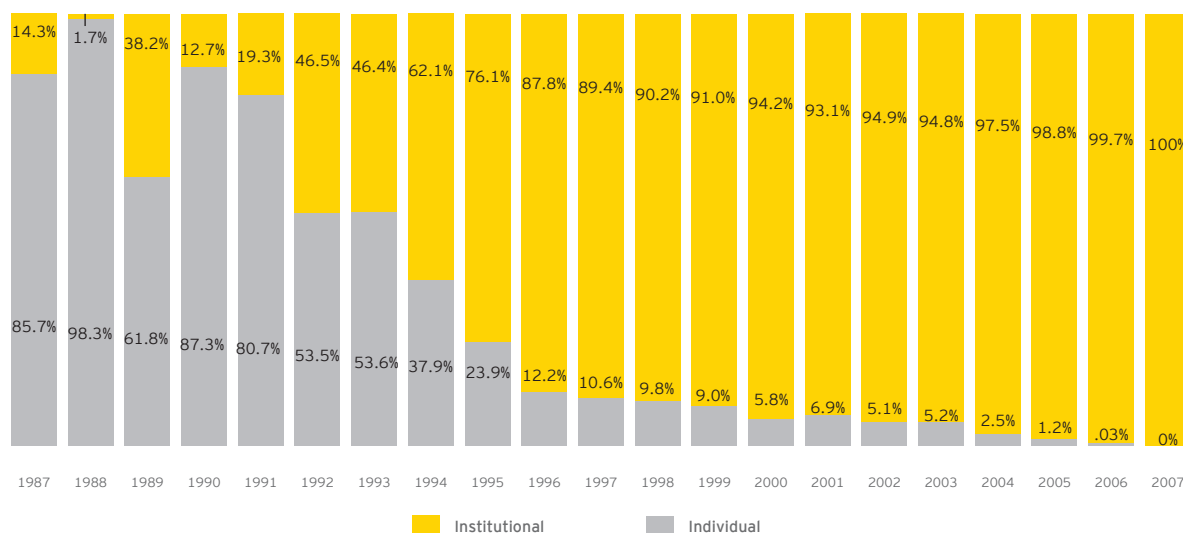
Since the inception of the low-income housing tax credit (housing credit) program in 1986, more than 1.7 million affordable apartment units had been placed in service¹. Affordability is achieved by replacing a portion of the mortgage loans that finance development costs with third-party investor equity. Since these properties typically generate little to no cash flow², private sector investors are incented to invest through the receipt of the tax credits which, coupled with depreciation deductions, provide them with an acceptable economic return on their investment.

In the early years of the program, prior to 1992, a vast majority of the equity capital came from individual investors, whose investments were pooled in funds raised and managed by intermediaries (syndicators), which in turn made investments in affordable apartment communities. However, as demonstrated below, institutional investors began to dominate the market in 1994, accounting for the majority of investment capital. Based on discussions with investors, investor attraction to the program during this period occurred due to several factors, including the program permanence in 1993 (which made them more willing

to invest the resources to undertake these investments) and the development of investment performance history to allow meaningful risk assessment. Syndicators quickly came to prefer the relative ease and lower cost of assembling large amounts of capital from a small number of investors, compared to the public syndication model.

By 2003, institutional investors had come to be the source for virtually all of the equity capital required to finance housing tax credit developments. Our data suggests that while investors came from a diversified base of industries in the early 1990's, the core of corporate investment has increasingly been concentrated in the financial services sector (see below). Interviews with industry representatives suggest that companies outside that sector began to decrease their investments and were ultimately "squeezed out" due to declining yields. These yields, which had fallen to as low as 4.25% by 2006, remained palatable to depository institutions because their low cost of capital continued to afford them a positive yield and because of their need to comply with the so-called "Investment Test" of the Community Reinvestment Act (CRA)³.

Proportionate share of individual vs. institutional investment capital over time



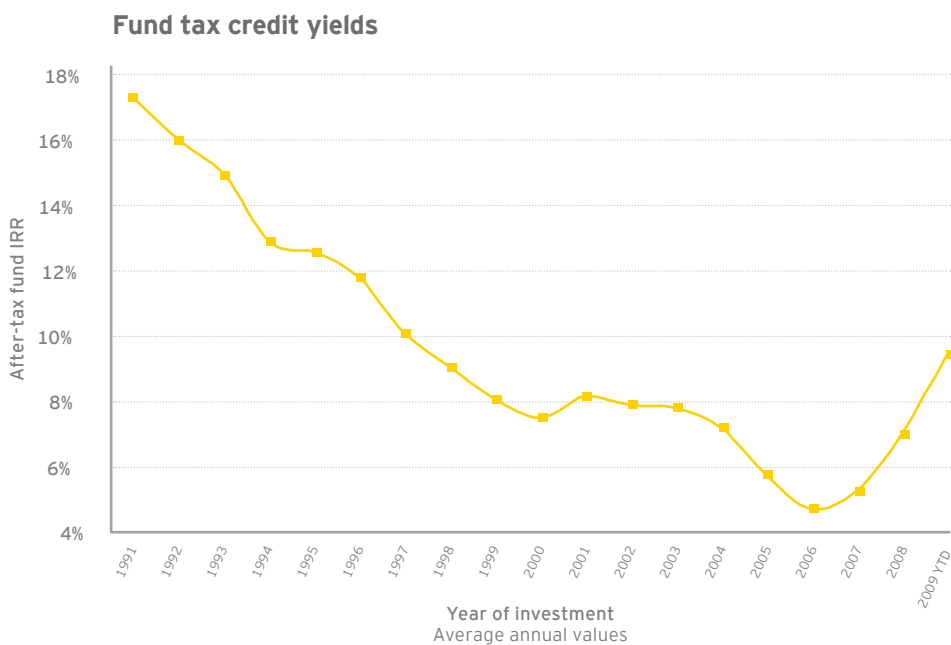
Source: *Understanding the Dynamics V: Housing Tax Credit Investment Performance*, Ernst & Young LLP

¹ Calculated from the HUD National Low Income Housing Tax credit (housing credit) database.

² *Understanding the Dynamics V: Housing Tax Credit Investment Performance*, Ernst & Young LLP, Figure 1.5, reports median cash flow per apartment unit of \$247 per year.

³ The Community Reinvestment Act was enacted by Congress in 1977 (12 U.S.C. 2901). Among other things, the CRA requires that banks undertake qualifying investments (such as in housing credit investments) in communities where they accept deposits, but which have been historically under served by the banking industry.

As the exhibit below demonstrates, investor demand for housing tax credit investments increased significantly after 1993, while the supply of credits was largely fixed by statute⁴. The economic outcome was a steep increase in the nominal price at which credits were “traded” between developers and intermediaries, or investors, and until fairly recently, a corresponding steady decrease in the yields available to investors, as the yield curve illustrates.

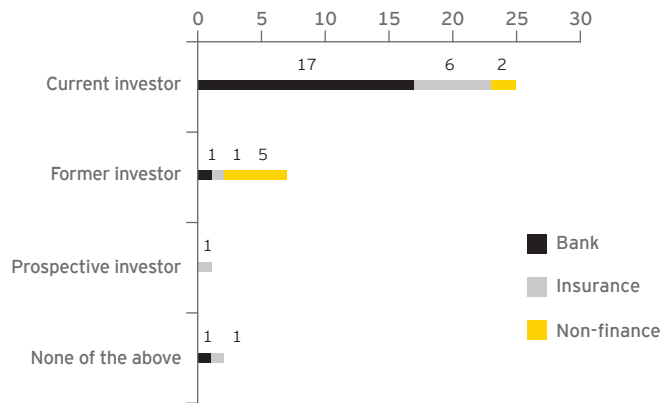


Source: *Understanding the Dynamics 5: Housing Tax Credit Investment Performance*, Ernst & Young LLP, updated with additional data 2008-2009

⁴Most housing tax credits are subject to a volume limit, indexed for inflation, as provided in IRC Section 42(h)(3). Congress also authorizes additional credits periodically to assist areas impacted by natural disasters. Housing credits are also available to certain projects financed with tax-exempt bonds.

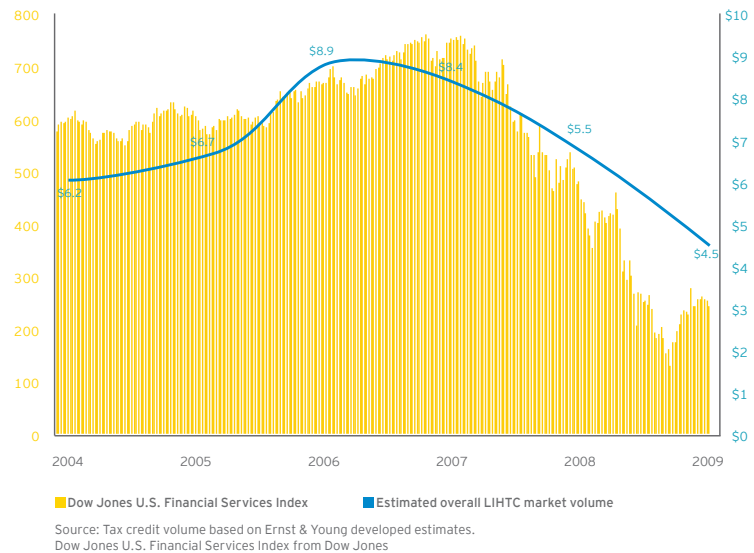
The class of investors that remain active in the market for housing credit investments continues to be dominated by a small number of very large banks (68%) according to those responding to the survey. In order for the housing credit market to return to vitality, and remain so over the long term, the program cannot be reliant on such a small number of investors for its equity needs. It is therefore clear that companies from sectors other than financial services, as well as a broader array of banks, will need to be attracted back to the market.

Respondent composition by investment status and industry



Ernst & Young estimates that over \$75 billion was invested in housing tax credits between 1987 and 2008⁵. The following figure shows the relationship between the Dow Jones U.S. Financial Services Index and annual estimates of housing credit equity volume, suggesting that investment volumes have been closely correlated with stock price performance over the past five years. Since the desirability of tax credits is in part a function of expected tax liability and capital availability, this relationship should not be surprising.

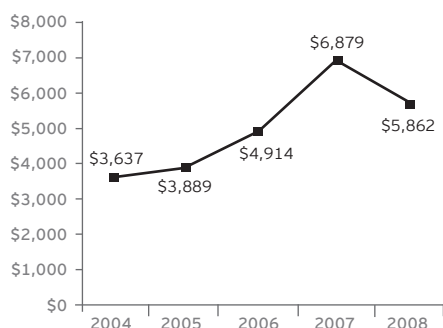
Estimated housing tax credit investment volume (in \$billions) vs. financial services stock performance



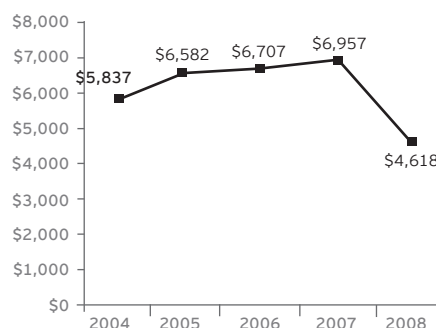
⁵The market investment volume presented in this report represents our best estimate based on data compiled from multiple sources.

The distribution of our survey responses demonstrates a similar pattern to the industry trend illustrated above, with investment volume peaking in 2006–2007 and dropping in 2008.

Investor respondent investment volume (in \$millions)

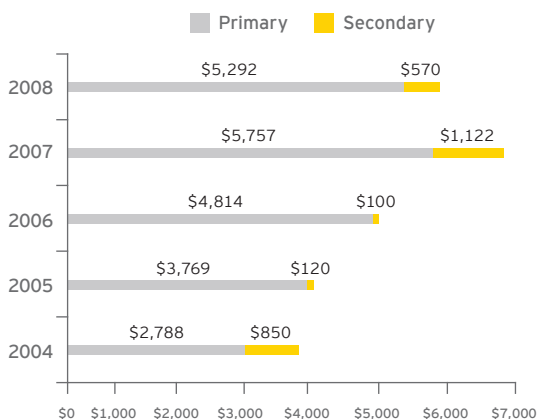


Syndicator respondent volume raised (in \$millions)

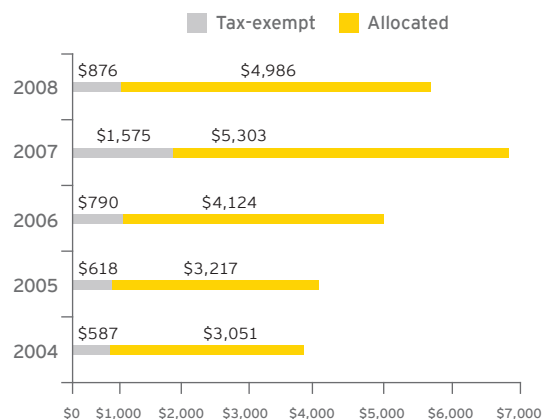


When secondary market trades are excluded from consideration, the pattern of rapidly diminished equity levels holds true among primary market transactions, as shown below⁶. Investment activity in tax credit transactions financed using tax-exempt bonds has declined even more precipitously from 2007 to 2008 than that of allocated credit transactions. As shown below, survey respondents indicated a 44.4% decline (from \$1.575 billion to \$876 million) in tax-exempt bond financed investments from 2007 to 2008, which is much more dramatic than the decline in allocated credit investments during the same period.

Primary vs. secondary market volume (\$ millions)



Allocated vs. tax-exempt market volume (\$ millions)



⁶Primary market activity refers to initial investments made by institutional investors. Secondary market activity refers to the “re-trading” of such investments from initial investors who subsequently decide to liquidate their positions prior to the expiration of the ten year tax credit period by transferring them to another investor.

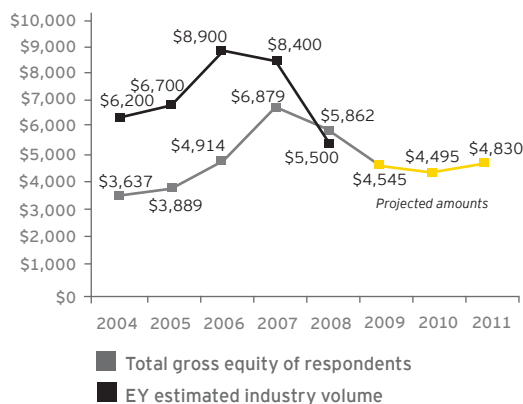
Current market conditions

The current recession appears to have exacerbated the already dwindling investor base in the tax credit equity market, as certain active investors have been forced to leave the market permanently, and others have been side-lined due to liquidity constraints, or because they no longer seek tax shelter due to lack of profitability. One group of corporations that has suffered the largest losses during the past twenty-four months is comprised of Fannie Mae, Freddie Mac and the 25 largest commercial banks in the U.S. It was this same group of companies which many analysts believe provided as much as 85% of all the housing tax credit equity capital raised in 2006. Some of these companies have left the housing tax credit equity market completely and now seek to sell some or all of their existing investments. Others are no longer in business or have been absorbed by other institutions. The remaining companies remain as active investors but are doing so, as a group, at pace far below their 2006 levels. A similar fact pattern exists throughout the balance of the banking industry – some banks having left the market, some liquidating older investments and the balance investing at lower levels. Among the handful of non-banking investors still in the market before the current economic downturn, primarily life insurance companies, this sector also experienced a decline in the number of investors and their level of investment. That said, industry representatives have advised us that there has been some recent growth in equity demand from this sector.

Survey respondents reported year-to-date equity volume of \$1.1 billion through June 2009, and predicted a total 2009 equity volume of \$4.5 billion (assuming no additional housing credit stimulus legislation). This would represent a 22.4 % decrease from the 2008 investment levels of those respondents, which itself represented a 14.8% decrease from 2007. Our estimates of the overall market investment volume reflect even more significant declines of 34.5% from \$8.4

million in 2007, to \$5.5 million in 2008. The variance in the degree of decline between our estimates and survey responses is partially due to the fact that active investors are more likely to respond compared to investors that have permanently exited the market, and accordingly, the data evidencing a more precipitous decline may be more accurate.

Historical and projected investment volume (absent legislative changes)



We also surveyed investors with respect to their expected investment levels over the near term based on their recent investment behavior. The majority of investors indicated that they had decreased their level of investment from 2007 to 2008. Among these investors, a majority indicated that they were more likely to maintain the already reduced investment levels, or even further reduce investments going forward, assuming no additional favorable legislative changes.

The scarcity of tax credit equity has caused a decline in the price per \$1 of tax credits, as shown in the figure below, reaching an average net price per credit of \$0.74 in 2009 among survey respondents.

Property tax credit pricing trends



Although tax credit pricing has clearly declined on a national basis, the level of the decline has been geographically disproportionate due to stronger investor demand in some markets, and a lack thereof in others. Based on interviews with industry participants, bank investors have continued to focus their equity in areas for which they will receive positive consideration under the CRA Investment Test. As a result, those areas with limited national bank presence are attracting significantly lower demand, resulting in a marked differential in tax credit pricing in these areas. The lower price per dollar of housing credits, especially that obtained for deals in “CRA-lite” markets, has resulted in financing gaps, preventing certain projects in these markets from coming to fruition, and a growing inventory of stalled housing credit developments. In addition to the strong desire for specific geographic locations, investors are also being more selective in terms of real estate markets, deal

structure, benefits profile and development team, including a preference for transactions with allocated (9%) credits relative to tax-exempt bond (4%) credits.

The reduction in tax credit pricing is occurring at the same time that bank credit standards for multifamily housing loans have tightened, which has led to so many stalled projects that in one state⁷, more than 90% of the housing developments that had been allocated housing credits in 2007 and 2008 had not yet received equity financing through the end of 2008. While the American Recovery and Reinvestment Act of 2009 (ARRA) was designed to help jump-start stalled projects⁸, this program was designed to absorb the excess supply of housing credit projects (by closing the financing gap for stalled projects through additional subsidy), not to attract more investor. Discussions with survey participants revealed that while new investors are expressing increasing levels of interest in housing credits in response to rising yields, there are long lead times associated with educating potential investors about the asset class, and obtaining organizational approvals.

It should be noted that similar market conditions are evident in investments with other types of syndicated tax credits, including solar, wind, historic rehabilitation and new markets credits. While those conditions have not resulted in the same type of geographic bias, there have been similar pricing trends, equity gaps and stalled projects. A discussion of current market conditions and investor preferences for these assets is provided in **Appendix A: Other syndicated tax credits.**

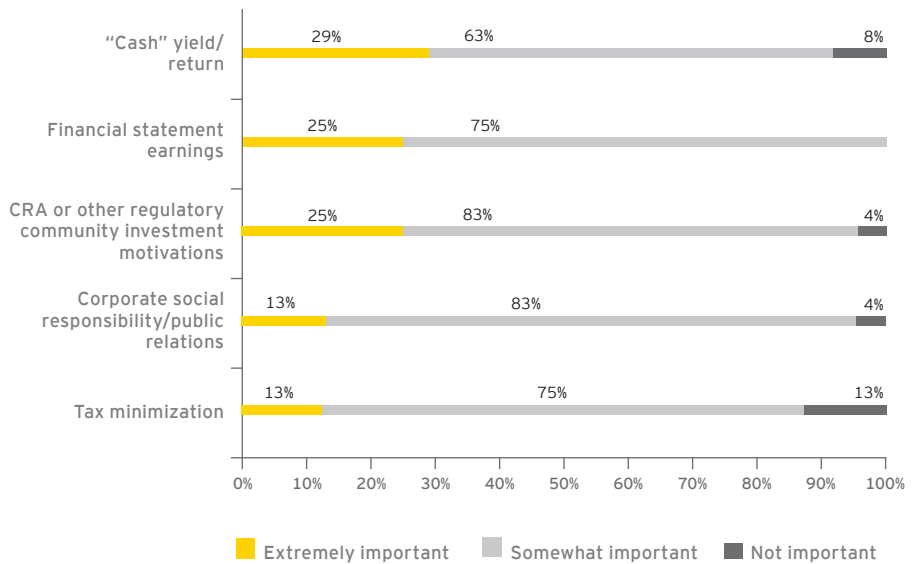
⁷Michigan State Housing Development Authority.

⁸The provisions of ARRA, enacted in February of 2009 include \$2.25 billion in grant funds under the HOME Investment Partnership Program to be used as gap financing along with a tax credit exchange provision allowing state housing agencies to exchange up to 40% of their 2009 volume cap, and 100% of unused 2007 -2008 credits in 2009 for grant funds at a rate of \$0.85 per \$1.00 of credit. The new law has given state tax credit agencies the flexibility to use these new subsidies to reduce the amount of tax credit equity needed for stalled projects to achieve feasibility. The so-called “TCAP and exchange” provisions are being implemented currently, and their effectiveness cannot yet be determined.

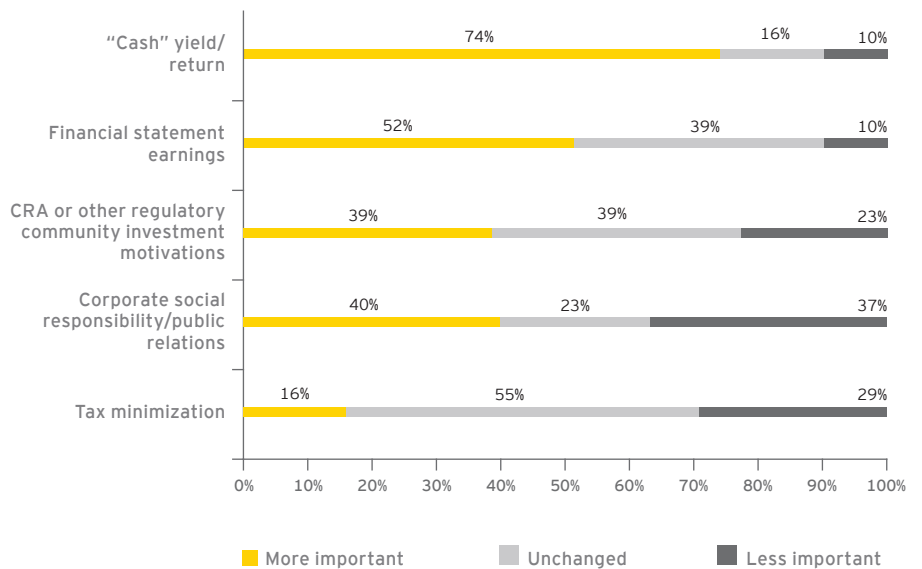
Investor motivations

To help understand why investor demand has deteriorated from its historically high levels, we surveyed industry participants regarding their motivation for making tax credit investments. The following exhibits illustrate how investor respondents rated a series of factors by their level of influence on the institution's decision to make housing credit investments. Investment yield was ranked the most significant factor by respondents, followed by the investment's impact on financial statement earnings⁹. We also inquired as to whether these motivations may have changed over the past two years. While their order appears to have remained unchanged for most, yield has become more important, followed by financial statement earnings and CRA/regulatory compliance.

Relative importance of investment objectives



Change in investment objectives over the past two years

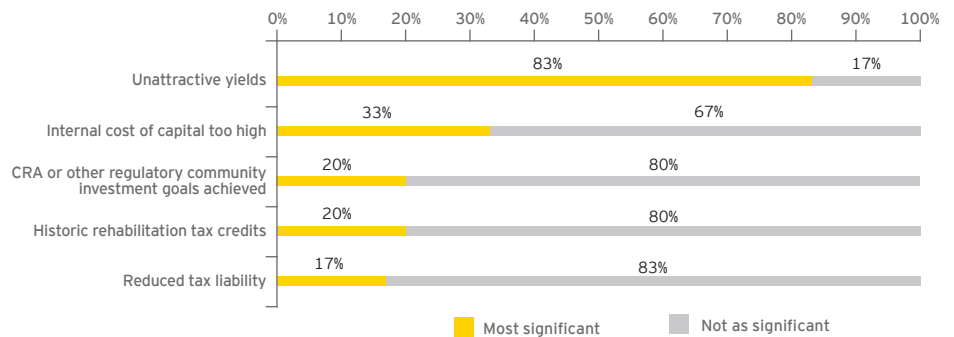


⁹Housing credit investments increase after tax earnings per share by permanently reducing a corporation's current liability for income tax. This is somewhat tempered by the reduction in a company's operating income produced by the investment's taxable losses.

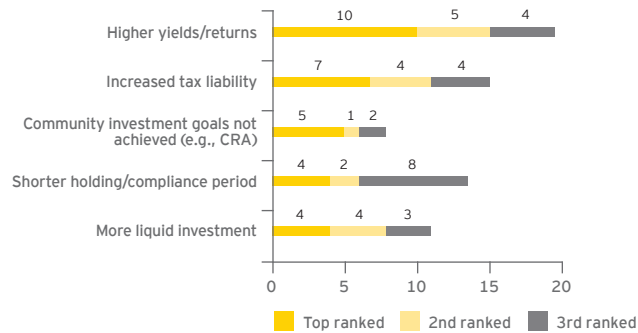
We also surveyed investors that had at some point exited the market to quantify their reasons for leaving. Former investors indicated that they had left the market at various points between 1995 and 2006. The figure to the right summarizes the responses we received from those companies that have left the market, with unattractive yields, the available market yield versus their internal cost of capital, community investment goals achieved, other tax credit investments with superior returns and reduced tax liability representing the leading causes for their market exits.

Survey participants were asked which factors would play the largest role in influencing them to increase their investment amount. As illustrated to the right, higher investment yields, increased tax liability, community investment goals not achieved, shorter investment benefit and compliance period, and more liquid investment features appear to be the most important drivers of investment for the survey respondents who are current investors. Similarly, higher investment yields, increased tax liability, shorter investment benefit period, stable tax liability and community investment goals not achieved were among the top ranked for former investors. Importantly, many of these factors relate to investment characteristics rather than the investor's financial condition, suggesting that modifications to the housing credit program's features could clearly assist in broadening the equity market.

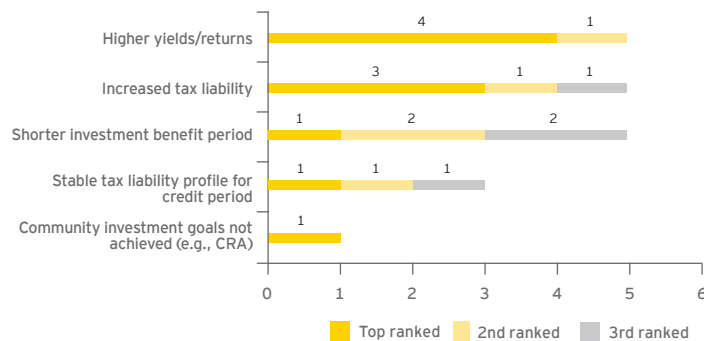
Reasons former investors ceased investing



Factors that would lead to increased investing for current investors



Factors that would lead to increased investing for former investors



Legislative proposals



Legislative proposals

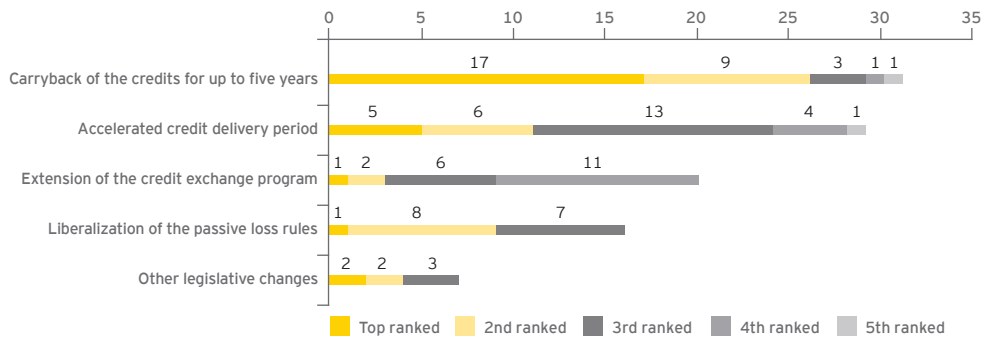
As part of this study, we surveyed expected investor response to four legislative proposals currently under discussion by industry observers:

1. Five-year carry-back: A two-part proposal – A legislative proposal that would allow investors with existing investments in housing credits earned between 2009 and 2011 (from pre-2009 investments) to carry those credits back for up to five years in exchange for a binding commitment to reinvest the funds in new housing credit investments made during the same period: 2009-2011 and in addition, the statute would provide that credits earned from new project investments in which credits are first claimed after 2008 could be carried back for up to five years at any time during the ten-year tax credit period for such investments without a requirement that any refund from such carry-backs be reinvested in the program;
2. Accelerated credit: a proposal that would allow for an accelerated credit delivery period;
3. Passive loss relief: a proposal that would liberalize the passive loss rules to permit individual investors to join corporate investors in the market;
4. Exchange extension: a proposal that would extend the current credit exchange program which allows states to convert credit allocations to grant dollars.

The main objective of the first three proposals would be to increase investor demand for credits, whether through enhancing the value of credits to investors that may have substantially reduced tax appetite (by expanding the current carry-back period from one year to five years), or by expanding the investor base by creating more flexibility for individuals to effectively participate in the housing credit market (by liberalizing the passive loss limitation). The so-called credit exchange program, in comparison, was primarily designed to absorb the “excess” supply of housing credit projects, thereby closing the financing gap for many stalled housing credit developments and accelerating the re-stabilization of the market.

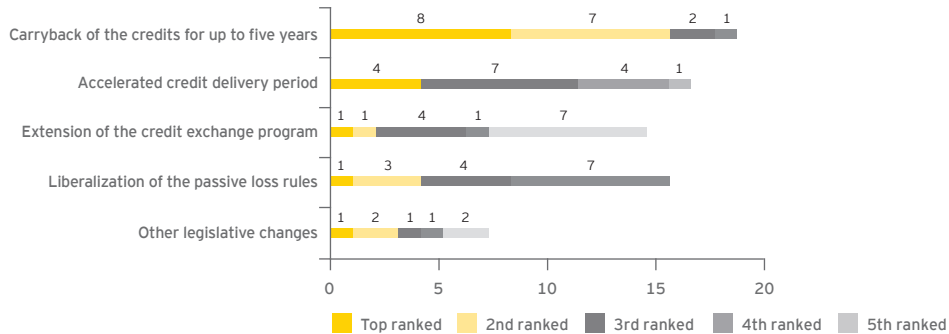
As shown below, the first legislative proposal appears to be the most attractive legislative option among those surveyed that could have the most impact on the market.

Legislative preferences among investor respondents



Syndicators' legislative preference ranking shows similar pattern as investor respondents.

Legislative preferences among syndicator respondents



Additional legislative changes outside of the four above were also proposed by respondents, including reducing the housing credit compliance period from 15 to 10 years, thereby eliminating the recapture risk (and thus changing the investment horizon) for years 11 to 15, and allowing institutions to apply unused credits to offset AMT or reduce other obligations such as TARP dividends.

Legislative proposal 1: Five-year carry-back

Under current law, a taxpayer can carry unused housing credits back for one year and forward for up to 20 years. In light of the economic downturn, this one-year limitation on credit carry-back appears to be less attractive to many investors, particularly for those that have recently experienced net operating losses. While the 20-year carry-forward is helpful, it does not appear to provide as much value to investors who do not anticipate predictable earnings, and given the loss in their present value when applied to future years. As noted in the “investor motivations” section of the report, 67% of the investor respondents that have stopped investing in housing credits indicated that, “reduced tax liability” as either a significant or the most significant reason for their exit.

If the first legislative proposal were to be enacted, investors would be allowed to carry-back excess housing credits from existing investments for taxable years 2008-2010 for up to five years, but only to the extent that they commit to new housing credit investments during the same years. In addition, credits earned from new project investments in which credits are first claimed after 2008 could be carried back for up to five years at any time during the ten-year tax credit period for such investments without a requirement that any refund from such carry-backs be reinvested in the program. This concept would be permanent in nature. For example, assume Corporation X has \$10 million in suspended credits in 2010 from investments made prior to 2009. This \$10 million investment would allow Corporation X to carry back, for up to five years, as much as \$10.0 million of suspended credits from investments made prior to 2009. In addition, further assume that Corporation X invests \$10 million in a new housing credit investment in 2010, which is anticipated to generate \$1.25 million in credits for Corporation X for each of ten years, a total of \$12.5 million (assuming a price per credit of \$0.80).

Assume further that credits allocated from the new investment were suspended seven years later due to a net operating loss in 2017. Under the proposed legislation, Corporation X could carry back its 2017 housing credits (\$1.25 million) for up to five years without an obligation to reinvest its refund. A similar provision already exists for Section 39 marginal oil and gas well production credits, which currently benefit from a five-year carry-back period.

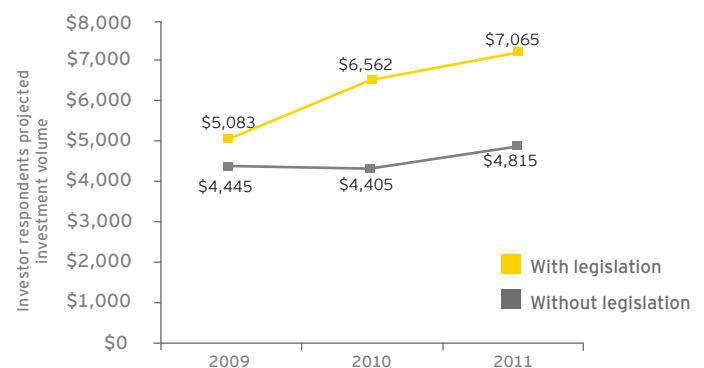
The pros and cons of this proposal include the following:

Pros

- Increase the potential for enticing investors to either increase their housing credit investment volume or re-enter the market. Investors would be able to immediately realize value by applying unused credits to offset their prior years' tax liability under the first part of the proposal (limited carry-back on existing investments). In comparison, the second part of the proposal (unlimited carry-back on new investments) would provide additional comfort to investors who are interested in current market yields, but remain concerned about the predictability of their future tax profile.

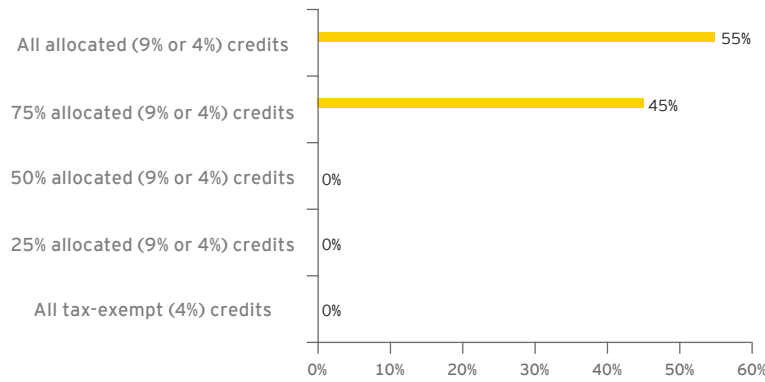
To further measure the potential impact that might result from this proposal, we inquired as to the level of equity an investor might consider committing to during the period from 2009 to 2011, should the carry-back proposal pass. Investor respondents, projected a total expected investment increase of 37% (\$5 billion) over the next three years if this legislation were to be enacted. Specifically, they would invest 14% more (\$5.1 billion vs. \$4.4 billion) in 2009, 49% more in 2010 (\$6.6 billion vs. \$4.4 billion) and 47% more (\$7.1 billion vs. \$4.8 billion) in 2011. In addition, since not all market participants responded to the survey, the total market investment amount would be higher.

Investor volume with legislative proposal 1 enacted vs. volume absent legislative changes



Separately, we requested investors to describe their desired allocation of investments between the tax-exempt bond (4%) credit and allocated (9%) credit projects should the first legislative proposal be enacted. As shown below, 55% of respondents would prefer to invest exclusively in allocated credit projects while the remaining 45% prefer a 75%/25% split. In contrast, 60% of the syndicator respondents consider the 75%/25% split most popular among their investor clients. This difference between investor sentiment and syndicator expectations confirms the depth of the bias among investors in favor of 9% tax credit projects, while the reasons for that are beyond the scope of this report.

Desired allocation between allocated and tax-exempt bond credits under legislative proposal 1



- ▶ Potential to accelerate the market pricing adjustment. If equity demand is restored more quickly, due to the reinvestment requirement, tax credit pricing would presumably increase quickly as well (consistent with the program's prior history). As the level of tax credit equity increases per dollar of housing credit, an increasing number of housing credit developments should become financially feasible and the overhang of stalled developments (which also tends to depress pricing) should begin to disappear.

Cons

- ▶ Cost to the federal budget. As utilization of existing housing credits increases, assuming the budget incorporates partial utilization assumptions, the incremental increase in credit utilization would have a cost to the Treasury.

Legislative proposal 2: Accelerated credit period

Among the four legislative proposals surveyed, an accelerated credit delivery period was ranked as the second choice among respondents. Under this proposal, the period over which credits are realized would be reduced from ten years to a lesser number, or the credits would be front-loaded instead of evenly distributed over ten years.

The pros and cons of this proposal appear to include the following:

Pros

- ▶ Respondents consistently chose a shorter investment among the top five reasons that would entice them to increase their housing credit investments or enter the market. For those that have left the housing credit market, 50% indicated that the length of the investment and holding period was a significant factor in their decision to exit the market.

Cons

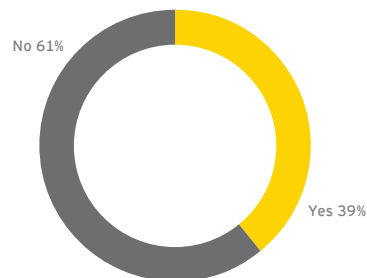
- ▶ Some industry participants expressed concern about the implementation of this provision. An accelerated credit delivery period without an accelerated compliance period would not shorten the corporation's view of the overall holding period, and would not change their investment horizon.
- ▶ Others noted that while an accelerated credit period increases the return on investment, it might also accelerate impairment recognition for financial statement purposes, resulting in earlier above-the-line financial statement losses, making this option less desirable.
- ▶ To the extent that investors have a fixed appetite for tax credits over the near term, accelerating the credits could decrease overall investments because a smaller investment volume would generate the same credits over the near term.

Legislative proposal 3: liberalization of the passive loss rules

As discussed in the “background and investment history” section of this report, individual investors constituted the primary source of housing credit equity prior to 1992. One major hurdle that prevented individual investors from effectively participating in the housing credit market is the impact of the so-called passive activity loss rule under IRC Section 469. Under the passive activity loss rule, losses and credits attributable to passive activities can only be used to offset income derived from passive activities. As a limited exception, individuals investing in housing credit investments may apply passive loss deductions (or credits calculated as a deduction equivalent) against up to \$25,000 of active income. This rule was enacted in 1986 in concert with a crack-down on the wide-spread use of abusive tax shelters by high-income taxpayers. As a result of the passive loss provision, syndicators are required to aggregate a significant number of individual investors in order to raise a sufficient level of capital to make just one housing credit project feasible.

Among the eighteen syndicator respondents, 39% supported liberalization of the passive loss rules and the concept of re-building the individual investor market to broaden the equity base for the housing credit program. More than half of the syndicators surveyed (56%) were not interested in offering funds to individual investors and stated that they would not pursue development of that potential new market were this change to be enacted.

Syndicator respondent’s perception: Liberalization of the passive loss rule



Syndicator respondent’s perception: interest in public funds offering



In addition to these survey responses, we spoke with syndication and brokerage firms, some of which had raised capital from individual investors when the housing credit program was still in its infancy. Some organizations believe that liberalization of the passive loss rules would lead to the development of a substantial individual investor market and that this would be a healthy development for the program. Among the reasons cited for their view:

- ▶ Individual investors, particularly those in higher income brackets, are likely to face higher personal income tax burdens in the near term. Rather than encouraging such investors to seek out the “next generation” of abusive tax shelters, better that the federal government should encourage the use of tax-motivated investments that were Congressionally sanctioned.
- ▶ Individual investors are much more likely to favor geographic diversification than to be interested only in projects that have CRA appeal.
- ▶ The inventory of potential individual investors is so large that this market will be immune to the type of single-sector concentration risk that proved to be so costly for the housing credit industry over the past two years.

Interestingly, the majority of firms we spoke with, including some formerly involved in

the public offering business, told us that they would not seek to raise housing credit capital from individual investors even if the passive loss rules were changed. A number of issues were cited for their opposition to passive loss liberalization:

- ▶ The primary reason cited was the significant on-going cost of SEC reporting compliance and investor reporting. Publicly registered securities offerings have traditionally been characterized by high costs. The firms we spoke with stated that there was no advantage to raising capital from individuals that would adequately compensate fund sponsors for the potential liability, the complexity and the cost of public securities compliance in the post Sarbanes-Oxley world.
- ▶ Concern was also raised about a possible decline in market discipline. In the late 1980s and early 90s, when significant amounts of capital were being raised from both the individual and corporate sector, industry participants told us that some public funds occasionally became a “dumping ground” for lower quality transactions. The argument advanced to support that claim was that individuals were not capable of underwriting investments as skillfully or negotiating with the same power as institutional investors.
- ▶ Some respondents expressed the view that broadening the investor base to include more individual investors could have only a limited impact on market volume in the near term. Raising capital from a large number of individuals lacking any awareness of this asset class would, they claim, require the establishment of a sales, investor education and securities compliance infrastructure that is not currently in place, and would take some time to become effective.
- ▶ Several firms predicted that individual investors would be unreceptive to housing-related investments generally given the current condition of the housing market and/or that they might easily be dissuaded from investing in areas where housing needs were the greatest.
- ▶ Finally, several syndicators expressed doubt about whether individual investors could be a reliable source of capital. Since a majority were likely to be one-time investors and since their firms would need to be perpetually selling and re-educating new groups of investors. These companies expressed a strong preference for raising capital from institutional investors, as they were much more likely to reinvest from year to year, and represent a much less expensive source of capital.

Legislative proposal 4: Extension of the credit exchange program

The credit exchange program, enacted as part of the American Recovery and Reinvestment Act of 2009, allows state housing credit allocation agencies to exchange up to 40% of their 2009 volume cap credits for a Department of Treasury grant at a rate of 85 cents per dollar of credit, and up to 100% of the credits that are either carried into or returned in 2009 at the same rate. The grant will have the same characteristic as credits – non-taxable to recipients, awarded to projects satisfying housing credit rules.

The pros and cons of this proposal include the following:

Pros

- ▶ Proponents of the exchange program believe that this provision will help close the financing gap for many projects that currently are not feasible due to the lack of tax credit equity. Due to the early stage of the current credit exchange program, we do not have sufficient data to adequately analyze the effectiveness of the exchange program. With that said, one benefit of this proposal is that it has the potential for immediate implementation as a simple extension of the existing program.

Cons

- ▶ In cases where the credit exchange program is used to completely replace tax credit equity, there will be a loss of the professional underwriting skills, management information systems and third party market discipline built into the current public/private partnership. Without the continuing involvement of syndicators and institutional investors, the underwriting, negotiation and asset management burden will shift solely to the state allocating agencies.
- ▶ Without additional legislative changes, the exchange program alone will have no impact on rebuilding investor demand, and therefore, represents a stop-gap measure.
- ▶ If extended for several years, this proposal could have long-term disintermediation effects that will be difficult to reverse, such as dismantling the effective compliance enforcement system required by investors and implemented by syndicators.

Conclusion

Housing credit investment levels declined significantly in 2007 and 2008 due to the severity of financial losses suffered in the banking sector, recession in the broader economy and their collective impact on the narrow financial services investor base, which accounts for the majority of active housing credit investors. This reduction has affected the ability of sponsors to raise sufficient capital, which has in turn caused housing credit projects already in the “pipeline” to either stall or become economically infeasible. Affordable housing developments financed through the use of tax-exempt bonds and associated housing credits have been even more adversely affected. These conditions are expected to persist from 2009 through 2011, absent additional legislative stimulus.

Investor respondents indicated that yield and financial statement earnings were key investment drivers and that these factors had increased in importance for them in recent years. Compliance with CRA obligations was cited as a continuing motivation for depository institutions. Among former investors, unattractive yields, the internal cost of their capital, the potential for lower future tax liability and the availability of alternative tax credit investments were the leading causes cited for their market exit.

Conversely, higher investment yields, increased tax liability, community reinvestment goals not achieved, shorter investment benefit and compliance period, and more liquid investment features were cited as the most important factors in enticing investor respondents to increase their housing credit investment levels. Importantly, most of these factors relate to investment attributes rather than investor financial health, suggesting that increased flexibility in the use of housing credits could serve as a powerful stimulus for the equity market.

Investor and syndicator respondents shared a similar preference towards the four legislative proposals currently under review by industry observers. Among the four proposals, the ability to carry-back tax credits for up to five years was ranked the most attractive option for investors and syndicators, followed by an accelerated credit period. Responses from investor respondents suggest that the carry-back proposal would have a significant impact on investing patterns – increasing total amounts invested by as much as \$5 billion (37%) over the three-year period from 2009 to 2011. Specifically, they would invest 14% more (\$5.1 billion vs. \$4.4 billion) in 2009, 49% more in 2010 (\$6.6 billion vs. \$4.4 billion) and 47% more (\$7.1 billion vs. \$4.8 billion) in 2011. In addition, since not all market participants responded to the survey, the total market investment amount would be higher.

Appendix

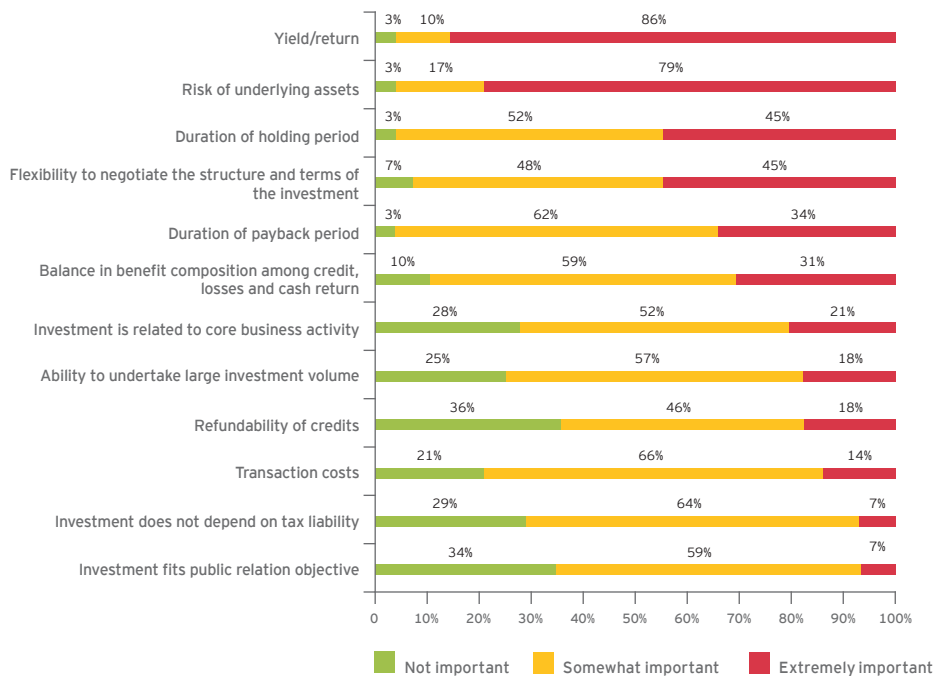


Appendix A: Other syndicated tax credits

In considering current market conditions, we also considered investor preferences for other tax credits, including new markets, renewable energy and historic rehabilitation tax credits, to better understand the competition for scarce investor dollars from such programs. These investments have also faced challenging times, with shrinking investor bases and stalled projects. Eighty-three percent of the investor respondents indicated that they either have invested in other tax advantaged investments or have considered doing so. The five features of these alternative investments that were marked as most important to the investor respondents were:

1. Yield/return
2. Risk of underlying assets
3. Duration of holding period
4. Flexibility to negotiate the structure and terms of the investment
5. Duration of payback period

Importance of features in affecting investor's decision in investing other tax-advantaged investments



Comparison of investment features

This exhibit provides a summary comparison of the major syndicated federal tax credits including the housing credit. To normalize the data for comparative purposes, we have used 2006 as the base year:

Program	Low-income housing tax credit	Historic rehabilitation tax credit	New markets tax credit	Wind energy production tax credit	Solar energy investment tax credit
IRC section	42	47	45D	45	48
Inception	1986	1976	2000	1992	1980 (2005)
Credit period	10 years	1 year	7 years	10 years	1 year
Recapture period	15 years	5 years	7 years	None	5 years
Primary return components	Tax credits Deductions	Tax credits Deductions Priority returns Put proceeds	Tax credits Cash flow Put proceeds	Tax credits Deductions Cash flow	Tax credits Deductions Cash flow
Annual market size (2007)	\$8~9 billion	\$1 billion, varies	\$1 billion	\$5 billion	\$0.5 billion

Annual Market Size Source: Ernst & Young estimates of industry volume

The principal difference between the housing credit and other tax advantaged investments is the length of the credit realization and recapture periods. As previously discussed, for those investor respondents that left the housing credit market, 50% indicated that lengthy investment and holding periods were the principal cause for their exit.

Renewable energy tax credits

The renewable energy industry has historically relied upon a small number of major tax equity investors, which were concentrated in the investment banking, utility, and oil and gas industries. Unlike the housing credit market, where the investor base is dominated by financial services companies, many of the renewable energy investors are involved in the cleantech industry in some capacity other than as tax equity investors, including as turbine manufacturers and corporate investors in wind or solar companies. Although there has been a significant amount of interest in renewable energy investment, it has been problematic for potential new investors to obtain the necessary information to successfully enter the market since developers of renewable energy facilities consider investment performance and other industry data to be proprietary.

Yield/return

Prior to the credit crunch, commercial and investment banks were able to offer financial products (debt and equity) at historically low rates; 6% after-tax rate of return for a wind project or 7.5% after-tax for a solar project, a 50 to 250-point spread above the yields on housing credit investment at that time. As the economic crisis ensued and the era of cheap capital came to an end, tax equity was no longer available at the historical low rates, making many deals less profitable or even unprofitable because of the higher cost of tax equity. Although investment yields have recently risen in the renewable energy market, they have not risen to the same level as the housing credit market, narrowing the spread between these investment types despite palpable differences in risk and reward potential. Wind investments appear to be offering investment yields in the 8% to 10% range at present, with solar investments at 10% to 12%, while housing credit yields are now uniformly in excess of 10% and may be substantially higher in some cases. In addition to the absence of a yield premium, the barrier to entry into the renewable energy market – a well developed intermediary community, information concerning investment performance and the like are simply not yet in place.

Risk of underlying assets

Housing credit investments are viewed by most observers as more predictable given their performance history, and are therefore considered to be safer investment vehicles by most tax equity investors. However, many investors in renewable energy come from related businesses (such as public utilities), and are thus armed with sufficient industry knowledge to feel comfortable with the underlying assets. In addition, renewable energy investors generally have specific “green” investment strategies that keep their attention solely focused on energy investments, much like the manner in which certain housing credit investors are driven almost exclusively by meeting CRA goals.

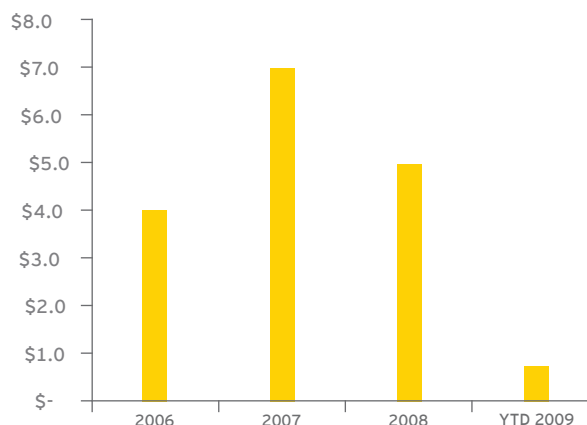
Duration of holding period

With a five-year holding period for solar and a ten-year investment period for wind credit developments, renewable energy investments have generally been considered more liquid when compared to housing credit investments, which are subject to a 15-year compliance period.

Current market conditions

Like the housing credit industry, the renewable energy industry has experienced a decline in its investor base, with a number of investors having left the market due to market turmoil, and with others having cut back their investment goals. This trend is evidenced in the figure below that shows estimated annual equity volume for renewable energy since 2006.

Renewable energy equity volume



Source: Renewable Energy equity volume figures based on Ernst & Young developed estimates.

While the decline in the investor base has contributed to the decrease in investment activity in the renewable energy industry, the number of projects that have become infeasible due to more expensive financing has also contributed to this phenomenon. Industry participants have argued that the issue is not that capital for new projects is not available, but that its cost has simply become too expensive for many deals.

The ARRA '09 provided a tax credit exchange program much like the one fashioned for the housing credit industry, with the intent of lowering the cost of converting tax credit equity into capital for project expenditures. However, the exchange program was executed at the project level for energy credits instead of the allocating agency level. Furthermore, the new law effectively changed the wind credit program from a ten-year, production-based credit to a one-year, investment-based credit (by giving investors that option), similar to solar credit investments and also provided owner/developers with an option to convert their credits to a cash grant. Since grant financing in lieu of tax credit equity is expected to be an attractive option for renewable energy developers, it is anticipated that it should allow most projects with financing gaps to move forward. It is also expected that there will be a significant reduction in the supply of renewable energy tax credits (since many credit-eligible projects will convert to grant financing resulting in fewer tax credit projects).

New markets tax credits

The New Markets Tax Credit Program ('the NMTC' or 'the Credit') was designed to stimulate investment and economic growth in low income urban neighborhoods and rural communities by offering a seven-year, 39% federal tax credit for Qualified Equity Investments made through investment vehicles known as Community Development Entities (CDE). CDEs use capital derived from the tax credits to make loans to or investments in businesses and projects in low-income areas. The NMTC program is administered by the Community Development Financial Institutions Fund (CDFI Fund) of the U.S. Department of Treasury, which allocates the credits annually under a competitive application process.

The rate of return in NMTC transactions has historically offered a premium over housing tax credit yields because of investor perception that the investments carry a higher level of risk, the fact that there are fewer transactions, its equity market is more shallow and there is very little efficiency in NMTC transaction structures. As a result, the market is dominated by heavily negotiated "one-off" transactions and lacks, for the most part, an aggregation vehicle for efficiently raising capital and acquiring NMTC investments. Projected rates of return appear to fall within a wide range from 12-20% with a set of variables that make comparison with housing credit yields complicated at best.

Risk of underlying assets

In the same way that NMTC investment "market" yields are difficult to estimate, any attempt to generalize about their relative risk profile is nearly impossible. The majority of NMTC investments involve commercial real estate projects where the NMTC equity has been paired with low-cost debt from a friendly source. The NMTC program has strict compliance rules with respect to the use of capital, the timing of repayment and community involvement, but the NMTC program appears to have developed a good track record thus far in terms of meeting Congressional intent, preventing compliance issues and meeting investor expectations.

Duration of holding period

New markets tax credit investments have a seven-year credit stream as well as holding period. The statute requires that any "repayment" of NMTC equity prior to the seventh year be recycled into another qualified investment.

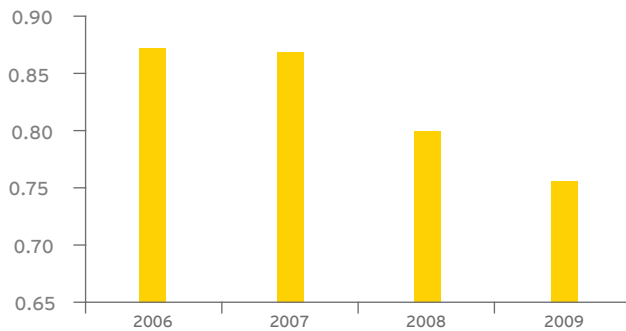
Current market conditions

Although ARRA increased the credit authority to the NMTC program by \$1.5 billion, securing project financing is challenging due to the diminished tax appetite of equity investors (primarily banks) and the tightening of credit standards by lenders. NMTC investments are qualified community development investments if located in the right communities (almost always the case) and thus help meet CRA goals. As a result, some of the country's largest commercial banks have been dominant players in this market.

The figure below shows the trend in estimated NMTC pricing since 2006 and demonstrates a downward trend in pricing (similar to that which occurred in the housing credit industry) as a result of reduced demand. While lower credit prices have resulted in a decline in NMTC investment volume, unlike the housing credit industry, equity volume estimates are not as good of a metric for demonstrating the state of the NMTC industry as credit pricing. Since all allocations are made at the same time and the amount of the allocation varies each year (unlike the housing credit program in which available credits are determined based on a volume cap per state resident that increases annually by inflation), investment activity is largely driven by the timing of the allocation rounds. Therefore, credit pricing is a more accurate measure of trends in the NMTC industry.

In this context, some industry participants have reported an increase in NMTC pricing in recent months.

New markets tax credit pricing



Source: New markets tax credit pricing based on Ernst & Young developed estimates.

Historic rehabilitation tax credits

The tax credit equity market for Historic Rehabilitation Tax Credits (HTC) shares a number of similarities with the NMTC: (1) the subsidy is much more “shallow” than the housing credit, making project economics much more important to the overall success of the investment, (2) the market is dominated by a handful of major corporations most, but not all of whom, come from the financial services industry, (3) HTC investments are uniformly random, one-off transactions each with its own structure and (4) the HTC market is too scattered to describe in terms of “market” volume or “market” pricing. Unlike housing credit investments, the great majority of HTC investments are made directly with developers instead of through intermediaries.

Yield/return

As noted above, the rate of return in HTC investments is transaction specific rather than driven by market forces.

Risk of underlying assets

Investors must hold an ownership stake in the certified historic structure that generates the historic credit. Since these are often commercial real estate properties - hotels, office buildings and the like, they carry all the risks attendant to such real estate in addition to the complexity and cost of rehabilitating the building in accordance with Interior Department building. As a result, investors tend to demand higher rates of return and more indemnification from risk than would be typical in a housing credit investment.

Duration of holding period

HTC investments typically generate the credit in the first year of investment. Investors must retain their ownership interest for a minimum of sixty months from the date on which the rehabilitated building is first placed in service to avoid ratable recapture of the historic credit (20% per annum). Both the credit realization and holding period are significantly shorter than those of housing credit investments.

Current market conditions

As noted above, some of the largest U.S. commercial banks dominate the HTC equity market much as is the case with the housing and new markets credit markets. Since the credits claimed under the HTC program in any given year are a function of the size and number of the projects that are rehabilitated (rather than based on an annual budgetary allocation as is the case for the housing and new markets credits), the HTC investment market is much smaller relative to those programs. In addition, given the fact that investment volume can vary substantially from one year to the next (based on the number of projects under rehabilitation), even material increases in the supply of HTCs tend not to impact the housing credit equity market.

Conclusion

The major “wildcard” in terms of a potential threat to the revitalization of the housing credit market is the potential for a major increase in the supply of energy credit investments. An increase of that magnitude is plausible given the enormous forces at work to change the manner in which energy is produced in the U.S. This risk is exacerbated by the absence of a volume limitation of any type on renewable energy tax credits. This makes it more difficult to predict the degree to which investment activity in the renewable energy sector might impact the housing credit equity market. In the near term, the fact that the energy credit community does not have a syndication infrastructure in place (and thus is racing headlong to the energy grant option) will make it much less likely that energy credits will impact the availability of capital for housing credit investments. That could well change, over the longer term, if and when the energy credit grant option program expires.

Appendix B: Methodology

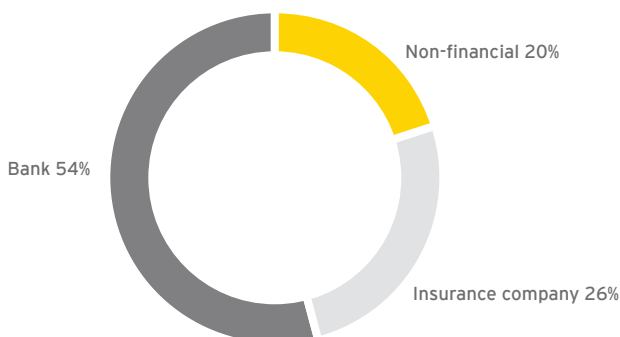
To help understand investor behavior and motivations, EY undertook a web-based survey of current, former and prospective housing tax credit investors, as well as syndicators and brokers. Survey requests were sent to 232 individuals at 155 organizations, of which 55 organizations responded yielding a response rate of 35.5%. Although requests were sent to multiple individuals at each organization to help ensure a higher response rate, only one response per organization was requested. Data was collected during the period from June 24, 2009 through July 10, 2009. All figures in this report represent the results of this survey unless noted otherwise.

The 55 respondents included 35 investors, 18 syndicators and two placement firms. Because of the low response rate among brokerage firms and data quality issues, their responses were not presented individually. Totals presented throughout this report represent those responding only, and no attempt is made to extrapolate these results to the entire population.

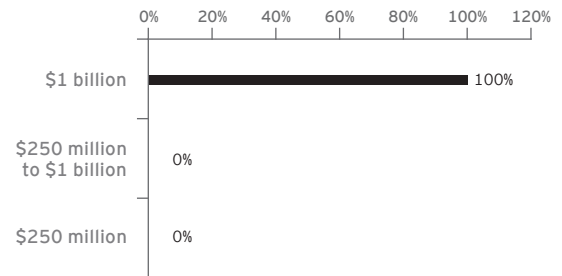
Investor respondents to the survey represent the industry sectors illustrated below. As shown, banks comprised the largest segment of respondents, all of which reported over \$1 billion of assets, suggesting that all were subject to the investment test requirements of the CRA, as described earlier in this report. Insurance companies were most frequently from the life insurance sector. Non-financial companies were predominantly energy and utility companies.

Based on our analysis of estimated market size data and interviews with program participants, we also attempted to estimate their respective share of overall market size represented by the investors and syndicators who responded.

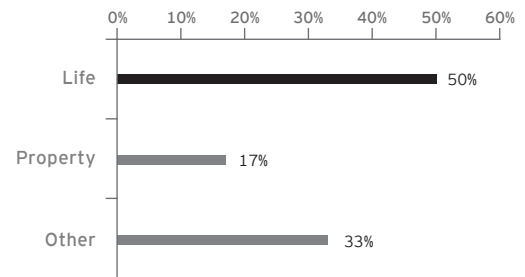
Investor respondent industry composition



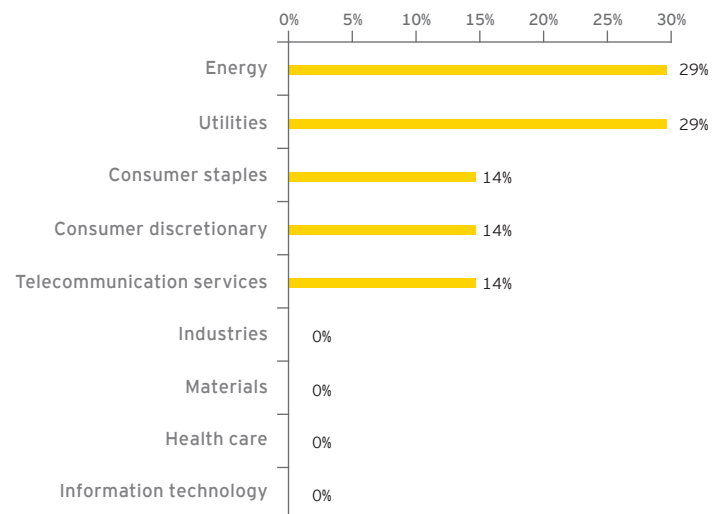
Bank assets



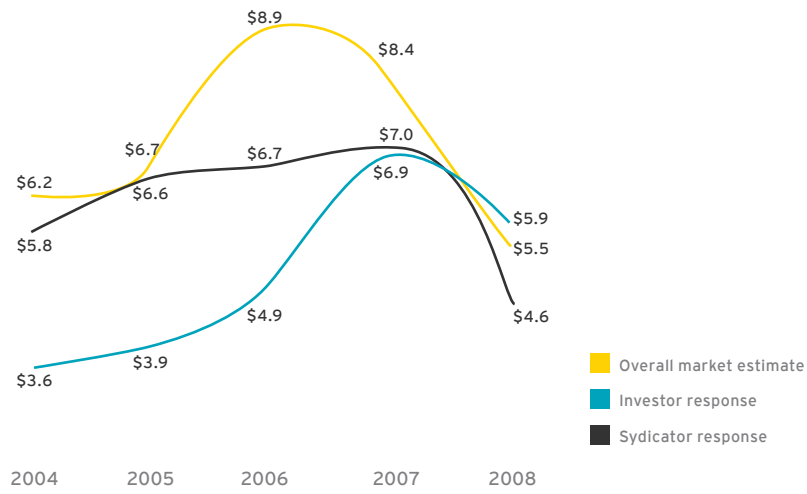
Type of insurance company



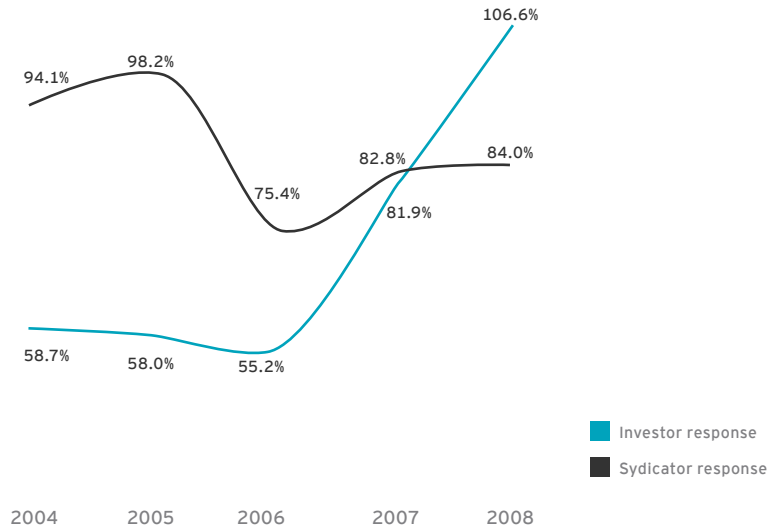
Type of non-financial company



Sample vs. total estimated universe – \$ billions



Sample vs. total estimated universe – %



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