FitchRatings

U.S. Public Housing Authority Capital Fund Housing Revenue Bonds Rating Criteria

Sector-Specific

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This criteria report replaces the report titled, "U.S. Public Housing Authority Capital Fund Housing Revenue Bonds Rating Criteria," dated Dec. 22, 2020.

Related Criteria

Public Sector Revenue-Supported Entities Rating Criteria (September 2021)

U.S. Public Finance Tax-Supported Rating Criteria (May 2021)

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Scope

This criteria report details Fitch Ratings' methodology for assigning obligation-specific ratings to bonds secured by U.S. Department of Housing and Urban Development (HUD) capital fund grants to public housing authorities (PHAs) in the U.S. The criteria apply to both new and surveillance ratings.

Key Rating Drivers

Nature of Federal Program: The revenue stream available to pay debt service on capital fund bonds comes exclusively from HUD's annual capital fund program (CFP) appropriation for an authority. A PHA's share of the appropriation is dependent on its housing inventory and how well it manages that inventory. Capital fund bonds will not be rated higher than one notch below the U.S. sovereign rating, to reflect the appropriation risk inherent in capital fund allocations.

Structural Features: Fitch reviews the bond and program documents to ensure the legal framework both mitigates the risks associated with the PHA's ability to pay bondholders and eliminates management performance issues related to the annual allocation. Among the program documents, the annual contributions contract (ACC) is a key agreement between HUD and a PHA that is reviewed annually.

Financial Profile: A significant part of Fitch's analysis centers on the bonds' debt service coverage (DSC) since the primary security for the capital fund bonds is the annual capital fund appropriation. The bonds' DSC is calculated using a stressed allocation amount that is divided by the maximum annual debt service (MADS) on the bonds.

PHA Program Management: Management's demonstrated ability to plan, develop and submit program documentation to HUD in a timely manner ensures appropriation funding and enhances bondholder security.

Of the key rating drivers, the nature of the federal program carries the most weight, as HUD's annual CFP appropriation and its allocation among the PHAs provide the primary security for the bonds.

In addition to the funding of the CFP, HUD has established parameters within which the program is administered. Changes to the program can significantly impact a PHA's allocation or its ability to use capital funds to provide security for its CFP bonds. The relative importance of the remaining rating factors is equally weighted since each may have a significant impact on the rating. However, the relevance of each factor may vary over time and/or between bond programs, particularly as programs approach maturity.

Nature of Federal Program

PHAs have received annually appropriated subsidies since 1937. In the past two decades, PHAs have been annually funded under two federal programs: the first providing operating subsidies for day-to-day operations and the second providing capital fund subsidies that can only be used for expenditures required to perform capital improvements and major rehabilitation of developments.

The revenue stream available to pay debt service on capital fund bonds comes exclusively from HUD's annual capital fund allocation to each authority. The ratings are capped at one notch below the U.S. sovereign rating to reflect the slightly higher degree of optionality associated with the HUD appropriation payments. Because there is no U.S. government guarantee, ratings are not linked to the U.S. sovereign rating (with the possible exception of ratings at the cap); rather, the final rating reflects the additional risk factors described in the criteria.

Each year's operating and capital improvement subsidies are part of the annual budget cycle of the federal government. The amount a PHA receives can increase or decrease every year depending on many factors — political, economic and/or regulatory.

Potential factors include the following:

- The political risks of having the federal budget allocate more for other programs and less for housing programs.
- Economic pressures that arise as the economy slows and the tax revenues sent to the U.S. Treasury are less than expected, thereby causing the U.S. Congress to cut appropriations across the board.
- The CFP is revised or replaced by a different program and/or the regulations require PHAs to once again competitively bid for a share of capital funds.

In addition to the above-mentioned risks, there is a further related risk to final appropriation and budget passage: the federal government does not always reach a settlement on the final appropriations and final budget in a timely manner each year. If a budget is not signed into law prior to the ensuing federal fiscal year (beginning Oct. 1), extensions usually are passed to fund government programs. The risk of a delay in the passage of a final budget and the consequent delay in receipt of the capital fund allocation can be mitigated by the presence of a debt service reserve fund (DSRF). Fitch will review the transaction documentation to determine if a DSRF is established and funded in an amount equal to at least six months of MADS.

Formulaic Distribution of Funding

The capital fund grants are allocated through HUD's capital fund formula. The formula considers the number of housing units the PHA maintains, their condition and the PHA's plan for its housing inventory in the future. The capital fund allocation addresses both the PHA's modernization backlog (existing capital improvement needs) and the PHA's accrual needs (additional future capital improvement expectations). The PHA's share of the total CFP appropriation is based on its percentage share of modernization and accrual needs when compared with the needs of all PHAs in the U.S. An add-on to the formula described above is Demolition and Disposition Transitional Funding (DDTF), which provides PHAs with up to five years of transitional funding for public housing units that have been removed from the PHA's inventory after July 1, 2013.

Consequently, if the number of housing units the PHA administers is reduced, the PHA could receive less funding over the long term. Should the PHA's capital needs increase or decrease in relation to the capital needs of other PHAs, capital funding could change because of the shifting needs relative to other PHAs.

Added to the capital funding allocation are two adjustment factors: one for replacement housing (in the process of being replaced by DDTF) and one for performance rewards. These adjustment factors will, where present, be included in Fitch's analysis for a specific PHA bond issuance as the additional allocation would only increase the DSC, thereby possibly allowing the bond to obtain a higher rating on a case-by-case basis.

Structural Features

Fitch reviews the bond documents to confirm that there is a commitment from the PHA and HUD to apply the first capital fund dollars available to the debt service accounts of the bonds prior to providing funds for any other PHA capital needs. Fitch believes that direct payments from the federal government to the bond trustee provide a stronger security structure. These direct payments in the amount required to pay debt service on the next scheduled bond payment date help to mitigate the risk of various timing and management issues, thereby reducing the risk of default. If the payments are not made directly from HUD to the trustee, the rating on the bonds may be negatively affected.

Currently, a PHA's CFP funds are requested through invoicing and submission to HUD for specific services performed. Funds to the PHA flow through a lockbox system. Fitch reviews the setup of lockbox accounts created to release funds for timely payment of debt service and/or reimbursement to reserve accounts.

Annual Contributions Contract

The CFP provisions are detailed in an amendment to the ACC between HUD and the PHA. The ACC amendment plays a key role in ensuring that the legal framework mitigates the risks associated with the PHA's ability to pay bondholders and eliminates management performance issues related to the annual allocation. Fitch reviews the amendment to the ACC prior to the application of the rating to the CFP to confirm that the below items are included:

- HUD's initial approval of the indenture, including the debt service payment schedule, is final and not subject to subsequent revisions other than for material amendments, and is not contingent on the annual approval of the five-year action plans.
- Bonds are legal public housing obligations under Section 11(b) of the U.S. Housing Act of 1937.
- Debt service payments will go directly from the HUD-appropriated budget funds (allocated to the specific PHA) to the trustee as a direct payment on predetermined scheduled dates, usually three days in advance of the debt service dates.
- Administrative sanctions will not delay payment of debt service or allow the recapture of funds approved for debt service payments.

Financial Profile

Addressing the Uncertainty of the Annual Appropriation

To reflect potential fluctuations in funding over time, Fitch stresses the annual allocation amount before calculating DSC levels. Grant amounts allocated by HUD are conservatively estimated using the past five years of capital fund appropriations allocated to the PHA issuing the bonds. The analysis uses the lowest actual allocation received over the past five years or 95% of the most recent year, whichever is lower, as a base for the current year allocation.

That base amount is then reduced again based on the number of years to bond maturity, with a 10% decrease for bonds less than or equal to five years to maturity, an 11%–15% decrease for six to 10 years to maturity, a 16%–20% decrease for 11 to 15 years to maturity, a 21%–25% decrease for 16 to 20 years to maturity and a 25% decrease for 20-plus years to maturity (*see table at lower right*). The second reduction was developed to cover the increased possibility of an allocation being reduced over the remaining term of the bonds. The longer the number of years to maturity, the greater the risk of lower annual appropriations over time. The result is a stressed allocation amount.

Debt Service Coverage

The final Fitch stressed allocation amount is then divided by the MADS on the bonds to calculate the adjusted DSC level. A minimum stressed DSC of 4.0x typically corresponds with a 'AA' rating, 3.0x corresponds with a 'AA–' rating, 2.0x with a 'A+' rating and 1.5x with a 'A' rating, respectively (*see table at top right*).

The adjusted rating scale is trying to capture the fact that, at higher DSC levels, the rating becomes less sensitive to small declines in the capital fund allocation to an individual PHA's bonds.

For CFP pooled financings in which the capital fund allocations from HUD are not cross-collateralized, Fitch considers the weakest DSC of the participating PHAs as the indicator of the credit's financial strength. In such transactions, each PHA is obligated to pay its share of debt service from its respective allocated funds, and, therefore, ratings are based on the PHA with the lowest DSC.

Adjusted DSC

(x)	Rating
4.00	AA
3.00	AA–
2.00	A+
1.50	A
1.35	BBB
1.25	BB

Source: Fitch Ratings.

Bond Term Adjustment

Bond Term Years to Maturity	Term to Maturity Adjustment (%)[a]
0–5	90
10	85
15	80
20+	75

[a]The term to maturity adjustment occurs after the current year allocation is stressed by using the lowest actual allocation received over the past five years or 95% of the most recent year, whichever is lower, as the base assumption.
Note: Maturity adjustments for years in between intervals are interpolated.
Source: Fitch Ratings.

PHA Program Management

Each year the PHA is required to make a capital fund submission to HUD. The capital fund submission includes, among other documents and certifications, the PHA's ACC amendments and a five-year action plan and budget. Only after HUD's approval of the five-year action plan and any required environmental reviews are the funds under the CFP available to the PHA. If a PHA fails to submit a capital plan in a timely manner, receipt of CFP funds can be delayed. As such, management's demonstrated ability to plan, develop and submit capital action plans to HUD in a timely manner ensures allocation funding and enhances bondholder security.

HUD evaluates PHA management performance through the Public Housing Assessment System (PHAS). Declining PHAS scores could reduce the amount of operational funding, thereby increasing the cash needs of the PHA for day-to-day operations. This may translate into the use of a portion of CFP funds for operating expenses. Additionally, poor scores may result in HUD sanctions, which include the placement of conditions on a future grant, a requirement that the PHA remit some or all of the grant back to HUD, a reduction of the level of funds the PHA would otherwise be entitled to and/or HUD's election not to provide future grants until the PHA takes appropriate actions.

Rating Assumption Sensitivity

Capital Fund Program Changes

Changes in the federal funding mechanism and/or levels may have a positive or negative effect on an individual PHA's DSC level and, therefore, may affect the outstanding rating on the bonds.

U.S. Government Rating

Any changes to U.S. sovereign creditworthiness would affect capital fund bonds that are rated at the cap of one notch below the U.S. sovereign rating.

PHA Capital Fund Allocation Changes

Changes in the capital funding allocation to a rated CFP of a PHA may have a positive or negative effect on the PHA's DSC level and, therefore, may affect the outstanding rating on the bonds.

Failure to Make Annual Capital Fund Submission

Although remote, the inability of a PHA to submit capital plans to HUD in a timely manner would apply negative pressure on the rating and could result in a rating downgrade.

Data Sources

Fitch's key rating assumptions used to derive these criteria and to assign ratings are based on the analysis of the following documents:

- U.S. government and/or HUD reports indicating historical federal funding levels.
- HUD's annual published allocation reports of capital funds to the individual PHAs.
- HUD press releases and/or reports regarding budget appropriations.
- The ACC between the PHA and HUD.
- Legal opinions.

Criteria Variations

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind the agency's ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All such variations, including their impact on the rating (where appropriate), will be disclosed in the respective rating action commentaries.

A variation can be approved by a ratings committee where the risk, feature or other factor relevant to the assignment of a rating, and the methodology applied to it, are both included within the scope of the criteria, but only when the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Limitations

Ratings, including Rating Watches and Rating Outlooks assigned by Fitch, are subject to the limitations specified in Fitch's Ratings Definitions and are available at www.fitchratings.com/site/definitions.

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