



KANSAS LEGISLATIVE DIVISION *of* POST AUDIT

The Rundown podcast transcript for Performance Audit report titled ***Private Activity Bonds: Comparing How Structure and Use of These Bonds in Kansas Compares to Other States*** – Released January 2020

Andy Brienzo, Host and Principal Auditor: [00:00]

From the Kansas Legislative Division of Post Audit. This is The Rundown. Your source for news and updates from LPA including performance audits recently released to the Kansas Legislature. I'm Andy Brienzo. In January 2020, Legislative Post Audit released a performance audit examining how Kansas' use of private activity bonds compares to other states as well as the advantages and disadvantages of the way Kansas administers its homebuyer's program. I'm with Josh Luthi, Senior Auditor at Legislative Post Audit who supervised this audit. Welcome to The Rundown, Josh. Thanks for taking the time to join me in the studio.

Josh Luthi, Senior Auditor and Supervisor: [00:42]

Thanks for having me Andy.

Andy Brienzo, Host and Principal Auditor: [00:45]

So let's start with what private activity bonds are, what they're used for, and how they work.

Josh Luthi, Senior Auditor and Supervisor: [00:51]

So, private activity bonds are a specific type of bond and they are issued by state and local governments. They're kind of different in that the state or local government is going to issue these bonds, but they're going to take the money from the sale of those bonds and they're going to give them to a private entity for use on a qualifying project and that private entity is then going to be responsible for repaying the investors on those bonds. So, there are six broad categories that define the kinds of projects private activity bonds can be used for. First, we've got exempt facility bonds, and this would cover things like airports or waste disposal facilities or multi-family housing that's at least partially for low-income individuals. Second, we have qualified mortgage bonds, which are meant to help first time home buyers with their mortgages. In this context, first-time home buyer, it means anybody who hasn't owned a home in the past three years, I believe. Third, qualified redevelopment bonds, which it's our understanding not a lot of people use these, there's just very little data about them. So, it's there to help blighted areas that's about all I can say

about that. Qualified small issue bonds are for small projects. They're generally manufacturing projects, and these are generally not supposed to exceed \$1 million on each bond issue, but they can run up to \$10 million under certain conditions. We also have qualified student loan bonds, which as you might expect are to help out with student loans. And finally qualified 501 (c)(3) bonds, which are bonds that are basically for charitable organizations like hospitals, that sort of thing. I should probably also clarify that this audit is talking about qualified private activity bonds. I'm just going to call them private activity bonds, but there are a whole bunch of private activity bonds. They're not really centrally tracked, but the qualified ones, the ones we're talking about here, are tax exempt, which means investors don't pay taxes on the interest they get from these bonds. So that's what we're talking about here.

Andy Brienzo, Host and Principal Auditor: [02:56]

The federal government limits states use of these bonds though, right?

Josh Luthi, Senior Auditor and Supervisor: [03:01]

Yeah, that's right. Each state gets its own annual limit and that limit is based on each state's population. Kansas population is relatively small, so it gets a minimum amount. In 2018, that was \$311 million. Since not all states have the same population that limit is going to vary from state to state. And it may also vary from year to year depending on the rules the federal government sets. So, throughout the report we talk about, other states use of private activity bonds in terms of percentages to keep things more apples to apples. I should also point out this limit does not apply to all of the qualified private activity bonds that I listed earlier. So, for example, those 501 (c)(3) bonds for the charitable organizations, those are not subject to this limit, which means nobody tracks them centrally.

Andy Brienzo, Host and Principal Auditor: [03:52]

So one of the questions this audit answered was how Kansas use of private activity bonds compared to other states. It looks like the team found that Kansas used much less of its bond authority than most other states in recent years. Tell me about this conclusion and how the team reached it.

Josh Luthi, Senior Auditor and Supervisor: [04:11]

So, I'll start by talking a little bit about our methodology. We looked at calendar years 2016 through 2018. To understand how Kansas uses private activity bonds, we worked with the Kansas Department of Commerce and reviewed documentation they had. We also worked with officials from Indiana, Iowa and Oklahoma to learn how they use private activity bonds. We picked those states because they're nearby and kind of similar to Kansas. So, we thought they might use private activity bonds in a similar way. And we also reviewed data from the Council of Development Finance Agencies for all 50 states plus the District of Columbia to try and get a sense for how Kansas compares nationally. However, I should note on that data from that Council, it was not totally reliable. For example, it misreported Kansas use of private activity bonds. That data also did not necessarily always match the data we got from those three states I listed. So, while we think it provides a good overview of how these bonds are used nationally, a reader should be wary of reading too much into

the details in that data. In terms of the actual finding itself, you're right, Kansas did use less of its bond authority than most other states. Kansas use was highest in 2018 when it used about 16% of its authority and by contrast at the three other states we looked at, they used between 29% and 69% of their authorities in 2018 and then nationally, the average use of that bond authority was about 61%. So, Kansas, in general, seems to use less of its bond authority than most other states in the nation. However, there can be significant year to year variation in how much of its authority a state uses. That said, like I said, we looked at 2016 through 2018 and in each of those years, Kansas use of private activity bonds was fairly low relative to most other states.

Andy Brienzo, Host and Principal Auditor: [06:04]

So, which of the six types of private activity bonds that you mentioned before, did Kansas use during the years the team reviewed? And how did this affect its overall use of its bond authority?

Josh Luthi, Senior Auditor and Supervisor: [06:16]

I mentioned six types of bonds earlier. I'm going to focus on three here. So, first of all, I'm not going to talk about 501 (c)(3) bonds because like I said, they're not subject to the cap and nobody really tracks those. I'm also not going to talk about the redevelopment or student loan bonds because while they are subject to the cap and they are tracked, they aren't used especially widely and they aren't used in Kansas. But what I am going to focus on are those exempt facility bonds, the qualified mortgage bonds, and the qualified small issue bonds because they're more commonly used either in Kansas or around the country. So, first of all, with the exempt facility bonds, these are the ones that are for like your airports and multifamily housing. Kansas only used up to 14% of its authority for exempt facility bonds and that was in 2018. In that same year, other states in the nation used an average of 32% of their authorities for these kinds of bonds. Then on qualified mortgage bonds, Kansas has not issued any of these bonds since 2008. By contrast, other states used an average of 29% of their authorities for these bonds in 2018. This is probably the biggest reason Kansas use of private activity bonds looks different from other states simply because Kansas just isn't using any of these bonds. I should note, however, Kansas is not the only state in the nation to not use these bonds in 2018, but by and large, most states do. In particular, one thing I found interesting was what happens when you compare Kansas to Oklahoma. In 2016 and in 2017, Kansas and Oklahoma have very similar private activity bond use levels. That's because in 2016 to 2017, Oklahoma officials told us they were not using mortgage bonds like Kansas. However, in 2018, they started doing that again and a private activity bond use increased. And then we have qualified small issue bonds. In 2018, Kansas used about 2% of its authority for these bonds and it also used somewhat more than that in 2016 and 2017, but not dramatically so. This doesn't sound like a lot, but most other states just don't use these bonds at all. For example, in 2018, only 16 other states use these bonds and Iowa was the biggest user, but they only used 10% of their authority on them. So, to sort of recap here, the two types of private activity bonds that are used most around the nation are exempt facility and qualified mortgage bonds. Kansas uses less of its authority for these exempt facility bonds and it doesn't use any of its authority for the mortgage bonds and even though it uses more of its

authority than average for the qualified small issue bonds., it's use there is sufficiently low that it's just not enough to make up for Kansas' lack of use of the other kinds of bonds.

Andy Brienzo, Host and Principal Auditor: [09:05]

So let's move on now to the second question this audit answered, which is the advantages and disadvantages of the way Kansas administers its home buyer program. Tell me about this program and how it's changed in the last decade or so.

Josh Luthi, Senior Auditor and Supervisor: [09:19]

Kansas has a program called the Kansas Housing Assistance program. It sells mortgage backed securities to finance its operations and to make mortgages to qualifying Kansas home buyers. There was a prior iteration of this program that ran up to 2008 that used qualified mortgage bonds. Like I said, those are a kind of private activity bond. They are for first time home buyers. So that's why we're talking about this program in the private activity bond report. There was no program from 2008 to 2014. That was in the wake of the recession and the housing finance crisis and then in 2014, the current iteration of the program, the Kansas Housing Assistance program started up and like I said, it uses those mortgage backed securities and it can serve more than just first time home buyers. According to the program officials, we spoke with these mortgage backed securities work better in the current interest rate environment where private activity bonds are just not as competitive. The reason private activity bonds are less competitive in the current interest rate environment is, the idea here is since the bonds are tax exempt, meaning the investors don't pay income tax on the interest they receive, they are therefore willing to accept a lower rate than they would accept on a taxable bond. So, because interest rates in general are very low right now, especially relative to how they used to be in decades past, private activity bonds competitive advantage is less. That's not to say it doesn't exist, but they're just not as competitive and the margins are as we understand it a lot tighter.

Andy Brienzo, Host and Principal Auditor: [10:59]

So it looks like the Kansas Housing Assistance program that you've been talking about is sponsored by Sedgwick and Shawnee counties rather than the state and is managed by a private firm. How does the setup work and how does it differ from how other states administer their home buyer programs?

Josh Luthi, Senior Auditor and Supervisor: [11:17]

Yeah, so the Kansas Housing Assistance program is sponsored by Sedgwick and Shawnee counties. They would be the ones to issue bonds if the program were to use bonds. Since that's the way state law is set up. But the program's day to day operations are managed by an investment banking firm called Stifel. Anyone in Kansas can use this program to buy a house provided the relevant local unit of government has an agreement with the program. Now in terms of how this compares to other states, one of the groups we've worked with, the National Council of State Housing Agencies told us that all states, except Kansas, have a state level organization that operates some home buyer programs. Kansas does have a state level housing organization. That's the Kansas Housing Resources Corporation or

KHRC. KHRC administers some federal programs, but it does not have a program that offers mortgages to home buyers. So that's the main way in which Kansas seems to differ from other states in terms of how the programs in those other states work. They use some combination of mortgage backed securities and qualified mortgage bonds. So, Kansas only uses the mortgage backed securities. There are some other states that also only use mortgage backed securities, but most states use both the mortgage backed securities and the qualified mortgage bonds.

Andy Brienzo, Host and Principal Auditor: [12:35]

So, throughout fieldwork, the team talked to a variety of different stakeholders about how Kansas and a few other states administer their home buyer programs. Who'd you talk to and what were their thoughts on how Kansas administers its program?

Josh Luthi, Senior Auditor and Supervisor: [12:49]

So in Kansas we spoke with officials from Sedgwick and Shawnee counties, Stifel, officials from the Department of Commerce, the Kansas Housing Resources Corporation, and the Kansas Development Finance Authority. Outside of Kansas, we spoke with officials from Indiana, Iowa, Oklahoma, Pennsylvania and the National Council of State Housing Agencies. You might note Indiana, Iowa and Oklahoma were the states we also looked at for question one. Again, we picked them because we thought they would be like Kansas. We selected Pennsylvania specifically because we thought they would be different and might provide an interesting point of contrast. Generally, I think officials from other states found Kansas' setup to be unusual. They mainly identified drawbacks with our setup-saying primarily that it may limit opportunities for state housing revenues and state control over program operation. However, it's also worth noting that they are speaking from a very specific perspective having been in states that have had long running home buyer programs. By contrast, Kansas has never had a state level homebuyer program like those other states. Officials in Kansas identified at least one overarching advantage to Kansas' current setup. The Kansas Housing Assistance program comes at no cost or risk to the state which is to say the state doesn't have to fund the program, it doesn't devote staff to this. The counties and Stifel are basically running it on their own and if the state were to want to set up a state administered program, according to KDFA officials, the state would likely need to invest funds in that, maybe even on an ongoing basis and then there would be some risk there because if the program were to struggle or were to not be successful, it's possible such a program would need continued cash infusions just to manage. For example, bond obligations and then legislators at that point would be faced with a decision to either provide more money to the program or to let it go belly up, which could damage the state's financial reputation.

Andy Brienzo, Host and Principal Auditor: [14:48]

Finally, what's the main takeaway of this?

Josh Luthi, Senior Auditor and Supervisor: [14:52]

I think the main takeaway is that Kansas is different from most other states, both in terms of its homebuyer program and its overall use of private activity bonds. Now one might wonder, could Kansas be like other states? And I think the thing here is

it's not clear that a hypothetical program in Kansas wouldn't necessarily be successful. Like I said earlier, other states' housing organizations set up programs in decades past. A lot of those housing agencies came into existence in the 60s, 70s and 80s and were likely able to take advantage of a very different interest rate environment and different rules governing the use of bonds. Those circumstances don't exist anymore. So, if Kansas were to try to start running a homebuyer program through a state agency or if it were interested in trying to use mortgage bonds again, it would be facing very different circumstances from those in other states.

Andy Brienzo, Host and Principal Auditor: [15:53]

Josh Luthi is a Senior Auditor at Legislative Post Audit. He supervised an audit examining how Kansas use of private activity bonds compares to other states as well as the advantages and disadvantages of the way Kansas administers its homebuyers program. Josh, thank you for walking me through your findings.

Josh Luthi, Senior Auditor and Supervisor: [16:11]

Thanks for having me, Andy.

Andy Brienzo, Host and Principal Auditor: [16:12]

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