EICHNER NORRIS & NEUMANN PLLC

ATTORNEYS AT LAW

THE JEFFERSON BUILDING

1225 19TH STREET, N.W., 7TH FLOOR

WASHINGTON, D.C. 20036

TEL: (202) 973-0100

FAX: (202) 296-6990

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By: R. Wade Norris, Esq.

COMBINING SHORT-TERM CASH BACKED TAX-EXEMPT BONDS WITH TAXABLE GNMA SALES FOR AFFORDABLE HOUSING PROJECTS USING FHA INSURANCE*

This memo explains a new program which our firm, including my partners Kent Neumann and Ad Eichner, played a significant role in developing to finance affordable housing projects using FHA-insured mortgage loans where the Borrower must finance 50% of project costs with tax-exempt bonds and keep those bonds outstanding until the project's placed-in-service date in order to get full value for the 4% LIHTC equity under the "50% Rule". The structure prices the permanent loan rate in the huge, highly efficient forward delivery market for taxable GNMA securities, rather than the much smaller, less efficient "fully funded" long-term tax-exempt multifamily housing bond market, and uses short-term, "cash backed" tax-exempt bonds to achieve compliance with the "50% Rule". The program (i) dramatically reduces (by approximately 100 basis points in the current market) the stated mortgage loan rate and all-in borrowing rate, and thus can substantially increase the mortgage loan amount and/or project cash flow and (ii) dramatically lowers (to roughly 1% of the mortgage loan amount from as much as 6-8% or more) the construction period negative arbitrage associated with these financings.

Background

The first quarter of 2009 was truly a "nuclear winter" for affordable housing finance. Following the financial crisis in the fall of 2008, two-thirds of the market for tax credits effectively had disappeared as Fannie Mae and Freddie Mac (formerly 40% of the tax credit equity buy side) and large commercial banks (formerly 25%) had suffered major losses, had no taxable income and no prospect of taxable income, and thus no need for federal tax credits of any type. Similarly, on the debt side, long-term, tax-exempt municipal rates had risen to a point where they were **400 basis points higher** than the rates on comparable taxable 30-year U.S. government securities. This reflected in large part a flight to safety of U.S. Treasuries, as trillions of dollars of formerly AA and AAA rated debt of large banks, insurance companies (e.g. AIG), securities firms (e.g. Lehman Brothers), bond insurance firms (e.g. AMBAC, MBIA, FGIC, ACA), CDOs, CLOs, CMOs and other paper of non-U.S. Government issuers became worthless or worth only pennies on the dollar. In such an environment, and even today (given the concern over European government and bank debt and other market uncertainties), there is a huge flight to safety of U.S. Government debt, and U.S. Government securities now trade at record low yields. On the municipal side, by contrast, yields have risen to levels often higher rather than lower than the rates on taxable U.S. Government debt of a similar maturity, as concerns regarding the credit quality of a wide

array of municipal bonds have risen and the long-term viability and value of the federal tax-exemption on municipal debt is increasingly challenged.

As many market participants discovered, in the first quarter of 2009 the only viable debt financing model was FHA. There were no bank letters of credit required to credit enhance bond issues or to cover the construction and rent-up period for Fannie Mae and Freddie Mac enhanced bonds. This is not needed for an FHA-insured loan, since FHA provides insurance of loan advances. Moreover, FHA insured loans can be "wrapped" with GNMA pass-through securities (called a Construction Loan Certificate or "CLC" during construction or a Permanent Loan Certificate or "PLC" once the FHA insured loan has been finally endorsed for insurance post-construction). These GNMA certificates provide the full faith and credit guarantee of the U.S. Government that the payment due on the FHA insured loan on the first of the month will be "passed through" to the holder of the GNMA on the 15th (minus a 25 to 37.5 basis point GNMA guaranty/servicing fee), even if the underlying FHA insured loan is in default and the payments due are not being made. As a result, in the taxable debt securities markets, GNMA securities trade at very tight spreads to U.S Treasury Bonds.

Thus a long-term tax-exempt bond issue to fund an FHA-insured mortgage loan might bear interest at approximately 3.75% in the current market and, with fees, produce a stated mortgage loan rate (including GNMA and servicing fees) of approximately 4.25% to 4.50%, depending primarily on issuer and other third party fees. When one adds the FHA mortgage insurance premium or "MIP" of 45 basis points for a 100% affordable project, this structure would produce an all-in borrowing cost of approximately 4.75% to 5.00%. The same loan, priced in the taxable market for GNMA's, might bear at a stated mortgage loan rate of about 2.75% to 3.25%, with an all-in borrowing cost of roughly 3.25% to 3.75%, if issuer and third party fees are the same. **The result is, that as irrational as it may seem, since the winter of 2009, the FHA-insured mortgage loan rate and all-in borrowing cost which can be achieved by selling GNMA securities in the taxable market is approximately a full percentage point lower than the mortgage loan rate which can be achieved by funding the same loan through the sale of long-term tax-exempt Aaa or AA+-rated municipal bonds.**

The debt markets for GNMAs are also "forward delivery" markets. This means that as each FHA loan advance is made and wrapped with a GNMA security, that security (having the previously agreed upon rate) is delivered to the buyer against payment – i.e., the debt investor advances money to the borrower (through the purchase of the GNMA Security from the Lender) when the funds are needed. This differs dramatically from publicly offered municipal securities markets, where all of the bonds representing the full loan amount must be delivered and begin to bear interest at the long-term borrowing rate of say 4.25% when the bond issue and loan is closed. Those undisbursed bond proceeds must be reinvested in an AA+-rated or Aaa-rated investment arrangement until the money is advanced to fund loan draws. Since short term reinvestment rates of this type range from 10 - 20 basis points per year in the current market, this can impose huge negative arbitrage costs and negative arbitrage deposit requirements. On a fully funded, long-term tax-exempt bond financing for new construction or substantial rehab, the actual negative arbitrage on such a financing can be as much as 2 – 4% of the loan amount and additional negative arbitrage deposits in a similar account can be required to cover the maximum potential negative arbitrage if construction on loan advancements is suspended or proceeds more slowly than expected. A 6 – 8% up front deposit of this type can be fatal to many deals.

The Light Bulb Lights Up

Thus, as we sat in our offices in that desperate winter of 2009, we asked ourselves the question: "If only there were some way we could access these extremely low long-term borrowing rates in the taxable market for GNMA securities and also take advantage of the forward funding aspect of that market to reduce or dramatically lower the negative arbitrage associated with such a deal." The "Ah Ha" moment came from tax-exempt bond financing structure we and others had developed in the mid-1990s for HOPE VI deals. HOPE VI is a program to replace former public housing units, through the provision of HOPE VI "grants" to the projects. Many such projects are targeted at populations with median incomes in the 15 – 20% of area median income range, and thus cannot carry any permanent debt without huge permanent rent subsidies. Instead, they are often financed with short-term tax-exempt bond issues in order to prime full value for a 4% LIHTC syndication. The tax credit syndication proceeds, together with loans to the Borrower funded from HOPE VI grants, and possibly other subordinated loans, provide all of the permanent funding. Short-term tax-exempt bonds in an amount equal to 50% of the project costs are issued with a maturity roughly twice the targeted placed-in-service date (to provide for construction delays) and two funds are established under the Bond Trust Indenture (and invested in the same highly rated investment vehicle) to provide funding for the Project: (i) a "Project Fund" in which all the tax-exempt bond proceeds are invested, and (ii) a "Collateral Fund" in which tax credit equity installments or money from HOPE VI funded loans are deposited when received. In our case, "replacement proceeds" take the from of FHA loan advances or proceeds from the sale of GNMA securities with respect to those FHA loan advances, which are deposited into the Collateral Fund when received. In addition, capitalized interest on the Bonds is deposited into the Bond indenture at closing from subordinate loan proceeds or some other bankruptcy remote source. By structuring such financings so that as each dollar of tax-exempt bond proceeds is disbursed from the Project Fund to pay project costs, an equal amount of "replacement proceeds" must be deposited into the Collateral Fund, the Bond issue remains 100% cash collateralized. One can thus obtain an AA+ or Aaa rating on the short-term bonds based on the unsecured debt rating of the provider of the investment vehicle (possibly U.S. Treasury bonds or a highly rated money market fund or investment agreement) without other credit enhancement. When the project loan has been fully funded, the tax-exempt bonds are repaid after the placed-in-service date and the project has no permanent senior debt.

This structure raised questions with many bond counsel firms as to whether it entailed an unnecessary "over-issuance" of tax-exempt bonds. After all, since the replacement proceeds had to be delivered before an equal amount of bond proceeds could be disbursed to pay project costs, why not just use these to pay the costs and forego the issuance of any tax-exempt bonds? On the other hand, under such a structure, the fundamental requirement that the tax-exempt bond proceeds be expended for qualified project costs of a residential rental housing facility is fully satisfied, so the other view was that the basic requirements of Section 103 of the Code were satisfied under the structure, and there was no reason a bond counsel firm could not issue a clean opinion.

The debate was largely resolved when language was added to Section 1437 of Title 42 if the United States Code by the Quality Housing and Work Responsibility Act of 1998 specifically endorsing the use of cash collateralized tax-exempt bonds in connection with "mixed use" HOPE VI financings. Since that time, almost all major bond counsel firms have given clean opinions on a wide variety of structures where all or a portion of tax-exempt multifamily housing bond issues have been cash collateralized with replacement funds of various types (HOPE VI monies, tax credit equity, proceeds of various federal and state subordinate loan funds) and kept outstanding until the placed-in-service date to meet the 50% test on the tax-credit equity side.

Our "light bulb" idea in the winter of 2009, was to simply apply that structure to finance affordable housing projects using FHA insurance, so as to get the low rates available in the taxable GNMA markets and dramatically reduce the often fatal negative arbitrage cost and funding requirements associated with long-term FHA/GNMA backed tax-exempt bond deals.

The following chart summarizes the principal benefits of the new structure versus the traditional funding method:

Tax-Exempt Bonds Issued: [1]Sized to meet 50% test (Assumes $25.0 Mil total cost)	$18,000,000		$13,000,000[1]	
Tax-Exempt Bond Term (Assume 12 Month Construction Period)	42 Years (Callable in 10 years)		2 Years (Callable 1 year)	
Mortgage Loan Interest Rate	Bonds	4.15%	Bonds	3.50%*
	3rd Party Fees	0.15%	3rd Party Fees	N/A
	Servicing + GNMA Fee	0.25%	Servicing+ GNMA Fee	0.25%
	Total ML Rate	**4.55%**	Total ML Rate	**3.75%**
	FHA MIP	0.45	FHA MIP	0.45
	Borrowing Rate	5.00%	Borrowing Rate	4.20%
Result → **0.80% ML Rate Savings (~7% of additional loan proceeds** on debt service constrained loan)				
Negative Arbitrage (Deposit):	4.30% x 18,000,000 x 2 years		1.00% x $13,000,000 x 2 years	
	$1,548,000 **(8.5% of ML)**		$260,000 **(2.0% ML)**	
Negative Arbitrage (Actual): (Assume even loan draws)	$774,000 (4.3% of ML)		$130,000 (1.0% of ML)	

Note that under the new structure, one only has to issue tax-exempt bonds in an amount sufficient to satisfy the 50% Rule, which can further reduce financing costs. Negative arbitrage is not eliminated, but since the short-term tax-exempt bonds under this structure would typically bear interest at rates of 0.70% to1.0%, actual negative arbitrage should be limited to approximately 1% of the loan amount versus slightly over 4% under the traditional long-term tax-exempt bond financing structure.

This structure has now been approved by 10-12 of the country's largest bond counsel firms. Over a dozen financings using this structure have now closed, and many more are now under way. In effect, this method has now been approved and used on financings with many HUD offices, and the structure has become the defacto new method for financing 100% affordable housing projects using FHA insurance. Moreover, given the high degree of uncertainty in the financing markets, we believe it is highly unlikely that conditions would change in the next 2 – 3 years so that the traditional long-term tax-exempt bond financing approach would once again be competitive with this new structure. Our firm would welcome any questions regarding this new financing device for affordable housing projects using FHA insurance.

* For 221(d)(4) financing; **Rates for 223(f) approximately 50 basis points lower**; Total savings in rate about 1.30%