Combining Tax Exempt, Short-Term Bonds with Taxable GNMA Sale for Affordable Apartment Financings

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Presented by:

R. WADE NORRIS, ESQ.
wnorris@ennbonds.com
(202) 973-0100

EICHNER NORRIS & NEUMANN PLLC
1225 19th Street, N.W., Suite 750
Washington, D.C. 20036
Fax: (202) 296-6990
Website: www.ennbonds.com

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COMBINING TAXABLE GNMA SALES WITH TAX EXEMPT BONDS AND 4% LIHTC

- New Program developed by Eichner Norris & Neumann PLLC in early 2009 to **dramatically reduce the long-term borrowing rate and negative arbitrage** associated with **affordable housing projects** financed with **FHA-insured mortgage loans**. Applies 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**”.

- **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.

- Uses **short-term, “cash backed” tax-exempt bonds** to achieve compliance with the “**50% Rule**”.

- **All-in Long Term Borrowing Rates** of approximately **3.70% (§223f)** to **4.20% (§221(d)(4)) versus approximately 5.00%** for traditional long-term tax exempt bond funding; **Negative Arbitrage deposit of 1.0% or less versus about 8 - 10%**.
• In the **fall of 2008**, numerous AAA-rated debt securities became **worthless** or worth only pennies on the dollar – almost unprecedented destruction of trust in the long-term debt market.

• Result: **Long-term debt investors all over the world fled to the safety of U.S. Treasury bonds.**

• At the same time, **yields on tax exempt municipals soared to new heights** as concerns about credit quality and liquidity mounted.

• The following chart plots an **amazing development** – long-term AAA-rated **tax exempt municipal bond rates** soared **above** the rates on now much lower yielding **federally taxable** U.S. Treasury Bonds.

• **We still live in that upside down world today**, as continuing economic uncertainty regarding Europe and the U.S. economy and worldwide financial systems are joined by growing concerns about the tax exempt status of municipal bonds.
Long Term Rate Comparison: 30-Year MMD (Tax Exempt) Versus 10-Year Constant Maturity Treasury (Taxable)

Early 2008 – **Taxable** US Government Securities Rates Fall **Below Tax Exempt** Municipal Rates
Long Term Rate Comparison: 30-Year MMD (Tax Exempt) Versus 10-Year Constant Maturity Treasury (Taxable) January 1, 2008 - Present

30-Year MMD

10-Year US Treasury

Jan-08 Jul-08 Jan-09 Jul-09 Jan-10 Jul-10 Jan-11 Jul-11 Jan-12

400 BPS

153 BPS

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Why not just borrow in the taxable markets through the sale of Taxable GNMA securities wrapping each FHA insured loan advance?

Dilemma: Owner is required to finance 50% of project’s land and depreciable basis with tax exempt bonds, and keep these tax exempt bonds outstanding until Project’s placed-in-service date

Solution: Issue Short-Term Cash-backed Tax Exempt Bonds; Sell GNMA$s into taxable market, cross proceeds (discussed below); pay off TE Bonds on placed-in-service date

Structure originally developed on HOPE VI Financings, where there is no permanent debt, but short term tax-exempt bonds were issued to get full value for critically important 4% LIHTC.
• Issue short-term tax-exempt bonds equal to 50% of the project costs with a maturity roughly twice the targeted placed-in-service date (to provide for construction delays). Two funds established under Bond Trust Indenture and invested in same AA+ rated investment vehicle:
  – a “Project Fund” in which all the tax-exempt bond proceeds are deposited, and
  – a “Collateral Fund” in which proceeds of sale of GNMA securities wrapping each FHA insured loan advance are deposited as the loan is funded

• Such financings are structured 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 simultaneously deposited into the Collateral Fund, the Bond issue remains 100% cash collateralized.

• Can obtain an AA+ rating on the short-term bonds from S&P based on the unsecured rating of the underlying investments (e.g. U.S. Treasury Bonds and/or a highly rated money market fund), without other credit enhancement.

• When the project loan has been fully funded, the tax-exempt bonds are repaid after the Project’s placed-in-service date and the Project has no permanent senior debt.
Benefits: Qualifies for 4% LIHTC; Low Mortgage Rate and nominal Neg Arb deposit
Section 223(f)

Existing Properties – Refinance or Acquisition + Light Rehab

• Rehab no more than 2 major building systems
• Up to ~$40,000 rehab per door under Pilot Affordable Program (described below); otherwise up to $17,000 per door in high cost areas.
• 35-year level payment loan
  DSCR: 1.11 for Affordable (generally 20% at 50% of AMI or 40% at 60% AMI)
  LTV: ≤ 85% for Affordable
• No Davis Bacon Wages
• 0.5 to 1.5% Orig. Fees; 25 BPS Svcg/ GNMA; 45 BPS MIP
• Low Market rates on Taxable GNMA Sale ~3.00% + 25 BPS + 45 BPS% → All-in ~3.70%
HUD Pilot 223f/ LIHTC Affordable Program

Goal: Encourage and expedite use of §223(f) loans on affordable projects & enhance compatibility with LIHTC

- Allow up to $40,000/ door rehab
- Waive 3-yr Refi prohibition; can use for perm loan
- Expected processing – Commitment 60-90 days; closing 90-120 days
- $25.0 Max Loan Amount
- Now available nationwide, loans processed through one of nine HUBS – LA, Chicago, Detroit, Boston, San Francisco, Seattle, Forth Worth, Atlanta and Denver
- Only certain pre-qualified MAP Lenders eligible
- Other requirements (eg, 6 mo DSRF) fund rehab costs in excess of normal 223(f) limit from LIHTC or other non-loan funds
Section 221(d)(4)

New Construction or Substantial Rehab

- No separate construction lender (FHA insured advances) and no re-underwriting of loan completion (only cost certification at final endorsement)
- 40 year level amortization loan

DSCR: 1.15 for Affordable (generally 20% at 50% of AMI or 40% at 60% AMI)
Max Loan-to-Cost: 87%

Disadvantages:

- Davis Bacon Wages Apply
- Long processing times – 6 to 10 months
- 1.0 – 2.0% Orig. Fees; 25 BPS Sv cg/ GNMA; 45 BPS MIP
- Low market rates on taxable GNMA Sale ~3.50% + 25 BPS + 45 BPS
  → All-in ~4.20%


## RESULTS OF STRUCTURE - SUMMARY

<table>
<thead>
<tr>
<th>Tax Exempt Bonds Issued: 1</th>
<th>Assume Project with <strong>$25,000,000</strong> Total Development Cost $18,000,000</th>
<th><strong>$13,000,000¹</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Traditional Long-Term Tax Exempt GNMA Backed Bonds</strong></td>
<td><strong>Short-Term Cash Back Bonds with Taxable GNMA Sale</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Tax Exempt Bond Term</strong></td>
<td><strong>223f</strong></td>
<td><strong>221(d)(4)</strong></td>
</tr>
<tr>
<td>35 Years</td>
<td>42 Years</td>
<td>2 Years</td>
</tr>
<tr>
<td><strong>Mortgage Loan Interest Rate</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td><strong>4.15%</strong></td>
<td><strong>4.15%</strong></td>
</tr>
<tr>
<td>3rd Party Fees</td>
<td>0.15%</td>
<td>0.15%</td>
</tr>
<tr>
<td>Servicing + GNMA Fee</td>
<td>0.25%</td>
<td>0.25%</td>
</tr>
<tr>
<td><strong>Total ML Rate</strong></td>
<td><strong>4.55%</strong></td>
<td><strong>4.55%</strong></td>
</tr>
<tr>
<td>Add: MIP</td>
<td><strong>0.45%</strong></td>
<td><strong>0.45%</strong></td>
</tr>
<tr>
<td>Total All-in Borrowing Cost</td>
<td><strong>5.00%</strong></td>
<td><strong>5.00%</strong></td>
</tr>
</tbody>
</table>

Result → Approximately **1.30% ML Rate Savings §223(f); 0.80% ML Rate Savings §221(d)(4) (~10% and 7%, respectfully of additional loan proceeds on debt service constrained loan)**

**Negative Arbitrage (Deposit):**

- 4.30% x $18,000,000 x 2 years
- $1,548,000 (8.5% of ML)
- $260,000 (2.0% ML)

**Negative Arbitrage (Actual):**

- $774,000 (4.3% of ML)
- $130,000 (1.0% ML)²

² If Project placed in service in month 12

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RESULTS OF STRUCTURE

Net Results – Borrower:

- **Approximately 80 to 130 basis points of savings** in permanent borrowing rate, resulting in a lower cost of capital over the life of the loan
  - Increased Loan Proceeds and/or
  - Increased Cash Flow

- **Negative Arbitrage deposit reduced** from ~8 - 10 points or more to ~1 point or less

- Full syndication value of **4% LIHTC equity** on affordable units achieved

Net Results – IRS:

- **$13.0 mil. of TE Bond proceeds used to fund Qualified Project Costs** – significantly lower TE Bond amount (by $5.0 million in example) than if $18.0 million FHA loan had been funded with long-term tax exempt bond issue

- **No arbitrage “artifice or device”** - all TE Bond Proceeds (and replacement proceeds) invested at far below TE Bond yield

- **No “over issuance” of bonds or “overburdening” of market** - only enough TE Bonds to meet 50% test, much lower all-in borrowing rate (<1.0% v. ~4.0%) and outstanding 2 years versus 42 years
CONCLUSION

• Approximately a dozen major law firms have issued or agreed to issue unqualified approving opinions on deals using this type of cash collateralized structure for all or part of numerous tax exempt multi-family housing bond issues

• Documents and rating agency criteria well developed

• This is THE NEW WAY to finance affordable housing projects backed by FHA insured loans

• Highly unlikely market conditions will change in next 1-2 years to favor traditional long-term tax exempt bond structure