Combining Tax-Exempt Short-Term Cash Backed Bonds with Taxable GNMA Sale on FHA and Rural Development Loans for Affordable Apartment Financings – Executive Summary

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BACKGROUND

- Short term cash backed tax exempt bonds are a tax exempt bond financing structure we have used **to satisfy the 50% Test relating to 4% low income housing tax credits (“4% LIHTC”)** since the financial crisis in the fall of 2008.

- This structure is **used primarily for 100% affordable multifamily rental housing projects** where all or substantially all of the units are rented to tenants whose incomes (for a family of four*) do not exceed 60% of Area Median Income for a 4-person family.

- **4% LIHTC** often **funds 30% to 40% of total development costs** on these projects.

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* The targeting test is adjusted up or down roughly six percentage points for larger or smaller family sizes. Under Section 42 of the Code rents charged must also be restricted to 30% of this income limit.

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BACKGROUND

- Immediately **following the 2008 financial crisis, interest rates on U.S. Government credits**, including GNMA securities that wrap FHA insured and USDA guaranteed Rural Development ("RD") loans, and on mortgage backed securities issued by Fannie Mae and Freddie Mac (the "GSE's") with respect to certain stabilized mod rehab loans, in the **taxable** debt market **fell below the rates** on long-term AA+ or Aaa rated **tax exempt municipal bonds** backed by those same GNMA or MBS securities.

- Short term cash backed tax exempt bonds **allowed these loans to be funded at the low interest rates that have prevailed** for those GNMA and GSE backed MBS securities in the taxable markets since that time while also satisfying the critical 50% Test relating to the vital 4% LIHTC*.

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* NGO partner Wade Norris played a major role in adapting the use of short term cash backed tax exempt bonds for use in connection with these FHA insured or USDA guaranteed RD and GSE backed loans in the days following the 2008 financial crisis. He and NGO partner Ethan Ostrow have played a leading role in the development and widespread adoption of this financing structure since that time.

THE 50% TEST

- **The 50% Test:** To be eligible for the full value of the 4% LIHTC on the affordable units in either of these types of projects, the Borrower **must finance at least 50% of basis in the building and land with volume limited tax-exempt private activity bonds** under Section 142(d) and **keep these bonds outstanding until the project's placed-in-service date** (receipt of a certificate of occupancy for new construction or completion of rehab for acq/rehab financings).

- **Why the 50% Test?**: Congress wanted projects receiving the 4% LIHTC subsidy to pass the **same hurdles one has to pass to be eligible for private activity bonds.**

- In short, the 50% Test assures that these projects receive a **thorough, local vetting and approval of public purpose** and that they will address local needs of the community where the project is located.

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4% LIHTC – A MAJOR FUNDING SOURCE

- As noted above, on 100% affordable multifamily rental projects the **4% LIHTC often funds 30, 35 or 40% of total development cost, or more**.
- In 2016, it is estimated that **tax exempt bonds combined with 4% LIHTC** provided funding for roughly **75,000 units** of 135,000 estimated affordable rental apartment units in the United States*
- **The market for 4% LIHTC** on 100% affordable projects **is well established**.
  - **Prices** ranged from the $0.70 to $0.80/dollar of LIHTC through most of the 1990's.
  - **Prices climbed to a level exceeding $1.00 – $1.10** on 100% affordable deals in some markets, during 2004 through the financial crisis in 2008 and, after dropping following the effective date of the Tax Cuts and Jobs Act in 2018, began to approach these levels once again **in last 2-3 years**.

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* It is estimated that the 60,000 balance of these 135,000 affordable rental units were financed with 9% LIHTC. These 135,000 affordable rental units were about 1/3 of the estimated 400,000 rental apartment units produced in the U.S. in 2016.

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4% LIHTC – A MAJOR FUNDING SOURCE

- **Since the onset of the COVID19** pandemic, **prices have declined** from the high 0.90¢ to slightly over $1.00 range in leading urban CRA markets **to the low or mid 90's or high 80's**. This reflects **a loss of 2-4 points** of total funding sources on most deals, but this has been **partially offset by increased state and local subordinate debt funding sources** in many markets; and prices may still approach $1.00 or slightly more in urban areas where banks have big CRA needs.

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Sample Transaction - Value of 4% LIHTC

	100% Affordable, DDA*
Assume: Total Development Cost	$25.0 Million
Less: Land	($3.5 Million)
Less: Commercial Qualified Basis	$0
	$21.5 Million
Assume: Difficult to Develop Area ("DDA") (e.g., entire City of LA) on 100% / No DDA on 20%	x 1.3
	$27.95 Million
Assume: 100% at 60% of AMI / 20% at 50% of AMI	x 1.0
	$27.95 Million
Tax Credit Rate	x 0.032
Annual Credit Amount	$894,400
Number of Years Credits Received – 10 years	x 10
Future Value of 10 Years of Credits	$8,944,000
Assume: **95¢** and **85¢**/$1.00 Pricing, respectively	x 0.92
Net Syndication Proceeds to Borrower	$8,228,480
	(33% of Total Development Cost)

* Difficult to Develop Area = 30% basis boost

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Typical "New Money" Private Activity Bond Financing
100% Affordable Project
Sources and Uses of Funds

Sources		
Tax-Exempt Bond Proceeds	$15,250,000	(61%)
4% Tax Credit Equity	8,000,000	(32%)
Subordinated Loan from City	1,000,000	(4%)
Deferred Developer Fee	750,000	(3%)
Total:	**$25,000,000**	**(100%)**

Uses		
Land	$3,750,000	(15%)
Construction Costs	17,500,000	(70%)
Financing Fees	1,250,000	(5%)
Other "Soft" Costs	1,750,000	(7%)
Deferred Developer Equity	750,000	(3%)
Total:	**$25,000,000**	**(100%)**

Bond Costs of Issuance
*($25 Million Transaction)**

Issuer	$62,500
Bond Counsel	65,000
Financial Advisor to Issuer or Issuer's Counsel	25,000
Underwriter	200,000
Underwriter's Counsel	50,000
Rating Agency	5,000
Trustee	5,000
TOTAL	***$412,500***
	(≈1.7%)

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Certain of these items may vary greatly from deal to deal, including issuer fees.

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Long-Term Tax-Exempt Municipal Bonds –
How we Financed Affordable Multifamily Housing
in the Pre-2008 "Right-Side Up" Interest Rate World

- Before the financial crisis in 2008, it was axiomatic that funding the debt side of these deals with **long-term tax-exempt bonds** produced **lower interest rates (by 50-100 basis points or more)** than taxable financings backed by the same credit (e.g., FHA/GNMA).

- Why? Because the **buyers of tax-exempt muni bonds** don't pay federal (and often state) income tax on municipal bonds, and thus they **will accept lower coupons**.

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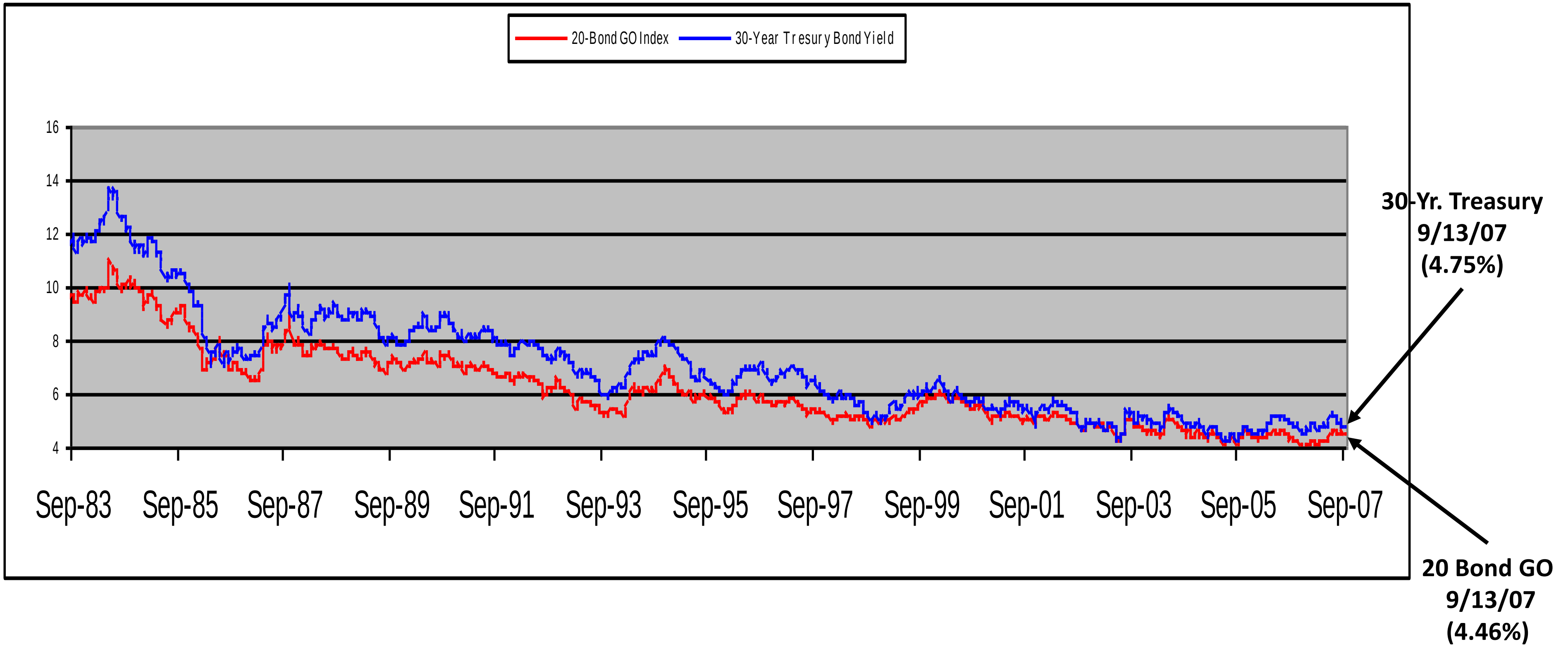
Pre-Financial Crisis Long-Term Tax-Exempt and Taxable Rates

Bond Buyer 20-Bond GO Index vs. 30-Year U.S. Treasury



- **The preceding chart shows** that over the 25-year period prior to the 2008 financial crisis, long-term **tax-exempt rates** were consistently **lower than** long-term **taxable rates.**

- Typical pre-2008 long-term interest rates:

AAA Rated **Taxable** Bond –	**6.0**%
AAA Rated **Tax-Exempt** bond –	**5.0**% (~85% of taxable)
Savings –	**1.0**% or 100 basis points!!!

- In these **"normal" interest rate markets,** this reduction in rates through financing with low-rate long-term fixed rate tax-exempt bonds often **increased loan proceeds** by **4% to 8%** over those achievable on a taxable fixed rate loan backed by the same credit, including GNMAs and GSE backed MBS securities.

Long-term Tax-Exempt Muni Bonds – Major Benefits and Disadvantages

- **Two Major Benefits**:
  - **1. Qualified for 4% LIHTC**;
  - **2. Before 2008, Lower Mortgage Rate** (50-100 basis points) than taxable GNMA.
- **Two Major Disadvantages**:
  - **1. Large (3.5 – 7%) negative arbitrage deposit** for new **construction/sub rehab (e.g., §221(d)(4))** deals;
  - **2. Ongoing** issuer, trustee, and rebate **fees (8 – 10 to 40 or 50 basis points!) for 35 or 42 years**.
- **This structure** using long-term municipal bonds backed by GNMAs wrapping FHA insured loans **was used to provide financing for hundreds if not thousands of projects** for **almost three decades through 2008......**

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Fall 2008 – The Extinction Event

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The Post-2008 World of Upside Down Rates

- 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 markets.

- Result: **Long-term debt investors all over the world fled to the safety of U.S. Treasury bonds* versus any other long-term credit in the debt markets.**

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

- The following charts plot an **amazing development** – **long-term rates** on **federally taxable U.S. Treasury Bonds** fell to levels **substantially below** those on **all other credits, including** rates on **long-term Aaa-rated tax exempt municipal bonds**.

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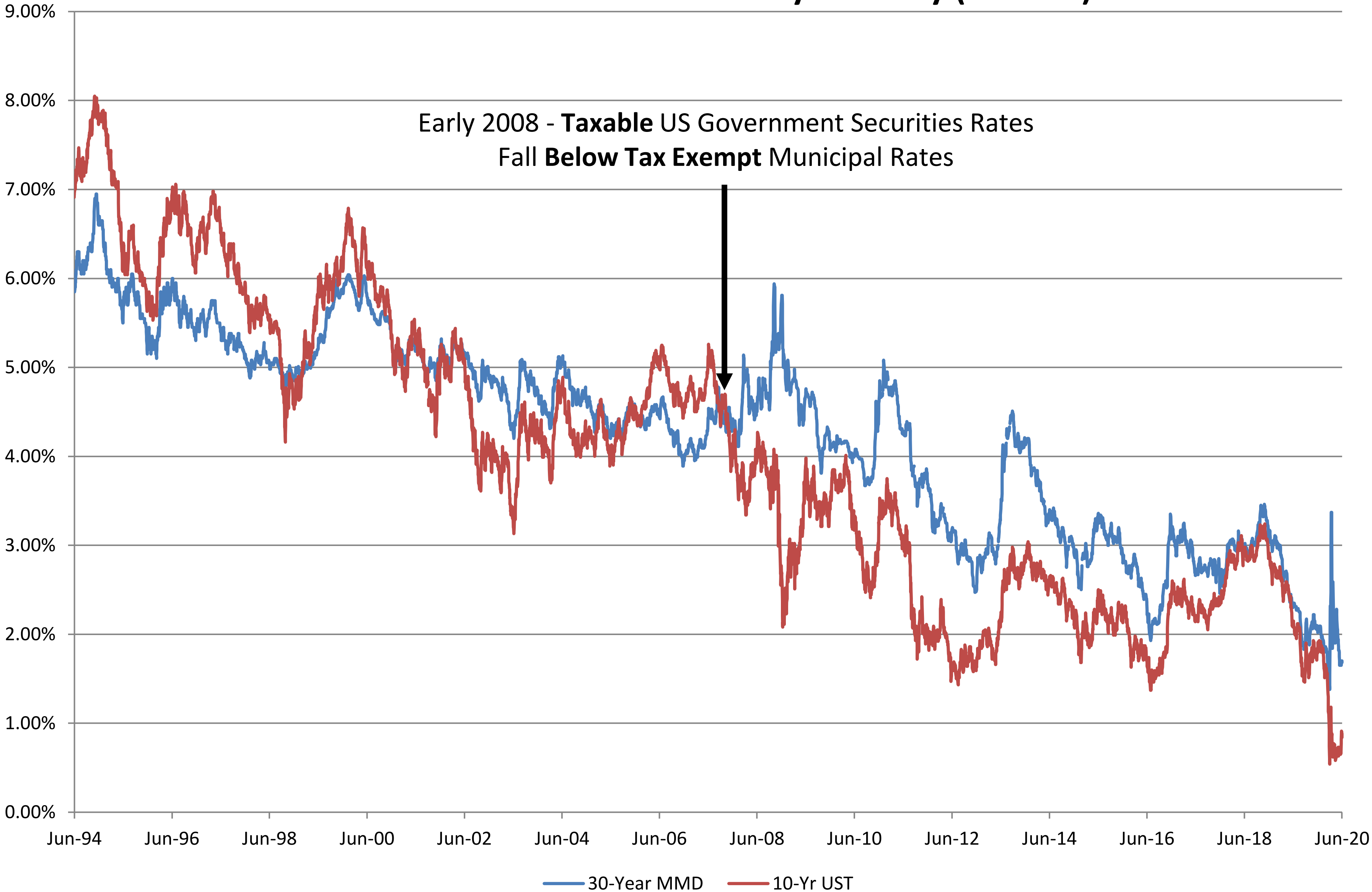
* GNMA securities are also backed by the full faith and credit of the United States and thus trade at tight spreads to U.S. Treasuries. GSE (Fannie Mae and Freddie Mac) backed MBS securities also trade at higher, but very tight, spreads.

Long Term Rate Comparison: 30-Year MMD (Tax-Exempt) Versus 10-Year Constant Maturity Treasury (Taxable)



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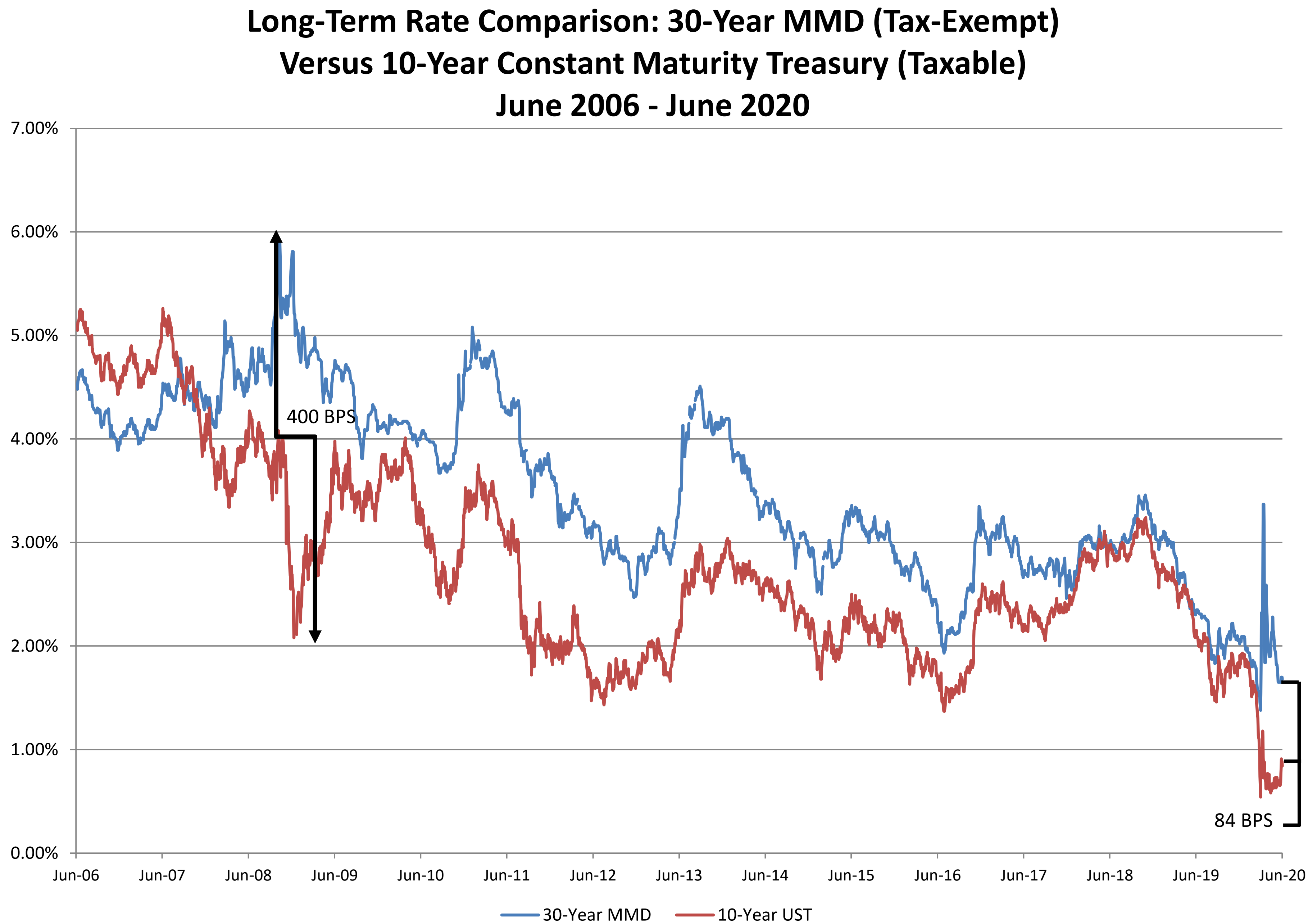

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Combining Taxable FHA and RD Loan Sales with Short-Term Cash Backed Tax-Exempt Bonds and 4% LIHTC

- **We still live in that upside down world today – taxable** U.S. Treasury Bonds **and GNMA and GSE backed MBS securities** trade at yields below all other long-term credits, including long-term **tax exempt** municipal bonds backed by those same credits.

Combining Taxable FHA and RD Loan Sales with Short-Term Cash Backed Tax-Exempt Bonds and 4% LIHTC

- **In this upside down interest rate world, why not just borrow in the taxable markets** through the sale of Taxable GNMA or GSE backed MBS securities wrapping each taxable loan advance? **Why use tax-exempt bonds at all?**

- **Remember Slide 4: The 50% Test!** The Borrower is required to **finance 50% of the project's eligible basis in the buildings plus land** with **tax exempt bonds,** and keep these tax exempt bonds outstanding until Project's placed-in-service date **to prime the vital 4% LIHTC**.

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Solution:

Buy Short-Term Bonds!

- Issue **Short-Term Cash Backed Tax-Exempt Bonds**; **Sell GNMAs (wrapping the FHA or RD Loan) or GSE backed MBS securities wrapping the stabilized GSE loan**; **pay off TE Bonds on placed-in-service date.**

- **Structure originally developed in the 1990's 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.

Cash Collateralized Tax-Exempt Bond Structure

- Issue **short-term tax-exempt bonds equal to 50% of project's eligible basis in the buildings plus land* with a maturity comfortably beyond 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 FHA Lender or RD Lender funds or GNMA are deposited

- Financings 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 **principal of the Bond issue thus remains 100% cash collateralized**.

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*Note: This may be greater than or lower than the taxable loan amount. Most developers aim for 52-55% of such aggregate basis to provide a cushion. The **short-term cashed backed bond structure often produces a lower bond amount**, which lowers bond financing costs.

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Cash Collateralized Tax-Exempt Bond Structure

- This cash collateralization of principal plus locked in coverage of interest enables the financing to obtain an **AA+ rating** on the short-term Bonds from Standard & Poor's **or a Aaa rating** from Moody's, based on the rating of the underlying investments, **without other credit enhancement.**

- **When** the project loan has been fully funded, rehabilitation or construction has been completed and the **project has been placed in service** the **tax-exempt bonds are redeemed.**

- In almost all jurisdictions, we can now **invest bond proceeds in U.S. Treasury securities** which **earn interest through a** 3-year bond maturity, or earlier (e.g. **2 year) mandatory tender date**, **at a rate which,** for much of the two years preceding the onset of the COVID19 pandemic in March **was equal to or slightly higher than the 1.40-1.50% coupon** on the tax exempt bonds. Thus **the investment earnings paid for the interest on the bonds** while they were outstanding, **eliminating any "negative arbitrage."**

- **This changed dramatically in March**, when the **yield on 2-year U.S. Treasury bonds fell about 120-130 basis points from the 1.40-1.50% level to about 20 basis points.** According to a recent Wall Street Journal article, the Fed is expected to keep short-term U.S. Treasury bond rates at these **very low levels** for as long as the **next 2-3 years**.

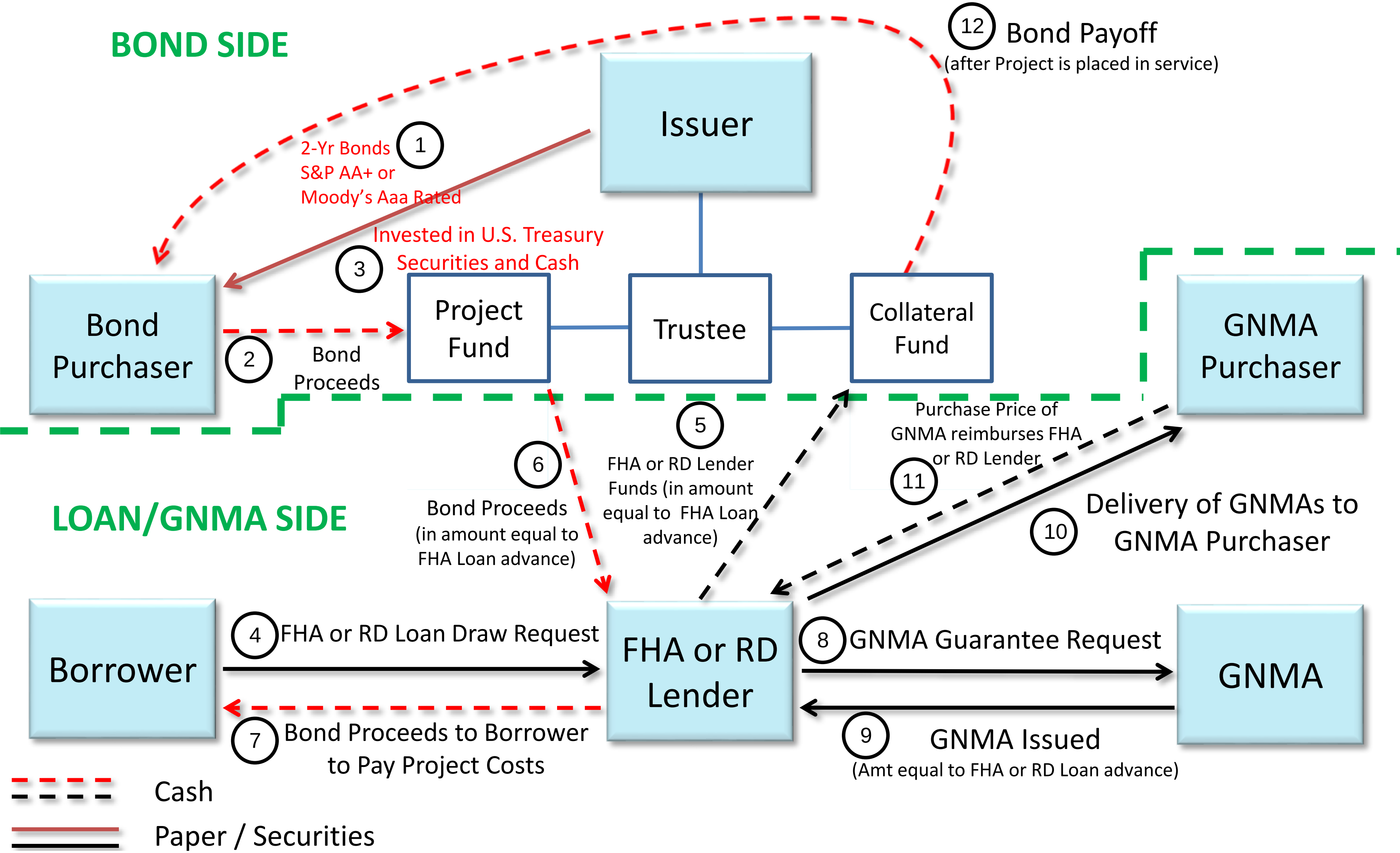
Cash Collateralized Tax-Exempt Bond Structure

- The good news is that **tax exempt bond coupons** at a 2-year mandatory tender have **now also declined about 80-90 basis points to about 0.60% – about 40 basis points above 2-year MMD, where coupons stood before the Covid 19 pandemic run-up in yields.** This leaves us with as much as about **2 points of gross negative arbitrage,** which needs to be funded in bankruptcy remote funds at closing.

- In addition, under this structure the Borrower has **two sets of construction period interest** – the interest on the short-term cash backed tax exempt bonds and the interest on the taxable FHA insured or RD loan. **Two sets of construction period interest** may **increase tax credit basis and thus 4% LIHTC proceeds, since many Section 42 lawyers will allow both sets of interest to be included in tax credit basis**. As shown in Exhibit A, the additional 4% LIHTC proceeds may further reduce the **net negative arbitrage as compared to other structures**.

- **Finally, we are now investing escrowed bond proceeds** in other **short-term cash backed tax exempt bonds** to **further reduce net negative arbitrage to 1/2 a point or even less.** As a result, we are, suddenly, once again at a point where **negative arbitrage is not a major factor in these financings.**

Taxable GNMA Sale with Tax-Exempt Short-Term Cash Backed Bonds Flow Chart



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- Note: under this structure, there is **no need for any type of lien or other claim on the real estate** – repayment of the Bonds is 100% assured by the deposit at closing of bankruptcy remote cash and locked in U.S. Treasury bond yields.

- In order to give a clean Bond Counsel opinion on any tax-exempt bond structure under Section 103 of the Code, **Bond Counsel will include** in the Bond Documents a "**Bond Note**," under which the Borrower recites a completely unsecured obligation to repay the loan of Bond proceeds from the Issuer.

- However, **the Borrower will never actually make a payment on this Bond Note** – **cash which will enable the Trustee** to **make all of those payments** on behalf of the Borrower **has been deposited at closing** with the Bond Trustee.

- In rare instances, state laws relating to the Issuer may require that the Issuer's bonds be secured by a "mortgage" on the Project. Where this is the case, even if a totally subordinate mortgage in favor of the Bonds is required, no payments should ever be needed on the "Bond Note" which that mortgage secures for the reasons set forth above.

Results of Structure

Assume Project with **$21,000,000** Total Development Costs
FHA or RD Loan = $15,000,000

Short-Term Cash Back Bonds with Taxable GNMA Sale

$11,000,000*

		223(f)	221(d)(4)
Tax Exempt Bond Term (Maturity or, more often, Mandatory Tender)		2 Years	2 Years
Mortgage Loan Interest Rate			
	GNMA Pass Through Rate	**2.50%**	**2.80%**
	3rd Party Fees	N/A	N/A
	Servicing + GNMA Fee	0.25%	0.25%
	Total **ML Rate**	**2.75%**	**3. 05%**
	Add: MIP	**0.25%**	**0.25%**
	Total **All-in Borrowing Cost**	**3.00%**	**3.30%**

- **Interest Rate Savings versus traditional long-term muni bonds:**

223f: 50 Basis Points; 221(d)(4) About 40 Basis Points; and, on new construction, 1-2 points versus 6-8 points of negative arbitrage!!!!

- Similarly, the **sale of a taxable Fannie Mae backed MBS** to finance a **mod rehab loan** may produce an all-in borrowing rate of about **3.25%, versus** about **3.55%** if funded through the sale of a 17-year monthly pay tax exempt **Fannie Mae M.TEB tax exempt bond**, and provide a lower all-in borrowing cost in the current market**.**

* Note: bonds are sized to 52 – 54% of Tax Credit basis; under long-term muni bond structures used before 2009, bond issue would be $4.0 million larger with higher costs.

Results of Structure - Borrower

Major Advantages:

1. **Qualifies for 4% LIHTC.**
2. **Lowers Mortgage Rate 40 to 50 basis points.**
3. **Avoids huge (6-8%) negative arbitrage deposit** on new construction/sub rehab (§221(d)(4)) deals.
4. **Eliminates on-going issuer/administrative fees after 1-3 years; huge benefit** where issuers charge major (25-50 basis points) ongoing fees as long as bonds are outstanding.

Major Disadvantages:

0. **None.**

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Sample Transaction

FHA 221(d)(4) New Construction – 3-Year Bonds, with 24-Month Mandatory Tender

Expected Placed-In Service Date	18 Months
Initial Mandatory Tender Date	24 months*
Stated Bond Maturity	36 Months
Bond Sale	Public offering (only) of S&P AA+ rated or Moody's Aaa—rated Bonds
Interest Earnings from Eligible Investments	20 to 30 or 40 basis points per year
Initial Bond Coupon Rate	0.60%
Net Negative Arbitrage	½ point or less

* Bonds are sold to the 24-month mandatory tender date. If delays are encountered on placing project in service then bonds can be remarketed to new buyers providing up to 12 additional months before tax exempt debt goes away.

Comparison of Short-Term Cash-Backed Bonds + FHA or RD to Private Placements and Other Executions

- **FHA** insured or RD loan is the **only available credit enhancement which is non-recourse during pre-Conversion phase –** all others (Private Placement, Fannie Mae, Freddie Mac) require deep pocket General Partner guarantees during this phase.*
- On an **FHA 221(d)(4)** sub rehab/new construction loan, there is a cost certification at final endorsement, but on RHA and RD loans there is **no new loan underwriting**; differs from sub rehab/new construction private placement deals and sub rehab/new construction Fannie/Freddie deals where there is a **new loan underwriting and possible loan downsizing** based on DSC or LTV **at "Conversion."**
- **Taxable FHA and RD loans offer a 35 year or a 40 year level payment loan amortization with no balloon; versus a 16 to 18 year balloon** on a private placement, Fannie or Freddie deal.
- **FHA and RD loans offer greater prepayment flexibility** – closed for 2 years to 108% decreasing 1% per year thereafter to par v. yield maintenance of 12% or higher declining over a longer period (e.g., 15 years) for all others (Private Placements, Fannie Mae, Freddie Mac).

*Note: Some guaranties will be required in connection with the 4% LIHTC on these financings.

Comparison of Short-Term Cash-Backed Bonds + FHA or RD to Private Placements and Other Executions

- **On the other hand,** especially in high cost markets, **many projects require a construction loan** that is **much larger than** the supportable **permanent debt.** A portion of the larger **construction loan often provides critical "bridge" financing** to later tax credit equity installments and subordinate loan pay-ins.

- **Private placement sponsors and bank construction lenders on Fannie/Freddie sub rehab or new construction financings will readily provide such a larger construction loan** since the entire construction loan is secured by a first deed of trust; **with FHA**, on the other hand, **no lien on real estate is permitted to secure a tax credit or other bridge loan**.

- Instead, **on FHA and RD loans the bridge loan** (either taxable or in the form of subordinate tax exempt bonds if needed to satisfy the 50% rule) must be **secured by a pledge of tax credit equity installments, deep pocket general partner guarantees of completion and payment and/or possibly a pledge of general partnership interests**. Such debt may be more difficult to place.

Conclusion

- **Hundreds of financings combining short term cash backed tax exempt bonds with taxable loan sales have closed in the twelve years since 2008.**
- **Almost all of the country's major bond counsel firms have now issued unqualified approving opinions and allowed fixed rate U.S. Treasury investments to eliminate or minimize any negative arbitrage. Documents and rating agency criteria also now very well developed.**
- In today's "upside down" interest rate world this is now **THE WAY (and THE ONLY sensible WAY)** to **finance affordable housing projects backed by FHA insured or RD loans. For these AFFORDABLE FHA AND RD loans, YOU WILL USE SHORT-TERM BONDS.**
- The structure **may also produce a lower borrowing rate on certain GSE backed mod rehab loans.**
- We believe it is **unlikely market conditions will change** in next **2-4 years** to favor traditional long-term tax exempt bond structure; **we think the "upside down" interest rate world,** at least with respect to these types of credits, **is here for a full generation following 2008**.

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EXHIBIT A

SAMPLE SHORT TERM CASH BACKED TAX EXEMPT BOND NEGATIVE ARBITRAGE CALCULATION

Assume total development costs are \$20.0 million and that we are satisfying the 50% Test with an \$11.0 million short term cash backed tax exempt bond issue. Negative arbitrage may be estimated as follows: Assume the bond coupon is 0.60% and 2-year U.S. Treasuries yield 20 basis points. Thus, there are about **8/10th of a point of gross negative arbitrage on the bond issue** over a 2-year period to a 24-month mandatory tender date on the bonds, or 0.8% x \$11,000,000 = \$88,000. But on top of the pre-Construction interest paid on the taxable FHA insured or RD loan (which is included in the eligible basis), the borrower is also paying 0.60% x \$11,000,000 x 2 years, or \$132,000 of "additional interest" over two years. Assume a construction period of 18 months (post construction interest is not includable basis). Multiply by 1.5/2.0 years = \$99,000 of additional tax credit basis. If an extra \$1.00 of tax credit basis sells for 35¢, this would offset about \$35,000 of our negative arbitrage, or perhaps even more if the project is eligible for state tax credits as well. In our example, this might offset about 30% of our negative arbitrage (or more with state tax credits), **bringing the net negative arbitrage down from 8/10th of a point to about 1/2 of a point in our example**. Moreover, since 2-year U.S. Treasury yields fell so dramatically (from about 1.60% to about 20 basis points) in mid-March of this year, we have begun to invest escrowed forwards M.TEBs proceeds in other short-term cash backed tax exempt bond issues which may raise reinvestment rates from 20 to 40 or 50 basis points or more. **This can further reduce net negative arbitrage to even less than 1/2 of a point on these financings. As a result we are once again, suddenly, at a point where negative arbitrage is not a major factor in short term cash backed tax exempt bond financings.**