NORRIS GEORGE & OSTROW PLLC

ATTORNEYS AT LAW
THE ARMY NAVY OFFICE BUILDING
1627 EYE STREET, N.W., SUITE 1220
WASHINGTON, D.C. 20006
TEL: (202) 973-0103

June 15, 2020

Fannie Mae Tax-Exempt MBS Pass-Through Bonds ("M.TEBs")

R. Wade Norris, Esq.
wnorris@ngomunis.com
(202) 973-0110 (direct)
(202) 744-1888 (cell)

Ethan Ostrow, Esq.
eostrow@ngomunis.com
(202) 973-0111 (direct)
(224) 216-2490 (cell)

Fannie Mae M.TEBs

- Fannie Mae M.TEBs product attempts to **lower long-term borrowing rates** in **two major ways**:

   1. **Monthly, tax-exempt, next business day pass-through of an MBS payment lowers bond coupon by 25-30 basis points** (versus traditional semi-annual pay bonds). **Very attractive bond rates** – e.g. **10-year Treasury (0.70%)** + **145 bps** = **2.15%**.
      - Buyers want the security of an (almost) **immediate, monthly agency pass-through.**
      - Structure allows holder to **exchange M.TEB for very liquid Fannie Mae taxable MBS** after placed-in-service date, which further lowers the rate.
   2. **Competitive guaranty/servicing spread – e.g. 120-140 bps**.

- **Produces a combined savings of 35-50 basis points: → All-in borrowing rate 2.15% + 1.30% ≈ 3.45%**.
- **Very attractive loan terms – 35-year or 40-year loan amortization** to balloon 16 – 18 years after placed-in-service/**1.15 DSCR/90% LTV**.

Fannie Mae M.TEBs

- For **projects designated as "green"** by one of a number of Fannie Mae approved organizations, the "green" M.TEBs may trade at a **5-10 basis points lower coupon**. In addition, Fannie Mae can **underwrite 75% of the projected operating cost savings realized by the project owner** and **25% of the tenant savings for up to an additional 5% of loan proceeds if supported by the loan-to-value test**.
- Under Fannie Mae's Healthy Housing Rewards Program **pricing discounts** of up to **30 basis points** may be available for **Enhanced Resident Services** and up to **15 basis points** for **Active Design**.
- The foregoing can make the M.TEBs structure even more competitive.

Fannie Mae M.TEBs

- **A disadvantage** of M.TEBs is that the **rate can only be set roughly 2-3 weeks before closing** when the M.TEBs are sold in the public markets; whereas certain bank and **other** private placement **structures may allow the borrower to lock** a **spread** to an index (**or** in a few cases, maybe even an **interest rate**) **at a much earlier stage**.
- For many projects this disadvantage and the negative arbitrage associated with forwards M.TEBs (discussed below) are more than offset by the favorable terms and flexibility on supplemental funding which the M.TEBs structure provides.
- **Over the past four years, Fannie Mae has closed** over 90 M.TEBs type financings having an aggregate dollar amount of **over $1.7 billion.** It has **another $500 million+** of **M.TEBs** financings **in its pipeline**.

Moderate Rehab “Immediate Delivery” M.TEBs

- The **mod rehab “immediate delivery”** structure M.TEB involves a 16-17 year tax-exempt monthly MBS pass-through bond **for mod rehab** projects.
- The **rehab may be as high as $40,000 or $50,000** or a bit more **per door**, so long as there are **no substantial tenant relocation** or re-tenanting issues.
- The Fannie Mae mod rehab DUS loan is funded by the DUS Lender at closing of the Bonds and commences amortization almost simultaneously with the issuance of the Bonds. **No separate construction loan** or construction lender is involved under this structure.
- In present **post-COVID19** pandemic financial **environment, rates on taxable Fannie Mae MBS securities may be lower** than the rate on an immediate delivery M.TEB by **20 to 30 basis points or more**, since they may be bought by or can be pledged to secure a loan from the Fed. **Thus, combining a taxable Fannie Mae MBS sale with a short-term tax exempt cash backed municipal bond to satisfy the 50% test may be a better alternative structure**, where available, at this time.

“Forwards” M.TEBs

- Fannie Mae’s **“forwards” M.TEBs** product is for **new construction/sub rehab projects**.
- This product not only offers **very competitive rates** (there is no conventional taxable forward delivery Fannie Mae MBS structure) and other underwriting terms.
- **Fannie Mae has also shown great flexibility in permitting earn-out and/or other supplemental loan funding** if supported by underwriting at conversion.
- The structure combines a 17 to 18-year fixed rate tax-exempt MBS monthly pass-through Bond with a **taxable draw down construction loan from a bank** or other construction lender.

“Forwards” M.TEBs

- At this time, the forwards M.TEBs structure entails roughly **4 points of gross construction period negative arbitrage: 2.25% M.TEB coupon - 0.20% 2-Year U.S. Treasury reinvestment rate x 2 years = 4.1 points.** See Exhibit A for sample calculations.
- However, under this structure the Borrower has **two sets of construction period interest** – the interest on the M.TEBs bonds and the interest on the taxable bank construction 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 reduce the **net negative arbitrage to 2.8 points or less**.
- **Moreover, we are now investing escrowed forwards M.TEBs proceeds** in **short-term cash backed tax exempt bonds** to **further reduce net negative arbitrage to 2 points or less.**

Borrowing Rates for M.TEBs

- Both versions of M.TEBs (mod rehab and “forwards”) combine very low all-in borrowing rates:

	Moderate Rehab Loan	**“Forwards”** M.TEB (New Construction/Sub Rehab)
10-Year Treasury	0.70%	0.70%
Spread	1.45	1.50
Tax-Exempt Bond Coupon/MBS Pass-Through Rate	2.15%	2.20%
Guaranty/Servicing	1.30	1.30
All-in Borrowing Rate*	**3.45%**	**3.50%***

*Excluding ongoing issuer, trustee, rebate fees and about 2 points of net construction period negative arbitrage in the “forwards” M.TEBS structure. Taking into account 2 points of **net** negative arbitrage on this “forwards” M.TEBs product, the equivalent permanent rate would be **comparable to a permanent lending rate about 20 basis points higher on the “forwards” structure** when compared to other draw down executions.

M.TEBs

- As Underwriter's Counsel, **the authors worked with Fannie Mae and other financing participants to develop the M.TEBs product**. The first M.TEBs transaction closed in January 2015. **NG&O has served as underwriter's counsel on a very large portion of the M.TEBs financings closed since that time.**
- **Fannie Mae will now finance 0.75% for issuance costs within the Fannie Mae DUS Loan –** Raises rate but lowers out-of-pocket expense of execution to better compete with bank balance sheet and Freddie TEL and private placements.
- The structure offers **greater prepayment flexibility –** yield maintenance/prepayment premium versus 15-year absolute lock-out under most other structures.
- Due to the factors summarized above, **the use of the M.TEBs structure** has become much more **widespread and** the growth in its use appears to be **accelerating**.

M.TEBs – How Does It Work?

- **Immediate Delivery (Mod Rehab) M.TEBs.**
  - **Two pots of money** under the Indenture. **DUS Loan is fully funded** by DUS Lender **at closing** from its own funds; deposited into a **Collateral Security Fund** under the Indenture **($ Pot 1)**.
  - **On a fully-funded "Immediate Delivery" M.TEB for mod rehab projects, these proceeds will be used 10-15 days after closing by Trustee to purchase the MBS** with respect to the fully funded DUS Loan.
  - **The Fannie Mae MBS becomes the long-term security for the M.TEBs.**
  - Fully funded "immediate delivery" **M.TEBs close simultaneously** in the **same principal amount** and Bond proceeds deposited into Proceeds Fund **($ Pot 2)**.
  - The majority of **M.TEBs proceeds are disbursed at closing to buy the Project**; the balance is deposited into a **Rehab Fund**.
  - We structured **as close as we could get it to be a "tax-exempt MBS."** Note **denominations down to $.01.**
  - **Monthly pass-through of P&I payment on MBS – on a tax exempt basis – one Business Day later.**

M.TEBs – How Does It Work?

- **Forwards (Sub Rehab/New Construction) M.TEBs**
  - Rehabilitation or construction is funded by a **taxable bank loan**.
  - Forwards M.TEBs are **secured by a verified escrow of cash and U.S. Treasury securities** for the **first 2.0 to 3.5 years** to allow time for construction, rent up and stabilization (“Conversion”).
  - **Monthly pay, interest only** tax exempt bonds during this period.
  - **If Conversion is attained** within the time permitted in the Fannie Mae Forward Commitment, then the **MBS** is delivered and **becomes the collateral for the M.TEBs**, which become a level pass-through of principal and interest.
  - **At Conversion**, the **escrow** of cash and U.S. Treasury securities matures and is, in effect, **used to retire the taxable bank loan**.

M.TEBs – How Does It Work?

- Note language from typical M.TEBs Official Statement cover page:

Maturity Date: ______ 1, 20__; Final Payment Date: ______ 26, 27, or 28, 20__; Interest Rate: __%; Price: __%; CUSIP No.: ___†

- M.TEBs carry **same kind of inherent payment lag as an MBS**; they pay **on the 26th day of the month** (unless Trustee is closed day after MBS pays or a holiday weekend, in which case 27th or 28th day), the investor gets a **pass-through of principal and interest paid** on the underlying loan at the MBS Pass-Through Rate **through the end of the prior month**.

- This lasts through the final payment date, which will be 26, 27 or 28 days after the stated maturity date. The M.TEBs buyer, **like the buyer of an MBS**, never makes that up; **yield on this is slightly lower than stated MBS Pass-Through Rate** by the impact of the never recovered 26-28 day payment lag.

Sample Key Terms From Recent M.TEBs Financings

- The chart below shows some of the key terms from recent M.TEBs financings.

Date of Official Statement	Issuer/Project	Underwriter	Type of M.TEB	$ Amount of Bonds/Loan	Maturity Date	10-Yr UST	Spread to 10-Yr	Bond Coupon	Yield Maintenance (10 years par call/15.5 years)	ML Rate***
December 11, 2019	City & Cnty of San Francisco – Eastern Park	RBC Capital Markets, LLC	Forwards	$60,006,000	19 years	1.79%	0.56%*	2.35%	14.5 years YM; then 3 Mos 1%; then par	3.71%
April 17, 2020	HFA of Leon County, FL – Magnolia Terrace	RBC Capital Markets, LLC	Immediate	$11,760,000	17 years	0.65%	1.65%	2.30%	16.5 years YM; then 3 Mos 1%	3.80%
April 14, 2020	INLIVIAN – Northcross Townhomes	Wells Fargo Securities	Immediate	$13,500,000	17 years	0.76%	1.79%	2.55%	CMT as defined in Fannie Mae Prospectus – 15+ years	3.71%
May 13, 2020	TX Dpt. of Hsg & Comm. Affairs – Oaks on Clark	Wells Fargo Securities	Immediate**	$10,000,000	16 years	0.64%	1.66%	2.30%	10 years YM; 1% till year 16	3.20%
May 28, 2020	FL Hsg. Fin. Corp. – Colonial Park	RBC Capital Markets, LLC	Immediate	$15,200,000	16 years	0.70%	1.63%	2.33%	10 years YM; 1% till year 15	3.29%
May 28, 2020	AZ IDA – Chandler Village	KeyBanc Capital Markets	Immediate**	$25,000,000	17 years	0.70%	1.42%	2.12%	15 years YM; 1% till year 17	3.36%
June 12, 2020	HRA of the City of St. Paul, MN - 848 Payne Avenue	Colliers Securities LLC	Forwards**	$11,800,000	18 years	0.73%	1.60%	2.33%	17 years YM; Then 3 Mos 1%; then par	3.63%

* Pre COVID19 pandemic; note lower spread to the 10-year UST.

** Green bonds

*** As with any financing structure, servicing/guaranty fees or spreads in M.TEBs financing can vary widely depending on project market, underwriting parameters and other factors, and ranged from a low of 90 basis points to a high of 150 basis points in the above financings. As noted above, servicing/guaranty fees in the 120-140 basis points range appear to be the mid-point range for M.TEBs financings at this time.

- Note that **following the dramatic shifts in financial markets triggered by the** emergence of **the COVID19 pandemic** in March, **M.TEBs spreads** to the 10-year U.S. Treasury **have risen roughly 75 basis points, from about 70 basis points to about 145 basis points**. This has has been **true with almost all long-term** tax exempt (and most taxable) **long-term debt execution spreads**, as has been the case on prior occasions, in reaction to a dramatic plunge in the U.S. Treasury yields. However, the **10-year U.S. Treasury yield has fallen about 90 basis points** from around 1.60% in early March to around 70 basis points today, which **has more than offset this increase in the spread**.
- The result is that the base **bond coupon is still competitive with other executions**.
- While g**uaranty/servicing fees have risen** from about **100 basis points to around 120-140 basis points** since the FHFA placed volume limits on both GSE's (Fannie Mae and Freddie Mac) in September of 2019, **other fees and spreads** on many competing products **have also risen**, thus **all-in borrowing rates** for Fannie Mae M.TEBs **remain generally competitive.**

IMMEDIATE DELIVERY / MOD REHAB M.TEBS COMPARISON TO SHORT-TERM CASH-BACKED TAX-EXEMPT BONDS WITH TAXABLE MBS SALE

- As stated above, under present market conditions, a taxable MBS sale combined with short-term cash backed tax exempt bonds **may** produce a lower borrowing rate than an immediate delivery M.TEB on a mod rehab financing, even though the immediate delilvery M.TEBs rate is generally competitive. Both structures entail negative arbitrage.

- **Negative Arbitrage – Fully Funded “Immediate Delivery” Mod Rehab M.TEB**

  - M.TEBs: 2 sets of funds prior to delivery of MBS.

  - Max 45 days: 2.25% Bond/Pass-Through - 0.15% 2-Month U.S. Treasury reinvestment rate x 45/365 days ≈ **only 26 BPS of Neg Arb**.

  - **M.TEBs Expected Neg Arb**: ½ of that ≈ **13 BPS, or ≈ 10 BPS net negative arbitrage** after increase in 4% LIHTC – Negligible.

-- Versus --

  - **Negative Arbitrage – Short-Term Cash-Backed Tax Exempt Bonds with Taxable Fannie Mae MBS Sale** – 24 month mandatory tender: 0.60% tax exempt bond coupon - 0.20% 2-Year U.S. Treasury yield = 40 BPS x 2 years = **80 BPS, or about 60 basis points of net negative arbitrage** after increase in 4% LIHTC.

IMMEDIATE DELIVERY / MOD REHAB M.TEBS COMPARISON TO SHORT-TERM CASH-BACKED TAX-EXEMPT BONDS WITH TAXABLE MBS SALE

- Thus, using the **taxable MBS sale** with **short-term cash backed tax exempt bonds** must factor in that it **may entail a half point greater negative arbitrage** under current market conditions.

- **On the other hand, the short-term cash-backed structure** combined with a **taxable Fannie Mae MBS sale** may (i) **lower the base coupon by 20-30 basis points or more** in the current environment and (ii) **avoid on-going issuer fees**, which **can be major consideration,** especially for issuers with higher ongoing fees; M.TEBs may remain outstanding for 16-17 years.

- The result is that **combining a taxable Fannie Mae MBS sale with short-term cash backed tax exempt bonds may produce 2-4 points of savings** with only a slightly higher amount of negative arbitrage for an **immediate delivery/mod rehab project than a Fannie Mae M.TEB financing** at the present time.

SUMMARY – MAJOR M.TEBs CONSIDERATIONS

- **Takes advantage of tight spread of quasi-governmental GSE securities to a very low 10-year U.S. Treasury yield**.
- **Competitive guaranty/servicing fees** & **liberal waivers.**
- **All in borrowing cost** of about **3.50%-3.55% or slightly higher** at the present time.
- For sophisticated developers, this **structure allows potentially more flexible prepayment options**; **yield maintenance** through 10 years and fee maintenance for 5 years thereafter, **versus** absolute **16-year lock-out** associated with most private placements (although such prepayment flexibility may trigger a **10-15 basis points higher bond coupon**).
- The M.TEBs product may be more attractive for immediate delivery mod rehab projects **where the issuer charges very low** (e.g., 6 or 7 to 12.5 basis points per year) or no **ongoing fees** versus an issuer which charges 25-50 basis points in ongoing fees**.**
- **Short-term cash backed bonds plus taxable Fannie Mae MBS sale** may be a **better option for mod rehab projects in the present market** where a taxable MBS sale may produce substantially lower rates.

EXHIBIT A

SAMPLE FORWARDS M.TEBS NET NEGATIVE ARBITRAGE CALCULATION

Assume total development costs are $20.0 million, of which 60% or $12.0 million are funded through a forwards M.TEBs offering, 4% LIHTC accounts for 35%, with subordinate loans accounting for the balance. Negative arbitrage may be estimated as follows: Assume the forwards M.TEBs coupon is 2.25% and 2-year U.S. Treasuries yield 20 basis points. Thus, there are about 4.1 points of negative arbitrage on the forwards M.TEBs over a 2-year pre-Conversion period, or 4.1% x $12,000,000 = $492,000. But on top of the pre-Construction interest paid on the taxable draw down bank loan (which is included in the eligible basis), the borrower is also paying 2.25% x $12,000,000 x 2 years, or $540,000 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 = $405,000 of additional tax credit basis. If an extra $1.00 of tax credit basis sells for 35¢, this would offset about $140,000 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 4.0% to 2.8% or less 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 and further **reduce net negative arbitrage to around 2 points or even less**.