Major Tax-Exempt Bond and Loan Executions for 100% Affordable and Mixed Use Apartment Projects

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I: THE BASICS: MAJOR INTERNAL REVENUE CODE PROVISIONS SUPPORTING AFFORDABLE RENTAL HOUSING IN THE UNITED STATES

- **Section 42** of the Internal Revenue Code provides **two forms of tax credits to support affordable rental housing:**

  A. **The 9% Low Income Housing Tax Credit ("9% LIHTC")**, which the Borrower can generally syndicate for an amount sufficient to **cover 70 – 75% of total development cost.** Very **powerful** subsidy, the Borrower simply obtains a small taxable loan from a bank and potentially other subordinate loans to cover the other 25%, and the financing package is complete.

Real Estate Developer Recipient of 9% LIHTC

  B. **Combination of 4%* Low Income Housing Tax Credits ("4% LIHTC") under Section 42 and tax exempt private activity bonds under Section 142(d)** on the debt side of the financing. **In some cases using tax exempt debt lowers the mortgage interest rate** versus comparable taxable rates.

Still Happy Developer Pursuing
TE Bonds +4% LIHTC

* The actual percentage is lower – about 3.2% at this time.

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- **These two programs** account for a roughly equal amount of affordable rental housing units each year in the United States – 9% LIHTC ≈ 60,000 units in 2016; **tax exempt bonds + 4% LIHTC ≈ 75,000 units** in 2016. Together they **fund about one third of annual rental apartment production** in the United States, about 400,000 units in 2016.
- The **9% LIHTC** is a much **more powerful** subsidy, **but** is often **over subscribed** by a factor of **4 or 5:1**, and is **generally allocated in small amounts** to **non-profit sponsors** for small to medium size 100% affordable housing projects.
- This means that **other Borrowers will use a combination of 4% LIHTC under Section 42 and tax exempt debt under Section 142(d)** to finance these projects.

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- **Tax Exempt Bond + 4% LIHTC Projects** fall into **two distinct** and very different **categories**.
  1. **"100% Affordable" Projects** where **all (or substantially all)** of the units in the Project are rented to tenants whose incomes do not exceed **60% of** Area Median Income **("AMI")** (for a family of four, adjusted up or down for family size).

    - To qualify for 4% LIHTC, the Borrower must also agree to **cap rents at 30%** of that amount.

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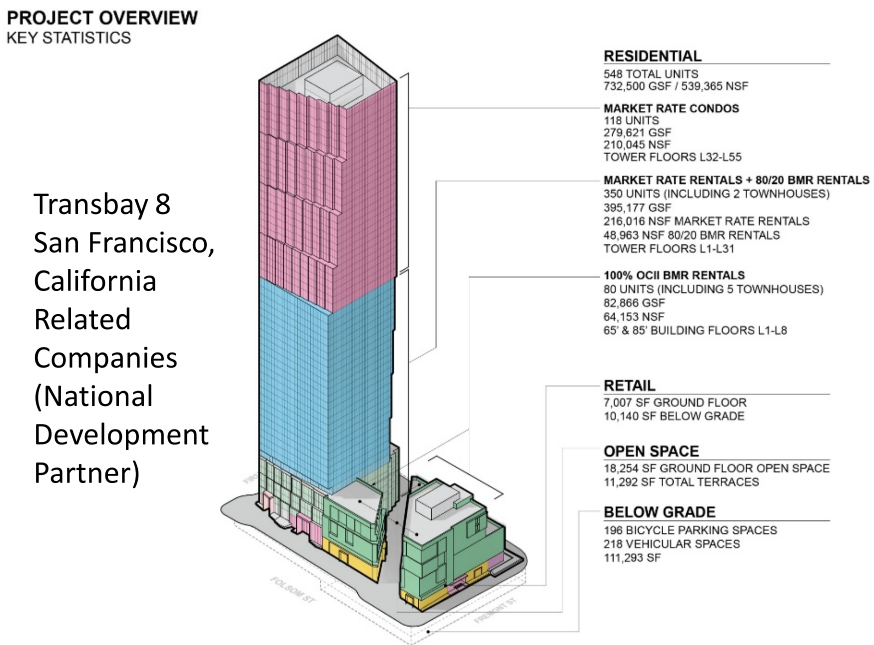
- This obviously depresses revenues versus revenues based on market rate rents that the Borrower could otherwise charge, and the project has to remain an **affordable rental** project for a **qualified project period** of **15 years or longer (almost always 30+ years).**
  - **Developer incentives are very different from most conventional real estate,** where developer buys and rehabs on builds, stabilizes, and then sells the property to long-term owner, takes out his or her profit, and moves on.
  - Here, the developer works for **upfront developer fee** of 8 – 12 %, possible contractor profit, possible **ongoing management fees** and **very slow, long-term appreciation** in value.
- **BUT**, the foregoing restrictions enable the Borrower to **syndicate 4% LIHTC (and maybe state tax credits)**, to finance **25% to 45% of total development cost** with **little give-up** by general partner **of cash flow or residual** – the investors are buying the tax credits and certain losses and perhaps getting CRA credit.

2. **“Mixed Use,”** usually **very large, complex urban projects** (which may involve for sale units, commercial and other components), where **80% of the apartment units** are market rate and **20% of the units** are **reserved** for persons whose income do not exceed **50% of AMI** (for a family of four, adjusted up or down for family size).



Transbay 8
San Francisco, California
Related Companies (National Development Partner)

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- Since **LIHTC** is **only available on the affordable units** – in this case **4% LIHTC** will account for **only 4-6% of total development cost; much less important.**
- These financings entail the same requirements for the property to remain a long-term rental with 20% of units affordable, but these projects present **greater appreciation opportunities since 80% of rental units are market rate.**
- The principal financing structures used for “100% Affordable” Housing Projects are discussed in Section IV of this outline; the two major tax exempt debt financing structures often used for “Mixed Use” projects are discussed in Section V.

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II. 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 two 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.**

  - The Project must **score high enough on public merit with state bond volume allocators** to receive a private activity bond volume award.

  - The Project must also have the **support of a municipal bond issuer like a state or local HFA**, a city or county who will apply for the volume.

  - The project must also have the **support of a governmental entity where the project is located** through a **TEFRA hearing and governmental approval.**

- 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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III: POSSIBLE ADDED BENEFIT OF LOWER TAX EXEMPT VERSUS TAXABLE LONG TERM DEBT FINANCING RATES

- **Until the 2008 financial crisis**, a major advantage of combining 4% LIHTC with tax exempt bonds or loans on the debt side of the financing was that, given the same rating and underlying credit, **debt purchasers would accept a lower interest rate** on **tax exempt** bonds. Why? Because they do not pay federal (and often state) income tax on the interest they receive. If a **taxable long term rate was 6.0%**, the **tax exempt rate might be 5.0%** or a little above.

- Since the **financial crisis in 2008**, that **relationship has flipped "upside down" for certain governmental credits** (like GNMAs versus long-term tax exempt municipal bonds backed by GNMAs), as discussed further below. However, under the **most frequently used debt structures** – tax exempt debt in the form of **bonds or loans** acquired or funded **by banks** in **drawn down private placement programs** and by Freddie Mac under its very similar **"TEL" structure** (See Part IV. A. and B. Below) – the **tax exemption still provides a lower mortgage rate by 50-100 basis points or more.**

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IV. MAJOR TAX-EXEMPT BOND OR TAX-EXEMPT LOAN EXECUTIONS FOR AFFORDABLE HOUSING

A. BANK AND OTHER PRIVATE PLACEMENT PROGRAMS

- **Dominant Tax Exempt Debt Financing Platform.** As noted above, bank and other private placements are **by far the dominant tax exempt debt financing structure** for affordable rental housing projects in **major urban markets** (e.g., Boston, New York, Washington D.C., Miami, Chicago, San Francisco, Los Angeles, Seattle).

- **These programs** comprise the **substantial majority (70% to 80%) of debt side executions** (by number of financings and dollar volume) **for 100% affordable projects** versus all other executions, especially in these markets.

- Large banks are required under the **Community Reinvestment Act ("CRA")** to do a certain dollar volume of public benefit **"lending" activities** and a certain dollar volume of **"investment" activities** in the markets where they have a presence, or they risk severe limitations on their future activities (e.g., new products, mergers, etc.). Thus, **large banks are huge buyers of both tax exempt bonds and funders of tax exempt loans** (and buyers of both 9% and 4% LIHTC) in markets where they have a presence. **This substantially lowers tax exempt all-in borrowing rates** (as well as tax credit yields) **in CRA driven markets**.

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BANK PRIVATE PLACEMENTS

- Starting in **the late 1990's**, to satisfy CRA goals, banks began to buy **non credit enhanced bonds, backed only by a first deed of trust and certain pre-"Conversion" general partner guaranties** (e.g., completion, payment).* The regulatory environment changed dramatically following the financial crisis in 2008, and to achieve "lending" treatment, which is generally more favorable, for CRA accounting, reserve, and other regulatory purposes, many banks developed tax exempt loan (versus bond) versions of their private placement programs. Freddie Mac's draw down private placement program – its Tax Exempt Loan or "TEL" program – is also structured as a tax exempt loan. **There is little difference in substance between tax exempt "bond" and "loan" programs**; it is almost totally a **difference in terminology**, albeit one with important regulatory consequences.

- **Draw Down Structure** - these tax exempt bonds or loans are funded **on a "draw down" basis**, as loan advances are made. This **eliminates negative arbitrage on a sub rehab or new construction loan** (similar to forward delivery funding on an FHA 221(d)(4) loan, discussed below), which is a **huge savings (1 – 3% of loan amount or more)** on these financings.

*In 1998, **Wade Norris** helped pioneer what has become one of the country's leading private placement platforms, and in 2001, the leading securitization structure for these issues through Freddie Mac. **Wade Norris** and **Ryan George**, led the development of documentation for the tax exempt loan (versus) bond format for these executions when the regulatory environment dramatically changed in 2008.

BANK AND OTHER PRIVATE PLACEMENTS

- **Low Variable All-In Pre-Conversion Borrowing Rate.** For sub rehab/new construction loans, the Banks and other lenders offer **very low all-in construction/ rent-up period borrowing rates (e.g., SIFMA (currently 0.05%) or 1-month LIBOR (currently 0.10%, subject to a 50 basis point 1-month LIBOR floor), plus 2.00 - 2.25% – i.e., all-in floating rates of 2.50 – 2.75% – until** the loan reaches **"Conversion"** or stabilized occupancy. This allows the Borrower to **access the debt markets during construction and rent-up at the very bottom end of the yield curve** (albeit with variable rate risk).

- **Low All-in Rate Permanent Rate**. This structure **also offers very low** – generally **3.50 – 4.25%** - **all-in tax exempt permanent rates for mod rehab as well as sub rehab/new construction loans** (at least in CRA driven markets), which is locked in at closing.

- **"Built-in" Tax Exempt Bridge Loan between Closing and Conversion.** Since the lender funding the loan has a first deed of trust on the project and other guarantees, these programs also allow the pre-conversion phase of the tax exempt loan to be "upsized" to fund project costs incurred prior to the receipt of tax credit equity, subordinate loans, and other permanent funding sources, which may not be available until after the related costs have been incurred.

- **Underwriting Terms Very Attractive**
  - **35-year or often 40-year loan amortization** to a 16 – 18 year balloon
  - **Very large (85 – 90%) loan-to-value,** and
  - **Very low debt service coverage (1.15).**

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TAX-EXEMPT BANK DRAW DOWN **PRIVATE PLACEMENT** BOND OR LOAN FINANCING STRUCTURE – **MOD REHAB, SUB REHAB, NEW CONS**

	Sample Interest Rates*
Bond Rate – Construction: One-Month LIBOR**	0.50%
Plus: Spread	2.00%
= Bond/Loan Interest Rate	**2.50% Floating***
Bond Rate – Permanent: 16 to 18-year LIBOR Swap	1.30%
Plus: Spread	2.50%
= Bond/Loan Interest Rate	3.80%
Credit Enhancement	N/A
Servicing Fees	0.00
Remarketing Agent	N/A
Issuer	0.125
Trustee	0.025
Total Fee Stack	**0.15**
Total Permanent Mortgage Rate (Underwriting Rate and Actual Permanent Borrowing Rate)	**4.10%**

	Upfront Fees (est.)
Origination	1.0 - 1.5%
App.	0.25
Bond Costs of Issuance	0.75 – 1.50
	2.00 – 3.25%

***Add 15 basis point fee stack below for all-in construction period borrowing rate.**

**** Most bond private placements funded on "draw down" basis, which eliminates construction period negative arbitrage.**

Estimated Rates as of 03/15/2021; 40-year loan amort.; 1.15 - 1.20 DSCR; 80 - 90% LTV. If the Project is not in a part of a Bank's CRA footprint, this type of product may only be available at somewhat higher rates and somewhat tighter underwriting terms from the Bank or perhaps from a non-bank provider.

***Actual rates may vary depending on various factors, including mod rehab/stabilized versus sub rehab/new construction, project; borrower; CRA or non-CRA market; and other factors.**

****One-month LIBOR is 0.10% but most lenders impose a floor of about 50 basis points.**

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B. FREDDIE MAC TAX-EXEMPT LOAN OR "TEL" STRUCTURE

- In 2014, **Freddie Mac** introduced its **Tax Exempt Loan or "TEL"** structure with **many of the same features and terms as bank private placements**. This structure also offers very low fixed perm rates and is potentially available in a broader range of markets (not just CRA driven).
- **Loan terms are 16 years (mod rehab) up to 18 years (new cons/sub rehab), often a 40-year loan amortization, 1.15 debt service coverage and a 85% - 90% maximum LTV.**
- The TEL structure was **expanded in 2015 to include sub rehab/new construction with a bank taking the risk on the tax exempt loan during the pre-Conversion phase**, and a **forward commitment from a Freddie Mac Targeted Affordable Lender and Freddie Mac to acquire the permanent phase component of the tax-exempt loan** at an agreed upon fixed rate at Conversion.*
- **The "forwards" TEL structure does require a separate bank (probably with separate counsel) to take pre-Conversion risk** on the tax exempt loan versus most other private placements, thus perhaps entails slightly higher costs.
- **Terms** are quite comparable to **those of bank and other private placements** (discussed above).

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*Wade Norris** and **Ryan George**, as **special outside counsel** to Freddie Mac, assisted in the drafting of program memoranda, model documents and other materials relating to the development and implementation of the Freddie Mac TEL structure.

C. FANNIE MAE ("M.TEBs") STRUCTURE

- Over the past eight years, **over $4.0 billion** of agency backed (Ginnie Mae, Freddie Mac, Fannie Mae) **tax exempt monthly pass-through bonds** have been sold in the **single family mortgage revenue bond market, lowering coupons by 25-35 basis points** versus traditional semi-annual pay long-term tax exempt bonds. Buyers want the security of an **immediate, monthly agency MBS pass-through**.
- In 2015, Fannie Mae pioneered a new, **16-year fixed rate tax exempt multifamily Fannie Mae MBS pass-through** structure initially for **mod rehab** projects.*
- **Under this structure, the Trustee on these monthly-pay fixed-rate bonds simply passes through the monthly Fannie Mae MBS payment** to the Bondholder on **next business day** on a **tax exempt basis**.
- The **savings** in bond rate **versus** a **taxable Fannie Mae MBS** has ranged from **5 to 10 basis points**, while the savings **versus** a **semi-annual pay Fannie Mae credit enhanced tax-exempt bond** has been **closer to 25-30 basis points**.

*__Wade Norris__ and **Ethan Ostrow**, together with their prior colleague, **Ad Eichner**, worked with Fannie Mae and other participants to develop the structure and documentation for the Fannie Mae M.TEBs product. This led to the closing of the first M.TEBs financing in February, 2015. Messrs. Norris and Ostrow then served as underwriter's counsel on the first seven M.TEBs financings which closed over the next two years, and NGO has served as underwriter's counsel on many subsequent M.TEB financings.

Fannie Mae M.TEBs

- **Bond coupon rates are around the 10-year U.S. Treasury rate plus 60 or 70 basis points: 1.70% + 0.70 = 2.40% in today's market.** This, like private placement and Freddie TEL, is another example where borrowing on a tax exempt basis provides at least a small interest rate advantage over taxable.
- **Fannie Mae is also offering very low guaranty and servicing fees of roughly 120-140 basis points to promote this program.**
- **Result: All-in borrowing rates as low as 3.60% to 3.80% on mod rehab; roughly the same rate on "Forwards," but several points of negative arbitrage on "Forwards" version,** suggesting **effective borrowing rates in the high – 3.0% to 4.0% range for the forward executions.** Still competitive with other permanent lending rates.
- **35-year or 40-year loan amortization to 16 to 18-year balloon, 1.15 DSCR; 85-90% LTV. Mod-rehab and forwards** (sub rehab/new construction) executions.
- **Fannie Mae will rebate 0.75% for issuance costs to compete with private placements within Fannie Mae DUS Loan –** Raises guaranty/servicing fee spread but lowers out-of-pocket expense of execution to better compete with bank private placements and Freddie TEL.

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Fannie Mae M.TEBs

- On recent tax-exempt M.TEBs, **bonds may be sold at up to a 3.0% premium**, **further enhancing proceeds** available to the Borrower.
- The product is be most likely to be used in **markets where tax-exempt bond volume is available through issuers who charge very low (e.g., 5-10 basis points per year) or no ongoing fees. Short-term cash backed tax exempt bonds plus taxable Fannie Mae MBS sale** (discussed below) may be continue to be a **better option** where **ongoing Issuer fees are very high (e.g., 25 – 50 basis points).** For sophisticated developers, this **structure allows potentially more flexible prepayment options; yield maintenance** through 10 or 15.5 years to par call **versus** absolute **10-year lock-out** associated with traditional municipal bonds and **15+ year absolute lock-out under private placements**.
- The program **may allow more lenient waivers** for certain loan underwriting criteria such as larger rehab per door for mod rehab loans with low tenant relocation risk, possible limited earn-out provisions for certain loans and other features previously associated with Fannie Mae DUS loans.

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D. SHORT TERM CASH BACKED TAX-EXEMPT BOND EXECUTIONS*

- Since the 2008 financial crisis, **in some government or quasi-governmental debt markets, taxable rates are lower than tax-exempt muni rates**. For example, **rates on taxable GNMA securities**, which are used to wrap **FHA insured and certain Rural Development Bonds**, **are lower by about 50-100 basis points (“bps”)** than rates on long-term municipal bonds rated AA+ or Aaa backed by **the same** GNMAs.
- **“That’s Crazy!!!”** you say. You pay federal and state income tax on the interest on Ginnies (40+% of your return if you are a high bracket tax payer), which, you keep if you instead purchase the long-term municipal bond backed by the Ginnie. How can the rates on the **taxable** Ginnies be lower?
- **We live in a crazy world.** Since 2008, **the world trusts U.S. Treasury Bonds, and GNMAs, and to a degree, Fannie Mae and Freddie Mac long-term debt securities, and not much else** (relatively), including even AA+ and Aaa-rated municipal bonds. To an extent, the world still questions that the reliability of the rating agencies; if they were that reliable they would have never rated hundreds of billions of dollars of AA and Aaa rated paper prior to 2008, which became worth 10 or 15¢ or nothing, these major disruptions in the financing markets take a generation or more to correct.

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*__Wade Norris__, working with other industry colleagues, played a major role in introducing the use of short-term cash backed financing with FHA insured loans in 2009, and in recent years he and **Ethan Ostrow** have helped pioneer a number of the innovations, including those described below, which have dramatically improved the efficiency of these executions.

THE ALL-IMPORTANT 50% RULE

- "So if I can do a simple taxable conventional FHA loan at a lower rate, **why** would I **use muni bonds?**"
- As described under II. above, to be sure your project is worthy of the subsidy inherent in 4% LIHTC, **Congress piggy-backed on the states' private activity bond volume allocation systems**.
- Thus, **the 50% Rule**: Again, to be eligible for 4% LIHTC, **you have to finance at least 50% of "aggregate basis" of the building(s) plus land with volume limited tax-exempt private activity bonds** under Section 142(d) of the Code **and keep them outstanding until the project's placed-in-service date** (roughly, completion of rehab for a mod-rehab project or certificate of occupancy for a new construction/sub-rehab project).
- So, if your project is affordable, **you will be using at least some tax-exempt private activity bonds!** (Remember: **No tax exempt bonds = No 4% LIHTC = No affordable rental housing project.**)

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SHORT-TERM CASH-BACKED TAX-EXEMPT BONDS

- HOW IT WORKS

- Issue **short-term tax exempt bonds equal to 50% of the project's aggregate basis of the building(s) plus land* priced to a mandatory tender date 6-12 months following the targeted placed-in-service date** (to provide for construction delays). **Stated maturity will be 6-12 months** later, **allowing a remarketing** of bonds if more time is needed to place project in service.

- **Two funds** established under Bond Trust Indenture and **invested in same AA+ or Aaa rated investment vehicle**:

- A "**Project Fund**" in which all the tax exempt bond proceeds are deposited, and

- A "**Collateral Fund**" in which FHA lender** advances or GNMA or Fannie Mae MBS proceeds loan proceeds are deposited.

- 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 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.

**For example, on 221(d)(4) new construction projects where the project is expected to be placed in service in 18-20 months, we would normally set a 36-month bond maturity, but price to a 24-month mandatory tender date to minimize interest costs.

SHORT-TERM CASH-BACKED TAX-EXEMPT BONDS

HOW IT WORKS

- **As noted above, the structure also works well with rural development loans** or loan pools where the RD lender funds a taxable loan to the Borrower and ultimately issues a GNMA security with respect to the stabilized Section 538 loan which is sold in the taxable GNMA market place. It **also works** where a **Fannie moderate rehabilitation DUS loan** is funded through the sale of the Fannie Mae MBS in the taxable markets.

- **In today's market**, the interest expense and upfront deposit **can often be almost totally offset or eliminated** through **investing** the **Indenture funds in U.S. Treasury bonds or SLGS. Current two-year bond coupons are about 30 or 35 basis points versus U.S. Treasury securities earnings of about 15 basis points.*** This **15 or 20 basis points of "negative arbitrage"** thus **equals only about 3/10 or 4/10 of a point.** It must be funded "up front" at closing in bankruptcy remote funds.

- This cash collateralization of principal plus interest enables the financing to obtain an **AA+ or Aaa rating** on the short-term Bonds from Standard & Poor's or Moody's, based on the rating of the underlying U.S. Treasury securities 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** on the mandatory tender date.

- The **Project's only remaining debt** (except for certain subordinate loans often used for affordable housing projects) is **the taxable loan.**

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*If investment earnings are higher than the interest paid on the Bonds, any such excess earnings or "positive arbitrage" must generally be paid to the U.S. Treasury.

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SHORT-TERM CASH-BACKED TAX-EXEMPT BONDS
SUMMARY OF ALL-IN BORROWING RATES

	§223(f) (Mod Rehab)*	§221(d)(4) (Sub Rehab/ New Construction)*
10-Year Treasury	1.70%	1.70%
GNMA to 10-Yr TSY Spread	0.70	1.35
Taxable GNMA Pass-Through Rate	2.40%	3.05%
Servicing/GNMA Guaranty Fee	.25	.25
Stated Mortgage Loan Rate	2.65%	3.30%
Mortgage Insurance Premium (Affordable)	.25	.25
All-In Borrowing Rate	**2.90%**	**3.55%**

*All-in borrowing rates on mod rehab and sub rehab/new construction Rural Development loans are very similar since they are also based on taxable GNMA sales. On a taxable Fannie Mae **mod rehab** DUS loan combined with short-term tax exempt cash backed bonds, the all-in borrowing rates in the current market through the sale of the Fannie Mae MBS in the taxable market would be about 10 basis points higher than the comparable tax exempt M.TEBs rate described above, producing an all-in borrowing loan rate pretty similar to the estimated rate above for a §221(d)(4) loan, but with about 2-2.5 points of negative arbitrage avoided by the FHA structure.

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SHORT-TERM CASH-BACKED TAX-EXEMPT BONDS
OTHER ADVANTAGES

- **Total issuance costs** are **lower on short-term cash backed bonds** than on long-term municipal bond financings backed by these FHA/GNMA and Fannie Mae credits, and Bond issues are sized to the 50% Test, which may be much lower than the taxable long-term loan amount.

- **Another potential major advantage** of short-term cash backed tax exempt bonds is **elimination of ongoing administrative issuer fees after Bonds are redeemed. Where ongoing issuer fees are high** (e.g. issuer fees of 25 to 40 or 50 basis points per year), this **can be a major advantage**. These issues involve an **average of 18 or 24 months of ongoing fees** or slightly more **versus 15 years** of ongoing fees for a long-term bond execution.

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- **Major Advantages of Tax Exempt Short-Term Cash Backed Bonds:**
  1. **Qualifies the Project for 4% LIHTC.**
  2. **Still lowers Mortgage Rate by 50 basis points or more.**
  3. **Avoids huge (4-8%) 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.
  5. **Flexible Financing Alternatives:** Can sell bonds in public offering or private placement and can finance multiple loans in one tax exempt bond issue as long as loans close at the same time.
- Major Disadvantages:

  0\. **Almost None** (only 3/10 to 4/10 of a point of negative arbitrage).

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BACK TO LONG TERM MUNI BONDS?

- It has taken 12 years, but **long-term tax exempt rates may finally be dropping to levels roughly equal to those on long term GNMA's.**
- Does this mean we will **go back to financing the debt side with long-term tax exempt muni bonds** backed by GNMA's? **Answer: Probably not quite yet.**
- **Long term muni bonds** are **fully funded** at closing → **huge (up to 6% – 8%) potential negative arbitrage** on **§221(d)(4) new construction / sub rehab deals** – v – $0 on short-term cash backed tax exempt bonds.
- **On going issuer / trustee / rebate fees** (often **15 to 30 basis points** or more) are eliminated on short-term cash backed bonds after 2-3 years.
- **Costs are lower on short-term cash backed tax exempt bonds.**
  - **Underwriting fees are lower** on short-term municipal bonds (0.50% to 0.70% on many deals v 1.0% to 1.25% for long-term)
  - **Other fees are lower too:** rating agency ($5,000 v $16,000 or more), etc.
- **We only issue tax exempt bonds in an amount up to the 50% test** → this further lowers underwriting fees and other costs of issuance.

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ADVANTAGES OF BANK AND FREDDIE "TEL" PRIVATE PLACEMENT STRUCTURE – v – FHA

- As noted above, 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.

- **As noted above, 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 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 and/or limited partnership interests**. Such debt may be more difficult to place.

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ADVANTAGES OF BANK AND FREDDIE "TEL" PRIVATE PLACEMENT STRUCTURE – v – FHA

- While private placement perm rates may be 50-100 basis points higher than FHA all-in rate, **private placements do offer very low perm rates described above** that are **locked at closing**; and, as noted above, **the structure readily accommodates a loan pay-down at Conversion** from other funding sources.
- **Private placements and Fannie and Freddie deals also avoid Davis Bacon wages** required for sub rehab (very generally > $40,000 per unit)/new construction FHA Section 221(d)(4) loans, and generally offer more flexible/quicker loan underwriting.
- Private placements **may also be available from non-bank financial institution sponsors** and may be especially attractive in non-CRA driven markets.

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SUMMARY OF BORROWING/ UNDERWRITING RATES
PRINCIPAL TAX EXEMPT DEBT PRODUCTS FOR 100% AFFORDABLE PROJECTS

	Estd. Actual All-In Borrowing and Underwriting Rate
1. Bank Private Placement	**3.50% to 4.25%**
2. Freddie Mac "TEL" Program (Mod Rehab, Sub Rehab, New Cons)	**Similar to Bank Private Placements above***
3. Fannie Mae "M.TEBS" Structure	**3.60% to 3.80%****
4. Short-Term Cash Backed Tax Exempt Bonds with Taxable Loan Sale	
FHA/ GNMA §223f (Mod Rehab)	**2.90%**
FHA/ GNMA §221(d)(4) (Sub Rehab / New Cons)	**3.55%**

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*Perhaps slightly higher in the current market.

**Plus 2-2.5 points of negative arbitrage during the pre-conversion phase on forwards M.TEBs for new construction / sub rehab.

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E. THREE OTHER DEBT STRUCTURING TECHNIQUES

- **Three debt structuring techniques** can make FHA loans more competitive with these competitive executions:
  1. Taxable and Tax Exempt **Tax Credit Equity Backed Bridge Loans**
  2. Taxable and Tax Exempt **Seller Take Back Debt**
  3. Tax Exempt **Cash Surplus Backed Bonds**

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1. TAXABLE AND TAX EXEMPT **TAX CREDIT EQUITY BACKED BRIDGE LOANS AND BONDS**

- **Especially on** financings involving an **FHA loan, any bridge loan** 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 and/or limited partnership interests**. Such debt can have no claim on the Project and is subordinate to the FHA Loan and payable only from the sources described above.
- Such tax credit equity bridge loans may take one of **two forms**:

a. Taxable Bridge Loan

- A taxable bridge loan is sometimes provided by the **tax credit syndicator,** backed by the collateral described above.

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b. Tax Exempt Tax Credit Equity Backed Subordinate Bonds

- **A Tax Exempt** Tax Credit Equity Backed Subordinate Bond issue, secured by the collateral described above can also be used.
  - If meeting the 50% test is a challenge, Tax Exempt Tax Credit Equity Backed Subordinate Bonds can sometimes be **delivered to the syndicator** to help meet that test*.
  - A number of our underwriter clients can also structure a **Publically Offered** Tax Exempt Tax Credit Equity Backed Subordinate Bond issue to provide this type of bridge financing on relatively attractive terms.
  - Such a separate series of tax exempt bonds can involve **additional documentation costs** and, if publically offered, will not reduce selling costs, but in the **few cases** where a short-term cash backed tax exempt issue involves **negative arbitrage**, **such an issue can substantially lower the amount of tax exempt cash backed bonds needed and thus substantially lower the negative arbitrage**.

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*These bonds may be taxable to the syndicator, but they will nonetheless count for purposes of meeting meet the 50% test.

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2. TAXABLE AND TAX EXEMPT **SELLER TAKE BACK DEBT**

The **need for** taxable or tax exempt **bridge loan** financing can often be **eliminated or reduced,** and other financing gaps can be closed, through the use of **"Seller Take-Back Debt."**

a. Taxable Seller Take Back Note

- Under this approach, a simple "**Taxable Seller Take Back Note**" is executed by the Borrower and **delivered to the Seller** in lieu of cash, in payment of a portion of the project purchase price. This is often used to **maximize the purchase price** on **RAD transactions and other preservation deals,** where the **new Borrower** has been set up by or **has a close relationship with the housing authority or profit-motivated project seller**.
- A **robust purchase price** also **increases the** federal and state **tax credits** available to the purchaser.
- A **simple Taxable Seller Take Back Note** can **dramatically reduce the need for cash at closing.**
- The **proceeds** of a simple taxable Seller Note **may sometimes be escrowed and delivered to the Bond trustee at closing to immediately collateralize part of a short-term cash backed tax exempt bond issue and reduce both selling costs and, in the small number of cases where negative arbitrage is an issue, negative arbitrage**.

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b. Tax Exempt Subordinate Seller Take-Back Bonds

- As an **alternative**, the seller take-back note or a portion thereof can also be effectively **converted to tax exempt debt by having** the **issuer** of the other tax exempt bonds issued to meet the 50% test also **issue Tax Exempt Subordinate Seller Take-Back Bonds,** backed by a surplus cash note from the Borrower. **Disadvantage: 2 sets of tax-exempt bond documents. Advantage: No underwriting or origination fee on these tax-exempt bonds** since they are acquired by the seller.

- Especially **if the Seller is a for-profit entity**, this also **makes the seller take-back terms more attractive** to the Seller (interest is tax exempt), and these Bonds count as tax exempt debt for **satisfying the 50% Test**, if needed. This **can reduce the size of a Series A Tax Exempt Cash Backed Bonds**, lowering the associated costs and reducing negative arbitrage on those bonds if that is an issue.

- Moreover, the subordinate tax exempt bonds can be **delivered to the Seller** as partial consideration of the transfer of the project **without cash changing hands,** reducing or eliminating the need for bridge financing and putting the FHA execution on a more even footing with private placements and other competitive executions.

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3. TAX EXEMPT **CASH SURPLUS BACKED BONDS**

- With both construction costs and interest rates rising in 2018, and tax credit equity pricing being impaired by lower corporate tax rates adopted in the recent Tax Cuts and Jobs Act, a number of **affordable housing developers are seeking additional funding sources** to plug the gaps left in their financing plans.
- To address these gaps it is possible to structure and sell **tax exempt subordinate bonds secured by a pledge of surplus cash from the Project** as defined in the FHA Regulatory Agreement. Such bonds typically also entail a debt service reserve fund typically sized to cover the maximum annual debt service on the bonds and/or a guaranty of the bonds by a deep pocket general partner of the Borrower.
- **Such bonds are generally structured as term bonds** set to mature, depending on the availability of moneys available from surplus cash term bonds, after the FHA insured loan has been fully amortized. In today's market, they might be expected to bear interest at tax exempt rates of 4.0 to 8.0%. While these rates are higher than most tax exempt bond rates, they are much lower than the yields which would be required to fill these gaps from equity funding sources.

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V: MAJOR TAX EXEMPT DEBT EXECUTIONS FOR "MIXED USE" PROJECTS

- As noted above, "mixed use" projects are usually very **large, complex urban projects** (which often involve a combination of for sale residential, commercial, and other components, combined with a rental apartment component where 20% of the units are rented to tenants where incomes do not exceed 50% of AMI (for a family of four, adjusted for family size at rents ≥ 30% of that amount). Usually, 80% of the units are rented to tenants at any income level at market rates.
- The developers of such projects tend to be **very large or national development firms**, who have the capability of using their **large, liquid balance sheets** to achieve, when desired, very high leverage and/ or the lowest possible borrowing rate.

ALTERNATIVE A. TAX-EXEMPT 7-DAY DEMAND VARIABLE RATE BONDS BACKED BY LARGE BANK DIRECT PAY LETTER OF CREDIT.

- Structure large tax exempt and, in some cases, taxable bond issues as **7-day demand "lower floater" bonds** backed by a **direct pay letter of credit** from a **large** foreign or domestic highly rated **bank**.
- In some cases, this debt may comprise as much as 85 – 90% LTV, when combined with a pledge of other collateral and/or completion, payment (or other guarantees for some portion of the exposure) strong, liquid corporate guarantors.

- Major Advantage:
  - Allows developer to **borrow at the very shortest end of the traditionally steep tax exempt yield curve** (e.g., SIFMA = ~5 basis points) and/or shortest end of taxable yield curve (e.g., one-month LIBOR = ~10 basis points).
  - Add letter of credit fees of 200 basis points, and **all-in borrowing cost of 2.50-3.00%** versus higher long-term tax exempt and taxable rates of 3.5% to 4.0% (tax exempt) or 5.0% or more (taxable) under other structures.
- Disadvantages:
  - **Variable rate risk,** but this can be limited with caps or swaps, and bonds are multi-modal the Borrower can trigger a mandatory tender and go into alternate interest rate modes.
  - **Limited duration.** These letters of credit typically expire in 4-6 years, and the Borrower must then extend or arrange an alternate credit and/or liquidity from another facility at then applicable market rates.

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ALTERNATIVE B. COMBINED WITH TOTAL RETURN SWAP PRIVATE PLACEMENT FIXED RATE BOND STRUCTURE

- Under a "total return swap" structure **bonds are typically structured as fixed rate (e.g., 5.0%) unrated, non-credit enhanced tax exempt bonds** sold to a **bank in a private placement.** The Bonds are issued in large minimum denominations (e.g., $100,000 or higher), and are subject to transfer restrictions.
  - The Borrower also enters into a separate **swap transaction** with the Bank which effectively **converts the Borrower's fixed rate borrowing into an extremely very low variable rate borrowing** as follows:
    1. *The Swap Counterparty (the Bank) makes fixed rate payments to the Borrower at a fixed rate equal to the fixed rate on the Bonds, generally on the same Notional Amount. This offsets the payments due from the Borrower to the Bank on the Bonds.*
    2. ***The Borrower makes floating rate payments to the Bank on the swap** based upon a stated notional amount which is equal to the outstanding principal amount of the fixed rate Bonds, **based upon the 7-day SIFMA or 1-month LIBOR index plus a spread** of a fixed number (e.g., 150-200) of basis points.*
  - The **net effective borrowing rate in this example is** what the Borrower pays on the floating rate leg of the swap – in this example the SIFMA index (≈ 0.05) + 2.25% = **2.30%, an extremely low borrowing rate**.

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- **Considerations: The Borrower will be required to post additional collateral** to the Bank to the extent the Notional Amount of the swap exceeds some percentage (e.g., 75%) of the market value of the Bonds or the underlying Project, as determined by the Bank on a periodic basis. **A termination payment may also be required** if the value of the bonds decline below the notional amount of the swap at termination and the swap is not excluded or the Bonds are not otherwise refinanced.
- **Limited Duration.** The **swap generally expires on a date 5-8 years** from the initial effective date, so this structure entails the same need to restructure debt in the near term as with most letter of credit backed financings.
- **Result**: This structure provides an **extremely low borrowing rate**, but only for a limited term (usually 5-8 years, which **may or may not be rolled forward**). Thus, it is only attractive to and available to **experienced large balance sheet Borrowers** who can post additional collateral if required and/or make any required termination payment.
- **Tax considerations** require the terms of the bonds and the Swap to be kept separate, which can introduce some **timing and other risks.**

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