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

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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.

# 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, 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 securities.

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

# 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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# Solution:

## Buy Short-Term Bonds!

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

- 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).

*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

- **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**.
- 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 at this time yield about 20 basis points lower than a current bond coupon of about 0.35% and 0.40%. This results in about one half point of negative arbitrage which must be funded upfront.**

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# Cash Collateralized Tax-Exempt Bond Structure

- This "cash" collateralization of principal plus locked in U.S. Treasury investment rates 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.**

# Sample Transaction

## New Construction/Sub Rehab – 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 | 15 to 20 basis points per year |
| Initial Bond Coupon Rate | 0.40% |
| 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.

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# ALL-IN BORROWING RATES ON THE RD OR FHA INSURED LOAN
# (The "Real" Construction/Permanent Loan)

| | | Moderate Rehab/ | Sub Rehab-New Cons/ |
|---|---|---|---|
| Tax Exempt Bond Term (Maturity or, more often, Mandatory Tender) | | 2 Years | 2 Years |
| Mortgage Loan Interest Rate | | | |
| | GNMA Pass Through Rate | **2.10%** | **2.65%** |
| | 3rd Party Fees | N/A | N/A |
| | Servicing + GNMA Fee | 0.25% | 0.25% |
| | Total **ML Rate** | **2.35%** | **2.90%** |
| | Add: MIP | **0.25%** | **0.25%** |
| | Total **All-in Borrowing Cost** | **2.60%** | **3.15%** |

* Note: bonds are sized to 52 – 54% of Tax Credit basis; under long-term muni bond structures used before 2009, bond issue would be larger (equal to taxable loan amount) with higher costs.

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# Short Term Cash Backed Tax Exempt Bond Financing
# 100% Affordable Project – RD or FHA Insured Loan
# Sources and Uses of Funds

- Assume: Total Development Cost $18,500,000 – could be a pool of 4 or 5 projects.
- Assume: $11,100,000 RD or FHA Insured Loan (60%)
- Assume: Tax Exempt Bond Amount $10,000,000 (54% of Basis)*

| Sources | | |
|---|---|---|
| RD or FHA Loan Proceeds* | $11,100,000* | (60%*) |
| Federal 4% Tax Credit Equity | 5,955,840 | (32%) |
| Subordinated Loan from City | 925,000 | (5%) |
| Deferred Developer Fee | 519,160 | (3%) |
| **Total:** | **$18,500,000** | **(100%)** |

| Uses | | |
|---|---|---|
| Land | $2,775,000 | (15%) |
| Construction Costs | 12,950,000 | (70%) |
| Financing Fees (Bond COI, RD or FHA Fees; Other) | 925,000 | (5%) |
| Other "Soft" Costs | 1,330,840 | (7%) |
| Deferred Developer Equity | 519,160 | (3%) |
| **Total:** | **$18,500,000** | **(100%)** |

* To satisfy the 50% Test, we will issue $10 million of tax exempt bonds (54% of basis). This is often less than the taxable loan amount. We will flow $10 million of the RD or FHA lender funds through the Bond Indenture out to the Borrower. The balance ($1,100,000 in our example) goes directly from the RD or FHA lender to the Borrower as discussed below.

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# *Bond Costs of Issuance*
# *($10 Million Tax Exempt Bond Issue)**

| | |
|---|---:|
| Issuer | $62,500 |
| Bond Counsel | 65,000 |
| Financial Advisor to Issuer or Issuer's Counsel | 25,000 |
| Underwriter | 100,000 |
| Underwriter's Counsel | 50,000 |
| Rating Agency | 5,000 |
| Trustee | 5,000 |
| ***Total Cost of Issuance*** | ***$312,500*** |
| ***Negative Arbitrage – See Slide 20.*** | ***$50,000*** |
| ***Total Cost of Bond Financing*** | ***$362,500**** |

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

***** 3.6% of Bond issue; 1.9% of total development cost.***

# Results of Structure

**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, if financed with long-term GNMA backed municipal bonds.
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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# Comparison of Short-Term Cash-Backed Bonds + FHA Insured or RD Guaranteed 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 a sub rehab/new construction loan, there is a cost certification at final endorsement, but 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).

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

# Comparison of Short-Term Cash-Backed Bonds + FHA Insured or RD Guaranteed 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, but this has been done on many financings.

# 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 guaranteed loans. For these AFFORDABLE FHA and RD loans, YOU WILL USE SHORT-TERM BONDS.**
- 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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