

# EICHNER & NORRIS PLLC

November 2-4, 2011

## COMBINING SHORT-TERM CASH BACKED TAX-EXEMPT BONDS WITH TAXABLE GNMA SALES FOR AFFORDABLE HOUSING PROJECTS USING FHA INSURANCE

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This memo explains a new program which our firm has developed to dramatically reduce the long term borrowing rate and negative arbitrage associated with affordable housing projects financed with FHA-insured mortgage loans where the Borrower must finance 50% of project costs with tax-exempt bonds and keep those bonds outstanding until the project's placed-in-service date in order to get full value for the 4% LIHTC equity under the "50% Rule". The structure prices the permanent loan rate in the huge, highly efficient forward delivery market for taxable GNMA Securities, rather than the much smaller, less efficient "fully funded" long-term tax-exempt multifamily housing bond market, and uses short-term, "cash backed" tax-exempt bonds to achieve compliance with the "50% Rule".

### Background

The first quarter of 2009 was truly a "nuclear winter" for affordable housing finance. Following the financial crisis in the fall of 2008, two-thirds of the market for tax credits effectively had disappeared as Fannie Mae and Freddie Mac (formerly 40% of the tax credit equity buy side) and large commercial banks (formerly 25%) had suffered major losses, had no taxable income and no prospect of taxable income, and thus no need for federal tax credits of any type. Similarly, on the debt side, long-term, tax-exempt municipal rates had risen to a point where they were 400 basis points higher than the rates on comparable taxable 30-year U.S. government securities. This reflected in large part a flight to safety of U.S. Treasuries, as trillions of dollars of formerly AA and AAA rated debt of large banks, insurance companies (e.g. "AIG"), securities firms (e.g. "Lehman Brothers"), bond insurance firms (e.g. "AMBAC, MBIA, FGIC, ACA"), CDOs, CLOs, CMOs and other paper of non-U.S. Government issuers became worthless or worth only pennies on the dollar.

## Background (Cont.)

In such an environment, and even today (given the concern over European government and bank debt), there is a huge flight to safety of U.S. Government debt, and U.S. Government securities now trade at record low yields. On the municipal side, on the other hand, yields have risen to record levels versus taxable U.S. Government debt as concerns regarding the credit quality of a wide array of municipal bonds have risen and the long-term viability and value of the federal tax-exemption on municipal debt is increasingly challenged.

As many market participants discovered, in the 1st quarter of 2009 the only viable debt financing model was FHA. There were no bank letters of credit required to credit enhance bond issues or to cover the construction and rent up period for Fannie Mae and Freddie Mac enhanced bonds. This is not needed for an FHA-insured loan, since FHA provides insurance of loan advances. Moreover, FHA insured loans can be “wrapped” with GNMA pass-through securities (called a Construction Loan Certificate or “CLC” during construction or a Permanent Loan Certificate or “PLC” once the FHA insured loan has been finally endorsed for insurance post-construction). These GNMA certificates provide the full faith and credit guarantee of the U.S. Government that the payment due on the FHA insured loan due on the first of the month will be “passed through” to the holder of the GNMA on the 15th (minus a 25 basis point GNMA guaranty/servicing fee), even if the underlying FHA insured loan is in default and the payments due are not being made. As a result, in the taxable debt securities markets, GNMA securities trade at very tight spreads to U.S Treasury Bonds.

Thus a long-term tax-exempt bond issue to fund an FHA-insured mortgage loan might bear interest at 5.75% in the current market and with fees, produce a stated mortgage loan rate of slightly over 6.0%. The same loan, priced in the taxable market for GNMA's, might bear interest at a rate of about 4.75%. The result is, that as irrational as it may seem, since the winter of 2009, the FHA-insured mortgage loan rate which can be achieved by selling GNMA securities in the taxable market is well over a full percentage point lower than the mortgage loan rate which can be achieved by funding the same loan through the sale of long-term **tax-exempt** Aaa or AA+-rated municipal bonds.

The debt markets for GNMA's are also "forward delivery" markets. This means that as each FHA loan advance is made and wrapped with a GNMA security, that security (having the previously agreed upon rate) is delivered to the buyer against payment – i.e., the debt investor advances money to the borrower (through the purchase of the GNMA Security from the Lender) when the funds are needed. This differs dramatically from publicly offered municipal securities markets, where all of the bonds representing the full loan amount must be delivered and begin to bear interest at the long-term borrowing rate of say 6.0%. Those undisbursed bond proceeds must be reinvested in an AAA-rated or AA+-rated investment arrangement until the money is advanced to fund loan draws. Since short term reinvestment rates of this type range from 30 – 50 basis points per year in the current market, this can impose huge negative arbitrage costs and deposit requirements. On a fully funded, long-term tax-exempt bond financing for new construction or substantial rehab, the actual negative arbitrage on such a financing can be as much as 3 – 5% of the loan amount and additional negative arbitrage deposits in a similar account can be required to cover the maximum potential negative arbitrage if construction on loan advancements is suspended or proceeds more slowly than expected. An 8 – 10% up front deposit of this type can be fatal to many deals.

## The Light Bulb Lights Up

Thus, as we sat in our offices in that desperate winter of 2009, we asked ourselves the question: "If only there were some way we could access these extremely low long-term borrowing rates in the taxable market for GNMA securities and also take advantage of the forward funding aspect of that market to reduce or dramatically lower the negative arbitrage associated with such a deal." The "Ah Ha" moment came from tax-exempt bond financing structure we and others had developed in the mid-1990s for HOPE VI deals. HOPE VI is a program to replace former public housing units, through the provision of HOPE VI "grants" to the projects. Many such projects are targeted at populations with median incomes in the 15 – 20% of area median income range, and thus cannot carry any permanent debt without huge permanent rent subsidies. Instead, they are often financed with short-term tax-exempt bond issues in order to prime full value for a 4% LIHTC syndication. The tax credit syndication proceeds, together with loans to the Borrower funded from HOPE VI grants, and possibly other subordinated loans, provide all of the permanent funding.

Short-term tax-exempt bonds in an amount equal to 50% of the project costs are issued with a maturity roughly twice the targeted placed-in-service date (to provide for construction delays) and two guaranteed investment contracts on bid with the same highly rated provider at the same rate: (i) a "GIC A" in which all the tax-exempt bond proceeds are invested, and (ii) a "GIC B" in which tax credit equity installments or money from HOPE VI funded loans are deposited when received. By structuring such financings so that as each dollar of tax-exempt bond proceeds is disbursed from GIC A to pay project costs, an equal amount of "replacement proceeds" must be deposited into GIC B, the Bond issue remains 100% cash collateralized, and one can obtain an AA or AAA rating on the short-term bonds based on the unsecured debt rating of the provider of the investment agreement, without other credit enhancement. When the project loan has been fully funded, the tax-exempt bonds are repaid after the placed-in-service date and the project has no permanent senior debt.

## The Light Bulb Lights Up (Cont.)

This structure raised questions with many bond counsel firms as to whether it entailed an unnecessary “over-issuance” of tax-exempt bonds. After all, since the replacement proceeds had to be delivered before an equal amount of bond proceeds could be disbursed to pay project costs, why not just use these to pay the costs and forego the issuance of any tax-exempt bonds? On the other hand, under such a structure, the fundamental requirement that the tax-exempt bond proceeds be expended for qualified project costs is fully satisfied, so the other view was that the basic requirements of Section 103 of the Code were satisfied under the structure, and there was no reason a bond counsel firm could not issue a clean opinion.

The debate was largely resolved when language was added to the Work Quality Assurance Act of 2000 specifically endorsing the use of tax-exempt bonds in connection with “mixed use” HOPE VI financings. Since that time, almost all major bond counsel firms have given clean opinions on a wide variety of structures where all or a portion of tax-exempt multifamily housing bond issues have been cash collateralized with replacement funds of various types (HOPE VI monies, tax credit equity, proceeds of various federal and state subordinate loan funds) and kept outstanding until the placed-in-service date to meet the 50% test on the tax-credit equity side.

Our “light bulb” idea in the winter of 2009, was to simply apply that structure to finance affordable housing projects using FHA insurance, so as to get the low rates available in the taxable GNMA markets and dramatically reduce the often fatal negative arbitrage costs and funding requirements associated with long-term tax-exempt bond funded deals.

The following chart summarizes the principal benefits of the new structure versus the traditional funding method:

Tax-Exempt Bonds Issued:	\$18,000,000	\$13,000,000 <sup>1</sup>
<sup>1</sup> Sized to meet 50% test (Assumes \$25.0 Mil total cost)		
Tax-Exempt Bond Term	42 Years	2 Years
Mortgage Loan Interest Rate		
	Bonds 5.75%	GNMA 4.50%
	3 <sup>rd</sup> Party Fees 0.15%	3 <sup>rd</sup> Party Fees N/A
	Servicing + 0.25%	Servicing + 0.25%
	GNMA Fee	GNMA Fee
	Total ML Rate <b>6.15%</b>	Total ML Rate <b>4.75%</b>

Result → 1.40% ML Rate Savings (~10% of additional loan proceeds on debt service constrained loan)

Negative Arbitrage (Deposit):	5.75% x 18,000,000 x 2 years	1.50% x \$13,000,000 x 2 years
	\$2,070,000 ( <b>11.5% of ML</b> )	\$390,000 ( <b>2.0% ML</b> )
Negative Arbitrage (Actual):	\$1,035,000 (5.25% of ML)	\$390,000 (2.0% of ML)



Note that under the new structure, one only has to issue tax-exempt bonds in an amount sufficient to satisfy the 50% Rule, which can further reduce financing costs. Negative arbitrage is not eliminated, but since the short-term tax-exempt bonds under this structure would typically bear interest at rates of 1.0 to 1.5%, negative arbitrage should be limited to 1-2% versus 8-10% under the traditional long-term tax-exempt bond financing structure.

This structure has now been approved by 8-10 of the country's largest bond counsel firms, and a number of transactions are now under way. Moreover, given the high degree of uncertainty in the financing markets, we believe it is highly unlikely that conditions would change in the next 12-18 months so that the traditional long-term tax-exempt bond financing approach would once again be competitive with this new structure. Our firm would welcome any questions regarding this new financing device for affordable housing projects using FHA insurance.