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**Use of Tax-Exempt Bonds in
FHA/GNMA Financings**

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WHY FINANCE MULTI-FAMILY RENTAL HOUSING WITH MUNICIPAL BONDS?

- **TWO BIG REASONS**

1. Low interest rates
2. “Automatic” 4% tax credit equity

1. LOWER INTEREST RATES

- In most markets, tax-exempt rates are much lower than taxable rates at a given rating level and maturity.
- Often, tax-exempt rates are a full percentage point (i.e., “100 basis points”) or more lower for 30- or 40-year AAA-rated obligations.

What is the effect of a Bond Purchaser not paying taxes on interest received?

Why would bond buyer accept 5.0% rather than 7.0%, if interest income on 5.0% is tax-exempt? It's not what you earn ...but what you keep!

<u>Tax-Exempt AAA Calif. Bond - 30 Yr.</u>	<u>Taxable AAA Bonds</u>
Assume \$10,000 Bond	
Interest Rate	5.0% 7.0%
Annual Interest on \$10,000	\$500 \$700
Tax (36%)	\$0 (\$252)
After Tax Income	\$500 \$448
After Tax Yield	5.0% 4.48%

Formula for Taxable Equivalent Yield.....

Taxable vs. Tax-Exempt Rates =

$$\frac{\sum_{i=1}^{30660} L S^* \int_{-\infty}^{\infty} \int_{-\infty}^{\infty} \frac{D(r_t, R_t) D(r_t, R_t)}{(2\pi\sqrt{1-\rho^2})} \exp\left\{-\frac{1}{2(1-\rho^2)} [R_t^2 - 2\rho R_t E_t + E_t^2]\right\} dR_t dE_t \prod_{\tau=1}^t (1+r_t)^{-\tau}}{\prod_{\tau=1}^t \int_{-\infty}^{\infty} \int_{-\infty}^{\infty} \frac{1}{(2\pi\sqrt{1-\rho^2})} \exp\left\{-\frac{1}{2(1-\rho^2)} [R_{\tau}^2 - 2\rho R_{\tau} E_{\tau} + E_{\tau}^2]\right\} dR_{\tau} dE_{\tau}}$$

$$30660 \sum_{t=1}^T t^* \left\{ \frac{1}{r_0} \left(1 - \frac{1}{(1+r_0)^T} \right) \right\}^{-1} \left(\frac{1}{r_0} \left(1 - \frac{1}{(1+r_0)^{T-t}} \right) \right)$$

Just Kidding!!!

Taxable equivalent yield $5.0\%/0.64 = 7.81\%$

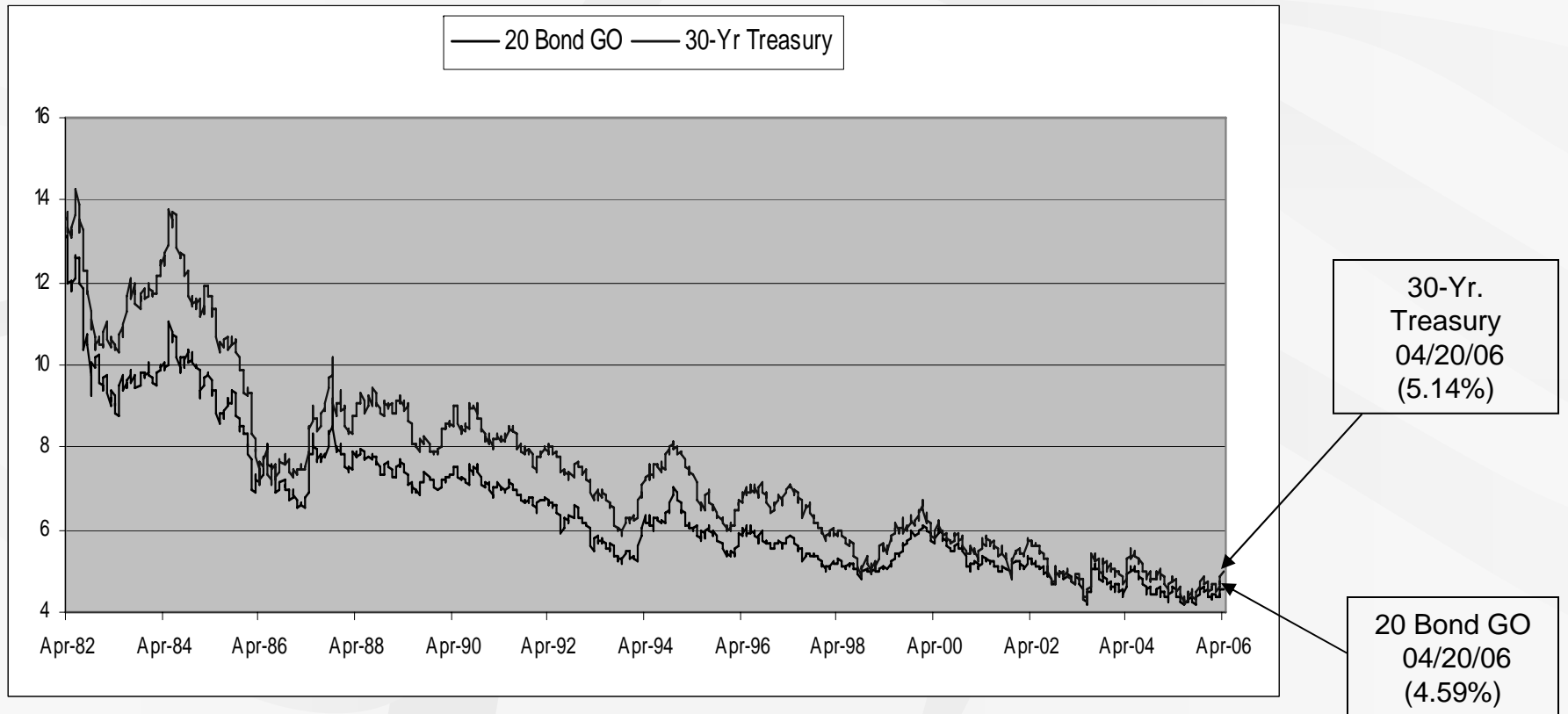
Taxable Equivalent Yields

Single	\$62,450	\$130,250	\$283,150	Over
Joint	\$104,050	\$158,550	\$283,150	Over
Federal	28.0%	31.0%	36.0%	39.6%
Combined	34.7%	37.4%	42.0%	45.2%
Tax-Exempt Rate	Taxable equivalent yield			
4.50%	6.89	7.19	7.76	8.21
4.75	7.27	7.59	8.19	8.67
5.00	7.66	7.99	8.62	9.12
5.25	8.04	8.39	9.05	9.58
5.50	8.42	8.79	9.48	10.04
5.75	8.81	9.19	9.91	10.49
6.00	9.19	9.58	10.34	10.95

Low Rates = More proceeds: 1% (100
“basis points”) reduction in interest rate
on debt = about **8% more proceeds** on
a 30-year level amortization loan

Comparison of Long-Term Tax-Exempt and Taxable Rates

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



2. ADDITIONAL EQUITY PROCEEDS FROM SYNDICATION OF 4% LOW INCOME HOUSING TAX CREDITS

- Applies only to new money “private activity bonds” under Section 142(d) for profit-motivated buyers
- Eligible to receive “4%” low income housing tax credits on affordable units
- No limited availability of 4% low income housing tax credits like very competitive pool for 9% low income housing tax credits

- Purchaser of credits receives a dollar-for-dollar credit against federal income tax liability equal to roughly 4% of the “qualified basis” of the affordable units for 10 years.
- “Qualified basis” excludes land and any commercial component, but may be multiplied by 1.3 for a project in a “difficult to develop” area (“DDA”) or QCT (eg. entire City of Los Angeles is a DDA).
- On a \$10.0 million 100% affordable project, assuming \$1.0 million for land and \$500,000 commercial, qualified basis would be \$8.5 million.

- At an actual tax credit percentage (published periodically in Federal Register), this would produce tax credits of 3.42% x \$8.5 million or \$290,000/year over 10 years, or \$2.9 million.
- Tax credit purchaser will pay about 95¢/\$1.00 of credits (due to time value of money and risk) = \$2.75 million or roughly **27.5% more proceeds** on a \$10.0 million deal, without giving up substantial cash flow on residual.
- Recently , this pricing has been \$1.05 to 1.10 per dollar on some projects, but this is extremely robust pricing and may prove to be temporary.

MAJOR 4% TAX CREDIT EQUITY RULES (Section 42 of Code)

- **10-Year Holding Period:** Generally speaking, project must have been owned by prior owner for at least 10 years to be eligible for 4% credits.
- **50% Test:** At least 50% of aggregate basis of the building and land must be financed from **tax exempt** bond proceeds to get full value for 4% credits.

MAJOR 4% TAX CREDIT EQUITY RULES (con't)

- **Generally same 20/50 or 40/60 income targeting** as Bond test under Section 142(d) of the Code. Most tax credit projects are 100% affordable to maximize tax credits – tax credits are only paid on the targeted units.
- Unlike bond rules, **tax credit rules limit rents charged** on targeted units **to 30% of the applicable income limit** for the targeted unit.

MAJOR 4% TAX CREDIT EQUITY RULES (con't)

- Tax credit units must continue to comply with above limitations for at least **15 years after placed in service**, or tax credit investors subject to “recapture” of tax credits claimed.
- **If project loan defaults and credit enhancer forecloses, remaining years’ credits convey with the property**, even though original tax credit investor paid for the entire stream of credits in first one or two years. Thus the tax credit investor, like the credit enhancer, will take various steps to minimize possibility of a loan default.

Summary for Using Tax Exempt Bonds

- Lower Interest Rates on Debt Side = +8%
- Sale of 4% Tax Credit Equity = +30%
- Additional Proceeds from Tax-Exempt Private Activity Bond Financing = **+38%**

Note: Non-Profit sponsors can use this mechanism. They simply become the sole general partner of a partnership which applies for private activity bond volume, but must have financial wherewithal to provide guarantees of completion, rent-up and stabilization required by syndicator of 4% LIHTC equity

Typical “New Money” Private Activity Bond Financing Sources and Uses of Funds

Sources

Tax-Exempt Bond Proceeds	\$6,600,000
4% Tax Credit Equity	2,750,000
Subordinated Loan from City	400,000
Deferred Developer Fee	<u>250,000</u>
Total:	\$10,000,000

Uses

Land	\$1,500,000
Construction Costs	7,000,000
Financing Fees	500,000
Other “Soft” Costs	600,000
Developer Fee	<u>400,000</u>
Total:	\$10,000,000

Advantages and Disadvantages of Tax-
Exempt Bonds Using FHA
221(d)(4)/GNMA Program

- versus -

**Other Credit Enhancement
Structures**

Financing Alternatives

Credit Enhanced Financing Alternatives	<u>DSC</u>	<u>LTV</u>	<u>Amort.</u>	<u>Fees</u>	<u>Speed</u>	<u>Var?</u>
– FHA / GNMA	1.11	90%+	35-40	Low	90-150	NO
– Fannie Mae and Freddie Mac	1.20	80	30	Mid	60-90	Yes
– Bank Letters of Credit	1.15-1.25	75-85	25-30	High	60-90	Yes
– Bond Insurers	1.35	65	25-30	Highest	60-90	Maybe
Non-Credit Enhanced						
– Stand-Alone Bond Rating						
• Standard & Poor's and Moody's Affordable Housing Programs	1.45	--	30	Mid to High	60-90	No
– Private Placement/Unrated						
• Conduit	1.10-1.15	90	35-40	Low	30-60	Yes
• Bank portfolio	1.15-1.20	90	30-35	Low	30-60	No

Advantages to FHA/GNMA

- Generally, **highest proceeds** of various senior debt programs.
 - Low debt service coverage requirements: 1.12 or so versus 1.20 to over 1.25 for most other structures.
 - 95% loan-to-cost versus 75% - 85% for most other programs.
 - 40-year Level Amortization Loan versus 30-years for most other programs.
- **Lowest credit enhancement cost:** 70 basis points (MIP + Servicer/Seller fee) versus 90 bp for Fannie Mae or Freddie Mac and 100 bp or more for most Bank letters of credit.

Advantages (cont.)

- **Provides both construction and permanent financing** (compared to Fannie Mae or Freddie Mac, which require separate bank L/C for construction and rent-up risk).
 - One origination fee/one underwriting process.
 - No conversion/stabilization requirements.
- **Non-recourse loan** versus recourse for Fannie and Freddie during construction and rent-up and throughout the financing for most Bank L/C's.

Disadvantages

- **Process and timing issues:** Loan underwriting requires 120 - 150 days, even under MAP program, compared to 60 - 90 days for some other programs.
- **Subject to Davis-Bacon wages.**
 - May raise construction costs by 20-30% or more in some labor markets.

Disadvantages (cont.)

- Depending on market conditions, a significant **negative arbitrage deposit** may be required.
- However, in the current market, negative arbitrage requirements have been virtually eliminated.
- Limited structuring flexibility; no balloon option.

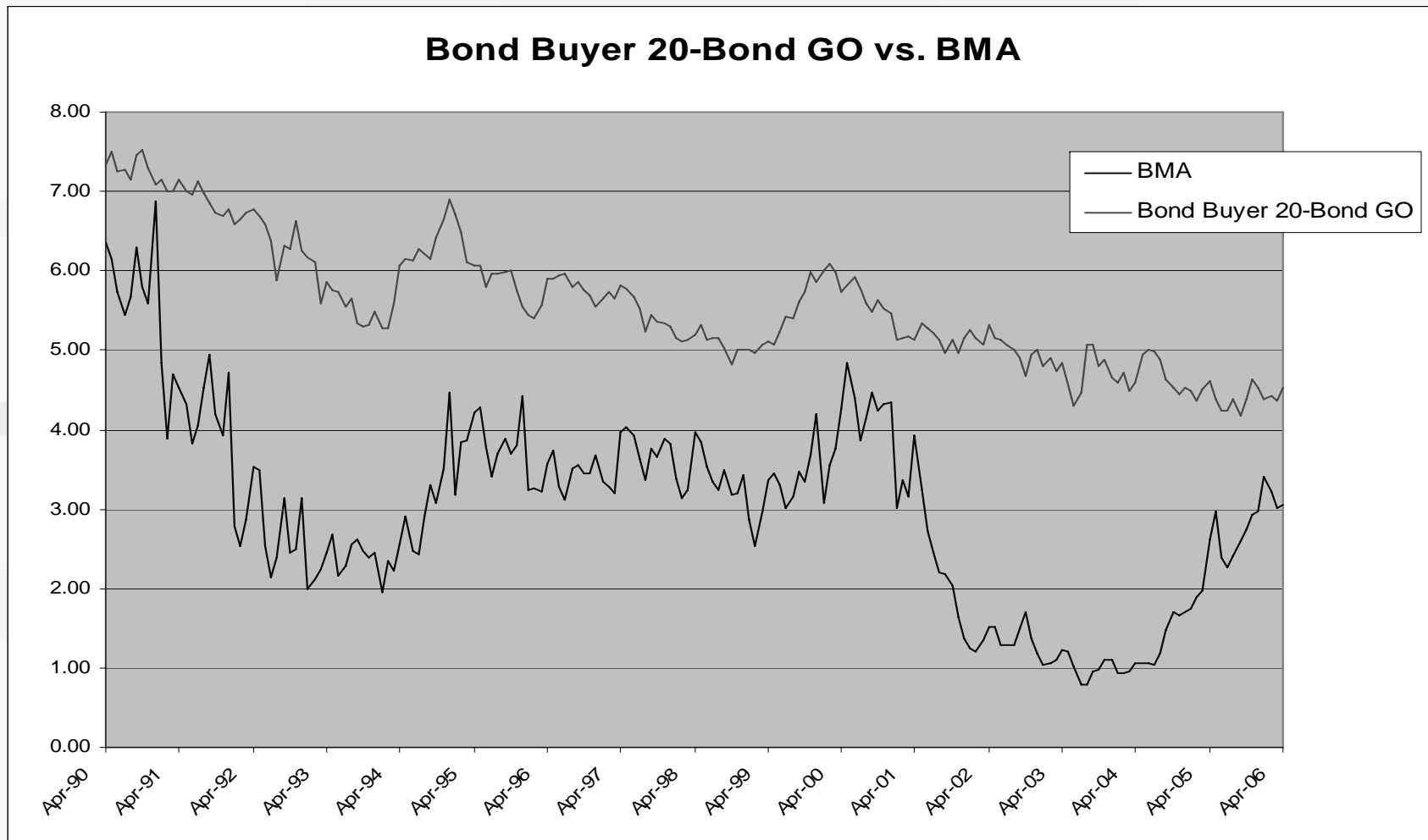
Disadvantages (cont.)

- **No Variable Rate Option**

- **Even in today’s market, many borrowers want variable rate option.**

- About 70% of Fannie/Freddie new money deals closing today are variable rate.
- Tax-exempt **yield curve** is almost always significantly “**upward sloping,**” especially for first ten years
- At current 7-day tax-exempt rates of about 3.50%, **effective all-in borrowing cost is about 4.75%** under most variable rate programs versus 5.75-6.25% for fixed rate loans (including credit enhancement).
- **Does not increase loan size** (because loans on variable rate bond issues are underwritten at rates close to long-term rates), **but can dramatically increase cash return** to borrower.

FIXED vs. FLOATING RATE COMPARISON



Variable Rate Financings

- What are “Low Floaters”?
 - Tax-Exempt Variable Rate Demand Notes
 - Interest Rates are typically reset every 7 days
 - Bondholders can “put” paper back with 7-days notice
 - A Remarketing Agent resets rates and remarkets “puts”
 - Credit Enhancer provides “liquidity” for failed remarketings
- Characteristics of Variable Rate Deals
 - May enable borrower to achieve **lowest financing rate** over time
 - Carries with it **risk of interest rates rising** above level which project cash flow will support; but
 - Most credit enhancers will require developer to purchase an interest rate “**cap**” or enter into “**swap**” for at least the first **five years** of the financing and allow the Borrower to **annually escrow** a pro rata portion of the estimated cost of purchasing **successor cap**
 - Some tax credit investors will insist that rate be capped or swapped on variable rate deals through end of 15-year tax credit compliance period.

Comparison

FHA 221(d)(4) / GNMA to Variable Rate

Fixed Rate Calculation

Tax-Exempt 40-yr Bond Rate*	5.15%
Trustee Fee	.025
Issuer Fee	.125
GNMA Pass-through rate	5.300%
Ginnie Mae Guaranty/Servicing Fee	.25
Mortgage Rate	5.550%
Mortgage Insurance Premium (MIP)	.45
<i>Total effective Interest Rate</i>	6.000%

Variable Rate Calculation

	<i>Actual</i>	<i>Underwriting</i>
Bond Interest Rate	3.440%	2.780%
Plus Fee Stack		
Serv. & Cred. Enhanc.	.800%	.800%
Liquidity Fee	.250%	.250%
Remarketing Agent	.100%	.100%
Issuer	.125%	.125%
Trustee	.025%	.025%
Escrow for Next Cap	.040%	.040%
Total Fee Stack	1.340%	1.340%
Underwriting Cushion		2.00%
<i>Total All-in Current Borrowing Rate</i>	4.780%	6.120%

Results in the Current Market

- Extra cash flow to partnership from going variable rate:

Fixed Rate All-in: 6.000%

Variable Rate All-in: 4.780

Additional 1.220% Additional Cash Flow
From Variable Rate

- or -

On a project with \$10.0 Million loan, an additional \$122,000 per year of cash flow!

How Variable Rate Bonds could be used with FHA/GNMA WITHOUT increasing the underwriting risk:

1. Keep all FHA loan underwriting criteria **exactly the same** as used on fixed rate transactions. Base the underwriting on rates determined at initial endorsement with no expected changes to any of the documents due to changes in interest rates on the Bonds.
2. Variable rate bonds should bear interest as determined by the market – not based on any index.

Variable Rate Bonds with FHA/GNMA (con't)

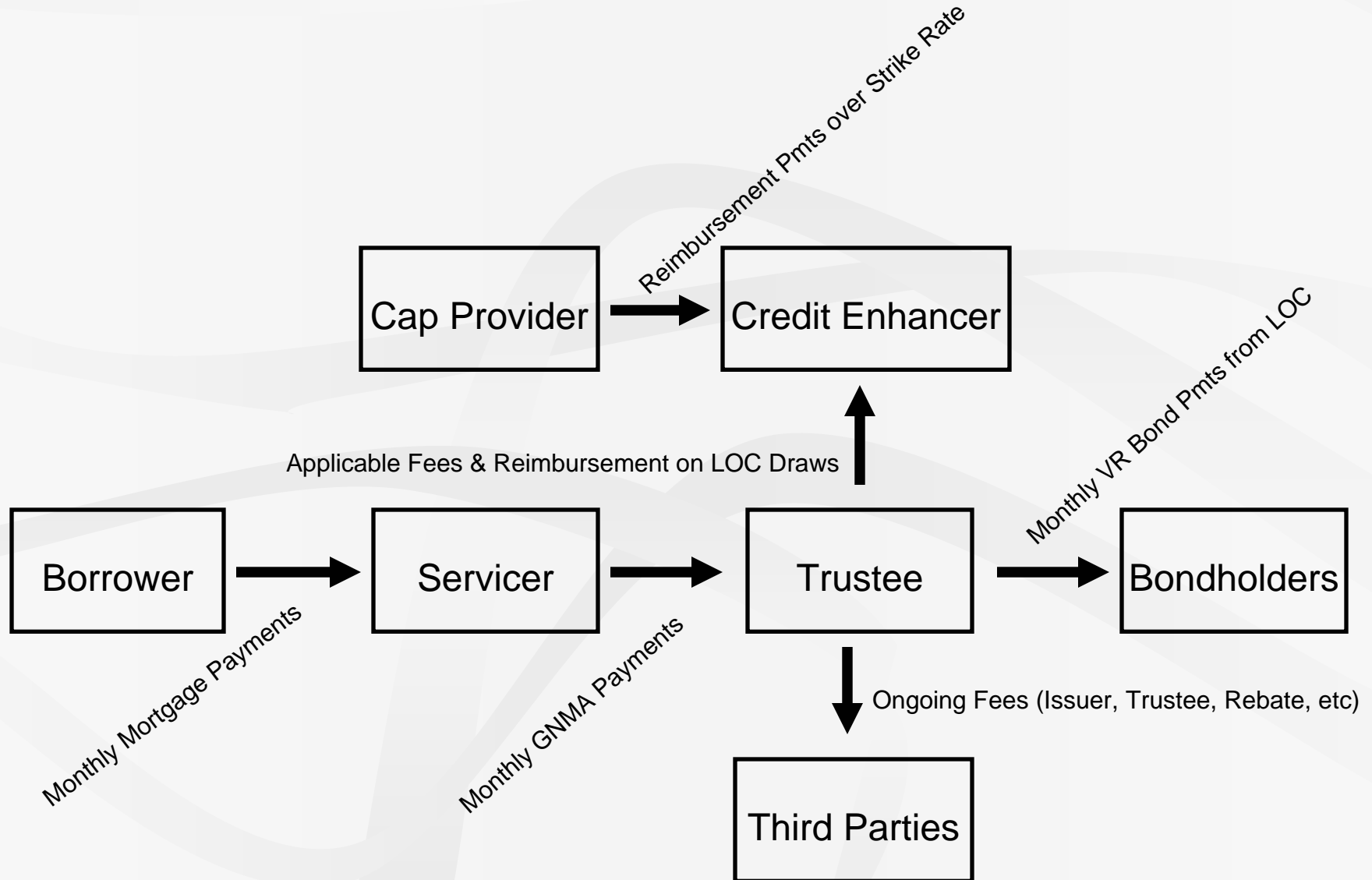
3. Require both the **credit enhancement facility provider** for the Bonds (i.e. Letter of Credit Bank) and the **liquidity provider** (if a separate entity) to have at least an “A” rating from one of the major rating agencies.

NOTE: Most credit enhancers/liquidity providers (and even tax credit investors) will either require or provide an interest rate hedge (i.e. a “cap”) and require the Borrower to cover the associated expense either upfront or on-going (out of surplus cash, if any).

Variable Rate Bonds with FHA/GNMA (con't)

4. Place all of the interest rate risk on the liquidity provider, limiting its reimbursement sources to (i) scheduled payments on the GNMA Securities, (ii) any interest rate reserve they may require funded from the spread, if any, between the rate on the GNMA and the interest rate on the bonds plus related costs (liquidity, hedge costs, issuer, etc.) and (iii) up to 75% of the surplus cash of the Project.

FHA/GNMA Variable Rate Bond Structure



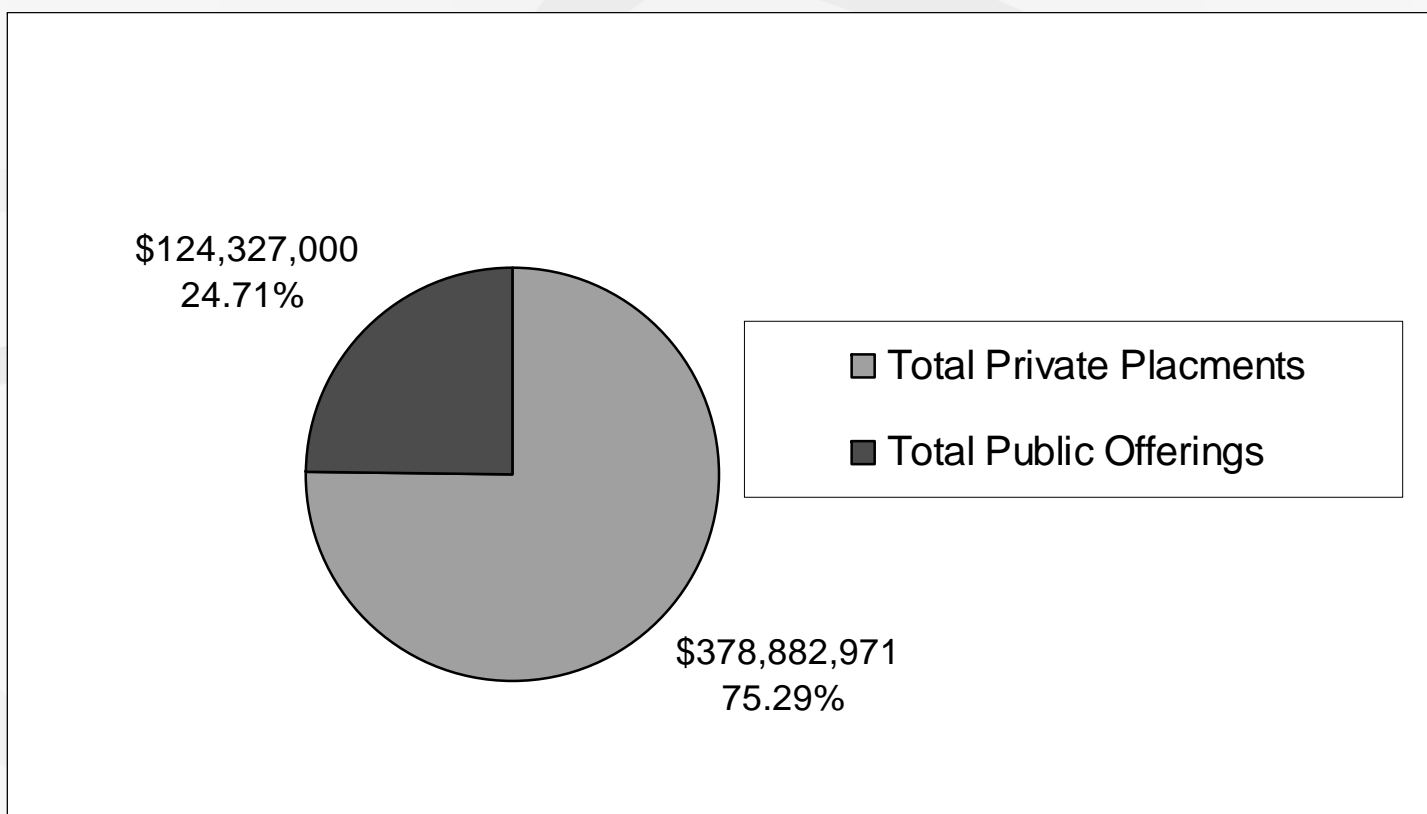
Competitive Threat from the Emergence of Tax-Exempt “Conduits” for Fixed-Rate Executions

- Conduits are organizations which **purchase long-term (eg. 35- to 40-year) non-credit enhanced, fixed-rate tax-exempt bond issues**, secured only by real estate and possibly a letter of credit through construction and rent-up.
- Examples: Newman Capital, Charter Mac, Muni Mae, U.S. Bank, Bank of America.
- Loan to value may be high (85-90%) and debt service coverage ratios low (1.10-1.15).
- Amortization periods may be relatively long (eg., 35 or, in some cases, 40 years).
- Interest Rates may be relatively high (5.50 – 6.75% or more), but front-end costs very low and underwriting process can be very short (eg. 60 days).
- Serious competition to FHA/GNMA execution, at least on small loans.

STIFF COMPETITION

California Private Placements vs. Public Offerings

Current List of Pending CDLAC Financings (as of April 1, 2006)





How Can HUD Be More Competitive?

1) **Continue efforts to make underwriting process predictable**

- Bond Financings are complex, and surprises in loan underwriting can have devastating results.

2) **Assure timely process; coordinate with Bond/Tax credit side.**

- Most allocations must be used within a discrete time period (eg. 90-120 days) or private activity bond volume allocation and commitment fee is lost.
- Most states allow “escrow closings” if loan almost in place, but such closings increase cost and complexity of deal.
- Some states, eg. Texas, do not permit escrow closings, so volume lost if FHA loan not closed in time allowed.

3) Allow use of variable rate bonds with FHA/GNMA, subject to appropriate restrictions, at least on pilot basis.