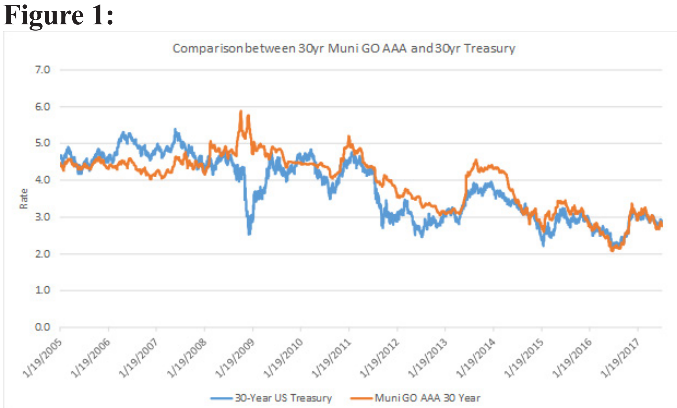
Cash Collateralized Tax-Exempt Bonds 2.0: Innovative Financing for the Current Environment

In late 2008, the global credit markets stood still in the wake of the most severe financial collapse since the Great Depression of 1929. Many highly rated fixed-income securities were decimated in what we now refer to as the "Great Recession". Global fixed-income investors seeking the relative safety of the U.S. Treasury mobilized a massive flight to quality, driving U.S. Treasury yields to unprecedented lows in the process. Meanwhile, credit concerns about municipalities and their ability to survive the downturn pushed tax-exempt yields sharply in the other direction. This perfect storm of declining investor confidence resulted in a yield curve anomaly: yields on long-term AAA-rated tax-exempt bonds exceeded those of U.S. Treasuries with similar maturities by as many as 200 basis points.

Figure 1:



Source: Municipal Market Monitor (TM3)

For developers of affordable housing, many of whom require the issuance of tax-exempt bonds in order to secure 4% low-income housing tax credit (LIHTC) equity, this represented a unique set of challenges.

IRC §42(d) provides that affordable housing projects funded with 4% LIHTC equity must be financed, in whole or in part, with tax-exempt bonds in an amount equal to 50% of the projects "aggregate basis" as also defined in IRC §142(d) (the "50% Test"). These bonds must remain outstanding until the project is "placed in service" – effectively until construction is complete. In 2009, as the long-term cost of tax-exempt bond financing threatened the viability of many affordable projects, a hybrid structure emerged as a practical solution. With the help of innovative attorneys, bankers and advisors, sophisticated affordable sponsors exploited the yield curve anomaly by combining long-term, taxable GNMA securities with short-term tax-exempt bonds. In a simultaneous transaction, the borrower/sponsor (1) issues short-term, tax-exempt bonds for construction and/or rehabilitation, and (2) secures a long-term, FHA-enhanced taxable permanent loan from the Department of Housing and Urban Development (HUD).

The financing team executes the transaction as follows:

- Bond investors purchase short-term tax-exempt bonds, and deposits cash into the bond proceeds account under a trust indenture administered by a trustee.
- The borrower requests monthly construction draws from the FHA/HUD lender.
- Once approved, the FHA lender funds the construction draws to the trustee for deposit into a separate collateral account also held under the same trust indenture.
- The trustee releases identical amount of bond proceeds from the bond proceeds account to the borrower for construction.
- The FHA lender requests a GNMA guarantee in amount equal to the construction draw.
- Upon approval, the FHA lender issues a GNMA security in an amount of the construction draw and delivers the GNMA security to the GNMA purchaser.
- Proceeds from the sale of the GNMA security are used to reimburse the FHA lender for the funds deposited into the collateral account earlier in the month.
- When the project is placed in service, funds accumulated in the collateral account, including accrued interest and negative arbitrage funded at closing, are applied to redeem the tax-exempt bonds.

This creative structure provided immediate benefits to both projects and state housing financing agencies (HFAs). For transactions that qualified for FHA permanent loans greater than the amount of bonds needed to satisfy the "50% Test", the cash-collateralized tax-exempt bond option significantly reduced the dollar amount of tax-exempt bonds required to complete the project. Meanwhile, the borrowing cost associated with the tax-exempt construction financing declined from more than 300 basis points (3.0%) per year to 50 basis points (0.50%) or less. Note that in today's market, net tax-exempt bond interest during construction for these transactions is close to zero. For debt service constrained loans, the lower taxable FHA loan rates produced significant additional loan proceeds compared to traditional, long-term credit enhanced bond executions.

In a hypothetical affordable transaction with a development budget of $20 million completed in 2009, this hybrid option reduced the amount of tax-exempt bonds requiring private activity bond volume cap allocation by approximately 25%. This resulted in significant negative arbitrage savings. When compared to traditional, long-term tax-exempt GNMA backed bonds, short-term cash collateralized tax-exempt bonds alongside either FHA 223(f) or 221(d)(4) mortgage loans produced long-term mortgage rate savings of 1.30% and 0.80%, respectively. In addition, the 223(f) option generated approximately 10% more proceeds that the traditional alternative, while the 221(d)(4) structure produced additional proceeds of approximately 7%.

The Current Environment

In today's post-recovery environment, combining cash collateralized short-term bonds with taxable permanent loans is still an attractive option. Although the yield curve anomaly described above is not as pronounced as in 2009, collateralizing short-term, tax-exempt bonds with taxable, FHA insured permanent debt is still the best option from a pricing perspective. However, unlike in 2009, today's real estate market is much more competitive, allowing sellers the freedom to eliminate contingencies, impose strict deadlines and reduce due diligence periods on affordable and market rate developers alike. Therefore, for time sensitive projects, preservation-minded transactions with stronger asset quality, or for projects seeking options beyond the FHA execution described above, a Fannie Mae alternative has emerged, using mortgage-backed securities (MBS) as collateral for tax-exempt bonds. This product, commonly known as M-TEBs ("MBS as Tax-Exempt Bond" collateral), has attracted cross-over attention from institutional investors that were not otherwise active in affordable housing and found its niche among preservation-minded developers with projects that tend to mature in 18 years or less. Fannie Mae's M-TEB reflects the next generation of a financing technique that first emerged out of absolute necessity during the Great Recession.

The Fannie Mae M.-EB structure is available for new projects and the refunding of existing bonds originally issued to finance 100% affordable and mixed-income developments in conjunction with 4% LIHTC. The transaction is executed as follows:

- The bond underwriter prices midterm tax-exempt bonds (15 – 18 years).
- The Fannie Mae lender originates the permanent mortgage loan and delivers those funds to the bond trustee.
- The lender's mortgage loan proceeds are held by the bond trustee as collateral for the bonds; bond proceeds are disbursed to the borrower.
- Fannie Mae issues an MBS (pass-thru rate = bond coupon) backed by the permanent mortgage loan.
- The MBS is delivered to bond trustee, identified as the "MBS investor".
- The trustee releases mortgage loan proceeds back to the lender in exchange for the MBS.

Figure 2 reflects indicative pricing levels in the current market using both the longer-term GNMA-backed option, which is most suitable for new construction projects, and the M.TEB option, which is popular with preservation projects having a final maturity of less than 20 years.

Figure 2:

$14,400,000
Short-Term Cash Backed Bonds With Taxable Ginnie Mae Sale

FHA Program:	223(f)	221(d)(4)
Term:	35 Years	42 Years
Permanent Mortgage Loan:		
GNMA Pass-Thru Rate	**3.00%**	**3.42%**
Servicing + Gty Fees	0.25%	0.25%
Total Loan Rate	**3.25%**	**3.67%**
Add: MIP	0.25%	0.25%
All-In Borrowing Costs	**3.50%**	**3.92%**

$10,400,000
Mid-Term Cash Backed Bonds With Taxable Fannie Mae Sale (M.TEB)

Term:	18 years
Permanent Mortgage Loan:	
FNMA Pass-Thru Rate	**2.87%**
Servicing + Gty Fees (1)	1.29%
Total Loan Rate	**4.16%**
Add: Issuer/Trustee	0.15%
All-In Borrowing Costs	**4.31%**

(1) Reflects Loan Amount in Excess of $10 million

Other Variations

From left to right, the above table illustrates two current, although not entirely comparable, bond structures that have become popular with long-term new construction and preservation projects respectively. However, under certain circumstances, short-term tax-exempt bonds issued to fund construction or moderate rehab and satisfy the 50% Test can be collateralized with credit-enhanced long-term bonds as well. Many state housing finance agencies (HFAs) offer subsidies and PILOT programs that remain in place only as long as the HFA's debt financing is outstanding. This can create an incentive to utilize state HFA funding for as long of a term as possible. For example, if a particular state HFA's PILOT program is considerably more attractive than a municipal alternative, the HFA's long-term bonds (either taxable or tax exempt) can be credit-enhanced by FHA, with the proceeds used to collateralize short-term tax-exempt bonds. This hybrid structure can be especially compelling, as it can produce both the mortgage loan savings described above, as well as operational savings resulting from a long-term PILOT.

Designated FHA/Fannie Mae lenders and FINRA registered broker dealers that are actively engaged in the innovative hybrid structures described above, can use market interruptions and volatility as an opportunity to deliver creative financing solutions for affordable developers.

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