THE CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

Private Activity Bonds Workshop

Wednesday, September 7, 2011

10:00 AM – 3:00 PM

Federal Reserve Building

950 So. Grand Avenue

Los Angeles, California 90015

Combining Tax Exempt, Short-Term Bonds with Taxable GNMA Sale for Affordable Apartment Financings

Presented by:

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COMBINING TAXABLE GNMA SALES WITH TAX EXEMPT BONDS AND 4% LIHTC

- **Taxable GNMA Markets** continue to deliver lower pricing than Long-Term Tax Exempts.
  - 221(d)(4) CLC/PLC Sale = Sub 5.00% Mortgage Note Rate
  - GNMA securities sold on "forward delivery" basis and thus no substantial negative arbitrage
- **Traditional Long-Term Tax Exempt Bond Financing**
  - Bond Coupon 5.75% + 25 BPS GNMA/Svcg + .15 Issuer Fee = 6.15% ML Rate
  - Major Negative Arbitrage Deposit (~10% of Loan Amount) on 221(d)(4) New Cons./ Sub Rehab Deal
- **Advantage of Taxable: Well over 100 basis point lower** permanent **borrowing rate** and **dramatic reduction in negative arbitrage** deposits required for long-term tax exempt bond execution

COMBINING TAXABLE GNMA SALES WITH TAX EXEMPT BONDS AND 4% LIHTC

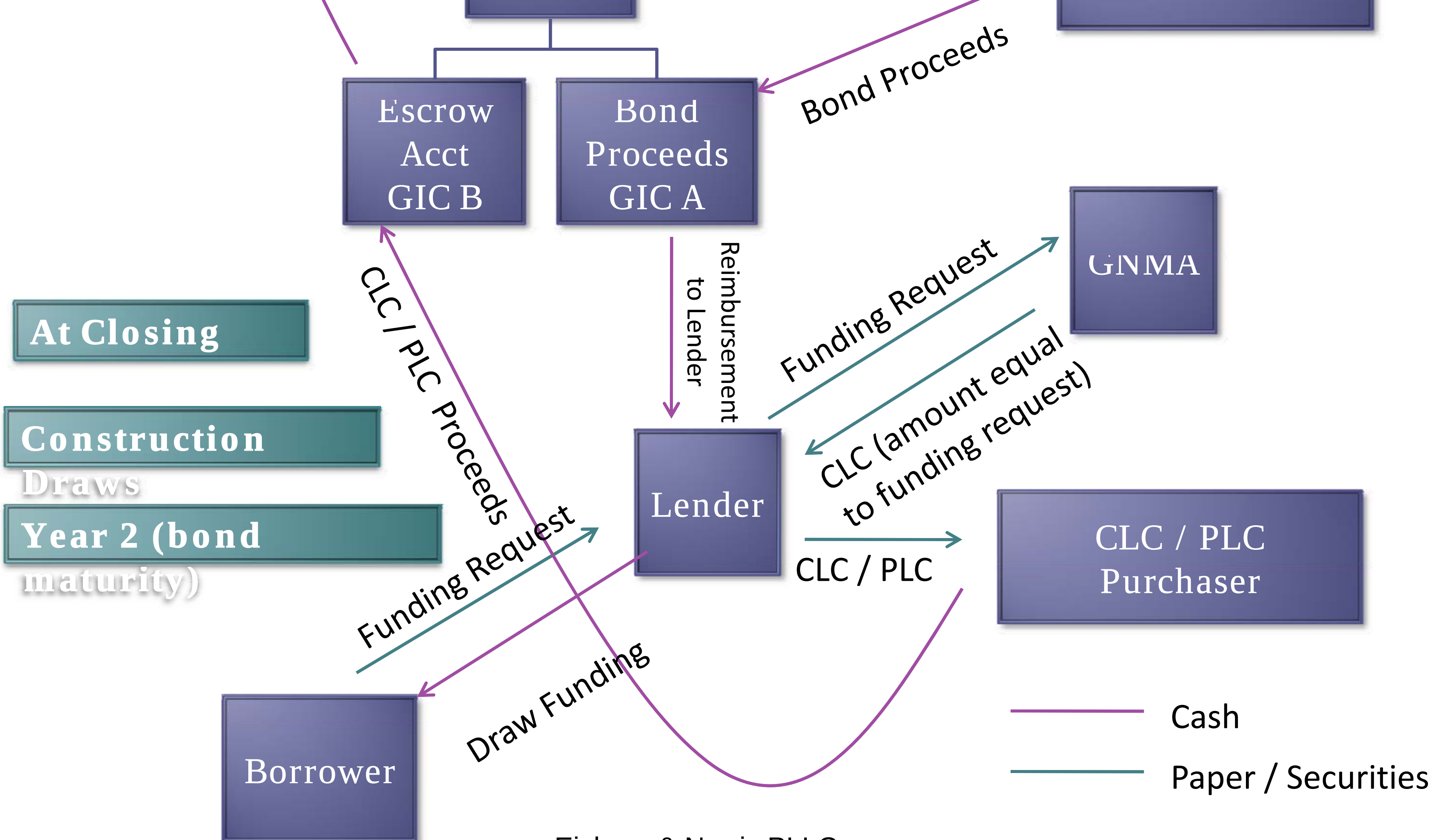
- **Dilemma:** Owner is required to **finance 50% of project's land and depreciable basis** with **tax exempt bonds,** and keep these tax exempt bonds outstanding until Project's placed in service date

- **Solution:** Issue **Short-Term GIC ("Guaranteed Investment Contract")-backed tax exempt Bonds**; **Sell GNMAs into taxable market**, **cross proceeds** (discussed below); **pay off TE Bonds on placed in service date**

PROPOSED TAX EXEMPT BOND STRUCTURE

- **Assume $25.0 Million Total Development Cost; $18 Million** Section **221(d)(4) FHA insured mortgage loan; 12 Month** FHA **construction** period
- **$13.0 Million Tax Exempt Bonds** issued (to meet "50% Test") **maturing 24 months after closing**
    - **~1.5% Interest Rate**
    - **Proceeds initially invested** in one of 2 GICs from same investment grade rate provider ("GIC A") – yield **~0.25%; Assume 0%**
    - **Negative arbitrage ~ 1.50%** x 2 yrs = **~3.0% Total Negative Arbitrage**

Alternative GNMA Bond Structure



MECHANICS OF PROPOSED TRANSACTION

Bond Side:

- **Underwriter Sells $13.0 million of TE Bonds** to **TE Bond Purchaser**
- **Bid two AA- or AAA-rated Guaranteed Investment Contracts** with same provider at same rate(eg. 0.25%):O ne **(GIC "A")** for investment of **Bond proceeds** until disbursed and second for **("GIC B")** for **replacement cash collateral** when received
- At closing $13 Million Bond Proceeds deposited into GIC A, $0 in GIC B

FHA Loan Side:

- **FHA Lender (also GNMA Issuer) sells $18.0 million of GNMA Securities ("CLC's" and "PLC",** discussed below**)** to be issued with respect to FHA insured 221(d)(4) loan to **Institutional GNMA Purchaser on "forward delivery" basis**

MECHANICS OF PROPOSED TRANSACTION (CONT'D)

Post Closing:

- As each **"construction loan certificate"** or **"CLC" is issued** by FHA Lender with respect to each insured loan advance and delivered to GNMA Purchaser, CLC **purchase price** paid is **deposited into GIC B** under Indenture, **against withdrawal of equal amount** of **Bond proceeds from GIC A**, which is delivered to FHA Lender to retire its warehouse credit line draw, which funded the corresponding FHA loan advance

- Upon delivery of each CLC, amount in GIC A goes down and amount in GIC B goes up by equal amount – **always totals $13.0 million – TE Bonds still 100% cash collateralized**

- Interim FHA loan draws above $13.0 million reimbursed to Lender directly by sale of CLC's to Institutional GNMA Purchaser

MECHANICS OF PROPOSED TRANSACTION (CONT'D)

- Upon final endorsement of FHA insured loan, FHA Lender issues GNMA in form of Permanent Loan Certificate ("PLC") against delivery to it by Institutional GNMA Purchaser of purchase price in form of previously issued CLC's plus cash in amount of final FHA Loan advance

- **TE Bonds kept outstanding until Placed in Service Date**, when $13 million of replacement proceeds in GIC B used to redeem Bonds

Result:

- **TE Bond proceeds spent on qualified Project costs** as contemplated by Section 142(d) of Internal Revenue Code

- **Bonds rated same** high investment grade rating **as GIC Provider – AA or AAA**, with **no separate credit enhancement**

RESULTS OF STRUCTURE

Net Results – Borrower:

- **Well over 100 BPS Savings in Permanent Borrowing Rate, resulting in a lower cost of capital over the life of the loan**
  - Increased Loan Proceeds and/ or
  - Increased Cash Flow

- **Negative Arb. reduced from ~10-12 points or more to ~2-3 points**

- **Full syndication value of 4% LIHTC equity on affordable units achieved**

RESULTS OF STRUCTURE - SUMMARY

	Traditional Long-Term Tax Exempt GNMA Backed Bonds		Short-Term Cash Back Bonds with Taxable GNMA Sale	
Tax Exempt Bonds Issued: 1 Sized to meet 50% test ($25.0 Mil total cost)	$18,000,000		$13,000,000[1]	
Tax Exempt Bond Term	42 Years		2 Years	
Mortgage Loan Interest Rate				
	Bonds	5.75%	GNMA	4.50%
	3rd Party Fees	0.15%	3rd Party Fees	N/A
	Servicing + GNMA Fee	0.25%	Servicing + GNMA Fee	0.25%
	Total ML Rate	6.15%	Total ML Rate	4.75%

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 $2,070,000 (11.5% of ML)	1.50% x $13,000,000 x 2 years $390,000 (2.0% ML)
Negative Arbitrage (Actual):	$1,035,000 (5.25% of ML)	$390,000 (2.0% ML)

RESULTS OF STRUCTURE – TAX LAW

Net Results – IRS:

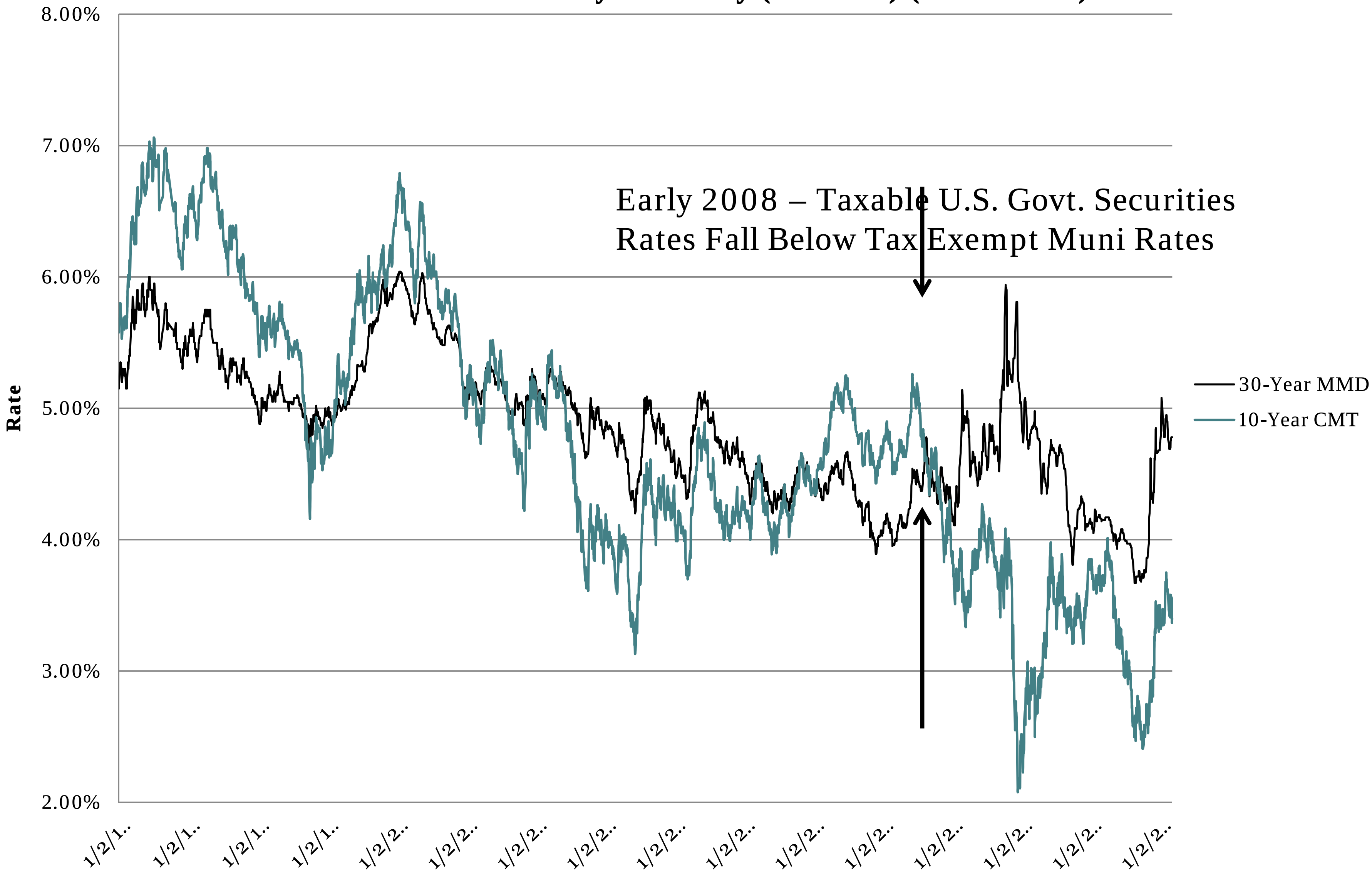
- **$13.0 mil. of TE Bond proceeds used to fund Qualified Project Costs** – significantly lower TE Bond amount (by $5.0 million in example) than if $18.0 million FHA loan had been funded with long-term tax exempt bond issue
- **No arbitrage "artifice or device"** - all TE Bond Proceeds (and replacement proceeds in GIC B) invested at far below TE Bond yield
- **No "over issuance" of bonds or "overburdening" of market - only enough TE Bonds to meet 50% test**, and **outstanding 2 yrs. versus 42 yrs!**
- **Over eight major law firms have issued or agreed to issue unqualified approving opinions** on deals using this type of cash collateralized structure for all or part of numerous Tax Exempt Multi-family housing bond issues.

WHY DOES STRUCTURE WORK?

- **Structure exploits the much greater efficiency of huge forward delivery market for sale of taxable REMIC-eligible GNMAs** (100-150 BPS lower rates with no neg arb) **versus much, much smaller specialty "fully funded" market for TE MF housing bonds**

- Also reflects recent **"upside down" relationship of tax exempt** long-term municipal **rates** and long-term **taxable** U.S. Treasury **rates**
  - Following charts show long-term **tax exempt municipal yields** (30-year MMD) have been significantly **higher** than comparable **taxable U.S. Treasury yields**
  - At peak (early 2009), 400 basis points "upside down," **today, still 130 basis points upside down**

Long Term Rate Comparison: 30-Year MMD (Tax Exempt) (Blue Line) versus 10-Year Constant Maturity Treasury (Taxable) (Black Line)



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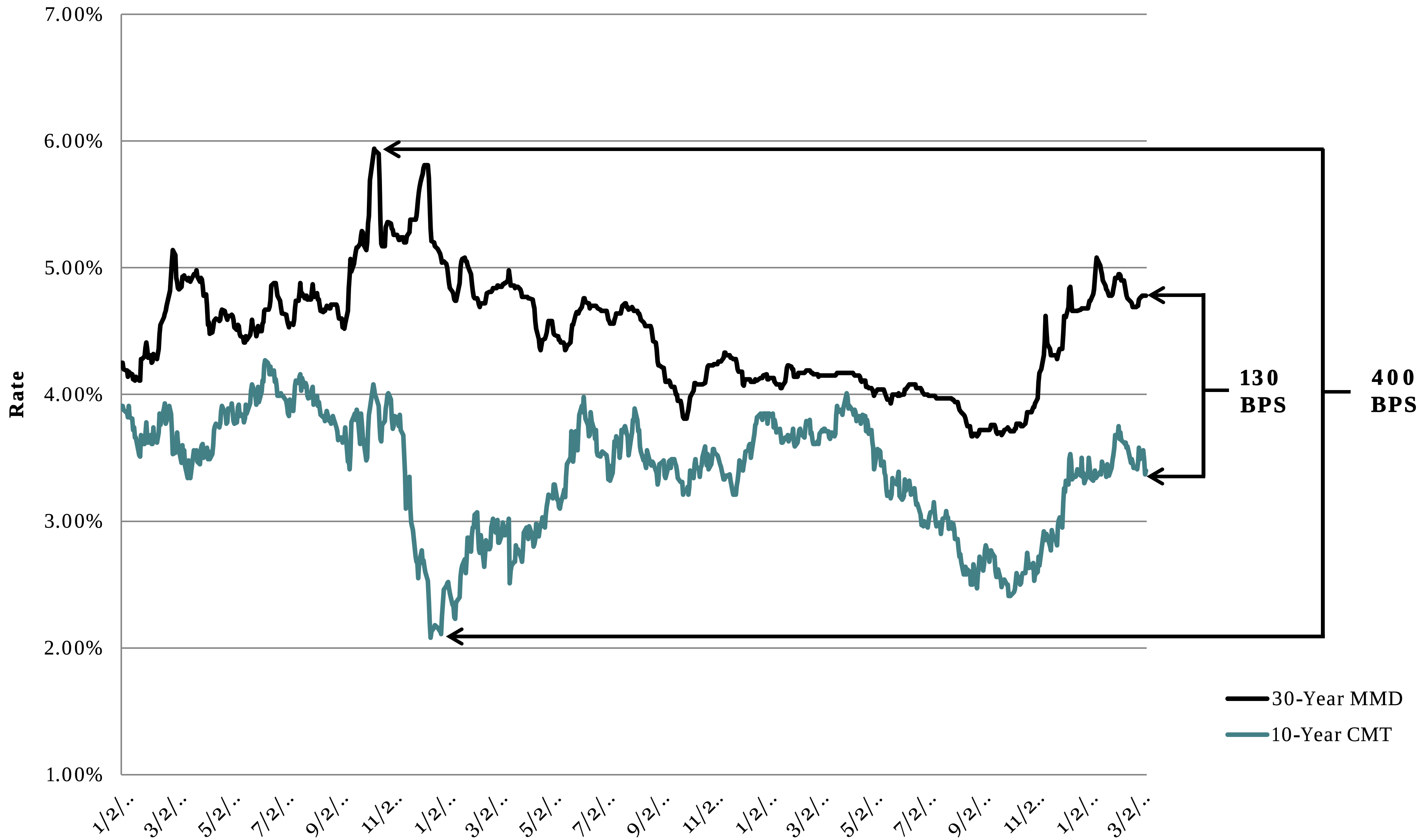

THE BIG PICTURE – OVERALL SOURCES AND USES

SOURCES - CONSTRUCTION PHASE	
TE Bond Financing (55% of tax credit basis)	$13.0 million
Sale of GNMA's with respect to Balance of FHA Insured Mortgage Loan	5.0 million
4% Tax Credit Equity	4.0 million
Subordinated Bridge Loan	2.5 million
Deferred Developer's Fee	0.5 million
TOTAL SOURCES	**$25.0 million**

THE BIG PICTURE – OVERALL SOURCES AND USES

SOURCES – PERMANENT PHASE	
Section 221(d)(4) FHA Insured First Mortgage Loan	$18.0 million
4% Tax Credit Equity	6.5 million
Various Subordinate Loan Funds	0.5 million
Total	**$25.0 million**

THE BIG PICTURE –USES

USES – PERMANENT PHASE	
Land	$3.5 million
Building	15.0 million
Soft Costs	2.5 million
Other	4.0 million
Total	**$25.0 million**

CONCLUSION

- **Documents and rating agency criteria well developed**

- Doesn’t work in all interest rate markets, but **now**, like early 2009, **relationship of rates on taxable GNMAs to rates on long-term TE MF Hsg Bonds very favorable**

- **Highly unlikely market conditions will change** in next **12-18 months** to favor traditional long-term tax exempt bond structure

- Most **major bond counsel** firms **will now approve**