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Financing Publicly Owned Multifamily Housing Through Build America Bonds

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WHAT IS A BUILD AMERICA BOND ("BAB")?

- The American Recovery and Reinvestment Act of 2009 ("ARRA") adopted February 17, 2009 permits issuers of certain **governmental municipal bonds** to elect to have **interest** treated as **includable in gross income** for federal income tax purposes and to receive (contemporaneously with the payments of interest on the bonds) a **cash subsidy payment from the U.S. Treasury equal to 35% of the interest payable on the bonds**
- These bonds are called "Direct Subsidy Build America Bonds" or **"Direct Subsidy BABs"**

BENEFIT OF BABS: DRAMATICALLY LOWER NET BORROWING COSTS

- The chart below illustrates an example of the low debt financing rates that can be achieved for publicly owned housing through the use of Build America Bonds, as compared to a traditional tax-exempt bond financing:

FHA § 221(d)(4) or § 232/GNMA New Cons/Sub Rehab:	**Tax-Exempt Bond Issue**	**Taxable "Drawdown" BABs Issue**
Est. Bond Coupon	5.20%	6.50%
(less 35% BAB subsidy)		(2.28)%
Net Interest Cost	5.20%	4.22%
Plus: GNMA Guaranty/ Svg & Mort. Ins. Prem.	0.70%	0.70%
All-In Borrowing Cost	**5.90%**	**4.92%**

Savings: Almost 100 Basis Points!!!

AND

No 6-8% upfront deposit for project fund negative arbitrage!!!

FHA § 223(f)/GNMA Acq/Light Rehab:	**Tax-Exempt Bond Issue**	**Taxable BABs Issue**
Est. Bond Coupon	5.10%	4.50%
(less 35% BAB subsidy)		(1.58)%
Net Interest Cost	5.10%	2.92%
Plus: GNMA Guaranty/ Svg & Mort. Ins. Prem.	0.70%	0.70%
All-In Borrowing Cost	**5.80%**	**3.62%**

Savings: Over 200 Basis Points!!!

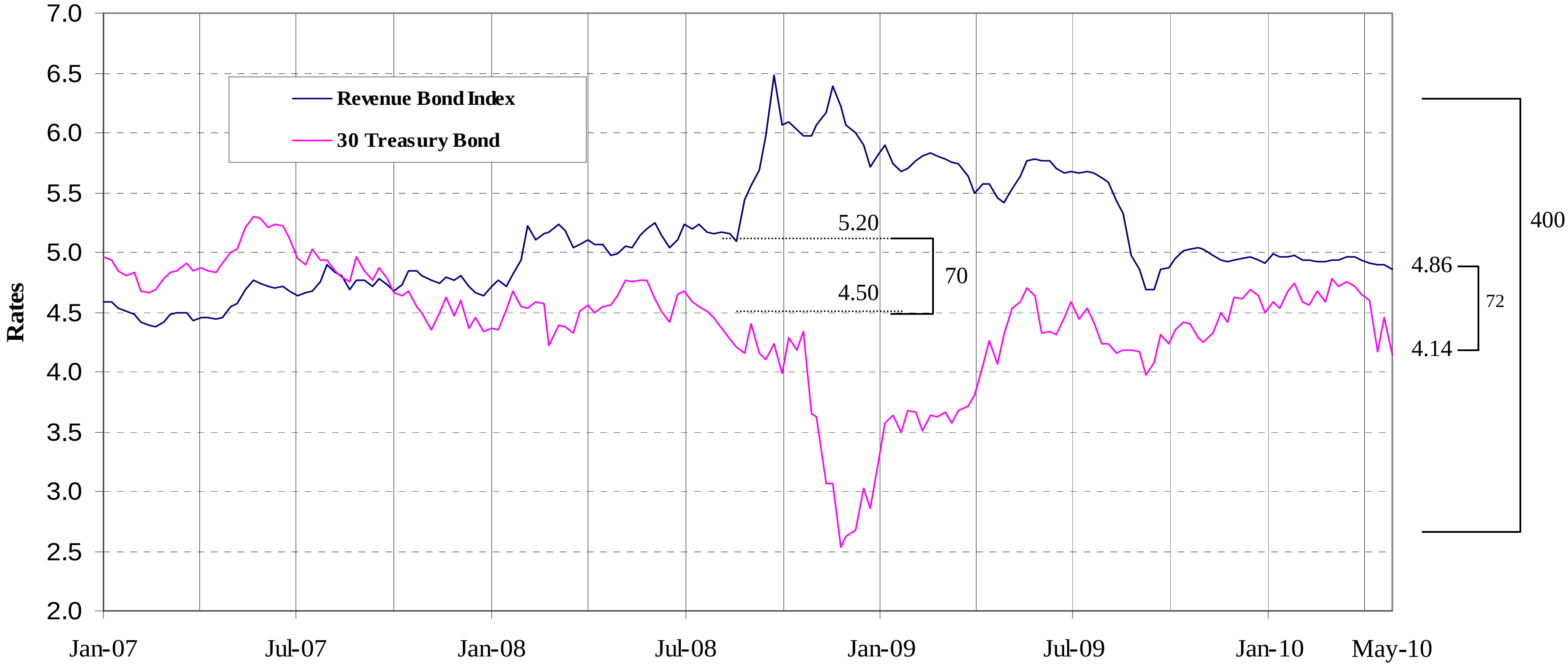
- **Similar low rates** achievable in financings credit enhanced by **Freddie Mac, Fannie Mae** or other credit enhancers or by the **general credit of the authority, city or county** if highly rated

BACKGROUND: WHY BUILD AMERICA BONDS?

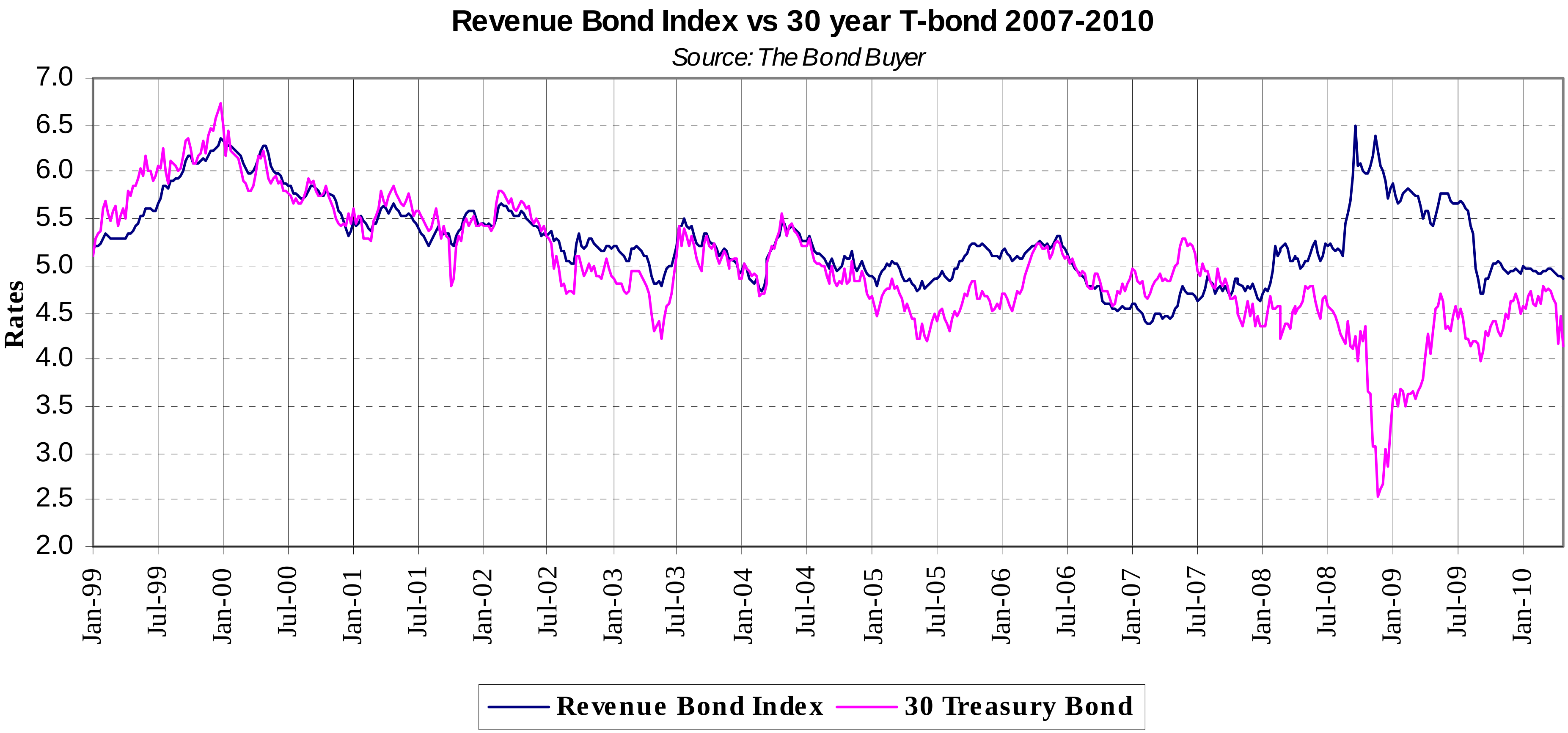
- Financial Markets Crisis in the Fall of 2008
- At peak in late November, 2008 long-term tax exempt revenue bond yields, which normally are about 90% of long-term U.S. Treasuries, were actually 400 basis points HIGHER than 30-year taxable U.S. Treasury Bond yields
- Result: For municipalities, tax exempt status of muni bond debt worthless – municipal issuers effectively unable to lower borrowing costs through issuance of tax exempt bonds

Revenue Bond Index vs 30 year T-bond 2007-2010

Source: The Bond Buyer



This longer term view of the preceding chart shows how unusual this rate inversion has been.



BACKGROUND: WHY BUILD AMERICA BONDS?

- State and local governments asked Congress for relief in stimulus legislation: allow issuance of **taxable muni bonds**, but have federal government offer issuers either (i) **a stream of cash payments equal to 35% of the interest paid on the taxable bonds ("Direct Subsidy BABs")** or (ii) entitle the purchaser to claim tax credits in an amount equal to 35% of the interest paid on the taxable muni bonds ("Tax Credit BABs")*
- **35% Subsidy stream is based on market-determined interest coupon**. Does not apply to "credit enhancement" and other ongoing fees which may be treated like "interest" for federal arbitrage/rebate purposes
- **Subsidy stream is paid for full term of bonds,** so long as bonds remain outstanding
- BABs have become a **major component of** all **municipal finance**. There were **878 issues** from April 15, 2009 through January 28, 2010 totaling **$71 billion** or **approximately 24%** of the approximately $301 billion **of municipal bonds** issued during this period

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**All BABs issued to date have been Direct Subsidy BABs*. The value of the subsidy of Tax Credit BABs is only about 25% of the interest coupon even for the highest bracket tax payers, and the market for tax credit bonds of all types has been very slow to develop.

BASIC REQUIREMENTS OF BUILD AMERICA BONDS

- **Under present law, the issuer of the bonds** and **the user of the facilities financed each must be a state or a political subdivision** of a state (e.g., a traditional municipal issuer/borrower, including counties, cities, housing authorities, redevelopment agencies). **The issuer and the borrower**/project owner **may be different public bodies**
- BABs **cannot be** issued for facilities owned by Section **501(c)(3) borrowers* or** by **profit-motivated sponsors. However, profit-motivated parties can perform** development, contracting, management and other **functions and be paid** for their services

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*See slide 15 on **Administration's budgetary proposal to extend BABs to some non-profit borrowers** and make the program permanent, albeit at a lower (28%) subsidy rate, and slide 17, describing the Build America Bond extension proposals in The American Jobs and Closing Tax Loopholes Act of 2010 (**"H.R. 4213"**), released from conference committee on May 20, which **does not extend BABs to non-public borrowers.**

BASIC REQUIREMENTS OF BUILD AMERICA BONDS

- The BABs must be **issued on or before December 31, 2010***
- The **proceeds** of Direct Subsidy BABs net of 2% allowed for costs of issuance and funding any reasonably required reserve funds must be **used for new construction or acquisition and rehab of new facilities** or other **capital expenditures**
- **Financing of working capital, refinancings and other such expenditures are not permitted** from proceeds of direct subsidy BABs, **but such expenditures may be financeable from traditional tax-exempt or taxable municipal bonds backed by same credit****

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* **See slide 15 on Administration's budgetary proposal to permanently extend BABs beyond December 31, 2010 at 28%** subsidy level; **H.R. 4213 would extend through 2011 and 2012 at subsidy levels of 32% and 30%, respectively**

Proceeds of **tax credit BABs, if this market develops, **can be used for refinancings** as well as capital expenditures. In addition, the **Administration's proposal** would **expand** the use of BABs proceeds to **refi's and working capital;** H.R. 4213 would permit BABs to be issued through December 31, 2012 to effect a current refunding of previously issued BABs, but not other debt obligations

BASIC REQUIREMENTS OF BUILD AMERICA BONDS

- BABs must satisfy the **same requirements** (arbitrage, rebate, issue price rules, etc.) as if they had been issued **as traditional tax exempt municipal bonds**
- Many issuers issue **combination of BABs** for capital expenditure component **and traditional tax exempt muni bonds** (with no BAB subsidy) for working capital and/or refi component
- Also, many issuers do **combination** of traditional **tax exempt** issue for bonds maturing in **first 10-15 years**, where tax exempt yield curve is very steep and borrowing costs are low, with **BABs** being used for **longer maturities**, where tax exemption doesn't lower the coupon paid nearly as much

STRUCTURING ISSUES

- Mostly relate to **reliability/duration of 35% U.S. Treasury cash subsidy stream**
- **Low or no appropriation risk**
- **Change of use; Code violation risk**. Considered manageable, as in the tax exempt arena
- **Potential for offset** against amounts owed to U.S. Treasury by municipal issuer, but risk considered very low with states and municipalities; only a few instances so far
- **Subsidy may only last as long as BABs outstanding**
  - Payable on amounts due on the bonds; would terminate upon early redemption

STRUCTURING ISSUES

- **HUD has recently agreed to "wrap" BABs cash subsidy stream** in mortgage loan underwriting.* This should enable public borrowers using FHA insurance to **achieve maximum proceeds**. In many instances, HUD's replacement cost limits (83.3% to 90% of replacement cost plus 8% Builder and Sponsor Profit and Risk allowance ("BSPRA") on a section 221(d)(4) new construction or sub rehab loan - or – 83.3% to 85% of value on a section 223(f) acquisition/light rehab loan) will limit the loan size. In other words, in many cases the **loan will not be debt service constrained**, and thus there will be some BABs subsidy not needed to support the FHA insured loan
- This should enable us to structure a small **separate subordinate series** of debt (may be taxable BABs, taxable non-BABs and/or tax exempt, depending on use of proceeds) and **pledge the unused portion** of the **U.S. Treasury cash subsidy stream plus project surplus cash** to prepayment of that debt
- HUD will require another public authority to agree to step in to assume ownership to maintain the BABs subsidy stream if the initial public mortgagor defaults
- **All debt must pass traditional debt/equity tests**

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* As of this date Fannie Mae and Freddie Mac have not agreed to wrap the BABs subsidy stream in their loan underwritings, but a county or other creditworthy body might pledge its credit under a lease lease-back arrangement

RECOVERY ZONE ECONOMIC DEVELOPMENT BONDS – SUPERCHARGED BUILD AMERICA BONDS

- Section 1401 of ARRA provides for the issuance of two types of recovery zone bonds: **(i) Recovery Zone Economic Development Bonds ("RZEDBs")** with a total nationwide volume allocation of **$10 billion** and recovery zone facility bonds ("RZFBs"), with a total volume of $15 billion. RZEDBs are essentially a **special type of Build America Bond**. RZFBs are a special type of tax exempt private activity bond to promote development or other economic activity in recovery zones
- Public authority issuer/borrowers who are considering the use of Build America Bonds to finance hospitals, nursing homes or housing projects and other types of facilities within an economic recovery zone, to the extent volume of such bonds as available in that jurisdiction, **can receive back from the U.S. Treasury** a cash payment in the amount of **45%** (rather than 35%) **of the interest paid** on this type of taxable Build America Bond

BENEFIT OF RZEDBS: EVEN MORE DRAMATICALLY LOWER NET BORROWING COSTS

- The chart below illustrates an example of the low debt financing rates that can be achieved for publicly owned housing through the use of RZEDBs, as compared to a traditional tax-exempt bond financing:

FHA § 221(d)(4) or § 232/GNMA New Cons/Sub Rehab:	**Tax-Exempt Bond Issue**	**Taxable "Drawdown" RZEDBs Issue**
Est. Bond Coupon	5.20%	6.50%
(less 45% RZEDB subsidy)		(2.93)%
Net Interest Cost	5.20%	3.57%
Plus: GNMA Guaranty/ Svg & Mort. Ins. Prem.	0.70%	0.70%
All-In Borrowing Cost	**5.90%**	**4.27%**

Savings: Over 160 Basis Points!!!

AND

No 6-8% upfront deposit for project fund negative arbitrage!!!

FHA § 223(f)/GNMA Acq/Light Rehab:	**Tax-Exempt Bond Issue**	**Taxable BABs Issue**
Est. Bond Coupon	5.10%	4.50%
(less 45% RZEDB subsidy)		(2.03)%
Net Interest Cost	5.10%	2.47%
Plus: GNMA Guaranty/ Svg & Mort. Ins. Prem.	0.70%	0.70%
All-In Borrowing Cost	**5.80%**	**3.17%**

Savings: Over 250 Basis Points!!!

REQUIREMENTS OF RZEDB'S

- Issuer must follow guidelines promulgated under **IRS Notice 2009-50** to designate an eligible area as a recovery zone: broadly defined as **"any area designated by the Issuer as having significant poverty, unemployment, rate of home foreclosures or general distress"**
- Proceeds can only be **used for qualified economic development purposes**, which include capital expenditures and certain other expenditures, but also for job training and educational programs but not for refinancing transactions
- **Sub-allocations of volume have been** made to states, cities, counties and other jurisdictions based on unemployment levels. Available at http://www.irs.gov/pub/irs-tege/rzblocalreallocations.pdf
- Example Allocation:

	Millions (Approx.)
New York City, New York	$81.0
Atlanta, Georgia	23.0
Charlotte, North Carolina	29.0
City of Chicago, Illinois*	133.2
Cook County, Illinois*	131.2
Entire State of Illinois*	667.0
Indianapolis, Indiana*	67.9
Entire State of Indiana*	313.1
Phoenix, Arizona	21.0
Los Angeles County, California	180.0
Chicago, Illinois	133.0
Richmond, Virginia	6.0

* See detailed allocations in the appendix

REQUIREMENTS OF RZEDB'S

- An issuer/borrower who contemplates use of Build America Bonds **might wish to designate the issue, or a portion of the issue, as a RZEDB**, in the event the activity being financing takes place in a recovery zone and there is still remaining RZEDB Bond volume in that jurisdiction to cover the activity proposed to be financed
- Could produce all-in borrowing costs to the issuer borrower in the range of **4% or below**
- **As of December, 2009, only about 5% of national RZEDB volume had been used**; **almost all states are reallocating** unused RZEDB volume in 2010
- **H.R. 4213, if adopted, would add another $10 billion of RZEDB Volume**, would allocate based on unemployment levels rather than job loss and would **allow program to run through 2011**

ADMINISTRATION'S PROPOSAL TO PERMANENTLY EXTEND AND EXPAND BUILD AMERICA BONDS

- The Obama **Administration**, with backing of the U.S. Treasury Department, **has** recently **proposed that BABs be extended and made permanent**. At the moment, the BABs program also appears to have broad Congressional support, so such an extension may be likely. Under the Administration's proposal:
  - The **cash subsidy** would be **reduced** from 35% of interest paid **to 28%**
  - **Proceeds could be used for refundings and refinancings** of completed capital projects **and** governmental **operating expenses and working capital**
  - **Section 501(c)(3)** organizations such as **nonprofit hospitals** and universities **would be eligible** to use proceeds of BABs
  - Would be **effective January 1, 2011**
  - **Part of President's FY 2010-2011 Budget; action unlikely before next Fall**

HOUSE AND SENATE PROPOSAL TO EXTEND BUILD AMERICA BONDS (H.R. 4213)

- "**The American Jobs and Closing Tax Loopholes Act of 2010**," released by the House Ways and Means Committee and the Senate Finance Committee on May 20, 2010:
  - **Would extend BABs for 2011 and 2012** at subsidy levels of **32% and 30%,** respectively
  - **Would allow BABs to be issued** through December 31, 2012 to effect a **current refunding of previously issued BABs, but not other debt** obligations and no funding of working capital
  - Would **not** extend to Section 501(c)(3) borrowers
  - **Would extend the RZEDB program through 2011,** and would allocate **an additional $10.0 billion** nationwide
    - Each State would get at least $90.0 million of this additional RZEDB volume
    - 2010 Allocation would be based on jurisdiction's share of that state's 2009 unemployment instead of net job losses
    - States would be given authority to by law treat a county or municipality as waiving any portion of an allocation of 2010 RZEDB volume if there is a reasonable expectation that such allocation would not otherwise be used

PROSPECTS FOR BABs EXTENSION

- **Very popular program** – now 30% of all municipal bonds – so **extension at some point may be likely**
- **Timing very uncertain** – **Not clear** extension will be done **by end of this year**
- **H.R. 4213 best hope for now but prospects very uncretain**; President's proposal not currently "on the table"
  - **BABs have been docoupled form extension of unemplyment benefits,** so unlikely to be acted on before Congressional recesses early August
  - **If not approved**, Congress might take up after Labor Day, but **must pass before Congressional adjournment in early October**, or attach BABs provisions to other legislation or a continuing resolution
  - At moment, up in the air
- **If no BABs extension in place by early fall, most borrowers will shift to fully funded structure to assure lock-in of 35% subsidy stream on all of the Bonds.** Will achieve lower interest rate, but requires substantial up front deposits for construction period negative arbitrage