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Major Tax-Exempt Multifamily Housing Debt Executions In An Era Of Rising Interest Rates*

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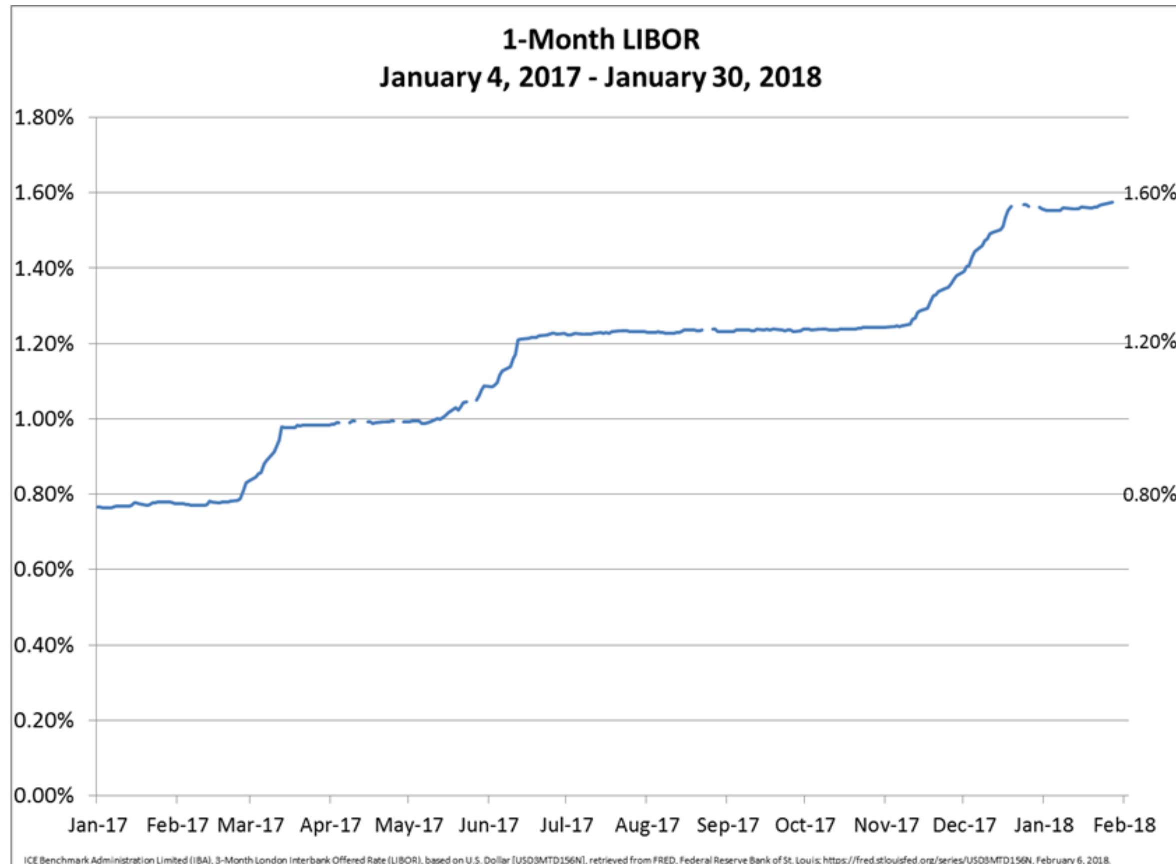
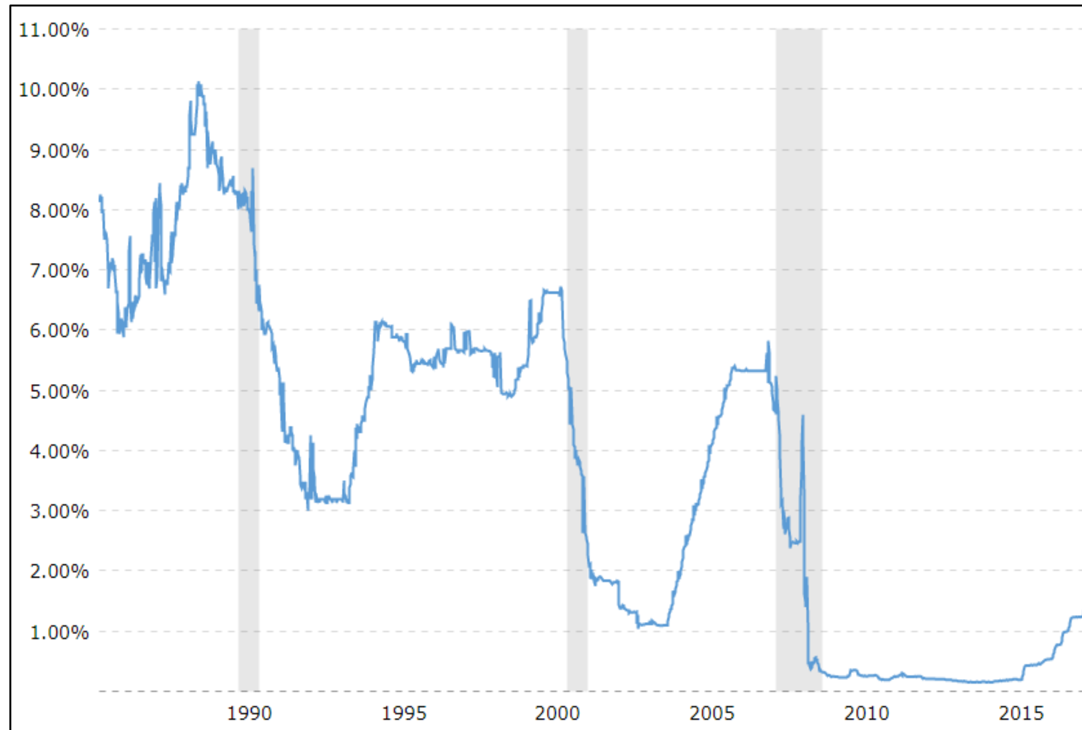
Interest Rates Appear to Be Heading Up, Possibly Reversing a 35-year Decline

- **Short-Term Rates.** The following charts show the level of one-month LIBOR over the past year and the past 35 years.



- As shown in the chart above, one-month LIBOR is around 1.60% today, or 20 basis points above last fall's 1.20% rate and 80 basis points above the rate in early 2017.

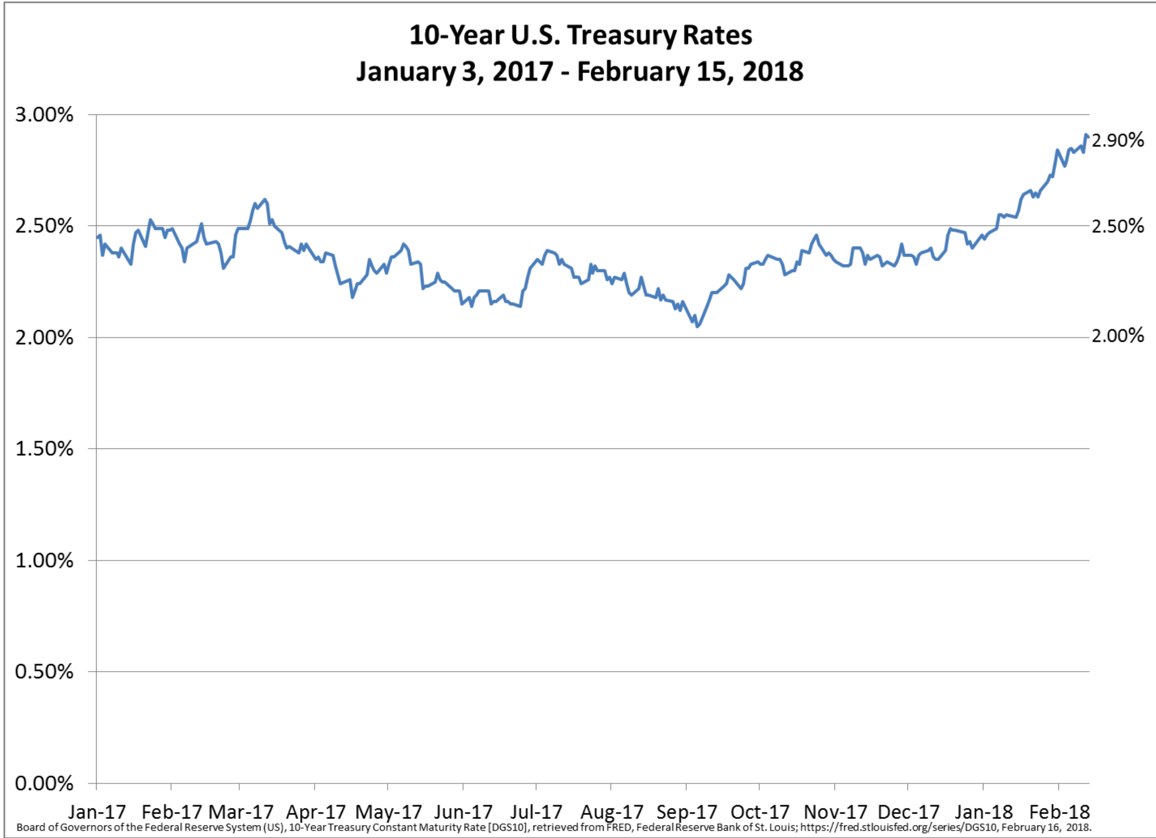
1-Month LIBOR
1985 - 2018



Source: http://www.macrotrends.net/2518/1-month-libor-rate-historical-chart

- As shown in the chart above, one-month LIBOR held at around 20 basis points for seven years from the fall of 2009 following the financial crisis in 2008 until it began to rise in 2015 to its present level of approximately 1.60%. While there have been major peaks and troughs, the general trend was down from a high of almost 10.0% in 1988 to the very low 20+ basis point level which prevailed from 2009 through 2015.

- **Long Term Rates.** The following charts show the yields on the 10-year U.S. Treasury Bond over the past year and over the past 54 years.



- As the preceding chart shows, the 10-year U.S. Treasury yield is now at 2.90%, up from a low of about 2.00% in September last year, and versus 2.20 – 2.30% for most of 2017 – a 60 to 70 basis point increase over the past year.

10-Year U.S. Treasury
1964 - 2018

Source: http://www.macrotrends.net/2016/10-year-treasury-bond-rate-yield-chart

- The preceding chart above shows the same long-term downturn in long-term rates as the second chart on one-month LIBOR shows in short-term rates. The 10-year Treasury yield peaked at a rate just under 15.0% in September of 1981 to a low of around 1.65% in late June of 2012. We are now over 100 basis points above that level.
- The Fed has announced that it may raise the discount rates 3 or 4 more times in 2018, and twice in 2019, which would be expected to raise both short-term and long-term rates.
- There is a lot of room for interest rates to move up from the historically low levels we have seen since 2008.

Borrowing Rates for Bank and Freddie Mac TEL Draw Down Private Placements

- In the past year, both the Pre-Conversion ("Construction") and Post-Conversion ("Permanent") interest rates on private placements have generally moved up, with the general increase in short-term and long-term rates shown in the one-month LIBOR rate charts above.

Pre-Conversion ("Construction") Borrowing Rates	January 2017	July-Nov. 2017	Early February 2018	
	0.80%	1.20%	1.60%	**Up about 80 Basis Points** in Last Year
1-Mo. LIBOR Spread (typically 220-250)	2.30	2.30	2.30	
	3.10%	3.50%	**3.90%**	

Post-Conversion ("Permanent") Borrowing Rates	January 2017	October 2017	Early February 2018	
	2.50%	2.10%	2.95%	**Up about 85 Basis Points** from Fall 2017
17-Yr LIBOR Spread (typically 200-240)	2.00 – 2.40	2.00 – 2.40	2.00 – 2.40	
	4.50 – 4.90%	4.10 – 4.50%	**4.95 – 5.35%**	

- Lenders will generally hold the **spread** for some time while the loan is underwritten, **but Lenders generally will not lock the Permanent Index Level** on which the Permanent Lending rate will be based until about a week before closing.

Fannie Mae M.TEBs

- The relatively new Fannie Mae M.TEBs product attempts to lower long-term borrowing rates by combining very attractive bond rates from publicly offered monthly pay MBS-backed tax-exempt bonds with a competitive guaranty/servicing spread.
- This product has really taken off over the past two years. Fannie Mae has now closed over 20 M.TEBs type financings in nine states having an aggregate dollar amount of over $300 million, and has another $650 million of M.TEBs financings in its pipeline.

Moderate Rehab M.TEBs

- The initial Fannie Mae M.TEBS structure involved a 16-year tax-exempt monthly MBS pass-through bond for mod rehab projects.
- The rehab may be as high as $40,000 or $50,000 or a bit more per door, so long as there are no substantial tenant relocation or re-tenanting issues.
- The Fannie Mae mod rehab DUS loan is funded by the DUS Lender at closing of the Bonds and commences amortization almost simultaneously with the issuance of the Bonds. No separate construction loan is involved under this structure.

New “Forwards” M.TEBs

- Fannie Mae’s new “forwards” M.TEBs product is for new construction/sub rehab projects. This product is just emerging and is rapidly gaining wide acceptance.
- This product not only offers very competitive rates and other underwriting terms, but Fannie Mae has shown great flexibility in permitting earn-out and/or other supplemental loan funding.
- The structure combines a 17 to 18-year fixed rate tax-exempt MBS monthly pass-through Bond with a taxable draw down construction loan from a bank or other construction lender.
- It entails 2-2.5 points of construction period negative arbitrage, but for many projects this disadvantage is more than offset by the favorable terms and flexibility on supplemental funding.

Borrowing Rates for M.TEBs

- Both versions of M.TEBs (mod rehab and "forwards") combine very low all-in borrowing rates and attractive loan terms (35-year loan amortization to balloon 15 to 16 years after placed-in-service/1.15 DSCR/85 to 90% LTV).

	Moderate Rehab Loan	"Forwards" M.TEB (New Construction/Sub Rehab)
10-Year Treasury	2.90%	2.90%
Spread	.70	.80
Tax-Exempt Bond Coupon/MBS Pass-Through Rate	3.60%	3.70%
Guaranty/Servicing	1.00	1.10
All-in Borrowing Rate*	**4.60%**	**4.80%**

*Excluding ongoing issuer, trustee, rebate fees and about 2 to 2.5 points of construction period negative arbitrage in the "Forwards" M.TEBS structure. Taking into account 2.5 points of negative arbitrage, the equivalent permanent rate would be **comparable to about a 5.00% permanent rate on the "Forwards" structure** when compared to other draw down executions.

FHA or RD/GNMA Taxable Loans and Short-Term Tax-Exempt Cash-Backed Bonds

- As interest rates move higher, we may ultimately return to a "right side up" interest rate environment which existed for decades before the 2008 financial crisis, when putting highly rated credit (like that of GNMA) behind long-term municipal bonds produced the lowest all-in borrowing costs for all executions.
- Selling long-term GNMA's in the taxable institutional markets still produces a significantly lower borrowing cost than selling long-term tax-exempt municipal bonds backed by GNMA.
- On new construction/sub rehab projects, also eliminates a potential 6-8 point negative arbitrage deposit associated with fully-funded long-term municipal bond financings.
- Finally, in financings with issuers that charge substantial ongoing fees, the short-term cash-backed bond structure can reduce all-in borrowing costs by as much as 25 to 40 basis points per year.

Borrowing Rates for FHA or RD/GNMA Taxable Loans (with Short-Term Tax-Exempt Cash-Backed Bonds)

	§223(f) (Mod Rehab)	§221(d)(4) (Sub Rehab/New Construction)
10-Year Treasury	2.90%	2.90%
GNMA to 10-Year Treasury Spread	.75	1.20
Taxable GNMA Pass-Through Rate	3.65%	4.10%
Servicing/GNMA Guaranty Fee	.25	.25
Stated Mortgage Loan Rate	3.90%	4.35%
Mortgage Insurance Premium (Affordable)	.25	.25
All-in Borrowing Rate	**4.15%**	**4.60%**

FHA or RD/GNMA Taxable Loans and Short-Term Tax-Exempt Cash-Backed Bonds

- As most industry participants are aware, over the past five years HUD **has quintupled** its FHA affordable loan volume and has dramatically improved its processing times.
- Loan terms continue to be very attractive (35-40 year level amortization (no balloon); 1.11 to 1.17 DSCR; 85% loan-to-value (223f); or 90+% loan-to-cost (221(d)(4)).
- Supplemental financing can be more challenging with HUD than under other platforms and Davis Bacon wages can be a barrier on Section 221(d)(4) loans in some markets.
- RD loans can require even longer to process than FHA, but in light of the willingness of RD to subordinate existing Section 515 financing, to provide additional financing under Section 538, the subsidies which are available, the unique focus RD brings to rural projects, and the ability to wrap the permanent loan component with GNMA securities, this execution now provides a uniquely effective loan platform for pools of these small project loans throughout the United States.

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RECENT DEVELOPMENTS ON SHORT-TERM CASH BACKED TAX-EXEMPT BONDS

- Good News: for such bonds combined with all forms of moderate rehab loans (e.g., FHA §223f, Fannie Mae, RD), we can now **eliminate or almost eliminate the bond-side negative arbitrage** on almost all of these bond issues.
- The same is now true with bonds issued in connection with new construction/sub rehab FHA (221(d)(4)) and RD loans, with all but a handful of issuers and bond counsel firms.
- In new construction/sub rehab FHA and RD projects, it continues to be **critically important** for the Borrower to speak with its Bond Underwriter and Underwriter's counsel **at the very outset** of these financings (i.e., **before applying for bond volume**) so that its reinvestment options can be maximized. This **can save hundreds of thousands of dollars** on these financings.

Where Are Interest Rates Headed Now and How Can Affordable Housing Borrowers Prepare for Further Potential Interest Rate Increases?

- Four factors suggest a higher yield curve in the near term:

1. Real Interest Rates are Still Low. The current rate on the 10-year Treasury of 2.90% is 90 basis points over the 2.0% approximate expected level of inflation over the next decade – a very low "real" rate of interest. At 2.0% inflation, a "real" interest rate on the 10-year Treasury would be 4.0%, or 110 basis points higher.

2. A Planned Massive 10-Year Deleveraging of the Fed's Balance Sheet Has Just Begun. The Fed has just commenced a 10-year planned deleveraging pursuant to which it will allow as much as $300 billion per year of $3.0 trillion of Agency (mainly MBS) securities it acquired in the financial crisis to amortize or mature without new purchases.

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3. Increased Federal Deficits will Require Increased Issuance of Treasuries. The Treasury's borrowing needs are projected to rise from $519 billion in the fiscal year ended September 30, 2017 to $955 billion in the fiscal year ending September 30, 2018 – **an 85% increase** - and to $1.083 trillion and $1.128 trillion in the two fiscal years thereafter. The Congressional budget compromise adds another almost $500 billion to federal spending and would increase the federal deficit by an additional $265 billion over the next two years alone.

4. Borrowers with Poor Credit Generally Pay More. The United States debt-to-GDP ratio now stands at about 77%. This is expected to rise to about 100% by 2027. The projected continuing decline in U.S. Credit generally is expected to exact a further upward influence on Treasury Rates.

- At today's rates, we lose one point in loan proceeds on a 35-year level amortization, debt service constrained loan per 7-10 basis points increase in rates from today's rates. If the 10-year Treasury rate is 100 basis points higher in 12 to 18 months, we may have lost 10-12% or so of our total funding on a typical deal.

What Can An Affordable Housing Developer Do?

- Perhaps the best general takeaway is this: If we are entering an era of continued rising interest rates, time is now your enemy, not your friend.
- For the immediate future, certainty and timeliness of execution may become more important hallmarks of a successful project financing.
- This may be especially true in states where the demand for private activity bond volume essential to these deals has now risen to levels which exceed supply.
- These states include Massachusetts, New York, New Jersey, Minnesota, Tennessee, Utah, Washington State, Texas and Virginia.
- Appling for volume and otherwise starting the financing process early may now be more important than ever in these states, especially if we are also facing rising interest rates.

Year 15 Forward Refinancing

- Remember: On a preservation project which has not yet reached Year 15, the borrower can pursue an immediate §223(f) or other refinancing at today's rates (perhaps partially prepayable), and transfer a major portion of the loan to a new borrower which it forms in Year 15. The new borrower can then have short-term tax-exempt cash backed bonds issued in year 15 to meet the 50% Test, close a 4% LIHTC syndication, and if necessary close a small supplemental loan to meet tax requirements. This can lock in today's rates for most of the debt two to three or more years in advance. The time to act on this may be now!