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Use of Principal Reserve Accounts in Variable Rate Credit Enhanced Tax Exempt Multifamily Housing Bond Financings

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Background

In most real estate secured bond financings, including tax exempt multifamily housing bond financings, the party or parties providing the credit enhancement for the bonds and taking the real estate risk on the project, will require the Borrower to be a bankruptcy remote, single asset mortgagor whose only substantial asset is the project. As a result, unlike the case with many corporate borrowings, there is no mortgagor with a large balance sheet having substantial liquidity component which will support the repayment of balloon debt at the end of a 20 or 30-year financing term. As a result, most real estate lenders require level amortization of the underlying mortgage loan commencing on a date after the projected date on which the project is expected to have completed construction or rehabilitation and rent-up and to have reached stabilized occupancy.

Traditional Loan Amortization Structure

On an FHA insured mortgage loan this commencement of amortization date is typically the estimated construction period plus four months allowed for cost certification. On most Fannie Mae and Freddie Mac credit enhanced transactions, "conversion" (i.e., stabilized occupancy) which triggers the loan amortization, is required to occur within a specified period of time (e.g., 24, 30 or 36 months) following the closing of the financing, with one or more six-month extensions allowed under most circumstances. Bond issues secured by such a level amortization loan are typically designed with so-called "mandatory sinking fund redemptions" or "scheduled mandatory redemptions" of the bonds which typically begin roughly six months after the underlying loan has begun to amortize. These scheduled sinking fund redemptions on the bonds simply aggregate the six monthly principal payments coming in on the mortgage loan (rounded up or down to a \$5,000 amount), and call for that dollar amount of bonds to be redeemed at six month intervals throughout the remaining life of the bond issue. These sinking fund payments, like the underlying loan principal payments, begin rather small and grow over the life of the bond issue, since during the early years of a level amortization loan, most of the underlying loan payments are interest, not principal. Toward the end of a bond issue, the substantial majority of the underlying loan payments will be comprised of principal, and scheduled mandatory redemptions or mandatory sinking fund redemptions on the bonds will be much larger.

On very large bond issues (e.g., \$20-30 million or more), especially where the investment banking firm has substantial retail capabilities, the first ten years of principal payments might actually be structured as “serial” bond maturities. In other words, each six month’s principal to be retired would be structured to comprise its own scheduled maturity of bonds. The buyer of that bond would know that all of its principal investment in that bond would be returned on the scheduled maturity date, and not before, unless some type of extraordinary redemption had occurred. The balance of such a bond issue would typically be structured as one or more term bonds (e.g., a 20-year term and a 30-year term), where each term would have a principal amount equal to the scheduled retirement of principal on the bond issue to occur during the period commencing six months after the latest serial bond maturity or the maturity of the next preceding term bond, and ending on that term bond’s maturity date.

Where a bond issue is structured either of these ways, once the underlying loan principal has been applied to pay a serial maturity or an underlying mandatory sinking fund redemption of a portion of a term bond, that portion of the bond issue is retired and ceases to remain outstanding for any purpose. This obviously provides the credit enhancer with comfort that the bond debt is being amortized in an organized and predictable fashion, so that its position as the credit enhancer and the party at risk on the real estate should become increasingly secure, assuming that the value of the project stays the same or increases over time. Most credit enhancers depend upon this ascending “asset coverage” when underwriting real estate loans according to whatever parameters they apply at the outset of the deal (e.g., 1.20 debt service coverage ratio and no more than 85% loan-to-value). The above technique is used on virtually all structured fixed rate multifamily housing bond financings, except in some circumstances usually involving very substantial developers on stabilized, exceptionally strong properties, where credit enhancers will sometimes allow some period of time (e.g., five or ten years after stabilization) for the debt to remain interest only and/or may allow a small “balloon” of principal due at the maturity of the loan and at final bond maturity or on some earlier mandatory tender date on the bonds. In the absence of these circumstances, virtually all structured tax exempt multifamily housing bond financings, like the underlying mortgage loans, are level amortization structures.

Emergence of the Principal Reserve Account Concept

As those familiar with tax exempt multifamily housing bonds are aware, a substantial percentage of borrowers have elected, due to the extremely steep slope of the tax exempt yield curve (typically 3.0% or 300 “basis points” or more), to finance their projects using variable rate 7-day demand “lower floater” tax exempt bonds, as compared to long-term fixed rate bond issues. This type of financing model has existed and been used in multifamily housing bond financings since the early 1980’s. However, with the emergence of more sophisticated risk management devices (e.g., caps, swaps, forward starting swaps) for variable rate debt, the use of variable rate financing for tax exempt multifamily housing bonds has expanded substantially over the past ten years. This has especially been the case since 2001, when the positive slope of the tax exempt yield curve has often been around 450 basis points as compared to a more normal 300 basis points or so, due to the Federal Reserve’s lowering the discount rate to an artificially low level of 1% over much of this period. This spread has very recently returned to a more traditional 300-350 basis points or even lower as the Fed has raised the discount rate toward a more neutral target, but variable rate deals remain very popular.

This increase in use of variable rate financings began to emerge at a time when multifamily housing private activity bond volume was a relatively scarce and valuable commodity in many states. While increases in the federal cap and greater allocations by states to multifamily have eased the pressure on bond volume in most states over the past several years, obtaining a bond volume allocation is in any event a time consuming, somewhat expensive and sometimes uncertain process. As a result, borrowers began to approach credit enhancers to develop a mechanism whereby they could make principal payments on an underlying mortgage loan as they would in a normal level amortization structure, but rather than having that loan amortization channeled to the payment of serial bonds or to mandatory sinking fund

redemptions of bonds, those principal prepayments would be set aside in a separate escrow, which could, if the lender deemed itself insecure, be applied to the redemption of bonds. This put the credit enhancer in substantially the same position it would have been in on a bond issue with scheduled bond amortizations, but if the loan were performing nicely, these funds could simply be returned to the borrower when the project was sold or refinanced. Thus, the principal reserve account concept was born.

The advantage of providing the lender with its desired growing “asset coverage” in this fashion is that it preserves the full tax exempt leverage on the property for the borrower. In the view of some borrowers, this could be especially attractive on resale, since the property could be offered to a subsequent owner with the full tax exempt leverage. Federal tax laws do not require any amortization of a tax exempt multifamily housing bond financing. Thus, if the borrower sells the project in year ten to another owner who assumes the existing credit enhancement or substitutes in a similar alternate credit facility, the new owner can continue to have the full tax exempt leverage on the property during the remaining twenty years it owns the facility without going through the lengthy, expensive and potentially uncertain process of applying for a new private activity bond volume allocation.

The advantage of this structure can become even greater in light of the rules applicable to tax exempt current refundings of multifamily housing bonds. Let’s assume an incoming owner wants to keep all of the bonds on the property outstanding, but is going to make such substantial changes to the structure of the bond issue, possibly bringing in its own substantially different credit enhancement mechanism, that the bonds would be treated as having been “reissued” for federal tax law purposes. The rules applicable to tax exempt “current refundings” (which is how such a transaction would be classified), permit a current refunding in an amount equal to the outstanding principal balance of the prior tax exempt issue, so long as the incoming owner continues to abide by the targeting and rental requirements applicable to the project (e.g., 20% of the units at 50% of area median income or 40% of the units at 60% of area median income and all of the units being rental). These rules will even allow an extension of the maturity in the context of such a refunding, provided that under certain circumstances a new “TEFRA” public hearing and approval is obtained, so long as the final maturity of the bonds does not exceed 120% of the reasonably expected economic life of the facility (taking into account significant rehabilitation work that may have been done to the project over time). As a result, a borrower can potentially have a given dollar amount of tax exempt bonds issued to finance a project and, if a principal reserve account mechanism is utilized, that amount of tax exempt debt might be maintained on the property for a number of decades and through multiple owners. This advantage of the principal reserve account technique is believed by many project developers to give them a significant opportunity to obtain a higher price on resale of the project than they might have been able to obtain had the bonds been amortized down under traditional mandatory sinking fund bond structure.

Disadvantages of Principal Reserve Account

The principal reserve account mechanism does have its disadvantages. Perhaps the greatest of those is that even though the lender’s risk has been eliminated or at least dramatically reduced to the extent of the money sitting in a principal reserve account, credit enhancers still typically charge some very low credit enhancement fee for having their credit enhancement on bonds that are outstanding and indirectly backed by such an account. Their rationale for this is that such funds could be tied up in a developer bankruptcy proceeding, and thus are not completely riskless. For example, on a Fannie Mae or Freddie Mac credit enhanced transaction, the combined guarantee and servicing fees on a variable rate issue might amount to 90 basis points. On the portion of the loan covered by the principal reserve account, the ongoing fee is reduced to 15 basis points, but not eliminated. As a result, the borrower is paying 15 basis points per year to keep these bonds outstanding.

Moreover, since the principal reserve account is deemed to be indirectly pledged to secure repayment of the bonds, under federal tax laws the investment of these moneys is required to be restricted

to the yield on the bonds. For this purpose, the yield on the bonds includes not only the floating bond coupon, but any credit enhancement and liquidity fees paid to the credit enhancer (but not servicing fees paid to a lender or servicer), so long as the credit enhancer is not a purchaser of tax credit equity or otherwise an owner in the Project (which Fannie Mae and Freddie Mac sometimes are). Thus, if the bonds are yielding 2.5% and Fannie Mae or Freddie Mac is charging a 45 basis point guarantee fee (and doesn't own an equity interest in the Borrower), the bond yield for a particular seven-day period would be 2.95%. This obviously can change from week to week. Federal tax law requires that any funds invested in the principal reserve account be invested at a yield that does not exceed the yield on the bonds as so defined. This is slightly different from investing funds which can be invested at any yield but are simply subject to the "rebate" requirements of the Code. In that case, one can earn as much of a taxable yield as possible and simply pay any excess over the bond yield to the federal government once every five years. While the economic result is basically the same, complying with yield restrictions is somewhat more cumbersome. To briefly discuss the matter, it would be possible to invest the principal reserve account in a taxable floating rate guaranteed investment contract; however, there could be no assurance that the amount earned would not exceed the bond yield using this approach, unless the borrower did very complex calculations and agreed to make so-called "yield reduction payments" to the federal government. To avoid the cost and complexity of this approach, given the size of most principal reserve accounts, most developers use a different alternative for complying with yield restriction – they instruct the Trustee, with the approval of the credit enhancer, to invest any funds on deposit in the principal reserve account in a tax exempt – non-AMT (non-alternative minimum tax) money market fund. Since multifamily housing paper generally trades more-or-less at the BMA index (this can vary a bit from state to state), and since non-AMT money market funds generally produce a yield that is 3-5 basis points lower, this is a source of "negative arbitrage" which adds an additional cost element to maintaining a principal reserve account. Together with the 15 basis points credit enhancement fee for the principal reserve account portion of the bonds, it can bring total ongoing cost of maintaining a principal reserve account to around 20 basis points times the balance in the account.

Operation of Principal Reserve Account

Some credit enhancers and/or bond counsel will require that once a principal reserve account has built up to a level that is equal to 20% outstanding principal balance of the bonds, any further loan amortization funds, when they accumulate to an amount equal to the \$100,000 minimum denomination for variable rate bonds, will be used to redeem bonds on a current basis rather than funding additional deposits into the principal reserve account. Assuming a 6.0% end loan rate for a thirty-year level amortization loan, this does not occur until about 11.5 years after commencement of amortization of the loan. When you add this to a two and a half year origination period, the result is that the borrower does not hit this limitation, where it applies on the build up of a principal reserve account, until fairly far into the deal (i.e., years 13 to 15 following bond closing on most deals), which is close to the time when the borrower may have sold or refinanced the loan. This especially true on private activity bond financings under Section 142(d) for profit motivated sponsors, where the tax credit compliance period may be expected to end at about 18 years following the issuance of the bonds and the bond regulatory requirements will expire assuming that the project is sold or refinanced and all of the tax exempt bonds are redeemed.

Lack of Attractiveness to Section 501(c)(3) Borrowers Financing under Section 145 of the Code

As one can tell from the above described benefits of the principal reserve account, this structure may not be nearly as attractive to a non-profit borrower where the bonds that have been issued to finance the project are issued under Section 145 of the Code in a transaction not involving a profit motivated borrower entity and/or low income housing tax credits. Such tax exempt bond financings are not subject to private activity bond volume limitations, so locking up and maintaining outstanding tax exempt bonds does not have the same attractiveness as it does for a profit motivated owner doing a tax exempt bond

financing under Section 142(d). Moreover, if a non-profit borrower who had financed a project with tax exempt bonds issued under Section 145 of the Code sells that project to a profit motivated sponsor, this constitutes a “change of use” under the applicable federal tax law requirements, and the tax exempt bonds issued under Section 145 of the Code would be required to be redeemed. As a result, there is little incentive for a Section 501(c)(3) Borrower to utilize the principal reserve account mechanism in these financings, since such a Borrower does not obtain the parallel benefit of a profit motivated sponsor financing its project under Section 142(d) and the Borrower may incur aggregate ongoing costs equal to or greater than 20 basis points in order to keep this mechanism in place.

Conclusion

Of course, the foregoing summary is a very general one. The requirements of various credit enhancers and liquidity providers with respect to these matters differ from program to program. It is important for a borrower and its counsel and advisors to confer with the proposed credit enhancer and its counsel, with the underwriter and its counsel and with Bond Counsel with respect to these matters before making a determination of whether or not this mechanism should be used in a particular financing and what the benefits and costs may be.