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Hot Topics in Multifamily: Adapting Issuer Policies to a World of Low Interest Rates

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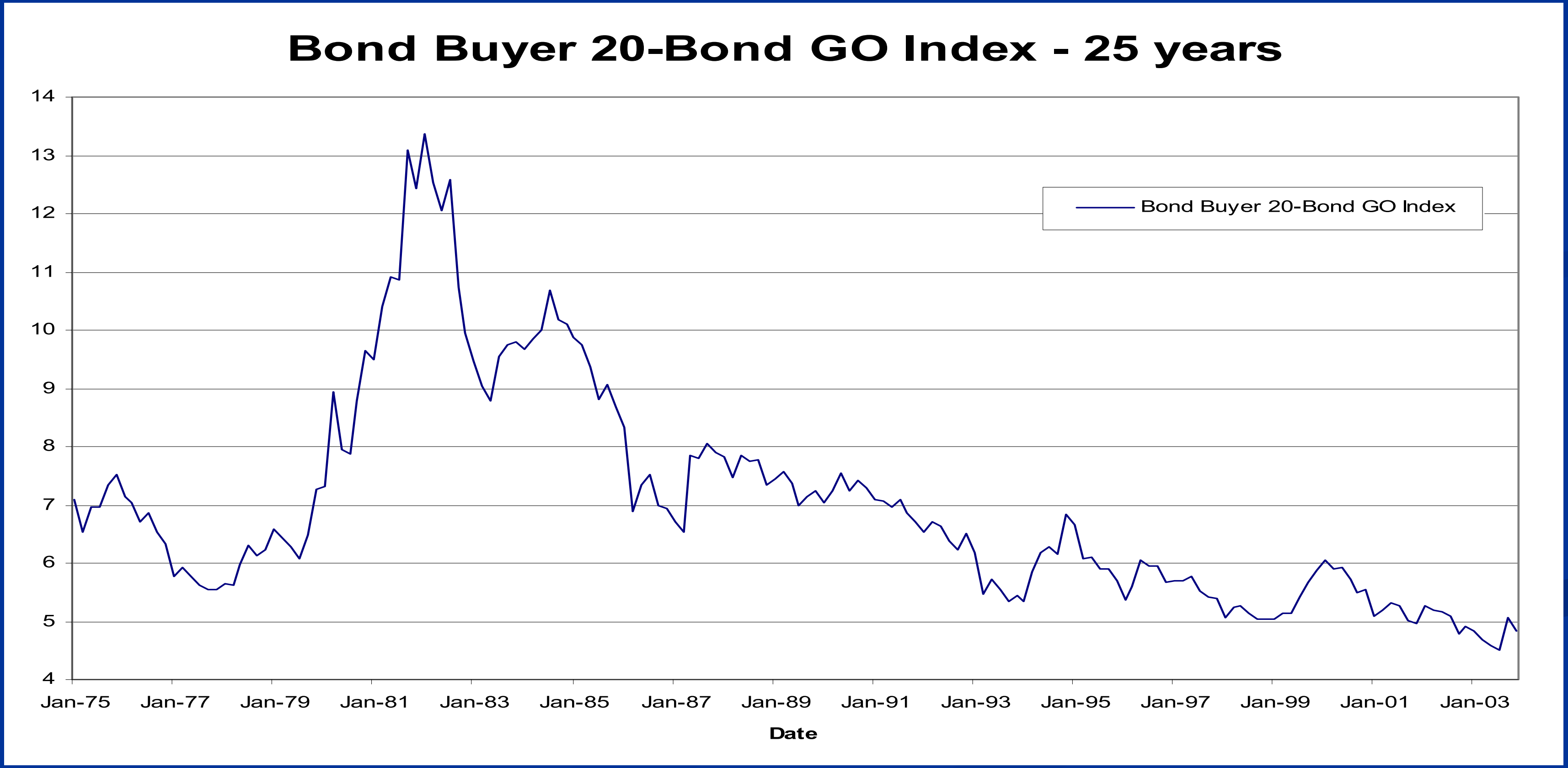
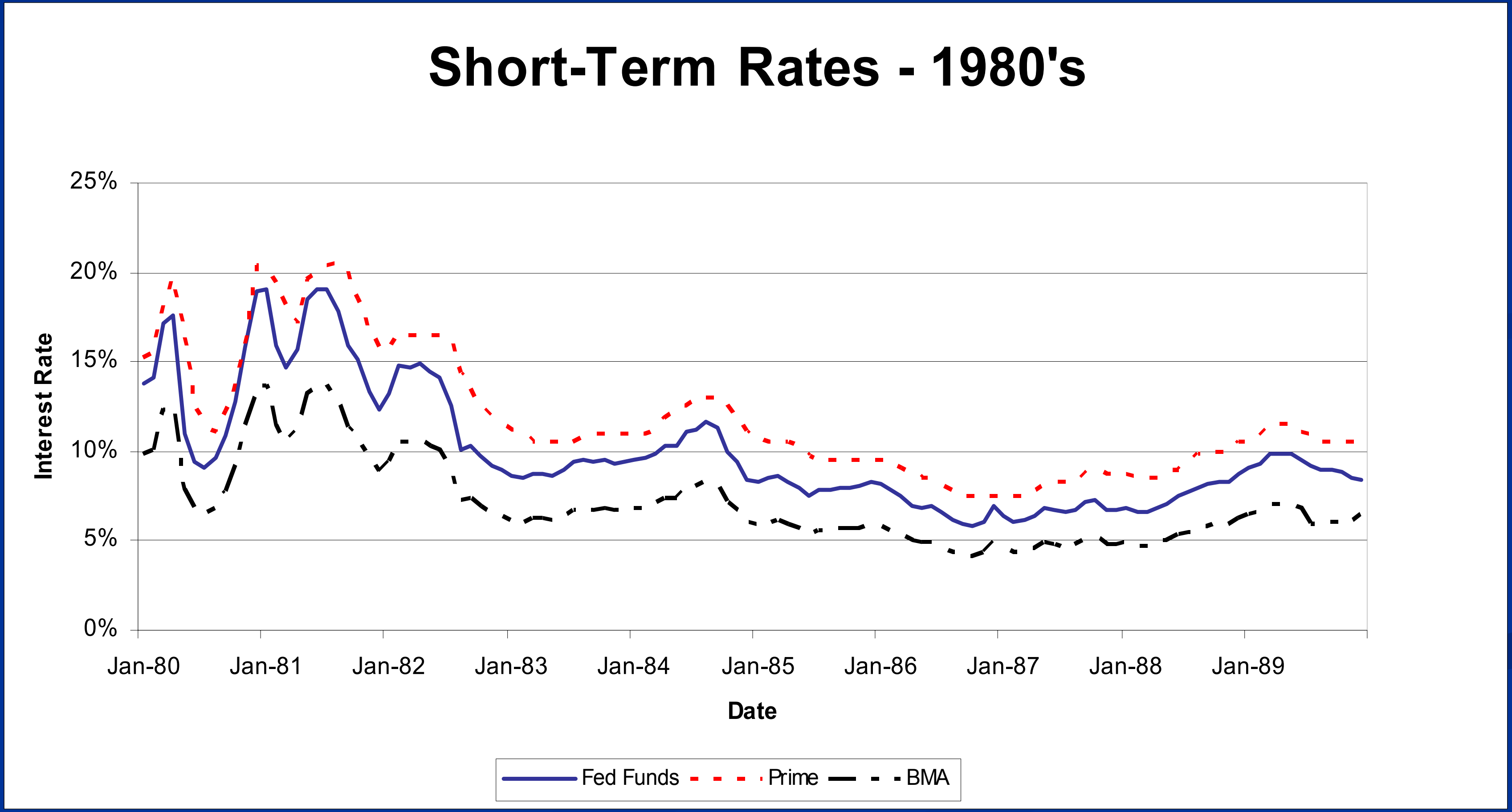
Downward Interest Rate Trends

- There has been a 20-year down cycle in long-term and short-term rates, beginning with the interest rate peak in 1982.
  - Long-term (LT) tax-exempt rates are near an all-time low.

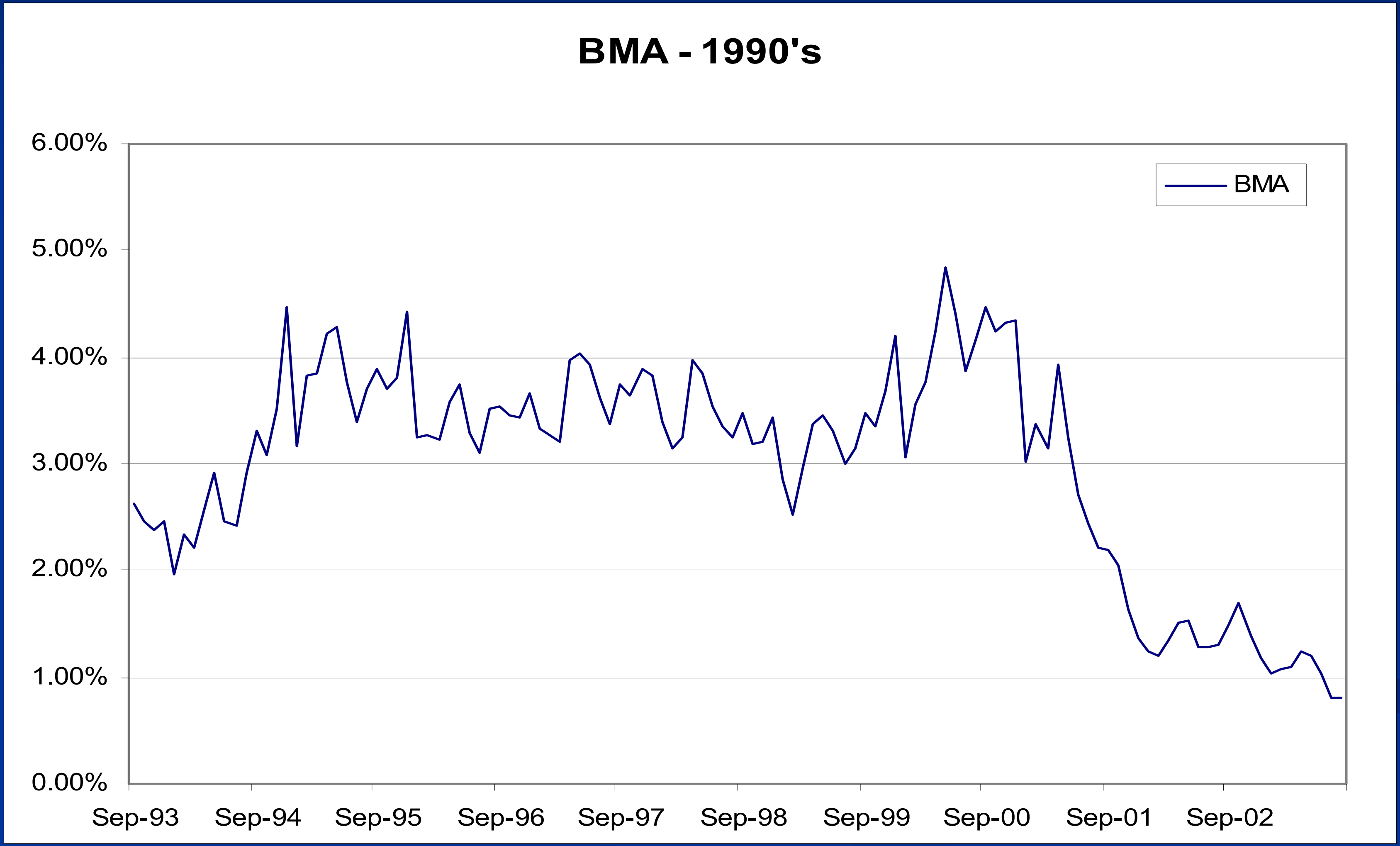


Downward Interest Rate Trends

- Short-term (ST) tax-exempt rates are even lower.



Downward Interest Rate Trends



Downward Interest Rate Trends

- Similar down trend in long-term and short-term taxable rates.

Major Consequences of Lower Rates

Assuming a constant relationship of tax-exempt to taxable rates (e.g., tax-exempt = 90% of taxable), the relative benefits of tax-exempt financing are lower in a low interest rate environment than in a high interest rate environment.

- Assume LT taxable = 10%; LT tax-exempt = 9%. The difference of 100 bps translates to **8%** larger loan on level 30-40 year amortization.
- Assume LT taxable = 5.0%; LT tax-exempt = 4.5% (90% of 5.0%). The difference of 50 bps translates to **4%** larger loan on level 30-40 year amortization.
- Result: Tax-exempt financing provides only half the mortgage loan increase in an interest rate era where interest rates are half of what they were before.

Relationship of Tax-Exempt and Taxable Rates

- Supply and demand factors in tax-exempt market very different from those in the taxable market.
- Taxable market rates tend to be much more volatile – up and down – than the markets for tax-exempts.

Relationship of Tax-Exempt and Taxable Rates

- In the last 18-24 months, a second major trend has been observed: During certain periods, the traditional spread between tax-exempt and taxable LT rates has narrowed dramatically and even inverted on occasion.
  - E.g., In January through March of 2003; 10-year municipal yields equaled 97% of 10-year Treasuries vs. a more normal 90-91%.
  - Ratio reversed toward normal (e.g., 91%) in April 2003.

June 2003:
The World Upside-down

- In mid-June 2003, the 10-year Treasury hit a 47-year low of 3.16%, and the **normal relationship** of tax-exempt to taxable rates **actually inverted** with taxable rates being **lower** than tax-exempts!
- At that time, the following were sample rates for tax-exempt long-term FHA/GNMA backed bonds (AMT)* and a comparable sale of GNMA's in taxable market for (i) stabilized 35-year loans (§223(f)) and (ii) new construction/sub. rehab loans (§221(d)(4)):

	Tax-Exempt (AMT)†	**Taxable GNMA Sale†**
35-yr Stabilized - **§223(f)**	4.65%	4.35%
40-yr New Cons. - **§221(d)(4)**	4.80%	4.50%

*Long-term fixed rate Fannie Mae and Freddie Mac, tax-exempt and taxable, stabilized and non-stabilized executions are comparable to FHA/GNMA, perhaps 5 to 10 bps lower at 30-year vs. 35-40 year maturities.

†Both sets of rates exclude 25 bps servicing/guarantee fee which must be added to get the stated mortgage loan rate and also exclude the 50 bps mortgage insurance premium payable to FHA outside the stated mortgage rate.

June 2003:
The World Upside-down

- **Taxable** rates 30 bps **LOWER** than **tax-exempt**. In addition, taxables impose no specific targeting requirements and involve lower upfront costs, lower on-going administrative fees, quicker execution and significantly fewer problems with construction period negative arbitrage.
- If you are a municipal issuer, trying to compete, the relative quote is: "**Other than that, Ms. Lincoln, how was the play?**"
- In such an environment, new money **private activity bond issues** under §142(d) **may still work** because effective syndication of 4% tax-credit equity depends upon at least 50% of eligible basis of the project being financed with **tax-exempt** bonds.

June 2003: The World Upside-down

- Also, **borrowers** who **want to** take advantage of very low **tax-exempt floating rates** (less than 1% bond rates and about 2.75% all-in borrowing rates) **may still finance tax-exempt.**
- **Almost all other long-term fixed-rate financings** - e.g., new money financings for 501(c)(3) owned or publicly owned facilities, or long-term fixed-rate refundings, **are likely candidates for taxable execution** in such a market.

The World Back in Balance

- Fortunately (for issuers, underwriters & those in the tax-exempt bond business), the recent "play" has been much less "tragic" than that described above.
- Run-up in rates between mid-June and early-August of 2003 hit taxables much harder than tax-exempts: 10-year Treasuries increased almost 140 bps in yield during this 6-week period vs. 70 bps for long-term tax-exempts.
- As of early-August, 2003, the forgoing chart appeared more as follows:

	Tax-Exempt (AMT)	**Taxable GNMA Sale**
35-yr Stabilized - **§223(f)**	5.40%	5.65%
40-yr New Cons. - **§221(d)(4)**	5.50%	5.80%

The World Back in Balance

- This gave the **tax-exempt** executions about a 25 to 30 bps **advantage over** the **taxables**, although this actually was still substantially offset by tax-exempt targeting requirements, higher up-front and ongoing fees and, for more stabilized loans, greater negative arbitrage requirements.

The World Today

- As of **November 10, 2003** the same table discussed above appeared as follows:

	Tax-Exempt (AMT)	**Taxable GNMA Sale**
35-yr Stabilized - **§223(f)**	5.10%	5.200%
40-yr New Cons. - **§221(d)(4)**	5.15%	5.625%

- In today's market, the tax-exempt execution provides a slight (10 bps) rate advantage in §223(f) stabilized financings, and a substantial (47.5 bps) advantage in §221(d)(4) new construction/substantial rehab deals, versus taxable executions.

Ramifications for Issuers and Other Tax-Exempt Participants

- We live in a brave, new and volatile world, where tax-exempt fixed-rate financings often have only small advantages versus taxable executions, for all except new money private activity bond issues seeking 4% tax-credits and borrowers seeking variable rate borrowings.
- In markets such as last June, which may or may not reoccur in the near future, nothing may keep a long-term fixed-rate (non-tax-credit) deal from going taxable.
- Tax-exempt variable rate executions generally remain much more competitive, because historically BMA has traded much lower than LIBOR and thus tax-exempt variable rate deals often underwrite more favorably than taxable variable rate financings.

Ramifications for Issuers and Other Tax-Exempt Participants

- About 70-75% of "new money" tax-exempt deals go variable rate at this time (80-85% of Fannie Mae and Freddie Mac deals; almost no FHA/GNMA deals due to lack of program) to take advantage of sub 1% BMA and 2.75% all-in borrowing rates.
- In markets more like early August and today, tax-exempt fixed-rate executions may have some advantages in rates, but not overwhelming ones when targeting, other costs, and negative arbitrage factors are considered.
- Issuers must minimize the operating restrictions imposed beyond those imposed by federal and state law to remain competitive in fixed rate executions.

Ramifications for Issuers and Other Tax-Exempt Participants

- All tax-exempt financing participants must keep costs to a minimum for the tax-exempt alternative to remain competitive.
- Tax-exempt participants should emphasize that keeping tax-exempt financing on a project may be a substantial asset at time of later sale or refinancing if rates rise (as many now expect) and the relationship of tax-exempt to taxable rates returns return to a more normal relationship.

This outline and a number of other articles on tax-exempt housing bond financing are available on our website: http://www.enbonds.com

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