Pairing Taxable GNMA Loans with Tax-Exempt Bonds
Maryland Department of Housing and Community Development

Updated Guidance
February 6, 2018 (supersedes and replaces the June 2011 and February 2013 guidance)

On June 29, 2011, and February 7, 2013, the Maryland Department of Housing and Community Development ("DHCD") issued guidance memos regarding a financing technique to be used to facilitate multifamily rental development activity that includes tax-exempt housing revenue bonds (the "Bonds") and 4% Low Income Housing Tax Credits (the "Tax Credits") from the Community Development Administration, a unit of the Division of Development Finance of CDA ("CDA"). The financing technique enables qualified multifamily rental housing developments to realize the lower interest rates associated with taxable GNMA loan executions (the "GNMA Loan") in conjunction with the Tax Credits available with tax-exempt bond issuances ("Tax/TE Financing").

This February 6, 2018 Guidance memo updates and replaces the June 29, 2011, and February 7, 2013 memos. It provides substantial additional detail concerning the Tax/TE Financing and will govern all transactions effective with its issuance.

Background

CDA originally offered this Tax/TE Financing as a new product to provide a strong financial alternative to traditional tax-exempt bonds and reduce borrowing costs in order to minimize subsidies and maximize leverage. In September 2012, CDA closed its first transaction using the Tax/TE Financing and since that time has completed numerous similar transactions. The February 2013 guidance addressed issues concerning the amount of taxable and tax-exempt loan amounts, bankruptcy risk, and the placement, credit enhancement and rating of the bonds.

CDA's first execution of the Tax/TE Financing was accomplished through a private placement of unrated Bonds. The decision to pursue unrated, private placements was predicated on the increased cost to the borrower associated with obtaining the necessary bankruptcy opinions required by the bond rating agency in connection with rated Bonds. Therefore, in order to continue to preserve the financial benefits of the Tax/TE Financing, CDA has determined that Tax/TE Financing will be accomplished by the private placement of unrated bonds or through rated Bonds. Sections A, B, and C below provide further details.

Initially, several borrowers had requested that CDA permit the issuance of Bonds in amounts necessary to meet the 50% test for Tax Credits, but which amount may be less than the GNMA Loan. CDA initially declined to accept this type of funding proposal and, in its June 2011 Guidance, required the Bonds be issued for the same amount as the GNMA Loan. However, as more projects and their financial needs were considered and reviewed, CDA recognized that this requirement can have the effect of making some projects financially infeasible by forcing on the project the burden of costs associated with higher than necessary Bond amounts. CDA subsequently worked through the administrative issues and funding mechanics of this structure and now permits a Bond amount which is less than the GNMA Loan. In addition, CDA can accommodate a Bond amount in excess of the GNMA Loan, provided additional collateral is provided. The flexibility to structure the Bond financing either way provides financial benefits to some projects, furthers the original goals of the Tax/TE Financing, and is administratively manageable by CDA.–Section D below provides further details.

Updated Guidance

A) Unrated Private Placement of the Bonds: CDA Tax/TE Financings involve the issuance of unrated Bonds. Project sponsors must choose an entity to purchase the unrated Bonds.

When this structure is used, the following conditions must be met to CDA's sole satisfaction:

1) The entity purchasing the Bonds must be approved by CDA;

2) The entity purchasing the Bonds must agree to retain the Bonds and not sell, pledge, transfer or otherwise dispose of ownership or control of the Bonds in any way for the entire term of the Bonds;

3) The interest rate on the Bonds must be approved by CDA to ensure the rate is competitive in the tax-exempt bond market;

4) Any relationship between the purchaser of the Bonds and the investor in the Tax Credits must not trigger the "substantial user" requirements of the Internal Revenue Code. For transactions with such a possible relationship (as determined in CDA's sole discretion) the borrower must provide a letter from qualified legal counsel (acceptable to CDA in its sole discretion) opining that the "substantial user" issue has not been triggered; and

5) The entity purchasing the Bonds must accept all possible risks that may result from the borrower becoming insolvent and/or bankrupt, and must execute an investor letter addressed to CDA prior to its purchase of the Bonds. In the investment letter the entity must acknowledge, among other things, that (i) the entity has sufficient knowledge and experience in business and financial matters in general, and investments such as the Bonds in particular, (ii) the entity is capable of evaluating the merits and risks involved in an investment in the Bonds, and (iii) the entity is able to

bear the economic risk, including an entire loss, of an investment in the Bonds.

<u>Please note</u>: The unrated private placement of Bonds is permitted by CDA only for projects making use of the financing techniques outlined in this Section A.

B) Rated Bond Transaction: A rated bond transaction will be required if (i) a borrower is unable to find an entity to purchase the Bonds as an unrated placement, or (ii) if CDA, working with its investment bankers and financial advisors, determines that a rating on the Bonds will be required to sell the Bonds at an acceptable interest rate as determined in CDA's sole discretion. In either event, CDA will require that the transaction be structured as a draw down loan and a bankruptcy opinion will be required that meets the requirements of Moody's (or other rating agency or agencies as determined by CDA, in its sole discretion). The borrower must agree to pay the cost of the bankruptcy opinion.

With a rated bond transaction, the following three additional conditions must be met in order to meet the requirements of the bankruptcy opinion:

1) The borrower will not be entitled to any residual amounts on deposit in the Bond indenture accounts covered by the bankruptcy opinion;

2) The borrower will not be entitled to collect or receive credit for excess investment earnings on the Bond indenture accounts covered by the bankruptcy opinion; and

3) The borrower will not be permitted to direct the investment of the funds held in the Bond indenture accounts covered by the bankruptcy opinion.

C) Unrated/Rated Transaction at CDA's Discretion: In some instances, investors may be willing to purchase the Bonds without a bankruptcy opinion, but only if the additional three requirements outlined in paragraph B above are present. In such circumstances CDA, in its sole discretion, may (i) choose to proceed as an unrated transaction and therefore not require a bankruptcy opinion, or (ii) may proceed as a rated transaction and therefore require a bankruptcy opinion, the cost of which shall be paid by the borrower.

D) Bond and GNMA Loan Amounts: The amounts of the GNMA Loan and the Bonds may differ. At all times, Bond proceeds must be sufficient to satisfy the 50% test for Tax Credits and the full amount of the Bonds must be secured 100% by cash collateral. A Letter of Credit is not sufficient. If the amount of the Bonds exceeds the amount of the GNMA Loan, funds from other sources, such as Tax Credit equity or a local government loan, may be provided as cash collateral to insure that the Bonds are always 100% cash collateralized.

E) CDA Underwriting Guidelines: The GNMA Loan must have HUD/GNMA credit enhancement via Section 221(d), 220, or other similar HUD programs. FHA Risk Sharing with CDA is not eligible. A MAP Lender must be engaged by the borrower. Applicants should use the following standards in structuring project sources and uses for the CDA financing application:

GNMA Loan Term/Payments: Interest-only payments during construction loan period; principal and interest amortized and paid over 40 year permanent loan period.

Bond Loan Term/Payments: Not less than 24 months, including any optional prepayment. Interest capitalized and paid in full at initial closing. Principal due in full at maturity.

Fees: Fees can be found at: http://dhcd.maryland.gov/HousingDevelopment/Pages/Fees.aspx

Tax Credit Percentage: Projects which propose using the 4% Low Income Housing Tax Credit are subject to risk associated with monthly changes to the Tax Credit Percentage.

F) Purpose of Guidance Memo: This guidance memo is being provided as a service to our partners to facilitate multifamily rental development activity, and CDA reserves the right, in its sole discretion, not to offer the financing technique discussed herein, or to modify it in whole or in part, at any time.

CDA Multifamily staff is available to meet with prospective borrowers to answer any questions as needed. Please contact:

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