NCSHA 2016 Annual Awards Entry Form

(Complete one form for each entry)

Deadline: Wednesday, June 15, 2016

Visit ncsha.org/awards to view the Annual Awards Call for Entries.

Instructions: Type entry information into the form and save it as a PDF. Do not write on or scan the form. If you have any questions contact awards@ncsha.org or 202-624-7710.

Fill out the entry name *exactly* as you want it listed in the program.

Entry Name: The Revival of the FirstHome Program while Restructuring Away Risk

HFA: Iowa Finance Authority

Submission Contact: (Must be HFA Staff Member) Cindy Harris **Email:** cindy.harris@iowa.gov

Please provide a 15-word (maximum) description of your nomination to appear on the NCSHA website.

Rejuvenating the FirstHome Program through the use of Resolution resources and innovative debt structuring

Use this header on the upper right corner of each page:

HFA: Iowa Finance Authority

Entry Name: The Revival of the FirstHome Program while Restructuring Away Risk

Select the appropriate subcategory of your entry and indicate if you are providing visual aids.

Communications	Homeownership	Legislative Advocacy	Management Innovation
○ Annual Report ○ Creative Media ○ Promotional Materials and Newsletters	○ Empowering New Buyers ○ Encouraging New Production ○ Home Improvement and Rehabilitation	○ Federal Advocacy ○ State Advocacy	◉ Financial ○ Human Resources ○ Operations ○ Technology
Rental Housing	**Special Needs Housing**	**Special Achievement**	Are you providing visual aids?
○ Encouraging New Production ○ Multifamily Management ○ Preservation and Rehabilitation	○ Combating Homelessness ○ Housing for Persons with Special Needs	○ Special Achievement	◉ Yes ○ No

<u>The Management Challenge</u>: The Iowa Finance Authority ("Authority") actively issued tax-exempt mortgage revenue bonds in the Single Family Mortgage Bonds Resolution ("Open Resolution"), adopted in 1991, to fund the Authority's FirstHome program. By 2008, the Open Resolution had accumulated nearly $1.2 billion bonds, of which 33% was variable rate debt. Like many of the HFAs after the Credit Crisis and the New Issue Bond Program ("NIBP"), the Authority struggled to find ways to fund its FirstHome program profitably through the issuance of tax-exempt bonds. Post crisis and NIBP, the Authority primarily sold its Mortgage Backed Securities ("MBS") in the To Be Announced ("TBA") market in order to fund both its FirstHome program and its taxable Homes For Iowans program. While selling everything generated current income, there was no rate differential between the tax-exempt and taxable loan programs because the funding source was the same. The Authority has seen the profit margins on these MBS sales narrow over the last few years. Seven years after the crash, selling all of our MBS in the TBA market and massive prepayments later, the Open Resolution had shrunk to approximately $155 million of bonds outstanding, of which 84% was variable rate debt. (See slide #1) This variable rate debt had associated interest rate swaps that had rapidly approaching par terminations which would create substantial unhedged interest rate risk in the future. (See the red shaded area in slide #2) In addition, the variable rate debt was siloed across 13 different bond series and trying to keep the swap and bonds aligned was challenging, often times forcing the Authority to call the low cost variable rate debt, which was not financially optimal. With a FirstHome program on life support, considerable variable rate risk to manage and smaller profit margins on the TBA sales to fund operations, the Authority needed an innovative and long term plan.

<u>The Management Opportunity:</u> The Authority first outlined our strategic objectives:

- Rejuvenate the FirstHome program to more effectively serve these borrowers by offering lower mortgage rates relative to the taxable Homes for Iowans program.
- Improve the long term financial health of the organization by profitably growing the Authority's single family MBS assets and diversifying its income stream.
- Reduce interest rate risk by reducing the ratio of variable rate debt to fixed rate debt while ensuring appropriate hedges are in place.

We shared these priorities with our financial advisor, cfX Incorporated ("cfX"), and asked them if they could help us figure out a way to get there.

<u>The Innovative Financing Plan:</u> cfX proposed a long term funding plan that would potentially span a couple of years and would involve replicable tax-exempt bond transactions, each one a step towards reaching our strategic objectives. The Open Resolution has old MBS outstanding that were no longer associated with bonds so that they were unrestricted and available to help pay down future debt issuance. The plan included issuing new bonds and dedicating a portion of these excess MBS to pay down structured ("PAC") bonds as well as refund old variable rate demand obligations ("VRDOs") into fixed rate bonds. Combining the old issues into one new issue would make it administratively and financially easier to manage the debt. Furthermore, the refunding would create excess mortgage yield subsidy ("zeroes") to help FirstHome borrowers in the future. In conjunction with the VRDO refunding, the Authority would issue new VRDOs to fund new MBS production and then transfer old swaps related to the refunded VRDOS to the new VRDOs. The Authority would add new less expensive forward starting swaps to cover the unhedged variable rate risk when the Authority terminates old swaps at par in the future.

The Authority executed the first leg of the plan, $121,255,000 of 2015 Series A, B and C Bonds ("2015 Bonds"), in September 2015. It included an economic refunding of 13 VRDOs into fixed rate bonds and issuance of new VRDOs to fund new MBS. (See Slide #3) With this transaction the Authority reduced its VRDO exposure by over $40 million and added $40 million of new MBS assets to its balance sheet which would generate future interest income.

When the Authority refunded the old VRDOs into fixed rate bonds the old swaps allocated to these VRDOs were still outstanding. Instead of terminating these old swaps at market value which would have required the Authority to pay a termination fee to its counterparties, the Authority transferred 6 of the swaps to hedge the new VRDOs. Since these old more expensive swaps had par termination options that could be exercised within the next couple of years, the Authority wanted to enter into a new lower cost swap that would become effective as the old swaps rolled off. Therefore, the Authority entered into a forward starting swap to hedge 75% of the VRDOs which would protect the Authority during a rising rate environment. The remaining 25% of the VRDOs would remain unhedged in the current low interest rate environment to benefit the FirstHome program.

The 2015 Bonds also included special (PAC bonds) that use MBS repayments and prepayments to create a short and stable average life that investors are willing to pay for by accepting a lower bond yield. cfX structured 2 of these PAC bonds, one using MBS payments from MBS allocable to the 2015 Bonds; the other using excess MBS in the Open Resolution. The unhedged VRDOs as well as these PAC bonds allow the Authority to borrow funds more cheaply and thus more profitably which allows the Authority to earn the permitted IRS full spread (1.125%). An estimated $6.9 million of zeroes will be generated within this issue. These zeroes will subsidize current and future mortgage rates, benefitting first time home buyers who use the Authority's loans.

The Authority executed the second leg of the plan, $70,540,000 of 2016 Series A, B and C Bonds ("2016 Bonds"), in March 2016 and it was similar to the 2015 bond transaction. The 2016 Bonds included an economic refunding of 3 old VRDOs into fixed rate bonds and issuance of new VRDOs and fixed rate bonds to fund $50 million of new MBS. The Authority allocated three old swaps to the new VRDOs and added a forward starting low cost swap to hedge 75% of the VRDOs as the old swaps rolled off. Approximately $5.1 million of zeroes will be created to help first time homebuyers.

Not only did the 2015 and 2016 bond transactions generate mortgage subsidy of about $12 million and reverse the trend of a declining asset base, but they also greatly improved the Authority's risk profile. Prior to the issuance of the 2015 Bonds, 84% of the debt in the Open Resolution was variable rate. After the 2016 Bonds, variable rate debt only comprised 31% of the debt. (See slide #4)

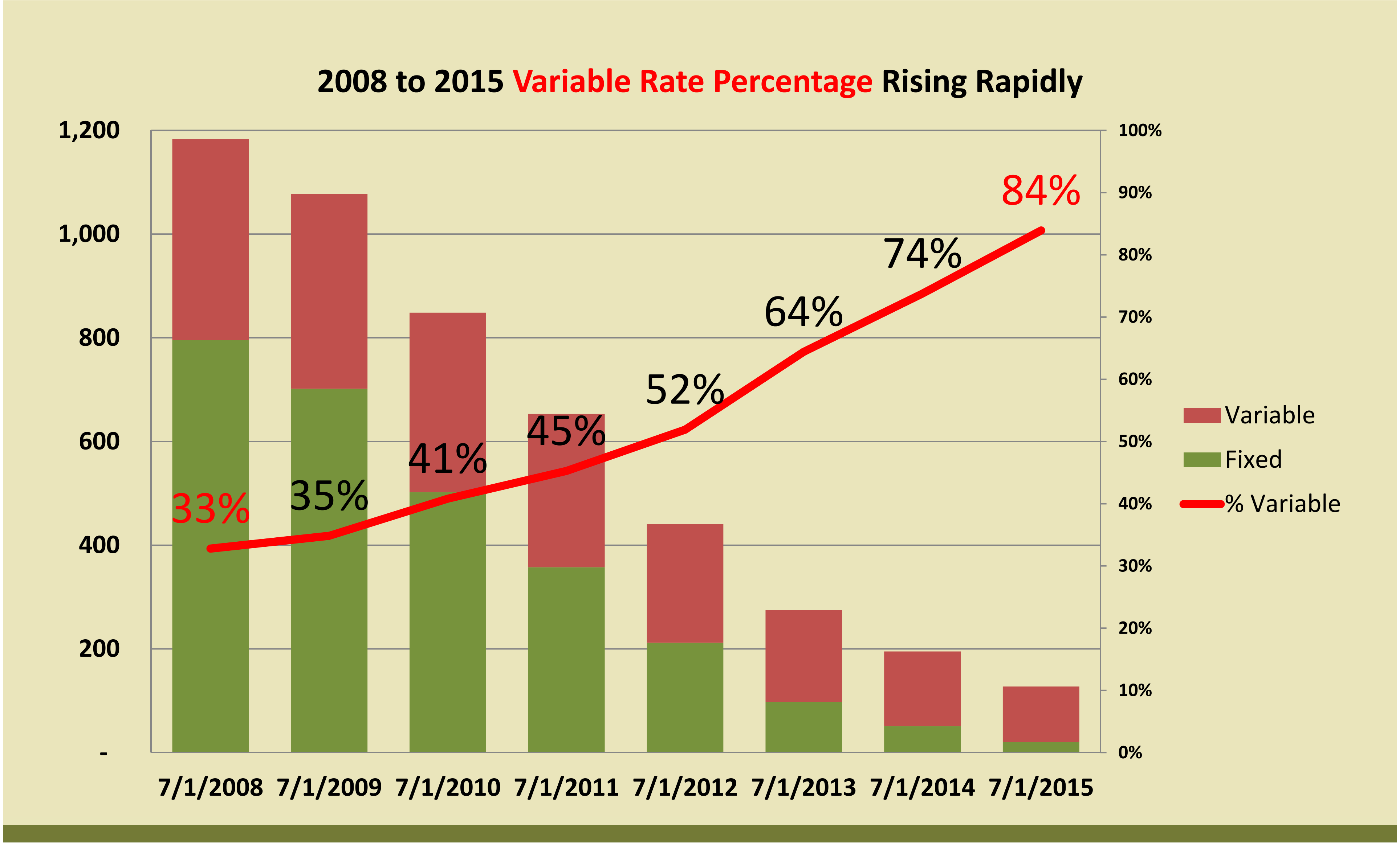
While securing a bond rating for the 2016 Bonds, the Authority worked with cfX and S&P to delink the credit rating of the bonds within the Open Resolution from the credit rating of the U.S. sovereign debt. The Open Resolution had been rated AAA prior to the Credit Crisis but the downgrade of the U.S. debt to

AA+ in 2011 caused a downgrade to the bonds in the Open Resolution because the Authority MBS are backed by government insurance guarantees. cfX submitted cash flows to S&P that showed the Open Resolution had enough wealth and liquidity to absorb additional losses, due to an 85% credit applied to the government guarantees. As a result, S&P upgraded their rating on the Open Resolution to AAA on February 12, 2016 which consequently allows the Authority to save approximately $30,000 per year on its liquidity facility for the VRDOs within the Open Resolution.

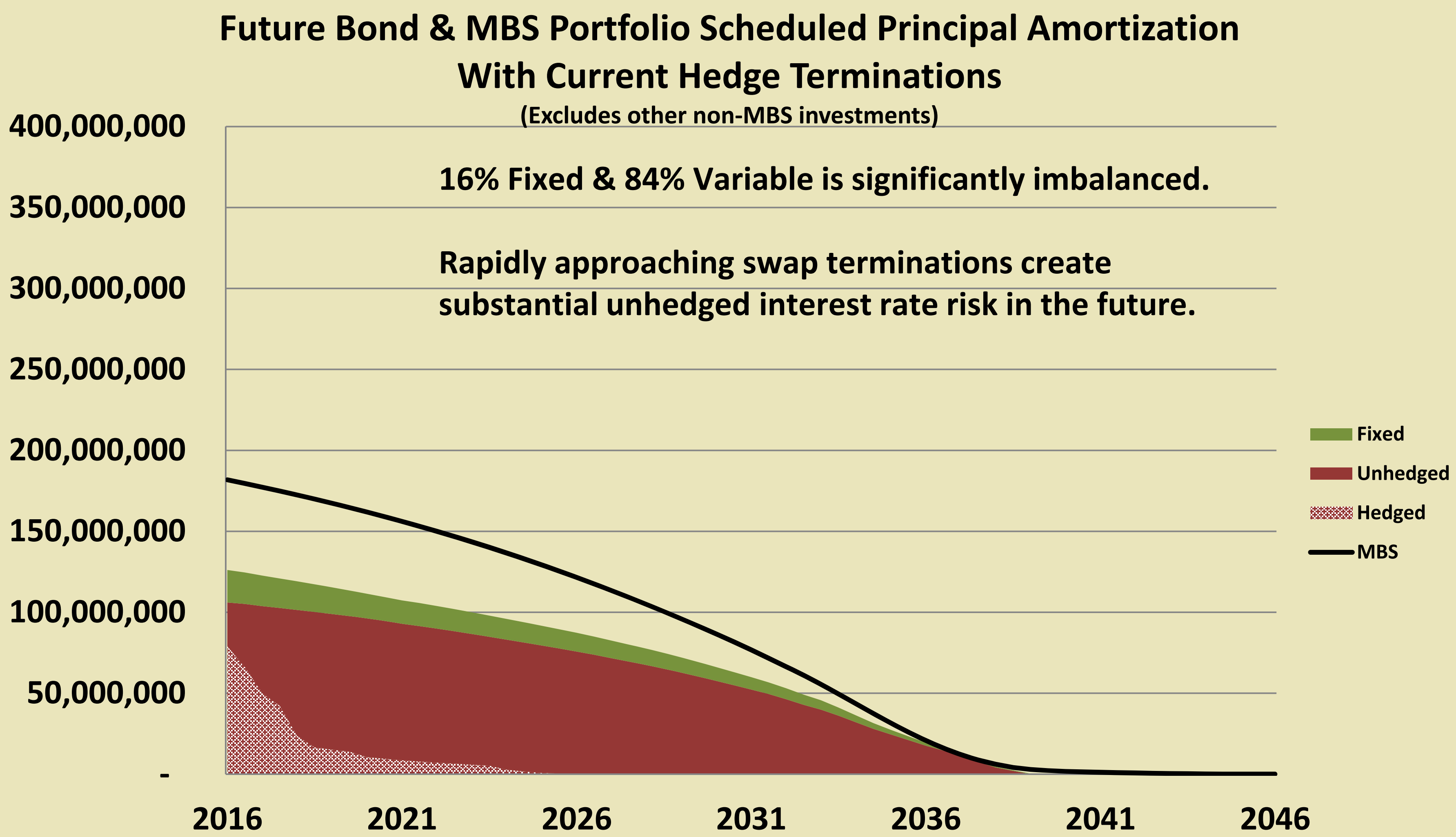
The Authority anticipates doing the third leg of the plan the fall of 2016. While there are no more bonds to refund, we anticipate issuing a mix of fixed and variable rate debt, using an old swap and entering into a forward swap to hedge the VRDOs. If needed, the Authority may also use excess MBS within the Open Resolution for a PAC bond. Slide #5 shows the debt profile and the growth in the balance sheet after funding $200 million of new loans profitably, restructuring the variable rate debt, and repositioning swaps over multiple bond transactions.

<u>The Conclusion:</u>
The Authority's purpose and core focus is to enhance the lives of Iowans by making affordable financing possible for home and community. When the Authority was established in 1975 its main purpose was to support the first time homebuyer. Rejuvenating the FirstHome program and funding it through tax-exempt bonds grounds us in our original purpose and those of other Housing Finance Agencies ("HFAs"). This funding plan may serve as a template for other HFAs who have a Resolution with accumulated wealth and/or challenging variable rate debt with swaps. The Authority is on the path to achieving its original strategic objectives and much more. Through this innovative and replicable funding plan the Authority has been able to:

- Benefit the first time homebuyer by offering a mortgage rate 0.125% lower than a Homes For Iowan mortgage
- Provide a deeper subsidy to the first time homebuyer by only increasing the mortgage rate by 0.25% for a down payment assistance ("DPA) grant compared to 0.50% for a Homes for Iowans mortgage with DPA
- Effectively leverage excess MBS in the Open Resolution to lower debt expense
- Efficiently use private activity volume cap for bonds rather than Mortgage Credit Certificates
- Generate approximately $12 million of zeroes to subsidize future first time home buyers
- Improve operational efficiency by restructuring debt to combine 13 small legacy bond issues into two which reduces the number of tax plans staff need to manage
- Grow the net assets in the Open Resolution by $52 million, or 10.2%, and position the Authority to have a more diversified future income stream to fund Authority programs and operations
- Improve its risk profile by reducing variable rate debt from 84% to 31% within the Open Resolution and adding new forward swaps to hedge future interest rate risk
- Improve the S&P credit rating of the Open Resolution from AA+ to AAA



IOWA FINANCE AUTHORITY



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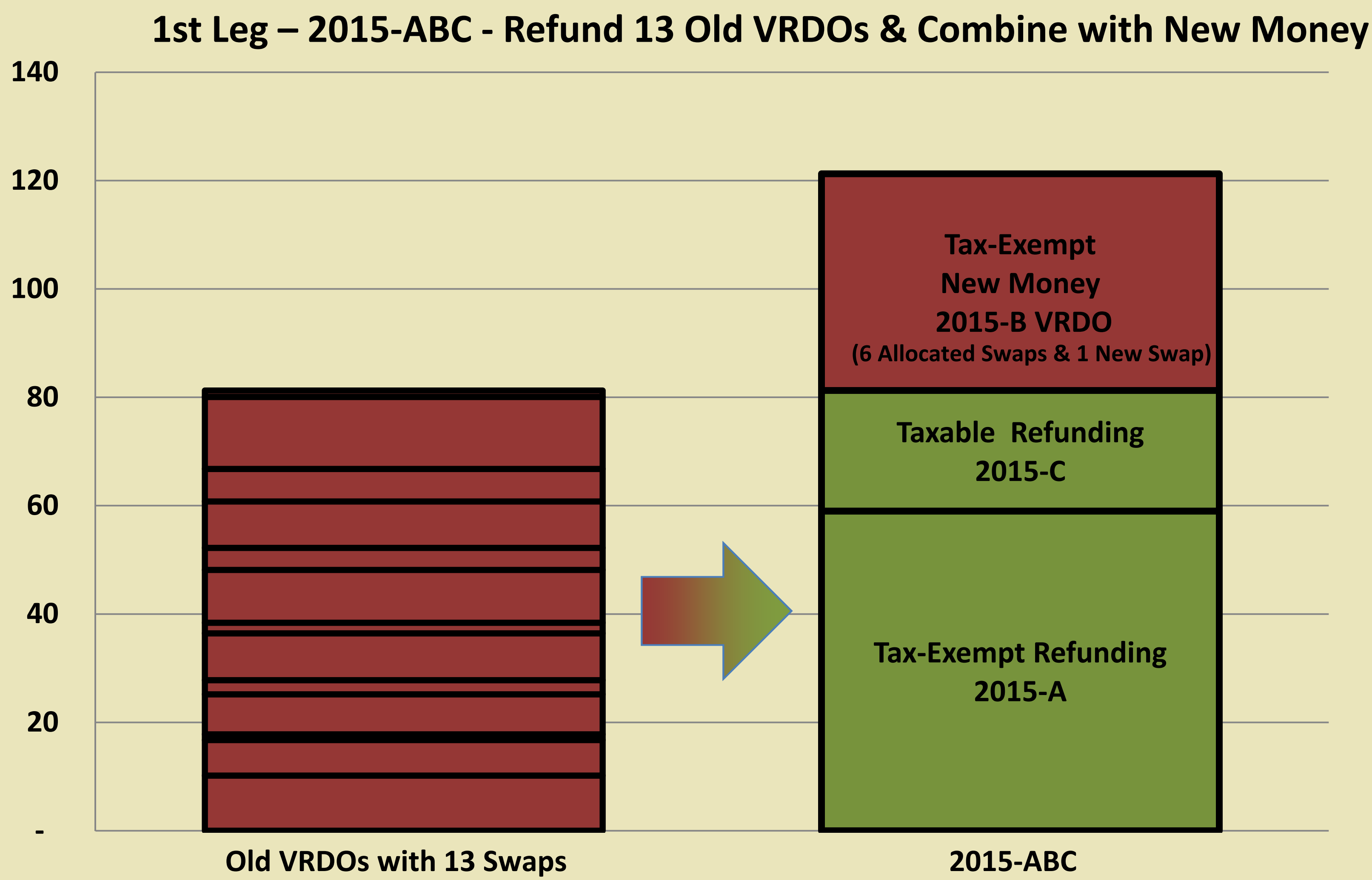

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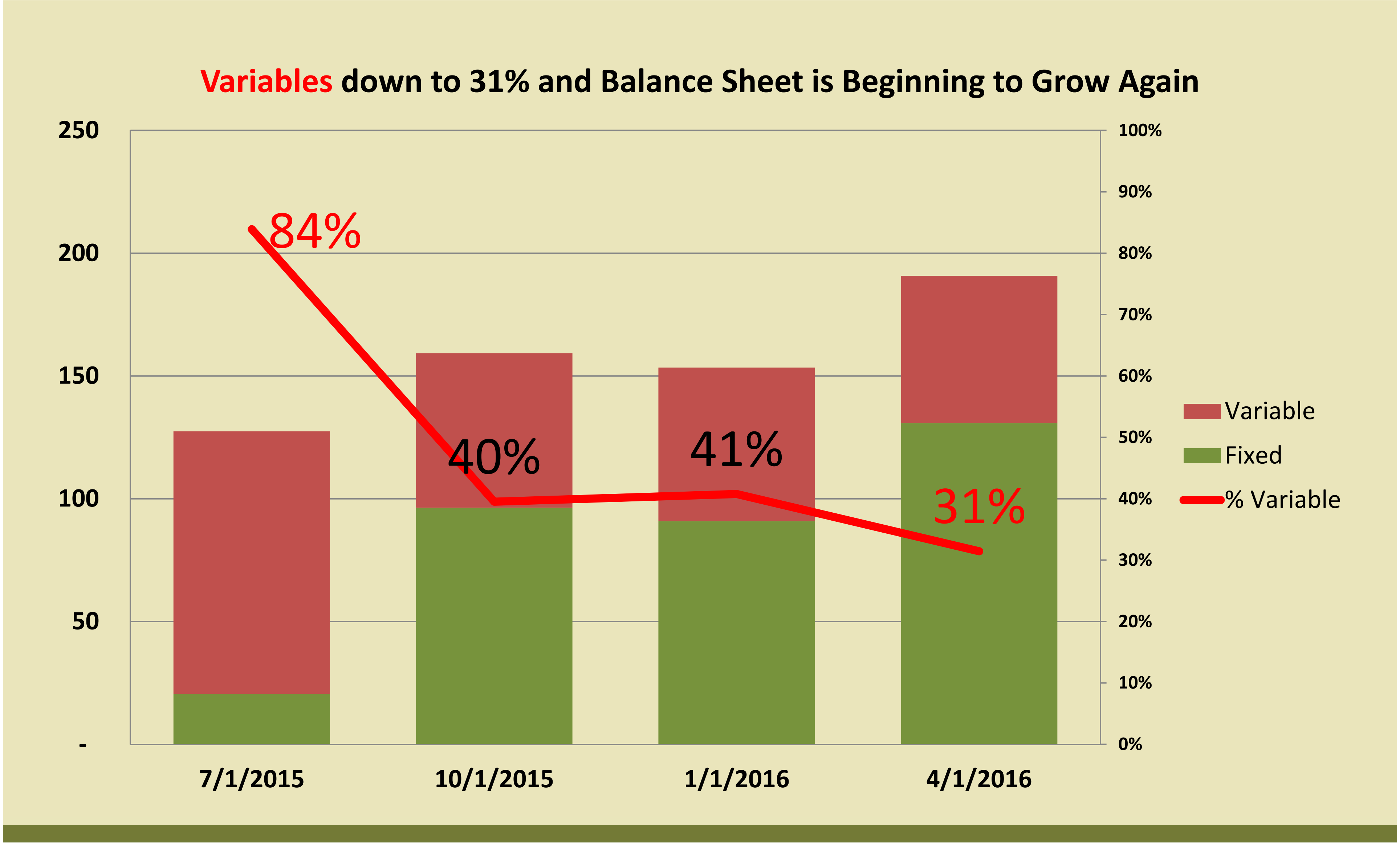

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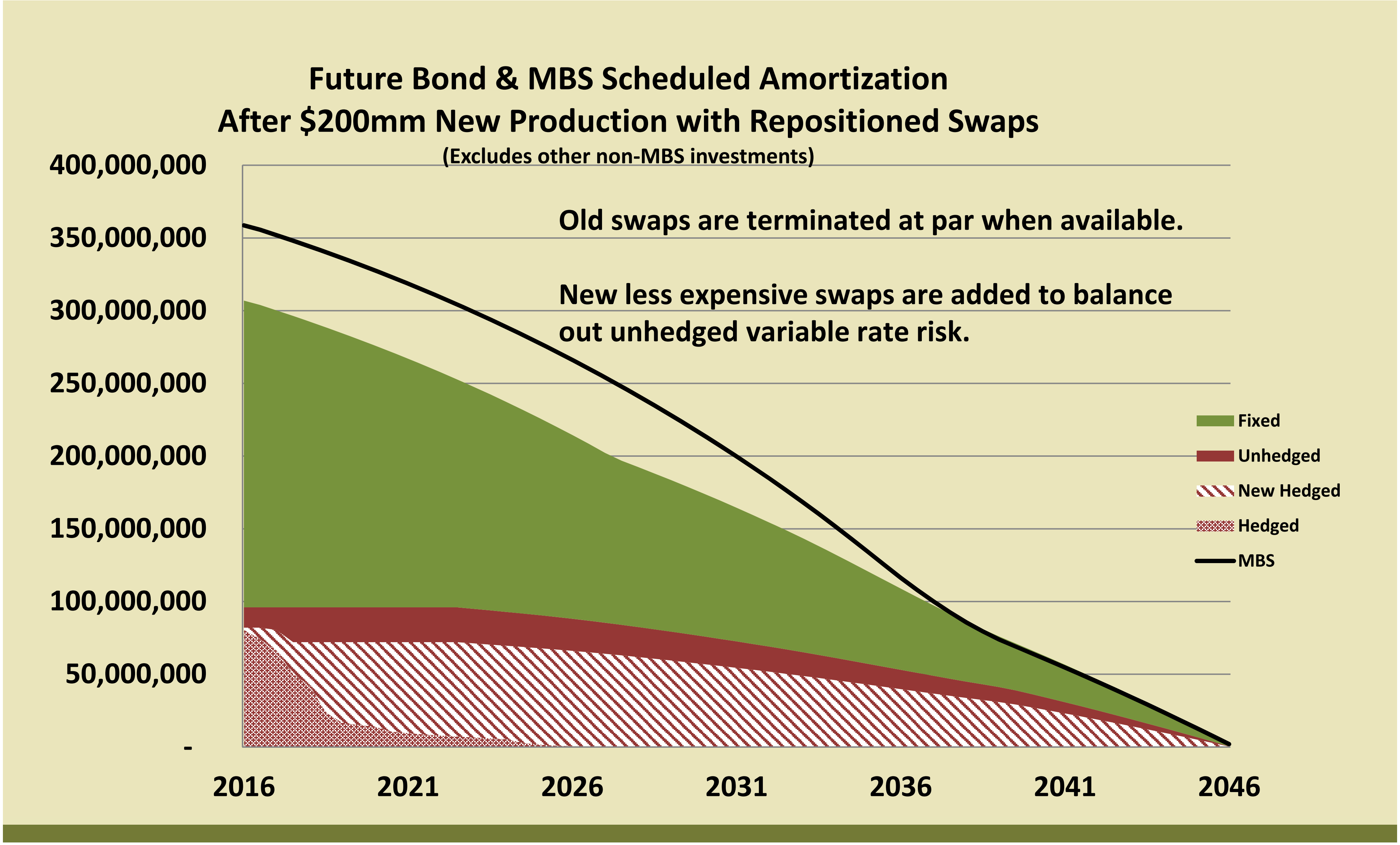

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