

### **This Is Different: A New Recipe for HFA's**

In the current interest rate environment, the traditional model employed by housing finance agencies (HFAs) for the issuance of mortgage revenue bonds (MRBs) to provide financing for first time homebuyers, is no longer competitive even with the federal tax-exemption. Using a "new" recipe to access the capital markets, the Nebraska Investment Finance Authority (NIFA) was able to "bake something simple, sweet and tasty" by issuing \$43.3 million of "TEMPS" bonds to finance its single family mortgage program.

#### **Introduction**

TEMPS combines the best of two worlds; an agency MBS-like structure with a federal income tax exemption on the security. As a result, the bonds issued by NIFA using a TEMPS structure are expected to behave with respect to prepayments similarly to the traditional agency MBS. And generally, bonds issued by an HFA using the TEMPS structure should have added value in the market because of certain loan characteristics often desired by agency MBS investors that may command higher prices. Some characteristics sought by agency MBS investors is a smaller loan size and the first time borrower nature of the HFAs' programs.

#### **The New Recipe: "Kolache\*" Bonds**

When the "traditional" market for the HFA bonds no longer provided a cost of funds which would enable NIFA to provide a competitive mortgage loan rate to its customers, NIFA sought a new recipe. With the end goal of maintaining and ideally increasing mortgage loan production levels at affordable interest rates, NIFA worked with J.P. Morgan to develop a product to eliminate the inefficiencies inherent in the traditional mortgage revenue bond market and to take advantage of the efficient pricing found in the agency MBS market. The result was the creation of a new recipe: "TEMPS: Tax-Exempt Mortgage Participation Securities."

The uniqueness of the TEMPS product is the ability to take advantage of the liquidity found in the traditional MBS market (e.g., Ginnie Mae and Fannie Mae MBS securities), with the addition of providing the purchaser of a security with interest exempt from federal, and in the case of NIFA state income taxes.

The current environment of the capital market calls for developing a different mental map. It was time to reshape our bond execution strategy. NIFA's traditional method of accessing the capital markets for its single family program had been to issue bonds secured with MBSs backed by Ginnie Mae and Fannie Mae (as opposed to whole loans). Working on the cutting edge, in June of 2011, NIFA became the first state HFA to sell a bond issue using the TEMPS model. Keeping the structure of the lower risk profile provided by the Ginnie Mae and Fannie Mae MBSs, NIFA's new recipe provided a competitive bond cost and favorable mortgage interest rates for NIFA's low and moderate income borrowers.

*\*For the uninitiated, a kolache is often found baking in the kitchens of Loup City, Nebraska. It is a basic pastry containing a fruit filled center and is best served warm.*

### **Why the Recipe Works**

Over \$60 billion of agency (Ginnie Mae, Fannie Mae and Freddie Mac) MBSs trade daily in a very efficient and transparent market. The result is very competitive pricing generated by the sheer size of the pools of capital and the number of investors participating in the market. Hundreds, if not thousands, of mortgage data points are viewed, tracked and then taken into account in valuing the traditional agency MBS. Not surprisingly, one of the most volatile and often unpredictable pieces of investing in MBSs is the speed at which prepayments are made on the underlying mortgage loans, which prepayments are passed through to investors causing a redemption of the MBS. Just like a MBS, NIFA's TEMPS security can be analyzed and compared in this highly developed market. Once an investor assures himself/herself as to the characteristics on a particular MBS pool, the MBS is valued to take such information into account. Based upon the specific MBS pool information available, the buyer and seller of an MBS both have clear views on the MBS and are both able to better price or value the security.

By contrast, we experience a certain amount of inefficiency in the "legacy" model of a HFA's MRBs that are backed by MBS. Many HFAs structure their bond issues to provide that mortgage loan prepayments (whether on whole loans or MBSs) may be recycled into new mortgage loans, may be used to redeem the HFA's bonds related to the mortgage loans or used to redeem other bonds of the HFA, in each case, at the option of the HFA. As a result, the predictability of prepayments cannot be modeled as effectively as the prepayments on a traditional agency MBS where such "flexibility" and "optionality" are not present. The investor of the "legacy" MRB issue thus demands a higher yield to compensate for the relative lack of transparency and lowered predictability (and the optionality retained by the HFA), making the "legacy" MRB program non-competitive in today's market.

### **Summary**

TEMPS are fondly referred to by the NIFA finance team as "Kolache" bonds. Why? The very apparent similarities between the two.\* Both are simple – the kolache recipe is basic and TEMPS are, in many ways, easier to execute than a traditional MRB. Both are sweet – kolachies are filled with a fruit filling; TEMPS provides a tax-exemption attractive to a large pool of investors. Tasty – people want more! With TEMPS, programmatic "optionality" is present, with liquid and transparent forward hedging ability.

NIFA is confident that as the TEMPS market expands and matures, the TEMPS structure will enable NIFA to continue to achieve very efficient bond costs with an added benefit of even lower interest rates driven by the tax-exempt nature of the instrument compared to agency MBSs. This in turn should enable NIFA and the other HFAs to continue to fulfill their mission of providing financing to those low and moderate income persons and families seeking to reach the American Dream of owning a home. NIFA can't wait to "bake" another "batch" of these simple, sweet and tasty kolache bonds!

## TEMPS Enables NIFA to Continue Financing Single Family Loans With MRBs

