IHDA's Direct Purchase Bond Program

Illinois Housing Development Authority

Rental Housing: Encouraging New Production

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Addressing a Universal Need

Across the nation, the demand for rental housing continues to grow. The country recently experienced the largest 10-year increase of renters on record while simultaneously losing a significant supply of low-cost rental housing. As a result, nearly half of all renter households are cost burdened. To address this need in an era of reduced resources and high construction costs, IHDA launched the Direct Purchase Bond Program, a new financing model that leverages the credit enhancement benefits of the FHA's Risk-Sharing program to provide competitive rates and terms while reducing overall project risks for construction and permanent multifamily loans.

Background

The FHA Risk-Sharing Program provides credit enhancement for multifamily mortgages underwritten by HFAs by allowing them underwrite FHA loans in returning for sharing the risk of losses on those loans. Participating HFAs may originate and underwrite affordable housing loans for new construction, substantial rehabilitation and refinancing deals, and the program will provide full FHA mortgage insurance to enhance HFA bonds to investment grade. By leveraging the Risk-Sharing credit enhancement, IHDA can achieve a reduction in permanent pricing, which in turn allows for increased loan proceeds. The extremely competitive rates and terms further reduces or eliminates financing gaps in deals. Given the limited resources available to fill financing gaps, this financing structure is an important tool that allows IHDA to produce more affordable housing units.

How it Works

The Direct Purchase Bond Program will work for either a taxable 9% deal or a 4% tax-exempt bond deal. Under this model, a bank provides financing and underwrites all risks during construction. IHDA can structure the construction period as either a loan or a bond, depending on the bank's needs, with a bank as the bond/loan purchaser. The same applies for the permanent period.

For the permanent period, IHDA utilizes a forward Bond Purchase Agreement ("BPA") in which the Authority has an agreement with a bank to deliver either a tax-exempt or taxable security (depending on deal type) at stabilization. The pass-through rate under the BPA for the permanent period is set at the initial closing of the construction loan. The term and amortization for the permanent period can be as long as 40-years. Assuming a bond is issued, IHDA will provide a rating as well as a CUSIP so the bond is a marketable security that can be sold by the bank at any time. The FHA Risk Sharing credit enhancement should equate to a AAA rating on the bond.

IHDA will originate and service the long-term bond/loan so all payments will flow through the Authority, generating long-term revenue opportunities through interest spread and servicing fees. One hundred percent of the credit risk during the permanent period is shared between IHDA and HUD (generally 50% IHDA / 50% HUD), which eliminates all credit risk to the bank. This eliminating of risk results in a reduction in the bank's cost of funds and reserve requirements, which lowers the pass-through rate to IHDA and ultimately to the borrower.

Benefits

The Direct Purchase Bond Program provides a number of direct financial benefits for HFAs, their lending partners and their borrowers. To start, this structure eliminates construction risk to the Authority by partnering with a bank to provide financing. Using IHDA's balance sheet to provide construction financing typically requires the use of either IHDA's GO or some other form of collateral as a guaranty for a construction loan. As rating agencies monitor the level of construction exposure an HFA carries, this can affect an Authority's bond rating. By using this structure, we have eliminated the need to provide a guaranty during construction.

In addition, this structure also allows IHDA to "play nice in the sandbox" with banks and other financing partners. While banks are traditionally motivated to provide construction financing to meet their Community Reinvestment Act ("CRA") goals, they are less interested in providing long-term project financing, and IHDA has historically competed with them to provide both construction and permanent financing facilities. However, since construction financing is typically greater than permanent financing, the Direct Purchase structure allows banks to continue meeting their CRA needs through higher construction financing facilities, while also reducing the costs and risks of providing permanent financing. Depending on the structure, the bank may be able to obtain CRA lending test credit for the construction financing and CRA investment test credit for the bond purchase related to the long-term loan within the same transaction.

This structure also provides fully-amortizing facilities that eliminate refinancing risks. While traditional bank loans utilize a balloon structure, which is the typical funding approach the Authority sees on taxable loans and many agency executions, the Direct Purchase structure provides long-term, fully-amortizing financing with a 10-year lockout and a small pre-payment fee of $5,000 after lockout.

Most importantly, this strategy lowers borrowing costs for HFA partners, increasing their capacity to create much-needed affordable housing. Current tax-exempt pricing utilizing the Direct Purchase structure for long-term, fully-amortizing financing is typically 0.2% below the rates of similar structures using a public bond issuance. Compared to current pricing of typical bank loans, IHDA estimates that the Direct Purchase structure reduces long-term taxable borrowing costs anywhere from 0.65% to 1.15%, a considerable savings for the borrower.

4% Bond Deal Example

1. Initial Closing: IHDA to issue three tranches of conduit loans (tax-exempt) with construction risk underwritten by note/bond purchaser
    a. Tranche A: $2,935,000 (fully funded)
        i. Term: 43 years (2-year construction + two 6 month extensions + 40 year perm)
        ii. Interest rate: TBD
        iii. Amortization: I/O for two (2) years, fully amortizing thereafter
        iv. Prepayment: allowed without penalty after 12-18 month lockout
        v. Investor: TBD
    b. Tranche B: $3,070,000 (draw down)
        i. Term: 2-years (two 6-month extensions available)
        ii. Interest rate: TBD
        iii. Amortization: I/O

    iv. Prepayment: allowed without penalty after 12-18 month lockout
    v. Investor: TBD
  c. Tranche C: $3,860,000 (draw down)
    i. Term: 2-years (two 6-month extensions available)
    ii. Interest rate: TBD
    iii. Amortization: I/O
    iv. Prepayment: allowed without penalty after 12-18 month lockout
    v. Investor: TBD

2. <u>Final Closing / Refunding Bonds</u>: IHDA to issue long-term 4% tax-exempt bonds backed by a risk-sharing loan.
   a. Refund Tranche A construction loan
      i. $2,935,000
      ii. Term: 40-years
      iii. Interest rate: TBD (to be locked at initial closing pursuant to a forward bond purchase agreement "Forward BPA")
      iv. Rating: Moody's
      v. Credit Enhancement: FHA Risk-Sharing Program
      vi. Prepayment: 10-year lock-out
      vii. Investor: TBD (purchase commitment pursuant to Forward BPA)

The structure summary above is an example of one utilized by IHDA with a large national bank as the construction lender using a Bond Purchase Agreement for the permanent financing. Similar structures have been utilized for 9% taxable deals, and the construction lender, who sets the interest rate(s) for construction facilities and faces the borrower, underwrites all construction risk.

All credit risk during the permanent period is assumed by IHDA under the FHA Risk-Sharing Program. IHDA originates a permanent loan/bond with a pass-through rate set by the bond purchaser or funding lender (depending on whether a bond or a loan is issued) plus a spread (including servicing and Mortgage Insurance Premium (MIP)).

Conclusion

Given the considerable savings generated by this structure and the need to stretch every available resource, this is an effective strategy to help HFAs keep pace with the growing demand for affordable housing. It provides favorable terms for both lenders and borrows, and achieves considerably reduced interest rates for the construction and preservation of much-needed affordable housing. This structure is a strategy that helps IHDA increase the stock of affordable housing throughout Illinois, and ensures the Authority will be able to offer competitive financing in an underserved segment of the market.