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November 23, 2011

Ms. Judith Smith
Tennessee Housing Development Agency
404 James Robertson Parkway, Suite 1200
Nashville TN 37243-0900

Dear Ms. Smith,

I am writing on behalf of NH&RA's Tennessee Developers Council (TDC) in response to the Tennessee Housing Development Agency's call for additional feedback regarding the 2011, 2012 and 2013 Low-Income Housing Tax Credit Qualified Allocation Plans (QAPs) and Tax-Exempt Bond Program Descriptions (BPDs).

We appreciate the opportunity to provide feedback on the allocation process and are pleased to extend our ongoing dialogue with THDA on these proposed changes. The following comments are meant to supplement our letters to the Agency dated July 18, 2011, August 4, 2011 and September 12, 2011, and to respond to discussions among TDC members and THDA Staff and Board Members at our convening on October 18, in conjunction with the Governor's Housing Summit.

Refining the Bond Program Description

THDA has two documents that govern the federal 9% LIHTC program (the QAP) and the tax exempt bond program (the BPD). At present, both 9% LIHTCs as well as 4% LIHTCs which are allocated with tax-exempt bond are governed in the Qualified Allocation Plan. Generally speaking, the 9% and 4% LIHTCs target different types of properties with different needs. TDC believes that many requirements that are appropriate for the 9% program are overly burdensome for the 4% program because of the difference in project economics between the two programs. This is especially relevant for construction, rehabilitation, environmental, and sustainability related expenses as bond transactions tend to involve acquisitions and rehabilitation. The current set of governing documents do not make this distinction and as a result make the tax-exempt bond program unfeasible for most developers. Most of the comments below address rehabilitation and preservation oriented transactions; however, it should be noted that new construction projects would be viable in some markets using tax exempt financing if additional policy changes were adopted by THDA.

To start, TDC recommends that policy regarding the 4% credits should be governed separately; ideally in the BPD. This will allow THDA to better refine and customize the Tax-Exempt Bond program and avoid confusion or unintended consequences to the bond program when changes to the QAP are made.

TDC has identified the following provisions in the QAP that should either be amended or moved to the BPD for projects financed using tax-exempt bonds. In some cases, it may be necessary to change the QAP and update with conforming language in the BPD:

Proposed Changes to 2011 QAP Regarding Bond Financed Transactions

Part VI: Limits on Amount Tax Credits Available

TDC understands that restrictions and limitations laid out in Part IV do not apply to transactions financed using tax-exempt bonds but rather only projects seeking competitive 9% LIHTCs. To avoid confusion and unintended consequences, TDC recommends that THDA insert clarifying language in the QAP clearly stating that these provisions only apply to the 9% LIHTC program and not allocated 4% credits associated with tax-exempt financing.

Part VI: Application Submission

Part VI (C): To avoid confusion, TDC recommends the QAP be updated to state clearly that application deadlines apply to competitive (9%) applications only. The tax-exempt bond program has a rolling deadline.

Part VII: Initial Application Eligibility and Scoring

Part VII (A)(4)(a)(v): TDC believes that the thresholds set in this section are appropriate for either the 9% LIHTC or the tax exempt bond program. As stated in earlier comments, TDC recommends that minimum rehabilitation requirements should be determined by a particular building's actual physical needs over the course of the tax credit compliance period, as determined by a physical or capital needs assessment. This could be coupled with a per-unit rehab expenditure floor that that takes into account financing mechanisms utilized (i.e. 9% LIHTC, tax-exempt bonds, etc…).

Part VII (A)(8)(b): As TDC has expressed in earlier comments, the market study should be used only for eligibility purposes (threshold), not scoring.

Part VII (B)(1)(a): As TDC has expressed in earlier comments, the Market Study should be used for eligibility (threshold), not scoring. In particular, scoring applications based on occupancy of comparable properties has many logistical challenges that could result in misleading data.

Part VII (B)(1)(b): TDC does not believe that tax-exempt bond financed transactions should be penalized for being in a QCT. Any limit in the QAP on bond financed transactions in QCTs serves only to limit the ability to maintain the affordability of existing properties simply because of their location.

Part VII (B)(2)(b)(i): TDC understands that THDA is considering a tiered rehabilitation minimum requirement standard based on the rehabilitation needs of a particular property financed using tax-exempt bonds. TDC is in general concurrence with this approach and looks forward to working with THDA to refine this further when the text becomes available. In the meantime, we suggest that the IRS rehabilitation requirements are appropriate for many properties and should be considered for the minimum standard. THDA should consider using a third party physical needs assessment to verify.

Part VII (B)(2)(d): TDC understands THDA would like to expand its minimum energy efficiency requirements in future rounds. We welcome the opportunity to work with the Agency to identify a solution that helps achieve its policy goals without being overly burdensome on the development community. We also recommend that the Agency consider separate energy efficiency requirements for projects financed using tax-exempt financing.

Part VII (B)(4): Given the economics of a bond transaction and the relative shortage of soft-financing available for affordable rental housing in Tennessee, TDC suggests that deep income targeting should not be a threshold requirement for projects financed using tax-exempt bonds.

Part VIII: Initial Application Eligibility and Scoring Review

Part VIII (C): It is TDC's understanding that the cure and review period does not apply to transactions financed using tax-exempt bonds. To avoid confusion, TDC recommends that the QAP be clarified to reflect this practice. Furthermore, as stated in previous comments, TDC believes that the formal cure process is unnecessary and overly burdensome to THDA. An informal application review with staff should be sufficient.

Part IX: Reservation of Tax Credits

Part XI (B): This section is not applicable to bond deals. To avoid confusion, TDC recommends that the QAP be clarified to reflect this practice.

Additional Changes to the 2012 DRAFT Bond Program Description

In addition to the changes noted above to the QAP, TDC also recommends the following changes to the 2012 DRAFT Bond Program Description (version released November 17, 2011).

Part I: Background, Eligibility, and Requirements

Part I (B)(1)(c): In conformance with our recommendation above (see QAP Comment RE: Part VII (A)(4)(a)(v)), TDC supports THDA's proposed change in the Draft 2012 BPD that eliminates the current threshold rehabilitation hard cost requirements.

Part I (F)(1): TDC members include developers that focus on both new construction as well as preservation and/or acquisition rehabilitation. Generally, we recommend that both the QAP and BPD be neutral in preference with regards to the type of project (new construction vs. rehabilitation) and as such recommend that THDA amend the BPD to set the maximum amount of bonds per development at the same level ($17,250,000) for both new construction and rehabilitation

Part I (F)(2): TDC applauds THDA's intent in proposing an amendment to the BPD to create a tiered rehabilitation requirement based on the physical needs of the property; however, we suggest that further refinements are essential to achieve the Agency's goals. TDC believes that setting a maximum eligibility for bond authority based on the category of rehabilitation is counterproductive. This could prevent larger scale projects from taking advantage of the opportunities inherent in this proposed amendment. TDC believes that the Physical Needs Assessment should be the determining factor as to eligibility to compete as a moderate or limited rehabilitation and not total bond authority.

Part I (F)(1) and (2) and Part1 (G): TDC believes that the current restrictions on bond allocation authority per project and developer are unnecessary given that the bond volume cap for multifamily is significantly undersubscribed.

Part I (J)(2) and Part VII (A)(1): TDC reiterates our comments expressed above in Part VII (A)(8)(b) and Part VII (B)(1)(a) regarding the proper use of the market study.

Part I (N): TDC recommends THDA amend the section pertaining to land use restrictive covenants as follows:

> THDA will provide a Land Use Restrictive Covenant with a term of fifteen (15) years for developments using Multifamily Tax-Exempt Bond Authority **without** noncompetitive Low-Income Housing Tax Credit. ~~THDA will provide a Land Use Restrictive Covenant for developments using Multifamily Tax-Exempt Bond Authority and noncompetitive Low-Income Housing Tax Credit based on the terms of and elections under the 2011 Qualified Allocation Plan.~~ *THDA will provide a Land Use Restrictive Covenant for developments using Multifamily Tax-Exempt Bond Authority and noncompetitive Low-Income Housing Tax Credit based on the terms of and elections under **this Bond Program Description.*** The Land Use Restrictive Covenant must be executed, recorded in the county where the development is located, and **the original** returned to THDA no later than the date specified in the Commitment Letter.

Part I (O): TDC recommends amending this section as follows to provide some additional flexibility regarding building code compliance requirements:

> The development must meet all applicable local building codes or in the absence of such codes, the development must meet the following, as applicable: new construction of multi-family apartments of 3 or more units must meet the 2009 International Building Code; new construction or reconstruction of single-family units or duplexes must meet the 2009 International Residential Code for One- and Two- Family Dwellings; and rehabilitation of rental units must meet the 2009 International Existing Building Code and the 2009 International Property Maintenance Code, *to the extent financially feasible*. Certification from the design architect will be required following the issuance of the Commitment Letter. Confirmation from the supervising architect will be required prior to any partial refund of the Commitment Fee pursuant to Part X-D.

Part VII: Scoring Criteria

Part VII (B)(4): In conformance with our recommendation above (see QAP Comment RE: Part VII (A)(4)(a)(v)), TDC supports THDA's proposed change in the Draft 2012 BPD that eliminates the current threshold rehabilitation hard cost requirements.

- Part VII (D): TDC supports THDA's proposed change in the Draft 2012 BPD. .
- Part VII (F): TDC reiterates our comments expressed above in Part VII (B)(2)(d) regarding energy efficiency requirements.

Part X: Fees, Partial Refunds of Fees, and Fees Retained by THDA

Part X (G)(2)(d): TDC requests THDA reevaluate the section regarding additional monitoring fees. We believe that $400/unit should suffice. The potentiality for additional monitoring fees complicates underwriting and project finances on transactions with already limited cash flow.

Part XI: Application for Low-Income Housing Tax Credits

TDC is concerned that THDA's proposed insertion to this section ("For purposes of determining the final amount, if any, of non-competitive Tax Credit to be allocated to the development, the original amount of Multifamily Tax-Exempt Bond Authority closed and sold will be used") may prevent developers from utilizing a variety of legitimate and desirable deal structures. Developers may legitimately pursue tax-exempt financing in order to obtain 4% LIHTCs without the intent of using tax-exempt financing as permanent debt. This can happen in a variety of reasons. For example, a property targeted to residents with special needs (e.g. homeless, mentally disabled, etc…) may not be able to support any level of permanent debt because the residents have minimal or no ability to pay rent. In this example, the bonds are paid down with other sources and in effect the 4% LIHTC serve as gap financing in conjunction with other sources of soft-financing. Outstanding projects like Minvilla Manor in Knoxville (developed by TDC member Southeastern Housing Foundation), utilized this structure and was funded using THDA programs. This project was a winner of numerous accolades including THDA's own Tennessee's Best Awards (Finalist for the Remarkable Achievement Urban/Rural Award Category at the Tennessee Governor's 2011 Housing Summit) and we fear would not be possible with this proposed rule.

Likewise, we are concerned that this proposed amendment could prevent developers from utilizing a popular new structure that takes advantage of current market dynamics (in today's unusual market tax-exempt financing has higher interest rates than taxable bonds) which combines short-term cash backed tax-exempt bonds (to achieve 4% LIHTCs) with taxable GNMA sales.[1] TDC recommends that this proposed amendment be dropped from the BPD.

Additionally, to reduce duplicative paper work, TDC recommends THDA adopt a single universal application that combines the tax exempt bond and 4% LIHTC applications.

Conclusion

We deeply appreciate the opportunity to provide you with this feedback. We would be very happy to discuss any specifics you might have regarding these comments or other subjects of concern. You may contact me directly with any questions at 202-939-1753 or tamdur@housingonline.com. Thank you for your consideration.

Best Regards,

Thom Amdur
Executive Director

[1] See Attachment I for a detailed explanation of this structure.

About the Tennessee Developers Council

The Tennessee Developers Council is an independent council of the National Housing & Rehabilitation Association comprised of LIHTC and affordable multifamily developers (both private and non-profit) who work with the Tennessee Housing Development Agency. The Council convenes on a regular basis to share ideas, network, and provide a clear voice on key policy issues being considered by THDA and state legislators.

About National Housing & Rehabilitation Association

NH&RA is a national trade association comprised of professionals involved in the development, ownership, operation and finance of multifamily affordable housing. Formed in 1971, our members include developers, owners, property managers, debt and equity providers, attorneys, accountants, and other professionals involved in tax-advantaged real estate.

cc: Ralph Perrey
Ted Fellman
Laura Sinclair
Ed Yandell

Attachments: COMBINING SHORT-TERM CASH BACKED TAX-EXEMPT BONDS WITH TAXABLE GNMA SALES FOR AFFORDABLE HOUSING PROJECTS USING FHA INSURANCE

Attachment I

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EICHNER & NORRIS PLLC

November 2-4, 2011

COMBINING SHORT-TERM CASH BACKED TAX-EXEMPT BONDS WITH TAXABLE GNMA SALES FOR AFFORDABLE HOUSING PROJECTS USING FHA INSURANCE

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This memo explains a new program which our firm has developed to dramatically reduce the long term borrowing rate and negative arbitrage associated with affordable housing projects financed with FHA-insured mortgage loans where the Borrower must finance 50% of project costs with tax-exempt bonds and keep those bonds outstanding until the project's placed-in-service date in order to get full value for the 4% LIHTC equity under the "50% Rule". The structure prices the permanent loan rate in the huge, highly efficient forward delivery market for taxable GNMA Securities, rather than the much smaller, less efficient "fully funded" long-term tax-exempt multifamily housing bond market, and uses short-term, "cash backed" tax-exempt bonds to achieve compliance with the "50% Rule".

Background

The first quarter of 2009 was truly a "nuclear winter" for affordable housing finance. Following the financial crisis in the fall of 2008, two-thirds of the market for tax credits effectively had disappeared as Fannie Mae and Freddie Mac (formerly 40% of the tax credit equity buy side) and large commercial banks (formerly 25%) had suffered major losses, had no taxable income and no prospect of taxable income, and thus no need for federal tax credits of any type. Similarly, on the debt side, long-term, tax-exempt municipal rates had risen to a point where they were 400 basis points higher than the rates on comparable taxable 30-year U.S. government securities. This reflected in large part a flight to safety of U.S. Treasuries, as trillions of dollars of formerly AA and AAA rated debt of large banks, insurance companies (e.g. "AIG"), securities firms (e.g. "Lehman Brothers"), bond insurance firms (e.g. "AMBAC, MBIA, FGIC, ACA"), CDOs, CLOs, CMOs and other paper of non-U.S. Government issuers became worthless or worth only pennies on the dollar.

Background (Cont.)

In such an environment, and even today (given the concern over European government and bank debt), there is a huge flight to safety of U.S. Government debt, and U.S. Government securities now trade at record low yields. On the municipal side, on the other hand, yields have risen to record levels versus taxable U.S. Government debt as concerns regarding the credit quality of a wide array of municipal bonds have risen and the long-term viability and value of the federal tax-exemption on municipal debt is increasingly challenged.

As many market participants discovered, in the 1st quarter of 2009 the only viable debt financing model was FHA. There were no bank letters of credit required to credit enhance bond issues or to cover the construction and rent up period for Fannie Mae and Freddie Mac enhanced bonds. This is not needed for an FHA-insured loan, since FHA provides insurance of loan advances. Moreover, FHA insured loans can be "wrapped" with GNMA pass-through securities (called a Construction Loan Certificate or "CLC" during construction or a Permanent Loan Certificate or "PLC" once the FHA insured loan has been finally endorsed for insurance post-construction). These GNMA certificates provide the full faith and credit guarantee of the U.S. Government that the payment due on the FHA insured loan due on the first of the month will be "passed through" to the holder of the GNMA on the 15th (minus a 25 basis point GNMA guaranty/servicing fee), even if the underlying FHA insured loan is in default and the payments due are not being made. As a result, in the taxable debt securities markets, GNMA securities trade at very tight spreads to U.S Treasury Bonds.

Thus a long-term tax-exempt bond issue to fund an FHA-insured mortgage loan might bear interest at 5.75% in the current market and with fees, produce a stated mortgage loan rate of slightly over 6.0%. The same loan, priced in the taxable market for GNMA's, might bear interest at a rate of about 4.75%. The result is, that as irrational as it may seem, since the winter of 2009, the FHA-insured mortgage loan rate which can be achieved by selling GNMA securities in the taxable market is well over a full percentage point lower than the mortgage loan rate which can be achieved by funding the same loan through the sale of long-term tax-exempt Aaa or AA+-rated municipal bonds.

The debt markets for GNMAs are also "forward delivery" markets. This means that as each FHA loan advance is made and wrapped with a GNMA security, that security (having the previously agreed upon rate) is delivered to the buyer against payment – i.e., the debt investor advances money to the borrower (through the purchase of the GNMA Security from the Lender) when the funds are needed. This differs dramatically from publicly offered municipal securities markets, where all of the bonds representing the full loan amount must be delivered and begin to bear interest at the long-term borrowing rate of say 6.0%. Those undisbursed bond proceeds must be reinvested in an AAA-rated or AA+-rated investment arrangement until the money is advanced to fund loan draws. Since short term reinvestment rates of this type range from 30 – 50 basis points per year in the current market, this can impose huge negative arbitrage costs and deposit requirements. On a fully funded, long-term tax-exempt bond financing for new construction or substantial rehab, the actual negative arbitrage on such a financing can be as much as 3 – 5% of the loan amount and additional negative arbitrage deposits in a similar account can be required to cover the maximum potential negative arbitrage if construction on loan advancements is suspended or proceeds more slowly than expected. An 8 – 10% up front deposit of this type can be fatal to many deals.

The Light Bulb Lights Up

Thus, as we sat in our offices in that desperate winter of 2009, we asked ourselves the question: "If only there were some way we could access these extremely low long-term borrowing rates in the taxable market for GNMA securities and also take advantage of the forward funding aspect of that market to reduce or dramatically lower the negative arbitrage associated with such a deal." The "Ah Ha" moment came from tax-exempt bond financing structure we and others had developed in the mid-1990s for HOPE VI deals. HOPE VI is a program to replace former public housing units, through the provision of HOPE VI "grants" to the projects. Many such projects are targeted at populations with median incomes in the 15 – 20% of area median income range, and thus cannot carry any permanent debt without huge permanent rent subsidies. Instead, they are often financed with short-term tax-exempt bond issues in order to prime full value for a 4% LIHTC syndication. The tax credit syndication proceeds, together with loans to the Borrower funded from HOPE VI grants, and possibly other subordinated loans, provide all of the permanent funding.

Short-term tax-exempt bonds in an amount equal to 50% of the project costs are issued with a maturity roughly twice the targeted placed-in-service date (to provide for construction delays) and two guaranteed investment contracts on bid with the same highly rated provider at the same rate: (i) a "GIC A" in which all the tax-exempt bond proceeds are invested, and (ii) a "GIC B" in which tax credit equity installments or money from HOPE VI funded loans are deposited when received. By structuring such financings so that as each dollar of tax-exempt bond proceeds is disbursed from GIC A to pay project costs, an equal amount of "replacement proceeds" must be deposited into GIC B, the Bond issue remains 100% cash collateralized, and one can obtain an AA or AAA rating on the short-term bonds based on the unsecured debt rating of the provider of the investment agreement, without other credit enhancement. When the project loan has been fully funded, the tax-exempt bonds are repaid after the placed-in-service date and the project has no permanent senior debt.

The Light Bulb Lights Up (Cont.)

This structure raised questions with many bond counsel firms as to whether it entailed an unnecessary “over-issuance” of tax-exempt bonds. After all, since the replacement proceeds had to be delivered before an equal amount of bond proceeds could be disbursed to pay project costs, why not just use these to pay the costs and forego the issuance of any tax-exempt bonds? On the other hand, under such a structure, the fundamental requirement that the tax-exempt bond proceeds be expended for qualified project costs is fully satisfied, so the other view was that the basic requirements of Section 103 of the Code were satisfied under the structure, and there was no reason a bond counsel firm could not issue a clean opinion.

The debate was largely resolved when language was added to the Work Quality Assurance Act of 2000 specifically endorsing the use of tax-exempt bonds in connection with “mixed use” HOPE VI financings. Since that time, almost all major bond counsel firms have given clean opinions on a wide variety of structures where all or a portion of tax-exempt multifamily housing bond issues have been cash collateralized with replacement funds of various types (HOPE VI monies, tax credit equity, proceeds of various federal and state subordinate loan funds) and kept outstanding until the placed-in-service date to meet the 50% test on the tax-credit equity side.

Our “light bulb” idea in the winter of 2009, was to simply apply that structure to finance affordable housing projects using FHA insurance, so as to get the low rates available in the taxable GNMA markets and dramatically reduce the often fatal negative arbitrage costs and funding requirements associated with long-term tax-exempt bond funded deals.

The following chart summarizes the principal benefits of the new structure versus the traditional funding method:

Tax-Exempt Bonds Issued: [1]Sized to meet 50% test (Assumes $25.0 Mil total cost)	$18,000,000	$13,000,000[1]
Tax-Exempt Bond Term	42 Years	2 Years
Mortgage Loan Interest Rate		
	Bonds 5.75%	GNMA 4.50%
	3rd Party Fees 0.15%	3rd Party Fees N/A
	Servicing + GNMA Fee 0.25%	Servicing + GNMA Fee 0.25%
	Total ML Rate **6.15%**	Total ML Rate **4.75%**

Result → 1.40% ML Rate Savings (~10% of additional loan proceeds on debt service constrained loan)

Negative Arbitrage (Deposit):	5.75% x 18,000,000 x 2 years	1.50% x $13,000,000 x 2 years
	$2,070,000 **(11.5% of ML)**	$390,000 **(2.0% ML)**
Negative Arbitrage (Actual):	$1,035,000 (5.25% of ML)	$390,000 (2.0% of ML)

Note that under the new structure, one only has to issue tax-exempt bonds in an amount sufficient to satisfy the 50% Rule, which can further reduce financing costs. Negative arbitrage is not eliminated, but since the short-term tax-exempt bonds under this structure would typically bear interest at rates of 1.0 to 1.5%, negative arbitrage should be limited to 1-2% versus 8-10% under the traditional long-term tax-exempt bond financing structure.

This structure has now been approved by 8-10 of the country's largest bond counsel firms, and a number of transactions are now under way. Moreover, given the high degree of uncertainty in the financing markets, we believe it is highly unlikely that conditions would change in the next 12-18 months so that the traditional long-term tax-exempt bond financing approach would once again be competitive with this new structure. Our firm would welcome any questions regarding this new financing device for affordable housing projects using FHA insurance.