Overview of Housing Bonds

Montana Board of Housing

Presentation to MBOH Board Members

April 14, 2014

RBC Capital Markets®

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Section A
General Housing Bond Review

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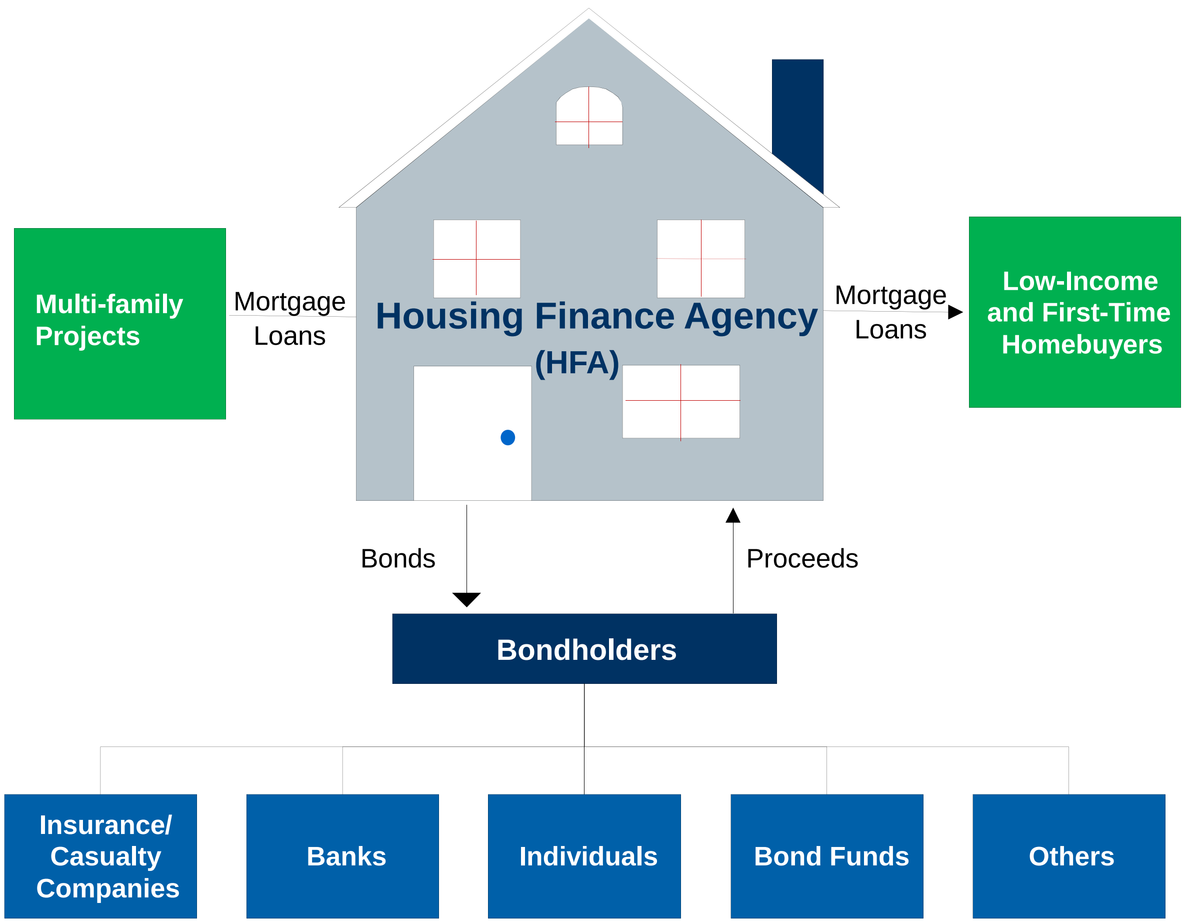
Flow of Funds – Bond Sale

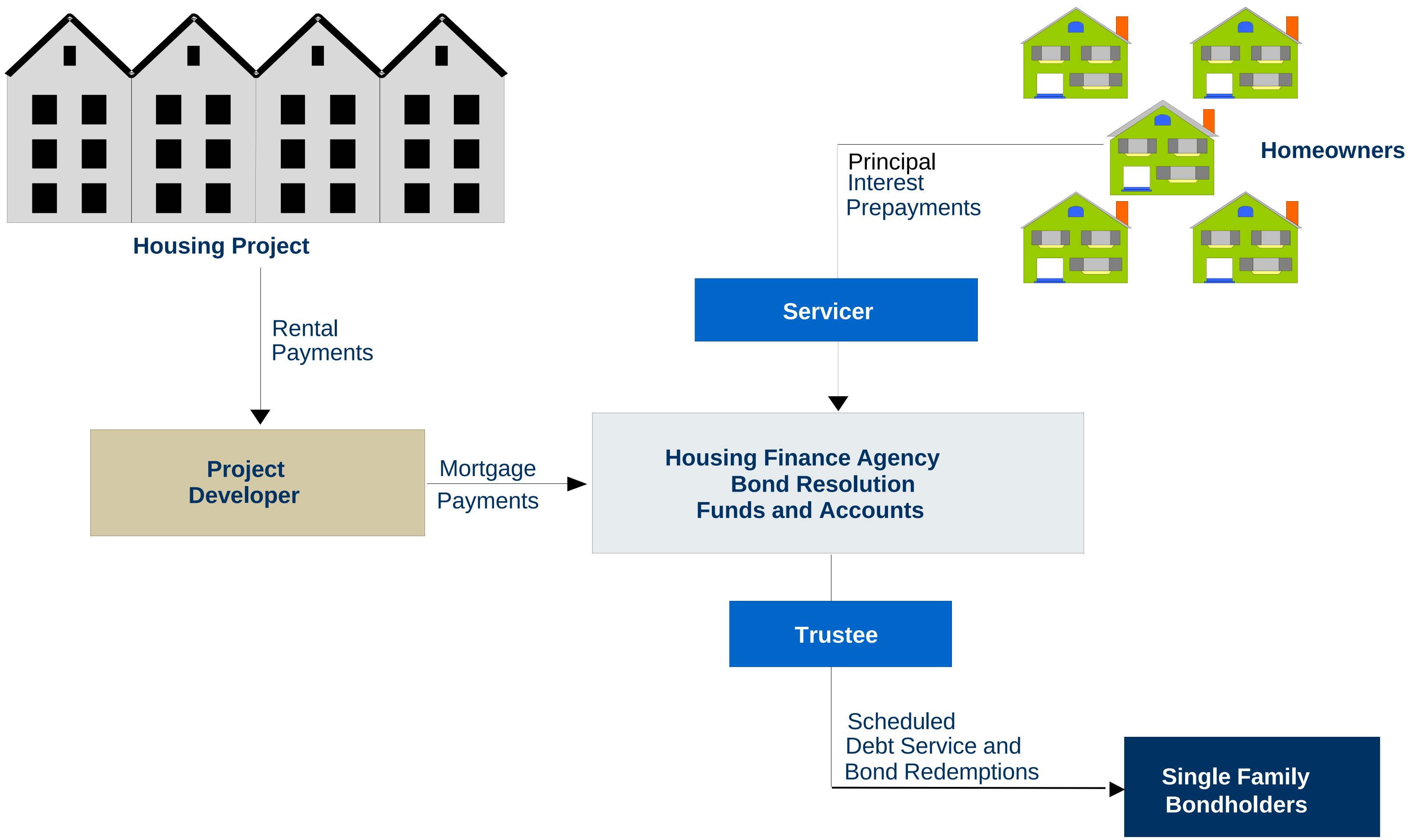
Bond – legally binding agreement between a borrower (issuer) and the lender (bond holder). In return for borrowing a sum of money (principal or par amount), the issuer pays interest (coupon) to the bond holder, generally every six months until the bond matures.



Flow of Funds – Ongoing

Bonds are secured by and payable from moneys pledged in the indenture (not the faith nor taxing power of the State of Montana or any political subdivision thereof).

MBOH bonds are “General Obligation” (GO) of the Board.



Early Redemption of Housing Bonds

MMD – "Municipal Market Data" index of high grade municipal bonds. Housing bonds generally trade at higher interest rates than MMD because they are revenue bonds, with no taxing power and are subject to early calls.

Types of Housing bond calls:

Prepayment Redemptions

- Loan prepayments are used to call bonds prior to their stated maturity dates
- "Super sinker" Bonds
  - All prepayments are used to call super sinker bonds first (until no longer outstanding)
- "PAC" Bonds (Priority Amortization Class)
  - First X amount of prepayments used to call the PAC bonds. Any additional prepayment used to call other bonds
  - Adds structure and stability to bonds

Excess Revenue Redemption

- Bond call from "excess" revenues within indenture

Non Origination Redemption (unexpended proceeds call)

- Call bonds if bond proceeds are not spent to purchase loans (42 months maximum)

10-year Optional Call

- "10 Year" optional call from any source of funds

Tax Status

- Housing bonds are Private Activity Bonds subject to bond cap (limited resource)
- Municipal bonds interest income from municipal bonds are generally free from Federal income taxation and state income tax (if any)
  - **Taxable**
  - **AMT** (Alternative Minimum Tax)
    - Tax Reform Act (1986)
  - **Non-AMT** (Not Subject to Alternative Minimum Tax)
    - Housing and Economic Recovery Act (2008)

Tax Requirement for Qualified Mortgage Bonds

Housing bonds issued after the 1980 Ullman Act have certain tax requirements

- Primary Residence Requirements (owner-occupied)
- Targeted Area (census tracts in which 70% of families have 80% AMI)
- First Time Homebuyer (no ownership for 3 years)
- Income and Purchase Price Limits (Federal IRS limits and HFA policy limits)
- Recapture Tax (home sold within 9 years with net gain and income higher than maximum)
- Unexpended Proceeds Redemption of Unused Bond Proceeds (42 months)
- 10-year Rule (loan principal repayments and prepayments must be used to redeem bond principal)
- Maturity Limitation (for refunded bonds – 32 years from original bond issuance date)
- Profitability limited to 1.125% spread

IRS Tax Law Limits Profitability

Conventional mortgage rate

Mortgage Yield

Maximum IRS Allowable Arbitrage Spread = 1.125%

Bond Yield

MBOH 2013B Yield Summary	
2013B Mortgage Yield	5.38%
2013B Bond Yield	4.27%
Spread	**1.11%**

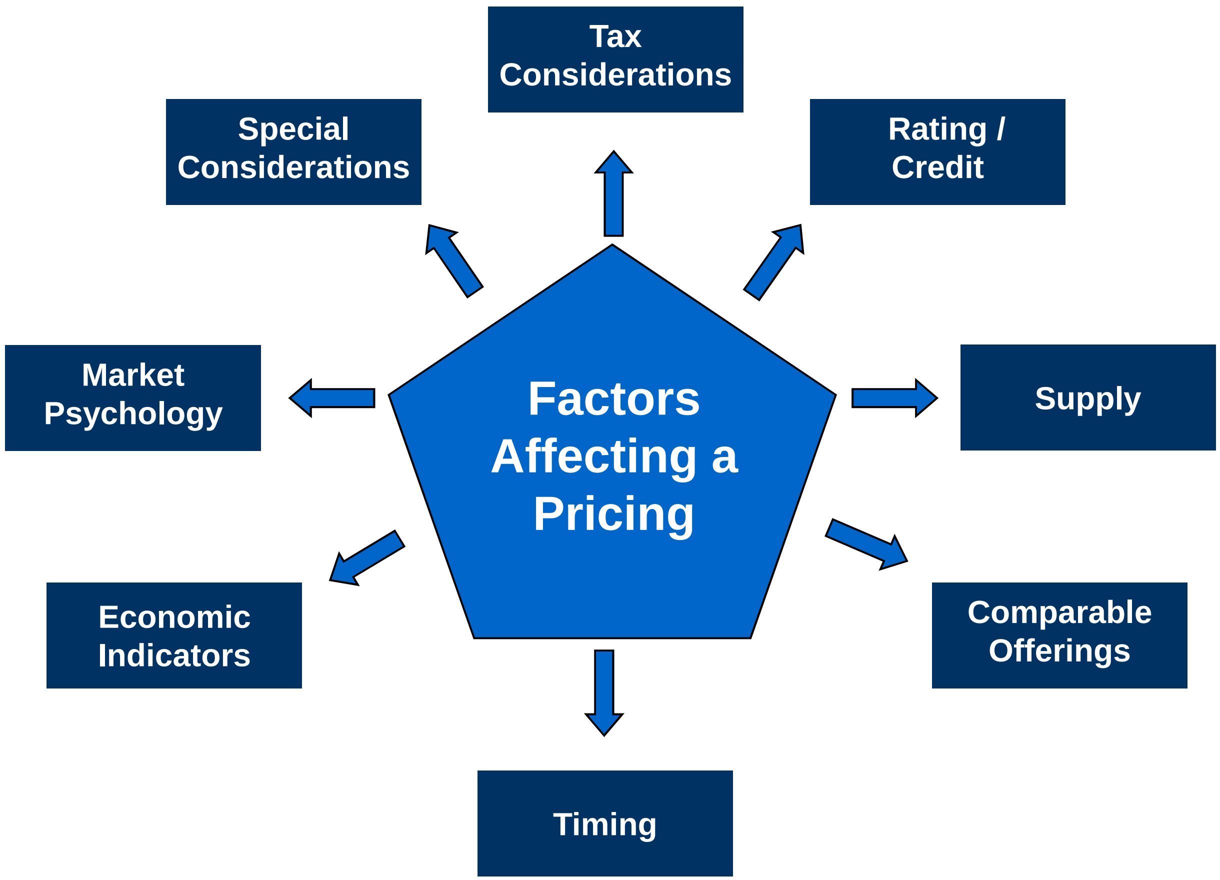
Spread between Mortgage and Bond Yield

- **To Cover Cost of Issuing Bonds**
- **To Cover Negative Arbitrage (if any)**
  - prior to loan purchase
  - between mortgage – bond payments
- **To Pay Ongoing Bond Costs**
  - Trustee Fee
  - Issuer (Admin) Fee
  - Servicing Fee
- **To Compensate MBOH For Risk**

Professionals in the Municipal Bond Industry

- **Issuer (MBOH)** – Issuers of municipal bonds are state and local government institutions (including Housing Finance Agencies)
- **Issuer's Counsel (Luxan and Murfitt) –** Issuer Counsel advises the issuer on all general legal matters (not necessarily relevant to bond financings) and delivers legal opinion
- **Bond Counsel (Kutak) –** Bond Counsel advises the issuer on legal matters as it relates to bond and tax issues. They draft bond documents and give legal opinions.
- **Financial Advisor –** Financial Advisor advises issuers on financial matters (cannot be underwriter)
- **Underwriters (Sr. Manager - RBC; Co-Managers - BoA Merrill Lynch, D.A. Davidson, Edward Jones & Piper Jaffray) –** Bankers work closely with issuers to meet their financings needs. Underwriters works with bond investors to determine market demand and sets appropriate interest rates on the bonds on pricing date.
- **Salespersons/Traders –** Buy and sell bond in the primary and secondary market, to provide liquidity to investors.
- **Underwriters' Counsel (Orrick) –** They represent the Underwriters. They draft Official Statements, Bond Purchase Contracts and Blue Sky.
- **Trustee (Wells Fargo) –** The trustee represents the interest of the bond holder. They act as custodian of the bonds proceeds and ensure the proper transfers of funds and accounts (and pays the bond holders).
- **Rating Agencies (Moody's, S&P) –** The rating agencies rate and rank bonds by assessing the creditworthiness of each security. They review program structures, cash flows and legal documents. They also provide ongoing oversight of the program structure, cash flows and financial condition of the issuer.
- **Investors –** Three major types of investors dominate the municipal marketplace: 1) Retail, 2) Bond Funds, 3) Institutions.

Factors Affecting a Pricing



Loan Insurance

"Whole Loans"

- Loans insured by FHA, VA, RD, HUD, deep equity, PMI
- Issuer can have "loan losses" and is subject to delinquent payment
- Bond issues need a reserve fund
- Bond issues need overcollateralization

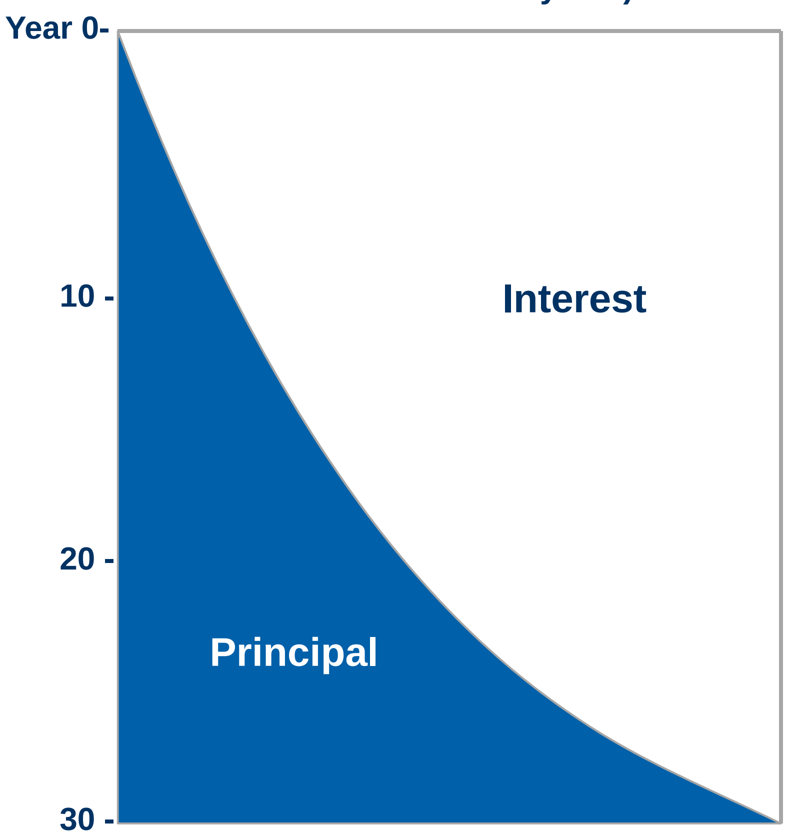
"MBS" (Mortgage Backed Securities)

- Loans pooled and securitized into GNMA, FNMA, FHLMC certificates
- Certificates pay 20th, 25th of month payment is due (regardless of borrower delinquency)
- MBS share same rating as US Government (Aaa/AA+/AAA)
- GNMA backed by the full faith and credit of the US Government
- FNMA and FHLMC (GSE with "implied" guarantee of the US Government)
- Bonds backed by MBS share rating of MBS

Housing Bond Structure

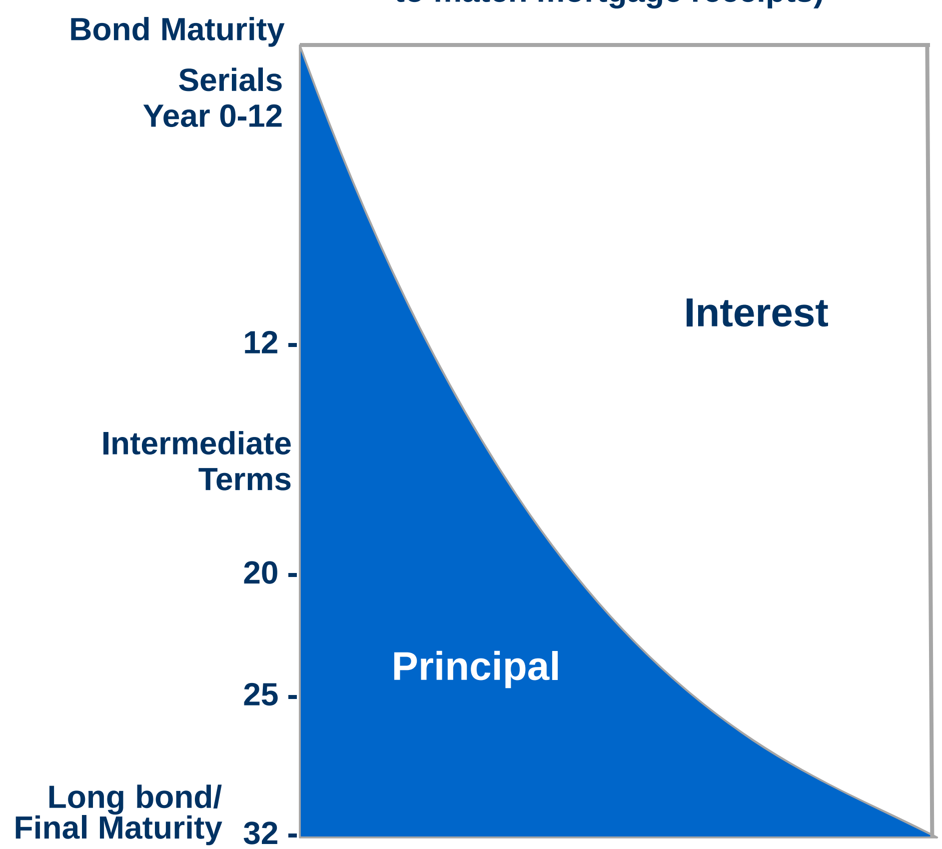
Mortgage Revenues

(collective monthly mortgage payments from borrowers – 30 years)



Bond Debt Service

(30-Year "Level Debt" – structured to match mortgage receipts)



Types of Bonds

Premium Bonds

- Sold at a price greater than 100%
- PACs are generally sold with higher coupon = price greater than 100%
- Premium often used to pay for cost of issuance or down payment assistance

Variable Rate Bonds

- Interest rate adjusts periodically
  - **Generally reset weekly by "remarketing agent"**
  - **Generally tracks SIFMA (Securities Industry and Financial Markets Association) Index**
  - **Need a liquidity provider**
    - **back stop if remarketing agent cannot find a bond investor at the "maximum" rate**

Counterparty Risk

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Counterparty risk is the risk to each party of a contract that the counterparty will not live up to its contractual obligations.

MBOH Counterparty Risk:

1. Mortgagor
2. Originating Lender
3. Government Mortgage Insurance – FHA, VA, RD, HUD
4. GIC / Repo Providers
   - Societe Generale ("A2/A/A") 2007A and 2007B DSRF 4.995%
5. Bond Underwriters
6. PMI – Private Mortgage Insurance – SFI

Section B
Current Market Environment / Structures

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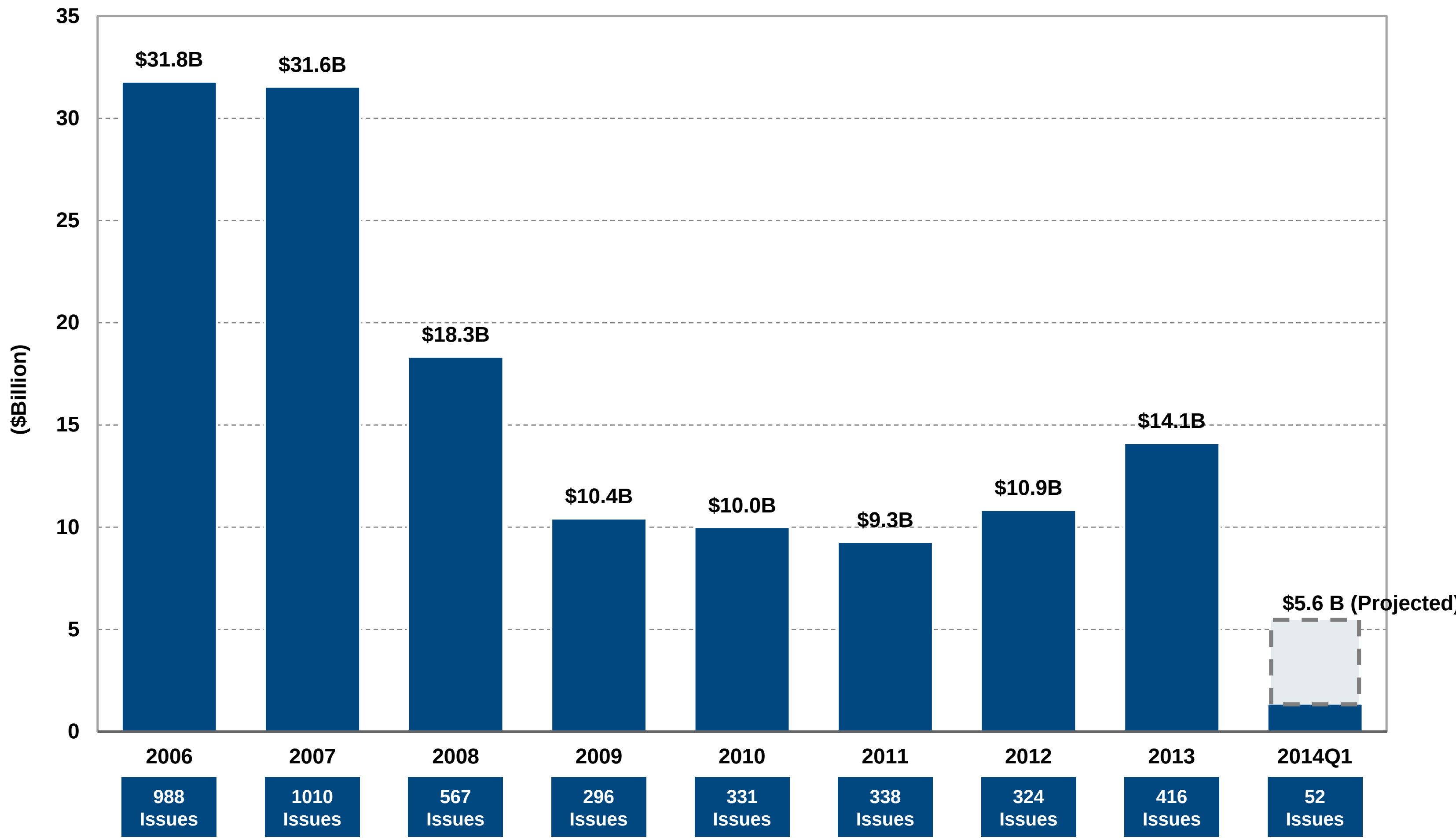
Volume of Housing Bonds Issued (in $billion)

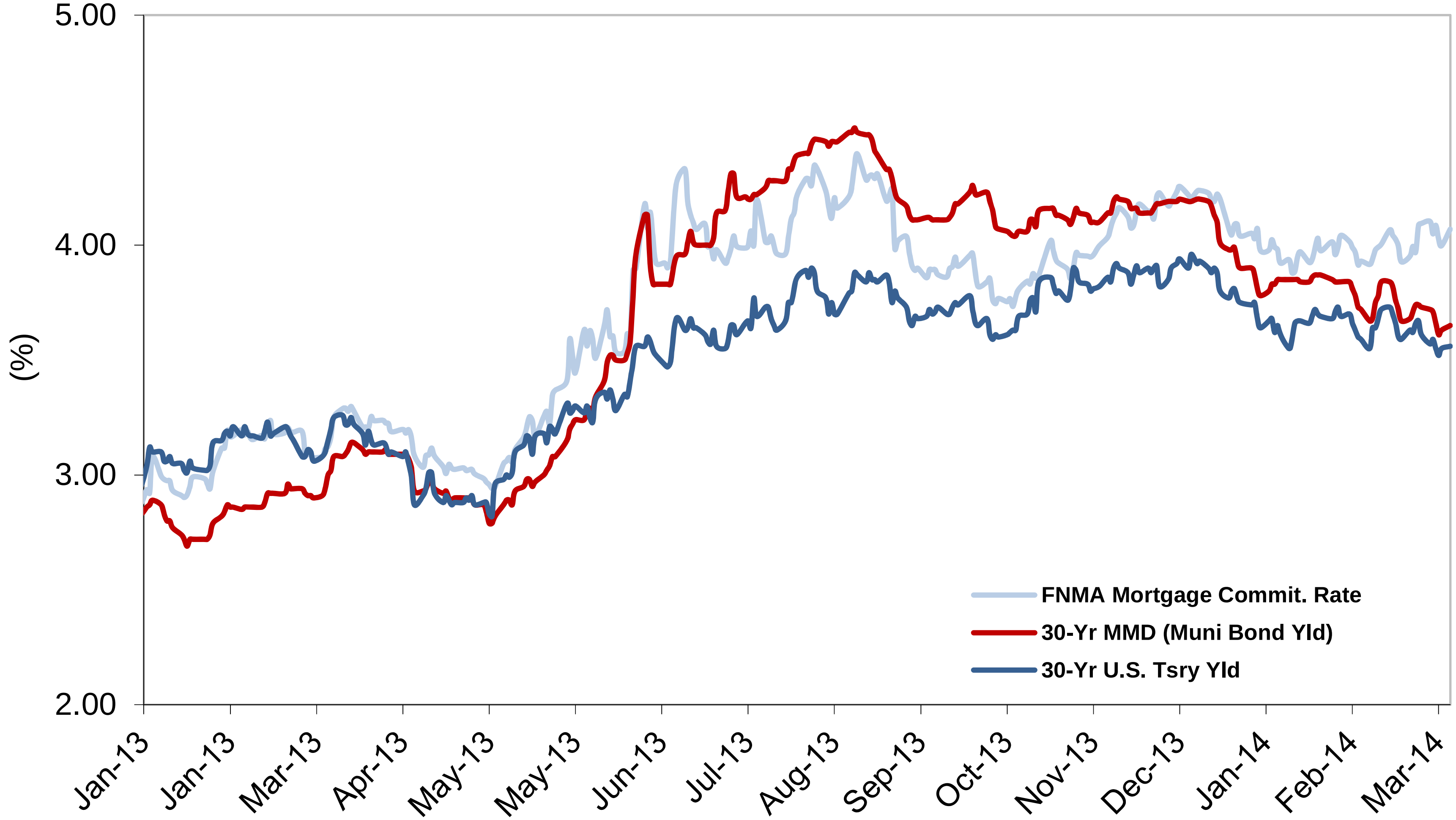


 Source: Thompson Financial

FNMA Rates, 30-Yr Treasury, 30-Yr MMD: 2006 – YTD 2014

 Source: Bloomberg

FNMA Rates, 30-Yr Treasury, 30-Yr MMD: Since 2013



 Source: Bloomberg

Current Market – Negative Arbitrage

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Negative Arbitrage – Origination Period

- When short term re-investment rates are high – no or nominal negative arbitrage
  - Bonds can be priced first (rates locked-in before mortgage program announced)
  - Bonds proceeds are reinvested in short term investments until loans are reserved / closed / purchased
- Current market – very low short term investment rate = significant negative arbitrage
  - Bond proceeds are earning nominal short term investment rate before they are used to purchase mortgages
  - Negative arbitrage prohibitively expensive to issue bonds prior to loan reservation
  - Issuers are now taking reservations and warehousing loans (prior to pricing bonds)
  - When loan rates are set prior to locking in borrowing cost of bonds, the issuer incurs "interest rate risk"

Negative Arbitrage - Float

- Mortgages pay monthly. Mortgage receipts invested by Trustee until bond payment
- Bond debt service is paid semi-annually
- Some issuers are calling bonds quarterly (or more often if prepayments reach a certain threshold)

New Structures / Financing Strategies

HFAs with MBS Programs (not whole loans) have more options in the current market

- MBS – In March 2013, an average of $246 billion of agency MBS was traded each day by primary dealers (this volume is second only to US Treasury Market). During the same period, an average of <u>$10.6 billion</u> of municipal bonds was traded each day.
  - Pass-through bond structure (municipal bonds designed to “look” like MBS)
  - TBA (“To Be Announced”) – originate loans, pool into MBS and sell

Pass-Through Bond Structure Characteristics

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Pass-through bonds – municipal bonds designed to look like MBS

- Backed by GNMA and/or FNMA collateral (no "whole loans")
- Single 30 year term bond
- No sinking fund amortization
- $1.00 denomination; DTC eligible with no redemption notice
- Par of Mortgage Backed Securities (MBSs) equal to par of the bonds
- No Debt Service Reserve Fund; Lag and trustee fees must be financed
- Aaa / AA+ / AAA rating from Moody's, S&P, or Fitch respectively
- MBS principal received during the month passed through to bond holders on first day of following month
- Full MBS portfolio delivered at closing
- All repayments and prepayments call bonds on 1st of each month

Overview of TBA Market

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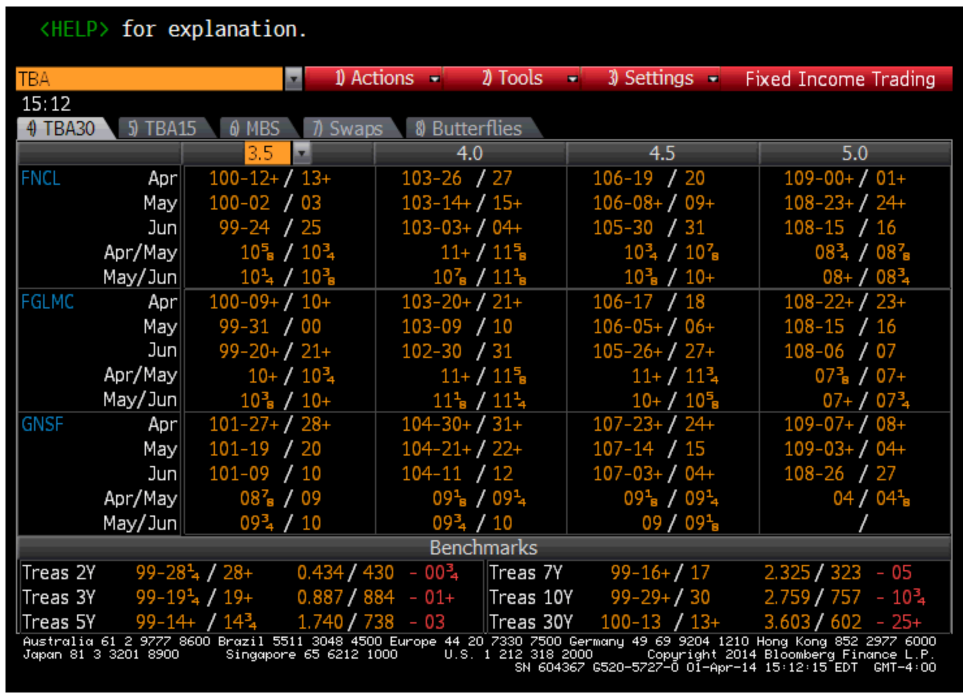
- TBA ("To Be Announced") market – highly efficient and liquid market which enables mortgage originators to hedge their interest rate risk from the time that mortgage rates are "locked in" to borrowers to when the mortgage is closed, pooled and securitized into Mortgage Backed Securities.
- TBA used by lenders to hedge their risk (after giving borrowers 30 day rate lock)
- HFAs sell MBS on a spot or forward basis to TBA market
- HFAs receive one-time upfront fee for selling MBS in TBA market (versus ongoing spread from bond issuance)
- TBA Market 4/1/2014:


<HELP> for explanation.

TBA | 1) Actions | 2) Tools | 3) Settings | Fixed Income Trading

15:12

4) TBA30 | 5) TBA15 | 6) MBS | 7) Swaps | 8) Butterflies

		3.5	4.0	4.5	5.0
FNCL	Apr	100-12+ / 13+	103-26 / 27	106-19 / 20	109-00+ / 01+
	May	100-02 / 03	103-14+ / 15+	106-08+ / 09+	108-23+ / 24+
	Jun	99-24 / 25	103-03+ / 04+	105-30 / 31	108-15 / 16
	Apr/May	10⅝ / 10¾	11+ / 11⅝	10¾ / 10⅞	08¾ / 08⅞
	May/Jun	10¼ / 10⅜	10⅞ / 11⅛	10⅜ / 10+	08+ / 08¾
FGLMC	Apr	100-09+ / 10+	103-20+ / 21+	106-17 / 18	108-22+ / 23+
	May	99-31 / 00	103-09 / 10	106-05+ / 06+	108-15 / 16
	Jun	99-20+ / 21+	102-30 / 31	105-26+ / 27+	108-06 / 07
	Apr/May	10+ / 10¾	11+ / 11⅝	11+ / 11¾	07⅜ / 07+
	May/Jun	10⅜ / 10+	11⅛ / 11¼	10+ / 10⅝	07+ / 07¾
GNSF	Apr	101-27+ / 28+	104-30+ / 31+	107-23+ / 24+	109-07+ / 08+
	May	101-19 / 20	104-21+ / 22+	107-14 / 15	109-03+ / 04+
	Jun	101-09 / 10	104-11 / 12	107-03+ / 04+	108-26 / 27
	Apr/May	08⅞ / 09	09⅛ / 09¼	09⅛ / 09¼	04 / 04⅛
	May/Jun	09¾ / 10	09¾ / 10	09 / 09⅛	/

Benchmarks

Treas 2Y	99-28¼ / 28+	0.434 / 430	- 00¾	Treas 7Y	99-16+ / 17	2.325 / 323	- 05
Treas 3Y	99-19¼ / 19+	0.887 / 884	- 01+	Treas 10Y	99-29+ / 30	2.759 / 757	- 10¾
Treas 5Y	99-14+ / 14¾	1.740 / 738	- 03	Treas 30Y	100-13 / 13+	3.603 / 602	- 25+

 Source: SIFMA -TBA Market Fact Sheet; EMMA; Bloomberg

Section C
Current Overview of MBOH Single Family Portfolio

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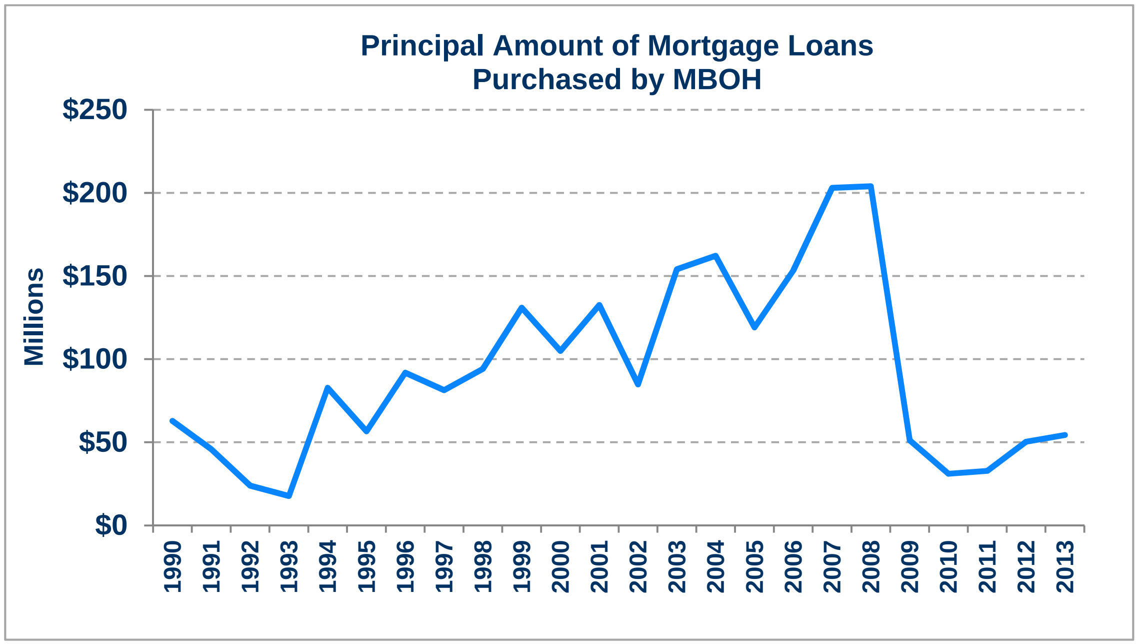
Current Overview of MBOH's Single Family Loan Portfolio

- **MBOH's mortgage loan portfolio has prepaid significantly in recent years**

Date	Mtg. Loan Outstanding
Dec 01, 2008	$875,178,567
Dec 01, 2009	$751,549,255
Jun 01, 2010	$706,034,569
Jun 01, 2011	$630,811,879
Jun 30, 2012	$547,304,051
Jun 30, 2013	$470,075,606

- **MBOH's new mortgage loan originations have rebounded somewhat since 2010**



- **Single family cash flows provide approximately 64% of MBOH operating budget (22% from servicing and 14% multifamily)**

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Single Family Indentures Overview

Balances as of December 1, 2013

	Single Family I Indenture	Single Family II Indenture	Single Family XI (NIBP) Indenture	Total
Assets				
Mortgage Loans	$171,572,344	$148,504,569	$160,013,344	$480,090,257
Reserve Funds	12,426,533	16,007,794	10,320,000	38,754,327
Other Funds	40,103,458	54,327,296	6,612,212	101,042,966
Total	$224,102,335	$218,839,659	$176,945,556	$619,887,550
Liabilities				
Bonds Outstanding	$183,140,000	$161,980,000	$172,625,000	$517,745,000
Excess Parity	**$40,962,335**	**$56,859,659**	**$4,320,556**	**$102,142,550**
PADR	122.37%	135.10%	102.50%	119.73%
Wt. Avg. Mortgage Rate	5.59%	5.35%	4.16%	5.04%
Less Servicing Fee	(0.375%)	(0.375%)	(0.375%)	(0.375%)
Less Wt. Avg. Bond Rate	4.94%	3.67%	3.25%	3.98%
Est. Profitability	**0.27%**	**1.30%**	**0.53%**	**0.68%**

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Single Family Indentures Overview Continued

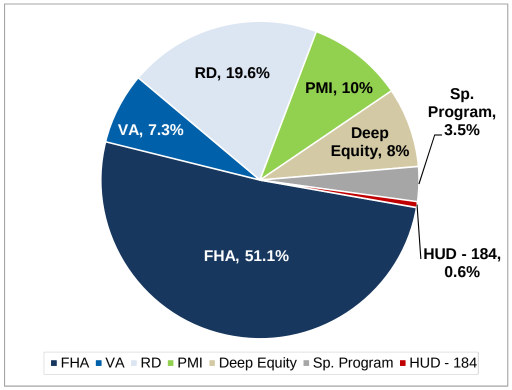
Loan Insurance Summary

Single Family I Indenture

Indenture Established: 1977

Bond Ratings: Moody's Aa1
S&P AA+

Mortgage Loan Collateral [1)]:

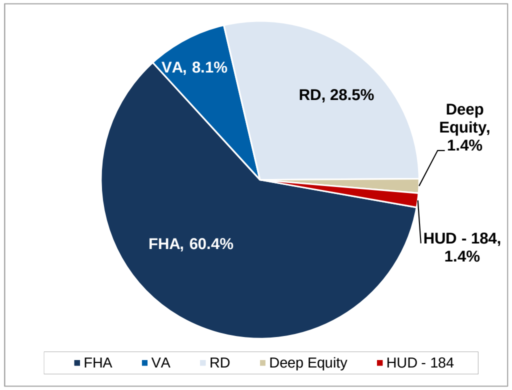


Single Family II Indenture

Indenture Established: 1978

Bond Ratings: Moody's Aa1
S&P AA+

Mortgage Loan Collateral [1)]:
[100% Government Insured]

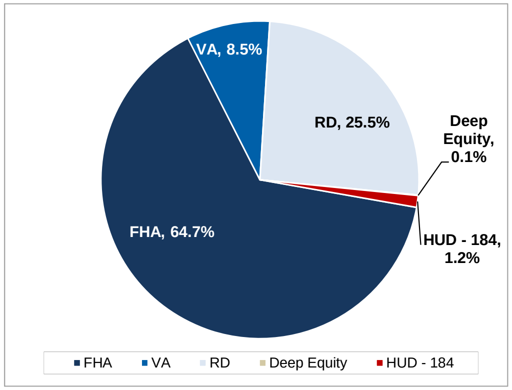


Single Family XI Indenture (NIBP)

Indenture Established: 2009

Bond Ratings: Moody's Aa3
S&P NR

Mortgage Loan Collateral [1)]:



[1)] *By insurance type/$ amount outstanding, as of Jan 2014*

Indenture Cashflow Summary

Single Family Indentures are strong and will provide significant cashflow to MBOH over time

- **Assumes no additional single family bonds are issued**
- **Residuals will depend upon mortgage loan prepayment speeds**
  - The longer loans remain outstanding, the more time MBOH has to earn the spread
- **Residuals projected with very conservative investment assumptions**
  - 0.00% through 12/1/2016
  - 0.50% from 12/1/2016 to 12/1/2019
  - 1.00% from 12/1/2019 to 12/1/2023
  - 1.25% thereafter

100% PSA Run

Indenture	Annual Fee	Fees plus Residual	PV at 4% Fees + Residual
SF I	$1,700,000	$49,328,687	$29,787,566
SF II	$2,300,000	$76,649,558	$43,152,406
SF XI (NIBP)	N/A	$14,532,248	$4,885,253
Total	**$4,000,000**	**$140,510,493**	**$77,825,225**

200% PSA Run

Indenture	Annual Fee	Fees plus Residual	PV at 4% Fees + Residual
SF I	$1,700,000	$46,081,795	$28,578,624
SF II	$2,300,000	$72,206,909	$41,866,513
SF XI (NIBP)	N/A	$11,159,196	$3,753,714
Total	**$4,000,000**	**$129,447,900**	**$74,198,851**

MBOH 2014 Series A Bonds

- **2014 Series A Bonds sale provides:**
  - 4.00% 30-year fixed rate mortgage loans (approximately $35MM)
  - refunding of 2005 Series A and 2005 Series RA which will generate economic savings
  - 4.83% current bond rate on 2005 bonds (TIC) vs. 3.25% new bond rate (TIC)
  - Higher rate loans from 2005 (5.42%) will subsidize new 4.00% loans

MBOH 2014A Sources and Uses		2014A-1 Non-AMT Refunding	2014A-2 AMT Refunding	2014A-3 Non-AMT New Money	Total
Sources:	Bond Par Amount	15,870,000	24,630,000	31,000,000	71,500,000
	PAC Premium	-	647,016	-	647,016
	Transferred Loans	19,550,000	19,350,000	-	38,900,000
	Transf. Assets From SFI Indenture	-	2,415,420	-	2,415,420
	Transf. Assets From SFII Indenture	9,275,536	-	-	9,275,536
	Total	**44,695,536**	**47,042,436**	**31,000,000**	**122,737,971**
Uses:	2014A-3 Program Fund - New Loans	-	-	32,320,000	32,320,000
	2014A-1 Program Fund - New Loans	3,030,000	-	-	3,030,000
	Refunding of Prior Bonds	15,870,000	24,630,000	-	40,500,000
	Transferred Loans	19,550,000	19,350,000	-	38,900,000
	Debt Service Reserve Fund (face)	3,882,426	2,415,420	-	6,297,846
	Mortgage Reserve Fund (face)	919,125	-	-	919,125
	Underwriters' Fee	134,652	174,222	254,126	563,000
	Cost of Issuance (Pro-rated)	46,167	71,651	90,182	208,000
	Total	**43,432,371**	**46,641,293**	**32,664,308**	**122,737,971**