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Housing Finance Group



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*Overview of Housing Bonds*

## **Montana Board of Housing**

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**March 2017**

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## **Bond**

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A bond is written evidence of a legally binding agreement of a borrower of money (the issuer) to repay the lender of money (the bondholder). In return for borrowing a sum of money (the principal amount), the issuer of the bond pays a stated rate of interest (the coupon rate) to the bondholder, generally every six months until the bond matures. At maturity, the issuer returns the money originally borrowed from the bondholder and the final interest payment.

## **Municipal Bond**

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Municipal bonds are bonds issued by state and local governmental entities to finance operating and capital costs or programs. Interest on a municipal bond is generally exempt from federal taxation, and in most cases is exempt from state taxes for bondholders who reside in the state from which the bonds are issued. Municipal bonds are typically issued in denominations of \$5,000 and are generally identified by five pieces of information:

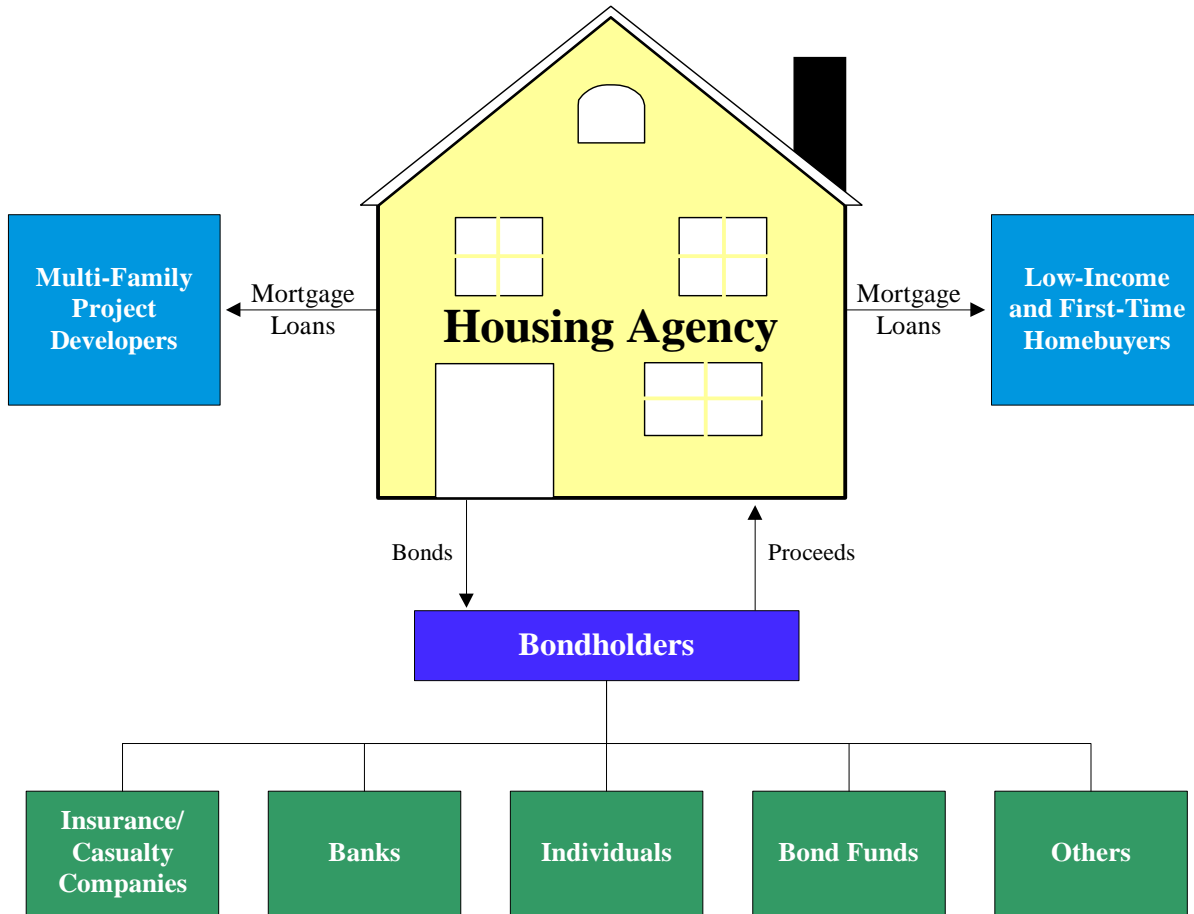
- (1) Name of Issuer
- (2) Coupon (the interest rate stated on the bond and payable to the bondholder).
- (3) Maturity date (date on which the investor will receive payment of principal and the final interest payment).
- (4) Yield or Price (the yield on the security or the dollar price of the security).
- (5) Ratings (the grade category given to the bond issue).

## **Housing Bond**

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Housing bonds are municipal bonds issued to finance mortgages for multi-family rental housing for low or moderate income tenants, or to finance mortgages on single family housing for first time, low or moderate income home buyers. They are also used to aid in regional redevelopment, housing rehabilitation or home improvements and in some states to support housing for senior citizens, veterans and special needs groups.

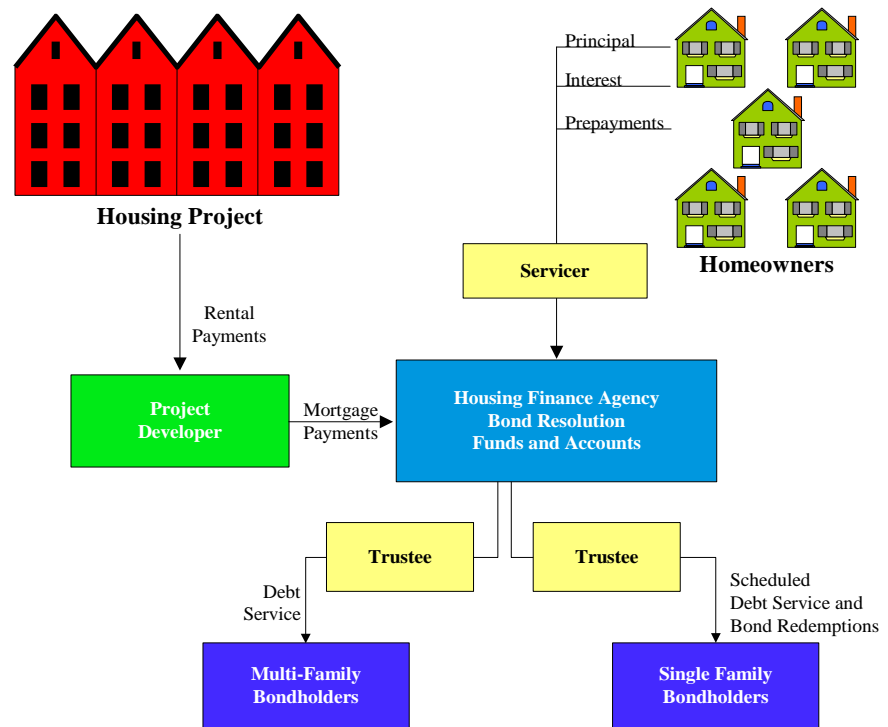
The Internal Revenue Code classifies housing bonds as private activity bonds if 10% or more of the bond proceeds finance property which will be used by a private person or entity and secured by the person/entity's property or payments. As illustrated on the following page, the issuer uses the amount borrowed from bondholders (the "proceeds" of the bond issue) to finance mortgage loans to low or moderate income homebuyers (single family bonds), or loans to project developers who build or rehabilitate housing for low income renters (multi-family bonds). Repayment of single family mortgages may be enhanced under federal programs, such as FHA guarantees or VA insurance, or through private mortgage insurance or agency self insurance. Repayment of mortgages on for multi-family rental properties may be secured, in whole or in part, by federal guarantees or subsidies, may also have private credit enhancement (e.g. GSE guaranties), or just a mortgage on the project.



Single Family Mortgage Prepayments

By their terms, single family mortgage loans can be prepaid in whole or in part at any time at par without a penalty to the borrower. Therefore, the underlying mortgage cash flows supporting single family bonds include unpredictable prepayments of scheduled mortgage principal. There are two principal types of mortgage prepayments: economic prepayments, which occur when interest rates are declining and homeowners can refinance their mortgages; and non-economic prepayments resulting from such events as sale of the home, death, divorce or other non-economic factors. During periods of declining interest rates, prepayments of higher rate mortgages increase as borrowers take advantage of lower conventional mortgage rates to refinance their home loans. However, due to the non-economic factors cited above, in any interest rate environment a steady stream of prepayments comes in on mortgages underlying single family housing bonds.

Housing Bonds: Payment of Debt Service



PSA Prepayment Model

Prepayments of single family mortgage loans are commonly projected in accordance with a prepayment standard or model. The municipal market uses “PSA”, which is the Securities Industry and Financial Markets Association (“SIFMA”) standard Prepayment Speed Assumption (each, a “PSA”). The standard prepayment model is based upon an assumed rate of prepayment each month of then unpaid principal balance of the mortgage loans. Prepayment speeds are projected as percentages of the standard prepayment model and are referred to as PSA. At 0% PSA, the standard prepayment model assumes no prepayment of mortgage loans. At 100% PSA, the standard prepayment model assumes an increasingly larger percentage of the mortgage loans prepaying each month for the first 30

months of the mortgage loans' lives and then assumes a constant prepayment rate of 6% per annum of the unpaid principal balance for the remaining life of each of the mortgage loans.

### **Prepayment Calls**

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Single family mortgage prepayments are passed on to bondholders generally through mandatory par redemption of bonds. Even though single family bonds have a stated maturity, they are often redeemed from prepayments, at the face value (or "par" amount) of the bonds, well before their final stated maturity. This "call risk" is detrimental to an investor's overall return because the prepayment calls often occur in a declining interest rate environment. As a result, investors are forced to reinvest their money at lower rates of interest. Due to the call risk that arises from prepayments on single family housing bonds, investors demand higher interest rates on housing bonds.

The issuer of multi-family bonds receives mortgage payments from project developers, who receive rental payments from the users of the project. In general, multi-family bonds have less significant prepayment call risk, because project owners are discouraged from prepaying their mortgage through prepayment penalties and other means. Most multi-family mortgage loans cannot be prepaid during their first ten years. Thereafter, they generally have prepayment penalties matching the bonds' optional call premiums. Also, federal subsidy programs and state loan considerations often make it difficult for project owners to voluntarily prepay their mortgage loans. Multi-family bonds can be paid at par at any time due to mortgage default, and casualty and condemnation proceeds.

### **Non-Origination Calls**

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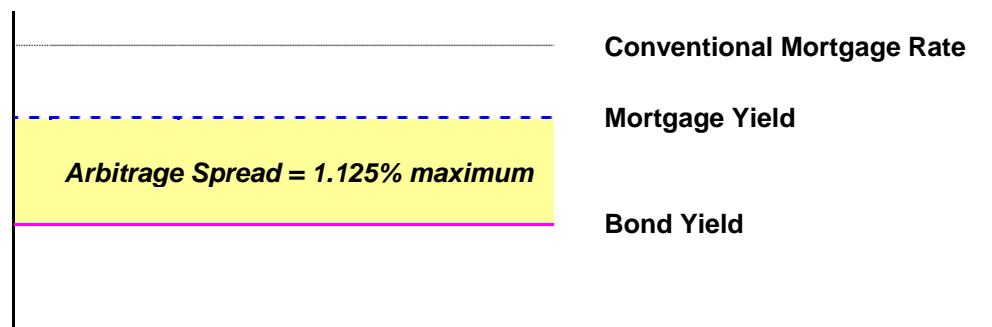
Proceeds from a new issue of single family housing bonds must be used to originate mortgage loans within 42 months of the issuance date of the bonds. Any proceeds that have not been used to purchase loans within the 42 month limit must be used to redeem bonds. This redemption is commonly called a non-origination call. This "non-origination risk" is also viewed unfavorably by investors as it is most likely to happen in a declining interest rate environment, leaving investors with funds which must then be invested at a lower rate. Investors will demand a higher yield on bonds issued by issuers who consistently experience large non-origination calls.

Proceeds from single family bonds used to refund prepayment or surplus revenue bond redemptions (see "Refunding" on page 7) are not restricted by the 42 month limit, and therefore, such bonds may experience less non-origination risk. In addition, refunding bonds backed by mortgages transferred from a prior series of bonds are not subject to non-origination risk and are viewed more favorably by investors.

**Setting the Mortgage Rate  
- Single Family Program**

The overall interest rate the housing issuer pays on its single family housing bond issue (the “bond yield”) determines the level at which the mortgage rate will be set. The mortgage rate must be set high enough to pay debt service on the bonds and all program costs, such as servicing, trustee and insurance fees, but cannot be set higher than the federal tax law limit described below. Because single family housing bonds are tax-exempt, the issuer has a lower cost of funds than a bank. Therefore, the issuer’s mortgage rate should be lower than conventional mortgage rates, as illustrated below.

Tax law restricts the housing issuer from establishing a mortgage yield that is higher than 1.125% above the bond yield for the related single family housing program. This 1.125% difference is referred to as the arbitrage spread. The mortgage yield includes all points and other fees (other than usual 3<sup>rd</sup> party fees) paid by the homebuyer and assumes the pool of mortgages prepays at a rate equal to 100% of the FHA decrement table last published in 1991. The mortgage rate chosen must balance an issuer’s goal of program affordability for the borrower and the potential for the issue to generate a positive cash flow for the issuer over time. The actual cash flow received will be affected by the level of prepayments on the mortgage loans. While most housing issuers establish a mortgage yield which is between the bond yield and the arbitrage limit, some issuers have programs that target very low income homebuyers who need a mortgage rate that is heavily subsidized. To reduce the mortgage rate below its cost of funds, an issuer can contribute money to the mortgage program and use it to “buy down” the rate on these targeted loans, or blend higher rate loans with low rate loans.



**Assumptions:**

2014A Mortgage Yield	4.3638%
2014A Bond Yield	3.3092%
<hr/>	
Spread	1.0546%

**Setting the Mortgage Rate  
- Multi-family Program**

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The overall interest rate the issuer pays on a multi-family bond issue determines the level at which the mortgage rate will be set on the loan for a multi-family project. For multi-family bond issues, tax law prohibits issuers from setting the project mortgage rates more than 1.50% above the bond yield (plus the costs of issuing the bonds). No prepayment assumption is built into this spread. Most issuer mortgage origination fees and expenses must be paid from the 1.50%.



### **New Construction**

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New construction programs consist of the issuance of either tax exempt or taxable debt to build, acquire or substantially rehabilitate a residential project. New construction programs may include construction period lending and review of disbursements from acquisition funds. Tax exempt bonds for multi-family programs generally provide permanent financing as well. The term of the permanent financing depends on numerous factors including the developer's needs, issuer requirements and the type of credit enhancement used. Government insured loans, either federal or state, are generally 30-40 years fixed rate. Loans with private insurance or guarantees generally are 5-10 years before a rate change and a call or tender.

### **Project Considerations**

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The type of project and the rents allowed are generally the product of policy debate within each agency as to the type of need that is to be addressed, the community in which the agency is trying to build and the economic feasibility of the project.

### **Refunding Programs**

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Bonds are sometimes issued to refund existing bonds to generate debt service savings for the agency or development, to work out troubled loans, to create subsidy for other programs or to reduce the level of federal or state subsidy payments. The term of the refunding is dependent on the underlying mortgage note, agency guidelines and developer requirements. The mortgage loans which stay in place must still satisfy the 1.50% maximum arbitrage limitation spread.

### **Credit Considerations**

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Municipal investors, as a rule, do not purchase multifamily real estate risk. Mortgages are generally insured by FHA (risk share), FannieMae, FHLMC, private mortgage or bond insurance, state mortgage insurance, or agency general obligations. In addition, investors look to various federal programs that support multifamily debt including Section 8 rent subsidy or Section 236 mortgage subsidy payments.

### **Unenhanced Bonds**

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A new market has developed where banks or tax exempt investors will purchase unenhanced whole loan bonds and underwrite the real estate risk.

### **Conduit Bonds**

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Most multifamily bonds are "conduit bonds", where the issuer has minimal legal and credit responsibilities.

**Asset Management**

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For issuer bond (non-conduit) programs, state agencies are required to provide continual asset management services to their multifamily portfolios. This includes monitoring of premises, maintenance, compliance monitoring, residual receipt management and other specific functions.

## **Low Income Housing Tax Credits**

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Most of the equity moneys for multifamily housing new construction or moderate rehabilitation is based on the federal low income housing tax credit program. This program allows owners to syndicate tax credits to private investors as limited partnership contributions. There is a 4% (tax exempt debt) and a 9% (taxable debt) program. This program provides developers with significant equity contributions in exchange for income restrictions on the units.

## **Qualified Costs**

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95% of tax exempt bond proceeds must be used for qualified costs, which, with certain limitations, means amounts spent on the exempt facility's capital costs. Non-qualified costs of up to 95% may be financed with net proceeds.

## **Residential Rental Property**

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A residential rental project is a building or structure, together with functionally related facilities, which is not used on a transient basis, is available to the general public and meets the rental requirements. The units must be complete facilities for living and contain kitchen, sleeping areas and toilets.

## **Low or Moderate Income**

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Certain units must be set aside for tenants of low and moderate income. The Code requires that either 20% of the units be occupied by tenants having incomes of 50% or less of the area median income, or 40% of the units be occupied by tenants having incomes of 60% or less of the area median income. The Code proscribes various methods of determining income, largely based on Section 8 program rules.

## **Qualified Project Period**

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The units required to be set aside for low and moderate income tenants must be continuously offered for a proscribed period which is generally the longer of: 15 years from 50% occupancy, the day the tax exempt debt is extinguished, or the date when any Section 8 assistance terminates.

### Program Mortgage Structure

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The types of mortgages that agencies offer to homebuyers vary among states to meet market and policy needs. Considerations in structuring mortgage programs include homebuyer points, the mortgage rate, homebuyer assistance programs and special subsidy programs. Subsidy programs include low rates for targeted populations (generally funded by other loans in the pool) and down payment/closing costs assistance.

### Origination Process

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Factors in the origination process include the depth of the lender pool, the ability of the agency to consistently offer funds, lender training and market demand for the product. Programs vary from state to state. Most agencies provide continuously offered programs where a program mortgage rate is regularly adjusted and based on market conditions. A portion of the reservations are taken prior to bond issuance and the remaining reservations and funding take place after bond closing. Some agencies vary the lender fee structure depending on local market conditions and agency resources and include refundable commitment fees from lenders to participate. Origination fees may be reduced over time from bond issuance. A very few agencies will self-originate portions of their program.

### Mortgage Loan Servicing

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The three types of servicing structures include: agency self-servicing, servicing by originating lender, and master servicing.

### Mortgage Insurance Programs

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The program mortgage loans are generally guaranteed or insured as follows:

- MBS
  - GNMA/FannieMae/FHLMC
- Whole Loan
  - FHA/VA/RD
  - PMI – LTVs of 80% or greater, generally accompanied by pool insurance
  - Self insurance programs

## **Tax-Exemption**

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Municipal bonds primarily distinguish themselves from other capital securities by their federal tax exemption status. Interest income from tax exempt bonds is free from federal income taxation. Hence, municipal bonds are often referred to as tax-exempt bonds. If a bond is exempt from state income tax, it possesses “double” exemption status. Housing bonds are generally exempt from state income taxes. “Triple” exemption bonds are exempt from municipal or local (e.g., New York City) income taxes as well as from federal and state income tax.

## **Tax-Exempt AMT**

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The Alternative Minimum Tax (AMT) is a federal surtax aimed at ensuring that wealthy individuals and corporations pay at least some income tax. Bonds subject to the AMT (“AMT bonds”) have a higher interest rate than non-AMT bonds. Housing bonds issued between 1986 and 2008, other than those issued to refund non-AMT bonds, were subject to the AMT. The AMT generally applies to taxpayers who take or rely on significant deductions from “preference” items, such as accelerated depreciation, incentive stock options or passive activity loss, charitable contributions of appreciated property, development costs, or basic deductions such as medical expenses and property taxes. The fact that a bond is subject to the AMT in no way makes the bond taxable, nor does it affect its creditworthiness. It merely means that for those investors subject to this tax, the coupon interest would be included in the AMT calculation. Investors not subject to the AMT are completely unaffected and continue to enjoy tax-free interest income. Individuals who purchase AMT bonds will benefit from the higher yields that must be offered in order for these bonds to be sold. The Housing and Economic Recovery Act of 2008 (HERA) made new money housing bonds no longer subject to AMT.

## **Taxable**

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A taxable municipal bond is a debt obligation of a state or local municipality whose interest is fully federally taxable. The Tax Reform Act of 1986 (TRA’86) placed many restrictions on the allowable uses of funds raised by municipalities in the bond market thus sometimes forcing many housing issuers into the taxable market. Taxable bonds are issued to finance “private activity” for non-governmental purposes, as bonds where volume caps apply, or as public purpose bonds where the 10% private use limitation has been exceeded. Taxable municipals are secured the same as tax-exempt bonds. Taxable housing bonds offer an alternative investment for investors seeking high taxable returns. Taxable bonds are often exempt from state/local personal income taxation.

## **Tax Requirements of the Code for Qualified Mortgage Bonds**

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**Residence Requirements:** Each of the premises financed with proceeds of qualified mortgage bonds must be a one-to-four family residence, one unit of which can reasonably be expected to become the principal residence of the mortgagor. A two-four family residence (other than two-family residences in targeted areas with borrowers whose family income does not

exceed 140% of applicable family median income) must have been occupied for at least five years.

**Targeted Areas:** A portion of single family bond proceeds must be set aside for 1 year for residences in targeted areas. Targeted areas are certain census tracts in which 70% of the families have an annual income of 80% or less of the statewide median income, and certain state designated areas of chronic economic distress.

**First-Time Homebuyer Requirement:** The mortgagor must have had no present ownership interest in their principal residence during the three-year period prior to the date on which the mortgage is executed (except for veterans and homes in targeted areas). The mortgage loan must be a new mortgage loan and not a refinancing of an existing mortgage loan.

**Income and Purchase Price Limits:** Family income of borrowers may not exceed 115% (110% for households with one or two persons) of the greater of area or state median income except in targeted areas. In targeted areas income may not exceed 140% of median income (120% for households of one or two persons) for two-thirds of such loans and the remaining one-third may be made without regard to income limits. These limits are subject to increase with respect to “high housing cost areas”.

The purchase price of the residence may not exceed 90% of the average area purchase price (110% for residences located in targeted areas)

**Recapture:** Upon sale of a residence within nine years of the closing date of the mortgage, the mortgagor may owe a recapture tax to the federal government in an amount equal to the “subsidy” provided by the tax-exempt bond financing. Such tax is levied on the mortgagor as part of his individual tax liability. The recapture amount increases over the period of ownership to a maximum amount (6% of the mortgage) if the residence is sold between years four and five of ownership and declines ratably to zero in the ninth year. The recapture amount is also reduced if the mortgagor meets certain income limitations and in any case cannot exceed 50% of the realized gain.

**Redemptions:** Bond proceeds must be used to make mortgage loans within 42 months from the date of issuance of the bonds (or the date of original issuance in the case of refundings of unexpended proceeds) except for a \$250,000 de minimis amount.

**10 Year Rule:** For bonds issued after 1988, repayments and prepayments of principal may be recycled into additional mortgage loans for the first 10 years after the date of issuance of the bonds (or the date of original issuance in the case of refundings). After this date, all repayments and prepayments must be used to redeem bonds except for a \$250,000 de minimis amount.

**Maturity Limitations:** The final maturity date for refunding bonds may not exceed 32-years from the date of issuance of the refunded bonds. This maturity may be extended to 120% of the useful life of the residence in the case of certain refunded bonds issued prior to 1980.

Housing bonds take many forms, are issued for a variety of purposes and can be payable from different sources. Highlighted below are the various types of housing bonds structures.

### **Serial Bonds**

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Serial bonds are bonds that mature serially, usually every six months. Serial bonds are bonds of an issue in which some bonds mature in successive years without interruption. Generally, serial bonds comprise the first 8-12 years of principal amortization.

### **Term Bonds**

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Term bonds, which come due in a single maturity at intervals greater than one year since the previous bond's maturity, comprise a large part of each particular issue. The issuer usually agrees to make periodic payments into a sinking fund for mandatory annual or semi-annual redemption of term bonds before maturity or for payment at maturity. A housing bond issue is generally structured with an intermediate term bond in year 20 and a final term bond in year 32 of the issue.

### **Current Interest Bonds**

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Current interest bonds are the most common type of housing bonds. Interest is paid every six months until the bond matures or is retired early from optional or mandatory redemption.

### **Capital Appreciation Bonds**

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Capital Appreciation Bonds (CABs): Payment of the periodic interest is deferred until maturity or redemption with capital appreciation bonds. The payment made at maturity or on the redemption date consists of principal and compounded interest (the "accreted value").

### **Super Sinkers**

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A super sinker bond is the first maturity in a bond issue which is to be called from single family mortgage prepayments and, occasionally, excess revenues. While a super sinker will have a stated maturity of 10 to 20 years, the average life of a super sinker at 100% PSA prepayments will be generally approximately 3 to 5 years. A super sinker provides other bonds in the issue with limited call protection. Super sinkers are priced at a lower yield than a regular bond of the same stated maturity and are priced off their average life as opposed to their stated maturity. Super sinkers also require special rating agency cash flow stress tests. If the bond issue receives prepayments at a rate less than 100% of the PSA tables, the actual average life of the super sinker bonds will be extended. This risk is borne by the buyers of the super sinkers.

### **Planned Amortization Class (PAC Bonds)**

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PAC bonds are a subset of super sinkers which receive a dedication of prepayments and are to be called out on an accelerated basis. PACs differ from generic super sinkers, in that, at a certain level of prepayment, i.e., above 100% PSA, the PAC is no longer called but other bonds are called. This provides a more stable average life to the investor. PAC bonds are usually sold at a premium to specialized investors capable of dealing with the prepayment risk.

### **Lock Out Bonds**

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These bonds perform in an opposite fashion from a super sinker. The issuer is prohibited from calling these bonds from prepayments (for other than federal tax reasons) for a specified period of time. Typical lock out periods range from 5-10 years.

### **Premium Bonds**

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Premium bonds are usually structured as supersinker or PAC term bonds and are sold at a price higher than 100% of their initial stated face value with a yield slightly lower than a par bond. They are used to generate additional bond proceeds requiring a lower upfront issuer contribution to the cashflows, but if prepayments of mortgage loans are lower than anticipated, the high coupon premium bond will remain outstanding and negatively affect the profitability of the program.

### **Convertible Option Bonds (COBs)**

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A COB is marketed for an initial short term period (usually 6-12 months) which may, at the issuer's option, be remarketed into additional short term remarketings or converted and remarketed or refunded as long-term, fixed rate serial and term bonds. The interest on COBs converts from a short-term interest rate to a long-term interest rate on the Conversion Date. The single family mortgage rates are also determined upon a Conversion Date. Conversion Dates occur upon predetermined dates or upon the occurrence of certain events. COBs are used by the issuer to preserve single family bonding authority which would otherwise be lost due to various legal reasons. During the COB period, bond proceeds are invested in securities or a guaranteed investment contract and are not available for the purchase of loans until the COB is remarketed or refunded.

### **Taxable Bonds (Federal)**

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Agencies will issue taxable bonds for many reasons, but primarily to increase the size of the pool of lendable proceeds without using limited private activity bond volume cap. Taxable bonds carry a higher interest cost, as the income is taxable on a federal basis to the owner. Taxable bonds are generally structured as serial bonds or super sinkers in order to reduce their average life which achieves a better pricing and enables the issuer to call them out early due to their high interest rate.



## **Variable Rate Bonds**

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Variable rate bonds have a long stated maturity, but the interest rate adjusts on a periodic basis. Most variable rate bonds have interest rates that are adjusted weekly and track the BMA (Bond Market Association) Index, and often bondholders have the right to tender their bonds at par (the tendered bonds are then remarketed to other purchasers). Variable rate bonds generally are secured by a liquidity facility (standby bond purchase agreement) which provides investors with the added security of being able to access their money at any time. These bonds are the lowest cost debt available and are often used in conjunction with interest rate swaps to protect from rising rates.

The municipal bond industry enlists various and distinct types of skilled professionals to achieve the common goal of raising capital and supporting the debt securities market. State and local government issuers, investment bankers, salespeople, underwriters, lawyers, federal regulators and investors are just some of the key participants in the industry. Their roles can be best understood by tracing how each participant contributes to the process.

### **The Issuer - MBOH**

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Issuers of municipal bonds are state and local governmental institutions, Washington D.C. and various territories and possessions. In addition, state and local governments have authorized smaller governmental units to issue bonds in order to effectively respond to the nation's growing capital needs. Housing issuers are among these entities. Each of the states except Arizona and Kansas has a state agency or authority which actively issues single family and/or multi-family housing bonds to provide affordable housing for low and moderate income persons and families. Certain large counties and cities also have local housing finance agencies which issue housing bonds. The issuers and their activities are strictly governed by state or local laws and ordinances.

### **Issuer's Counsel – Luxan and Murfitt**

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Issuer Counsel advises the issuer on all general legal matters (not necessarily specific to bond issuances.) They work in conjunction with bond counsel on legal issues pertaining to bond issues.

### **Bond Counsel – Kutak**

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Bond counsel advises the issuer on legal matters pertaining to bond issues and programs. They decide what steps the issuer can take under state, local and federal law with regard to the bond issue. They draft bond and program documents and provide legal opinions on transactions undertaken. In housing bond issues, bond counsel gives extensive advice about the impact of tax and securities laws on the bonds and housing programs to be financed.

### **The Underwriters**

*Senior Manager – RBC Capital Markets*

*Co-Managers – BofA Merrill Lynch, D.A. Davidson, Piper Jaffray*

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The Senior Manager is primarily responsible for structuring the bond issue. Underwriters are primarily responsible for establishing prices and yields on new bond issues. In addition to working closely with the issuer and investment bankers and coordinating with the management team, the underwriter maintains close working relations with investors and salespeople to determine the market demand and appropriate yields for an issue. Senior Manager and Co-Managers commit capital to underwrite the Bonds.

### **Underwriter's Counsel – Orrick**

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The underwriter's counsel advises the underwriters on federal securities law requirements. They draft official statements, which detail security and financial information about the bond issue, and in addition, prepare

purchase contracts for bonds and other documents controlling the agreements the underwriters have with each other and with the selling group, if any.

### **Salespeople and Traders**

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The salesperson's role in both primary and secondary markets involves the sale/purchase of securities. Municipal bond traders maintain the secondary market for securities by actively buying bonds and selling them to other dealers and investors, thereby providing liquidity to all investors.

### **Trustee – Wilmington Trust**

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The trustee represents the interest of the bondholders. It acts as custodian of the bond proceeds and program revenues, ensuring and overseeing the proper transfers of funds and accounts. It monitors issuer compliance with bond covenants and exercises any remedies in the event of a bond default.

### **Rating Agencies – Moody's, S&P**

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Given the large number of different issues in the marketplace, bond ratings issued by rating agencies are heavily relied upon by bond purchasers. The rating agencies 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. The three dominant rating agencies for housing bonds are Moody's Investors Service, Inc., Standard and Poor's Corporation, and Fitch Investors Service, Inc. The SFI and SFII Indentures of MBOH are currently rated Aa1/AA+ by Moody's and S&P, respectively. The NIBP Indenture is currently rated Aa3 by Moody's.

### **Investors**

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Three major types of investors dominate the municipal marketplace: (1) Retail, which involves individuals acting directly or through the agency of trust companies and investment advisors; (2) Bond Funds, which are registered investment companies whose assets are invested in diversified portfolios of bonds; and (3) Institutions, which are companies and corporations, particularly commercial banks, property and casualty insurance companies and government sponsored enterprises, such as FannieMae and Freddie Mac. The buying patterns of all three groups constantly change due to profitability, interest rates, tax rates, tax regulations, portfolio mix and the economy.

Rating reports are published regularly by Moody’s and Standard & Poor’s as part of their information service to investors. These reports provide investors with updated information on the issuer and its operations, providing the rationale for the ratings assigned to the issuer’s indentures. The following table defines the investment grade categories of ratings of long term issues assigned by the rating agencies. Most housing bonds are rated in one of the top three categories when initially issued.

**Rating Definitions**

Moody’s	Standard & Poor’s	Fitch	Definition
Aaa	AAA	AAA	Highest capacity to pay interest and repay principal
Aa	AA	AA	Very strong capacity to pay interest and repay principal
A	A	A	Strong capacity to pay interest and repay principal
Baa	BBB	BBB	Adequate capacity to pay interest and repay principal.
Ba	BB	BB	Speculative with respect to capacity to pay interest and repay principal.
B	B	B	Small assurance of interest and principal payments.
C	D	D	The lowest rated class of bonds. For Moody’s “C” can be regarded as having extremely poor prospects of ever attaining any real investment standing. For S&P and Fitch, “D” indicates a default bond, and payment of interest and/or repayment of principal in arrears.
1,2,3	+/-	+/-	Modifies ratings to show relative standing within major rating categories. For Moody’s “1” indicates a stronger rating and “3” is one notch above the next lower major rating; for S&P and Fitch, “+” indicates a stronger credit rating while “-” indicates a weaker credit rating.

Numerous factors affect the pricing of a bond issue. Recent developments in the marketplace, other comparable issues and economic indicators are just some of the factors monitored and closely observed as benchmarks for determining the final outcome of the issue being underwritten. Below are the factors RBC Capital Markets considers in setting a price as senior manager on a housing financing. All these factors are inter-related and impact each other.

### Factors Affecting a Pricing

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**Market Psychology:** What is the current market sentiment? In what direction does the economy appear headed?

**Economic Indicators:** Numerous economic indicators are closely watched by users of the financing futures markets. Both retail and institutional demand fluctuate with the prevailing economic outlook. Generally, interest rate futures will rise in price amid signs of a slowing economy since a sluggish economy reduces credit demand. On the other hand, a strong economy generally lowers futures prices since increased credit demand tends to force interest rates upward.

**Supply:** Investors continuously monitor the supply of competing issues in both the primary and secondary market for additions to their portfolios.

**Comparable Offerings:** Yields required on different types of bonds change relative to one another as interest rates move up and down.

**Rating/Credit:** High ratings generally correspond with lower yields (since investors require a smaller return from a safe investment than from a risky investment).

**Timing:** Movements in interest rates have a tremendous effect on pricing since investors constantly evaluate their alternatives. Other timing factors include April 15 (personal income tax deadline), market data releases (CPI, PPI, unemployment rate, etc.), geo-political concerns and announcements from the Federal Reserve.

**Tax Considerations:** Investors (particularly retail investors) are sensitive to tax considerations. Bonds not subject to Alternative Minimum Tax (non-AMT) are more desirable than those subject to AMT.

States that have higher state income tax tend to price with lower yields on the serial bonds than states with lower or no state income tax.

**Special Considerations:** Redemption features are particularly important for housing bonds. Retail participation can be impacted by takedown, which is the component of the Underwriters' fee that includes the salesperson's compensation.

## Priority of Orders

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The following is the priority of orders used for the Board's financing.

- (1) **In State Retail** (during a 1-day advance retail order period): Encourages retail orders, particularly in volatile markets, due to its higher status. This priority has become more popular in many financings. First priority goes to Montana residents
- (2) **National Retail** (during a 1-day advance retail order period): same rationale as (1) In State Retail.
- (3) **Net Designated:** Bonds are sold at the net price and the total takedown is designated by the investor to one or more underwriters.
- (4) **Member Orders:** Bonds are bought less the total takedown (known as "the net"). The bonds are sold at the net and the total takedown is paid out as sales credit. No benefit to the syndicate takes place in this situation. Retail orders generally are member orders.

Listed below are the rules governing the priority of orders.

### **Priority Policies (for MBOH)**

- (1) At least 3 firms must be designated
- (2) No firm may receive more than 70% of any designation
- (3) Senior manager requests the identification of all priority orders at the time the orders are entered
- (4) Selling group member may not enter priority orders, and may not be designated

A "RETAIL" ORDER IS DEFINED AS AN ORDER PLACED FOR THE ACCOUNT OF AN INDIVIDUAL, BANK TRUST, OR INVESTMENT ADVISOR ACTING ON BEHALF OF AN INDIVIDUAL, WITH A MAXIMUM OF \$250,000 PER ACCOUNT, OR AT THE DISCRETION OF THE ISSUER, SOME LARGER AMOUNT. RETAIL ORDERS DO NOT INCLUDE BANK PORTFOLIOS, INSURANCE COMPANIES, BOND FUNDS OR MUNICIPALITIES. ZIP CODE & CATEGORY SELECTION ARE REQUIRED ON ALL ORDERS.