Overview of Housing Bonds

Presentation to MBOH Board Members
April 14, 2014
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Section A
General Housing Bond Review
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 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

### Maximum IRS Allowable Arbitrage Spread = 1.125%

<table>
<thead>
<tr>
<th></th>
<th>Mortgage Yield</th>
<th>Bond Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2013B Mortgage Yield</strong></td>
<td>5.38%</td>
<td>4.27%</td>
</tr>
<tr>
<td><strong>2013B Bond Yield</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Spread</strong></td>
<td>1.11%</td>
<td></td>
</tr>
</tbody>
</table>

### 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

- Tax Considerations
- Rating / Credit
- Special Considerations
- Market Psychology
- Economic Indicators
- Supply
- Comparable Offerings
- Timing
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)

Year 0-

Interest

Principal

30 -

20 -

10 -

Bond Debt Service
(30-Year “Level Debt” – structured to match mortgage receipts)

Bond Maturity
Serials
Year 0-12

Intermediate Terms

Long bond/ Final Maturity

32 -

25 -

20 -

12 -

Interest

Principal
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

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


4. GIC / Repo Providers

5. Bond Underwriters

6. PMI – Private Mortgage Insurance – SFI
Section B
Current Market Environment / Structures
Volume of Housing Bonds Issued (in $billion)

- 2006: $31.8B (988 Issues)
- 2007: $31.6B (1,010 Issues)
- 2008: $18.3B (567 Issues)
- 2009: $10.4B (296 Issues)
- 2010: $10.0B (331 Issues)
- 2011: $9.3B (338 Issues)
- 2012: $10.9B (324 Issues)
- 2013: $14.1B (416 Issues)
- 2014Q1: $5.6 B (Projected)

Source: Thompson Financial
FNMA Rates, 30-Yr Treasury, 30-Yr MMD: Since 2013

Source: Bloomberg
Current Market – Negative Arbitrage

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)
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 $10.6 billion 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
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

- 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:

Source: SIFMA - TBA Market Fact Sheet; EMMA; Bloomberg
Section C
Current Overview of MBOH Single Family Portfolio
MBOH’s mortgage loan portfolio has prepaid significantly in recent years

<table>
<thead>
<tr>
<th>Date</th>
<th>Mtg. Loan Outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec 01, 2008</td>
<td>$875,178,567</td>
</tr>
<tr>
<td>Dec 01, 2009</td>
<td>$751,549,255</td>
</tr>
<tr>
<td>Jun 01, 2010</td>
<td>$706,034,569</td>
</tr>
<tr>
<td>Jun 01, 2011</td>
<td>$630,811,879</td>
</tr>
<tr>
<td>Jun 30, 2012</td>
<td>$547,304,051</td>
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<tr>
<td>Jun 30, 2013</td>
<td>$470,075,606</td>
</tr>
</tbody>
</table>

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)
## Single Family Indentures Overview

**Balances as of December 1, 2013**

<table>
<thead>
<tr>
<th></th>
<th>Single Family I Indenture</th>
<th>Single Family II Indenture</th>
<th>Single Family XI (NIBP) Indenture</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage Loans</td>
<td>$171,572,344</td>
<td>$148,504,569</td>
<td>$160,013,344</td>
<td>$480,090,257</td>
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<tr>
<td>Reserve Funds</td>
<td>12,426,533</td>
<td>16,007,794</td>
<td>10,320,000</td>
<td>38,754,327</td>
</tr>
<tr>
<td>Other Funds</td>
<td>40,103,458</td>
<td>54,327,296</td>
<td>6,612,212</td>
<td>101,042,966</td>
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<tr>
<td>Total</td>
<td>$224,102,335</td>
<td>$218,839,659</td>
<td>$176,945,556</td>
<td>$619,887,550</td>
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<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds Outstanding</td>
<td>$183,140,000</td>
<td>$161,980,000</td>
<td>$172,625,000</td>
<td>$517,745,000</td>
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<tr>
<td><strong>Excess Parity</strong></td>
<td>$40,962,335</td>
<td>$56,859,659</td>
<td>$4,320,556</td>
<td>$102,142,550</td>
</tr>
<tr>
<td>PADR</td>
<td>122.37%</td>
<td>135.10%</td>
<td>102.50%</td>
<td>119.73%</td>
</tr>
<tr>
<td>Wt. Avg. Mortgage Rate</td>
<td>5.59%</td>
<td>5.35%</td>
<td>4.16%</td>
<td>5.04%</td>
</tr>
<tr>
<td>Less Servicing Fee</td>
<td>(0.375%)</td>
<td>(0.375%)</td>
<td>(0.375%)</td>
<td>(0.375%)</td>
</tr>
<tr>
<td>Less Wt. Avg. Bond Rate</td>
<td>4.94%</td>
<td>3.67%</td>
<td>3.25%</td>
<td>3.98%</td>
</tr>
<tr>
<td><strong>Est. Profitability</strong></td>
<td>0.27%</td>
<td>1.30%</td>
<td>0.53%</td>
<td>0.68%</td>
</tr>
</tbody>
</table>
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):
  - FHA, 51.1%
  - VA, 7.3%
  - RD, 19.6%
  - PMI, 10%
  - Sp. Program, 3.5%
  - Deep Equity, 8%
  - HUD - 184, 0.6%

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

**Single Family II Indenture**
- Indenture Established: 1978
- Bond Ratings: Moody’s Aa1
  - S&P AA+
- Mortgage Loan Collateral 1):
  - FHA, 60.4%
  - VA, 8.1%
  - RD, 28.5%
  - Deep Equity, 1.4%
  - HUD - 184, 1.4%
  - Sp. Program, 3.5%
  - HUD - 184, 0.6%

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

**Single Family XI Indenture (NIBP)**
- Indenture Established: 2009
- Bond Ratings: Moody’s Aa3
  - S&P NR
- Mortgage Loan Collateral 1):
  - FHA, 64.7%
  - VA, 8.5%
  - RD, 25.5%
  - Deep Equity, 0.1%
  - HUD - 184, 1.2%
  - Sp. Program, 3.5%
  - HUD - 184, 0.6%

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

<table>
<thead>
<tr>
<th>Indenture</th>
<th>Annual Fee</th>
<th>Fees plus Residual</th>
<th>PV at 4%</th>
</tr>
</thead>
<tbody>
<tr>
<td>SF I</td>
<td>$1,700,000</td>
<td>$49,328,687</td>
<td>$29,787,566</td>
</tr>
<tr>
<td>SF II</td>
<td>$2,300,000</td>
<td>$76,649,558</td>
<td>$43,152,406</td>
</tr>
<tr>
<td>SF X (NIBP)</td>
<td>N/A</td>
<td>$14,532,248</td>
<td>$4,885,253</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$4,000,000</strong></td>
<td><strong>$140,510,493</strong></td>
<td><strong>$77,825,225</strong></td>
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</tbody>
</table>

### 200% PSA Run

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

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