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ALASKA INDUSTRIAL DEVELOPMENT AUTHORITY

POSITION PAPER

Senate Bill No. 783  
Twelfth Legislature - Second Session

By: Sturgulewski

An act adding multi-family dwellings as a qualified project for purposes of the Alaska Industrial Development Authority.

Attached is a copy of a study prepared for the Alaska Industrial Development Authority by Lehman Brothers Kuhn Loeb Incorporated dated February 15, 1982, and titled "A Strategy for Tax-Exempt Financing of Multi-Family Rental Housing Development Projects in Alaska".

It is the position of the Alaska Industrial Development Authority that the Authority is able and willing to implement a program for financing multi-family dwelling enterprises following any of the feasible scenarios presented in the study as it is directed to follow except a direct loan to borrower program.

The Authority does not have the staff which would be needed for a state-wide direct loan to borrower program and does not feel that such staffing would be economically justified nor satisfactorily productive.

The Authority does recognize a need for financing vehicles enabling the construction of multi-family dwellings in the State of Alaska and feels that the energies of the Authority may well be directed towards achieving suitable financing for such projects.

February 24, 1982

**A STRATEGY FOR TAX-EXEMPT FINANCING  
OF MULTI-FAMILY RENTAL  
HOUSING DEVELOPMENT PROJECTS  
IN ALASKA**

**Parts 1 and 2 (Complete)**

**ALASKA INDUSTRIAL DEVELOPMENT AUTHORITY**

**Public Finance Division  
Lehman Brothers Kuhn Loeb Incorporated  
February 16, 1982**

## PART I

### I. INTRODUCTION

The purpose of this report is to provide the Alaska Industrial Development Authority with an outline of alternative approaches for the financing of multi-family rental housing projects. This report is intended to serve as an initial focal point for the discussion and clarification of the goals and constraints under which AIDA can implement programs to support rental housing development. Among the issues that can and should be discussed are the following:

- a) the size and scope of an AIDA multi-family housing program (e.g. \$20 million versus \$200 million);
- b) the size and income levels of the target population for such rental housing;
- c) the cost and market rent levels for new rental housing;
- d) vacancy rates in existing rental units; (i.e. Demand Study)
- e) the form of any State assistance including, as examples: rental subsidies, a State moral obligation to back-up AIDA multi-family bonds, or State appropriations for AIDA operating or debt service outlays.
- f) the ability of private domestic (Alaskan) financial intermediaries to participate in, or pledge collateral for new rental housing loans.
- g) the ability and willingness of AIDA to add staff members with experience in administering multi-family loan programs; and
- h) the applicability of various federal programs to an AIDA-sponsored multi-family loan program.

Following clarification of these issues, a more complete report will develop detailed financing alternatives targeted to meet the special needs and resources of AIDA.

This initial report is based on a set of underlying assumptions that may be revised or refined in subsequent discussions. In particular, it is assumed that an efficient and effective mechanism for importing capital funds must expressly address the concerns of investors with the risks inherent in multi-family rental housing projects. Section II of this report reviews these risks and discusses methods used by other agencies in reducing these risks to bondholders. This report also assumes that these risks will not be borne solely by AIDA; rather any program must expressly provide for a sharing of risks by private financial intermediaries domiciled in Alaska and by project owner/mortgagors.

Many of the program characteristics that may be necessary to successfully attract outside investors will not vary with the choice of taxable versus tax-exempt financing alternatives. Nevertheless, since it is assumed that a major goal for AIDA is to attract the lowest cost source of funds, this report is restricted to a discussion of tax-exempt financing alternatives. Under present market conditions, tax-exempt financing carries a cost advantage of approximately 300-400 basis points over taxable financing of equivalent projects. For rental units with a cost, say, of \$40,000 per unit financed over 30 years, these savings may amount to more than 16% of annual debt service costs and cumulatively amount to more than \$34,000 over the life of the mortgage. By the same token, it is presumed that these cost savings will be passed through from project owners to renters.

Finally, because of uncertainty and a lack of information regarding the applicability of various federal programs in the Alaska housing market, this initial report assumes that multi-family projects financed through AIDA will not carry FHA insurance nor will such projects be subject to rental subsidy payments through the Section 8 program.

## II. GENERAL CONSIDERATIONS IN THE DESIGN OF ALTERNATIVE FINANCING VEHICLES

### A. Eligibility Requirements for Tax-exempt Financing

Based on the assumptions outlined above, the development of an AIDA financing program must first meet the requirements outlined under federal statutes including the Mortgage Subsidy Bond Tax Act of 1980 ("MSBTA"). Briefly, the principal tests that must be met are three:

- a) Bonds issued after December 31, 1981 must be in registered form;
- b) The interest rate on mortgage loans cannot exceed the true interest cost of the tax-exempt bonds by more than 150 basis points; and
- c) At least 20% (15% in targeted areas) of the rental units financed must be provided to low-income tenants as defined by the Internal Revenue Code, Section 167(K)(3) (B).

More specifically, low-income tenants are defined as households with incomes (adjusted for family size) not in excess of 80 percent of the median income for the area as determined by the U.S. Department of Housing and Urban Development. Moreover, under present interpretations of the 1980 legislation, these units must be rented to eligible tenants for a minimum of twenty years and maximum rents charged cannot exceed 30 percent of the maximum monthly income allowed for occupants of such units.

The combined effects of the "20% - 30%" requirements mean that alternative subsidy arrangements will generally be necessary for any given housing development to generate adequate revenues. In theory, the rentals charged for the remaining 80 percent of the units could be raised to the point necessary to meet projected revenue goals. The feasibility of this approach depends on the level of required rental revenues for unsubsidized units relative to "market rents" on alternative housing units in the area. A more complete

analysis of this approach requires specific data on such factors as income and rent limits for eligible low income tenants, project costs, and area market rents. It should also be noted that AIDA and the State legislature may decide, as a matter of policy, that rental subsidy payments can and should be provided from State resources.

B. General Considerations in Insulating Bondholders from Project Risk

Investors, generally, are risk-averse and multi-family rental housing projects are generally perceived as inherently risky. Therefore, a viable financing program must devise suitable methods to insulate bondholders' from the risk of losses associated with project delinquencies or defaults.

The ability of owners of multi-family rental developments to meet required mortgage payments and operating expenses depends upon a variety of factors, including the achievement and maintenance of a sufficient level of occupancy; sound management; timely and adequate increases in rents to cover increased taxes, utility costs and maintenance; and social and demographic factors that influence consumer demand for the project.

Bondholders, particularly investors outside the State, cannot be expected to incur the costs of monitoring these factors or of absorbing these risks.

Traditionally, issuers of tax-exempt bonds have developed a variety of methods designed to shield bondholders from these risks, including the use of FHA insurance and/or the pledge of rent subsidy payments under the Section 8 program. Under the assumption that these federal programs do not apply in the present Alaska housing market, AIDA will need to develop other methods of credit support and the choice will, to some extent, be dictated by the type of programmatic approach followed in implementing a multi-family housing program.

The two generic approaches adopted by other agencies are direct loan programs and loan-to-lender programs.

C. Direct Loan Programs

Under these programs, the agency (e.g. AIDA) issues tax-exempt securities and uses the proceeds to grant mortgage loans directly to project owners or to purchase mortgages from eligible originators. The agency's bonds are secured in the first instance by mortgage loan repayments, including any insurance or subsidy payments directly related to the mortgage portfolio.

It should be emphasized that investors and rating agencies place particular importance on the experience and resources of agency staff members in assessing the quality of bonds issued under direct loan programs. As stated by Standard & Poor's Corporation:

"Considerable emphasis must be placed on the agency staff since a detailed analysis of each project is impossible and the resolutions generally provide for additional series of bonds. We consider the size and experience of the staff in the key areas of design, underwriting, finance, legal, construction management and property management." (Standard & Poor's Corporation, Bond Rating Guide)

Among the tasks required to be performed or monitored by agency staff under direct loan programs are site selection and market review, economic feasibility analyses, construction inspection and management selection and review.

The evaluation of site selection and review may include an inspection of site characteristics, surrounding land uses, availability of public transportation and utility systems, proximity of the site to recreation, health care, religious and social amenities, shopping and educational facilities, and employment opportunities. Such analysis may also include review of demographic factors as

well as current rent levels and vacancy rates for comparable housing units in the market area.

The analysis of economic feasibility requires assessment of construction costs and possible delays in construction or future increases in cost; the financial and management capabilities of the developer and/or project owner; the projection of rent levels, operating expenses and taxes; and the compatibility of the project with governmental building codes and Federal and State environmental requirements.

During the critical construction phase, suitable arrangements must be developed to monitor compliance with plans and specifications, to review and approve changed orders, and to approve requisitions for construction advances.

This brief discussion of the functions required to be performed under direct loan programs carries important implications for the implementation of new programs.

While it may be possible to contract with outside parties for the performance of certain of these functions from time to time or project to project, the interests of the agency (AIDA) in managing its risk exposure can be expected to require in-house staff capabilities. There will necessarily be a significant lead time to recruit and staff these functions and to develop appropriate operating procedures for direct lending. These staff resources must also be viewed as "fixed costs" and will entail a significant increase in annual operating expenses. In the short run or start-up period, these costs may require appropriations from other AIDA programs or State appropriations. In the long run, the incremental resources and costs may be funded from fees charged to mortgagors and developers. However, the viability of this approach requires a substantial, sustained commitment by AIDA and the State to multi-family

programs so that these fixed costs may be economically allocated over a sizeable number of projects.

While adequate professional staff resources are a prerequisite to developing marketable bonding programs, it will also be necessary to develop other sources of credit support to further insulate bondholders from project risks. The most common approach used in other programs is to provide bondholders with:

- a) the general obligation pledge of the agency under which any otherwise unencumbered revenues may be used to supplement mortgage loan repayments;
- b) the use of a debt service reserve fund invested in marketable securities and pledged solely for the purpose of meeting temporary cash flow aberrations from projects; and
- c) the "moral obligation" pledge of the State to replenish the debt service reserve fund.

It should be noted that this approach has been followed by AIDA in the implementation of its Umbrella Bond Program.

The use of an additional moral obligation pledge by the State requires, obviously, State approval and this will occasion a review of the costs and benefits of such "contingent" State liabilities.

The potential benefits are clear: rating agencies generally accord revenue bond issues with State "moral obligation" backups a rating one level below the rating on State general obligation debt. Moreover, with adequate project supervision and selection, the likelihood for actual cash outlays by the State can be mitigated.

The costs are more difficult to measure but require an analysis of the effects of added "contingent liabilities" on the cost and ratings of State general obligation debt. Further analysis of these important issues requires additional data and is beyond the scope of this report.

Other important issues in evaluating the efficacy of a multi-family direct loan program for AIDA include the analysis of construction loan versus permanent mortgage financing and the extent of risk-sharing or participation by private lending institutions.

D. Construction Lending versus Permanent Mortgage Financing

The past experience of many agencies in other States has pointed out that substantial risks in multi-family rental housing lending occur during the construction phase of projects. Several approaches have been used to mitigate these risks to lending agencies and their bondholders. Several State agencies have opted to restrict program lending activities to permanent mortgage purchases for recently completed projects. Simply, this approach permits the agency to avoid construction risks. It also requires mortgagors to seek alternative, higher-cost, construction financing from conventional sources at taxable interest rates. Thus the full potential benefits of lower tax-exempt borrowing costs are not passed through to the initial capital costs of project development. A second approach followed by agencies restricts construction loan financing to projects covered by FHA insurance on construction loan advances and commitments by GNMA to take out the permanent mortgage upon final endorsement for insurance by FHA. This approach generally protects the agency from construction risks and results in high ratings and low borrowing costs. However, the applicability of this approach assumes that projects and mortgages can meet the appropriate requirements under these Federal programs.

Finally, other agencies provide combined construction loan and permanent mortgage financing. Generally, the implementation of this approach is restricted to agencies with a successful track record of multi-family lending and to projects with substantial Federal subsidy supports.

E. Mortgage Participations by Private Lending Institutions

It may be appropriate for AIDA to develop a mortgage loan participation program to shift relatively more of the construction risks to private mortgage origination intermediaries. For example, AIDA could provide, say, 50% of construction loan financing while private lending institutions supply the remaining loan advances. Permanent mortgage financing, contingent upon the successful completion of construction, could then provide for 90% AIDA participation and 10% participation by private mortgage lending institutions.

In general, the concept of risk sharing through a loan participation program can serve as an added element of latent credit support for AIDA and its bondholders. Participation, either through loans or equity, by private lending institutions helps ensure that these institutions will select economically viable projects and will provide extra resources in monitoring and managing projects over the long run. Moreover, AIDA has established the precedent for participation programs through its Umbrella Bond Program.

Assessing the appropriate level of private lender participation does require further analysis to determine the effects on overall project financing costs and the willingness and ability of private lending institutions to fund various levels of participation.

F. Loan to Lender Programs

A major alternative to direct loan participation programs is a loan to lender program. These programs have been increasingly popular in recent months and are fairly easy to implement in a short period of time. Under the loan to lender concept, the agency issues its tax-exempt bonds and relends the proceeds to participating lending institutions. These institutions, in turn, make

construction loans and/or permanent loans to developers of rental housing. The private lenders thus retain the mortgage loan and assume the risks. The loan from the agency to the lender is a general obligation of the lending institution and repayment of the loan is additionally backed by the pledge of acceptable collateral or a letter of credit from a major bank with a high credit rating. Thus, the terms of the agency loan to the lender provide the primary security for the agency's bonds. This effectively insulates the agency and its bondholders from project risks, shifting these risks to the lending institutions that may be best suited to analyze and manage such loans.

Under the loan to lender concept, private lenders and developers function in the same manner as with traditional sources of mortgage capital. For example, developers use private architects to draw up plans and specifications; private attorneys to handle the legal work; private engineering companies to survey the property and do test borings; private suppliers to provide materials; private general and subcontractors to build the development; private marketing firms to advertise and promote the development; private leasing agents to rent the new units; and private management companies to collect rents and maintain the property. Lenders underwrite loan applications using their normal stands. They perform the credit analysis of developers; review the track record of contractors; accept or reject locations, analyze the cost and marketability of the proposed housing; see that codes and other governmental requirements are met; and inspect construction through to completion.

Developers interested in the program may apply to a participating lender for construction and permanent financing. The lender can reserve funds from the prospective bond issue by signing a Commitment Agreement and paying a Commitment Fee to the agency (which fee can be passed on to the developer).

The agency-to-lender loan rate is established after bonds are sold, typically at a level 1/8th % to 5/8th % above the bond interest cost. The lender-to-developer loan rate is set at a level no greater than 150 basis points above the bond interest cost.

While the agency bond maturities and lender loan repayments may be tailored to the normal long-term amortization of the multi-family mortgage loan, recent loan to lender bond issues have resulted in relatively short maturity structures, which require mortgagors to refinance loans in approximately 10 - 13 years. Although this does shift a potentially serious interest rate risk to the mortgagor, this risk is offset somewhat by the lower cost of tax-exempt financing under the shortened bond maturity structure. Moreover, banks as participating lenders have been reluctant to pledge collateral beyond 10 - 13 years.

Lehman Brothers Kuhn Loeb has pioneered the development of recent loan to lender bond programs, meeting the requirements for multi-family loans under the MSBTA of 1980, by working with issuers to develop both collateralized programs and letter-of-credit (LOC) backed programs. Under the collateralized approach, bonds have been structured with serial maturities beginning in the third year and a final balloon payment in the 13th year. Bond maturities and lender loan maturities are matched to mortgage loan maturities, which are, in turn, based on amortization over a 30-year period.

Under this program, to secure an AA bond rating, lenders are required to pledge collateral securing the agency bonds according to the following schedule:

Direct U.S. Government or U.S. Government guaranteed securities in an amount whose market value equals 125% of the lender loan; FHA/VA single family mortgage loans whose market value equals 140% of the lender loan, and/or conventional, single family mortgage loans whose market value equals 150% of the lender loan.

It should be noted that other underwriters have proposed alternative methods for structuring bond maturities under collateralized loan-to-lender programs.

While no bond issues appear to have been sold under these proposed structures, the basic difference in approach with the type of program developed by Lehman Brothers is in the mismatching of bond principal maturities and mortgage loan maturities. As advanced by this alternative approach, the mortgage loan repayments are scheduled basically identically with the Lehman approach. Bonds, however, are scheduled on a level debt basis over a 13 year period. Thus, lenders repay principal to the agency more rapidly than principal is received from the developer. In effect, then, this approach results in a negative cash flow for the lender.

Generally, the ability and willings of lenders to pledge collateral is of primary importance in developing a successful loan-to-lender program. In order to reduce the collateral requirements, Lehman Brothers has developed a letter of credit (LOC) alternative. Simply, this alternative involves the purchase of a LOC from a triple-A rated bank as additional credit support for the agency's bonds. The principal advantages of the LOC-backed bond are significantly lower interest rates associated with the Aaa rating and the reduced collateral requirements. Under this alternative, the bank issuing the LOC does require originating lenders to secure the LOC with a pledge of collateral based on U.S. Government securities with a market value of 105% of the lender loan, or mortgages with a market value of at least 110% of the lender loan.

### III. A PROPOSED STRATEGY FOR THE ALASKA INDUSTRIAL DEVELOPMENT AUTHORITY

The discussion in the previous section has pointed out that each of the two principal approaches to multi-family lending has its unique advantages and disadvantages. By way of summary, the principal advantages of direct loan programs are the wide flexibility permitted AIDA in selecting projects and structuring appropriate financing terms, and the centralized focus permitted for targeting State or Federal subsidy programs.

The principal disadvantages are the need for explicit credit support arrangements, the lead time necessary to implement such a program, and the significant operating expenses required to properly administer a direct loan program.

The principal advantages of the loan to lenders approach are that such programs minimize the need for other sources of State support and they may lead to generally higher ratings and lower interest costs. The principal disadvantages include limitations on the ability and/or willingness of domestic financial institutions to pledge sufficient collateral, and the refinancing risk faced by mortgagors.

It is our opinion that AIDA may best serve the long-run interests of Alaska by the development of a direct loan participation program. However, given the lead time necessary to properly implement this program, AIDA may choose to first initiate a modestly-sized loan to lender program utilizing a bank letter of credit. Implementing such a program will establish an immediate presence for AIDA in the multi-family rental development market. Moreover, this initial step can be used to buy additional time and experience for the development of an AIDA direct loan program.

## PART 2

### I. INTRODUCTION

You have informed us that capital market conditions in recent years have been particularly damaging to housing markets in Alaska. The continuing high level of interest rates and the extreme volatility of the rates have seriously disrupted conventional real estate lending instruments and institutions. Moreover, the pervasive uncertainties surrounding the future course of fiscal policy and monetary policy do not promise a short-term resolution to the problems faced by traditional lenders or borrowers. The restructuring of financial markets that is now underway will last long beyond the next peak in the interest rate cycle and will force new approaches for the financing of basic shelter needs, particularly for low and moderate income families.

The high level of taxable interest rates on conventional mortgage loans has effectively priced new rental housing units beyond the reach of many families. Furthermore, conventional lending institutions, buffeted by the extreme volatility of market interest rates, are increasingly reluctant to provide long-term fixed-rate loans.

At the same time, demand for rental housing is increasing in Alaska. In part, this increased demand can be traced to the cost of credit in the single-family mortgage market. Also, basic social and demographic changes have increased the demand for "affordable" rental housing. Earlier adulthood, later family formations, and more mobile lifestyles have combined to stimulate the need for rental as opposed to owner-occupied housing units.

The Alaska Industrial Development Authority or another public corporation should be positioned to play an important role in meeting these fundamental and lasting changes in multi-family housing finance.

Mortgage lending, multi-family housing finance is essentially a business loan market. A centralized focus for the implementation and management of shared public-private sector roles and responsibilities in multi-family housing exercised by an entity with an understanding of lending to the private business sector would be a particularly efficient and effective way of monitoring housing needs, administering the myriad of federal programs and developing unique programs responsive to the needs of Alaskans.

A central focus would permit cohesive but flexible financing programs, including direct loan or mortgage-purchase programs utilizing FHA insurance under Section 221(d)(4), Section 8 project financings, and FHA-insured construction loan financings with permanent loan takeouts under commitments from GNMA. Moreover, innovative methods of State of Alaska support could be integrated with or developed independent of these traditional methods of financings. Such innovations could include low-rate loans delayed amortization loans or equity participations. Other methods of State support could include direct legislative appropriation of existing State assets to provide supplemental cash flow that could be used to secure bonds issued to further multi-family housing financing.

Fashioning such a role for a public corporation require a thorough assessment of present and future rental housing needs in Alaska, a review of the current roles of the State and its agencies, as well as private lenders and developers in this market, and a strategic plan for effectively targeting the programs that could be developed.

Our discussions with representatives of lending institutions and public officials in Alaska indicate an urgent need to access low-cost funds to stimulate new construction. Vacancy rates are extremely low and new construction is virtually at a standstill.

Most of the traditional financing approaches employed by other states in the past do not appear applicable or feasible for financing multi-family projects today. For example, while a mortgage-purchase program utilizing FHA-insured loans under Section 221 (d)(4) could theoretically be implemented in a reasonable timely fashion, this would require the use of long-term (30 year) bonds. At present yields, the high level of interest rate on long-term bonds in the tax-exempt market effectively foreclose this option as the resulting mortgage loans could not be amortized by the underlying dwelling units.

Moreover, the cutbacks proposed and implemented in other federal programs, such as the GNMA tandem program along with the inevitable delays in developing the necessary interface with these programs and between the appropriate Federal agencies further frustrates moving ahead positively and quickly.

Table 1

Current Market Yields on  
Aa-Rated State Agency  
Housing Bonds (FHA-VA Insured)

February 9, 1982

<u>Maturity</u> (in Years)	<u>Yield</u>
10	11.25%
20	13.00
30	13.50

Table 1 above points out that yields on 30-year Aa rated housing agency bonds are presently around 13 1/2%. The effective mortgage loan rate on new issues at this yield level would necessarily range between 14 1/2% and 15%. Since our understanding of housing market economics in Alaska indicates that projects may not be feasible at loan rates above 13-13 1/2%, it is clear that long-term financing cannot provide a short-run solution to prevailing construction demand.

Because of these frustrations inherent in financing along traditional lines, the State must look elsewhere if financing support is to be made available for addressing existing demand given financial market constraints. Building on alternative financing ideas employed in the lower forty-eight, refined to meet the restrictions existing in Alaska, we believe a loan to Master Lender financing approach is the desirable and effective way to proceed. This program - the Master Lender Multi-family Housing Loan Program - is outlined in the next section of this report. We believe that the Master Lender program concept has many advantages. First, it is designed to enable the State of Alaska to quickly channel funds into new construction for the 1982 building season.

- o A Master Lender bond sale could be ready for market within 90 days from the date of enabling resolution by the corporation.

Second, the program is designed to enable the bonds issued to carry a high rating (at least double A) and thereby achieve significant interest rate savings.

- o Based on present market conditions, we believe that a Master Lender bond issue could be marketed at tax-exempt rates that would permit effective mortgage loan rates within the 13-13 1/2% limit.

This program also is highly efficient in that existing institutional arrangements are utilized to the maximum extent possible.

- e The Master Lender program preserves the traditional roles of the local lender and developer, enabling each to share in the risks and returns from private capital investment.
  
- e The Master Lender concept also requires no subsidies or outlays by either the public corporation issuing the bonds or the State.

## II. The Master Lender Multi-family Housing Loan Program

The basic structure of the Master Lender program is outlined in Chart 1 and involves important roles for the corporation, the Master Lender, local lenders and developers/owners of multi-family housing developments.

Briefly, the program works as follows:

1. Upon adoption of appropriate resolutions, selection of the Master Lender - which could be a bank, property or casualty firm or any other lending institution or entity - and the development of program loan guidelines, the designated corporation would announce its plan to implement a Multi-family Loan Program and sponsor an information meeting for interested local lenders and developers.
2. Interested local lenders would reserve commitments from the program by underwriting a participation loan commitment agreement and paying a commitment fee to the corporation. We believe that a commitment fee of 1 point is appropriate. This fee, which would be passed through to the developers, provides a contribution to the expenses of the program, and makes possible early amortization of the costs associated with the financing.
3. Local lending institutions, in conjunction with the Master Lender, will apply standard underwriting criteria to select projects and developers for program participation. Local lenders will originate new loans under program guidelines and will provide 100% of the necessary construction loans (at taxable market rates). At the completion of construction, local lenders will retain a participation in the permanent mortgage financing, at market (e.g. taxable) rates. We believe that a 10% local lender participation in the permanent loan allows for a suitable sharing of risks between the Master Lender and the local lenders, insures diligence on the part of local lenders in the origination and servicing of loans, and permits profit making by the local lenders in return for their participation on the permanent financing.
4. Shortly after finalizing local lender commitments, but prior to actual construction of the project, the corporation will issue bonds in the amount necessary to finance 90% of the permanent loans. Based on estimates supplied to us by AIDA, an initial bond issue in the \$75-100 million range appears feasible.
5. During the construction period, which should be limited to two years, bond proceeds will be invested in high-grade, short-term securities at a yield substantially in excess of the bond yield. This yield spread will produce net income which will in part offset bond issuance expenses and permit the corporation to pass-through a lower financing rate. We recommend a construction period not longer than two years we believe this to be advisable because it insures that the projects constructed will address discernable and realistically be assessed demand. Further, two years will insure that all proceeds

from the financing will be spent within the traditional IRS-defined temporary period.

6. At the completion of construction, the corporation will loan the bond proceeds to the Master Lender ("Lender Loan"). The Master Lender will provide 90% of the permanent mortgage loan at a rate pegged to the effective interest cost of the bond issue.
7. The Lender Loan will be structured as a general obligation of the Master Lender. The Master Lender should be selected on the basis of it being a nationally recognized institution possessing an AA rating or better on its general obligation debt securities. Structuring the loan as a general obligation insures that the Master Lender's rating can be passed through to the corporation's bonds.
8. Local lenders will act as originating and servicing agents and will commit to make loan repayments on the permanent loan to the Master Lender on a timely basis. In turn, the Master Lender will undertake repayment of the Lender Loan to the program trustee.
9. Excess cash flows in the program after bond debt service requirements have been satisfied will revert to the corporation.

In our view, there are a number of important benefits from the structure of the Master Loan Multi-family Housing Loan program.

First, the use of the Master Lender provides to the corporation's bonds the security requisite to expedite the marketing and distribution of the bond issue to investors. Moreover, structuring the corporation's loan to the Master Lender as a general obligation obviates the need for cumbersome and costly collateralization.

Second, local lending institutions retain the important function of client maintenance and development with local developers and owners. These local lending institutions are best positioned to evaluate the suitability and marketability of proposed developments and the capabilities of developers. It is appropriate, therefore, that these local institutions provide origination and construction loan financing and shield bondholders and the Master Lender from the inherent risks of the construction period.

Third, the developer/owner, under this program, can maintain a working relationship with local lending institutions and benefit from a low-cost blend of 10% taxable - 90% tax-exempt financing at rates well below (400-600 basis points) conventional mortgage rates. Based on our assessment of preferred local lending practice, we would suggest that the loan-to-value ratio be established at 75%, thus establishing a significant local equity capital contribution to further insure the success of the program.

Fourth, a potential long-term benefit to the corporation and, more generally, the State, stems from the development of a good working relationship with out-of-state capital sources.

While the rates and fees for the various loan components are subject to negotiation and tax-exempt market conditions, terms that appear foreseeable are:

Lender Loan:	Rate within 25 basis points of the TIC on the bonds
Construction Loan:	Market rate + 2 points origination fee
Permanent Loan:	90% -Rate at 1% above the Lender Loan + 2 points origination and 1 point Stand By Commitment Fee  10% -Market Rate + 2 points origination fee
Servicing Fee:	One-fourth of 1% for loans below \$1 million; one-sixth of 1% for loans over \$1 million

The loan origination fee is paid by the developer on the closing date of the respective loan. The fees are designed to compensate the appropriate lender for closing and administrative cost, for the risk of undertaking the loan, and the commitment to subsequently refinance either as a permanent loan or upon maturity of the balloon. The Stand By Commitment Fee is a unique charge assessed by the Master Lender for the use of its credit and the risk assumed by

that institution to make possible the developer's access to low cost tax exempt "balloon" maturity financing.

#### Bond Maturities and Loan Terms

As noted earlier, present market conditions preclude the issuance of long-term bonds at rates sufficiently low to provide mortgage loans at or below 13 1/2%. Assuming that present market conditions continue for the near-to-mid-term, we recommend that the initial issue of the corporation's Master Lender Multi-family bonds be structured with a 7-12-year final maturity.

The Master Lender Loan and the subsequent mortgage loan should be structured on the basis of a 20-25-year amortization schedule of equal annual debt service payments, with a "balloon" or term maturity in a year consistent with the bond maturity. It must be recognized that this loan maturity structure has the positive feature of small principal amortization in the critical early stages of the project's life. Conversely, the Master Lender assumes the greater risk of refinancing almost the entire principal amount of the mortgage loan.

Based on recent market conditions, this structure would permit a bond interest cost of approximately 11-11 1/2%, a tax-exempt developer loan rate of approximately 12 1/2% and a blended (10% taxable - 90% tax-exempt) permanent loan rate of approximately 13% (assuming a rate of 17% on the 10% local lender permanent loan).

Given current market conditions with very wide differentials between short and long-term yields, this maturity structure represents a compromise between the prohibitively high cost of long-term financing and the refinancing risks inherent in low-cost, short-term financing. The use of this type of maturity structure in recent bond sales indicates that this is an acceptable tradeoff of

cost-risk factors in that it does provide for low-cost permanent financing for at least five to ten years dependent on the final maturity selected. The final maturity schedule, should be tailored to market conditions at the time of sale.

To comply with federal regulations under the MSBTA and to increase the supply of rental housing at the lowest administrative cost, adherence to the following program parameters have varying degrees of importance:

Type of Housing: Newly constructed rental housing developments. All developments required to be used as rental housing for a period equal to that of the outstanding bonds. Both of these requirements are mandated by the MSBTA and govern housing financed with the proceeds from tax-exempt bonds.

Income Restrictions on Tenants: At least 20% of the units in each development financed under the program must be occupied by low income tenants as that term is defined by 167(k)(3)(B) of the Internal Revenue Code. The remaining 80% of the units must be occupied by tenants whose adjusted gross income per household was less than the maximum income limit established by the corporation. Projected adjusted gross income will be used to determine compliance. This information is to be obtained during the tenant application process and sworn to (notarized) by the applicant.

Recertification of Tenant/Income Annual Audit: No recertification of tenant income is necessary following original occupancy. As long as a tenant occupies a unit in the development (not necessarily his or her original unit), the tenant/unit continues to qualify under the development's income restrictions. However, the corporation acting through the trustee bank will conduct an annual compliance audit of each development financed under the program.

Distribution of 20% Income-Restricted Units: The 20% income restricted units must be reasonably interspersed on a pro rata basis throughout the development.

Rent Restrictions on Units: For the 20% of the units set aside for the low income tenants, rents cannot exceed 30% of the maximum monthly income allowed for occupants of such units.

Tenant Acceptance: As long as the same standards applied to the 20% restricted income tenants are applied uniformly throughout the development, the developer may reject any tenant on the basis of bad credit, poor job history, and other reasons evidencing tenant undesirability. For example, the development may be designed and marketed exclusively to the elderly or to childless couples.

Selection of Income and Rent Restricted Units: Specific units meeting income and rent restrictions requirements may be redesigned by the developer from time-to-time (with notice to the corporation and the bond trustee), so long as at

least 20% of the units within the development are so designated for 20 years and further so long as the designated units are reasonably interspersed throughout the development.

Violation of Income Restriction Requirements: Loan documents between the lender and developer will include a variety of mechanisms for enforcing the income restriction requirements. A violation of such requirements would constitute an event of default under the loan, subject to reasonable and standard notice and cure provisions prior to any foreclosure action on the mortgage.

Regulatory Agreements and Deed Restrictions: The developer, the corporation and the bond trustee will enter into a regulatory agreement and the developer will be required to record certain deed restrictions requiring use of each development for 20 years following completion of construction of such development as rental property in which at least 20% of the units are occupied by lower income tenants. The regulatory agreement may be ultimately enforced by default and acceleration of the mortgage note. The deed restrictions, which run with the land, may be enforced by any available judicial proceedings.

Equity Joint Ventures: Any qualified lender may, in its name or through a subsidiary, establish an equity joint venture with a developer, with such joint venture then borrowing from the lender under the program. (It must be noted that national banks are prohibited from taking an equity interest in projects they finance.) In such cases the lender must make an actual cash, property or in-kind contribution of equity. This requirement will give comfort to the program that any ventures are, in fact, bona fide. Further, the lender's percentage share in ownership return may not exceed the lender's pro rata share of equity contribution. In addition to insuring that ventures formed are legitimately what they represent to be, this requirement protects the financing from possible accusation that a disproportionate return is simply a device for circumventing IRS-imposed arbitrage restrictions existing on tax-exempt financing. Finally, it should be the policy of the corporation that a lender's percentage share in ownership of the equity joint venture not exceed 50%. This protects against lender's program participation being simply self-serving to the exclusion of intended program beneficiaries.

Units: The key details of the Master Lender Mult. family Housing Loan Program outlined above have been tested and are acceptable in the bond market. It should be noted however, that the basic financing structure can and should be adapted to be responsive to the needs or interests of the corporation.

### Collateralized Loan to Lender Programs

One option, that obviates the need for a Master Lender, is the use of a collateralized lender loan program with a standby letter of credit from an A or AA Rated national lending institution. Discussions with representatives of the Alaskan financial community, evidence that the capacity of local lenders to pledge acceptable collateral may be limited.

We understand, however, that the State owns a substantial portfolio of mortgages loans. The corporation, along with appropriate levels of State government, may wish to explore whether these loans could be placed in trust with a bond trustee such that the cash flow from this portfolio could serve as added security for local lender loans.

A version of this approach is outlined in Chart 2. Briefly, the key differences are:

- 1) The Master Lender Loan is replaced by a 90% participation in the permanent loan by the corporation, and
- 2) The corporation's bonds are backstopped by a pledge of the cash flow from the pledged collateral.

The key to this approach lies in how acceptable is the collateral to the rating agencies. An outline of the criteria used by these agencies is included in Exhibit A. While we do not have sufficient information to express any judgements regarding the pledging of these loans, we can indicate that an additional tier of protection could be obtained by supplementing the collateral pledge with a letter of credit from a nationally-recognized lending institution with a AA or AAA rating, or through collateral insurance from a mortgage insurance Company. This variant, outlined in Chart 3, permits the rating on the national lending institution to be passed through to the corporation's bonds.

In the event that the trustee is required to draw on the third party security to meet bond debt service requirements, the corporation will agree to reimburse such drawings. The corporation's commitment would be secured by the collateral pool.

Either approach could be developed into a workable bonding program. The key steps in this approach are:

- 1) Legislative appropriation of the loan portfolio to be placed in trust.
- 2) Valuation of the loan portfolio and its cash flow.
- 3) Securing the requisite enhancement to insure the highest possible bond rating with the resulting lowest borrowing cost.

Because of the likely time delays in undertaking these steps, it is our opinion that the Master Lender Multi-family Housing Loan Program is the most promising alternative for an immediate lending program.

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## EXHIBIT A

### Collateral:

For non-rated or less than AA rated institutions, approximate collateral requirements are as follows: The lender loan must be secured by (i) direct U.S. Government or U.S. Government guaranteed securities in an amount whose market value equals 125% of the lender loan, (ii) letter of credit from an eligible bank in an amount equal to 100% of the lender loan, (iii) FHA insured, VA guaranteed or conventional single family mortgage loans whose market value equals 150% of the lender loan. Single family mortgage loans used as collateral must (a) have a fixed interest rate and substantially equal monthly installments of principal and interest, (b) have an original term of 25 to 30 years, (c) have a remaining term at least equal to 15 years, (d) qualify as legal investments for federally chartered savings and loan associations (if lender is a savings and loan association), (e) be of the type which have been generally eligible for purchase by FNMA or FHLMC, (f) not have more than 90 days in arrears at any time during the preceding 12 months and remain in a current status while on deposit in the Collateral pool, (g) be serviced by the lender or the lender's qualified agent, (h) if a condominium mortgage loan, have a principal amount such that the aggregate amount of all such pledged condominium loans are not in excess of 10% of the collateral requirement, and (i) possess generally acceptable insurance based on loan-to-value ratios if a conventional loan and FHA flood insurance if in a flood zone. Government securities used as collateral must be (a) direct obligations of the United States of America or any agency or instrumentality thereof, or obligations fully guaranteed by the United States of America or any agency or

EXHIBIT A  
(con't.)

instrumentality thereof (including, without limitation, mortgage loan pool participation certificates issued by GNMA), provided that such direct obligations or guarantees, as the case may be, are entitled to the full faith and credit of the United States of America; or (b) mortgage loan pool participation certificates issued by the Federal Home Loan Mortgage Corporation.

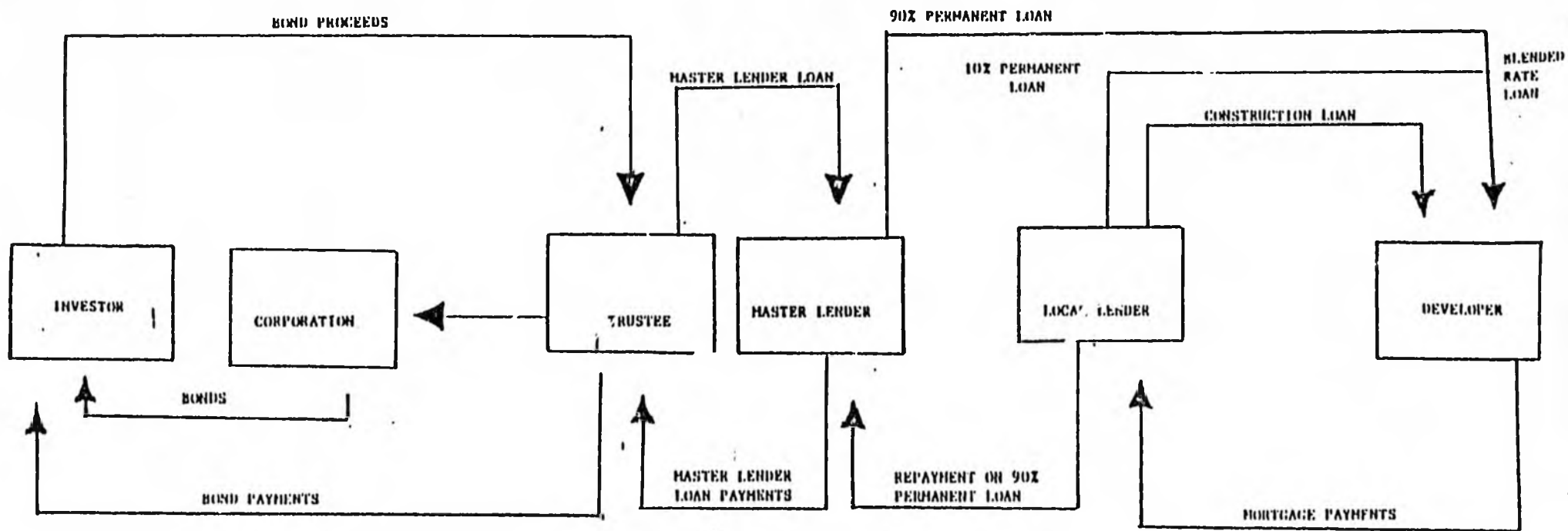
Collateral Valuation and Maintenance:

Collateral must be valued at market and must be revaluated no less frequently than quarterly and brought back to required levels within 30 days (i.e., by pledge of additional collateral to make up a deficiency or by release of excess collateral). FHLMC and FNMA auction yields are to be used for valuing the collateral pool using the "mortgage yield" defined as yield-to standard prepayment date. The standard prepayment is normally 12 years or half of the remaining life of the mortgage, whichever is shorter.

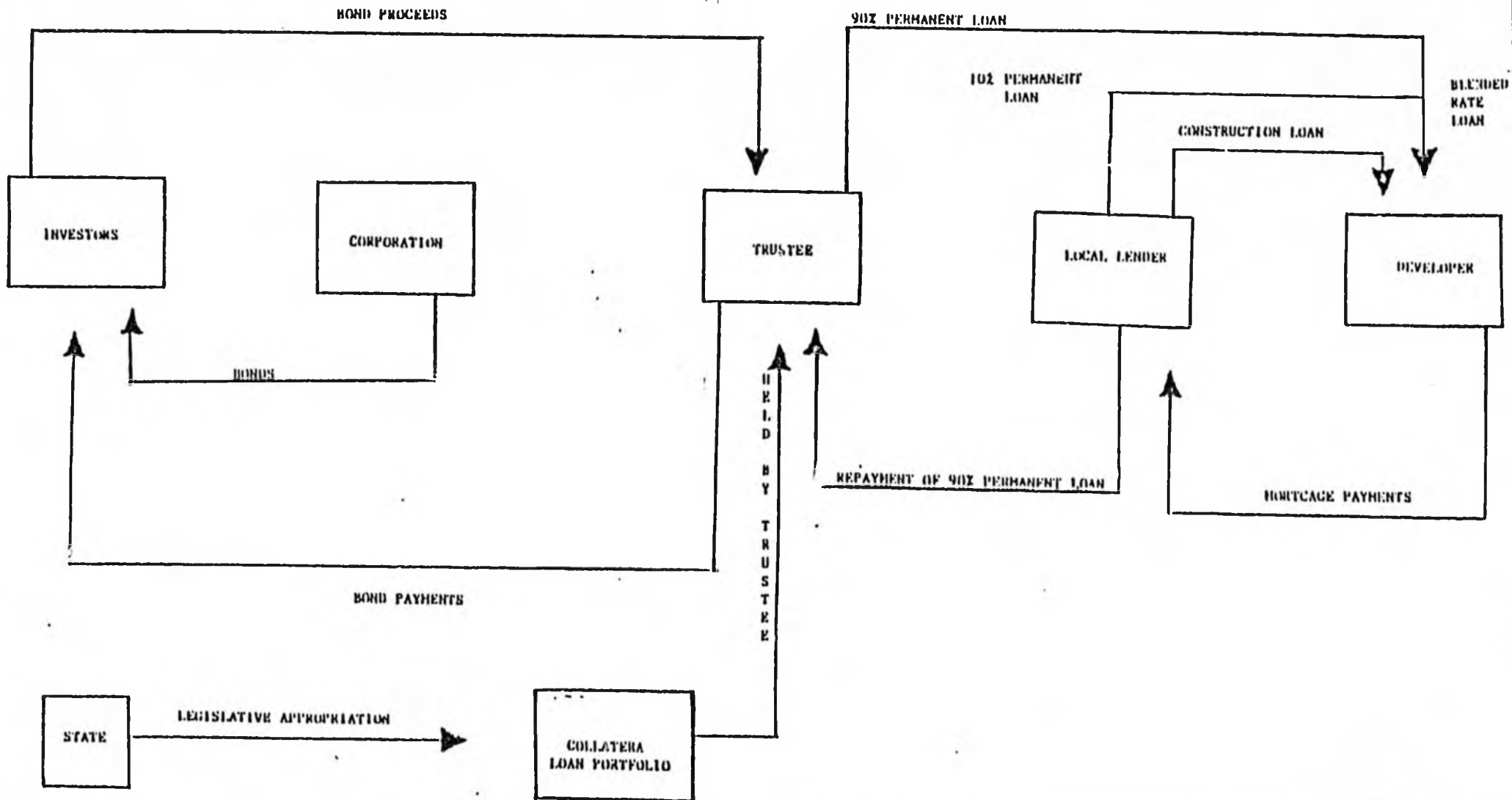
Collateral Substitution:

Free and unlimited substitution of permitted collateral in required amounts at each established valuation date. More frequent substitution is permitted in the event of early payoffs of loans in the collateral pool or to conform to regulatory requirements.

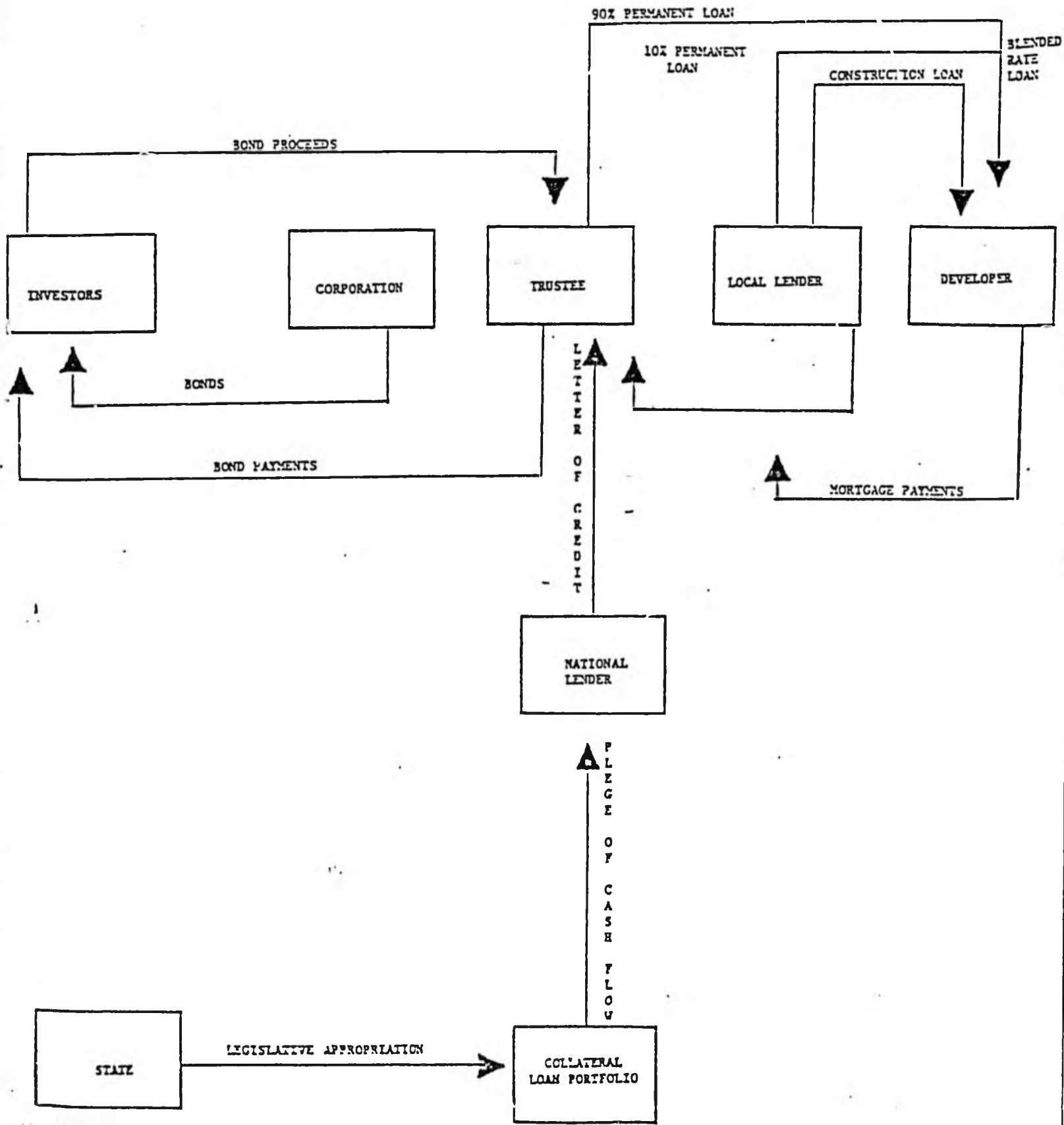
Chart I  
 Key Funds Flow for a  
 Master Lender Multi-Family Housing Loan Program



**Chart 2**  
**Key Funds Flow for a**  
**Multi-Family Housing Loan Program**  
**Collateralized by State Portfolio of Loans**



**Chart 3**  
**Key Funds Flows for a**  
**Multi-Family Housing Loan Program**  
**Utilizing Collateral Pledge and Letter of Credit**



**Effective dates.** — Section 52, ch. 115, effect July 28, 1981, in accordance with AS SLA 1981, provided that this section take effect July 28, 1981, in accordance with AS 01.10.070(c).

#### Article 4. General Provisions.

##### Section

- 165. Delinquent loans
- 212. Fees charged by authority
- 220. Definitions

**Sec. 44.88.165. Delinquent loans.** If more than two percent of the total outstanding balance of loans purchased from a financial institution under AS 44.88.010 — 44.88.220 becomes delinquent for 90 days or more, the authority shall discontinue purchasing loans from that financial institution until the delinquency is reduced to less than two percent. (§ 42 ch 115 SLA 1981)

**Effective dates.** — Section 52, ch. 115, effect July 28, 1981, in accordance with AS SLA 1981, provided that this section take effect July 28, 1981, in accordance with AS 01.10.070(c).

**Sec. 44.88.212. Fees charged by authority.** (a) An application fee may not be charged for an application for authority participation in a loan under AS 44.88.158.

(b) The commitment fee for a loan commitment by the authority may not exceed two percent of the principal amount of the loan. (AS 44.88.085; § 34 ch 115 SLA 1981)

**Effective dates.** — Section 52, ch. 115, SLA 1981, provided that this section take effect July 28, 1981, in accordance with AS 01.10.070(c).

**Editor's notes.** — This section was originally enacted as AS 44.88.08f and was renumbered by the revisor of statutes pursuant to AS 01.05.031(b).

**Sec. 44.88.220. Definitions.** In AS 44.88.010 — 44.88.220

(1) "authority" means the Alaska Industrial Development Authority created by AS 44.88.010 — 44.88.220;

(2) "business enterprise" means a single proprietorship, corporation, firm, partnership, or other association of persons organized in any manner, for any business purpose, other than on a nonprofit basis;

(3) "federal agency" means the United States and any officer, department, agency or instrumentality of the United States;

(4) "governing body of a political subdivision" means, when used with respect to the location of a project, the council of a city if the project is to be located in a city in the unorganized borough, or the assembly if the project is to be located in an organized borough or a unified municipality;

(5) "project" means

(A) a plant or facility used or intended for use in connection with making, processing, preparing, or producing in any manner, goods, products or substances of any kind or nature or in connection with

developing or utilizing a natural resource, or extracting, smelting, transporting, converting, assembling or producing in any manner, minerals, raw materials, chemicals, compounds, alloys, fibers, commodities and materials, products or substances of any kind or nature, any plant or facility used or intended for use as an industrial park or in connection with air and water transportation, or any plant or facility for the prevention, limitation or control of air or water pollution, for the disposal of sewage or solid waste, for the local furnishing of gas, or for the furnishing of water;

(B) a plant or facility used or intended for use in connection with a business enterprise;

(C) commercial activity by a small enterprise;

(6) "plant" or "facility" means real property, whether above or below mean high water, or an interest in it, and the buildings, improvements and structures constructed or to be constructed on or in it, and may include fixtures, machinery, and equipment on it or in it, and tangible personal property, regardless of whether the tangible personal property is attached to or connected with real property, if the owner has agreed not to remove the tangible personal property permanently from the state for the period the authority sets; "plant" or "facility" does not include work in process or stock in trade;

(7) Repealed by § 70 ch 106 SLA 1980;

(8) "project cost" or "cost of a project" means all or any part of the aggregate costs determined by the authority to be necessary to finance the construction, expansion, or acquisition of a project, including without limitation the cost of acquiring real or tangible personal property, and, in connection with real property, the cost of constructing buildings and improvements, the cost of constructing means of access to and from the project, the cost of constructing extensions of utility systems to the site of the project; the cost of a project includes, without limitation, the cost of financing the project, interest charges before, during or after construction, expansion, or acquisition of the project, costs related to the determination of the feasibility, planning, design or engineering of the project and, to the extent determined necessary by the authority, administrative expenses, the cost of machinery or equipment to be used in the operation of the project and expenses of installation, replacement or rehabilitation, and all other costs, charges, fees and expenses which may be determined by the authority to be necessary to finance the construction, expansion, or acquisition;

(9) "project applicant" means a business enterprise or enterprises proposing to

(A) use or occupy a project; or

(B) agree to permit others to use or occupy a project;

(10) "real property" means land and rights and interests in land, including, without limitation, interests less than full title such as easements, uses, leases, and licenses;

(11) "lease" includes, when used as a noun, an interest in, or when used as a verb, the transfer of an interest in, property less than fee simple title, including, without limitation, when used as a noun, agreements to use or occupy property;

(12) "small enterprise" means a business enterprise which is a project applicant with gross income of \$10,000,000 or less for its annual reporting period ending immediately before the application to the authority for a loan;

(13) Repealed by § 51 ch 115 SLA 1981.

(14) Repealed by § 51 ch 115 SLA 1981.

(15) Repealed by § 51 ch 115 SLA 1981.

(16) "commercial activity" includes work in process or activity involving stock in trade, accounts receivable, or the refinancing of existing indebtedness, subject to the provisions of AS 44.88.158. (§ 1 ch 64 SLA 1967; am §§ 4, 5 ch 64 SLA 1977; am § 70 ch 106 SLA 1980; am §§ 43 -- 47, 51 ch 115 SLA 1981)

**Effect of amendments.** — The 1981 amendment, effective July 28, 1981, substituted "for any business purpose, other than" for "which is not organized" in paragraph (2). The amendment rewrote paragraphs (5) and (12). In paragraph (8), the amendment added "expansion" following

"construction" in three places. The amendment also added paragraph (16) and repealed paragraph (13) which defined "tourism enterprise," repealed paragraph (14) which defined "commercial fishing enterprise" and repealed paragraph (15) which defined "mining enterprise."