Next Generation Housing Policy: Standardized Transparent Bond Market Solution
The Most Efficient Way to Finance the Largest Number of Affordable Rental Units

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Absalon Project is a joint venture between Soros Fund Management and the Danish Financial System, through their shared services company VP (www.uk.vp.dk), dedicated to promoting the beneficial aspects of the world's second largest mortgage bond market. The Danish mortgage system has been in existence for 214 years, and benefits from very efficient design rooted in the complete separation of credit and interest rate risks. The Principle of Balance requires mortgage banks to precisely match their assets and liabilities. This eliminates interest rate risk and allows them to focus on the credit risk they are best placed to underwrite and manage. Their mortgage borrowers issue directly into highly standardized bond series, which become quite large and liquid. Transparency is assured through real time reporting on the NASDAQ website (www.nasdaqomxnordic.com/obligationer/danmark). This has resulted in a very efficient market which offers very low interest rates to a wide range of borrowers, from owner occupied residential to municipal affordable rental housing. For more information on the Absalon Project and the Danish Mortgage System, go to www.absalonproject.com .

The timeframe of our proposal is short-term: 1 to 2 years to implementation. This is due to the simple nature of this proposal. We are suggesting that all of the building blocks have been used before in the US housing finance system, and it is just of question of organization and prioritization.

Policy Question Answered: Rental Housing Finance. Solving the other policy questions is too expensive and beyond what a standardized, transparent bond market can offer. However, lower finance costs and more efficient use of existing State HFA funds, Federal LIHTCs and Federal loan guarantee programs will result in a dramatic expansion of affordable rental housing. Larger supply of state directed multi-family rental housing should result in clearing Section 8 voucher program waiting lists and exert downward pressure on market rents.

The main problem we address is the highly inefficient use of capital by State HFAs, supplied by borrowing. States are faced with significant budget problems and constitutional restrictions on deficit financing. States are being forced to radically cut spending, as tax receipts have fallen and are not projected to recover in the medium term future. States are also confronted with significantly higher borrowing costs than in the past. Historically, the municipal bond market was able to borrow a lower rates than the Federal government, owing to the issuer's tax exempt status. Today, municipal bonds yield significantly more than Treasuries and yield as much as junk bonds on an after-tax basis. State HFAs are being shut out from bond market financing. HUD has offered some temporary stop-gap funding to the HFAs. Not only can the HFA not borrow for new projects, they are unable to roll existing debt which is financing existing affordable rental housing. This exposes a common but unnecessary risk that HFAs have been running for years: a mismatch between the tenor of their assets and liabilities.
A second problem is the difficulty in placing Low Income Housing Tax Credits (LIHTCs) in an environment where the typical participants are no longer paying Federal Corporate Income Tax. Since LIHTCs act as a major source of capital for affordable housing, this has stopped development of many projects. The Treasury's 1602 program partially addressed this issue, but expires in December.

The Policy Proposal is to have the State HFA's band together and form a mutual bond issuance conduit. Instead of each State HFA running a balance sheet and taking both credit and numerous interest rate risks, they will restrict their activities to underwriting and guarantees of quality affordable multifamily loans in their jurisdictions. The Federal Government, through FHA and USDA re-insurance guarantees and a bond issuance program run by GNMA, will help this conduit to create a standardized and transparent multi-family mortgage bond market.

State HFAs to act as the primary mortgage insurance companies within their jurisdictions.

- Reverse the traditional process, first establish bond series then issue mortgages
- After the State HFA underwrites and guarantees the creditworthiness of the affordable rental project, the loans are funded by selling into the bond series, which is fully taxable at the federal and state level.
- Project developer receives proceeds from bond sale, thus establishing a direct link with the bond market and allowing for optional redemption in the future
- Interest rate risks are eliminated for the HFA, allowing them to use the economic value of the LIHTCs to guarantee credit risk. The HFA no longer needs to run a balance sheet, eliminating financing risk and need for back up financing from the US Treasury
- Elimination of all interest rate risks leads to significant reduction in capital needs, or the existing capital base can be used to guarantee more affordable housing projects
- HFA's take the first 10% of the loan loss, with the percentage of risk sharing rising by 2% per annum until reaching 20% first loss share in year 6 of the program. This would be an expansion of the Section 542© HUD/HFA risk sharing program, which has been limited by ineligibility into GNMA securitization programs and HUD requirements for NEPA clearance.
- HFA focus is solely upon credit risk. They become the "liability advisor" to the affordable housing developers, constantly seeking ways to improve the underlying credit quality and find the cheapest liability available in the market.
- HFAs should expect to hold 20% capital against their first loss credit guarantees. Thus $100 million can backstop $500 million in first loss guarantees and $4 billion in loans for affordable housing.

The Federal Role should be in the form of re-insurance is provided by either FHA or the USDA's Rural Housing Service

- Agencies provide full faith and credit guarantee for ultimate payment of principal and interest
- Re-insurance is offered on the bottom 90% of the loan amount, AAA rating flows from reinsurance guarantee
- FHA/RD should charge an appropriate annual fee for the reinsurance. At a 90/10 (HUD/HFA) split, the annual MIP should be 45bp, slightly below that of traditional FHA programs. Given the required equity and HFA first loss guarantees, the Federal government can expect a cash cost in a very low probability tail event.
- Bond holder looks to the reinsurer for full faith and credit guaranty
- Re-insurer looks to HFA to remove bad loans from the pool
    - HFA purchases parri passu amount of bonds from pool at lower of market or par
    - If a State HFA fails to perform, they lose their ability to issue new loans into the Federal re-insured bond program.

A Tap Issue Bond Series is established by GNMA

- Bond series are established with standardized coupons, amortization and maturity dates
- State HFAs fund their permanent loans by selling a parri passu amount of bonds in the open market. This is done on a daily basis.
- GNMA can run the auction, in which qualified broker/dealers may participate
- This is identical to how GNMA II Jumbo MBS are created today

- Very similar to the old Freddie Mac Cash Series program (16 and 17 series). Loans entering the cash window were priced at a daily auction. Pools were open for tap issuance for one month.
- Large, standardized, liquid bonds will be created. If current markets can be a guide, borrowers can expect to see a 30 year fixed rate commercial mortgages at 4%.
- GNMA should charge no more than 5 bp per annum for such service
- GNMA should improve its' trust services by either writing the bond trustee functionality or purchasing existing software. The Absalon Project is the sole owner of the software licences of

The Precedent for our proposal can be found in the way private and public multifamlily finance operates in Denmark. The number of rental homes totals approx. 1,000,000, of which 54.5% are social housing units and 45.5% private rental units. These loans comprise 18% of the outstanding debt in the Danish mortgage bond market. Loans have been granted to social housing amounting to approx. DKK 140bn, or $24.5 billion. These loans are financed through the same market as private multifamily and owner-occupied homes. This gives the municipality the same low cost of credit that is the hallmark of the Danish mortgage system.

The number of social housing units being built each year varies, as shown in the attached figure from the Ministry of Social Affairs. The figure covers family housing, housing for elderly people and housing for young people; in Denmark they are all termed 'social housing' or 'subsidized housing'. The maximum LTV for social housing in Denmark is 84%. The balance of the construction cost is covered by local government capital grants (14%) and resident deposits (2%). The capital grant is interest free and repayments can be deferred for up to 50 years. Residents contributions are equal to 3% of the cost of the building and indexed to changes in the national wage index. The stock of public housing is 75% for families, with the remainder split evenly between housing for the elderly and housing for young people. Large efforts are made to help socially deprived areas with the intent to minimize the concentration of low income households. There is some debate as to whether social housing is too nice, with the private sector having trouble competing.

Kommune Kredit is a special purpose mortgage bank which acts as the joint issuance platform for the municipalities in Denmark. It holds 3.1% equity against the bonds that it issues and requires that its' member municipalities guarantee the credit performance of social housing loans. The municipalities are also bound together by joint and several liability. Kommune Kredit is very efficient, with an expense ratio to total assets of 6 basis points. Like other Danish mortgage credit institutions, it takes zero interest rate risk and only focuses on credit risk of the borrowers it guarantees. For more information, please go to www.kommunekredit.dk.

This proposal would funded by the elimination of existing loan guarantee programs at HUD and RHS as well as eliminating the direct affordable multifamily finance programs like FHA 221 (d) or 223(f). The annual budget allocations to HUD and USDA that are saved in such programs with be more than sufficient to act as the capital required to provide reinsurance to the State HFA joint issuance platform. The State HFAs will have an alternative to the temporary stop gap funding provided last year by HUD and Treasury. The Treasury will also benefit from the fully taxable nature of the new standardized affordable multifamily housing bonds.

To conclude, the affordable multifamily market in the USA faces a significant shortage of capital and funding. Bank regulators have clamped down on ADC (acquisition, development and construction) loans, the CMBS market is in tatters, the demand for LITCS is very low and State HFAs have lost the ability to efficiently fund independent balance sheets. We recommend that the State HFA's band together and form a mutual bond issuance conduit. Instead of each State HFA running a balance sheet and taking both credit and numerous interest rate risks, they will restrict their activities to underwriting and guarantees quality affordable multifamily loans in their jurisdictions. The Federal Government, through FHA and USDA, will offer re-insurance guarantees and a bond issuance program run by GNMA. Federal participation should focus on creating a standardized and transparent multi-family mortgage bond market.