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Equal Opportunity Housing and Equal Opportunity Employment

MINNESOTA HOUSING FINANCE AGENCY BOARD

NOTICE OF SPECIAL MEETING

DATE: **Tuesday, October 7, 2014**

TIME: **1:00 p.m.**

LOCATION:

In person: Minnesota Housing
Boardwalk Conference Room
400 Sibley Street, Suite 300
St. Paul, MN 55101

By phone*: 1-888-742-5095; Code: 2680427896
**some members will participate by phone*

The topics for discussion at this meeting are:

- A. Approval, Resolution Authorizing Issuance and Sale of Minnesota Housing Finance Agency Residential Finance Bonds, 2014 Series D

The Agency may conduct a meeting by telephone or other electronic means, provided the conditions of Minn. Stat. §462A.041 are met. In accordance with Minn. Stat. §462A.041, the Agency shall, to the extent practical, allow a person to monitor the meeting electronically and may require the person making a connection to pay for documented marginal costs that the Agency incurs as a result of the additional connection.

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AGENDA ITEM: A
MINNESOTA HOUSING BOARD MEETING
October 7, 2014

ITEM: Resolution Authorizing Issuance and Sale of Minnesota Housing Finance Agency Residential Housing Finance Bonds, 2014 Series D

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REQUEST:

Approval Discussion Information

TYPE(S):

Administrative Commitment(s) Modification/Change Policy Selection(s) Waiver(s)

Other: Finance

ACTION:

Motion Resolution No Action Required

SUMMARY REQUEST:

Agency staff is preparing to issue bonds to provide funds for the acquisition of newly originated mortgage backed securities. Kutak Rock LLP, the Agency's bond counsel, will send the resolution and Preliminary Official Statement describing the transaction under separate cover. The board will be asked to adopt a resolution approving the terms of one or more bond issues on a not-to-exceed basis.

FISCAL IMPACT:

The transaction will result in the Agency earning the maximum allowable spread on the bonds.

MEETING AGENCY PRIORITIES:

Promote and support successful homeownership Preserve federally-subsidized rental housing
 Address specific and critical needs in rental housing markets Prevent and end homelessness
 Prevent foreclosures and support community recovery Strengthening Organizational Capacity

ATTACHMENT(S):

- Series Resolution (sent under separate cover)
- Preliminary Official Statement (sent under separate cover)
- Single-Family Approach for 2014

**Minnesota Housing Finance Agency
Single-Family Approach for 2014: Updated
September 29, 2014**

OVERVIEW

Last December, CSG Advisors working with staff and the underwriters outlined an overall proposed approach for financing single-family this year. The approach was based on the following key features and assumptions:

1. **Strong Pipeline.** Minnesota Housing's new single-family pipeline continues to be robust, with the volume of loans purchased or expected to be purchased from January through August 2014 similar to the same period last year.
2. **Balanced Production.** By establishing rates on different types of loans (GNMA, Fannie Mae, Fannie Mae preferred risk share) to provide the same net yield to the Agency, Minnesota Housing has been effectively offering a wide range of attractive loans, including significant numbers of all three types.
3. **Effective Hedging.** The system for hedging and selling new mortgage-backed securities is working well, both for the taxable loans it was originally intended for and, since July 2013, for tax-exempt loans as well.
4. **Balancing Current and Future Income.** The Agency has sought and seeks to be able to retain and bond finance at least a significant share of new production. Such on-balance sheet production provides a stable ongoing revenue stream for Agency operations and funding of Pool 3, as opposed to relying on fluctuations in up-front revenue from new production.

A key focus has therefore been finding creative and effective ways to use single-family bond financing to add to the balance sheet, while continuing the strong pipeline, balanced production and effective hedging. The recent and proposed approaches to this challenge have been a major part of the work of the Finance Team. This memo briefly explains and updates the approaches for 2014.

CRITERIA

In evaluating the range of options, we outlined the following important criteria which would apply to potential bond issues to help assure benefit to the Agency.

1. **Avoid Major Interest Rate Risk.** The current hedging system is designed to protect the Agency against changes in interest rates from the time loans are reserved until they are either sold or permanently financed. Funding options that include bond financing should not significantly increase risk since reservations have been hedged. The Agency does have a limited amount of zero participations (about \$8 million at the beginning of the year and now about \$12 million) that it can utilize if interest rates were to rise.
2. **Continue High Ratings on all Minnesota Housing Single-Family Bonds.** New bond financing should be structured in such a way as to maintain the current high (AA or AAA ratings) on Minnesota Housing's existing single-family indentures, and avoid long-term stresses on indentures that could create future problems.

3. **Provide At Least a Comparable Expected Level of Return to Selling MBS.** In deciding whether to sell MBS or include them in a bond financing, Minnesota Housing should look at the overall expected return at a range of prepayment speeds to determine that (a) bond financing can reasonably result in the same or better returns than (b) selling the same MBS and reinvesting cash in current available investments. Such comparison needs to take into account any gains or losses the Agency would have as a result of 'paring out' of hedges and putting the loans in a bond issue instead.
4. **Enhance Long-Term Financial Sustainability.** The mix of bond financing and sales of MBS should provide more balanced and financially sustainable results for Minnesota Housing over the long term, taking into account likely prepayment speeds and various interest rate markets.

SINGLE-FAMILY BOND FINANCING: GOING FORWARD

1. New Single-Family Pass-Through Issues

Minnesota Housing was the national pioneer for single-family monthly pass-through bonds, helping establish the market in July 2012 and using it through June 2013 to finance new production and earn at or near full spread. These bonds are AAA rated, MBS-backed under the Homeownership Finance Bond indenture (HFB).

Demand diminished for pass-through bonds both for Minnesota Housing and other issuers in the summer of 2013. Several months ago RBC was able to again find investors for relatively modest-sized pass-through tax-exempt bond issues (in the \$30 +/- million plus range) that preferred to buy pass-through bonds versus buying MBS in the secondary market. Since this provided an excellent opportunity for the Agency to expand the range of bond tools it had available, the Board approved a resolution in June 2014 permitting up to \$100 million of new pass-through issues in 2014. The aim is to structure such issues so as to:

- a. finance new production at or close to full spread with only modest use of the existing zero participations,
- b. utilize the tax yield benefits permitted by bond counsel for taking into account associated net hedging gains or losses.

Two new bond issues have been successfully priced:

- Series A for \$ 38,526,925 at a yield of 3.0%, and
- Series B / C for \$ 32,531,000, with the yield on tax-exempt series B at 2.95% and taxable series C at 3.25%.

On both issues, orders for the tax-exempt bonds were approximately three times the amount available, indicating healthy new investor appetite for such pass-through bonds. In fact on the second issue, a portion was financed taxably simply because Minnesota Housing would have been above full-spread if the entire issue had been tax-exempt. These tax-exempt bond yields are about 20 basis points below the yields on equivalent new taxable GNMA's sold in the global market.

To deal with this anomalous and enviable problem of yields being too low, the finance team has designed a way to create zeros to then be used in conjunction with future pass-through issues. The Agency has long done this with its traditionally structured bond issues, but extensive work was needed with tax counsel to design a way to do this with pass-through issues. This should give the Agency more flexibility in the future when using pass-through bonds.

Timing Flexibility. In order to have the flexibility to come to market when it is most desirable, staff is asking the Board to approve issuance of up to an additional \$150 million in multiple issues.

Criteria In each case, we, together with staff, would look at each issue to help assure that it meets the criteria described above. This is especially important since the Agency can of course continue to sell its new MBS' directly into the secondary market. The aim is to balance how production is financed where the net present value from issuing bonds is at least comparable to selling. As with all bond issues, the return to the Agency depends on prepayment speeds so these would be taken into account as well.

2. Overcollateralized Bond Issues and Refundings in RHF

This approach, first presented to the Board last December, took advantage of the fact that the Agency had previously refunded several old bond issues into the Residential Housing Finance Bond indenture (RHF) leaving approximately \$60 million of unencumbered loans. These loans need to remain in the indenture to meet rating agency tests, but the fact that they have higher interest rates and shorter maturities than new loans created an important potential opportunity.

The principal payment on these loans can be used, together with the principal payments on new loans, allowing for more bond principal to occur in the early years. This allows Minnesota Housing to sell bonds at a lower interest rate, thus allowing Minnesota Housing to achieve at or near full spread without using any of its remaining zero participations.

Because the overcollateral needs to remain in RHF, the bonds are issued under the AA-rated RHF indenture.

How This Has Worked In December the Board authorized issuing up to \$150 million of new bonds in RHF that would leverage this overcollateral, and allow staff to move quickly and flexibly to take advantage of market opportunities. This has worked exceptionally well:

- In January, Minnesota Housing sold \$50 million of new RHF Bonds, 2014 A, with these shorter maturities by pledging \$16 million of the overcollateral. The average interest rate was approximately **2.5%**.
- In March, the Agency sold RHF 2014 B, also \$50 million, again by linking to about \$16 million of the overcollateral. The average interest rate on the new bonds was **2.3%**.

These low rates enabled Minnesota Housing to finance a combination of the low-rate loans it had purchased in Pool 2 when the pass-through bond market had weakened, and new production. The low-rate loans, mostly in the 3 to 3.5% range, were able to be permanently financed at full spread, and in fact generating additional zero participations from the 2014 B transaction.

Remaining Potential. There is still approximately \$24.5 million of remaining additional collateral in RHF which can be used in conjunction with future issues. This will enable Minnesota Housing to finance new production with another over-collateralized issue under RHF towards the end of 2014. Such issue will also take advantage of the ability to refund optionally callable bonds in RHF at today's much lower rates. This is expected to enable Minnesota Housing to achieve full spread on the overall issue.

3. Potential Future Use of Variable Rate Bonds Fully Hedged by Cash in RHF Indenture.

Any use of variable rate bonds would be very carefully scrutinized to assure it does not add to indenture

risks, as set forth in the RHFB criteria guidelines adopted by the Board in 2007 and revised by the Board in May 2014.

The RHFB indenture does provide a built-in risk protection that is similar to many other HFA single-family indentures: a significant amount of cash (because of termination of downgraded guaranteed investment contracts, loan prepayments, etc.). This cash is invested in money market funds and thus in low interest rate environments like today is earning virtually nothing. As a result, Minnesota Housing like almost all state HFAs, performs much better in high interest rate environments than in low ones.

To reduce this gap, and to do better in low rate environments, Minnesota Housing can consider issuing a limited amount of variable rate bonds without interest rate swaps. Since the rate on these bonds tracks the rate earned on cash already under the indenture, the cash provides a natural 'hedge': the higher rates move on the bonds, the higher Minnesota Housing's investment earnings. Equally important, when interest rates are low, Minnesota Housing pays very low rates on these bonds.

As part of the current Risk-Based Capital Study for the Agency as a whole, we will evaluate the risks and benefits of having such additional variable rate exposure and bring that back to the Board before considering any individual transactions.

Furthermore, to make this approach safe and avoid liquidity risks, it would ideally be designed in conjunction with floating rate notes placed with the Federal Home Loan Bank or other bank, so there is no risk of higher liquidity fees or termination or downgrading of liquidity facilities. Under these circumstances, and possibly with the purchase of interest rate caps to provide additional protection if rates do rise, we think such an approach is likely to be quite useful for the Agency.

In any case, any such approaches would be presented to the Board before such bond issues would be structured and sold.

4. Value of Pool 2 in providing flexibility

Minnesota Housing has much more flexibility in financing single-family loans than some housing finance agencies. Pool 2 with relatively large cash balances can be used to purchase new MBS, either to:

- boost its long-term investment return or
- provide a way to fund new production at least for a period of time.

For example Pool 2 was used effectively to purchase the MBS in June 2013 when the 2013 C bond issue was reduced in size. These MBS could have remained as a long-term investment without needing to re-sell them on the market. However when the overcollateralized bond structure became available, it was possible to buy these out of Pool 2 at par (well above their market value) and now finance them long-term at full spread.

This in turn replenished Pool 2's cash and can thus continue to play an exceptionally valuable role for the Agency in how it finances new loans.

OVERALL IMPLICATIONS

Minnesota Housing is in an excellent position to continue to use bond financing for a very large amount of its single-family production. Many other state housing finance agencies have largely stopped issuing single-family bonds for new lending, while relying solely on selling securities in the secondary market. What distinguishes Minnesota Housing and puts it in this strong position are:

1. **Separating tax-exempt eligible new production from those that cannot be financed tax-exempt**, thus allowing the great majority of new loans to ultimately be financed through tax-exempt issues.
2. **Using TBA hedging in a way that new securities can either be sold in the secondary market or included in bond issues.** This allows production to be fully hedged up to the moment when bonds are priced, and allows Minnesota Housing to choose its best ultimate execution.
3. **Creating a mechanism for TBA gains and losses to be included in bond yield calculations**, so that the Agency can take them into account in meeting IRS allowable spread.
4. **Utilizing Pool 2 to purchase and hold mortgage-backed securities**, that can be included in bond issues, sold in the secondary market or retained in Pool 2. This gives Minnesota Housing the greatest flexibility to deal with market fluctuations while continuing its program.
5. **Developing and now renewing the use of single-family pass-through bonds for new production.**
6. **Designing a way that pass-through bonds can be used to generate and then utilize zero participations.** Excess spread on one issue when rates are very favorable will now be able to be utilized to assist in achieving full spread on subsequent pass-through issues.
7. **Effectively utilizing the resources of RHFB, including the timing of principal and interest from previously undesignated collateral and refunding opportunities, to permit full spread issuance of traditional tax-exempt bonds.** The resulting shorter maturity bonds produce very low bond yields for Minnesota Housing.
8. **Maintaining and efficiently using zero participations.** Minnesota Housing has \$12 million of existing zero participations and may increase that amount by year-end, providing an important tool for achieving full spread on future issues.
9. **Evaluating and comparing benefits of MBS sales and bond issues.** Together with the flexibility to choose its ultimate form of financing, the finance team has developed an effective framework for systematically evaluating the relative benefits of bonds in a given market situation.
10. **Being able to consider the natural hedge of RHFB cash for a limited amount of unhedged variable rate bonds.**

As a result of having developed all these tools, Minnesota Housing is in a strong position to go into 2015 with the widest range of approaches for financing production while maintaining its balance sheet.