REO AND REACH AT THE MASSACHUSETTS HOUSING FINANCE AGENCY

by

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Submitted to the Department of Urban Studies and Planning and
the Sloan School of Management
in Partial Fulfillment of the Requirements for the Degrees of

Master of City Planning

and

Master of Science in Management

at the
Massachusetts Institute of Technology
February 1993

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I dedicate this thesis to my husband
because he dedicated his thesis to me.

ACKNOWLEDGEMENTS:

I would like to note that I am extremely grateful to the members of the Development Department at the Massachusetts Housing Finance Agency, particularly Shirley, Nancy, Charles, Mike and Amy. Without their unusual tolerance for pesky graduate students, this thesis, and surely many others, would not have been possible.

I also thank my thesis advisor Larry Bacow for his patience and straightforwardness; and Christian for his presence throughout my time at MIT.

Finally, I thank my parents for 25 years of unconditional support.

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ABSTRACT

The savings and loan scandal and the soft real estate market of the early nineties left banks and bank regulators with the disposition of thousands of foreclosed real estate properties. These properties are now the focus of a new housing program at the Massachusetts Housing Finance Agency, a quasi-public institution that encourages affordable housing with below-market rate financing. Through Recovery Through the Acquisition of Housing (REACH), developers finance existing properties, held by a bank or bank regulatory agency such as the FDIC or RTC, that may be vacant, occupied, complete, incomplete, or in need of capital improvements.

The program's main objective is to turn the overbuilding of the 1980s, especially in the condominium and luxury markets, into much-needed affordable housing while simultaneously contributing to the Commonwealth's economic recovery. REACH's secondary objective, like other MHFA programs, is to encourage projects that further the Agency's social and economic development program goals.

MHFA based these objectives on many implicit operating assumptions. This thesis is concerned with the following two: 1) The REACH program is the appropriate instrument for both converting REO properties into affordable housing and fulfilling MHFA program goals; and 2) REACH is a competitive financing source for developers seeking REO opportunities. The purpose of this thesis is to test these operating assumptions and determine whether the goals of REACH are realistic.

After eight months of observing the program, one financed project, and a series of interviews with affordable housing professionals, this thesis concluded that the REACH program as originally designed was not an appropriate mechanism for financing REO properties. Problems with the program included insufficient financial support, unattainable underwriting standards, and the lack of interest of REO property holders. Therefore, though MHFA's efforts represented an innovative use for REO properties, the program's package was not attractive to the real estate industry.

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CHAPTER I: INTRODUCTION

(1) INTRODUCTION
(2) RESEARCH QUESTIONS
(3) SIGNIFICANCE
(4) METHODOLOGY
(5) THESIS OUTLINE

(1) INTRODUCTION

The savings and loan scandal and a softening real estate market have left banks and bank regulators with the disposition of thousands of foreclosed real estate properties. These properties are now the focus of a new housing program at the Massachusetts Housing Finance Agency, a quasi-public institution that attempts to stimulate the production of affordable housing by providing below-market financing to housing developers.

Recovery Through the Acquisition of Housing (REACH) is the Massachusetts Housing Finance Agency's (MHFA's) newest program. Developers refinance existing properties held by a bank or bank regulatory agency such as the FDIC or RTC that may be vacant or occupied, complete or incomplete, or in need of capital improvements. MHFA advertises favorable mortgage rates and flexible processing in return for an affordability restriction on 20% of the units for the 30 year life of the mortgage:

> MHFA's ability to provide acquisition, rehabilitation and long-term debt financing in a single underwriting provides a unique opportunity to utilize bank and government held housing resources. For qualified projects and borrowers, below-market tax-exempt financing used in conjunction with low-income housing tax credits and discounted acquisition costs can provide a cost-effective financing package with little or no state or local subsidies.[1]

The program's main objective is to turn the overbuilding of the 1980s, especially in the condominium and luxury markets, into much-needed af-

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[1]MHFA Information: Recovery Through the Acquisition of Housing 1992, (REACH), p. 1.

fordable housing. In the state's sluggish development environment, REACH's secondary objective is to establish MHFA as a participant in one of the few active real estate markets, Real Estate Owned (REO). And finally, like other MHFA programs, program guidelines attempt to select projects with strong economic development potential. Specifically, MHFA is interested in stimulating the real estate industry, creating jobs, unburdening banks, or serving specialized housing needs, such as elders, the homeless, or minority households. MHFA has identified in its annual strategic goals, that it intends to develop five REACH properties in fiscal year 1993.

MHFA based the program's objectives on two implicit operating assumptions: 1) there is a stock of REO units that is suitable and efficient for conversion to affordable housing; and 2) MHFA's subsidy provided through REACH is sufficient to cover the financial shortfalls that originally rendered these projects infeasible. The purpose of this thesis is to test these operating assumptions and determine whether the goals of the REACH program are realistic.

(2) RESEARCH QUESTIONS

Despite the high expectations of REACH and MHFA's offers of favorable financing, only one project, Broadway Tower, has received funding since the inception of the program in 1991. This tepid reception and the splashy relaunch of REACH in the Spring of 1992 suggest that either the developments or the program cannot meet the objectives of the Agency and, at the same time interest local banks and developers. Thus a closer look at the REO market, the first and only REACH deal, and MHFA's package may provide clues as to why demand for REACH has been limited, and if the program can be

improved. The larger part of this thesis is based on the following research questions:

1. Is REACH a competitive financing product?
2. Can REACH, in its current form, meet MHFA's goals outlined for the program?
3. Is the REACH initiative an adequate response to the REO market?

(3) SIGNIFICANCE

In a real estate environment that is unfavorable to almost any type of development, there are dismally few incentives for developers to take on the challenges of affordable housing. Programs such as REACH and the Low Income Housing Tax Credit literally provide the only subsidies available for multifamily affordable housing. In addition, MHFA believes that REACH can help unburden some of the ailing private banks holding large amounts of foreclosed properties, and give a boost to the Massachusetts economy. Therefore, REACH is identified as a top priority in the Commonwealth's Comprehensive Housing Affordability Strategy (CHAS) as well as MHFA's Strategic Goals.

(4) METHODOLOGY

This thesis is organized as a case study and program analysis of the REACH financing program. It draws on interviews with over twenty Massachusetts housing and development professionals, recent trade articles, and the program literature of more than ten housing finance programs. Additionally, an important source of primary information has been the author's own observations at the Massachusetts Housing Finance Agency; experience with the program's marketing; and innumerable, informal, and invaluable conversations with the staff of the Development Department at MHFA.

(5) THESIS OUTLINE

The following four chapters explore various aspects of the REACH program. Chapter 2 is a case study of the first development financed through REACH. Chapter 3 is a cursory survey of selected lending institutions and a comparitive analysis of REO financing options. Chapter 4 critiques the REACH initiative at MHFA. And finally, Chapter 5 presents a synthesis of the observations and lessons learned from the initial efforts, and direction for enhancing the initiative.

Chapter II: Broadway Tower, The First REACH Deal

(1) Introduction
(2) Project Description and History
(3) The First MHFA Proposal
(4) The Concord Management Company Proposal
(5) The Revised MHFA Deal
(6) Conclusion and Significance for the REACH Program

(1) Introduction

Broadway Tower is the first development to receive mortgage financing through the REACH program – Recovery Through the Acquisition of Housing. The Broadway Tower deal illustrates first, why Real Estate Owned (REO) properties require special underwriting, and second, the need for MHFA to offer a competitive, flexible financing package. Broadway Tower also illustrates the difficult path that any affordable housing project must travel to secure adequate financing. The developer first submitted the project to MHFA, which turned it down. It was then submitted in revised form to a conventional mortgage company; and then it was resubmitted to MHFA, which finally approved it under the new REACH program. The Agency's experience with this project and its developer will likely prove useful in assessing future REACH deals and MHFA's competitiveness in financing REO properties.

The purpose of this chapter, therefore, is to examine the history of the deal, identify the characteristic that made MHFA's financing first unattractive and then attractive, and illustrate what further analysis might be necessary to analyze the REACH program. This chapter is organized as a case study of Broadway Tower. It details the development's history, the three mortgage proposals, and the deal's significance for the REACH program.

(2) Project Description and History

Vincent C. Fantasia and the Revere Investment Trust developed Broadway Tower as condominiums and commercial units at 250 Broadway in Revere, Massachusetts.[1] The project was completed in 1990. The development contains 95 one- and two-bedroom residential units, 1,411 square feet of commercial storage space, a first floor covered parking unit of 30 spaces, and uncovered space for additional parking. The six-story building features brick veneer, balconies, a sprinkler system and two elevators. Each unit contains a refrigerator, electric range/oven, dishwasher, garbage disposal, carpeting, washer/dryer hook-ups, smoke detector and gas meter.

The original development concept was to appeal to 'empty-nesters' (older couples and individuals with no children) to distinguish Broadway Tower from the luxury condominiums on Revere's popular waterfront targeted to young professionals. The original unit prices for a 2-bedroom apartment ranged from $129,000 - $149,000.

Broadway Tower is located in Revere, Massachusetts in its central business district. The development benefits from easy access to Broadway's commercial and retail amenities, as well as bus service on Broadway and a "T" stop one mile away. Revere is approximately five miles north of Boston on the North Shore and has a stable population of about 42,000. According to the Concord Mortgage Company,

> Revere is generally a typical older, close-in suburb to a major city. The city has some manufacturing, commercial and retail employment and opportunities; however, no major industrial , manufacturing, commercial, or retail facilities are located within its boundaries. The workforce can generally be characterized as blue collar. . .[2]

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[1]The Project History and Concord Mortgage Company Proposal sections are adapted from an Underwriting Memorandum of the Concord Mortgage Company, 1991.

[2]Underwriting Memorandum of the Concord Mortgage Company, 1991, p. 7.

Housing within Revere consists of single-family, row/townhouses, apartments and condominiums. In addition, there are a number of failed condominiums. There is a need for affordable housing, however, in the entire metropolitan Boston area and the Revere Housing Authority has a waiting list of over 700 families for affordable units.[3]

The timing for Broadway Tower could not have been worse. The marketing for the project coincided with the collapse of the Massachusetts real estate market. As a result, the original developer sold only three of the condominiums, the commercial storage space, and the covered parking unit before the project failed. Like thousands of other properties in the Northeast that were built near the end of the 1980s real estate boom, Broadway Tower was a victim of the softening market and simultaneous condominium glut. Then, in June, 1990, the Eliot Savings Bank failed and the Federal Depositors Insurance Company (FDIC) obtained Broadway Tower's $7,800,000 construction mortgage loan. At this point, the property had not yet been foreclosed and Vincent Fantasia was still working with the FDIC in a effort to sell more of the units or find a new developer.

In March of 1991, the Winn Development Company entered into a Purchase and Sale Agreement with Vincent Fantasia and the FDIC to purchase Broadway Tower excluding the three condominiums and commercial units that had already been sold. The price was $5,500,000 plus $600,000 to Vincent Fantasia and the Revere Investment Trust who were still technically the owners of the property. Winn Development Company proposed purchasing the 92 available units to lease to tenants as affordable housing. Arthur Winn, the founder of Winn Development, is an experienced developer of commercial properties like the Bostonian Hotel, and an affordable housing

[3]Ibid.

veteran with over 2400 units in his portfolio and $114,000,000 in loans. Winn's most relevant experience, moreover, was the conversion and management of Kendrigan Place, another failed, luxury condominium project,

> . . . in Quincy containing 78 units. Financing and operations for the project were provided by a modification of the existing private debt, RDAL subsidies, and Federal Low income Housing Tax Credits. The development punchlist items were completed by the Winn Organization and it now enjoys sustaining occupancy and a positive cash flow.[4]

Thus it would appear that Broadway Tower was an ideal project for MHFA. The project had already failed. Winn had substantial experience converting a similar project to affordable housing. And Revere was clearly in need of additional affordable units. The next section describes Winn Development's first financing proposal submitted to MHFA on March 25, 1991.

(3) THE FIRST MHFA PROPOSAL

Affordable housing deals are by necessity a patchwork quilt of multiple subsidy programs. The first deal submitted by Winn to MHFA was no exception. To make the deal work, Winn proposed that the reduced purchase price be financed by a below market rate mortgage from MHFA. To this advantageous financing, Winn proposed obtaining an annual operating subsidy from the State of Massachusetts RDAL[5] program, an allocation of Low Income Housing

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[4]Ibid., p. 4.

[5]RDAL - Rental Housing Development Action Loan - is a now defunct loan program of the State of Massachusetts. It was designed as an operating subsidy to encourage the development of rental units affordable to low income people.

Tax Credits[6], and a target population of Section 8 Certificate[7] holders (See Exhibit 2).[8] The owner of the development would be the Broadway Tower Limited Partnership (See Exhibit 4 for the structure of the partnership) and the deal did not include the three purchased condominiums, parking spaces, or storage space.

MHFA declined to provide a mortgage for Broadway Tower under these terms for several reasons. First, MHFA was uncomfortable about financing a development where the developer did not have ownership (control) of all the units. The Agency feared complications from the private owners of the condominiums, such as complaints about declining property values, inability to enforce control or standards over the privately-held units, or difficulties securing ownership. Therefore, the Agency suggested that Winn also acquire the purchased units from the individual owners in order to avoid complications that might arise.[9]

Second, MHFA prepared its own analyses of value and feasibility that did not agree with Winn's mortgage proposal (See Exhibit 5). For example, on April 19, 1991, MHFA's in-house Appraisal and Marketing Department appraised Broadway Tower between $5.7 and $5.9 million, depending on the capitalization rate. (An independent appraiser hired by MHFA reported a

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[6]The Low Income Housing Tax Credit is one of very few federal initiatives to encourage low income housing. Private investors receive direct tax credits to income for contributing equity to developments with significant low income housing components. It is a complicated program that relies heavily on the expertise of syndicators, accountants, and lawyers for administration.

[7]The Section 8 Certificate is one of the last widespread federal programs in housing. People earning less than 50% of an area's median income receive a certificate that can be used in any type of housing. It guarantees that the Department of Housing and Urban Development (HUD) will pay the difference between HUD-established fair market rents for an area and 30% of a tenants income.

[8]The development budgets are not shown, but each deal includes an allocation of The Low Income Housing Tax Credit.

[9]This information obtained from a letter to Winn Development Company from Broadway Tower's Development Officer at MHFA; May 24, 1991.

lower value of only $4.8 million.) Since the Agency's underwriting standards for loan amount was a maximum of 90% of value, it could agree to a mortgage no greater than $5,278,725. By contrast, Winn was requesting a loan of $6,581,800, which included $4,990,500 for acquisition costs, plus expenses for the broker, past invoices, the private units, and land.

MHFA's appraisal was substantially below the value claimed by Winn largely because of the conservative assumptions adopted by MHFA in its *pro forma* for Broadway Tower, which differed from Winn's estimates regarding the number of expected tenants that would pay market-rate rents, one-bedroom rents, operating expenses, and trending rates. MHFA's analysis suggested that the deal could not meet the Agency's 110% debt service coverage requirement. Winn Development felt that Broadway Tower was an invaluable affordable housing resource and that MHFA's underwriting standards should be more flexible as a result. At this point, negotiations deadlocked, Winn took the project out of active status at MHFA, and approached The Concord Mortgage Company for financing.

(4) The Concord Mortgage Company Proposal

The Broadway Tower proposal to the Concord Mortgage Company was based on a mortgage from the Federal National Mortgage Association (FNMA). FNMA also thought the mortgage was unusual because it did not cover all the units, but could find no legal reason not to approve it. Winn requested a mortgage of $6,300,000 for 18 years, a 25 year amortization period and a rate of 10.375% under FNMA's joint venture Affordable Housing Initiative (See Exhibit 2). The high loan amount was not a problem, as Concord agreed with Winn's independent appraiser, who found Broadway Tower to be worth approximately $8,000,000. (This enormous difference in appraisals suggests that

far from being a science, appraisal is an art. Moreover, the criteria used in appraising a particular property are highly subjective.)

Winn's appraiser, RPR Economic Consultants of Vienna Virginia, and the Massachusetts Housing Finance Agency's Appraisal and Marketing Department's estimation of value differed on the following major points:

	MHFA		RPR	
Gross Rental Income	$854,112		$916,836	
Annual Laundry Income	$6,624		$9,384	
Operating Expenses	$407,580	($4,430/unit)	$372,255	($4,046/unit)
Net Operating Income	$453,156		$553,965	

As with any loan, it is ability to pay that limits the amount of the loan. In this case, MHFA's lower estimate for Net Operating Income meant a smaller amount available to pay debt service and therefore a lower loan amount. It is the Net Operating Income that also determines the value of the investment. In the Direct Income Capitalization method of appraisal, the present value of the cash flow and an assumed sale value are discounted at a discount rate that reflects the current market risk to arrive at the value the investment. Therefore, MHFA's lower NOI would, of course, lead to a lower maximum loan amount. RPR, however, selected a discount rate that reflected a higher degree of risk -- 12%. If they had assumed 11%, like MHFA, their estimate would have been even higher.

	MHFA	RPR
Value (Direct Capitalization)	$5,865,249 (11%)	$8,073,899 (12%)[10]

MHFA's more conservative estimates for income and expenses were based on the following observations of comparable developments:

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[10]MHFA Appraisal and Marketing report prepared by Robert Quealy. April 19, 1991, p. 4.

> The subject offers little in the way of amenities, no pool, grounds or view, smaller than average units, and an active, main street location. All of the comparable developments except [one] offer a pool. The subject also offers the smallest 1BR unit of the 12 comparables and the third smallest 2BR unit.[11]
>
> The Effective Rental Income appears to be calculated incorrectly.... The management fee [therefore] should be reflected at $49,394.... The subject property's 1992 administrative expenses are considerably lower than ... the comparables. The comparison is as follows:
>
> | | |
> |---|---|
> | Broadway Tower | @ $404 per unit |
> | Comparable Properties | @ $1,495 - $1,858 per unit. |
>
> [Broadway Tower's] Management did not budget for Legal, Audit, and Accounting and Data Processing fees. Also, the Administrative Payroll at $19,000 is considerably lower than the Administrative Payroll at most of the other developments managed by Winn....
>
> The subject property's 1991 maintenance expenses, on a per unit basis, are significantly lower than... comparables...:
>
> | | |
> |---|---|
> | Broadway Tower | @ $765 per unit |
> | Comparable Properties | @ $1,495 - $1,858 per unit.[12] |

These estimates arguably reflect MHFA's extensive experience with the region, similar developments, other management companies, and affordable housing in general.

In the proposal to the Concord Mortgage Company, the Executive Office of Communities and Development (EOCD) also committed an annual operating subsidy of $230,000 for 13 years through their program Rental Housing Development Action Loan Program (RDAL). For Broadway Tower, participation in RDAL required only the following two deal-specific conditions: 1) reserve in perpetuity 25% of the purchased units as affordable rental housing for individuals or families whose incomes are below 80% of the area

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[11] Ibid., p. 2.

[12] MHFA Management Document prepared by Leslie Giddings and Colleen Kelley. April 19, 1991, p. 2.

median and 2) reserve for 15 years an additional 36% of the units as affordable housing.[13]

The final component of the Concord deal was an annual allocation of $500,000 of Tax Credits for 10 years. The expected equity value to the sponsors was estimated at $2,200,000. The Tax Credit occupancy restriction required 50% of the units to be rented to individuals or families at 80% of the area median income level for 15 years.

The target occupancy was 59 low income units for Section 8 certificate holders and 33 market-rate units. Winn, the Concord Mortgage Company, and independent appraisers RPR Economic Consultants felt that the project's quality of design and construction, easily accessible location, minimal improvements ($140,000) and new financing plan would "support Broadway Tower's long-term attractiveness and marketability."[14]

At the last minute, the Massachusetts Legislature failed to fund the RDAL program for Fiscal Year 1992. EOCD could not honor the commitment and the deal collapsed. Without the $230,000 annual operating subsidy, the project was no longer feasible. Winn was under considerable pressure to find financing before the Purchase and Sale agreement with the FDIC expired.

At the same time that Winn was seeking financing for Broadway Tower, affordable housing developers were embroiled in a debate with MHFA. The debate was over who should share in the savings derived from a portion of the HUD Section 8 subsidy known as the Financing Adjustment Factor (FAF). A Development Officer at MHFA describes FAF as follows:

[13]At MHFA, and for the purposes of REACH, "affordable" annual rent is defined as 30% of 50% of a federally recognized statistical area's median income.
[14]Underwriting Memorandum of the Concord Mortgage Company, 1991, p. 9.

> The FAF, granted in the early 80's, was necessary because exceptionally high interest rates were affecting the production of affordable housing. The FAF represented additional Section 8 subsidy which was used as an interest subsidy which equalled the difference between an 8% feasibility rate and the actual bond funding rates. In 1992, MHFA took advantage of a program offered by HUD to refund the existing bonds at lower bond rates. FAF savings were shared between MHFA and HUD. Use of savings received by MHFA are restricted to very low income housing uses. [15]

Aware that MHFA expected a large refund of FAF, Winn returned to MHFA and strongly proposed that the Agency finance the deal and replace the RDAL commitment with FAF money.

(5) THE REVISED MHFA DEAL

By this time, there was a different climate for financing at MHFA. Two factors contributed significantly to this. First, the increasing number of REO properties in Massachusetts had gained more political exposure. The State's Comprehensive Housing Affordability Strategy (CHAS), the Executive Office of Communities and Development (EOCD), and MHFA had all identified REO properties as a priority affordable housing resource and a way to boost the Massachusetts economy. Even while the formal REACH program was still under consideration, the Deputy Director of MHFA, Eleanor White, had already intervened with the FDIC to strategize on a role for the Agency in promoting REACH-type deals.

Second, many professionals at MHFA concluded that the Agency could no longer afford to choose only traditional developments for financing; a difficult development climate necessitates more flexible underwriting and more

[15] Personal interview with Shirley Abrams, Development Officer, MHFA. August 8, 1992.

aggressive marketing for financial products to insure a stream of business.[16] The Agency supports its own operating costs largely through the financing fees charged included in project mortgages. Furthermore, Judith Richards notes that

> ...the imbalance in financial returns to developers and lenders in the 1970s and dramatic fluctuations in interest rates in the 1980s caused lenders to rethink their traditional role as fixed-rate, long term lenders. Real estate financing is now a more creative art in which each financing package is fully negotiable.[17]

Thus this trend has, in part, brought about the negotiated *pro forma*.

When Winn approached MHFA for the second time, the Agency reconsidered both the developer's extensive relationship with MHFA and its own traditional way of analyzing developments. Negotiations between MHFA and Winn began again and both parties conceded on the following four points: 1) the final deal did not include purchasing the privately-owned units; 2) the loan amount was only $3,750,000, but The Massachusetts Government Land Bank provided a second mortgage for $2,500,000.[18] 3) MHFA honored the RDAL commitment at $165,000 per year with FAF money; and 4) MHFA allowed some less conservative assumptions, mainly higher rents (although the operating budget was increased) in the *pro forma* projections (See Exhibit 3).

According to Mike Jacobs, Senior Development Officer at MHFA and a key player in the negotiations, there were many reasons for MHFA's new po-

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[16]Noted in conversations at MHFA with Mike Jacobs, Senior Development Officer, Shirley Abrams, Development Officer, and Nancy Andersen, Development Officer. August 27, 1992.

[17]Judith W. Richards, *Fundamentals of Development Finance; A Practitioners Guide* (New York: Praeger: New York), p. 22.

[18]The MHFA loan was financed at a taxable rate of 10% plus a .5% Agency administrative fee for 30 years. Since then, credit enhanced rates have decreased to 6.75% for tax exempt and 8.5% for taxable, plus the Agency's administrative fee.

sition.[19] As noted earlier, MHFA was interested in REO properties as a new market. Mary Padula, the Secretary of the Executive Office of Communities and Development (EOCD) also urged that MHFA honor Broadway Tower's RDAL commitment because the contract had already been executed before funding was terminated.

Additionally, Fannie Mae changed its position on purchasing the loan from MHFA. When Winn first approached MHFA, Fannie Mae was hesitant to purchase Broadway Tower's mortgage because it did not control all the units. By the time Winn went to Concord, Fannie Mae had still not found any actual guidelines for dealing with the uncontrolled units and decided it could still purchase the mortgage.

From an underwriting standpoint, the Agency does not normally underwrite deals based on HUD's 'fair market rents.'[20] Therefore, rent levels are subject to adjustment. In order to satisfy both EOCD and MHFA's desire to try the REO market, MHFA staff accepted Winn's projections, but required additional security to protect MHFA. The additional security included letters of credit equivalent to 12% of the loan (6% is normal), personal guarantees, the higher operating budget, and a $2.5 million loan from the Massachusetts Government Land Bank in second position.[21] (See Exhibit 4.) That is, MHFA's mortgage in first position meant that if the property ever experienced difficulties managing its debt, the MHFA mortgage would have to be fulfilled before

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[19]The following rationale for MHFA's concessions were largely taken from a conversation with Mike Jacobs, Senior Development Officer, September 16, 1992.

[20]Fair market rents (FMRs) are rents that HUD has determined are typical or attainable for a particular statistical area. FMR is the level up to which HUD will subsidize federally assisted tenants.

[21]The Land Bank, another quasi-public, was in part able to accept a riskier position than MHFA because its financing does not come from bond issues or investors. MHFA may issue only the highest investment grade bonds to finance its projects.

any other debt received payment. The new deal received final commitment from MHFA's Board of Directors on March 10, 1992.

(6) Conclusion and Significance for the REACH Program

In the case of Broadway Tower, an experienced developer rejected the MHFA's prohibitive conditions, found a more competitive mortgage company, and was forced back to MHFA only when the State withdrew a critical subsidy that only MHFA could replace.

The key point in this case is that the developer could easily have found a comparable, more easily obtained mortgage to replace REACH financing at a standard mortgage company, but the deal was not feasible without the operating subsidy. (See Exhibit 7) In fact, MHFA's taxable financing rates are generally recognized as not competitive with those of many conventional mortgage companies — though MHFA's low, tax-exempt financing rates are not offered by conventional mortgage companies.[22] Without MHFA's unconventional provision of the RDAL substitute, however, the lower acquisition cost alone would not have made the deal feasible and the deal would not have existed.

Therefore, it is difficult to estimate REACH's costs and benefits to the deal. Many people at MHFA feel that the true costs of doing business with the Agency are hidden in the Agency's higher management and maintenance standards, extra monitoring and audit requirements, additional equal opportunity standards, high security requirements, and limited dividend restrictions.[23] Two factors, however, eliminate the cost issue: 1) the other subsidy

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[22]Conversation with Development Officer at MHFA, August 11, 1992. In order to qualify for tax-exempt financing rates a development may use no more than 5% of gross space for commercial uses. Additionally, in the case of rehabilitated developments, the level of rehabilitation work must exceed $15,000 per unit.
[23]Ibid.

components included in each of Winn's mortgage proposals and critical to the deal imposed use restrictions equal or greater than those of the REACH program; and 2) the deal had to be financed at MHFA because of the RDAL substitute, not REACH. The case of Broadway Tower is more useful in illuminating two emerging trends in housing development at MHFA: new underwriting standards for REO properties, and MHFA's competitiveness in the REO market.

As we saw with Broadway Tower, the composition of development deals is changing at MHFA. As a relatively new, existing development, Broadway Tower, and many REO properties, do not fit the characteristics of most multi-family developments: expiring use projects, substantial rehabilitation, or new construction. In addition, REOs may not stand up to MHFA standards for construction, location, or design. They do not meet financial feasibility standards without creative packages: REO properties by definition have demonstrated infeasibility and need more assistance.

Broadway Tower highlights the need for new, less conventional underwriting standards, creative financing packages, and relatively expedited processing. These are the criteria for competitiveness that MHFA must meet in its REO program. In the case of Broadway Tower, MHFA clearly did not meet these criteria when the deal was first proposed and Winn Development went elsewhere. Furthermore, the REACH program only offers developers financing for the acquisition cost agreed to by the entities holding the properties: banks, the FDIC, or the RTC. Clearly, this reduced cost may not provide an adequate subsidy for feasibility. Given, then, that MHFA offers no advantage in terms of acquisition costs, the following chapters seek to answer two questions to evaluate the REACH program: Does MHFA need more agressive underwriting standards for REO properties? And are MHFA's financing op-

tions adequate, and comparable or better than those of other mortgage companies?

CHAPTER III: THE COMPETITIVE POSITION OF REACH

(1) INTRODUCTION
(2) THE RESOLUTION TRUST CORPORATION
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(4) THE QUASI-PUBLIC AND HOUSING FINANCE ORGANIZATIONS
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(1) INTRODUCTION

This thesis has tried to highlight two key questions for analyzing the Massachusetts Housing Finance Agency's REACH program for financing REO properties:

- Is REACH appropriate and useful for the existing market?
- Is REACH competitive with similar programs targeted at the same market?

This chapter considers the second question. It examines loan products similar to REACH, offered directly from the Resolution Trust Corporation, banks, traditional mortgage companies, and other quasi-public housing organizations such as the Massachusetts Housing Partnership.[1]

Each of these types of institutions, like MHFA, has expressed interest in financing foreclosed properties, though the focus and motivation vary in each organization. Banks, for example, must deal with REO properties to strengthen their own balance sheets and profit margins. Quasi-public institutions, such as MHFA, may be concerned about profits, but are also influenced by strong social mandates. Typically, quasi-public institutions require an affordable housing component in exchange for 'competitive' or expedited financing or other features.

[1] Quasi-public institutions in Massachusetts are generally created by the legislature to fulfill a public need not being met by the private sector. The organizations are generally considered quasi-public because of their ability to issue bonds and raise their own funds.

The purpose of this chapter, therefore, is to compare REACH with the products of other institutions and assess its relative competitiveness. Specifically, I will compare program features, restrictions, and market segments associated with the loans from both the borrower and lender perspective.

REACH's underwriting standards build on its less successful predecessor, READI, which also targetted foreclosed and distressed properties.[2] Among READI's biggest problems, however, were a premature launch and a low priority status. The launch may have come before the real estate industry had recognized the magnitude of the REO problem.

MHFA launched REACH, on the other hand, on the heels of the Massachusetts Comprehensive Housing Affordability Strategy, which identified REO properties as a top priority in the state, hired an aggressive program director, and began an exclusive direct-mail marketing campaign to alert selected developers of the opportunity. This new campaign has already generated interest among several developers with proposals in hand.

REACH's program concept is as follows:

> MHFA's ability to provide acquisition, rehabilitation and long-term debt financing in a single underwriting provides a unique opportunity to utilize bank-and-government-held housing resources. For qualified projects and borrowers, below-market tax-exempt financing used in conjunction with low-income housing tax credits and discounted acquisition costs can provide a cost-effective financing package with little or no state or local subsidies.[3]

REACH's fixed interest rate as of July 1992 was 6.75% for tax-exempt financing and 8.5% for taxable. (Only projects that fulfill one of the Federal

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[2]READY—Rental Acquisition Development Initiative—was launched in 1990 to provide below market-rate tax-exempt acquisition and rehabilitation financing for older, at-risk rental properties or partially completed new developments. It also recognized that the softening Massachusetts real estate market had left many of these developments infeasible.

[3]REACH General Information Brochure, July 1992.

Government's criteria for public purpose qualify to be financed through tax-exempt bonds. Affordable housing is one of the qualified public purposes.) Mortgages are capped at a 90% loan-to-value ratio and owners must reserve at least 20% of the development's units for low-income households for at least 30 years. The rents of the units reserved for low-income families may not rise above 30% of 50% of the geographic area's median income as determined by HUD.[4]

Finally, MHFA seeks development proposals that satisfy the following criteria in their lending programs in general:

1. Location in geographic areas that continue to experience high levels of need for affordable housing relative to supply;
2. Sensitivity to particular housing needs in the contexts of local demand, such as families, elders, persons with mental or physical disabilities, single parents, the homeless, or minority households;
3. Permanent expansion of the supply of affordable housing in conjunction with efforts to create or preserve jobs, or to revitalize urban neighborhoods or rural areas;
4. Strong community support, private sector participation, and/or creative use of financial and human resources.

From the above features and the lack of a distinct subsidy or special underwriting guidelines, we can conclude that REACH is not a 'program.' It is more a willingness to consider using MHFA financing to acquire properties that might be technically REO, but basically conform to MHFA program standards.

(2) THE RESOLUTION TRUST CORPORATION

The Resolution Trust Corporation was created by the government under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) to

[4] In some cases, Section 8 certificates—a federal program where the government pays the difference between 30% of the certificate holder's income and the market rate rent—may be counted towards the 20% low income units.

dispose of Federal Savings and Loan Insurance Corporation (FSLIC) insured bank properties. The RTC differs conceptually from MHFA in the public purpose of the institution. Though the federal government has mandated that a portion of these assets be allocated to non-profit and public institutions for affordable housing, the RTC is also is also concerned with maximizing its return on the properties. MHFA's sole purpose is to create affordable housing.

The original strategy of the FDIC and the RTC was to offer direct sales, refinancing and auction programs to developers. The response, however, was largely negative due to the RTC's widely perceived bureaucracy, mismanagement, and discrimination against non-profits and public agencies. The discrimination stemmed from the original requirement of a 30% down payment on RTC properties, which affordable housing entities had trouble meeting.

The RTC then created the Affordable Housing Disposition Program, a special option for direct sales to public agencies and non-profit organizations. This program is similar to REACH in that its goal is to create affordable housing, but REACH also targets private developers willing to accommodate an affordable housing component. Under this option, the RTC offers permanent, market rate, seller financing for up to 95% of a property's acquisition price. The program requires at least 35% of all units in a multifamily apartment building to be reserved for low and very low-income residents with incomes below 80% and 50% of area median income respectively.

According to Barbara Bryan, an officer with the National Association of Home builders, the revised underwriting for public agencies and non-profits doubled the annual participation rate of the Affordable Housing Disposition Program from 100 to 200 properties purchased.[5] More organizations have been able to purchase properties directly from the RTC since the changes were

[5]Conversation with Barbara Bryan, National Association of Homebuilders, 9/28/92.

implemented. In addition, for nonprofit developers, the underwriting process only takes approximately 150 days, as compared with 180-200 for other qualified buyers.[6] (See Exhibit 8.)

These features also highlight a significant difference between the RTC's program and REACH: the level of program standardization. As a regional lender, MHFA tries to cultivate relationships with the development teams of its projects. MHFA is likely to take each developer's experience, especially with the Agency, heavily into account in the transaction. For example, MHFA competitions for subsidies award points to more experienced developers. And it was the developer's track record with the Agency that helped Broadway Tower finally come to agreement with MHFA. Each deal is open to negotiation for security and mortgage amount, and interest rates are influenced by the need for credit enhancement, and tax status. Finally, as noted in the introduction, MHFA has explicit community goals that are never addressed by the RTC.

Both of these programs, as well as those of other quasi-public agencies, however, differ from conventional mortgage companies. We examine the REO situation in banks, mortgage companies and other quasi-public housing agencies in the next two sections.

(3) Banks and Traditional Mortgage Companies

Private banks have generally had three responses to the significant number of bad real estate loans left in their portfolios by the depressed real estate market and imprudence of the 80s:

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[6]RTC brochure: Direct Sales Program for Public Agencies and Nonprofit Organizations; Affordable Housing Disposition Program.

1. Offer individual foreclosed properties at reduced acquisition prices;
2. Auction non-performing assets to the public.
3. Package foreclosed properties, with healthy and non-performing mortgages, at deeply discounted prices to investment entities.

The first strategy has been tried by almost every entity holding an REO property to discover what price the market will bear. This approach may have been unsuccessful because a property's maximum supportable mortgage may be much lower than the price banks are ready to accept.

The FDIC and RTC have both tried the second strategy, but still hold large portfolios of multi-family housing properties as well. Now Shawmut Bank is considering a large public auction for as many as 200 of its commercial properties.[7]

The last strategy, attempted by both the FDIC and Shawmut Bank in its sale to GE Capital Corp. and Lehman Brothers, is interesting because it adds another player to the REO market: investment bankers.[8] Arguably, investment banking firms, may be the best positioned to dispose of foreclosed real estate because of their access to investors and ability to create financial products. Analysts, however, are divided as to the effect of wholesale packaging on the real estate industry.

> Whether they agree with the package sales strategy or not, most analysts concur that present conditions afford banks a unique opportunity to clean up their books, a narrow window... that might close as quickly as it opened. And no one denies that non-performing loans have a number of negative consequences.[9]

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[7]Banker and Tradesman; "Lenders Rush to Dump Underwater Real Estate Loans." October 14, 1992.
[8]Ibid.
[9]Ibid., p. 10.

Other analysts believe that the low prices will not clear the market, but "depress market values generally, which in turn, will reduce the value of other real estate assets the banks hold."[10]

Some private mortgage companies will also finance REO properties. These lending institutions differ, however, in their relationships to the properties. Mortgage companies do not hold property and usually sell their mortgages in the secondary markets. Therefore, they are limited to refinancing low risk properties in order to sell the mortgage to an institution such as Fannie Mae. Mortgage brokers seek to match developers with loan programs, but also only for top investment grade properties. In other words, REO, foreclosed properties would require additional credit enhancement, security or higher rates to reflect the risk involved.

Additionally, mortgage companies usually have no social investment obligations. When deals include other subsidies, however, then the structure must conform to requirements of other programs, as we saw in Chapter 2 when Winn brought Broadway Tower to the Concord Mortgage Company. The development's participation in the Low Income Housing Tax Credit Program, the RDAL program, as well as Fannie Mae's purchase of the mortgage required many conditions on affordability, regardless of the conventional mortgage.

(4) THE QUASI-PUBLIC AND HOUSING FINANCE ORGANIZATIONS

In Massachusetts, two quasi-public state agencies offer financing for REO properties in addition to MHFA:

1. The Massachusetts Housing Partnership (MHP)
2. The Massachusetts Government Land Bank.

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[10]Ibid.

In addition, several state housing finance agencies have begun offering programs for REO properties. Neither Massachusetts agency, nor any other state agency, however, has a program or policy designed specifically for evaluating multi-family REO properties. Nonetheless, it is important to consider MHFA's closest competitors, MHP and the Land Bank, in order to assess more accurately the supply and demand for REO financing, as well as strategies and innovations.

The Massachusetts Housing Partnership

The Massachusetts Housing Partnership Fund is a quasi-public housing finance institution that specializes in the financing of smaller, multifamily developments, usually fewer than 20 units. Fleet Bank has recently capitalized a program in partnership with the MHP Fund, which will execute "a $63.7 million loan agreement to provide financing for affordable housing across the Commonwealth."[11] As at MHFA, affordability means that the rents of units reserved for low-income families may not rise above 30% of 50% of the geographic area's median income as determined by HUD.

Though MHP's program does not apply exclusively to REO properties, REOs clearly fall within the guidelines:

> Over eighty percent of the private rental housing stock in Massachusetts cities consists of smaller buildings of 20 units or less.... These properties are usually investor owned and are therefore particularly vulnerable to disinvestment during tough economic times. Disinvestment occurs when landlords default on their mortgage or tax payments and then walk away from their properties or lose them to foreclosure. Currently, there are well over 5,000 abandoned, vacant, and foreclosed multifamily rental properties in the state's larger cities, and thousands more statewide.[12]

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[11]Fleet Bank/MHP Fund Loan Agreement Summary. July 28, 1992.

[12]Massachusetts Housing Partnership Fund Brochure: Permanent Rental Financing Program. 1992.

In addition, MHP offers a credit enhancement waiver, coordination with other lenders and equity sources, and "fast turn-around and sensible underwriting":

> The MHP Fund's lending standards have been designed to recognize the special nature of affordable housing development and the often limited resources of sponsors of affordable housing. While the Fund will only finance credit-worthy projects, our standards are less restrictive than those imposed by conventional lenders.[13]

MHP also believes that "the greatest affordable housing 'subsidy' currently available is the low price of existing stock. These discounts represent the foundation for building the financing for an affordable project."[14] MHP offers a maximum loan of $2 million, 20 year terms, and an interest rate set at 2.1% above Treasury yields of comparable maturities. They require a minimum loan of $100,000, debt service coverage of 110% or 115% for projects with fewer than 20 units, and a maximum loan to value ratio of 80%, though they indicate flexibility. (See Exhibit 1).

To finance this program, Fleet provided long-term financing to the Fund. Eligible uses consist of 20 year, fixed-rate loans by the MHP Fund for affordable rental housing. There is a priority for 5-20 unit buildings in urban neighborhoods that do not have other sources of permanent financing.

The Massachusetts Government Land Bank

The Massachusetts Government Land Bank is a quasi-public institution funded by state issued bonds. Its purpose is to promote beneficial, affordable housing and economic development in targeted regions of the Commonwealth. More significantly, it provides financial, technical, and development assistance to achieve its goals.

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[13]Ibid.
[14]Ibid.

The Massachusetts Government Land Bank is also an alternative source of permanent financing for REO properties. As noted in Chapter 1, the Land Bank provided the second mortgage for Broadway Tower. According to Robert Baker, the Director of Development at the Land Bank, the quasi-public institution does not actively pursue REO properties, but several developers have approached the Land Bank, including BayBanks' REO department. The Land Bank's policy, in general, is that the REO property must fit the Bank's regular social and financial underwriting criteria. For this reason, the Bank normally considers significantly different properties from the Massachusetts Housing Finance Agency, i.e. the organizations distinguish themselves with different affordable housing goals and by targeting different kinds of projects.

Chart A: Land Bank vs. MHFA

Eligible Uses for Financing:	Land Bank	MHFA
Housing:		
Multifamily Housing	Yes	Yes
Limited Equity Coops	Yes	Occasionally
Single Family Homes	No	Yes
Single Room Occupancy	Yes	Occasionally
Transitional Housing	Yes	No
20-40 Units	Yes	Occasionally
> 40 Units	Occasionally	Yes
Economic Development:		
Industrial Parks	Yes	No
Industrial Buildings	Yes	No
Small Business Incubators	Yes	No
Downtown Commercial Buildings	Yes	No
Other Uses:		
Technical Assistance for feasibility studies	Yes	Yes

More specifically, the Land Bank currently offers mortgages on affordable housing up to $2.5 million. Rates vary depending on public benefits, need, term, and risk, but average 7% over 15 years, with an amortization period of 30 years. The Land Bank requires a minimum of 10% of total development costs in equity, a maximum loan to value ratio of 90%, minimum debt service coverage of 1.10 and matching financing from a private lender on loans over $1,000,000. In addition, security requirements typically include project real estate, a senior mortgage or shared first mortgage, and maybe assets of the developer.[15] The Land Bank also has a development arm to act as a partner in carrying out development tasks or as developer.

It is an important characteristic, however, that in the case of REOs both organizations have proved more flexible in their criteria. MHFA, for example, has expressed an interest in accommodating smaller developments than average. And the Land Bank financed the 92 unit Broadway Tower, which is larger than their usual 50 unit maximum.

In order to compare the various features of MHP's and Land Banks' financing to REACH, I used the following general assumptions under each program's terms (See also Exhibit 9 and the summary in Chart B):

Assumptions:		
	Mortgage	$2,000,000
	Equity	$200,000
	Per unit cost	$50,000
	Number of units	44

At MHP, this mortgage would result in one-time financing fees of approximately $22,500. Their current 9.5% interest rate would require monthly debt service of $16,817. Collateralizing the 6% letter of credit would also be a one-time payment of $120,000.

[15]MHFA "One-Stop" Affordable Housing Finance Application Instructions. September 1, 1992. p. 19.

At the Land Bank, this mortgage would generate between $10,000 and $50,000 in fees (assume upper limit for extended REO due diligence). The 7% interest rate would require $13,306 in monthly debt service. The operating reserve at 35% of the annual operating budget plus 3% of monthly income was estimated as follows:

Budget	44 units @ $5000/unit =	$220,000	
		$220,000 x .35 =	$77,000
Income	44 units @ $750/unit =	$33,000	
		$33,000 x .03 =	$990
			=====
		Total Reserve	$77,990

The same project financed with REACH would require $56,000 in one-time Agency fees (2.8% for construcion and permanent financing) and $120,000 to collateralize a letter of credit. The mortgage would generate $13,038 in monthly debt service at 6.8% (6.75 + .05 Agency Adminitrative Fee).[16] (Although both MHFA and Land Bank offer below market-rate financing, each changes its own financing rate based on market conditions. Each organization makes this decision based on the discretion of internal financial officers without collaborating with other agencies.)

[16]This analysis is simplified and for illustration only. It was confirmed as typical of actual calculations conducted at MHFA by Shirley Abrams, Development Officer at the Massachusetts Housing Finance Agency, December 2, 1992.

Chart B: Comparison of Financing Fees

	MHP	Land Bank	MHFA
Monthly DS	$16,817	$13,306	$13,038
One-time Fees	$22,500	$50,000	$56,000
LOC/Reserve	$120,000	$77,990	$120,000
Total Fees and Reserves	$142,500	$127,990	$176,000

This chart shows that, except for slightly higher reserve requirements, the Land Bank offers a better financing deal than MHFA.

Other Housing Finance Agencies

In order to put MHFA's REO efforts in a national perspective, I inquired of the activities of other state housing finance agencies. According to the National Council of State Housing Finance Agencies, several other states have begun offering financing programs for REO properties, including the Texas Department of Housing and Community Affairs, the Oklahoma Housing Finance Agency, the Missouri Housing Development Commission, and the Mississippi Home Corporation. All but the Mississippi Home Corporation offer financing exclusively for single family REO properties as a way to provide affordable home ownership. The Mississippi Home Corporation does not offer any REO financing and merely acts as a information clearinghouse for RTC and FDIC properties.[17] Thus it is clear that MHFA has a more developed and focused strategy for the State's non-performing asset problem than any other state housing finance agency.

[17]National Council of State Housing Authorities. HFA Program Catalogue; Section H: RTC/FHA/HFA REOs.

(5) CONCLUSION AND SIGNIFICANCE FOR REACH

This chapter reviewed several financing sources for developers interested in acquiring REO properties. It is clear that the viable options for obtaining financing are limited. MHFA is one of the very few financing sources in Massachusetts that have expressed an interest in REO. Apparently, the limited supply of financing programs has kept MHFA from assembling a truly useful or effective package for REACH. Use restrictions, high financing fees and a lack of subsidy or incentive all decrease the attractiveness for developers to take a chance on A risky REO property. We can conclude initially that although MHFA has expressed more interest in REO than other finance institutions, it has not really endeavored to create a useful package. To further assess whether MHFA's program has the potential to capture the growing REO market, the next chapter examines the development community's response to REACH. First, however, it is worth clarifying why any lender would be interested in financing REO properties.

Lender Interest

The need for additional subsidies to insure REO viability and financial returns, raises an important question: Why would a lender want to get involved with this type of risk? This chapter has dealt substantially with the interests of the borrower. It is worth examining the motivation of the lenders for clues to understanding how the non-performing asset crisis will play out.

The motivation for banks is obvious. There is increasing pressure for banks to dispose of their non-performing assets in order to strengthen their balance sheets and their ability to do business. I believe this pressure has lead to the drastic measure of dumping billions of dollars of foreclosed mortgages on the market in the hopes of starting over.

Quasi-public organizations with social purposes, however, seek to fulfill other goals. The past two chapters have underscored the changing development climate of multifamily housing in Massachusetts. Financing has become scarcer and more complicated. This trend has driven quasi-public lenders as well as developers to consider new financing programs and opportunities in order to stimulate the development industry.

Housing professionals at MHFA have taken note of these changes and have strived to keep the agency on the cutting edge of housing finance. Such recent programs and initiatives to increase the Agency's flexibility include Elder CHOICE for elderly residents that need additional services to continue independent living; Options for Independence for mentally disabled and other special needs populations, and the Small Projects Task force to help the Agency better accommodate developments with fewer than 40 units.

Many housing professionals now view REOs as the next frontier in affordable housing. A supply of empty, existing housing and the chronic need for a variety of affordable housing options seem to be a natural match. The scarcity of financing and the downturn in the real estate market have also led lenders to seek additional business in the form of targeted new programs. A program that can successfully service the REO market will likely enjoy a busy market in the near future.

Thus, in this thesis' attempt to analyze the REACH initiative, we have seen that MHFA is in a favorable position to tap the REO market, and there are several incentives to do so. But over the past 8 months, MHFA has not been able to create a program to stimulate significant demand. The next chapter examines MHFA's actual attempts to enter the REO market and analyzes some of the lessons learned from initial experiences.

CHAPTER IV: THE MHFA PIPELINE

(1) INTRODUCTION
(2) THE REACH MARKET
(3) THE DOG FACTOR
(4) MHFA UNDERWRITING STANDARDS
(5) PROGRAM MARKETING
(6) THE WHOLESALE PHENOMENON

(1) INTRODUCTION

As noted earlier in this thesis, in the 1980s, Massachusetts's real estate industry experienced a cyclical upturn concurrent with the excitement on Wall Street. Developers continued to build commercial and residential properties, regardless of the vacancy absorption capacity and demand for types of uses in geographic areas. Then, the 1990's recession brought an unparalleled slump to the real estate market. Years of over-building in the 'good times' finally came back to haunt the over-zealous bankers and developers. Foreclosed condominiums and multifamily developments throughout the state stand incomplete, vacant, or in need of extensive capital improvements. These REOs are generally held by the Federal Depositors Insurance Company (FDIC), the Resolution Trust Corporation (RTC), and various private banks in Massachusetts.

Despite the existence of the market, and the lack of available finance options for REO, MHFA's attempts to stimulate demand through the REACH program, fewer than 15 proposals have come through MHFA and only 2-3 are likely to receive financing. The purpose of this chapter, therefore, is to examine the REACH initiative, market, and the possible reasons for the disappointingly low response rate.

(2) THE REACH MARKET

The potential REACH market includes all the multifamily, foreclosed properties of the FDIC, RTC, and ailing banks of Massachusetts. According to the Citizens' Housing and Planning Agency (CHAPA), this market contains approximately 300-400 properties in Massachusetts and should increase as more bankers and developers come forward with troubled properties in search of opportunities.

The market should represent opportunity for MHFA because the FDIC and RTC have an affordable housing mandate. The mandate was imposed by the Federal Government to facilitate the potential public good the properties can provide. Briefly, it states that the FDIC and the RTC must first offer single and multi-family properties that fall below a certain percentage of their original value to preferred buyers, including households with income below 115% of area median, first time home buyers, and non-profit developers. In addition, buyers purchase the properties for their appraised value with low-income use restrictions. Supposedly, the Federal Government was to reimburse the FDIC the difference between this value and their (higher) value without the restrictions.[1] The MHFA, therefore, is an ideal partner for the RTC because of its experience in the affordable housing community.

In light of MHFA's competitive position, the Agency should be poised for brisk business. Based on conversations with officers in the Multifamily Development Department of the MHFA, the experience of Broadway Tower, the lists of available REO properties, and interviews with developers, there are four key areas where the REACH program strategy may not have anticipated the reality of the REO market.

- The Dog Factor

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[1]The status of this funding for multi-family properties is currently unclear.

- MHFA Underwriting Standards
- Program Marketing
- The Wholesale Phenomenon

(3) The Dog Factor

Many Massachusetts real estate professionals agree that their industry has been in decline since 1987. In spite of the large potential market, MHFA's small REACH portfolio may simply reflect the difficult nature of REACH projects. From the Agency's perspective, to obtain REACH financing, a development must overcome the inherent liabilities that caused foreclosure initially, meet the Agency's stringent design and feasibility criteria, and provide well-conceived affordable housing. The REACH financing terms must then satisfy the developer, owner, or bank. These requirements are rigorous for any development in a sluggish economy, but especially for the less favorable REACH projects, or dogs.

Many of the multifamily properties built in the real estate boom of the eighties have significant, inherent liabilities. For example, mortgages were optimistically based on high rent levels with little cushion if rents ever fell. Bargain-hunting developers may have purchased any properties that were still in reasonable condition when acquired by a bank and with any chance for operating at a profit due to the lower acquisition or financing costs.

Some failed condominiums contain an abundance of luxury amenities, or are located in wealthy suburbs. Converting these failed condominiums and luxury units into affordable housing may not be a cost-effective strategy if the units require large subsidies, or more than HUD will support for fair market rents. MHFA's Appraisal and Marketing Department's criteria, for instance, include the desirability of the location and attractiveness of the property, environmental quality, and proximity to civil, social, transportation and com-

mercial services. MHFA's Design Department's criteria include architectural impact/appropriateness, energy conservation, and design for efficient operating costs. Condominiums may also have financial structures that necessitate more due diligence or concessions than other mortgages. MHFA underwriting will certainly flag inflated soft costs that can easily break fragile deals.

MHFA's social program goals also limit the number of suitable developments. Housing program concepts have increasingly stressed the importance of an economic development component or another social goal beyond providing shelter, and REACH is not exempt. MHFA's award-winning Inner City Task Force is a prime example of a housing social component. Tenants, police patrollers, housing managers, community organizers, and youth leaders strategize with MHFA to combat comprehensively chronic urban problems, and protect MHFA's investment.

In addition to the above underwriting standards, the ideal REACH project must reserve 20% of the total units as affordable to families that earn less than 50% of the area's median income – the Agency's minimum criteria. The project must also meet more expansive program guidelines to hold up under public scrutiny, including appropriate siting and design, and access to public transportation and amenities. Developers must demonstrate at least a concept for integrated affordable housing. In fact, the REO properties' external economic impact is one of their greatest selling points to the State and the public:

> Utilization of these properties can aid in the recovery of the Commonwealth's lending institutions, generate employment opportunities, and enhance neighborhood revitalization efforts.[2]

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[2]MHFA Information: Recovery Through the Acquisition of Housing (REACH); p. 1. 1992.

Though the Agency prefers new financial products that stem the decline of a neighborhood or positively influence the maintenance and longevity of surrounding properties, as well as cover the agency's costs associated with financing, it is not evident that these characteristics are present in REO portfolios. In the past five years, banks and developers have been working creatively to salvage the over-abundance of residential properties, particularly luxury and condominium units, of the 1980s boom years. It is popular belief that the properties remaining in banks' and the RTC's portfolio are the most difficult to make viable in our present economy.

According to Charles Gladstone, the development officer coordinating REACH at MHFA, fewer than 20 proposals have been submitted to the Agency for review since the program inception in June, 1992. This low number may reflect several macro-conditions: developers have been scared or put out of business by the difficult economic climate and trouble finding investors; many banks leery of more real estate exposure have already discouraged developers from borrowing to develop; developers have rejected REO projects because of the high risks and low incentives.

There are currently 15 REACH projects under review at MHFA, but Mr. Gladstone's initial estimate is that only 2 or 3 of the projects would be able to support the debt service on even the reduced acquisition prices. This condition supports the theory that the available REO properties are so poorly conceived as investments, that they cannot even support their own mortgage and maintenance costs, or a worthwhile return for investors. Mr. Gladstone has subsequently submitted a proposal to the Agency's management to consider providing subsidy in the form of equity or subordinate debt.

(4) MHFA UNDERWRITING STANDARDS

The second reason for MHFA's limited pipeline of REACH projects may be MHFA's conventional underwriting standards. Three incidents provide evidence for this theory: Broadway Tower, the Small Projects Task Force, and MHFA's perceived niche and reputation in affordable housing.

Chapter 2's case study of Broadway Tower outlined the project's problems with feasibility, including MHFA's hesitance to provide a mortgage for the property when three of the units were privately owned condominiums (as well as the need for an operating subsidy.) MHFA's insistence that Arthur Winn conform the first proposal to meet conventional underwriting standards drove Winn to seek alternative financing.

MHFA's very first filter for identifying potential properties, in fact, is that all the units be included in the deal. A review of the RTC's listing of available properties, however, indicates that many of the multifamily condominiums include only a fraction of the units.

MHFA's second filter is typically the size of the property. The Agency has historically been reluctant to finance properties smaller than thirty units due to disproportionate risk and costs involved with bond financing and underwriting, according to findings of The Small Projects Task Force.[3] A review of the RTC's properties, however, again indicates an abundance of properties under forty units. Though MHFA has initiated, through the Small Projects Task Force, an effort to address a market shift towards smaller affordable housing developments, the incremental changes suggested to underwriting do not create a vehicle for financing the volume of small projects suggested by the REO market.

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[3]The inter-departmental Task Force was assembled by MHFA management to investigate the risk and costs associated with financing small projects.

The final underwriting filter is the outside perception MHFA has cultivated in the housing market. Based on anonymous interviews with developers, MHFA is known in the development community as being professional, but rigorous, demanding, and bureaucratic. MHFA also has an acknowledged reputation for discouraging small project proposals. This belief may have contributed to the segmentation of the market, as evidenced by the Massachusetts Government Land Bank target of properties between 20 and 40 units and the Massachusetts Housing Partnership target of properties smaller than 20 units.

This evidence strongly suggests that MHFA has limited its own pipeline by not recognizing the characteristics of the existing market. In addition, MHFA has not made any attempts through program literature or outreach to change perceptions that the Agency is now kinder, friendlier, and more willing to accept less conventional (smaller) projects.

(5) PROGRAM MARKETING

Six months after REACH's official launch, only 15 projects are in the pipeline and few seem viable. We have discussed the possible impact of the projects' inherent liabilities and MHFA's high standard of underwriting. The next questions concern the effectiveness of MHFA's marketing of the program:

1) Did MHFA's advertising attempts reach enough developers?
2) Did the direct mail campaign fail to convey the benefits of the program, the competitive advantages of MHFA, or the Agency's attempts to accommodate new kinds of projects?

The REACH program was released after a less-successful predecessor. The original program was also to target REO properties, but was given no special priority or attention at MHFA. When the Agency's management met

with RTC officials and decided to make REO a priority in the next year, the Multifamily Development Department redesigned the READI program into REACH. The Agency hired an aggressive program director (Charles Gladstone) to spearhead the initiative and launch a direct-mail campaign to over 1000 developers, bankers, and brokers in the Massachusetts real estate community.

The REACH brochure mailing was the largest effort at MHFA to inform developers of the program. The REACH brochure is two pages: the first page is General Information about Program Objective, Background, and Program Concept; the second page is a term sheet with mortgage rates, amortization, loan-to-value ratios and other information. The two-color brochure was widely expected, at MHFA, to initiate an avalanche of development proposals. (See Exhibit 10.)

Other strategies to inform the real estate community included a newspaper advertisement in Banker and Tradesman, the region's largest real estate trade newspaper, and the program director's personal conversations with developers (word of mouth).

In retrospect, it is important to compare the marketing of REACH to the marketing of other MHFA initiatives. The SHARP program was MHFA's last widespread, well-received, affordable housing initiative. SHARP was a State initiative to fill the gaps created by the demise of the federal Section 8 program which provided developers deep subsidies and guaranteed rent levels. It was launched by the governor who had assembled a diverse task force of esteemed housing professionals to create the program. MHFA then held developer workshops to familiarize the real estate community with the program. Both the State and MHFA generated press releases, advertisements and mailings.

Several differences between the SHARP and REACH launches are immediately obvious:

1. SHARP was State sponsored by and carried the blessings (and clout) of the Governor's Office.
2. SHARP's subsidy in the booming 1980s was an attractive proposition for developers.
3. SHARP was created by a diverse task force that represented the interests of developers and lenders.
4. SHARP's launch included more marketing efforts, such as developer workshops and press releases.

MHFA has had similar experiences with other federal programs. In fact, most of MHFA's lending is associated with popular federally subsidized programs such as Section 8, 236, and the Low Income Housing Tax Credit, or State initiatives such as SHARP and RDAL, though individual descriptions of these programs are beyond the scope of this thesis. The recently initiated MHFA programs, READI, 80/20, REACH, Elder CHOICE for Independence, on the other hand, have financed fewer than 10 developments combined. Apparently, independent MHFA programs may lack the required subsidy and momentum provided by national organizations, media, and cooperation.

Moreover, closer critique of the brochure itself reveals several other possible weaknesses. The General Information page is long and dense. The information given emphasizes foremost the liabilities of the projects, "such properties are generally characterized by high vacancy rates and financial unfeasibility" and the Agency's larger social goals served by the program:

> In addition to providing an opportunity to increase the supply of affordable rental housing, utilization of these properties can aid in the recovery of the Commonwealth's lending institutions, generate employment opportunities, and enhance neighborhood revitalization efforts.

Not until the third paragraph, in Program Concept, does the brochure mention some of the benefits of the program:

> MHFA's ability to provide acquisition, rehabilitation and long-term debt financing in a single underwriting provides a unique opportunity to utilize bank- and government-held housing resources. For qualified projects and borrowers, below-market tax-exempt financing used in conjunction with low-income housing tax credits and discounted acquisition costs can provide a cost-effective financing package with little or no state or local subsidies.

The remainder of the brochure outlines MHFA requirements and prioritization of projects with a high likelihood for socio-economic impact.

The brochure suggests that the content was not written with MHFA's largest customer—struggling private developers looking for business and profits—in mind. If they took the time to read the entire brochure, they were mainly informed of MHFA's social criteria and many requirements. MHFA's second most prevalent customer is non-profit developers, who might share MHFA's social vision, but also feel daunted by MHFA's underwriting standards. In fact, the brochure may serve to perpetuate MHFA's reputation for difficult standards and extensive requirements for documentation.

The brochure's failure to entice gun-shy developers becomes especially evident when it is compared to a private mortgage broker's literature. The broker's advertisement utilizes more pictures, exclamation points, graphics, and differentiating font styles. (See Exhibit 11.) It emphasizes only one thing: how low financing rates are: "If you're waiting for rates to bottom out, we believe it's time to get off the fence!!! ...lowest point in over two decades." It speaks directly to the development community about the willingness of financial institutions to negotiate deals. Inside the four-page folder are clear charts with bold print. Two of the pages also list contact names for more information, which adds a personal touch to the advertisement. Thus the clarity, enthusiasm, and personal touches create an enticing and effective marketing tool.

(6) THE WHOLESALE PHENOMENON

A final explanation for the lack of response to the REACH program may lie in the announcement of a new strategy created by banks and the RTC: wholesale packaging of millions of dollars of non-performing residential mortgages and REOs for sale to investment banking houses and secondary markets. If this approach is successful, it may indicate that any one typical REO mortgage is too risky for investors, but slices of bundles of mortgages with varying risk levels and carefully allocated cashflows may be more enticing to investors, especially if they stand to gain from an upswing in the market.

The RTC and FDIC have been disposing of their properties both through auctions and individual sales. Many banks have tried creative financing with developers to salvage REO properties and value including debt restructuring, reduced acquisition costs, and partnerships with public and quasi-public institutions to create affordable housing. REACH is another attempt to heal individual properties by restructuring their financing. This approach might have eventually worked except that the staggering volume of REO properties in Massachusetts alone is surpassed only by the number of underwriting and workout hours required to restructure them. CHAPA has estimated between 300 and 400 RTC, FDIC, and bank held properties, not including properties that sick banks have not yet announced.

Some banks, such as Shawmut and Fleet Financial are beginning to realize that a more significant, and maybe drastic, solution is required. According to *Banker and Tradesman*, First Chicago Corp., Fleet Financial Group, and Nations Bank announced plans to sell over $3.2 billion of

distressed and bad commercial real estate loans.[4] Shawmut Bank has already signed a preliminary agreement to sell $75 million in non performing residential real estate loans and foreclosed properties to GE Capital Corp. and Lehman Brothers.[5] And the FDIC is planning a similar package.

A package of REO mortgages might resemble a successful financial product created from a package of junk bonds: Collateralized Bond Obligations (CBOs). CBOs are credit worthy bonds mixed with junk bonds to guarantee a stream of payments and average the credit worthiness of all the bonds. Investors are interested in the cash flow, but are also betting on the likelihood that the value of the junk will increase and their investment will realize a capital gain in the secondary market. The main difference, however, is that the mortgages are based on physical empty properties that still require maintenance, development, and management as well as tenants to provide an income stream. If the investment banks can resolve these issues and interest investors, commercial banks might be willing to clear their balance sheets of REOs once and for all.

The purpose of looking at this product is that it suggests that the REACH program may be the wrong scale and approach to the REO dilemma. Banks may be more interested in dumping the properties and freeing their reserves than dabbling in affordable housing. In addition, a $75 - $200 million sweep may be more cost effective in the long run for banks than individual mortgages. If this is the case, it may be difficult for MHFA and developers to get banks to focus on moving volumes of REOs into the affordable housing arena. A better approach might be to pool resources with other quasi-publics

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[4] *Banker and Tradesman*; Oct. 14, 1992; "Lenders Rush to Dump Underwater Real Estate Loans"; p. 1.
[5] Ibid., p. 10.

to purchase a package cheap and maintain it until an owner is found or the market turns around. This approach and other potential strategies are discussed in the Conclusion of this thesis.

CHAPTER V: CONCLUSIONS AND RECOMMENDATIONS

(1) INTRODUCTION
(2) SUMMARY AND CONCLUSIONS
(3) OPTIONS AND RECOMMENDATIONS

(1) INTRODUCTION

This thesis has examined the Real Estate Owned crisis in Massachusetts and the attempts of the Massachusetts Housing Finance Agency to address it. The current industry downturn is largely the result of three factors:

- the over-zealous building of the 1980s and consequent glut of housing properties
- the imprudent investing of banks and S&Ls and their consequent failures
- the current scarcity of credit.

MHFA saw the gap between existing multifamily housing and sources of financing as an opportunity for the Agency. MHFA has a national reputation for being the most financially sophisticated and innovative state housing finance agency in the country. The REO crisis was an immediate opportunity to create affordable housing, possibly more cheaply and efficiently, and lead the way for other organizations with another housing innovation. The added bonus of high-profile publicity from the Government, the RTC, and media was not a coincidence. Turning foreclosed, empty properties into affordable housing, in the words of MHFA's Deputy Director, was a "no-brainer."[1]

In the nine months that this thesis has observed MHFA's efforts to identify and finance REO properties, however, only one deal, Broadway Tower, received financing and only due to unusual circumstances. This thesis has documented the trial-and-error development of the REACH program, as well as the virtually simultaneous development of strategies at other financial institutions. In

[1] Based on a conversation with Eleanor White, Deputy Director, MHFA. 4/15/1992

hindsight, the Agency's efforts have been thwarted on many dimensions, from competition to marketing to the inherent difficulties of REOs in a recessed market. By looking at the problems from several angles, however, this analysis has tried to suggest areas in which the Agency's efforts might be bolstered to achiev its goals. The purpose of this Chapter and conclusion, therefore, is twofold:

1. To summarize the insight gained from examining the REO market and MHFA;
2. To raise new ideas, based on the below insights, for fulfilling the Agency's commitment to affordable housing through the productive use of REO properties.

(2) SUMMARY AND CONCLUSIONS

Broadway Tower was MHFA's first experience with REO. Although the deal closed, it provided several clues to the real disadvantages of the current REACH model. Attention to these clues may help the Agency restructure future REO financing programs. Broadway Tower's developer, Winn, an experienced and influential affordable housing developer, approached MHFA with the proposal over a year ago. MHFA's hesitation and excessive requirements, however, caused Winn to take the deal to another mortgage company.

The lesson learned here was that foreclosed properties have characteristics which differ from conventional deals that MHFA must accommodate if it wants to enlarge its pipeline of properties, such as the three privately owned condominiums in the Broadway Tower complex. Another lesson is that in a slow development market MHFA must compete with other entities for business. The Agency's expensive monitoring, negotiating, and requirements will cause developers to look elsewhere for financing, or not take the risk.

When the RDAL program was cut and Broadway Tower was no longer feasible, Winn came back to MHFA for assistance. This event highlights two issues:

1. REO properties that have failed and may even have been refinanced, but are still not financially viable, probably need an even deeper subsidy than the current reduced acquisition price provides.
2. MHFA, with its impressive track record and excellent bond rating, is in a good position to seek additional and less conventional subsidies.

After Broadway Tower's closing, MHFA launched the official REACH program, MHFA's answer for REO. The program's primary objective was to attract developers to the Agency with below-market tax-exempt rate financing and reduced acquisition costs. In exchange, the developer would

1. identify a feasible property that complements the Agency's larger social goals,
2. carry the inherent risks of developing an REO, and
3. provide low-rent, affordable housing in at least 20% of the total units.

In an effort to compare the REACH program with other programs, Chapter 3 reviewed several other types of institutions that could be REACH's competitors, including banks, mortgage companies, the RTC, and other Massachusetts quasi-public housing finance agencies. In this review, I discovered that MHFA was far beyond any other institution's development of a program to rehabilitate individual properties.

Chapter III clearly identifies MHFA as more aggressive and more willing to consider REOs that any other quasi-public or state housing finance agency. It highlights these organizations' lack of inclination to pursue the REO market, regardless of perceived differences in specialities or more competitive financing fees.

Banks and the RTC, however, after limited success with refinancing- and direct sales-type programs, have moved on to other strategies for disposing of

REOs, such as auctions and bulk sales. The appropriateness of bulk strategies was elaborated on in Chapter IV. Radically different approaches could prove significant competitors for MHFA. For example, a wholesale bulk sale to an institutional investor, such as GM Capital Corporation, who could offer lower acquisition prices, a selection of developments, and attractive financing, would be a formidable opponent to MHFA's REACH program.

The potential benefits of an all-in-one institution for purchasing and developing REOs are echoed by developers. Subsequent interviews with Massachusetts affordable housing developers resound with the increasing difficulties of finding financing. Developers have perceived two results of affordable housing trends that the Agency has recognized, but not factored in to the REACH program:

1. Financing availability drives development by influencing which projects a developer will attempt.
2. Financing sources are often attached to individual developments long before owners by the properties' feasible uses or community demand.

In other words, the ability to attain an attractive financing source will encourage developers to seek the targeted property and then apply to the source. For example, the State's prioritization of AIDS housing financing has stimulated developers to seek developments appropriate for this population in order to qualify for subsidy programs. In turn, developments that are selected by communities for a particular use will also self-select the financing source.

This long interpretation indicates that a truly successful program would stimulate developers to seek REO projects. Or, a connection to the developments at an early stage in the marketing process would help establish MHFA as a competitive financing source. Currently, the REACH program appears to achieve neither and suggests that MHFA both restructure the program, or forge stronger bonds with the source of the properties: the RTC and banks with large portfolios.

Chapter IV presents the strongest evidence for restructuring the REACH program. Based on the RTC's sales of over $12 billion, Massachusetts banks' sales of REO portfolios worth hundreds of millions of dollars, and a starving development community's search for financing, a market for these properties must exist. Then the question becomes, if MHFA has so few competitors, why is the REACH pipeline so small? Chapter IV compiled several factors that may have limited the MHFA pipeline and the Agency's ability to identify feasible REACH candidates.

The basic dog factor immediately eliminates many properties from consideration. Some properties are simply so poorly conceived, even considerably reduced acquisition prices would not reduce debt service enough to make them feasible. Second, MHFA's high underwriting standards dismisses many properties for non-compliance, and discourages others from even applying. As noted many times in this thesis, these properties were not built with MHFA's goals in mind. Despite the Agency's willingness to negotiate some contract points, such as security requirements, overall standards may still be too high for these properties. Therefore, the Agency should consider where it is willing to be more lenient without sacrificing feasibility. Broadway Tower also illustrated this point with the much-disputed, privately-held units.

The third factor in limiting the pipeline concerns program and Agency marketing. The lack of fanfare, and the abundance of requirements do not seem to have enticed many developers. Though it is difficult to assess how many people received the REACH brochure, a spot check of two well-respected community development corporations as well as a development consultant revealed that several project managers had never heard of the program. These facts, plus developers' perceptions that MHFA comes into the financing picture

too late to influence proposals, discussed above, support the conclusion that the program has not been effectively marketed.

Interviews with developers also indicate that the Agency itself has a lingering reputation for being bureaucratic and "picky." This indicates that the Agency might consider trying to change its image to one that is more open to less conventional projects in order to enlarge the pipeline to all of its programs.

The final factor in determining the size of the REACH pipeline is suggested by the Wholesale Phenomenon. As introduced in Chapter II, banks are trying aggressive strategies of bulk sales and securitization to dispose of bulk properties. The trade off, of course, is the higher price-less risk of individual workouts versus the lower price-more risk of a bulk sale. As bulk sales become a more accepted strategy, as numerous professionals and trade magazines have indicated, developers, investors, and lenders will weigh the benefits offered by each approach. In addition, bulk sales may have an effect on the accepted price for other non-performing properties. A commitment to REO, therefore, should consider the potential for MHFA to purchase a portfolio and pass substantial savings on to developers.

This thesis has raised many issues that the implementation of a program designed to finance non-performing assets must address. The next sections offer some steps that MHFA can begin to take to synthesize these issues. I also offer some less conventional suggestions to consider as REACH rethinks its own direction and goals.

(3) OPTIONS AND RECOMMENDATIONS

The general consensus of the MHFA Development Department and this thesis is that REACH has not done what it was designed to do: create affordable rental housing opportunities and promote economic recovery. It is worth revisiting

these goals here to assess whether they were realistic. If MHFA decides to pursue a commitment to converting REO properties to affordable housing, the remainder of this section concentrates on three directions the Agency can pursue to increase the REACH pipeline:

1. improving the program's marketing
2. restructuring the program's financing and underwriting, and
3. reconsidering the Agency's approach to REO

Goals

Though the REACH program was an expression of MHFA's willingness to consider REO, it was not significant enough to signal to developers, or banks, that there was a real commitment on the Agency's part. This indicates that the Agency may not have had as deep an interest in converting REO properties to affordable housing as was initially promoted. Nor was the Agency's interest strong enough to commit adequate resources to create a real program. This is evidenced by the extremely small number of projects in the REACH pipeline and the failure to finance another deal since Broadway Tower.

REACH's secondary goal was to promote economic development. This topic was not addressed in this thesis largely because REACH's role in economic development has been neglible, based on the number of developments in the pipeline.

Obviously, Revere's downtown benefitted from having an occupied Broadway Tower versus an empty building. Empty buildings are often the sites of illegal uses, eyesores, and a cause of decreased consumer confidence. Broadway Tower may also have provided several temporary construction jobs. But the REACH program's economic development goals addressed economic recovery and the rehabilitation of banks—an extremely tall order. Therefore, this thesis may be most useful if used as a catalyst for MHFA to reassess its commitment to REO and its goals for the program.

Clearly defined goals with a smaller scope, such as a new subsidy or alternative financing, might be the most logical step to take—after MHFA's initial step of declaring interest—in the development of an REO strategy. Once MHFA defines more attainable goals, and reassesses its commitment to REO, it can begin to process the experiences learned from the initial REACH launch. The following section looks at diverse strategies for increasing the pipeline, should the Agency conclude that it is indeed committed to REO.

Marketing

One of the biggest obstacles between the REACH pipeline and developers is the Agency itself. MHFA suffers from its own reputation as bureaucratic, discriminating, and conservative. Although these are qualities that often describe a prudent financial institution, MHFA must address the impact its image is having in a difficult development period. An integrated, cost-effective strategy for publicizing REACH and indicating the Agency's openness to new ideas might include a series of developer workshops, press releases, more high-profile partnerships with the State and the RTC on REACH, and more advertising. A follow-up brochure or mailing to the REACH mailing list might also follow the lead of more successful advertisers with punchier copy and fewer demands. It might also signal the Agency's renewed commitment to REO.

REACH has also suffered from ineffective developer input. The ability to respond to the voice of the customer is an advantage for any product. Tailoring the program to address developer concerns, would also improve MHFA's image, as well as improve the product. For example, once non-profit developers told the RTC that the high loan-to-value ratio required for participation in their direct sales program was a hardship, the RTC changed the requirement and participation has increased. REACH's developer input originated mainly from MHFA's Multifamily Advisory Committee, which was very sceptical of the

program. MHFA staff members will counter defensively that other developers can always give their input to the Agency. A stronger message, however, would be for the Agency to call a focus group of developers and appreciate the real value of their insight. A focus group would have the added benefit of involving MHFA in the REO thinking process much earlier.

Restructuring

A second direction for the Agency to pursue is the restructuring of the program to make it more attractive to developers. In addition to incorporating developer feedback, the Agency is in a good position to improve the program with an additional subsidy. In the case of Broadway Tower, Winn suggested that the MHFA provide the retracted RDAL subsidy with money that has been refunded to the Agency from HUD due to the lowering of interest rates. The inclusion of a subsidy is currently being proposed by the program's director.

The benefits of an additional subsidy would be to allow MHFA to subscribe to more of its current underwriting standards. Some properties that meet agency guidelines for affordable housing, but cannot support debt service, would become feasible. Charles Gladstone suggests that

> the structure for the REACH subsidy should take the form of subordinate debt to be serviced if possible from available cash flow. Payment of outstanding principal and any accrued interest would occur upon sale or refinancing of the property which would not be permitted prior to 10 years from the initial draw down of the loan. This structure represents a basic shift from the debt service reduction/operating subsidy popular in the 1980s. The change in structure reflects the lack of interest income that could be generated today by investing the subsidy fund in an annuity used to leverage debt in the early years of the project life.[2]

Mr. Gladstone also believes the Agency could be working with other institutions, such as the FDIC or Massachusetts Executive Office of Communities and

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[2]Based on a conversation with Charles Gladstone, Development Officer and REACH program director, MHFA. 11/5/1992

Development, to allocate a subsidy for REO properties. The second prong in restructuring the program involves revising the Agency's underwriting standards. Though it is beyond the scope of this thesis, and the experience of this author, to recommend specific changes to underwriting, developers have indicated several possibilities worth exploring. For example, decreasing replacement reserve requirements, negotiating lower credit enhancement fees, and decreasing Agency inspection and financing fees.

Reconsidering

The final direction the Agency could pursue would be to consider a different approach to, or different role in, the REO market. Trade journals and newspapers have recently reported the growing markets in bulk real estate sales and asset securitization. Entering this market at the outset may provide a way for MHFA to enter the marketing process earlier, provide more attractive acquisition prices to developers, and facilitate the selection of properties available to developers.

For example, the RTC and several private banks have begun selling packages of non-performing mortgages and REO properties to institutional investors at deeply discounted prices. Once the institutional investors purchase the packages, they have three options available to them.

1. holding
2. flipping
3. securitizing

It is worth looking briefly at each of these strategies and how they could comprise a more comprehensive strategy at MHFA. After an investor, such as GE Capital Corporation or an investment bank, purchases a bulk sale, it can hold the property until the real estate market improves and some of the excess property is absorbed. Investment banks also try to improve the management of distressed properties to facilitate their recovery. Flipping also takes advantage of the

discounts associated with very large packages. Large investors can then sell smaller packages to other investors interested in adding to their own portfolios.

The securitization of these non-performing mortgages is largely anticipated by investment banking houses, but the market is not completely developed. In this option, an institutional investor purchases a bulk sale, and then allocates the cash flows to different classes of investors based on their appetite for risk. In this way, the securities attain a higher credit rating than the underlying assets.

Though the bulk sales and securitization markets are definitely developing, such an approach represents a radical departure from typical MHFA financing. It is hard to deny, however, that as the Agency becomes more experienced with non-traditional loans and its own non-performing asset management, purchasing a bulk sale for future development could be a viable and cost-effective strategy.

As a strategy now being considered by many banks, it might also be the most competitive strategy for attracting developers. Purchasing a bulk sale, rehabilitating it, and managing it back to health, and then marketing to developers, could all be performed by Agency staff. It could be the ideal option for the goal of converting REO to affordable housing. Before MHFA can consider another strategy, however, again it is imperative to consider goals and where the Agency stands on REO.

It is clear that MHFA has taken great strides in affordable housing innovation. Also evident, though, is the magnitude of the REO and non-performing asset problem, which seems to require a multi-faceted approach. MHFA has been a strategy leader at the project level, but must continue to improve on itself, and recognize new trends in the real estate market.

Exhibit 1 The First MHFA Proposal—from the Broadway Tower Official Action Status Application to MHFA, 3/12/91.

Annual Increase Income	3.00%									
Annual Increase Expenses	3.00%									
INCOME/YEAR	1	2	3	4	5	6	7	8	9	10
Rental Income	$937,536	$965,662	$994,632	$1,024,471	$1,055,205	$1,086,861	$1,119,467	$1,153,051	$1,187,643	$1,223,272
Less Vacancy	($46,877)	($48,283)	($49,732)	($51,224)	($52,760)	($54,343)	($55,973)	($57,653)	($59,382)	($61,164)
5.00%										
Other Income:										
Laundry	$6,624	$6,823	$7,027	$7,238	$7,455	$7,679	$7,909	$8,147	$8,391	$8,643
Owner's Subsidy	$16,200	$0	$0	$0	$0	$0	$0	$0	$0	$0
RDAL Subsidy	$230,000	$249,624	$233,838	$217,578	$200,830	$183,580	$165,813	$147,512	$128,662	$109,247
Total Income	$1,143,483	$1,173,826	$1,185,766	$1,198,064	$1,210,730	$1,223,777	$1,237,216	$1,251,057	$1,265,314	$1,279,998
OPERATING EXPENSES	($386,400)	($397,992)	($409,932)	($422,230)	($434,897)	($447,944)	($461,382)	($475,223)	($489,480)	($504,164)
Per Unit=	($4,200)									
NET OPERATING INCOME	$757,083	$775,834	$775,834	$775,834	$775,834	$775,834	$775,834	$775,834	$775,834	$775,834
DEBT SERVICE	$705,303	$705,303	$705,303	$705,303	$705,303	$705,303	$705,303	$705,303	$705,303	$705,303
$6,600,876	Mortgage									
10.09%	Rate									
30	Year Term									
CASHFLOW	$51,780	$70,531	$70,531	$70,531	$70,531	$70,531	$70,531	$70,531	$70,531	$70,531
DEBT SERV. COVERAGE	1.07	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10
PV of CF 20 years @ 12%	$546,236									

Exhibit 2 The Concord Mortgage Company Proposal.

Annual Increase Income	3.00%
Annual Increase Expenses	3.00%

INCOME/YEAR	1	2	3	4	5	6	7	8	9	10
Rental Income	$916,836	$944,341	$972,671	$1,001,851	$1,031,907	$1,062,864	$1,094,750	$1,127,593	$1,161,420	$1,196,263
Less Vacancy	($45,842)	($47,217)	($48,634)	($50,093)	($51,595)	($53,143)	($54,738)	($56,380)	($58,071)	($59,813)
5.00%										
Other Income:										
Laundry	$9,384	$9,666	$9,955	$10,254	$10,562	$10,879	$11,205	$11,541	$11,887	$12,244
Owner's Subsidy	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
RDAL Subsidy	$230,000	$249,624	$233,838	$217,578	$200,830	$183,580	$165,813	$147,512	$128,662	$109,247
Total Income	$1,110,378	$1,156,414	$1,167,831	$1,179,591	$1,191,703	$1,204,180	$1,217,031	$1,230,266	$1,243,899	$1,257,941
OPERATING EXPENSES	($372,255)	($383,423)	($394,925)	($406,773)	($418,976)	($431,546)	($444,492)	($457,827)	($471,561)	($485,708)
Per Unit=	($4,046)									
NET OPERATING INCOME	$738,123	$772,991	$772,906	$772,818	$772,727	$772,634	$772,539	$772,439	$772,337	$772,233
DEBT SERVICE	$715,510	$715,510	$715,510	$715,510	$715,510	$715,510	$715,510	$715,510	$715,510	$715,510
$6,300,000	Mortgage									
10.40%	Rate									
25	Year Term									
CASHFLOW	$22,613	$57,481	$57,396	$57,308	$57,217	$57,124	$57,029	$56,930	$56,827	$56,723
DEBT SERV. COVERAGE	1.03	1.08	1.08	1.08	1.08	1.08	1.08	1.08	1.08	1.08
PV of CF 20 years @ 12%	$430,605									

Notes: The Concord Mortgage Company estimated a debt service payment of $707,063 for the same terms. Their PV of the cash flow plus the reversion value totalled $8,073,899.

Source: Underwriting memorandum of the Concord Mortgage Company (reformatted). 1991.

Exhibit 3 — The Revised MHFA Proposal Under the REACH Program—from MHFA Project Commitment Proposal Form, March 9, 1992.

Annual Increase Income	3.00%
Annual Increase Expenses	3.00%

INCOME/YEAR	1	2	3	4	5	6	7	8	9	10
Rental Income	$937,536	$965,662	$994,632	$1,024,471	$1,055,205	$1,086,861	$1,119,467	$1,153,051	$1,187,643	$1,223,272
Less Vacancy	($46,877)	($48,283)	($49,732)	($51,224)	($52,760)	($54,343)	($55,973)	($57,653)	($59,382)	($61,164)
5.00%										
Other Income:										
Laundry	$6,624	$6,823	$7,027	$7,238	$7,455	$7,679	$7,909	$8,147	$8,391	$8,643
Owner's Subsidy	$39,999	$0	$0	$0	$0	$0	$0	$0	$0	$0
MHFA Subsidy	$165,000	$165,000	$165,000	$165,000	$165,000	$165,000	$165,000	$165,000	$165,000	$165,000
Total Income	$1,102,282	$1,089,202	$1,116,928	$1,145,486	$1,174,900	$1,205,197	$1,236,403	$1,268,545	$1,301,652	$1,335,751
OPERATING EXPENSES	($449,432)	($462,915)	($476,802)	($491,106)	($505,840)	($521,015)	($536,645)	($552,745)	($569,327)	($586,407)
Per Unit=	($4,885)									
NET OPERATING INCOME	$652,850	$626,287	$640,125	$654,379	$669,060	$684,182	$699,758	$715,800	$732,325	$749,344
DEBT SERVICE	$414,482	$414,482	$414,482	$414,482	$414,482	$414,482	$414,482	$414,482	$414,482	$414,482
$3,750,000	Mortgage									
10.50%	Rate									
30	Year Term									
DEBT SERVICE MGLB	$179,875	$179,875	$179,875	$179,875	$179,875	$179,875	$179,875	$179,875	$179,875	$179,875
$2,500,000	Subordinate Mortgage									
CASHFLOW	$58,493	$31,930	$45,769	$60,022	$74,704	$89,825	$105,401	$121,444	$137,968	$154,987
DEBT SERV. COVERAGE	1.10	1.05	1.07	1.10	1.12	1.15	1.18	1.20	1.23	1.26
PV of CF 20 years @ 12%	$873,083									

Exhibit 4 BROADWAY TOWER LIMITED PARTNERSHIP
As of March 1, 1992

SCHEDULE A

Name and Business Address	Capital Contributions	Percentage of Partnership Interests for Class
GENERAL PARTNER:		
Broadway Holdings, Inc. c/o Winn Development Company Six Faneuil Hall Marketplace Boston, Massachusetts 02109	$99.00	99.00%
Arthur M. Winn c/o Winn Development Company Six Faneuil Hall Marketplace Boston, Massachusetts 02109	$1.00	1.00%
ORIGINAL PARTNER:		
Winn Broadway Tower Limited Partnershi c/o Winn Development Company Six Faneuil Hall Marketplace Boston, Massachusetts 02109	$10.00	100.00%
SPECIAL LIMITED PARTNER:		
SLP, Inc. 101 Arch Street Boston, Massachusetts 02110	$10.00	100.00%
INVESTOR LIMITED PARTNER:		
Boston Financial Tax Credit Fund Plus, A Limited Partnership 101 Arch Street Boston, Massachusetts 02110	$2,200,000.00*	100.00%

* $1,000 has been paid in as of the date of the Investment Closing;
$2,199,000 is to be paid in pursuant to Section 5.1a, subject to adjustment
and conditions to payment as provided herein.

Source: MHFA Broadway Tower closing documents, 1992.

Exhibit 5 PRELIMINARY FNMA PROJECT VALUE—DIRECT CAPITALIZATION

Project Name: Broadway Tower	MHFA #: 91-003-R File Name: BT.FNMA
Location: Revere	Date: 4/25/91 Revised
Developer: Broadway Tower L.P.	Appraiser: R. Quealy

Annual Project Income			
	Market:		$300,600
	Subsidized/Low:		$553,512
Vacancy & Collection:			
	Market:	0.070	$21,042
	Subsidized:	0.030	$16,605
Effective Gross Rental Income:			$816,465
Other Income:			
	Laundry		$6,624
	Less Vacancy:	0.05	$331
	Parking:		$0
	Less Vacancy:		$0
	RDAL Loan: If Funded (Yr. 1)		$230,000
Total Other Income:			$236,293
Effective Gross Total Income:			$1,052,757
Annual Operating Expenses:			$407,580
			(4,430 p/u)
Net Project Income:			$645,177
Capitalized Value: Market Rate		0.110000	$5,865,249
Maximum Mortgage: (90%)		0.90	$5,278,725

Requested Loan:	$6,600,000
Less FNMA Fee @ 4.75%	$313,500
Maximum Loan Less FNMA Fee	$6,286,500
(6,286,500/5,865,249)	107.18%

Rent Summary:

Market:	Unit Type	Number	S.F.	Rent
	1BR/1B	9	630sf	$650
	2BR/2B	54	950sf	$800
Low-Income: (Section 8/707 Certificates)				
	1BR/1B	5	630sf	$650
		(Maximum FMR of $672 is above estimated Market)		
	2BR/2B	24	950sf	$794
Total:		92		

Source: MHFA Appraisal and Marketing Department, Robert Quealy, 1991.

Exhibit 6 Mortgage Position

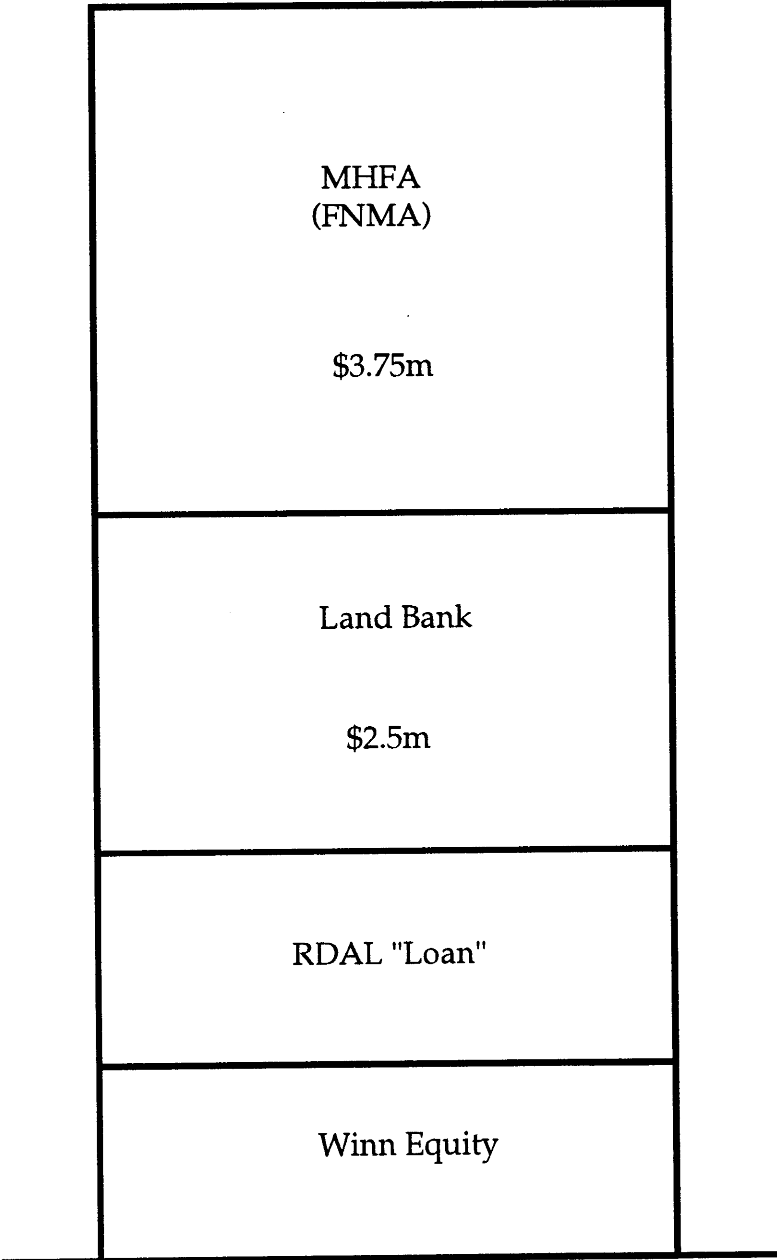
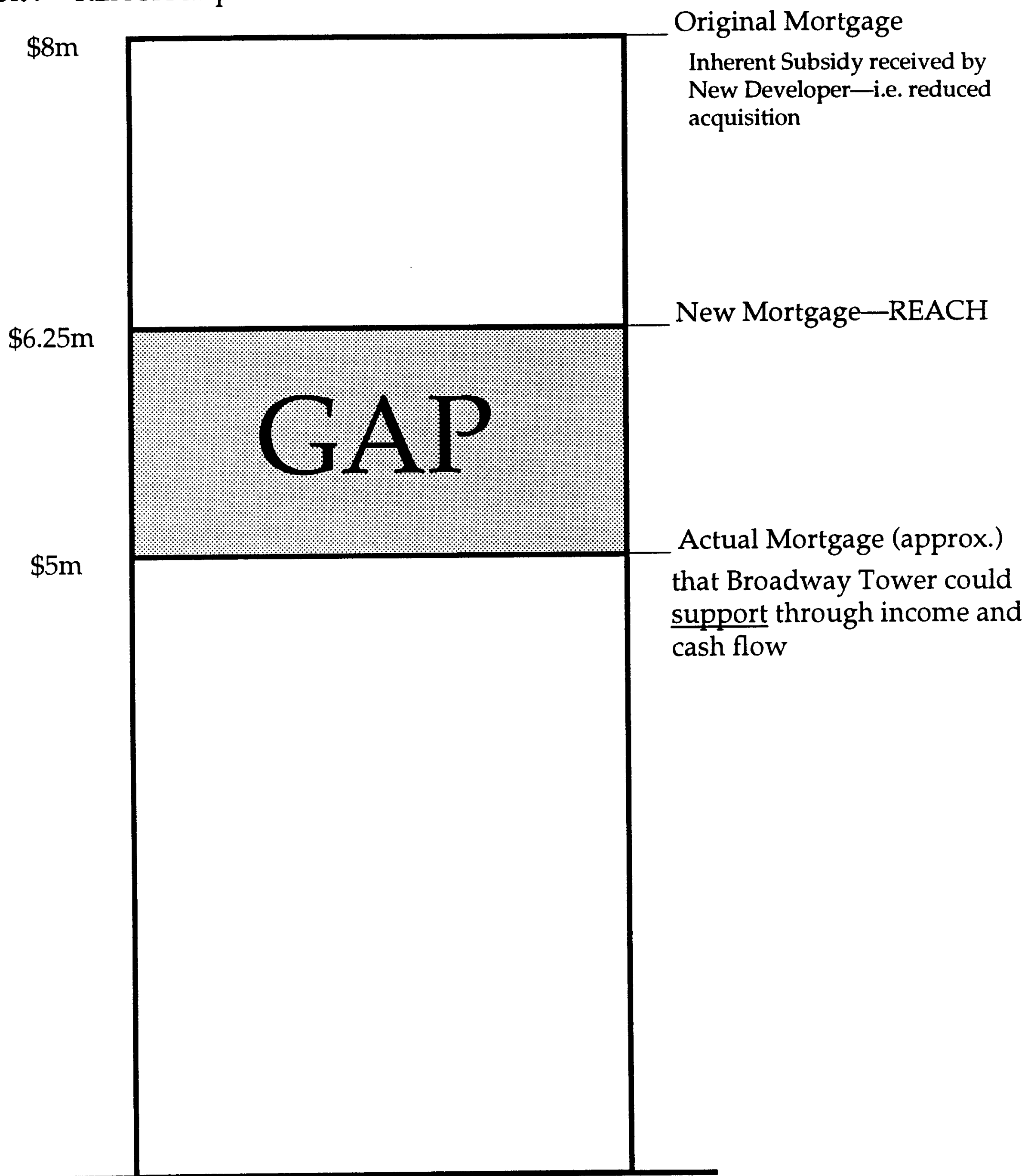


Exhibit 7 REACH Implications

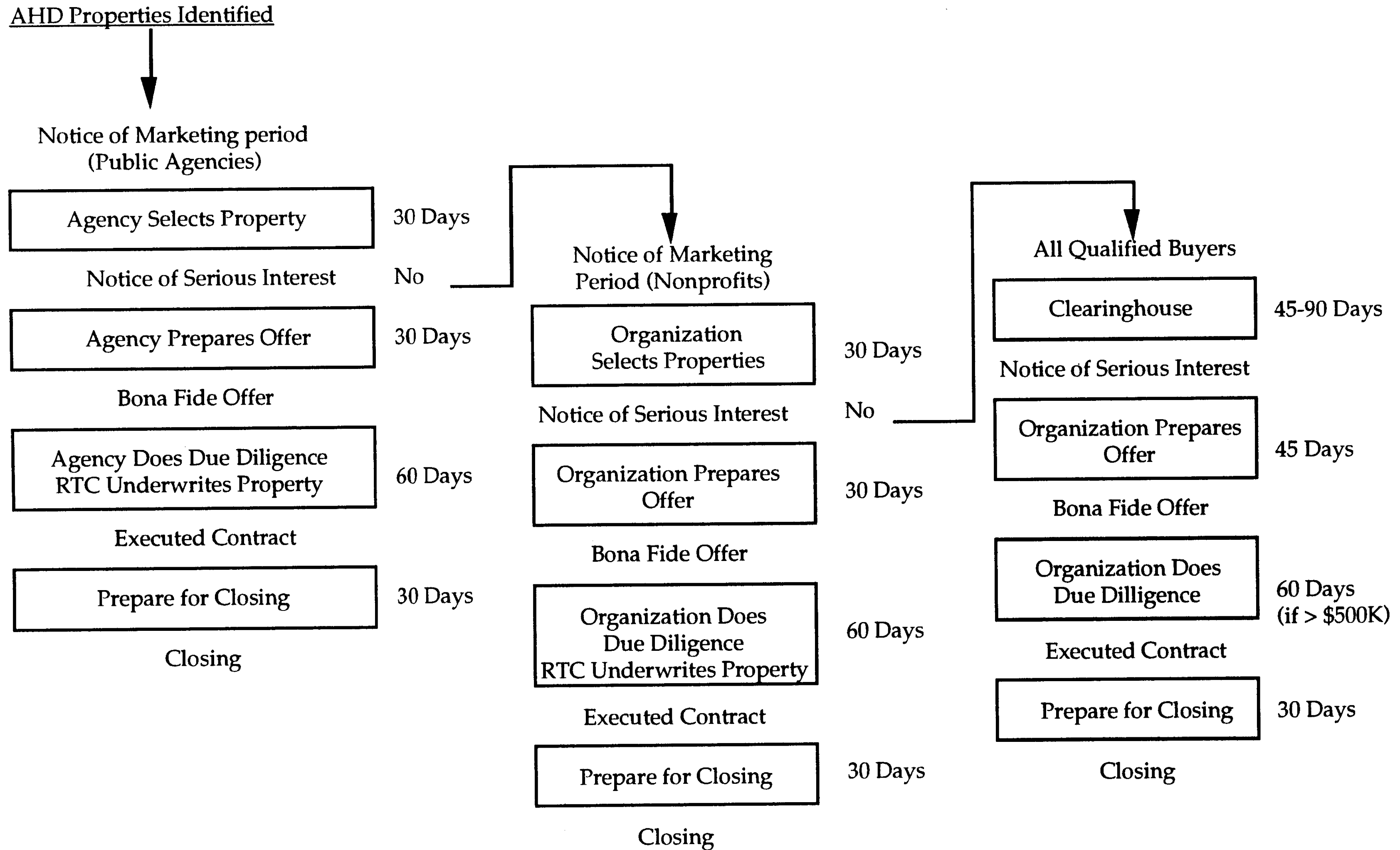


Implications:

1. The reduced acquisition price is the real subsidy
2. REACH is still not enough to make REOs feasible
3. The deal would not have been feasible without the RDAL operating subsidy to replace the debt service required to receive the higher loan amount.

Exhibit 8

AFFORDABLE HOUSING DISPOSITION PROGRAM
MULTIFAMILY SALES PROGRAMS



Source: Resolution Trust Corporation, 1991.

Exhibit 9

SOURCES OF DEBT FINANCING AVAILABLE TO SMALL PROJECTS WITH 40 OR FEWER UNITS

A Comparison of Terms and Standards of Three Quasi-Public Agencies

	MHFA Current Policy	Massachusetts Land Bank	Massachusetts Housing Partnership
Eligible Borrowers	ltd. dividend, non-profit	For profit, non-profit, public	For profit, non-profit
Min. Loan Size	none published	none published	$100,000
Max. Loan Size	none	$2 mil, or 50,000/afford. unit	$2 million
Max. Loan to Value	90%	90% (80% on subordinates)	80% (exceptions to 85%)
Project Size	none published	Family: 20-50 units SROs: 8-30 units	projects with 5-20 units have been prioritized
Max. Loan Term/Amortization	30-35 years/30-35 years	15 years/30 years	20 years/30 years
Contruction Financing	yes.	no; breakeven occupancy	no; breakeven occupancy
Debt Service Coverage	minimum 110%	minimum 110%	minimum 110% (115% for < 20 units
Loan Security	6% Letter of Credit	Operating reserve = 35% of annual operating budget plus 3% of gross mo. Inc.	6% Letter of Credit
Subordinate Loans	Limited to soft 2nds	Provides LB amortizing 2nds; allows other soft 2nds	Allows soft 2nds
Replacement Reserves	Min. $275/unit/year	Case by case basis	Min. $275/unit/year ($180/unit/year for SROs)
Rates (October 1992)	8.5% + .5% Taxable 6.75% + .5 Tax Exempt	7.0% Taxable (from General Ob. Bonds)	2.1% above Treasury yields (9.5%, on 10/21/92)
Fees	2.8, Constr. & perm. 1.15%, Perm. Only '2-4.75% Credit Enhancmt	.5% plus actual LB expenses for public hearing, appraisal, arch. & Const. review, closing.	$250-500 applicatn (non-vs. for profit) plus .1% for amts over $500,000 1% loan origination fee

Source: Report of the Small Projects Task Force, Nancy Andersen, MHFA, 1992.

Exhibit 10

R · E · A · C · H

RECOVERY THROUGH THE ACQUISITION OF HOUSING

General Information

Program Objective

To create affordable rental housing opportunities and promote economic recovery by financing the acquisition and rehabilitation of distressed, bank-foreclosed and government-held properties.

Background

Over the past two years, banks and federal banking regulators have become the holders of significant amounts of foreclosed multifamily properties in Massachusetts due to the softening of real estate markets. These developments include newly constructed projects which were never completed or fully rented, as well as older properties with significant deferred maintenance and/or capital replacement needs. In either case, such properties are generally characterized by high vacancy rates and financial infeasibility.

In addition to providing an opportunity to increase the supply of affordable rental housing, utilization of these properties can aid in the recovery of the Commonwealth's lending institutions, generate employment opportunities, and enhance neighborhood revitalization efforts. Taking maximum advantage of these properties is, in fact, identified in the Commonwealth's Comprehensive Housing Affordability Strategy (CHAS) as a top priority for the 1990's.

Program Concept

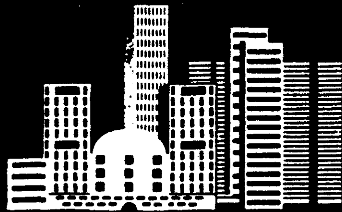
MHFA's ability to provide acquisition, rehabilitation and long-term debt financing in a single underwriting provides a unique opportunity to utilize bank- and- government-held housing resources. For qualified projects and borrowers, below-market tax-exempt financing used in conjunction with low-income housing tax credits and discounted acquisition costs can provide a cost-effective financing package with little or no state or local subsidies. Rehabilitation expenditures for such projects must equal or exceed 15% of the cost of acquiring the buildings, and owners must reserve at least 20% of the development's units for low-income households for at least 30 years. For other projects, taxable bond financing may be combined with below-market acquisition costs and outside subsidy resources to produce economically viable developments.

Developers of properties under the REACH program must demonstrate awareness of the needs of existing residents, particularly in terms of avoiding relocation and involuntary displacement. To reduce the need for off-site relocation, an eligible development should have sufficient vacancies to accommodate existing residents during the renovation process. In addition, an analysis of existing rents and incomes should be performed so that a rent phasing plan can be developed which enables current residents to continue their tenancies.

REACH is a service of the Executive Office of Communities and Development and the Massachusetts Housing Finance Agency

Exhibit 11

The Real Estate Executive Rate Guide



CIRCULATE

The Boston Financial Group
Mortgage Finance Group

Wayne L. Clough | George J. Fantini, Jr.
John R. Gorga | Suzanne L. Lafond

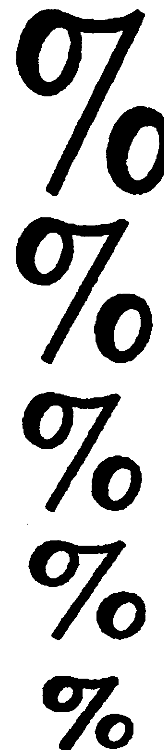
Financing Spotlight

3rd Quarter 1992

PERMANENT FINANCING BELOW 8%!

If you're waiting for rates to bottom out, we believe it's time to get off the fence!!!

Rates are currently at their ***lowest point in over two decades.*** We currently have a limited supply or ***immediate and forward funding loans for apartment, retail, owner-occupied or builts-to-suit properties.*** Do not delay in calling us for a quote. The backlog of loan proposals is building quickly and the consensus is that rates will rise later this year as the economy begins to rebound. Many of your existing lenders are eager to reduce their exposure to real estate. They may be willing to discuss negotiating prepayment premiums you might be subject to.



Remember, in today's more complex financing market it takes at least 90 days to take a loan proposal through committee and to closing. So, lock into these favorable rates now!

Rates are as low as:

3 years - 7%
5 years - 7-1/4%
7 years - 7-3/8%
10 years - 8-1/2%

The Boston Financial Mortgage Finance Group, representing Lincoln National Life Insurance Company as mortgage loan correspondent, is pleased to announce ***some enhancements to Lincoln's programs:***

- Lincoln has ***reduced*** their ***fees*** from 1/4-1/2% of the loan amount to a flat $2,500.
- Lincoln has eliminated full board review for loans below $7,000,000.
- They have initiated a more simplified application and closing process.

If you would like to lock into these lower rates or find out more about Lincoln's program, please contact us.

Wayne Clough or John Gorga
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(617) 439-9979 (Fax)

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Interview List

Shirley Abrams, Development Officer, MHFA
Nancy Andersen, Development Officer, MHFA
Lawrence Bacow, Professor of Urban Studies, MIT
Robert Baker, Director of Development, Land Bank
Timothy Bassett, Executive Director, Land Bank
Barbara Bryan, National Association of Homebuilders
Frank Creedon, Operation Officer, MHFA
Charles Gladstone, Development Officer, MHFA
Michael Jacobs, Senior Development Officer, MHFA
Donna Jervey, Investor Services, RTC
Langley Keyes, Professor of Urban Studies, MIT
Cynthia La Casse, Development Officer, MHFA
Jean McCarthy, Appraisal and Marketing Officer, MHFA
Jan Nicholson, Vice President, Real Estate Group, Citicorp
Bernard O'Shaugnessy, Attorney, MHFA
Lawrence Packenham, Shawmut Bank
Rufus Philips, Senior Public Information Officer, MHFA
Robert Quealy, Appraisal and Marketing Officer, MHFA
Cynthia Reed-Workman, Attorney, MHFA
Jim Roth, Securities Division, RTC
Christopher Seyfarth, Vice President, Kenneth Leventhal, Inc.
Sue Valenti, Associate, Mortgage Department, First Boston Corporation
Eleanor White, Deputy Director, MHFA

Four developers were also interviewed, but they prefer to remain anonymous due to the nature of their relationship with the Massachusetts Housing Finance Agency.