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Strategies for Selling Smaller Pools of Loans

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In September 2006, the Federal Reserve hosted a conference on secondary markets for community development loans. A theme that emerged was that techniques, programs, and structures that work for large loans do not necessarily work for small ones. In this article, I briefly outline why smaller deals can be more difficult to finance, and describe two ways in which the Community Preservation Corporation (CPC) has used unrated transactions to overcome these obstacles. Finally, I suggest that a broad secondary market for small loans is more likely to grow organically from numerous small transactions, rather than by a herculean effort to create a copy of the commercial mortgage-backed securities market. I also suggest how the Federal Reserve could help speed this growth.

The Need for Different Techniques for Smaller Deals

Despite the well-known obstacles to creating a secondary market for community development loans, it is possible to get pools of these loans rated and sold to investors. The Community Reinvestment Fund proved this with two rated securities, CRF-17 and CRF-18, which were salable in the general capital markets. CPC attracted institutional investors in a different way by swapping mortgage pools for investment-grade GSE securities (in two transactions totaling $70 million). These are laudable achievements. They could be replicated for other similar asset pools, but many community development assets are not at all similar to these. In fact, we have found that securing a rating, whether from a public ratings agency or from a GSE, is not a workable strategy for large numbers of community development assets.

A rated security transaction can work for some community development asset types, but not for others. First, the transaction costs are too high for small deals. Public ratings cost $75,000 or more–plainly prohibitive on small deals–and legal fees are also a high fixed cost. Second, many community development originators do not collect the extensive project-level data that GSEs require, nor are project owners on these loans accustomed to supplying this information. Intensive data collection not only raises transaction costs, but it may alienate both originators and borrowers of community development loans. Lenders in this area pride themselves on flexibility in financing complex projects, and may have difficulty enforcing inflexible, non-negotiable demands for copious data on their customers. Finally, community development loans often do not have the historical data necessary to forecast prepayment rates, delinquency rates, and other data required for the sale of investment-grade securities.

Given these obstacles, another approach to consider is the issuance of an unrated security. Two successful ways of using this approach are discussed below, one using insurance and the other employing pooling and tranching.

State and Local Government Mortgage Insurance

Both the State of New York and New York City have entities that insure community development mortgages. They are the State of New York Mortgage Agency (SONYMA) and the City's Residential Mortgage Insurance Corporation (REMIC). Both were created in the 1970s to encourage investors to purchase risky urban long-term mortgages. The state funds SONYMA with dedicated tax revenue and the city funded REMIC with a capital grant. The capital bases of both entities grew over time from new investment and from premiums. Losses in these programs have been negligible, and the SONYMA is rated AA.

SONYMA and REMIC pay first losses on a default, up to a cap. The cap amount varies from 20 percent to 75 percent of the loan amount, depending on loan type, though loans owned by public employee pension funds receive 100 percent insurance. The "loss" definition is comprehensive, covering interest, principal, and the costs of litigation and property protection. Payment is made upon conclusion of foreclosure or deed-in-lieu. Mortgages bought by public employee pension funds receive monthly periodic payments for the two years following four consecutive months of default.

SONYMA and REMIC provide insurance on individual whole loans (REMIC currently is not writing new insurance business). Both insurers review the underwriting of the individual loan. This loan-by-loan review is workable, as both agencies are local, and so are thoroughly familiar with the markets and developers, including the special features of community development loans. This familiarity, and the staff's responsiveness, makes this mortgage product a highly effective and flexible tool to credit enhance mortgage loan pools.

Tranches in Pools[1]

CPC was forced to consider different securitization strategies, however, because SONYMA and REMIC did not insure construction loans, which are a substantial need in our markets. CPC also faces capacity constraints. Its annual construction loan origination volume is roughly twice its warehouse line capacity.

While a standard private loan sale worked well for large construction loans–investors re-underwrote each loan and purchased pro rata shares with priority on remittances equal to CPC's–the same technique did not work for small construction loans. Because banks allocate administrative overhead for investments, earnings after overhead on a 50 percent share of a small loan generally would be insufficient to meet a bank's revenue requirements. To create the needed transaction size, CPC pooled these smaller construction loans and sold senior tranches in the pools. As CPC closes new loans, it assembles pools to meet investor needs. Pools have been as small as $3 million, and the largest have been more than $50 million. Importantly, CRA-motivated investors can receive pools of loans located in low- and moderate-income census tracts in the banks' assessment areas.

[1] For a fuller explication of these securities, see the article in the June 2006 *Community Development Investment Review* at http://www.frbsf.org/publications/community/review/062006/mccarthy.pdf.

Typically, these pools have a senior tranche that is 80 percent of the pool and CPC retains the other 20 percent. The senior investor has first call on remittances on all loans in the pool and CPC receives the remainder. If delinquencies late in a pool's life were to cause shortfalls for the senior tranche investor, it can "claw-back" previously received sums from CPC.

This credit structure substantially simplifies an investor's conclusion of investment strength. If, for instance, all pool loans were underwritten at 75 percent of cost, the 80 percent senior tranche is, in effect, a 60 percent-of-cost position. In other words, investors at the senior tranche level have a 40 percent cushion before they would experience real economic losses. This would be a relatively low-risk credit even for a single loan. The pool is even less risky through diversification among all the loans in the pool. This strong credit structure in favor of the senior tranche investor enables more streamlined due diligence, and therefore lowers the administrative costs. In nearly three years, in over $400 million in pools, there has not been a single month in which a senior tranche share failed to be paid in full. Finally, there is no interest-rate risk since the loans in the pool have a floating rate.

The tranche structure created a secondary market by bundling community development construction loans and creating a tranche asset as a stronger credit than any one individual loan. This credit strength by itself, though, only partly addressed investors' need to control administrative overhead in reviewing and closing the investment. The bundling yielded a strong credit but also enabled a shorter, faster due diligence review to verify the credit strength. In this review, it was not necessary to re-underwrite each loan, as would have been the case for single-loan, *pari passu* participations.

In this review, however, bank investors still had to note features of individual loan assets. To keep this process as efficient as possible, CPC adopted standard loan documents and prepared loan files with standard naming conventions (i.e., the same document always has the same name). There is also a standard file order (i.e., the same document is always in the same location). These naming conventions streamline the reviews of multiple files. Lastly, all documents are scanned in Adobe PDF format, suitable for electronic delivery. Prospective investors can review all loan files electronically, in their own office, and can make on-site visits to inspect individual loan files if necessary.

The tranche structure has been very popular with both CRA-motivated investors and other investors who simply seek a strong, floating-rate asset, with roughly a two-year life. CPC now uses this structure for most of the construction loans it closes. Investor demand for this loan product exceeds the supply. CPC has also begun to use it with the permanent loan pools.

Conclusion

From the secondary investor's point of view, a viable secondary market depends on an ability to: (1) acquire a meaningful volume of loans, (2) ascertain the soundness of the loan assets, and (3) execute transactions with acceptable transaction costs. For many community

development originators, these criteria may be met with relationships with secondary market investors that, for various reasons, "know the story" of the originator and its community development asset type. These investors, while favorably inclined to buy the assets, will buy even more readily with credit enhancement. Unfortunately, given the small size of most community development investments, their heterogeneous loan terms, and other factors, investment-grade enhancements are unlikely to be achievable.

A secondary market for community development assets is more likely to grow organically out of experiments in vehicles that are less costly and less complex than public ratings or GSE structures. This "organic" growth, however, will more quickly lead to larger, better vehicles if the experimenters are encouraged to standardize themselves as much as possible. For this to be possible, standardization criteria would be published on an advisory basis, and a centralized tracking mechanism would be established to record secondary sales. It would disseminate information on innovations, experiments, and sales as they occur, and evaluate the degree of conformity with the advisory criteria. The Federal Reserve might be a good candidate to fill this role. Eventually, numerous local experiments would probably converge on standardized parameters. A national model based on this approach could scale up to the point that it could access conventional markets and thereby bring the liquidity and pricing advantages now enjoyed by originators with access to today's CMBS and GSE outlets.

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