Case Study: The Community Development Trust Taps Wall Street Investors

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The Community Development Trust

The Community Development Trust (CDT) is the country's only real estate investment trust (REIT) devoted solely to providing debt and equity capital for financing community development projects. CDT was created in 1998 by the Local Initiatives Support Corporation (LISC), a national nonprofit community development intermediary, and 17 socially motivated institutional investors. As a private, mission-driven REIT, CDT operates much like a mutual fund, combining the capital of institutional investors to acquire or provide financing for affordable housing. In line with our mission, all CDT investments must satisfy Community Reinvestment Act (CRA) requirements. Through our debt-and-equity financing programs, CDT invests: (1) long-term debt capital by purchasing smaller, fixed-rate multifamily mortgages from community lenders; and (2) equity capital either in cash or by providing a tax-advantaged transition for existing properties to a new set of owners committed to long-term affordability.

CDT's initial effort to meet its mission was the introduction of the debt program, which focused on creating a secondary market for smaller (under $3 million) Low Income Housing Tax Credit (LIHTC) loans. CDT's equity capital was insufficient to fund and retain the whole loans created under the program. As a solution, CDT sought out institutional investors to purchase a 90 percent senior interest in each loan with CDT holding a 10 percent subordinate interest. In this way, every $1 million of CDT's equity capital would finance $10 million in loans. CDT entered into a participation agreement with a socially motivated pension fund, the General Board of Pensions and Health Benefits of the United Methodist Church (the Board). Under this agreement, the Board agreed to purchase a senior interest in each mortgage loan subject to certain underwriting criteria, and CDT agreed to retain the subordinate interest.

The initial commitment from the Board was for a $30 million facility. By 2004, as the program became more successful, the Board had increased the facility to $100 million. CDT had fifteen active originators around the country and volume was increasing to the point that additional capacity beyond the existing $100 million was needed.

CDT approached the Board with a proposal to repurchase a portion of the Board's senior interests and then combine them with the CDT-retained subordinate interests. CDT would then securitize the whole loans for sale in the open market. CDT also included several whole loans that it had not yet syndicated. In aggregate, the pool totaled $44.9 million and consisted of thirty-one affordable multifamily housing mortgages and more than two thousand units of affordable housing. CDT swapped the mortgages for an equal amount

of Fannie Mae Mortgage-Backed Securities (MBS). The MBSs were then sold to JPMorgan Chase (JPMC).

The loans had an average balance of $1.4 million and were secured by properties in eight states. The majority of the loans were on properties having LIHTCs. By repurchasing the senior interests CDT had previously sold to the Board, CDT was able to increase its program capacity with the Board and at the same time demonstrate its ability to securitize the previously illiquid senior interests. According to David Zellner, Chief Investment Officer of the Methodists Pensions and Health Benefits Board, "This transaction was a terrific way to illustrate the high quality of the affordable housing mortgage portfolio that we have been purchasing from CDT."

The transaction provided several advantages to the Board and to CDT. First, the Board's ability to sell its senior interests at market prices validated the underlying value of the senior interests. Second, a securitization provided liquidity to CDT by freeing up capital committed to its existing subordinate pieces. Furthermore, under the securitization, CDT's credit enhancement was reduced to a level below the level provided to the Board. Finally, the Board agreed that the repurchase of the seasoned senior interests would allow CDT to deliver new senior interests on a dollar-for-dollar basis, thus increasing the capacity of the facility with the Board.

Evaluating the Options

CDT had to evaluate several alternatives for structuring the securitization transaction.

Senior Investor Facility

The first alternative CDT considered was to deliver senior interests on the mortgages through an existing participation facility with another large institutional investor. This structure was similar to the senior/subordinate agreement in place with the Board. However, each senior interest would be sold on a stand-alone basis and consequently CDT would not capture the value generated from pooling the mortgages. Furthermore, the facility limited the senior investor to a par purchase price. The mortgage loans were well seasoned with an excellent credit history and all were originated in a much higher interest-rate environment; thus, the pool was worth well above par.

Real Estate Mortgage Investment Conduit (REMIC)

The second option was to pool the mortgages and issue securities via a REMIC with CDT retaining the below investment grade interest. Some REMICs are entities that own pools of mortgages used for collateral to issue Commercial Mortgage Backed Securities (CMBS). Assets held by REMICs must comply with IRS regulations, and all securities issued by non-GSE (Government Sponsored Enterprise) REMICs must have a rating assigned from at least one of the nationally recognized rating agencies. Post issuance, the rating agencies are required, at a minimum, to monitor asset performance annually. However, on average,

rating assignments carry a $100,000 upfront fee and a $15,000 annual surveillance charge. In addition, legal fees and other transaction costs can be substantial. The cost of a rated transaction relative to the small size of the pool was likely to result in an inefficient execution. The minimum size for a REMIC transaction is generally at least $100 million.

Guaranteed Mortgage-Backed Securities (MBS)

The third option was to pool the mortgages and issue securities credit enhanced by a GSE to a broker dealer. Broker dealers have access to a wider variety of investors in the capital markets and may elect to include the CDT securities in a much larger securitization. The GSE guarantee would allow CDT to issue AAA-rated securities without going through the rating-agency process. The AAA rating would result in a higher price for the securities and alleviate investor uncertainty regarding affordable housing mortgages. In exchange for the GSE's credit enhancement, CDT would provide a collateralized first-loss guarantee. The first-loss guarantee could be secured by cash, by retaining a percentage of the securities, or by providing a payment guarantee backed by a letter of credit. This obligation would remain constant for the life of the securities and would not decline as the underlying mortgages amortize.

However, the MBS option presented challenging corporate finance, tax, and accounting issues specific to CDT's REIT status. Some of the major issues included: (1) selling the loans and foregoing the future income stream of principal and interest payments; (2) assessing the financial and administrative costs to provide CDT's first-loss guarantee; and (3) managing the potential gain/loss on sale and any tax implications.

Transaction Overview

CDT chose the MBS route. The primary reasons were costs and time. Under the MBS structure, we did not need to incur the costs of securing a rating from one of the independent rating agencies. Our legal costs were also substantially less than under the REMIC structure. At the time we were considering the securitization, the ten-year U.S. Treasury was trading at a level that would generate substantial value from the securitization. Any significant increase in the U.S. Treasury yield would eliminate much of the economic value of the transaction. A prolonged process would expose CDT to this risk, whereas the MBS execution appeared to have significant benefits in terms of coming to market quickly.

CDT swapped the mortgages for an equal amount of Fannie Mae Guaranteed Mortgage-Backed Securities (Securities) and then sold the Securities to JPMC. The portfolio was separated into nine smaller pools as required by Fannie Mae's Mortgage-Backed Securities program. Securities were exchanged on a per pool basis; thus, CDT received a total of nine Securities.

Fannie Mae Pool Stratification
Interest Basis – 30/360 vs. A/360
Amortization – based on fully amortizing vs. balloon mortgage
Unique Call Protection – non yield maintenance or defeasance, fully prepayable without penalty, declining prepayment premium
Maturity – loan terms of 30 or more years
Coupon Variance – for any given pool, the spread between the highest and lowest coupon may not exceed 200 bps

Rhoda Newman, senior account executive of Fannie Mae, said, "CDT's first securitization with Fannie Mae was a milestone. It helped to achieve Fannie Mae's continued goal to support affordable housing and CDT's goal to expand program activity. With Fannie Mae and CDT's common commitment to affordable housing, we view this as a model for future securitized transactions."

For a more efficient capital market execution, JPMC worked with Fannie Mae to exchange the securities into a single bond, FNGT 2004. The bond was divided into two tranches (Class A and an I/O class)[1] and sold to four institutional investors (a bank and three insurance companies).

Although the entire pool of loans was sold to Fannie Mae, CDT is still responsible for ongoing asset management of the securitized loans. Because of the ongoing asset management and administrative costs of managing the transaction, CDT will receive an annual administration fee. An annual fee is also payable to CDT to compensate for the credit enhancement it provided. These amounts were determined by using comparable fees charged in similar transactions.

Key Portfolio Characteristics

The high DCRs and the seasoned nature of the loans, along with the duration and geographical and borrower diversification of the pool, resulted in a subordination level or guaranty obligation substantially less than the average CDT-retained subordination interests on individually syndicated loans. The reduced subordination level illustrates the benefits of completing a pooled transaction. To back its credit enhancement, CDT provided a letter of credit to Fannie Mae.

The participation of experienced, quality business partners, coupled with the proficiency of CDT's employees, virtually eliminated the need to engage outside consultants. However, CDT did work closely with its independent auditors and outside legal counsel to address corporate accounting and legal issues.

1 Class A–senior tranche in which cash flow from principal and interest payments on the underlying mortgage loans are used to pay Class A note holders. I/O–(interest only) note holders repaid only from interest payments of the underlying mortgage loans.

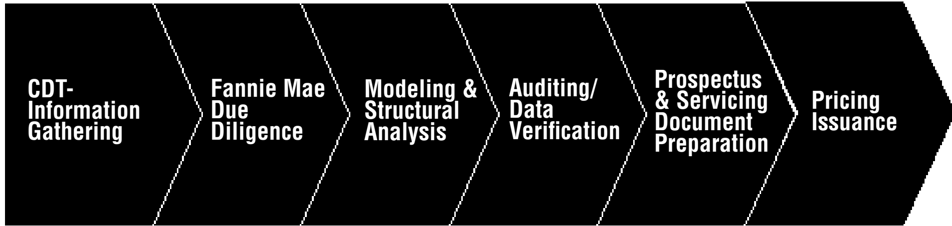
Collateral Characteristics	
Initial Balance	$44,918,184
Number of Pools	9
Number of Loans	31
Weighted Average Coupon	7.92%
Weighted Average DCR	1.24x
Weighted Average LTV	72.7%
Weighted Average Remaining Maturity (months)	203
Weighted Average Remaining Amortization (months)	293
Weighted Average Seasoning (months)	30
Expected Weighted Average Life (years)	13.31

Geographic Distribution	
Texas	25%
Pennsylvania	23%
California	22%
Wisconsin	11%
South Carolina	5%
Connecticut	5%
Louisiana	4%
Tennessee	3%
Ohio	2%

Asset Affordability	As % of UPB
LIHTC	88%
Non-LIHTC/Other affordable program	12%

The Securitization Process

The securitization was one of CDT's most complex fixed-income transactions to date. Despite the complexity, CDT was able to complete the entire process within ninety days. This is a significant achievement for a first-time issuer. The chart below summarizes the process step-by-step.



Midland Loan Services, Inc. (MLS), a Fannie Mae approved servicer, was the current servicer for a large portion of the loans in the portfolio. Fannie Mae's agreement stipulated that the entire mortgage pool be serviced by a Fannie Mae–approved servicer. As a result, CDT transferred all of the non-MLS servicing rights to MLS. This step was specific to this transaction and unnecessary for most newly originated CMBS deals.

Due Diligence

The aggressive time line was achieved largely because of the quality of information and CDT's rapid response time in providing the required due diligence items to Fannie Mae and JPMC.

Sample List of Required Due Diligence Documentation	
Promissory Note	Legal Opinion
Deed of Trust/Mortgage	Partnership/Operating Agreements
Title	Inspection Reports
Survey	Environmental Reports
Endorsements	Property Financials
Assignment Documents	Rent Rolls
Reserve Agreements	Loan Agreements
Management Agreement	Regulatory Agreements
Certificate of Borrower	Appraisal/Market Study

CDT submitted much of the material electronically. Individual loan files were indexed and scanned into portable document format (PDF) and then transferred to compact disks. Rather than sift through stacks of hard copies, the electronic format made the review, retrieval, and forwarding of information much more manageable. Through this strategy, the due diligence time frame was reduced by at least three to six weeks.

Conclusion

The transaction was a milestone for CDT as well as for the entire community development industry.

CDT	Community Development Finance Industry
Increased forward commitment capacity with the Fund	Created a model for future securitized transactions
Reduced credit and interest rate exposure by selling subordinate interests and warehoused whole loans	Validated that smaller LIHTC whole loans could be securitized as AAA securities and sold for a premium
Created an income stream to cover ongoing administrative expenses and guarantee fees	Illustrates the value of high quality affordable housing mortgages

The fixed costs associated with MBS issuance will continue to provide challenges to the community development finance industry. These extremely high costs can be a barrier to entering the MBS market, and intermediaries often lack the ability to generate the loan volume needed for an efficient execution. The industry will continue to look to GSEs to design new programs and develop innovative strategies such as the Fannie Mae MBS program. The MBS market has slowly expanded to include community development assets, and CDT looks forward to continuing to work with experienced partners such as Fannie Mae and JPMorgan Chase to create liquidity for community development finance investments.

Judd Levy is the founder, President, and CEO of CDT, and has been a leader in affordable housing for thirty years, including serving as Deputy Director at the New Jersey Mortgage Finance Agency and heading Merrill Lynch's Housing Finance Department for ten years.

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