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Case Study: Selling Affordable Housing Loans in the Secondary Market

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The California Community Reinvestment Corporation (CCRC) is a nonprofit Community Development Financial Institution (CDFI) formed by a consortium of California commercial banks in 1989 to provide permanent mortgages for affordable housing projects. The corporation has funded over $360 million in first mortgages, most secured by Low Income Housing Tax Credit projects.

CCRC provides long-term mortgage and bond financing for new construction, acquisition, and rehabilitation. Funded by more than fifty member banks in California providing in excess of $360 million in resources, CCRC offers CRA lending, investment, and service test credit to commercial banks and savings and loans through a variety of loan pools, investments, and service opportunities. Historically, CCRC has funded its mortgage program through a credit line provided by its fifty member banks, but it has bumped up against its credit limit as it has increased loan production.

One solution to this problem has been selling loans to free up credit-line availability for new loans. CCRC had bad experiences with early efforts to sell loans to federal agencies. But in the late 1990s, it returned to this strategy when it again outran its credit availability. Its renewed interest in sales coincided with the insurance industry's creation of its own consortium, Impact Community Capital, to head off statewide CRA-like legislation that would regulate insurers.

CCRC and Impact partnered on CCRC's first large loan sale. The transaction included twelve loans totaling $40 million, and it sold at an aggregate price of par. Since both organizations were learning by doing, the transaction was protracted and painful, but it finally closed in August 2000. CCRC has held ten more loan sales since 2000 totaling over $200 million (including the first Impact sale). The sales ranged from a single loan of less than $1 million to a portfolio of more than $46 million. Buyers have included two other secondary market purchasers of community development loans (the Community Reinvestment Fund, based in Minneapolis, and the Community Development Trust, based in New York) as well as a CCRC member bank (Bank of the West). Impact is CCRC's largest loan purchaser, thanks to two subsequent loan-pool sales (see Table 1).

Table 1. Recent CCRC Loan Sales to Impact Community Capital		
	March 2004	August 2005
Portfolio Total	$38,441,502	$46,242,763
# of Loans	25	48
Average Loan Size	1,537,660	963,391
Minimum Loan	167,841	185,042
Maximum Loan	5,159,265	3,913,427
# of Housing Units Financed	1,812	2,377
% LIHTC Projects	96%	89%
Weighted Average DCR	1.38	1.56
Weighted Average LTV (restricted value)	64%	64%
Weighted Ave. Months Since Funding	43.2	64.0
% of Loans that Re-price	68%	56%
Weighted Average Coupon	7.51%	7.48%
10 Year T-Note Yield at Price Fix	4.16%	4.17%
Sale/Offer Price Premium/ (Discount)	3.50%	5.81%

CCRC's Loan Sales Process

Selling loans is a lot like selling used cars. The seller usually knows much more about the product than the buyer, and the buyer is naturally suspicious about the seller's motivation for selling. To counter this "asymmetric knowledge" discount, CCRC works to create a bid package that contains everything an analyst needs to value each loan without leaving his or her desk. When delivering the package to interested buyers, CCRC requests bidders to price each loan in the portfolio subject only to confirming the information in the bid package.

CCRC will vary the contents of the bid package depending on what it is selling and to whom (see Table 2). Because it takes so much effort to evaluate a loan portfolio, CCRC limits the distribution of bid packages to encourage each prospective bidder to conclude that its chances of winning the bid are good enough to be worth the effort.

Table 2. Contents of a Typical CCRC Bid Package	
Loan Spreadsheet	Containing 50 or so data items per loan
Individual Loan Summaries	Short narratives summarizing the structure, credit, real estate, and participants
Loan Reviews	Dated within one year with a spread of historical operating statements
Collateral Inspections	Dated within 6 months, containing photographs of the project
Payment History Reports	From loan inception
Legal Documents	Loan agreement, deed of trust, note

The choice of loans to include in a sale depends on the seller's objectives and the needs of the prospective buyers. If the seller's goal is to obtain the highest possible price, for example, the seller should choose the loans with the highest interest rates and strongest credits. In selecting a recent sale portfolio, CCRC first eliminated all of the loans closed within the last year due to insufficient seasoning for the prospective buyers. It then eliminated all "problem" loans that would not be salable to the prospective buyers. Of the remaining loans, CCRC selected those from its largest borrower concentrations (to reduce exposure concentrations), and those with the lowest interest rates (to take advantage of the low market rate environment) to make up the sale portfolio.

After selecting the sale portfolio, CCRC takes the following steps:

1. **Prepare the bid package.** The package includes current loan reviews, collateral inspections, and financial information. Any credit issues must be thoroughly documented and explained.
2. **Identify potential bidders.** Distribute to interested parties a "sanitized" (i.e., with all confidential customer information deleted) loan spreadsheet and a confidentiality agreement. Request interested bidders to return the signed confidentiality agreement, if they want the bid package. This serves to get an early read on the extent of bidder interest, weed out inappropriate bidders, and protect sensitive customer information.
3. **Distribute bid package to bidders.** Ask bidders to respond within 30 days with a letter of intent (LOI) containing a loan-by-loan pricing, other significant terms, sample seller representations ("reps") and warranties, and the buyer's source of funds and approval process.

4. **Evaluate responses and select the best proposal.** Evaluate and compare bids on price, costs of sale, terms, any requirements for residual guarantees, required reps and warranties, and approvals required.
5. **Buyer due diligence.** This may require as long as 90 days for the selected buyer to review every loan file, conduct collateral inspections, obtain title endorsements, and negotiate a loan purchase agreement. Due diligence also requires considerable seller's resources to answer file reviewers' questions, collect additional information from borrowers, and, often, to correct deficiencies in documentation.
6. **Closing.** The closing involves assigning loan documents and sending loan files to the buyer and confirming the receipt of the sales proceeds.

Who Are the Buyers?

The buyers of CCRC loans have been the specialized community-development secondary market firms and commercial banks. When considering potential purchasers, it is important to understand how they are funded because this will affect the types of mortgages they can buy and in general their flexibility. For example, a common reason for rejecting a loan from a sale is that it is not "Fannie Mae" compliant. In contrast, a purchaser intending to securitize the affordable housing loans in a larger securitization has the ability to take loans with blemishes (although the price likely will be reduced) as a few of these loans in a large securitization can be accommodated through a larger subordination level (i.e., a larger unrated portion of the resulting security).

In general, we have found that the federal mortgage agencies are not flexible enough to be purchasers of these loans. The agencies are designed to handle large volumes of highly standardized product, and neither quality typically applies to CDFI loan production.

How Are Loan Portfolios Priced?

Bids on portfolios of CCRC loans have usually resulted in a wide range of prices. For example, bids on CCRC's last sale ranged from 101 (i.e., a 1 percent premium) to 105. It is best to get bids from bidders who are familiar with the affordable housing field because they take into account loan strengths that other bidders may not understand. An example is the strength that the presence of a well-known tax credit syndicator can add to a loan with relatively low debt-service coverage.

A recent Ernst & Young survey found that at any one time, as many as 34 percent of LIHTC projects show a below break-even debt-service coverage (DSC).[1] A low debt-service coverage will result in a rejected loan or a low price, unless the seller can convince the buyer that the low DSC is temporary. Other "events" that cause challenges for loan sellers are construction defect litigation, pending changes in property managers or general partners, the receipt of a notice of noncompliance from the tax credit agency, recent rehabilitation expenses, and the many other challenges that all properties face. Because such "events" can

1 "Understanding the Dynamics II," Ernst & Young, June 2004. The report is available at the following link: http://www.ey.com/global/download.nsf/US/Afforable_Housing/$file/Understanding_the_Dynamics.pdf.

occur at any time, it is in the seller's interest to minimize the time between the acceptance of a letter of intent and the closing of the sale.

It is important to consider exactly when the portfolio price is fixed during the sales process. In recent sales, CCRC has received offers that fix the price at the acceptance of the letter of intent. This eliminates CCRC's interest-rate exposure during the time between the acceptance of the LOI and the closing–a period of up to 120 days when the ten-year U.S. Treasury note rate has varied by as much as 50 basis points. A change of 50 basis points can mean the difference between a sale at a healthy premium and a sale at a discount.

CCRC prices its sale portfolios beforehand with a spreadsheet model that simplistically discounts the loan cash flows to a present value without taking into account optionality (the borrower's option to prepay). This model has been surprisingly accurate in the aggregate, although it sometimes misses on individual loans. CCRC's portfolio valuation provides a benchmark against which to measure prices offered in LOIs.

Lessons Learned

There are many compelling reasons to pursue a loan sale. First, it brings in additional investors to create more competition for loan-pool purchases. For example, by securitizing its loan purchases, Impact Community Capital is able to create attractive investments for insurance companies that are otherwise constrained in the amount of whole mortgages they can hold. Similarly, the Community Reinvestment Fund has been able to attract pension-fund investment into affordable housing. This increased competition ultimately lowers the cost of capital for the industry.

Second, securitization creates liquidity. Successful lenders will ultimately outgrow their credit capacity and will be forced to sell loans or slow or even stop their growth. Loan sales are also a way for lenders to manage their exposure concentrations so that they can continue making loans to good customers without exceeding prudent borrower, geographic, or other exposure limits.

Third, loan sales can improve balance sheets. In a falling interest rate environment, selling high-yield loans can result in substantial sale premiums, which go directly to the CDFI's bottom line. Sales will also cause the recognition of any related deferred loan fees and the reversal of loan loss provisions, which also go to the bottom line. Nearly half of CCRC's fund balance is the result of these effects of its loan sales. Loan sales can also demonstrate to a CDFI's creditors and investors that its assets are properly valued (or not, depending on the price received) and provide them with additional comfort as to the CDFI's underwriting skills.

A CDFI should consider several disadvantages before selling loans. Lenders will lose servicing and interest-rate spread income they would otherwise have received from the sold loans. Loan sales will also increase the volatility of a CDFI's financial statements and cash flow. A sale early in a fiscal year may offset the loss of servicing and spread income with the income recognition resulting from the sale, as discussed above. However, a sale at the

end of a fiscal year may result in a "boom" year (the sale year) followed by a "bust" year (the following year when revenue is low because of the loss of servicing and spread income and the absence of an extraordinary income event).

Another major concern for selling loans is the loss of control over subsequent customer contact on a loan that continues to be associated with a CDFI. CCRC has found that some customers whose loans were sold have valid complaints about the attitudes or lack of affordable housing knowledge shown by subsequent servicers. It is not surprising that a multi-billion-dollar servicing operation would have a different servicing approach than a "boutique" specialized lender like CCRC, and, as a result, the transfer of servicing may create an additional obstacle to getting the customer's next loan. Sellers can insist on retaining loan servicing, but they will thereby eliminate bidders who intend to securitize the loans. Such securitizations usually require credit ratings from national credit agencies, which in turn usually require that the loan servicers be "rated." (Most CDFIs will not qualify as "rated" servicers.)

CDFIs may also confront issues from their funding sources resulting from sales. They should be wary of breakage fees or prepayment penalties for repaying a mortgage line early. Warehouse lenders may experience costs from getting their money back earlier than anticipated, and they may try to pass these costs on to the CDFI.

CDFIs should resist providing residual guarantees that are sometimes required as a condition of the sale. These guarantees can greatly diminish the benefits of the sale. They will require continual uncompensated monitoring. A CDFI that retains the top 10 percent loss position in a sold loan is not really reducing its exposure concentration to that borrower. Nor is it getting paid for bearing the residual credit risk.

This brings us to the core of the decision to sell loans: how to strike an appropriate balance between mission and loan liquidity. The secondary market values standardization in types of loans, loan terms, and loan documentation. Many CDFIs, however, value their ability to customize credit facilities to better meet their customers' needs. Standardization and customization stand in direct conflict; so too do the secondary market values of large volumes and market risk-based pricing versus CDFI values of local orientation and making difficult projects happen. These conflicts force CDFIs into a delicate balancing act.

Further Innovations

CCRC is in the midst of conducting its first sale of tax-exempt bonds. We expected a thin market for CCRC's small private activity housing bonds with no credit enhancement but were pleasantly surprised by the level of interest we found. We selected a bid from a member commercial bank because it seemed the most certain to close according to the proposed terms, but we were intrigued by a proposal from the broker/dealer subsidiary from another member bank to securitize the portfolio. The feasibility of securitization depends entirely on the existence of a large enough spread between the sale portfolio yield and the market rate for investment-grade rated tax-exempt securities to cover the high expenses of the transaction, so a securitization will not always work. Nevertheless, we need to develop disposition

alternatives for tax-exempt bonds since CCRC's major secondary market loan purchasers as of yet have little appetite for the product.

George Vine has worked with CCRC since 1996 in secondary market sales, new product development, credit quality, and portfolio management. Most recently he organized the CCRC Workforce Housing Fund, a private equity fund for affordable for-sale housing projects in California.