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Leverage: Securitizing Community Development Construction Loans

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By securitizing construction mortgages, the Community Preservation Corporation (CPC) has met demand for financing that far exceeded its existing capital sources. CPC loans fund new construction and substantial or moderate rehabilitation of affordable apartment buildings in long-neglected New York neighborhoods. In recent years, housing construction here has risen to thirty-year highs. Areas have been repopulated after decades of blight and abandonment and–obviously–negligible housing investment. Today, more than $700 million is outstanding in CPC-originated loans in these areas. This situation would not have been possible without enlisting other investors, since CPC's main source of debt capital is a credit line capped at $300 million.

When we began seeking other investors, high due-diligence costs were a major obstacle. Not only were most projects small, but many of their builders were not typical bank customers. They included immigrants and small contractors. Even though they had the knowledge and the will to redevelop small sites, many were not traditionally "bankable." Moreover, the project locations, in emerging areas, were unfamiliar. A ten-unit rental building might be a good deal, even in long-neglected north Brooklyn. However, an investor's overhead to verify that fact could easily cost more than the loan would generate in revenue. Loan-by-loan review was simply not feasible.

Our solution was a structure that made the loan originator–CPC–absorb the first 20 percent of losses in a multiloan pool. Its key features:

- We pool loans shortly after closing, and sell a senior tranche (80 percent of the pool, in our case). "Senior" means that the investor is paid first out of each month's collections.
- CPC retains the other 20 percent, which is subordinate. As originator and loan servicer, we therefore deal with the vagaries of late payments or borrower issues.
- We streamlined securitization with internal processing. We use standard underwriting and standard loan documents, and we electronically scan all files into Adobe PDF format. Investors receive all documents by email or CD-ROM and can do file reviews in their own office.

All of these procedures dramatically cut the time and cost for investors to conclude that 80 percent tranches are bankable. Our 20 percent first loss turns a pool of 75 percent loan-to-value loans into a very safe 55 percent loan-to-value bank position. The first loss being pool-level credit support (not loan-by-loan) makes it even better. (To date, no 80 percent tranche has suffered a late payment.) Investor approvals have been simple and quick, given

the manifest strength of pooled tranches with credit enhancement. Streamlined process and standardization cut costs too.

CPC is a nonprofit lender founded in the 1970s during New York City's fiscal crisis. In our early years, while loan volume slowly grew, we rarely had to seek capital from conventional markets. Instead, our lending was supported by credit lines from institutions familiar with "the CPC story," chiefly the bank consortium that had founded the company.

When volume began to outstrip our traditional capital sources, as it did in recent years, we needed for the first time to find additional funding elsewhere. Securitization tapped a wide field of conventional lenders to fund our mission.

This success is replicable, but with limits. The limits are seen in the special features that made our pooling possible:

- Steady deal flow, so pools were frequent. Rapid growth in loan volume made pooling necessary for CPC, but it also made it possible. Investors knew the pools were regularly available, and they asked to buy them. In our earlier history, small volumes would have allowed only infrequent "one-offs." Securitization would not have worked then.

- Similarity of individual deals. Multifamily loans are not quite plain vanilla, but standard underwriting covers most credit parameters. Deal-specific peculiarities can be manageably few. This streamlines due diligence. It would be much harder to pool small deals, each with unique, significant complexities.

- CPC's balance sheet must carry the whole pool, since the 20 percent first-loss feature precludes "true sale" accounting treatment, which would get the pool off the books. Therefore, the 80/20 structure supplies cash liquidity, but it does not relieve capital-ratio constraints on lending growth. Our core capital still limits the aggregate loan volume supportable by our own credit enhancement.

CPC's pool structure has been highly effective in leveraging our origination capacity. It has enabled us to enlist capital from sources that otherwise could not invest in these loans. Other community originators may find it a tool for accessing conventional capital, when the circumstances are right.

John McCarthy is the Executive Vice President of The Community Preservation Corporation, a nonprofit affordable housing lender operating in New York and New Jersey. He is an attorney and a board member of various nonprofits active in affordable housing and community development.