Looking Back and Moving Forward:

Changes in the Affordable Multifamily Mortgage Industry

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Much like looking at old photos of yourself, re-reading thought pieces you wrote years ago, especially those in which you made predictions about the future, can be a humbling experience. Twelve years ago, we published an article in *Community Investments* on the topic of affordable multifamily mortgage risk.[1] We were both recent arrivals at California Community Reinvestment Corporation (CCRC), a multi-bank multifamily lending consortium, and the economy was thriving—job growth was strong and was driving housing demand, a very different picture from today. We observed strong credit performance of the Low Income Housing Tax Credit (LIHTC) mortgages that CCRC specialized in and concluded that the lessons to be learned were: (1) although LIHTC mortgages will pay like clockwork, do not expect to see strong cash flows, (2) nonprofit sponsors require careful analysis, and (3) the structures of these complex loans need to be well thought out prior to close because after closing, the lender's tools are blunt. Now, more than a decade later, there are new lessons to be learned as the affordable housing industry grapples to deal with the significant policy and economic changes that impact our work. In this article, we reflect on the industry's historical performance and identify how recent lessons can improve our collective ability to meet the affordable housing needs of low- and moderate-income communities, despite the many challenges of the current environment.

What Has Changed?

With respect to credit quality—not much. A 2011 study by the Reznick Group revealed that among 16,399 LIHTC properties surveyed, 98 experienced foreclosure through the end of 2010—an aggregate foreclosure rate of 0.62 percent, measured by property count.[2] Approximately 50 percent of the stated foreclosures were reported to have occurred from 2008–2010.[3] In CCRC's 23 years, it has foreclosed on two loans—an aggregate foreclosure rate of 0.49 percent. Its total realized loan losses over the 23 years is less than $1 million, about 0.15 percent of total loan originations (not including tax exempt bonds for which it has realized no losses). Annualized, this is just a few basis points of credit losses per year. It is very difficult to find directly comparable information, but the industry tends to outperform other real estate debt classes. For example, the California Bankers Association reports that as of the 3rd quarter of 2011, 1.6 percent of all multifamily loans and 2.4 percent of all single family loans held by California-based banks were on non-accrual – indicating that repayment in full was not expected.[4]

What explains this incredible performance among LIHTC mortgages?[5]

- Rents are typically at least 10 percent, and often 20 percent to 40 percent, below market. The result is continual low vacancy rates and low marketing expenses.
- The loans are usually funded upon completion of construction or substantial rehabilitation. The result is several years of low repairs and maintenance expenses.
- The mortgage amount per unit is low, usually not much more than 10 percent of total development cost. The implication is that other capital providers have large investments to protect and the cost of keeping the mortgage current is small relative to their investments.
- In particular, LIHTC investors (typically Fortune 500 companies) have major incentives to keep projects from defaulting on their mortgages during their first 15 years due to the potential for tax credit recapture.
- Finally, a foreclosure will eliminate or greatly reduce the rent restrictions, allowing a conversion of the project to market, or at least to a much lower level of affordability, often creating millions of dollars of additional real estate value. Whereas the average loan to value ratio of CCRC's mortgage portfolio is 67 percent, its loan to value ratio after a foreclosure, assuming a conversion to market, is 48 percent. This implies a 40 percent increase in property value following a conversion.

While credit quality remains strong, the broader landscape of the affordable housing industry has changed dramatically. State and local government budget shortfalls hit California particularly hard last year, when the governor eliminated local redevelopment agencies (historically a source of subsidies for most CCRC projects). CCRC escaped immediate damage because it funds loans only after projects are completed, rented, and all other financing is in place, but CDFIs providing earlier stage financing are up a creek without a paddle. Even though we survived the immediate effects unscathed, we wonder how future deals will be done without this important source of subsidy.

Banks, many of which suffered a near-death experience in the Great Recession and are facing regulatory uncertainty, are less likely to accommodate CDFIs. We have seen an increase in the number of our credit line banks that now look through individual loans in order to underwrite CCRC. This requires us to spend more time providing information and answering questions, and we must allow more time for funding requests and credit line renewals than ever before. Some banks feel the need to impose financial covenants which allow CCRC even less latitude for reacting to the current turmoil.

Other changes are in the wind and we know they will affect the industry, we just don't know how. Examples are the uncertain futures of the GSEs and the possibility of Federal corporate tax reform and its effect on LIHTCs.

Lessons Learned from the Great Recession

In mid-September 2008, we took a call from a representative of one of the nation's largest financial institutions, which had agreed to buy $26 million of CCRC's tax-exempt bonds the following week. CCRC depends on the sale of mortgage loans and bonds to replenish its origination capacity and bond sales are particularly difficult because of the small pool of prospective buyers.

"The sale's off," the representative said. "But we have a signed agreement," we argued. "Haven't you heard? Lehman filed for bankruptcy and the market fell 500 points this morning. The world has changed…"

As CCRC and its member banks continued to be rocked by the effects of the Great Recession several truths became apparent:

- ***The industry had changed, and our business model needed to adapt to survive.*** For 23 years, we offered permanent mortgages to affordable housing developers of LIHTC-financed construction in California, funded by our member banks. In essence, we delivered a single product to a narrow set of customers in a niche industry, in a single geography, funded by one source of funds. Clearly it would be organizational suicide to expect this business model to work for the next 20 years.
- ***New financial regulation and policy directly impacted our ability to do business.*** With a mortgage line in excess of $350 million on a net asset base of $14 million, CCRC has reached the end of its members' abilities to provide additional credit in an era of Dodd Frank and Basel III.

- ***A strong secondary market for community development loans was not going to materialize any time soon.*** CCRC's traditional secondary market purchasers reduced their appetites, and our historically largest purchaser closed the door entirely.

In light of these realizations, one of the critical lessons we learned was the importance of engaging in a company-wide strategic planning effort. CCRC surveyed its member banks and engaged its staff in brainstorming sessions to bring forth all of the changes occurring in the environment and to develop speculative judgments on ways the organization could exploit these changes. These "speculative judgments" would then be subject to further testing. It developed a financial model of its operations to project the effects of differing business model scenarios on its financial statements up to four years into the future.

Through this process, CCRC determined that it needs to diversify its customer base, its product offerings and its source of funds. The financial model demonstrated that CCRC had evolved to a business model that neither allowed for growth, nor for the additional investments in knowledge and personnel required to accomplish its diversification.

A key to CCRC's past success has been the favorable mortgage credit line provided by member banks since its inception. The line finances 100 percent of CCRC's mortgage amounts at a rate of the organization's portfolio yield minus its servicing fee for an indefinite term with no prepayment penalties. Recognizing how favorable that credit line is, CCRC cut its servicing fee to 25 basis points to maximize the yield to the member banks. In so doing CCRC was only able to cover operating costs, but unable to grow its balance sheet. It was in effect providing the credit enhancement offered by its balance sheet to the member banks for free. And until recently, member banks were willing to offer this concessionary financing without looking too hard at CCRC's financial statements and without any financial covenants.

Now that the world has changed, we believe the path forward requires four steps:

1. ***Continue developing alternative outlets for affordable housing mortgages.*** In the last year, CCRC became an approved FNMA affordable multifamily lender, a HUD MAP lender, and completed its first participation transaction (essentially a sale) with the pension plan of the United Methodist Church (UMC). CCRC continues to attempt whole loan sales which increasingly seem to require GSE-style underwriting. It would require an entirely separate article to explain why GSE underwriting of California LIHTC mortgages is akin to mixing oil and water, but we must continue to try.

In light of these realizations, one of the critical lessons we learned was the importance of engaging in a company-wide strategic planning effort.

2. ***Maintain flexibility to adapt to new regulatory requirements.*** CCRC is considering ways of reducing the size of the mortgage credit line and pricing and structuring it more conventionally with shorter and more definite terms to keep commercial banks at the table as their numbers decline and as Dodd Frank and Basel III kick in.
3. ***Build organizational capacity to operate in a more complex environment.*** CCRC is investing in the additional staff and training needed to meet the HUD, FNMA and UMC underwriting and asset management requirements. We must also develop the CFO skills required by a more complex organization and manage the interest rate risk that will come from "conventionalizing" the mortgage credit line.
4. ***Identify ways to raise additional equity.*** The required additional investment and most of the alternative mortgage outlets generate a need for additional equity funds. The staff and training investments are needed years before they result in additional earnings, and that gap must be bridged. And most of the alternative mortgage outlets demand some credit enhancement (which requires equity funds). Since CCRC cannot raise these funds internally in a reasonable time frame, it is about to undertake a campaign to raise equity-like funds from the corporate social responsibility sections of the member banks and other corporations, and from foundations and government agencies.

In regions across California, rents have been increasing while rental vacancy rates have been declining,[6] suggesting that the housing bust did not solve California's shortage of affordable housing. Over the past 23 years, CCRC has demonstrated its ability to finance affordable rental housing safely and efficiently. The times may have changed, but by taking these steps now, CCRC intends to continue to be part of the solution. It's our hope that twenty years from now, we can look back on these times and see that the industry rose to the challenge, bringing creativity, adaptability, and passion to meet the affordable housing needs of low- and moderate-income communities across the nation.

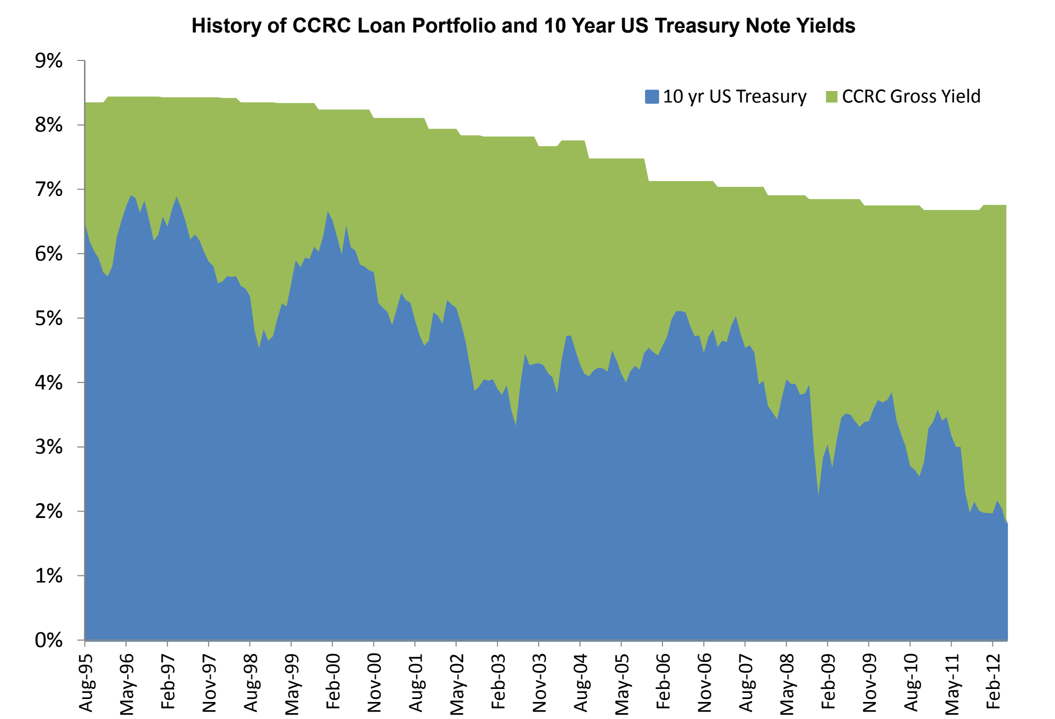
23 Years of CCRC

Since 1989, CCRC has provided permanent financing for housing for seniors, families, and individuals with special needs, for renters with incomes ranging from 20 percent to 60 percent of area median income. This financing has led to the substantial rehabilitation and new construction of more than 25,000 units of affordable housing in rural and urban communities across the state of California.

In addition to enabling these social benefits, CCRC has provided value to its 44 member banks. Their participation in CCRC's mortgage line and bond program has simultaneously given them CRA credits and good investments – the often unreachable "double bottom line." The graph below shows the portfolio yield on CCRC's mortgage loan portfolio compared to the yield on the U.S. 10 year Treasury note that is frequently used as a pricing benchmark for commercial mortgages.

Over the past 10 years, the spread between them has averaged 3.35 percent. For the past five years, until the beginning of this year, CCRC charged a servicing fee of 25 basis points. During that time CCRC's member banks earned 300 bps over 10 year U.S. Treasury notes (CCRC's current servicing spread for 2012 only is 40 bps). And since its inception, CCRC's member banks have not lost a dime on their investment in the mortgage line or the tax exempt bond programs. The $1 million in from-inception loan losses mentioned previously were fully absorbed from CCRC's resources.

Another benefit to member (as well as some non-member) banks is that CCRC's forward mortgage commitments are a source of repayment for the banks' construction loan business. Finally, member banks earn CRA services credit by allowing employees to serve on CCRC's board of directors and loan committee, and by providing the credit review teams that review CCRC's portfolio annually.



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4. My calculations, based on 2009 Current Population Survey data. See online appendix section 5.A3 (see Note 1).

5. Figures 1 and 2 display estimated 90/10 income achievement gaps from all available nationally representative studies that include reading- or math-achievement test scores for school-age children and family income. For most of the longitudinal studies (HS&B, NELS, Prospects, ELS, and ECLS-K), only estimates from the initial wave of the study are included. ECLS-B estimates come from wave 4, when children were five years old and tested on school readiness; SECCYD come from wave 5, when children were in third grade and were first administered a broad academic achievement test. The quartic fitted regression line is weighted by the inverse of the sampling variance of each estimate. Included studies are Project Talent, NLS, HS&B, NLSY79, NELS, Add Health (reading only), Prospects, NLSY97, ELS, SECCYD, ECLS-K, HLS, and ECLS-B. Family income is student-reported in Project Talent, NLS, and HS&B. See online appendix for details on computation of 90/10 gaps (see Note 1).

6. See online appendix 5.A4 (see Note 1).

7. My calculations, based on Main NAEP math and reading scores. See National Center for Education Statistics website, available at: http://nces.ed.gov/nationsreportcard/naepdata/dataset.aspx (accessed March 7, 2011).

8. Grissmer, D. W., Flanagan, A. & Williamson, S. (1998). "Why Did the Black-White Score Gap Narrow in the 1970s and 1980s?" *In The Black-White Test Score Gap,* edited by C. Jencks and M. Phillips. Washington, D.C.: Brookings Institution Press; Hedges, L. & Nowell, A. (1998). "Black-White Test Score Convergence Since 1965." *In The Black-White Test Score Gap,* edited by C. Jencks and M. Phillips. Washington, D.C.: Brookings Institution Press; Magnuson, K. & Waldfogel, J. eds. (2008). *Steady Gains and Stalled Progress: Inequality and the Black-White Test Score Gap*. New York: Russell Sage Foundation; Neal, D. A. (2006). "Why Has Black-White Skill Convergence Stopped?" In *Handbook of the Economics of Education,* edited by Hanushek, E. A. & Welch, F. Vol. 1. New York: Elsevier.

9. Figures 3 and 4 show estimated 90/10 income gaps (solid symbols) and estimated black-white gaps (hollow symbols) based on the thirteen studies with family income data. The estimated trends in the income and black-white gaps are fitted lines (quartic for income gaps, quadratic for black-white gaps), weighted by the inverse of the sampling variance of each estimate. The estimated black-white gap trend from NAEP is a fitted line (quartic for reading, cubic for math) through all available NAEP-LTT and Main NAEP black-white gap estimates. The NAEP trend is adjusted for the age of the NAEP samples and the difference between Main and LTT NAEP (the line is the predicted trend for thirteen-year-old students in NAEP-LTT). See appendix section 5.A5 for details (see Note 1).

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11. My calculations, based on Current Population Survey, 1968–2009. See appendix section 5.A3 (see Note 1).

12. See appendix section 5.A6 and 5.A7 for details (see Note 1).

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17. Because of the relatively small within-school samples in many of the studies that include measures of family income, it is difficult to assess the trends in school income segregation using the data available.

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1. Kaiser, M. & Vine, G. (2000). Affordable Multifamily Mortgage Risk: One Lending Consortium's 10 Year History. *Community Investments*, May 2000. http://www.frbsf.org/publications/community/investments/cra00-1/May-CINewsAffordable.pdf

2. Reznick Group. (2011). The Low-Income Housing Tax Credit Program at Year 25: A Current Look at Its Performance. Retrieved from http://www.reznickgroup.com/sites/reznickgroup.com/files/papers/reznickgroup_lihtc_survey_2011.pdf We hasten to add that both the Reznick and CCRC data may be favorably biased, in the case of the Reznick data because of survivorship bias as discussed in the article and in the case of CCRC because CCRC sold over $500 million of its mortgages and doesn't formally track its sold loans. We did check with CCRC's three major secondary market mortgage purchasers and they confirmed that they had not foreclosed on any CCRC-originated loans.

3. Ibid.

4. Thornberg, C. & Levine, J. (2012). March 2012 Banking and Economic Update, California Bankers Association.

5. Vine, G. The Breakeven Point. Vine Associates LLC, Vol. 1, No. 1.

6. According to the Marcus & Millichap Apartment Research Market Reports, 3rd quarter 2012.

CDFI Industry Analysis: Summary Report

1. This article is an excerpt from the report "CDFI Industry Analysis: Summary Report," funded by the CDFI Fund, under Contract TPD-CDF-10-C-0003, Task Order 0002 and 0003. The curriculum and opinions expressed in these documents are those of the authors, who are solely responsible for the content, and do not reflect the opinions of the CDFI Fund or any other person, entity, or organization. The full report can be accessed at http://www.cdfifund.gov/docs/CBI/2012/Carsey%20Report%20PR%20042512.pdf or http://www.carseyinstitute.unh.edu/publications/Report-Swack-CDFI-Industry-Analysis.pdf

2. Although 282 CDFI Loan Funds were sampled, the outstanding question is: are the CDFI Loan Funds examined (as a result of their applying for 2010 funding to the CDFI Fund) different than those that did not apply? If one assumes that they are no different, then the results presented are representative of all CDFI Loan Funds, within the confidence levels and error margins discussed below. If, in fact, they are different, then the results may be representative of all CDFI Loan Funds. For CDFI Banks, CDFI Holding Companies and CDFI Credit Unions, a census was performed; in other words the data represents all of these CDFI institutions.

3. Median loans and lease value.

4. In this table, each year's number is averaged, so there is one number per organization.The median number is taken. The N Value for number is taken. The N Value for all CDFI loan funds is 282.

5. Leverage ratio= total notes payable/net assets.

6. Margin ratio = loan yield ratio minus charge-off ratio – combined interest and operating expense ratio.

7. This number is the average of each year's median deployment ratio.

8. This number is the average of each year's median charge-off ratio.

9. For a full discussion of this issue see: Tansey, C., Swack, M., Tansey, M., & Stein, V. (2010). Capital Markets, CDFIs and Organizational Credit Risk. The Carsey Institute. Available at http://www.carseyinstitute.unh.edu/docs/Swack_CapitalMarkets.pdf.