

# AFFORDABLE MULTIFAMILY MORTGAGE RISK

## One Lending Consortium's 10-Year History

*By Mary Kaiser, President, California Community Reinvestment Corporation, and George H. Vine, Principal, Vine & Associates*

Ten years ago a group of California-based commercial banks created the California Community Reinvestment Corporation (CCRC) as a means of sharing “risky” long term affordable multifamily housing mortgages. The Federal government had just created the Low Income Housing Tax Credit program and mortgages for the program were hard to find.

CCRC staff and loan committee developed expertise in underwriting tax credit projects and helped to pioneer lending that is now offered by many commercial banks. A recent analysis of CCRC’s loan portfolio provided the opportunity to assess how well these pioneers in affordable housing finance managed risk. As part of an annual review of loan loss reserve adequacy, we totaled CCRC’s historical loan losses since our inception 10 years ago, and divided the sum by total loans funded during that time. In the last 10 years CCRC has originated nearly \$200,000,000 in mortgages secured by projects containing over 7,500 affordable housing units.

To our surprise, we found that CCRC’s loan losses since inception amounted to only 0.34% of all loans originated. This is a loss history more in keeping with a good portfolio of investment grade bonds than a high-

risk pool of low-income, multifamily housing mortgages. Chief credit officers at most of CCRC’s member banks would die for such a loss history. Some additional portfolio statistics follow.

CCRC’s current (as of May 1999) portfolio consists of 79 loans totaling \$152,000,000. Most of CCRC’s loans are between \$250,000 and \$3,000,000 in size and the average loan size is \$1,900,000. The portfolio is well diversified with respect to borrower and geographic concentrations (given that all mortgages are secured by California projects). Eighty-two percent of the portfolio is secured by Low Income Housing Tax Credit (LIHTC) projects. Most CCRC borrowers include non-profit corporations in some capacity ranging from the minimum participation required to qualify for the property tax welfare exemption to 100% ownership. The weighted average loan-to-value ratio is 74% and the weighted average debt service coverage ratio is 1.16. Classified (i.e. troubled) loans amount to less than 2% of the portfolio. None of the portfolio’s loans are delinquent and historically delinquencies are rare.

Both authors became involved with CCRC within the past four years, and both came to CCRC from extensive careers in (non-community develop-

ment) commercial banking. Even after four years the exceptionally low loan losses are a surprise. We attribute CCRC’s exemplary loan loss experience to the following five factors:

### **1. CCRC’S LOAN COMMITTEE**

The loan committee meets once a month and includes senior credit and community development officers from each of the five “major bank” members (Bank of America, Wells Fargo, Union, Sanwa and City National) and from three of the remaining bank members (currently Comerica, Union Safe and Deposit and Bank of the West). They give their time generously to review extensive loan committee packets and they take their jobs seriously, as their approval of a loan commits CCRC’s bank membership to fund. The committee’s focus is first on the basics of credit, then on “how do we do the deal.” Loan committee discussions can become spirited providing a creative tension that frequently leads to innovative solutions. Rarely, if ever—never in our recollection—does the committee decline CCRC staff loan submissions.

### **2. EXTENSIVE LOAN REVIEW PROCESS**

CCRC prepares a comprehensive annual review of every loan based on

financial information provided by borrowers. Additionally it inspects all properties at least annually. Loan review findings are scored to a single “risk rating” given to each loan. These risk ratings become the basis for assigning loss reserves and determining the frequency and intensity of each loan’s monitoring. The results of these reviews are presented to the loan committee, which must confirm or reject CCRC staff-assigned risk ratings. As the portfolio gets larger it becomes more difficult to maintain this intensive review discipline, but the benefits of an intimate knowledge of the portfolio, including early warnings of problems and up-to-date market data are worth the effort. The handful of borrowers who inadvertently neglect or—nonwithstanding promises made in loan documents—refuse to provide updated financial information impede this monitoring, but most cooperate fully.

The culmination of the portfolio review process is the annual credit review by a professional credit review team provided by one of the “major” bank members on a rotating basis. The team scrutinizes the portfolio using their employer’s standards. Because

they are often new to affordable multi-family housing mortgages, they keep CCRC staff on its toes by questioning basic assumptions and reviewing loan monitoring down to the smallest detail. CCRC typically emerges with a “satisfactory” portfolio rating—usually the highest rating given—with a few areas flagged for improvements, which are made the following year.

### 3. AGGRESSIVE PROBLEM ASSET MANAGEMENT

CCRC is a firm believer in proactive problem asset management. When a loan review indicates problems, the loan is given a worse risk rating and the frequency of formal loan reviews may be increased to quarterly. Borrower contact is intensified. Problem borrowers sometimes fix their properties just to avoid CCRC’s frequent, even daily, inquiries!

Signs of problems include: high vacancy rates, debt service coverage ratios below break-even, non-funding of replacement reserve accounts, deferred maintenance revealed by CCRC’s property inspections, delinquent property taxes, and lack of response to CCRC’s letters and tele-

phone calls. When problems such as these develop, CCRC tries to work with the existing borrower to resolve the issue. Usually it is a temporary problem caused by a random fluctuation in occupancy, a change in property management firms or borrower staff turnover, and the property rapidly gets back on track. Even when problems turn out to be long-term, in nearly all cases CCRC’s borrowers come up with the capacity and integrity to fulfill their obligations.

Very rarely, payments are not made, there is no prospect for improvement, and CCRC forecloses. Fortunately, CCRC has foreclosed on only two loans to date. Once CCRC takes title to the property the goal becomes a rapid sale of the property to a qualified purchaser at a fair price, under terms which will allow CCRC to account for the transaction as a sale. With both foreclosures, CCRC tried first offering the properties to nonprofits but was unsuccessful at finding one that could meet CCRC’s foreclosure sale goal. In our opinion, the nonprofit housing provider that can perfect the art of acquiring foreclosed properties from financial institutions will have that mar-

109th Street before



109th Street after



This 6-unit property was purchased, completely renovated and permanently financed with a single fixed rate, 20% down loan that is due in 10 years under CCRC’s Acquisition/Rehab lending program.

ket niche to itself in the next real estate downturn.

Even rarer than a foreclosure is when CCRC has such strong doubts about a borrower's management capacity that it decides to exit the relationship even though payments are not yet delinquent. In these cases CCRC will work with the borrower to get CCRC's loan refinanced elsewhere.

#### **4. PREVALENCE OF TAX CREDIT PROJECTS IN CCRC'S PORTFOLIO**

Most projects financed by CCRC get their equity from large tax credit investors such as SunAmerica, Related Capital, and Edison International, who acquire Low Income Housing Tax Credits by purchasing limited partnership interests in the projects. An investment in a project is often several times CCRC's loan amount. During the 10-year tax credit period and the subsequent 5-year "compliance" period, these investors have a strong interest in keeping CCRC's loan current, since a foreclosure can result in the loss of tax credits as well as recapture penalties. Indeed, we recently projected the costs of the loss of tax credits and penalties for a typical project and found that a tax credit investor would be better off up through the 12th year of a project paying off CCRC's mortgage in full *at a total loss*, rather than allowing CCRC to foreclose on its loan. This is a powerful incentive to keep payments current. CCRC has a few loans secured by tax credit projects that continue to be kept current in the face of major project cash flow shortfalls.

Additional protection is provided by the reduced rents mandated by the program which are often 10% or more below rents offered by competing properties. Projects with rents this far below market are much more forgiving of poor marketing and management. As a last resort, a foreclosed property with below-market rents can

be converted to a non-rent restricted property and the rents can be raised. Higher rents mean a higher property value, which provides an additional cushion to the mortgage lender.

One problem with tax credit projects occurs when local market rents drop to a level close to the restricted rents in a tax credit project within that market. In many cases such tax credit projects will not be able to achieve market rents. Rather, they must offer units at discounts below market (and below the project's restricted rents) to offset the continuing tenant income monitoring requirements and the projects' reputations as "low-income" properties.

The major issue with tax credit projects is what happens at the end of the 15-year compliance period—with 15 years of payments left on CCRC's mortgage. Most projects are still subject to rent restrictions for another 40 years. The tax credit investors no longer have an interest in supporting the projects, since the tax credits have been consumed and the penalties no longer apply. We won't know for sure until 2002, when the compliance periods on the earliest tax credit projects begin to expire, but we expect that the 15 years of amortization and inflation during the first half of CCRC's 30-year loan will protect the loan during the last half of its life. We predict that fifteen years of amortization will reduce CCRC's typical loan balance by 23% and fifteen years of inflation compounded at 2% annually *may* increase a project's value by 35%.

#### **5. THE STRONG CALIFORNIA ECONOMY AND THE SERIOUS AFFORDABLE HOUSING SHORTAGE IN CALIFORNIA**

Apartment vacancy rates in many of California's major markets are approaching 5% or below. Few if any markets in the state have vacancies in excess of 10%. California accounts for

seven of the eight least affordable rental housing markets in the country. Job growth in the major California markets is creating housing demand growth well in excess of housing supply growth. These statistics are well documented so we won't delve into them here. Ironically, the housing shortage so harmful to CCRC's low-income constituents strengthens the credit quality of CCRC's loan portfolio.

We have learned several lessons as ex-commercial bankers from this alternative universe of affordable housing mortgage credit as follows:

##### **1. DO NOT LOOK FOR CASH FLOW**

CCRC's portfolio debt service coverage ratio (1.16) seems low to those accustomed to conventional seasoned multi-family loans. A subset of CCRC's loans was recently subjected to the scrutiny of a rating agency and several potential purchasers who anticipated debt service coverage ratios of 1.3 and above.

The explanation is simple—many of CCRC's projects carry "residual receipt" subordinate loans in favor of government agencies. Borrowers must repay these only if there is cash left over after paying expenses and debt service. Some of the loans are even forgiven if they are not repaid within their term. These "residual receipt" debts create a powerful incentive for borrowers to pay out all of a property's income in expenses, since any left over pays a bill that otherwise would not have to be paid. High property management fees are a favorite device for reducing reported cash flow as are "tenant services" expenses. Some projects show stable debt service coverage ratios from review period to review period, which remain at 1.0 (break-even cash flow) despite wildly varying vacancy rates and expense levels.

## 2. CAREFULLY REVIEW YOUR NONPROFIT SPONSORS

Nonprofit borrowers are more difficult to analyze than for-profit borrowers because the analyst cannot count on the profit motive to predict their behavior. Nonprofits are more likely to be highly dependent on a single dedicated individual or grant source. We know of several projects where the real estate is performing well, yet the project is in trouble because there is no one left with interest in managing the asset. Our experience has shown that nonprofits whose primary mission is providing affordable housing are better bets than those whose primary mission is providing other social services.

## 3. GET WHAT YOU NEED BEFORE LOAN CLOSING

CCRC frequently creates innovative loan structures to shore up loan applications that otherwise would not meet its underwriting standards. These structures often require third parties with the experience or financial strength the borrower lacks to maintain an involvement with the project. Others may conditionally require the borrower to take some action after the loan closes. However, we have found that many of these provisions are not enforceable under California law absent a monetary default.

An example is the promised funding of replacement reserve accounts. Replacement reserve accounts are essential protection from the rare borrower that, for whatever reason, milks a property for cash flow by deferring required maintenance. Replacement reserve funding is the first thing cut out when cash flow gets tight. Getting a borrower back on schedule after a several year hiatus is harder than getting your kids to clean up their bedrooms. CCRC holds a property's replacement reserve account and requires a deposit to the account with each loan payment. Non-payment of the required deposit is treated like a loan payment delinquency.

## THE NEXT 10 YEARS

The credibility and improving balance sheet engendered by CCRC's favorable 10-year affordable multifamily mortgage origination history allows CCRC to pursue its mission in several related areas.

One such area is a small loan acquisition/rehabilitation lending program targeted to inner-city investors. In April 1999, CCRC introduced this program in Los Angeles County with promising results. To date, there have been six loans approved of which three have funded. We are looking to introduce this program to other parts of the state this year.

Another initiative is a tax-exempt bond permanent loan program in partnership with some of our member banks, the California Statewide Community Development Authority and bond counsel Orrick, Herrington and Sutcliffe, LLP. Its purpose is to increase the feasibility of small (\$1-\$3 million) multi-family housing bond issues thus extending the benefits of tax-exempt financing to smaller projects. This program became operational in January 2000.

Finally, CCRC's board of directors has approved the placement of a portion of CCRC's capital in direct opportunistic investments in affordable housing projects. We expect to make the first investment this year.

These are exciting, albeit challenging times given the extent of California's affordable housing shortage. The vision of CCRC's creators, and the commitment and wisdom of CCRC's members and board of directors in implementing that vision, has provided CCRC with the confidence, skills and resources to pursue today several programs that appear just as risky as tax credit project mortgages appeared 10 years ago. However, we look forward to reporting similarly favorable results 10 years from now. *CI*



### ABOUT THE AUTHORS

MARY KAISER joined California Community Reinvestment Corporation (CCRC) as its president in September 1995. She contributes a wealth of experience gained from over 20 years as a commercial banking executive. Prior to joining CCRC, Ms. Kaiser spent eight years with the Bank of A. Levy as an executive vice president and chief operating officer, overseeing the retail branch system, marketing, customer service and operations, trade finance, trust, and corporate facilities. Prior to the Bank of A. Levy, Ms. Kaiser held a variety of management positions with First Interstate Bank from 1976 through 1987.

She is a member of the executive committee of the National Association of Affordable Housing Lenders, a member of the Low Income Housing Fund loan committee, serves as an advisor to the Ventura County Community Foundation, a trustee to the Ventura County Leadership Academy and the United Way. She holds a bachelor of arts in psychology and a master's degree in business administration.

GEORGE H. VINE established his consulting practice, Vine & Associates, in 1996 to provide financial restructuring and analysis services to affordable housing investors and lenders. He has worked with CCRC since then providing real estate credit and problem asset advisory services. Prior to forming Vine & Associates, Mr. Vine was a commercial banker specializing in real estate credit for 12 years, and he worked with local community development nonprofit corporations for four years prior to that. Mr. Vine is a chartered financial analyst and has a master's degree in urban planning from UCLA.