

# Selling Affordable Multifamily Mortgages

by George Vine, Vine & Associates

*This article will explain how affordable housing lenders can plan for loan sales, highlight some of the issues that should be addressed in such planning and show one possible approach to conducting a sale.*

## BENEFITS OF SELLING LOANS

Loan sales are valuable portfolio management tools, enabling lenders to reduce concentrations of credit risk in single loans, borrowers, project sponsors and geographies. The greatest benefit of loan sales may be to entice investment in affordable housing from capital sources who would not otherwise invest—investors without the capacity to originate or those uncomfortable with the perceived risk profile of whole loans (e.g. pension funds and insurance companies). Secondary market buyers can convert whole loans into securities with different risk profiles that can be doled out to the most appropriate final investors.

Affordable housing lenders need to plan for the sale of their mortgages long before they expect to sell them. This is not because loan sales are long drawn-out affairs (although they can be), but because loans made without consideration for their sale may never be sale suitable. Even if lenders have no intention to sell, they should still make loans that are saleable to maintain financial flexibility in case circumstances change.



## IMPEDIMENTS TO SELLING LOANS

There is an active secondary market for conventional multifamily mortgages. Fannie Mae and Freddie Mac dominate this market with billions of mortgage dollars changing hands each year. However, the functioning and volume of the conventional secondary market require a standardized mortgage “product”—not the kind of loans affordable housing lenders typically make, which tend to have complicated borrower structures. In short, these loans are complicated and unique.

The risk mitigants that affordable housing lenders have come to rely on—below-market rents, tax credit limited partners, and the senior lender’s option to convert a project to market

rents after a foreclosure—are given short shrift by conventional market participants.<sup>1</sup> Compounding the difficulties, many affordable housing lenders will likely have to sell far less than the upwards of \$100 million desired in the secondary market for a “good execution” (i.e. many interested bidders resulting in a good price).

## OVERCOMING LOAN IMPEDIMENTS

So far, the impediments discussed are unavoidable in the world of affordable housing. Others, such as pricing, are to some extent under the lender’s control. Mission-oriented secondary market purchasers exist, but none who

will subsidize below-market loans. Affordable housing lenders that intentionally (or inadvertently) originate such loans must sell them at discounts below their remaining principal balances. The size of the sale discount increases as the spread between the loan’s interest rate and the market rate increases. Lenders who continually adjust their rates to the current market may expect that on average the premiums on higher rate loans will offset the discounts required on lower rate loans—provided that the loans contain prepayment penalties. High rate loans without effective prepayment penalties—the longer the better—will command little, if any, premium over face value in the secondary marketplace.

Other loan structure impediments include adjustable interest rates (fixed

<sup>1</sup> See for example “Valuing Tax Credits in Affordable Multifamily Transactions”, “Standard & Poor’s Public Finance” August 30, 1999 or “Using Low Income Tax Credits in Affordable Housing Deals: Two Sides of the Story”, “Moody’s Investors Service Municipal Credit Research” August 2000.

rates are preferable), non-standard amortization periods and terms (both should be 30 years or less), and lack of reserve provisions (replacement reserves under the lender's control are often required, operating reserves are desired). It is also important that the lender compile quarterly and annual financial information on the property, borrower and partners.

Standardized loan documentation throughout the sale portfolio is critical. Buyers do not want to read every loan document on each loan to understand the portfolio. The closer the loan documents conform to conventional multifamily standard, (set by Fannie and Freddie) the better. Loan files should be well organized, current and complete. In addition to the usual items

(box 2), they should include current utility allowance schedules, information on current market rents, amount of tax credits awarded and remaining, and subordinated debt and regulatory agreement documents. A potential purchaser may extrapolate the condition of the loan files to the lender's skill and care in making the loans. Problems here will bias the purchaser toward rejecting loans or lowering the offer price.

### RECOGNIZING PROPERTY IMPEDIMENTS

In evaluating loans, purchasers focus laserlike on historical debt service coverage ratios (DSCR's), generally requiring ratios of 1.15 and above. Affordable housing project owners, however, often manage to a break-even cash flow

(equivalent to a 1.0 DSCR) to keep rents as low as possible. Or, they load up property expenses to avoid making payments on junior mortgages. Loans on these properties are difficult sells. Loans in the midst of "events" are also difficult sells. Such events include the replacement of a property manager or partner, construction defect litigation, testing for mold infestations or even extensive property renovation that results in higher than normal maintenance expenses. Lenders should recognize that these loans might have to be held to maturity.

Chronically poor performing loans (no matter how strong their payment history) are difficult to sell at all, and if a buyer can be found the discount

## Box 1

### PURCHASERS OF AFFORDABLE MULTIFAMILY HOUSING MORTGAGES

THE COMMUNITY DEVELOPMENT TRUST, based in New York City, will purchase existing individual loans and loan portfolios as well as forward commitments underwritten to its specifications. They will consider smaller loans (under \$5MM), inner-city and rural locations, assisted living facilities, scattered site and urban rehabs as well as more conventional loans. They have developed a comprehensive selling and servicing guide that can be very helpful to lenders new to selling mortgages in the secondary market.

Judd S. Levy, President and CEO,  
(212) 271-5099  
[www.CommDevTrust.com](http://www.CommDevTrust.com)

THE COMMUNITY REINVESTMENT FUND, based in Minneapolis, Minnesota, purchases existing economic development and housing loans and portfolios. They do loan servicing and provide technical assistance to community development lenders. They have an extensive client list in the western United States including several loan consortia, public agencies and CDCs.

Frank Altman, President  
(612) 338-3050 or (800) 475-3050  
[www.crfusa.com](http://www.crfusa.com)

IMPACT COMMUNITY CAPITAL LLC is a consortium of insurance companies based in San Francisco, California. It is a new organization that, to date, has focused on relatively large transactions like purchases of \$125 million of affordable housing loans from the Bank of America and \$40 million from the California Community Reinvestment Corporation. Currently they concentrate on California loans.

Daniel F. Sheehy, President and CEO  
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will likely be enormous. One option for such loans is to restructure them (e.g. by getting a paydown in exchange for a lower interest rate) prior to attempting their sale.

## POTENTIAL LOAN BUYERS

Given all the impediments listed above, the industry is fortunate to have at least three organizations that specifically target the secondary market purchase of affordable housing mortgages. They are (in alphabetical order) the Community Development Trust, the Community Reinvestment Fund and Impact Community Capital, LLC (see box 1). All of these work by purchasing pools of affordable housing mortgages, credit enhancing the pools and re-selling the higher graded portions to insurance companies and/or pension funds—thus facilitating affordable housing investment by non-traditional investors.

Other potential purchasers are banks and savings institutions seeking Com-

munity Reinvestment Act investments. Having the borrower refinance the loan somewhere else is another viable alternative. If the loan is at an above-market rate with a prepayment penalty, the lender may offer to reduce or eliminate the penalty for a short period of time in order to encourage a pay off.

## HOW TO CONDUCT A LOAN SALE

### *Identify loans to sell*

Select loans to sell based on their interest rate (e.g. take advantage of low-interest rate periods to sell low-yielding loans), performance or to reduce exposure to certain borrowers or locations. Recognize that after several loan sales a lender's remaining portfolio will contain a higher proportion of poorly performing loans as the good ones are sold off.

### *Identify potential buyers*

Consider the secondary market purchasers listed as well as local banks and savings institutions and other lenders.

### *Prepare a bid package*

Loan purchasers are at a disadvantage in negotiating loan purchases since they cannot know as much about the loans as the seller does. For this reason, purchasers will evaluate the quality and the integrity of the seller as thoroughly as the loans that are offered. Similarly, sellers typically will not know the secondary market as well as a purchaser, who is in that market every day. Sellers often use a bid process to reduce the risk of getting a below market price. Three seems to be the right number of bidders—it is large enough to get a good cross-section of opinion, yet small enough so that each bidder will believe the chance of success is worth the cost to make the bid. Box

## Box 2

### CONTENTS OF A BID PACKAGE

1. Summary spreadsheet containing project name, address, number of units and unit mix, rent restrictions, borrower information, loan commitment, current balance, monthly payment, interest rate, re-pricing dates and spreads, maturity, amortization, prepayment information, operating performance information, subordinate debt information, appraised value, tax credits remaining
2. Payment histories
3. Summary project descriptions
4. Project photographs
5. Most recent inspection reports
6. Copy of the notes
7. Spreadsheets of year to date and last three years operating history
8. Copies of selected appraisal information
9. Most recent rent rolls
10. Year-to-date income statements
11. Last two years annual project audits
12. General partners financial statements
13. Most recent utility allowance schedules
14. Applicable apartment market research reports

two shows the contents of a typical bid package. The objective of the package is to make the process of evaluating and pricing the portfolio from the bidder's desk as easy as possible.

#### *Evaluate the Offers*

The offers should list a proposed purchase price for each loan. The proposed price will be indicative only, subject to the completion of a file review. The portfolio will be re-priced closer to the sale date, taking into account any changes in market interest rates and interest rate spreads over U.S. Treasury notes. The seller is often in the dark with respect to the purchaser's pricing model and must rely on good faith (as well as the threat of terminating the transaction) that the re-pricing will be reasonable. The seller should develop their own pricing model or portfolio valuation against which to test the bids and subsequent re-pricing.

The offers may reject certain loans (they should provide a reason for the rejections) or they may offer to purchase certain loans only with some form of seller enhancement (e.g. a top loss guaranty or with seller retention of a first loss participation). Enhancements can often be reduced or eliminated by providing the bidder with additional information relating to particular concerns.

To evaluate the offers, the seller must consider not only the price and the number of accepted loans, but whether any requested enhancement can be provided. Most importantly, the seller should evaluate the probability that absent new negative information, the final purchase commitment will mirror the original offer. Contact references provided by the bidder and ask how those transactions closed. Under some circumstances the seller may consider requiring a good faith deposit of the buyer.

#### *Due diligence*

The due diligence period will require from 30 days to four months or longer depending on the size of the portfolio and the resources each party devotes to closing. The seller's interest is best served by minimizing this time period—the longer it takes the more chance of an untoward “event” or an adverse change in market interest rates or spreads.

During the due diligence period, the purchaser will go through the loan files in detail and may visit the properties and order some new third party reports. The purchaser's thirst for information will likely test the seller's and borrowers' patience, as answers will likely require repeated borrower contact.

At the end of the due diligence period the focus will change to negotiating the seller's representations and warranties in the purchase agreement. The purchaser wants them to be as many and as broad as possible to protect from everything the purchaser does not know. The seller wants them to be as few and as specific as possible to protect against both what the seller does not know and future eventualities. Violations of the reps and warranties may require the seller to repurchase the mortgages and/or pay damages. The seller should get a good legal review before signing the final purchase agreement

#### *Closing*

Finally, the purchase agreement will be signed, funds will change hands and the loan files will be transferred to their new home. The seller can now heave a sigh of relief and begin preparing for the next sale if business is good. **CI**

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*edited by Patricia Rea*

#### ABOUT THE AUTHOR



GEORGE VINE, CFA, established his consulting practice, Vine & Associates, in 1996 to provide financial restructuring and transaction analysis services to affordable housing investors and lenders. The firm's client list includes the California Community Reinvestment Corporation and Impact Community Capital LLC. Vine, formerly a commercial banker specializing in real estate credit, is a chartered financial analyst with a masters degree in urban planning from UCLA. He may be reached at (818) 957-0534 or email: gvine@VineAssociates.com.