NYC HDC

NEW YORK CITY
HOUSING DEVELOPMENT
CORPORATION

MEMORANDUM

To: The Chairperson and Members

From: Gary Rodney
President

Date: September 11, 2014

Subject: FFB / HUD Financing Program

I am pleased to recommend that the Members authorize the Corporation to sell beneficial ownership interests in mortgage loans to the Federal Financing Bank (the "FFB"), a federal corporation under the supervision of the U.S. Department of the Treasury, as part of a new financing program to be established with the FFB and the U.S. Department of Housing and Urban Development ("HUD"). In addition, I recommend that the Members authorize the Corporation to participate in a new FHA Risk-Sharing mortgage insurance program with HUD in order to obtain Risk-Sharing mortgage insurance on loans that will be financed by the FFB.

The Corporation is proud to be the pilot housing finance agency nationwide for this new federal initiative to reduce the cost of capital for affordable housing. This memorandum will discuss the program to be established with the FFB and HUD, the agreements to be entered into by the Corporation, and the associated risks.

Background

The FFB/HUD program is the latest product of the Corporation's ongoing efforts to partner with the federal government in response to the extraordinary conditions in the capital markets that have prevailed since the 2008 financial crisis.

The roots of the program begin in 2009, when Corporation staff played a lead role in designing and implementing the Treasury Department's New Issue Bond Program ("NIBP") for multifamily housing. NIBP was an effort to support state and local HFAs and reinvigorate HFA financing opportunities in the wake of the financial crisis. Under the program, the Treasury provided favorable interest rates in financing multifamily housing bonds issued by HFAs. The Members approved the Corporation's participation in NIBP in December 2009.

For NIBP, Treasury officials initially sought to finance three categories of mortgage loans—those with supplemental security provided by (1) Fannie Mae or Freddie Mac, (2) Ginnie Mae,

110 William Street, New York, NY 10038 tel: 212.227.5500 fax: 212.227.6865
info@nychdc.com www.nychdc.com

or (3) the FHA, including under the FHA Risk-Sharing mortgage insurance program. The Risk-Sharing program, which dates to the early 1990s, allows HUD to partner with an HFA originating an affordable housing mortgage loan to share the risk of an FHA mortgage insurance claim on the loan. The goal is to expand access to FHA mortgage insurance and streamline approvals for HFAs, while managing the additional risk taken on by the federal government. For each Risk-Sharing loan, HUD and the HFA split the mortgage insurance premium based on the percentage of risk that each party has assumed.

The Corporation originally entered into a Risk-Sharing Agreement with HUD in 1994, as approved by the Members at that time, but the Corporation had elected not to insure any loans under the program through 2011. As NIBP developed, the Corporation succeeded in winning federal approval to finance a fourth category of mortgage loans—the so-called "fourth-rail" mortgage loans—which benefitted from permanent credit enhancement provided by REMIC or the State of New York Mortgage Agency. The fourth-rail loans constituted a significant portion of the loans that the Corporation financed with NIBP bonds.

Nevertheless, NIBP prompted the Corporation to re-evaluate its participation in the Risk-Sharing program, and the Corporation decided to seek Risk-Sharing insurance on suitable loans in the pipeline as part of NIBP and future non-NIBP financings. In connection with this change, the existing Risk-Sharing Agreement was amended and restated in November 2011 as described to the Members at that time. Since 2011, the Corporation has obtained Risk-Sharing mortgage insurance on one loan to date with firm commitments for five additional projects. Another five projects in the pipeline are currently expected to receive Risk-Sharing mortgage insurance.

NIBP was a temporary program from the outset, and it ended in 2011. The extraordinary conditions in the capital markets have persisted, however, and the Corporation has pressed the case for continued federal support for HFA multifamily lending programs.

As a follow-on program, the Obama Administration has proposed permitting taxable Ginnie Mae securitizations of mortgage loans that are insured with Risk-Sharing mortgage insurance. As interest rates on Treasury bonds have reached historic lows, the interest rates on tax-exempt housing bonds issued by many HFAs have exceeded the rates on comparable taxable mortgage-backed securities. This "inversion" in the market has negated the traditional advantage of tax-exempt financing and makes taxable securitizations attractive to HFAs. The obstacle is that Ginnie Mae securitizations of loans with Risk-Sharing mortgage insurance are currently barred by the federal statute authorizing the Risk-Sharing program. Legislation is pending to remove the prohibition, but its fate in Congress is uncertain.

Program Description

The Obama Administration has turned to the FFB to provide an interim solution. The FFB is authorized to use the Treasury's borrowing capacity to finance, among other things, loans that are fully insured by federal agencies. Under the FFB/HUD program, the FFB has agreed to purchase beneficial ownership interests in mortgage loans that are originated by HFAs and insured with Risk-Sharing mortgage insurance.

Beneficial ownership interests in mortgage loans that the Corporation sells to the FFB will be evidenced by certificates of participation from the Corporation. Each certificate will pay a fixed interest rate to the FFB approximating the rate that the market is then providing on a comparable Ginnie Mae security. The rate on a 30-year Ginnie Mae security is currently approximately 3.25% per annum. The Corporation will remain mortgagee of record and will retain the spread between the interest rate on the mortgage loan and the interest rate on the certificate (minus fees and expenses). The spread that the Corporation expects to earn will help to provide subsidy for additional projects in support of the Mayor's housing plan.

The Corporation anticipates using the FFB/HUD program to obtain low-cost capital for the permanent financing of suitable mortgage loans that have been or will be separately presented to the Members. Suitable loans will include: (1) projects that are completing a new construction or substantial rehabilitation project and converting to permanent financing and (2) refinancings of existing projects with no or only minor repair work. The FFB and HUD have decided not to finance construction loans at this time, but anticipate expanding the program to do so at a future date.

The pilot transaction will provide permanent financing for Arverne View Apartments (formerly known as Ocean Village), which is nearing the completion of its rehabilitation phase. Arverne View is an 11-building Mitchell-Lama rental property containing 1,093 residential units, six commercial spaces and surface parking. The complex is located at 57-17 Shore Front Parkway in the Arverne section of the Rockaway Peninsula in Queens. The Corporation-financed rehabilitation by L+M Development Partners has given new life to a property that was in severe distress prior to Superstorm Sandy and that suffered extensive damage as a result of the storm. In addition, Arverne View has already satisfied many of the requirements for obtaining Risk-Sharing mortgage insurance. The Members previously approved the financing of Arverne View with Open Resolution bonds in September 2012 and August 2013.

Corporation staff and the Corporation's bond counsel at Hawkins Delafield & Wood LLP have worked closely with the Treasury, the FFB and HUD to design the nationwide program and prepare the pilot transaction.

The FFB Agreements and the Certificates of Participation

The Corporation expects to enter into two primary financing agreements in connection with the program: (1) a Master Escrow and Custody Agreement among the Corporation, the FFB and a Custodian and (2) a Master Purchase and Sale Agreement between the Corporation and the FFB.

The Master Escrow and Custody Agreement resembles a trust indenture or resolution and will govern the distribution of revenues related to the FFB-financed mortgage loans. The parties will enter into a supplement to the master agreement for each financing, akin to the execution of a supplemental indenture or resolution. Below is a summary of key terms:

1. *Certificates of Participation.* The Custodian will deliver a certificate of participation to the FFB for each loan that the FFB finances. Each certificate will evidence the beneficial ownership interest in a single loan and will not be cross-collateralized.

2. *Mortgage Reserves.* The agreement will require a mortgage reserve or other amounts to be funded with respect to each loan to cover an aggregate amount that is not expected to exceed two months of the borrower's scheduled loan payments. The Corporation anticipates financing these amounts from its unrestricted reserves.

3. *Loan Servicing.* The Corporation or another permitted entity will act as the servicer of the loans and will receive the monthly payments of principal and interest from each borrower.

4. *Distribution of Revenues.* After paying the mortgage insurance premium and servicing fee for a loan, the Corporation (or alternate servicer) will pass the remaining loan payment through to the Custodian, which will pay to the FFB: (1) the principal due under the loan and (2) the interest due under the certificate of participation. The interest due under the certificate will be at the rate that is expected to be comparable to a Ginnie Mae security as described above. After the Custodian replenishes the mortgage reserve with available revenues, if necessary, and pays any other fees and expenses, the Corporation will receive the remaining spread between the interest paid by the borrower on the loan and the lower interest amount that is payable to the FFB under the certificate.

5. *Mortgage Loan Defaults.* The Corporation will retain the traditional role of lender with respect to control of the loan documents and remedies upon default. The Corporation will covenant, in the event of a default under a loan, to timely file a claim for the Risk-Sharing mortgage insurance in order to ensure payment to the FFB.

The Master Purchase and Sale Agreement will govern the procedure for selling beneficial ownership interests in mortgage loans to the FFB. In connection with each sale of a beneficial ownership interest, a description of the loan to be sold will be attached to the master agreement. The agreement will also provide the Corporation with the right to repurchase any beneficial ownership interest sold to the FFB at any time after the 10th anniversary of its sale, regardless of whether the borrower has prepaid the loan. The agreement will allow the FFB to transfer its beneficial ownership interests only to other federal agencies.

Risk-Sharing Mortgage Insurance

As described above, the Corporation and HUD have an existing Risk-Sharing Agreement in place, pursuant to which the Corporation has sought and will continue to seek Risk-Sharing mortgage insurance on mortgage loans that are not financed by the FFB. The FFB and HUD have determined, however, that the FFB's financing requires a handful of changes to the existing Risk-Sharing terms. The two key changes are as follows:

1. *50% Risk-Sharing Percentage.* Under the Corporation's existing Risk-Sharing Agreement, the Corporation may assume as little as 10% of the mortgage insurance risk for a loan (with the balance assumed by HUD). Of the 10 loans that have firm commitments in place or that are in the Corporation's Risk-Sharing pipeline, six are such "90/10" loans; the remaining four loans are expected to be "50/50" loans. The one loan

on which the Corporation has received Risk-Sharing insurance to date is also a 90/10 loan. Under the FFB/HUD program, however, HUD is requiring all participating HFAs, including the Corporation, to assume 50% of the risk for all insured loans.

2. *Indemnification of HUD for Fraud or Misrepresentation.* The new program will require the Corporation to indemnify HUD for the total amount of any mortgage insurance claim if the Corporation has committed fraud or made a material misrepresentation in obtaining the mortgage insurance for the loan. Under the existing Risk-Sharing Agreement, HUD would cancel the FHA insurance in such a case, but it cannot do so for FFB-financed loans because the FFB is only authorized to purchase loans that are fully insured by HUD. Accordingly, instead of cancelling the insurance, HUD will pay the claim for the FFB's benefit, but will then turn to the Corporation to cover the full amount of the claim.

These changes are to be documented in a new Risk-Sharing Agreement that will mirror the terms of the existing agreement, save for the FFB-specific provisions, or in an addendum to the existing Risk-Sharing Agreement. For the Arverne View pilot transaction, the Corporation and HUD expect to enter into a new Risk-Sharing Agreement. HUD anticipates insuring all future FFB-financed mortgage loans under the existing Risk-Sharing Agreement as further amended by an addendum.

In addition, as approved by the Members in November 2011, the Corporation currently sets aside reserves equal to 20% of the insured amounts that it is responsible for with respect to loans insured under the Risk-Sharing program. These reserves are not required by the FFB/HUD program (or by the existing Risk-Sharing Agreement). Nevertheless, Corporation staff believes that it is prudent to maintain such reserves for Risk-Sharing loans that are insured in connection with the FFB/HUD program, though the percentage set aside may be reduced at the discretion of the President or any other authorized officer of the Corporation.

<u>Risks and Risk Mitigation</u>

1. *Mortgage Loan Payment Defaults.* The primary risk associated with each certificate of participation is that the borrower of the underlying mortgage loan will default on the payments due under the loan. The Corporation has no independent obligation, however, to pay the amounts due to the FFB under the certificate, as it does, for example, when it issues a bond under the Open Resolution (but to be clear, the Corporation's obligation in the bond case is only with respect to pledged revenues). If a borrower defaults on an FFB-financed mortgage loan, the Corporation or the Custodian must file a Risk-Sharing mortgage insurance claim within a certain period of time to cover the amounts due under the certificate. The Corporation's obligations with respect to its share of the total loss following such a claim are discussed in paragraph 2 below. The Custodian may also draw on the mortgage reserve and any excess revenues held by the Custodian prior to the filing of a claim. Additionally, the Corporation is under no obligation to replenish the mortgage reserve from any source other than excess revenues held by the Custodian.

   If the Corporation wishes to work out a borrower's default, the Corporation may choose to fund additional amounts to the Custodian from its unrestricted reserves. Each certificate of participation will stand on its own and will not be cross-collateralized, reducing the ease with which the Corporation may rely upon performing loans to carry loans that are in default and in a work-out. That said, spread and other excess revenues from loans that are not in default may be released to the Corporation in the ordinary course and can support the Corporation's efforts with respect to working out a loan in default. Ultimately, the Risk-Sharing program requires mortgage insurance claims to be filed within 180 days of default in most cases, and no later than 360 days from default, which limits the time permitted for a work-out.

2. *Mortgage Insurance Risk Share*. The Corporation will be obligated to cover 50% of the total loss following a claim on the Risk-Sharing mortgage insurance with respect to any loan that is financed by the FFB. Corporation staff believes that this is an acceptable level of risk given the favorable terms of the FFB financing. In addition, as discussed above, the Corporation maintains appropriate reserves with respect to its Risk-Sharing obligations.

3. *Indemnification of HUD for Fraud or Misrepresentation.* Please see the discussion under "Risk-Sharing Mortgage Insurance" above. Corporation staff believes that this is an appropriate indemnification given the FFB's requirements and the Corporation's internal controls.

Fees

The Corporation expects to service the mortgage loans that are financed by the FFB and will receive a servicing fee as negotiated in the ordinary course with each borrower.

The Corporation anticipates funding from its unrestricted reserves any costs associated with the sale of beneficial ownership interests and delivery of certificates of participation to the FFB, in an amount not to exceed 2% of the applicable mortgage loan for each sale and delivery. The Corporation expects to reimburse itself for these costs of delivery from excess revenues released by the Custodian to the Corporation.

Custodian

To be determined.

The Custodian's role under the Master Escrow and Custody Agreement will be analogous to the role of a bond trustee.

Bond Counsel

Hawkins Delafield & Wood LLP

Pricing Advisor

Caine Mitter & Associates Inc.

Action by the Members

The Members are asked to approve an authorizing resolution that provides for (i) the execution of the Master Purchase and Sale Agreement; (ii) the execution of the Master Escrow and Custody Agreement; (iii) the execution of a First Supplemental Escrow and Custody Agreement; (iv) the execution from time to time of additional Supplemental Escrow and Custody Agreements; (v) the execution of all documents necessary, useful or convenient in connection with (1) obtaining Risk-Sharing mortgage insurance on mortgage loans to be financed by the FFB, including a new Risk-Sharing Agreement, any addendum or other modification to the existing Risk-Sharing Agreement, and any related mortgage loan documents, (2) the financing agreements described in (i)-(iv) above, and (3) the delivery of certificates of participation to the FFB; and (vi) the funding, from the Corporation's unrestricted reserves, of an amount or amounts not to exceed in the aggregate two months of scheduled mortgage payments on each FFB-financed mortgage loan, to be held by the Custodian in a mortgage reserve account or such other account as permitted by the Master Escrow and Custody Agreement.

The Members are asked to authorize the sale of beneficial ownership interests in mortgage loans, which have been or will be separately presented to the Members, to the FFB pursuant to the agreements described above and from time to time as selected by an authorized officer of the Corporation. The Members are also asked to authorize a not-to-exceed interest rate of 10% per annum for each certificate of participation; however, the certificates are expected to bear interest at a fixed rate that approximates the then-current rate on comparable Ginnie Mae securities. Further, each certificate is expected to bear a lower interest rate than the related mortgage loan.

Finally, the Members are asked to approve the creation of a Risk-Sharing reserve, to be funded from the Corporation's unrestricted reserves, in an amount not to exceed 20% of the insured amounts that the Corporation is responsible for under the Risk-Sharing program with respect to mortgage loans financed by the FFB, or such lesser percentage as the President or any other authorized officer of the Corporation may determine.