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Investing in Non-putable FHA Projects

As is typically the case, trading in projects has been sporadic. Recent activity has centered on non-putables, with securities offered from 75bp-95bp over the 30-year bond, depending on dollar price. Meanwhile, the putable sector has been dormant.

With such high yields, it's surprising more investors aren't involved in non-putable projects.

Despite the large investor base for CMBS and other agency multifamily MBS, FHA non-putables have only limited sponsorship. And yet, with these wide spreads over the long bond, non-putables offer some of the fattest yields in the high-quality, non-derivative mortgage universe. Why does a government-insured mortgage have to trade at such a high yield? And why don't more investors buy these project pools?

Non-putables seem well-suited to institutions with private placement areas.

Actually, we think more investors should have projects on the menu, but only if they have the necessary personnel to support the product. FHA projects are physical delivery with fairly strict documentation requirements. Thus, project investors need personnel with the right expertise to settle the securities and manage the paperwork. This expertise could reside in the back office, private placement or real estate areas, but a portfolio manager used to running a portfolio of public, book entry securities will find the task onerous without help. Nevertheless, most insurance companies, pension funds and larger money managers should have the necessary resources in house.

Once the settlement hurdle is cleared, investors still have to deal with the supply, information and valuation issues. First, secondary trading is sporadic and new production light. Therefore, investors have to plan on accumulating a position over time. Second, information flow is substandard compared to other agency or nonagency sectors. This is another area where the portfolio manager can leverage other resources, for example, in the back office or real estate department. In fact, loan level information is usually obtainable, but someone needs to spend time with a servicer or third party provider.[3] Third, FHA non-putable projects are long-term (30- to 40-year original terms), fully-amortizing multifamily mortgages *without* yield maintenance provisions. Most of the non-putables in the market are 10 to 15 years seasoned. Although there are lock out provisions and prepayment penalties, as well as prepayment prohibitions associated with Section 8 rental subsidies, seasoned FHA projects are not call protected for most of their remaining life, in contrast to the vast majority of other multifamily and CMBS structures.

Valuing non-putables is a challenge because of prepayment uncertainty.

Non-putables are *not* for investors who need to know the duration of their holdings to the nearest tenth of a year. Effective durations and convexities of these pools cannot be accurately estimated for two reasons: 1) uncertainties surrounding Section 8 (see below) and, 2) the refinancability of the underlying mortgages depends on the quality/viability of the property and cannot be modeled. Still, investors can value the security on a yield-to-worst basis, as well as using scenario analysis to bracket potential average lives and yields. Furthermore, if investors purchase the project loans at a discount, an early payoff will enhance the yield and widen the spread, as long as the yield curve is upward sloping.

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[3] One such third-party provider is U.S. Select. Our thanks to Rodney Brown of U.S. Select for his input to this article.

We cannot project with certainty what will happen to mortgages with Section 8 rental subsidies. What we do know is that under current legislation (which expires 9/30/97), no expiring contract for Section 8 subsidy can be renewed for more than 120% of local "fair market rent" (FMR). This may pose some default risk for properties with subsidies significantly in excess of 120% FMR, but taxpayers will still be on the hook for the bulk of Section 8 expenditures. Moreover, with many Section 8 contracts expiring in the next three years, Congress will have to increase HUD's budget authority dramatically, in order to keep paying these subsidies — even at 120% FMR.

Section 8 legislation is unlikely to be passed in the short run.

There is proposed legislation that would extricate the government from overpaying on Section 8 subsidies by "marking to market" FHA-insured project loans to a level supportable at 120% FMR. The amount of mortgage debt would be reduced, with the "forgiven" balance being paid to investors out of HUD's pocket as a partial prepayment. The sticking point is that forgiveness of debt is deemed to be ordinary income by the IRS, which has a negative impact on the borrower. Alternatives have been proposed, including changing the forgiven debt into a "soft" second mortgage that would not have to be paid off until after the first mortgage was retired. But even this option may still be deemed forgiveness of debt. The fate of this legislation is unclear, but near-term prospects of a solution appear low.

In summary, FHA projects present an investor with some major management and valuation challenges. At the same time, however, non-putables offer high cash flow yields, the full faith and credit of Uncle Sam (defaults are passed through at 99 cents on the dollar) and at least some near-term call protection (one to seven years). Given how narrow spreads are in other high-quality multifamily and commercial sectors, projects deserve a look from institutions that fit the profile described above.