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Mortgage-Backed Certificates Issued by Neighborhood Housing Services of Chicago

Neighborhoods and communities have long benefited from the work and commitment of local nonprofit housing development organizations. Yet working at the local level is not without its challenges, especially as nonprofits struggle to scale the level of their operations to reach more customers and to provide more comprehensive services.

One of these challenges is accumulating enough capital to adequately serve an organization's lending needs. The Neighborhood Housing Services (NHS) of Chicago, which has a 33-year history of financing the homeownership needs of Chicago residents in nine neighborhoods, found itself in this particular situation four years ago. Until that time, NHS replenished its loan capital by selling shares of individual loans. NHS staff spent much time tracking the payment streams of each loan in its several loan pools and the proportion of those payment streams that had to be remitted to each investor. It soon became clear that NHS required a more efficient way of maintaining liquidity in order to support its lending programs, which include loans for home purchase, home improvement, refinance,[1] and rehabilitation.

To help it find a new financing structure, NHS created an advisory committee consisting of lenders and other NHS stakeholders. Borrowing an idea from the capital markets, NHS found a new funding instrument: mortgage-backed certificates[2] (MBCs). The advisory committee recruited a law firm and a retired senior banker to help structure the funding mechanism and to produce all the necessary documents and agreements. In 2003, NHS obtained a $100 million commitment from 24 Chicago banks to purchase MBCs. This commitment enabled the $10 million line of credit offered by a syndicate of city lenders and the $3 million in community development block grants (CDBG) and private city funds to be recycled many times over.

NHS also has a related entity, Neighborhood Lending Services, Inc. (NLS), which is a nonprofit, state-licensed mortgage lender. Under this new funding mechanism, NLS originates loans with capital drawn from the line of credit and holds the loans in its own portfolio until the individual loans can be placed into an MBC and sold to investors. NLS has contracted with a local financial institution to service all of its own portfolio, as well as all loans placed into the MBCs. NLS normally holds the loans in its portfolio for two to three months or until any rehabilitation work attached to the loan transaction is completed — a process that can take up to 12 months. Loans that conform to agreed-upon underwriting criteria and have no delinquencies are eligible to be assigned to an MBC. Once NLS determines which loans are appropriate for certification, investors are given a five-day notice of impending sale, and on the day before the sale, a lock is placed on the mortgage accounts that make up the certificate in order to determine the precise principal and interest of the loans that make up the certificate. After the sale is executed, NHS/NLS uses the infusion of capital from the sale of MBCs to pay back the line of credit it initially used to originate loans.

According to Jim Wheaton, deputy director of programs and strategy at NHS, one major factor contributing to program efficiency is the use of the industry-accredited servicer MB Financial Bank to service the loans and pay the investors. NHS had previously carried out these functions in-house but outsourced them with the creation of the Neighborhood Lending Program (NLP) in 2003. The NLP serves as the umbrella for a variety of NHS's loan programs.

The sale of MBCs has allowed NHS to achieve a number of efficiencies: MBCs streamline an organization's secondary-market operations because investors purchase pro-rated shares of the certificate, as opposed to shares of the individual loans that make up a loan pool, decreasing the number of transactions involved; MBCs generate larger amounts of capital for an organization's lending program; and MBCs enable an organization to leverage its current relationship with area banks. For example, NHS offered this investment opportunity to banks that have historically supported its programs through contributions or participation on advisory committees or on NHS's board of directors. In exchange, the banks help NHS rebuild and stabilize neighborhoods in which the banks can make future investments and gain new deposit and loan customers. In addition, the banks have a loan or investment in NHS for which they can claim CRA credit.[3]

In its 2003 certificate series, NHS received commitments from 23 investors totaling $100 million for a three-year period. The smallest investor committed to purchasing

NOTE: Footnotes are on back.

1 percent of the certificates ($1 million) and the largest investor committed to 9 percent of investments ($9 million). Investors paid a 5 percent premium for the MBCs: 1.5 percent was used for a loan loss reserve established to cover losses in the event of default, and 3.5 percent served as an administrative fee to support NHS. From this sale of mortgage-backed certificates, NHS originated 980 loans for a total dollar amount of $82 million.

In its 2006 certificate series, which will continue until early 2009, NHS received a similar number of three-year commitments totaling $100 million. At the mid-point of the commitment period, NHS had drawn on more than half of the total committed capital to replenish its loan fund. The premium in the 2006 series was reduced to 3 percent, and investors were given the option to contribute to the loan loss reserve, with only two investors electing to contribute.

More than just another way to raise capital, this innovative funding instrument has given NHS regular and steady access to capital, enabling it to focus on a broad and comprehensive approach to tackling neighborhood problems. But Wheaton sees NHS's new secondary-market instrument as only one of many tools serving community residents. In addition to pre-purchase and post-purchase education, one-on-one counseling, and loss mitigation assistance, NHS, through its well-known Home Ownership Preservation Initiative (HOPI) and this funding stream, reclaims foreclosed homes to preserve neighborhoods.

Purpose	To replenish the capital of the Neighborhood Lending Program (NLP) of the Neighborhood Housing Services (NHS) of Chicago, for the origination of loans for home purchase, home improvement, refinance, rehabilitation, and foreclosure intervention.
Investment Vehicle	Mortgage-backed certificate (MBC)
Certificate Characteristics	Certificates typically have a face value of $7 million to $9 million; are secured by loans with terms that range from 5 to 30 years; and contain no more than 35 percent of subordinate loans.
Eligible Investors	Mortgage-backed certificates are offered to investors[4] who have historically supported NHS and its programs.
Length of Commitment	Investors commit funds for the purchase of MBCs for a period of three years.
Length of Investment	Collateralized by a pool of loans with terms ranging from 5 to 30 years, the investment can continue for up to 30 years.
Size of Investment	NHS raises a total commitment of $100 million for each series of MBCs, with individual investors investing anywhere from 1 percent to 11 percent of the total certificate.
Price	Investors paid a 5 percent premium on their commitment in 2003 and a 3 percent premium in 2006.
Yield	NHS's yield target is 50 basis points above the weighted average on Fannie Mae's 15-year fixed-rate note; however, NHS has historically exceeded its yield target by 75 or more basis points.
Loan Loss Reserve	In 2003, 1.5 percent out of the 5 percent premium paid by investors was contributed to a loan loss reserve. In 2006, the premium was reduced to 3 percent, and contributions to the loan loss reserve were made optional.
Servicing	A rated servicer both services the loans and acts as trustee for the investors.
CRA Test	Historically, investors have received CRA credit for their investments; however, investors should contact their regulatory agencies for more specific information on CRA eligibility.
Loan Underwriting Loan-to-Value Ratio	First-mortgage loans have a maximum LTV of 80 percent. Subordinate loans may have a total LTV of up to 105 percent of the improved value or 120 percent CLTV for loans that include home rehabilitation.
Debt-to-Income Ratio	Borrowers' total debt ratios are targeted at 40 percent of gross monthly household income, although debt ratios can go up to 45 percent with compensating factors.
Credit Performance	Credit scores are not used to determine the credit decision. Recent credit performance and documented explanations are taken into consideration.
Income Stability	Borrowers must have 24 months of documented income.
Program Performance	At the end of the second quarter of 2007, the 2003 series had experienced less than $350,000 in chargeoffs, and the 2006 series had no chargeoffs. Delinquency (30+days) rates on the 2003 series and 2006 series were 3.3 percent and 2.75 percent, respectively.
Program Information	Jim Wheaton, Deputy Director, Programs and Strategy, Neighborhood Housing Services of Chicago, 1279 N. Milwaukee Avenue, 5th Floor, Chicago, Illinois, 60622; (773) 329-4108; jwheaton@nhschicago.org

[1] *See the* Technical Brief *on NHS' Neighborhood Ownership Recovery Mortgage Assistance Loan (NORMAL) program, at http://www.philadelphiafed.org/cca/capubs/tbriefs3.pdf.*

[2] *Mortgage-backed certificates are securities that derive their value from some underlying collateral — in this case mortgages — and are sold at a premium to investors. In return for their investment, investors receive a monthly payment stream of principal and interest stemming from the pool of mortgages that comprise the certificate.*

[3] *For more specific information on CRA eligibility, investors should contact their regulatory agencies.*

[4] *These investors are Chicago-area lenders with whom NHS has cultivated relationships.*

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