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The Federal Housing Authority (FHA) Project Market

Introduction

The market for Federal Housing Authority (FHA) multi-family home loans represents a large sector of the secondary mortgage market, with an outstanding balance of approximately $40 billion. These loans have characteristics quite distinct from the traditional single-family mortgage market. This report provides an overview of these programs and their characteristics as investments.

The FHA Multifamily Insurance Program

The FHA was created under the National Housing Act of 1934. Developed initially to attract credit to the housing market, the programs primary function has been to enhance the nations multifamily housing stock. To facilitate both the construction and maintenance of multifamily projects, the FHA provides insurance on the financing of construction, purchase and rehabilitation of rental housing projects, condominiums and cooperatives, as well as the refinancing of mortgages on such units.

FHA insurance typically provides coverage of 85%-100% of the value of the project with owners' equity making up any amount under 100%. The mortgagee must be an approved lender by both the Department of Housing and Urban Development (HUD) and the FHA. Mortgagors can be mortgage bankers, commercial banks, savings and loan associations, trust companies, insurance companies and/or pension funds. The types of projects covered under the HUD/FHA mortgage insurance program include hospitals, healthcare facilities and housing for the elderly and handicapped as well as traditional multi-family housing for families.

Programs

Since its introduction in the early 1930s, the FHA has introduced a vast number of HUD/FHA insurance programs to serve different purposes. Each of these programs is referred to by the section of the housing act under which it was authorized. Given the inherent variations in purpose, each program will have different guidelines and restrictions. These differences will have an impact on the amount of issuance as well as the investment characteristics of the securities which these loans support.

The following is a brief overview of selected FHA programs:

Section #	Inception	Description	Form of Payment if Assigned to HUD	Comments
207	1934	Multi-family Rental Housing (Middle- to Upper Income)	Cash or debentures	Not a significant force in the market today but considered a prototype for later programs Drawbacks to 207: (1) a value-based program and (2) no
213	1950	Cooperative Housing	Cash or debentures	—
221(dX3)	1954	Rental and Cooperative Housing for Low-to Moderate-Income Households	Cash	Two distinct groups of outstanding (dX3) loans: (1) below market interest rate (BMIR) loans, and (2) market rate loans.
221(dX4)	1959	Rental Housing for Low-to Moderate-Income Households	Cash	No BMIRs in the (dX4) program. The (dX4) program is one of the largest of the FMA Project programs.
223(f)	1974	Existing Housing for Moderate-to High-Income Households	Debenture	Facilitates purchase and refinance of existing projects. Currently a coinsurance program (lender and HUD share the risk in event of default).
231	1959	Rental Housing for the Elderly and Handicapped	Cash or debentures	—
232	1959	Nursing Homes and Intermediate Care Facilities	Cash or debentures	—
236	1968	Rental Housing for Low-to Moderate-Income Households and the Elderly	Cash, unless the mortgagee files a written request for payment in debentures.	Interest rate subsidy plan. Interest subsidies to be passed to tenants in the form of lower rent. There is a 40-year prepayment "lock-out" on nonprofit 236 loans and on limited dividend 236 loans with rental supplements and a 20-year "lock-out" on limited dividend loans without rental supplements.
242	1968	Hospitals	Cash or debentures	—

Investment Characteristics

There are two major events which can affect the performance of these securities. The first is the ability of the mortgagor to prepay and thus unexpectedly shorten the maturity of the security. The second is default, which again, shortens the security but can also affect the investor through the amount and type of proceeds received from HUD.

Prepayments

Loans in all programs can be prepayed without approval from HUD 30 days after notification by the mortgagor to the mortgagee, except in programs 221(d)(3) and 236. For loans in the 221(d)(3) program prepayments can only be made with HUD approval. Additionally, most loans in this program carry below market interest rates (BMIR), further reducing the incentive to refinance. Loans in the 236 program also have interest rate subsidies which are passed through to the tenants in the form of lower rent. These loans have a 40 year "lockout" from prepayments because of this subsidy. While there are no BMIRs in the 221(d)(4) program, it does have rent subsidies like the (221(d)(3)) program, and loans originated before November, 1983 may include a very unique "put" feature which allows the investor to exchange the loan certificates for a 10-year FHA debenture with a current market interest rate, for one year after the securities twentieth anniversary.

These features can create securities which are highly protected from prepayments due to the lockout and/or low interest rates which typically accompany the underlying loans. Furthermore, the put feature is a hedge against rising interest rates, giving an investor the ability to sell the security at an above market price and reinvest the proceeds in a higher yielding asset.

Defaults

Upon default of an FHA project loan the loan is assigned to HUD and the securities can be retired by repayment of the principal balance with cash, the issuance of new debentures in lieu of the FHA project loan, or a combination of both as determined by the HUD Commissioner at time of payment. The new debentures will have a 20 year maturity and will have a coupon similar to the coupon of the initial FHA security. Of all FHA programs only the 221 and the 223 programs must pay either cash or issue a debenture. The 221 program receives cash and so can be viewed as a prepayment, while the 223 program will receive only debentures. Investors must be aware of how they will be prepayed due to changing market conditions. If cash is received reinvestment rates may be lower than at the time of the original investment, thereby reducing returns. If new securities are received, the maturity of the securities may be different than the securities which were redeemed, producing a different interest rate exposure than originally planned.

The stability of these securities due to the prepayment protection and the government guarantee may produce superior return characteristics versus similar government and corporate securities. Below is a table of scenario returns, showing the performance of securities under rising and falling interest rate environments.

Total Rates-of-Return

			Int Rate Change						
Security	Dur		-150	-100	-50	0	50	100	150
UST 8 6.50 10/06	6.9		16.4	13.2	9.98	6.9	3.8	0.85	-2
Merrill Lynch 7.00 3/06	6.7		16.2	13.2	10.3	7.4	4.6	1.9	-0.8
FHA Project Note	6.7		16.9	13.8	10.7	7.7	4.7	1.95	-0.6

As shown above, the FHA Project Note outperforms equal duration securities in all scenarios due to the prepayment protection which allows the security to participate fully in a rally, while earning higher yields in a sell off.

Conclusion

FHA project loans have very unique features which may, on occasion, make them very attractive investments. Few if any mortgage securities have the agency credit quality, high yields and stable investment profiles of FHA project loans. Vanderbilt analyzes both the prepayment and default aspects of these securities to find the most attractive opportunities. We then use these securities in various forms to increase yields in the portfolios while also increasing the credit quality and performance of the portfolios.

Vanderbilt Research Team

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Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than $300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as *The Journal of Forecasting*, *The American Economist* and *The Journal of Fixed Income*. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

Emad is an FINRA Arbitrator. He is also a member of the National Association for Business Economists and The Economic Club of New York. Emad served as an adjunct professor at the University of Kansas and St. John's University.

Emad holds a Bachelor of Science from the University of Albany, and a M.A. and Ph.D. in Economics from the University of Kansas.