# FHA PERFORMANCE REPORT
# MORTGAGE LOAN SALES

## HAMILTON SECURITIES ADVISORY SERVICES, INC.

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## ♣ BACKGROUND ON HAMILTON

Hamilton was established in 1991 to capitalize on new opportunities being generated by changes in real estate finance. Hamilton's founders became convinced that new technologies presented bold new opportunities to rebuild communities. We began to see how housing could be a delivery point for helping people get the education and job training they need to start down the path towards self-sufficiency. And we felt these changes provided an opportunity to build a successful business.

From the outset, we described Hamilton as a *two-test* firm. That means investments of time and money must meet two criteria . . .

*value for the community*
and
*value for the firm*

Every dime of capital in Hamilton has come from the firm's employee-owners. No Wall Street firms, investment banks or institutional lenders have provided investments, loans, or any other kind of financing. Entrepreneurs interested in the long-term play were attracted to the company and cash flow has constantly been put back into operations. By company policy, the highest salaries in the company are $125,000 per annum. The firm has not paid cash bonuses or otherwise had agreements that put cash in the employee-owners' pockets.

At year-end 1996, Hamilton had 47 shareholders and employees. Another 18 employees had been hired by *e.villages*, a data servicing company launched in 1995 by Hamilton and Adelson Entertainment.

Hamilton has served about two dozen financial advisory and broker dealer clients - including federal, state and local government agencies; nonprofit entities; and private corporations and investors. In one way or another, each assignment was undertaken to improve our position, our knowledge and our basic understanding of the future of community development and housing.

## ♣ MORTGAGE SALES: ADDRESSING FHA'S VULNERABLE AREAS

HUD is best known to most Americans by its mission:

*to build strong communities and*
*ensure the availability of decent, safe and affordable housing*

Through its primary agency - the Federal Housing Administration (FHA) - the Department oversees a $400 billion portfolio of mortgage insurance, assigned mortgages and properties, on single family, apartments, nursing homes, and hospitals. FHA is the world's largest insurer of home and apartment mortgages.

All mortgage insurers experience some loan defaults resulting in demands for payment of the insurance claim. Upon payment of the claim, the insurer then "owns" the loan. During the 1980s, the number of defaulted FHA mortgages grew substantially and by 1993, the Department had inherited enough troubled mortgages to house a medium-sized city. The backlog included 2,400 multifamily mortgages and 95,000 single family mortgages - with a balance owed to the government of about $11 billion. The inventory was so large that it was consuming the scarce resources just to service the troubled loans. The larger mission of overseeing the multi-hundred billion dollar insured portfolio was taking a back seat. Servicing the mortgages was costing taxpayers millions of dollars each year. ***This was the ultimate "lose-lose" situation.*** The public has seen time and again that a government entity cannot service complex, past due mortgages. But attempting to do so continues to take time away from other important functions.

HUD's Office of Inspector General and FHA's outside accounting firm both found the huge inventory of past due mortgages in the portfolio to be a "material weakness." To remedy the situation, Congress authorized the Department to launch a program to sell the mortgages. To date, 16 sales have been conducted; additional sales are in process and still others are on the drawing board. Hamilton has served as HUD's financial advisor since the inception of the mortgage sales program in 1993.

## ♣ MORTGAGE LOAN SALES: A REPORT CARD

| *As of June 1997* | |
|---|---|
| Single Family Mortgages Sold | 79,000 |
| Multifamily Mortgages Sold | 1,200 |
| Title 1 Manufactured Housing Loans Sold | 16,000 |
| Title X Land Development Loans Sold | 11 |
| Number of Sales Held | 18 |
| Number of Winning Bidders | 100 |
| Number of Bids Submitted | 2,000 |

- Since 1993, almost 100,000 mortgages have been sold. HUD's backlog of mortgages has been cut by more than half, and staff can again focus on the job they were hired to do – build better neighborhoods, provide affordable housing, and protect the taxpayers' investment in HUD's portfolio.

- The sales have generated almost $2 billion in profits that are being used for housing programs and deficit reduction. Congress has authorized $520 million of those savings for use by HUD for new multifamily insurance and other programs.

- The mortgage sales have improved the capital strength of the FHA Fund – and in so doing helped to preserve mortgage insurance at low cost for first-time home buyers.

- Nearly 1,200 multifamily mortgages have been sold back to the private sector, which has far greater flexibility to attend to the assets and the needs of individual properties, to the benefit of residents and the surrounding community.

- The fair and professional conduct of the sales established HUD as a strong and credible player in the marketplace. About 500 bidders have submitted more than 2,000 bids in these sales. The winning bidders have included large institutions, regional and small firms and some defaulted borrowers.

- The mortgage sales program has been widely recognized as a leader in government reengineering. The program received a Hammer Award from Vice President Gore's National Performance Review Committee. The sales team's achievements were also highlighted in the Administration FY1997 budget. In light of HUD's success, Congress directed the Office of Management and Budget and the individual federal departments and agencies to report on their own potential loan sale opportunities.

- The expertise necessary to sell mortgages has been transferred to HUD career staff to ensure a mortgage build up never recurs. That same technology is also helping HUD reengineer other outdated housing programs. Beyond HUD, other government agencies, too, can benefit from the mortgage sales technology invented at HUD.

- A representative of the HUD Field Office in Atlanta recently wrote to HUD Headquarters describing the impact of the mortgages sales on her staff:

  > "We had 36 mortgages sold. This has been a tremendous relief for our staff. Prior to the sales, we executed 13 or 14 Workout Arrangements. These are very, very time consuming. Had it not been for the sales, we would have had to review workouts on most all of these properties as they were all in default.
  >
  > The asset managers that previously worked on these properties were able to then concentrate on other properties in the portfolio and were actually assigned additional properties, thereby lessening the workload on other asset managers.
  >
  > Sales are a much quicker alternative to defaulted/assigned mortgages than foreclosures. Foreclosures also take a lot of work hours to bring to a closure. Even though we have had excellent results in recouping dollars in foreclosure sales in Georgia, the mortgage sales actually had even better results. From a Field Office prospective, it takes much less time for a sale than a foreclosure, which then decreases the HUD-Held defaulted inventory, thus creating additional time for other asset management functions to, hopefully, prevent other defaults."

- HUD's innovative marketing techniques enabled the sales program to achieve new standards of fairness and breadth, not to mention a new measurement standard for *lowered costs* (to both buyer and seller)

- HUD's pioneering use of trust structures and securitization technology has given the Department important tools that can be applied to reengineer more of the its portfolio on highly competitive terms - while simultaneously fulfilling public policy goals and commitments to tenants.

- A 1995 Barron's story on the mortgage sales program may have most aptly captured the program's accomplishments. Its headline read: "Believe It Or Not, HUD Does Something Right For Taxpayers." More than 50 articles about the mortgage sales program are available for reading on the FHA Loan Sale Information website at http://www.fhaplace.com. A selection of those articles appears in Appendix B.

## ♣ SUMMARY OF HAMILTON'S ASSIGNMENTS FOR HUD: 1993 - 1996

| Contract / Prime | Assignment | Time Frame | Task Order |
|---|---|---|---|
| HC-18161 / Hamilton | Financial advisor on sale of Section 221(g)(4) multifamily mortgages | 1993 | 001 |
| HC-18161 / Hamilton | Financial advisor on sale of Section 221(g)(4) single family mortgages | 1993-1994 | 002 |
| HC-18161 / Hamilton | Development of multifamily disposition plan, called the MAP | 1993-1994 | 003 |
| HC-18161 / Hamilton | Design/implementation of pilot sales of subsidized mortgages to state housing finance agencies<br><br>Analysis of the Section 8 portfolio and consulting on policy alternatives | 1995-1996 | 004 |
| HC-18161 / Hamilton | Financial advisor and due diligence support on sale of multifamily mortgages in the SE | 1994-1995 | 005 |
| HC-18161 / Hamilton | Support for FNMA reassignment; design of sales; marketing | 1994-1996 | 006 |
| HC-18161 / Hamilton | Financial advisor on sale of multifamily mortgages in the West and South | 1995-1996 | 007 |
| HC-18161 / Hamilton | Disposition analysis of the Section 530 premiums | 1995 | 008 |
| HC-18161 / Hamilton | Financial advisor on two single family sales | 1995-1996 | 009 |

| Contract / Prime | Assignment | Time Frame | Task Order |
|---|---|---|---|
| HC-18161 / Hamilton | Support for building relationships between FHA and rating agencies | 1995 | 010 |
| HC-18410 / Williams Adley (Hamilton as subcontractor) | Design/implementation of the first structured transaction of partially subsidized multifamily mortgages | 1995-1996 | 004 |
| HC-18410 / Williams Adley (Hamilton as subcontractor) | Financial advisor for sale of performing multifamily mortgages | 1995 | 005 |
| HC-18410 / Williams Adley (Hamilton as subcontractor) | Consulting on credit reform issues and exploration of value of developing template models to estimate the credit subsidy of mortgage sales | 1995 | 006 |
| HC-18410 / Williams Adley (Hamilton as subcontractor) | Consulting for the financial advisor on the sale of Title I loans | 1995 | 009 |
| HC-18437 / Price Waterhouse (Hamilton subcontractor) | Multifamily product market, pricing and design support | 1996 | 002 |
| HC-16986 / Coopers & Lybrand (Hamilton subcontractor) | Services and support in development a computer-based model to evaluate HUD's portfolio | 1995 | 009 |
| HC-18505 / Hamilton | Financial advisory crosscutting services on $400 billion portfolio and mortgage sales | 1996-1998 | 001 |

## ♣ THE FIRST FINANCIAL ADVISORY CONTRACT: SEPTEMBER 1993:

In February 1993, Hamilton received a call from an attorney at Dunnells and Duvall (now Holland and Knight) informing us of a newly issued HUD Request for Proposal (RFP). The RFP sought a financial advisor to assist HUD in the sale of Section 221(g)(4) single and multifamily mortgages, as well as provide other housing advisory services.

While the solicitation's primary focus was to assist HUD in carrying out Section 221(g)(4) sales, the scope also anticipated future sale or refinancing of HUD-held mortgages. Hamilton's bidding team included three subcontractors: Samuel A. Ramirez & Co., Asset Strategies Group, and Coopers & Lybrand.

The solicitation specified that the assignment would be performed under a variety of different task orders issued by HUD. Separate scope and pricing negotiations would be undertaken for each task order. Two sample task orders were included as part of the RFP - covering the sale of multifamily and single family Section 221(g)(4) "put" mortgages. The RFP offered three pricing options: (1) cost-plus fixed fee; (2) time and materials; and (3) flat fixed fee. Hamilton proposed cost-plus fixed fee for the two sample task orders included in the RFP.

After a nine month competitive process, Hamilton won the procurement and signed the contract with HUD on September 30, 1993. The contract initially authorized up to $5 million in services over a four-year period.

A HUD response to an October 1996 letter from Senator Lauch Faircloth (R-NC) provides additional detail on the competition for that first financial advisory contract. In that letter, HUD notes that it received 9 proposals from competitors seeking the assignment. A Source Evaluation Board reviewed the proposals and determined that two firms, including Hamilton, were in the competitive range. The two firms submitted Best-And-Final offers and participated in oral discussions with HUD representatives. The Source Evaluation Board reviewed the offers and recommended Hamilton's selection.

## ♣ EARLY SALES SET THE STAGE

### • *Multifamily Section 221(g)(4) Sale: October 1993*

Because the first Section 221(g)(4) sale in the RFP was scheduled to occur only three weeks after the signing of the contract, Hamilton's role in support of that sale was small.

- *Single Family Section 221(g)(4): A Credit Reform "First"*

Hamilton's role as financial advisor in the March 1994 sale of single family Section 221(g)(4) mortgages was far more substantial. The sale included 15,000 single family (g)(4) notes and ten land development loans issued under the Title X program. These Title X loans were among the most troubled in HUD's portfolio.

The Department had held Section 221(g)(4) mortgage sales in the past. Provisions in the program permit lenders to "put" these mortgages back to HUD after 20 years and be paid at par. HUD's practice was to gather "put" (g)(4) mortgages and then conduct "reflector" sales - so named because the mortgages were not technically assigned to HUD. The Department's most recent Section 221(g)(4) sales had been held in 1988.

This Section (g)(4) sale, however, was noteworthy. It was HUD's first asset sale covered under the Credit Reform Act of 1990. To comply with that law, the Department had to prepare special "credit reform" models and analyses. Hamilton assisted HUD in this preparation. The process is overseen by the Office of Management and Budget (OMB)

Congress passed the Credit Reform Act to establish controls on federal insurance and loan guarantee programs. The 1990 Act, authored by Richard Darmen, required federal agencies to estimate and budget for potential defaults and losses on the loans they insured or guaranteed. OMB regulations accompanying that law provided a methodology for valuing government-held assets.

The credit reform process required HUD and OMB to calculate the value of HUD's mortgages if they were to remain in the government's inventory. Any sales proceeds generated above this value would be scored as budgetary savings - also known as "negative credit subsidy." The law permits Congress to use negative credit subsidy to fund other initiatives or apply to deficit reduction. Credit reform works the other way, too. If sales over a fiscal year net less than the value of the mortgages if HUD had kept them, the Department would pay the difference back to the US Treasury.

In determining the credit reform number, OMB requires that the analysis be based on the net present value of anticipated cash flows from the mortgages based on historical collections (not counting administrative expenses).

The results of the March 1994 sale were an early harbinger of how much friendlier the market climate had become for government asset sales. This realization quickly proved to be a major impetus in the design and implementation of the mortgage sales program.

## ♣ Designing The Sales Program

- *The Multifamily Action Plan*

As Hamilton was assisting HUD in its March 1994 single family Section (g)(4) sale, the Department requested Hamilton also to analyze options for managing and disposing of the Department's 2,400 HUD-held multifamily mortgages. Hamilton prepared a Multifamily Action Plan (MAP) that would go on to serve as a strategic framework to help guide HUD in the design of its sales program. The preparation of the MAP was performed under a task order especially designed for that purpose - Task Order 003.

Completed in mid-1994, the 200+ page MAP provided a wide range of detail on HUD's mortgage portfolio, illuminated many of the key decisions that would have to be made in selling the mortgages, and offered background to evaluate HUD's options, including the asset management and disposition experience of other agencies and private firms. The MAP did not recommend a course of action - but it clearly justified the case for disposition of the mass of defaulted HUD-held mortgages.

*Task Order 006*

Hamilton performed the preliminary design work for many facets of the sales program under Task Order 006. This task order was broadly written so as to allow HUD to request highly varied assistance. The scope of work provided for multiple meetings and briefings, memos on key sales issues, policy papers, and a mortgage sales information and marketing campaign. As sales "researched" under Task Order 006 moved from the conceptual stage to actual implementation, they were typically shifted to separate task orders. Under Task Order 006, Hamilton also assisted HUD in the reassignment of 85 multifamily mortgages to the Federal National Mortgage Association.

In designing the mortgage sales program, HUD officials built on the experience of the Resolution Trust Corporation. The RTC had played a key role in creating the nonperforming mortgage sale market through its disposition of hundreds of billions of dollars of assets inherited from failed savings and loan institutions. HUD program staff met with RTC officials, expanded on successful aspects of that program, and worked to address key the problem areas that RTC encountered - including disgruntled borrowers and due diligence and asset management contractors, financial advisors paid large fees, bidder complaints about the quality of the due diligence material, and inadequate loan stratification technology.

### ♣ DISCOVERING THE "PRODUCTIVITY GAP"

Even as HUD's sales program was on the drawing boards, it was becoming clear that the climate for government loan asset sales was improving. A "productivity gap" had developed, enabling private firms increasingly to extract more value from troubled assets than federal agencies. By 1994, the private sector was showing signs that it was willing to pay higher prices for those assets than ever before.

And there were assets aplenty to be had. Over the years, the federal government had insured or guaranteed more than $5 trillion worth of private loans through a wide array of programs - ranging from agriculture to export credits. Selling assets that the government inherited through defaults had always been one vehicle for managing the government's large credit portfolio.

Until the mid-1990s, however, such dispositions typically did not generate much in the way of incremental resources. Indeed, the government's cheaper cost of funds, among other factors, outweighed any financial advantages of selling these assets off the federal balance sheet.

The March 1994 single family 221(g)(4) sale was an early indication that the environment was shifting. More definitive proof of the productivity gap would not come until the Southeast Sale in March 1995. But even in mid-1994, it was clear that the timing might finally be right for privatization on a wider scale.

Several factors were at work to create the productivity gap:

- The RTC had created a robust new market for troubled assets - and a vibrant industry to buy and restructure them. With the RTC sales winding down, HUD's mortgage sales came at an optimal time to take advantage of this existing market before it dispersed.

- The private sector had moved quickly to embrace advances in technology that reduced the cost of managing troubled assets and expanded the options available for dealing with them. In other words, private firms had learned how to do more with these assets - and do it at lower costs.

- The private sector's standard competitive advantages over government in financial transactions had become more pronounced. The private sector had always been able to move more quickly and decisively to preserve asset values. With advanced technology, the difference in speed between a nimble private sector and a slow-moving government was even wider. Government agencies had also become far more sensitive to the growing climate of scrutiny and scandal. This hampered their already weak ability to negotiate business transactions for fear of inviting charges of unfairness or favoritism. In HUD's case, there were few alternatives when FHA-insured borrowers defaulted. The Department could foreclose or grant a workout. Operational and legal constraints made both alternatives difficult. As a result, defaulted mortgages typically remained in HUD's inventory for years -where their value plummeted.

- The productivity gap was not only evident between government and the private sector. There was also a widening gap between the most productive players in the private sector and the least productive. Asset management firms with substantial management expertise and with links to multiple capital sources brought a new world of competition and efficiency to what had heretofore been a smaller niche market of FHA and HUD buyers.

## ♣ MORTGAGES SLATED FOR SALE

From the outset, HUD involved many of its own divisions as well as outside agencies in the design and implementation of the loan sales program. This included HUD's own Office of Inspector General and Office of General Counsel, both of which had significant input and ongoing involvement in the program. Congress too, was involved from the beginning and remained a participant in the mortgage sale effort - including the passage of 1994 legislation authorizing the program. Proposed rules for the sales were published regularly in the Federal Register. At no time during the sales design or implementation process did Hamilton receive any negative feedback, complaints, questions or contract inqüiries from any of these participants.

By November 1994, HUD had largely completed the design of its mortgage sales program and outlined a schedule of sales through 1996. With Hamilton's assistance, HUD inaugurated a major marketing campaign to announce the program. HUD officials visited market participants and distributed a General Information Package. A Q&A package about the sales program was uploaded on the Internet (prior to the popularity of the World Wide Web) in a format that allowed interested parties to post their own questions. HUD's mortgage sales were among the first government asset sales ever to be digitally marketed.

- *Unsubsidized Mortgages*

HUD determined that it would sell the vast bulk of its inventory of its unsubsidized HUD-held multifamily mortgages in a series of competitive whole loan auctions, grouped for sale by geography and performance characteristics. Approximately 10-12 sales were outlined. To encourage participation by the widest potential audience of bidders in its unsubsidized sales, HUD agreed to provide the maximum amount of due diligence information on the mortgages and permit bidding on individual notes as well as pools of mortgages. In addition, HUD decided to go well beyond the traditional manner in which due diligence was made available to prospective bidders - again seeking a broader and more diverse bidder audience.

- *HUD-Held Multifamily Mortgage Inventory: 1993*

| Performance Type | Unsubsidized Mortgages | Subsidized Mortgages |
|---|---|---|
| Performing | 260 mortgages<br>$ 469 million UPB | 904 mortgages<br>$1.1 billion UPB |
| Nonperforming | 904 mortgages<br>$ 5.1 billion UPB | 273 mortgages<br>$ 533 million UPB |
| **Total in inventory**<br>2,341 mortgages<br>$ 7.20 billion UPB | 1,164 mortgages<br>$ 5.57 billion UPB | 1,177 mortgages<br>$ 1.63 billion UPB |

- *HUD Single Family Mortgage Inventory: 1993*

| | | |
|---|---|---|
| **Total in inventory** | 95,000 mortgages | $4 billion UPB |

- ***Subsidized Mortgages***

In contrast to the competitive sale of unsubsidized multifamily mortgages, HUD determined that its 1,177 HUD-held subsidized mortgages would not be sold competitively - given the nature of the underlying properties as federally-assisted low income housing. Rather, these mortgages would be transferred to public and nonprofit entities in negotiated sales.

- *Single Family Mortgages*

HUD also decided to sell its burgeoning inventory of defaulted single family mortgage loans. Such sales had been halted for several years by a legal challenge known as the "Walker" case; by 1993 the backlog was huge. Rather than flood the market with one large sale, HUD planned to sell mortgages in batches of 12,000-16,000 mortgages, in 4-6 sales.

### ♣ THE FIRST BIG EVENT: THE SOUTHEAST SALE

HUD's March 1995 sale of unsubsidized multifamily mortgages in the Southeast was the kick-off event in HUD's sales program. While it was not technically the first sale - the Fannie Mae reassignment and Section 221 (g)(4) sales had already occurred - it was the wider marketplace's first look at HUD's assets. As a result, it was particularly important that the sale go well. A key objective from the outset was to demonstrate to the markets that HUD could conduct a large and innovative auction in a highly professional manner. This would help ensure that the Southeast Sale - and subsequent sales - generated maximum proceeds. A related objective was to ensure the Department expanded its capacity to carry out future sales.

The sale took nine months to plan and execute. A range of key issues had to be addressed that would significantly affect the conduct of future sales. Among them: HUD's approach to borrower compromises (there would be none); whether or not to continue FHA insurance on the mortgages (there would be no continuing insurance); the type and level of due diligence to provide (as much as possible); and optimization technology (it would be used).

The Southeast Sale was an unqualified success. Proceeds exceeded initial projections by a substantial amount. Bidders paid nearly $710 million for the 177 mortgages in the auction. This translated to 78% of the mortgages UPB. By way of comparison, HUD was typically recapturing only about 23% of the value of foreclosed multifamily properties it sold.

HUD and OMB had estimated the value to the government of the mortgages in the Southeast Sale at approximately $290 million if they were to remain in government hands. Actual proceeds exceeded this estimate by more than $400 million.

The sale also brought much deserved public recognition to the Department for a job well done. The proceeds were so surprising to some that a rumor began in the marketplace that GE Capital, the successful bidder on a pool of 162 assets, had overpaid by $100 million due to a technical mistake and that GE would not close on the purchase. The rumor was unfounded, and GE actually closed one month earlier than was required.

- *The Southeast Sale Was Part of A Larger "Plan"*

The Southeast Sale was conceived of and marketed not as a single event, but rather one component of a larger portfolio strategy to sell approximately $6 billion of multifamily mortgages and $4 billion of single family mortgages. Moreover, the mortgage sales program itself was key element of a broader effort to re-invent HUD and create a new FHA based on principles of sound financial management.

The fact that the Southeast Sale was anchored to these larger programmatic and policy goals was a major advantage. It ensured that the sale had the support of HUD leadership and career staff, and equally important, a priority call on their attention when needed. Active support and participation in the sale by the Office of General Counsel, the Comptroller's Office and HUD's Office of Inspector General were particularly consequential.

Designing a new sales program required making hundreds of decisions and selecting among dozens of competing options. Among other advantages, the presence of a clear plan with concrete objectives helped the mortgage sale team drive toward clarity and make decisions that were as consistent as possible, even in the face of challenges.

- *Optimization Permitted Disparate Markets To Participate*

The Southeast Sale was the first federal government auction to successfully use advanced optimization techniques. Offering bidders an almost unlimited array of bidding alternatives increased competition and raised proceeds above what they would have been using other, more limited bidding methods. Optimization helped ensure a fair bidding process and created a level playing field for small and large investors alike. Through its pioneering use of a sophisticated optimization model developed by AT&T Bell Laboratories (now Lucent Technologies), the Department enhanced its credibility in the financial markets.

The marketplace of investors for nonperforming loans has typically been offered only two choices: to purchase groups of loans ("wholesale" strategy) or to purchase individual loans ("retail" strategy). The RTC consistently fielded complaints that the wholesale strategy advantaged large investors, while the retail strategy gave the edge to small investors. Through the use of optimization, the Southeast Sale enabled bidders to buy mortgages wholesale or retail -- or both.

As a result, large institutional bidders seeking pools of mortgages participated in the sale, as well as smaller investors seeking to purchase only one or a handful of mortgages.

Defaulted borrowers were also permitted to submit bids - including bids on their own properties.

By permitting investors from disparate markets to participate on an equal basis, the Southeast Sale was able to take advantage of the market for nonperforming products that was most liquid and active at the time of the sale.

The bidding community demonstrated exceptionally strong interest in the mortgages. 105 bidders submitted 707 bids. This included 215 pool bids (from 35 bidders) and 492 single asset bids (from 70 bidders). The universe of bidders was well distributed among large institutions, regional bidders, small investors and borrowers. Of the 12 successful bidders, one large pool bidder won 162 mortgages, and 11 bidders won the remaining individual assets. Every mortgage was sold.

An analysis of the Southeast Sale results show that if only pool bids had been accepted, proceeds would have been $703 million -- or $6 million less than what was actually generated by optimization. Conversely, had the auction only permitted individual bids, proceeds would have been $531 million - or $179 million less than the actual optimized results.

- *Superior and Accessible Due Diligence Lowered Barriers To Entry*

Due diligence in the Southeast Sale was thorough, accessible and inexpensive. As part of the due diligence process, databases were created in user friendly formats. These enabled potential bidders to figure out what was in the inventory - and whether or not the assets fit their bidding parameters - at far lower costs than is typical in loan asset sales. The due diligence databases, formats and protocols developed for the Southeast Sale will be used in subsequent sales.

In addition to establishing high standards of quality for due diligence information, HUD also made the materials widely available. The entrance fee to bid in the Southeast Sale was nominal. In many such sales, a substantial due diligence fee is required just to enter the bidding field -- as much as $25,000. Asset review files and related due diligence materials were made available for only the cost of reproduction - approximately $125 per file. Generally, potential bidders must physically visit a due diligence facility to complete their reviews. HUD/FHA permitted potential bidders to pick up due diligence files at a "war room" site, but also sent the files out via overnight mail to bidders at their request. In addition, detailed loan summaries and bidding information were made available free on the Internet.

- ***Strategic Communications Widened Market Interest***

The Southeast Sale was highly publicized, with marketing efforts beginning more than six months before the auction date. Communications were planned in advanced, coordinated and consistent. In addition, communications efforts were centralized and managed outside of the Department. Information about the sale was widely distributed - at no cost - so that no bidder had an advantage over another. Marketing materials were attractive, provided objective information, and were updated regularly.

The marketing effort included the distribution of more than 3,000 bidder information packages. The Southeast Sale was marketed over the Internet and over the Bloomberg Information system, a business wire service distributed widely throughout the financial community. Portfolio information on Bloomberg included current property inspection reports and color photographs of properties securing mortgages in the sale. A Q&A Bulletin Board containing more than 60 key questions and answers about the mortgage sales program was uploaded on Bloomberg and on the Internet, where interested parties could learn more about the sales and post their own questions.

The markets were initially informed of the mortgage sales program in November 1994 via a General Information Package. The package described the overall mortgage sales program, provided a two-year sales schedule and outlined general sales procedures

- ***Internal Coordination Ensured Professionalism***

The mortgage sales team demonstrated an unusually high level of cohesiveness and coordination which helped to guarantee the success of the sale. This was especially noteworthy considering the fact that coordination had to include numerous offices within Headquarters, HUD field offices, and a large network of contractors and teaming partners.

Communications by e-mail were a major factor ensurng tight coordination. Because the full sales team was "wired" - including headquarters, field office personnel and outside financial advisors, attorneys and due diligence contractors - input could be rapidly received and the information flow could be almost unlimited. Weekly meetings (with agenda and minutes) and weekly status reports (available in hard copy and via e-mail) recorded all major decisions and posted important action items for the team. This advanced communications system contributed to a process which pushed most decision making to the people who had the responsibility for implementation. Importantly, when issues or confusion did arise, the team had already established forums for resolution.

Internal coordination enabled the Department to anticipate strategic issues and challenges and manage them proactively. A prime example is the temporary restraining order filed just days before the Southeast Sale by an owner seeking to stop the auction. The team had learned of the potential suit days earlier. A response had already been prepared and vetted before the suit ever got filed. Because of this preparation, the Department handily beat back the challenge in federal court.

- *Permanent Sales Capacity Was Institutionalized At HUD*

The design and implementation of the Southeast Sale represented a significant investment of taxpayers resources. The process was intentionally designed to enable the Department to capture that investment by developing a permanent capacity to conduct mortgage sales and portfolio analysis going forward. HUD career staff and contractors worked hand-in-hand to carry out all aspects of the sale, from structuring to closing. The "bottoms up" design of the auction - combining contractors' expertise and the first hand knowledge of HUD staff - proved to be a highly workable approach.

All decisions and policies were carefully documented to ensure subsequent sales could benefit from the experience and facilitate replication. Additionally, all analysis, financial models, policy development and other technology developed for the Southeast Sale were turned over to the Department - in the form of a Design Book - for use in conducting subsequent sales.

The Southeast Sale established the technology, systems and professional networks required to manage future loan sales. It also pointed up areas for improvement in upcoming transactions. Chief among these was the need to develop a process that allowed for faster decision-making. Because financial markets can change so rapidly, delay can be costly. A protracted procurement process ate up nearly six months from the time work on the Southeast Sale was requested until negotiations were completed and work began. This delay cost taxpayers millions of dollars in lost proceeds as the value of HUD's assigned portfolio declined due to interest rate movements. The sale suggested that contracting mechanisms, in particular, needed to be streamlined to permit greater flexibility.

♣ CONSISTENT POLICY IMPLEMENTATION KEEPS SALES PROGRAM ON TRACK

One question that has arisen in connection with HUD's mortgage sales program is why the Department kept expanding its assignments for Hamilton. The reason is that Hamilton's financial advisory contract was one of the only vehicles HUD had available to keep the sales program on track during 1995.

In mid-1994, months before the Southeast Sale, Hamilton urged HUD to begin a procurement process to add additional members to its mortgage sale team - including financial advisors, due diligence contractors and legal advisors. The volume of work involved in the sales program was too large for the current team to execute going forward. HUD concurred with that assessment and initiated new procurements. However, it took until early 1996 for HUD to complete the procurement process for additional advisors.

Meanwhile, the value of HUD's mortgage portfolio was dropping because of changes in interest rates and because of the length of time the mortgages were remaining in government hands. Millions of dollars were at risk because of difficulties responding to the market environment. Delay was already proving to be expensive. For example, in the six months it took HUD and Hamilton to agree upon a scope of work and pricing for the Southeast Sale, the value of HUD's multifamily portfolio dropped by $150 million.

HUD program officials understood this market volatility and the need to move quickly and deliberately. It was also extremely important for HUD's reputation in the marketplace that the mortgage sale program keep moving on schedule. Moreover, HUD's program was premised in part on taking advantage of the market for distressed assets that had been created by the RTC. Because the RTC sales were nearing their end, HUD had a relatively narrow window in which to capitalize on this existence of this market before it began shrinking.

Hamilton's performance on the mortgage sales program in 1993-1994 had been well received at HUD. The Department had the option under existing contract vehicles to expand the amount of work it asked Hamilton to perform while HUD completed the process of securing additional advisors. HUD exercised that option and Hamilton agreed to undertake the additional assignments.

- *Williams Adley Added To Mortgage Sales Team*

In late 1994, HUD added another contractor to its mortgage sales team -- Williams Adley. Based in Washington, Williams Adley was hired by HUD - not Hamilton -- under an "8A" vehicle processed through the Small Business Administration. Williams Adley's initial assignment was to work on the Southeast Sale, providing due diligence

Subsequently, HUD awarded a number of additional task orders to Williams Adley to serve as its prime contractor on various sales. On two transactions and two advisory assignments - including the National Performing Sale and the Partially Assisted Sale - Hamilton bid competitively to Williams Adley to be its subcontractor and was awarded the assignments.

- *National Performing and West of the Mississippi Sales*

Five months after the Southeast Sale, HUD held a second in its series of multifamily auctions with the sale of 138 performing mortgages secured by properties nationwide. The mortgages carried a UPB of $286 million. Williams Adley served as HUD's prime contractor on the sale. Hamilton performed financial advisory work as subcontractor.

The sale generated proceeds of $254.7 million for the government - or almost 89 percent of the UPB. Bankers Trust Co. won mortgages on 137 of the properties, with a pool bid of 88.6% of UPB and outstanding interest. Leetsdale Western Terrace Limited Liability Co. won the mortgage on one property, with a bid of 104.6%. The sale drew 231 bids from 25 different bidders; each mortgage received at least seven bids.

In addition to being the only performing mortgage sale on the mortgage sale calendar, the National Performing sale also tested the concept of partial securitization in HUD's mortgage sales. Prior to the sale, the mortgages were taken to the rating agencies, which provided "Comfort Letters" establishing subordination levels assuming internal credit enhancement. The rating agencies' reviews were provided to the successful bidders at no additional costs. Using this approach, HUD was able to achieve better pricing than would have otherwise been possible - without having to go through the cumbersome and time consuming process of hiring an underwriter.

One month later, on September 19, 1995, HUD auctioned 158 nonperforming multifamily mortgages on properties in the Western and Southern U.S. (The sale became known as West of the Mississippi - or WOM Sale). The mortgages carried a UPB of $622.3 million. The auction generated proceeds of $385.2 million - or about 62 percent of the mortgages' UPB. The sale drew 400 bids from 73 different bidders. There were 26 successful bidders - the most in any HUD sale.

These National Performing and WOM Sales, like the Southeast Sale, continued the use of optimization. Bidders were permitted to submit bids on an unlimited number of individual mortgages and up to 20 bids on groups of assets which could consist of any combination of mortgages the bidder chose. Using the computer model developed by Bell Labs, HUD was able to determine the bid combination providing the best results.

## ♣ SINGLE FAMILY LOAN SALES BUILD A NEW MARKET

- *Single Family #1: Learning By Doing*

Work on HUD's first major single family loan sale - Single Family #1 -- began in June 1995. The sale team included representatives from HUD, as well as Williams Adley, Asset Strategies Group (ASG), Coopers & Lybrand, Singley and Associates, Saul Ewing and Hamilton, which served as financial advisor and prime contractor on the sale. The sale offered approximately 13,000 loans, with a UPB of $522 million. The initial schedule called for due diligence and document preparation to take place between early June and early August, with a sale date of September 20. The actual sale did not take place until October 25 due to delays in the due diligence process.

On September 3, ASG stopped work on the sale, alleging that it would not continue work unless HUD immediately made a series of changes in the due diligence for the sale. These issues had not been raised previously, even though ASG had been involved in the sale from the outset. There had been no irregularities in the assembly of bid packages. And the due diligence procedures, schedule, and quality controls were all comparable to those used in other HUD sales, as well as in sales conducted by RTC and the Federal Deposit Insurance Corporation. HUD told Hamilton to continue with the sale and proceed with the due diligence as planned. Hamilton asked ASG to continue working. When ASG did not respond, Hamilton replaced ASG with another firm, Utendahl Capital.

On October 25, six bidders submitted 15 bids on the loans. Because the bids collectively did not amount to a price HUD considered sufficient, the Department decided to sell only about 10,000 loans on bid day and to re-offer the remaining loans one week later. The three successful bidders for the first group of loans sold were Bear Stearns/EMC, CF/SPC 1995, and Albert Schillinger. One of the remaining bidders, BlackRock Capital, protested the decision on the grounds that BlackRock did not know that HUD would not necessarily sell all of the loans. In a letter to BlackRock, HUD noted that it had always had the right to reject any and all bids and that its objective was to maximize proceeds to the taxpayer.

In the re-offering that took place on November 6, four bidders participated; approximately 3,000 loans were awarded. The winner was the bidding group that included BlackRock. The aggregate percentage of UPB of the winning bids in the sale and re-offering was 75%.

While some critics have charged that the results in Single Family Sale #1 were not as strong as they might have been, the sale fared better than most RTC offerings and successfully laid the groundwork for very strong performance by HUD in its subsequent single family sales series. As with all new programs, the market tended to price conservatively at first. As the sales program developed, investors came to understand the cash flow on this product much better, and the prices increased substantially - from 75% in Single Family #1 to 83.5% in Single Family #2 to 90.7% in Single Family #3.

After each sale, HUD and its financial advisors conduct a "post-auction review" to determine what went well and what could be improved upon in future sales. This includes debriefing not only the sales team, but also bidders and other market participants. The post auction review of the Single Family Sale #1 pointed out two enhancements that could boost prices paid for these assets in future sales. Both enhancements were made.

The first enhancement involved the payment histories HUD supplied as part of the due diligence available on the loans. Most bidders in Single Family #1 had initially assumed that HUD's product was similar to the nonperforming single family loans sold by the RTC. In those RTC sales, the loans were typically very nonperforming. Most bidders did not pay much attention to cash flows, and focused instead on the value of the underlying collateral. To help assess that value, RTC bidders generally purchased Broker's Price Opinions (which are similar to appraisals but not as in depth). Even though the Single Family #1 marketing program stressed the fact that these loans were different from the RTC loans, it was not until after the loans were sold and serviced that the winning bidders understood how different these loans were. Many could be refinanced and/or worked-out rather than foreclosed on - which is a substantially more expensive "exit" strategy.

While much cash flow information was provided on a loan-by-loan basis in Single Family #1, it became apparent during the marketing period and following the sale that bidders needed to see monthly collection information to value the loans accurately. HUD tried to accommodate bidders immediately. Although this information existed in HUD's system, however, there was no easy way to extract and prepare the data.

In subsequent sales, HUD did provide detailed credit histories on each mortgage for a 36-month period. As a result, bids escalated substantially. A second change following Single Family #1 also contributed to higher bids in subsequent sales. HUD agreed to modify post-sale servicing requirements, which many participants had considered especially ominous.

Interestingly, neither enhancement was among those raised in ASG's recommendations. Rather, ASG had staunchly advocated supplying Broker Price Opinions for all of the loans. Because of cost considerations, HUD agreed to provide the BPOs on half of the notes in the sale. ASG also urged HUD not to use optimization on the sale, contending bidders could be confused. ASG objected to the creation of four stratifications, each with 600 mortgage loan blocks. After reviewing ASG's concerns, HUD decided to that the sales structure and optimization would go forward as planned.

- *Single Family #2: Innovations Improve Results*

In addition to providing 36-month payment histories on the loans, HUD's second single family sale on March 20, 1996 also featured other innovations. These contributed to the strong results registered by the sale. HUD sold all 16,231 loans in the auction. The sale generated approximately $140 million in budget savings - second only at that time to the Southeast Sale. The loans carried an outstanding balance of approximately $740 million. The average per mortgage balance owed was $45,000, with the largest concentrations of loans in California, Texas, Colorado and Arizona.

Among the innovations in this sale, HUD provided detailed information to potential buyers on computer diskettes and CD-ROMs to reduce due diligence costs and enable bidders to review information about the loans in their own offices. Bidders who wished could still come to HUD's "war room" to view bid files. To encourage banks to participate in the sale, HUD asked federal bank regulators to pre-review the mortgages and qualify them as eligible under the Community Reinvestment Act.

In another novel feature, HUD asked bidders on some mortgages in Los Angeles, Washington, DC and New Orleans to describe what they intended to do with the loans should they win and what impact they anticipated those activities may have on the community where the loans are located. Such information - which was voluntary and did not impact the financial bids - was to be used as market feedback in structuring future mortgage sales.

## ♣ PARTIALLY ASSISTED SALE FEATURES MANY "FIRSTS"

On June 27, HUD sold 158 Partially Assisted mortgages in a particularly innovative financial transaction known as a *structured finance.* The results far exceeded expectations. Indeed, few experts believed HUD could actually accomplish such a complex and novel transaction.

Not only did the sale raise more than $200 million for affordable housing programs and deficit reduction. The sale also pioneered a new approach for transferring assets back to the private sector - while still retaining their public purpose objectives and protecting tenants.

The mortgages in this sale were designated as "Partially Assisted" because each was secured by a privately-owned buildings that received project-based Section 8 assistance on up to 50% of the apartments. The sale was HUD's first involving mortgages on multifamily properties with Section 8 units.

The mortgages were secured by properties in 28 states and carried an aggregate UPB of $884 million. Thirteen of the loans in the pool were current. The rest were delinquent - with owners owing more than $250 million in back payments. On average, 23% of the units in these properties were receiving Section 8.

The structured finance approach that HUD used in this sale had been pioneered by RTC in its N-Series transactions. HUD pooled all of the mortgages into a trust. The trust then issued equity and debt (in the form of bonds) based on the cash flow from the mortgages. The equity and debt were sold separately to the private sector - with HUD keeping 30% of the equity as a passive interest. Under the structure, a private servicer resolves the defaulted mortgages by working out a new payment schedule with the defaulted borrowers or using other means. Once the bondholders are paid in full with the proceeds of these resolutions, HUD receives a 30% share of the remaining proceeds.

The equity piece in this sale was purchased by WHUDA General Partners, Inc., a partnership sponsored by Whitehall Street Real Estate. The debt was purchased by Condor One, Inc., a special purpose corporation sponsored by GE Capital Corp. HUD received approximately $585 million in cash from the sale.

HUD had used a "whole loan" sale format in its previous single family and multifamily auctions. It decided to use a different approach in the Partially Assisted sale for two reasons.

First, the structured finance enabled HUD to maintain an ongoing regulatory interest in this portfolio, strengthening HUD's ability to ensure that the purchasers of these mortgages fulfill their legal obligation to protect tenants and continue the Section 8 contracts. The Section 8 contracts remain in effect for their full term. As part of the transaction, the Department also issued a rule mandating that the new owners must not discriminate against Section 8 voucher holders. The trust structure legally binds the servicer of the trust to enforce and monitor tenant protections.

The second advantage of the trust structure was that it helped to guarantee that HUD would not be penalized by the mortgage-buying market's lack of familiarity with Section 8 mortgages. In designing this transaction, HUD assumed that uncertainty about Section 8 - about how to value these mortgages or deal with anticipated changes in federal assistance programs - would cause purchasers to discount their bids. Even so, the mortgages were likely to be resolved for more than the discounted price, particularly as the new owners became more experienced in working with Section 8 loans. If the mortgages had been sold in a whole loan format, that discount would be permanently lost to HUD and the taxpayers. By contrast, HUD's ability to retain a passive equity interest ensured HUD would share in the upside and mitigate the financial penalty associated with market discounting.

Another advantage of this type of sale is that it provides HUD with an important tool for managing its portfolio going forward. Finally, the ability to issue securities gives HUD the ability to tap into a far larger universe of investors - including retail buyers - than other sales structures.

- *BlackRock's Role*

HUD's Partially Assisted team consisted of Williams Adley - the prime contractor and due diligence provider - and Hamilton, which served as subcontractor and financial advisor. Assisting Hamilton in structuring this transaction as its subcontractor was BlackRock. The presence of BlackRock on the team was cited as an issue in the *US News* story because BlackRock later bid in HUD's single family auctions. Although referred to as a "Wall Street" firm in the *US News* story, BlackRock is, in fact, a highly successful money management firm - with extensive experience in structuring mortgage securities. BlackRock's work on the partially assisted transaction added substantial value.

BlackRock was hired by Hamilton to work on this sale in early 1995. Representatives from BlackRock worked out of their own offices in New York and came to Washington about once every week or two to meet with the full sales team. Several months into this effort, BlackRock informed Hamilton that it might be interested in bidding separately in Single Family #1, which was slated for October 1995. After BlackRock notified Hamilton of this possibility, BlackRock's representatives were not allowed to work in Hamilton's central facility - but instead used a separate space several blocks from our 7 Dupont Circle offices. In addition, all BlackRock representatives working on the Partially Assisted transaction were required to execute sworn statements, on penalty of criminal prosecution, that no confidential information would be transmitted or in any other way misused.

BlackRock's role as subcontractor on one multifamily sale and potential bidder in a separate upcoming single family sale was fully disclosed to HUD prior to both sales. BlackRock, like many investment firms, from time to time finds itself involved in different transactions. Bidding on a one sale and working on a completely different sale does not violate HUD's conflict of interest rules, federal regulations or contracting requirements and is consistent with the practices of the RTC.

## ♣ HUD EXPANDS ITS ADVISORY TEAM: HAMILTON BECOMES CROSSCUTTER

In early 1996, HUD completed its solicitation of other financial advisors. Four firms were selected: Hamilton, Merrill Lynch, Cushman Wakefield and First Boston. Subsequently, First Boston dropped from the advisor team and was replaced by E & Y

Kenneth Leventhal. Under the terms of the advisory agreement, assignments were to be divided among the firms on a relatively equal basis and would be parceled out by individual task orders.

Meanwhile, HUD also completed the process of securing additional due diligence and legal advisors, under separate procurements.

In March 1996, HUD issued three task orders, seeking competitive proposals from its new financial advisors to provide services respectively on two single family sales, one multifamily sale, and a Crosscutting Advisor. Hamilton bid on all three task orders and was awarded the Crosscutting Advisor assignment. Merrill Lynch won the competition to serve as advisor on the two single family sales, while Cushman Wakefield was selected by HUD to serve as its advisor on the North and Central multifamily sale. E & Y Kenneth Leventhal has been assisting HUD in its Portfolio Reengineering activities.

- *Hamilton's Crosscutting Role*

Hamilton's Crosscutting role has occasionally been mischaracterized as being some sort of "super" advisor. This is not so. Hamilton's Crosscutting activities are specifically defined in a workplan that Hamilton and HUD designed and reviewed over a period lasting several months. As Crosscutting Advisor, Hamilton does not "supervise" other financial advisors. That is HUD's role. Rather, the Crosscutting Advisor helps to ensure the policies and protocols across the various loan sales are consistent. Any one sales team tends to focus on "their sale;" it's the Crosscutter's job to spot issues that cut across sales, portfolios and departments.

Mortgage sales are only part of Hamilton's scope as Crosscutting Advisor. The workplan also spells out how Hamilton will assist HUD in several other defined areas - including budget and credit subsidy support, portfolio analysis and strategy, new product design, training and strategic communications.

- *Technology Transfer: The Design Books*

As Crosscutting Advisor, one of Hamilton's primary responsibilities is to make sure all the technology, knowledge and experience from the earlier sales are fully transferred to the other advisors and institutionalized within HUD. One way this is being accomplished is through the use of "Design Books" created for each sale. This formal transfer of all sales "technology" means that HUD pays the "invention costs" on its sales only once. It also enables those conducting future sales to build on the expertise already developed. The dollars saved by the continued technology transfer can be expected to far exceed the dollars that are actually paid out to contractors. Already, this sharing of knowledge and experience has enabled HUD to keep the costs of its mortgage sales to 50% of the average spent by RTC - even while HUD's sales are registering better results.

The Design Books are a key reason why the new financial advisors that HUD selected in late spring 1996 were able to maintain a tight sales schedule - even though the procurement of new advisors took longer than anticipated - and produce excellent results immediately.

The Design Books contain the full record of each sale - everything from marketing plans to copies of the actual bid documents. When Hamilton initially served as financial advisor on HUD loan sales, it originated the Design Books and delivered them voluntarily to HUD. This process is now institutionalized through the Crosscutting Advisor to guarantee the transfer of knowledge and experience for all sales, involving many advisory teams. By having this technology widely distributed internally at the Department, HUD is able to strengthen its own internal portfolio management and asset sale capabilities.

Hamilton has converted many of the Design Books to hyper-linked text files - like websites - which are being distributed in digital form to HUD's financial advisors and HUD staff. More than 80 copies of these "Design Books on a Disk" have already been distributed throughout the HUD field office network.

- *Portfolio Strategy Support*

As Crosscutting Advisor, Hamilton is focusing much of its attention on HUD's $400 billion portfolio of insurance in force, assigned mortgages and properties to illuminate how HUD can protect its investment in that housing and strengthen its portfolio management capacity long term. We're designing and inventing practical tools for the real world situations and helping HUD grapple with how to deal with the upcoming changes that will result from welfare reform and the changing composition of HUD housing subsidies. Examples of such analyses range from determining how to do simple property valuations for Section 8 apartments to how federal housing programs can be viewed in the larger context of overall federal spending. Sample charts showing the type of analyses Hamilton performs for HUD can be found in Appendix C.

- *An Extended Network of Support*

As Crosscutting Advisor, Hamilton is typically involved in about 20 projects and activities at HUD at any one time. About 40 Hamiltonians and additional consultants hired under Hamilton's Crosscutting contract work on various parts of the workplan. We also have an extended network of subcontractors whose services we provide through the Crosscutting task order - including Bell Labs, which provides bid optimization for all the sales (including those handled by other financial advisors); MelaNet, a locally-based website developer who maintains the mortgage loan sale website for HUD; and Edgewood Technology Services, the data management company formed by Hamilton, Adelson Entertainment and the residents of HUD's housing at Edgewood Terrace. We are presently preparing to link in Global Business Network to HUD through our Crosscutting task order to help the Department with portfolio strategy and scenario planning.

### ♣ NORTH/CENTRAL SALE PUTS HUD OVER THE BILLION MARK IN SAVINGS!

The first sale undertaken by HUD's newly expanded advisory team was the North/Central sale. Held on August 5, 1996, the auction featured 151 nonperforming multifamily mortgages, carrying a UPB of $847.2 million, secured by unsubsidized apartment properties in the North and Central parts of the US. The auction generated proceeds of $621.7 million for the government - or about 73.4 percent of the mortgages' UPB. Cushman Wakefield served as financial advisor. Due diligence was performed by Tradewinds International.

Proceeds from the North and Central sale exceeded the value-to-government number by approximately $235 million, bringing the total savings from the sales program to approximately $1.1 billion. There were 13 successful bidders.

The North and Central sale drew 678 bids from 82 different bidders. Each mortgage was sold. As in previous sales this year, bidders in the August sale were permitted to submit bids on an unlimited number of individual mortgages and up to 20 bids on groups of assets that could consist of any combination of mortgages the bidder chose.

Only weeks before the North and Central sale, HUD was notified that its mortgage sales team had been selected to receive a "Hammer Award" for excellence in reinventing government. The award was presented by Vice President Gore's National Performance Review Committee. In making the award, the Committee commended HUD for cutting red tape, empowering employees to improve service to the Department's customers, and lifting the burden of managing and servicing HUD-owned mortgages from Headquarters and field office staff.

### ♣ HUD TRANSFERS SUBSIDIZED MORTGAGES TO MISSOURI HOUSING AGENCY

In 1994, Congress passed legislation authorizing HUD to sell subsidized multifamily mortgages in the HUD-held inventory to state and local housing finance agencies and similar public entities. Because of the public purposes inherent in such transactions, the sales were to be undertaken on a negotiated basis. In 1995, HUD initiated a pilot program to test approaches for such sales. Three HFAs were selected in a competitive process for the demonstration: Maryland, Missouri and Pennsylvania. Hamilton served as HUD's financial advisor and prime contractor on this pilot. Holland and Knight provided legal support.

One pilot sale ultimately closed. In September 1996, HUD transferred 26 loans to the Missouri Housing Development Commission (MHDC). Through this process, HUD learned a great deal about how to approach the balance of its HUD-held subsidized portfolio. HUD developed a range of needed tools and policy for additional sales of this portfolio and learned how such sales could be modified and enhanced in the future. Importantly, the sale began the process of developing policies, tools and technologies that will be critical for shifting millions of poor tenants from welfare to work.

The mortgages in this Missouri sale had originally been insured under a variety of multifamily insurance programs. HUD owned 16 mortgages because the borrower had defaulted on an FHA-insured mortgage or because the lending institution making the mortgage had failed. For ten of the mortgages, lenders had "put" the mortgages back to HUD after 20 years as permitted under the program that originally insured the mortgage.

In taking ownership of the mortgages, MHDC assumed all regulatory responsibilities that had previously been borne by HUD. The Missouri housing agency will service the mortgages and enforce the tenant protections. MHDC will also administer the Section 8 contracts on the 930 apartment units in the portfolio receiving Section 8 project-based assistance.

MDHC paid the nominal sum of $10 for the mortgages. In return, MHDC assumed the responsibility for $8.4 million in repair obligations. The average estimated rehabilitation costs per unit in this portfolio is $4,100.

In a novel arrangement, MHDC also committed to spend $720,000 on initiatives that promote economic self-sufficiency for residents in these properties - including, for example, installing computer learning centers in the apartment buildings or providing on-site service coordinators. HUD agreed to a transaction structure which enables MHDC to use financial resources generated by the portfolio to fund such initiatives.

The Missouri pilot addressed multiple areas that had not previously been examined in a HUD mortgage sale:

- *First Sale of a HUD-Held Subsidized Portfolio*

The sale was HUD's first sale of subsidized mortgages on apartments which house very low income residents. As a result, HUD had to ensure that these assets remained affordable housing and that needed physical rehabilitation occurred. Unlike other loan sales where it was assumed that the marketplace would appropriately address the housing needs of residents and neighborhoods, HUD had to structure this sale so as to accomplish these goals after HUD no longer owned the mortgages. By the terms of the sale, these objectives became obligations of the purchaser.

- *Rehabilitation*

For the first time, HUD developed a standard for post-sale rehabilitation and imposed on the purchaser the obligation to use best efforts to see that rehabilitation occurred. The cost of performing the needed repairs was accounted for in the sale price to ensure the purchaser had sufficient resources to fund rehabilitation. As in past sales, environmental assessments were performed on all of the properties. For the first time in the HUD-held sales program, however, the costs of the recommended remediation were calculated in determining the sale price.

- *Retention of the Regulatory Agreements*

Because HUD's post sale legislative and policy goals for this portfolio were substantially greater than in prior mortgage sales, regulatory agreements on the mortgages had to survive the sale until the HFAs and the owners agreed on the terms of modified regulatory agreements which would meet or exceed the minimum standards prescribed by HUD. Developing this new standard and the authority to transfer the regulatory agreements were major accomplishments for the pilot.

- *Sales of Loans with Interest Reduction Payments ("IRP")*

Section 236 loans had not been sold previously in HUD's current sales program. Doing so required HUD to work through complex decisions on whether to transfer the IRP, whether such a transfer could be accomplished under existing legislation, the mechanism for executing the transfer and the method of valuing the transferred IRP. HUD also developed, for the first time, a contract provision stipulating that the IRP (and a defined portion of future Section 8 payments) were placed in a restricted account to use only for the benefit of the projects and residents.

- *Loan Valuations*

Because prior sales were conducted competitively, HUD had never been required to determine the actual values of loans or portfolios other than to set reserve prices. Here, for the first time, HUD addressed the loan valuation question and developed a methodology and model to calculate value of the mortgages. This included valuing the subsidies on the portfolio and the anticipated cost of rehabilitation. Importantly, the valuation had to account for the possibility of significant changes in the Section 8 program.

- *Resident Initiatives*

For the first time in HUD's mortgage sales program, the sale included provisions to help the residents of the properties to move toward economic self-sufficiency. HUD helped underwrite the cost of such initiatives - and helped define what they could entail. But the purchaser accepted the obligation to undertake the initiatives.

### ♣ SINGLE FAMILY SALE #3 PRODUCES STRONG RESULTS

On September 4, 1996, HUD auctioned 16,996 single family mortgages in the third in its series of single family loan sales. The notes, which were performing, nonperforming and subperforming, carried a UPB of $804.5 million. The sale generated proceeds of $730 million for the government - about 91 percent of the mortgages' UPB - the highest return of any HUD sale to date.

Proceeds exceeded by $164 million the value assigned to the mortgages if they were to have remained in HUD's hands.

The sale included a novel "place-based" component. Two of the 811 blocks of mortgages in the sale were sold separately. The two blocks, composed of 31 nonperforming loans with an outstanding balance of $1.7 million, were secured by single family homes in Albuquerque, New Mexico, with the mortgages clustered in contiguous zip codes. The objective was to test the concept of whether investors would be more attracted to purchasing a critical mass of mortgages in one area.

In another innovation, this sale limited pool bids to mortgages in only one of three asset groups: performing, non-performing and subperforming. Previously, pool bids could consist of a mixture of these types of mortgages.

The sale drew 215 bids from 25 different bidders. Each mortgage was sold. The 3 winning bidders were Salomon Brothers, CS First Boston and Berkeley Federal.

As in previous sales this year, bidders were permitted to submit bids on individual blocks of mortgages as well as combinations of mortgage blocks. Using a computer optimization model developed by Lucent Technologies Bell Laboratories, FHA was able to determine the bid combination providing the maximum return to the taxpayers. HUD's financial advisor for this sale was Merrill Lynch Mortgage Capital, Inc. Due diligence was performed by Gardiner Kamya & Associates.

## ♣ MIDWEST SALE GENERATES $300+ IN BUDGET PROFITS

HUD's 17th mortgage sale took place on December 12-13, 1996, when the Department auctioned 107 nonperforming multifamily mortgages with a UPB of $873.2 million. The mortgages were secured by unsubsidized apartment properties primarily in the Midwest region of the US, with the heaviest concentration in Michigan and Illinois.

The auction generated proceeds of $762.7 million for the government - 87.3 percent of the mortgages' UPB.

The sale brought the budget profits generated by the mortgage sales to a total of more than $1.6 billion since 1994. Proceeds from the Midwest sale exceeded the value-to-government credit reform number by approximately $360 million. Winning bidders have the option of closing either in December or January. The names of the successful bidders will be released upon closing.

The Midwest sale drew 559 bids from 62 qualified bidders. There were 13 winning bidders, 43% of whom had not previously won mortgages in HUD's auctions. All of the mortgages were sold. As in past sales using optimization, bidders were permitted to submit individual bids on all mortgages and up to 20 bids on groups of assets that could consist of any combination of mortgages the bidder chose. HUD's Financial Advisor for this sale was Cushman & Wakefield. Due diligence was performed by Tradewinds International.

## ♣ SINGE FAMILY SALE #4 REGISTERS HIGHEST RETURNS

The fourth national sale of single family mortgages, in January 1997, featured 18,894 loans, with a UPB of $1.13 billion. The sale included performing, nonperforming and subperforming mortgages. Proceeds were $1.04 billion, or about 92% of UPB. HUD's historical recovery rate for such mortgages is 70% of UPB. Budget savings generated by this sale exceeded $247 million. The sale drew 1,696 bids. There were three winning bidders.

## ♣ UPCOMING SALES SINGE FAMILY SALE #4 REGISTERS HIGHEST RETURNS

- **Health Care Mortgage Sale Planned for Summer.** FHA anticipates a Summer 1997 auction of 36 mortgages secured by nursing homes. The mortgages came into FHA's inventory through defaults. The 36 nursing home mortgages have a UPB of $141 million.

- **Single Family Securitization Under Consideration.** About 33,000 single family mortgages, with a UPB of nearly $2 billion, remain in FHA's sales inventory. The next offering of single family mortgages is planned for Summer 1997. Agency officials are considering a securitized transaction for some of the remaining inventory.

- **Multifamily Structured Finance on the Drawing Boards.** Fall 1997 is the tentative date for FHA's next upcoming sale of unsubsidized multifamily mortgages. The sale is likely to include approximately 66 apartment mortgages (UPB: $244 million) and 20 partially assisted mortgages (UPB:$58 million). A structured financing is likely.

- **Focus Shifts to Subsidized Mortgages.** With its backlog of unsubsidized multifamily mortgages nearly depleted through mortgage auctions, FHA is shifting its attention to the 847 subsidized mortgages in its inventory. The mortgages, which were insured under a variety of housing programs, have an outstanding balance of about $1.3 billion. Among its options, FHA is considering a trust structure to sell the mortgages to public-private partnerships involving private investors, government agencies and not-for-profit organizations.

## ♣ MARK-TO-MARKET/PORTFOLIO REENGINEERING

During 1995 and 1996, Hamilton advised HUD on a range of policy issues and conducted several numerical and budget analyses related to the Section 8 program. The work was carried out under two separate task orders: (1) Task Order 004, with Hamilton as prime contractor, for the design/implementation of pilot sales of subsidized Section 8 mortgages to state housing finance agencies; and (2) Task Order 004, with Williams Adley as prime, for the sale of Partially Assisted mortgages (including Section 8 mortgages).

Hamilton's initial work in 1995 included assisting HUD in the development of models to estimate the budget impact of a tidal wave of expiring Section 8 contracts and supporting HUD in the drafting of a Mark-to-Market Operating Framework, released publicly in May 1995. Over the next 18 months, Hamilton helped HUD with a variety of related analyses of Section 8 issues, including providing support for a series of issue forums in January - February 1996. Hamilton initially performed some support for HUD's Portfolio Reengineering initiative under its Crosscutting scope of work, but that assignment was completed in October 1996.

## ♣ CONCLUSION

HUD and its financial advisors have relentlessly pursued a mortgage sales process which is open and fair. The sales have succeeded in eliminating all traces of politics and preferential treatment in determining winning bidders. All types of bidders are permitted to participate in most HUD sales - not only large firms, but also small companies, regional firms, specialty investors, and even defaulted borrowers themselves.

Unfortunately, some people who benefited from the old ways of doing business at HUD are unhappy with the Department's success at reform. This includes contractors whose services are no longer required, and defaulted property owners who owed the federal government hundreds of millions of dollars in past due mortgage payments. A few opponents are actively throwing up roadblocks at every turn. Sadly, they have succeeded in commanding some attention from the media. The noise generated by HUD's opponents may continue well into 1997 - particularly if others seize upon the noise as a political opportunity to take raise unfounded criticisms at the Department or the Administration. Hopefully, this will not be the case - and HUD can continue its courageous efforts to focus on the relevant problems facing our nation and its low income populations.

We at Hamilton are extraordinarily proud of our work for HUD in support of the mortgage loan sales program and other Departmental re-engineering initiatives. Today, after 16 successful mortgage sales, HUD's backlog of troubled mortgages has been reduced dramatically, and HUD staff can again focus on the job they were hired to do - build better neighborhoods, provide affordable housing, and protect the taxpayers' investment in HUD-supported housing.

Our efforts have helped HUD eliminate a material weakness and created $2 billion in value for the American taxpayers. By anyone's performance measure, we believe this is an excellent return for HUD.

One question that has arisen in connection with HUD's mortgage sales program is why HUD kept expanding its assignments to Hamilton. The reason is that Hamilton's financial advisory contract was one of the only vehicles HUD had available to keep the sales program on track during 1995. In mid-1994, Hamilton urged HUD to begin a procurement process to add additional members to its mortgage sales team, including financial advisors, due diligence contracts and legal advisors. The volume of work involved in the sales program was too large for the current team to execute going forward. HUD concurred with that assessment and initiated new procurements. However, it took until early 1996 for HUD to complete the procurement process for additional advisors. In the meantime, HUD undertook emergency procurements to bring in additional advisory support, for instance, from Williams Adley.

## History of the IG Investigation and Political Interference

CAB

In its November 11, 1996 issue, *U.S. News and World Report* ran an article, called "Of Contacts and Confidence," (a copy of which is attached as Exhibit __) that reported allegations of irregular contracting practices at HUD involving Hamilton and aired accusations that Hamilton had steered some of the HUD note sale business to favored Wall Street firms. Prior to publication, the reporters covering the story for *U.S. News* interviewed the officers of Hamilton. During those interviews, the principal reporter, Ed Pound, told Hamilton that the HUD OIG "at the highest level" had assured him that Hamilton was guilty of criminal acts. More recently, reporters from other publications have told Hamilton that the HUD IG is personally telling reporters that Hamilton is guilty of criminal wrongdoing.

Since the fall of 1996, Hamilton has responded to repeated information requests from the HUD IG pursuant to its investigation of alleged contracting irregularities. As of this date, Hamilton has provided over one hundred thousand xeroxed pages of documents and more than 1,000 gigabytes of electronic data in a determined effort to comply with the IG's demands. Our on-going dialogue with the staff of the OIG over the past 16 months leads us to believe that the OIG's staff have yet to use this information to educate themselves about the legal, financial or management issues associated with HUD's loan sales program. We realize that this program is intellectually demanding and may require a depth and breadth of professional expertise that the HUD OIG does not possess. But this has not prevented the OIG from asking for even more information which it cannot digest or make sense of. It is also unfortunate that the OIG's lack of understanding does not prevent them from continuing to influence executive decisions within HUD and the Administration about the real costs and benefits of this program.

In recent weeks, the Department abruptly terminated Hamilton's contract at the convenience of the Government without giving the routine prior advance notice that the Department and, indeed, the Federal Government generally gives under such circumstances. Since then, the IG has issued subpoenas to Hamilton, Austin Fitts and Austin Fitts's bank, in what appears to be little more than a fishing expedition. The cost to Hamilton and the American taxpayer of complying with these demands is scandalous in itself. But the greatest danger is that the IG will allow this investigation to drag on for years without resolution, thereby crippling Hamilton's ability to operate as a going concern.

# FHA PERFORMANCE REPORT
## Mortgage Sales

### Executive Summary

The Department of Housing and Urban Development (HUD) is best known to most Americans by its mission: to build strong communities and provide decent, safe and affordable housing. But HUD also performs other vital functions. Its primary agency, the Federal Housing Administration (FHA), is the largest insurer of home mortgages in the world – with more than $400 billion in mortgage insurance outstanding.

Like all large insurers, FHA must routinely deal with mortgage defaults. Typically, the government pays the balance owed on the mortgage to the private lender, takes the mortgage into its own inventory, and assumes responsibility for collecting payments and otherwise servicing the debt.

During the 1980s, however, the number of defaulted mortgages in FHA's inventory grew substantially. By 1993, FHA had inherited enough troubled mortgages to house an entire mid-sized city. The backlog was so large that it was compromising FHA's capacity to perform its principal functions. Servicing these troubled mortgages was costing taxpayers millions of dollars and diverting staff away from more important objectives. Many defaulted borrowers had not made mortgage payments in years; collectively they owed hundreds of millions of dollars in back payments. To address the losses, Congress authorized FHA to launch an ambitious mortgage sales program.

As of mid 1997, 18 sales had been conducted; additional sales are underway. The sales are among the most visible and successful steps FHA has undertaken to strengthen the management of its investment in affordable housing.

The mortgage sales are benefiting homeowners and apartment residents. Nearly 1,200 multifamily mortgages have been sold back to private owners, who have far greater capacity and resources than FHA to improve conditions and management in these properties. Nearly 80,000 defaulted single family mortgages and 15,814 defaulted Title 1 manufactured housing loans have also been sold. Most of the single family loans sold are being refinanced or otherwise put on a sound financial basis with the current owner in place. While in FHA's inventory, refinancing the single family loans was not possible.

FHA has institutionalized an internal capacity to sell defaulted mortgages back to the private sector. This will prevent another mortgage build-up in the future.

FHA has reduced the heavy burden on its staff resulting from the servicing of defaulted mortgages. This has enabled personnel to pay more attention to FHA's healthy insured portfolio and to stave off future defaults.

The sales have generated almost $2 billion in deficit savings and funds for housing and neighborhood initiatives. These are not paper dollars. They are real resources that are being reinvested in our communities. Congress has authorized that $520 million of those savings be used by HUD for new multifamily insurance and other programs.

The fair and professional conduct of the sales has established FHA as a strong and credible player in the marketplace. More than 500 bidders have submitted over 3,000 bids in FHA's sales. The 94 winning bidders have included large institutions, regional and small firms and defaulted borrowers. FHA's use of "optimization technology" has broadened competition across disparate markets, created a more level playing field for participation in the sales, and raised proceeds by hundreds of millions of dollars.

FHA's program is widely recognized as a leader in governmental reengineering. FHA's mortgage sales team received a 1996 Hammer Award from Vice President Gore's National Performance Review Committee. The program's achievements were also highlighted in President Clinton's FY 1997 federal budget. In light of FHA's success, Congress directed the Office of Management and Budget and the individual federal departments and agencies to report on their own potential loan sale opportunities. The Administration's FY 1998 federal budget highlights FHA's success at reengineering and lays out a framework for reviewing and reforming credit programs government-wide.

This report focuses special attention on FHA's mortgage loan sale program. Launched in 1993, this innovative effort has successfully addressed a material weakness in the Department's portfolio management capabilities and, in the process, added significant value to the nation's taxpayers and communities.

## In This Report

# The Importance of Portfolio Management

## Introduction

Effective portfolio management is critical for protecting the value of the federal government's substantial investment in affordable housing. The Federal Housing Administration carries the largest single risk position of any federal credit program. Indeed, because its portfolio is so large, even small macro economic changes can have a large dollar impact, and tiny interest rate movements can change the value of FHA's portfolio by billions of dollars. This makes careful oversight a high priority.

About 85% of FHA's outstanding credit today extends to single family housing. Even so, FHA is still the largest insurer of apartment mortgages in the country. FHA's $45 billion in outstanding multifamily mortgage insurance is more than any private real estate company, more than Freddie Mac and Fannie Mae, more than any state or local government, and more than any other federal agency with property assets. FHA's insured multifamily portfolio – its condition, ownership, location and economics – is especially complicated, and its management has long-term liability and budget implications.

In the past, FHA's structure sometimes made aggressive portfolio management difficult. Attention and resources tended to focus on the individual component parts of the portfolio – i.e. multifamily housing, single family housing, nursing homes, hospitals – with less attention paid to monitoring the portfolio's performance as a whole. In recent years, FHA has taken concerted steps to strengthen its overall portfolio strategy and management.

Importantly, these steps go beyond actions that focus solely on improving the financial or management side of FHA's insured housing. New initiatives are also underway to improve the self-sufficiency and earning power of the residents of FHA-supported housing. Such initiatives are among the most effective means for protecting FHA's credit position. This type of investment is particularly important to lower the risk of losses in a changing economy and a new environment of welfare reform.

The mortgage loan sales program highlighted in this Performance Report is one of many initiatives HUD and FHA have undertaken to better manage and safeguard the federal government's housing portfolio. Highlights of other activities include:

**Reorganization Improves Efficiency.** The Department has modernized its technology and information systems and has shifted more decision-making authority closer to the action in HUD field offices. HUD has also expanded efforts initiated in the last administration to bring its credit operations more in line with the markets of the 1990s. The effort is yielding strong results. Thanks to the management improvements, FHA earned in FY 1993 its first-ever clean opinion from its auditor for its consolidated financial statements. Since that time, FHA's financial management has continued to strengthen.

**Neighborhood Networks Brings Computers to Poor Communities.** This program to create computer learning and job centers in federally assisted housing projects has spread rapidly. More than 500 centers are in operation or on the drawing boards across the country. Under the Neighborhood Networks umbrella, public and private organizations, property owners, managers and residents are being linked through computer hardware and software to each other, as well as to jobs, educational and training programs and other community building activities. The telecommunications network also offers a new opportunity to coordinate resources provided by and through multiple federal agencies, in combination with local and state and private service providers.

**SWAT Takes Over Ailing Apartment Properties.** Through its SWAT program, FHA is reengineering apartment properties that have been inadequately maintained by their owners, leaving tenants and FHA's investment at risk. By 1997, SWAT teams had analyzed more than 250 troubled properties and taken over 130 enforcement actions, affecting 17,000 families. The SWAT team has also been involved with the relocation of more than 500 families to safe and decent housing.

**HUD Tackles the Crisis in Expiring Section 8 Contracts.** Over the next few years, Section 8 contracts expire on about one million units of FHA-insured low income housing. About 2/3 of the 8,500 projects involved receive federal subsidies above market rate rents for their area. Budget resources do not exist to continue to fund these contracts at those inflated levels. Without the inflated payments, however, many owners of Section 8 properties will default on their FHA-insured mortgages, leaving the federal government liable for billions of dollars in mortgage claims. Recognizing this dilemma, HUD has put forward an innovative program to restructure the Section 8 program. The HUD plan preserves affordable housing, protects tenants and communities, and enables responsible owners to keep their properties.

**Operation Safe Home Combats Crime in HUD Housing.** These special task forces join law enforcement resources at the federal, state and local levels to fight violent crime in HUD's housing. Participating federal agencies include the FBI, Drug Enforcement Agency, Alcohol, Tobacco and Firearms, US Marshals Service, Secret Service and Department of Justice. To date, Special Agents from HUD's Office of Inspector General have participated in more than 100 task forces around the country. In many cases, entire city blocks have been cleared of violent crime and neighborhoods made safe for the low income tenants.

## The Mortgage Loan Sale Program: How it Evolved and Why

Since 1934, the federal government has stimulated investment in home ownership and affordable rental housing by insuring mortgages that might not otherwise qualify for conventional private financing. And like all mortgage insurers, FHA has always had to deal with a small but steady stream of defaults. As a result of weak real estate markets and related factors in the 1980s, the number of defaulted mortgages in FHA's inventory grew substantially.

By 1993, FHA owned almost 2,400 multifamily mortgages, with an outstanding balance of more than $7 billion, and about 95,000 single family loans, with an outstanding balance of about $4 billion. This backlogged inventory was so large that it was compromising FHA's capacity to perform its other principal functions and costing taxpayers millions of dollars to service and hold.

To address the losses, FHA received approval from Congress for an ambitious program to sell the mortgages. Under the program, single family mortgages and unsubsidized multifamily mortgages are being sold to the private sector in a series of competitive auctions. Subsidized mortgages – typically secured by properties housing very low income residents – are being transferred to state housing agencies and other public entities.

To date, 18 mortgage sales have been held – eight multifamily sales, five single family sales, two land mortgage sales and two sales of Title I manufactured housing rehab loans, and are structured transaction with a state housing finance agency. Additional sales are underway. The sales program will continue throughout 1997.

In designing the mortgage loan sales program, FHA officials built on the experience of the Resolution Trust Corporation, which had held numerous sales of distressed assets inherited from failed thrifts. FHA program staff met with RTC officials, expanded on successful aspects of that program and worked to address key problem areas RTC encountered, including unhappy borrowers and due diligence and asset management contractors, financial advisors who were paid large fees, and inadequate loan stratification technology

By building on this base of experience, FHA estimates that it has paid roughly half as much for financial advisory services on its mortgage sales as the RTC – and FHA got better results.

## The Impact on Tenants and Communities

FHA is presently gathering information on what has happened to properties whose defaulted mortgages were sold in the loan sales program. What is known is that mortgages on nearly 1,200 multifamily properties have been turned back to the private sector, which has far greater capacity and resources than FHA or HUD to attend to the needs of individual properties.

Since October 1995, nearly 80,000 single family mortgages have been sold. More research will be needed to determine the amount of reinvestment and other impacts. On the single family side, anecdotal evidence suggests that 70-80% of the mortgages purchased in FHA's auctions are being refinanced or otherwise put on a sound financial basis without foreclosing on the defaulted owner. FHA does not have the flexibility to refinance such loans, and if the mortgages had remained in the agency's inventory, a much larger percentage would eventually have foreclosed. By contrast, the new private sector owners are predisposed to refinance and less prone to foreclose because foreclosure is their most expensive exit strategy.

# The Mortgage Loan Sales Program - Accomplishments

The mortgage loan sales program has demonstrated that HUD's mission can be pursued in harmony with the private capital markets, whose powerful tools can be mobilized to serve public goals.

## Primary Results

FHA has successfully institutionalized the internal capacity to sell defaulted mortgages back to the private sector. In so doing, FHA – a government agency – has engaged and managed private sector financial resources to undertake highly complex and novel transactions for the benefit of the American taxpayer. The fair and professional conduct of the sales has established FHA as a strong and credible participant in the marketplace. All of the protocols, technology, and information needed to conduct mortgage sales have been successfully transferred to FHA.

FHA has reduced the heavy burden on its staff resulting from servicing defaulted mortgages. This has freed up staff to monitor the health of the insured portfolio – ensuring fewer defaults in the future – and to attend to the Department's other principal objectives.

Nearly 1,200 multifamily properties whose mortgages had been insured by FHA have been turned back to the private sector, which has far greater capacity to attend to the assets and the needs of individual properties, to the benefit of residents and the surrounding community.

The sales have generated nearly $2 billion in budget savings that are being applied to deficit reduction or being used to fund housing and neighborhood initiatives.

The mortgage sales have improved the capital strength of the FHA fund – and in so doing helped to preserve mortgage insurance at low cost for first-time home buyers.

## Secondary Results

FHA has illuminated a portfolio management approach that is broadly applicable across the federal credit system and can be used by other agencies to reengineer assets in their portfolios. It is currently estimated that $25 billion to $50 billion in savings could be realized government-wide from such reengineering.

FHA's sales program has helped make HUD a leader in governmental reengineering. The mortgage sales team recently received a Hammer Award from Vice President Gore's National Performance Review Committee for reinventing a process for reducing the inventory of government-owned mortgages.

The achievements of FHA's mortgage loan sales program were highlighted in both President Clinton's FY 1997 and FY 1998 federal budgets. The FY 1998 budget lays out a framework for the federal government to undertake a review and reengineering of all of its credit programs. FHA's mortgage sales are cited as an example of the savings and efficiencies that may be possible government-wide. In describing FHA's portfolio-wide reengineering efforts, the FY 1998 budget notes:

> *Downsizing is being accomplished by prudent consolidation of functions much as private sector counterparts have undergone in the last decade, along with core business process reengineering, greater use of technology, and contracting out work more efficiently performed by the private sector...Sale of defaulted single family and multifamily mortgages is another tool to reduce workload and allow a smaller staff to maintain focus...These sales have allowed FHA to cut dramatically its backlog of troubled mortgages and focus its staff on such core functions as mortgage originations and prevention of future defaults. These sales have saved $1.6 billion for the Federal Government.*

The sales have helped to re-establish FHA's reputation through positive press and demonstrated the Department's ability to act efficiently and decisively to benefit the taxpayers and communities. More than 50 articles about the mortgage loan sales program are available for reading on the FHA Loan Sale Information website (http://www.fhaplace.com).

### Process Innovations

Innovative marketing techniques enabled the sales program to achieve new standards of fairness and breadth.

Internet marketing ensured wide access to information. FHA began using the Internet in the sales program in 1994 – even before the World Wide Web had become a household word.

Digital technology provided comprehensive due diligence information at low or no cost. Interested bidders could access the data via disk or modem in the comfort of their own offices. Bidder costs were among the lowest historically for government asset sales.

FHA's use of optimization technology broadened competition across different markets, created a more level playing field for participation in the sales, and enhanced return to the taxpayers.

FHA's use of trust structures and securitization technology has given the Department important tools that can be applied to reengineer more of the its portfolio on highly competitive terms – while simultaneously attending to HUD's public policy goals and commitments to tenants.

### Answering Critics Concerns

Despite the strong indicators of the positive impact of the mortgage loan sales, some critics have claimed that the program is jeopardizing the nation's supply of affordable housing and displacing poor tenants. These charges are untrue. They tend to be motivated by defaulted borrowers and asset servicing contractors who have profited from having these mortgage's in FHA's possession.

Indeed, many defaulted borrowers had not made mortgage payments in years. In one multifamily sale this year, borrowers owed more than $250 million in back payments. Such owners typically fear that the purchaser of their mortgage will take more aggressive steps than FHA to try to collect back payments or negotiate workouts and other resolutions of the debt. There have also been some complaints from contractors who earned substantial fees servicing the assets held by FHA. To date, owners and others have filed a series of lawsuits attempting to block mortgage sales. Each of these efforts to stop the sales failed in the courts, where judges affirmed the mortgage loan sales program.

The sales are not jeopardizing the supply of affordable housing. The vast majority of the mortgage loans sold to date are unsubsidized mortgages. That is, they are secured by properties that do not house very low income people. The sale of these mortgages often brings improved conditions, as managers and owners have to pay the bills and manage to serve the residents and the community.

In September 1996, 26 mortgages on subsidized properties were transferred to a state agency, which agreed to continue to serve low income tenants. In June 1996, FHA sold 158 partially assisted mortgages to the private sector. On average, about 23% of the units in these properties receive Section 8 rental assistance. The sale, which was accomplished through a structured finance, came with the stipulation that the Section 8 subsidy would continue for the life of the Section 8 contract – and that the new owner must not discriminate against subsidized tenants.

## FHA Mortgage Sales Results: 1994 – 1997

| Transaction | Date | Mortgages | UPB ($ MM) | Proceeds ($ MM) | Savings ($ MM) |
|---|---|---|---|---|---|
| SF: HUD-held G4<br>First Boston, United Mortgage, Kidder | 6/94 | 15,212 | 97.5 | 84.1 | 1.7 |
| Title X Land Loans<br>Atlantic Gulf, Oppenheimer, Beal Mort., TRM, Jack Weglarz, City of San Bernadino, Wm. Lyon Homes | 6/94 | 10 | 98.7 | 16.8 | 8.5 |
| MF: FNMA Reassignment | 8/94 | 85 | 89.0 | 89.0 | NA |
| MF: HUD-held G4<br>Lehman Brothers | 10/94 | 206 | 151.7 | 110.0 | 3.9 |
| MF: Nonper. Unsub. SE<br>Allied Capital, CCAT 2, Charles Warwick, Condor I (GE Capital), DS Kendall, Heartland Bank, Kisco Retirement, Maunion Realty, Mortgage Recovery Fund, Recoveries Fund 1, Twin Lakes LP, WRH Mortgage | 3/95 | 177 | 907.0 | 724.0 | 437.6 |
| MF: Perf. Unsub. National<br>Bankers Trust, Leetsdale Western Terrace, Limited Liability Corp. | 9/95 | 142 | 282.3 | 250.2 | (25.6) |
| Title 1 Manufactured Hsg. Lns<br>Sagres Co. | 9/95 | 2,702 | 26.0 | 0.17 | 0.1 |
| SF: National #1<br>EMC Corp., BCGS (BlackRock, Cargill, Berkeley, Security National), CF/SPC (Commercial Federal), Schiillinger Dvlpmt. | 10/95 | 13,009 | 523.2 | 392.8 | 7.9 |
| MF: Nonper. Unsub West/So.<br>ALI, CA Bianco, CCAT2, Chas. Gower & Kelsey Kennon, Delmar Gardens, Herbert Zieben, Hillside LLC., J&B Management, Jack Menzie, Kisco Retirement Communties, Lamesa Villa Apartments, Liberty National, Liberty Oaks, Loan Acceptance Corp., Mary R. Wolff Real Estate Management Co., Misty Hollow Partnership, National Income Realty Trust, Norman Lofthus, OPEY, Pecan Acres II, Pioneer Land Co., Quail Valley, Realty Partners, Retirement Housing Fdn., River Oaks Land, Second WHUD Real Estate LP | 11/95 | 152 | 622.3 | 385.2 | 107.8 |
| SF: National #2<br>BCBF, LLC (BlackRock and Berkeley) | 3/96 | 16,539 | 758.4 | 633.8 | 143.6 |
| Title X Land Loan<br>Creative Communities, Inc. | 5/96 | 1 | 11.1 | 2.0 | 2.6 |
| Title 1 Manufactured Hsg. Lns<br>United Mortgage | 5/96 | 13,112 | 161.9 | 1.54 | 0.9 |
| MF: Partially Assisted<br>Condor 1 (GE Capital), Whitehall, JE Roberts | 6/96 | 158 | 883.6 | 645.5 | 213.0 |
| MF: Nonper. Unsub. No/Cent<br>Lennar Atlantic Ptns, Berkeley, Loan Acceptance Corp., Lehman ALI, Maunion Realty Corp., CCAT2, ARV Assisted Living Corp., Asset Recovery Fund, Mortgage Investment, John Pyzyk, Resource Properties XXIII, Chrismond Financial Corp., Riverview Tower Homeowners Assn. | 8/96 | 151 | 847.2 | 621.7 | 235.0 |
| SF: National #3<br>Salomon Brothers, First Boston, BlackRock | 9/96 | 16,996 | 804.5 | 730.2 | 164.0 |
| MF: Nonper. Unsub. Midwest<br>Condor 1/CS First Boston, WHBCF, LLC, ALI, Inc., BCFL, LLC, Loan Acceptance Corp., Beaver Creek Acquisitions, Charles A. Glower, Maunion Realty, Vaughn A. Pengelly, James L. Hubbard, Hartman & Tyler, River City Apartments Assn., Charles Hamlett Assoc. | 12/96 | 107 | 873.2 | 762.7 | 360.0 |
| SF: National #4<br>Salomon Brothers, Ocwen, EMC Mortgage | 1/97 | 18,894 | 1,131.0 | 1,039.1 | 247.4 |
| **TOTAL** | | **97,653** | **8,268.6** | **6,488.7** | **1,908.4** |

## Highlights of Individual Mortgage Loan Sales

### 1. Single Family 221(g)(4) Sale: June 1994

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 15,212 | $97.5 million | $84.1 million | $1.7 million |

- First sale conducted pursuant to the Credit Reform Act of 1990.
- Set precedent that FHA would hold firm to closing deadlines.
- Provided significant staff relief to field offices in Detroit, Philadelphia and Los Angeles.

### 2. Title X Loan Sale: June 1994

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 10 | $98.7 million | $16.8 million | $8.5 million |

- Cleaned up portfolio with the highest default rate and losses

### 3. Fannie Mae Reassignment: August 1994

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 85 | $89.0 million | $89.0 million | NA |

- Created a flexible structure that enabled FHA to save $4 million by quickly executing this transaction. Speed was important because of the impact of interest rate movements on the value of the portfolio. Interest rates rose shortly after the sale was executed.

### 4. Section 221(g)(4) Multifamily Sale: October 1994

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 206 | $151.7 million | $110.0 million | $3.9 million |

- Introduced concept of "accreted" value to prevent possibility of future windfall losses to FHA. The sale was structured such that the yield to default for the investor was the same no matter what year a default occurs.

### 5. Southeast Sale of Nonperforming Unsubsidized Mortgages: March 1995

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 177 | $907.0 million | $724.0 million | $437.6 million |

- First government loan sale to successfully use computer optimization to widen the market of bidders and maximize returns to taxpayers.
- Due diligence provided more information to potential bidders at far lower costs than other similar asset sales. Information could be accessed digitally at bidders' offices or in the traditional way of bidders traveling to a central place to view files.
- Innovative marketing through the Internet ensured widespread access to information
- Marketing began with a broad campaign targeted to sell the loan sale program itself, setting the stage for successful sales in the future.
- Success of the sale reestablished FHA's and HUD's reputation in the marketplace.
- First use of multifamily credit subsidy model.
- Preparation and quick action by legal team successfully turned back one borrower's attempt to stop the sale through a temporary restraining order in U.S. District Court.
- Results of sale proved the existence of a significant disparity in the value of defaulted assets in government hands versus in private hands.
- Following the sale, FHA's financial advisors gave FHA a 1,000 page instruction manual on how the loan sale was conducted – including copies of the bid packages, marketing materials, advertisements, loan sale agreement and closing documents. This technology transfer, which has continued for other sales, has significantly cut FHA's transaction costs. This detailed record of all sales procedures was later converted by to an interactive digital "Design Book on a Disk series."
- Provided significant staff relief to SE field offices.

### 6. National Performing Sale of Unsubsidized Mortgages: September 1995

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 142 | $282.3 million | $250.2 million | ($25.6 million) |

- Established the concept of partial securitization – i.e. the mortgages were taken prior to the sales to the rating agencies, which provided "comfort letters" establishing subordination levels assuming internal credit enhancement. The results of the rating agencies' reviews were supplied to successful bidders at no additional costs. This approach increased FHA's pricing without having to go through the cumbersome and time consuming process of hiring an underwriter

## 7. Title I Manufactured Housing Rehab Loans: September 1995

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 2,702 | $26.0 million | $171,000 | $90,000 |

- First ever sale of defaulted Title I loans

## 8. Single Family National Sale #1: October 1995

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 13,009 | $523.2 million | $392.8 million | $7.9 million |

- First large sale of single family loans that had come through FHA's assignment program. The big challenge was convincing potential bidders that the payment history on these loans was better than the payment history they had experienced on defaulted loans coming out of the RTC. This message was finally communicated successfully in Single Family National Sale #2, which reflected more aggressive bidding.

- Established that FHA would not sell the mortgages for bid prices that were too low. The Department stuck to its guns, despite angry pressure from unhappy bidders. FHA sold 10,000 mortgages on bid day and then held a successful reoffering of 3.000 loans one week later and achieved a higher price.

- Provided significant staff relief to field offices in Pennsylvania, Florida, Ohio and Illinois.

## 9. West/South Sale of Nonperforming Unsubsidized Mortgages: November 1995

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 152 | $622.3 million | $385.2 million | $107.8 million |

- Proved that the markets would accept lower quality multifamily assets than in the Southeast Sale and still pay a price that exceeded the value of the mortgages if they had stayed in the government's hands.
- FHA hired and supervised due diligence contractors for this sale, rather than outsourcing that task to its financial advisor.
- FHA introduced further enhancements to the optimization process, allowing even more flexibility for the investment community.

### 10. Single Family Sale #2: March 1996

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 16,539 | $758.4 million | $633.8 million | $143.6 million |

- Offered state-of-the-art due diligence – supplying expanded information at lower cost and making information widely available in digital formats. Among the key innovations was providing 36 months of payment history. Demonstrated that the loans did have much better cash flows than product that had come out of the RTC.
- Loans pre-reviewed for eligibility under the Community Reinvestment Act.
- Developed an innovative "place based survey" to solicit from bidders voluntary information on what they intended to do with these loans if they won. The survey also asked bidders their views on new approaches to stratifying loans for sale in future FHA sales. Specifically, the survey asked for comments on a potential new type of FHA sale that would group assets for sale by "place" and include multiple types of assets.
- Expanded FHA's marketing efforts to include a new category of potential bidders for these assets: commercial banks and bank community development corporations

### 11. Title X Loan: May 1996

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 1 | $11.1 million | $2.0 million | $2.6 million |

### 12. Title 1 Manufactured Housing Rehab Loans: May 1996

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 13,112 | $161.9 million | $1.5 million | $0.9 million |

### 13. Partially Assisted Sale: June 1996

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 158 | $883.6 million | $645.5 million | $213.0 million |

- For the first time in this sales program, FHA introduced the markets to mortgages secured by properties which receive some Section 8 project based assistance.
- Preserved tenant protections upon sale of the mortgages.
- Created an innovative trust structure that enabled FHA to return these mortgages to private ownership while at the same time fulfilling a critical public objective: affordable housing.
- Retained a passive equity interest in upside generated from mortgage resolutions.

- Developed understanding of securities technology, broadening FHA's capacity to reengineer its portfolio and expanding the universe of potential investors in FHA-related products.
- Recouped impressive proceeds on a portfolio where back payments due exceeded $250 million.

**14. North/Central Sale of Nonperforming Unsubsidized Mortgages: August 1996**

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 151 | $847.2 million | $621.7 million | $235.0 million |

- First sale by FHA's expanded sales team that included 17 separate contractors and subcontractors for crosscutting, financial advisory, due diligence and legal services.
- Tested the value of the "design book" concept for technology transfer.
- Continued successful pattern of marketing to the investment community, thereby generating maximum return to the taxpayers

**15. State Housing Finance Agency Transactions (Missouri): September 1996**

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 26 | $30.0 million | N/A | N/A |

- Mortgages transferred successfully to Missouri Housing Development Commission. Through this process, FHA learned a great deal about how to approach the balance of its FHA-held subsidized portfolio. The agency developed needed tools and policy for additional sales of this portfolio and learned how such sales could be modified and enhanced in the future.
- In taking ownership of the mortgages, MHDC assumed all regulatory responsibilities that had previously been borne by HUD. The Missouri housing agency will service the mortgages and enforce the tenant protections. MHDC will also administer the Section 8 contracts on the 930 apartment units in the portfolio receiving Section 8 project-based assistance.
- MHDC paid the nominal sum of $10 for the mortgages. In return, MHDC assumed responsibility for $8.4 million in repair obligations. The average estimated rehabilitation cost per unit in this portfolio is $4,100. MHDC also committed to spend $720,000 on initiatives that promote economic self-sufficiency for residents in these properties – including, for example, installing computer learning centers in the apartment buildings or providing on-site service coordinators. The structure of the transaction enables MHDC to use financial resources generated by the portfolio to fund such initiatives.
- The Missouri pilot addressed multiple areas that had not previously been examined in a FHA's mortgage sale

- **First Sale of an FHA-Held Subsidized Portfolio.** The sale was FHA's first sale of subsidized mortgages on apartments which house very low income residents. As a result, FHA had to ensure that these assets remained affordable housing and that needed physical rehabilitation occurred. Unlike other loan sales where it was assumed that the marketplace would appropriately address the housing needs of residents and neighborhoods, FHA had to structure this sale so as to accomplish these goals after FHA no longer owned the mortgages. By the terms of the sale, these objectives became obligations of the purchaser.
- **Rehabilitation.** For the first time, FHA developed a standard for post-sale rehabilitation and imposed on the purchaser the obligation to use best efforts to see that rehabilitation occurred. The cost of performing the needed repairs was accounted for in the sale price to ensure the purchaser had sufficient resources to fund rehabilitation. As in past sales, environmental assessments were performed on all of the properties. For the first time in the sales program, however, the costs of the recommended remediation were calculated in determining the sale price.
- **Retention of the Regulatory Agreements.** Because FHA's post-sale legislative and policy goals for this portfolio were substantially greater than in prior mortgage sales, regulatory agreements on the mortgages had to survive the sale until the HFAs and the owners agreed on the terms of modified regulatory agreements which would meet or exceed the minimum standards prescribed by FHA. Developing this new standard and the authority to transfer the regulatory agreements were major accomplishments for the pilot.
- **Sales of Loans with Interest Reduction Payments ("IRP").** Section 236 loans had not been sold previously, and doing so required FHA to work through complex decisions on whether to transfer the IRP, whether such a transfer could be accomplished under existing legislation, the mechanism for executing the transfer and the method of valuing the transferred IRP. FHA also developed, for the first time, a contract provision stipulating that the IRP (and a defined portion of future Section 8 payments) were placed in a restricted account to use only for the benefit of the projects and residents.
- **Loan Valuations.** Because prior sales were conducted competitively, FHA had never been required to determine the actual values of loans or portfolios other than to set reserve prices. Here, for the first time, FHA addressed the loan valuation question and developed a methodology and model to calculate value of the mortgages. This included valuing the subsidies on the portfolio and the anticipated cost of rehabilitation. Importantly, the valuation had to account for the possibility of significant changes in the Section 8 program.
- **Resident Initiatives.** For the first time in the mortgage sales program, the sale included provisions to help the residents of the properties to move toward economic self-sufficiency. FHA helped underwrite the cost of such initiatives – and helped define what they could entail. But the purchaser accepted the obligation to undertake the initiatives.

16. **Single Family Sale #3: September 1996**

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 16,996 | $804.5 million | $730.2 million | $164.0 million |

- Expanded FHA's exploration of a "place based" component in asset sales by creating and auctioning separately a "pool" of 31 nonperforming loans with an outstanding balance of $1.7 million, secured by single family homes in Albuquerque, New Mexico.
- **Registered returns price of 91% of UPB.** Permitted bidders to create pools only containing mortgages of one performance type. This stratification contributed to strong results because bidders could bid aggressively on the type of mortgage most suitable for them while not having to bid on other types of mortgages.

17. **Midwest Sale of Nonperforming Unsubsidized Mortgages: December 1996**

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 107 | $873.2 million | $762.7 million | $360.0 million |

- Generated proceeds of $762.7 million for the government – 87.3 percent of the mortgages' UPB.
- Brought the budget profits generated by the mortgage sales to a total of more than $1.6 billion since 1994. Proceeds from the Midwest sale exceeded the value-to-government credit reform number by approximately $360 million.
- Drew 559 bids from 62 qualified bidders. There were 13 winning bidders, 43% of whom had not previously won mortgages in FHA's auctions.

18. **Single Family Sale #4: January 1997**

| # of mortgages | UPB | Proceeds | Budget Savings |
|---|---|---|---|
| 18,894 | $1,131.0 million | $1,039.1 million | $247.4 million |

- Included performing, non-performing and sub-performing mortgages.
- Registered highest returns of all loan sales to date: 92% of UPB versus HUD's historical recovery of 70%.
- Drew 1,696 bids from 11 different bidders. There were 3 winning tables

## Upcoming Sales for 1997

- **Health Care Mortgage Sale Planned for Summer.** FHA anticipates a Summer 1997 auction of 36 mortgages secured by nursing homes. The mortgages came into FHA's inventory through defaults. The 36 nursing home mortgages have a UPB of $141 million.

- **Single Family Securitization Under Consideration.** About 33,000 single family mortgages, with a UPB of nearly $2 billion, remain in FHA's sales inventory. The next offering of single family mortgages is planned for Summer 1997. Agency officials are considering a securitized transaction for some of the remaining inventory.

- **Multifamily Structured Finance on the Drawing Boards.** Fall 1997 is the tentative date for FHA's next upcoming sale of unsubsidized multifamily mortgages. The sale is likely to include approximately 66 apartment mortgages (UPB: $244 million) and 20 partially assisted mortgages (UPB:$58 million). A structured financing is likely.

- **Focus Shifts to Subsidized Mortgages.** With its backlog of unsubsidized multifamily mortgages nearly depleted through mortgage auctions, FHA is shifting its attention to the 847 subsidized mortgages in its inventory. The mortgages, which were insured under a variety of housing programs, have an outstanding balance of about $1.3 billion. Among its options, FHA is considering a trust structure to sell the mortgages to public-private partnerships involving private investors, government agencies and not-for-profit organizations.