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Single Family Mortgage Prepayment Recycling - A Rising Bond Rate Alternative: Kutak Rock

As prevailing interest rates rise dramatically, funding costs for new debt are similarly increasing. For housing finance agencies (HFAs), this can put upward pressure on the mortgage rates they are able to offer borrowers. Accordingly, some HFAs are looking at the possibility of utilizing an alternate source of lower-cost funding of new loans — recycling repayments/prepayments from existing seasoned loans associated with outstanding lower-rate tax-exempt single-family mortgage bonds. Some background and considerations when employing recycling strategies:

- Single-family bond resolutions and indentures typically permit recycling of loan collections into new loans, subject to the need to pay current debt service including scheduled maturities, required redemptions and PAC bond requirements.
- Federal tax law generally permits recycling for only the first 10 years from the issue date of the related new money mortgage bonds that first financed a given loan. (Financial advisors and quantitative consultants generally track the portion of each bond issue (or loan) for which this 10 year period has elapsed, as refundings and the tendency to combine refundings with additional new money bonds can complicate the necessary math.)
- Some fixed rate bond issues utilize “closed” tax plans, in which the bond yield and mortgage yield are calculated at closing or after a relatively brief loan origination period, using prepayment assumptions authorized by applicable tax regulations. [Note – this is not available if any of the bonds are variable rate bonds.] Absent subsequent changes, these yield calculations are then used to demonstrate compliance with applicable arbitrage restrictions on the portfolio of financed loans (such as the 1.125% maximum positive spread permitted to an issuer) for the life of the bond issue. Such calculations generally are not required to be updated to reflect actual bond or loan repayment activity. However, when loan collections are used for recycling, it becomes necessary to recalculate the bond yield and loan yield to reflect both actual repayment experience to date and actual repayment experience for as long as recycling continues (unless the loans financed by the recycled collections have the same or lower yields than the initial new money loans). Once recycling ends, a final calculation of bond yield and loan yield can be made based on repayment experience to date and future prepayment assumptions authorized by applicable regulations.
- As suggested above, some analysis and calculation will be necessary to determine which of an HFA’s existing bond issues is suitable for recycling, and at what rates. It is possible, for example, that recycling could cause the HFA’s positive spread on the mortgages financed by a given bond issue to exceed the 1.125% arbitrage spread limit. Technical corrective action for excess yield, such as rebating interest to mortgagors or making a yield reduction payment to the U.S. Treasury, are available, but very rarely used; rather, HFAs recycle collections into new lower rate loans (or lower yield participations thereof).
- The common method of dealing with excess arbitrage spread on mortgage portfolios is to utilize a combination of recycled funds from an existing bond issue and sale proceeds of newly issued bonds to jointly finance a pool of loans. Recycled funds from a variety of bond issues could also be aggregated to make recycling economical. Subject to certain limitations, federal tax rules permit the yield on such jointly financed mortgage pools to be disproportionately allocated to the respective bond issues, enabling HFAs to allocate mortgage portfolio yield between bond issues to

meet the federal arbitrage limitations. HFAs pursuing such a strategy should plan to consult with counsel to confirm that both tax law compliance and logistic bases are covered.

If you have any questions about this, please feel free to contact one of the attorneys in Kutak Rock's Housing Finance Agency Practice Group.

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