Category: Management Innovation
Sub-Category: Financial
Entry Name: Innovative Management During Market Turmoil

"The fiscal choices we've made together as One Maryland have allowed us to weather this severe financial storm better than most."

- Governor Martin O'Malley

Successful and Innovative Management of Financial Integrity during Market Turmoil

Due to the recent turmoil in the financial and housing markets, the Maryland Department of Housing and Community Development's Residential Revenue Bond indenture was faced with cash flow stresses, decreased liquidity, the threat of a rating downgrade by Moody's that might have had a severe impact on the agency's ability to do business and a possible operating fund state raid in mid 2009.

Management had worked hard to maintain the agency's primary single family indenture rating of Aa2 since its inception in August 1997. Most of the circumstances taking place in the market were beyond its control; downgrades of the private mortgage insurers, the loss of liquidity in the auction rate market, the high cost of variable rate debt and cash flow stresses due to increased foreclosures and delinquencies. Already on negative watch, the consequences of a downgrade would put a significant strain on the administration's ability to raise capital and potentially force DHCD to suspend the state's mortgage program. This was not an option. Through the Maryland Mortgage Program, DHCD has empowered thousands of Maryland families to realize the American dream of homeownership. Suspending the program would impede the agency's ability to provide financing to thousands of Maryland first-time homebuyers.

The agency's Community Development Administration finance team developed a three-pronged approach in order to boost the strength of the indenture, maintain the bond rating and realize significant overall cost savings. The success of these simultaneous responses allowed the agency to weather what has been described as one of the worst collapses in the national housing markets since the Great Depression and continue to assist homebuyers just as they faced their greatest need.

Providing Financial Flexibility

First, in August 2009, CDA Finance defeased the few remaining bonds in the older, multifamily indenture, Multi-Family Housing Revenue Bonds, and transferred all remaining assets and reserves from that indenture into the Residential Revenue Bond indenture. The total amount transferred was approximately $58 million in loans, cash and investments. This action significantly boosted the asset base in the Residential Revenue Bond indenture to cover Moody's concerns about private mortgage insurance coverage. This was the first step to enable CDA Finance to enhance the cash flows within the indenture to allow the continuance of the program, cushion further downgrades of private mortgage insurers and provide financial flexibility while weathering the storm of delinquencies and foreclosures.

Restructuring Taxable Interest Rate Swaps

CDA Finance's second approach occurred during September and October, 2009. CDA Finance began to restructure three variable rate taxable bond series and their associated interest rate swaps. These bonds and swap contracts were originally entered into during 2007. All three swaps were underperforming and were creating a strain on CDA's cash flows. The goal over the life of each swap contract is to have the net interest expense less than or equal to the fixed rate of the swap, which is what is expected if the swap is working as planned. Given the pressure on Residential Revenue Bond's credit rating however, CDA could not afford to wait for the market to turn. CDA Finance went to market in September and October 2009 with the only three Residential Revenue Bond series of the calendar year and used the proceeds to remarket these three taxable variable rate series.

In conjunction with the remarketing, CDA also successfully restructured the three underlying taxable interest rate swaps to tax-exempt resulting in an annualized savings in the first year of over $2 million and a net present value savings of $14 million over the life of the three swaps combined. The remarketing of the swaps was done without any cash outlay and resulted in new fixed rates that were each over 80 basis points less than the original fixed rates in the taxable swap contracts. In the process CDA Finance was also able to successfully negotiate a new rate with the liquidity provider at a time when rates were high and mitigated counterparty risk by adding a new counterparty. Again, the remarketing of the taxable variable rate bonds and underlying swaps to tax-exempt will result in a major jump in positive cash flows and has further strengthened the financial integrity in the Residential Revenue Bond indenture.

Creating More Flexible Cash Flows

The third and final approach that CDA embarked on in order to boost the assets and create more flexible cash flows in Residential Revenue Bond was to essentially transfer another older, inactive single family indenture (Single Family Program Bonds) into Residential Revenue Bonds in May and June 2010. This approach was broken up into three different steps. First, CDA placed a Residential Revenue Bond issuance in the market in order to refund into Residential Revenue Bond the largest outstanding series in the old indenture which resulted in a net present value savings of $1.6 million over the life of the bonds. The next step was to liquidate the older investments in the Single Family Program Bonds indenture which were trading at significant premiums and use the sale proceeds of approximately $30 million along with other cash within Single Family Program Bonds to call the remaining outstanding bonds. There was enough cash after the calls to set aside funds to pay the rebate with a surplus of almost $5 million. The final step in this approach was to complete the transfer of approximately $123 million worth of Single Family Program Bonds loans into Residential Revenue Bond which will strengthen the parity ratio and add vintage seasoned loans to the portfolio.

Finding Innovation in the Face of Turmoil

The methodical completion of the three financial approaches taken by CDA during the period of July 1, 2009 through June 30, 2010 has enabled the administration to maintain the Residential Revenue Bond Aa2 rating, strengthen the indenture cash flows, provide increased liquidity to the indenture to maintain and even enhance the Maryland Mortgage Program, and offer surplus cash for CDA's operating fund. This three-pronged approach of two different indenture transfers and the replacement of inefficient taxable variable rate bonds and swaps for tax-exempt instruments resulted in an innovative challenge for CDA's financial management team. As a result of these management decisions , CDA Finance was also able to increase the Residential Revenue Bond warehouse fund essentially using CDA's own line of credit to purchase single family loans in preparation for the administration's first escrow break in the single family NIBP later in the year. The administration was also able to create more "zeroes" or over yield within Residential Revenue Bond to cushion the blow of increased delinquencies and foreclosures, and to assist struggling borrowers to keep their homes with loan modifications. Finally, even amid the financial turmoil and the resulting stresses for Maryland’s only state housing finance agency, the administration was able to provide evidence to the state of Maryland that CDA’s total assets of over $3.3 billion are, and always will be, obligated to its bondholders and a raid on the operating fund would further weaken the underlying financial integrity of the administration.