Securitizing Funds for Social Housing

by Teuvo Ijäs and Harri Hiltunen

After the Second World War the need for housing in Finland was urgent, and there was not enough private capital to create new housing. Therefore, the state had to take a major role in financing both owner-occupied and rental housing.

A temporary organization named The Housing Production Committee, which became known as ARAVA (an acronym from the Finnish name Asuntorahoitusvaltuuskunta), was established to handle state lending for housing in 1949.

The first state housing loans (ARAVA loans) were granted the same year. The financing came directly from the state budget. Next year, then, ARAVA will celebrate its 50th anniversary. In 50 years 430,000 new owner-occupied dwellings and 400,000 new rental dwellings have been financed with ARAVA loans.

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HOUSING FUND OF FINLAND

The Housing Fund of Finland (ARA) was instituted at the beginning of 1990 when the ARAVA loan receivables of the then-National Board of Housing and its predecessors were transferred to this state off-budget fund. ARA at that time was solely a fund for social housing loans; it operated outside the national budget but its debt is an obligation of the Republic.

The National Housing Board was disbanded in December 1993. At the same time ARA became an administrative agency under the Ministry of the Environment.

The aim of these reforms was to ensure that the funding of ARAVA loans would remain independent of the financial institutions and to move it outside the budget. However, because the Fund is part of the state financial structure, its liabilities are ultimately government liabilities. Therefore, its direct borrowing also forms part of the government debt.

ARA´s principal functions are:

- Granting ARAVA loans and approving interest subsidies for social housing;
- Granting state guarantees on loans to private individuals;
- Controlling price and quality of state-subsidized housing construction and renovation, and supervising housing regulations to ensure competition;
- Monitoring the need for new housing and renovation, and allocating funds accordingly;
- Allocating repair and other grants for housing.

At the end of 1997 ARA´s total assets were about FIM 57 billion, mainly ARAVA loans (see Figure 1). Capital and reserves amounted to FIM 42.5 billion, whereas liabilities totalled FIM 14.9 billion. These figures illustrate ARA´s solvency level and its ability to manage its liabilities.

In 1997 work started on the construction of nearly 30,000 new dwellings of which two-thirds were financed with ARAVA or interest-subsidy loans. In the same year 6.4 billion FIM of new ARAVA-loans were granted and 4.9 billion FIM of new interest-subsidy loans were approved.

Sources of Funding

The Housing Fund has traditionally financed its outlay from three sources: first, the receipt of interest and principal on existing ARAVA loans; second, appropriations from the government budget (but because of the limitations arising from the state budget deficit, the last appropriations were received in 1993); and third, borrowing in its own name in the bond market (see Figure 2).

Figure 1. ARA's Total Assets and External Funding

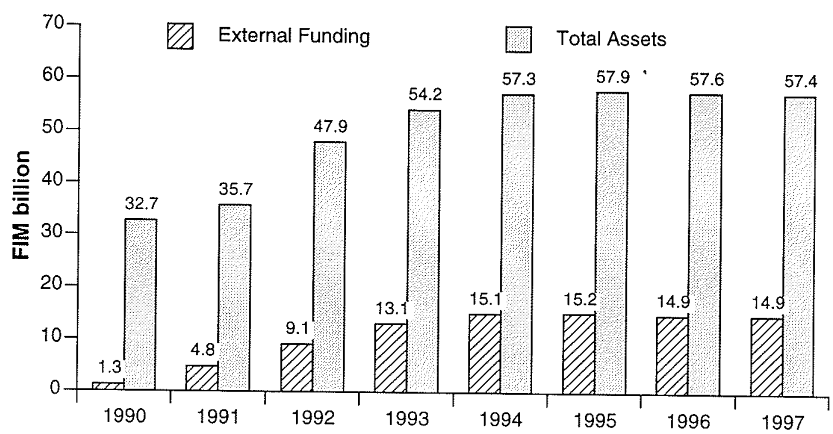
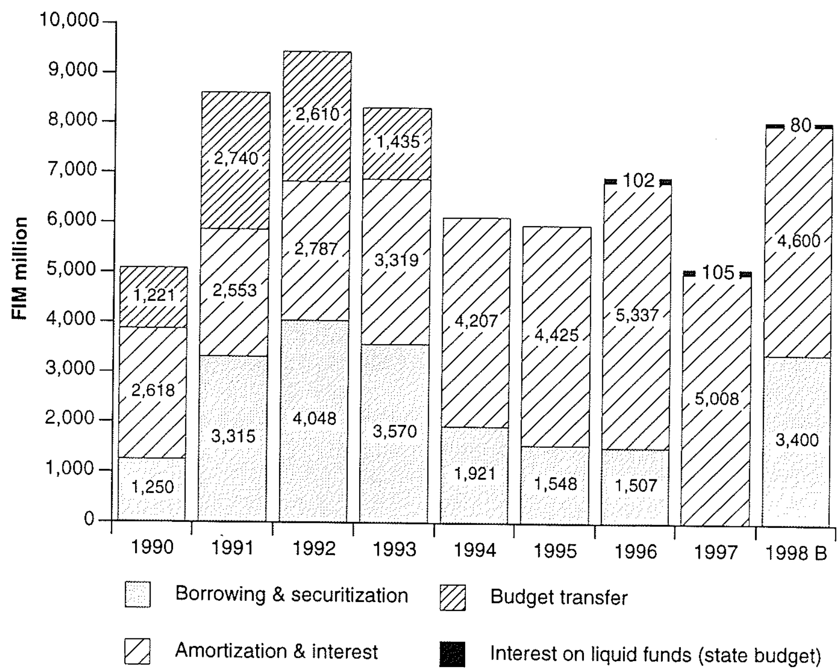


Figure 2. ARA's Sources of Funding 1990–1998



Securitization adds a fourth source of funds, which relies for repayment on the performance of the underlying loans. It also collects charges from partial state guarantees.

STATE DEBT RESTRICTIONS

Although separate from the state budget, the Housing Fund has not been immune to fluctuation in public finances. For instance, although its assets are outside the state budget, ARA´s annual appropriations of external funding are regulated by the state budget. Also, the appropriations for granting loans are limited by the budget.

In the early 1990s the Finnish economy was in a severe depression, which meant that the state debt began to grow at a rate that was unsustainable in the long run. The government was forced to reduce the budget deficit and strictly control public sector borrowing.

As part of the European integration, the aim of the Finnish government was to be among the first to join the third stage of EMU. This decision gave exact figures for the public economy's budget deficit and state debt, which could not be overstepped. Since ARA´s debt is considered part of the state debt, social housing production was among the many sectors where attention was focused.

How to Maintain Social Housing Production?

The government also wanted to maintain the level of social housing production to promote employment, and it became necessary to find other ways of raising funds for the social housing program or, alternatively, replace the state loans with the already coexisting interest-subsidy schemes.

Limited by state debt requirements, ARA started to examine other possible ways of funding the government social housing program. The answer was securitization of the old ARAVA loans. The work, which eventually emerged as the so-called Fennica program, the first securitization transaction ever made by a sovereign republic, began late in 1994.

This process was managed by the Steering Group, comprising the Finnish Ministry of Finance and Ministry of the Environment, the Housing Fund of Finland and the State Treasury.

TARGETS FOR SECURITIZATION

There were four general targets set out for the Fennica program:

- The first was to produce an efficient AAA-rated securitization structure that would provide a sound platform for a program of subsequent transactions.
- The second, and very important, was a desire to raise funding for social housing that would not count against government debt totals. With the constraints set by the EMU criteria, there was a clear incentive to adopt a funding solution that would rely on the assets alone.
- The third objective was to find a place for a "special purpose vehicle" (SPV), needed in securitization, which is well-known among international investors and which has a completely respectable, efficient, tax-neutral jurisdiction, since that cannot yet be fully achieved in Finland.
- Finally, as for any responsible government anywhere, value for money was an important benchmark throughout the process.

An essential part of the securitization process is a special purpose vehicle which issues the bond and is responsible for paying investors the interest and amortizations. Setting up an SPV usually requires specific legislation.

Selection of Dublin as the SPV location was influenced by the following factors:

- Ireland, and especially the international finance center of Dublin, is well-known to investors, an important factor when a new product is being issued by a new issuer;
- The Irish legislation is "securitization-friendly";
- Ireland has a well-functioning "securitization infrastructure," as a result of which the arrangements involved in the establishment of an SPV can be carried out quickly and smoothly; and
- The European Union has approved the favorable tax treatment companies can enjoy in the international finance center of Dublin.

THE LOAN POOL

The first loans to be securitized were all made in the period 1973–1989 for the construction, renovation or acquisition of social rental housing. They are all second mortgages (original LTVs 55%–60%), ranking behind, typically, a bank primary loan (original LTVs 30%–35%).

The interest rates are concessional: they start at a very low level (0.5% p.a.) and increase over time according to a fixed schedule. (The current maximum interest rate is 7% p.a.; the current weighted average interest is 4.6%.) The loans are all amortizing, with very low proportions of principal due in the early years. The amortizations rise throughout the life of the loan. These terms of loans can be adjusted by a Decree or by a State Council Decision.

The weighted average combined loan-to-value ratios at the time the loan was made were up to 95%, although time had reduced it to about 56% by 1995. Maturities for ARAVA loans for new construction were either 24 or 27 years during the 1970s and 1980s. When the securitization process took place, approximately an average 13 years had already passed since the initial closing of the loans; this made it possible to evaluate the risk of payment default on the basis of the actual servicing history.

The September 1998 Pool

Fennica 3 was launched September 1998. The loans securitized included loans from the previous provisional pool, replenished with new types of graduated payment loans granted from 1990 to 1994 and also loans granted up to 1993 conforming to the 1980s legislation.

In the graduated payment system (GPS), an ARAVA loan for construction or purchase forms 90%-95% of the total costs and for renovation 80%-95%. The ARAVA loan is the first ranking loan. The interest rates of these loans are linked with changes in the consumer price index, generating a positive real interest rate.

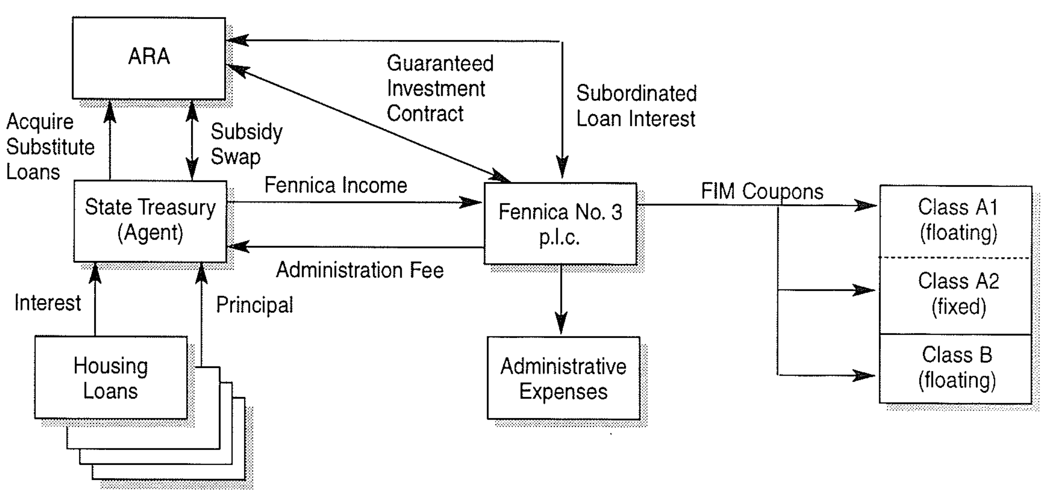
The current base interest margin of loans for construction of rental dwellings is 3.1%. The amortization will begin when the annual payment is bigger than the interest due. Generally the loans are fully amortized around the 35th loan year, but the final maturity is no longer than 45 years. The GPS loans don't have negative amortization, so if the annual payment is insufficient to meet the interest payment due, the unpaid interest is forgiven. Since 1993 a maximum change of 10% in the CPI is allowed when determining the increase in the annual payment.

Security is required for all ARAVA loans other than those granted to municipalities,

Table 1. Fennica Issues

Time of Issue	*Name*	*Notes*	*Amount (million)*	*Initial Rating*	*Coupon, Semiannual (step up to)*	*Expected Maturity*	*Legal Maturity*	*BIS Weighting*
Nov. 1995	Fennica 1	A	US$350	AAA	6m LIBOR + 23 bp (+ 100 bp)	5 year	May 2025	100%
		B	US$13.7	A	6m LIBOR + 55 bp (+ 150 bp)		May 2025	
Sept. 1996	Fennica 2	A1	FIM 775	AAA	6m HELIBOR + 19 bp (+ 75 bp)	4 year 8 mo	May 2024	100%
		A2	FIM 675	AAA	6.32% (same as A1 notes)	6 year 8 mo	May 2024	
		B	FIM 57	A	6m HELIBOR + 48 bp (+ 125 bp)	6 year 8 mo	May 2024	
Sept. 1998	Fennica 3	A1	FIM 1425	AAA	6 m HELIBOR + 19 bp (+ 75 bp)	5 year 8 mo	Nov 2054	100%
		A2	FIM 550	AAA	4.60% (same as A1 notes)	6 year 8 mo	Nov 2054	
		B	FIM 77	A	6 m HELIBOR + 48 bp (+ 125 bp)	6 year 8 mo	Nov 2054	

Figure 3. Fennica No. 3: On-Going Cash Flows



which are unsecured. The form of security is either a mortgage, a pledge of shares, a guarantee or, in a very few cases, a pledge of a bank deposit.

The provisional loan pool for the Fennica 3 securitization had loans with security of municipality guarantees (7.5% of the number of the loans), mortgage (83.4%) and unsecured loans to municipalities (9.1%).

STRUCTURE

The bonds were issued by Special Purpose Vehicles that were set up in Ireland.

In November 1995, for example, Fennica 1 (SPV) issued an AAA-rated US$350 million floating-rate bond. An A-rated US$13.7 million bond was also issued.

In September 1996, Fennica 2 issued an AAA-rated FIM 775 million floating-rate bond and an AAA-rated FIM 675 million fixed-rate bond. An A-rated FIM 57 million bond was also issued. These credit ratings were given by Standard & Poor and Duff & Phelps.

Last September Fennica 3 issued a FIM 1,425 million floating-rate bond and a FIM 550 million fixed-rate bond, both of which had an AAA creditworthiness rating by Moody´s and Duff & Phelps. An A-rated FIM 77 million bond was also issued (see the structure of Fennica 3 in Figure 3; also see Table 1).

The interests of the investors are protected in several ways. The required levels of credit enchancement were set by the rating agencies on the basis of static loan pool analysis. The four main sources of credit enhancement are (see Figure 4):

- Pool selection criteria;
- An excess spread of 20 bp p.a.;
- A cash reserve fund funded by a subordinated loan (1% of the loan balances) from the ARA;
- Single-A rated mezzanine notes (privately placed).

The selection of the provisional loan pool was based on factors like the population of the municipality concerned, the capacity utilization rate of the rental housing, and the record for loan payment and arrears. An upper limit was also set on the size of the loan. The loans which were finally securitized were randomly selected.

The excess spread is available on each interest payment date to replenish the reserve fund against any losses or provisions on the portfolio. To the extent it is not used on any interest payment date, it reverts to the ARA through the profit extraction mechanism.

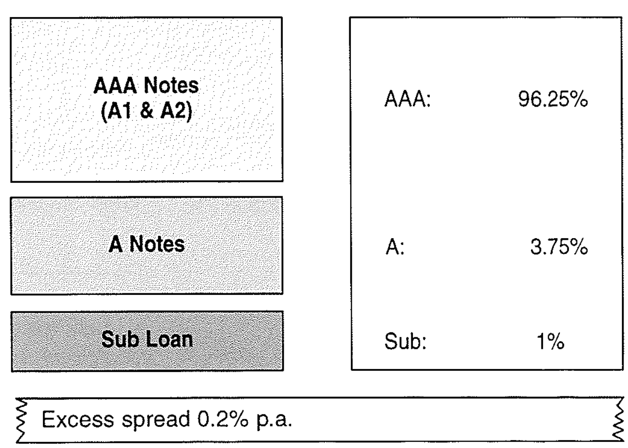
Built-in Interest Subsidy

The most innovative of these precautionary measures is perhaps the interest subsidy built into the Fennica structures, which secures for the investor the coupon interest rate independently of the interest income created from the securitized loans.

An interest subsidy procedure aims to level out the difference between the interest accumulating from the ARAVA loans and the interest paid by the special purpose vehicle to the investors. The interest subsidy is paid by ARA if Fennica liabilities to investors are higher than its anticipated interest revenues from the ARAVA loans. Otherwise, the interest subsidy is paid to ARA.

ARAVA loans form part of state-subsidized housing production. The securitization has, therefore, been designed to ensure that the status and treatment of the securitized loans is the same as for other loans. For example, the interest subsidy procedure guarantees that the loan interest can be changed on ARAVA loans granted during a calendar year on housing policy grounds, irrespective of whether an individual loan has been securitized or not.

Figure 4. Fennica 3: Credit Enhancement Structure



Equal Treatment for Rental Housing

If a rental housing company runs into financial difficulties, securitized loans also have equal access to the same kind of rescheduling and reliefs. This is possible through the substitution procedure and also by extending the loan period. Securitized loans can change over to a graduated payment system under the same conditions as other loans. Even after securitization, the loans are administered by the Finnish State Treasury.

Because the collateral for the ARAVA loans is used as security for the funding, the bonds issued by the special purpose vehicle are not covered by state guarantees, and the state is not responsible for repayment.

EXPERIENCES OF SECURITIZATION

The first transaction widened the investor base and brought ARA considerable experience in using the new forms of financing. Through systematic risk analysis, the Housing Fund also got to know its own ARAVA receivables portfolio better.

Fennica 2, for its part, was the first public securitization transaction in Finnish markka and introduced an entirely new instrument to Finnish financial markets. With the euro-convertible Fennica 3, ARA widened the investor base to the emerging euro-market. The Finnish long-term money market has been dominated by fixed-rate government bonds. The corporate loan market is still fairly weak and unsophisticated. Thus, the Fennica program gave Finnish investors an opportunity to become familiar with a new instrument. The transaction made a versatile addition to investment opportunities on the corporate loan market. It also offered an interesting—and highly rated—alternative to government bonds and was very favorably received by investors.

Alternate Route for Subsidized Housing

In a situation where the government's debt and liabilities must not be increased, securitization is a financially competitive method of acquiring funds for state-subsidized housing production. The interest rate is determined in an open competition situation, where the margins are much tighter than in investments in individual housing projects with interest subsidies, for example.

The securitization of loan receivables is a relatively complicated project involving much effort, both in the structuring and also in drawing up contracts. In fact, each securitization involves more one-time expenses than normal borrowing. In addition to the underwriting fees on bond sales, costs are created in the planning and development of the securitization process (legal fees, costs of credit ratings and fees to advisers). However, this experience can be used in subsequent securitization projects, so that the one-time expenses are considerably lower than in first-time projects.

WHAT IS NEXT?

The Fennica securitization program will continue. According to the government's budget proposal for the year 1999, ARA will be authorized to securitize 3.3 billion FIM. Therefore, the preparations for Fennica No. 4 have been started.

As before, the Fennica 4 loan pool will include loans granted for rental housing. However, as a part of the securitization, ARAVA loans for right-of-occupancy housing are likely to be included in the pool. The main difference with these loans is the occupant's participation in financing: a 15% equity.

The euro-denominated transaction will probably take place in the spring of 1999. As an originator, the Housing Fund expects to benefit from EMU. ARA hopes to see some tightening in the spreads as currency risks will disappear and the asset-backed-security transactions will have a broader investor base.