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Some HFAs Change Their Business Models for MRBs

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WASHINGTON — Despite several turbulent years and the gloomy outlook for single-family housing bonds, municipal bond housing experts are optimistic about the future of housing finance agencies.

Some housing experts, as well as a high-level Treasury Department official, say the HFA business model for mortgage revenue bonds is temporarily broken and out-of-date in the current low interest rate environment.

Mary Miller, the Treasury's undersecretary of domestic finance, told housing officials meeting here earlier this year, "We face the question of whether the current outlook for HFAs still represents a temporary disruption, or a new equilibrium that will require HFAs to change their business model."

"The old model is not right for today," agreed John Murphy, executive director of the National Association of Local Housing Finance Agencies. "I don't think the model is broken or out-of-date on the multifamily side," he added.

However, experts are hopeful that with new sources of revenue, HFAs will rebound and continue to be a leading force in issuing single-family housing bonds for affordable housing.

"We think the agencies continue to play a very important and unique role in the marketplace," said Barbara Thompson, executive director of the National Council of State Housing Agencies. "They continue to be a key provider of affordable mortgages to low- and moderate-income people, particularly first-time home buyers, an area where they truly specialize."

Thompson added that HFAs offer a prudent approach to their lending, which involves not only low-cost financing but other services such as a down payment, closing costs and counseling assistance.

Despite their prominent role in the housing market, the forecast doesn't bode well for HFAs.

The outlook for state HFAs remains negative in 2012, for the fourth straight year, Moody's Investors Service said in a February report that focused on the fundamental credit conditions in the sector over the next 12 to 18 months.

Moody's said six primary factors will drive the negative outlook through at least mid-2013. They are low conventional mortgage rates, low interest rates on investments, deterioration of counterparty credit quality, high unemployment, high liquidity fees for variable-rate debt and new strategies for financing loan origination.

Standard & Poor's doesn't have the entire housing sector on watch, but some HFAs, which have seen consistent drops in profitability over the past few years, have been downgraded.

In 2011, Standard & Poor's lowered the ratings on 1,300 affordable housing issues and put 226 others on credit watch with negative implications, mostly because their mortgages were guaranteed by the Federal Housing Administration.

The ratings were directly linked to the sovereign credit rating of the United States and they were lowered in the wake of the first U.S. credit downgrade last August.

The rating agency said demand for multifamily housing will continue to rise, but the market for single-family affordable housing has stagnated despite pent-up demand.

Single-family housing bond issuance is likely to remain low because of low interest rates and the unsettled market for credit enhancements, it said.

Traditionally, HFAs have financed their mortgage lending business by issuing tax-exempt bonds and using the proceeds to offer affordable mortgage loans for first-time, low-income home buyers.

This method has allowed them to issue debt approximately 50 to 100 basis points lower than conventional mortgage rates, according to Charles Giordano, senior director in the tax-exempt housing group at Fitch Ratings.

MORTGAGE RATES

However, with the slow economic recovery and the Federal Reserve Board's monetary policy aimed at maintaining low interest rates, conventional mortgage interest rates have generally been lower than those that can be achieved through the issuance of bonds. As a result, tax-exempt bond financing does not provide a cost of funds low enough to offer competitive mortgage rates, experts said.

The 30-year fixed-rate mortgage interest rate has hovered around 3.5% during the past few months, making it nearly impossible for HFAs to offer competitive mortgage loans. By comparison, in 2006 and 2007 when conventional mortgage rates reached 7%, HFAs could issue bonds at 5% and offer mortgage loans at 6%.

HFAs were heavily competing with the subprime market and issuing good loans in 2006 and 2007, housing experts said. But in 2008, issuance started to dwindle, and in 2009, it became clear HFAs couldn't make mortgage loans with tax-exempts.

"The whole way of their programs has changed because of the limitations of mortgage interest rates, but they are still performing their mission," Giordano said.

Single-family housing bond issuance plummeted since its peak in 2007, when volume totaled $22.74 billion in 567 deals, according to data from Thomson Reuters.

In 2011, issuance only reached $5.58 billion in 153 deals, a 75.46% plunge from 2007. As of Aug. 15 this year, issuance was only $3.24 billion in 63 deals. When the financial crisis hit in 2008, issuance plummeted to $12.24 billion from the previous year, a 46.2% decline.

“Interest rates went down so dramatically that we couldn’t issue bonds because of negative arbitrage,” Murphy said. “That drove virtually everyone out of the market.”

In late 2009, the housing finance market received a jolt. The Treasury Department created the New Issue Bond Program to revitalize bond issuance among state and local HFAs.

Under the program, the Treasury agreed to buy $15.3 billion of securities from Fannie Mae and Freddie Mac that were backed by new mortgage revenue bonds or multifamily housing bonds issued by the HFAs.

The NIBP and a temporary credit and liquidity program boosted struggling HFAs through the financial crisis and some experts say even leveled the playing field.

“These agencies have actually really held their own,” said Florence Zeman, associate managing director at Moody’s. “We haven’t seen that many downgrades. A lot has to do with their financial positions back in 2008 when they started to face a lot of challenges.”

Murphy called the NIBP a “highly successful program” and “the best-kept secret in town.” He said it was a very important tool to expand homeownership for lower- to middle-income households.

Forty-seven local HFAs — almost half of NALHFA’s members — participated in the NIBP and created nearly 17,000 affordable housing opportunities for first-time home buyers and low-income renters, according to Murphy. About 97% of the purchases were first-time homebuyers, with average incomes of 78% of area median income, he said.

The NIBP expires at the end of 2012 and almost all of the bond issuance authority has been used.

Housing groups like NALHFA and the National Council of State Housing Agencies have been pressing the Treasury to launch another round of the NIBP.

Some issuers have capacity remaining to utilize the NIBP, but it’s not as big a factor as it was a few years ago when the program first launched, said Bob Coleman, managing director of the national housing group with Raymond James | Morgan Keegan.

Currently, HFA issuance is largely dominated by refundings, Coleman said. Roughly 50% of all bond issuances in 2012 have had a refunding component. By comparison, refundings one year ago comprised of only 10% of the total issuance because the NIBP was an option for HFAs, Coleman said.

HFAs can current refund housing bonds and use the subsidies from the previous bond issues to create a more competitive mortgage product, he said. In a current refunding, all of the previously issued bonds must be redeemed with 90 days of the issuance of the refunding bonds. They cannot advance refund these bonds.

If interest rates rise back to 7%, then tax-exempts for housing could be viable again, Murphy said.

HFAs will likely not know if they can revert to issuing bonds until at least 2014 because interest rates are expected to remain low until then.

In the meantime, HFAs are re-evaluating their funding model and seeking alternative sources of revenue in order to survive in a low-interest rate environment.

BUSINESS MODEL

“The agencies are shifting their strategic business plan,” said Valerie White, senior director of corporate and government ratings at Standard & Poor’s. “They are diversifying their business strategies to find other ways to supplement the revenue that they customarily only got from bond issuance in the past.”

Zeman said HFAs are “in essence becoming mortgage-backed securities lenders.”

Under the new business model, an HFA uses its own resources or even a warehouse line to fund mortgages that are pooled into Ginnie Mae, Fannie Mae or Freddie Mac mortgage-backed securities, which ultimately are sold in the market, according to Coleman.

Some may sell loans directly to Fannie or Freddie. but housing experts said it’s more likely that they would sell them into the open market. Under this pool bond finance model, the collateral for the bonds is Ginnie Mae, Fannie Mae and-or Freddie Mac.

“If you can’t beat it, join it,” Coleman said. “The good news is that it’s pretty nimble of them to do that. It allows them to serve their constituencies and meld their mortgage products with other things that they bring to the table that have been such keys to their public purpose and success over many years.”

White agreed, saying, “If HFAs can adapt to this new model, they can be sustainable with “good strategic long-term planning, creativity and a good understanding of what the risks are.”

Thompson also said some HFAs “are looking to alternatives, and a key one is the mortgage-backed security market. Certainly there has been a movement to that execution, which makes sense. It’s not the right environment for a really robust national bond program because of the rate situations.”

For those HFAs that haven’t already adopted this model, virtually all of them are at least considering it, Coleman said.

John Craford, executive vice president of the Connecticut Housing Finance Authority, said his organization has been reviewing the mortgage banking model, in which they would just originate loans and sell them to Fannie Mae or Freddie Mac.

“We would continue to do what we are doing as long as we could make it work, but we are basically trying to open up this other avenue so we can keep the program going in a way that hopefully benefits as many people as we can,” he said.

In the past few years, the Connecticut HFA has predominantly refunded and restructured its debt to take advantage of the low interest rates and to try to compete in the market, Craford said.

“We are very aggressive and active in managing that outstanding debt and sort of optimizing what the arbitrage and tax rules allow us to do,” he said. “It’s a matter of splicing and dicing and putting together the outstanding bonds so you can save with the outstanding mortgages and make money on the whole package.”

The Connecticut HFA has been making standard 30-year fixed-mortgage loans at 3% with down payment assistance.

Still, Craford said business has slowed considerably because it's difficult to compete with Fannie Mae and Freddie Mac. The HFA assists approximately 1,200 homeowners each year, compared with 1,700 from earlier years.

Until they adopt a new financing model, the agency plans to do another refunding this fall.

Howard Zucker, member of the management committee at Hawkins Delafield & Wood LLP and author of the book, "ABCs of Housing Bonds," said, "This isn't the first time HFAs have adapted to extreme changes in the market. HFAs have evolved dramatically since the early 1970s when they were first created."

"Starting with the Nixon administration's slashing of the Department of Housing and Urban Development budget to produce new housing, the HFAs have become, among other things, the delivery vehicle and administrator for many federal housing programs," Zucker said. "Even with the diminution of housing bond issuance, the HFAs still play a critical role in the housing finance market."

Thompson suggested that there is a silver lining to the HFAs' current troubles.

"Ultimately, we'll look back at this period as difficult as it has been, but I think there will be some good legacy," she said. "That legacy will be that they have more tools in their arsenal that they can draw upon going forward."

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