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The U.S. Treasury's New Issue Bond Program Offers Housing Finance Agencies Possible Increased Market Access

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Market conditions over recent years have contributed to a significant drop in issuance in the U.S. affordable-housing market. Typically, housing finance agencies (HFAs) issue affordable-housing bonds and provide mortgages for first-time homebuyers with lower incomes, as well as mortgage products for rental housing development, much of which is government subsidized. In the early part of the decade, bond financing was rising at an average of about $4 billion per year until 2003. Issuance declined in 2004 to about $21 billion and held steady in 2005 and then hit a record high in 2006 of almost $30 billion. In 2008, however, issuance dropped dramatically to under $20 billion, and in 2009 hit the decade-low of about $10 billion.

Standard & Poor's attributes many of the changes in HFA issuance to the changes in the commercial mortgage market, which traditionally didn't serve the low-to-moderate income first-time homebuyers. However, the availability of nontraditional mortgage products in the commercial mortgage market in the late 1990s and early 2000s provided more options to these borrowers that had often borrowed under HFA programs, and HFA programs primarily focus on fixed-rate 30-year mortgages. However, to maintain issuance, as well as to maintain traditional fixed-rate 30 year mortgage offerings, many HFAs turned to less traditional bond structures, including ones that used variable-rate debt. Volatile market conditions resulted in a significant drop in these issuers' ability to compete in the bond market, as evidenced by the unprecedented low bond issuance in 2009.

Attempts To Bridge The Funding Gap

In late 2009, the U.S. Treasury, in partnership with the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac, launched the New Issue Bond Program (NIBP) to help spur HFA issuance of affordable housing bonds to support low- and moderate-income families. Using authority under the Housing and Economic Recovery Act of 2008, the U.S. Treasury purchased securities from Fannie Mae and Freddie Mac backed by these new mortgage revenue bonds.

The initiative offered relief under three programs. The single-family NIBP provides financing for HFAs to issue new housing bonds to fund new mortgages. Similarly, the multifamily NIBP supports new mortgages on multifamily properties. Finally, the Treasury agreed to purchase a participation interest in temporary credit and liquidity facilities, providing credit and liquidity coverage for HFA variable-rate bonds for a period of no more than three years. Under the Temporary Credit and Liquidity Program (TCLP), housing agencies have been able to stabilize their existing variable-rate debt portfolios, which have suffered from a decrease in the supply of highly rated liquidity providers eligible for money market funds investment, a dramatic increase in the cost of liquidity, and failed remarketings in recent years causing credit exposures that are associated with bank bonds. However, HFAs will need to re-enter the liquidity provider market at the expiration of their TCLP facility.

Although the program was announced in October 2009, the authority for the Treasury to purchase the bonds under the Housing and Economic Recovery Act was set to expire on Dec. 31, 2009. Hence, the NIBP offered a limited opportunity for housing agencies to structure their bond issues to appeal to the traditional retail investor. Under the program, the HFAs can sell up to 60% of each bond issuance to the U.S. Treasury as program bonds and the

remaining 40% in the public market as market bonds. To help lower the overall cost of financing, most HFAs structured the program bonds as long-term maturities and the market bonds as serial maturities from one to 20 or 25 years, with a 10-year call option.

Given the short time frame available to implement the program, HFAs sold only the 60% portion of their bonds to the Treasury by Dec. 31, 2009. Agencies have the option to draw down the escrowed proceeds during 2010 in up to three separate draws, provided that they sell the remaining 40% of the bonds to the public at the time of each draw. Thus, HFAs around the country will be issuing the market bond components of their allocations throughout 2010.

Housing agencies had the option of locking in rates for the program bonds at the 10-year treasury rate at the time of issuance plus costs. A majority of HFAs locked in program bond rates that averaged about 3.8%--well under the typical bond rate for affordable housing bonds. This locked-in rate for the market bonds allows the HFAs to achieve attractive spreads because it is lower than the rate on mortgages typically offered by the agencies, which ranges from 4.75%-5.25%. In some cases, HFAs are offering rates as high as 5.5%, but these loans typically include down payment assistance to their borrowers. Market bonds will pay rates achieved in the sale of the bonds at the time of drawdown.

According to the National Council of State Housing Agencies, more than 90 issuers have participated in the NIBP and 12 have participated in TCLP. For the NIBP, the federal government allocated $17.7 billion for state and local housing agencies; agencies issued $15.3 billion (87% usage) (see chart 1). Twelve HFAs participated in the TCLP for an aggregate total of $8.2 billion. Under the NIBP, California HFA was allocated the most funds ($1.6 billion), followed by Florida Housing Finance Corp. ($795 million) and Pennsylvania Housing Finance Agency ($754 million), making up 18% of the total national allocation.

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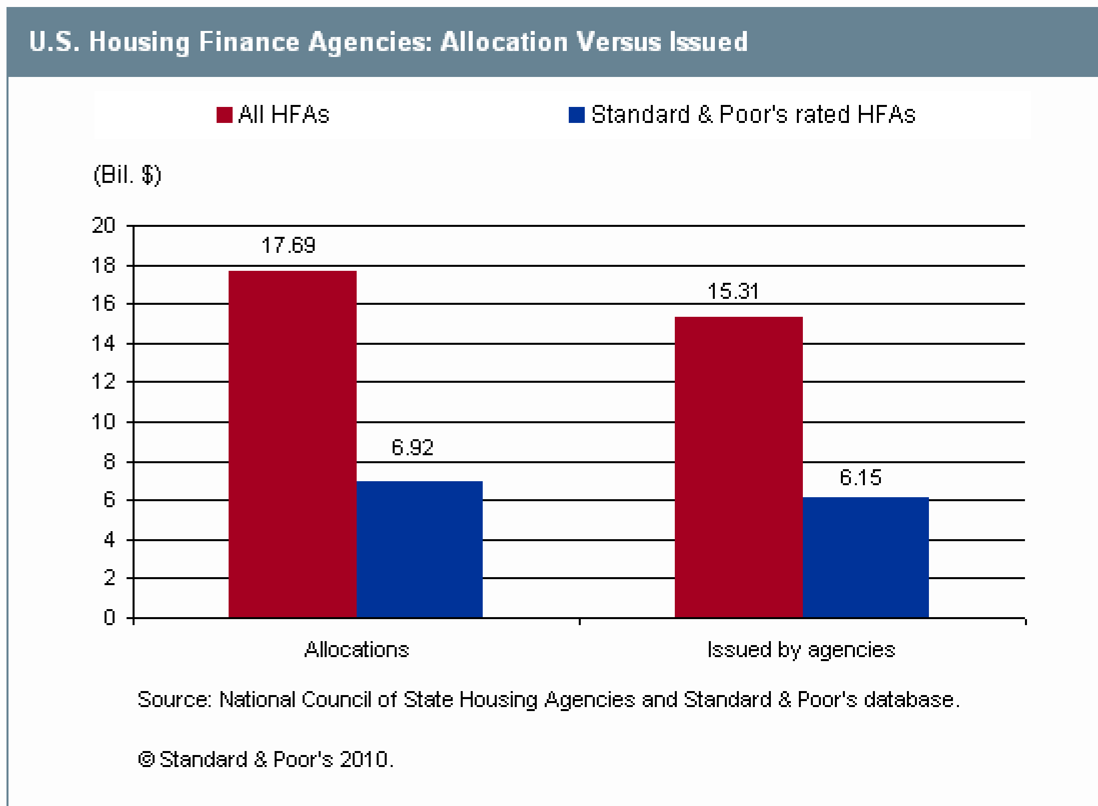
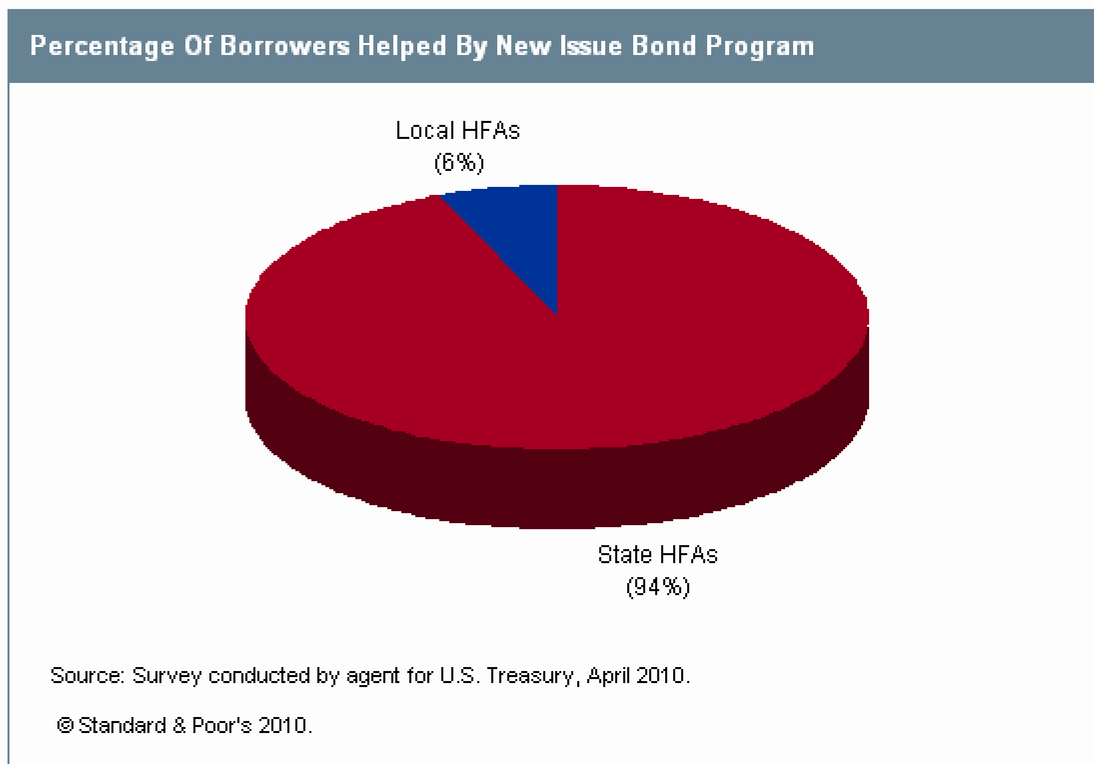
Chart 1



Program Expectations At The Half-Year Mark

Based on a survey completed on behalf of the Treasury, housing finance agencies anticipated assisting more than 128,000 borrowers through this program beginning in January 2010 through Dec. 31, 2010. Approximately 94% of these borrowers are expected to get help from state agencies, and nearly 6% are expected to get help from local issuers (chart 2). However, as of April 2010, housing finance agencies, through the NIBP, have only originated mortgages financed from bond proceeds to approximately 7,700 borrowers. In addition, agencies have warehoused loans for future bond issues for another 5,800 loans, for a total of about 13,500 loans financed as of April 2010 under the NIBP--or about 10.5% of total number for borrowers the program intends to reach--for a total par value of NIBP loans of approximately $1.1 billion.

Chart 2



Bond issues are a possibility for the final quarter of the year

We expect that many HFAs will draw down the majority of their funds from escrow and issue market bonds in the fourth quarter of 2010. Initially, many stakeholders in the industry believed most housing agencies would issue three times in the year, with the first issuance being late in the first quarter or early in the second quarter. While some HFAs have rolled out bonds so far this year, many have yet to issue market bonds and instead have elected to warehouse mortgage originations with funds under their balance sheets or through financed lines of credit that they would repay upon bonds issuance.

Although the first-time homebuyer housing tax credit has spurred mortgage origination in certain markets and some areas have done well with mortgage origination, other regions of the country, the Northwest for instance, continue to struggle. We believe that the federal purchase program of mortgage-backed securities, which the government initiated last year and continued through March 2010, placed an additional burden on HFAs' ability to generate mortgages, as low rates in the open market have hurt the competitive advantage of many agencies to generate loans. Lack of demand for mortgage loans in areas with severe economic troubles also has affected issuance under the NIBP.

Agencies have traditionally offered 30-year fixed rate mortgages. Typically, HFAs offer loans in the range of 4.75%-5.5%--depending on borrower credit quality and if they're offering subsidized down-payment assistance to the borrower. However, current mortgage rates in the commercial market average about 4.93%, and in some markets the HFAs simply cannot compete with current low interest rates for commercial mortgages.

Chart 3

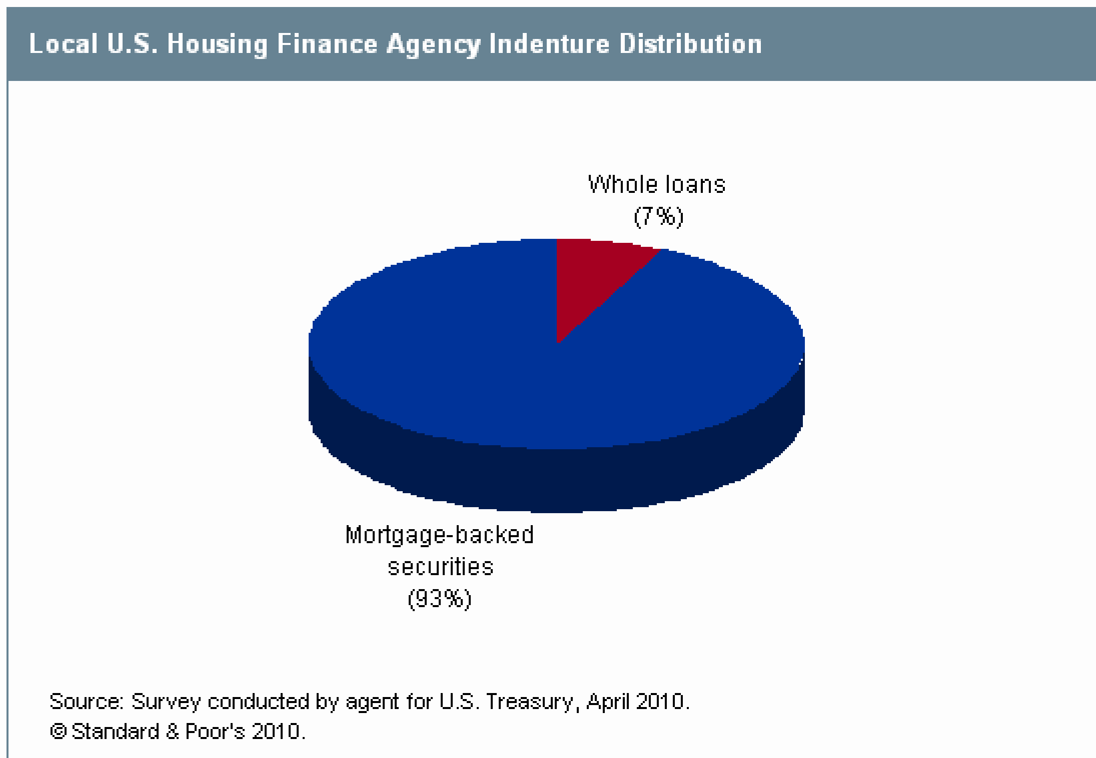
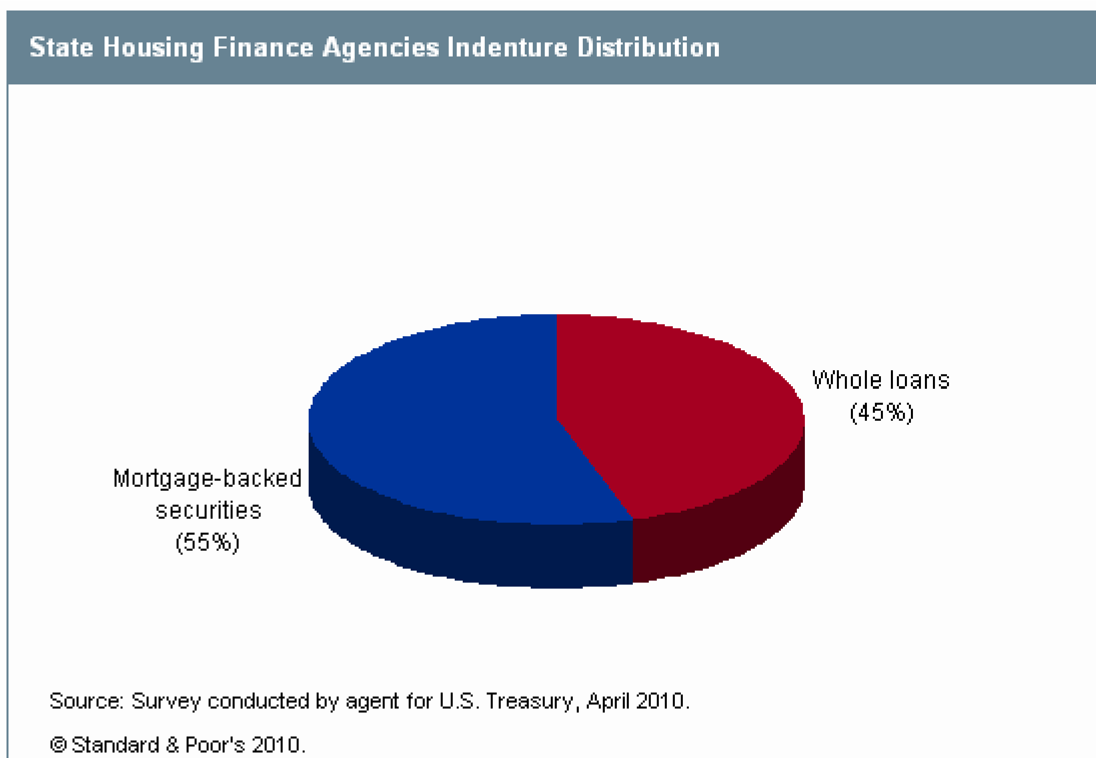


Chart 4



Based on our interactions with housing agencies, we believe the majority of the loans will be enhanced by mortgage-backed securities that the GSEs offer. This is particularly the case for local HFAs, which typically avoid the credit risks and costs associated with bond issuances backed by single-family whole loans. State HFAs originate more whole-loan mortgages than local agencies (charts 3 and 4). For whole loan mortgages, FHA, Veterans Administration (VA), Rural Development (RD), and private mortgage insurers (PMI) have been the major source of insurance for HFAs. However, the recent credit deterioration of PMIs has led most housing agencies to FHA, RD, and VA as their mortgage insurers. However, RD insurance is no longer insuring mortgages this year because it has reached its reserve capacity under its funding as of May 2010.

Market Compression Is Likely For The Remainder Of The Year

Industry groups are seeking extension of the NIBP to beyond Dec. 31, 2010. Under the NIBP, issuers had to sell the program bonds by the end of 2009 and place the proceeds in escrow. The bonds, which HFAs typically sold as short-term taxable debt, were to convert this year to long-term tax-exempt bonds, the proceeds of which HFAs would use to originate new mortgage loans. The agencies would have to use any proceeds left by the end of 2010 to redeem the bonds outstanding, according to the program's requirements. However, low rates for commercial mortgages and other regional market conditions have hampered some HFAs' ability to originate mortgages at a rate that would allow them to use all allocated funds by the end of the year.

Standard & Poor's has no indication as to whether the Treasury will extend the program beyond its Dec. 31, 2010, deadline. However, we do expect market compression (or an excess of housing bonds availability and therefore more market competition among issuers) in the last quarter of 2010 for affordable housing bonds as many agencies will come to market in an attempt to issue the remaining portion of their market bond allocation. However, if the Treasury doesn't extend the program, we expect to see in some cases redemption of unused NIBP proceeds based on the rate of mortgage origination some housing agencies have experienced year to date.

Guarav Rai contributed to this article.

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