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Access and Sustainability for First Time Homebuyers: The Evolving Role of State Housing Finance Agencies

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Introduction

State Housing Finance Agencies (HFAs) entered the homeownership policy scene in the early 1970s through the sale of tax-exempt mortgage revenue bonds, which HFAs would then pass along as an interest rate savings on mortgages to qualified low and moderate-income (LMI) first-time homebuyers. With mortgage interest rates rising as high as 18 percent in the early 1980s, many otherwise creditworthy homebuyers were cut off from the mortgage market simply because the monthly payments associated with the mortgage were too high. HFAs helped to reduce this barrier to entry by offering mortgages at below market interest rates (often 2 to 4 percentage points below market), thereby reducing the monthly mortgage payment burden for the homebuyer. This mortgage payment "subsidy" was often viewed as the primary benefit of state HFAs for mortgage markets.

Since their creation four decades ago, HFAs have issued a cumulative total of nearly $260 billion in mortgage revenue bonds, funding mortgages for more than 2.9 million LMI households.[1] HFAs have further evolved to offer mortgage markets more than monthly payment subsidies. Many have helped develop statewide infrastructures that bring together lenders, realtors, nonprofit organizations, and local governments to address the needs of LMI first-time homebuyers. Through their structures and programs, HFAs not only offer subsidies to homebuyers, but they are positioned to address informational barriers that contributed to the recent financial crisis. Borrowers often lack information about loan products for which they can qualify, originators may lack information about borrowers' ability to repay their loan, and investors may lack information about the true default risk of a pool of mortgages. HFAs can address these challenges by increasing the flow of information about mortgage products, risks, and costs between borrowers, lenders, and investors, and by increasing the incentives for participants to use information in origination and servicing decisions. The Great Recession and its aftermath, along with recent regulatory reforms, have also created challenges and opportunities for HFAs to reassess their business models and strategies.

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[1]NCSHA *Factbook 2010*, Table 1, 63.

While state HFAs administer a variety of housing programs, including the Low Income Housing Tax Credit (LIHTC) program for rental housing development and the recent U.S. Treasury's Hardest Hit Fund (HHF) initiative for homeowners in financial distress, in this chapter we limit our focus to state HFA programs for single-family home purchase. More narrowly, using administrative and survey data, we catalog the different financing instruments, products, and activities employed by HFAs to promote and sustain first time homeownership. We also discuss the central role that HFAs may be able to play in a national housing finance infrastructure post-reform. As important as the later point is, it has little attention in the research literature. From this perspective alone, this chapter addresses an important void.

Overall, we find HFAs to be highly effective in addressing important market functions while at the same time fulfilling the public purpose of facilitating access to mortgages to creditworthy but otherwise underserved borrowers. The fact that the performance of HFA loans compares favorably with that of similar non-HFA loans is a reflection of that effectiveness. We find that HFAs' traditional mortgage revenue bond business remains critical. At the same time, most HFAs are diversifying funding for single-family mortgage assets in significant ways, including direct participation in the mortgage backed securities market. Not surprisingly, we find that the capacity to undertake this and other new, flexible, and diversified activities varies by HFA. Efforts to increase HFA sophistication in these areas are likely critical to future success.

Pending regulatory changes may create opportunities for HFAs to develop new products to serve borrowers otherwise cut off from mortgage financing. HFAs have the potential to become a key mechanism to provide sustainable mortgage credit for low-income, minority, and other underserved borrowers in a future reformed national housing system. However, the discretion of HFAs to set innovative standards for their loan programs is often constrained by the private market participants on whom they rely for origination, servicing, and/or investments. Changes to servicing strategies and the secondary market environment, in addition to innovative product development, may be necessary to create additional demand for future HFA mortgage products.

State Housing Finance Agencies & Homebuyers

Two pieces of federal legislation in the 1960s led to the creation of state HFAs. The 1968 Housing Act provided federal funding to states to develop rental housing, and the 1968 Revenue and Expenditure Control Act permitted the use of tax exempt industrial revenue bonds for "residential real property for family units." By 1987, 47 states had developed an HFA. By 2002, all states as well as Puerto Rico, the US Virgin Islands, and the District of Columbia had functioning HFAs.[2] In addition to facilitating housing development, the ability of state HFAs to issue tax exempt bonds was viewed as a vehicle to attract new capital into the state, particularly institutional and individual investors in the long-term capital market who would typically purchase tax-exempt securities, but not residential mortgage securities.[3] Further, state HFAs were largely self-sustaining, requiring no state budget allocations or subsidies beyond the federal tax expenditures to incentivize the bonds. Initially, most state HFAs initially sold bonds to support rental housing development, but beginning with Virginia in 1974, HFAs began selling tax-exempt bonds to expand homeownership opportunities.

The entry of state HFAs into mortgage markets was initially justified by Congress as a vehicle to benefit low- and moderate-income households unable to qualify for mortgage financing with conventional interest rates.[4] Extraordinarily high mortgage interest rates in the 1970s and early 1980s created substantial affordability barriers for households. State HFAs could use the proceeds from the tax-exempt mortgage revenue bonds (MRBs) to originate mortgages to borrowers at reduced interest rates. MRBs are tax exempt, private activity bonds purchased by investors at lower yields because of the tax-exempt status of interest income they receive; HFAs traditionally use the spread between the market rate and the issue rate to originate mortgages at below market rates to homebuyers. Further, HFAs are permitted a spread between the interest rate on the MRBs and interest rate on mortgages originated (arbitrage), which they can use to finance program administration and additional services, making the programs largely self-sustaining.[5] Changes in the prevailing interest rates and

[2]NCSHA *Factbook* 2010, 3.
[3]Stegman.
[4]GAO 1988.
[5]The spread amount (arbitrage) is currently limited to 1.25 percent.

marginal tax rates[6] over time have affected the magnitude of the interest rate subsidies, ranging from 360 basis points in 1981, to 200 basis points in 1985, down to 50-100 basis points in 1988, and on par with conventional mortgage rates today.[7]

The early years of HFA homebuyer programs were marked by some controversy. Particularly, some questioned the extent to which MRBs were effectively targeted to underserved borrowers. Part of this controversy stemmed from the entrance of local governments into the tax exempt MRB market between 1978-1980, with much less regulation and oversight than state-administered MRBs.[8] For example, one study found that two-thirds of the population would have qualified for a local MRB subsidized mortgage based on income in 1978.[9] Such coverage was beyond the intent of the enabling Federal legislation. As a result, the 1980 Mortgage Subsidy Bond Tax Act limited the amount of MRBs states could issue, thus granting states oversight of the amount of MRB volume delegated to local authorities. Further restrictions were placed on borrowers to be first-time homebuyers (borrowers who have not owned a home in the previous three years) buying homes below a specified price. Special treatment was permitted for targeted underserved areas. Restrictions were placed on the amount of fees that the implementers could earn from administering MRBs.

Despite the 1980 legislative changes, controversy over the targeting of the MRB program continued, fueled by a 1983 report by the GAO finding that 78 percent of 1982 recipients had incomes above median income, and the majority could have afforded homes without additional subsidies.[10] Tax reforms in 1986 further reduced the amount of funds that HFAs could leverage, making them competitive with other state private purpose bonds for total state bond limits.[11] Eligible borrowers were restricted to residents earning less than 115

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[6]Because of lower marginal tax rates, the spread between the market rates and the MRB subsidized rate was permitted to decline, as investors needed more of a tax break to offset their lower total tax liability (Durning 1992).

[7]Gross, 126.

[8]Calkins and Aronson; Cooperstein; Durning 1992; GAO 1988.

[9]Durning 1992.

[10]GAO 1983.

[11]From 1986-2000, the annual bond cap was set at $50 per capita or $150 million if greater, per state. Beginning in 2002, the bond cap was raised to $75 per capita ($225 million if greater), and in 2003 was indexed to increase annually for inflation. For 2013, the bond cap per state is the greater of $95 per

percent of the area (or state) median income, and eligible homes were limited to less than 90 percent of area average home price, with some exceptions for target areas (limits that are still in place today). Congress also authorized an alternative Mortgage Credit Certificate (MCC) program in 1984, providing eligible homebuyers a tax credit for a set fraction of mortgage interest paid,[12] rather than a monthly payment subsidy. Presumed to be more efficient and less affected by interest rate fluctuations, states could substitute MCCs for MRB authority. However, because the MCC is a non-refundable tax credit, demand has been limited to relatively higher-income borrowers.[13]

Aside from challenges regarding the targeted population, early studies also questioned the *efficiency* of the MRB subsidy. GAO studies found that the cost to the federal government in terms of lost tax revenue from MRBs could be as high as four times the amount of the benefit provided as a monthly payment subsidy to homebuyers.[14] Additional research suggested that a portion of the monthly payment subsidy may be capitalized into housing costs, whereby those homebuyers with MRB subsidies pay more for the same home than they otherwise would without the subsidy due to inefficient shopping and seller (or builder) control over access to MRBs and home prices.[15] A more recent study highlights the relative efficiency of the MCC program to the MRB program, due to lower administrative costs associated with issuing a one-time certificate versus subsidizing and servicing mortgages. The authors suggest that a simple change to make the MCC refundable could shift the demand in favor of MCCs.[16]

The studies above focus primarily on the value of the direct subsidies provided by HFAs, and not the value of HFAs broader role in mortgage markets. Since the onset of the Great Recession, HFAs are viewed as playing an important countercyclical role in stabilizing mortgage markets. For example, the 2008 Housing and Economic Recovery Act (HERA) included a

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capita, or $291.875 million. HFAs can carry forward unused bond authority tied to a specific purpose or project for 3 years (NCSHA 2010).

[12]This fraction is typically 10-40 percent of total interest paid, or no more than $2,000. The remaining amount can be taken as a typical mortgage interest deduction.

[13]Greulich and Quigley.

[14]GAO1983; 1988.

[15]Durning and Quigley; Cooperstein; Durning 1992.

[16]Greulich and Quigley 2009.

temporary increase[17] of $11 billion in the annual private activity bond cap for housing activities (single- and multi-family). In October of 2009, Treasury launched the temporary "HFA Initiative" under HERA authority, in order to "maintain the viability of HFA lending programs and infrastructure".[18] The initiative increased the liquidity for HFA mortgages through the purchase of 13.9 billion in MRBs under the New Issue Bond Program (NIBP).[19] Articulating the case for HFA involvement in mortgage markets is thus an ongoing and important discussion.

The Role of HFAs in a Brave New World

HFAs combine both market and mission driven purposes, effectively balancing a sustainable business model while at the same time fulfilling their public purpose. A few important characteristics uniquely position state HFAs to fulfill these purposes: (1) most HFAs are independent authorities (80 percent in 2010),[20] benefiting from a quasi-governmental structure that provides them with more capacity for flexibility and innovation than mainline governmental entities; (2) HFAs are largely self-sustaining, generating their own revenue (only 30 percent were even included in the governors' budgets in 2010 for a direct appropriation);[21] and (3) HFAs exist across all 50 states, as well as the District of Columbia, the US Virgin Islands, and Puerto Rico, providing a common infrastructure while allowing for local variation in response to state specific housing needs.

While the relatively independent position of HFAs within state government offers more flexibility than other state agencies, their historic reliance on mortgage revenue bonds to finance their operations tends to make them more risk averse than other agencies. In 1993, Goetz critiqued HFAs as having a "conservative, banker like outlook on housing development."[22] In fact, most state HFAs operate within the origination channels and underwriting standards of conventional mortgage lenders to operate their homeownership

[17] Available through 2010.
[18] Treasury 2009.
[19] NCHSA 2010.
[20] NCSHA 2012.
[21] NCSHA 2012.
[22] Goetz, 77.

initiatives.[23] Further, most mortgages originated by HFAs are guaranteed by the federal government through Fannie Mae, Freddie Mac, or Ginnie Mae (e.g. FHA insured mortgages), and/or limit investor risk through a moral obligation clause,[24] thus providing credit enhancement so that even if the borrower fails to make their mortgage payment, the MRB investor will be repaid. Sometimes HFAs do not securitize their loans and instead retain them in portfolio ("whole loans"). In this case, HFAs can reduce MRB purchaser risk through a "moral obligation clause," or a non-binding commitment that MRBs issued by the state housing finance agency will be backed by state funds, through a budget recommendation to the state legislature to finance shortfalls (e.g. due to excessive borrower delinquencies).

Thus, rather than serving as an alternative to private market financing, HFAs leverage the private market to fund and guarantee mortgages. What, then, is the benefit-added of HFA involvement in the mortgage market, above and beyond what could be provided through the private market alone? The role of state HFAs in mortgage markets is part of a broader discussion about government involvement in mortgage markets, which can be broken into two distinct justifications: (1) government support for and promotion of *homeownership* to *increase access,*[25] and (2) government oversight of and intervention in consumer *mortgage transactions* to *reduce risk*.[26] Traditionally, the role of HFAs in mortgage markets has been defined as increasing access to homeownership for underserved populations, falling squarely under the first justification above. In this chapter, we suggest that HFAs are increasingly evolving to play an important role in reducing risk, as they are uniquely positioned to correct market failures related to the nature of exchange in the mortgage transaction. We describe both roles briefly below, followed by a presentation of survey data on current HFA strategies.

Access: Reduce Barriers to Entry

To the extent that owning one's home is associated with individual benefits for the owner as well as positive externalities for communities and markets, government intervention

[23]Dylla & Caldwell-Taugtes.
[24]A moral obligation clause is a non-binding legislative commitment to ensure minimum levels of capital reserves for the HFA's origination activities.

may be justified to remove barriers that prevent certain creditworthy individuals from entering the market. Such barriers could be financial (e.g. lack of sufficient funds to qualify) or structural (e.g. lack of access to affordable mortgage products). The exclusion of certain groups of individuals or neighborhoods from mortgage markets may not only be unfair, but may also be economically inefficient, particularly to the extent to which otherwise creditworthy borrowers are not provided the opportunity to participate or are provided with unnecessarily high cost products.[27]

State HFAs can help address these barriers by providing direct subsidies, through reduction to the monthly payment and/or through up front funding for downpayments. HFAs also help address access barriers by enhancing access in local underserved communities, through targeting and outreach to underserved populations and by building networks with community organizations, local lenders, and realtors. When HFAs entered the homeownership market in the 1970s, potential borrowers with otherwise good credit histories were excluded from the market because of high interest rates. Mortgage underwriting at the time relied heavily on "affordability ratios" to be approved for financing; generally, mortgage payments (principal, interest, taxes, and insurance) had to be lower than 29 percent of a household's gross monthly income, and all financed debt including mortgage payments had to be lower than a 36 percent threshold. By lowering the interest rate on the mortgage, HFAs were effectively able to lower the monthly payment, thereby increasing the likelihood that a given homebuyer would qualify for a mortgage. Today, lack of sufficient wealth to make a downpayment for home purchase presents a significant barrier for homebuyers.[28] Many HFAs thus offer up-front downpayment subsidies to otherwise credit-worthy borrowers by leveraging state and federal funds, in conjunction with the affordable mortgage product.

Aside from direct subsidies, HFAs are also positioned to break down structural barriers that may reduce access to affordable mortgages for certain populations. Recent research suggests that LMI homebuyers don't necessarily self-sort into the lowest-priced product for which they may qualify. For example, a good portion of LMI homebuyers who received higher

[27]Lax, Manti, Raca and Zorn; Belsky and Wachter.
[28]Quercia, McCarthy, and Wachter.

cost subprime mortgages during the housing boom would have likely qualified for lower cost sustainable conventional mortgages.[29] To the extent that HFAs strategically target affordable mortgage products to areas otherwise targeted for higher cost lending, they may help address issues of allocative inefficiency.[30]

Sustainability: Informational Barriers

While increasing access may help address market inefficiencies, market expansions created by increased access may not be sustainable if participants in the transaction lack full information and/or lack the incentives to engage in adequate screening and monitoring for the transaction.[31] As was characteristic of subprime lending, incomplete information may lead borrowers, lenders, or investors to make decisions about mortgages that they would otherwise not make if they had full information. Insufficient incentives for careful screening and monitoring can lead lenders and investors to approve or finance loans in the short term with less scrutiny over the borrower's ability to repay the debt over the long term.[32] Both incomplete information and insufficient incentives have been cited as contributing factors to the recent mortgage crisis.[33]

For individual borrowers, mortgage decisions can be complex, requiring sufficient understanding of terms and conditions that many first-time homebuyers may not possess.[34] By incorporating education and counseling to homebuyers as part of the mortgage product, HFAs can help improve the likelihood that borrowers make informed mortgage decisions, both before and after purchase. Further, the network of lenders, realtors, and nonprofits involved in HFA funded mortgages increases the potential flow of information about borrowers and local markets, including "soft" information that may not be reflected in a borrower's credit report, such as their commitment to repay the mortgage that is demonstrated by their regular

[29]Carr and Schuetz; Chomsisengphet and Pennington-Cross.
[30]Moulton and Bozeman.
[31]Glaeser and Kallal; Belsky and Wachter.
[32]Agarwal, Chang and Yavas; Keys,Seru, and Zig; Purnanandam.
[33]Jiang, Nelson and Vytlacil; Quercia, Freeman, and Ratcliffe.
[34]Bucks and Pence.

attendance at homebuyer education classes in the community.[35] There is some evidence suggesting that this type of "relationship lending" may reduce the probability of borrower default.[36]

Even if information is available, obtaining information can be costly and thus market participants must have incentives to collect and use information in mortgage decision-making. HFAs face financial and reputational risk if loans within their portfolio default at rates higher than projected, including eventual downgrading of their bond issues (critical to their financial viability). While most HFAs fund mortgages originated through a network of private lenders, they typically require participating lenders to enter into an agreement with the HFA that can be terminated if a particular lender originates mortgages with excessive default rates. Further, some require originators to repurchase mortgages that default within 6 or 12 months after home purchase, increasing the incentives for lenders to screen borrowers carefully.

On the servicing side, state HFAs often service the loans that they fund in house or contract with a Master Servicer or a limited set of servicers. Incentives to prevent default often lead to preventative servicing strategies, such as early interventions at the first sign of delinquency and/or immediate referral to a housing counselor. Research suggests that such preventative strategies may be associated with reduced default for otherwise similar borrowers.[37]

Current HFA Strategies

In the following section, we describe the current scope and strategies of state HFAs, with information collected through two primary sources. First, we extract data from the National Council of State Housing Agency's (NCSHA) annual *Factbook*. NCSHA is a nonprofit membership organization representing the interests of state HFAs. Each year, NCSHA conducts a survey to document the scope of HFA activities, with a 95-100 percent response rate. We primarily draw from data collected for the 2006 and 2010 *Factbook*s (2010 is the most recent available at the time of this writing). Second, we administered our own web-based survey to

[35]Ergungor.

[36]Ergungor and Moulton; Moulton.

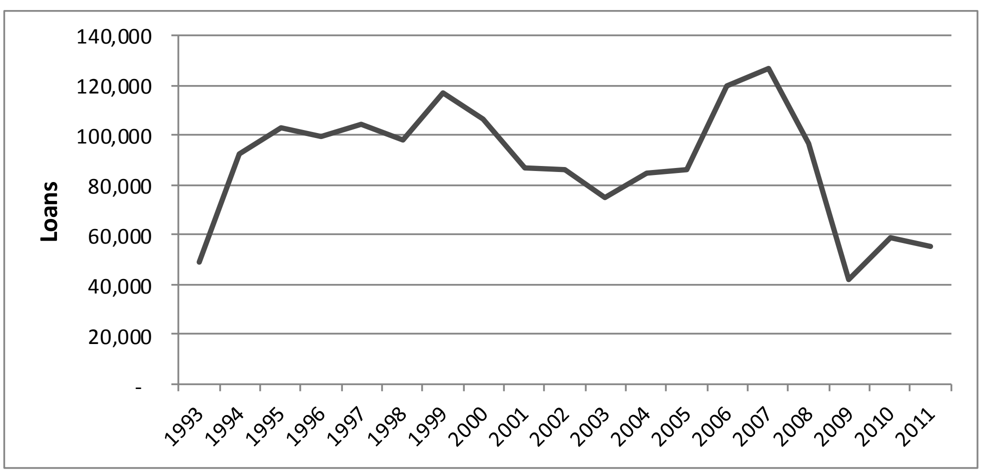
[37]Cutts, Crews and Green; Stegman, Quercia, Ratcliffe, Ding, and Davis.

state HFAs between December 2012 and January 2013, with a response rate of 71 percent, or 37 out of 52 states and territories with active homebuyer programs. We supplement these two surveys with data recently collected through a study on HFA homebuyer education and counseling programs,[38] as well as statistics on loan performance from the National Delinquency Survey reported by the Mortgage Bankers' Association.[39]

Size and Scope of Homebuyer Programs

From program inception through 2010, HFAs have funded nearly 3 million loans, 2.91 million through the sale of MRBs and 165,600 through MCCs.[40] The volume of loans closed by state HFAs (financed through MRBs) averaged about 100,000 per year from 1994 to 2008, with a peak of 126,611 loans in 2007. Loan volume dropped significantly two years later to a low of 41,857 loans in 2009, with a slight rebound to 59,127 loans funded in 2010 (Figure 1). The decline in 2009 mirrors the overall decline in mortgage originations in the market.

Figure 1: Number of MRB Subsidized Home Purchases, By Year



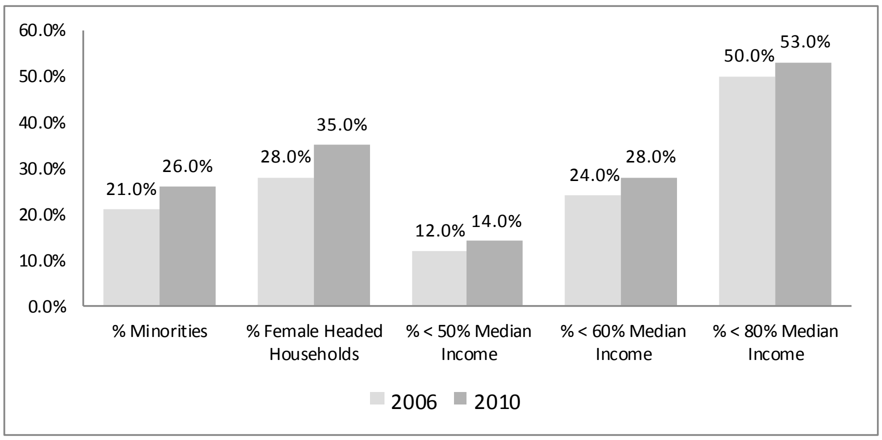
Source: National Council of State Housing Agencies

Despite fluctuations in loan volume, HFAs continue to extend credit to underserved populations. In fact, the share of mortgages to those populations has increased since 2006.

[38]Dylla and Caldwell-Taugtes.
[39]MBA.
[40]NCSHA *Factbook* 2010.

Figure 2 provides summary statistics from the NCSHA *Factbook* for the years 2006 and 2010. The proportion of HFA funded loans to minority households, female headed households, and very low (<50% area median) and low (<80% area median) income has increased.

Figure 2: MRB Borrower Characteristics, by Origination Year

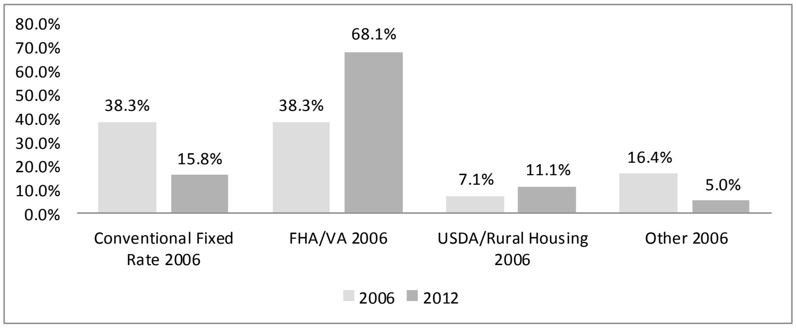


Source: Author compilation from NCSHA *Factbooks*, 2006 & 2010

Loan Products, Securitization, and Financing

Most HFAs offset risk to investors by ensuring that loans are guaranteed in the case of default, either through conventional financing (e.g. sold to Fannie Mae and Freddie Mac), or insured/guaranteed through the Federal Housing Administration, Veteran's Administration (FHA/VA), or the US Department of Agriculture (USDA) Rural Housing Services. The proportion of loans distributed by these three guarantors fluctuates over time, following general market trends (see Figure 3). For example, FHA insured mortgages as a share of total HFA portfolio has increased significantly between 2006 and 2012, due in part to the tightening of underwriting guidelines for conventional mortgages during the economic recession. Some states have offered other, uninsured loan products, although the proportion was higher during 2006 than in the more conservative lending environment of 2012 (e.g. the need for federal insurance to offset investor risk and strengthen HFA credit ratings).

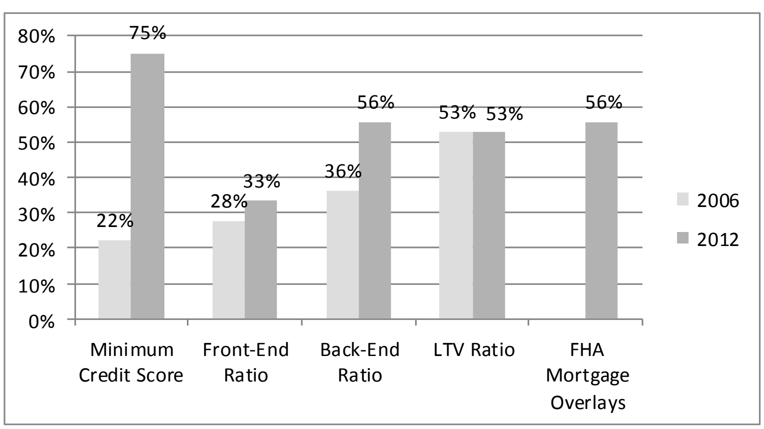
Figure 3, Product Distribution 2006 & 2012



Source: 2012 author survey of state HFAs; N=37

Indeed, many state HFAs have added their own underwriting criteria (credit enhancements, or overlays) on top of the secondary market criteria to preserve the quality of loans in their portfolios and to ensure standards in line with participating lender and servicer demands. Following general industry trends, this has increased substantially since 2006, as demonstrated in Figure 4. For example, 75 percent of HFAs report having a minimum credit score requirement for at least some of their loan products in 2012, an increase from only 22 percent in 2006. The credit score threshold fluctuates between agencies and over time; the majority (63 percent) of those with a requirement in 2012 set the minimum at 620, with 30 percent setting the floor at 640. Some HFAs add additional requirements for all loan products, others only require additional underwriting criteria for particular loans (for example, those with HFA funded downpayment assistance).

Figure 4, Proportion of HFAs with Additional Overlays



Source: 2012 author survey of state HFAs; N=37

Perhaps the most significant change is the gradual diversification of the financing mechanisms for HFA single family mortgage assets. A significant number of HFAs have transformed their MRB financing structures from in-house ("whole loan") status to financing through mortgage backed securities (MBS), potentially reducing credit risk (Table 1). Under the whole loan structure, MRBs issued by state HFAs are backed by the full faith and credit of the state HFA, collateralized by mortgage loans to borrowers. HFAs thus assume the risk for borrower repayment. When HFAs securitize mortgages financed by MRBs, the risk is passed on to the secondary market purchaser, guaranteeing that the MRB investors are repaid, regardless of borrower repayment (i.e., the secondary market purchaser assumes the risk of borrower repayment). Second, while MRBs still comprise the dominant source of financing, in light of 40-year record low interest rates and increasing regulations that limit the profitability of MRBs, HFAs are beginning to engage other mechanisms. For example, 37 percent of HFAs report selling non-MRB mortgage backed securities (MBS) to finance at least a portion of their single family mortgage assets in 2012, compared with none in 2006. This strategy allows HFAs to bundle and sell a pool of loans directly into the MBS market (including the "to be announced," or TBA market) for an up-front financial return, rather than earning revenue over time from the mortgages backed by MRBs (which is less profitable when the spread between the MRB interest rate and conventional rates is very low to non-existent). It is unclear the extent to which this shift will be temporary (reverting to MRB financing when interest rates rebound), or if this shift may bring with it a new era in single-family financing products and structures for state HFAs.[41]

Table 1, Funding for Single-Family Mortgage Assets

	HFAs Holding These Assets		
	2006	**2012**	**Change**
MRB MBS	33.3%	43.0%	9.7%
MRB Whole Loan	63.9%	43.0%	-20.9%
Non-MRB MBS	0.0%	37.0%	37.0%
Non-MRB Whole Loan	11.4%	11.0%	-0.4%

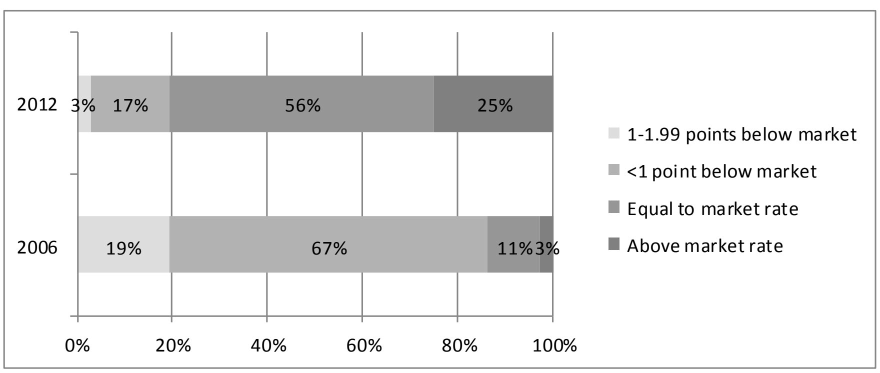
Source: 2012 author survey of state HFAs; N=37

[41]Moody's Investor Services.

Subsidies: Interest Rates & Downpayment Assistance

Historically, the benefit-added by state HFA mortgages has been defined as the interest rate subsidy provided to homebuyers. To the extent that interest rate subsidies reduced the monthly payment burden (which may have been a barrier for mortgage financing), HFAs were increasing access to credit for otherwise underserved populations. While the spread between conventional and MRB subsidized interest rates has fluctuated over time, the recent economic —downturn—with interest rates reaching 40 year —lows—has resulted in the loss of the "interest rate advantage" for state HFA mortgage products. For example, the proportion of HFAs providing below market interest rates decreased from 77 percent in 2006, to 19 percent in 2012 (Figure 5). In fact, 24 percent of HFAs reported financing mortgages with interest rates slightly above market rates in 2012. In the words of one state HFA executive: "The interest rate is no longer the driver of our perceived value." For better or worse, this shift has led HFAs to redefine their benefit-added to the market.

Figure 5, HFA Funded Mortgage Interest Rate, 2006 & 2012



Source: 2012 author survey of state HFAs; N=37

One advantage frequently cited by HFA executives is their provision of downpayment assistance (DPA) subsidies. While some HFAs have historically offered DPA in conjunction with their affordable loan products, the recent tightening of underwriting standards, including lower loan to value (LTV) thresholds, has increased demand for HFA-provided downpayment assistance. For example, in 2011, 88 percent of HFAs offer some form of DPA.[42] Further, HFA

[42]Dylla& Caldwell-Taugtes.

executives report that about 50 percent of HFA financed loans had DPA in 2006, compared with about 70 percent of loans in 2012. This DPA is structured in a variety of ways, including grants, loans, and deferred and/or forgivable loans.

Pre- and Post- Purchase Support

Another benefit-added of HFA funded mortgages is additional support provided to homebuyers before and after purchase. Prior to purchase, many HFAs require or recommend that assisted borrowers participate in homebuyer education and counseling (HEC). According to a recent study, one-third of HFAs require homebuyer education and counseling (HEC) for all of their loan products, while an additional 49 percent require HEC for some of their loan products and 12 percent provide buyer incentives to take-up HEC services.[43] Further, 59 percent of HFAs provide financial or technical support to other providers of HEC, while 14 percent provide HEC services directly. Aside from the instrumental benefits of HEC for borrowers, HFAs' involvement with HEC providers increases the capacity and diffusion of best practices statewide.

Almost all HFAs facilitating HEC services report that HEC "prepares borrowers for the complexities of the homebuying process (97.5 percent), and "reduces loan delinquencies and foreclosures" (92.5 percent). The content of HEC may vary, including topics such as assessing readiness for homeownership, general budgeting and credit, mortgage financing, and home maintenance. More than half of HFAs (55 percent) have adopted the National Industry Standards for Homebuyer Education and Counseling,[44] which stipulate content and delivery standards for quality HEC programs, and 29 percent of HFAs have established their own standards for HEC providers.[45] Further, simply by establishing a relationship between borrowers and HEC counselors prior to purchase (in house or within community organizations), HFAs help build bridges for vulnerable homeowners to seek help if they experience difficulties after purchase.

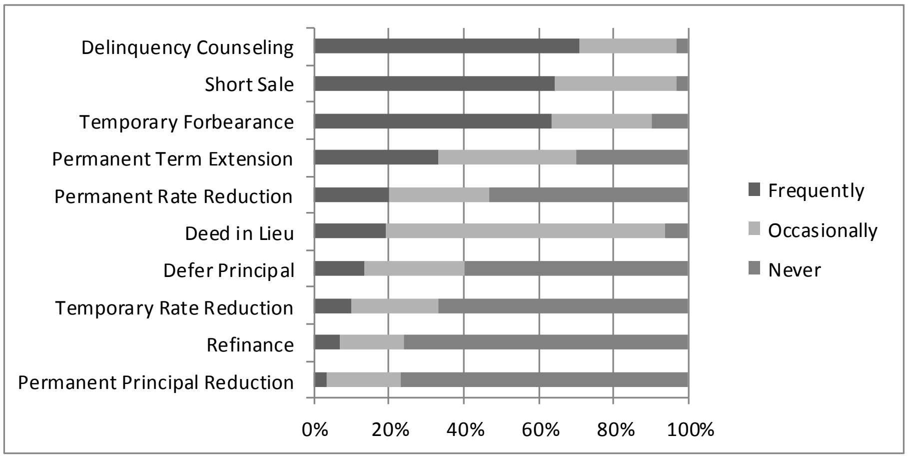
[43] Dylla& Caldwell-Taugtes.
[44] http://www.homeownershipstandards.com/Uploads/National%20Industry%20Standards%20Code%20of%20Ethics%20Guidelines.pdf
[45] Dylla& Caldwell-Taugtes.

In addition to preparing borrowers prior to purchase, many state HFAs employ preventative servicing strategies to reduce mortgage defaults. These strategies can be structural, based on the servicing structure for HFA funded mortgages and how servicers are held accountable, and/or programmatic, with specific interventions identified to respond to early delinquency. First, structurally, many HFAs have reorganized servicing to allow for more direct agency oversight. This may be accomplished through locating servicing in-house, rather than contracting out to single or multiple providers, and/or contracting with one Master-Servicer, rather than several independent lenders each with their own servicing procedures. While modest, HFA executives report a slight increase in centralized servicing (in-house or with a single master-servicer) in 2012; 67 percent report using this strategy up from 62 percent in 2006. Shared servicing models between HFAs are also developing, where one HFA will provide servicing for multiple HFA portfolios.

Further, 49 percent of HFA executives report programmatic strategies to intervene with HFA assisted homebuyers to prevent default, above and beyond what the servicer would ordinarily provide for non-HFA mortgages. Of those with programmatic strategies, 82 percent intervene within 30 days of a missed payment, and 18 percent between 30 and 60 days of a missed payment. Some HFA executives report requiring borrowers to sign authorization for Early Default Counseling at the time of closing, thereby giving permission for a housing counselor to make contact with delinquent borrowers as soon as they miss a payment.

Once a borrower enters default, HFAs employ a variety of different strategies to assist their borrowers. Figure 6 provides a breakdown of the strategies used by HFAs for loans funded in their single-family portfolios. For example, 71 percent report frequently offering counseling and 63 percent report frequently offering temporary forbearance. Other strategies, such as permanent principal reduction and refinancing are less common.

Figure 6, Preventative Servicing Strategies for HFA Single-Family Mortgages



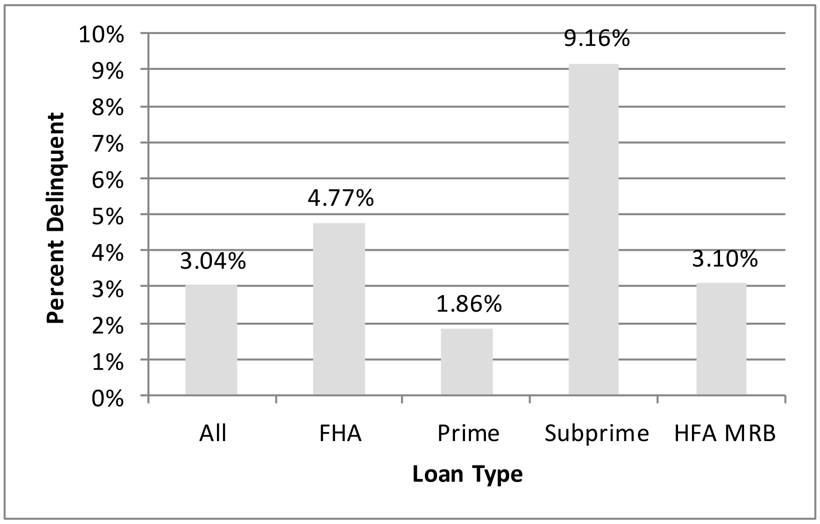
Source: 2012 author survey of state HFAs; N=31 (of states reporting any strategies)

HFA Loan Performance

HFA single family mortgages tend to be less likely to become delinquent or default than non-HFA mortgages to otherwise similar borrowers. HFAs have not been immune to the effects of the housing market crash and related economic shocks; the proportion of mortgages in HFA portfolios that are in distress has increased substantially post the 2007-2008 crisis. According to data on 20 HFAs with debt rated by Standard and Poor's, delinquency rates for HFA funded mortgages increased from 3.14 percent in 2006 to 7.1 percent during the third quarter of 2011.

Despite increases in delinquencies due to the Great Recession, on average, HFA-funded mortgages perform relatively better than non-HFA mortgages, likely due to the proper underwriting of affordable loan terms, diligent screening and servicing, and borrower support discussed above. Of the 30 HFAs reporting data on loan performance for our survey, the average proportion of loans 90 or more days delinquent as of June 30, 2012 was 3.10 percent, and the average proportion of loans in foreclosure was 1.89 percent. Comparatively, delinquency data from the Mortgage Bankers' Association for the same period demonstrates that HFA mortgages out- perform FHA delinquency rates (4.77 percent) and subprime mortgages delinquencies (9.16 percent) during the same period (See Figure 7). While HFA delinquencies are slightly higher than the delinquency rates for prime conventional mortgages, the risk characteristics of HFA first-time homebuyers are more similar to FHA and subprime borrowers, with higher loan to value ratios and lower incomes.

Figure 7, % Loans 90+ Days Delinquent as of June 30, 2012



Source: Mortgage Bankers Association (MBA) National Delinquency Survey Q3, 2012; compared to HFA self-reported loan performance data per 2012 author survey of state HFAs; N=30 HFAs with loan performance data

Future Opportunities and Challenges for State HFAs

Several factors stemming from the great recession have challenged the traditional business models of HFAs: lower market interest rates that reduce the potential spread on MRB loans; fewer options for mortgage insurance or guarantees to reduce investor risk; and tightened regulations and underwriting standards for mortgages, specifically those with lower downpayments and higher risk borrowers. While interest rates will eventually rebound, changing market conditions and new legislation will likely continue to be part of the HFA reality.

On the survey, we asked HFA respondents a series of open-ended questions about future opportunities and challenges. Through a content analysis of responses, we summarize the opportunities and challenges in four broad areas: (1) increase flexibility and funding diversification; (2) enhance agency capacity to implement change; (3) maintain strong agency standards; and (4) provide innovative products that meet local needs. Each is described in more detail below.

Increase Flexibility and Funding Diversification

More than 70 percent of the HFA respondents mentioned "flexibility" or "funding diversification" as part of their response to the "single most important lesson their agency learned from the economic recession." The relatively nimble structure of HFAs as quasi-governmental entities allows them to adapt to changing economic circumstances. Several economic changes have led to new strategies, each with their own set of challenges.

Record low private market interest rates has reduced the potential spread between MRB-funded mortgages and conventional mortgages. This not only reduces the competitiveness of HFA mortgages to homebuyers, but it also reduces the revenue available to fund agency operations and additional services. HFAs generate revenue, in part, on the difference (spread) between the interest rate charged to the homebuyer and the interest rate on the MRB to investors. Over time, this spread has allowed HFAs to not only finance operations, but to develop substantial capital reserves (also important to preserving bond ratings). To the extent that the spread is no longer generating revenue, HFAs look to other strategies, such as short-term sale of bundled mortgages into the mortgage backed securities (MBS) market, with or without financing through mortgage revenue bonds.

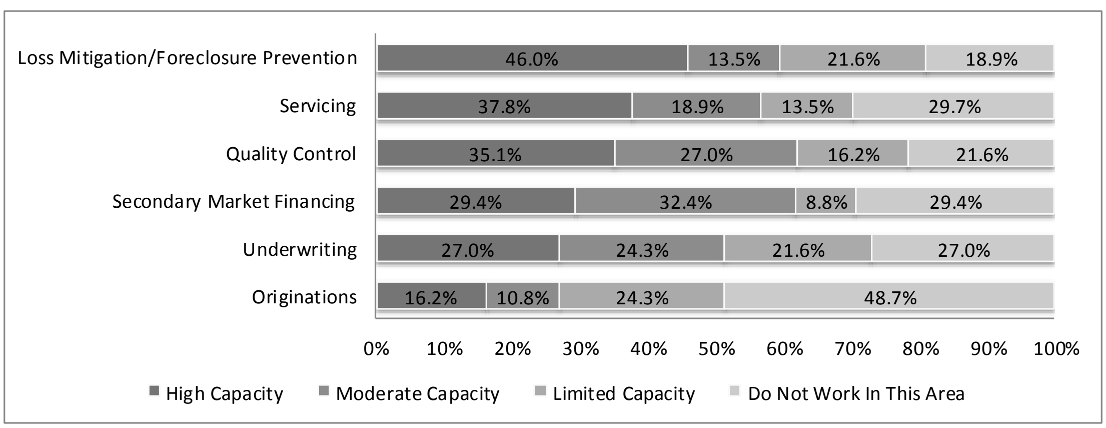
This strategy can provide HFAs with immediate, short-term return for their funded mortgages, rather than the longer term revenues associated with traditional 30 year MRB pools of mortgages. Further, this strategy reduces the potential exposure (risk) of HFA funded mortgages, particularly when compared with agencies that traditionally held all of their HFA mortgages in-house (sometimes referred to as "whole loan states"). However, the challenge for HFAs will be balancing the potential short-term payoff with longer-term financial security. Balancing the risk and return associated with these different strategies requires a level of financial sophistication that many HFAs may not currently have. While new strategies are important for weathering economic cycles, MRBs have provided a historic benefit to HFAs that should remain part of their financing structures over the long term. In the words of one HFA executive, HFAs need to "adapt to the ever changing market, but be ready when the municipal bond market does return to be able to issue tax exempt mortgage revenue bonds."

Enhance Agency Capacity to Implement Change

Many of the changes noted in the survey, including diversified funding for single family assets, more complex loans products, increased servicing of HFA funded "loans in house" and preventative servicing strategies, require changes in agency capacity. Indeed, many HFAs reported challenges related to developing a “new way to do business.” These challenges include investments in infrastructure and staff, designing new processes and procedures, and learning new technology and software. The ability of HFAs to leverage sufficient financial (and staff) resources to make these sorts of capacity investments can present a significant challenge. According to our 2012 HFA survey, state HFAs employ on average 145 full-time staff persons, with 12 (8 percent) dedicated to single family homeownership programs.

On the survey, we asked HFA respondents to rate their capacity in a variety of areas related to single family loan programs, if they engage in that area at all (Figure 8). Most HFAs expressed the strongest perceived capacity in areas such as foreclosure prevention and servicing, and less capacity in areas such as secondary market financing, underwriting, and quality control. For example, 40 percent of respondents reported moderate or limited capacity in secondary market financing, and more than 45 percent of respondents reported moderate or limited capacity in underwriting—both areas with significant (recent) change for HFAs that are critical to their long-term viability.

Figure 8, HFA Self-Reported Capacity



Source: 2012 author survey of state HFAs; N=37

Maintain Strong Agency Standards

A key component of the relative success of HFA homeownership programs despite the economic downturn has been commitment to strong lending and financing standards. More than one-third of HFA respondents mentioned the importance of "financial strength," "moderation," and/or "strong lending standards" as being critical to their success through the Great Recession. Indeed, even the rating agencies that evaluate HFA bonds have indicated that HFAs have maintained a strong position, and note that any downgrades in ratings to date have largely been to downgrades in the federal government as a whole, which guarantees or insures many of the HFA-funded mortgages.[46]

Maintaining strong financial performance is critical to HFAs. On the survey, 92 percent of respondents identified bond ratings as being "very critical" to their agency, with the remaining 8 percent selecting "somewhat critical." A variety of factors affect the bond ratings of HFAs, including the proportion of delinquent HFA funded loans, adequate mortgage insurance or credit enhancements for HFA funded loans, securitization of HFA funded loans,and agency financial position, including level of capital reserves relative to equity.[47] On the survey, HFA respondents were asked to identify strategies they have used to preserve bond ratings. About half of the respondents noted decreased use of conventional mortgages with private mortgage insurance, in favor of government insured (FHA) loans, as well as the switch to MBS rather than whole loan assets.

HFAs also report an increased use of credit overlays, such as minimum credit score requirements or maximum debt-to-income ratios, in order to preserve the strength of their portfolios. Not unlike the rationales for the tightening of FHA underwriting criteria, the primary rationale for this change is to prevent HFA funded mortgages from being adversely selected by higher risk borrowers, concentrating those who would not otherwise qualify for mortgages in government funded programs.[48] This presents a risk not only to the state HFAs, but also to the market participants such as originators, lender servicers, and investors who are directly and indirectly invested in the performance of the program.

[46]Standard and Poor's; Moody's.
[47]Standard and Poor's; Moody's.
[48]Spader 2010.

Future federal regulatory changes in the market that broadly limit the eligibility of certain types of loans or borrowers, such as those under the Dodd-Frank Act's "Qualified Mortgage" (QM) and "Qualified Residential Mortgage" (QRM), will likely create opportunities and challenges for HFA funded mortgages.[49] Because of the strong performance of HFA-funded mortgages, it is likely that they may be granted exemptions from some of the QM/QRM standards and requirements, similar to certain exemptions for GSE- and FHA-insured mortgages. This is important, as HFA funded borrowers tend to have lower incomes with higher debt-to-income ratios, and relatively high loan-to-value ratios (low down-payments) that may be the target of regulatory changes. However, to the extent that a dual market develops, where HFAs only serve borrowers with higher risk profiles who would otherwise not qualify under new QM/QRM guidelines, the financial strength of HFA portfolios that has been critical to their viability may be threatened.

Provide Innovative Products& Services that Meet Local Needs

The ultimate opportunity—and challenge—for state HFAs is to continue to provide homeownership products and services that fulfill their public purpose to meet housing needs not otherwise met by the private market, while at the same time balancing a successful business model. Supply and demand side factors that affect this delicate balance are dynamic. On the supply side, the types of products and services offered depend on financing structures available to HFAs, investor expectations, and financial return. On the demand side, the types of borrowers who are considered "underserved" also varies based on market dynamics, including interest rate structures, underwriting requirements, and mortgage availability. The key to HFA success is to provide access to *affordable mortgage financing* for *underserved but creditworthy LMI borrowers* that will *be sustainable over time*.

On the survey, HFA respondents were asked to identify the top three advantages of HFA-funded mortgages in today's market environment (Table 2). More than 70 percent of

[49]For example, proposed QM rules require lenders to demonstrate a borrower's ability to repay their mortgage via set standards at the time of closing (including debt to income thresholds), or the originating lender could be held responsible for the loan if the borrower defaults. QRM rules require lenders to retain a set percentage (e.g. 5 percent) of the loans that they originate and sell to the secondary market, unless the loans meet certain eligibility criteria (e.g., loan that fall under maximum loan to value thresholds).

respondents listed downpayment assistance as the number one benefit of HFA mortgages in today's market environment, with many adding that this is the primary factor that attracts borrowers and participating lenders to their programs. However, affordable interest rates still remain among the top three benefits for more than 80 percent of respondents, a positive indication that the emphasis on affordability is still strong, despite the inability to offer below market rates. Of note, lender relationships were also listed as an important benefit for more than half of HFA respondents. Lender relationships were identified as critical to reaching the first-time homebuyer market with affordable loan products. As noted previously, such relationships may also allow HFAs to overcome informational barriers in mortgage markets.

Table 2: Perceived Market Advantage of HFA Loans

	Top Benefit	**Top 3 Benefit**
Interest Rate	14%	81%
Downpayment assistance	72%	94%
Customer service	0%	22%
Flexible guidelines	6%	17%
Lender relationships	6%	53%
Other	3%	19%

Source: 2012 author survey of state HFAs; N=37

It is important to highlight that flexible underwriting guidelines are not mentioned frequently, as most HFA loans are securitized and/or government insured and currently abide by these pre-established underwriting standards. HFAs have historically stressed their role as increasing access to homeownership by providing affordable mortgages, not by lowering underwriting standards. In the future housing finance system, HFAs may have an opportunity to target borrowers who are cut-off from private market financing because of new regulatory requirements (e.g. QM/QRM), but who are still considered to be creditworthy. For example, HFAs may allow relatively higher loan to value (LTV) ratios, or debt-to-income ratios than would be available through traditional channels, combining these relaxed standards with other tightened screening or servicing mechanisms. However, the discretion of HFAs to set their own underwriting standards for their loan programs may be constrained by the private market participants on whom they rely for origination, servicing, and/or investments. These entities may lack the capacity or willingness to adopt separate criteria for HFA funded mortgages.

Conclusions

In this chapter, we described the different financing instruments, single-family purchase products, and activities employed by HFAs today. Since their creation, HFAs have supported the extension of mortgage credit to more than 2.9 million low- and moderate-income households. HFAs have evolved into highly sophisticated financial entities that assist creditworthy homebuyers to access mortgage credit and promote post-purchase sustainability by addressing informational barriers. The benefit-added of HFA participation in mortgage markets is not limited to below market interest rates. While HFAs continue to fund mortgages with affordable interest rates, record low mortgage interest rates combined with tightening of underwriting standards has increased the salience of HFA-provided downpayment assistance. Further, many HFAs require homeownership education and counseling for borrowers, and some provide preventative servicing strategies to reduce mortgage default. Our analysis suggests that these various strategies seem to be working. From our survey data, we find that the 90-days loan delinquency rate for HFA loans to compare favorably with the performance of similar non-HFA loans.

The brave new world of housing finance, post the Great Recession, creates both opportunities and challenges for state HFAs. While MRBs still remain a critical component of HFA financing strategies, many are diversifying funding for single family mortgage assets, including increased participation in the mortgage backed securities (MBS) market. Not surprisingly, we find that the capacity to undertake new, flexible, and diversified activities varies by HFA. For example, about four in ten HFAs report having limited capacity in areas such as secondary market financing, underwriting, and quality control. Ensuring HFA financial capacity and sophistication is critical to their future success.

It is likely that regulatory reforms, such as the Dodd Frank Act's QM and QRM standards, will constrain the types of products and eligible borrowers receiving mortgages through private market channels. Otherwise creditworthy low- and moderate-income households may have difficulty obtaining mortgage credit through the private market, increasing the role for government involvement, such as through FHA-insured mortgages at the federal level and HFA-funded mortgages at the state level. As detailed in this chapter, HFAs offer strategic advantages for low and moderate income homebuyers, including providing additional subsidies and addressing informational barriers that are likely to become increasingly more complex in a post-financial reform world.

However, originating mortgages that fall outside of conventional standards poses challenges for HFAs. Structurally, the discretion of HFAs to set their own underwriting standards may be constrained by the private market participants on whom they rely for origination, servicing, and/or investments. These entities may lack the capacity or willingness to adopt separate criteria for HFA funded mortgages; thus, product offerings by HFAs may become less flexible and more standardized. Changes to servicing strategies and the secondary market environment, in addition to innovative product development, may be necessary. Further, to the extent that HFAs serve borrowers with higher risk, the strong financial performance of the HFAs could be put at risk. Thus, new product development must be combined with emphasis on creative strategies to mitigate risk, including education, counseling and preventative servicing. Given their expertise and record, HFAs have the potential to become key lenders for low-income, minority, and other underserved borrowers.

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