Special Comment

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Contact	Phone
New York	
Florence Zeman	212-553-4836
Bill Fitzpatrick	212-553-4104
Ali Sistani	212-553-4356
David Parsons	212-553-4537
Maria Ting	212-553-4461
Rachael McDonald	212-553-4456
Ferdinand Perrault	212-553-4793
Nicole Addalli	212-553-7823
Lisa Washburn	212-553-4133
Dallas	
Toby Cook	214-220-4352

Hot Topic in Housing

State Housing Finance Agencies' Bond Programs Expected to Safely Weather the Subprime Storm

In recent months, the rise in subprime mortgage delinquencies has garnered a great deal of media attention. Moody's has been asked by market participants whether the current issues in the subprime market are impacting the state HFAs' loan portfolios and how we expect the HFAs' bond programs to fare in an environment of flat or declining home prices. We believe that the HFAs' bond programs are less likely to suffer the problems experienced by the subprime lenders due to the following factors:

- Differences in business practices of HFAs vs. subprime lenders including preservation of underwriting standards, nature of mortgage products offered, maintenance or strong oversight of loan servicing and the HFAs' mission of home ownership for first-time home buyers
- Presence of mortgage insurance
- Financial strength of the bond programs

Although declining housing prices could have some negative impact on all mortgage portfolios, in our view, HFA bond programs are well positioned to withstand significant price declines without adverse impact on the ratings of the programs.

We also believe that some HFAs may see opportunities in the current subprime market to further their mission and assist financially distressed borrowers by refinancing loans to enable them to stay in their homes.

STATE HFAS SHARE FEW CHARACTERISTICS WITH SUBPRIME LENDERS

State HFA Loan Underwriting Standards Differ from those of Subprime Loans

State HFA single-family loans are generally originated to first-time home buyers who earn no more than the area median income or AMI (as detailed in the rules of the tax code). These loans may bear some characteristics in common with subprime loans, such as high loan-to-value ratios and borrowers who may have lower credit scores or weaker credit profiles than traditional prime borrowers. As the subprime mortgage market flourished and grew, one of the consequences was a deterioration of credit standards as many loans were made to borrowers who would have trouble qualifying for traditional loans. In contrast, HFAs with Moody's-rated bond programs have generally maintained their solid underwriting and documentation standards thus avoiding one of the causes often cited for the current rise in subprime delinquencies.

One key example of this deterioration of credit standards in the subprime market is the proliferation of loans made without income verification. Once reserved for the self-employed, "no or low documentation" loans were offered to wage earners by some subprime lenders. HFAs, however, maintained their requirements for documentation including proof of income, which is needed to verify that the borrowers' incomes are in compliance with the tax code.

HFAs Offer Fixed Rate Mortgage Products

The types of mortgage products offered by the HFAs has helped them to avoid the delinquency problems and defaults associated with some of the more exotic products offered by the subprime lenders The HFAs have traditionally offered a 30-year, fully amortizing, fixed-rate, level payment mortgage loan product. This mortgage type is the least risky type of mortgage as borrowers know what their monthly payment will be and can factor it into their budgets and the lenders can incorporate the payment in the underwriting of the loans.

Many subprime lenders, by contrast, have offered mortgagors a large variety of mortgage instruments including various adjustable rate mortgage (ARM) products. These ARMs can have rapid and steep changes in the mortgage interest rates and in the associated monthly mortgage payments. The sharp increase in a mortgage payment from one month to the next can create "payment shock" leading to delinquencies and defaults as borrowers encounter difficulties paying their unanticipated, higher monthly mortgage payments.

While a few HFAs have begun offering some nontraditional mortgage loan products such as 40-year amortization loans and interest-only loans, Moody's does not believe that these loans present the same level of risk as the more exotic ARMs offered by conventional and subprime lenders. Forty-year loans are still fixed-rate loans without any changes in the monthly payments. While the slower build-up of equity from the longer amortization could result in higher foreclosure frequency and loss upon default, we believe the increase in risk is minimal.

HFA interest-only loans are loans in which the borrower pays only interest on the mortgage for a set period of time (generally 5 to 10 years) and then the principal on the loan begins to amortize for the remaining term of the loan (anywhere from 23 to 30 years.) In addition to the slower equity build-up that these loans have, the loans do contain a risk of "payment shock" as the monthly mortgage payment will increase when the loan begins to amortize. We believe that these interest-only loans are less risky than some other mortgage products since the mortgage payment only changes once and the borrower is knows in advance what the higher payment will be upon mortgage closing. In fact, some of the HFAs that offer this product maintain regular contact with the borrowers to ensure that they are aware of the upcoming increase in their monthly mortgage payment.

Although the newer HFA products introduce some additional risks not associated with 30-year fixed-rate mortgages, Moody's incorporates these risks into the cash flow projections and loan loss models that we analyze during the rating process for HFA bond programs.

HFAs' Loan Servicing Results in Stronger Loan Performance

One of the keys to maintaining the credit quality on a pool of mortgage loans is the quality of the loan servicing. A strong servicer will, in addition to performing the daily functions of processing mortgage payments, closely monitor the performance of a portfolio and take early action to reach out to nonperforming borrowers. Many of the HFAs service all or a part of their loans in-house. Those HFAs who use outside servicers generally monitor the performance of the servicer and the portfolio regularly. If a loan defaults, most HFAs will become involved in the process in order to mitigate any losses to the program.

State HFAs' Mission Mitigates Foreclosure Risks

The mission of the state HFAs is to make affordable housing accessible to low and moderate income persons. As such, in addition to focusing on providing affordable mortgages to enable first-time homebuyers to achieve homeownership, they also aim to keep the borrowers in their homes. Accordingly, they offer products and services that mitigate the risks of the weaker credit profile of the borrowers. For example, most state HFAs suggest and, at times, require that its borrowers take homebuyer education courses and counseling prior to obtaining a loan. This education has proved to be an effective tool to reducing mortgage delinquencies as borrowers are given a clear understanding of the financial responsibilities they are taking on with homeownership.

For borrowers who have trouble paying their mortgage loans, the HFAs try to work with them to limit any losses and to try to help them get current on their loans. If a mortgagor is delinquent because of a job loss, many state HFAs have arranged with primary mortgage insurers to offer job loss protection to borrowers. In addition, some HFAs may be able to modify mortgage loans or provide second loans or state or federal grants to the borrower in order to avoid a default.

DECLINING HOUSE PRICES MAY INCREASE LOSSES BUT ARE NOT EXPECTED TO IMPACT PROGRAM RATINGS

As discussed above, a state HFA may take many steps to prevent a loan default; however, if those fail and the borrower is still not able to make the required payments, the loan will default and the loan servicer will commence foreclosure procedures. The loss to the bond program will be primarily the difference between the loan value and the market value of the property, plus foreclosure expenses. If prices of single-family homes decline, the likelihood of losses to the portfolio increases. While we expect that HFAs will not be able to avoid increased losses in a declining real estate market, we do not expect these losses to be material enough to impair ratings on HFA bond programs. This is due to several factors, including the presence of mortgage insurance on the loans and the support provided by a bond program's financial strength.

Loans are Covered by Mortgage Insurance to Mitigate Losses

HFA loans are generally covered by various types of mortgage insurance, which will mitigate losses in the event of foreclosure and a market value decline. In most HFA programs, loans with loan-to-value ratios (LTV) above 80% must be covered by mortgage insurance, at least until the LTV reaches 80%. The insurance may come from the federal government, through the Federal Housing Administration (FHA), Rural Housing Services (RHS) or the Veterans Administration (VA), or from a private mortgage insurance company. The mortgage insurance will cover losses, up to a certain predetermined amount, if a property is in foreclosure and is ultimately sold for an amount insufficient to fully pay off the mortgage. Although the percentage of loans with FHA insurance has declined markedly in many HFAs, traditional private mortgage insurance provides levels of coverage sufficient to mitigate significant losses upon foreclosure.

To shield bond programs from the financial implications of mortgage defaults not covered by primary insurance, secondary or pool insurance or program overcollateralization is typically present. When Moody's rates a state HFA transaction, we test the program's ability to withstand severe levels of foreclosures and property value declines, which vary depending on the targeted rating level. These assumptions are tested by the models used in the rating process.

Programs' Financial Strength Provides Further Security to Bondholders

The performance of many HFA bond programs is further enhanced by the strong financial position of the program, which will provide additional cushion against adverse conditions in the single-family markets. HFA programs typically have more assets than liabilities and this overcollateralization, along with the profitability of the programs, provides for coverage of loan losses without impairing their ability to pay bond debt service. The median asset to debt ratio of 1.11x and the 13% profitability ratio of Moody's-rated HFA single-family whole loan programs is evidence of their financial strength.

HFAS MAY FIND OPPORTUNITIES TO EXPAND PROGRAMS AND MISSION

While we do not expect the problems in the subprime market or declining house prices to impact the ratings on single-family program bonds, heightened oversight on the part of the HFAs may be required to manage their portfolios through these more difficult times.

As part of their mission, some HFAs may be able to work to assist homeowners with problem loans that they did not originally finance by offering refinancing or other assistance to subprime borrowers. While these refinancings cannot be funded by tax-exempt bonds, some HFAs may use other sources, such as taxable financings or other funds, to provide the funding for these purposes. This would both enhance the HFAs' mission by preventing borrowers from losing their homes and also expand and diversify the HFA portfolios by borrower type as these new loans may be made to mortgagors with higher income levels who may not be first-time homebuyers. If HFAs engage in an effort to assist subprime borrowers to enable them to stay in their homes it could introduce a new aspect of risk to the HFAs' programs. However, we would anticipate that given the HFAs' solid underwriting and servicing capabilities, they will continue to maintain solid program financial performance going forward.

Related Research

Special Comments:

2006 Medians For Housing Finance Agency Single Family Whole Loan Programs, December 2006 (101445)

State HFAs Begin Offering Alternative Mortgage Products, July 2005 (93393

Moody's Use of Single Family Loan Loss Model Within Rating Analysis, June 1998 (35156)

Rating Methodology:

Moody's Rating Approach For Single Family, Whole-Loan Housing Programs, May 1999 (45064)

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Author

Florence Zeman

Production Associate

Shubhra Bhatnagar

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