2014 Outlook: State Housing Finance Agencies

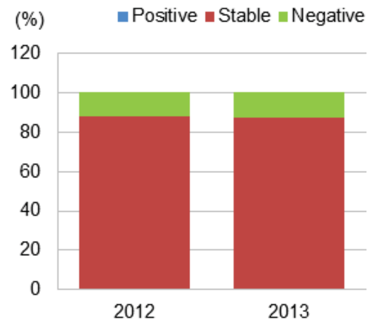
Outlook Report

Rating Outlook

STABLE

(2013: NEGATIVE)

2012–2013 Housing Portfolio Rating Outlooks



Sector Outlook

STABLE

(2013: NEGATIVE)

- Improved housing market fundamentals.
- Home price appreciation.
- Better mortgage loan performance.

Related Research

Other Outlooks

www.fitchratings.com/outlooks

Other Research

State Housing Finance Agencies Statistical Information (July 2013)

State Housing Finance Agencies Statistical Information (January 2013)

The Fitch Fundamentals Index (October 2013)

Go to appendix for list of rated entities

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Rating and Sector Outlook Stable: Fitch expects most state housing finance agency (SHFA) ratings to be stable in the coming year following five years of Negative Rating Outlooks. The sector outlook is also stable given improved housing market fundamentals. The main drivers for the ratings outlook include the resourcefulness of SHFAs, which is contributing to their profitability and sound financial ratios, and the combination of SHFAs building more equity while deleveraging bond programs.

SHFA Finances Sound Despite Challenges: Fiscal 2012 results show that SHFAs were able to increase net operating spreads and reduce debt-to-equity ratios despite a slowly recovering housing market and a low rate environment. Fitch anticipates that this sound financial performance will continue in fiscal years 2013–2014.

Origination Strategies Boost Revenue: Most SHFAs have adapted well to the changed housing environment by moving away from the traditional funding sources for mortgage origination. They are now originating loans through the to-be-announced (TBA) market, the direct sales of mortgage backed securities (MBS) and the issuance of MBS pass-through instruments.

Replacement Liquidity Concerns Reduced: SHFAs have reduced their reliance on liquidity providers through the issuance of floating-rate notes (FRNs) to refund outstanding variable-rate demand obligations (VRDOs). For those SHFAs that did not refund VRDOs and sought replacement liquidity, fees for standby bond purchase agreements were greatly reduced from last year.

Delinquency Rates and Foreclosure Inventory Improved: There has been modest improvement in mortgage delinquency and foreclosure levels in the general housing market, and SHFA portfolios are slowly showing signs of improvement in loan performance from elevated delinquency levels.

Outlook Sensitivities

Significant GSE Reform: In the unlikely event that government-sponsored enterprise (GSEs) reform occurs, there could be many negative consequences for SHFAs and the general housing market; this could have a negative effect on both the sector and individual SHFA outlooks. Prior to the government shutdown, momentum was gaining to reform GSEs. However, given other pressing budget issues, Fitch does not expect Congress will attempt reform in 2014.

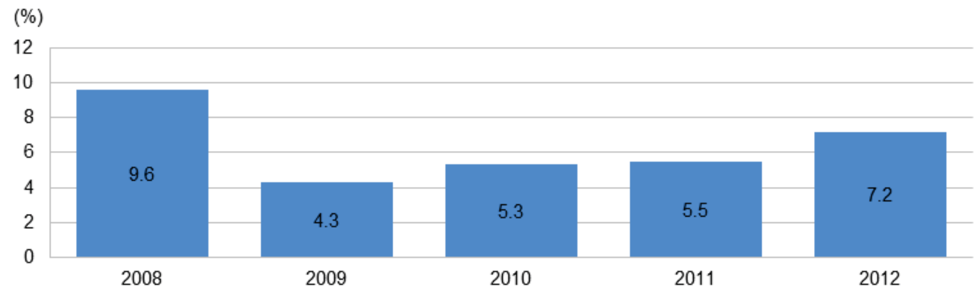
Economic Growth Reversal: Since job growth drives the general housing market, a decline in that growth and/or increase in unemployment could stall or reverse home price appreciation and negatively affect mortgage loan performance. If these macroeconomic trends show decline, the sector outlook could revert to negative.

Key Issues

SHFAs Prove Resourceful and Profitable

After four years of declining net operating revenue for SHFAs, results for fiscal 2012 demonstrated improvement in this area and across the board for issuer financial ratios. Median net operating revenue as a percentage of total revenue for all SHFAs increased to 7.2% in fiscal 2012 from 5.5% in fiscal 2011, as shown in the chart below. This occurred despite the continued low interest rate environment that has made it challenging for SHFAs to remain competitive and generate investment income. Fitch expects that these positive financial trends will continue for the remainder of 2013 and throughout 2014. While SHFAs are still realizing scarce investment income in the low rate environment, many have managed to find other ways to boost and/or maintain profitability.

Median Net Operating Revenue as % of Total Revenue without GASB No. 31 Adjustments

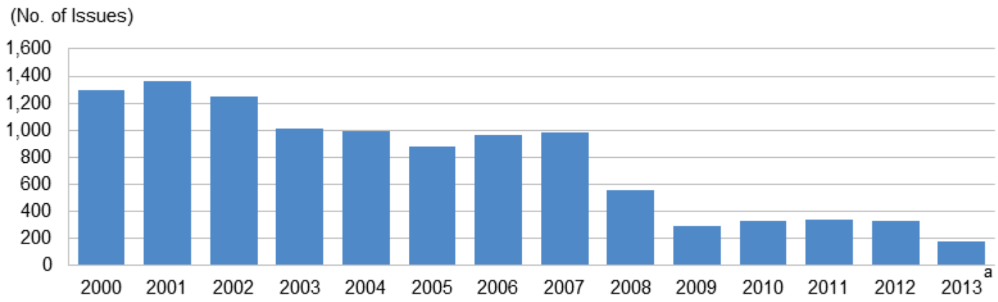


For several years now, SHFAs have been forced to find new ways of doing business and new funding sources for mortgage origination. Historically, SHFAs have funded their activities by issuing tax-exempt mortgage revenue bonds and keeping the associated mortgage collateral produced on their balance sheets. However, due to strain throughout the housing sector and the widening of spreads in the tax-exempt market, SHFAs have experienced challenges issuing new bonds to fund new mortgage lending. SHFAs have moved away from the traditional business model by diversifying out of mortgage revenue bonds and instead selling loans that they originate for securitization into MBS. This allows SHFAs to remain in the business of originating loans and generate revenue from the related sales.

A number of SHFAs are actively using available internal liquidity or lines of credit to originate new loans that are then sold to the GSEs with servicing rights retained, thereby generating a one-time source of revenue at the sale and an ongoing source of revenue through servicing. Some SHFAs have kept origination funding levels up by issuing MBS using a stand-alone pass-through bond structure. The use of this strategy has the added benefit of creating assets that can be kept on SHFA's balance sheets.

SHFAs continue to deleverage within their existing bond programs, and the volume of new bond issuance remains low relative to historical norms, as shown on the chart on the top of page 3. This has resulted in lower debt-to-equity ratios, illustrating again the overall improvement in SHFAs' finances. Fitch expects that SHFA bond issuance will remain curtailed for the near term given market conditions.

Housing Bonds Issuance



[a]As of June 30, 2013. Source: Bond Buyer.

Alternatives to VRDOs and Finding Replacement Liquidity

The credit risk of bank liquidity expirations related to outstanding VRDOs has diminished due to the prevalence of better options for replacement liquidity. The current price of liquidity facilities has fallen since Fitch's 2013 outlook was published, and SHFAs are reporting that they are receiving multiple bids to provide replacement liquidity. Now SHFAs looking to reduce their liquidity risk and transition to private market liquidity providers have better opportunities than the prior year. While most SHFAs have reduced their need for Treasury liquidity support, some SHFAs are still participating in the federal U.S. Treasury Department's Temporary Credit and Liquidity Program that was extended to 2015. For those SHFAs that still need to find replacement liquidity and exit the program, market conditions for replenishment have improved.

Some SHFAs are not pursuing replacement liquidity for their outstanding VRDOs but instead are refinancing or converting their VRDOs with securities that do not have a demand feature and, therefore, do not require liquidity support. FRNs, which do not have a demand feature and therefore do not need liquidity, have become a popular option for taking out VRDOs.

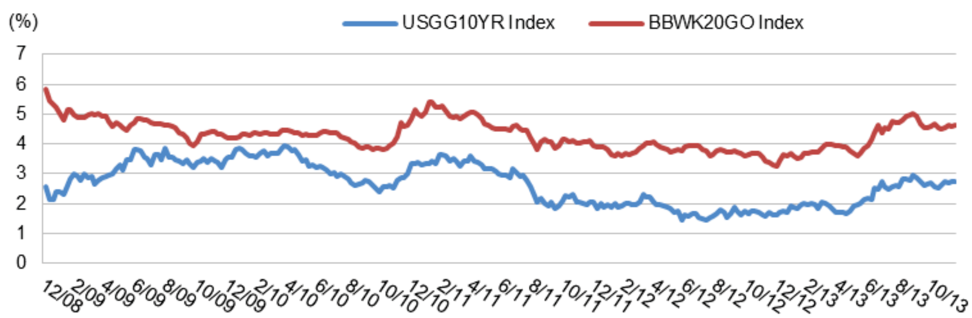
There are some SHFAs with VRDOs that are still constrained by current market conditions, as they have a corresponding swap and refinancing or converting them would require a swap termination. The termination would require a fee be paid that may be economically feasible but not economically desirable to the SHFA. Some SHFAs have opted for issuing refunding index bonds and have kept corresponding swaps outstanding. This has been one way for SHFAs to reduce exposure to liquidity rollover risk while not incurring high swap termination costs. Other SHFAs have also reduced their liquidity exposure by entering into direct bank loan transactions.

Improved Housing Market Fundamentals and Potential Future Changes

The main drivers of the sector outlook are improved housing market fundamentals in terms of home price appreciation and mortgage loan performance, which are due to moderate but stable economic improvement driven by job gains. This economic improvement, albeit slow, has contributed to an improved housing market.

Eventually, the Federal Reserve will slow the pace of the bond purchasing stimulus program that has helped keep interest rates artificially low. Once this occurs, mortgage rates will increase. SHFAs stand to benefit from an increased rate environment, as their mortgage loan product will become more competitive with the conventional market. A return to the historical spread between long-term taxable and municipal debt could lead to increases in SHFA bond program loan origination, the creation of long-term SHFA assets and increases in investment earnings. However, Fitch does not expect a return to the historical spread to occur in the near term.

10-Year U.S. Treasury vs. Bond Buyer U.S. Weekly Yields 20-Year



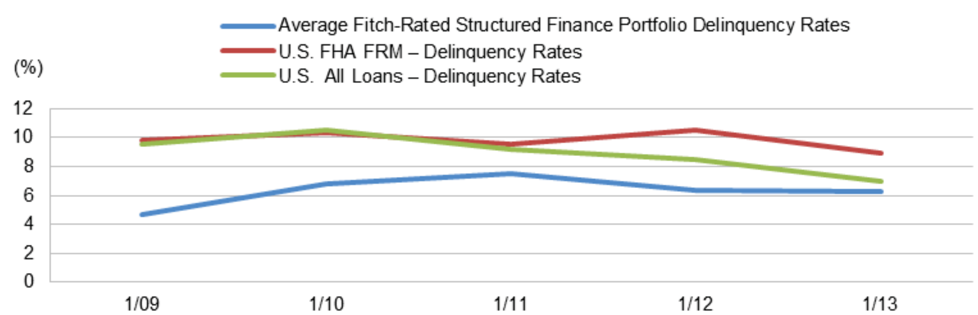
Sources: Bloomberg, Bond Buyer.

There is also the potential for substantial changes to the SHFA industry and housing in general, as the bi-partisan congressional budget committee, which was established in October with the agreement to end the government shutdown, addresses changes to sequestration budget cuts and/or tax reform. The outcome of these negotiations could potentially stall or reverse the economic strides that contributed to the improved but fragile housing market fundamentals.

Fitch Rated SHFA Program Loans Experience Improved Loan Performance

The loan portfolios that secure Fitch-rated housing bonds have experienced some improvement in delinquency and foreclosure levels, as seen in the chart below. While the improvements are not significant and delinquencies are still above pre-financial crisis levels, they have stabilized and are trending in the positive direction. Fitch is cautiously optimistic that this trend will continue if current economic trends such as job growth and employment do not decline.

Fitch-Rated Single-Family Portfolio Delinquency Rates (60+ Days Delinquent)



FHA – Federal Housing Administration. FRM – Fixed-rate mortgage. Source: Mortgage Bankers' Association National Delinquency Survey and SHFA disclosure reports.

SHFA loan performance statistics tend to lag that of the conventional mortgage market. This is because SHFAs typically exhaust all workout options available for the homeowner, which is in keeping with their stated mission to promote and maintain homeownership.

Majority of Negative Outlooks Due to U.S. Sovereign Rating Linkage; Main Threat to SHFA Rating Stability

Just over half of the Fitch-rated housing bonds that currently have a Negative Outlook or Rating Watch Negative (RWN) are secured by Ginnie Mae (guaranteed by the U.S. government), Fannie Mae or Freddie Mac MBS. The ratings of Fannie Mae and Freddie Mac are linked to the U.S. sovereign rating, which was placed on RWN on Oct. 15, 2013. The longer the necessary decisions on tax and spending reform are deferred, the greater the uncertainty over the fiscal outlook will weigh on the still-fragile economic recovery.

Fitch expects to resolve the RWN statuses of bonds it rates by the end of first-quarter 2014 at the latest; however, timing would necessarily reflect developments and events, including the duration of any agreement to raise the debt ceiling.

2013 Review

Fitch's 2013 rating outlook for SHFAs was negative based on the macroeconomic trends that were present in the greater housing market. When considering Fitch's revision of its housing sector outlook for 2014 to stable from negative, note that prior outlook reports only included a rating outlook. Had the recently developed sector outlook concept been incorporated in last year's report, Fitch would have assigned the sector a negative outlook and the rating outlook would have been stable.

The most significant credit event for SHFA ratings in 2013 was Fitch's placement of the U.S. sovereign rating on RWN on Oct. 15. This affected 7% of the housing portfolio, which is directly linked to the U.S. sovereign rating. While fiscal 2013 Rating Outlooks shifted to a slightly greater percentage in the negative category (13% in 2013 compared with 9% in 2012), the majority of the individual SHFA bond ratings in both years maintained Stable Outlooks.

The increase in SHFA bond ratings with Negative Outlooks on a portfolio basis in 2013 was due to the addition of new ratings to the Fitch portfolio that were assigned 'AAA' ratings with either a Negative Outlook or RWN based on the linkage to the U.S. government. Currently, no Fitch-rated housing bonds have a Positive Outlook. Only a small portion of the housing portfolio, 6%, has a Negative Outlook based on performance issues. Over the course of the year, Fitch downgraded only two housing bond ratings, and there were no rating upgrades.

Appendix

Trends in Housing Rating Activity

(% of Ratings)

	2013	2012
Affirmed	85	82
Downgraded	1	3
Upgraded	0	2
Rating Watch Negative	14	13
Rating Watch Positive	0	1