Management Innovation: Financial
Georgia Housing – Retaining our AAA Bond Rating

Overview

Since our inception, Georgia Housing and Finance Authority (GHFA) has never lost sight of our strategic objective of providing affordable housing options for the low and moderate income residents of the state. Through our homeownership programs we have helped nearly 100,000 Georgians realize their dreams of homeownership with our affordable first mortgage and down payment assistance programs. One of the ways we have been able to provide low cost first mortgage financing is through the historically favorable interest rates we pay on our mortgage revenue bonds which we sell in order to generate funds for our first mortgage program. We have achieved this goal by maintaining a AAA bond rating with our rating agency which is the highest rating they offer. Maintaining this rating is critical to the success of our homeownership programs.

In recent years, it has been challenging to avoid some of the more exotic bond structures, such as variable rate debt and swaps, which would have provided us with lower short term interest rates, but might also threaten our AAA rating. Our standard procedure is to perform a financial analysis before each bond deal to determine not only the short term benefit of all available bond structures but also the long term implications. In order to continue to achieve our strategic objective, we feel that we must first ensure the long term financial strength of the agency. As a result, we have avoided bond structures that have potential long term risk.

The Management Challenge

One of the components of maintaining our AAA rating is meeting the rating agency's stress tests. The rating agency measures our cash flows under various economic conditions. The most strenuous condition is referred to as the depression scenario. In the depression scenario, a bond indenture is analyzed to determine if it will be able to meet its debt obligations in the event of the worst possible economic conditions. Under this model, the bond issuer's reserves are taken into consideration in determining if the bond issuer could continue to meet its monthly debt obligations in the event of an economic depression.

Over our history, we have been a whole loan state with a portfolio of primarily government insured loans. Prior to 2006, our purchases were typically 90% government insured and 10% conventionally insured. Beginning in 2006 through the first half of 2008, not only did our product mix change to 50% government insured and 50% conventionally insured, but our purchases doubled. Additionally, a portion of the conventionally insured loans were Interest Only (IO) loans. In early 2008, the bond market was changing and our bond rating agency was looking at conventionally insured and IO loans as being more risky than they had in previous years.

As the economic outlook in the country worsened, our bond rating agency began to discount the value of conventionally insured loans. The rating agency also applied an additional reserve multiplier to IO loans. As a result of our rapidly increasing conventionally insured and IO portfolio, our reserves, which had always been more than adequate to meet all of our rating agency's stress tests, were just barely sufficient to cover our AAA rating in the depression scenario. This threatened our ability to maintain our AAA rating status. In order to continue meeting our strategic objective of offering the lowest interest rates possible to our customers, we had to find a way to mitigate our risk so that future GHFA bonds would carry AAA ratings.

Innovative Solution

In order to sufficiently mitigate our risk and maintain the integrity of the program we needed to either reduce the financial impact of our conventionally insured and IO loans on the depression scenario or exchange the risky collateral for collateral that carried little to no risk. We carefully reviewed our options and prepared an RFP for pool insurance which would reduce the financial impact of our loans on the depression scenario. At the same time we were exploring options with the GSEs to securitize our loans with them for Mortgage Backed Securities (MBS).

NCSHA had previously entered into an Affinity Agreement with Fannie Mae which allows HFAs to do business with Fannie Mae at reduced fees. A few states had already taken advantage of the agreement and sold whole loans to Fannie Mae through the My Community Mortgage (MCM) Program's cash window, but no state HFA who serviced their own loans had securitized their loans by swapping them for Fannie Mae MBS. The few states that had swapped loans for MBS used a Master Servicer to do the swap for them.

We approached Fannie Mae with our desire to swap for MBS and the time frame in which we needed to complete the swap. We were advised of the complexity of the transaction. According to Fannie Mae, because of the complex nature of swaps the typical Fannie Mae Seller/Servicer gets experience first doing the easier MCM cash window sales. Even Fannie Mae had never done an IO swap. If we were to proceed we would be charting new territory. We would be the first Fannie Mae customer to ever swap IO loans. Being first has never stopped us before, especially if it means a better product for our customer. We proceeded and by working closely with Fannie Mae we developed the systems needed in order to do an IO swap.

Cost vs. Benefit of Swap

The results were a resounding success. We swapped more than $100 million in conventionally insured and IO loans for Fannie Mae MBS. The only cost of the swap to GHFA was the guarantee fee. Under the terms of the Affinity Agreement, we were able to swap our loans at par which means regardless of how much below market the interest rates were on our loans, we did not have to swap them at a discount. Additionally, under the terms of the Affinity Agreement, our guarantee fee (which is the fee we pay to Fannie Mae for guarantying the monthly pass through to the Fannie Mae security holders) was significantly less than it would have been without the agreement. GHFA saves a minimum of $27,000 a month in guarantee fees as a result of the Affinity Agreement.

By replacing over $100 million in conventionally insured and IO loans with Fannie Mae MBS, the benefit to us was the reserves we were required to maintain for our AAA rating were reduced by $21million. Chart 1 in Appendix A reflects the benefit we derived from the swap. Note how close we were to not meeting the reserve requirements of our AAA rating before the swap and then how much benefit we derived from the swap.

Effective use of Resources Achieves Improvements in Agency Operations

After the swap, we had replaced $100 million of conventionally insured and IO loans as collateral for outstanding GHFA bonds with a $100 million of AAA rated Fannie Mae MBS. This reduced the required reserves to maintain our AAA bond rating by $21 million. The guarantee fee GHFA pays Fannie Mae saved us $27,000 the first month. Our savings continue to grow each month as mortgages pay off and amortize. Since we executed the swap, our bond rating agency has increased the required reserves for conventionally insured and IO loans. Had we not swapped our mortgage loans for Fannie Mae MBS when we did, we may not have been able to meet the reserve requirements of our rating agency and our next bond issue may not have been AAA rated. This would have made it more difficult to sell our bonds in the current market making the cost to us and ultimately to our customers even higher. Many HFA's are now working with Fannie Mae to duplicate the type of swap we completed in July 2008. As a result of our foresight and willingness to be first, these HFAs now have a blueprint to follow for a successful swap.

Currently, we only purchase government insured loans. The reserves required to maintain our AAA bond rating for government insured loans is much lower than it is for conventionally insured and IO loans. Based on the reserves required at the time of the swap to maintain our AAA bond rating, Chart 2 in Appendix A shows the amount of government insured loans we could have purchased at that time had we not done the swap and the amount of government insured loans we could have purchased after we did the swap, a ten fold increase. The swap with Fannie Mae has allowed us to move forward with new programs and initiatives without having to factor in the impact they would have on the depression scenario. As a result of the swap, we now have the ability to maintain our AAA bond rating while at the same time provide low cost financing to an additional 16,000 families that we would not have been able to serve had we not proceeded with this transaction.

Replicable

We were the first state to swap conventionally insured loans with Fannie Mae for Mortgage Backed Securities without outside help. As the first Fannie Mae customer to ever swap IO loans, the work we did with Fannie Mae to set up the systems and procedures that allowed us to successfully complete the IO swap are now in place. Any other state HFA who wants to do an IO swap with Fannie Mae has the systems and procedures we established available to them.