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2015 Outlook - US State Housing Finance Agencies

Strong Margins Drive Stable Outlook

Summary

Our outlook for the US State Housing Finance Agency (HFA) sector is stable. This outlook reflects our expectations for the fundamental business, financial and economic conditions in the sector over the next 12-18 months.

Strong and improving margins (net revenue/total revenue), which reached 11% in 2013, drive our stable outlook for the US State HFA sector. We anticipate that margins will increase incrementally in 2014 and 2015 as revenue from loan sales increases, full spread mortgages drive revenue growth and loan portfolio performance continues to improve. While HFA margins are the key driver of the outlook, strong margins must come in tandem with an ability to cover operating expenses with mortgage loan revenues, as demonstrated by a healthy ratio of mortgage loan interest income/general and administrative (G&A) expenses. This ratio declined to a low 3.6x in 2014; a drop below 3x could introduce instability into the sector.

» **We expect state HFA margins to continue rising, albeit more slowly, in the next 12-18 months.** Revenues from loan sales will increase incrementally and HFAs will continue to enjoy the benefits of full-spread mortgage loans. However, we expect that margins will remain below the pre-crisis peak level of 15%.

» **Mortgage loan revenues, HFAs' most stable long-term revenue source, continue to cover G&A expenses by a margin of 3.6x in 2014.** However, this ratio has declined significantly since 2008 due to run-off of mortgage loan portfolios and a further decline below 3.0x would be a risk factor for the sector.

» **What could change our outlook**. Margins of 10%-15% support a stable sector outlook; margins above 15% could drive a positive sector outlook and margins below 10% could drive a negative outlook. However, additional factors, such as HFAs' ability to cover G&A with mortgage loan revenues as well as weakness in portfolio performance could preclude a positive sector outlook despite strong financial performance.

State HFA margins continue upward trend

State HFA margins continued to rise in 2013, hitting 11%, and we anticipate they will increase incrementally in the next 12-18 months (see Exhibit 1). Rising margins have resulted from the shift in HFA business models to finance loan originations via a combination of both bond financing, their legacy operating model, and by selling loans through secondary market channels. Rising margins are attributable to the following:

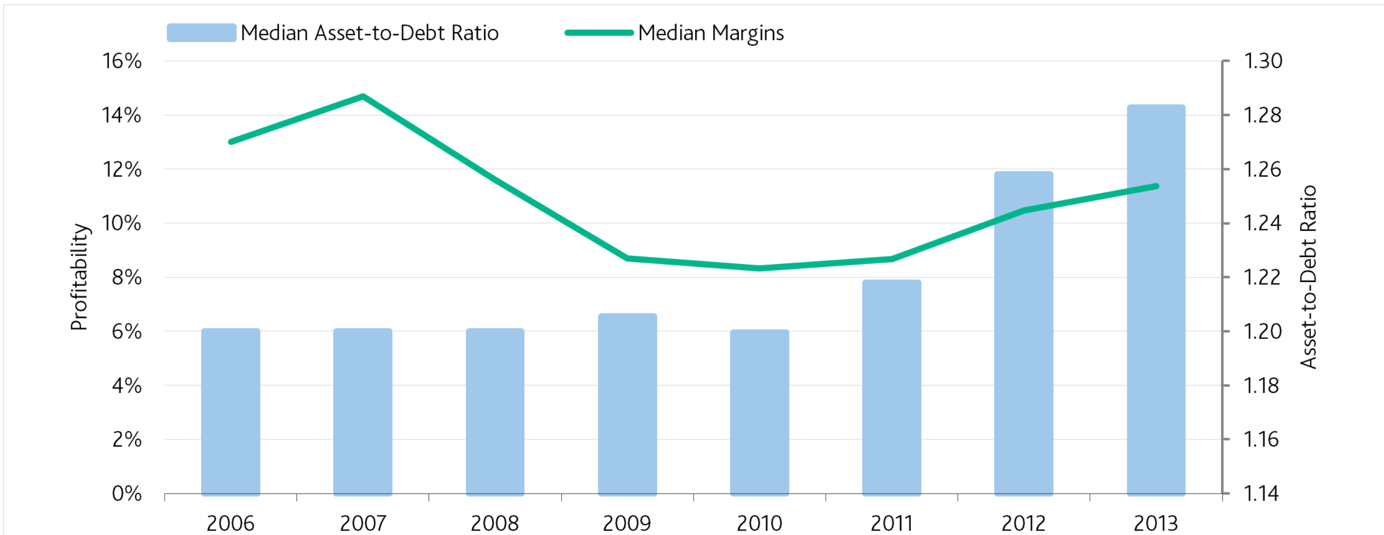
» Full-spread mortgage loans continue to be the key driver of margin growth.

» Fee income from secondary market transactions, including both transaction fees and servicing revenue, provide a new source of revenue for HFAs.

» Increasing asset-to-debt ratios, as well as redemption of higher coupon bonds, contribute to higher margins.

Exhibit 1

HFA Financial Metrics Are Strong But Margins Lag Pre-Crisis Levels

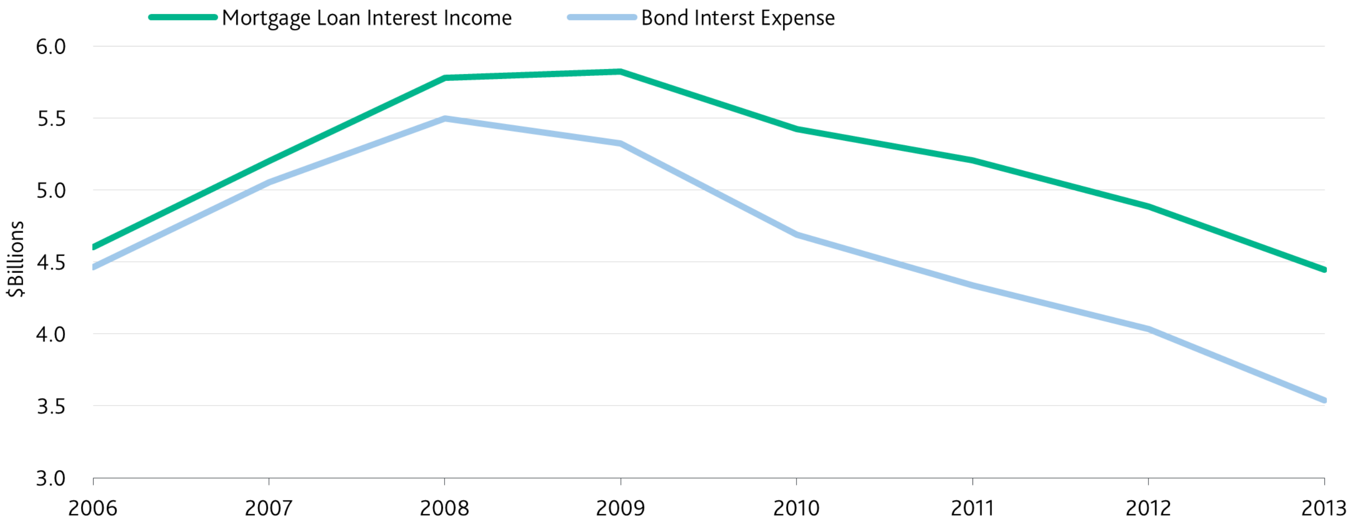


Source: Audited HFA Financial Statements

We anticipate that HFA margins will increase at a slower rate in the next 12-18 months and that margins will continue to lag pre-crisis levels, when they reached almost 15%. Most HFAs succeeded in ramping up their secondary market activity by 2013, so we expect that most of the financial gain from this activity has already been realized. Therefore, increases in margin will be primarily driven by continued run-off of the bond portfolios and the economic benefits of recent refundings (see Exhibit 2). Furthermore, higher interest rates would drive margins upwards as HFAs realize more income from investments.

Exhibit 2

Increasing Spread Between Mortgage Income and Bond Costs Drives Margins



Source: Audited HFA Financial Statements

G&A coverage becomes key metric as balance sheets shrink

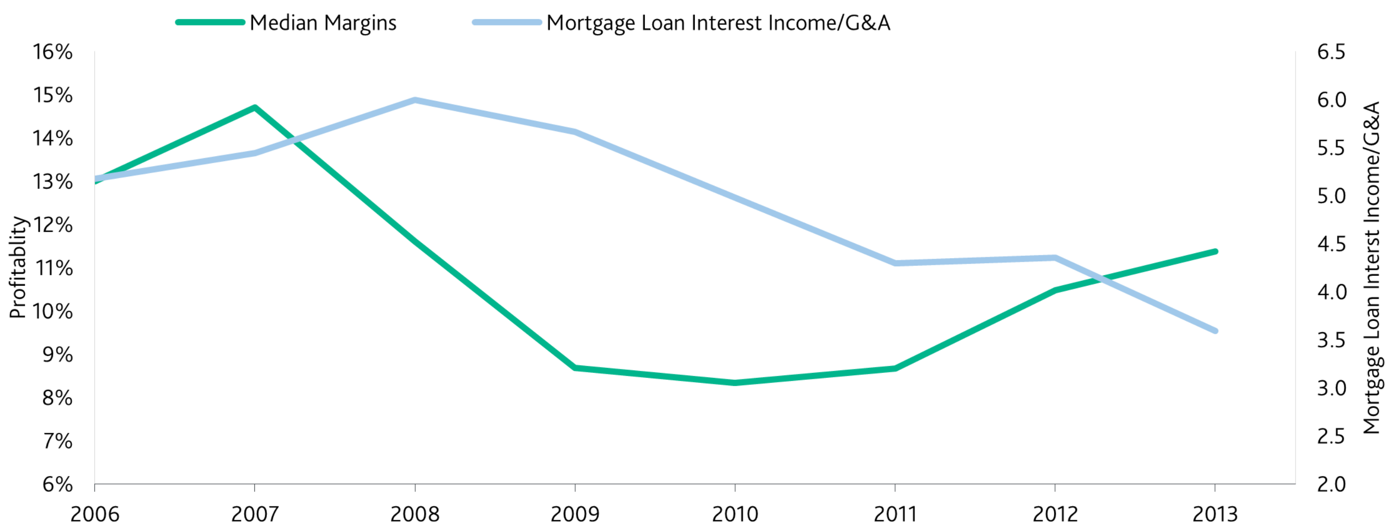
Historically, a key driver underpinning the sector's credit strength has been the availability of mortgage loan interest income, a long-term and predictable revenue stream, to cover operating costs. Since the financial crisis, HFA balance sheets have been contracting as HFAs have moved away from financing on-balance sheet mortgage loans to selling loans via secondary market channels. On-balance sheet loans, which were typically 30-year insured (or government sponsored enterprise (GSE) guaranteed) fixed-rate loans, provided a long-term, relatively predictable revenue stream to support agency operations.

In contrast, selling loans via the TBA market or directly to the GSEs produces point-in-time fee income that is more volatile due to its dependency on the current market conditions. Some of this volatility is off-set for those HFAs that continue to service the loans that they sell, but the servicing income is not comparable to the volume of net interest revenue received from on-balance sheet loans. Therefore, HFA revenue streams have become exposed to increased volatility as HFAs have changed their loan financing mechanisms.

In order to measure the impact of long-term vs. point-in-time revenue on the HFA sector, we utilize the ratio of mortgage loan interest income to G&A expenses, a proxy for agency operating costs. This ratio remained healthy at 3.6x as of 2013, although it has been declining since 2008 due to run-off of loan portfolios (see Exhibit 3). A decline to below 3x would indicate a negative trend for the sector, even if fee income or investment was driving up margins, as HFAs would have less predictable sources of income paying their operating costs.

Exhibit 3

Coverage of G&A Expenses by Mortgage Loan Revenues is Declining, Introducing Risk

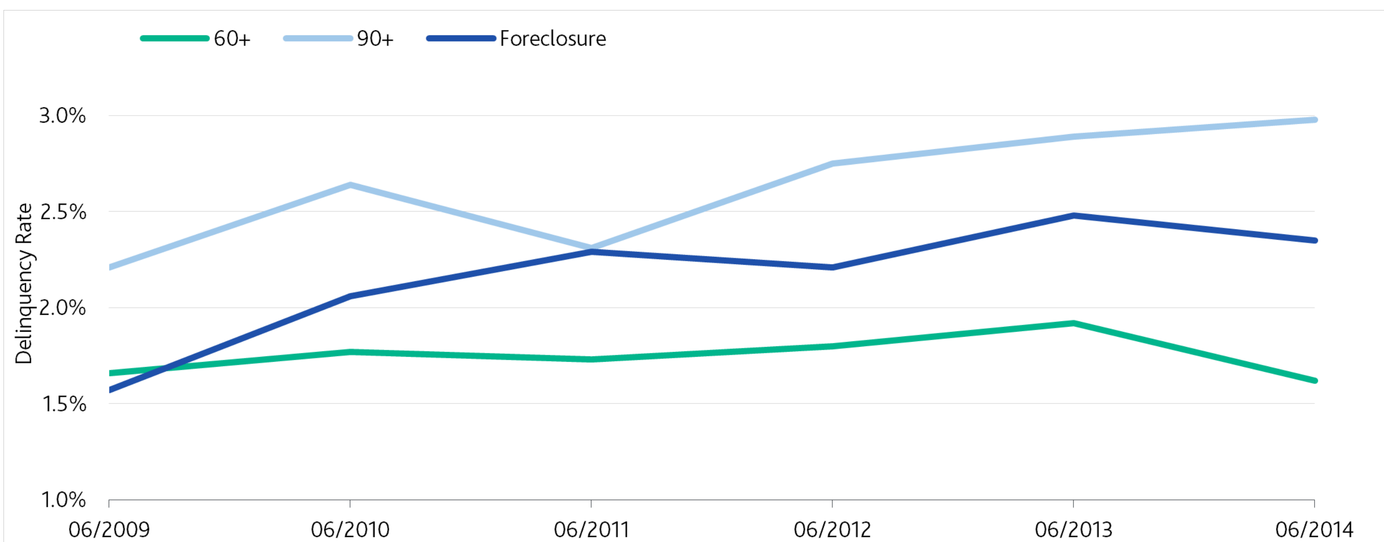


Source: Audited HFA Financial Statements

HFA portfolio performance continues to strengthen, which will bolster both current and future mortgage loan interest income (see Exhibit 4). A year-over-year decline of over 4% in single-family delinquencies, as of June 30, 2014, will both reduce loan losses and help to steady monthly mortgage loan revenues. The substantial decline in the 60-89 days' category to 1.62%, the lowest in the past five years, indicates that fewer loans are becoming delinquent, thereby curtailing the growth of the foreclosure pipeline and ultimately, the potential loan losses to the program.

Exhibit 4

Improving Single Family Portfolio Performance Will Bolster Mortgage Loan Income

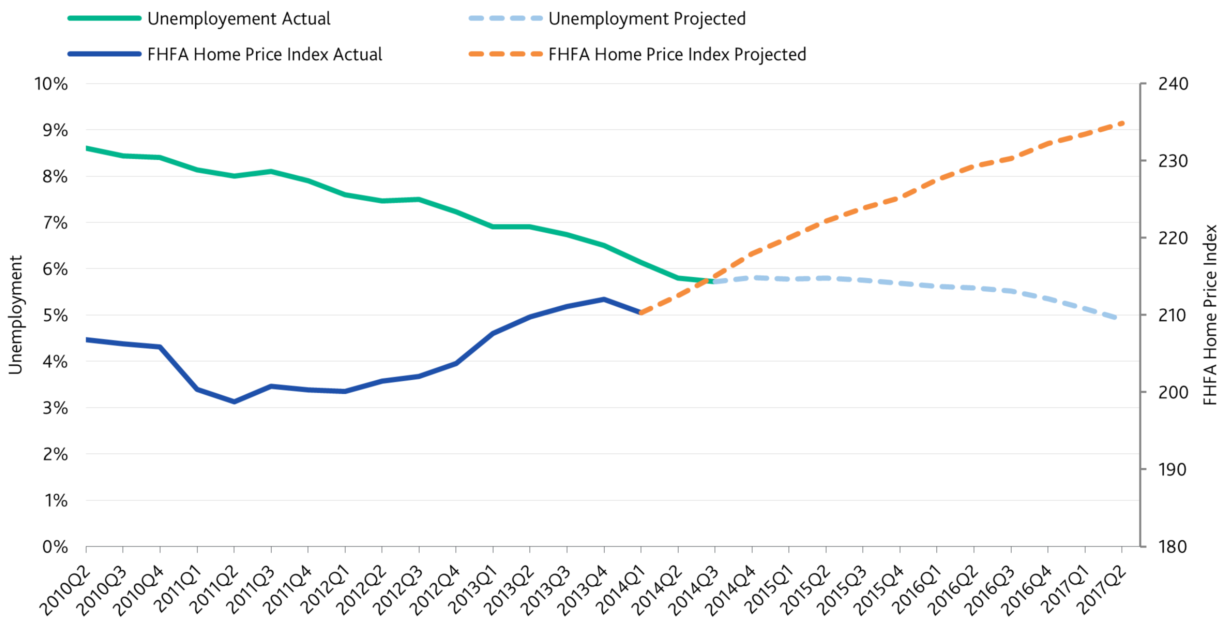


Source: HFA Surveys

We expect single-family portfolio performance to continue to improve at a measured pace as the stress of unemployment eases and median home prices continue their upward trend (see Exhibit 5). Multi-family performance continues to be strong, with delinquencies under 1%.

Exhibit 5

Unemployment and Home Prices Will Continue to Improve, Bolstering Portfolio Performance



Source: Moody's Economy.com, Federal Housing Finance Administration

What could change the outlook

Margins of over 15% would provide HFAs with enough cushion to weather a housing or economic crisis that rivaled the most recent one. Between 2007 and 2010, median HFA margins declined seven basis points from 15% to 8%. Operating margins of over 15% would signal that HFAs had enough income to endure a similarly stressful hit to their income.

Margins over 15% are not the only prerequisite for a positive outlook. In addition to strong financial performance, HFAs must make a marked return to financing on-balance sheet mortgage loans so that they have a predictable revenue stream to cover their operating costs. A ratio of mortgage loan interest income/G&A expenses of over 4x would indicate strong coverage of G&A expenses. In addition, strong portfolio performance would also be a prerequisite to a positive sector outlook.

Conversely, several factors could drive a negative sector outlook including operating margins under 10%, mortgage loan interest income/G&A expenses of under 3x or a significant weakening of portfolio performance.

Moody's Related Research

Special Comments:

» Single Family Delinquencies for 2nd Quarter 2014 Decline for State HFAs, October 2014 (176619)

» New Financing Tools Pose Few Risks to HFAs, June 2014 (171484)

Median Reports:

» US Housing Finance Agencies FY 2013 Medians Show Continued Strength in Profits Driven by Continued Loan Origination, August 2014 (174747)

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