LOUISIANA HOUSING CORPORATION

BOARD OF DIRECTORS

Agenda Item 8

BRENDA EVANS, PROGRAM ADMINISTRATOR

July 11, 2012

Table of Contents

LOUISIANA HOUSING CORPORATION

The following resolution was offered by _______________ and seconded by ___________________ :

RESOLUTION

A resolution to authorize and direct the Finance Team of Louisiana Housing Corporation ("**Corporation**") develop and recommend to the Board of Directors a **revenue generating homeownership financing and/or refinancing program** that may be implemented by the Corporation throughout the State without significant financial risks to the Corporation; and providing for other matters in connection therewith.

WHEREAS, the Corporation's homeownership loan products financed with tax-exempt bonds without any assistance from federal or state program funds ("**Program Funds**") will be at a competitive disadvantage compared to other market homeownership loan products for the duration of the low-interest rate policies currently maintained by the Federal Reserve Board;

WHEREAS, one or more members of the Corporation's Finance Team has recommended that the Corporation explore non-bond financed initiatives to finance or to refinance mortgage loans throughout the State by sponsoring mortgage origination through the Corporation's network of lenders (the "**Lenders**") using mortgage interest rates within specified periods in the to-be-announced market (the "**TBA Market**") for the delivery mortgage loans originated during such periods; and

WHEREAS, the Corporation desires to manage assets and debts in a manner which provides the best economic benefit to the Corporation and has received recommendations from members of the Corporation's Finance Team;

NOW, THEREFORE, BE IT RESOLVED by the Board, acting as the governing authority of the Corporation, that:

SECTION 1. The Corporation's Finance Team is hereby authorized and directed to prepare a comprehensive strategic financing initiative (taking into account the prevailing market interest rate challenge for a bond financed homeownership initiatives) that permits the Corporation to maintain a continuous homeownership financing program in all market interest rate environments or conditions.

SECTION 2. The Corporation staff and Financing Team are authorized and directed to prepare any documents, agreements and take appropriate actions, as may be necessary, to implement a homeownership financing/refinancing initiative and to report to the Board of Directors at the August meeting the costs and benefits of such an initiative.

This resolution having been submitted to a vote, the vote thereon was as follows:

YEAS:

NAYS:

ABSTAIN:

ABSENT:

And the resolution was declared adopted on this, the 11th day of July, 2012.

________________________________ ________________________________

Chairman Secretary

STATE OF LOUISIANA

PARISH OF EAST BATON ROUGE

I, the undersigned Secretary of the Board of Commissioners of the Louisiana Housing Corporation, do hereby certify that the foregoing two (2) pages constitutes a true and correct copy of a resolution adopted by said Board of Directors on July 11, 2012, entitled: "A resolution to authorize and direct the Finance Team of Louisiana Housing Corporation ("**Corporation**") develop and recommend to the Board of Directors a revenue generating homeownership financing and/or refinancing program that may be implemented by the Corporation throughout the State without significant financial risks to the Corporation; and providing for other matters in connection therewith."

IN FAITH WHEREOF, witness my official signature and the impress of the official seal of the Corporation on this, the 11th day of July, 2012.

____

Secretary

Presentation for Possible Strategies for the Single Family Program

<u>HOMEOWNERSHIP FINANCING STRATEGIES</u>

I. FINANCING HOMEOWNERSHIP PERSPECTIVE:

A. Business Model History

(i) <u>Tax-exempt Competitive Financing Advantages</u>: The original business model of the Louisiana Housing Finance Agency (**"LHFA**") to finance homeownership primarily for first-time homebuyers relied upon mortgage loan products that provided substantially lower (at least 100 basis points or more) interest rates compared to other market loan products. The LHFA's competitive advantage was primarily attributable to tax-exempt single family mortgage revenue bonds ("**SFMRBs**") issued by the LHFA. Historically, tax-exempt SFMRBs provided the lowest cost of capital to finance mortgage loan products in the market for qualified first-time homebuyers.

(ii) <u>Premium SFMRBs and Program Funds</u>: The original business model adjusted when the LHFA commenced to issue a portion of its SFMRBs at a premium price. With premium SFMRBs, the LHFA provided down payment and closing cost assistance grants to first-time homebuyers for up to four percent (4.0%) of the mortgage loan without the investment of any LHFA general funds. LHFA's business model adjusted further when the LHFA combined program funds ("**Program Funds**"), such as HOME Funds, in a soft second mortgage loan with SFMRB's. Program Funds allowed the LHFA to target the beneficiaries (generally households at or below 80% of area median income) with deeper down payment and closing cost assistance. In order to reduce issues associated with two separate mortgages at closing and to obtain the benefits of repayment guarantees from Fannie Mae, Freddie Mac and/or FHA ("**MBS Guarantors**"), the LHFA blended Program Funds and SFMRB proceeds into a single mortgage loan product ("**MRB Program Loan**"). The interest rates on MRB Program Loans may be reduced by the percentage of Program Funds invested in each MRB Program Loan. For example, a MRB Program Loan funded equally with SFMRBs and Program Funds (i.e. 50% each) could bear a blended interest rate as low as 2.5% if the portion funded with SFMRB proceeds carried a 5.00% interest rate.

(iii) <u>Business Model Adjustments by Pool Mortgage Insurance Industry Retrenchment and Extraordinary Events</u>: The departure of rated pool insurers in support of whole loans originated by housing finance agencies and other extraordinary events reduced the capacity of the LHFA to provide mortgage financing with significant competitive advantages in the market.

(a) <u>Mortgage Loan Pools in Mortgage-Backed Securities</u>: In the early years of LHFA's existence, "whole loans" were purchased by a trustee bank ("**Trustee**") with proceeds of SFMRBs from qualified lenders who contracted with the LHFA. Each whole mortgage loan purchased required primary mortgage insurance on each loan. The pool of mortgage loans purchased by the LHFA also received "pool insurance" from an insurance company that excess losses not otherwise covered by the primary mortgage insurer on each mortgage loan. Following the demise of rated pool insurance providers and the rapid ascent of mortgage-backed securities ("**MBS**") backed by pools of mortgage loans, the LHFA's SFMRB program evolved to finance only mortgage loans that qualified for securitization through a MBS Guarantor. Securitization required the LHFA to use one or more servicers ("**Master Servicers**") approved by the MBS Guarantors qualified to service the pools on mortgage loans backing MBSs. The LHFA's reliance on MBSs as the vehicle to secure money borrowed by the LHFA also resulted in the use of underwriting standards of both the Master Servicers and the MBS Guarantors, including elevated FICO scores for households failing to make a substantial down payment that reduce first mortgage loan-to-value ratios. Notwithstanding the reliance on external underwriting standards, the LHFA's network of lenders ("**Lenders**") often shifted their origination activities to non-LHFA loan products as market conditions favored alternative loan products that were not encumbered with tax-exempt bond documentation requirements.

(b) Hurricane Katrina and Rita: Hurricanes Katrina, Rita, Ike and Gustav (the "**Catastrophes**") were cataclysmic physical and financial disasters to the State. The housing unit destruction and the default of many homeowners with mortgage financing through the LHFA caused unprecedented mortgage pre-payments and reductions in the LHFA SFMRB portfolio. The losses sustained by Master Servicers from reduced servicing fees that paid for their upfront contributions to the LHFA for servicing rights also reduced the interest of several Master Servicers in continuing to contract with the LHFA.

(c) The Great Recession**:** The cataclysmic collapse of the financial markets in 2008 precipitated one of the worst recessions since the Great Depression. In response, the Federal Reserve Board commenced and continues to maintain a low-interest monetary policy that effectively eliminates the historical competitive advantages of LHFA mortgage products based on mortgage products financed solely with SFMRB proceeds. But for the GSE Bond Purchase Program ("**NIBP**") through the U.S. Treasury (which effectively acts as an interest rate hedge as the LHFA warehouses MBSs which may be purchased with NIBP proceeds) LHFA is currently unable to offer competitive mortgage loan products. The market manipulations by the Federal Reserve Board are expected to last into late 2014.

B. Lessons Learned from Business Model History: The brief history of LHFA's business model for homeownership identifies a number of issues that affect prospective LHC loan products and the SFMRB Program as a source of financing homeownership by the LHC.

(i) Competitive Lowest Interest Rates: Unless the LHC accesses low interest capital without the tax-exempt encumbrances to finance low rate mortgage loan products without assistance, the LHC will be at a competitive disadvantage to market loan products for the duration of the low-interest policies currently maintained by the Federal Reserve Board.

(ii) Availability of Assistance: So long as the LHC relies exclusively on NIBP proceeds to finance mortgage loans, assistance for down payment and closing cost assistance must come from Program Funds and/or LHC general funds.

(iii) Underwriting Constraints: So long as the LHC relies upon MBS Guarantors and Master Servicers to originate mortgage loans at prevailing industry standards, the pool of qualified borrowers who may otherwise need mortgage financing in the current regulatory environment will be severely curtailed.

(iv) Program Funds Limitations: So long as the LHC relies upon traditional federal sources of Program Funds such as Home Funds, the sources of assistance to households seeking homeownership financing through the LHC will be limited to households at or below 80% AMI.

(v) Future SFMRB Programs Without Change in Interest Rate Environment: Following the NIBP Program which permits the NIBP Program to serve as a interest rate hedge in conjunction with the Dallas Federal Home Loan Bank's warehouse line of credit, the investment of significant Program Funds or LHC Funds will be required to jump start a SFMRB Program in the current interest rate environment.

II. HOMEOWNERSHIP FINANCING CHALLENGES TO THE LHC

Homeownership financing strategies for the LHC in the current interest rate environment may be evaluated in light of the following issues:

(i) Cost of Funds: The costs of funds borrowed by the LHC on a tax-exempt basis in the current interest rate environment may not alone provide the historical mortgage loan pricing advantages to the LHC. Although the LHC may generate premiums from the issue of a SFMRB, the interest costs associated with such premium SFMRBs may make the LHC loan products even less competitive without the investment of other Program Funds and/or LHC Funds. Program Funds or LHC Funds may be provided as soft second mortgages or as part of a very low interest blended 1st mortgage loan. If LHC Funds are invested in a SFMRB Program, the financial analysis of the program should assess the likelihood of such LHC funds being returned to the LHC with a present value rate of return under conservative prepayment scenarios over the life of the SFMRB Program.

(ii) Interest Rate/Mortgage Origination Risks: Interest rate/mortgage origination risks associated with LHC borrowing moneys in advance of originated mortgage loan products increase the costs of a SFMRB Program. Access to the Dallas Federal Home Loan Bond as a warehouse line of credit provides some profits to manage and offset costs when SFMRB are issued in advance; however, unless the LHC has a pool of funds that may serve as a direct hedge and funding source of mortgage loan products originated in advance of delivering a SFMRB, interest rate risks may be too high and uncertain to rely upon the Dallas Federal Loan Bank as a permanent funding source for LHC mortgage loan products.

(iii) Limited Beneficiaries of SFMRBs and Program Funds: Absent other LHC funds without income restrictions, SFMRBs and traditional federal Program Funds impose income and other limitations. These income limitations restrict the universe of beneficiaries of a LHC homeownership financing program below the incomes of moderate income households in need of homeownership financing throughout the State. A taxable program may provide a competitive financing option for LHC mortgage loan products only if such taxable financing is combined with more flexible funds not subject to the income limitations associated with SFMRBs and/or traditional Program Funds.

(iv) Availability of Federal Program Funds and/or other LHC Funds: The volume of competitively priced LHC mortgage loan products for a cost effective and net revenue producing program is currently dependent upon the amount of Program Funds that may be invested in a LHC homeownership financing program financed in part with tax-exempt or taxable bonds. While limited amounts of HOME Funds (and since the Catastrophes, limited amounts and geographically restricted CDBG Funds) have been routinely invested in SFMRB Programs, the household beneficiaries are limited to 80% AMI. The LHC should vigorously pursue other soft funds, including CDBG Program income and funds received by the Attorney General of the State from settlements with major banks ("**Settlement Funds**"), to invest in LHC homeownership financing programs. Such additional funds may be invested in LHC mortgage loan products on a statewide basis with more flexible household income limits compared to recent SFMRB Programs.

III. COMPETITIVE LHC MORTGAGE LOAN PRODUCTS

A review of the Business Model History and Homeownership Challenges suggests the following:

(i) The LHC should pursue homeownership financing strategies that provide substantial interest rate concessions on 1st mortgage loans that do not include down payment or closing cost assistance.

(ii) The LHC should continue to invest Program Funds to provide both down payment and closing cost assistance for households at or below the income limits associated with such Program Funds.

(iii) The LHC should vigorously pursue other funding sources (i.e., CDBG Program Income and Settlement Funds) to provide down payment and closing cost assistance for households whose incomes exceed current Program Funds income limits (80% AMI) to expand the beneficiaries of LHC homeownership financing initiatives. These funds may be made available as a grant for closing cost or down payment assistance and in the form of a soft-second mortgage loan and/or a blended first mortgage loan.

(iv) The LHC should explore the capacity of the LHC general fund balance sheet as a source of hedging and/or directly funding mortgage loans that may be securitized by a MBS Guarantor. The investment and rate of return on LHC funds should be consistent with investment types, investment horizons and rates of return on LHC general fund reserves or fund balances not needed for current and sort term annual operating budgets.

(v) The LHC should explore the utility of using the LHC fund balance sheet as a source for reimbursing losses from more flexible underwriting standards promulgated by the LHC that are not consistent with the standards of the MBS Guarantors and Lenders. If the LHC balance sheet is not a viable option, the LHC should explore the availability of CDBG Program Income and/or Settlement Funds to serve as a loss loan reserve against mortgage loans originated pursuant to LHC directed standards. If such mortgage loans are not subject to being securitized by MBS Guarantors, the LHC should explore servicing of such non-standard loans by internal staff or qualified third party servicers.

Louisiana Housing Corporation
Single Family Loan Production
Presented by Raymond James | Morgan Keegan
June 20, 2012

Background

- LHC's mortgage program, using proceeds of the NIBP program, is not originating given current mortgage market conditions. Besides the above-market 3.99% rate, borrowers are only receiving 1.50% net in assistance (3.00% DPA less 1.50% points paid by the borrower).
- Proposed solution ideally will include at least 2.50% down payment assistance, 2.00% for the lenders, and some profit for the Corporation.
- There is no servicing release premium.
- LHC has the ability to warehouse mortgages.
- The goal is to obtain the lowest possible mortgage rate with the maximum possible down payment assistance.

Strategy

To effectively originate mortgage loans in today's market given the constraints mentioned above, Raymond James | Morgan Keegan proposes a non-bond mortgage securitization program.

In today's market, Louisiana Housing Corporation could originate loans at a 3.75% gross rate, accumulate these loans until a sufficient amount has been obtain to securitize into a mortgage-backed security, then sell the mortgage-backed security in the market. These mortgage-backed securities could be sold in the market today at about a 105.25% price. The premium would be available to:

(1) 2.50% provide down payment assistance to borrowers
(2) 2.00% pay the lenders for originating the mortgages
(3) 0.75% spread to the Corporation

(The 5.25% can be allocated differently if the Corporation desires, among DPA, lender fees, and spread.)

Advantages

- No bond issue is required.
- Active, liquid market makes it easy to sell the mortgage-backed securities.
- DPA and lender fee goals achieved.
- LHC product at 3.75% with 2.50% net assistance becomes a competitive product again.

Disadvantages

- If mortgage rates increase, LHC risks losing money on the unsold loans during the time between loan closing and MBS sale.

Comments

Effectively originating mortgage loans in today's market given the constraints mentioned above will require LHC to accept more risk and operate more like a mortgage company. If mortgage rates increase while LHC holds loans, LHC will suffer losses. On the other hand, if mortgage rates decline, LHC will be able to sell the mortgage-backed securities for higher prices and make profit.

We also note that it would be possible for LHC to increase the amount of down payment assistance to 5% or so by creating a hard second mortgage associated with each loan and committing LHC funds to purchase such second mortgage. The second mortgage bond privately placed to the Corporation can be structured to have a higher return than the Corporation's current investments. The second mortgage payments would be included with the first mortgage payment. If the mortgage-backed securities are sold in the market, the trustee can administer the splitting of the mortgage payment between the mortgage-backed security and the Corporation's second mortgage bond.

J.P.Morgan

Memorandum

To:	**Louisiana Housing Corporation ("LHC")**
From:	**J.P. Morgan**
Date:	**June 20, 2012**
Subject:	**Financing Strategies**

Since the reopening of the single family program, LHC has faced a disappointing welcome back into the market. Production levels are well below expectations and the competitive landscape presents challenges. In the text that follows, J.P. Morgan offers some ideas and perspective on the program, the LHC's peers and what LHC might do to increase production.

Competitive Landscape. LHC's single family program faces stiff competition from two primary sources (i) competing local HFA programs and (ii) the conventional loan market. The competing local HFAs are offering rates as low as 3.50% with four points of assistance and 3.25% with no assistance (Finance Authority of New Orleans). As a competitive matter, LHC needs to be able to at least match the locals and, to thrive, offer a better product and make it available to more Louisiana residents. The conventional market is driven by forces largely beyond LHC's control. The current state of geopolitical affairs, the financial situation in Europe and investors' perception of the likelihood another round of fiscal stimulus to the economy have kept U.S. Treasury prices high (yields low) and the mortgage-backed securities market ("MBS") including GNMA, FNMA and FHLMC prices have followed suit. Unfortunately for LHC, GNMAs with lower coupons (precisely the market in which LHC competes) have seen the greatest price appreciation due to the direct government guarantee and investors' perception of the potential refinance/restructuring possibilities of the underlying loans. This continued MBS price appreciation has made the conventional market rates extremely competitive and often better than HFA rates.

Federal Funds. As the statewide HFA in Louisiana, LHC should have better access to federal money than local HFAs. While the Corporation uses CDBG and HOME funds (together, "Federal Funds") from time to time to subsidize its mortgage bond programs, LHC should ask the question as to what other uses there are for Federal Funds. For example, could either of these sources of funds be used for some or all of the downpayment assistance to or instead of LHC funds? The use of Federal Funds in today's market as a subsidy to LHC's mortgage revenue bond program with an NIBP takeout will not be sufficient to match the rates and terms of the local HFA loans. As downpayment assistance, however, LHC may be able to offer a deeper subsidy than local HFAs or, as will be shown below, be more competitive in the conventional loan market.

To Be Announced ("TBA") Market. One technique that is available to LHC and is currently being used by some (and an increasing number) of HFAs is to sell their GNMAs into the market. Given the strength of the GNMA market, HFAs find themselves in a position where they can offer a more competitive mortgage rate by mimicking the conventional market than using tax-exempt bonds. The HFAs also retain the competitive advantage of being able to offer downpayment assistance – a feature that cannot be replicated by commercial lending institutions. Accessing the TBA market would also allow LHC to expand its reach to borrowers that are not first time homebuyers since the first time homebuyer requirement under LHC's bond program is a result of the use of tax-exempt bond proceeds. The Corporation should also note that the nature of its borrowers (lower FICO, higher LTV, smaller loan size, etc.) will, from time to time, command certain premiums relative to more generic MBS created by conventional lenders. These premiums will vary from time to time, both in availability and size, so it would be difficult for LHC to rely on them for a funding source. However, there are certain techniques which LHC can employ to give it a better probability to see a premium. In order to fully take advantage of the TBA market, LHC must adjust its thinking from a "bond issuer" to a "mortgage originator." The TBA market offers mortgage originators great flexibility with respect to the mortgage origination process in a market with liquidity approaching the U.S. Treasury market with pools of capital that are many, many times larger than the municipal housing bond market. An originator can sell a security in the current market or the TBA market offers the ability for an originator to sell a security up to three months forward at an agreed-upon price today. LHC will face a strategic decision regarding the timing of the sale depending on the level and types of risk it wants to accept. The process of using the TBA market to hedge – and the techniques for hedging – fall outside of the scope of this assignment. However, if LHC wants to pursue forward sales of MBS in the TBA market, J.P. Morgan would be glad to provide greater illustration. In addition, there are several HFAs which are actively using the TBA market to hedge all or nearly all of their mortgage production and we would be happy to make introductions to peer HFAs should LHC wish to pursue this route.

However, a quick analysis of what an MBS sale might look like is certainly within the scope of this discussion. Listed below is a loan level sources and uses of and MBS sale. For purposes of this analysis, the price of a GNMA with a 3% coupon for a July settlement (July 19th to be precise) as of the close of business on June 18th was approximately 103.875%. Let's further assume that LHC would like to offer a 3.50% mortgage rate with four points of assistance.

Sources of Funds	
GNMA Sale	103.875%
Total Sources	103.875%
Uses of Funds	
Loan Proceeds	100.000%
Lender Comp	2.00%
DPA	4.00%
Shortfall	(2.125%)

Based on the analysis above, LHC would need to contribute 2.125% to make the program work. Although the gap seems large, one important point to remember is that in prior years, LHC received a servicing release premium for the sale of the loan servicing to the master servicer. In the current program, such a premium is unavailable to the Corporation.

TBA Program Considerations. There are a few important programmatic considerations that must be evaluated when using the TBA market. First, the coupon of the GNMA security that is created must be on the ½ point increment in the case of a GNMA I MBS. For example, a 3.50% mortgage rate with 0.50% of servicing and guaranty fee nets a 3% GNMA security which is relatively liquid. A 3.49% mortgage rate with 0.50% of servicing and guaranty fee nets a 2.99% GNMA security which is relatively illiquid and, as a result, will have a price lower than the 3% pass-through GNMA that is much lower than the 1 bp differential would indicate. A GNMA II MBS, on the other hand, does allow for some deviation on the servicing fee and, as a result, will allow for a more flexible mortgage rate. Even with a more flexible mortgage rate, however, the net coupon on the MBS must be on the ½ point increment and the servicing fee can be adjusted to keep the MBS pass-through coupon on the ½ point increment. It is extremely important that LHC be mindful of the fact that with its MRB program, keeping MBS rates on the ½ point increment was not important, but for the TBA program, MBS rates on the ½ point increment could make or break the program.

Improving the TBA Program–Federal Funds. In order to improve upon the example above, LHC may be able to improve upon the TBA program by incorporating Federal Funds. If LHC could use Federal Funds to fund some or all of the downpayment assistance in the example above, the program would become more sustainable since it would not rely on LHC funds exclusively. The use of Federal Funds could also fill the gap created by the lack of a servicing release premium. The use of Federal Funds could also provide programmatic flexibility if, for example, LHC received feedback from lenders that a five point DPA program would be helpful in the market. As a competitive matter, LHC should have better access to these funds than the local HFAs and, conventional lenders are not able to offer any sort of downpayment assistance.

Self Servicing. Another item that may prove valuable to LHC in the future is become a self servicer and, in the case of MBS, a master seller-servicer. As everyone is aware, LHC recently ran a competitive process for a new master servicer to replace its prior master servicer. Due to a highly constricted market, the Corporation had few options for a master servicer. As a result, the value from the sale of the servicing is valued below market levels. The lack of available master servicers has lead some HFAs to become their own master servicers. (To be fair, many of these HFAs were self-servicers of whole loan programs prior to transforming their programs into MBS programs.) However, if the Corporation were the recipient of the ongoing 44 basis point servicing fee, it will have flexibility to adjust the mortgage rate by reducing the servicing fee. In this case, LHC, like other HFAs in this position, can view the loan revenue process holistically and adjust the mortgage rate or servicing rate to meet revenue expectations. Becoming a self-servicer is not something that LHC can do overnight and great consideration must be given by the LHC board and staff to decide whether or not to go down that road, but the payoff could be a more competitive loan product and a great deal of self-sufficiency. A few HFAs have grown their servicing operations to a point where they are servicing (or seeking to service) loan from other HFAs or lending institutions. As servicing is a volume business, LHC may need to follow this route if it does decide to become a self servicer. While it is difficult to ascertain the value of the 44 basis point servicing revenue on a present value basis, a simple rule of thumb at 25bp running is equal to one point on a present value basis puts the present value of servicing close to two points. That value could also reduce the shortfall described in the example above. LHC needs to be realistic about the time and effort required to build a servicing platform. Becoming a self-servicer is a longer-term goal for the Corporation and its programs that will likely require time and money, including hiring staff with experience in loan servicing.

Seize Opportunities. Although the topic has been discussed, LHC has opportunities to either (i) refund callable bonds with new lower-rate bonds or (ii) sell the MBS at a premium and redeem the underlying bonds at par. Many other HFAs that have MBS programs with in-the-money refunding options have sold the underlying MBS and generated handsome profits. Refundings of older tax-exempt bonds with new lower-rate tax-exempt bonds will also work. The main difference between the two approaches is that the uses of the benefit from the refunding is restricted in the case of a tax-exempt refunding whereas the use of the benefit from the MBS sale does not have tax restrictions (although LHC may have self-imposed uses for such funds.)

Whether the benefit comes in the form of tax-exempt bond proceeds or from the MBS sale, the benefit could be earmarked for future DPA or rate buydowns or any other technique that LHC wants to use to enable past financings to improve LHC's current market position. In the case of benefit from tax-exempt bonds, the Corporation may be able to "transfer" the benefits over time by creating 0%-participations. A 0% participation would allow the Corporation to fund a portion of a future loan at 0%, thereby bringing down the overall cost to the borrower. Although the Corporation has discussed 0% participations, they have not yet been used in the program. The 0% participations are merely a tool to use and preserve subsidy dollars, but the subsidy dollars must be created by market-driven opportunities. The important point is that LHC has an in-the-money option that it paid for through a higher bond yield years ago when the eligible bonds were sold. By leaving the bonds outstanding LHC is allowing the investors' to profit at LHC's expense. As new refinancing opportunities come up due to old bond issues hitting their redemption date, LHC should move quickly to monetize the value of the option it owns.

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Presentation to the Louisiana Housing Corporation Regarding Considerations in Finance for Housing Finance Agencies

June 20, 2012

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INVESTMENT BANKERS SINCE 1928

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Table of Contents

George K. Baum & Company
INVESTMENT BANKERS SINCE 1928

Section 1

Background

George K. Baum & Company
INVESTMENT BANKERS SINCE 1928

Background

- Economic reality is forcing HFAs to look to the mortgage market to fund their programs

- Although some HFAs who service their own loans have been using the mortgage market for years, many HFAs can not take the political or economic risks of ”becoming a mortgage company” without third party assistance.

- HFAs and the markets they serve are different and although

- HFAs have been part of the mortgage industry there are numerous challenges to understand and use the mortgage market

- There are many different ways that HFAs can use the mortgage market to fit their specific needs, mission and capacity.

George K. Baum & Company
INVESTMENT BANKERS SINCE 1928

GKB as Program Advisor

- GKB's National Housing Group has made a market niche as investment bankers that provide more than financial expertise as experts in mortgage banking and the support of affordable housing programs.
- GKB has the skills, staff, and experience and been involved in over $5 billion in mortgage originations funded by the mortgage market.
- GKB recognizes that its clients are unique and has developed an approach to tailor programs for its clients rather than taking a one-size-fits-most approach with one type of program.
- GKB can act as program advisor or manage the program and take the interest rate and fallout risk inherent in using the secondary mortgage market.

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Section 2

Program Considerations

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Program Considerations

- There are several different approaches that HFAs can take to the secondary mortgage market

- GKB believes that HFAs should analyze factors including the following when deciding how to use the secondary mortgage market as a source of funding:

  - Goals, mission, and market
  - Capital constraints
  - Risk tolerance
  - Staff resources
  - Statutory constraints
  - Lender and servicer landscape
  - Political landscape

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Program Considerations

- Lender participation and lender needs
- Widening lender base and potential borrower base beyond requirements for tax-exempt bonds
- Conventional loans versus government-insured loans
- Loan compliance standards and tracking
- Master servicer restrictions
- Implementation timing

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Financial Considerations

- Down payment assistance (“DPA”) funding source
- Lender Fees
- HFA Fees
- Execution strategy (i.e. strategic pooling and sale of MBS)
- Counterparty exposure
- HFA Fees
- Hedging Risk options:
  - ➢ Outsource to GKB for a fee or
  - ➢ Take the risk and use GKB as advisor or
  - ➢ Outsource to Master Servicer(s) using GKB as Advisor to recruit, negotiate and manage
- Hedging and execution strategy

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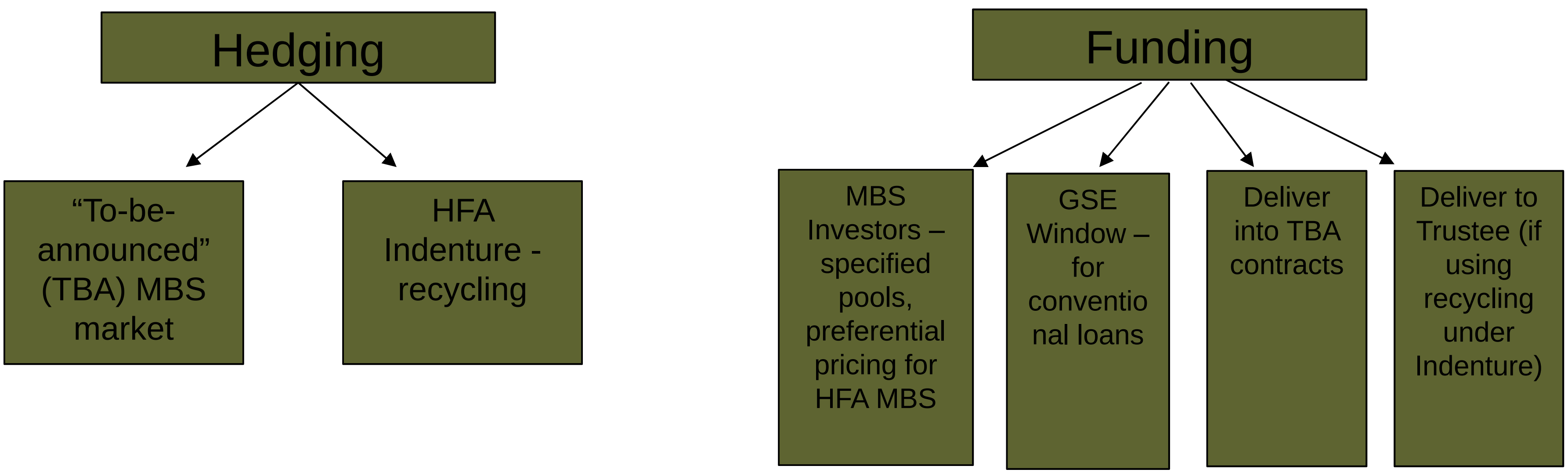
Hedging and Execution Considerations

- **One key distinction in this discussion is that there are two decision points that HFAs have in this discussion (in a post-NIBP world)**

  1. **How to hedge the interest rate risk?**

  2. **How to fund the loans or MBS?**

- The answer to those questions will not be the same for each HFA and may vary over time



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Section 3

Program Variations

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Program Variations: Master Servicer Model

- GKB recruits and assists in negotiating agreements with Master Servicer(s)
- Master Servicer provides daily pricing and takes pipeline risk
- HFA sponsors the program providing DP and Closing Cost assistance along with any GSE waivers/pricing benefits available to HFAs and receives fees in return
- HFA engages GKB as Program Advisor to monitor the Servicer(s) and the program on behalf of the HFA
- Eventually multiple Master Servicers are possible, providing competition, better coverage, and improved service

Program Variations: Turn Key Model

- HFA engages GKB as investment bank to provide daily rates and take all hedging risks
- GKB recruits master servicer, trains lenders, markets programs, and manages the program's pipeline taking all the hedging risk
- HFA sponsors the program and receives a sponsorship fee based on the par amount of loans that are securitized
- HFA provides DP and closing costs assistance plus any GSE waivers and pricing benefits provided to HFAs

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Program Variations: Investment Bank Hedging Model

- HFA engages GKB as investment bank to provide daily rates and take all hedging risks

- GKB interfaces with the HFA's master servicer and manages the program's pipeline risk

- HFA sponsors the program and receives a sponsorship fee based on the par amount of loans that are securitized

- HFA has counter party risk if GKB does not perform

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Program Variations: HFA Runs Program with GKB as Program Advisor

- GKB is engaged by HFA to analyze the Agency's options with respect to the secondary mortgage market, analyzing risks and benefits within the goals and mission of the HFA

- GKB assists in implementing chosen option working with the Agency on a recommended strategy (may be multi-pronged), develop policies, procedures, reporting and infrastructure to execute the strategy.

- The HFA implements a hedging strategy taking all the benefits and risks but using GKB as an Advisor for a definitive time period

- GKB provides on going monitoring of program performance and continual assistance in program design, hedging, and execution

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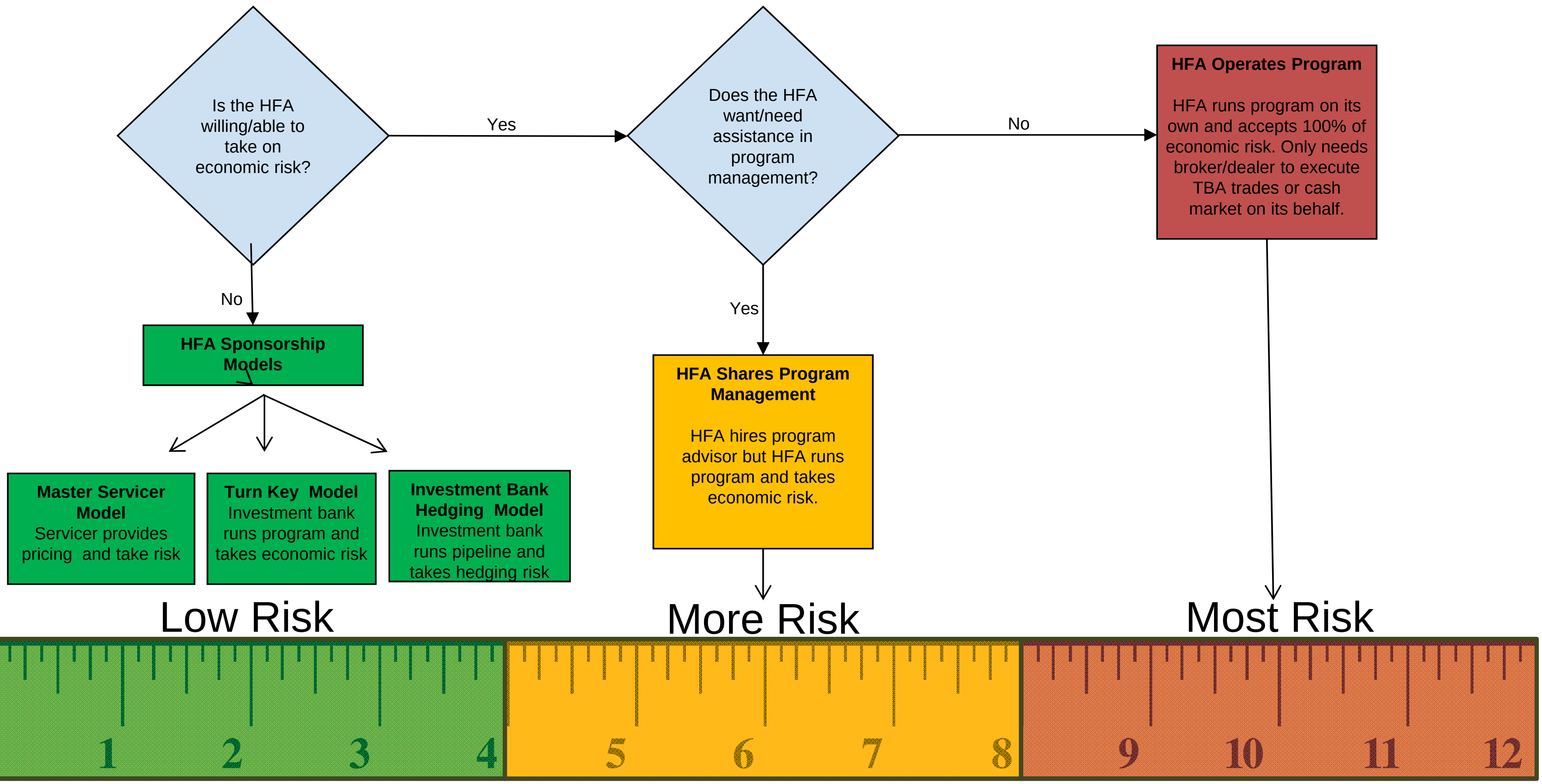
Managing a Market Rate Program: Which one is right for you?

➢ Below is a diagram that describes several execution strategies for implementing a market rate program. The specifics of each program option follow.



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LOUISIANA HOUSING CORPORATION

"Community Second" Assistance Program
Program Term Sheet

In order to participate, Lenders must execute three (3) copies of the Program Lender Agreement and be approved and in good standing as a Correspondent Lender with Standard Mortgage Company.

Sponsor	Louisiana Housing Corporation (LHC) qualifies as an "instrumentality of government" in accordance with FHA and Fannie Mae guidelines and an approved Community Seconds provider.
Available Funding	Limited offering to a select group of Correspondent Lenders. Up to $5,000,000 in Second Loans initially, available on a first-come, first-served basis.
Seller/Servicer	First Loans will be purchased and serviced by Standard Mortgage Company as "Seller/Servicer". Second Loans will be serviced by the LHC or another sub-servicer.
Eligible Loan Area	State of Louisiana
Loan Reservation	Lenders lock First Loan rate and price with the Seller/Servicer. Lender must lock in Second Loan separately through LHC with a separate confirmation.
Eligible Borrowers	Primary residences, owner occupied. No first-time homebuyer requirement. Non-occupant Borrowers or co-signers are not permitted.
Eligible Properties	Single family, owner-occupied, 1-2 unit principal residences that are detached structures, or condominiums, town homes/PUDs or duplexes, subject to FHA and Fannie Mae guidelines. Manufactured homes are not eligible.
Income Limits	For FHA loans, not to exceed 120% of the County median income (see Exhibit A) in each State. For Fannie Mae loans, no income limits if property is located in a Fannie Neighbors census tract.
Purchase Prices	No maximum purchase price limits.
Borrower Investment	Borrower must contribute a minimum [1%] from his/her own funds towards the down payment required for an FHA or Fannie Mae loan.
Credit Score Minimum	Minimum credit score for FHA loans is subject to Seller/Servicer approval (640 minimum is suggested); 680 minimum for Fannie Mae MCM 97 (660 minimum for MCM 95).

Rate and Price Adjustments to Existing Seller/Servicer Rate Sheet

Purpose	1st Loan (LTV)	Rate Adjustment	Price Adjustment	HFA 2nd Loan	Closing Cost Assistance	Borrower Investment	Min CS
Purchase/RTR	FHA (96.5%)	Add .125%	Deduct 1%	2.5% 2nd	3% (Lender)	1% minimum	640+
Purchase/RTR	FNMA (97%)	Add .1875%	Deduct 1%	3% 2nd	2.5% (Lender)	1% minimum	680+

First Loan Terms and Guidelines

First Loan Types	**FHA, Fannie Mae My Community Mortgage 97 (MCM 97).**
Transaction Type	Purchase transactions only for owner-occupied principal residences. Rate term refinancings (no cash back to the Borrower) are permitted with certain restrictions.
First Loan Terms	30-year fixed rate fully amortizing FHA and Fannie Mae MCM 95 or 97 First Loans.
Loan Underwriting/ Ratios/Reserves	FHA and Fannie Mae/mortgage insurer guidelines with respect to underwriting. Ratios may not exceed [45%] DTI, minimum [1 month] in reserves.
LTV/CLTV	• FHA LTVs apply; no CLTV limit relative to Second Loan sizing offered. • MCM 97 with offered Second Loan may not exceed 102.5% CLTV.
First Loan Rates	First Loan rates and prices will be posted daily by the Seller/Servicer, are subject to change and should not be considered confirmed until they are locked in and confirmed by Seller/Servicer's Correspondent Lock Desk.
Rate and Price Adjustments	Applicable rate and price adjustments will be posted separately on the Seller/Servicer Rate Sheet. Price adjustments and fees are considered closing costs and may be funded with Second Loan proceeds.
Prepay Penalties	None.
First Loan Limits	FHA and Fannie Mae first loan limits apply. There are no purchase price limits.
Lender Advance	Lenders shall advance the Second Loan proceeds at the close of escrow, to be reimbursed by the Seller/Servicer upon the purchase of the First and Second Loans.

Second Loan Terms and Guidelines with FHA Loans

Size of Second Loan, Use of Proceeds	• Sized at up to 2.5% of the sales price. • 30-year term, no monthly payments, principal due at maturity, or prior to upon sale or refinance. • No scheduled or accrued interest. • The Second Loan proceeds may only be applied towards the Borrower's down payment (subject to the Borrower's minimum investment). • With FHA First Loans, the **LHC** must serve as lender and beneficiary of the Second Note and Deed. • Second Loan may not be re-subordinated. • Second Loans will be serviced separately by LHC.
Closing Cost Assistance	Lenders may premium price FHA First Loans to cover closing costs, prepaids, Sponsor fees or discounts and other related fees and expenses.

Second Loan Terms and Guidelines with Fannie Mae MCM Loans

Mortgage Insurers	UGIC, MGIC and Genworth. See "HFA" guidelines for each mortgage insurer.
Size of Second Loan, Use of Proceeds	• Sized at up to 3% of the sales price. • 30-year term, no monthly payments, principal due at maturity, or prior to upon sale or refinance. No scheduled or accrued interest. • The Second Loan proceeds may only be applied towards the Borrower's down payment assistance (subject to the Borrower's minimum investment). • With MCM First Loans, the **Lender** must serve as lender and beneficiary of the Second Note and Deed. • Second Loan may not be re-subordinated.

	• Second Loans will be serviced separately by LHC.
Closing Cost Assistance	Lenders may premium price FHA First Loans to cover closing costs, prepaids, Sponsor fees or discounts and other related fees and expenses.

Second Loan Documents, Second Loan Representations and Warranties

Second Loan Disclosure	Lenders must conform to federal RESPA and Truth-in-Lending laws in disclosing the initial terms of the Second Loan on a preliminary and final basis.
Second Loan Documents	• Second Note • Second Deed of Trust • Second Loan Truth in Lending Statement • Mortgagor's Agreement and Acknowledgment • Authorization to Release Information and Request for Counseling Form. • Assignment through MERS or recorded assignment.
Post-Closing Documents	Lenders agrees to deliver post-closing Second Loan documents to the Seller/Servicer within 90 calendar days after the loan closing date, with extensions permitted by the Seller/Servicer if Lender is using all reasonable efforts to obtain such documents. Seller/Servicer has the right to charge late document delivery fees if the documents are not delivered within 120 days. Lender agrees to correct any post-closing documents within 20 calendar days after being notified of any errors or omissions..
Representations and Warranties	Lenders make the same representations and warranties as to the Second Loan to the Seller/Servicer as of the purchase date that Lender has represented and warranted as to the First Loan to the Seller/Servicer as of the purchase date pursuant to the Correspondent Agreement. Lender is obligated to repurchase the Second Loan if the Lender is required to repurchase the related First Loan because of fraud or misrepresentation or if it determined by the Seller/Servicer that the Second Loan does not meet the requirements of the Program.

Homebuyer Education and Counseling	Recommended for first-time homebuyers. Face-to-face counseling courses are recommended, but on-line courses are acceptable. All borrowers must execute the Borrower Authorization to Release Information and Request for Counseling Form, which authorizes the Seller/Servicer to share relevant account information with the MI company and/or third party counselor should the borrower become delinquent.

Lender Compensation	Lender compensation is limited as follows: • Up to 1% origination fee for First Loans, Servicing Release Premium (SRP). • Reasonable and customary fees and closing costs, as long as such compensation payments are fully disclosed to the borrower. • There is no origination fee or SRP associated with the Second Loan, but Lenders are permitted to charge a fixed fee as additional compensation.
Loan Purchase Price	• Seller/Servicer will purchase the First and Second Loan at a rate and price reflected on the confirmation (net of any LLPA, fees, SRP). • First and Second Loans will be purchased concurrently at a purchase price equal to 100% of the outstanding principal balance, plus accrued interest.
Seller Contribution	Permitted subject to Fannie Mae and FHA guidelines.
Program Fees	TBD

Louisiana Housing Corporation
TBA/Second Loan Program
Key Discussion Points

TBA/MBS Secondary Markets

- No viable MRB market or NIBP? HFAs as mortgage bankers, look to access the "TBA" secondary market for affordable loan and cash to close assistance needs.
- HFAs may not be able to compete on rate, but cash-strapped homebuyers are willing to accept a higher loan rate in exchange for cash to close assistance.
- A homebuyer looking to purchase a home in Baton Rouge on June 26 could lock in a 3.50% FHA loan rate (at par) for 30 days. In the TBA forward market, that same FHA loan rate, for a September delivery, is valued at 103.125%. A 3.75% loan rate is valued closer to 104.5%.
- FNMA's HFA Preferred Cash Window offers LHC its own My Community Mortgage 97 rate sheet, with low guarantee fees, no loan level price adjustments and various premium pricing options for cash to close assistance. Premium could also be used to prepay the MI fee, eliminating any ongoing MI premium, lowering the borrower's monthly payment.
- Delivery into the GNMA/TBA market or to the FNMA Cash Window is mandatory; if you fail to deliver, in part or in whole, you owe the investor or Fannie Mae a pair off fee.

Issues Related to Premium Pricing and Down Payment Assistance

- HUD has not authorized the use of loan or MBS premium pricing by an HFA as a gift, grant or second loan to cover any portion of the borrower's down payment; the funding of closing costs and prepaids are permitted.
- Lenders have expressed concerns about a return to "no down" FHA programs, future defaults and impact on HUD compare ratios.

GKB Recommendations

- As a GNMA/FNMA seller as well as servicer, Standard Mortgage Corporation will manage LHC's loan pipeline, interest rate and loan cancellation risk on a daily basis.
- Standard Mortgage will post an LHC Daily Rate Sheet with a variety of FHA and FNMA loan rates and prices to LHC Lenders.
- LHC-funded 2.5% sized Second Loan as downpayment assistance, 15 year terms, monthly payments due, at a 5-6% interest rate, serviced separately.
- Not limited to first-time homebuyers, purchases or refinances, may be used in connection with an MCC, MRB income limits apply (by family size).

First Loan	Purpose	1st Loan	2nd Loan Size (Down Payment)	Closing Costs	MI Subsidy	Min Borrower Investment	Min Credit Score
FHA	Purchase	96.5%	2.5%	2.5%		1%	640-679
MCM	Refi	95%	3.0%	1.5%	1.5%	1%	660-679
MCM	Purchase	97%	3.0%	1.0%	2.0%	1%	680+

- As the Second Loan investor, LHC will receive all Second Loan payments monthly together with a First Loan Rate Add On of .125%-.1875%, the sum of which will provide LHC with an 8%-10% yield as the Second Loans are aggregated.
- LHC will purchase and aggregate the Second Loans from the Lenders until a minimum $2,500,000 issuance size is reached, at which time the Bonds may be underwritten by GKB and sold to accredited investors on a private placement basis.

Loan Product, Credit and Assistance Specifics

- FHA: 2.5% sized, 15-year term, monthly principal amortization, maximum 6.0% interest rate, may be applied against the homebuyer's 3.5% down payment, subject to the homebuyer's own 1% minimum investment from his/her own resource, [2 month PITI in reserve], and a 640 minimum credit score. FHA's marketability here is higher monthly payment but less cash to close.
- FNMA MCM 97: 3% sized, 15-year term, monthly principal amortization, maximum 6.0% interest rate, may be applied against the homebuyer's down payment subject to a minimum 1% from the homebuyer's own resources, 2 month PITI in reserve, and a 680 minimum credit score (660 for an MCM 95). MCM's marketability here is the lower monthly payment than FHA and more cash to close.
- HFA will add .125% to each FHA First Loan rate. .1875% to each FNMA MCM First Loan rate, as an ongoing HFA fee, to be remitted monthly by the Master Servicer.

Loan Rates, Monthly Payments and Cash to Close

First Loan	Purpose	1st Loan	2nd Loan Size (Down Payment)	Closing Costs	MI Subsidy	Min Borrower Investment	Min Credit Score
FHA	Purchase	96.5%	2.5%	2.5%		1%	640-679
MCM	Refi	95%	3.0%	1.5%	1.5%	1%	660-679
MCM	Purchase	97%	3.0%	1.0%	2.0%	1%	680+

	Purchase Price	Loan Amount	Loan Rate	Cash to Close	Monthly MI Payment	Monthly Payment (PITI)
"At Market" FHA	$150,000	$147,375	3.50%	$10,147	$147.38	$1,019.15
LHC FHA	$150,000	$147,375	3.875%	$2,802 [1]	$153.52	$1,087.62
LHC MCM 95	$150,000	142,500	4.375	$6,337 [1]	$0	$957
LHC MCM 97	$150,000	145,500	4.375	$3,972 [1]	$0	$973

[1] Minimum $1,500 from the homebuyer's own resources. Remaining cash to close may be gifted from a documented relative or paid by the home seller (up to 3% maximum)

Louisiana Housing Corporation
Loan Comparison – Market FHA and FNMA MCM with Assistance

	Lender	LHC	LHC	LHC
Loan Type	FHA	FHA	MCM 95	MCM 97
LTV Maximum (MIP)	96.5%	96.5%	95%	97%
Credit Score Min	640	640	660	680
Up-front/Mnthly	*1.75%/120 bp*	*1.75%/120 bp*		
Single LPMI			*1.50%*	*2.00%*

	Lender	LHC	LHC	LHC
Loan Type	**FHA (98.25)**	**FHA (98.25)**	**MCM 95**	**MCM 97**
2nd Loan	No	2.5% 2nd @6%	3% 2nd @6%	3% 2nd @6%
2nd Loan Repay		15-Yr Amort	15-Yr Amort	15-Yr Amort
Gift/Grant/Premium		2.50%	3.00%	3.00%
Loan Amount (MIP)	$ 147,375	$ 147,375	$ 142,500	$ 145,500
Purchase Price	$ 150,000	$ 150,000	$ 150,000	$ 150,000
Adj Loan Rate [1]	**3.500%**	**3.875%**	**4.375%**	**4.375%**

[1] Adjusted to reflect premium pricing and Rate Add On for Administration Fee.

Principal & Int	661.78	693.01	711.48	726.46
Property Taxes	150.00	150.00	150.00	150.00
Home Insurance	60.00	60.00	60.00	60.00
2nd Loan Pmt	0.00	31.09	36.07	36.83
Private Mortg Ins	***147.38***	***153.52***	***0.00***	***0.00***
Estimated PITI	**$1,019.15**	**$1,087.62**	**$957.56**	**$973.29**
Down Payment	5,250.00	5,250.00	7,500.00	4,500.00
Up-front Mtg Ins	0.00	0.00	2,137.50	2,910.00
1% Origination Fee	1,473.75	1,473.75	1,781.25	1,818.75
Closing Costs	3,542.00	3,542.00	3,542.00	3,542.00
Impounds	1,381.98	1,404.69	1,426.21	1,431.60
Cash to Close:	**$11,647.73**	**$11,670.44**	**$16,386.96**	**$14,202.35**
Less LHC 2nd Loan	$0.00	$3,684.38	$4,275.00	$4,365.00
Less 1% Seller Pymt	$1,500.00	$1,500.00	$1,500.00	$1,500.00
Less Gift	$0.00	$3,684.38	$4,275.00	$4,365.00
Net Cash to Close	**$10,147.73**	**$2,801.69**	**$6,336.96**	**$3,972.35**
Min Borrower Cash	**$5,250.00**	**$1,500.00**	**$1,500.00**	**$1,500.00**
Lender Comp	**2.50%**	**2.50%**	**2.25%**	**2.25%**

Yield Calculations for LHC as Second Loan Investor

Aggregation of Second Loans by LHC

2nd Loan Amount	2nd Loan Size [1]	1st Loan IO	Price	Bond Proceeds	Term	Coupon	Maturity	Interest	Rating
2,500,000	2.5%	.125%	100	------	15 Year	NA	5/1/2027	Monthly	NR
	3.0%	.1875%	100						

[1] Based on $100,000,000 in Accompanying First Loans.

Yields from the Combined Cash Flows Received from the Second Loans and First Loan Interest Payments

Annual Defaults	0% PSA	100% PSA	150% PSA	200% PSA	300% PSA	500% PSA
1.0%	15.28%	14.43%	14.20%	14.33%	14.38%	15.03%
3.0%	13.29%	12.46%	12.23%	12.11%	12.13%	12.75%
5.0%/3.0% [1]	11.98%	10.98%	10.68%	10.50%	10.41%	10.92%
7.0%/3.0% [1]	10.69%	9.53%	9.16%	8.91%	8.71%	9.09%
9.0%/3.0% [1]	9.43%	8.11%	7.65%	7.33%	7.02%	7.26%

[1] First percentage represents the annual default rate for the first 5 years, 3% thereafter for the remaining life.

Private Placement of Mortgage Revenue Bonds

2nd Loan Amount	2nd Loan Size [1]	1st Loan IO	Price	Bond Proceeds	Term	Coupon	Maturity	Interest	Rating
$2,500,000	2.5%	.125%		$2,500,000	15 Year	**10%**	5/1/2027	Monthly	NR
$3,000,000	3.0%	.1875%		$3,000,000					

Average Lives (in Years) of the Combined Second Loan and First Loan IO Cash Flows:

Annual Defaults	0% PSA	100% PSA	150% PSA	200% PSA	300% PSA	500% PSA
1.0%	4.44	3.67	3.39	3.15	2.79	2.31
3.0%	4.87	3.97	3.64	3.37	2.95	2.45
5.0%/3.0% [1]	5.42	4.38	3.99	3.66	3.17	2.53
7.0%/3.0% [1]	6.17	4.97	4.50	4.11	3.49	2.71
9.0%/3.0% [1]	7.31	6.06	5.65	5.51	4.64	3.04

Residual Value after Bonds are Redeemed in Full

PV Rate Used: 3%

Annual Defaults	0% PSA	100% PSA	150% PSA	200% PSA	300% PSA	500% PSA
1.0%	2,226,431	1,506,236	1,296,421	1,142,984	939,181	729,820
3.0%	1,470,202	1,010,873	878,584	782,714	657,214	531,930
5.0%/3.0% [1]	1,082,289	705,195	601,831	529,584	440,274	361,656
7.0%/3.0% [1]	699,216	398,905	324,080	275,871	224,457	195,109
9.0%/3.0% [1]	301,720	59,196	No CF	No CF	No CF	No CF

[1] First percentages represent the annual default rate for the first 5 years, 3% thereafter for the remaining loan life.

SINGLE-FAMILY LOAN PRODUCTION
AND THE LOUISIANA HOUSING CORPORATION

A LENDER / SERVICER PERSPECTIVE

- **PRICING**

  - **The Facts**

    The current thirty year mortgage rate for market-rate transactions is approximately 3.50% with zero discount points. Average hard closing costs are between 1.5% and 2.5% of the loan amount (not including escrows).

  - **The Challenge**

    The current MRB program offers a 3.99% assisted rate and a 3.49% unassisted rate, both with a 1% origination fee and .50% discount. Hard closing costs are covered in the assisted program and obviously not in the unassisted. As others have mentioned, prior agency issues that have originated and, more importantly, performed best are those that are priced appreciably below the open market at the time of origination.

  - **The Suggestion**

    If it is feasible, increase the unassisted allocation available and reduce the rate of the unassisted product to a rate below 3% while concurrently reducing the assisted allocation and the amount of assistance on that product. Certainly, dropping the .50% discount point would also get attention. This would at least be an attempt to present a competitive product (an attractive unassisted product) to the target market while reducing cash flow exposure on the product (assisted product) getting no attention at this time. The Sellers will also step up with contribution at the table.

- **THE COMPETITION**

  - **The Facts**

Currently, the majority of originations in the industry are Refinance transactions at 70 -75% nationwide. Refinances are predicted to hold that range or increase with an improved Home Affordable Refinance Programs (HARP) rolled out by Fannie Mae and Freddie Mac making loan-to-value no longer an impediment to approval for customers with an excellent payment history for the last twelve months. Business is booming in most mortgage shops due to this opportunity. Conversely, 25 - 30% of the industry activity is in purchase transactions. This is an indication that real estate sales, although improving, have not rebounded to a healthy pace. Therefore, the market is still classified as a "buyer's market" and sellers will subsidize the transactions. Additionally, approximately 85% of new production nationwide is currently conventional mortgages and 15% are government.

- **The Challenge**

The current LHC program is going "against the grain" in many ways. First, the only transaction allowable is a purchase transaction. Second, the LHC product is limited to government loans only. As stated above, conventional refinances are dominating the marketplace and have completely absorbed the attention of the lender participants, their origination staff, their production support, and their funding lines. The refinances are "low hanging fruit" with streamlined processes and underwriting concessions from Fannie Mae and Freddie Mac that are overwhelming the lender community and providing stiff competition for MRB originations.

- **The Suggestion**

If it is feasible, redirect the assistance provided by LHC to facilitate a refinance program for existing loans originated in prior programs. One example of opportunity with the current Master Servicer is the 1452 non-delinquent loans totaling $173 million with interest rates equal to or greater than 5%. More specifically, within this sample are over 700 Freddie Mac loans totaling $80 million with HARP opportunity (most of the loans were 100% LTV but that is not a problem with HARP 2.0). If allowable, LHC could provide 2% assistance to the existing borrower with an acceptable payment history to cover closing costs associated with a refinance. The borrower with an average loan of $115,000 with an average rate of 5.5% would reduce their principle and interest payment from $652.97 to $517.50 with a 3.5% rate, thereby saving $135.47 per month.

Understanding that this suggestion may be more than "creative" and a "long shot" for the current issue, hopefully it can be considered over the next two years for future issues. The current Master Servicer would certainly offer assistance in the design of the program and discussions with Freddie Mac. Since this would be an internal effort with the current Master Servicers (Standard Mortgage,U.S Bank and BOA), a concurrent purchase program could be offered to the marketplace.

- **MARKETING**

  - **The Facts**

    It appears that LHC is currently utilizing newspaper, website, Lender/Buyer Fairs, and random contact with participating lenders to promote the current MRB program. There may be other efforts that I am not aware of. The current effort seems to be valuable as a "broad" approach to marketing by LHC.

  - **The Challenge**

    This broad approach of marketing the program to consumers and lenders, although necessary, is ineffective in this refinance-driven origination market. The current lack of commitment from a distracted participant group overwhelmed by less challenging refinance transactions almost guarantees ineffective use of marketing dollars with that segment. It is not as simple as paying more for the MRB origination as has been proven in the past.

  - **The Suggestion**

    Utilize LHC staff to perform more specific marketing activity such as:

    - ✓ **Product awareness meetings with the CRA / Affordable Housing departments of the Louisiana bank participants…they have built-in programs that may value the program**
    - ✓ **"Hurdle" the lenders with direct mail to all Louisiana realtors and builders with a quality brochure highlighting the positives of the current program…they are not being marketed right now by the refinance-distracted lenders**
    - ✓ **Direct mail and venues with Louisiana state government employees, First Responders, Teachers, Veterans and other specific groups….the assistance will speak loud to these groups**

These efforts will not cause the program to "outpace" the refinance arena, but may have a positive effect on the current pace and certainly allow LHC to utilize staff and gain valuable experience and feedback from the new approach.

Again, this is a Lender / Servicer perspective with limited knowledge of the ability to and technicalities involved with changes to a tax-exempt MRB program…just some suggestions and certainly not criticisms of the program.

MOODY'S INVESTORS SERVICE

SPECIAL COMMENT

State Housing Finance Agency Single Family Programs in Run-off Likely to Maintain Credit Quality

Low Short-Term Interest Rates and Variable Rate Debt Pose Special Challenges

Table of Contents:

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Summary Opinion

State Housing Finance Agency (HFA) single family bond issuance has declined substantially over the past three years, as the current interest rate environment has reduced the effectiveness of mortgage revenue bonds as a source of mortgage funds. As this trend is likely to continue, we foresee an increasing number of HFA single family programs entering run-off. We believe that these programs will maintain stable credit quality during run-off, because their structure allows them to become stronger as no new mortgages are added, and we expect that HFA financial management teams will continue to make decisions that support credit quality. There are three key factors underlying this view:

» HFAs generally apply mortgage prepayments to periodic special redemption of bonds, so that mortgage assets and bonds decline at parallel levels and the ratio of assets to liabilities increases. This increases the protection against losses from mortgage loan delinquencies and foreclosures and other negative pressures on cash flows.

» As mortgages become more seasoned, their loan- to-value ratios decrease and they generally experience lower levels of delinquencies and foreclosure, reducing losses to the program.

» HFA managers in the past have avoided withdrawals of excess assets from single family programs that were not consistent with maintaining credit quality, and have continued to provide skillful financial management for their inactive programs.

At the same time, certain risks may increase as programs run off:

» As mortgage loans are repaid, program cash and investments often increase as a percentage of assets. If the current era of low short-term interest rates persists, low returns on these non-mortgage assets may reduce program profitability.

» Reduced diversification of mortgage loans by vintage may heighten the impact of adverse trends in loan performance as a result of economic cycles.

» For programs with variable rate debt, the percentage of variable rate debt may increase as high-cost fixed rate bonds are redeemed, magnifying the impact of variable rate risks including rollover, counterparty and interest rate risk. Reducing notional amounts of interest rate swaps in line with redemptions of variable rate bonds will be an additional factor in managing the variable rate programs.

In light of these risks, HFA management will continue to be a key factor in our assessment of individual credits. Program strength will be a function of the levels of excess assets retained to support bond indentures, as well as the level of resources devoted to management of bond programs. Skilled financial management will be important in areas such as selection of bonds for redemption, exercising refunding opportunities, and managing exposure to counterparties, variable rate debt and interest rate swaps.

Many Well-Established HFA Single Family Bond Programs are Likely to Enter Run-Off

Mortgage revenue bonds have provided the primary source of funding for state HFA single family mortgage loan programs over the past 30 years. These programs generally shared a basic structure that has contributed to credit stability. Basic features of the structure include the following:

» The HFA issues bonds periodically (several times a year for the more active programs), with each issue creating new series under a common indenture. Bond proceeds are used to finance single family mortgage loans, which remain pledged to the indenture to support bond repayment. Proceeds of each bond issue are applied to originate mortgages at a positive spread to bond costs, generally targeting the 1 1/8% maximum spread permitted by federal tax law.[1]

» The bonds are issued on parity, so that all of the bonds issued over time are secured by all of the mortgages financed over time

» Bonds are subject to special redemption at any time, at par, from mortgage prepayments. Special redemptions maintain mortgages and bonds at relatively even levels over time.

» Bonds are also subject to optional redemption, generally ten years after issuance, allowing for economic refundings that may replace higher cost bonds with lower cost bonds.

» Over time the programs became well over-collateralized, as a result of accumulation of excess revenues as well as HFA contributions. Since 2008, for example, median PADR for Moody's-rated programs has increased from 1.06x to 1.10x while new origination has been low.

Bond issuance under HFA single family programs has declined substantially over the past three years. Conventional mortgage interest rates have fallen to 40-year lows in line with falling levels of U.S. Treasury rates. Although yields on HFA mortgage revenue bonds are low, they have not experienced a level of decline parallel to that of Treasury and conventional mortgage rates. In the current environment, therefore, mortgage revenue bonds do not provide a cost of funds low enough to fund mortgage loans that are competitive with conventional rates, and HFAs have increasingly turned to other sources of funding for mortgages.[2] As we expect this interest rate environment to persist, we anticipate that mortgage revenue bond issuance will remain depressed over the near to medium term and an increasing number of HFA bond indentures will enter run-off.

1 1 1/8% spread between mortgage yield and bond yield, calculated as prescribed in the federal income tax provisions authorizing tax exemption of the bonds.

2 Please see our Special Comment, *Secondary Market Funding Strategies Buoy State HFAs' Growth But Add to Their Risks* June 12, 2012 for a discussion of the interest rate environment and other sources of mortgage funding being used by HFAs.

Credit Considerations for Programs in Run-off

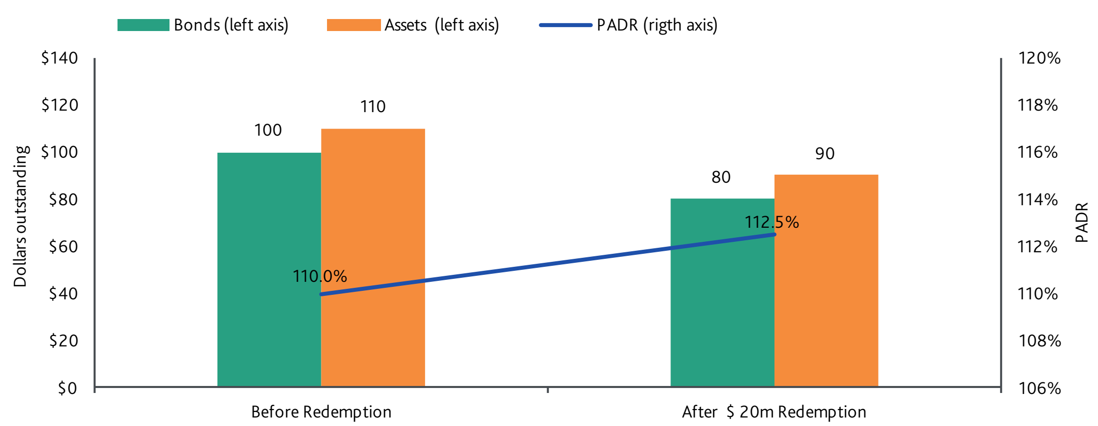
We believe that credit quality is likely to be maintained for programs in run-off, because fundamental financial performance should remain strong and because we expect the HFAs to continue sound financial management. The following four factors will be important for individual programs:

1. Fundamental financial performance: including increased balance sheet strength and stable net income levels
2. Asset quality: For whole-loan programs increased mortgage seasoning and other changing portfolio characteristics
3. Variable Rate Debt: For programs with variable rate debt and swaps, potential increases in variable rate percentages and related risks
4. Management: Continued allocation of resources to maintain bond program strength, as well as continued skilled financial management of programs,

1. Fundamental Financial Performance: Increased Overcollateralization Adds to Balance Sheet Strength; While Net Income Can Be Maintained through Bond Redemptions, Low Short-Term Rates will Decrease Earnings

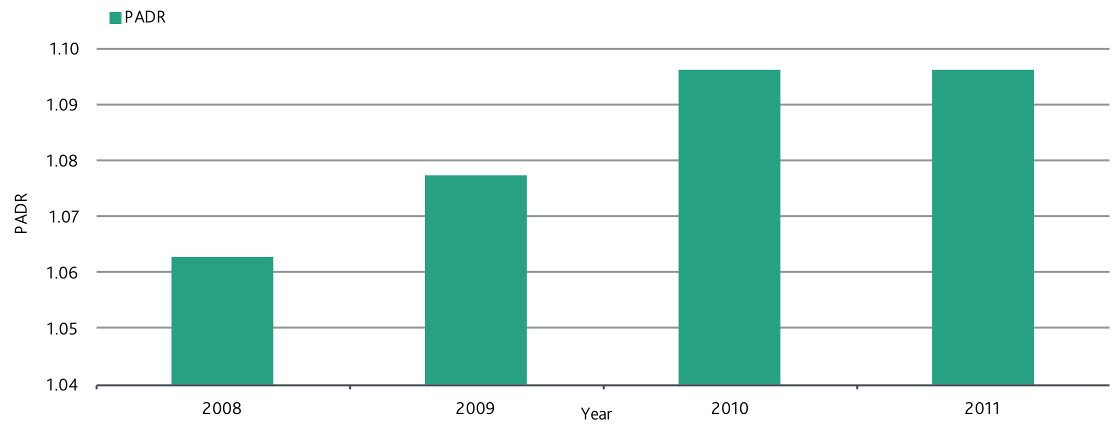
Balance Sheet - Increased Over-collateralization: We consider over-collateralization to be an important source of credit strength for these programs. The excess of assets over liabilities provides an important cushion against losses from mortgage loan delinquencies or foreclosures and other potential sources of stress on future cash flows. Over-collateralization tends to increase during run-off. As mortgage prepayments are applied to redeem bonds, the levels of mortgages and bonds decline proportionately, and the excess of assets over debt increases as a percentage of debt. This concept is illustrated very simply in Figure 1, which shows the impact of a $20 million reduction through prepayment redemptions.

FIGURE 1
PADR Increases as Balance Sheet Declines



Trends in PADR (Moody's-adjusted asset to debt ratios) for single family programs rated by Moody's over the past four years, as shown in Figure 2, illustrate how PADR increases during periods when issuance is low.[3]

FIGURE 2
Asset-to-Debt Ratios Have Increased as Issuance has Declined



Source: Moody's databases; HFA audited statements

HFAs generally are permitted to withdraw excess revenues from the lien of the bond indenture, subject to meeting certain cash flow tests set forth in the legal documents. In the past, HFAs have limited withdrawals so as to maintain program credit quality, and we expect this practice to continue. However, the levels of any withdrawals will be a factor in our assessment of individual programs.

Program Net Income - Mortgage Spreads: As mortgage payments are the principal source of funds for repayment of bonds, maintaining positive spread between mortgage yields and bond yields is another key credit consideration. Through selection of bonds to call from prepayments, HFAs can maintain the spread between mortgage yield and bond cost, both within bond series and for the indenture as a whole. However, a number of factors limit flexibility in selecting bonds for redemption and in some cases may affect the impact of redemptions on future cash flows. These include the following:

» Bond series may have been structured with bond maturities shorter than mortgage maturities ("front loaded") or may have been structured with bond maturities that assumed certain mortgage prepayment speeds, with the goal of reducing bond costs.

» Bond series may have included special features such as PAC bonds, which commit to applying prepayments first to redemption of certain maturities in the bond structure.

» Federal tax law applies other constraints to bond redemption, such as a requirement that prepayments received after ten years be applied solely to redemption of bond of the original bond series (the "ten year rule").

When the program is growing the addition of new full-spread mortgages may partly offset the effects of cash flow mismatches that may develop in older series. In higher rate environments, some agencies have continued to add new mortgages to programs by "recycling" prepayments into new mortgages, providing another option for maintaining profitability. When no new mortgages are added, the impact of any mismatches may increase. We consider periodic review of cash flow projections as a significant practice in evaluating the impact of redemptions on future cash flows.

3 Please see our Median Report, *State HFA Medians Reflect Stability Due to Federal Initiatives; Future Financial Performance Will be Weaker,* dated October 17, 2011

Program Net Income - Low Earnings on Cash and Investments: As the program's assets consist of cash and investments as well as mortgage loans, the current low-interest rate environment has had a negative effect on profitability due to lower investment rates on short-term assets and on reserve funds.

When a program is in run-off, the impact of low investment rates may be magnified as cash and investments may increase as a percentage of assets. Bonds and mortgage loan levels decrease proportionately, leaving excess revenues and reserves funds as a greater percentage of overcollateralization. These excess revenues are generally held in cash which incur negative arbitrage compared to bond costs in a low-rate environment. Regular and frequent special prepayment redemptions will be a factor in determining the effect on program profitability.

For both float funds and debt reserves, the form of investment is also a factor in the impact of investment rates. Assets invested in long-term guaranteed investment contracts (GICs) or repurchase agreements generally have fixed rates and are not affected by low current rates. The GICs frequently apply to the reserves and/or revenues of particular bond series, and were entered into at the time of issuance of those bonds. The maturity of a GIC or repurchase agreement, or its termination as a result a provider downgrade, may dramatically lower the investment rate on the funds affected.

2. Asset Quality: Changing Mortgage Loan Characteristics May have both Positive and Negative Aspects

For a program in run-off, changes in the composition of the mortgage loan portfolio may have both positive and negative credit aspects.

Over time, the existing mortgage loans become more seasoned. All things being equal, seasoned mortgage loans have historically tended to demonstrate lower levels of delinquency and foreclosure, as the homeowners' economic circumstances stabilize or improve. More seasoned loans tend to have lower loan-to-value ratios, which may decrease delinquencies and losses on foreclosure. However, the recent period of rising unemployment has been a contributor to a rise in delinquency and foreclosure rates among HFA loans, which may work against performance of loans of all vintages in the near term.[4]

Run-off may have negative effects on other aspects of the mortgage portfolio. Prepayments may tend to be concentrated among loans made in certain time periods (vintages), for example because rates were relatively high at the time of origination. Diversification of the portfolio as to vintage and mortgage insurers will tend to decline. This may magnify the impact of future economic trends on the remaining vintages.

3. Variable Rate Debt: Risks Associated with Variable Rate Debt and Swaps May Increase as Fixed Rate Bonds are Redeemed

Certain HFA programs issued variable rate debt during the period from 2000 to 2008, often entering into interest rate swaps to hedge interest rate risk. As programs decline in size, the risks associated with variable rate debt may become more pronounced.

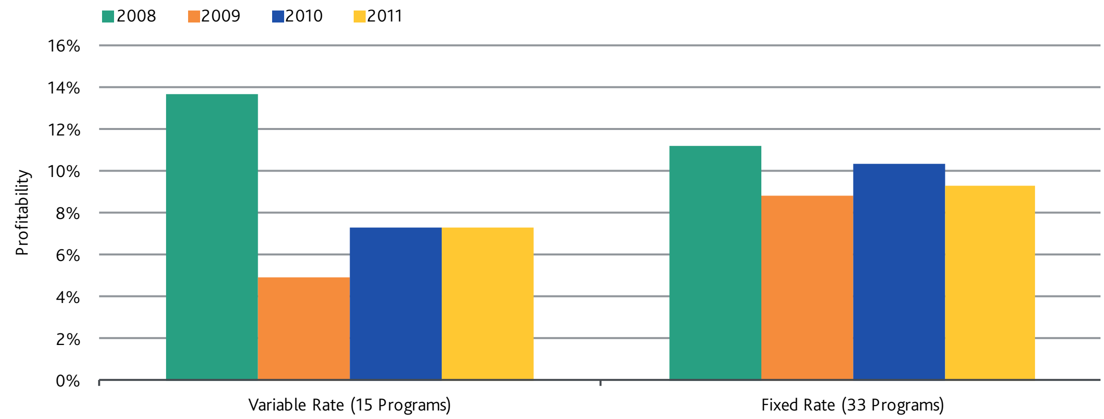
Percentages of Variable Rate Debt May Increase: To the extent feasible, HFAs select higher coupon bonds for redemption first in many programs. We have observed that this results in redemption of higher cost fixed rate bonds before variable rate bonds, potentially increasing variable rate bonds as a percentage of bonds outstanding. The impact of certain risks associated with variable rate debt may be magnified. These include the following:

[4] Please see our recent Special Comment, *Semiannual State HFA Delinquency Report: Seriously Delinquent Single Family Loans Continue to Rise*, May 30, 2011 for a review of trends in State HFA single family mortgage performance.

» Programs with higher levels of variable rate debt have proven less profitable in recent years, as costs of liquidity, combined with greater-than-expected basis spread between swap receipts and bond payments, have increased bond costs. As the percentage of variable rate increases in a particular program, this trend may become more pronounced.

FIGURE 3

Variable Rate Programs Are Less Profitable Than Fixed Rate Programs



Source: Moody's databases; HFA audited statements

» HFAs have obtained external liquidity support, generally in the form of standby bond purchase agreements, for VRDBs. Replacement of expiring facilities may become more challenging, although to date HFAs have been successful in renewing or replacing facilities. Higher cost of replacement liquidity facilities will increasingly impact program cash flow if the percentage of variable rate debt increases.

» Another key risk associated with VRDBs is the possibility that bonds will become "bank bonds" due to market disruptions, lower credit quality of the HFA, or inability to replace expiring liquidity facilities. Bank bonds typically bear higher interest rates and must be repaid over a short period of time ("term out"), placing stress of cash flows.

Interest rate swaps are a factor in variable rate bond redemptions: The majority of HFA variable rate bonds were combined with floating-to-fixed interest rate swaps to hedge interest rate risk. Swaps were typically structured with notional amounts that declined over time, to stay in line with expected levels of bond maturities and/or redemptions; however, swaps typically cannot be reduced at the option of the HFA in the same way that bonds are subject to special redemption from prepayments. Therefore, as prepayments occur, HFAs face the challenge of managing swaps so that swap notional amounts and bond variable rate bonds outstanding remain in balance:

» If prepayment levels are *higher* than contemplated when the swap was structured, bond levels may be lower than swap levels, so that the program will be paying for a hedge that is not needed unless the swap notional amount can be reduced.

» If prepayment levels are *lowe*r than contemplated, bond levels may be higher than swap levels, so that the bonds are unhedged and subject to interest rate risk.

With interest rates at all-time lows, the swaps have a negative market value to the HFAs, so that terminating the swap may require a substantial mark-to-market payment. Some HFAs purchased par termination options for the swaps, giving them a higher level of flexibility in reducing swap notional amounts as bonds are redeemed.

In the long term, as fixed-rate bonds are redeemed, prepayments must be applied increasingly to redeem variable rate bonds, potentially requiring swap termination payments or continued payments on hedges that are no longer needed.

Unhedged Bonds Will be Subject to Interest Rate Risk: Some programs incorporated variable debt that was left unhedged to take advantage of low interest rates. As discussed above, additional bonds may become unhedged as bonds are redeemed exposing the indenture to increasing costs if interest rates begin to rise going forward.

Interest rate levels have different effects on single family programs

Lower Interest rates	Higher Interest rates
High levels of prepayments	Low levels of prepayments
Low investment earnings	High investment earnings
GICs rates may be more favorable than market rates	GIC rates may constrain earnings
Low cost of unhedged variable rate bonds	High costs of unhedged variable rate bonds
Swap termination requires mark-to-market payment	Lower or no payment for swap termination

4. Management: Unique Challenges of Programs in Run-off Underscore the Importance of Strong Financial Management

HFA management is a key factor in our assessment of programs in run-off, including strategic decisions that support program credit quality, as well as overall financial management.

Specific areas requiring ongoing decision-making include the following:

» **Withdrawals of assets:** As parity levels increase, HFAs generally are permitted to withdrawn excess assets free and clear of the indenture for use in other programs, subject to constraints in the legal documents. Management's commitment to maintaining a level of excess parity in the program that is consistent with its rating level will affect future program credit quality.

» **Bond redemptions**: Regular and timely application of mortgage prepayments to special redemption of bonds maintain balance between bonds and loans and prevent excess revenues from generating negative arbitrage for extended periods. Careful selection of bonds for redemption assures that legal requirements are met and periodic cash flows continue to be positive over the long term.

» **Review of cash flow projections**: We generally review cash flow projections at least annually for each program. Management review of cash flows and demonstrated responsiveness to developing trends may affect rating levels.

» **Prudent management of variable rate debt:** We monitor renewal or replacement of liquidity facilities. Management of variable rate bond and swap portfolios, to maintain balance between swaps and debt and facilitate redemptions, will also be a factor.

» **Commitment to financial management:** As bond programs no longer provide the source of new mortgage loans, they may be less central to the Agency's program objectives. The continued commitment of resources maintaining highly skilled financial managers to oversee to the programs is an additional credit factor.

Sources Referenced in this Report

- Moody's Investors Service Databases
- HFA Audited Statements

Moody's Related Research

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- Sector Outlook for US State Housing Finance Agencies Remains Negative, February 2012 (139858)

Rating Methodology:

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

Rating Implementation Guidances:

- Approach to State HFA Cash Flow Projections, August 2006 (97505)
- Methodology Update: Additional Cash Flow Tests for State Housing Finance Agency Programs, February 2009 (114598)

Special Comments:

- Secondary Market Funding Strategies Buoy State HFAs' Growth But Add to Their Risks, June 2012 (143141)
- Semiannual State HFA Delinquency Report: Seriously Delinquent Single Family Loans Continue to Rise, May 2012 (142364)
- State HFA Medians Reflect Stability Due to Federal Initiatives; Future Financial Performance Will be Weaker, October 2011 (136360)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Report Number: 143182

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SPECIAL COMMENT

Secondary Market Funding Strategies Buoy State HFAs' Growth But Add to Their Risks

Table of Contents:

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Summary Opinion

With conventional mortgage rates at 40-year lows, state Housing Finance Agencies (HFAs) have found that they are not able to offer competitive single family mortgage loan products utilizing their traditional financing method of issuing mortgage revenue bonds (MRBs). In order to continue meeting their mission of offering single family loans to first time home buyers, many state HFAs are now turning to the secondary mortgage market as a funding source – a strategy which brings with it certain benefits and challenges.

This Special Comment describes the secondary market, including the TBA (To Be Announced) program, the opportunities and challenges the State HFAs may face utilizing these financing strategies, and their implications for HFA credit quality. Our key conclusions are:

» In general, we view HFAs' expansion into secondary market activities as a positive step, although its challenges could be a negative if they are not properly managed.

» HFAs' participation in the secondary mortgage market is advantageous as it allows them to remain active in the mortgage market and opens up an additional avenue to earn revenue through increased loan servicing income, loan processing fees and positive carry on the loan warehousing facility.

» HFAs will continue their mission of providing loans to first-time homebuyers and maintain their presence in the lending community.

» Implementing a secondary market operation may entail considerable upfront costs to build the infrastructure necessary to initiate and maintain the program.

» The secondary market may expose HFAs to potential interest rate risk in the event the market shifts adversely against the hedges executed in secondary market trades.

HFAs Consider Alternative Strategies for Financing Single Family Loans

Since 2008, various factors have increased interest rates on fixed-rate bonds, including a premium demanded by investors for housing bonds. With certain classes of institutional buyers less active in the market, there is less overall demand for fixed-rate, long-term housing bonds, which in turn increases the yield demanded. This, in combination with other municipal market factors, has resulted in higher interest rates on fixed-rate bonds, particularly in relation to the mortgage rates that HFAs can offer. As fixed-rate, long-term housing bond costs have increased, Treasury yields have decreased (see discussion below). Treasury yields are used as a benchmark for mortgage rates. As Treasury yields decline, conventional mortgage rates typically decline as well.

As a result, MRBs yields are not low enough to allow HFAs to compete with the conventional mortgage market, which is enjoying historically-low rates. In 2009, a federal program called the New Issue Bond Program (NIBP)[1] offered HFAs very low financing by allowing HFAs to sell a portion of their bonds to the US Treasury at below market interest rates. The NIBP enabled HFAs to continue financing their programs with MRBs through the end of 2011. Although NIBP has been extended through the end of 2012, the majority of HFAs have depleted their NIBP allocation. With MRB financing currently not a feasible option, HFAs are pursuing alternative financing sources in order to continue providing single family loans to their constituents.

Why do conventional mortgages have lower rates than mortgages financed with tax-exempt bonds?

Historically, tax-exempt bonds have provided HFAs a competitive advantage since they have allowed HFAs to borrow money at lower rates than in the taxable market because of the associated tax benefit for the investor. For instance, the 10yr. US Treasury note, which is used as a benchmark for conventional mortgage rates, yielded between 4.62% and 4.90%[2] in January of 2007, whereas during the same period Aaa-rated 10yr. municipal bonds were yielding between 3.69% and 3.91%[3] (tax-exempt). However, such advantages have evaporated for HFAs since the disruption in the US financial markets in 2008. In April 2012, the 10yr. US Treasury note was yielding between 1.95% and 2.30%, and Aaa-rated 10yr. tax-exempt municipal bonds were yielding between 2.10% and 2.57% (Exhibit 1).

The heightened concerns over the housing market since 2008 have kept municipal housing bond yields high relative to other municipal securities. In contrast, US Treasury yields declined to ultra-low levels on the back of purchases of US Treasury bonds by the US Federal Reserve meant to stimulate the flagging economy, and increased investor demand for lower-risk investments. As US Treasury yields declined to historic lows, so did conventional mortgage rates, making it extremely difficult for HFAs to compete if they continued to finance mortgages with bonds. For example, last week, HFAs' breakeven bond-financed mortgage rate would have been approximately 4.5%, compared to the benchmark Freddie Mac 30-year, fixed-rate mortgage rate of 3.67%.

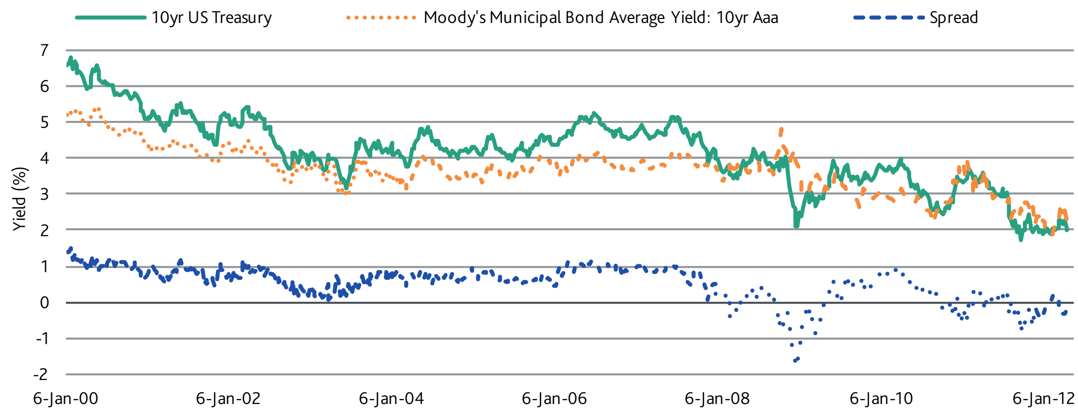
1 US Treasury's Extension of Bond Purchases is Credit Positive for State Housing Finance Agencies, December, 2011.

2 Source: US Department of the Treasury

3 Source: Moody's Economy.com

EXHIBIT 1

Comparison of Trading Levels of the 10-Yr. US Treasury to the 10-Yr. Aaa Municipal Bond Average



Sources :US Department of the Treasury and Moody's Economy.com

The Secondary Market is a Viable Alternative for HFAs

With the current tax-exempt bond market not a feasible funding source, many HFAs are turning to the secondary market. While the secondary market is relatively new for HFAs, conventional lenders have participated in this market for many years. There are several approaches that an HFA can take; some HFAs will employ all of these, and those who are very new to the market may choose only one type of transaction.

All of the approaches allow HFAs to continue to originate mortgage loans to their traditional customer base. In addition, they offer HFAs the opportunity, to the extent permitted by their enabling legislation, to expand their business model since the loans do not need to meet the MRB requirements for the homebuyer, which include: being a first-time homebuyer of a primary residence purchased below a certain price, and having an income below a certain level. Several HFAs using the secondary market are already offering products for loan refinancings, mortgages for second homes and other non-MRB products.

Cash Window Sale of Whole Loans to Fannie Mae and Freddie Mac (the GSEs): Loans that conform to the GSEs' requirements are originated as whole loans and are sold directly to them. Funds acquired through the sale of the loans allow for the origination of additional loans by the HFA. Often, HFAs are able to obtain special terms or pricing levels for their loans which enable them to offer a competitive mortgage rate.

The GSEs will purchase most types of mortgages provided the loans meet their eligibility and underwriting guidelines. There is no minimum delivery amount for whole loan sales, which makes it possible for HFAs to package and deliver loans one at a time as they are closed. Additionally, the delivery execution can be on a best efforts or mandatory basis. With a mandatory commitment, an HFA agrees to sell a specified dollar amount of mortgage loans at an agreed-upon price within a specified timeframe. If the loans are not delivered, a fee may be incurred. This option will result in more favorable pricing. A best efforts commitment, conversely, allows an HFA to enter into an agreement to sell loans, but if the loans do not close, there is no fee for non-delivery. Best efforts is ideal for HFAs that prefer not to manage their pipeline interest rate or loan fallout risk.

Cash Sale of Mortgage-Backed Securities: This option enables HFAs to securitize their loans into mortgage-backed securities and then sell the MBS directly into the secondary market, which provides immediate liquidity. A mortgage-backed security (MBS) is a pool of mortgages of similar rate and amortization type which is guaranteed as to full and timely payment of principal and interest by the GSEs or Ginnie Mae regardless of the actual performance of the underlying pool of mortgage loans. Each security bears interest at a "pass-through rate" equivalent to the composite interest rate on the underlying pool of home ownership mortgage loans, less servicing fees and the guarantee fee payable to the GSE. Each mortgage loan underlying an MBS must meet the GSEs' requirements.

Depending on the interest rates on the mortgage loans relative to the then current rates, HFAs may be able to sell the MBSs at a premium. This provides HFAs with a funding source for first-time homebuyer initiatives, such as downpayment and closing costs assistance.

TBA Market: The "To Be Announced" (TBA) market is a futures market for MBSs which facilitates the forward trading of MBSs. It is called TBA because only a few characteristics of the underlying pool of mortgages are known at the time the contract is entered into. The buyer, generally a financial institution, agrees to purchase a mortgage coupon under a particular program on a specified delivery date.

HFAs enter into a TBA contract to deliver MBSs on a date, generally 60 to 90 days in the future, at agreed-upon terms (such as maturity, coupon, par amount and settlement date), effectively hedging their exposure to rising interest rate risk from the time a loan reservation is accepted to the time the MBS is delivered. HFAs will determine the mortgage rate to be offered based upon the terms of the TBA contract. Since the HFAs are pricing the trade in the same market as conventional lenders, they are able to offer competitive mortgage rates.

What is the TBA Market?

TBA = To Be Announced

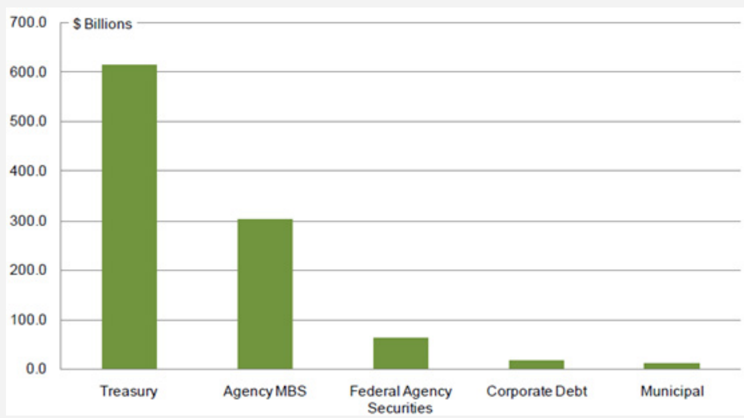
Established in the 1970s, the TBA market facilitates the forward trading of MBSs. The TBA market creates parameters under which mortgage pools can be considered fungible and thus do not need to be explicitly known at the time a trade is initiated. This is where the name for the product "To Be Announced" comes from. The TBA market is based on one fundamental assumption -- homogeneity; at a high level, one MBS pool can be considered to be interchangeable with another pool.

The TBA market is the most liquid, and consequently the most important, secondary market for mortgage loans.

EXHIBIT 2

U.S. Bond Market Average Daily Trading Volume

2011: Q2



Source: The Securities Industry and Financial Markets Association (SIFMA), TBA Market Fact Sheet 2011

TBAs facilitate hedging and funding by allowing lenders to pre-arrange prices for mortgages that they are still in the process of originating, thereby hedging their exposure to interest rate risk. In the US, lenders frequently give successful mortgage applicants the option to lock in a mortgage rate for a period of 30 to 90 days. Lenders are exposed to the risk that the market price rises in the period between when the rate lock is set and the time the loan is eventually sold in the secondary market. The ability to sell mortgages forward through the TBA market hedges originators against this risk. This is critical for originators to offer applicants fixed-rate loan terms before a mortgage actually closes, which greatly facilitates the final negotiations of house purchases and the overall viability of the 30-year fixed-rate mortgage as a business line.

How does a TBA trade function?

Trades allow loans of $100-400k to be aggregated into pools of up to $10 million. There is no need to value each individual security, only the set of risks associated with the parameters of each TBA contract. This helps encourage market participation from a broader group of investors which translates into a greater supply of capital for financing mortgages and thus, lower rates for homeowners.

Terms of a TBA trade: Issuer, Maturity, Coupon, Par Amount, Price, Settlement Date; the actual identity of the securities to be delivered at settlement is not specified on the trade date. These trading conventions are set forth in the "good delivery" guidelines published by the Securities Industry and Financial Markets Association (SIFMA), an industry trade group whose members include broker-dealers and asset managers.

The Secondary Market Offers HFAs Opportunities But Introduces Various Risks

Benefits to participation include increased revenue potential, furtherance of mission, and programmatic advantages

HFAs have the potential to realize financial gains through increased loan origination in the secondary market, providing additional revenue at a time when HFAs are experiencing decreased profitability due to low reinvestment rates[4]. The additional revenue may be achieved through servicing income, loan processing fees, the gain on the sale of the securities to the cash market and the positive carry on the warehousing facility.

HFAs have the option of performing the loan servicing in house, which, if properly structured and managed, can be a profitable undertaking. Alternatively, HFAs may outsource the servicing under a sub-servicing agreement under which they retain a portion of the interest payment as a fee or sell the servicing for a fee to a master servicer.

Additionally, revenue will be generated through increased loan origination fees, the premiums realized on the sale of an MBS to the cash market, and possibly through the positive carry on the warehousing facility used to temporarily fund the loans until the loans are either sold, pooled and delivered into the secondary market. Also, since the HFAs' involvement in the secondary market does not necessitate the issuance of bonds, costs of issuance will not be incurred.

An HFA's participation in the secondary market is also beneficial to the furtherance of their mission by allowing them to maintain a presence in the single family mortgage market. In order to reach the largest group of potential homebuyers, HFAs try to remain active with their lending partners by offering competitive loan products on a continuous basis.

Furthermore, the HFAs' ability to potentially sell the MBSs to the market at a premium provides funds to continue offering down payment and closing costs assistance, a critical component to facilitating home ownership for first-time homebuyers.

HFAs that fail to originate loans over a long time period may suffer operationally. For example, without growth in the program, the staff administering these programs may become costly to maintain. While the loan origination through the secondary market may require HFAs to modify their current loan origination system, many HFAs have the ability to retrain existing staff.

Lastly, as discussed above, the secondary market offers HFAs a programmatic advantage over MRB financing since the loans do not need to meet the MRB requirements.

Drawbacks include financial consequences, possible interest rate risks and potential program implications

An HFA's secondary market operations may negatively affect their financial position, especially with respect to any necessary upfront costs and the funding of any required reserves. The upfront costs may include: a) fees for a consultant with industry expertise; b) technology costs; c) the need to hire additional staff with the required expertise to manage a sophisticated portfolio; and d) the considerable amount of time required to convert loan origination operations.

[4] Sector Outlook for US State Housing Finance Agencies Remains Negative, February 2012.

There are additional financial consequences associated with counterparty risks, warehousing costs for non-delivery of loans, and costs related to loan delivery failure. HFAs utilizing the TBA market are susceptible to the risk that their trading counterparty will not be able to take delivery of the loans. Additionally, in the event an HFA is not able to deliver a loan, there is a cost associated with maintaining the loan in their own portfolio.

Furthermore, if an HFA fails to deliver loans, fees may be due for the undelivered amount, depending on market conditions. Participation in the secondary market enables HFAs to hedge the risk that rates will change between the time a borrower locks the rate and the HFA sells the loan. However, if an HFA enters into either an MBS or TBA forward commitment and fails to deliver any portion of the loans, they will be required to pay a fee on the undelivered amount in a falling interest rate environment.

Credit Implications of HFAs' New Funding Initiatives

While new strategies can help HFAs earn revenue and remain active in the mortgage market, they also bring with them a new set of credit risks. Since the scope of each HFA's involvement in the secondary mortgage market varies considerably, we will review each HFA's secondary market undertaking to quantify and evaluate all the risks as they relate to any necessary balance sheet adjustments. Participation in the secondary market will be considered as part of the issuer rating and will be incorporated into the financial strength and management assessment. The important elements that Moody's takes into account are discussed below. The determination as to the impact, if any, to an individual HFA's issuer rating will depend on the outcome of the assessment.

HFA's Secondary Market Strategy: Factors That Could Impact Rating

» Whether the HFA is servicing the loans in house and the associated costs

» "Key man" risk: staffing levels and expertise

» Monthly volume of market participation

» Extent of expansion of borrower base

» How an HFA manages its loan pricing and pipeline

» What options are utilized in the event of a failed delivery of loans

» Does the existing risk management system provide real time information on the pipeline, outstanding trades and whole loan sales

» What type of loan warehousing facility is utilized and the costs associated with the facility

» The amount of time needed to determine the financial feasibility of implementing a secondary market program

» The ability to decide when to activate the program and possibly deactivate the program if a determination is made to return to the MRB market

Will MRB Issuance Recover?

HFAs' inability to achieve favorable financing through the MRB market has necessitated the adoption of new financing approaches. If and when the disparity between bond rates and mortgage rates reverses, we anticipate that many HFAs will resume financing through MRB issuance. A number of factors may influence their ability to do so, including whether they have maintained sound working relationships with their lending community or if they have determined that the secondary market approach is more effective.

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