DISCUSSION OF FUNDING AFFORDABLE HOUSING USING MORTGAGE BANKING CONCEPTS

Prepared for:
The House Joint Committee on
Affordable Housing

This document provides a general overview of the mortgage banking industry and, within that context, its fundamental components and processes. With the overview as a background, the document outlines how the Texas State Affordable Housing Corporation, a nonprofit corporation, d.b.a. Texas Star Mortgage Company ("TSM"), intends to use mortgage banking concepts as a solution to the overwhelming affordable housing need. For the purpose of this dialogue, addressing "affordable housing need" relates not only to increases in housing stock, but accessibility to the mortgage funds which are necessary for homeownership. Currently, the Department is limited in access to secondary market capital due to the State's ceiling cap on tax-exempt bond issuance authority. By using traditional mortgage banking concepts, TSM can provide additional secondary market capital to the affordable housing arena. The discussion further links the benefits of leveraging state and federal housing program dollars with this new source of private sector capital, Additionally, we are proposing the recycling of housing program funds, as a general rule, as well as use of TSM revenues generated through mortgage banking activities to increase affordable homeownership and housing stock in Texas.

By using traditional mortgage banking principles, TSM will deliver innovative loan product, as well as standard secondary market loan product, into areas of the State that are currently under-served by the private sector and in need of affordable housing. Part of the challenge is leveraging state and federal housing program funds, i.e, "affordable housing equity", with standard secondary market capital, For reasons outlined herein, the products envisioned by TSM do not exist in today's volume driven secondary market. Management suggests that by using mortgage banking principles as outlined in this document, new loan products can be designed to provide for specific affordable housing needs. The success will depend, in part, on generating affordable housing loan products in enough volume to entice participation by a secondary market investor, which will be the fundamental capital provider.

Consistent with operating a successful mortgage banking operation, our final goal is to build long-term assets that will generate ongoing revenue streams. In light of growing affordable housing demand and decreasing federal and state funding, these ongoing sources of revenue will become a vital source for replacing lost revenues and assist in funding the long-term affordable housing demand within the State.

Simply put, TSM desires to address the State's growing affordable housing need in an environment of reduced federal and state spending. By understanding that need, TSM will use mortgage banking concepts to bring additional funding sources to the affordable housing arena.

MORTGAGE BANKING OVERVIEW

Mortgage banking is the process of originating, selling and servicing mortgage loans secured by single family and multifamily real estate. Mortgage bankers are intermediaries, or middlemen, that bring together those people who need to borrower money and investors who are looking for investments and thus willing to provide capital to the mortgage lending system.

The most common mortgage banking firm is a "full-service" mortgage company that provides a vast array of loan product to meet the needs of its customers. Because of the efficiencies offered within the industry and as evidence of its success, the basic processes created by the mortgage banking industry can now also be found in the daily operations of traditional banks and lending institutions.

In 1990, more than 80% of all single-family home originations were sold into the secondary market.

The mortgage banking process begins when a mortgage banker makes a long-term mortgage loan secured by real estate. The borrower uses the borrowed funds to purchase, improve or refinance a parcel of real estate which is the primary function of the process. This is referred to as the "primary" mortgage market, where new loans are created. The "secondary" mortgage market is where mortgage bankers and investors buy and sell existing loans.

The term "mortgage banking" is somewhat misleading in that it implies that mortgage bankers are funded or capitalized by customer deposits, as are commercial banks and savings institutions, Mortgage bankers typically fund their operations with short-term borrowings,. usually from commercial banks in the form of lines of credit. These lines of credit are called "warehouse" lines because the originated loans which are funded by the line of credit are essentially warehoused until sold into the secondary market. Warehousing allows the mortgage banker to leverage capital, thus permitting increased loan production.

The mortgage banker groups similar types of loans into pools that are sold to investors in the secondary market. The proceeds received from the sale of the loan pools to the investor repay the outstanding lines of credit, and provide the mortgage banker with revenue. The repayment creates additional borrowing capacity under the revolving warehouse line of credit and allows the cycle to continue over and over again.

The mortgage banker often remains associated with the loans as the loan servicer after the loans are sold into the secondary market. Most investors who purchase loans are not in the business of servicing loans and therefore do not have the expertise or systems to do so. Servicing, or loan administration, consists of collecting monthly payments, maintaining escrow accounts for the payment of taxes and insurance on the secured real estate, forwarding payments to the investors who own the loans, and acting as the investor's representative if any problems arise with the loans. The investor pays the mortgage banker to service loans.

The primary benefit of the mortgage banking process is the allocation of capital from areas of the country where there is a surplus of capital to areas in need of capital. Additionally, the standardization of documentation and procedures has allowed for an efficient, highly production-oriented system that results in lower costs and interest rates to the borrowers. Because of standardized underwriting criteria and the extensive market data available to investors regarding loan performance, risks associated with mortgage lending are better understood and better mitigated.

Overall, the mortgage banking process is a series of interrelated activities conducted in accordance with specific investor requirements and government regulations. Because the capital is provided by investors in the secondary market, the terms and conditions of the loans provided to the borrowers in the primary market are mandated by those investors.

Notwithstanding the benefits of the mortgage banking system, the standardization that is required to achieve the system's efficiency does not generally allow for flexibility in loan terms or underwriting criteria. Flexibility is paramount in the affordable housing arena.

MORTGAGE BROKERS & CORRESPONDENTS

Mortgage banking has become increasingly specialized in recent years, creating many functions and spin-off businesses which are a part of the mortgage banking process. Mortgage brokers, for example, are loan originators that have no funding capacity but rather earn a commission for placing a borrower and a lender together, or in some cases for bringing lenders and investors together. Correspondents, on the other hand, specialize in the origination and processing of loans but may not actually underwrite, close or fund the loans.

Mortgage bankers have come to rely on mortgage brokers and correspondents to increase loan production. Just as mortgage brokers and correspondents place loans with numerous mortgage banking firms, mortgage banking firms use numerous brokers and correspondents. Occasionally, a mortgage banker will "broker" a loan to another mortgage banker if it is a specialized product. The relationships between mortgage brokers, correspondents and mortgage bankers center around the specific product types and pricing as offered by the mortgage banker as well as reputation and ability to close loans.

MORTGAGE BANKER PROFITS

Mortgage bankers earn revenues on the origination of loans by collecting application fees and origination fees. These revenues are used to cover the overhead and personnel expenses associated with taking the loan application, processing and closing the loan. The mortgage banker earns profits while warehousing the loans and on the sale of the mortgage loans to investors. Generally, the profit on a per loan basis is very low, therefore, high volumes of loans are needed to create a profitable mortgage banking operation.

As mentioned earlier, the mortgage banker earns additional revenue on servicing the loans it originates. The servicing function is vital to a mortgage banking firm because it makes the largest contribution to net income. Through originating loans, the mortgage banking firm is able to build a servicing portfolio that becomes in itself a marketable asset of the mortgage banker. Therefore, servicing rights which are created through the origination process can either be sold with the mortgage loan to the investor or retained by the mortgage banker to build a servicing portfolio. Most small mortgage banking firms sell their servicing for a servicing release premium (usually 75 to 100 basis points) to generate cash flow, while larger mortgage banking firms generally retain servicing to create a stable ongoing source of revenue that is insulated from fluctuations in the economic cycles of the primary origination market, thereby generating a steady positive cash flow stream.

MORTGAGE LOAN TYPES

The secondary market has created two predominant loan types: government-backed (FHA and VA loans) and conventional loans (loans without government backing). Specific underwriting guidelines and borrower criteria have been established for FHA and VA loan programs by the government agencies providing guarantees or mortgage insurance for loans under those programs. There are various conventional loan products, each with specific underwriting guidelines and borrower criteria designed to match the risk level acceptable to secondary market investors who are purchasing the loans.

Conventional loans carry no government insurance or guarantee. The loans are, however, often enhanced by private mortgage insurance (PMI), Because there is no government backing, the loans usually require a larger down payment and carry higher interest rates than government sponsored loans. Although not government backed, the most predominate conventional loan programs were originally developed by government or quasi-government sponsored agencies, namely Fannie Mae (FNMA), Ginnie Mae (GNMA), and Freddie Mac (FHLMC).

TARGET MARKETS & PRODUCTS

Mortgage banking is a retail business. In other words, mortgage bankers will originate and sell products that are in demand by customers, in areas where customers are located and products can be readily sold into the secondary market. Most mortgage bankers provide standard FNMA, GNMA, FHA, VA and FHLMC products as well as other conventional loan products created by large institutional buyers of loans. These products are marketed in the primary market as any retailer would market goods and services. Because mortgage bankers depend on high production volumes

to remain profitable, mortgage bankers will exclude certain kinds of loan products if there is not enough demand for the product in their market area. Other products will likewise be excluded if the processing is too difficult, and therefore expensive, or does not fit readily into a production-oriented system.

Marketability is the key ingredient for a mortgage banker in determining whether to originate a certain loan product. The mortgage banker wants to be assured that there are numerous investors to purchase the loan in the secondary market and that the cost to originate the loan is not prohibitive.

RISK MANAGEMENT

As with any business, identifiable risks are associated with the mortgage banking process. These risks generally relate to interest rate volatility, product selection, pipeline fallout and investor credit.

The industry has developed widely accepted measures and techniques to manage these risks and mitigate them. For example, interest rate risk exists because of the potential for a change in interest rates that could occur between loan origination and the sale of the loan to the investor. A change in interest rate during this period can leave the mortgage banker with a loan that is not salable or a loan that must be sold at a large discount. Hedging the work in process (or "pipeline") is one way to manage interest rate risk. Some hedging instruments include the use of investor commitments that lock the loan pricing at the time of origination for sale and delivery of the loan in the future. While this method eliminates interest rate risk, it generally produces less profit for the mortgage banker on the sale of the loan.

Product risk occurs when no market exists for a particular loan product due to peaks and valleys in popularity, often depending on prevailing economic conditions. By coordinating investor requirements with borrower needs and by carrying a large menu of product, this risk can be easily avoided.

Pipeline fallout results from loans in the mortgage banker's pipeline (pending loans) that fail to close. While there are many reasons for fallout and some fallout is normal and easily anticipated, too much fallout can result in non-delivered product to the investors, which can significantly reduce or produce negative profits for the company. Generally, a lender must apply a prudent coverage to the pipeline to compensate for some degree of fallout based on experience with current market conditions. For example, if a mortgage banker generally experiences a 15% fallout on FHA loans, the mortgage banker may only commit 80% of the FHA pipeline for sale to a secondary market investor. This 20% coverage factor allows for the anticipated fallout to occur, with a 5% margin for error, without affecting the number or price of the FHA loans eventually delivered to the investor.

Investor credit risk results when an investor refuses to purchase the loans or cannot take delivery because of financial difficulty. Prudent investigation into the track record and financial condition of the investor is the best way to avoid credit risk. This is the primary reason why mortgage bankers only want to originate loan product that has a high demand in the market, and therefore many buyers.

Management qualification and employee skills are paramount to any successful business venture. Fortunately, due to the depth of the industry and the specialization that has occurred, the industry has produced many competent managers and technical employees. As a result, management risk is no greater in Us industry than any other field in the private or public sector.

TEXAS STAR MORTGAGE

The Texas State Affordable Housing Corporation, d.b.a. Texas Star Mortgage Company, has the, potential to be a full-service mortgage banking operation. As a nonprofit corporation, Texas Star

Mortgage distinguishes itself from the typical mortgage banking firm by exclusively targeting the affordable housing sector and addressing housing need, as opposed to corporate profits. The company recognizes, however, that the application of basic mortgage banking techniques and methodologies can provide significant additional capital and cash flow to the affordable housing arena. Through the use of innovative leveraging of available funds, the company can increase the affordable housing supply in the State of Texas.

Profit motivated mortgage banking organizations focus on providing standardized, efficient loan products and services to high volume markets that result in levels of production which maximize profits. As a result, most mortgage lenders and secondary market participants do not target the affordable housing segment which inherently does not allow for efficient standardization and high volumes.

Because of its association with the Texas Department of Housing and Community Affairs, Texas Star Mortgage has a unique opportunity to combine the resources of the secondary market with federal and state funds targeted for affordable housing. By leveraging these scarce resources with traditional secondary market capital, TSM can create and deliver mortgage products to fulfill housing needs in under-served areas of the State.

TSM - TARGET MARKETS & PRODUCTS

TSM will directly market and originate loans across the State. In addition to direct origination activities, TSM will use mortgage brokers, correspondents and other mortgage banking firms to deliver its product to all areas of the State. This provides for increased penetration of TSM's loan product and effectively provides the private sector mortgage banker with additional loan product that comes with the assurance of a buyer for the loan. That assurance eliminates the product ask and therefore will result in a higher level of participation by mortgage bankers, as well as commercial banks and thrift institutions, in the affordable housing arena. Rather than competing with these entities, TSM will be facilitating their production of affordable loans in a collaborative, cooperative effort.

TSM will develop loan product to address affordable housing needs in specific target markets. These target markets may be defined geographically, such as the Colonias, or defined by income level or other demographic divisions. In any event, product will focus on specific need to overcome identified hurdles. Numerous programs will be developed specifically to meet the many difficulties facing affordable housing. There is not a "one product fits all" solution. All programs, however, will share a common goal, which is the salable loan component. A universal fact of financial life is that in order to utilize private capital, market interest rates must be paid. TSM, through TDHCA programs, can help provide borrower assistance to lessen the cost burden through use of second lien and other creative financing techniques without which no loan could, or would, have been made.

Loan programs will emphasize the use of traditional secondary market products, wherever possible, to maximize the amount of secondary market capital in the affordable arena. To accomplish this, standard secondary market product must typically be augmented with, or leveraged by, other loan products which may or may not be secondary market salable product. Without the use of this leveraging concept, the standard secondary product does not underwrite, causing the affordable housing arena to lose a significant source of capital. This concept is similar to the tax-exempt bond transactions issued by TDHCA. The difference is that no state ceiling cap is used and the costs are less.

Generally, existing standard secondary market product will not work for low and very low income borrowers regardless of the amount of leveraged public sector funds, In these cases, nontraditional loan products can be specifically designed to overcome the specific problem issues. The overall goal for these types of programs are to maximize the use, of scarce housing program subsidy dollars and

to generate loan product in ample volumes that can be pooled, credit enhanced and sold to the secondary market. With its statewide lending territory and broker/correspondent network, TSM offers the ability to generate sufficient product under these types of programs to allow for this to occur, and allow the private sector to originate loans that otherwise would not have been made.

The overall impact to the affordable housing arena offered by operating a mortgage banking company in the proposed manner is the addition of secondary market capital to areas typically overlooked by mortgage bankers. Through direct originations and by providing a viable loan product for other mortgage bankers to originate, TSM can create enough volume of specialized product that makes it economically feasible to sell to the secondary market.

TSM will effectively create a new role in the mortgage banking process by creating product to meet affordable housing needs and providing the product to the market directly and indirectly through private mortgage lenders.

TSM - FUNDING SOURCES

TSM contemplates utilizing traditional mortgage banking funding mechanisms, specifically, warehouse lines of credit established at commercial banking and savings institutions and retained earnings to fund a large portion of its production.

In addition to these sources, TSM has a unique funding opportunity through the Federal Home Loan Bank system (FHLB). Essentially operating as a lender for banks, the FHLB provides loans at below market interest rates to banks and thrift institutions. The FHLB is owned by member financial institutions and in addition to providing credit services to banks purports a mission of supporting homeownership and affordable housing opportunities. Recent legislation has allowed non-member entities to make application for participation in the services offered by the FHLB. Currently, the TDHCA has been approved as a non-member borrower and the, application for TSM is pending.

TSM intends to use surplus cash from bond indentures, borrowed from TDHCA, and purchase government insured mortgage-backed securities. These securities are then pledged to the FHLB as collateral against advances (borrowings). The advances are used to fund originations for TSM's affordable housing programs. Loans made under the affordable housing programs can then be subsequently pledged as collateral for additional advances. Through this leveraging technique, more affordable housing loans can be originated.

For example, assume that S5 million of mortgage-backed securities are purchased with excess cash from bond indentures and pledged to the FHLB, TSM would draw up to $4.9 million (assuming a 98% collateral value on the securities) to originate affordable housing mortgage loans. The $4.9 million in mortgage loans would be pledged back to the FHLB as additional collateral for subsequent advances. Assuming an 80% collateral value for the mortgage loans originated under TSM's program, another $4.4 million becomes available to borrow. Continuing this cycle, TSM could leverage the initial $5 million in cash to generate approximately $25 million in mortgage loans. Leveraging funds in this mariner creates 5 times the amount of affordable housing loans that would be available through direct lending of those funds.

In addition to the benefits of leveraging based on the example above, TSM would generate $250,000 of origination fees (assuming 1% fee and that all loans are originated by TSM) that can be used to cover operating costs of the company and be retained to fund other housing programs. As noted above, it is normal in the mortgage banking industry for origination revenues to roughly equate to the costs associated with originating the loans. If the loans are originated by mortgage brokers or correspondents, the origination fees would be retained by those service providers.

The FHLB advances can also be used to fund standard product to be sold into the secondary market loans. These loans would be underwritten to secondary market parameters with the TDHCA providing any necessary gap financing or credit enhancement. Once pooled, the loans would be sold and the proceeds of the sale used to repay the FHLB advance. Any profits from the sale of the pool create additional funding sources that can be used for subsequent programs. Once the advance is repaid, the process can be repeated.

TSM - RISK MANAGEMENT

TSM's management is experienced with proven risk management techniques developed within the mortgage banking industry as well as other balance sheet and interest rate risk management techniques found within financial institutions. Consistent with TDHCA policy and practices, TSM will engage an independent third-party financial advisor with mortgage banking experience to advise on interest rate risk issues and other matters.

Movement in interest rates presents the single largest risk for the mortgage banking industry. As interest rates fluctuate tip or down, the value of the mortgage banker's assets (the value of the mortgage loans) change, as will the interest rate fluctuations directly impact operating cash flows. Because short and long term interest rates move independently of each other, balance sheet management is critical to maintaining profitable operations.

Interest rate risk occurs during the warehousing period on loans. Generally, warehouse lines of credit carry a floating interest rate tied to a short-term market index. A short-term rate is used because these loans are warehoused for a short-term period, usually less than 60 days, before being sold to the secondary market. Conversely, the typical loans securing the warehouse line are fixed-rate loans tied to a long-term market index, because the loans are long-term mortgages. This creates a mismatch on the mortgage banker's balance sheet, i.e. long-term assets (the mortgage loan inventory) funded with short-term borrowings (the warehouse line of credit), Again, short and long term interest rates do not necessarily move in concert with each other. Therefore, the mortgage banker runs the risk that the short-term interest rate on the warehouse line, could rise fast enough to potentially cause a negative warehouse spread prior to the loans being sold to the investor. Should this occur, the interest earned by the mortgage banker would be less than the cost of the borrowing during the hold period. The single critical factor in managing this source of interest rate risk is efficient management of the pipeline and delivery of the loan product to the investor. The shorter the hold period, the less risk incurred by the mortgage banker.

TSM intends to hold non-salable loan product in its portfolio, and therefore must match the interest earned on the loans (interest income) to the cost of the funds used to make the loans (interest expense) to mitigate the interest rate risk in the portfolio. As one example of a matching technique, the term, or maturity, on FHLB advances (borrowings) can be matched to the anticipated average life of loans intended to be held. This maturity matching locks the interest spread between the interest income and interest expense over the anticipated hold period. Prepayable advances, although more expensive than nonprepayable advances, can be used to fund loan product where the average life of the loans in the portfolio is not determinable or uncertain. In any event, prudent asset/Iiability management using match funding techniques and hedge instruments will mitigate portfolio interest rate risk.

SUMMARY

Many other housing finance agencies around the country are looking for innovative methods to increase funding for affordable housing needs. The Dade County Housing Finance Authority has requested approval from federal regulators to establish a thrift institution to place more dollars in the affordable housing market. The West Virginia Housing Development Fund continues to operate a secondary market loan program. In its sixth year of servicing operations, the Fund services $600

million in more than 12,000 loans. The fund originated $100 million during 1995 and is generating $95,000 a month in operating revenues that go to fund affordable housing initiatives. These are merely two examples of other states' efforts.

As a mortgage banking company, TSM intends to use basic mortgage banking concepts as a solution to the overwhelming affordable housing need by accessing additional secondary market capital for the affordable housing arena. Through leveraging state and federal housing program dollars with this new source of private sector capital, TSM will deliver innovative affordable housing loan product. TSM, as a successful mortgage banking operation, will build long-term assets that will generate ongoing revenue streams. These ongoing sources of revenue will become a vital source of replacing lost state and federal revenues and assist in funding the long-term affordable housing demand within the State.