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HFAs Still Facing VR Debt Woes

No Relief Till 2011 Even With U.S. Aid

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By Richard Williamson

SAN ANTONIO — The market for variable-rate housing bonds is not likely to recover until 2011, even if the Obama administration comes through with plans for $15 billion of liquidity, finance experts told the National Council of State Housing Agencies conference here.

Until banks normalize their operations after 18 months of unprecedented upheaval, letters of credit and other liquidity provisions will remain rare and costly, they said.

For banks willing and able to provide liquidity for variable-rate demand bonds, the cost of those provisions have skyrocketed from a mere 12 to 15 basis points before 2008 to as high as 150 basis points since the financial crisis, said Peter Shapiro, managing director of Swap Financial Group.

With the collapse of the auction-rate securities and VRDB markets, variable-rate long-term bonds have reverted to bank bonds with higher rates and short amortizations.

"If you reel the clock back 18 months, bank bonds were something you almost never heard of," Shapiro said. "Today, it's a commonplace. The notion that VRDBs were going to fail in massive waves and hit banks was just something you didn't think of."

Based chiefly on the theory that markets seek equilibrium, Shapiro expects rates for liquidity to begin falling next year.

"We think they'll be back below 50 in 2011," he said. "In conversations with the guys who run the various letter-of-credit banks, they've said to us that they don't think they're going to be able to hold a rate of over 100 for another year."

Terrence Finn, chief executive of Stern Brothers & Co., concurred.

"I do think it's going to improve, but it's going to be a while — 2011 is probably about right," said Finn, who called the last 18 months "a roller coaster of unprecedented proportions."

Through September, 98 U.S. banks have failed in 2009 as mortgages on residential and commercial real estate and other loans faltered. The wave of collapsing banks has sent the Federal Deposit Insurance Corp. fund used to protect bank deposits into the red. The FDIC expects the cost of bank failures to grow to about $100 billion over the next four years.

It's been a long, tough battle," Finn said. "It's not over yet, but it certainly feels a little better each and every day."

The NCSHA had hoped that the Obama administration would announce this week its $35 billion plan to support low- and moderate-income housing bonds, but the Treasury Department is still working on the proposal, according to the group's executive director, Barbara Thompson.

While $20 billion of the fund would be used to buy housing bonds, another $15 billion would provide liquidity for the VRDB market. Finn said variable-rate debt is an important element for state housing finance agencies, which retain strong credit ratings.

“I’ve been a believer in variable rate for the last 25 years,” he said. “I don’t think it’s going to change if you’ve got access to credit.”

But variable-rate debt represents a significant drag on the assets of HFAs, according to Florence Zeman, senior vice president at Moody’s Investors Service.

“Variable rate does continue to be a significant aspect of HFA liabilities, although the pace of new variable-rate debt has slipped,” she said. “We are still seeing some issuers doing new variable-rate debt.”

With $5.5 billion in outstanding variable-rate bonds, the California Housing Authority — the largest issuer of such debt — saw its credit downgraded two notches by Moody’s in July to A1 from Aa3 with a negative outlook. Analysts cited sharply increasing delinquencies and foreclosures in the HFA’s single-family portfolio, risk related to funding its variable-rate debt, and uncertainty regarding future business activity.

Twelve state HFAs now have $3 billion of outstanding former VRDBs that have become bank bonds. Finn said the steep drop in issuance of bonds backed by LOCs illustrates the lack of variable-rate availability.

Among those joining the NCSHA in urging Obama to deliver the $15 billion in federal liquidity is Rep. Joe Sestak, D-Pa., who wrote a letter to the president warning that a lack of action could jeopardize the entire U.S. economy.

“State HFAs unable to find buyers for their VRD have been forced to convert it to bank-bond status, requiring them to pay it off under accelerated amortization schedules at high interest rates,” Sestak wrote. “This VRD payment burden at minimum reduces the HFAs productive housing activity and at worst threatens the financial health of the HFAs themselves.”