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Executive Director and Board of Directors
Texas Department of Housing and Community Affairs
221 East 11th Street
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At the request of Department staff, CSG Advisors ("CSG") prepared this report to address certain provisions of the Texas Government Code, Title 10, Subtitle G, Chapter 2306, specifically the feasibility and potential economic impact to the Department of complying with Section 2306.142(l). As noted below, we are not providing the Department with any legal advice. We are retained by the Department in an expert financial capacity only. For legal analysis of Texas Government Code, Title 10, Subtitle G, Chapter 2306, or any other applicable law or regulation, please contact your legal counsel.

This report updates and reiterates the findings and determinations of the Department's previous Financial Advisor, Stifel, Nicolaus & Company ("Stifel"), Stifel's annual reports to the Board from 2017 through 2023 (the "Prior Reports") and provides our analysis of feasibility and economic impact, as well as a summary of how the Department serves the credit needs of borrowers in underserved economic and geographic submarkets. We understand that the Department completed the market study required under Section 2306.142(c) in 2002. This report reconfirms the findings of the Prior Reports and concludes that compliance with the requirements of Section 2306.142(l) remains unfeasible and could damage the financial condition of the Department. This is consistent with the conclusion reached by the Bond Review Board ("BRB") in granting waivers to the Department since 2002.

Background

Section 2306.142(l) of the Texas Government Code requires that single family mortgage revenue bonds issued by the Department contain specific set-asides or reservations of funds for mortgage loans, including subprime mortgage loans, to be originated in underserved economic and geographic submarkets in the state. Specifically, Section 2306.142(l) states:

In the state fiscal year beginning on September 1, 2002, and in each subsequent state fiscal year, the department shall allocate not less than 40 percent of the total single-family mortgage revenue bond loan volume to meet the credit needs of borrowers in underserved economic and geographic submarkets in the state, subject to the identification of a satisfactory market volume demand through the market study.

As permitted under Section 2306.142(m) the Department has requested and received from the BRB a waiver of this provision for every new origination single family mortgage revenue bond issue closed by the Department since 2002. The BRB began issuing annual waivers based, in part, on the Board's acceptance, approval, and submission of the Financial Advisor's report. These waivers were granted on the basis that compliance with Section 2306.142(l) is unfeasible and could damage the financial condition of the Department.

Feasibility and Economic Impact

Under current market conditions, fulfilling the requirements of Section 2306.142(l) (specifically allocating or reserving any portion of the bond proceeds) is not feasible, not economically viable, would not be "consistent with the reasonable financial operation of the Department", and could damage the financial condition of the Department. Further, it is anticipated and assumed that, due to the financing structures implemented by the Department, the Department will continue to request an annual waiver from BRB of the requirements of Section 2306.142(l).

Compliance with the 40% set aside requirement of Section 2306.142(l), which includes the subprime requirement of Section 2306.142(f), is not feasible and could damage the financial condition of the Department for the following reasons:

1) Single family indentures require "MBS eligible" loans. The Department has not used "whole loan" collateral to support its indentures since 1988. The Department currently pools all mortgage loans into mortgage-backed securities ("MBS") backed by Ginnie Mae, Fannie Mae, or Freddie Mac, which effectively guarantees the timely receipt of underlying mortgage loan payments to meet the debt service requirements of the Department's indentures. This financing structure results in a higher rating on the bonds and a lower cost of debt, while the Department pledges fewer assets to the bond indenture than otherwise would be required. In addition, the MBS structure eliminates (i) the cost of overcollateralization, (ii) the need to fund debt service reserves, (iii) the costs, expenses, and losses typically associated with whole loans, and (iv) provides the Department with additional methods of funding its production.

Each agency (Ginnie Mae, Fannie Mae, and Freddie Mac) has specific mortgagor eligibility requirements for mortgage loans that are securitized into an MBS. While the definition of subprime has changed over time (particularly since the events of 2008), subprime loans generally are not eligible for securitization. As such, the Department would have to maintain and carry those loans as whole loans. As detailed in the previous paragraph, there are significant economic reasons for the Department to maintain its MBS financing structure as it allows the Department to assist the maximum amount of low- and moderate-income homebuyers in the most efficient manner without incurring unnecessary credit risk. The cost of foregoing these efficiencies to accommodate the introduction of a significant number of low rated whole loans would be impractical and could damage the financial condition of the Department.

2) Master Servicers have minimum credit requirements. The Department uses a Master Servicer to purchase, pool, and service mortgage loans originated through its single-family mortgage programs. The Master Servicer typically has minimum credit requirements for eligible borrowers. The Department's Master Servicer, The Money Source ("TMS"), has a minimum FICO score requirement of 620. Therefore, the Department cannot originate loans for credits below 620 FICO due to the Master Servicer's credit requirements.

3) The 40% set-aside requirement creates significant interest rate risk in the form of rate buy-down and/or unexpended proceeds call risk. Because the bond rate is set at closing, the Department is subject to interest rate risk on set-aside amounts. If the market interest rate for mortgage loans drops, the Department's mortgage rate may be unattractive. For short periods of time or for relatively small amounts, this is manageable; however, a 40% set-aside could be quite costly. The Department would be faced with a choice: a) contribute its own funds to "buy down" the mortgage rate, or b) invoke a non-origination call on the bonds, potentially damaging the Department's reputation among bond purchasers and possibly increasing its borrowing cost in

the future. Once again, compliance with Section 2306.142(l) is not feasible and could damage the financial condition of the Department.

4) Excessive cost of negative arbitrage to meet the 40% set aside requirement. Negative arbitrage is the cost that results when the interest rate paid on the bonds exceeds the interest rate earned on bond proceeds. When bond proceeds are required to be set aside, the required amount is deposited and invested until used; concurrently, the bonds accrue and pay interest at a higher rate than that earned on the set-aside amounts. While a small amount of negative arbitrage might be absorbed by a financing structure, the amount of negative arbitrage associated with setting aside 40% of the bond proceeds would be cost prohibitive.

However, a financing structure with no set-aside requirements can, and has been, implemented by the Department resulting in significant savings related to negative arbitrage. When the requirements of Section 2306.142(l) are waived, the Department is able to originate and pool mortgage loans in advance of the bond issuance and can purchase the resulting MBS using bond proceeds at the closing of the bond issue. This eliminates negative arbitrage associated with that portion of loans purchased when the bonds are issued.

Serving the Needs of Borrowers in Underserved Economic and Geographic Submarkets

The Department regularly serves borrowers in underserved economic and geographic submarkets. Through both bond programs and its “to-be-announced” (or TBA) program, also known as the Taxable Mortgage Program (“TMP-79”), the Department offers daily financing options to homebuyers throughout the State. TMP-79, which began in October 2012, is a continuous funding program that currently serves as the Department’s primary mortgage loan origination mechanism for single family programs. Summary highlights of TMP-79 include the following:

- TMP-79 is currently the only statewide down payment assistance program that offers financing to borrowers with FICO scores as low as 620 without charging a penalty at loan closing (considered by the industry to be non-prime).

- Since October 2012, the Department has financed and purchased over $13.3 billion in first lien mortgage loans and provided over $485 million in associated down payment and closing cost assistance (in the form of a 30-year term, 0% interest, due on sale or refinance, second mortgage loans). Of the $13.3 billion approximately 45% or $6 billion of those loans went to borrowers with FICO scores under 660 (as of August 31, 2025.)

- Approximately 73% of program borrowers earn less than 80% of Area Median Income (“AMI”).

- The Department is responsible for the Texas Statewide Homebuyer Education Program, which is offered through third party providers. This program provides training to Texas Homebuyers providing comprehensive pre- and post-purchase homebuyer education and/or counseling that is used to provide quality homebuyer education throughout the state and is one of the requirements for participation in one of the Department’s single family loan programs.

Based on the costs and risks described above, and consistent with the conclusion reached by the Bond Review Board ("BRB") in granting waivers to the Department since 2002, we believe that meeting the requirements of Section 2306.142(l) remains unfeasible.

The Department, however, continues to achieve its objectives by adapting and innovatively structuring its programs to serve an ever-expanding borrower base of Texas homebuyers in underserved markets – economic, credit, geographic, or otherwise. The Department's use of MBS to secure its bonds programs significantly reduces the Department's risk and borrowing cost. Therefore, the Department expects to continue to request an annual waiver of Section 2306.142(l) from BRB each calendar year. The Department will continue to monitor its ability to meet these requirements as it looks for ways to better serve its borrower base, which is composed primarily of low, very low-, and moderate-income first-time homebuyers. The Department also will maintain the integrity of its bond indentures and operate in a manner that is "consistent with the reasonable financial operation of the Department".

Use of the Report

It is expressly understood and agreed that (a) this report is provided solely for the information of and assistance to the Texas Department of Housing and Community Affairs and the Texas Bond Review Board and is not to be used, circulated, quoted or otherwise referred to without our written consent, and (b) this report is not intended, and is not under any circumstances to be construed, as legal advice or as requiring us to perform services which may constitute the practice of law. We are retained and engaged by the Department in an expert financial capacity only. Our statements and conclusions are based in part on information provided to us by Department staff, and we assume that information to be materially complete, accurate and true. We have not undertaken any responsibility or duty to independently verify that information, and this report is not intended to and does not attest that such information is materially complete, accurate or true.

Sincerely,

David Jones

CFO, Principal

CSG Advisors