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Mr. Edward DeMarco, Acting Director
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Dear Mr. DeMarco:

In FHFA's February 2012 Strategic Plan, you asked the Enterprises to "undertake a market analysis of the viability of multifamily business operations without government guarantees" and to review "their respective business models and the likely viability of these models operating on a stand-alone basis after attracting private capital and adjusting pricing if needed, to attract and retain that capital".

Since late 2010, we have been studying this issue. We released a policy paper in November 2011 (copy attached), making the case that a federal guaranty for multifamily mortgage debt is counter to the public interest and pointing out that federal guaranties pose risks for the industry as well. Earlier this year, we began additional research (funded in part by ourselves and in part by the American Enterprise Institute) on the practical question of how best to manage a transition away from federal guaranties. In the course of the current research, we interviewed a variety of capital markets experts and multifamily finance experts. The purpose of this letter is to give you our research findings and recommendations to assist you in evaluating analysis by the Enterprises.

**Overview**

Multifamily has broader access to capital, on better terms, than any other commercial real estate asset class, because of the Enterprises and their federal guaranties. The guaranties gave the Enterprises such a powerful pricing advantage that they dominated every multifamily market segment in which they chose to compete.

Not only do these guaranties distort capital flows (causing over-investment in the multifamily sector), they also prevent the formation of the sort of viable private multifamily financing market that serves other commercial real estate asset classes today and that served multifamily until the early 1990s.

The Enterprises have made noteworthy contributions as well. They have demonstrated how to pursue multifamily financing while maintaining a strong credit culture. They have developed a trusted brand in multifamily financing, delivered through risk-sensitive networks of originating lenders who (together with the Enterprises) have developed the multifamily lending programs of the Enterprises.

Multifamily loans are made to businesses. Fundamentally, better terms inure to the borrower in the form of larger loans and/or higher cash flow, and not to tenants. Thus multifamily finance policy is largely economic policy, with little or no overlay of social policy.

We believe that the federal guaranties should be phased out and should not be continued, but we also believe that the Enterprises' multifamily business units should be privatized and thereby preserved.

In this paper, we will tell you who we are and why we believe that the Enterprise multifamily business operations can be viable without government guarantees. This letter also will point out some factors that we recommend FHFA keep in mind when evaluating multifamily privatization proposals from the Enterprises and from other interested parties.

**Who We Are**

Capping his 45 year career developing and financing multifamily housing, Tom White was Senior Vice President at Fannie Mae responsible for all Fannie debt and equity investments for multifamily properties including the DUS program. During Tom's tenure at Fannie Mae, from late 1987 to mid-2001, innovations included creating the DUS model (including capital requirements for participating lenders), creating the DUS lender network, designing Fannie Mae's reviews of the lending practices of participating lenders, developing a more sophisticated approach to underwriting repairs and reserves over the loan term (this approach has since become an industry standard), and designing a permanent loan takeout product for Low Income Housing Tax Credit properties. Previously, Tom was Executive Vice President of the National Council of State Housing Agencies, held senior positions at HUD, Bear Stearns and the Michigan State Housing Development Authority, and co-directed a major study of the USDA multifamily programs. Early in his career Tom was a social worker, a community organizer for the City of Detroit and a State Legislator representing Downtown Detroit. Tom currently is a Trustee of Centerline Capital (a debt and equity investor in multifamily properties) and of Enterprise Investments (the for-profit arm of Enterprise Partnerships). The opinions expressed in this letter are Tom's personal opinions and do not reflect the views of Centerline or Enterprise.

Charlie Wilkins has spent nearly 40 years in the multifamily business. Since mid-1997, he has been a consultant who works with regulatory agencies, owners, managers, and lenders regarding affordable housing policy, finance, asset management and property management. He is an advisor to HUD's Mark to Market program (which has restructured the financing of thousands of troubled apartment properties), to HUD's Green Retrofit Program (which financed energy-saving improvements to over two hundred apartment properties), to HUD's HOME program, to HUD's Neighborhood Stabilization Program, and to the State of Louisiana's hurricane recovery program (through which the State invested over $700 million in apartment properties to replace units lost to Hurricanes Katrina, Rita, Gustav and Ike). He formerly advised the Department of Agriculture's Rural Housing Service. As a senior executive with The National Housing Partnership (then the nation's largest owner and operator of apartments) from late 1988 to mid-1997, Charlie was responsible for asset management of NHP's 60,000 units of affordable rental housing, and for NHP's relationships with the Congress and HUD. He is a Senior Fellow in the School of Public Affairs at the University of Maryland, a past President of the National Affordable Housing Management Association, and a Board member of the National Center for Healthy Housing.

**Potential Viability without Federal Guaranties**

The multifamily business platforms of the Enterprises are ripe for privatization. Both among those we interviewed, and in the industry generally, there is consensus that the Enterprises' multifamily portfolios are well underwritten, are well structured, and are performing well. The Freddie Mac K-Series securities have established a market for non-guaranteed junior multifamily mortgage backed securities (MMBS) and represent an excellent platform for developing the market for non-guaranteed senior MMBS.

As we pointed out in a paper we released last November (copy attached), the multifamily mortgage loan markets will be viable without federal guaranties (other than a limited role for FHA). Indeed, mortgage markets for all other commercial real estate classes operate without federal guaranties, as did multifamily prior to the early 1990s. Section I of this letter will summarize the reasons why the current federal guaranties should be viewed as an anomaly and should be eliminated over time.

We also believe that the multifamily business units of the Enterprises will be viable without federal guaranties. Sections II through V of this letter will discuss why we believe this.

As one would expect, the multifamily industry is advocating very strongly for continuation of the status quo. Section VI discusses the factors underlying the industry's positions and calls into question each of the industry's arguments, which we believe are largely intended to draw attention away from these realities:

- The status quo provides taxpayer-funded subsidies to the industry.
- These subsidies serve no significant public purpose.
- These subsidies have led to excessive leverage in the industry.

Section VII will provide our thoughts on a variety of issues that FHFA may need to consider when evaluating multifamily privatization proposals.

**Summary of This Letter**

In this letter, we use the acronym MMBS to mean multifamily mortgage backed securities (backed solely by multifamily mortgage loans), and the acronym CMBS to mean commercial mortgage backed securities (backed by mortgage loans from multiple commercial real estate asset classes, which could include multifamily mortgage loans).

I. The current federal guaranty should be phased out and not replaced.

II. Selling the Enterprises' multifamily business platforms is a sensible conservatorship action that will create value for taxpayers.

III. With regard to multifamily loans currently owned by the Enterprises, there are a variety of sensible conservatorship actions. However (see VI below), we believe the various industry proposals to bundle these loans with the Enterprises' multifamily business units would sacrifice value rather than conserve value for taxpayers.

IV. With regard to MMBS currently guaranteed by the Enterprises but held by investors, the existing Enterprise guaranties (now federal guaranties) will need to be maintained in place for the duration of the MMBS.

V. Enterprise competitive advantages include their trusted brand, their networks of expert lenders and their securitization platforms.

VI. Many multifamily properties are over-leveraged today. This causes owners to lobby for solutions that include ongoing federal guaranties, to make it easier for owners to roll over their current excessive debts. Recognize this lobbying for what it is; a call for continuation of unwise taxpayer subsidies in perpetuity for owners of apartments, subsidies that have little if any public benefit.

VII. When soliciting and reviewing proposals to sell the Enterprises' multifamily business platforms, follow these principles:
- Phase out all federal guaranties, over a firm but prudent timeframe.
- Determine the appropriate future of the existing Enterprise-held portfolio of whole multifamily mortgage loans separately.
- Consider how the existing Enterprise guaranties of MMBS (that are held by others) should be managed over their remaining terms.
- The privatized businesses should develop best-of-class MMBS structures and servicing to distinguish their MMBS from the conflict of interest flaws and servicing flaws that have become apparent since 2007 in the private label CMBS market.

Additional discussion of each topic follows, numbered as shown above.

**I. The Current Federal Guaranty Should Be Phased Out and Not Replaced.** This section summarizes findings from our earlier paper (attached).

A. **Other Commercial Real Estate Asset Classes Have no Guaranties.** Owners of retail, office, industrial and hotel properties finance and refinance their properties despite having no federal guaranties available. Periodically, financing and refinancing is more difficult to obtain, particularly for riskier properties, but industry participants correctly see this as a normal business risk. Except for a limited role for FHA, multifamily operated the same way until the early 1990s.[1] There is every reason to expect that multifamily finance can operate successfully with no federal guaranties.

B. **Political Dangers.** The Enterprise federal guaranties pose at least the following political dangers:

1. **Risk is Shifted From Borrowers and Lenders to Taxpayers.** Taxpayers <u>will</u> incur losses on Enterprise multifamily loans, the next time the industry goes through bottom-of-cycle conditions (the last bottom of cycle was 1989-1991). Taxpayers should not be bearing this risk; as we point out in Section VI there is little if any public-purpose benefit of the Enterprise multifamily guaranties.
2. **Risk is Mis-Priced.** Riskier borrowers are charged essentially the same price as safer borrowers, which not only is self-evidently wrong from a pricing standpoint but also encourages borrowers to use more debt and less equity. Another effect is to encourage purchasers to overpay for riskier properties.
3. **Political Pressure for Riskier Lending.** The legislative and executive branches of the federal government periodically pressure the Enterprises to make riskier loans.

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[1] Because multifamily investments counted heavily toward the Enterprises' affordable housing goals that were established by Congress in 1992, management of both Enterprises prioritized multifamily, with the result that both Enterprises use their pricing advantages to gain market share in multifamily.

4. **Stakeholder Pressure for Riskier Lending.** Borrowers want larger loans, and loans on riskier properties. Advocates want a variety of risky loans.
5. **Economic Pressure for Riskier Lending.** The Enterprises are tempted to make riskier loans, because the Enterprises earn profits from successful loans while taxpayers bear the risk of unsuccessful loans.

C. **The Private Label MMBS / CMBS Markets Can Absorb Multifamily.** The private asset backed securities markets are so large that there is no question they could provide a much greater share of multifamily financing. The current multifamily market share for private CMBS is low <u>because</u> of the current Enterprise guaranties, which keep multifamily interest rates artificially low.

D. **A Reduced Enterprises Footprint Would Be Replaced by an Increased Private Label MMBS / CMBS Footprint.** Other multifamily mortgage market participants (primarily life insurance companies, pension funds, and banks) have some ability to expand their multifamily lending, and should be expected to expand their multifamily lending once the Enterprises' competitive advantage is phased out. However, those participants do not have sufficient ability to increase volume to <u>replace</u> the Enterprises. Hence, it is generally true that reductions in Enterprise multifamily lending will necessarily result in increases in private label MMBS and in the multifamily component of private label CMBS. As noted above, expansion of private label MMBS and expanded multifamily volume in private label CMBS will occur naturally with the phase-out of Enterprise federal guaranties.

E. **Loan Pricing and Availability For Multifamily Would Mirror Other Commercial Real Estate Asset Classes.** After the current Enterprise guaranties are phased out, multifamily mortgage loans would carry modestly higher interest rates mirroring rates achieved by other commercial real estate asset classes (instead of the current modestly lower interest rates that multifamily enjoys). Availability of multifamily mortgage loans would also mirror availability for other commercial real estate asset classes (instead of the relatively greater availability that multifamily currently enjoys).

F. **A Ginnie Mae Guaranty Would Be An Especially Bad Idea.** Some of the multifamily finance reform proposals circulating in the industry propose an especially inappropriate form of federal guaranty. The current Enterprise guaranties are of timely payment of interest and eventual payment of principal. By contrast, the Ginnie Mae guaranty (that adds to an underlying FHA guaranty) is of timely payment of interest and <u>timely</u> payment of principal. When given on top of the FHA guaranty, the Ginnie Mae guaranty has only a modest cost to the government (covered by user fees) but adds disproportionately to the value of the resulting securities. As a result, essentially all FHA multifamily loans are securitized through Ginnie Mae; a lender would be leaving money on the table to do otherwise. There are two major drawbacks to extending the Ginnie Mae type of guaranty outside FHA (as some industry proposals advocate).

1. There is no sufficiently robust underlying guaranty. That is, the guaranty of a privatized Enterprise multifamily business unit is not even in the same league as the FHA guaranty, thus the risk exposure of Ginnie Mae (i.e., taxpayers) would be very large.

2. The Ginnie Mae guaranty is under-priced, which means that adding a Ginnie Mae guaranty (even if there were an adequate underlying guaranty) would constitute a wealth transfer from taxpayers to the privatized entities[2].

## II. Selling the Enterprises' Multifamily Business Platforms is an Attractive Conservatorship Option

A. **The Enterprises Have a Trusted Brand.** See V below.

B. **The Enterprises Have Other Competitive Advantages.** See V below.

C. **The Enterprises Could be Engaged to Provide Services for Existing Enterprise Loans.** The ongoing cash flow stream from such services would be highly valued by potential investors in and potential purchasers of the privatized entities. Services could include administering the guaranties for existing MMBS held by investors, and overseeing servicing[3] for existing loans now in the Enterprises' portfolios. Later in this paper, we argue against transferring Enterprise-owned multifamily loans as part of a privatization. However, we believe that the privatized entities would be logical choices to provide various services for those loans, and that compensation for any such services should be profitable to the privatized entities (and reasonable in relation to taxpayers' options for obtaining those services from others).

D. **However, the Enterprises Would Not Dominate The Industry.** We asked numerous experts whether the Enterprise multifamily businesses would be viable as completely private entities. Most (though not all) thought so. No one, however, thought that the privatized business would be dominant. The predominant view (which we share) is that the privatized businesses have an excellent opportunity to create a niche based on quality loans but that other competitors will continue to play a strong role.

E. **Though Likely Feasible, Spin-Off is Unlikely to be Lucrative.**

1. **Little Servicing Income, If Any.** When mortgage banking companies are sold, typically the price is most heavily influenced by the net revenues from servicing existing loans. Because the originating lenders typically have the right to service loans that are guaranteed by the Enterprises, that source of value generally will not be available to support spin-off of an Enterprise's multifamily business unit.
2. **No Guaranty Fee Income.** Both Enterprises receive significant guaranty fees on existing MMBS. However, we assume that the responsibility to perform on the guaranties, and thus the ongoing guaranty fee income, would remain with the Enterprises, and thus that the guaranty fee revenue stream would not be available to support spin-off of an Enterprise's multifamily business unit.
3. **Other Fee Streams Related to the Existing Portfolios.** Other ongoing revenue streams (if any) from existing loans are likely to be relatively highly valued by potential investors.
4. **Value of Origination / Securitization Platforms.** However, value of a mortgage banking company's origination platform typically is discounted by investors because its actual value will be heavily influenced by how competitive the company will be in the future

[2] The Ginnie Mae guaranty is priced at the government's cost rather than taking into account the value of the guaranty to the issuer (the value being much greater than the government's cost).
[3] Typically, the originating lenders hold the right to service the loans.

(value that, in the eyes of an investor or purchaser, belongs to the investor or purchaser rather than to the seller).

Accordingly, our expectation is that spin-off of an Enterprise multifamily business platform is likely to be feasible but unlikely to generate recovery that is material in relation to taxpayers' investments to date.

F. **Do Not Phase Out Issuance of New Guaranties Precipitously.** For example, in 2007 the Enterprises withdrew precipitously from the Low Income Housing Tax Credit (LIHTC) equity markets. New investors entered the market, but the LIHTC equity market did not re-stabilize until two years later.

G. **Phase Out Issuance of New Guaranties Over a Defined, Firm, but Prudent Timeframe.** The phase-out needs to have these attributes:

1. **Certainty.** Private competitors need to be able to trust that the Enterprise guaranties will end and that they will not be replaced by, for example, expanding the role of FHA.
2. **Predictability.** The timing of the phase-out needs to be publicly announced, and the government needs to be accountable to carry out the phase-out as promised.
3. **Reasonable Timeframe.** The example noted in F above suggests that two years is an absolute minimum. We suggest four to five years (a shorter period might be too stressful on the multifamily mortgage markets, and a longer period might discourage potential private competitors from entering the market).

H. **The Privatized Businesses Will Have Good Access to Warehouse Financing.** A privatized Enterprise multifamily business unit would necessarily have to aggregate multifamily mortgage loans for securitization[4], thereby requiring a "warehouse line of credit" to provide funds necessary to acquire loans at origination and hold them until sale of the MMBS. Our discussions with major banks suggest that banks would have a strong interest in providing this type of financing to privatized Enterprise multifamily businesses. As one banker told us, the most important factor in warehouse lending is agreement on credit quality standards, and the Enterprises' high multifamily credit quality standards would make it easy for banks to agree to provide warehouse financing.

I. **Potential Objection: Potential Lack of Access to Capital by Multifamily Owners During Periods of Financial Stress.** Some in the industry argue that a 'liquidity backstop' should be provided so that multifamily owners can access mortgage capital even when the global financial markets are in crisis. See VI.C below for why we think no multifamily-specific liquidity backstop should be provided. The existing liquidity backstop for the entire economy is the Federal Reserve. When there is a problem of liquidity (with no problem of solvency), the Fed purchases high quality securities. We see no reason to think that any additional liquidity backstop should be provided for multifamily. However, if the Enterprise multifamily business units were privatized and continued to originate prime multifamily mortgage loans, we believe that it would be logical for the Fed to purchase MMBS secured by prime multifamily mortgage loans during liquidity crises. This type of liquidity backstop would not require any federal guaranties or other federal risk-taking during normal market conditions.

[4] Without a federal guaranty, those we interviewed expected that the Fannie Mae single-loan-securitization approach would be infeasible (at least not initially), and that after privatization an aggregation approach similar to the Freddie Mac K-Series would likely be necessary.

J. **Potential Objection: Current Enterprise Borrowers' Fear That Existing Enterprise Multifamily Loans Cannot Be Refinanced At Maturity.** As discussed in more detail in Section VI, we believe that the core of the industry's reluctance to embrace privatization is a fear that current borrowers will not be able to refinance their loans at maturity. Because typical Enterprise multifamily loans have maturities of five to twelve years, many loans would mature during the transition to privatization. Although we see every reason to believe that the private capital markets would respond, we have identified a transition approach that would provide comfort to borrowers: providing a one-time opportunity for existing borrowers to refinance (with a federal guaranty) on conservative terms including a loan amount limited to 90% of current indebtedness.[5] This would provide borrowers with comfort that refinancing would be available during the transition while limiting the new federal guaranties to very sound loans.

## III. Attractive Conservatorship Options for Existing Enterprise-Owned Multifamily Loans.

**III. Attractive Conservatorship Options for Existing Enterprise-Owned Multifamily Loans.** This section addresses multifamily loans that are owned by the Enterprises, as opposed to loans owned by others but guaranteed by the Enterprises, which we discuss in Section IV below. At March 31, 2012, we calculate that multifamily loans owned by the Enterprises totaled $186 billion ($73 billion in "whole multifamily loans" and $31 billion of "MBS in portfolio" for Fannie Mae[6] and $82 billion in "un-securitized multifamily loans" for Freddie Mac[7]).

Currently, each Enterprise holds multifamily loans and multifamily MBS that generate roughly one billion dollars per year in net interest income (roughly two billion dollars per year in net interest income for both Enterprises combined). It is important that the value of this portfolio be realized in a way that transparently captures value for taxpayers and is not open to criticism that value was diverted to investors or to privatized spin-off entities. Specifically, we believe that proposals now circulating in the industry (to transfer portfolio loans as part of a proposed spin-off) do divert this value and are not transparent and thus should not be used as models for privatization.

Finally, because the Enterprise-owned multifamily loan portfolio is diverse, we expect that the optimum strategy, to maximize value to taxpayers, will vary for different segments of the portfolio. Strategy selection should consider factors such as remaining loan term, how strongly the property is performing, servicing rights, risk sharing arrangements, and whether there are unusual features of the underlying legal documents.

A. **Option to Sell Seasoned Performing Loans Without a Guaranty.** Seasoned performing loans have demonstrated their low-risk characteristics and likely would receive favorable prices when offered for sale without a guaranty.[8] Accordingly, it would be sensible to offer

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[5] We favor limiting this opportunity to existing borrowers (that is, the opportunity to refinance cannot be assigned to a purchaser), limiting the opportunity to performing loans, and specifying appropriately conservative underwriting criteria such as a 70% maximum loan-to-value ratio, a 1.40:1 minimum debt service coverage ratio, a maximum 25 year amortization period, and a maximum 10 year maturity. The opportunity to refinance could be limited only to those loans that mature during the transition period or could be extended to loans that mature soon after the transition period expires.

[6] Fannie Mae Form 10-Q at March 31, 2012, Table 19.

[7] Freddie Mac Form 10-Q at March 31, 2012, Table 44.

[8] Fannie Mae DUS loans pose additional issues because the originating DUS lender is responsible for reimbursing Fannie Mae for a share of Fannie Mae's losses when a non-performing loan is resolved through foreclosure or

seasoned performing multifamily loans for sale periodically (without a federal guaranty), as a mechanism for reducing the government's exposure to risks associated with holding the Enterprises' current large portfolio of multifamily loans.

B. **Option to Retain Performing Loans to Maturity.** Alternatively, in periods when the capital markets do not appropriately value seasoned performing loans, the government might receive a greater return by holding Enterprise-owned multifamily loans to maturity. Loan servicing (generally carried out by the originating lender) could be overseen by the Enterprises or by third parties. Similarly, loans could be held on the Enterprises' balance sheets or could be transferred to a receiver or liquidating trust.

C. **Special Considerations for Non-Performing and Poorly Performing Loans.** Loans that are delinquent or that are current but poorly performing represent special challenges. Because there is a large amount of capital available for and interested in multifamily, it would be sensible to offer portfolios of non-performing and poorly performing loans without guaranties to determine the viability of simply disposing of these loans (in an efficient market, the price realized would fairly compensate the government, taking into account all risks). Alternatively, in periods when the capital markets do not appropriately value these loans, the government might receive a greater return by holding these loans and, as appropriate, working them out. As with performing loans, a variety of servicing and ownership strategies are available.

D. **The Option to Transfer Loans to Spin-Offs is Not Attractive.** Some privatization proposals that are circulating within the multifamily industry include spin-off not only of the Enterprise multifamily business platforms but also of the Enterprise-owned portfolios of multifamily mortgage loans. We believe this would not be a sound approach. One reason is that it perpetuates the unsound borrow-short / lend-long strategy that led to the aggressive hedging strategies that generated the Enterprise accounting scandals in the mid-2000s.[9] Another is that this approach would sacrifice value to the government and taxpayers; proponents of these proposals basically seek to use the value of the existing portfolios (value that properly belongs to the taxpayers) to subsidize the spin-offs' ability to raise capital[10].

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workout. One option is not to sell these loans. Another is to offer the DUS lender an opportunity to buy back its partial guaranty, then to sell the loans with no guaranties. Another is to sell the DUS loans with a federal guaranty, and with the government retaining the benefit of the DUS risk-sharing. Another special case is Fannie Mae and Freddie Mac structured financing products for large borrowers.

[9] One reason that this strategy is unsound is that there is no hedging strategy that is 100% effective in all market conditions. Thus holding multifamily loans in portfolio, financed by short-term borrowing, carries with it the 'black swan' risk of infrequent catastrophic loss. A second reason is illustrated by the Enterprise accounting scandals: the very complexity of hedging strategies carries with it the risk that insiders may manipulate the hedging strategies, or their accounting of the effects of the hedging strategies, without those manipulations being detected.

[10] The underlying logic is basically this: the spin-offs would guaranty their own MMBS, the guaranty would not be sufficiently credible without a very large capital base, the ongoing business value would not be sufficient to raise that much capital, therefore the existing Enterprise loan portfolios should be transferred also, to allow sufficient capital to be raised. In other words, these proposals involve hidden subsidies.

**IV. Conservatorship Options for Enterprise-Guaranteed MMBS Held by Investors.** At March 31, 2012 we calculate that there were $129 billion of Enterprise-guaranteed multifamily loans held by investors.[11]

A. **Guaranties Will Need to be Maintained in Place.** Although it is possible in theory to negotiate with each individual investor for a payment in exchange for which the guaranty would be canceled, we recognize that the practical reality is that the existing guaranties will be maintained in place and will run off over the remaining term of the guaranteed MMBS.

B. **Most MMBS Have Relatively Short Maturities.** Typical Enterprise-guaranteed MMBS were secured by loans with maturity terms in the 5-12 year range. Accordingly, most guaranties will expire within a manageable time period.

C. **'Special Servicing' Options.** If a guaranty is called upon, a special servicer will have to pursue foreclosure or other resolution options. The existing Enterprise multifamily business units (whether privatized or not) would represent one logical choice for special servicer. Third party special servicers could be engaged as an alternative.

**V. Enterprise Competitive Advantages.**

A. **Trusted Brand.** Since 1992, the Enterprises have convincingly demonstrated how to carry out multifamily lending in a prudent, low-risk manner. In our earlier paper, we proposed a definition of 'prime multifamily mortgage loan' that drew heavily from actual Enterprise practice, and we found that prime multifamily mortgage loans have a level of default risk that is on the order of one-fifth that of sub-prime multifamily mortgage loans (such as those made by Wall Street conduits in the 2000s).

B. **Network of Expert Lenders.** Both Enterprises have assembled and maintained excellent networks of capable, expert and careful lenders. These lenders follow consistent, prudent lending practices disciplined by the Enterprises. These networks would constitute a significant competitive advantage to privatized Enterprise multifamily business units.

C. **Securitization Platforms.** Both Enterprises have proven the ability over time to securitize and service large volumes of multifamily mortgage loans. These proven, high-volume securitization platforms would constitute a significant competitive advantage to privatized Enterprise multifamily business units. It is important, however, to note that without a federal guaranty, privatized Enterprise multifamily business units necessarily would have to issue MMBS backed by multiple multifamily mortgage loans; the Freddie Mac K Series is a good example. To prepare for privatization, Fannie Mae would have to shift to a similar securitization approach, as opposed to the single-loan securitization approach that Fannie Mae has historically followed.

D. **The 1996 Sallie Mae Privatization is a Potential Analogy.** In 1996, Sallie Mae gave up its GSE status with respect to student loans and made a successful privatization transition. Sallie

[11] $315 billion of total multifamily loans ($196 billion for Fannie Mae and $119 billion for Freddie Mac), minus $186 billion held by the Enterprises as noted in Section III, equals $129 billion held by investors. Sources: Forms 10-Q at March 31, 2012 (Tables 16 and 19 for Fannie Mae; Tables 16, 19 and 44 for Freddie Mac).

Mae continued to service existing loans after the privatization. The implicit federal guaranty of Sallie Mae's existing corporate bonds was removed via a defeasance transaction. Subsequent to the privatization, Sallie Mae financed new student loans through a combination of asset-backed securitization and issuance of (non-federally-guarantied) corporate bonds.[12]

## VI. The Arguments of Multifamily Owners are Flawed and Hide the Fact that Many Properties Are Over-Leveraged.

A. **The Industry's Concern is About Capital Availability, Not About Price.** Because of the Enterprise federal guaranty, the multifamily sector experiences lower mortgage interest rates than the retail / industrial / office / hotel sectors, but this interest rate advantage is modest, probably not exceeding 25 basis points and almost certainly not exceeding 50 basis points.[13] Those we interviewed pointed out that while 25-50 basis points would be an important consideration in an individual financing transaction, a systemic rate increase of 25-50 basis points higher would not have a material impact on the multifamily development or ownership businesses. However, capital availability is another matter; for the past twenty years, multifamily owners have become accustomed to having mortgage capital very readily available across a wide spectrum of property location / age / quality and across all types of capital market conditions, and clearly that would change if the Enterprise federal guaranty for multifamily were phased out. As one of our interviewees pointed out, a good analogy is strip shopping centers anchored by grocery stores. In difficult capital market conditions, centers with relatively weak anchors, in relatively weak locations, or in relatively weak markets faced loan terms that were much less favorable than loan terms that were available only a few years previously when capital market conditions were favorable. Once the Enterprise federal guaranty for multifamily is phased out, riskier multifamily properties likely would face similar fluctuations in the availability of mortgage capital. We think that those fluctuations are appropriate and that they reflect the underlying higher level of risk in those properties, but we understand that current borrowers have a vested interest in continuation of the status quo. We further think that this factor (fear by current borrowers on weaker properties that their existing loans cannot be refinanced on favorable terms) underlies the industry's strong advocacy against privatization.

B. **The Multifamily Leverage Boom in the 2000s.** The multifamily industry has noted, correctly, that there was no construction boom in multifamily during the 2000s. However, there was a multifamily borrowing boom. The total multifamily rental housing stock rose just over 10%

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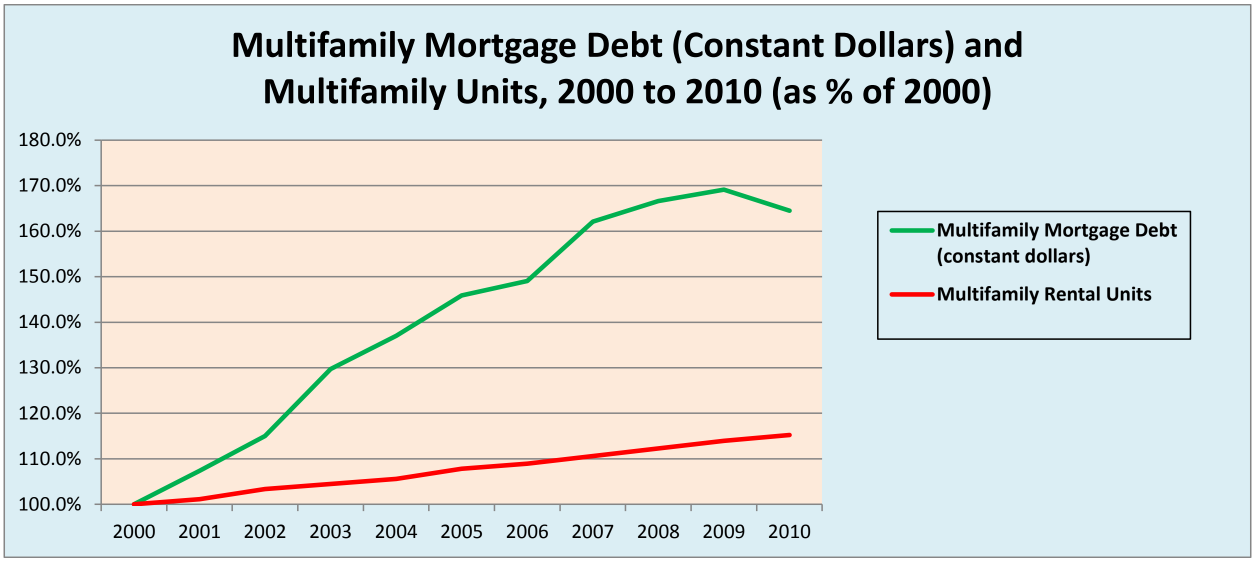
[12] "Lessons Learned from the Privatization of Sallie Mae, Department of the Treasury, Office of Sallie Mae Oversight, March 2006. Also: "Privatizing a Government Sponsored Enterprise: Lessons from the Sallie Mae Experience", Michael Lea, Cardiff Economic Consulting (paper presented at the Conference on "Fixing the Housing Finance System", Wharton School, University of Pennsylvania, April 26-27, 2005).

[13] We found the following approach useful, for arriving at a rough estimate of the interest rate advantage: The spread between interest rates on Agency securities and A-rated corporate securities tends to fall in the 30-50 basis point range. A portfolio of high quality multifamily loans is at least as safe as an A-rated corporate security. Accordingly, the interest rate advantage to a multifamily borrower cannot exceed the spread between Agency rates and A-rated corporate rates. Following this line of thought, even if most of the spread advantage were passed through to the borrower, the interest rate savings to the borrower likely would be no more than 25 basis points and almost certainly would not be more than 50 basis points.

during the 2000s, but (on an inflation adjusted basis) multifamily mortgage debt outstanding rose over 60% (the rise was even greater in nominal dollars).




Sources: Authors' analysis based on Federal Reserve flow of funds data, Census Bureau data, and CPI-U data

It is noteworthy that in 2000, there had been nine years of recovery from the 1989-1991 bottom-of-cycle conditions, so it is not as if 2000 represented down-market conditions. Rather, 2000 represented normal market conditions.

C. **As a Result, Many Properties Are Over-Leveraged Today.** When evaluating the multifamily industry's advocacy positions, the over-leveraged situation of many apartment owners needs to be kept firmly in mind. Put bluntly, for many owners, continuation of the very multifamily-borrower-friendly status quo is probably necessary so they can stay in business. For many other owners, phase-out of the federal guaranty of Enterprise multifamily mortgage loans would require them to make painful adjustments (such as selling properties, or bringing in new equity partners) in order to stay in business.

D. **The Flawed Argument that Lower Interest Rates Benefit Tenants.** The industry argues, incorrectly, that lower multifamily interest rates benefit tenants. We address this issue in some detail in our attached paper. In summary, lower multifamily interest rates result in larger loans and larger cash flow for owners, not in lower rents for tenants. Supply and demand conditions in each local market – not interest rates or any other component of apartment owners' costs -- determine rents for tenants.

E. **The Flawed Argument that Multifamily is Special.** The industry argues, incorrectly, that multifamily should be distinguished from other commercial real estate classes because many working Americans live in apartments. We see this as being as transparently self-serving as grocery store owners advocating for subsidies because many working Americans buy food in grocery stores, or shopping center owners arguing for subsidies because many working Americans shop in shopping centers. Also, as we pointed out in our earlier paper, multifamily properties of 50+ units comprise less than one-third of the nation's rental housing stock, so "multifamily" and "rental housing" are not synonymous.

F. **The Flawed Argument that Enterprise-Style Multifamily Lending is Essentially Risk-Free.** The industry correctly points out that the Enterprises' multifamily portfolios have performed well, by contrast to multifamily loans included in Wall Street conduit CMBS during the early to mid-2000s. However, many in the industry go on to argue, incorrectly, that since taxpayers have incurred no multifamily losses yet, there is no cost to providing the Enterprises with a multifamily guarantee. Nothing could be farther from the truth. The Enterprises' current multifamily approaches began in 1992, after the severe 1989-1991 bottom of cycle in multifamily, and after both Enterprises sustained heavy losses in multifamily lending in the 1980s. There has been no subsequent bottom-of-cycle period in multifamily. Accordingly, the Enterprises' multifamily portfolios have not been tested in bottom-of-cycle conditions, and any estimate of loan losses should start with actual historical loan losses and add a significant premium for the additional losses that will occur when bottom-of-cycle conditions next occur for multifamily. Given that a bottom-of-cycle is much worse (in terms of property failure) than the sort of mild stress that multifamily experienced in 2007-2008, that additional premium should be significant.

G. **The Flawed Argument That a Guaranty Can Be Priced Correctly.** Proponents of a continued federal guaranty for multifamily propose a guaranty fee that will be paid directly to the Treasury, priced to cover the risk to taxpayers. As we pointed out in our earlier paper, there is no reason to think that a guaranty can be priced accurately. In particular:

1. A guaranty fee that is fixed will create an incentive to compete by making riskier loans.
2. A guaranty fee that is priced based on risk will undergo political attack by those who want riskier loans to be made on the same terms as prime loans.
3. Hence a federal guaranty will have a fixed price (not varying by risk) as a matter of political necessity. Everyone we interviewed mentioned the importance of lending only to multifamily borrowers who are expert, experienced, and financially solid, but this is exactly the sort of risk-based differentiation that political forces tend to eliminate in governmental guaranty programs.
4. If the guaranty fee is priced at its value, then it will not be profitable to either the Enterprises or to borrowers, so as a matter of economic necessity the guaranty fee will be too low.
5. There is every reason to think that the political process will result in a guaranty fee that is too low. Borrowers and lenders alike will exert political pressure for lower fees, and both groups are politically powerful.

H. **The Flawed Argument that Multifamily Needs Uninterrupted Access to Capital.** The industry argues, incorrectly, that terrible things will occur if apartment owners have to delay refinancing their properties because of a global financial crisis (such as occurs for a few months every ten to fifteen years). As long-time multifamily professionals, we can assure everyone that an apartment owner's ability to replace carpets and refrigerators and keep the building clean is not impacted by having to delay refinancing for a few months. The reality underlying the industry's advocacy is that when an apartment owner has borrowed too much money, the real solution is to bring in more equity and to pay down the excessive mortgage loan, but that's very painful and difficult for the owner, so owners (and their trade associations) advocate for easy-money policies such as would be facilitated by a continuing federal guaranty for Enterprise multifamily mortgage loans.

I. **The Flawed Arguments Regarding Small Loans, Small Properties, and Weak Markets.** The industry argues, incorrectly, that continued Enterprise federal guaranties for multifamily are needed because it is vitally important to improve the availability of multifamily mortgage debt in small loan amounts, to small properties, and to properties in weak markets. Our view is that this is <u>not</u> vitally important (indeed, increasing first mortgage lending would be a bad idea), and that in any event a federal Enterprise guaranty is not likely to be effective in achieving the goal. Specifically, there are these important flaws in the industry's arguments.

1. These types of properties have very limited ability to support commercial first mortgage loans.
   a. Small loans are less efficient to originate and to service, so of course fees and interest rates should be higher for small loans than for larger loans.
   b. Small properties and properties in weak markets have very volatile cash flows, which makes lending money to them especially risky.
   c. These properties have relatively low cash flows (per unit), which means that they can't support very large mortgage loans even in the best of circumstances.

2. Thus, if one concluded that these types of properties needed additional capital, commercial first mortgage loans are not the right <u>form</u> of capital; the sorts of soft loans and grants made under HUD's Home Investment Partnerships (HOME) and Community Development Block Grant (CDBG) programs are much more sensible approaches.

3. For the reasons noted above, first mortgage loans to these types of properties are made largely by banks and are largely collateralized by other assets of the owners rather than by the properties themselves. That is, these are not properly 'commercial real estate loans' at all, but rather more akin to personal loans. In summary, there are good reasons why the Enterprises have not made these sorts of loans historically and do not make these sorts of loans now.

4. When these factors are taken into account, several things are evident:
   a. A first mortgage loan is not a particularly effective resource, by comparison to a grant or soft-second.
   b. A non-recourse first mortgage loan is a particularly unsound approach.
   c. A national-scale originator is the wrong sort of lender.
   d. Thus a federal guaranty for Enterprise multifamily mortgage debt can hardly be expected to increase lending to small properties or to properties in weak markets.

5. As noted above, we think it is a bad idea in the first place to try to increase first mortgage lending to these types of properties. However, if one did want to do so, the logical approach would be to create a method for securitizing seasoned loans, with default risk being shared between the investor, the originating lender, and the borrower. Such an approach would not require a federal guaranty (indeed, we would think that providing a federal guaranty would result in excessive risk-taking and would saddle taxpayers with future losses).

## VII. Suggested Principles for Review of Spin-Off Proposals.

A. **Phase Out all Federal Guaranties, Over a Firm But Prudent Timeframe.** As noted above, we recommend a four to five year transition period, announced in advance and adhered to, with an endpoint in which there are no new federal guaranties either of the privatized entities or of their securities.

B. **Do Not Transfer Existing Enterprise-Owned Multifamily Loans.** As noted above, we believe it would be a mistake to allow a privatization transaction to include the existing portfolios of Enterprise-owned multifamily loans.

C. **Utilize a Strong MMBS Structure.** The failure of so many private label CMBS issues has taught some painful lessons. The privatized Enterprise multifamily business units have an opportunity to play a leadership role, by solving structural problems that currently plague existing private label CMBS:

1. At least in hindsight, it is evident that the servicing arrangements for private label CMBS were inadequate. Non-performing properties are facing a lack of capacity among the "special servicers" who step in when a loan is in trouble. The situation is also bad for performing loans; borrowers complain that "no one is home" for simple servicing actions such as obtaining lender approval for new commercial leases.

2. There is an inherent conflict of interest between senior and junior security holders. 2000s-vintage private label CMBS attempted to resolve that conflict in various ways that have led to gridlock in resolving non-performing loans. The Enterprise multifamily business units have an opportunity to incorporate stronger structures that will work in both performing-loan and non-performing-loan contexts.

The preceding necessarily summarizes considerable research and study. We would be pleased to provide additional information if that would be helpful.

T W White

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