No Federal Guaranty for Multifamily

And Other Ideas for Multifamily Housing Finance Reform

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This paper is limited to the multifamily sector (rental properties with 5+ units). The paper will not discuss single family housing finance.

That said, we feel it is important to point out that single family loans are made directly to the household the government seeks to benefit, whereas multifamily loans are made to businesses, and (as we discuss later in this paper) the benefits of the loan accrue to the business and not to the individual tenants. Accordingly, in multifamily, the federal guaranty question is essentially a question of economic policy with little if any overlay of social policy.[1]

When we use the term 'prime multifamily mortgage loan' we are describing a multifamily loan that is a safe investment suitable for retail securitization. This should not be confused with an evaluation of the property on which the loan is made. In fact, we have seen very risky loans on extremely high quality properties, as well as very safe loans on properties that -- while fundamentally sound -- may be older, may have only moderate physical quality, and may be located in moderate-income neighborhoods.

References to source documents are provided in the body of this paper but not in the Executive Summary.

1. Executive Summary

No Federal Guaranties in Multifamily. Period. Everyone now agrees that it was a bad idea to have an implicit federal guaranty for the multifamily activities of Fannie Mae and Freddie Mac. The public debate is now focused on the question of whether there should be explicit federal guarantees for at least some multifamily loans, in at least some market conditions. We believe that (other than FHA and Ginnie Mae, which we discuss below) there should not be any federal guarantees in the multifamily sphere, and we believe that there should be no exceptions to this principle.

Federal Guaranties Are Not Necessary. There is strong evidence that a federal guaranty is not necessary in order to produce a smoothly functioning multifamily debt market.

- A review of other countries' real estate finance markets indicates that, in the absence of government guaranties, capital flows smoothly and efficiently to real estate.
- In the United States, the debt markets for industrial, retail, office and hotel properties function smoothly and efficiently, with no federal guaranties.
- If, in some future financial crisis, the government determined that it needed to provide capital to the multifamily sector, the Treasury could simply purchase multifamily mortgage-backed securities at their fair market value.

We acknowledge that, because of the recent market-distorting presence of Fannie Mae and Freddie Mac, the United States' multifamily debt markets are dominated by the federal government in one way or another. We also acknowledge that it will take time to return to a fully private multifamily debt

[1] Some in the industry claim that the interest rate on a multifamily mortgage loan has an effect on the rents that tenants pay. This claim is clearly wrong. We provide an extended discussion below in Section 4.G.

capital market. But there is no reason to believe that it is essential to have a government-dominated multifamily debt market.

Even if Federal Guaranties Were Necessary, They Are Bad Policy. Not only are federal guaranties unnecessary, they are also bad from a policy standpoint. The main reasons include:

- A federal guaranty will drive out private competitors, in exactly the way that Fannie Mae and Freddie Mac drove private competitors out of the prime multifamily loan market, slowly but steadily over the last twenty years. Some of those competitors left the business entirely, and others moved into the below-prime market (which subsequently collapsed as a result of unsound lending). This is why multifamily is so dependent on federal lenders at the moment.
- If there is a federal guaranty, the temptation for both the legislative and executive branches to intervene -- to drive down underwriting standards in the name of 'affordability' – will prove irresistible, placing us in danger of future housing finance crises. Because the recent GSE multifamily programs were created in reaction to past failures and because meeting multifamily affordable housing goals did not require loosened underwriting, the GSE multifamily programs were largely insulated from these sorts of interventions. It is unlikely any program with an explicit federal guaranty would experience the same insulation.
- If there is a guaranty, then as a matter of economic and political necessity, the guaranty will be priced well below its value.
- Even if the guaranty has a relatively low risk to taxpayers in the context of high quality ('prime') multifamily loans, the normal course of politics will result in the extension of the guaranty to more risky loans.
- Despite claims to the contrary from the industry, there is no connection between multifamily mortgage interest rates and the rents that tenants actually pay. It is important to remember that these are loans to businesses. The interest rate and other loan terms affect the profits of these businesses, but local market conditions (not the owner's costs) determine the rents that tenants pay.
- A federal guaranty will result in a mis-allocation of credit, with the multifamily sector receiving more credit than it should, relative to other borrowing sectors.

The Downside Risk of Federal Guaranties is Unacceptable. When there is a credit crisis regarding private debt, there is a problem of liquidity, in which government needs to provide temporary additional liquidity until the crisis is past. When there is a credit crisis regarding government-guaranteed debt, there is a problem of solvency, in which government needs to absorb the losses as well as provide additional liquidity. Said differently, when a government guaranty is provided, no matter how carefully the guaranty is structured, there is a material risk that the guaranty will lead to a future crisis of solvency. Taxpayers should accept the risk of a crisis of solvency only when the government guaranty has very powerful advantages. In the case of multifamily debt, the advantages (to taxpayers) of a government guaranty are negligible or non-existent, which leads us firmly to the conclusion that a government guaranty should not be provided.

Federal Guaranties Are Not Desirable for the Multifamily Business. Even if federal guaranties were necessary, and even if they could be provided prudently, we believe that federal guaranties are bad for the multifamily business in the long run. This is because a guaranty will result in a government-dominated multifamily debt market, which exposes the industry to periodic capital crises when (not if) government changes its policy stance.

Below-Prime Multifamily Loans Are High Risk Loans Not Suitable for Retail Investors. A salient lesson from the recent housing finance crisis is that the retail securitization process is inappropriate for below-prime mortgage loans. One reason is that the retail securitization of below-prime loans – no matter how well regulated – will allow lenders to transfer the risk of those loans to others, thereby undercutting market discipline. Also, the recent housing finance crisis also demonstrated, beyond any doubt, that below-prime mortgage loans (whether single family or multifamily) cannot be accurately evaluated by rating agencies or retail investors. We believe that below-prime loans should be made – in multifamily as well as in single-family -- but only by private lenders with their own capital at risk. We also believe that many below-prime loans should be securitized, but we believe that the resulting CMBS should not be allowed to be sold to retail investors.

Defining Prime Multifamily Loans, Suitable for Retail Investors. We propose that retail securitization should be allowed for only two categories of multifamily loans: what we call 'prime tier one' multifamily mortgage loans, and what we call 'prime tier two' multifamily mortgage loans. The 'prime tier one' category mirrors the bulk of multifamily loans made by the GSEs over the last fifteen years. The 'prime tier two' category allows for limited departure from 'prime tier one' requirements, recognizing the diversity of the multifamily portfolio and the diversity of America's real estate markets, but the added risk as a result of each departure from 'prime tier one' requirements must be offset by added strength in some other key dimension of the loan (for example, if the property size is smaller than required for 'prime tier one' status, the debt service coverage ratio would have to be higher and/or the loan-to-value ratio would have to be lower).

Consider Market Approaches Instead of Regulatory Approaches. When we recommend breaking multifamily loans into prime and below prime categories, we do not necessarily envision a regulatory approach. Better would be an approach that utilized the rating agencies (with appropriate reforms to prevent a repeat of the mid 2000s disaster when the rating agencies served the Wall Street originators instead of investors). Another market alternative would be to require private mortgage insurance for multifamily loans.

The GSEs Should Continue to Guaranty Steadily Declining Amounts of Multifamily Loans During the Transition to a Fully Private Market. The multifamily origination activities of Fannie Mae and Freddie Mac should be wound down, but over a reasonable period of time, to allow the new multifamily finance system time to evolve. We recommend a five year period, with the total volume of GSE multifamily lending being on a declining glide path over that period.

The GSE Multifamily Portfolios Should Be Managed In Place Rather Than Sold. We believe that the GSE multifamily portfolios should not be sold (the existing risk sharing and servicing arrangements would be difficult or impossible to accommodate in a sale transaction). We provide several options for the management of this book of business, during and after the transition to a fully private market.

FHA and Ginnie Mae Should Focus on Below-Prime Loans. We believe that FHA and Ginnie Mae are good examples of transparent government initiatives in the below-prime segment of the multifamily lending business. Each FHA loan product, and the Ginnie Mae guaranty, involve fees to the borrower that, when carefully evaluated on a net present value basis, are sufficient to cover the risk to taxpayers. The FHA structure also allows for FHA to guaranty loans for which the fees do not cover the risk to the government, but only if Congress appropriates funds in advance to cover the net risk to taxpayers. We think that this governance approach, laid down in the Federal Credit Reform Act of 1990, is a good one.

That said, we think that FHA should be restricted to the below-prime portion of the multifamily lending universe. This has the following implications for the FHA multifamily product line:

- The Section 221(d) construction-permanent loan product would continue, because construction loans are below-prime by definition.
- The Section 223(a)(7) refinance product (for loans that already have FHA mortgage insurance) would continue; this is a defensive asset management tool that lowers risk for both the borrower and FHA.
- The Section 223(f) refinance product (for loans that do not have FHA mortgage insurance) would be restricted to non-prime areas (i.e., locations that do not pass the 'stable market area' test that we discuss in Section 6).

The Existing Government-Assisted Apartment Stock. Because market rate multifamily rental housing is inherently not affordable for many low-income households, we believe that any conversation about multifamily must also include a conversation about affordability. Currently, in the United States, we have roughly four million multifamily units that have received significant governmental investments to promote affordability.[2] In addition, roughly 1.5 million low-income tenants receive portable ("tenant based" or "voucher") governmental assistance that pays part of their rent.[3] In summary, the federal government is currently providing rental subsidies on a large scale. Reasonable and knowledgeable people differ about how many households should be subsidized, whether the subsidies should be attached to projects or be portable, and who should be eligible, but there can be no doubt that the need is significant. Similarly, there is no reason to expect this to change in the future. Accordingly, what to do about the existing stock of government-assisted multifamily properties is an extremely important question.

From having spent our careers developing and attempting to sustain existing subsidized multifamily properties, we know that the United States needs a more systematic and principled approach for deciding whether, and if so how, to preserve existing government assisted multifamily properties that serve low-income tenants. We will mention some key points now:

- Too often, when multifamily properties are built specifically for low-income use, the theoretical benefits of the project-based approach –location in a neighborhood in which potential tenants want to live, long-term physically sound housing, at rents that remain affordable long-term – are not realized. Instead, locations often are below average or worse, initial subsidies are inadequate to support sound physical condition, and initial affordability evaporates when it becomes necessary to increase rents.

- Properties initially intended as workforce housing are converted to concentrated-poverty housing. In the process, the rents that tenants actually pay are reduced, while rents that are paid by government are increased substantially. Sometimes, the low rents paid by tenants act as bribes, to stay in housing that is unsafe, ill-maintained, and undesirable.

- All housing deteriorates (physically) over time unless reinvestment is both careful and intensive. Subsidized housing programs – including the Low Income Housing Tax Credit – have systematically under-invested in properties over time. Assisted properties that are preserved

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[2] See Table 1.

[3] Of the roughly 1.5 million households who receive tenant-based rental subsidies, some live in one-unit to four-unit buildings and others live in multifamily buildings.

must be structured with reserves that are adequate to fund 100% of anticipated major repairs and major systems replacements for a significant period of time such as 20 years. State allocating agencies should strengthen their LIHTC underwriting requirements so that LIHTC properties will be physically and financially viable through the extended affordability period.

- All housing deteriorates (from a marketing / desirability standpoint) over time.[4] Older properties tend to have bedrooms that are too small, kitchens that are inadequate, and not enough bathrooms. These are problems that are prohibitively expense to remedy. Similarly, many older properties no longer fit into the neighborhood architecturally. Once a property reaches an age of 30-40 years, it is likely that it is obsolete in this sense and should not be preserved as government-assisted housing.

- At origination (for new government-assisted properties) or at the time of refinancing or contract renewal (for existing government-assisted properties), we favor structuring the finances of government-assisted properties, so that they are viable long-term at or below local neighborhood market rents. Once that is accomplished, it is possible to make more use of tenant-based assistance rather than project-based assistance. In that situation, we think that tenant-based assistance has very powerful advantages and that there should be a presumption in favor of utilizing tenant-based assistance.

Structure of This Paper

Section 2 briefly discusses the multifamily rental housing stock.

Section 3 discusses why a federal guaranty is not necessary.

Section 4 discusses why a federal guaranty for multifamily loans is a bad idea.

Section 5 discusses why the securitization process should be limited to high quality loans.

Section 6 presents proposed definitions for the 'prime tier one' and 'prime tier two' multifamily loans that are suitable for retail securitization. This section also discusses FHA and Ginnie Mae.

Section 7 presents recommendations for winding down the multifamily origination activities of Fannie Mae and Freddie Mac.

Section 8 presents recommendations for managing the multifamily portfolios of Fannie Mae and Freddie Mac.

Section 9 presents recommendations for addressing the existing stock of government-assisted apartments serving low-income tenants.

[4] The industry term for this is "functional obsolescence".

2. The Multifamily Rental Housing Stock (Market Rate and Subsidized)

Roughly one-third of Americans live in rental housing. In the wake of the recent housing finance crisis, that percentage is rising. Over 40% of the nation's rental housing stock is "multifamily", meaning that it is in buildings of five or more units. The remainder of the rental housing stock is in 1 unit ("single family") structures (just under 40%) and in 2-4 unit structures (20% of the rental housing stock).

Like all housing, multifamily rental housing requires upkeep. Continuous reinvestment is essential, and periodically properties need significant repairs that require significant capital. Traditionally, apartment loans have terms of 7 to 12 years, and significant repairs are paid for at the time of refinancing (and required by the new lender).

See the table below for our estimate of the size of the nation's rental housing stock (in 2009), and for our estimates of the composition of the nation's rental housing stock.

Our estimates for "subsidized multifamily" do not include properties whose only subsidy is tax exempt bond financing (i.e., without LIHTCs).

Our estimates for "subsidized multifamily" also do not include market rate units where the tenant receives a Section 8 voucher. There are roughly 1.5 million vouchers in circulation, many of which are utilized in 1-unit to 4-unit structures, and some of which are utilized in market rate multifamily properties.

In terms of the size of the mortgage debt market financing multifamily housing, data from the MBA and the Federal Reserve[5] indicate 2011 first quarter multifamily mortgage debt outstanding of $800-840 billion. MBA survey data would indicate annual multifamily originations of $60-100 billion.[6]

By any measure, the multifamily rental stock is large and significant, which means that the questions we address in this paper cannot prudently be ignored.

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[5] Fed Flow of Funds, L. 219, http://www.federalreserve.gov/releases/z1/current/z1.pdf

[6] Mortgage Bankers Association of America, Multifamily Real Estate Finance Markets & Outlook May 2011, http://www.mbaa.org/files/Research/Presentations/2011_05_25Multifamily.pdf

Table 1: Our Estimates for the United States Rental Housing Stock (2009)

Note: the total rental housing stock was roughly 39 million units in 2009, of which roughly 16.5 million units were multifamily units (i.e., in buildings of 5 or more units)

Rental Housing Stock Category	Rental Housing Stock 2009	Data Source
Total Rental Housing Stock	38,667,000	Harvard Joint Center 2011
Single Family	14,615,000	Harvard Joint Center 2011
2-4 Unit Buildings	7,594,000	Harvard Joint Center 2011
5+ Unit Buildings (multifamily)	16,458,000	Harvard Joint Center 2011
Multifamily (5+) Rental Units By Subsidized / Market Rate:		
Subsidized (roughly)	4,050,000	See below
Market Rate (roughly)	12,408,000	Remainder of 5+ unit buildings total
Multifamily (5+) Rental Units By Property Size:		
Properties of 50+ units (roughly)	11,600,000	Residential Finance Survey 2001 (note 1)
Properties of 5-49 units (roughly)	4,858,000	Remainder of 5+ unit buildings total
Subsidized Multifamily (5+) Rental Units by (Project Based) Subsidy Type:		
Public Housing	1,100,000	Based on Millennial Housing Commission (note 2)
Section 8 New Const / Sub Rehab	575,000	Based on Millennial Housing Commission (note 2)
Section 202 / 811	350,000	Based on Millennial Housing Commission (note 2)
Section 236 / 221d3	500,000	Based on Millennial Housing Commission (note 2)
USDA Section 515	425,000	Based on data from USDA (note 3)
Low Income Housing Tax Credit	1,100,000	See Note 4
Total Subsidized Multifamily	**4,050,000**	

Note 1: The Census Bureau's Residential Finance Survey 2001 estimated that 30% of the rental stock is in properties of 50 or more units.

Note 2: The Millennial Housing Commission estimated the assisted stock as of 1999. We made adjustments to reflect new development and loss of stock since that time.

Note 3: The Section 515 portfolio at 11/01/03 totalled 434,296 units. There has been limited new development, and some loss of older 515 properties to prepayment, since that time.

Note 4: HUD's LIHTC database contains information on 1,843,000 LIHTC units placed in service from 1987 through 2007. We estimate that 100,000 additional units were placed in service in 2008. We estimate that 400,000 units have been removed from the program due to expiration of the compliance period. We also estimate that roughly 1/3 of the remaining units have been counted in one of the previous subsidy categories (i.e., the LIHTC transaction preserved an existing subsidized property).

3. Why Federal Guarantees for Multifamily Debt Are Not Necessary

A. Other Countries Have Efficient Real Estate Debt Markets Without Government Guaranties

As pointed out in the American Enterprise Institute's white paper on housing finance reform,[7] there is solid international evidence that a governmental guaranty is not a prerequisite for a smoothly functioning housing finance system; indeed many foreign countries appear to achieve better housing finance results than the United States but without providing a governmental guaranty for mortgages.[8]

We acknowledge that, in the United States, rental apartments comprise a larger share of the housing stock than is typical for other first-world countries. However, other first-world countries have robust commercial real estate sectors. Also, it is common knowledge that prime multifamily mortgage loans are less risky than prime loans to office buildings, shopping centers, industrial buildings and hotels. It stands to reason, then, that any finance system that serves commercial real estate efficiently will also serve the rental multifamily sector efficiently.

Accordingly, we believe the fact that other first-world countries have efficient commercial real estate debt markets without federal guaranties provides strong support for our view that a federal guaranty should not be provided for multifamily mortgage debt in the United States.

B. In the U.S., Office, Industrial and Retail Properties Have Efficient Capital Markets Without Government Guaranties

All other forms of commercial real estate – offices, retail, industrial buildings and hotels – obtain their mortgage financing from the global capital markets without support from the U.S. government. There is no reason to think that – once a private multifamily loan market is re-established -- multifamily real estate needs government support in order to attract its fair share of capital on competitive terms.

We acknowledge that the other commercial real estate debt markets have more volatility than we have become accustomed to in the multifamily debt market. Our view is that the other commercial real estate debt markets have a <u>normal</u> level of volatility, and that this same normal level of volatility is acceptable for multifamily as well. In our view, the strong GSE presence in our industry has led to abnormally low volatility that is one of the many ways in which the strong GSE presence has resulted in an over-allocation of capital to our industry. Many in our industry have benefitted from this mis-allocation of capital, but those benefits to us come at the expense of all other borrowing sectors. We believe that, should a

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[7] Peter J. Wallison, Alex Pollock, and Ed Pinto, Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market, American Enterprise Institute, January 20, 2011. See in particular pages 3-5.

[8] Dwight M. Jaffee, Reforming the U.S. Mortgage Market through Private Market Incentives (presentation, Federal Reserve Bank of St. Louis, November 17, 2010) http://research.stlouisfed.org/conferences/gse/Jaffee.pdf (accessed January 14, 2011).

federal guaranty be continued, there will be a cost to taxpayers as well, when the next bottom-of-cycle period occurs.

C. **What Does the Current Dependence of Multifamily on the GSEs, FHA and GNMA Teach Us?**

- *Multifamily has a lower cost of capital than other commercial real estate classes.*

  This is common knowledge. It also is common knowledge that this advantage is due to the GSE presence in multifamily.

- *Below-market rates available through the GSEs drove private competitors out of the prime loan sector of the multifamily debt markets.*

  This also is common knowledge. Once the GSEs both began competing aggressively for multifamily market share, starting in the early 2000s, most private lenders could not compete for prime loans (life insurance companies were a prominent exception), and either exited the business or shifted their attention to below-prime loans.

- *Other commercial real estate classes are not dependent on government lending sources.*

- *Inescapably, we conclude that the current dependence of multifamily on government lending sources is because of the long-term GSE presence in multifamily.*

  Absent GSEs for the past twenty years, multifamily would have a fully private debt financing market, in the same way that fully private debt financing markets exist for office, retail, and industrial properties.

D. **Analogy: the LIHTC Equity Market**

A useful analogy is the market for Low Income Housing Tax Credit (LIHTC) equity. In 2006, the GSEs accounted for some 40% of LIHTC equity capital,[9] only to withdraw completely from the market as the housing finance crisis unfolded. The GSEs have not returned to the LIHTC equity market, which underwent very difficult times in 2007 through 2010 but now is approaching stability, having attracted a variety of new investors and having attracted increased participation from other investors who were less active in the LIHTC equity markets previously.

This has three useful lessons for multifamily. The first is that government domination of a market is a recipe for instability. The second is that GSE participation in the multifamily lending market should not be withdrawn precipitously. The third is that, in a relatively short time, private competitors -- that had been kept out or been driven out of the market for prime multifamily loans by the GSEs' unfair pricing advantage – will replace the GSEs' former share of the multifamily debt financing business.

E. **Liquidity in Difficult Market Conditions**

[9] Recapitalization Advisors Update 72, December 23, 2008, reported that in 2006 the GSEs accounted for 40% of total LIHTC equity raised. Anecdotally, we understand that the GSE share was significantly higher in some years.

Those who favor a federal guaranty for multifamily loans point to the difficulty of obtaining multifamily debt financing during global financial crises (such as when, in the late 1990s, Russia defaulted on its national debt). They call for a federal guaranty so that apartment owners can raise debt capital in all market conditions.

We see why apartment owners would desire this, but we cannot see why the government should provide it. Every other consumer of capital faces the risk that, periodically, capital will cost more and that, periodically, underwriting standards will be higher. The federal government doesn't protect other businesses from this sort of risk, and we see no reason that the federal government should protect apartment owners.

That said, if there were a future crisis of such magnitude that the federal government felt a need to support the flow of capital to multifamily, it would be sufficient for the Treasury to purchase multifamily mortgage backed securities at their fair market value. There is no need to create a federal guaranty. Said differently, in such a future crisis the government could provide liquidity to solve the problem. There is no need for the government to take a solvency risk in addition.

F. **Access to Capital For Below-Prime Properties and Below-Prime Market Areas**

Proponents of a federal guaranty sometimes advance the notion that the interest rate and other business terms of a multifamily mortgage loan should not vary because of the age of a property, because the local market is declining in population, or because the market area is small. We think this notion is naive at best. Those factors affect the lender's risk, so of course they should affect the loan terms. We believe that loans should be made to these sorts of properties, and to properties in these sorts of areas, but make no mistake: these are not prime loans, they should not be eligible for retail securitization, and they should be made only by private lenders with their own capital at risk.

G. **A Note Concerning Capital Requirements**

There is legitimate concern in the multifamily industry about whether a fully private multifamily debt financing market can provide the volume of loan funds that is needed. If the U.S. and international financial regulators set capital requirements too high for multifamily loans, there could indeed be a problem.

For example, currently an 8.0% capital requirement is required for multifamily loans made by banks. This is far too high for prime multifamily loans.

In Section 6.C we discuss the relative risks of prime and below-prime multifamily loans. Our conclusion is that below-prime multifamily loans carry credit risk (i.e., the risk that the lender will suffer a loss of principal) that is in the neighborhood of five times that of prime multifamily loans.

We do not criticize the current 8.0% capital requirement in the context of below-prime multifamily loans. However, we believe it is essential for the financial regulatory system to recognize the safety of prime multifamily mortgage loans by establishing appropriate capital

requirements (for prime multifamily mortgage loans) that are much lower than the current bank capital requirement rate of 8.0%.

4. Why Federal Guaranties for Multifamily Debt Are A Bad Idea

A. The Main Effects of the Existing GSE Multifamily Guaranties Have Been To Reduce Interest Rates to Below Market Levels and to Drive Out Private Competitors

The GSEs have had such a powerful pricing advantage over all other providers of multifamily financing that all other providers of financing were able to compete only at the margins and at the higher end of the risk curve. The GSEs were able to dominate each sector of the multifamily loan business in which they chose to compete. As a result of the exit of private competitors, today the GSEs and FHA are providing virtually all of the capital to multifamily. It is important for the long term health of the multifamily sector to remove the GSEs' artificial competitive advantage, so that the multifamily finance market can normalize. Of course, this requires a prudent transition; in Sections 7 and 8 we discuss transition strategies.

B. A Government-Dominated Multifamily Finance System, Like We Have Today, Is Dangerous for the Industry

The history of government housing programs makes it clear that the government changes its mind with some frequency. Typical housing programs have a "shelf life" of seven to ten years before they are repealed or overhauled. If the multifamily industry ties itself to federal guaranties, private lenders will exit the multifamily market (in exactly the way they have done over the recent period of GSE dominance), and when (not if) government changes its mind, the industry will be left without a financing system. Moreover, experience has shown clearly that government (no matter how nimble) cannot innovate and adapt to market conditions as quickly as the private market; accordingly, a government-dominated system would inevitably serve this very diverse and dynamic industry poorly.

C. Government Guaranties Inevitably Result in Government Mandates for Unsound Lending

A key factor in the GSEs' recent multifamily success was that, with certain exceptions, HUD and Congress never found ways to apply 'affordable housing goals' pressure on the GSEs' multifamily business. One reason was that both GSEs had failed in multifamily in the 1980s, by not being careful enough about the multifamily loans they made. It also should be noted that multifamily tenants are almost exclusively drawn from the segment of the population with incomes below the median (as a result, essentially all multifamily loans were "goals rich").

However, advocates for a federal guaranty[10] describe a variety of especially risky multifamily loans that they would like for current or future GSEs to make, specifically:

- Construction loans (the industry standard is to require that credit-worthy private guarantors take the construction risk, and that is the right approach).

- Loans to properties in declining markets (such loans are much less likely to be repaid, because of risks to the long term value of the collateral).

- Loans to properties in small markets (such loans are much less likely to be repaid, because of risks to the long term value of the collateral).

- Loans to properties that have especially complex subsidies, such as public housing redevelopment projects (lending to such projects does involve added risk, and any subsidies for such lending should be explicit rather than hidden).

- Loans with 30 year maturity terms (because there are periodic peaks in the major repair and replacement needs of multifamily properties, the first of which occurs between years 15 and 20, 30 year loan terms are imprudent for multifamily properties).[11]

Accordingly, it seems reasonable to assume that, if the GSEs are allowed to continue to guaranty multifamily loans, or if future GSEs are allowed access to a federal guaranty for multifamily loans, the GSEs will be pressured into making these kinds of risky and imprudent loans, in addition to the generally prudent and sensible loans the GSEs have been making since the mid 1990s.

We note that the conventional wisdom in the policy community seems to be shifting away from "homeownership everywhere for everyone" toward "rental everywhere for everyone". If this trend continues, the risk of governmental pressure to make unsafe multifamily loans would be dramatically heightened. To perpetuate the current federal guaranty for multifamily loans would tempt fate.

D. **Multifamily Lending is Difficult and Risky Unless Pursued With Great Care**

In recent years, GSE multifamily loans have performed well, perhaps creating the illusion that multifamily lending is safe and that it is easy. Nothing could be farther from the truth. Multifamily lending is inherently more risky than single family lending, providing another

[10] For example, the Center for American Progress (http://www.americanprogress.org/issues/2010/10/multifamily_rental_housing.html) and the National Housing Conference (http://www.nhc.org/media/NHC-Urgues-Policymakers-to-Strengthen-the-Nations-Multifamily-Finance-System.html) call for a federal guaranty for a variety of below-prime multifamily loans. The National Multi Housing Council calls for an explicit federal guaranty but does not call for changes in GSE lending practices; see http://www.nmhc.org/Content/ContentList.cfm?NavID=425.

[11] The 7 to 12 year maturities that are typical for GSE apartment loans provide a very important market discipline, in which owners are held accountable for the physical condition of properties before there is a risk of serious deterioration. With appropriately sized reserves, we believe that maturity terms up to 20 years can be prudent but that longer maturity terms are inconsistent with sound policy. Also see Section 6, in which we discuss amortization terms as well.

reason not to distort the market via government support. Both GSEs had disastrous experiences with multifamily lending prior to finding their current quite conservative approaches. We believe that it was only because of these former disastrous experiences that the GSEs were politically able to develop and enforce their recent conservative and successful multifamily lending practices. Real estate industry proposals regarding the GSEs make it clear that the industry wants the GSEs to move further out the risk curve and to make a variety of loans that the GSEs – for good reason -- are not currently making. To do so would be a recipe for a future taxpayer bail-out.

E. A Federal Guaranty Necessarily Will Be Under-Priced

Proponents of a federal guaranty say that government will be able to charge a fee for its guaranty, sized to cover the risk to taxpayers. This is clearly wrong, for two different reasons.

The first is the economics of the future GSEs. Each such new GSE will have to raise private capital, based on the likely profitability of issuing the federal guaranties.[12] Unless the guaranty is priced significantly below its value to the future GSEs, the future GSEs likely will not be able to raise capital (in the absence of the ability to profit significantly from a federal guaranty, potential investors would have no reason to invest in the future GSE and logically would prefer to invest in an existing multifamily mortgage lender instead). So the guaranty, as a matter of economic necessity, will have to be significantly under-priced relative to its market value.

The second is the way U.S. politics works. The federal flood insurance program guaranty is under-priced. The federal pension guaranty is under-priced. The federal savings and loan guaranty is under-priced. Fannie and Freddie, in their heyday, were politically invulnerable. Developers and realtors are politically powerful. Those forces will necessarily result in the guaranty being under-priced, resulting in mis-allocation of capital and risks to taxpayers.

F. A Federal Guaranty Will Have An Elastic Waistband

Suppose that there is a new federal guaranty for multifamily debt, and that new GSEs are created to issue the guaranty. Those GSEs will compete with each other. Some of that competition will be competition on price, which is good for the economy (provided that it does not interfere with the solvency of the GSEs). But some of that competition will be competition on risk, which is bad for taxpayers. This pressure for the GSEs to compete on risk will raise risk to taxpayers, and this increase in risk will either be completely invisible or mostly invisible.

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[12] The value of the guaranty to a future GSE lies in the relationship between what the GSE has to pay for the guaranty, and the increment in price that a guaranteed loan will command, over and above the price of that same loan absent the guaranty. Where the future GSE has a choice between the federal guaranty and a private guaranty, a similar comparison can be made: is the federal guaranty (taking into account its price and the increment of value it adds) a better deal than the private guaranty (taking into account its price and the increment of value it adds)? From this it can readily be seen that unless the federal guaranty is priced well below its value, it will not be profitable to a future GSE.

Moreover, Congress and the executive branch will be in a good position to pressure the future GSEs to create 'pilot programs' that are 'innovative', that 'promote affordability', and that promote 'better access to credit'. These are all euphemisms for 'riskier loans', which means increased risk to taxpayers. The guaranty – designed for a different, lower-risk pool of loans – will thereby be extended to higher-risk loans for which it was not designed.

G. **Note: There is <u>No</u> Connection Between Multifamily Interest Rates and Rents**

Proponents of a federal guaranty sometimes suggest, or even claim outright, that lower multifamily interest rate benefit tenants (and thus, implicitly, it is OK to subsidize multifamily interest rates). This is an irresponsible claim, and policy makers should ignore it.

In general, decades of experience with subsidized multifamily programs clearly teaches that – in the absence of heavy-handed regulation -- there is no reason to expect that a benefit to the business that owns the apartments will result in any benefit to the tenants.

More specifically, apartment rents are determined by local supply and demand pressures. If there is a surplus of apartments in the market, rents will be low, whether the multifamily interest rate is 6% or 8%. If there is a shortage of apartments in the market, rents will be higher, whether the multifamily interest rate is 6% or 8%.

However, there is a grain of truth underlying the largely spurious claim that interest rates affect rents. In those markets that are growing, where there is a shortage of apartments, the multifamily interest rate is one factor (among many) that developers take into account when deciding whether the rents on a potential new apartment property are likely to be high enough to justify the cost and risk of developing the property. To that very limited extent, lower multifamily interest rates would help motivate developers to build. Once developers <u>did</u> build, however, again local market forces would determine the rents that they could charge (and without regard to multifamily interest rates). To the extent developers build, there will be more apartments, which will tend to result in lower rents than if they had not built. So, at the top end of the apartment market, in a relatively few neighborhoods, within not all cities, the multifamily interest rate might have a small effect on rents. But in the other 99% of situations – including 100% of <u>affordable</u> apartment situations – multifamily interest rates have no bearing on rents whatsoever.

5. Why It Is Important to Distinguish Prime Multifamily Loans from Below-Prime Multifamily Loans

A. **What Did We Learn from the Recent Finance Crisis?**

- *Investors in mortgage backed securities (MBS) pay attention to ratings and to guarantees but do not pay attention to collateral.*

There is no reason to think that investors will behave differently in the future. Rating agency reform is needed, so that below-prime multifamily loans cannot result in prime-level ratings (which happened routinely in the mid-2000s).

- *Rating agencies and guarantors understand real estate risks, but only for relatively sound projects and only for traditional mortgage loan types.*

  One clear conclusion from the recent crisis is that almost everyone under-estimated the risks inherent in creative mortgage products, in lending against marginal properties, or in lending to marginal borrowers. In the multifamily sphere, prime lending is relatively safe, and everything else is a specialty product that requires extraordinary expertise and involves well-above-prime risk even in the best of circumstances.

  There is no reason to think that rating agencies and guarantors will be better able to assess risk in below-prime multifamily loans, in the future.

- *Below-prime multifamily loans performed very badly under moderate stress.*

  We now have considerable information on the poor performance of below-prime multifamily loans placed into private market securitizations in the early to mid 2000s via Commercial Mortgage Backed Securities (CMBS). Multifamily mortgages -- with their steady cash flow and monthly mark to market -- are considered a major asset by Wall Street for inclusion in a multi-asset securitization. Other types of commercial real estate tend to have intermittent cash flows due to their multi-year lease terms and the long gestation periods for new leases.

  The Wall Street conduits chased multifamily loans without regard to good underwriting practices, simply for rating advantages unwisely conferred by the rating agencies. Disaster was quickly forthcoming as these below-prime multifamily loans are performing very poorly. It should also be remembered that the mid 2000s presented only mild stresses in the multifamily sphere; had the very difficult market conditions that prevailed in the late 1980s and early 1990s been repeated in the mid 2000s, performance of these speculative loans would have been much worse.

  The overriding lesson is this: the private market lost its discipline and did not have a clear definition of quality loans and quality lending processes.

  If below-prime multifamily loans continue to be allowed to be securitized and sold to retail investors, there is no reason to believe that the private market will be more disciplined in the future.

  Similarly, there is no reason to think that below-prime multifamily loans will perform better in the future.

B. What Does the GSEs' Recent Success in Multifamily Teach Us?

One of the few bright lessons from the Fannie Mae and Freddie Mac debacle is how to make sound multifamily loans.

Because of a history of failure in multifamily finance -- in the savings and loan institutional setting, in early failures in Fannie and Freddie multifamily lending, and in prior poor FHA experiences -- both Fannie and Freddie had to redesign their multifamily lending in the early to mid 1990s. Freddie withdrew from multifamily finance in the late 80s and early 90s. Fannie Mae reinvented its lending in the same era.

Thus, the continued good performance of GSE multifamily loans over the intervening twenty year period has established a benchmark for defining high quality multifamily mortgage loans that are suitable for securitization. Key features of both GSEs' multifamily origination processes are:

- Conservative underwriting standards
- Rigorous third party reports procured by the lender
- Strong approval processes
- Strong and standardized documentation

It should be noted that one reason for the strong performance of the GSE multifamily portfolios over the past twenty years is that, by and large, government regulators did not intervene (as they did with the GSEs' single family businesses) to drive down underwriting standards. It would be folly to expect the same in the next twenty years.

C. **Proposed Guiding Principles**

We believe that the following are sound guiding principles for future securitized (and non-securitized) lending in the multifamily arena.

i. **High quality multifamily mortgages are good investments.** High quality will be achieved by building off of the proven GSE programs to create mortgage standards known to perform well under normal conditions as well as under stress conditions.

ii. **Define a 'prime tier one multifamily mortgage loan', with a capital requirement reflecting its investment quality.** See Section 6.A for our proposal for characteristics of a prime tier one multifamily mortgage loan.

iii. **Define a 'prime tier two multifamily loan', with a capital requirement reflecting its investment quality, to accommodate the diversity of the multifamily housing stock.** Loans that fail a 'tier one' criterion, but that have compensating strengths, can qualify for a tier two (and still prime) status. See Section 6.B for an illustration of how a 'tier two prime multifamily loan' could be defined, consistent with prudence and safety.

iv. **Other multifamily loans are high risk loans that should be made only by private lenders, with their own capital at risk, or with on-budget government subsidies (such as through FHA).** These high risk loans would include construction loans, loans to properties during lease-up, loans to properties encumbered by governmental subsidy programs, and loans in areas that do not meet a 'stable market area' criterion. Also see Section 5.D below for an expanded discussion of the proper use of on-budget government subsidies for higher-risk multifamily lending.

v. **Governmental lenders should be restricted by statute to high risk loans.** The converse of the preceding principle is that governmental lenders, such as FHA, should not be allowed to make prime loans.

vi. **Provide for capital requirements that recognize the safety of prime multifamily mortgage loans.** As discussed in Section 6.C, we believe that the appropriate capital requirement for a prime multifamily loan should be one-fifth of the capital requirement for a below-prime multifamily loan.

D. **If for social policy reasons, Congress wants to subsidize certain multifamily loans through FHA or other government programs, these subsidies should be on budget, structured to limit risks to taxpayers, and structured so that results and risks are transparent to taxpayers.**

If Congress should decide to subsidize some of the riskier loan types noted above, Congress should implement those subsidies through FHA, with explicit credit subsidies, rather than through the present or any future GSEs.

We believe that FHA's current multifamily credit subsidy approach is an example of how to structure programs so that risks to taxpayers are explicit and transparent. Under the supervision of OMB, FHA evaluates the risks associated with each form of FHA multifamily mortgage insurance and determines a program-specific credit subsidy rate for each. If (on a net present value basis) the mortgage insurance premiums paid by the borrower exceed the government's cost for assuming the default risk on the loan (also on a net present value basis), taxpayers profit; if the NPV of the mortgage insurance premium stream is less than the NPV cost of the government's guaranty, taxpayers assume a risk that is fairly measured by the gap (and Congress must fund that gap in order for FHA to guaranty the corresponding loans).

However, in general, existing multifamily subsidy programs other than FHA mortgage insurance (for example, the various project based Section 8 programs) present significant risks to taxpayers, are not transparent, and do not include adequate risk controls.[13] For example, experience with these programs confirms that additional subsidy is often required in the short run and is almost always required in the long run. Similarly, even in the worst situations, it is difficult for government to extract itself from properties that are failing. See Section 9 for general principles for reforming these programs.

[13] Examples of the problems with existing subsidy programs include the following. Because it is politically difficult to allow the affordability of a property to cease, no matter how old and tired it is, every decision to fund a new property in effect also incurs a hidden future obligation to re-subsidize the property for a long period of time. No one even attempts to estimate these future costs of preservation. Most newly developed properties are financially structured (with too much private debt and reserves that are too small) so that when it is time to re-preserve the property, the government's costs to do so will be higher than necessary. Typical properties receive a variety of subsidies, from a variety of subsidy providers, but "subsidy layering" reviews (designed to measure the total amount that taxpayers have invested and to assure the reasonableness of that investment) are not universally required and, even when required, are largely ineffective.

E. **Ginnie Mae should continue.**

Ginnie Mae provides a federal guaranty that supplements FHA multifamily mortgage insurance. Basically, in the event of a default, FHA pays the lender 99 cents on the dollar, and Ginnie Mae pays the remaining amount. The cost of the Ginnie Mae guaranty is fully covered by the fee that Ginnie Mae charges. This is a sound approach that should continue.

F. **FHA should continue to provide multifamily mortgage insurance, but with changes to focus FHA's role so that FHA does not compete for prime multifamily mortgage loans.** [14]

We believe that FHA's Section 221(d) product, which provides mortgage insurance for combined construction – permanent loans, should continue. Construction financing is below-prime, by definition, so this product does not compete in the prime segment.

FHA has a Section 223(a)(7) product, which basically allows an interest rate reduction on an existing FHA-insured multifamily loan. We believe this product should continue, because it is an asset management tool that reduces risk for both the borrower and the taxpayers.

However, FHA's Section 223(f) product, which provides refinancing loans in other situations, often competes in the prime and near-prime segments and should be reformed to limit FHA to below-prime loans. Specifically, we believe that FHA should provide Section 223(f) loans only in areas that fail the 'stable market area' test for prime loan status. These would be areas with small population, areas with declining population, and areas with high overall rental vacancy rates.[15]

6. Proposed Definitions for Prime Multifamily Mortgage Loans

A. **Proposed Definition of 'Prime Tier One Multifamily Mortgage Loan'**

Our proposed definition of 'prime tier one multifamily mortgage loan' is based on the recent successful GSE multifamily lending programs. The table below shows the key characteristics of multifamily loans, and the standards we propose for 'prime tier one' status.

A note regarding 'stable market area'. In the table that follows, we propose that one criterion for a prime tier one multifamily mortgage loan should be a 'stable market area'. This recognizes that the lender's level of risk is strongly influenced by market-wide factors. We believe that the following market-wide factors should be taken into account when determining whether a market area is acceptable for prime multifamily loans:

(1) The overall size of the market (i.e., total population). All else equal, the lender's risk is lower if the market population is large. This is commonly recognized in the

[14] This paper does not address FHA's health care mortgage insurance programs that facilitate lending to nursing homes and hospitals. These programs are managed through HUD's Office of Multifamily Housing but are not "multifamily" programs as we use that term in this paper.

[15] We do not suggest that FHA should make loans in these areas carelessly. Indeed, loans in these areas will require higher rent loss assumptions, shorter amortization, and/or greater debt service coverage ratios than similar loans in stable market areas.

industry through the industry-wide designation of 'primary markets' with lowest risk, 'secondary markets' with moderate risk, and 'tertiary markets' with higher risk. We do not propose any particular standard for the market population level that is consistent with a 'stable market area'.

(2) The historical trend for population growth in the market. All else equal, the lender's risk is lower in markets with consistent positive population growth. Similarly, the lender's risk escalates significantly in markets with declining population. We do not propose any particular standard for the rate of population change that is consistent with a 'stable market area'.

(3) The market-wide rental vacancy rate. All else equal, the lender's risk is lower where market vacancy rates are also low. Where the market vacancy rate is high, the lender's risk escalates significantly. We do not propose any particular standard for the market-wide rental vacancy rate that is consistent with a 'stable market area'.

(4) Volatility. There is risk in apartment loans in rapidly-growing markets. Recent experience in Phoenix and Las Vegas is one example; the devastating experience in Houston in 1989-1991 is another. We do not propose any particular standard, but we note that it could be a prudent counter-cyclical policy to require increased DSCR and decreased LTV when recent population growth has been very high.

We acknowledge that barriers to entry are a factor. Examples of barriers include lack of buildable land (e.g. Boston and San Francisco) and growth boundaries (e.g. Portland Oregon). Conversely, some cities have little or no barriers to entry; examples include Houston, Phoenix and Las Vegas. In general, we think that barriers act to make otherwise 'prime' areas more attractive for lenders, and that a lack of barriers act to make otherwise 'prime' areas less attractive for lenders.

We recognize that the optimal approach may be to consider all four factors together, in combination. We also recognize that the optimal approach may involve three levels: 'stable market areas' that qualify multifamily loans for prime tier one status, a second category of market areas that can qualify for prime tier two status with offsetting strengths in other key loan characteristics (e.g., higher DSCR / lower LTV), and a third category of market areas in which multifamily loans would be below-prime by definition.

A note regarding requirements for owner experience and liquidity. To be considered 'prime', a loan needs not only a sound property as collateral, a sound underwriting process, and key business terms consistent with low risk, but also a sound borrower. In the table that follows, we list borrower experience as a key factor. We also list borrower liquidity. We believe there are two relevant aspects to liquidity. The first is a 'balance sheet' measurement of liquid and near-liquid assets. The second is a 'P&L' measurement of the cash flow potential of the borrower's real estate portfolio. Both are important, and we intend that the eventual standard would take both factors into account. In the table that follows, we recommend standards that mirror recent GSE practice.

Proposed Definition of 'Prime Tier One Multifamily Mortgage Loan'

Multifamily Loan Characteristic	Requirement for Tier One Prime Status
1. **Project Size**	50 units or more
2. **Seasoning**	At least 12 months have elapsed since achievement of at least 93% physical and economic occupancy. An average 93% physical and economic occupancy has been maintained, on average, during the most recent 12 months.
3. **Minimum Debt Service Coverage**	1.20:1 DSCR
4. **Maximum Loan to Value**	75% at 1.20 DSCR or 80% at 1.25 DSCR
5. **Underwriting of Rents**	Current lease rates, with no adjustment for the time period between underwriting and closing
6. **Unit Features**	At least one full bath. Full kitchen.
7. **Maximum Amortization Term**	25 years.
8. **Balloon Payments**	If the maturity is shorter than the amortization period, the loan must meet reasonable stress tests, consistent with current GSE practice, for refinancing at the end of the maturity term.
9. **Interest Rate**	Fixed. Floating rate loans are allowable but will be underwritten at the contractual maximum interest rate.
10. **Secondary Financing**	Not allowed. An exception would be available for secondary loans with debt service that is limited to available cash flow, and whose lender executed a standard subordination agreement.
11. **Documentation**	Standard state of the art documents (loan agreement, note, mortgage, …). We propose the current Fannie Mae documents as the initial standard.
12. **Process**	Rigorous underwriting and verification process, including periodic audits of originating lenders.
13. **Evaluation of Capital Needs**	Third party physical needs assessment commissioned by the lender, establishing required initial improvements, and establishing the level of reserve deposits needed so that anticipated capital needs, for the entire maturity term, can be funded solely from the reserve.
14. **Market Area**	Meeting a 'stable market area' definition as demonstrated in the appraisal.
15. **Owner Liquidity**	Appropriate standards mirroring current GSE practice.
16. **Owner Experience**	Appropriate standards mirroring current GSE practice.
17. **Occupancy**	General Occupancy only (no age restrictions, no income restrictions).
18. **Office / Retail Component**	Not allowed, except for management office.

B. **Proposed Definition of 'Prime Tier Two Multifamily Mortgage Loan'**

A loan could fail one of the tier one loan characteristics noted below as not being required for tier two status, provided that the loan also had the required offsetting strengths.

See the table below for our proposal for defining tier two prime status.

Tier One Multifamily Loan Characteristic	Required for Tier Two?	Offsetting Strength
1. Project Size (50+)	30-49 OK for Tier Two	Higher DSCR / Lower LTV
2. Seasoning (12 mos+)	Yes	
3. Minimum DSCR (1.20+)	Yes	
4. Maximum LTV (80%)	Yes	
5. Underwriting of Rents	Yes	
6. Unit Features	Yes	
7. Max Amortization (25)	Up to 30 OK for Tier Two	Higher DSCR / Lower LTV
8. Balloon Payments	Yes	
9. Interest Rate	Yes	
10. Secondary Financing	Yes	
11. Documentation	Yes	
12. Evaluation of Capital Needs	Yes	
13. Market Area	Yes (but see below)	
14. Owner Liquidity	Yes	
15. Owner Experience	Yes	
16. Occupancy	LIHTC Allowed for Tier Two	Maximum 20 year amortization[16], rents must be at least 10% below market[17]
17. Occupancy	55+ Allowed for Tier Two	Higher DSCR / Lower LTV
18. Office / Retail	Up to 10% for Tier Two	Underwrite only 50% of gross possible commercial rent

[16] The most socially valuable LIHTC projects (i.e., those serving the lowest income tenants) typically have no private debt, and typical LIHTC projects have private debt of $25,000 per unit or less. At 6% / 20 years, the monthly payment on a $25,000 loan is $179. At 6% / 30 years, the payment is $150. In other words, there is no reason to believe that 30 year amortization is essential for LIHTC projects, rather than the 20 year amortization that is prudent, given the very aggressive way that typical LIHTC projects are underwritten and given the statutory 30 year extended affordability period.

[17] A LIHTC property whose estimated rents are close to market is an especially risky proposition for a lender. When underwriting rents, a lender will seek to balance downside risk (the risk that actual rents will be lower) with upside potential (the potential that actual rents will be higher), but in a LIHTC project the upside potential is capped by the LIHTC rent restriction. Another risk factor is that a LIHTC property cannot be expected to command the same rents as it would command in the absence of regulation, because knowledgeable tenants would not willingly pay the same rent while being subjected to LIHTC requirements such as the requirement to disclose and verify income and assets annually. We also point out that the public policy benefit of such a property is minimal, compared to an otherwise similar property with rents well below market.

As discussed above, we believe that it may be possible to define a secondary type of market area that does not meet the 'stable market area' criterion for tier one status but that is sufficiently close to 'stable' that tier two status could be achieved with offsetting strengths such as higher DSCR / lower LTV.

C. **Relative Capital Requirements for Prime and Below Prime Loans**

As discussed earlier in this paper, the current bank capital requirement of 8.0% is far too high for prime multifamily loans. Below, we provide thoughts on how capital requirements might be tiered, to reflect risk differences between prime tier one, prime tier two, and below-prime multifamily loans.

Our over-arching point is this: prime multifamily loans are dramatically less risky than below-prime multifamily loans. Accordingly, capital requirements should not be 'one size fits all'.

For prime multifamily loans, the recent track record of the GSEs is instructive. From the start of their current multifamily programs through the mid-2000s, serious delinquency was well under one-half percent. Recently, serious delinquency approached one percent. Because much serious delinquency is cured by the borrower short of foreclosure, the frequency of actual loss to the lender will always be somewhat less than the serious delinquency rate. All of this suggests a loss frequency well below one percent, over the last 15-20 years. However, the last twenty years have been relatively favorable for multifamily, and allowances need to be made for more difficult market conditions such as those that prevailed in the late 1980s and early 1990s. Say, then, that the likely loss formula for a prime tier one multifamily mortgage loan assumes a loss frequency of 2.0% (a frequency twice as high, or more, than the frequency indicated by actual GSE experience in the last twenty years). Combined with the industry rule of thumb of 50% as an average loss severity, this indicates a likely loss of 1.0% (100 basis points) for what we call 'prime tier one multifamily mortgage loans'.

For what we call 'prime tier two multifamily loans', each departure from tier one criteria must be offset by higher DSCR / lower LTV or some similar strengthening of another key loan feature. Logically, tier two loans should perform nearly as well as tier one loans. Say, however, that in the interest of prudence we assume that tier two loans are twice as risky as tier one loans, with a likely loss rate of two hundred basis points.

For the remaining loans (loans to very small properties, loans in shaky markets, loans to properties under construction or under lease-up, …),we need to look at the relative serious delinquency rates for GSE multifamily loans (generally matching our prime tier one criteria) and for Wall Street conduit multifamily loans (generally representing below-prime loans).[18] It seems fair to say that, in the early to mid 2000s, the serious delinquency rate for below-prime multifamily was at least five times as high as for prime multifamily. This implies a likely loss rate in the range of 500 basis points or more.

Accordingly, we believe that the relative risks of prime tier one, prime tier two, and below-prime multifamily loans are very different. This implies that the relative capital requirements for these three types of loans also should be very different.

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[18] See, for example, the Mortgage Bankers Association February 2010 update, presented at the MBA meeting in Las Vegas.

One illustration of this is the recent experience with below-prime loans originated by the Wall Street conduits during the speculative lending boom of the mid-2000s. Conduit multifamily loans have been experiencing serious delinquency rates in the 8% to 12% range, whereas GSE multifamily loans have been experiencing serious delinquency rates below 1%.

Translating the likely loss into a capital requirement requires taking into consideration how losses would actually be funded. In an ideal system, where cash is set aside at the time a loan is made, and left in the reserve account (invested safely) until the loan is repaid, the likely loss <u>would be</u> the capital requirement. However, in the United States banking and tax systems, losses are actually funded by banks in the year when the losses occur, largely by borrowing. Accordingly, bank capital requirements must be somewhat higher than the likely loss rate, because at the time a loss occurs, it is the financial strength of the bank -- rather than a funded reserve account -- that matters.

This paper will not address the question of how much higher a bank capital requirement needs to be, over and above the loss rate. That said, the capital requirement does not need to be <u>eight times</u> the loss rate.

We leave it to banking regulators and other relevant experts, to translate these large differences in risk into appropriate differences in capital requirements.

In summary, we believe that appropriately differentiated capital requirements would more accurately reflect the relative risks in prime and below-prime multifamily loans, would provide appropriate signals to retail investors (with respect to multifamily loans that are securitized), and would allow a wide array of private competitors to serve the multifamily lending market.

D. Potential for Counter-Cyclical Adjustments

Using this approach, it would also be possible to track, over time, the relative market shares of prime tier one, prime tier two and below-prime multifamily mortgage loans. Such tracking could be quite useful in gauging whether the multifamily lending market is over-heating (a high percentage of below-prime loans would be a strong warning signal).

For example, if in the preceding year the share of below-prime multifamily loans rose above the long-term average, the capital requirement for below-prime multifamily loans could be automatically increased above the normal level. This type of automatic increase would be an effective counter-cyclical force that would help to avoid the speculative excesses that tend to occur at the top of market cycles (such as we experienced in the mid 2000s).

7. Winding Down GSE Multifamily Origination Activities

We suggest the following as a conceptual framework for providing GSE support to the multifamily debt markets while the new fully private market is evolving.

The length of the wind-down period needs to take into account two major factors. One is the volume of existing multifamily mortgage loans that will need to be refinanced. The other is the pace at which private lenders can expand their multifamily origination activities (this, in turn, is likely to depend on the pace at which rating agencies and private guaranty firms can build the capacity to accurately assess risk in multifamily mortgage loans). We believe that five years is a reasonable wind-down period, taking into account those factors, and accordingly the framework below specifies a five year period.

- *Glide path:* eliminate GSE multifamily lending authority after five years.

- *Alternative approaches:* following are four different approaches, each of which would create a viable glide path, and of which the first approach is our preference:
    - *Origination volume:* limit new GSE multifamily loans to $50 billion principal amount in the aggregate (both GSEs combined) in the first year, declining by $10 billion each year thereafter ($10 billion shared between the two GSEs in the fifth year).
    - *Pricing:* in the first year, the borrower will pay to the Treasury a 50 basis point origination fee. The origination fee will rise by 50 basis points each year thereafter, ending at 250 basis points.
    - *Loan to value:* limit new GSE multifamily loan amounts to 75% LTV in the first year, decreasing by 5% each year for the next four years (55% maximum LTV in the fifth year).
    - *Debt service coverage:* require new GSE multifamily loans to be underwritten to produce debt service coverage ratios of at least 1.25:1 in the first year, increasing by .05 each year for the next four years (1.45:1 minimum DSCR in the fifth year).

- *No subordinate debt:* New GSE multifamily loans would include a prohibition on subordinate secured debt. It is clear from the recent single family and multifamily experience that the level of the owner's cash equity is a significant predictor of risk.

- *Prime loans only.* New GSE originations would be limited to prime tier one and prime tier two loans. No boutique programs, demonstration programs, or other forays into the below-prime space would be allowed.

8. Winding Down the GSE Multifamily Portfolios

A. **Existing loans held in portfolio generally have remaining terms of ten years or less and can either be held to maturity or possibly sold.**

Background: the GSEs retained a large portion of their multifamily loans, not because the loans could not be sold, but in order to profit from the spread between loan rates and the GSEs' lower costs of short term borrowing. This practice was counter to the public interest,

should not have been permitted, and should be stopped. However, because of existing loan servicing and risk / cash flow sharing arrangements, selling these loans is likely to be inferior to holding them and allowing the portfolio to run off through maturity (most loans had original maturity dates of 12 years or less).

Glide path: allow existing loans held in portfolio to run off in the normal course of business.

Potential asset management mechanisms for overseeing the run-off of the existing GSE multifamily portfolios:

- Leave the existing GSE multifamily portfolios under GSE management at least through the five year period we recommend for winding down GSE multifamily origination authority.
- Transfer the GSE multifamily portfolios to the Treasury to be held to maturity. Set the transfer price at a level that provides adequate cushion for potential losses.

Potential asset management mechanisms for liquidating the existing GSE multifamily portfolios:[19]

- Require the GSEs to liquidate their multifamily portfolios in equal installments over a five year period. The most seasoned loans would be sold first. Loans would be sold without guaranties of any sort, and subject to existing servicing rights and existing arrangements for the sharing of risks and cash flows with the originating lenders. This approach will mark to market the credit risk that the taxpayers are now taking. As the loans season, investors can judge their risk, which will be modest for most GSE multifamily loans. In competitive sales, prices will reflect the level of risk.
- Same as the preceding mechanism, except that responsibility for liquidating the portfolio would be given to a receiver.

B. **Do not allow GSEs to retain any new multifamily securities or loans in portfolio; all new mortgages purchased must be securitized and sold.**

9. Dealing With Existing Government Assisted Properties

The discussion below addresses the remaining segments of the existing multifamily subsidy system:

- Active production programs, the most significant of which are the Low Income Housing Tax Credit (LIHTC), the Home Investment Partnerships (HOME) program, and the Community Development Block Grant (CDBG) program. Other examples include HUD's Section 202 and 811 programs (for development of nonprofit-owned properties for the elderly and for special needs populations).

- The wide array of subsidies remaining from past production programs, the most significant of which are:

[19] As noted above, we believe that existing risk-sharing and servicing arrangements make sale of existing GSE-held loans problematic. If, however, Congress were to decide that liquidation of the GSE multifamily portfolios is necessary, we believe that the approaches we suggest should be considered.

- (From HUD) public housing, the various project-based Section 8 programs, existing Section 202/811 projects, and the early below-market-interest-rate mortgage programs (Section 221d3 BMIR, Section 236).
    - (From the Department of Agriculture) the Section 515 mortgage interest credit program and Section 521 rental assistance program.
    - Existing projects with LIHTCs.

- The existing Section 8 Housing Choice Voucher program, which is "tenant based" (the subsidy remains with the family when it moves out) rather than "project based" (the subsidy remains with the unit when the family moves out).

The existing mix of subsidy programs is extensive, each program is complex, and each program serves some participating properties well and others less well. Accordingly, resolution of the existing programs should be guided by general principles but with discretion for tailoring approaches for different types of properties and different types of markets.

A. The Preservation Decision

Existing government-assisted properties currently operate under a long term (though not perpetual) subsidy and finance structure that is designed to support affordability to tenants and to support the physical / financial viability of the property. Typically, this subsidy and finance structure has a term of 15 to 30 years. During that term, government should honor its agreements, and owners (so long as they honor their agreements) should be entitled to whatever financial benefits flow from the existing structure.

However, typically there comes a time when the existing structure no longer supports the property's viability. Similarly, there comes a time when the property's obligation to maintain affordability ceases, and someone (either the existing owner or a purchaser) wishes to extend affordability, which usually requires additional governmental subsidy.

We use the term "preservation decision" to refer to the process by which owners, purchasers, and government decide whether to extend affordability, for how long, and at what cost, whenever an existing assisted property is failing, and whenever its affordability period is coming to an end.

B. Making the Preservation Decision: Overview

In general, whenever an existing assisted property can be viable at local neighborhood market rents, we believe that property should be preserved and deregulated. See Section 9.C below.

In general, whenever an existing assisted property <u>cannot</u> be made viable at local neighborhood market rents, we believe it should not be preserved as assisted housing. See Section 9.D below. This discussion also presents a range of strategies for restructuring the finances and subsidies of existing properties, so that they <u>can</u> be made viable at local neighborhood market rents on a going-forward basis.

In Section 9.D we also provide a conceptual structure for making the preservation decision for these properties, and guiding principles for financially restructuring these properties so that subsidies above local neighborhood market rents are kept as small as possible.

Generally, we believe that the reformed subsidy programs should be converted to block grants and administered by the states. See Section 9.E.

C. **Generally, existing subsidized properties that can be made viable at local neighborhood market rents should be preserved and deregulated.**

Following are general principles for simultaneously improving outcomes for tenants, improving viability for properties, improving transparency, and decreasing risks to taxpayers, in properties that have a viable option to operate successfully at local neighborhood market rents.

1. *Subsidies should be transitioned to tenant-based rather than project-based assistance.*

   This will improve mobility options for tenants. Because the properties are viable at local neighborhood market rents, conversion to tenant-based assistance will not impact the financial viability of the properties.

2. *Over time, governmental rent regulation should be eliminated for these properties.*

   Long-term data from subsidized properties developed in the 1970s and 1980s suggests that it is unrealistic to expect very many properties to be viable long-term at below-market rents (this is so largely because apparent savings in the early years evaporate once it is necessary to recapitalize the property as it ages). [20]

   Said differently, the period during which rents can reliably be held below local market levels is limited and, we believe, is no more than 20 years.[21]

[20] For example, one of the authors analyzed 249 properties that were preserved during federal FY 2009 and 2010, to see if rents could have been as much as 10% below local neighborhood market rents without new subsidies. The analysis showed that less than 20% of the properties could have achieved rents 10% or more below local neighborhood market rents without new subsidies (basically, in the form of capital for renovations that does not have to be repaid from rental income). The lesson is that affordability is not inherent but has to be purchased – by government – and repurchased – by government -- periodically. In concept, we believe that if government makes an investment sufficient to maintain affordability for 20 years, the governmental restriction on rents should also last no more than 20 years.

[21] The duration of affordability is fundamentally tied to the natural life cycle of expensive long-lived building systems. HVAC systems and refrigerators tend to need replacement every 15 years, roofs tend to need replacement every 15-20 years, parking lots tend to need resurfacing every 15-20 years, siding tends to need replacement every 20-30 years, windows tend to need replacement every 20-30 years. When these systems need replacing, typical properties need significant new capital. If that capital is provided at market rates of return, affordability will not persist. If that capital is provided in the form of a government grant, affordability can persist, until the next time that significant capital is again required.

Also it is clear that governmental regulation of rents imposes high costs on government for monitoring, on owners for compliance, and on properties for which the regulated rent is inadequate to support long-term viability.

Given that benefits of rent regulation are limited and costs of rent regulation are high, on balance it is better not to attempt to regulate rents beyond the first 15-20 years after a property receives public funding for construction or rehabilitation.

However, if at the time a property is converted to this deregulated structure, if it appears that deregulation would confer a windfall on the owner, government should eliminate most of this windfall in some way. Likely the best approach will be for government to take back a second mortgage to be repaid from the estimated excess rental income.

3. *Long term use agreement.*

Despite our conviction that there is no benefit and little point in regulating rents long term, we do believe that a long term use agreement (not regulating <u>rents</u> but regulating <u>use</u>) should remain. This use agreement should be structured to survive foreclosure and to survive other changes of ownership.

To prevent conversion to an alternative use, the agreement should require continued use as residential rental housing.

The use agreement should also obligate the owner not to discriminate on the basis of receipt of tenant-based rental assistance (at least not with respect to a number of units equal to the number units receiving project-based subsidy at the time of conversion).

D. **Generally, existing subsidized properties that <u>cannot</u> be made viable at local neighborhood market rents should either be made viable at those rent levels (and preserved and deregulated as discussed below) or should be allowed to fail.**

Following are general principles for resolving these properties.

1. *Generally do not preserve these properties.*

2. *For properties that are not to be preserved, convert existing rental assistance to tenant-based form, and support the property financially for a limited time such as six to twelve months to allow existing tenants to relocate.*

3. *Evaluation for preservation-worthiness.*

A significant weakness of current preservation efforts is the lack of a sound conceptual framework for deciding when to preserve and when not to preserve. Instead, we favor a more structured approach that explicitly takes into account at least the following factors:

a. The age of the buildings. We favor the retention of older properties only if they are viable or can be made viable relatively easily.

b. The level of prevailing market rents. We favor the removal of government assistance from housing located in the worst neighborhoods, unless that housing is viable at prevailing rents.

c. The overall level of rental vacancy in the area. We favor the removal of governmental assistance from markets that already have an adequate supply of rental housing units.

d. Whether the property can be made viable at local market rents, via forgoing repayment of existing debt held or guaranteed by government.

e. The incremental governmental cost to make the property long-term viable.

f. The willingness of the state and/or local governments to contribute toward preservation.

g. Whether the property can be restructured with tenant-based assistance and deregulated rents, by using any of the strategies discussed in subsections 4 and 5 below.

4. *When preserving any such properties, eliminate (or take all possible steps to minimize) the margin above market rents that is needed for long-term viability.*

This has at least the following implications:

a. Existing 'must pay' debt[22] should be eliminated.

b. No new 'must pay' debt may be obtained or created.

c. The willingness of the local government to offer a real estate tax reduction or abatement should be a material consideration in whether the property is preserved.

d. Any optional operating costs such as service coordination or service provision, no matter how desirable, should be eliminated unless they can be funded from non-rental-revenue sources.

5. *A preference for restructuring the property with tenant-based assistance and deregulated rents, while providing the needed increment above market rents in the form of an annual subsidy stream that is committed for a limited time such as ten years.*

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[22] We use the term 'must pay' to mean debt with required monthly payments that must be made without regard to the actual cash flow of the property. A synonym is 'hard' debt (as opposed to 'soft' debt that has payments that are deferred, that are dependent on cash flow, or both).

This principle allows owners time to attempt to make the property viable without ongoing subsidy and allows government the ability to make a time-limited commitment to preservation that can be re-evaluated.

6. *Long term use agreement.*

The same sort of long term use agreement discussed at the end of Section 8.B above should also be part of the preservation transaction for a property that is not viable at local neighborhood market rents.

E. **Generally, the reformed subsidy programs should be converted to block grants and administered by the states.**

With respect to any remaining tenant-based or project-based subsidy programs, states should be allowed to decide key policy parameters such as:

1. *Which potential tenant households are eligible.*
2. *Preferences for admission, if any.*
3. *Level of subsidy.*
4. *Time limits.*
5. *Who administers the subsidy.*

Conclusion

We have spent our careers working in the market rate and affordable segments of the multifamily industry. Today, the United States faces housing finance policy decisions more important than at any other time during our careers. Yet, we have been dismayed with the types of solutions being proposed by industry participants and housing advocates.

The solutions proposed by others are largely ‘more of the same, except with less discipline’. We offer the ideas in this paper in order to broaden the scope of the debate. In summary, ‘more of the same is the wrong idea, and we need more discipline not less’.

We believe that the solutions offered by others will result in losses to taxpayers when the next bottom-of-cycle period occurs. At that point, and possibly before, the industry will be left without a financing system, having become completely dependent on government at a time when government decides its involvement was a mistake. We also believe that an explicit federal guaranty will result in a reduction in the flexibility and innovation that Fannie Mae and Freddie Mac brought to our industry.

If, instead, the approaches we suggest are followed, we envision an apartment debt market in which the GSEs have been replaced by a robust, fully private CMBS industry. Multifamily loans that are ‘prime’ will be recognized as such and priced as such. Multifamily loans that are below-prime will also be recognized as such and priced as such. Many CMBS will be rated, with a rating assigned to each individual loan as well as to the various tranches of the CMBS. CMBS containing below-prime loans will not be eligible for sale to retail investors, assuring that below-prime risk is taken only by those best in a position to assess it. Many CMBS will be credit enhanced through some combination of risk retention by

the CMBS originator and private guaranties. Below-prime loans will be made by specialty originators, often requiring significant equity from the sponsor, which we think is as it should be. Many of these below-prime loans will also be securitized, but sold to sophisticated investors only. We also envision that local banks and other entities with local market expertise would become more significant players. The government will continue to have a presence in below-market multifamily lending through FHA. Taking everything into account, we think that the multifamily industry and taxpayers both will be better served by pursuing our approach.

We look forward to the debate.