

Government-Sponsored Enterprises and Multifamily Housing Finance: Refocusing on Core Functions

September 3, 2010

Commissioned by the National Housing Conference



Prepared by: Ethan Handelman
David A. Smith
Todd Trehubenko

Contents

- Foreword: Scope of this paper 3
- 1. Executive Summary..... 4
 - 1. A. Multifamily rental is essential and requires finance 4
 - 1. B. Multifamily financing functions require federal involvement 5
 - 1. C. Implications for federally-backed multifamily finance..... 6
- 2. Context: today's housing, GSEs, and multifamily 7
 - 2. A. The GSEs today: activity and tensions..... 7
 - 2. B. Multifamily rental is an essential asset class 8
 - 2. B. 1. Benefits of multifamily housing 9
 - 2. B. 2. The professionalization of multifamily..... 10
 - 2. B. 3. Professional permanent multifamily is an essential asset..... 10
 - 2. B. 4. Professional multifamily requires a robust finance system 10
 - 2. B. 5. Multifamily affordable housing..... 11
- 3. Core financial functions for multifamily finance 12
 - 3. A. General liquidity function..... 12
 - 3. B. Countercyclical liquidity function..... 12
 - 3. C. Federal guarantee is needed 13
 - 3. D. Liquidity requires scalability..... 13
- 4. Current and Past Roles of GSEs 14
 - 4. A. Current GSE multifamily financing models..... 14
 - 4. B. Past multifamily financing models..... 15
 - 4. C. GSE multifamily outperformed single-family and CMBS..... 15
 - 4. D. Underserved sections of the multifamily finance market..... 16
 - 4. D. 1. Long-term fixed rate multifamily mortgages 16
 - 4. D. 2. Credit enhancement for affordable and construction loans..... 17
 - 4. D. 3. Specialized affordable housing loans 18
 - 4. D. 4. Small multifamily mortgages 19
 - 4. E. Other possible product areas..... 20
 - 4. E. 1. LIHTC equity aggregation, liquidity, and securitization 20
 - 4. E. 2. Providing capital to state HFAs 21
 - 4. E. 3. Distinguishing financing from subsidy..... 21
- 5. Implications for GSE redesign 23
 - 5. A. Government guarantee 23
 - 5. B. Portfolio capacity 23
 - 5. C. Strong government regulation 24
 - 5. D. Broad market participation, including conventional 24
 - 5. E. Proven models to mitigate risk, with some innovation..... 25
 - 5. F. Limited, if any, private ownership 26
 - 5. G. More than one, but not many more 26
- 6. Conclusion: much will emerge in transition 26

Appendix 1: Background interviews

Foreword: Scope of this paper

The debate on the future of Fannie Mae and Freddie Mac (the “Government-Sponsored Enterprises” or “GSEs”) has focused principally on the role of these entities in financing single-family homeownership. However, the GSEs have also played a major role in financing multifamily housing, including and especially multifamily rental housing (defined here as rental apartments in buildings with five or more units). The GSEs' proper role in the multifamily market deserves evaluation in its own right, apart from any evaluation of the GSEs' activities in single-family housing. Though smaller in total volume than single-family lending, multifamily lending is essential to financing American housing and the health of our economy. Multifamily housing is financed independently from single-family housing, along quite different channels, with separate and unconnected origination, underwriting, approval, and securitization protocols.

At this point, it is unclear whether policy-makers will determine that the nation is better served by a large, combined entity with a unified federal regulatory structure and guarantee or instead by separate entities focused on single-family and multifamily lending. In either event, it is essential that policymakers respond specifically to the needs of the multifamily housing sector. Multifamily should be prepared to work with and around whatever structures are developed for single-family, as long as they are compatible with the basic functions described here. When the nation resolves the GSEs' future, however, it should be informed by the unique economic circumstances, value proposition, and societal benefits of multifamily housing finance.

To advance, frame, and clarify the issues involved in financing multifamily housing, the National Housing Conference engaged Recap Real Estate Advisors (“Recap”) to prepare this concept paper with the goal not to prescribe but to describe and explore. Starting from first principles, the paper lays out the relevance of multifamily housing in America today, identifies value-chain activities and asset clusters needing capital, and describes the GSEs' current roles in those spaces. It then identifies the core functions that effective multifamily finance requires and reasons from those to necessary roles that any future housing finance system must play. This paper is therefore decidedly not a formal policy proposal, but rather a set of principles and an encouragement to sharper discussion and a better resolution.

The paper is based in the authors' experience—Recap is an active consultancy exclusively focused on multifamily and providing financial transactions, asset management, advisory services and physical condition/ capital planning. It is further informed by interviews with nineteen of the nation's thought and market leaders in multifamily housing finance (for details, see Appendix 1). Sources had the option to speak on or off the record as they chose. The final paper reflects input from NHC's Multifamily Housing Working Group and staff of NHC and its research affiliate, the Center for Housing Policy; their many helpful comments were incorporated where appropriate.

NHC and Recap are pleased to make this paper available to help inform the ongoing policy debate on the future of the nation's housing finance system.

1. Executive Summary

Multifamily rental housing is an essential asset class, serving more than 15 million American households, that depends on a robust and continuously functioning housing-finance market providing general liquidity, countercyclical liquidity, and rapid scalability. In considering how multifamily finance should be supported in the future, it is important to understand that Fannie Mae and Freddie Mac's multifamily business has performed much better than that of other players in the multifamily market and the single-family mortgage market more generally. As of 2009, the GSEs' current multifamily mortgage and Mortgage Backed Securities (MBS) portfolios had distress rates of less than 1%, compared to roughly 7% for Commercial Mortgage Backed Securities (CMBS) and roughly 11% for the single-family market as a whole.¹

In restructuring the federal role in housing finance, we should not unduly disrupt the availability of capital for multifamily housing. Fannie Mae and Freddie Mac's multifamily operations have generated liquidity without compromising lending quality, ensuring the availability of long-term fixed-rate financing, which in turn helped to reduce risk and thus costs. They also helped to support the development of housing for low- and moderate-income households and brought capital to rural and other underserved markets. More than 60% of the annual multifamily lending by Fannie Mae and Freddie Mac over the past five years has financed housing for households earning less than 80% of the area median income.² Whether or not the GSEs continue in their present form, their core functions in the multifamily market need to be filled.

Explicit federal backing is a practical necessity to ensure adequate liquidity and the continued availability of long-term financing for multifamily housing, but it should be carefully deployed and strongly regulated. That said, these activities are compatible with many, though not all, possible revisions to the GSE structure. The goal of this paper is to encourage thoughtful discussion now so that redesign of the GSEs is informed by the unique functional requirements and societal benefits of multifamily housing finance.

1. A. Multifamily rental is essential and requires finance

Along with FHA, the Government Sponsored Enterprises (GSEs)—Fannie Mae and Freddie Mac³—are the primary vehicles for ensuring the ongoing liquidity of the market for multifamily financing. These entities continue to fulfill an essential function despite a future that is completely uncertain and will be decided by others. Resolution of this untenable situation will shape and perhaps in large part dictate the future of American multifamily housing.

Multifamily rental is an essential asset class in American housing. Some 15 million U.S. households live in multifamily rental housing, representing more than 13% of all U.S. households and nearly 43% of U.S. renters.⁴ Multifamily rental housing is an element of national economic competitiveness for it enables workforce mobility, household formation,

¹ The Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2010*, p. 26. Accessed at <http://www.jchs.harvard.edu/publications/markets/son2010/son2010.pdf>.

² Data collected by the National Housing Trust from Fannie Mae (www.fhfa.gov Table 4: "Distribution Of Rental Units Financed By Multifamily Mortgages Purchased By Fannie Mae By Affordability Of Rent", and Table 1: "Fannie Mae Mortgage Purchases by Unit Type and Housing Goals Status, Summary Table on Housing Goals and Subgoal Performance") and Freddie Mac (in the Annual Mortgage Report, Table 4).

³ The term GSE often includes the Federal Home Loan Banks, but we use it here as a term of convenience to refer to Fannie Mae and Freddie Mac collectively. The Federal Home Loan Banks have provided capital for multifamily housing since 1989, separate from Fannie Mae or Freddie Mac.

⁴ 2009 American Housing Survey Table 1-1. U.S. Census Bureau. Accessed on August, 27, 2010 at <http://www.census.gov/hhes/www/housing/ahs/ahs09/ahs09.html>.

rebuilding of personal credit and capital accumulation for those aspiring to homeownership, and a quality retirement for the elderly.

Over the last thirty years, multifamily housing has become an institutional investment, offering stable, predictable returns based on professional, reliable management of high-quality assets assembled into portfolios diversified against risk. That system depends on a multifamily finance system that delivers:

- Capital always available on known, though not unchanging, terms
- Sufficient diversity of loan products for asset types
- Standardized execution
- National availability with local underwriting

Such a finance system requires liquidity that can be expressed in three distinct functions:

1. **General liquidity** involves purchasing loans from originators, assembling them into portfolios, and reselling them into the capital markets (via whole-loan pools, securitization, covered bonds or otherwise). This is the bread-and-butter function that Fannie Mae and Freddie Mac have historically performed quite effectively for the multifamily market.
2. **Countercyclical liquidity** mitigates damage from sudden, system-wide contraction in credit availability. It implies expansion when private credit is scarce and then contraction as private credit becomes more available.
3. **Rapid scalability** flows from the preceding two. Capital crunches arrive suddenly, so countercyclical expansion has to respond rapidly and effectively without throwing caution to the winds.

1. B. Multifamily financing functions require federal involvement

As in the single-family market, Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA) have played important roles in ensuring the continued availability of credit for multifamily housing during the recent housing market downturn. According to the Federal Housing Finance Authority, "During 2008, all sources of multifamily financing, with the exception of the GSEs and FHA, virtually dried up."⁵ The continued availability of credit from the GSEs and FHA illustrate the importance of providing countercyclical liquidity, which helps ensure the continued availability of credit to meet the nation's multifamily housing needs.

Because a countercyclical liquidity provider cannot be created out of whole cloth the minute a crisis emerges, the need for countercyclical liquidity also requires that the provider operate during ordinary years as well, although likely with a smaller share of the total market. The value of a federal guarantee to support multifamily financing even in years in which the private market is otherwise functioning well is further evidenced by the inconsistent availability, before the crisis, of long-term fixed-rate financing for multifamily housing as well as the ongoing challenges associated with getting private financing in rural and other underserved areas (such as smaller cities). While FHA is well suited to meet certain financing needs, there is widespread agreement among practitioners that the government structure inherent in FHA does not provide sufficient speed, flexibility,

⁵ Federal Housing Finance Agency. 2009. "ESTIMATING THE SIZE OF THE CONVENTIONAL CONFORMING MARKET FOR EACH HOUSING GOAL IN 2009." Accessed on Aug. 27, 2010, at: http://www.fhfa.gov/webfiles/2307/Mortgage_Market_2009.pdf.

scalability, or efficiency to meet the full range of multifamily financing needs. Purely private capital markets will not emerge to provide these liquidity functions any time soon.

There is thus a need for ongoing involvement of the GSEs, or successor entities to the GSEs, in the multifamily financing market to support the following core products:

1. ***Long-term fixed rate multifamily mortgages***, which are generally unavailable from sources other than FHA and can be provided as part of a full suite of multifamily mortgage products.
2. ***Credit enhancement for multifamily mortgages***, in particular to allow investors to efficiently manage the risks of complex multifamily bonds and permanent take-outs linked to construction financing.
3. ***Mortgages for underserved asset classes***, including affordable housing, rural housing, and small property loans, which require both capital availability and market discipline. This should generate substantial economic and community benefits.

1. C. Implications for federally-backed multifamily finance

Seven basic structural implications follow from these products and core functions:

1. A government guarantee is necessary to draw in capital broadly and provide countercyclical liquidity. The guarantee should be explicit in its potential cost, priced to allow transparency of government exposure, and focused on public benefit. Even with careful limits, the government cannot entirely escape the possibility of entity-level guarantees due to the countercyclical liquidity function. However, protections should be put in place to minimize the extent of government losses in the event the guarantee needs to be called, for example, by requiring lenders to absorb a share of the first losses and by requiring the maintenance of capital balances at the entity level to offset losses.
2. The GSEs or their successor entities will need a limited portfolio capacity for multifamily housing to support the core functions identified here. However, the large majority of their business should be to package loans for sale to the capital markets.
3. Strong government regulation is necessary and desirable to ensure the safety and soundness of the multifamily financing activities of the GSEs or their successors, as well as to ensure they make multifamily credit available for underserved market segments, including affordable housing development and preservation, small multifamily loans (5 to 50 units), and rural housing. Rather than push the GSEs to reduce lending standards to unprofitable levels in order to meet arbitrary targets, the regulator should work collaboratively with the GSEs to identify opportunities to take advantage of their expertise and market channels to test new approaches that could ultimately be both profitable and effective.
4. The GSEs or their successors should provide liquidity broadly for multifamily housing, including both conventional mortgages and underserved segments like affordable housing, rural markets, and small multifamily loans. To effectively fill the spaces the private market does not and to be ready to provide countercyclical liquidity, the GSEs or their successors must have the expertise, discipline, and market knowledge that only comes from regular participation in the conventional mortgage market. To make sure that underserved market segments are addressed, standards should be developed to ensure the GSEs or their successors continue to provide financing for a broad range of multifamily housing needs, including housing occupied by households with incomes below 80% of the area median.

5. Origination should rely on proven models which have produced and preserved large volumes of multifamily housing with low default rates. Principal existing examples are Fannie Mae DUS and Freddie Mac prior approval. Whatever models are used must be flexible enough to innovate and evolve with changing market dynamics to limit government exposure.
6. There will likely be limited, if any, private ownership of GSEs given the strong regulation, limited product suite, and other constraints on growth. The core multifamily functions identified here are compatible with various mixes of public-private GSE operations.
7. Competition is important, but scale can only support a small number of multifamily GSEs.

In sum, the existing GSEs have largely been effective in safely providing liquidity to multifamily housing using the basic products of mortgage-backed securities (MBS) and credit enhancement. Furthermore, the transition of GSEs to a new form will likely take five years or more, even as multifamily loans continue to be originated, closed, and securitized. Given these conclusions, it makes sense to tread carefully in modifying the current model for financing multifamily housing and to ensure that any successor entities build on the lessons learned by the current GSEs rather than inventing a new multifamily financing system out of whole cloth.

2. Context: today's housing, GSEs, and multifamily

This paper examines the future of the multifamily housing finance system in the U.S. approached from first principles. The conclusions are guided by four overall questions:

1. What **basic functions** (such as secondary market liquidity) does multifamily finance require?
2. Which of those functions are **already provided** by the private sector?
3. Which of those functions are **lacking or filled primarily by GSEs** or other government sources?
4. For which functions are the **GSEs or GSE-type entities the best long-term solution?**

The conclusions identify a cluster of activities best handled by GSEs or their successors taking into account business and policy goals. These activities have implications for a redesign of the overall structure of government involvement in the housing finance system—they are compatible with many, though not all, possible revisions. Given the importance of a healthy multifamily finance system to the overall economy and therefore the risk inherent in instituting an entirely new scheme, recalibrating the GSEs' multifamily activities is far superior to drastically overhauling or even eliminating these functions.

2. A. The GSEs today: activity and tensions

America's housing finance (both single-family and multifamily) today depends on the creditworthiness of the federal government. Banks are doing little except in concert with GSE takeouts, constrained as they are by capital requirements and uncertain balance sheets. Life companies are beginning to be active again but volume is low in comparison to the market and limited to very high quality assets. State HFAs are financing as they have in the past, but their resources are limited and their activity has not expanded materially during the credit crunch.

Together with FHA, Fannie Mae and Freddie Mac are the essential liquidity provider or credit enhancer for the vast majority of all new or refinancing housing lending, nearly all of that focused on capital markets. Without that liquidity source, housing markets could stop literally overnight. The stakes are enormous.

Meanwhile, the GSEs are a financial ward of the state. They are in conservatorship, having booked over \$145 billion in cumulative losses over the last three years (and no warranty against future losses to come—the Congressional Budget Office estimates total cost of \$389 billion through 2019⁶). The U.S. Treasury Department has come to their rescue, injecting billions to help them meet their obligations. Closely supervised by the Federal Housing Finance Agency (FHFA), they have continued in business (close to but not quite as usual) without any resolution as to their permanent status, directed generally to keep doing whatever they had been doing, but not anything new or anything risky. That situation is not sustainable for long because reality will not sit still.

Nor can the GSEs move and innovate as a private business may. They are a political lightning rod, with their future uncertain, and there has been a tacit consensus to leave them untouched for a while as temporarily too hard to solve. Illustrative of this conundrum, the *Economist* bravely called for their abolition at some future unknown date, via some future unknown mechanism, without any future unknown adverse consequences.⁷ At the same time, Congress enacted the largest financial-regulatory overhaul in a quarter century, a statute which did not substantively address the future of the GSEs. The Administration recently solicited input on the future of the GSEs and held a conference on the future of the GSEs on August 17, 2010; it has further committed to holding a series of regional roundtables to gain additional input. Congress has requested that the Treasury Department develop an analysis of options for ending the conservatorship of the GSEs, along with analysis of the future federal role in housing finance, by January 31, 2011. Among other topics, that analysis is required to address the “the impact of reforms of the housing finance system on the financing of rental housing.”⁸

Congress may take up the GSEs' future next year. It will likely focus on single-family, which is both larger economically and draws a broader set of political stakeholders than multifamily. Also, single-family is the major source of the losses, multifamily having performed much better. With all the political debate certain to surround the homeownership issues, multifamily could be overlooked, buffeted about, and tucked into an omnibus statute as an afterthought. Early and thoughtful discussion now can keep multifamily housing finance part of the policy process to ensure its continuing benefits to American housing.

2. B. Multifamily rental is an essential asset class

Stable, good quality affordable housing is a core American value. Ever since the 1937 Housing Act, the federal government has committed our nation to delivering decent, safe, and sanitary housing for every American household. The moral component is compelling—every American deserves a place to call home. It is also sound policy, because housing affordability delivers benefits to individuals, families, and communities: health, employment, community engagement, a sense of belonging, wealth accumulation, political participation, and more.

Multifamily rental housing is an essential part of America's housing ecosystem that enables other forms of housing to flourish. Not everyone can, should, or wants to be a homeowner.

⁶ Congressional Budget Office, “CBO’s Budgetary Treatment of Fannie Mae and Freddie Mac” January 2010.

⁷ Economist, July 22, 2010, “Unnecessary Evils”, Accessed at <http://www.economist.com/node/16640359>.

⁸ Section 1074 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

That need not diminish their housing quality. America's multifamily rental housing has a scale, professionalism, and value-to-price ratio unmatched in the world.

Multifamily rental housing is by definition income-producing real estate, a commercial asset class that is bought and sold using debt financing as an integral component of the capitalization. For multifamily rental to provide the stable, good quality housing we expect for Americans, therefore, it must have access to a set of financing tools that can direct capital efficiently.

This paper focuses on multifamily rental housing—rental apartments in buildings of five or more units. This is distinct from rental housing generally, which includes single-family homes and properties with fewer than five rental units.⁹ It is also distinct from multifamily homeownership, which is mostly condominiums and cooperatives. The homeownership market segment is largely beyond the scope of the paper, but its financing needs should also be addressed. Many of the considerations applicable to financing multifamily rental housing also apply to financing multifamily condominiums and cooperatives.

2. B. 1. Benefits of multifamily housing

Though overshadowed by homeownership, multifamily rental housing is a cornerstone of housing in America. Some 15 million U.S. households live in multifamily rental housing, representing more than 13% of all U.S. households and nearly 43% of U.S. renters.¹⁰ Rental apartments allow independent household formation without the need to accumulate or deploy a lot of capital. Rental housing therefore serves Americans across the income spectrum:

- People of all income levels that prefer to rent due its lower cost, greater flexibility, and reduced maintenance obligations
- Young people establishing new households
- People of all income levels in urban centers
- Seniors of many income levels, some who are leaving homeownership
- A mobile work force, both urban and rural
- Households recovering from job loss, foreclosure, or other dislocation
- Low-income or poor credit households that cannot access homeownership

Multifamily rental has a lower cost of occupancy than homeownership, requires far less up front capital, and on balance presents a lower credit risk for a landlord than home lending does for a lender. It allows renters to build their credit, accumulate capital, and form an independent family household. Seniors who no longer need a large family home can downsize, allowing their home to serve a new family and enabling them to tap home equity. Individuals and families who relocate to pursue employment can rely on rental housing as a transition in their new community before purchasing a new home. All of these allow labor and capital to flow more efficiently and make homeownership more accessible.

⁹ Indeed, rental housing defined broadly houses nearly one third of the population. The Census Department's 3-year 2006-2008 American Community Survey reports 37,023,213 renter households, 33% of the nation's 112,386,298 total households. Accessed at <http://factfinder.census.gov>.

¹⁰ 2009 American Housing Survey Table 1-1. U.S. Census Bureau. Access on August, 27, 2010 at <http://www.census.gov/hhes/www/housing/ahs/ahs09/ahs09.html>.

2. B. 2. The professionalization of multifamily

Historically, rental housing has been the domain of small entrepreneurs. Many began with just two or three rental units—some worked up to larger portfolios of hundreds of units. These rental units form the core of many neighborhoods, particularly in America’s cities.

The apartment business has professionalized and scaled over the last 30 years, with small entrepreneurs increasingly given way to professionalized development, ownership, and management of apartment housing. Small entrepreneurs do continue to play a role, especially in smaller properties and single-family rentals. Finance of apartments has also scaled as GSE executions entered what had previously been the preserve of banks, some insurance companies, and FHA. Particularly with the rising capital presence of Real Estate Investment Trusts (REITs) in the 1970s, multifamily housing has become more and more an institutional investment sector. It has become so by demonstrating the characteristics required by institutional investors:

- Stable, predictable returns
- Professional, reliable management
- High-quality assets
- Portfolios that diversify against risk

Today, apartment REITs total over \$40 billion in market capitalization.¹¹ Property management is increasingly a business of scale, with several leading firms managing portfolios of well over 100,000 privately owned apartments.¹²

2. B. 3. Professional permanent multifamily is an essential asset

Professionalization of the multifamily rental sector by scale, consolidation, and sophistication provides national economic and policy benefits to America:

- **Better housing quality.** The institutional sector is leading the way with higher-quality construction including greener, more energy efficient properties maintained in better condition.
- **Lower rents.** A functional and competitive industry naturally reduces costs to residents over time.
- **Greater availability.** Experienced, well-capitalized, professional organizations can produce more units in markets where they are needed.

These are public goods generated by a more efficient rental sector. While small community developers and lenders deserve support from the finance system as well—see the discussion of affordable and small multifamily lending below—a liquid and stable finance system for multifamily housing is particularly important for ensuring the ongoing viability of the professional actors needed to bring scale and efficiency to both the conventional and affordable multifamily housing markets.

2. B. 4. Professional multifamily requires a robust finance system

To produce reliable results, the professional multifamily sector requires reliable sources of capital provided by a robust finance system. Standardized financial products allow property development and management to achieve scale and efficiency by providing lower cost

¹¹ Data published by NAREIT, “Investment Performance by Property Sector and Subsector”, June 30, 2010, <http://returns.reit.com/returns/prop.pdf>.

¹² The three largest are Riverstone Residential (which is owned by Recap’s parent company), Pinnacle Properties, and AIMCO.

capital through channels upon which businesses can rely. Cyclical crises that dry up credit for multifamily housing jeopardize the continued viability of professional multifamily developers and lenders, placing the benefits of the professional multifamily sector at risk.

Elements of the robust finance system that supports professionalized multifamily:

- **Capital always available on known, market-responsive terms.** To build a business pipeline that produces reliable returns, developers and lenders must have a capital source upon which to rely. Opportunistic sourcing of capital, however effective for small entrepreneurs, cannot support a professional pipeline or generate results at scale. Availability can and should adjust its rate and terms with the market, but it should have a stable baseline against which market participants can plan.
- **Sufficient diversity of loan products for asset types.** Multifamily is very much not a one-size-fits-all mortgage market. It demands significantly more complexity in execution than does single-family, depending on asset size, market strength, submarket niche, and owners' capital demands, among other factors.
- **Standardized execution.** This helps to keep transaction costs low and predictable, reducing capital outlay and making refinancing easier. The benefits are largely passed along to end-users, including residents.
- **National availability with local underwriting.** Professional multifamily requires scale—businesses need to be able to expand into new geographies using the same business model. Underwriting will necessarily be local, but capital availability needs to be national, the more so as owner and management entities become larger, spanning multiple markets and states.

This is as true for affordable as for conventional. Both can be part of a professionalized multifamily business such as property development, management, or loan origination.

2. B. 5. Multifamily affordable housing

Conventional multifamily housing has led the professionalization of the sector, but affordable housing has also progressed toward professionalization, if more slowly. The affordable sector is perhaps most advanced in terms of housing quality—new developments are indistinguishable from market-rate housing and indeed exceed it in quality in some markets. The Low Income Housing Tax Credit (LIHTC) fuels the preservation and development of 50,000 to 100,000 apartments a year, via \$5-\$7 billion of investment capital, mostly from major financial institutions.¹³ Both for-profit and non-profit developers of affordable housing are becoming larger and more professionalized. Indeed, they must to survive in this environment.

For affordable housing to truly fulfill its mission, it should be physically and economically equivalent to market-rate housing. Properties that can operate as real estate, subject to the same risks and rewards, will attract the highest caliber of ownership and management to care for and sustain them over time. They will also contribute to healthy, mixed-income communities.

¹³ Before the recent crisis, LIHTC produced over 100,000 apartments per year and attracted over \$8 billion in capital annually. Contraction in investment pricing and pipeline disruption since the crisis has caused a contraction, hence the range in description.

3. Core financial functions for multifamily finance

The finance system that supports multifamily requires liquidity, provided in two distinct functions: general liquidity and countercyclical liquidity. Both require an explicit federal guarantee and ability to scale rapidly.

3. A. General liquidity function

This is the bread-and-butter function that Fannie Mae and Freddie Mac have historically performed quite effectively. It involves purchasing loans from originators, assembling them into portfolios, and packaging them to attract capital sources that would not otherwise be in the business of making multifamily mortgage loans. Capital sources rely on the GSEs to translate the complexity of multifamily loan underwriting into reliable yields. The GSEs have also used portfolio lending to provide liquidity in the multifamily housing sector.

Even before the financial crisis, the GSEs were central to the liquidity of the multifamily mortgage markets. Post-crisis, they are the primary source, kept in business by government support and vastly outstripping all other sources of capital. By illustration, in the first half of 2010, Fannie Mae did \$5.9 billion of multifamily housing lending, \$5.5 billion of that sold to capital markets.¹⁴ Market participants uniformly describe the GSEs as a necessary source of plentiful capital citing expertise in underwriting, efficiencies of scale, and a generally robust range of products. Fortunately, this has kept multifamily debt and equity markets functioning when they otherwise might have failed, but it also demands extraordinary care when reforming the GSEs to ensure that liquidity is not further disrupted.

3. B. Countercyclical liquidity function

In a downturn when credit retreats, there is national economic value in ensuring liquidity. Doing so prevents costly retrenchment and maintains a functioning pipeline of multifamily lending and development that can respond when credit becomes more available. Right now, the GSEs are the vehicle by which the federal government is providing countercyclical liquidity, mostly by the Fed purchasing Fannie Mae and Freddie Mac securities. Any new GSE structure should maintain the capacity to provide countercyclical liquidity.

Implications of the countercyclical liquidity function:

- **GSEs' market share should naturally decline in good times and rise in bad times.** When other credit is plentiful, there should be less need for government-guaranteed sources. When private credit is scarce, GSEs should end up with a greater share of the market, filling in with reliable liquidity. Implementing this feature will affect regulatory oversight that relies on measures of market share, and market share will also be affected by GSEs' general liquidity function.
- **Government should control additional liquidity injections.** Countercyclical liquidity, unlike baseline liquidity, is not a function that the market can price or self-regulate entirely. Although having an explicit government guarantee will help to keep GSE securities (and the resultant supply of capital) flowing in downturns, there may be a need for further action. Regulators in the trenches with the GSEs cannot necessarily see all the implications of liquidity decisions. So, the trigger for injections of countercyclical liquidity, such as purchase of MBS by the Fed, should therefore lie fully outside the liquidity provider, such as with Treasury or the Fed.

¹⁴ "Fannie Mae Announces Semiannual Multifamily Investment Volumes" Fannie Mae press release, July 27, 2010. Accessed at <http://www.fanniemae.com/newsreleases/2010/5102.jhtml?p=Media&s=News+Releases>.

3. C. Federal guarantee is needed

A federal guarantee seems essential to these liquidity functions. For non-expert capital sources that are essential to a broad capital market, a federal guarantee provides needed comfort. The challenge is that too often scrutiny stops at the guarantee—investors providing capital to the GSEs may not impose necessary discipline with respect to underlying loan quality. When the countercyclical function is primary, the federal guarantee is unavoidable, by definition.

To manage the risk to the public of providing a guarantee to support the liquidity functions, the federal guarantee must be limited in several ways:

- **Explicit**, so that all market participants can know what is and is not guaranteed, particularly during the transition to a redesigned system. We are currently experiencing the downside of an implicit guarantee that got called and turned out to be much more expensive than anticipated. Government backing of timely payment of principal and interest, including full payment at maturity, is critical to maintaining capital markets' confidence as the GSEs are redesigned. As the market evolves more toward pooled offerings, this becomes even more important.
- **Priced**, for instance via a guarantee fee or insurance premium. This does not limit government's exposure (a guarantee is still a guarantee), but it does provide transparency, so that the public can observe the potential call and the provision to fund it. It also helps to distinguish GSE securities with a limited federal guarantee from, for example, Treasury securities.
- **Focused on public benefit**, rather than allowing private arbitrage of public risk. This has become a staple of recent discussions of a future guarantee for GSEs. The goal is to prevent an entity from selling its debt or equity against a federal guarantee, then taking excessive risk. The principle is logical, though not as limiting as first appears (see 5. A).
- **Junior to originators' capital**, so that for individual loans, originators are exposed to first loss at a meaningful level, which motivates them to control risk. It also insulates the entity's capital and the federal guarantee.
- **Backed by capital at the entity level**, maintained as permanent equity at risk which will therefore act as a portfolio-level loss reserve. That equity base could be funded as private capital supplied by investors, by an endowment created during a GSE restructuring, via reinvestment of GSE earnings, or something else—the source is less important than the existence of a known reserve that can be compared to potential obligations.

3. D. Liquidity requires scalability

Both liquidity functions require scalable capacity—the ability to do more or less business as times change. Scalability supports efficiency in the general liquidity function, and it is particularly important for the countercyclical role. As discussed below, the GSEs' existing multifamily origination models have proven ability to scale as required.

FHA's programs serve important needs in the market, particularly where FHA's credit enhancement enables loans for complex affordable and service-enriched properties in some of the toughest markets, but the origination is far less scalable. FHA loans must be reviewed and approved by FHA staff, so to add production capacity, FHA must expand its staff. Such expansion requires federal budget authority and therefore approval of Congress and be subject to annual budgetary pressure. Similarly, changes to FHA underwriting guidelines and premiums must obtain regulatory and legislative approval, respectively, further limiting FHA's ability to scale and adapt to market conditions.

4. Current and Past Roles of GSEs

Past approaches to multifamily finance inform the analysis of possible changes. Fannie Mae and Freddie Mac have developed approaches that are generally effective and largely free of the quality problems that have caused major financial problems on the single-family side. On the multifamily side at least, there is value in seeking to continue many of the successful functions played by the GSEs.

4. A. Current GSE multifamily financing models

The principal multifamily financing models used by Fannie Mae and Freddie Mac are both scalable and effective, although they take slightly different approaches.

Fannie Mae's Delegated Underwriting and Servicing (DUS) approach is eminently scalable. In it, Fannie Mae specifies underwriting terms in advance but delegates the origination to lenders, reducing Fannie Mae's internal staff demands. Ramped up production can rely on capacity from originators, many of whom can shift resources from other business lines if needed to rapidly scale up. When less capacity is needed, originators can shift resources to other lines of business or downsize as needed. Originators take a first loss position that enforces careful risk evaluation.

DUS certainly has tradeoffs. First-loss exposure is effective only if (a) the originator's loss share is material to the originator, and (b) the originator's total exposure is less than their fluctuating liquid equity capital. Hence DUS can be dialed too tight or too loose, and it requires a population of creditworthy originators. DUS's delegation implies a rigidity of standardization; market participants point to a lack of flexibility in DUS guidelines at times which forces originators to negotiate waivers. Against this natural complaint of customizers, standardization lowers costs of capital as it allows post-underwritten loans to be aggregated and sold in homogenized loan pools or single loans packaged in a standardized way. Furthermore, underwriting by waiver is extremely effective in surfacing differences and refining DUS loan products over time. Fannie Mae must also set standards and oversee its originators, evaluating the stability and capacity of originators on an ongoing basis. These are tradeoffs at the margins, however, for a model that is robust overall.

Freddie Mac's prior approval model takes a different approach to the same tradeoffs. Freddie Mac does not, in this model, delegate credit authority, although originators carry much of the underwriting workload. Freddie Mac's internal underwriting staff carry more burden than Fannie Mae's, as is appropriate given that Freddie Mac ultimately takes the credit risk. The prior approval model requires less oversight of originators and takes less delegation risk.

Conversely, by definition a prior-approval model uses holistic underwriting rather than the exception-waiver approach of DUS. When loans or properties become large or complex, DUS can break down under the combined weight of 'too many waivers,' whereas in a prior-approval model, the larger and more challenging properties float upwards within the underwriting administrative hierarchy until the most senior people are making the most important decisions.

Regardless of these side-by-side differences, both DUS and prior-approval show distinctive advantages when viewed against the backdrop of past failed alternatives (see 4. B below). The two together provide complementary elements of an efficient liquidity function.

4. B. Past multifamily financing models

Debate over how to provide core financial functions often gets portrayed in extreme terms: government control as disciplined or inflexible, markets as efficient or risk-loving. Without belaboring an often hyperbolic comparison between government and the private sector, it is worth noting past unsuccessful attempts to provide these core functions:

- **Coinsurance.** FHA's insurance products enable the provision of essential capital, particularly to much-needed affordable housing, but via slow procedures that drive many borrowers to other options. FHA's §221(d)(4) coinsurance program, active only in the mid 1980s, used a loan-level first-loss structure (distinct from DUS) but failed in a way that created serious federal exposure. Originators outmaneuvered FHA's control process, charging fees high enough to cover their loss position, tolerating credulous or unqualified appraisals,¹⁵ and overleveraging properties against the federal guarantee. Amid heavy losses, HUD was forced to shut the program down and has never revived it. Subsequent attempts to improve FHA, like Multifamily Accelerated Processing, have been useful but ultimately improvements at the margin.
- **Savings and Loans.** During the early 1980s, small S&Ls, backed by explicit FSLIC guarantees and subject to very low capital requirements (e.g. 3% of assets), were 'taken private' by equity acquirers who then used the FSLIC deposit to draw in large CD's that formed the cash source for risky construction loans. These S&Ls' balance sheets exploded on new deposits, then imploded, leading to massive bailouts and hastening the demise of the S&L industry. What could have been an effective capital channel—loans based on deposits—proved unreliable in part due to the problem of originators' moral hazard when investing federally-insured deposits.
- **Conduits and CMBS.** Complex capital structures and thirst for yield caused capital sources to accept unsustainable levels of risk that were obscured by complex derivative instruments like strips, CDOs, and CDSs.¹⁶ Originators extended unsustainable loans resulting in over-levered assets. This contributed to the overall market problem of capital chasing too little yield followed by the destructive flight from risk.

All of these were attempts to bring scale and standardization while trying to balance discipline with efficiency. They stand in sharp contrast to the successful example of the GSEs, particularly during the 1990s.

During the 1990s and early 2000s, the GSEs were effective issuers of mortgage-backed securities. As long as they stuck to the pass-through function of packaging loans, they avoided the trap of borrowing short to lend long. This is distinct from their CMBS purchases held in portfolio, which ramped up during the late 2000s. Under conservatorship, Fannie Mae and Freddie Mac have returned to this earlier stable model—packaging loans for the capital markets.

4. C. GSE multifamily outperformed single-family and CMBS

The multifamily portfolios of both GSEs stand out from their overall portfolio (which includes single-family and multifamily) in terms of performance. In general, multifamily has been far more stable than single-family, in part because loans are underwritten individually with far more detail than commoditized single-family mortgages. Although the credit boom did push

¹⁵ Later prohibited through the appraiser-certification procedures established by FIRREA.

¹⁶ See, for instance, Janet Tavakoli's predictions in her February 13, 2007 comments to the SEC's proposed rules over rating agencies and her accompanying 2006 article, *The Elusive Income of Synthetic CDOs*.

lenders to loosen terms somewhat, overall performance has seen far less decline than single-family.

As of the fourth quarter 2009, severe delinquency in the Fannie Mae and Freddie multifamily portfolios was less than 1%, compared to roughly 7% for multifamily Commercial Mortgage Backed Securities (CMBS) and roughly 11% for single-family.¹⁷ The second quarter 2010 SEC filings by Fannie Mae and Freddie Mac show multifamily remains strong:¹⁸

Table 4. C. Delinquency results, 2nd Quarter 2010

<u>Serious delinquency rate</u>	<u>Multifamily</u>	<u>Single-family</u>
Fannie Mae	0.80%	4.99%
Freddie Mac	0.28%	3.96%

Fannie Mae's multifamily delinquency rate is less than one-sixth its single-family delinquency rate, and Freddie Mac's is less than one-tenth its single-family rate. These are admirable results in normal times, and especially so in this most challenging of real estate environments.

The GSEs' multifamily lending is widely seen by knowledgeable industry observers as steady, professionally underwritten, and profitable business, a conclusion generally supported by comparative performance of the GSEs' portfolios versus those of large private financial institutions. Further, the GSEs' multifamily performance is far better than their single-family lending. According to the Conservator's Report issued for the second quarter of 2010, during the 2½ year period from January, 2008, through June 30, 2010, in the single-family area Fannie Mae lost \$109 billion while Freddie Mac lost \$58 billion. Over that same interval, the worst downturn in half a century, the multifamily businesses operated much more stably: Fannie Mae's multifamily business showed a \$6 billion loss (net of LIHTC equity investment writedowns due to lack of taxable earnings), and Freddie Mac's multifamily broke even.¹⁹

Even as it performed strongly, the GSE's multifamily business provided societal benefits. More than 60% of the annual lending in these portfolios from 2004-2009 (over 80% in some years) has financed housing for households earning less than 80% of median income, and it has brought housing to areas not served by other capital sources.²⁰

4. D. Underserved sections of the multifamily finance market

There are several sections of the multifamily financing market—unoccupied or underserved by purely private sources—that require liquidity. That liquidity can be provided by the basic function of packaging affordable and conventional multifamily loans for capital investment, with the support of a government guarantee.

4. D. 1. Long-term fixed rate multifamily mortgages

Providing long-term fixed rate mortgage debt for multifamily properties that can be packaged in MBS and sold to capital markets should be a core loan product for the GSEs or their successors. Multifamily is the slow and steady tortoise to single-family's speedy hare, and as such it benefits from long-term fixed costs of capital. It is also willing to accept prepayment lockouts and yield maintenance requirements that can mitigate the maturity risk to investors. Long-term fixed-rate mortgages help to attract a wider range of investors,

¹⁷ State of the Nation's Housing 2010, p. 26.

¹⁸ See Fannie Mae's 2Q2010 10-Q filing, Tables 39 and 45, and Freddie Mac's 2Q2010 10-Q filing, Table 4.

¹⁹ Federal Housing Finance Agency. Conservator's Report on the Enterprises' Financial Performance Second Quarter 2010.

²⁰ Data collected by the National Housing Trust from Fannie Mae and Freddie Mac.

ensuring that more multifamily transactions can get done and thus helping to boost the supply of multifamily rental housing. They also play an essential role in ensuring properties can comply with the requirements of the Low-Income Housing Tax Credit program over the full fifteen-year compliance period.

Private capital sources appear unable to consistently provide loans of the needed length.²¹ Capital requirements generally limit banks to offering 3-5 year terms, based on their capital sources. Life insurance companies offer 5-10 year fixed rate loans. Conduit lenders during the past decade provided up to 10 year fixed rate loans, but their model involved, in general, unrealistic underwriting and what turned out to be risky capital.

Private capital sources also shy away from making loans in certain locations, leaving those areas underserved. This is most acute in markets with weaker economic activity, such as rural areas, that yet have serious housing needs and viable multifamily housing projects. Recap's experience and the interviews suggest that absent GSE involvement, these areas would be critically underserved.

Affordable housing properties in particular require long-term mortgages. LIHTC investors need to mitigate foreclosure risk that can threaten their tax credit investment and have a 15-year tax exposure, so they need fixed-rate debt of 15-18 years to eliminate an exogenous variable that could overturn property performance and affordability compliance during the tax credit delivery period. This is more than just an operating risk—it threatens to squelch development. Because these properties are already underwritten to close margins (albeit more conservative than two years ago), the additional uncertainty of a variable rate or a required refinancing can present risks that prevent developments from coming together.

FHA provides long-term fixed-rate financing via its 35 and 40-year term insurance products, chiefly §221(d)(4) new construction/substantial rehab and §223(f) refinancing. FHA loans have only worked for a subset of properties, however, for two reasons: (1) lengthy processing times compared to market imperatives, and (2) incompatibilities between the LIHTC allocation process and FHA requirements. These combine into processing delays that are long enough to prevent many developments from coming together. Although the 2008 Housing and Economic Recovery Act made some improvements in this area and practitioners report that FHA is more reliably executing certain products, such as §223(f) refinancings, FHA's product suite remains a useful complement to but not a substitute for the GSE product suite.

The GSEs or their successors can and should offer a full suite of loan products of various maturities as long as they are based on sound underwriting. That provides useful diversification and an effective set of options to borrowers and originators. The GSEs must, however, serve the long-term end of that spectrum because of their unique capacity to do so reliably. Private capital providers can and should play a role, but the GSEs or their successors should always be a component of the market so that they maintain the capacity and market knowledge to provide countercyclical liquidity when needed.

4. D. 2. Credit enhancement for affordable and construction loans

Apart from the more standardized multifamily mortgage loans described above, more specialized affordable housing loans should benefit from involvement of the GSEs or their

²¹ The one exception that arose in the interviews was Citi, which offered 30-year fixed-rate multifamily loans from roughly 2002-2007. The program was quite successful in terms of market share and loan performance, although it was eventually shut down in the face of continual market pressure toward more aggressive underwriting. Its uniqueness serves only to reinforce the conclusion that private capital alone cannot fulfill this liquidity function consistently, and certainly not in the face of a major economic downturn.

successors. Affordable housing loans in particular involve specialized risks that many capital sources are simply not equipped to underwrite. By providing separate credit enhancement, via a letter of credit wrapped around a mortgage or other mechanisms, GSEs allow capital markets to fund these mortgages without separately evaluating the specialized affordability risks.

Examples of loan types that benefit from wraps are:

- Mortgages financed with §501(c)(3) tax-exempt bonds
- Mortgages financed with private activity bonds and accompanied by 4% LIHTC
- Floating-rate construction loans that need a permanent, fixed rate takeout at closing

The GSEs are currently not offering the product widely (apart from some federal support, see 4. E. 2). Private capital sources have not filled the space, liquidity is short, and transaction volume is down as a result. This appears to be because the costs for individual investors to evaluate the specialized risks involved are too costly to price into yields on small bond issues. Credit enhancement through the GSEs or successor entities is therefore an efficient mechanism to provide liquidity in tax-exempt multifamily bonds.

The financial crisis stimulated some holders of GSE letters of credit to exercise put options—historically, a rare occurrence. FHFA, the GSE’s regulator, has shied away from allowing more to be issued. Reinvigorated and redesigned GSEs emerging from conservatorship should once again make multifamily credit enhancement a core product.

4. D. 3. Specialized affordable housing loans

Affordable housing properties often involve project-based rental assistance, social services, and additional state or local gap funding. That complexity in the subsidy structure or junior capital stack leads market participants to describe these as “story deals,” involving so much complexity in the subsidy structure or capital stack that it can cause lenders to either refuse or price the loan at infeasible terms.

Complex affordable housing properties would benefit both from GSE capital availability and the discipline imposed by those resources. The GSEs or their successors should have origination channels with enough flexibility to accurately underwrite mortgages for such properties. DUS-like delegation should document consistently granted waivers to general underwriting guidelines, including the criteria properties need to meet to obtain the waiver. Affordable properties, however, need to have sustainable development and operating plans with sufficient resources to provide security to the lender.

Given the individualized features of these properties, their loans may well require that the GSEs or their successors have some portfolio capacity so that some loans can be held and seasoned before being packaged into securities. For instance, properties with unique combinations of multiple affordability programs may need to show ability to operate effectively over time—this is distinct from the basic risks of construction and rentup. Capital markets will be more likely to accept such loans as MBS if they have a period of proven performance. Many affordable housing loans do not need such seasoning, such as those participating in federal programs of long standing without complicating factors. Although the need for seasoning in any particular affordability program should abate as the program proves itself, changing markets and programs imply a continuing need for a limited GSE warehousing and seasoning capacity.

Some interviewees pointed out that GSEs have the expertise to correctly price and hedge against risks specific to affordable housing, such as the remote risk of non-renewal of

Section 8 property-based rental assistance contracts. Without slighting the substantial GSEs' expertise, the perceived value may also stem from connecting renewal of Section 8 to federally-guaranteed loans (hence matching a non-commercial government risk to a government-backed funding source). Presumably, government would be less likely to cut the rental assistance program if defaulting loans would come back to bite the federal balance sheet.

Specialized lending also applies to preservation and adaptive reuse of existing affordable properties. With a national inventory in excess of 3,500,000 units under various federal and state programs, the market share of preservation transactions within affordable housing continues to increase, as these properties need periodic refinancing and recapitalization to modernize, add green or energy conservation measures, and extend their useful life. As compared with new construction, preservation lending requires specialized knowledge of existing or legacy government programs that will be carried over into the refinanced property, but one that should also benefit from GSE-provided liquidity.

4. D. 4. Small multifamily mortgages

Efficiency in mortgage markets right now is in single-family loans or in very large loans. At the small-loan end are single-family mortgages, which are commoditized; origination, underwriting (when done properly), and servicing are based on known reliable standards. Margins for lenders and servicers are thin and competition is fierce, which contributes to inexpensive capital for borrowers. At the large-loan end lie complicated multifamily loans. These require detailed, individualized underwriting by analysts who understand local markets and rental dynamics. Costs of the underwriting are paid via fees which are small relative to multi-million dollar loans. Both single-family loans and large multifamily loans show reasonably efficient loan activity.

In between is an under-served space: small multifamily loans, on properties from 5 to 50 units. Unlike single-family loans, they are not occupant-owned; unlike large multifamily loans, they are not run by proven large professionals. They are income-producing assets requiring the same detailed, individualized underwriting as large multifamily loans, but the loans, in the \$500,000 to \$3,000,000 range, support much smaller loan fees and must be packaged in greater volume to attract investors. This makes it hard to build a profitable pipeline or bring much standardization. Most origination for small multifamily loans comes from community banks, state housing finance agencies, and specialized local or regional loan pool originators. Much still relies either on recourse financing or community development motivations.

The market has not yet found a way to make these loans efficiently, and opinions differ as to why. Nor is the market likely to solve the problem soon: had the market truly found an efficient method, most of those opinions would cease to be relevant. The challenges of small loan amounts with disproportionately high origination costs persist.

Although the GSEs have explored this space, they have never achieved the scale or efficiency desired. For instance, both Fannie Mae and Freddie Mac increased their purchases of seasoned small multifamily loans in 2003 when pinched to meet affordability goals, but purchases dropped off the following year. Although Fannie Mae has had an ongoing small-scale program to explore this sub-sector, neither GSE has created a sustained program to bring capital market efficiencies to small multifamily properties. The inherent caution of conservatorship has further pushed attention away from small multifamily loans.

It is therefore a logical area for exploration and, ideally, growth by redesigned and reinvigorated GSEs. Bringing efficiency to small multifamily loans will require innovation in origination processes, efficient capital, and sustained attention over time. No entity other

than properly regulated GSEs appears to be in a position to provide these. The GSEs or their successors could use a small, carefully regulated portfolio capacity to purchase, season, and package small multifamily loans in pursuit of an efficient model. Origination capacity from community banks, specialized consortia, and state HFAs provides a pre-existing resource for the GSEs. Small multifamily properties represent roughly one third of the rental sector, so bringing efficient capital to this subsector could have a substantial impact on housing costs and quality nationwide.

4. E. Other possible product areas

Several other products have been proposed for the GSEs or their successors, both formally and informally. These should not initially be core offerings, if they are offered at all, although some are potential areas for exploration and growth.

4. E. 1. LIHTC equity aggregation, liquidity, and securitization

The market for Low Income Housing Tax Credits (LIHTC) is beginning to emerge from a major correction sparked by the financial crisis. Before 2008, the major LIHTC investors were Fannie Mae, Freddie Mac, and major banks, all of whom suddenly decreased their investments after the crisis, with the GSEs ending their purchases entirely. The result was a sudden drop in investor demand leading to higher yields, lower prices for credits, and properties in the pipeline stranded without sufficient funding sources.²² Although investment is flowing back in and prices are slowly rising again, the market is far less efficient and productive than it was before the crisis.

One proposal would have GSEs issue short-term LIHTC securities with a guaranteed after tax yield.²³ GSEs would use staff previously focused on buying LIHTC as an investment to take in LIHTC as a raw material for packaging into short-term securities. Rather than buy a 15-year LIHTC investment in a property or pool of properties, investors could buy a 2-3 year strip, receive the tax benefits while they held it, and then sell it back to the issuing GSE at a guaranteed minimum yield. In effect, the GSEs would create a synthetic LIHTC that fundamentally changes the LIHTC investment mechanism without requiring any legislative changes.

Such a guaranteed, more liquid product would quite likely draw new investment into the LIHTC arena. The problems with the proposal, however, exceed the benefits:

- **Guarantee would undermine the investor oversight function.** The LIHTC is an historic advance in the efficiency of affordable housing subsidy delivery that relies on the skilled oversight of motivated investors. Investors buying a short-term guaranteed product would not exert that level of oversight.
- **Guaranteed strips would crowd out primary LIHTC.** From an investor perspective, the guaranteed yield (effectively a federal guarantee, coming as it would from a GSE) would make traditional LIHTC investments unattractive in comparison. Even large yield spread between the two may not be enough to interest investors in primary LIHTC.
- **Origination would require new DUS-like structures.** GSEs would be responsible for virtually all of the investor oversight but would necessarily have to rely on syndicators to originate the LIHTC raw material. Absent traditional investor

²² Recap has written extensively about this LIHTC market disruption. See Policy Updates 73, 74, and 75 (Jan-May, 2009).

²³ Apart from securitization, the GSEs also have large portfolios of past LIHTC investments still on their books. Treasury and FHFA have prevented resale of these assets, believing that injecting additional supply to an over-supplied LIHTC market is counterproductive, and selling the LIHTC at any price below \$1 results in a net loss to the government. We therefore expect the GSE LIHTC portfolios to remain locked away.

oversight, GSEs would have to develop all new DUS-like regulatory structures to evaluate the soundness of syndicators and their offerings.

- **Adverse selection would strain GSE portfolios.** To cut 15-year LIHTC investments into 2-3 year strips, GSEs would need a portfolio capacity to hold the portions they could not sell (for instance, the last 5 years of exposure). Unsold portions would likely be adversely selected, with the out years and least attractive properties going unsold.
- **A new synthetic LIHTC model would be irreversible.** Once the market adjusted to a three-year fully liquid guaranteed LIHTC strip, it would never go back to a ten-year, illiquid, unguaranteed 'raw' LIHTC equity position.

4. E. 2. Providing capital to state HFAs

State Housing Finance Agencies (HFAs) have been a mainstay of affordable multifamily housing finance. They play multiple roles: issuing bonds, multifamily lending, single-family lending, allocating federal LIHTC, regulating property operations, administering state subsidy programs, and in many states administering federal Housing Choice Vouchers as well. As lenders, they could certainly benefit from access to capital markets via the GSEs.

State HFAs have the benefit of a proven track record. In general, their portfolios have weathered the crisis well, and they certainly avoided the excesses of the banking sector during the lead up to the crisis. They have also made progress, often by necessity, in originating small and complex affordable loans. Recently, under the New Issue Bond Program (NIBP) and the Temporary Credit and Liquidity Program (TCLP), HFAs have received liquidity support from Treasury via the GSEs. Together, these have provided over \$4 billion in liquidity to support multifamily financing through HFA lending program.²⁴

Since state HFAs already issue their own bonds, why would they need GSEs as a channel to capital markets? Part of the answer lies in credit enhancement, as discussed in Section 4. D. 2. GSE wraps could efficiently separate certain risk elements, making it easier for capital markets to accept the rest. Another part is efficiency in capital markets execution—individual HFAs in general lack the scale to match the efficiency of GSEs. It is also far simpler for investors to rely on a GSE wrap than review individual state agency bond issues.

One particular example stands out: the State of New York Mortgage Agency (SONYMA). This state agency issues bonds and insures mortgages made by preapproved lenders. It has a dedicated state funding source supporting an insurance fund with \$1.2 billion in reserves. Although its focus has been preservation of existing housing, it has gradually expanded its product suite while maintaining and improving its credit rating. Given the unique advantages of New York's real estate market and state-level resources, the SONYMA model is likely not replicable in most other states, but it could certainly be expanded further as either a complement or counterparty to GSE operations. Expanding interactions with state HFAs is a logical growth area for GSEs.

4. E. 3. Distinguishing financing from subsidy

Because concessionary financing has an embedded and inexplicit subsidy, it is tempting to use it as an indirect subsidy, with below-market interest rates, longer-term loans, or more favorable loan-to-value and debt service coverage ratios than offered in the market. That temptation can prove especially strong if there is no explicit collateral reservation requirement (akin to credit subsidy), making the benefits appear free and riskless when in fact they are neither. In thinking about how to strengthen the existing model for the GSEs,

²⁴ For multifamily, NIBP usage totals \$1.2 billion and TCLP usage totals \$2.82 billion. Data provided by the National Housing Trust in August 2010.

we should strive to make the direct and indirect costs of subsidizing affordable housing more transparent.

This matters because true affordable housing—market quality at below-market occupancy rate to a targeted household—must necessarily benefit from some subsidy somewhere. The subsidy may be local (e.g. real estate tax abatement, zoning density bonus), state (housing trust funds or state tax credits), or national (FHA loans, Section 8 rental assistance, LIHTC, tax-exempt bonds), but it must always be present, and it is better if not disguised.

Subsidy, in short, should be sufficient and transparent:

- **Sufficient** means enough to sustain capital and operational needs of the properties.
- **Transparent** means subsidy flows to the property via explicit rental or capital subsidy rather than disguised via concessionary lower rates.

Although concessionary lending rates for affordable housing make property development and acquisition more feasible in the short term, they can also encourage imprudent lending and development. Recap has directly observed the effects of properties developed with too much inexpensive debt—eventually, they disappointed lenders, regulators, residents, and communities when owners failed to sustain them over time. Many factors contribute to this problem (ownership failures highest on the list), but hidden concessionary lending only exacerbated it, by encouraging a focus on raising capital cheaply rather than developing long-term sustainable properties. Had subsidy been transparent, lenders may well have enforced more discipline up front and some deals likely would not have been done.

For professionalization to continue and succeed, participants in the market must see the costs and benefits of their decisions clearly. That allows developers to choose projects wisely, lenders to make prudent loans, and investors to deploy capital efficiently.

Government can aid this transition by making sure:

- Rental subsidies, like Section 8, are available, sufficient, reliably funded, and tied to market rents.
- Capital subsidies take advantage of market mechanisms, like the LIHTC investor market.
- Debt markets provide liquid capital efficiently to affordable properties based on sound underwriting and with subsidy made explicit.

Affordable properties need to be economically viable on the same basic terms as conventional properties—paying for operations, capital needs, debt service, and a return to the owners. Affordable properties necessarily do so by relying on a subsidy stream from government that buys affordability for low-income residents and the community benefits that flow to all.

The GSEs, in short, should not be tasked with affordability requirements that can be fulfilled only through camouflaged subsidy. Affordability mandates should be tied to commercially defensible lending propositions built around extant subsidy programs. The regulator should work closely with the GSEs or their successors to make sure they are addressing underserved segments of the market, such as rural areas, affordable housing generally, preservation specifically, and small multifamily properties. Rather than push the GSEs to reduce lending standards to unprofitable levels in order to meet arbitrary targets, the regulator should work collaboratively with the GSEs to identify opportunities to take advantage of their expertise and market channels to test new approaches that could ultimately be both profitable and effective.

5. Implications for GSE redesign

If the GSEs were redesigned and reinvigorated to provide general and countercyclical liquidity through a focus on the core functions of:

- packaging affordable and conventional multifamily loans for capital markets, and
- providing credit enhancement on multifamily mortgages

as described above, several basic structural elements would logically follow.

5. A. Government guarantee

There is no getting around the truth: GSE's ability to attract plentiful capital relies on investors' perception of the government guarantee. The past of an implicit guarantee was clearly far from ideal, so the redesigned and reinvigorated GSEs should have a guarantee that, as discussed in 3. C, is:

- Explicit in its extent and potential cost
- Priced to allow public observation of government exposure
- Focused on public benefit rather than private arbitrage of risk
- Junior to originators' capital
- Backed by capital at the entity level

Such a guarantee could work effectively if it were limited to the securities issued as distinct from the entity issuing the securities. Guarantee of the securities should satisfy the requirements of capital markets, and given the GSEs strong multifamily performance record, an entity-level guarantee does not seem essential.

As the current crisis demonstrates, however, government may not fully escape the possibility of entity-level intervention. If GSEs are to be a mechanism for countercyclical liquidity, there may be times when government must keep an entity functioning even when it is insolvent (much like the current state of GSE conservatorship). While such an arrangement would likely wipe out the entity's debt holders²⁵ and equity investors, we have yet to fully resolve the current test of this notion, so it would be pointless to speculate as to how government and markets would react to a future iteration. Explicit limits on the guarantee, along with requirements for capital reserves to stand in front of the guarantee, would certainly help to mitigate taxpayer risk and exposure.

5. B. Portfolio capacity

Future GSE multifamily operations will need a limited portfolio capacity—the ability to hold loans on balance sheet, either for warehousing, aggregation, seasoning, or very occasional maturity mismatch. Multifamily loans are large, complex, and take time to season. GSEs should not be limited to those loans that can be sold immediately to capital markets—that would cut against their liquidity mission and their affordable housing commitment. Furthermore, some products require a small portfolio capability, particularly small loans and credit enhancement products. This should be kept to a manageable amount for a regulator to oversee effectively.

²⁵ We distinguish here between holders of GSE property securities and GSE entity-level lending. The former are to be protected, the latter to be at risk.

5. C. Strong government regulation

As with the guarantee, this is a necessary element. Both political and policy imperatives require strong oversight of whatever GSE structures emerge. For multifamily specifically, regulation should:

- **Help to substitute for market limits on risk that are weakened by the guarantee.** The regulator is in part standing in for the discipline imposed by investors, and so should seek to replicate investor-level evaluations. Regulators should maintain frequent contact with investors and seek to gain strength from their understanding of GSE exposure.
- **Avoid simplistic market-share tests.** Especially given need for GSEs to provide countercyclical liquidity in times of capital market distress (see 3. B), market share indicators will be confusing at best, misleading at worst.
- **Keep GSEs focused on basic functions.** That means selling loans to capital markets and providing credit enhancement. There is a necessary tradeoff between innovation and stability. Given recent history, a regulator will likely err on the side of stability, although this should be balanced by continuing need for innovation.
- **Maintain separate control for additional countercyclical liquidity.** The Fed or Treasury should decide when and how to inject additional liquidity into the system through, for instance, purchase of mortgage securities. The GSE regulator will be an essential advisor in that decision, but the decision-making power must remain distant from the sector.
- **Recognize that liquidity serves the affordable housing mission.** If the new GSEs function properly, they will make capital more reliably available to both conventional and affordable multifamily housing. That should be their primary goal, one separate from creating subsidies for affordability.

This regulation will necessarily have to work within the overall financial regulatory framework. The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law July 21, 2010, will likely have significant impact on the GSEs, both directly and through requirements on their originators and counterparties. The law addresses financial regulation broadly, but not the GSEs specifically. Implications of this legislation for GSEs or their successors are beyond the scope of this paper.

5. D. Broad market participation, including conventional

GSEs should provide liquidity broadly in multifamily for a full range of conventional mortgage products, credit enhancement, and loans to underserved areas like affordable housing, rural markets, and small multifamily loans. To effectively fill the spaces the private market does not and to be ready to provide countercyclical liquidity, GSEs must have the expertise, discipline, and market knowledge that only comes from regular participation in the conventional mortgage market. This will also support their ability to innovate and extend efficiency to underserved areas and avoid over-exposure as market conditions change.

If relegated solely to affordable housing, for instance, GSEs will fail to attract and maintain the underwriting expertise and discipline fostered by participation in market-rate rental housing finance. They would also be far smaller and far more hostage to political pressure to extend affordable loans at concessionary terms. Only GSEs with full exposure to conventional, market-rate multifamily finance will be able to effectively provide liquidity, either generally or countercyclically in a downturn.

In providing liquidity and efficiency to underserved markets like affordable housing, there are dual risks to navigate between:

- **Pressure to favor market returns at the expense of doing any affordable lending.** Affordable housing need not and often does not perform worse than conventional multifamily, but it usually requires more nuanced evaluation and underwriting to perceive that. It can be convenient to point to credit standards as the reason for doing very little affordable housing lending, even though that results in poor social outcomes and missed opportunities for profitable business.
- **Pressure to do affordable housing loans at inefficient concessionary terms.** The ever-present need for affordable housing and multifaceted challenges of assembling development resources create pressure to direct resources through any available channel. Simplistic quantitative goals and perception of untapped resources can push resources into suboptimal deployment that fails to encourage economically viable operations. Affordable housing can and should meet the same credit standards as conventional multifamily, even if that means it requires additional government subsidy. That subsidy should come as explicit rental assistance rather than largely invisible yet still distortive concessionary lending.

To avoid the first risk, government will need a mechanism by which to direct GSE efforts. To be most effective, such a mechanism should give regulators the ability to adjust to market conditions. Too inflexible a mechanism could push GSEs into the second risk, seeking to fulfill regulatory requirements even at concessionary terms. This suggests that allowing regulatory discretion to adjust and evaluate is far more important than the precise benchmark used.

We must navigate between these pressures, and there is no simple structural fix for doing so. GSEs with an active conventional pipeline are important. Having a strong, independent regulator with a nuanced understanding of multifamily is essential. That regulator should develop standards to ensure the GSEs or their successors continue to provide financing for a broad range of multifamily housing needs, including housing occupied by households with incomes below 80% of the area median. Competition among GSEs and feedback from investors purchasing MBS will help. Also important is an active, involved stakeholder community that continually educates the legislators who help to set the regulatory agenda.

5. E. Proven models to mitigate risk, with some innovation

Both Fannie Mae's DUS model and Freddie Mac's prior approval model have effectively managed origination risk in multifamily. Each has its strengths relative to scalability, flexibility, fit with particular asset types, and overhead cost, but these are differences around the margin. We have two proven models for sound origination and capital market execution in multifamily—both should be used going forward.

Whatever structure emerges should allow room for innovation as well. There are problems as yet unsolved, notably the lack of efficiency in small multifamily loans. Finding a solution to this problem and others will likely require modifying origination models. Nor will solving today's problems end the need. Multifamily product and capital markets will continue to evolve, and we need a sophisticated multifamily finance innovator leading positive change. Purely government entities like FHA have never shown the ability to innovate fast enough, in part because they always need statutory authority to do so. GSEs, with their private market involvement, appear to be the most likely avenue for innovation.

Innovation can be part of many possible GSE structures, but we have to plan for it early on by allowing regulatory flexibility and room for controlled experimentation.

5. F. Limited, if any, private ownership

Given strong regulation, a limited product suite, and the other elements listed above, opportunities for growth of the enterprises will be small. Without a government guarantee at the entity level, it is hard to imagine private investors buying equity in a GSE entity at a yield compatible with the apparently limited potential returns.

This structural question, however, will likely be something the multifamily sector must adapt to, rather than one it can influence strongly, because the GSEs' ownership future will be decided based largely on single-family considerations. Fortunately, the core multifamily functions identified here are compatible with various mixes of public-private GSE operations.

5. G. More than one, but not many more

Competition improves outcomes generally, even when the competition is limited to two. Fannie Mae and Freddie Mac tended to settle into complementary niches, historically. For instance, at any given time, one could usually predict whether on a particular loan, Fannie or Freddie would have the best bid, simply by looking at the type of property involved. However, their positions could and did switch from time to time, and executives at each were always conscious that the other GSE was ready to step in and seize market share.

Scale is also a challenge. The liquidity function creates efficiency, but it does so at the margins, measured in basis points on loans. Having many GSEs would dilute that efficiency, leading to needless duplication of systems while taxing regulators to monitor many different operations. Two or three GSEs is likely the most multifamily alone can support.

We fully recognize that decisions about single-family GSE operations will dominate the question of the number of new entities, in particular. If many are created, it might well make sense for a small subset of them to have multifamily operations.

6. Conclusion: much will emerge in transition

The transition of Fannie Mae and Freddie Mac from federal conservatorship to a new form will be long, likely five years or more. There are existing assets and obligations to resolve, back-end systems in place, and skilled personnel to retain, all while making sure the multifamily capital pipeline flows. Nor can we forget the federal funds awaiting repayment.

Even were the GSEs not at the center of political controversy, the situation would require a careful and measured transition. With intense political focus from both ends of the spectrum and a transition likely to span several congressional and at least one presidential election, the outcome is even more likely to be a carefully brokered compromise.

All of this points to a careful readjustment of what has largely been an effective model for supporting multifamily lending—GSEs that provide liquidity to multifamily housing using the basic products of MBS and credit enhancement. Maintaining and expanding that function will support the continued professionalization of multifamily housing, leading to lower-cost, better-quality, more-available rental housing for Americans.



Appendix 1

Background interviews

To provide background information for this paper, Recap interviewed nineteen knowledgeable market participants. Interviewees had the option to provide comments on or off the record, and interviews were mostly unstructured, exploratory conversations. Recap is grateful for the generosity interviewees showed with their time and information.

Among those interviewed for this paper are:

Kenneth J. Bacon	Executive Vice President, Housing and Community Development, Fannie Mae
Peter Donovan	Senior Managing Director, CBRE
Steven Fayne	Managing Director, Citi Community Capital
David Johnson	Executive Vice President and Chief Financial Officer, Fannie Mae
Hal Kuykendall	Managing Director, Citi Community Capital
Judd Levy	Chairman, New York State Housing Finance Agency
Jack Markowski	President, Community Investment Corporation
Alan Wiener	Managing Director, Wells Fargo Multifamily Capital
Mark Willis	Resident Research Fellow, Furman Center for Real Estate and Urban Policy
David Worley	Chief Risk Office-HCD, Fannie Mae
Barry Zigas	Director of Housing Policy, Consumer Federation of America

NHC's Multifamily Housing Working Group provided review and discussion that helped to refine this paper. Recap thanks in particular the following participants for their detailed and thoughtful written comments:

Michael Bodaken	Executive Director, National Housing Trust
Theodore S. Chandler	Chief Operating Officer, AFL-CIO Housing Investment Trust
Stillman Knight	President and CEO, The Knight Company
Douglas Moritz	Associate Vice President Multifamily, Mortgage Bankers Association
Shekar Narasimhan	Managing Partner, Beekman Advisors
Barry Zigas	Director of Housing Policy, Consumer Federation of America