MORGAN
PROPERTIES

160 Clubhouse Road
King of Prussia, PA 19406

August 31, 2020

Alfred M. Pollard
General Counsel
Attention: Comments/RIN 2590–AA95
Federal Housing Finance Agency
Eighth Floor, 400 Seventh Street SW
Washington, DC 20219

Re: Enterprise Regulatory Capital Framework Proposed Rules

Dear Mr. Pollard,

Morgan Properties is pleased to provide comments on the Federal Housing Finance Agency's ("**FHFA**") proposed Enterprise Regulatory Capital Framework (the "**Proposed Rule**").

Morgan Properties is a privately-owned real estate investment management founded in 1985 by Mitchell Morgan, who is its chief executive officer today. He is assisted in the operations of the business by his sons, Jonathan and Jason Morgan.

Morgan Properties operates two divisions: the first owns and operates a sizeable multifamily portfolio and the second is one of the largest purchasers of B Pieces issued by Freddie Mac in connection with its K Series program.

Multifamily Portfolio

Morgan Properties owns and manages a portfolio of over 260 communities with 70,000 apartment units in 15 states serving approximately 135,000 residents. Morgan Properties multifamily portfolio is valued at approximately $11 Billion. The properties are primarily concentrated in the Mid-Atlantic, with most of our properties located between Northern Virginia and Northern New Jersey, with a substantial presence in Western New York. In total, Morgan Properties has over 2,000 employees.

According to the National Multifamily Housing Council, Morgan Properties is the fifth largest owner of multifamily housing in the United States and it believes that it is the largest (or second largest) owner of multifamily housing in Pennsylvania, New York, New Jersey and Maryland.

The average rent for a one-bedroom apartment owned and operated by Morgan Properties was $1,239 as of July 2020 and the average rent for a two-bedroom apartment was $1,511. The average apartment owned by Morgan Properties is leased to residents with an average combined household income of approximately $72,000. Typical employers of our residents include hospitals, state and local governments and retail establishments.

Company Mission and Strategy

Morgan Properties exclusively focusses on providing quality housing to working class Americans (these properties are sometimes referred to as Class B properties). Morgan Properties typically seeks to purchase garden style apartments built in the 1960's through the 1980's located in infill suburban locations and to then improve the housing for our residents by renovating kitchens and bathrooms, installing in-unit washers and dryers, and adding new resident amenities.

In 2019 alone, Morgan Properties invested over $115 million of capital in renovating and improving its properties. Immediately upon purchase of a property, Morgan Properties focuses heavily on investing capital to address all life safety, building code violations and asset preservation needs of the property, typically within 90 days of purchase. As soon as the immediate needs are addressed, Morgan Properties then focusses on remedying all deferred maintenance needs and addressing outstanding in-apartment work orders. Once the property has been stabilized, Morgan Properties begins to add and/or upgrade existing amenities, such as fitness centers, package rooms, playgrounds, dog parks, sport courts, as well as replacing kitchens, bathrooms and windows in the units at the property.

After the property has been improved, Morgan Properties continues to invest in the properties. It develops a five-year capital plan for every property and then continues to update that plan each year. The investment decisions are consistent with Morgan Properties approach of holding assets for decades. For example, in the last few years, it has spent considerable amounts of money replacing windows with energy efficient windows and seeking to remove or encapsulate lead-based paint which are investments a short-term holder would never consider.

Morgan Properties does not have a goal of gentrifying its properties or of changing any neighborhoods that it enters – it seeks to stabilize and gradually improve its individual communities and then provide best-in-class workforce housing that continues to be affordable to its existing base of residents.

Major Agency Borrower

Since our company mission of providing quality workforce housing is well-aligned with that of Freddie Mac and Fannie Mae, Morgan Properties is a frequent Freddie Mac and Fannie Mae borrower. Morgan Properties had loans with an outstanding principal balance, as of June 30, 2020, of $4.94 billion owed to Freddie Mac, $1.87 billion owed to Fannie Mae, and $1.18 billion owed to all other lenders.

As workforce housing is at the core of Freddie Mac and Fannie Mae's mission, our experience is that, together with their lenders, they are simply the best at underwriting the risks associated with workforce housing. Their lending program helps ensure stability in asset pricing for multifamily assets. Our experience has been that Freddie Mac and Fannie Mae are both predictable and prudent. They are clear as to their underwriting and lending standards and do not deviate from them either when times are good or when times are difficult. Moreover, Freddie Mac and Fannie Mae consistently provide loans that meet their rigorous underwriting standards throughout the business cycle. Their predictability decreases uncertainty around lending, and thus decreases asset price volatility throughout the business cycle. Loans come due, and need to be refinanced, every day, including in recessions. Without the stability provided by Freddie Mac and Fannie Mae's lending programs, multifamily asset pricing would wildly fluctuate, leading to debt-driven excessive speculation and pricing bubbles during market expansions and excessive foreclosures in the multifamily space during downturns.

Our experience with other financial institutions has been less favorable. Other lenders have tended to have plenty of funds available when the market is rising and have been prepared to support very aggressive valuations, but simply cannot be found when the market becomes challenging (such as in March through May of 2020 as the economy started to drop into a deep recession). Such lending behavior increases asset price volatility. Therefore, it should not be a surprise that, when considered together with the strength of the underwriting process at Freddie Mac and Fannie Mae, the default rate of Freddie Mac and Fannie Mae are a fraction of the default rates experienced by multifamily CMBS lenders (see discussion and chart below).

Because we can depend on Freddie Mac and Fannie Mae to consistently provide loans, using the same lending criteria, we strongly prefer to borrow from them to provide the capital needed to invest in, and reinvest in, our portfolio of quality workforce housing.

Debt Platform

Since 2018, Morgan Properties has become one of the largest buyers of subordinate debt components (so called "**B Pieces**") of multifamily mortgage loans that are regularly sold by Freddie Mac pursuant to its K Series bond program.

Morgan Properties has purchased twelve separate B Pieces, representing approximately $11.85 billion of unpaid principal amount of approximately 557 separate mortgages.

Prior to purchasing a B Piece, Morgan Properties engages in a robust due diligence exercise to re-underwrite every loan in the proposed pool to ensure that the risks match the expected rewards. We review every property's income statement and construct a model to evaluate the likelihood of default, stressing all key assumptions, we send underwriters to visit every property in the pool, reviewing the market and the competitive set, we independently develop an opinion of value and carefully compare our opinion against each of the appraisals.

Based on our extensive due diligence on these 557 separate mortgages, we are always impressed with the quality of Freddie Mac's underwriting. We believe that Freddie Mac consistently makes loans in line with their core mandate to provide lending to work force and affordable housing without taking imprudent risks.

Proposed Rule

As stated in the Proposed Rule, the FHFA is seeking to ensure that Fannie Mae and Freddie Mac (collectively the "**Enterprises**") are properly capitalized, allowing them, both during and after conservatorship, to operate in a safe and sound manner in order to properly fulfill their statutory mission to provide stability and ongoing assistance to the secondary mortgage markets across the economic cycle.

As both a major borrower from the Enterprises and a purchaser of mortgage securities, we strongly support these goals. We firmly believe that Morgan Properties is only able to provide quality housing to working class Americans if a thoughtful regulatory framework is put in place that creates a proper set of incentives for the Enterprises to operate in a safe and sound manner. If the Enterprises were to engage in unreasonable risk taking (which we have not seen them do), we believe it would add tremendous risk and volatility to our markets, which would eventually put the working class multifamily homes that we own and operate in jeopardy.

Further, we believe that the capital requirements of the Enterprises should be set in a manner that helps ensure that the Enterprises act in a prudent manner and, in particular, protects the US taxpayer from the types of problems that caused the US Government to place the Enterprises in conservatorship during the Great Recession. However, the Proposed Rule will fail to achieve their ultimate goal (ensuring adequate capital to withstand a sizeable downturn), if the minimum capital requirements are not properly structured to reflect the actual risks of the specific underlying activities of the Enterprises. In particular, if the capital requirements are not appropriately tied to the risk profiles of the different lines of business conducted by the Enterprises, the regulations may create perverse incentives for the Enterprises to grow those riskier business lines that require less capital compared to safer business lines that may require proportionately greater capital.

Therefore, while we support the goals of the FHFA, we believe that the Proposed Rule should be modified in several respects.

Morgan Properties' Recommendations

As discussed in further detail below, Morgan Properties urges the FHFA to adjust the proposed risk weights, particularly those for multifamily exposures, to more accurately reflect the risk being assumed by the Enterprises.

- First, the FHFA should rethink its approach to credit risk transfer ("**CRT"**) transactions. CRT is a long-standing risk management tool that allows the Enterprises to shift to the private sector a portion of their risk exposure. As CRT effectively acts as an additional private capital buffer, it should be both encouraged and accounted for in the capitalization requirements.
- Second, the risk weighting of multifamily loans should set minimum capitalization requirements that are based on a prudent stress test of the actual loss history associated with such multifamily loans.
- Third, not all multifamily loans present the same risks. The risk weighting should be set based on the actual risks of the various subclasses within multifamily loans. In particular, the regulations should set risk weights in line with the risks associated with its core mission of providing financing to work force housing separately from the risk weight associated with higher risk financing such as providing loans to Class A and luxury housing, student housing and senior housing.

Credit Risk Transfer.

Credit risk transfer (CRT) transactions transfer potential credit losses on single-family and multifamily mortgage exposures from the Enterprises to private institutional investors – a critical risk management tool that has been effectively deployed by the Enterprises for several years. CRT is not unique to the Enterprises; it is commonly used by most sophisticated financial institutions and is typically encouraged by minimum capitalization policies.

Morgan Properties is one of Freddie Mac's largest buyers of B Pieces in its K Series program, thus we are very familiar with Freddie Mac's version of CRT.

The structure of Freddie Mac's K Series materially reduces the risk to Freddie Mac from its multifamily loan exposure. In every K Series securitization, Freddie Mac sells a so-called B piece, which is an unguaranteed principal-only bond that is entitled to only receive distributions after the senior bonds are paid their share of the principal in full, only then is the B Piece bond entitled to receive its share of the principal, which is limited to a maximum of 7.5% of the original principal amount of the securitization pool less any losses incurred by the securitization pool.

In the event that there is a default on a mortgage, and it results in a foreclosure, the lender takes a loss if the property sells for a price less than the outstanding principal amount of the mortgage. As the Enterprises only provide loans with a principal amount equal to 70% to 75% of the appraised value of the property, a lender would only incur a loss if a property sells in foreclosure for a price low enough to eliminate all of the owner's equity (which is typically 25% - 30% of the capital stack). After the equity is eliminated, the lender would be exposed to potential losses.

However, in Freddie Mac's K series program, it is difficult to construct a reasonable scenario where any losses incurred by a securitization pool are not fully absorbed by the B Piece owner.

The best way to understand the structure of CRT in connection with Freddie Mac's multifamily securitization is to review a typical transaction such as Freddie Mac's Structured Pass-Through Certificates Series K-114 securitization ("**K-114**"), that recently closed in August 2020. K-114 was comprised of approximately $1.3 billion of original principal amount of 59 loans secured by first mortgages on multifamily properties. In K-114, the B Piece owner effectively absorbs the first $98 million of losses (7.5%) incurred by the pool, as the B Piece owner is not entitled to receive any distributions until the senior bond owners are paid in full their share of the outstanding principal amount (a total of $1.22 billion (or 92.5%)). Only after the senior bond owners are paid their $1.22 billion of principal in full, then the B Piece owner is entitled to whatever additional principal payments are received by the trust, which in K-114, would be an amount equal to $98 million less any losses incurred by the pool of mortgages in K-114.

The key to the risk transfer in Freddie Mac's K series is the B Pieces are very large compared to Freddie Mac's loss history, thus creating a sizeable buffer to absorb potential losses before there is any potential for a loss to be incurred by Freddie Mac or the senior bond owners. In K-114, the average property was appraised at $32.5 million and the average loan was $22.15 million (a loan to value of 68%), implying an average equity per property of $10.25 million in each of these 59 properties. If, in K-114, somehow 20% of the loans (or 12 of the loans) went into default and were foreclosed, those 12 properties would have to sell at foreclosure for prices in the aggregate that were greater than $98 million below the original principal amount of the mortgages, implying that those properties would have to sell in foreclosure at a price that was greater than a 56% decline from the appraised value of the property at origination. Only after a 56% decline in value on 20% of the loans, would the B Piece no longer be entitled to any distributions and the senior bonds would suffer its first dollar of losses.

Such a default rate and decline in value are many, many multiples (17.04x) of the worst losses in the history of Freddie Mac's multifamily program. The worst year of losses for Freddie Mac multifamily loans was for those loans originated in 2006 (just prior to the Great Recession), where approximately 1.6% of the loans originated that year eventually defaulted but, in the aggregate, Freddie Mac was able to mitigate the losses from these defaulted loans and only suffered a loss of 0.44% of the original principal amount of those loans. Thus, in any reasonable model, the B Piece buyer will absorb all such losses through its 7.5% first loss position.

As CRT effectively transfers the risk of loss away from the Enterprises and onto private investors, we would have expected that FHFA would endorse the use of CRT. However, the Proposed Rule would significantly reduce the associated capital reduction benefit for CRT transactions via a ten percent haircut on capital relief and a ten percent capital floor. The FHFA notes that under this approach more capital is required than would be if the underlying mortgage exposures were not in a CRT; i.e., this is a departure from capital neutrality. The

FHFA argues that this change is necessary to manage the "potential safety and soundness risks of CRT, including…model risk posed by the calibration of the loss-timing and counterparty risk adjustments".

This proposed ten percent floor and haircut will lead to a significant reduction in the number of CRT transactions, thus creating incentives for the Enterprises to retain risk instead of transferring it to third parties. We are uncertain why FHFA is applying the haircut and floor, but would strongly prefer all capital requirements be driven purely by an analytical approach to understand and weigh the risks, perhaps with appropriate stress scenarios to determine a prudent amount of capital that the Enterprises should retain to ensure the safety and soundness of the Enterprises considering both the risks of the various loans as well as the structure of the CRT.

Risk Weighting of Multifamily Loans

The Proposed Rule requires the Enterprises to hold appropriate capital for multifamily lending equal to 6.49% of the outstanding principal amount of a multifamily loan at origination, compared to a capital requirement of 4.66% for single family loan, which would only make sense if multifamily lending was significantly riskier than single family lending. The premise is not supported by facts outlined below. Alternatively, the disparity in capital requirement could make sense if we, as a society, wanted to subsidize single family home ownership and at the same time increase the cost of renting multifamily homes, which seems to be a policy mistake at a time when multifamily homes are typically rented by lower middle class and middle class Americans and there is rising concern about the growing lack of affordability of rent in many markets.

Multifamily Housing is Far Less Risky Than Single Family Lending

The relatively high capital requirements for multifamily exposures does not reflect the risk profile of multifamily real estate lending in the modern era.

Since the 1970's, multifamily lending has consistently been one of the safest, best performing commercial real estate sectors, across the economic cycle. While internet-based businesses may decimate local retail establishments, strip shopping centers and regional malls, and offices may downsize as people increasingly work from home, people always need a place to live.

Morgan Properties has owned multifamily properties for over 35 years. During that period, the sector has been characterized by consistently high occupancy, steadily rising rents and solid collections. Over the long term, multifamily demand is highly correlated with population growth and the United States population has been steadily growing. Moreover, unlike single family home values, multifamily values have not experienced radical booms and busts in the 35 years that Morgan Properties has been in existence. As a result, our experience has been that multifamily loan defaults are exceedingly rare.

As the following graphs demonstrate, multifamily delinquency rates have remained significantly lower than single family delinquency rates.[1]

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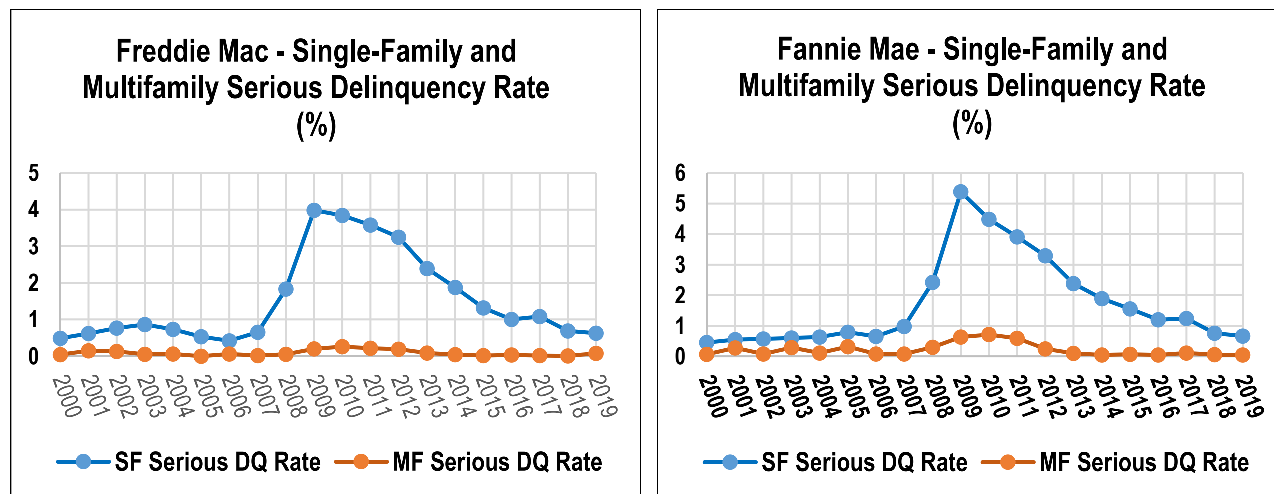
[1] **Freddie Mac serious DQ rates** for single-family are based on the number of mortgages 90 days or more delinquent or in foreclosure. For multifamily, before 2008, rates were based on the net carrying value of mortgages 60 days or more delinquent or in foreclosure and exclude other guarantee transactions. Beginning in 2008, rates were based on the unpaid principal balance of loans 60 days or more delinquent or in foreclosure and include other guarantee transactions. **Fannie Mae serious DQ rates** for



Source: Freddie Mac and Fannie Mae; CREFC

Moreover, almost all of the losses incurred by the Enterprises during the Great Recession are attributable to single family lending activities.

For example, Fannie Mae reports on their website that from 2009 to 2019, aggregate losses incurred by Fannie Mae from multifamily loans amounted to only $970 million over that decade (which includes losses from the Great Recession)[2], which obviously is dwarfed by the $167 billion of peak cumulative single family losses of Fannie Mae from 2008 through the first quarter of 2012 referenced in the Proposed Rule.

Freddie Mac has a similar loss history. In the 25-year period starting in 1994, only 0.16% of Freddie Mac's multifamily loans have defaulted, resulting in total credit losses of only $207.5 million over the period. The worst year of loan origination during that period were the loans that originated in 2006, 1.6% of those loans defaulted and those loans resulted in credit losses of only $50.1 million, which was 0.44% of the unpaid principal amount of the loans originated in 2006. In contrast, in the Proposed Rule, FHFA notes that Freddie Mac lost $64 billion on its December 31, 2007 single family guarantee portfolio, which appears to have been a loss of 6.4% of the unpaid principal balance, or 14.5x the rate of multifamily losses during the Great Recession.

Freddie Mac and Fannie Mae have historically performed much better than traditional commercial mortgage-backed securities ("**CMBS**") financing. Even during the Great Recession, Freddie Mac and Fannie Mae delinquency rates were under 80 bps versus the delinquency rates for multifamily CMBS which peaked at 1,200 bps.

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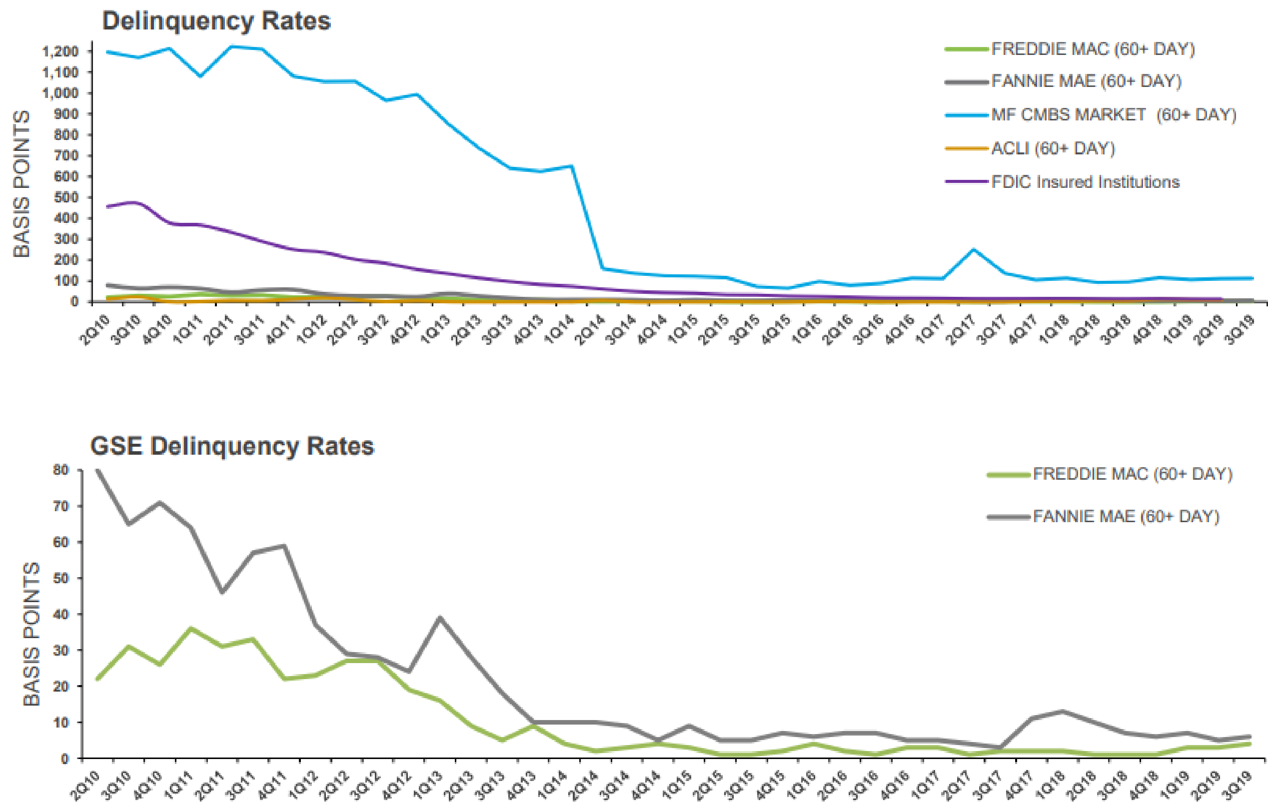
single family are based on the number of loans 90 days or more past due or in the foreclosure process. For multifamily, beginning in 1998, data include all multifamily loans and securities 60 days or more past due.

[2] See. http://www. https://multifamily.fanniemae.com/sites/g/files/koqyhd161/files/2020-03/multifamily-business-information.pdf



Sources for the two charts: Freddie Mac, Fannie Mae, TREPP (CMBS multifamily 60 + delinquency rate, excluding REOs), American Council of Life Insurers (ACLI) Quarterly Investment Bulletin and FDIC Quarterly Banking Profile

It is not an accident that the Enterprises have experiences a low rate of default on its multifamily loan portfolio. As is discussed elsewhere in this letter, multifamily asset values have not been volatile over the last few decades, operations have been steady with gradual growth in net operating income, and the Enterprises are prudent in their underwriting and lending practices. Moreover, virtually every multifamily owner would like to borrow from the Enterprises, but not all qualify, as demand for loans from the Enterprises greatly exceeds the supply. We are a major borrower from the Enterprises and speak to many other large and small borrowers and the universal consensus of all institutional borrowers is that none of them are prepared to permit any of their loans from one of the Enterprises to go into default, as it would result in them being excluded from being able to borrow from both Enterprises in the future. In the past, Morgan Properties has chosen to recapitalize the occasional 'underwater' asset rather than permit it to go into foreclosure. We are certain our well capitalized competitors would do the same thing. Because of this, the Enterprises can comply with their mandate while effectively managing their risk.

Multifamily Capital Requirements Should be Adjusted by Subclass

While FHFA should create an average risk weighting for multifamily loans in the aggregate, it should also instruct the Enterprises to disaggregate that average risk weighting and develop appropriate risk weightings

for different subclasses of multifamily properties based on the risk of loss and volatility of the rents associated with each such subclass of properties.

For example, student housing and senior housing multifamily properties have different demand drivers and are more volatile than traditional multifamily housing. The same volatility is experienced by multifamily properties that cater to 'tenants by choice' such as luxury apartments located in resort locations or in center cities.

On the other hand, it has been our experience that multifamily properties that cater to 'tenants by necessity" such as workforce and affordable housing are the least risky subclasses of multifamily properties. During the Great Recession, revenue in workforce housing barely contracted compared to Class A multifamily, both in top 20 MSA markets as well as in the second-tier markets (defined as MSA's 21 – 80). In 2009, Class A net revenue growth declined by -2% in the Top 20 MSAs and -3% in the Second Tier, compared to workforce housing which had declines of -0.5% in the Top 20 MSAs and -1% in the Second Tier (Source: Freddie Mac). The experience of Morgan Properties' multifamily portfolio has been consistent with the overall market. In both the Great Recession and thus far in the current COVID-19 driven recession, none of occupancy, net rental income or net operating income of Morgan Properties' Class B properties have declined in any material manner.

In the United States today, there is a significant housing affordability issue that explains the lack of volatility in Class B multifamily performance. While the demand for Class B/C multifamily has increased, the supply has not. In the chart below, REIS data shows that there has been very little new construction of workforce housing over the last twenty years. Since 1999, there has been an average increase in new Class A apartments of 3.4% per year, while only a 0.1% increase in Class B/C. The lack of supply growth has been compounded by the fact that Class A rents have been growing more and more unaffordable to the typical Class B/C tenant. REIS reports that in 1999, the average Class B/C rents were $679 per month while Class A rents were $272 more expensive ($951 a month), in 2017, the spread between Class B/C average monthly rent ($1,103 per month) to Class A average monthly rent ($1,586 per month) had expanded to $483.

Average Rental Rate	Average	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Class A		$ 951	$ 1,028	$ 1,048	$ 1,052	$ 1,064	$ 1,082	$ 1,106	$ 1,149	$ 1,194	$ 1,220	$ 1,186	$ 1,205	$ 1,233	$ 1,276	$ 1,322	$ 1,378	$ 1,462	$ 1,516	$ 1,586
Class B/C		$ 679	$ 724	$ 753	$ 763	$ 772	$ 786	$ 806	$ 834	$ 869	$ 889	$ 871	$ 880	$ 899	$ 927	$ 951	$ 981	$ 1,028	$ 1,066	$ 1,103
Spread Differential	***$ 345***	***$ 272***	***$ 304***	***$ 295***	***$ 289***	***$ 292***	***$ 296***	***$ 300***	***$ 315***	***$ 325***	***$ 331***	***$ 315***	***$ 325***	***$ 334***	***$ 349***	***$ 371***	***$ 397***	***$ 434***	***$ 450***	***$ 483***
Discount to Class A	***-28.0%***	***-28.6%***	***-29.6%***	***-28.1%***	***-27.5%***	***-27.4%***	***-27.4%***	***-27.1%***	***-27.4%***	***-27.2%***	***-27.1%***	***-26.6%***	***-27.0%***	***-27.1%***	***-27.4%***	***-28.1%***	***-28.8%***	***-29.7%***	***-29.7%***	***-30.5%***

Occupancy	Average	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Class A Occupancy	94.1	95.7	96.3	94.3	92.7	92.4	92.9	94.4	94.1	94.1	92.8	91.8	93.6	95.0	95.3	95.2	94.7	94.4	94.5	94.2
Class A Completions as % of Total Inventory	3.4%	6.0%	4.9%	4.6%	3.9%	3.4%	2.8%	2.5%	2.5%	2.4%	2.9%	3.3%	2.2%	0.9%	1.8%	3.2%	4.1%	4.4%	4.3%	4.4%
Class B/C Occupancy	94.9	96.4	97.0	95.8	94.3	93.5	93.5	94.2	94.1	94.3	93.5	92.0	93.1	94.4	95.3	96.0	96.4	96.7	96.9	96.5
Class B Completions as % of Total Inventory	0.1%	0.1%	0.2%	0.2%	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.0%	0.0%	0.0%	0.1%	0.1%

Simply put, existing Class B/C tenants do not have a lot of other affordable housing alternatives. Thus, even in recessions, it has been Morgan Properties experience that occupancy stays high and Class B/C tenants remain highly focused on paying their rent in a timely manner.

As a result of the stability of the asset class, owners of workforce housing are able to pay their mortgages. In our 35-year operational history, Morgan Properties has never missed or been late on a mortgage payment and has never defaulted on any loan.

Therefore, the Enterprises should be instructed to develop appropriate risk weighting and capital requirements for each of the different classes of multifamily properties. We would expect that this would result in lower capital requirements for loans to workforce and affordable housing and higher capital requirements for loans

to Class A, student housing and senior housing. This would create appropriate incentives for the Enterprises to prudently manage their portfolio of multifamily loans. In particular, riskier loans should require more capital and less risky loans should require less capital. A proper alignment of risk and capital requirements should encourage the Enterprises to grow those lines of businesses which have the lowest risk and to appropriately price riskier loans.

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We appreciate this opportunity to comment on the proposed Enterprise Regulatory Capital Framework and look forward to working constructively with the FHFA on this important matter.

Sincerely,

Mitchell L. Morgan
Chief Executive Officer