

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

Subject: (RIN) 2590-AA95 FHFA Proposed Rule on Enterprise Regulatory Capital Framework

Dear Mr. Pollard:

On behalf of the DUS Peer Group¹, the DUS Advisory Council² welcomes the opportunity to comment on the proposed rule on Enterprise Capital Requirements published on June 30, 2020. The DUS Advisory Council represents the 23 DUS Lender firms that do business with Fannie Mae. As our business is originating, underwriting and servicing multifamily loans our comments will primarily pertain to the multifamily business, as well as certain elements shared with the single-family business.

We appreciate the FHFA's ongoing efforts to ensure a viable and vibrant housing finance system, and support the FHFA's stated intention of responsibly ending the Enterprises' conservatorships. However, there are certain elements in the Proposed Rule that miss the mark on conceptual grounds, and as a result distort real-world incentives – and discourage the potential investors needed to end conservatorships – on practical grounds.

As we directly share risk with Fannie Mae, we and the FHFA have a mutual interest in formulating a well-constructed capital framework, that promotes safely lending in accordance with Congressional & FHFA goals. In this response letter we explain our core positions that:

- Multifamily Credit Risk Capital requirements remain too high relative to historical data, and should be held to the same standard as Single-Family
- Procyclicality should be addressed in Multifamily where it still presents a large and hidden capital requirement, and fixed in Single-Family
- Certain multifamily multipliers do not reflect historical data or fundamentals, resulting in an adverse impact on conventional business, affordable loans and loans with longer terms.
- Certain provisions of the Proposed Rule – led by the leverage ratios – disincentivize exactly the types of behavior the FHFA seeks to encourage
- DUS risk-sharing should not be equated to back-end CRT and thus should not be subject to the Overall Effectiveness Adjustment

¹ The Delegated Underwriting and Servicing (DUS) Peer Group is a coalition of lenders who originate the preponderance of multifamily mortgages that are sold to or securitized by Fannie Mae. Most of our members also utilize the Freddie Mac and Ginnie Mae programs for financing rental housing. Our members are key participants in the multifamily rental housing market as originators, securitizers and servicers of mortgages on rental housing for millions of U.S. households. For a complete list of DUS lenders who form the DUS Peer Group, see <https://multifamily.fanniemae.com/about-multifamily/our-partners/dus-lenders>.

² The DUS Advisory Council is elected by the DUS Peer Group to represent the DUS network. The members of the DUS Advisory Council include Bellwether Enterprise Real Estate Capital, LLC; Berkadia Commercial Mortgage, LLC; Capital One, National Association; CBRE Multifamily Capital, Inc.; Greystone Servicing Company, LLC; KeyBank National Association; ORIX Real Estate Capital, LLC; PGIM Real Estate; Walker & Dunlop, LLC; and Wells Fargo Multifamily Capital

We thank you for considering our concerns in the formulation of the final rule governing Enterprise Capital. Should you have any questions or need additional information, please feel free to contact Kyle Draeger, Chair, DUS Advisory Council, at kyle.draeger@cbre.com.

Sincerely,

The DUS Advisory Council

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Executive Summary

The DUS Advisory Council's interests are substantially aligned with the FHFA's as we both seek a safe, sustainable, and profitable multifamily housing market. As our businesses retain risk on Fannie Mae originations but are prohibited from transferring it via credit risk transfer as the Enterprises are required to do, we have at least as great an interest in encouraging sound lending practices as the Enterprises themselves.

This does not mean we desire capital that's excessively punitive, or features in a capital regime that could incentivize the wrong behavior. In addition, we're sensitive to the fact that for Enterprise lending to continue it must balance the needs of at least six stakeholder groups – the Enterprises, the FHFA (representing the American taxpayer), private lenders originating and servicing loans, borrowers, impacted renters, and the investors whose funding will recapitalize the Enterprises and help to end conservatorship.

As a result, in this letter we share our concerns with the 2020 Proposed Rule and specific recommendations on how to address them, with the goals of prudent and data-driven risk management, and aligned incentives for continued success.

Focus Areas

The DUS Advisory Council believes certain elements of the Proposed Rule suffer from improper calibration relative to historical data, contain mechanical flaws that could lead to unintended consequences, incentivize higher-risk lending than necessary, and/or disincentivize investment. In order of priority, our focus areas include:

- 1) **Multifamily appears to be held to a much higher capital standard than Single-Family, despite clear and well documented historical data demonstrating that Multifamily performance was superior to Single-Family.** We investigated all available performance data dating back several decades, and demonstrate that peak Multifamily losses were a fraction of peak Single-Family losses seen during the Great Financial Crisis. This is exhibited by Fannie Mae's credit loss ratios dating to 1989 which show peak rates of 32 bps for Multifamily (1991) versus 80 bps in Single-Family (2010). Supporting this with FHFA-mandated MLPD data, we demonstrate that on a vintage basis the worst for Multifamily was 77 bps, a fraction of Single-Family's 393 bps (both 2007), and that the rate of loss for all resolved loans across vintages was 29 bps for Multifamily versus 81 bps for Single-Family. Multifamily outperformed SF even when we included Multifamily CMBS data. Despite all this, Multifamily is charged almost exactly double the Credit Risk Capital as measured by risk weights. We recommend the FHFA ensure that when modeled stresses are used, both asset classes use a consistent underlying economic forecast, and are calibrated to the historical record. We recommend that Multifamily's aggregate risk weight not exceed 29%.
- 2) **Procyclicality was not addressed in Multifamily, and this presents a large and hidden capital requirement.** The FHFA made no adjustments for Multifamily relative to the 2018 Proposed Rule, and we estimate Credit Risk Capital needs will approximately double if the mandated stresses (35% value, 15% NOI) are realized. Moreover, consistent with the FHFA's "managerial cushion" discussion the Enterprises may be required to raise this capital upfront, as it would be scarce and expensive to do so in a downturn. We investigated in detail the FHFA's proposed Single-Family mechanism that relies on a trend, and found it to be internally inconsistent with other framework elements, as well as unstable in its estimation. The DUS Advisory Council proposes an alternative Countercyclical Adjustment that could be employed, which is mathematically equivalent to our 2018 proposal but streamlined and conformed to the 2020 Proposed Rule's terminology.
- 3) **Certain Multifamily multipliers do not reflect historical data or fundamentals.** The elimination of the Affordable multiplier appears to contradict with FHFA statements backing their lower risk, and appears to have been eliminated in its entirety due to a perceived inability to make nuanced adjustments for subsidy level (notwithstanding the FHFA's not establishing whether this subsidy level had an impact). The FHFA's term multiplier is positively correlated to loan term, despite both GSE and CMBS conduit history clearly demonstrating an opposite relationship. The FHFA has cited non-conventional property subtypes as a reason for Multifamily's high capital and supposed risk, but made no adjustment for Seniors Housing and a minor 1.15x multiplier for Student Housing. We recommend the FHFA reevaluate its term multiplier, reinstate the Affordable multiplier

subject to any minor adjustments deemed necessary, and reduce requirements on conventional business to reflect that business's historical risk profile while adopting higher multipliers for Seniors and Student Housing of 2.00x and 1.25x respectively.

- 4) **Leverage-based requirements are high enough to undermine risk-based capital, and incentivize riskier practices.** The minimum leverage ratio of 2.5% of adjusted total assets, together with the 1.5% Prescribed Leverage Buffer Amount ("PLBA"), form a 4.0% floor on capital. As the FHFA acknowledged, this exceeds risk-based capital requirements and acts as the binding constraint for Freddie Mac; it is nearly binding for Fannie Mae. The preponderance of the Proposed Rule is devoted to risk-based capital, but this is outstripped by a simple leverage ratio. We appreciate the FHFA's desire to provide a credible backstop, but it should remain a pure backstop; otherwise an ROE-motivated Enterprise would be motivated to a) originate / acquire riskier assets with a higher coupon (i.e. boost numerator), and/or b) decrease CRT transactions which carry an economic cost but would cease to give denominator relief. We recommend that the PLBA be reduced to 0.75% so that capital could never fall below a robust 3.25% level, where it would remain a credible backstop without being likely to distort the Enterprises' incentives relative to the FHFA's goals.
- 5) **Front-End Risk Transfer for Lender Risk Sharing is not the same as structured back-end CRT.** We appreciate the FHFA's concerns that some CRT derivatives may not correlate with the underlying risks. Lender Risk Sharing typical of Multifamily DUS is *perfectly and contractually* correlated with the risks of the underlying mortgages. Further, interim and/or final Asset Valuation Dates generally require the DUS Lender to pay Fannie Mae its portion of the loss prior to final disposition, minimizing accounting risk. We recommend that front-end loss sharing like DUS risk sharing with lenders not be subject to the Overall Effectiveness Adjustment ("OEA").

With respect to potential investors, the capital raise triggered by the Proposed Rule appears likely rival the top 10 IPOs *combined*. We encourage the FHFA to carefully consider this perspective with respect to incentives it creates (e.g. via the leverage ratio) or areas which may create unnecessary volatility in capital needs (e.g. procyclicality and the Advanced Approach). Also, since potential investors may wish to spin off Multifamily operations from Single-Family, we ask that the FHFA be particularly mindful of Multifamily versus Single-Family capital as independent units, as opposed to primarily evaluating Enterprise-wide adequacy.

We note that certain themes overlap with our 2018 response letter. Most Multifamily-specific elements of the Proposed Rule remain intact, but we do not reiterate the same points. This document instead builds upon and acts as a supplement to our 2018 letter, and where there is overlap, we've introduced new data or made adjustments.

Since the Enterprises' Multifamily businesses form an essential element of the US housing system, including for low-income renters, much is at stake with the Proposed Rule and it's critical that the FHFA get it right. The Proposed Rule provides a good foundation upon which to recapitalize the Enterprises, and we believe that by addressing the concerns outlined herein the FHFA can help ensure a safe, sustainable, and profitable housing market.

The DUS Advisory Council's Specific Recommendations

The DUS Advisory Council presents the following specific recommendations to the FHFA:

1. **Risk Weights:** Hold Multifamily Base Credit Risk Capital / Risk Weights to the same standards as Single-Family. We recommend the FHFA ensure that when modeled stressed are used, both asset classes use a consistent underlying economic forecast, and are calibrated to the historical record. We recommend that Multifamily's aggregate risk weight not exceed 29%, and that relief favor lower-leverage loans as we demonstrate relative risk-insensitivity in the current proposal.
2. **Procyclicality:** Address Procyclicality by adopting the DUS Advisory Council's streamlined framework presented herein. In essence, this proposal remains grounded in surveillance but does not increase capital for market-wide shocks within the bands that capital is intended to protect. It adds back the first 15% of market-wide NOI declines to MTMDSCR, and 35% of market-wide value declines to MTMLTV, subject to discretionary FHFA limitations. We feel this is more internally consistent with other Proposed Rule elements, and less prone to estimation error, than the FHFA's Single-Family mechanism.
3. **Multipliers:** We recommend the FHFA reevaluate its term multiplier, reinstate the Affordable multiplier subject to any minor adjustments deemed necessary, and reduce capital on conventional Multifamily with correspondingly higher multipliers for Seniors and Student Housing (we suggest 2.00x and 1.25x respectively). We also propose a small modification to the loan size multiplier, introducing interpolation as opposed to a pure lookup table, to discourage overextending on loans to obtain capital relief.
4. **Leverage Buffer:** Decrease the PLBA from 1.50% to 0.75% of adjusted total assets, so that leverage requirements would remain a credible backstop while being less likely to present an incentive-distorting binding constraint
5. **Front-End CRT:** Front-end loss sharing like DUS risk sharing with lenders should not be subject to the Overall Effectiveness Adjustment ("OEA") in the Credit Risk Transfer ("CRT") calculations.

Hold Multifamily to Same Standards as Single-Family

The DUS Advisory Council again requests that the FHFA perform a quantitative reevaluation of the Proposed Rule with respect to Base Credit Risk Capital / Risk Weight grids for Multifamily, as they appear to be the results of a standalone modeling exercise that was neither grounded in its own history nor held to the same standard as the larger Single-Family business.

In this section we explore the FHFA's dichotomy in treatment between the two asset classes, as a function of historical calibration and structural features. We demonstrate that Multifamily is charged more capital despite exhibiting lower losses through multiple business cycles, and explore structural elements of the FHFA's approach that appeared to differ. Our findings echo certain themes of our 2018 response letter, but we've added considerable amounts of new data and have responded to statements the FHFA made in its 2020 Proposed Rule.

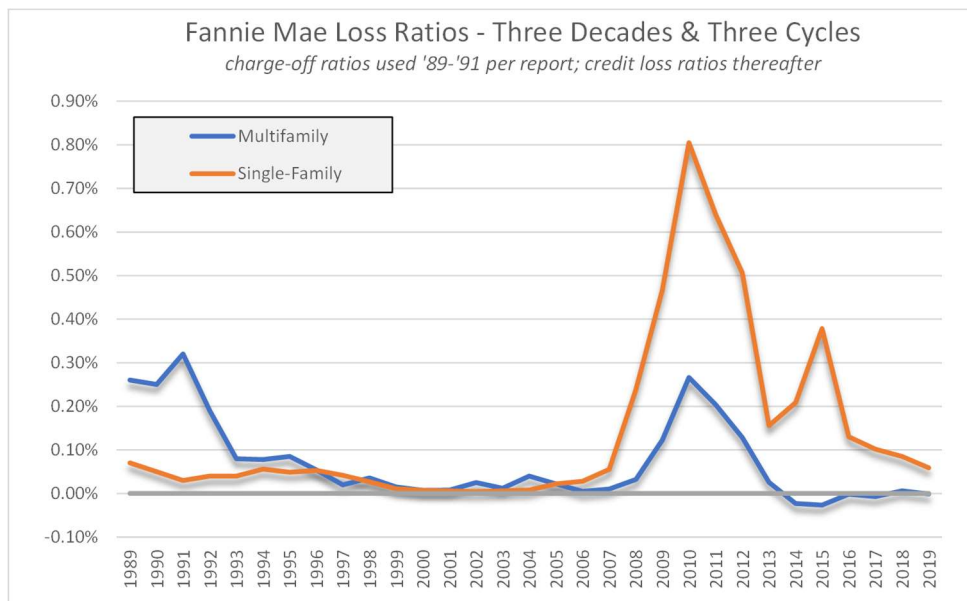
We are concerned that Multifamily, a minority of the FHFA's responsibilities and the Enterprises' businesses, was not afforded the same degree of consideration shown to Single-Family, raising the stakes for unintended consequences.

Evidence SF and MF Treated Differently

There are several quantitative and qualitative features of the 2020 Proposed Rule that we believe demonstrate capital was applied inconsistently between the asset classes.

Examining the Long-Term Historical Record

Multifamily and Single-Family have markedly different track records. We begin by demonstrating this via Fannie Mae's Credit Loss Ratios going back to 1989, which we compiled via Information Statements supplied to the FHFA and/or 10-K / Annual Reports³.



It's quickly apparent that Multifamily's losses were in fact higher in the wake of the S&L crisis than during the 2007-2009 Great Financial Crisis ("GFC"). However, both periods' Multifamily loss ratios were eclipsed by Single-Family's experience in the GFC. Single-Family's peak loss ratio more than *doubled* that of Multifamily.

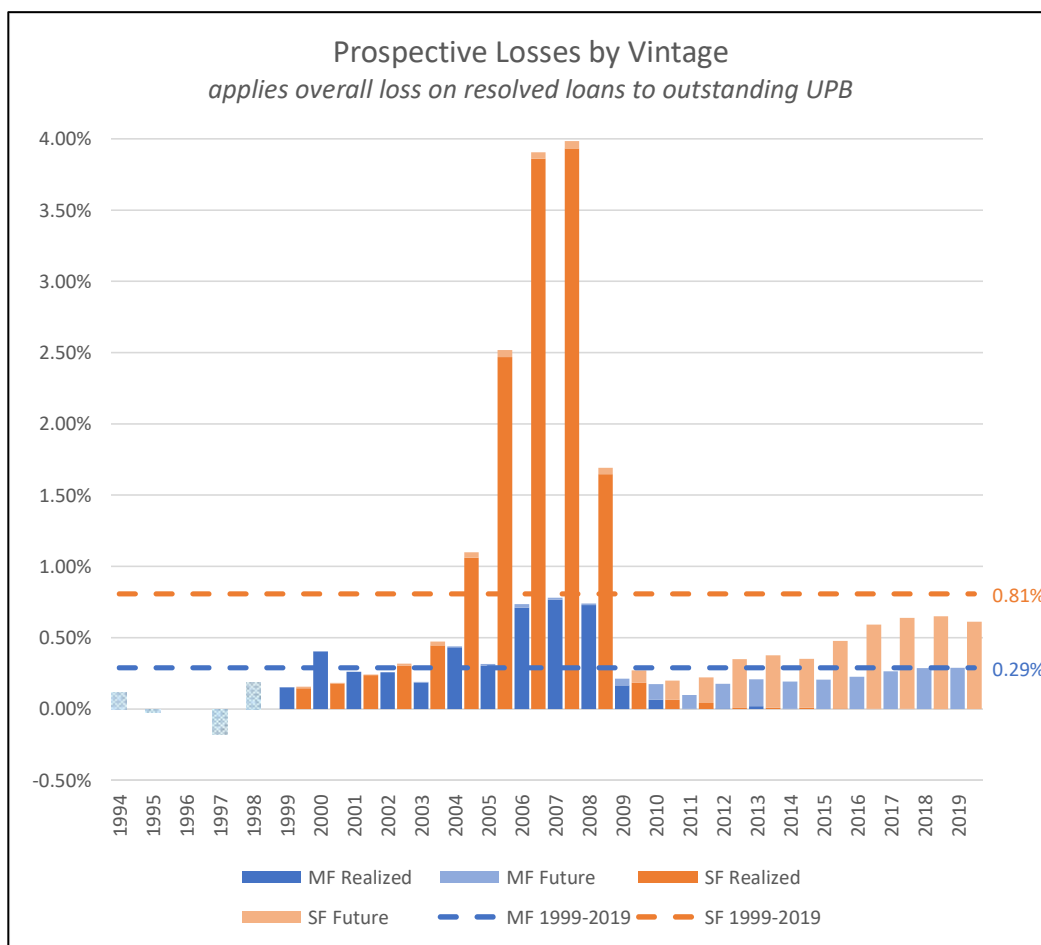
As these measures reflect the year of loss, they're highly illustrative given their length (back to 1989) but not directly relevant to capital concepts which evaluate unexpected *lifetime* losses. We believe vintage analyses are a better

³ Reported credit loss ratios from 1992 onward. 1989 to 1991 present charge-off ratios as adjusting factors were not available; since this does not include foreclosed property income typical of the period, it therefore is expected to err on the conservative side for Multifamily.

theoretical comparison, and so have used published Fannie Mae and Freddie Mac’s FHFA-mandated MLPD databases to construct losses for each vintage.

In the chart below we show the following elements:

- **Solid Bars:** Cumulative realized loss rates by vintage
 - For completeness includes pre-1999 Freddie MF in checkered blue, without comparative figures
- **Dashed Lines:** Rate of loss for all resolved loans across vintages, by asset class
- **Pale Bars:** Estimated lifetime loss rates by vintage,
 - This accounts for any unresolved loans by applying the lifetime rates of loss (i.e. 81 or 29 bps)



This vintage-based analysis supports the preceding chart – realized losses for the worst single-family vintage (2007, 3.93%) outstrip realized losses on the worst Multifamily vintages (2007, 0.77%) by a multiple of more than 5x.

Contrasting with FHFA suggestions⁴, this is a relevant comparison because GFC-era loans are substantially resolved for both Single-Family and Multifamily. In fact, the 2007 Vintage has fewer unresolved loans in Multifamily than in Single-Family (4.4% vs 6.3% as of our analysis). When we apply lifetime loss rates to remaining pool factors⁵, this adjustment therefore has an immaterial effect on the projected lifetime loss for crisis-era vintages, relative to realized levels.

This analysis also presented the DUS Advisory Council with another striking conclusion – since capital only encompasses unexpected losses and the chart above is total losses, under modest assumptions of expected losses, GFC-era Multifamily loans would have lost virtually no capital.

⁴ See “FHFA Comments” subsection below

⁵ Given robust market appreciation since pre-crisis levels we believe this is, if anything, conservative.

Freddie Mac's S&L Experience

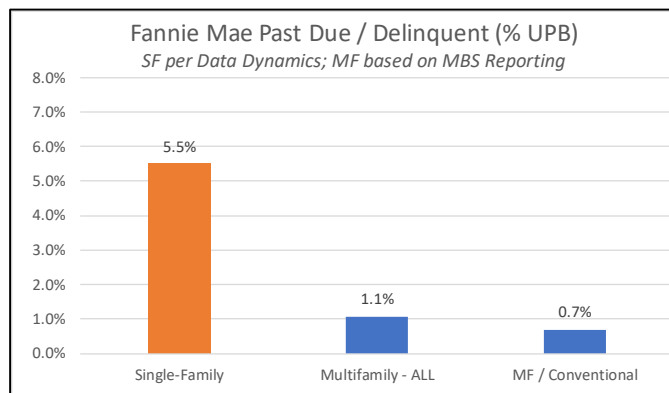
The only evidence we found that could possibly suggest Multifamily's risk approaches that of Single-Family is Freddie Mac's losses during the S&L crisis of the late 1980's and early 90's. We could not locate any public information quantifying the amount of these losses as a rate, but qualitatively we understand they were large.

Freddie Mac's losses during that are period are also irrelevant to the current discussion as they related to structural differences. Consider the following comments presented in 1991 Congressional testimony (see footnote⁶):

- **Investor behavior was tax-driven:**
 - "Particularly in the last decade, the federal tax treatment of rental housing often so dominated the fundamental underlying economics of rental housing deals that many analysts conclude that such projects have been tax driven rather than market driven transactions." (DDP)
 - "The decreases in marginal income tax rates and the increases in the capital gains tax rate under the 1986 Tax Act significantly lower the after tax return on rental housing." (DDP)
 - "For many investors the [Tax Reform Act's eliminating the ability to offset income with losses from real estate] substantially eliminated the tax benefits of investing in rental housing." (DDP)
- **Freddie Mac had a lack of expertise running its program – and was shutting it down:**
 - "Interviews with Freddie Mac staff indicate that Freddie Mac did not really develop the special expertise necessary to underwrite and service multifamily loans" (DDP)
 - Per Freddie: "Last fall, we announced the indefinite suspension of our multifamily programs. We needed to devote our full resources to our problems until we were comfortable that they were under good control... We now have a heightened appreciation of some of the fundamental considerations in underwriting and managing the unique risks associated with multifamily properties" (TW)
- **It was not a data-driven industry like today:**
 - "Compared with other real estate investments, data on the risks and returns of multifamily housing are scarce" (DDP)
 - "Most lenders/investors admit that they do a poor job of tracking the performance of their multifamily housing investments [and are] unsure whether to compare them to single family loans or to nonresidential loans" (DDP)

Current COVID Crisis

Although it's far too soon for conclusive statements, early evidence suggests that Multifamily is weathering yet another crisis better than Single-Family – COVID. Based on June reporting, Multifamily past due / delinquency rates (inclusive of loans in forbearance) were roughly a fifth the rate of Single-Family. Stripping out non-traditional property types such as Seniors Housing, which we separately address, this disconnect further increases.

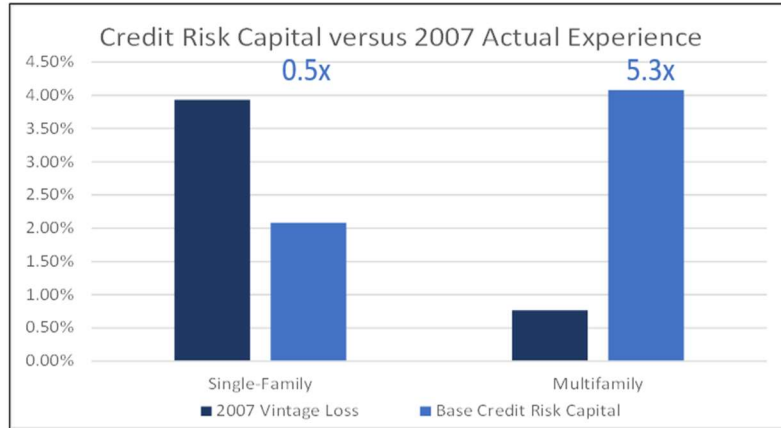


⁶ Hearing before the Subcommittee on Housing and Urban Affairs, of the Committee of on Banking, Housing and Urban Affairs, United States Senate; 10/29/91. Quotes from prepared statements of Thomas Watt ("TW"), SVP of Multifamily Housing at Freddie Mac; and submitted report of Denise DiPasquale ("DDP"), Associate Director, Joint Center for Housing Studies, Harvard University

Capital versus the Historical Record

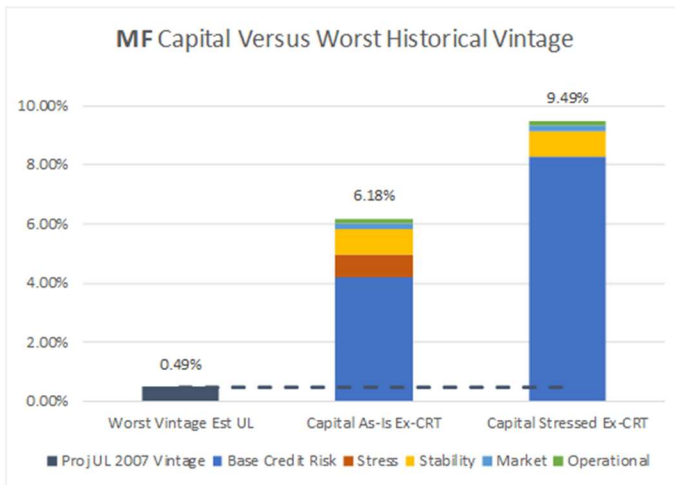
Given the historical record above, we’d expect a data-driven analysis to conclude Multifamily should be charged a fraction of the required capital assessed to Single-Family. Instead, the FHFA determined an average on-book Risk Weight for Multifamily of 51% versus just 26% for Single-Family – almost exactly double – translating to pre-CRT Credit Risk Capital of 4.08% and 2.08% respectively.

Simply comparing these levels to realized losses in the *worst* historical vintage we could locate⁷, the difference is striking – Single-Family’s capital is half its 2007 vintage loss, while Multifamily is charged *more than five times* its worst vintage loss.

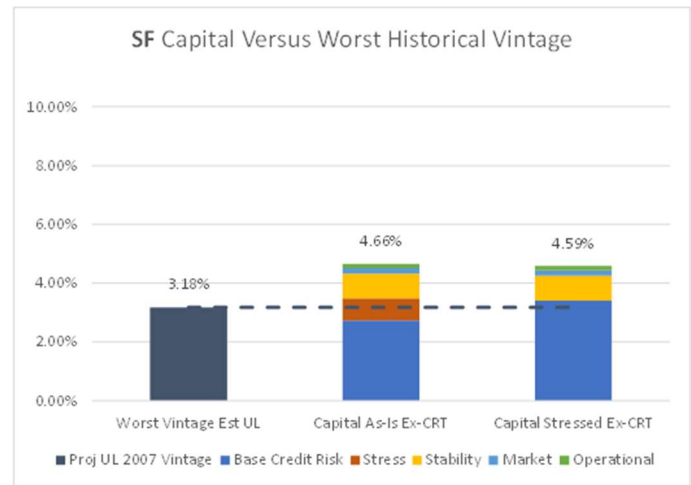


This difference is only more pronounced if we consider the following as it relates to setting capital for new loans⁸:

- EL⁹ should be deducted from realized losses for comparison to capital as it represents only UL;
- Additional non-Credit Risk components of risk-based capital (i.e. PCCBA amounts); and
- Potential Procyclicality influences, which could raise capital now or in the future (*see next section*)



Base Credit Risk uses Fannie Mae issuance data 1/19 to 5/20 excluding facilities, yielding 53% risk weight
 2007 Vintage Losses based on combined Fannie & Freddie Multifamily
 Expected Loss adjustments use cumulative loss rate on all resolved loans (0.29%)
 MTM adj based on passing shocks through Fannie issuance data
 Stability buffer estimated using 23% market share



Base Credit Risk uses 26% risk weight, adj using new issue stats from 2018 Proposal
 2007 Vintage Losses based on combined Fannie & Freddie Single-Family
 Expected Loss adjustments use cumulative loss rate on all resolved loans (0.81%)
 MTM sensitivity of 1.25x assumed to be comparable to MF analysis after application of the collars
 Stability buffer estimated using 22% market share

⁷ Losses use Fannie Mae Data Dynamics, Freddie Mac MLPD and published Summary Statistics

⁸ Note that these build in loss allowances for unresolved loans, and use capital reflecting new issuance. We calculated 420 bps for MF per recent Fannie new issuance loan-level data. We estimate 273 bps for SF, based on the 2018 Proposed Rule’s 257 published for new issue adjusted for changes in the overall levels (26% RWA = 208 bps in 2020 vs 196 bps in 2018).

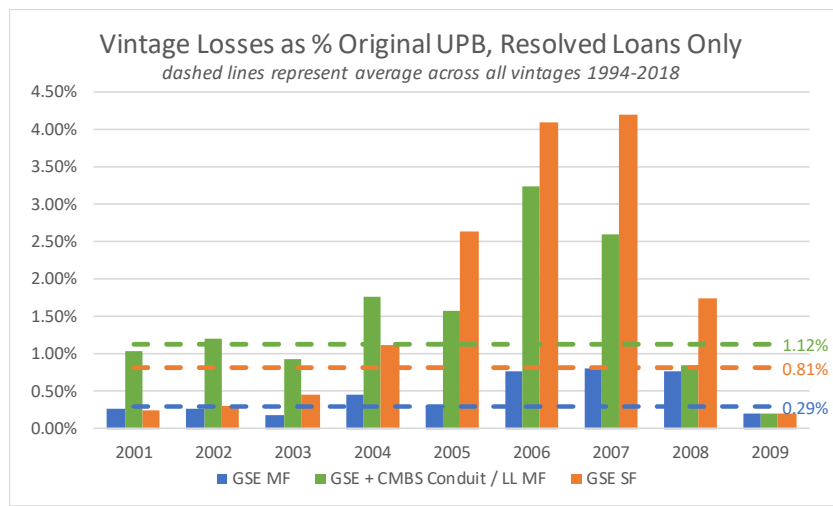
⁹ Estimated here as the average losses on all resolved loans across the GSEs (81 bps SF and 29 bps MF)

Including Crisis-Era CMBS Continues to Favor Multifamily

As a final demonstration of Multifamily’s historically stronger performance, we performed perhaps the *least* favorable comparison we could make: combining CMBS Conduit & Large Loan¹⁰ originations with GSE data on the Multifamily side, and comparing losses against GSE-only Single-Family originations.

The DUS Advisory Council has heard the arguments that many properties financed with CMBS in the past are now GSE-financed, and that as the GSEs took market share from the conduits they assumed the same risk profile. We strongly disagree, but nonetheless felt obliged to address this.

For the avoidance of doubt, we do not believe this to represent a valid comparison. Pre-crisis CMBS loans were not subject to the same underwriting standards as the GSEs, and were known for “proforma” underwriting that often materially exceeded in-place levels. CMBS also generally did not attract the same caliber of borrowers and is sometimes called the “lender of last resort.” This also creates a bias against Multifamily because private-label Single-Family mortgages were omitted – Single-Family losses presented are only GSE loans, and would have shown materially higher had we included Alt-A and Subprime RMBS.



Nonetheless, Multifamily loans outperformed Single-Family. Across all resolved loans (i.e. addressing the FHFA’s concern of outstanding mortgages), Multifamily losses peaked at 3.24% relative to Single-Family’s 4.20%.

With respect to capital determination, merging product types would also require a reassessment of expected losses. These are not observable historically, nor are the FHFA’s and GSEs’ assumptions covered in the Proposed Rule. Still, it’s reasonable to assume that the inclusion of CMBS would increase Expected Loss allowances. Across all vintages for which we have data, GSE and CMBS losses were 1.12%. Deducting this from the 3.24% maximum¹¹ yields an estimation of 2.12% excess “unexpected” losses, which would loosely translate to a risk weight of 27%.

	Multifamily GSE Only	Multifamily GSE & CMBS	Single-Family GSE Only
Peak Vintage Losses	0.80%	3.24%	4.20%
Average Losses	0.29%	1.12%	0.81%
Excess Losses	0.51%	2.12%	3.39%
Approximate RW	6%	27%	42%

The DUS Advisory Council is aware that capital is not determined exactly in this manner. We find it illustrative, though, that even if we take what we believe to be an unreasonable approach of including CMBS and evaluating peak vintage losses (nominal or “excess”), this further calls into question the Multifamily capital portion of the Proposed Rule.

¹⁰ Data per Trepp, using CREFC property type of “MF”. Organized by Deal closing. Data uses most recent as of August 7, 2020.

¹¹ This method in effect applies the loss rate on resolved loans *for a given vintage* to unresolved loans, which is excessively conservative but presented for simplicity.

This underlying theme is generally consistent with the 2018 Proposed Rule to which the DUS Advisory Council responded. In the 2020 Proposed Rule, we contrast the following two statements:

Multifamily: “After consideration of the commenters’ suggestions, FHFA believes the calibration of the multifamily grids is appropriate. The base risk weights in the multifamily grids represent estimates of lifetime losses (net of expected losses), so one should expect the base risk weights in the multifamily grids to be larger than observed losses experienced during the recent financial crisis.” (p. 163)

Single-Family: “FHFA calibrated the base risk weights and risk multipliers for single-family mortgage exposures to require credit risk capital sufficient to absorb the lifetime unexpected losses incurred on single-family mortgage exposures experiencing a shock to house prices similar to that observed during the 2008 financial crisis.” (p 105). However “absent [the] 15 percent risk weight floor, the proposed rule’s credit risk capital requirements as of the end of 2007 would not have been sufficient to absorb each Enterprise’s crisis-era cumulative capital losses on its single-family book.” (p. 148)

From this we conclude that the FHFA was highly sensitive to historical calibration on Single-Family. Adequacy was determined at a book level, not a worst-vintage level as presented above which we expect would drive capital requirements higher. Still, capital sufficiency would have been borderline and necessitated a loan-level 15% risk weight floor that increased *average* risk weights from just 21% to 26%. This leads us to believe that at a *book* level capital would now exceed unexpected losses by at most 24% (26%/21% - 1).

On the Multifamily side, however, we question why no historical calibration seems to have been performed as in Single-Family. The distinction of lifetime versus realized losses distracts from this point, as it would only be valid if a material portion of the then-current book were still active and susceptible to losses.

In fact, this is both untrue and backwards. 2007 Vintage Multifamily is largely resolved, with just 4.4% of loans still outstanding. Using figures in the previous section, even fully writing off these assets would barely justify Multifamily capital levels. Instead those few outstanding loans are generally performing and have enjoyed the benefits of 13 years of robust price appreciation during which prices increased 85% from the pre-crisis peak per RCA’s CPPI Index (to June 2020). Moreover, this statement doesn’t hold up since there are *fewer unresolved loans in Multifamily than in Single-Family* (4.4% vs 6.3% as of June 2020 across the GSEs). Why wasn’t this a concern in the Single-Family analysis?

We take this to mean that the FHFA’s Multifamily grids were strictly modeled results that were neither calibrated to nor evaluated against historical data. At a macro level we ask, if this was not data-driven then why does the FHFA feel comfortable with its capital levels? Following is a partial list of FHFA comments and DUS Advisory Council responses.

FHFA	DUS Advisory Council
It could be argued that Multifamily benefited from the housing crisis and hasn’t gone through a crisis itself.	First, although homeownership rates declined post-crisis, MF values still declined by more than SF. Second, contributing factors that could have benefited MF (e.g. sustained low rates) also helped SF. Third, as FHFA noted the SF industry received specific government support (e.g. Home Affordable Modification Program)
Seniors Housing and Student Housing lead to Multifamily being riskier.	We agree that these asset types are riskier, but these represent a small fraction (~6%) of MF at large. Also, this could be dealt with via Multipliers where the FHFA makes zero adjustment for Seniors and a minor 1.15x multiple for Student (see discussion below).
Balloon payments make Multifamily riskier	Balloon payments were present in GFC-era loans too, and Multifamily fared much better than SF. Within MF, as we discuss in the Term multiplier section, this is the largest concern for short-term loans which the FHFA <i>incentivizes</i> .

Potential Reasons for This Discrepancy

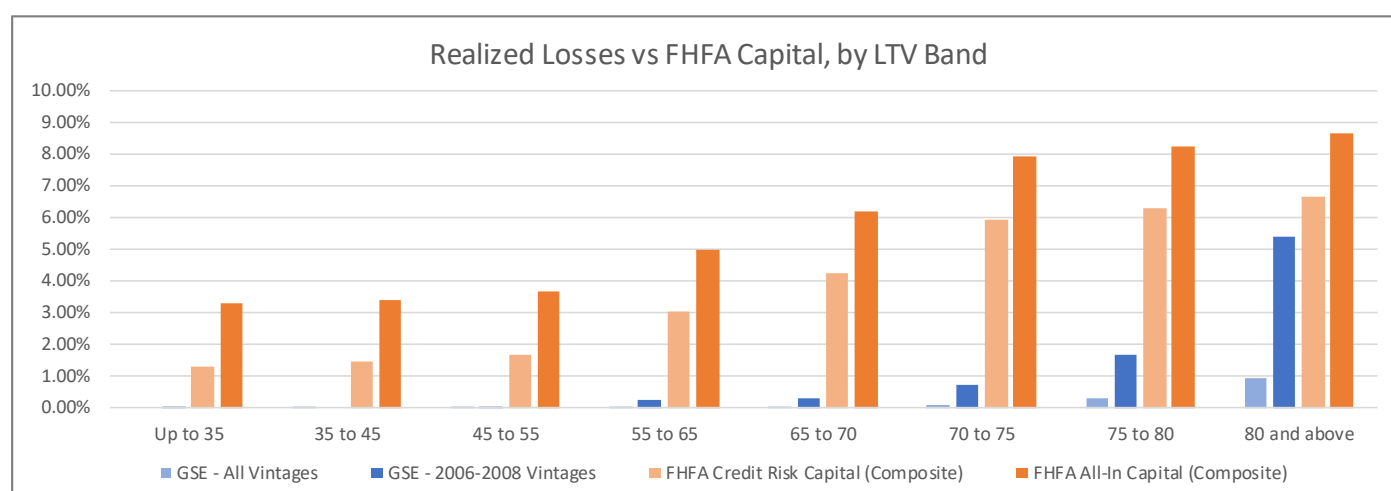
Without a clear indication of what drove the higher capital grids for Multifamily relative to Single-Family, the DUS Advisory Council attempted to determine potential drivers of these results.

Risk-Insensitivity

We first evaluated observed data in the GSEs' combined MLPD¹² databases, to identify problem areas that could indicate invalid modeling assumptions.

The largest area uncovered was leverage. Per the data below, at the highest-LTV band of 80%+ LTV, Credit Risk Capital is high but not drastically so. The combined 5.37% Stressed Loss (here defined as the 2006 to 2008 vintages) less the 0.90% "Expected" Loss (proxied as all vintages) equates to estimated 4.47% historical unexpected losses, compared to composite credit risk capital¹³ of 6.65%. This results in a capitalization multiple of 1.5x – high but not unreasonably so.

As leverage decreases however, the relative differences become more and more pronounced. Below 55% LTV, losses have been virtually nonexistent, leading us to estimate that these loans are more than 50x overcapitalized.



LTV Band	Up to 35%	35% up to 45%	45% up to 55%	55% up to 65%	65% up to 70%	70% up to 75%	75% up to 80%	80% and above
Stressed Loss (2006-2008 Vintages)	0.02%	0.00%	0.04%	0.25%	0.31%	0.69%	1.68%	5.37%
Expected Loss (All MLDP Vintages)	0.00%	0.00%	0.01%	0.04%	0.04%	0.10%	0.31%	0.90%
Historical Unexpected Loss	0.02%	0.00%	0.03%	0.21%	0.27%	0.60%	1.37%	4.47%
FHFA Credit Risk Capital (Composite)	1.28%	1.43%	1.65%	3.00%	4.22%	5.90%	6.26%	6.65%
Credit Risk Capitalization Multiple	59.5x	<i>inf</i>	51.4x	14.1x	15.7x	9.9x	4.6x	1.5x

figures may not foot due to rounding

The DUS Advisory Council therefore believe that the Proposed Rule is relatively risk-insensitive, when compared to history.

Mathematically, we can think of two assumptions that could generate the losses in the chart at the low-leverage bands: a) a sustained period of distressed values in the FHFA's mandated stress, combined with b) high assumptions of volatility / idiosyncratic risk.

¹² Multifamily Loan Performance Database. As of this writing performance data available through 2019 for Fannie Mae and 2018 for Freddie Mac.

¹³ Built using loan-level Fannie Mae new-issuance data on all conventional DUS originations between 1/2019 and 5/2020.

FHFA Standards and Assumptions

We speculate that only a prolonged amount of stress could generate the values in the table. The FHFA has published its mandated shocks of 15% for NOI and 35% for value, but was silent regarding other modeling parameters such as the duration of the stress and strength of the recovery. For instance, did Single-Family assume a “V”-shaped recovery versus Multifamily taking a much longer time? We appreciate that different asset classes would behave differently, but recommend that the FHFA at a minimum ensure that its underlying economic forecasts for modeling are consistent between Single-Family and Multifamily.

Idiosyncratic Risk Assumptions

We also strongly suspect that the models used assumed high levels of idiosyncratic risk. Otherwise, it would be impossible to generate losses below 65% LTV given the FHFA’s 35% peak-to-trough value decline (subject to di minimis allowances for friction costs).

In our 2018 response letter, we detailed our estimation that the models used an idiosyncratic risk assumption (expressed as annualized standard deviation) of approximately 10.6%, versus our extensive data analysis which resulted in a far lower 8.75% figure. We will not repeat that analysis here since the FHFA has not made any refinements to the Multifamily grids since, but recommend that the FHFA and/or Enterprises reevaluate this important modeling parameter.

Recommendations for Correction

The DUS Advisory Council does not believe it would be prudent or helpful to offer our own proposed capital grids, multipliers, etc. as this is squarely the responsibility of the FHFA. Instead, we propose that the FHFA reevaluate its Multifamily capital grids and multipliers, and ensure that levels are a) done using a consistent forecast of underlying fundamentals between the Enterprises and with Single-Family, b) calibrated to the historical record, especially relative to Single-Family, and c) more risk-sensitive with respect to leverage than the current grids.

That said, we believe that based on data presented herein, a reasonable overall result for Multifamily would be an aggregate Credit Risk Capital level not exceeding a 29% risk weight (232 bps). This would continue to far exceed Multifamily’s historical level based on available data and offer a **3x** multiple of the worst vintage’s experience, but significantly alleviate the potential adverse impacts that could result from the Proposed Rule.

Procyclicality Must Be Addressed in Multifamily

Introduction: Defining the Problem

Procyclicality presents a large and hidden capital requirement that adds to – or more accurately *compounds with* – Base Credit Risk Capital / Risk Weight requirements being too high. At their core, capital requirements are calibrated to insulate an Enterprise from a given level of systemic shock, so that the Enterprise could use a portion of its capital to offset losses. However, if the market sustained the very systemic shock from which capital offers protection, the Proposed Rule does not allow drawing this capital down but instead triggers additional capital requirements. As capital would typically be both scarce and expensive in the midst of a recession, a prudent manager would consider raising the capital in advance of a market stress. This feature was recognized by the FHFA:

“Under the 2018 proposal, the Enterprises would have likely found it necessary to maintain a considerable capital surplus in anticipation of a financial stress... Because a managerial cushion in anticipation of an eventual stress would have been a practical, if not legal, necessity for the Enterprises, comparisons to the 2018 proposal should start with a reasonable assumption regarding the amount of this capital surplus.”

In its 2020 Proposed Rule, the FHFA has made a concerted effort to address procyclicality as a general matter. Superficially, at an Enterprise-wide level, they succeeded. However, we believe the FHFA made two significant errors.

First, Procyclicality in Multifamily was not substantively addressed and remains alive and well. This is a significant concern. The use of MTMLTV and MTMDSCR for capital determination result in Credit Risk Capital that would essentially double from stated values if the mandated shocks were realized. As procyclicality is multiplicative, this feature compounds with capital that’s already too high relative to Single-Family and its own merits, as described above. If stated capital requirements are too high by a factor of even 2x (which is if anything low given our analysis above), and during a stress capital requirements would approximately double (as we demonstrate below), then Procyclicality forces *effective* capital requirements to 4x their defensible values in Multifamily.

We argue that Procyclicality is more important to Multifamily than Single-Family, as Procyclicality could *create* balloon risk at maturity. If Enterprises are forced to raise capital when loans are due, they’ll be less able to provide refinances and this will directly increase credit risk. This also runs counter to the FHFA’s expressed desire to “[preserve] room for a larger role during a period of financial stress”. The Procyclicality in MF should have been addressed *before* SF.

Second, we recommend that the FHFA reconsider the manner in which it addressed Procyclicality on the Single-Family side as we find it both conceptually internally inconsistent and mechanically unstable. Conceptually, the application of a trend to MTMLTV means that rather than using the stated 25% peak-to-trough decline, the effective shocks consist of “current-to-collar” adjustment together with a 25% “trend-to-trough” shock – which may result in more or less than the 25% peak-to-trough decline. Moreover, marking to the “trend” to address a perceived build-up of risk seems to conflict with the Countercyclical Capital Buffer. In any event, the trend construction is highly sensitive to beginning and ending periods used, any adjustment to which could result in values appearing too low or too high.

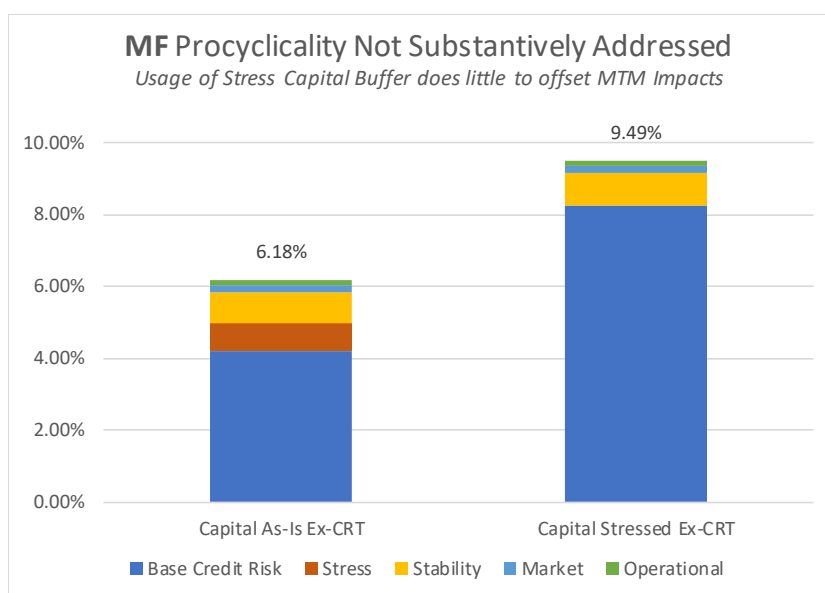
We propose a different approach, which mitigates Procyclicality while realigning the Proposed Rule with its stated intentions of a) defining stresses in terms of peak-to-trough declines while b) leaving judgment as to whether the market is over- or undervalued as the purview of the Countercyclical Capital Buffer. This proposal is mathematically equivalent to that of our 2018 response letter, but simplified and conformed to the 2020 Proposed Rule’s terminology.

As an aside, we urge the FHFA to consider another factor addressed in neither the Proposed Rule nor our recommendations – that retaining even a fixed amount of capital is inherently Procyclical. Capital is intended to cover unexpected losses exceeding “expected” levels. Meanwhile, EL is addressed via income & retained earnings and falls almost entirely outside the umbrella of capital rules. In theory, realizing the stress should lead to EL converging on the original UL + EL, depleting capital as it’s converted to EL via earnings. Thus, adding a fixed UL level to an expanded EL level increases the effective stress. Increasing UL levels via MTM mechanisms only exacerbates this phenomenon.

Quantifying Procyclicality in Multifamily

As in the 2018 Proposed Rule, Base Risk Weights / Credit Risk Capital represent unexpected losses corresponding to a 15% NOI and 35% value peak-to-trough decline, but are calculated as a function of the most recent or “MTM” DSCR and LTV. As a simple example, a fixed-rate loan with an original DSCR of 1.40x and LTV of 70% would carry an initial 59% risk weight / 4.72% base capital. If there were a recession with 15% NOI and 35% value declines – the FHFA’s stress – then MTMDSCR would be expected to deteriorate to 1.19x and MTMLTV to 108%. This would lead to a risk weight of 134% / 10.72% base capital, more than double the original level despite it being a function of the exact stress capital was intended to cover.

In the Multifamily segment, the only change with respect to Procyclicality between the 2018 and 2020 Proposed Rules was the ability to draw down on the Stress Capital Buffer (replacing the Going-Concern Buffer). Demonstrated using all conventional DUS loans originated between January 2019 and May 2020, we can see that Base Credit Risk Capital requirements essentially double (+97%) when origination DSCRs and LTVs are shocked by 15% and 35% respectively. The potential to draw down the Stress Capital Buffer only mitigates about a sixth of this increase, leaving all-in capital requirements to increase by more than half (+54%).



This is flawed for two primary reasons.

First, capital is theoretically framed as covering a *peak-to-trough* decline, but this usage treats income & value declines as always occurring relative to *current* levels. As a result, if the stated 15% income / 35% value declines are realized, this is effectively *compounded* to require peak-to-trough 28% income and 58% value declines.

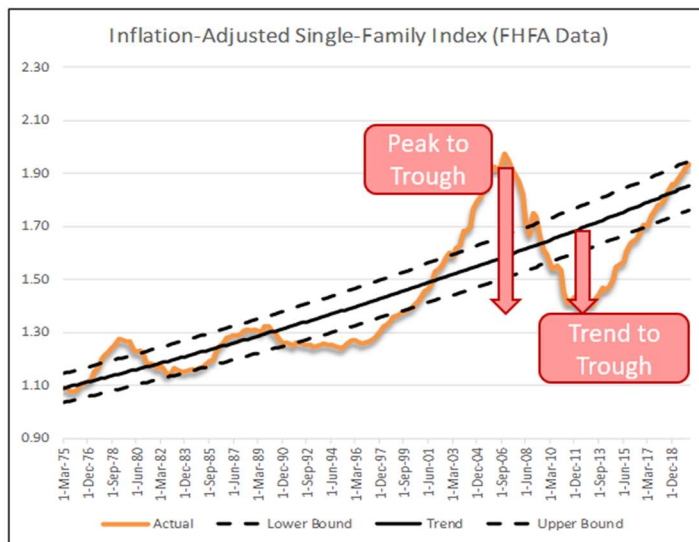
Second, it concerns us that the Procyclicality issue forces the Enterprises to choose between burdening themselves by raising the marginal capital now, or repeatedly gambling with the prospect of undercapitalization, whereby an eventual downturn would force raising capital when it’s most scarce and expensive. Since the FHFA claimed that a “managerial cushion in anticipation of an eventual stress would have been a practical, if not legal, necessity for the Enterprises” we expect that the FHFA is prescribing the former option, and that Procyclicality presents a large & hidden shadow capital requirement that could have a negative impact on the ability to raise capital.

FHFA’s Flawed Single-Family Countercyclical Adjustment

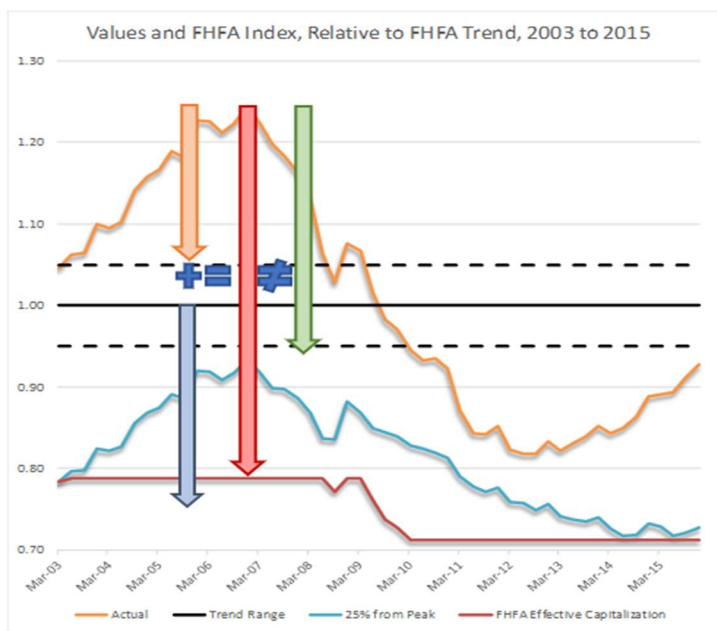
On the surface, the FHFA solved the issue of procyclicality for Single-Family via a combination of the Stress Capital Buffer and, primarily, the introduction of the trend-based Countercyclical Adjustment. We support the conversion of the Going-Concern Buffer to the Stress Capital Buffer as this capital can now be drawn upon in times of distress. While we lack granular Single-Family data, we estimated that the combined impact of these features would effectively tame Procyclicality in Single-Family.

That said, we find the manner in which the Countercyclical Adjustment was constructed to be problematic on conceptual and practical grounds. We explore the FHFA to address Multifamily's Procyclicality, but we do NOT recommend adopting this mechanism for Multifamily (and suggest it be changed for Single-Family) for four reasons.

First, we're unsure of the significance of *any* simple trend in the first place, and why the FHFA believes it to represent the appropriate benchmark from which economic shocks should be applied. In any event, shocks are typically defined relative to peak values as the FHFA outlined.



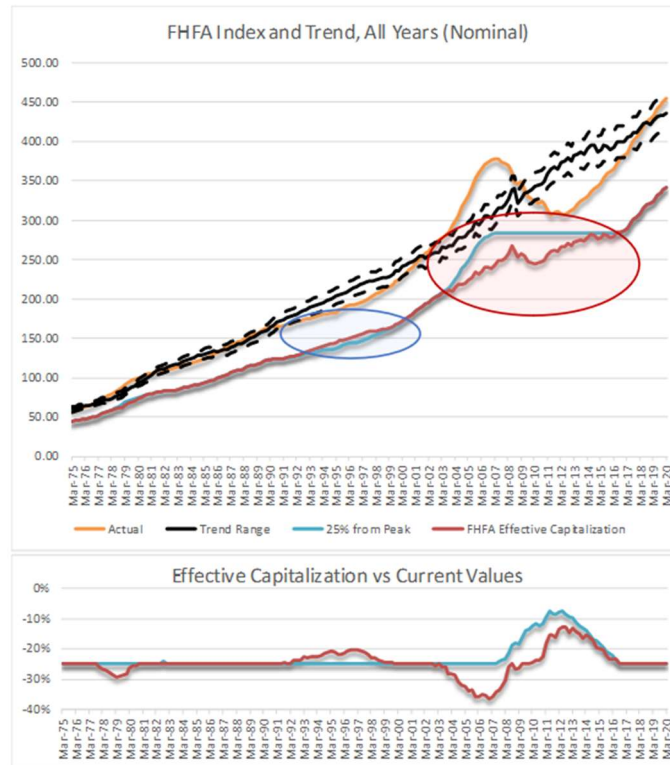
Second, this construction puts the Proposed Rule at odds with itself conceptually. The usage of the "trend" paradoxically conflicts with the stated intention of the shocks that capital is supposed to protect from. Whereas the shocks are intended to be "peak-to-trough" declines of 25%, the effective shocks instead consist of "current-to-collar" plus "trend-to-trough" which we find equally unintuitive and complicated. In 2007, this would have led to a capitalized *peak-to-trough* decline of 37%.



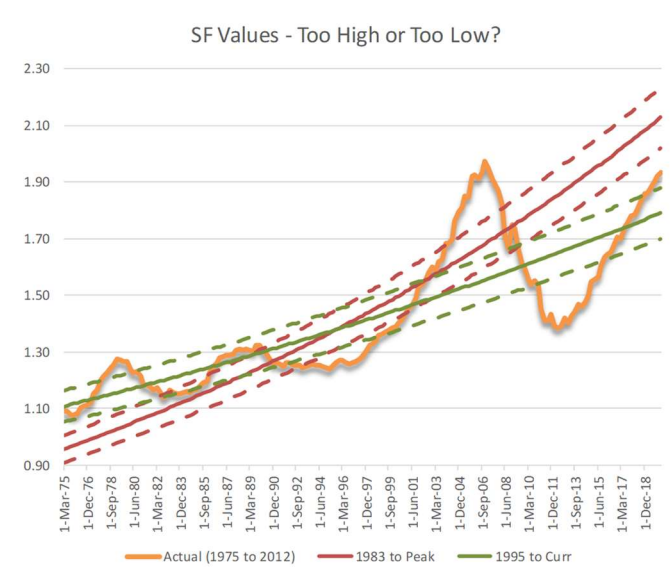
	Haircut	Multiplier
Countercyclical Adjustment / "Current to Collar"	-16%	0.84x
x Implied 25% Decline vs Trend / "Trend to Trough"	-25%	0.75x
= Effective Decline Capitalized	-37%	0.63x
vs Capitalization to 25% below Peak	-25%	0.75x

Note: arrows correspond to 2007 peak

Shown in nominal values, this deviation versus the mandated 25% peak-to-trough decline would have existed in both directions historically, this would have persisted for long periods of time, and this difference is not directly tied to how values fall relative to the FHFA’s index.



Third, the “signals” from the trend are highly sensitive to the beginning and ending periods used – and therefore unstable. While the FHFA cut off its trend definition at the 2012 trough, we reconstructed the trends using the FHFA’s data but adjusting the time periods regressed. Are Single-Family values too high, too low, or just right?



Last, the feature of marking values down to a trend to handle “hot” markets conflicts with another core element of the Proposed Rule. The Countercyclical Capital Buffer’s intent is to handle when “excess aggregate credit growth is judged to be associated with a build-up of system-wide risk.” We’d have more faith in the discretion of those at FHFA adjusting this buffer, compared to turning over this crucial judgment to a simple regression equation.

The DUS Advisory Council's Proposed Framework

The DUS Advisory Council offers its own suggestion for dealing with Procyclicality, with the following core objectives:

- Present a simple construction that fits the contours of the Proposed Rule
- Ensure capitalized stresses represent peak-to-trough declines
- Ensure systemic stress does not increase capital requirements (i.e. cyclical movements do not lead to Procyclical capital) until the prescribed stresses have been substantially realized
- Leave judgment on whether markets are overvalued in the purview of the Countercyclical Capital Buffer
- Retain the importance of surveillance to capital (i.e. not use at-origination values)

Multifamily shocks at the foundation of the Base Credit Risk Capital grids are 35% value and 15% NOI peak-to-trough declines. We therefore can only interpret the axes of the grids as corresponding to *at-peak* values – or else the Enterprises would always be capitalizing to *additional* shocks of 35% / 15%, regardless of the stage in the cycle.

As a starting point for discussing our proposal, if capital levels are calibrated to absorb systemic shocks of these levels, we think it's only logical that additional capital should not be required until the market has breached these hurdles, or is close to doing so. In simple terms, our framework adds back the first 35% of market-driven value declines and 15% of market-driven NOI declines versus peak values, subject to allowances discussed below.

We recognize that there is always risk of some additional NOI & value declines even in the depths of a recession, and therefore introduce a variable ($Stress_{Min}$) to ensure coverage to a given level of stress at the FHFA's discretion – for example always ensuring capitalization to another 5 or 10% decline regardless of the market cycle.

We commend the FHFA for devoting considerable thought to the role of asset surveillance – as evidenced by its mandating an expanded risk rating infrastructure and requiring MTM-driven inputs to the capital grids. We agree with the FHFA that it would be reckless to undermine this function's connection to capital by using at-origination values. Our framework therefore maintains the ability to differentiate between loans exhibiting large idiosyncratic swings relative to market (e.g. over- and underperforming assets), as well as loans originated in different economic environments (a 75% LTV loan originated in 2013 has a much different risk profile than a 75% loan from 2019).

We propose a Countercyclical Adjustment that's governed by two simple ratios:

- How peak values relate to current values, and
- The maximum allowable credit or "add-back", governed via factors capturing the FHFA's discretionary minimum stress, relative to the prescribed stress (e.g. 35%) used for capital calibration

$$\text{Countercyclical Adjustment} = \text{MIN}(\text{Index}_{\text{Peak}} / \text{Index}_{\text{Curr}}, \text{Stress}_{\text{Min}} / \text{Stress}_{\text{FHFA}}) - 1$$

$$\text{Adjusted MTMLTV} = \text{MTMLTV} / (1 + \text{Countercyclical Adjustment})$$

$$\text{Adjusted MTMDSCR} = \text{MTMDSCR} * (1 + \text{Countercyclical Adjustment})$$

Where:

$\text{Index}_{\text{Curr}}$ = Current Index Value (e.g. CPPI for value)

$\text{Stress}_{\text{FHFA}}$ = 1 – Mandated shock (i.e. 35% value / 15% NOI)

$\text{Index}_{\text{Peak}}$ = Peak Index Value (e.g. CPPI for value)

$\text{Stress}_{\text{Min}}$ = 1 – Minimum shock (if applied)

With respect to index values, a wide range of alternatives could be used including but not limited to:

- Value: RCA's CPPI repeat-sales index, CoStar's Market Sale Price Index, and CBRE Econometric Advisors' Value Index; *we note that such an index is already a permitted method of determining MTMLTV itself*
- Income: CoStar's NOI Index, CBRE Econometric Advisors' NOI Index

All motivations for this proposal are conceptually-driven, but there are also practical advantages. It does not rely on logarithms and regressions like the FHFA’s which require recalibration, and terminology adheres closely to the FHFA’s Single-Family Countercyclical Adjustment, so we believe it would be very easy to integrate into the Proposed Rule.

The examples below reinforce the principles that capital should be raised *once* for a specified *systemic* shock, that all loans with the same risk profile should be treated equally, and that surveillance should remain linked to capital.

Examples of Our Proposal in Action

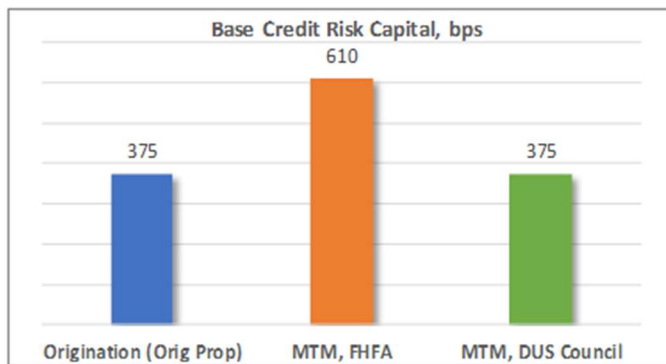
We now present four examples of how our proposal would behave, relative to the FHFA’s, for an original 75% LTV / 1.50x DSCR loan in four situations. Please note that for simplicity of demonstration we’ve set our minimum additional stress to zero ($Stress_{Min} = 100\%$), but this could be adjusted by the FHFA to achieve slightly more conservative results.

Scenario A: Loan behaves like market, market in decline but within specified bands

In Scenario A, the loan’s MTMDSCR and MTMLTV have suffered as a direct result of the market’s performance and are now estimated at 1.35x and 88% respectively. Under the original usage of the grid, this would have led to a capital requirement increasing by more than 50% to 610 basis points. In the DUS Advisory Council’s formulation, since the market is well within the prescribed shocks and the loan showed no idiosyncratic behavior, the Countercyclical Capital Buffer compensates and no additional capital is charged.

Market Indicators					
	Index _{Peak}	Index _{Curr}	Stress _{FHFA}	Stress _{Min}	CCycl Adj
Value	100%	85%	65%	100%	18%
Income	100%	90%	85%	100%	11%

Loan Indicators & Capital			
	Origination	MTM (FHFA)	AdjMTM (DUS C)
LTV	75%	88%	75%
DSCR	1.50x	1.35x	1.50x
Capital	375	610	375



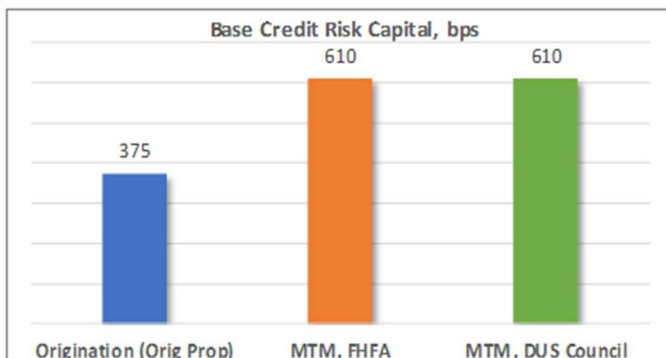
Key Takeaway: Capital should not increase, since market experiencing a shock within the range that capital was originally intended to cover

Scenario B: Loan underperforms the market, market at peak levels

In Scenario B, the loan’s MTMDSCR and MTMLTV have suffered as a result of its own idiosyncratic poor performance and are estimated at 1.35x and 83% respectively. This shows that the poor performance translates to more capital – to 610 basis points under either regime.

Market Indicators					
	Index _{Peak}	Index _{Curr}	Stress _{FHFA}	Stress _{Min}	CCycl Adj
Value	100%	100%	65%	100%	0%
Income	100%	100%	85%	100%	0%

Loan Indicators & Capital			
	Origination	MTM (FHFA)	AdjMTM (DUS C)
LTV	75%	83%	83%
DSCR	1.50x	1.35x	1.35x
Capital	375	610	610



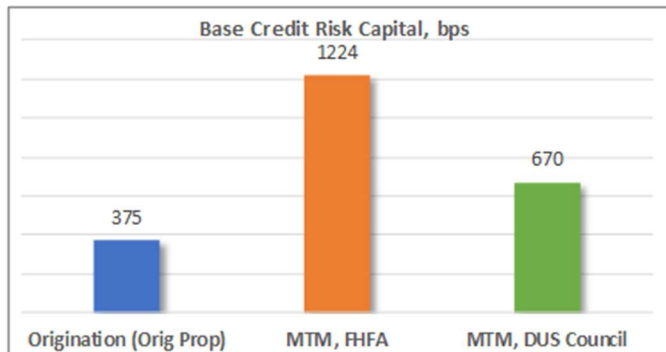
Key Takeaway: Loan surveillance is still important, and if poor performance is unrelated to market forces, no credit should be given

Scenario C: Loan behaves like market, market in deep decline outside specified bands

In Scenario C, the loan’s MTMDSCR and MTMLTV have suffered due to the market’s extremely poor performance and are now estimated at 1.13x and 125% respectively. Under the original usage of the grid, this would have led to a capital requirement more than tripling to 1224 basis points – due to the fact that the implied value drop of its stress is now an aggregate 61% decline. In our proposal, the Adjusted MTMDSCR and Adjusted MTMLTV would reflect the revised values but no additional stress (subject to $Stress_{Min}$) resulting in 670 basis points of capital.

Market Indicators					
	Index _{Peak}	Index _{Curr}	Stress _{FHFA}	Stress _{Min}	CCycl Adj
Value	100%	60%	65%	100%	54%
Income	100%	75%	85%	100%	18%

Loan Indicators & Capital			
	Origination	MTM (FHFA)	AdjMTM (DUS C)
LTV	75%	125%	81%
DSCR	1.50x	1.13x	1.32x
Capital	375	1,224	670



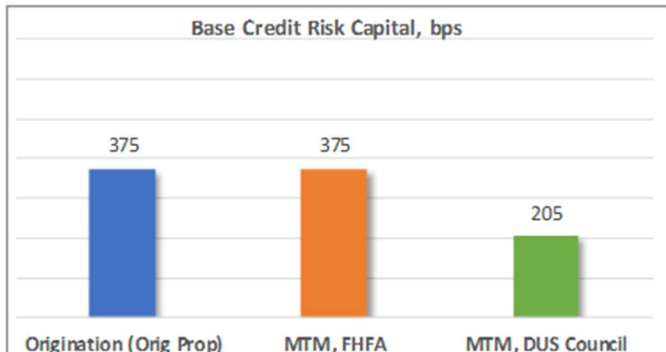
Key Takeaway: Capital should and does increase due to the depth of market’s decline, but unlike FHFA only capturing extent of bands being exceeded

Scenario D: Loan originated while market in distress

In Scenario D, the loan is originated into a distressed market. As the distressed peak-to-trough “path” has already been realized and not assumed to repeat (again subject to $Stress_{Min}$), the asset would be charged 45% less capital or 205 basis points. We note that this ensures consistent treatment, and application of market shocks, across all assets – after all, following a 35% value decline a 50% OLV asset originated at peak has the same MTMLTV as a 77% OLV asset originated in the trough.

Market Indicators					
	Index _{Peak}	Index _{Curr}	Stress _{FHFA}	Stress _{Min}	CCycl Adj
Value	100%	65%	65%	100%	54%
Income	100%	85%	85%	100%	18%

Loan Indicators & Capital			
	Origination	MTM (FHFA)	AdjMTM (DUS C)
LTV	75%	75%	49%
DSCR	1.50x	1.50x	1.76x
Capital	375	375	205



Key Takeaway: The DUS Council proposal calls for less capital at the bottom of the market, as less susceptible to stress than same LTV lent at market peak

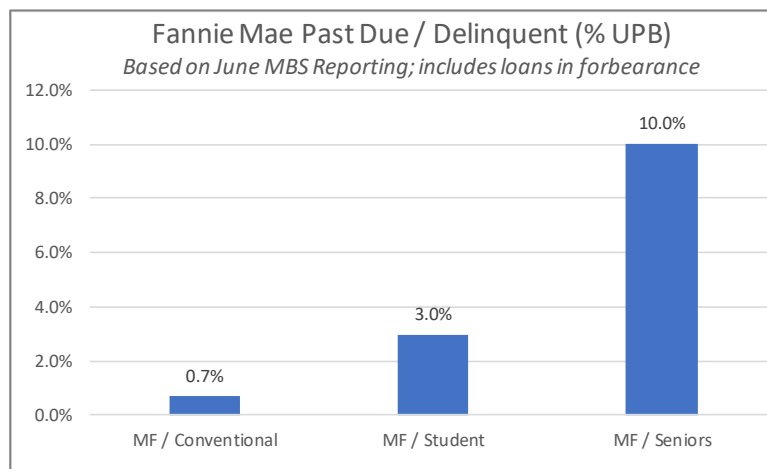
Four Key Multipliers Must Be Addressed

While our first two recommendations relate to capital at a product type level, we believe that four areas merit special attention within the Multifamily sector.

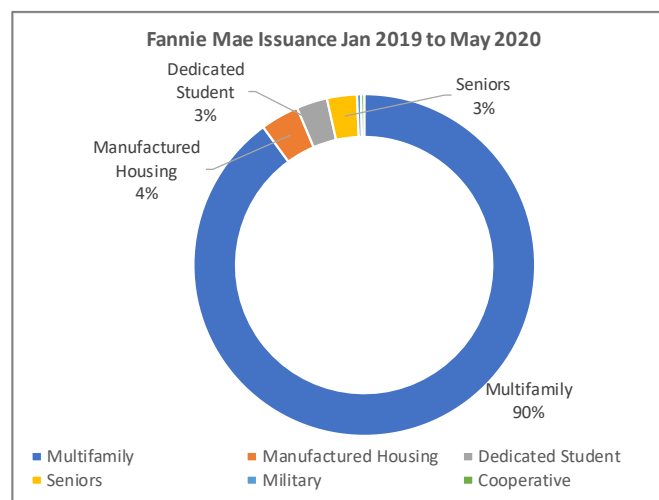
Property Subtypes

In meetings, the FHFA has referenced Seniors Housing and Student Housing as particular concerns in Multifamily – and even held them up as reasons that Multifamily deserves higher capital as an asset class.

We completely concur with the FHFA that, all else equal, these assets merit special attention and are generally much riskier. For example, Seniors Housing typically exhibits far higher operating leverage / expense ratios than do the other property types; digging deeper, Assisted Living can be susceptible to Medicare & Medicaid payments for services, and Independent Living demand is largely discretionary. Student Housing can be especially dependent on university enrollments, shows seasonal fluctuations, and is reliant on a strong leasing season over a few months. This is borne out in performance data:



However, we estimate that these property types are a small minority of Multifamily at large. Each only represents about 3% of deal volumes, so we cannot see the rationale for penalizing the other 94% of the Enterprises' loans that have far different risk profiles.

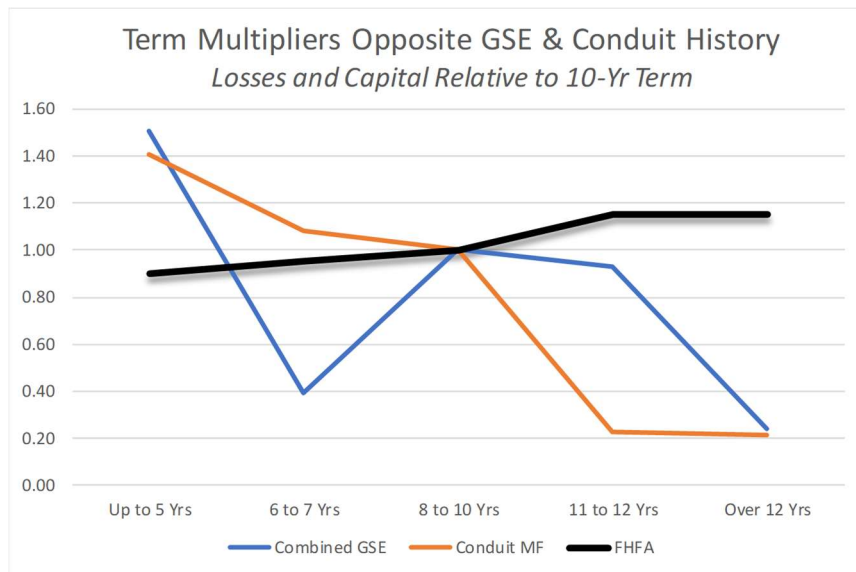


Oddly, despite using these subtypes as justification for charging more MF capital at large, the FHFA made only modest adjustments for Student Housing (115% Multiplier) and no adjustment for Seniors Housing.

We recommend that the FHFA re-evaluate and reduce capital on conventional Multifamily with correspondingly higher multipliers for Seniors and Student Housing (we suggest 2.00x and 1.25x respectively).

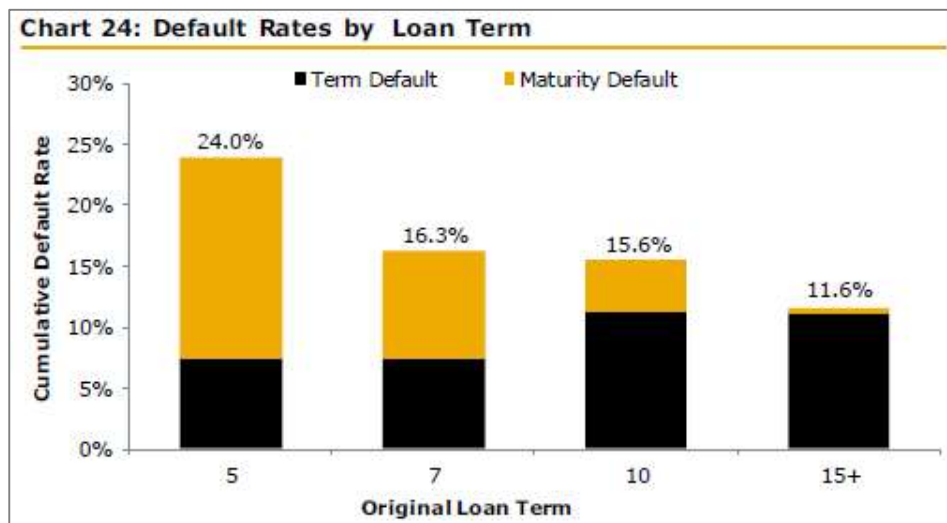
Loan Term

The FHFA’s treatment of loan term directly *contradicts and runs opposite* the historical record. Multipliers positively-correlated with loan term, whereas the GSEs as well as CMBS conduit markets have clearly demonstrated that risk decreases as loan terms extend. Below, we show this historical record which was constructed from Fannie Mae’s and Freddie Mac’s respective MLPD databases, and Trepp data for conduit Multifamily loans.



Rather than a strictly observational recommendation, this is backed by theory. As loan terms extend, term risk of course increases to an extent. The FHFA specifically mentioned balloon risk as a driver of Multifamily’s relative risk, and balloon risk *decreases* with term since loan amortization reduces the balance, while the general trend of price increases cash flow and value. Balloon risk is most relevant when a shock comes early in a loan’s term, so generally declines as underlying trend growth and amortization are allowed to work.

This is again borne out in historical data. Kroll investigated term and maturity risks across the conduit universe¹⁴, and found that a pronounced decrease in maturity risks that more than compensated for marginal increases in term risks, as loan terms extended. In total, a 10-year loan’s default risk was 32% *below* that of a 5-year term, not 11% *above* as in the FHFA’s grids.



We recommend that the FHFA either correct the slope of this Multiplier or eliminate it entirely.

¹⁴ 2018 “CMBS Default and Loss Study”; Kroll Bond Rating Agency, October 15, 2018. Includes all property types.

Loan Size

In our 2018 Response Letter we highlighted our belief that the Loan Size Multiplier’s construction invited bad behavior, since the hard “steps” found in the capital grids created a motivation to stretch on proceeds (i.e. a riskier loan) in order to obtain capital relief. We suggested that interpolation be used between certain levels, so that the Multipliers would smoothly adjust.

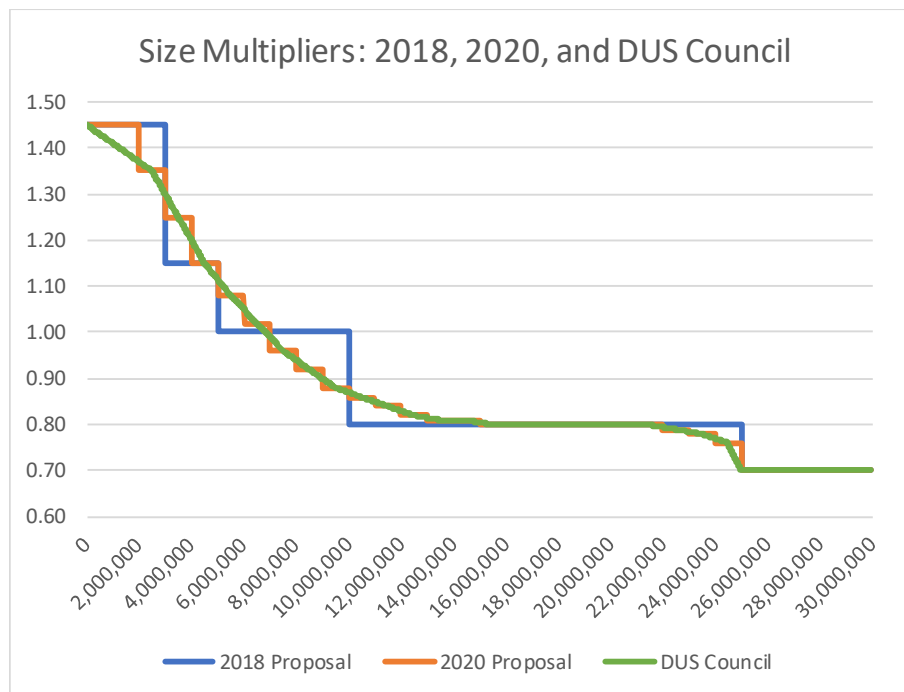
In the 2020 Proposed Rule, the FHFA partially addressed this risk by making the grids more granular, creating 18 distinct buckets instead of the 5 in the 2018 Proposed Rule. We fear that the FHFA may have decreased the benefit of hitting the next size cutoff, but drastically increased the number of opportunities to do so. For example, if a loan sized to \$6.99 million but a 6% capital reduction could be obtained by justifying a \$7.01 million loan, we expect a material portion of loans could be nudged upwards.

We suggest that the FHFA recast the grid at its midpoints (except highest and lowest points) to reduce cumulative impact; then require linear interpolation between the points – with a formula rather than a grid. In effect, this would create an infinite number of steps, and therefore cut the incentive to pass any given threshold. For example:

2020 FHFA Lookup (Excerpt)	Midpoint	Factor
\$6 million < loan size <= \$7 million	6,500,000	1.02
\$7 million < loan size <= \$8 million	7,500,000	0.96
\$8 million < loan size <= \$9 million	8,500,000	0.92
\$9 million < loan size <= \$10 million	9,500,000	0.88

This small adjustment would have minimal impact at an aggregate level but could have a meaningful impact on loan-level behavior.

Loan Size	2020 FHFA Mult	DUS Council Mult
6,950,000	1.0200	0.9930
7,010,000	0.9600	0.9894



We also recommend that if the FHFA adopts this proposed interpolation methodology, it considers using the beginning dollar amount rather than the midpoint as we presented here. Total capital needs would decrease slightly and offset the apparently-unintended increases seen from 2018 to 2020.

Affordability

We are equally curious and puzzled by the FHFA's decision to eliminate the Government Subsidized multiplier of 0.6x in the 2020 Proposed Rule – curious, because this seems to run counter to the FHFA's mission and goals; puzzled, as to the FHFA's rationale.

Per the FHFA in 2018 (emphasis added):

*“The benefits of these subsidies to investors and/or renters generally lead to **property incomes that are less volatile than incomes associated with otherwise comparable whole loans and guarantees**. Less volatile income broadly translates to **lower risk**, and as a result, government-subsidized whole loans and guarantees would be assigned a risk multiplier lower than 1.0.”*

... and in 2020:

*“FHFA analyzed the available performance data for government-subsidized multifamily mortgage exposures, due to the **relatively low instances of loss across multifamily loan programs that include a government subsidy**, FHFA determined it was not feasible to accurately calibrate thresholds at which the **level** of government subsidy impacted the probability of loss occurring or the severity of that loss. As a result of that analysis, FHFA has determined to take the approach of eliminating the government subsidy risk multiplier from the proposed rule to avoid instances where a loan with a **limited** subsidy would qualify for the risk multiplier.”*

This leaves us with the following fact pattern:

- The FHFA sees conceptual validity to subsidized loans having lower risk
- Backing this up, the FHFA has found few instances of loss on these loans
- The FHFA cannot determine any relationship between the level of subsidy and loss
- Notwithstanding this lack of relationship, and on the unproven theses that a) low subsidies equated to higher risk; and b) that low-subsidy loans were a significant portion of subsidized loans, the FHFA decided to eliminate the Multiplier entirely.

Even if there is validity to the FHFA's speculation that lower-subsidy loans carry reduced benefits, we're puzzled as to why the FHFA would not reduce or even eliminate the benefit on *lower-subsidy properties only*. We do not understand why the FHFA would penalize *all* subsidized loans due to an unproven possibility that a subset carried a lower benefit, and not maintain the Multiplier for materially-subsidized loans.

Supplementing the FHFA's own findings, Cohn & Reznick analyzed a database of 18,412 low income housing tax credit (“LIHTC”) properties and just 0.63% suffered foreclosure, which at an assumed 30% severity equates to losses of just 0.2%.

We believe that this topic merits special attention not only because of the FHFA's mission goals but the impact to financing housing for the lowest-income Americans. All else equal, we estimate that this elimination could translate to 28 basis points of loan cost¹⁵, much of which would be borne by low-income renters, and/or further constrain the supply of affordable housing¹⁶.

We recommend the FHFA reinstate its original Multiplier of 0.6x from the 2018 Proposed Rule. If the FHFA has specific concerns on subsidy levels / types (e.g. LIHTC vs Section 8) they should be addressed directly.

¹⁵ 4.20% average capital using new-issue DUS originations, times (1 – 0.6x multiplier), times 71% assumed capital retained for standard loss sharing, times 12% assumed required ROE, divided by (1 – 23% assumed tax rate), times 1.5x to account for accompanying S-Fee increases

¹⁶ This is because a) owners would attempt to pass through some costs directly, while b) lower returns to owners from costs *not* passed through would attract less new capital to increase new projects & developments, further constraining supply.

The Prescribed Leverage Buffer Amount (“PLBA”) Should Be Reduced

We understand and appreciate the FHFA’s desire to set minimum leverage ratios as a component of capital that would, in the FHFA’s words “provide a credible backstop to the risk-based capital requirements... with a simple, transparent, independent measure of risk.”

However, we’re puzzled at the FHFA’s rationale regarding the level, for three reasons.

First and most importantly, to the extent that risk-agnostic leverage ratios become the binding constraint for capital, they introduce moral hazard and radically distort incentives – encouraging riskier lending while discouraging CRT. Thus, we believe they should only be binding in the most extreme situations. The combined 4.0% Leverage Ratio and PLBA acts as a binding constraint to capital for Freddie Mac and nearly for Fannie Mae. The FHFA acknowledged it was cognizant of this, but did not discuss the ramifications.

For as long as leverage ratios remain the binding capital constraint, all else equal an Enterprise seeking to maximize returns will do some combination of the following to maximize ROE:

- Originate / Acquire Riskier Assets, as these would maximize the numerator with a locked-in 4% denominator on the margin.
- Decrease CRT, as the Enterprise could reduce the cost associated with CRT (reinsurance premia, MCAS spreads, etc.) with zero penalty in the denominator – an infinite ROE absent extreme stress

We recognize that other considerations unrelated to ROE (e.g. other risk management, consolidation) may enter into these decisions, but feel that this remains a critical principle that the FHFA overlooked.

Second, this is held up in large part as addressing “model risk and measurement error” – but the FHFA builds capital for this uncertainty directly into risk-based capital itself. For instance, this was a primary justification for the reductions in CRT capital relief, elimination of a capital neutrality assumption, the risk weight floor, and the mandated model risk management supervision; as well as source of concern reflected in Question 91 about whether to increase *additional* capital requirements¹⁷. How many times should the same risk be capitalized?

Third, this provision is held up as mitigating procyclicality. We feel there’s two types of procyclicality – the “bad” type resulting from conceptually-flawed construction as we try to address in this response letter, and the “good” kind that simply reflects well-calibrated changes in the portfolio’s risk profile and resiliency emanating from a changing environment. Of course, procyclicality also could be completely eliminated by dispensing with Risk-Based Capital entirely and employing a fixed capital charge, but that wouldn’t lead to capital being aligned with the risks or good policy. We’re curious as to why the FHFA would want to reduce the connection between capital and the actual risk profile of the asset base.

Fourth, we’re extremely concerned that the FHFA created a 424-page Proposed Rule, and then proceeded with the PLBA to undermine the detailed risk-based capital requirements consuming about 414 of those pages – with all of the attenuating grids, multipliers, haircuts, CRT mechanisms, onerous Advanced Approach-driven infrastructure, etc.

This all leads to two critical and fair questions – to what extent did the FHFA consider the incentives it would create with the Proposed Rule, and do the FHFA’s comments referenced above reflect a lack of confidence in the analysis and modeling backing the risk-based capital regime?

To address these concerns while acting as a pure backstop, we recommend that the PLBA be reduced to 0.75% so that capital could never fall below a robust 3.25% level, where it would remain a credible backstop without being likely to exceed risk-based capital and distort the Enterprises’ incentives relative to the FHFA’s goals.

¹⁷ The only credible area remaining – SF capital’s segregating borrower vs. product risk – would be best addressed in SF capital directly and offers a clue as to why SF capital is treated so much more generously than MF relative to history.

Front-End Lender Risk Sharing Not Equivalent to Structured Back-End CRT

The DUS Advisory Council appreciates the FHFA's concerns that some CRT derivatives may not correlate with the underlying risks, and the FHFA's motivation to create a haircut reducing capital relief obtained through CRT as a result. By citing correlation risks and CRT premia, the 10% Overall Effectiveness Adjustment ("OEA") haircut appears intended to cover structured back-end risk transfer agreements.

However, Lender Risk Sharing typical of Multifamily DUS is not one of them. It is perfectly and contractually correlated with the risks of the underlying mortgages. Further, interim and/or final Asset Valuation Dates generally require the DUS Lender to pay Fannie Mae its portion of the loss prior to final disposition or other realization, minimizing accounting risk.

We believe the OEA is misplaced and inappropriate as applied to front-end Lender Risk Sharing, and look to the FHFA's Single-Family framework for support. Per the FHFA, "capital requirement on the Enterprises' single-family mortgage exposures [reflects] the benefit of private mortgage insurance but no adjustments for CRT." Like Lender Risk Sharing, PMI reflects loan-level (i.e. correlated) front-end risk transfer. While both these front-end mechanisms are assessed capital for counterparty risk, only Lender Risk Sharing is assessed the OEA.

Despite our own confidence in our businesses to continue serving as a reliable counterparty to Fannie Mae, we agree with the FHFA that – from a theoretical standpoint – "a loss sharing CRT generally exposes the Enterprise to counterparty credit risk." We understand the need for a haircut, but are appreciative that the FHFA recognized the value of servicing fees and restricted liquidity.

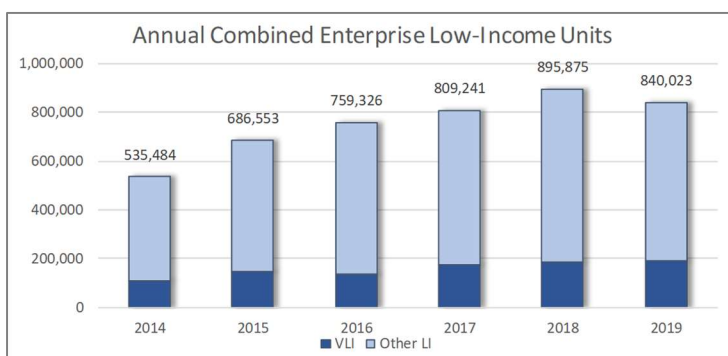
We recommend that front-end loss sharing like DUS risk sharing with lenders not be subject to the Overall Effectiveness Adjustment ("OEA").

Appendix: The Enterprises' Multifamily Business: A Crucial Component of US Housing System

The DUS Advisory Council respects that the FHFA's primary task, and Proposed Rule's intent, is strictly to ensure that the Enterprises are well-capitalized. The Proposed Rule is not – nor should it be – intended to ensure the Enterprises are always profitable, that they remain competitive with other lender types, or that they lower interest rates for borrowers or rental rates for renters. Our response letter has been constructed in kind, and speaks only to how Proposed Rule relates to the safety and soundness of the Enterprises.

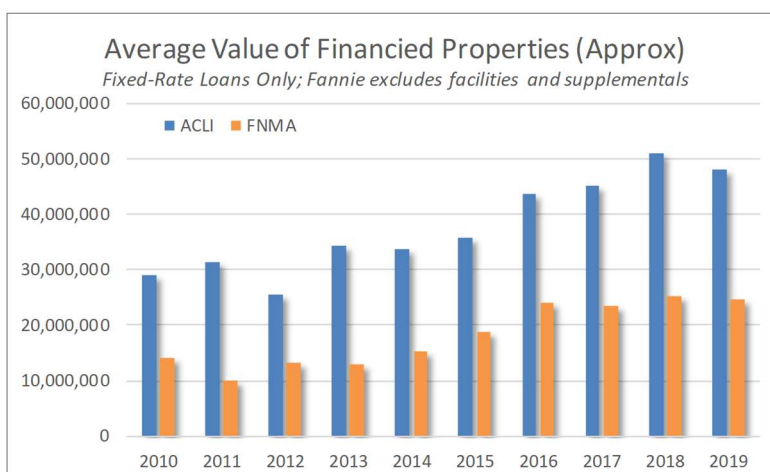
In closing, we offer this Appendix to demonstrate what's at stake.

As the FHFA has stated, the Enterprises "serve the underserved." Per its annual reports to Congress, between 2014 and 2019 the Enterprises provided financing for 4,526,502 low-income housing units, of which nearly a million were very-low-income units. We are not suggesting that capital be set artificially low to facilitate this lending – which would be unsustainable – but if capital is set *higher than the underlying data suggest* then this translates to many low-income families that would be adversely impacted.



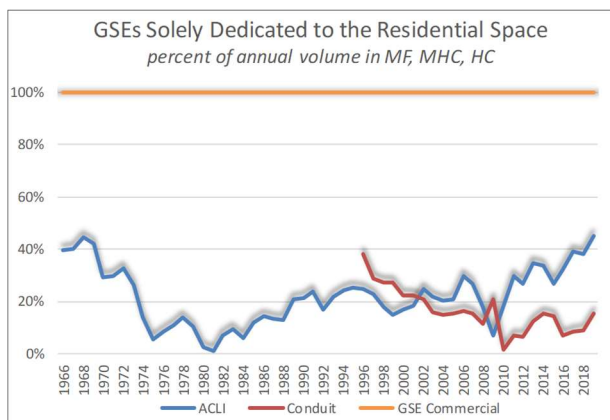
Of course, we recognize that these impacts would be indirect, unlike in Single-Family where borrowers are individuals – but would be no less real. To the extent that borrowing costs increase, landlords would be immediately affected rather than renters. However, faced with lower levered returns rational landlords would attempt to pass on these costs to renters, with likely mixed success. To the extent they're *not* successful it would depress returns available to new projects, in turn leading rational developers to decrease development and exacerbating the affordable housing crisis.

Informally supporting their lower-income profile, the Enterprises lend on distinctly different types of projects than institutional lenders. We estimate that the average property Fannie Mae finances has a value about half that of a life company¹⁸.



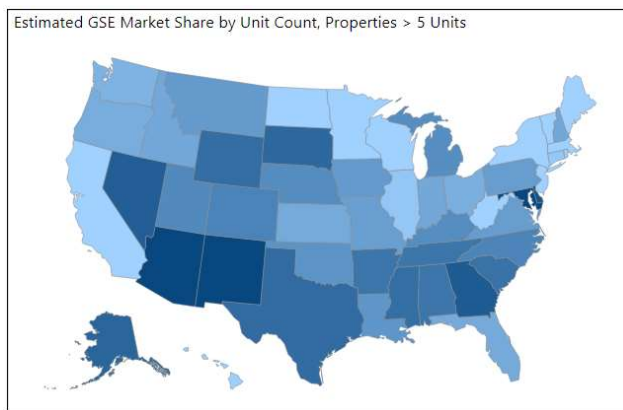
¹⁸ Estimated based on average loan size and average LTV

The Enterprises are purpose-built. Other commercial lenders aren't dedicated to the Multifamily space like the Enterprises, and lend on Multifamily much differently. Whereas the Enterprises' Multifamily businesses by definition lend on residential buildings, other lenders can allocate wherever they see the highest returns. As evidence, we contrast the Enterprises' stability through market cycles with Life Companies¹⁹ and the CMBS Conduit²⁰ markets who have alternated between being active in, and stepping away from, the space.



The Enterprises are geographically diverse. While other lenders focus disproportionately on the largest markets with the highest expected returns, the Enterprises consistently lend across the country. For example, relative to life companies the Enterprises' business is less concentrated in their respective largest markets, shows wider breath²¹, and is less concentrated in states like New York and California.

Geographic Diversification of 2019 Originations			
	Fannie Mae	Freddie Mac	ACLI
Top 10 Markets % Lending	32%	35%	47%
Equiv Equally-Weighted Markets	59	54	31



No factors raised in this section should directly inform the FHFA's capital framework; however *all of them* demonstrate why the FHFA should give Multifamily the same level of care and consideration afforded to Single-Family, and what's at stake in getting it right.

The Enterprises' Multifamily operations support housing for both high and low-income Americans, across America, in good times and bad. They are a crucial component of the American housing system.

We thank you for your consideration.

¹⁹ Based on ACLI Commercial Mortgage Commitments. ACLI excludes MHC and Healthcare since these are not identified.

²⁰ Data per Trepp using CREFC property types

²¹ Geographic breadth shown as Herfindahl index. ACLI data represents fixed-rate only. Fannie based on issuance dates and excludes credit facilities. Freddie data based on securitized loans per Trepp, by deal closing date.