

November 24, 2021

Clinton Jones, General Counsel
Attention: Comments/ RIN 2590-AB17
Federal Housing Finance Agency
400 Seventh Street, SW.
Washington, DC 20219

Subject: Amendments to the Enterprise Regulatory Capital Framework Rule

Dear Mr. Jones

On behalf of the DUS Peer Group¹, the DUS Advisory Council² welcomes the opportunity to comment on the Amendments to the Enterprise Regulatory Capital Framework Rule. We generally support the proposal and believe that it represents a significant improvement over the Final Capital Rule, and a positive step towards a viable and vibrant housing finance system. We do not limit the scope of our response to the proposal, as we put it in the context of the Enterprises' mission and other FHFA rulemaking, in particular the Final Capital Rule.

The FHFA has historically relied on two mechanisms that may come into conflict with each other – 1) prescriptive requirements that the GSEs *must* fulfill, and 2) financial mechanisms that incentivize the GSEs to *want to* achieve desired outcomes. While directives ensure that some minimum requirements are met, properly-aligned incentives are more effective means to maximize the degree to which goals are intelligently met and even surpassed in a dynamic market. Fannie Mae's Credit Risk Transfer program was suspended in 2020, in large part because the Final Capital Rule had disincentivized the practice, and only recently restarted when incentives were proposed to be realigned.

We appreciate the renewed emphasis on incentives over directives, which can be further extended to the Enterprises' missions of affordability, liquidity, and stability. Specifically, we recommend:

1. The prescribed leverage buffer amount (PLBA) should be reduced to a level comparable to FHFA's recommendation. However, it should not be tied to the stability capital buffer. Doing so conflicts with the Enterprises' countercyclical mission and therefore undermines market stability.
2. The DUS Advisory Council fully supports the proposed CRT modifications.
3. Credit Risk Capital factors should be reviewed in the Final Capital Rule, particularly for low-leverage loans, and the Risk Weight Floor should be significantly reduced or eliminated. As currently constructed, the risk-based capital mechanism is not reflective of actual risk.
4. Stability should be increased by addressing procyclicality in Multifamily. We detail our proposed system herein - endorsed by Fannie Mae - which is based on free and publicly-available index data, and is internally consistent with other Final Capital Rule guidance.
5. The Capital multiplier should be restored to 0.6x for subsidized housing, as this reflects the underlying risk profile and more tangibly helps the renter than do the current and proposed LI/VLI targets.

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 Berkadia Commercial Mortgage, LLC; Capital One, National Association; CBRE Multifamily Capital, Inc.; JLL Real Estate Capital, LLC; KeyBank National Association; Newmark; NorthMarq; PGIM Real Estate; Walker & Dunlop, LLC; and Wells Fargo Multifamily Capital

6. Capital multipliers should be reconsidered for property subtypes and loan terms. Once again, this would properly align capital requirements to actual risk on underlying loans.

We appreciate the FHFA's ongoing efforts to ensure a viable and vibrant housing finance system. Should you have any questions or need additional information, please feel free to contact Pattie Farrell, Chair, DUS Advisory Council, at pattie.farrell@wellsfargo.com.

Sincerely,

The DUS Advisory Council

Contents

The Leverage Requirement & PLBA 4

Credit Risk Transfer Modifications..... 5

The Capital Rule and the Stability Mission 5

Procyclicality 8

Incentives and Multipliers 9

Subsidized Loans 9

Property Subtypes 10

Loan Term 11

Conclusion..... 12

Appendix: The DUS Advisory Council’s Proposed Framework 13

Examples of Our Proposal in Action 14

The Leverage Requirement & PLBA

The DUS Advisory Council fully supports reducing the PLBA so that the “backstop” is no longer the binding constraint, as we share the FHFA’s concern that this could dramatically skew Enterprise incentives in favor of more risk-taking.

We’re concerned, however, that tying the PLBA to the Stability Capital Buffer could directly conflict with the Enterprises’ stability mission and the FHFA’s statement that “The Enterprises are chartered to fulfill a countercyclical role in the housing finance market.” The issue relates to marginal capital per dollar lent, as market share would naturally increase if the Enterprises were to fulfill that role. Specifically, each marginal dollar lent in a downturn at increased market share would increase the aggregate market share, increasing capital requirements across all existing assets and, therefore, the marginal capital per marginal dollar lent.

To demonstrate this idea, consider the following example where an Enterprise carried a 25% market share leading up to a crisis but stepped up to a 50% market share through the crisis. For each new loan the aggregate stability buffer rate would only increase marginally, but the *marginal* rate applied to new lending would be far higher.

Illustrative Impacts of Marginal Stability Buffer					
25% Precrisis versus 50% Crisis Market Share					
	Market	Enterprise	Market Share	Stability Buffer %	Stability Buffer \$
Pre-Crisis	1,000.00	250.00	25.000%	1.00%	2.50
After \$10 New Lending	1,005.00	252.50	25.124%	1.01%	2.54
Marginal Impact	5.00	2.50	0.025%	1.63%	0.04

The exact relationship is a function of the new / crisis versus original / precrisis market share. Mathematically, the marginal stability buffer charge can be expressed as:

$$\text{Marginal Stability Buffer} = \left((MS_{New} - MS_{Orig}) * \frac{MS_{Orig}}{MS_{New}} + MS_{Orig} - Allowance \right) * CapChrg$$

where *MSOrig* is the pre-downturn market share, *MSNew* is the market share in the current environment, *Allowance* is the 5% exemption from the buffer, and *CapChrg* is the Stability Buffer’s rate of capital charge per unit of market share (i.e. 5 bps).

This can be shown across more market share combinations as:

Stability Capital Buffer, as Rate					
Precrisis		Marginal Rate varying Crisis Share			
Mkt Share	Rate	25%	50%	75%	100%
15%	0.50%	0.80%	1.03%	1.10%	1.14%
20%	0.75%	0.95%	1.35%	1.48%	1.55%
25%	1.00%	1.00%	1.63%	1.83%	1.94%

As shown above, the construction of the Stability Capital Buffer directly disincentivizes the Enterprises increasing their market shares in a downturn, and its presence under both the risk-based and leverage-based regimes makes it impossible to circumvent. Coupled with procyclical capital in Multifamily that could already challenge capital adequacy, structurally increasing the capital required for new loans disincentivizes new lending and undermines the countercyclical role sought by the FHFA.

The DUS Advisory Council supports the reduction of the PLBA to make the leverage backstop the true backstop; however, we do not believe that achieving this via the Stability Capital buffer (even at 50%) is the most prudent way to do so. We support substituting this with a fixed rate or some lower fraction of risk-based capital to supplement the fixed Minimum Leverage Requirement.

Credit Risk Transfer Modifications

Under the Final Rule’s treatment of Credit Risk Transfer, higher capital led to *more* risk for the Enterprises and market stability because it reduced the incentive to engage in prudent and rational behavior.

The DUS Advisory Council fully supports the proposed amendments to the Credit Risk Transfer. In both the examples FHFA provided and our own analyses of other risk transfer mechanisms, it’s apparent that the removal of the Overall Effectiveness Adjustment and the reduction of the prudential floor from 10 to 5% materially reduce capital for risks that have been economically transferred. This increases the degree to which the transactions are accretive and therefore the chances that the Enterprises will engage in them, to the benefit of taxpayers and the Enterprises.

Further, since the capital relief is targeted to the portions sold while continuing to discourage regulatory capital arbitrage, we’re confident that these changes will not unjustly reduce capital requirements.

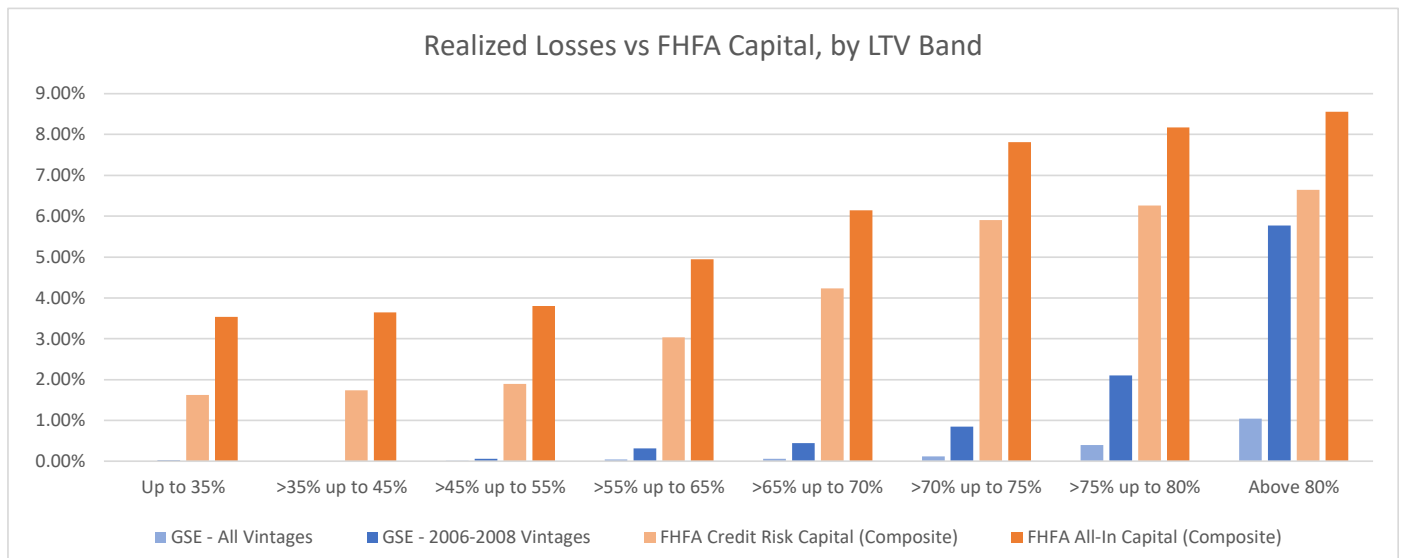
The Capital Rule and the Stability Mission

The DUS Advisory Council’s key recommendation to the FHFA continues to be that the Capital Rule be specifically reevaluated for the Multifamily business. While the Final Rule increased loss-absorbing capital for the Enterprises, at a deeper level it directly undermined the stability mission. In particular, the risk-based capital regime is insufficiently risk-based, is highly procyclical (which increases the risk of an Enterprise being undercapitalized), and contains other multipliers that incentivize the wrong behavior.

In previous letters and meetings the DUS Advisory Council detailed its belief that Credit Risk Capital was set too high for Multifamily, particularly when compared against the performance history and against Single-Family.

To reframe our point, our concerns emanate from the risk-based capital regime being insufficiently risk-based. The DUS Advisory Council believes that capital for higher-risk properties is a bit conservative but generally appropriate. However, capital for lower-risk properties is not proportionately lower versus the risk – which leads to Multifamily being charged excessive capital. This is illustrated below – during the Financial Crisis, GSE losses were not only a fraction of their Credit Risk Capital for all but the highest-tier LTV loans (few loans exceed 80% LTV), but the disconnect grew as leverage declined³.

Furthermore, the well-intended, but risk-agnostic, buffers only compounded this dynamic.



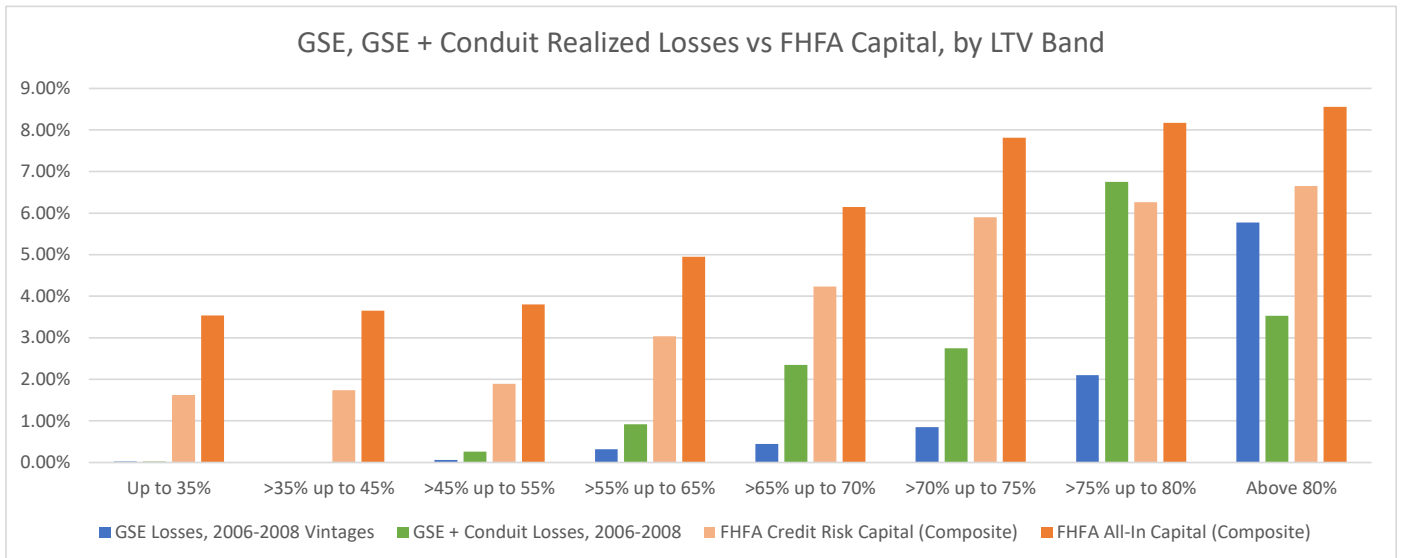
³ GSE histories built from respective Multifamily Loan Performance Databases with performance through 2019 (Fannie Mae) and 2018 (Freddie Mac). Impact of Fannie loss sharing estimated and grossed up.

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%	Above 80%
Stressed Loss (2006-2008 Vintages)	0.02%	0.00%	0.06%	0.32%	0.45%	0.85%	2.10%	5.78%
Expected Loss (All MLDP Vintages)	0.00%	0.00%	0.01%	0.05%	0.06%	0.12%	0.40%	1.04%
Historical Unexpected Loss	0.02%	0.00%	0.05%	0.27%	0.39%	0.73%	1.70%	4.73%
FHFA Credit Risk Capital (Composite)	1.62%	1.74%	1.89%	3.04%	4.23%	5.91%	6.26%	6.65%
Credit Risk Capitalization Multiple	75.5x	<i>inf</i>	41.0x	11.3x	11.0x	8.1x	3.7x	1.4x

figures may not foot due to rounding

The DUS Advisory Council understands that there have been structural changes in the market owing to the financial crisis. Many (though not all) properties that had been financed with CMBS Conduit loans during the precrisis period are now financed by the GSEs, on the back of their comparatively low interest rates. For the avoidance of doubt, the GSEs' and DUS Lenders' standards are significantly higher than for conduit lenders in the precrisis era, which relied on proforma underwriting and often-dubious assumptions, and which also had structurally higher severities⁴.

Below, we evaluate capital against combined GSE and conduit production from the 2006 through 2008 vintages, using data sourced from the GSEs' performance databases and from Trepp⁵.



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%	Above 80%
GSE Losses, 2006-2008 Vintages	0.02%	0.00%	0.06%	0.32%	0.45%	0.85%	2.10%	5.78%
GSE + Conduit Losses, 2006-2008	0.02%	0.00%	0.26%	0.92%	2.35%	2.75%	6.75%	3.53%
FHFA Credit Risk Capital (Composite)	1.62%	1.74%	1.89%	3.04%	4.23%	5.91%	6.26%	6.65%
FHFA All-In Capital (Composite)	3.53%	3.65%	3.80%	4.95%	6.14%	7.82%	8.17%	8.56%

This analysis is conservative as it incorporates all conduit metrics at face value and does not back out an expected loss component. While it lends some support to the FHFA's capital above 75% LTV – it highlights a capital level far too high for all lower bands of risk.

The Multifamily capital regime can be fixed with a twofold approach:

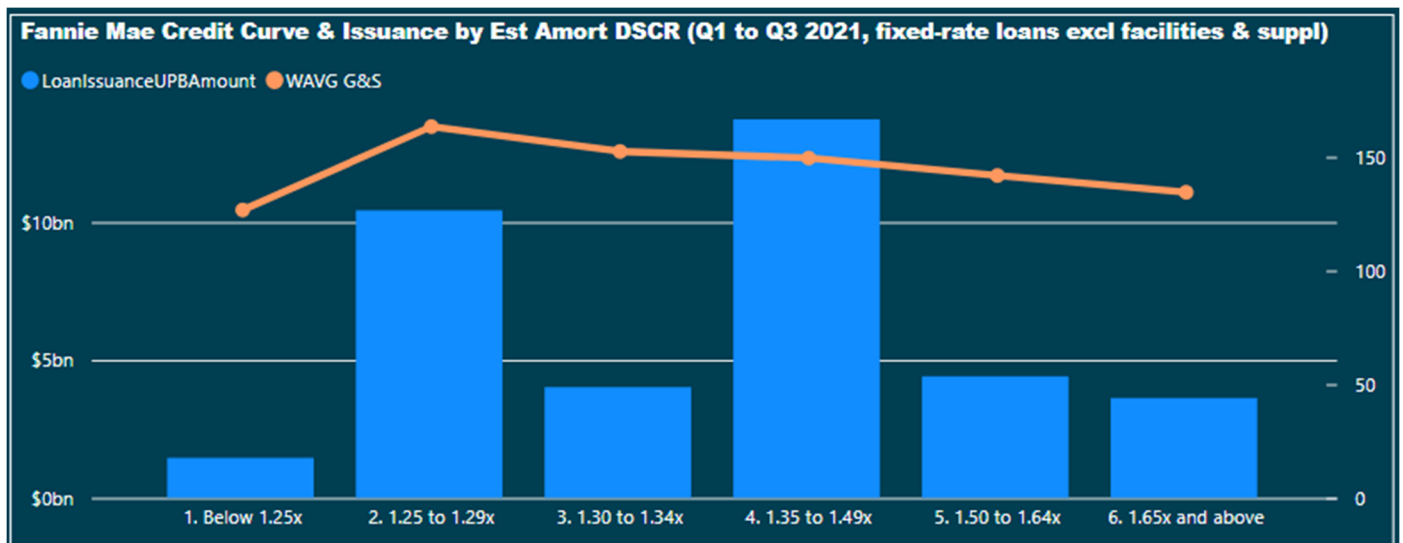
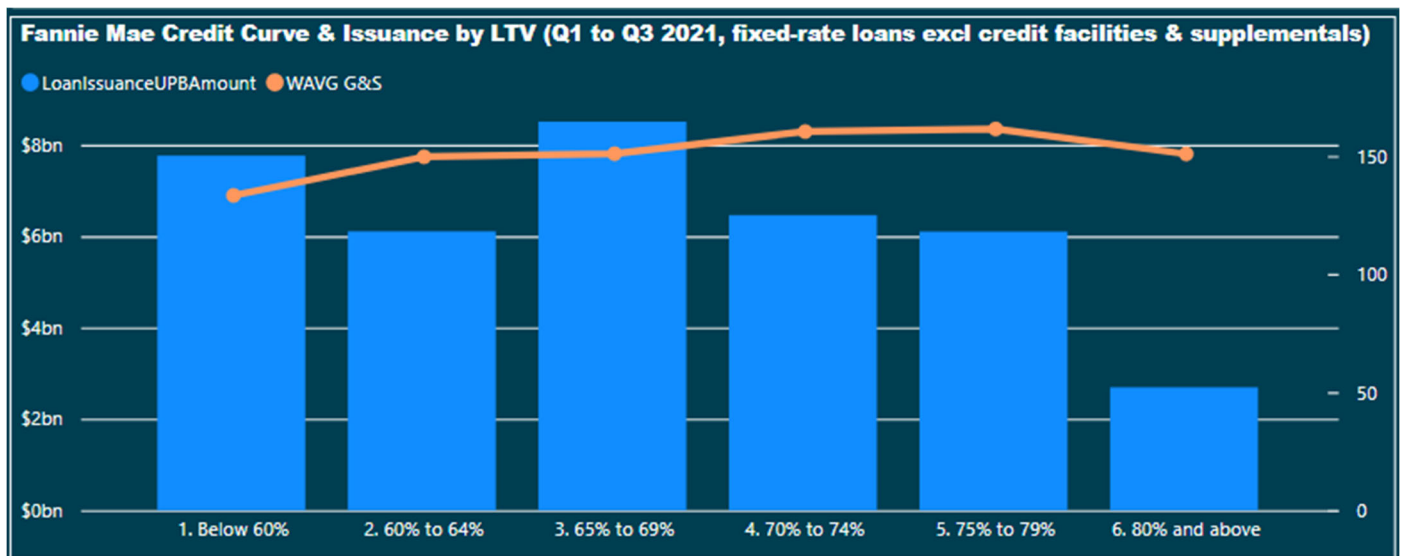
⁴ Interest and interest shortfall (ASER) reimbursement was due through final resolution rather than DUS loans which are repurchased from the trust in advance of resolution.

⁵ Trepp data includes Multifamily loans from conduit deals and was accessed November 11, 2021.

First, the FHFA should reevaluate the capital grids themselves. The DUS Advisory Council has heard conflicting accounts of their derivation, specifically whether they are the result of a modeling exercise or a function of the historical record or something else entirely. We first heard that the grids were the average of Fannie Mae and Freddie Mac results from a modeling exercise, but we've employed various modeling methodologies and cannot reasonably replicate the results in the final grid. Later, referencing the historical record, Dr. Mark Calabria stated "I want to emphasize the grids are driven by historical experience... the math is what the math is." Dr. Calabria stated that the FHFA has the analysis to demonstrate that it reflects the historical experience, but was shared neither with us nor with any lawmakers despite repeated requests. After extensive analysis of both the Enterprises' own performance databases and available data from other market segments we cannot fit the grids to any version of the historical experience. We again ask the FHFA to share their modeling methodology and/or data.

Second, the DUS Advisory Council believes that the Risk Weight Floor should be reduced or eliminated. Although this has a relatively modest impact, it currently serves to decrease the relative cost of risk, which would seem the opposite of what would be intended.

The impact of the FHFA's policies has been twofold negative - to make the Enterprises relatively leverage-agnostic and to lack the incentive to fully price risk. This is backed up by the following charts, which are based on Fannie Mae's DUS Disclose data from January through September 2021 and use implied Guaranty and Servicing ("G&S") fees as a proxy for risk compensation.



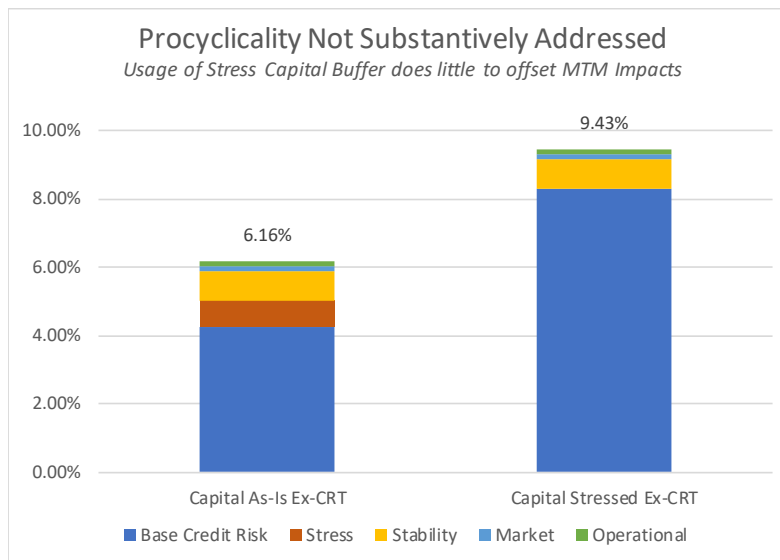
Common themes in these charts:

- The credit curves are strikingly flat
- Fannie Mae charges less for the highest-risk bucket than for the several immediately preceding it
- Origination volumes are robust through the second-riskiest bucket

Macro-level buckets aren't all-encompassing for risk, and there are undoubtedly other contributing factors such as property quality and sponsorship that influence loan-level decision-making and may be offered as mitigants at a micro level. However, these and other factors were also present in the historical loss data, which nonetheless shows a pronounced sensitivity to headline leverage. Stepping back, the summation of loan-level factors does not negate the portfolio-level implication of not pricing for risk relative to the historical record, and the FHFA as regulator should not create a system that encourages higher-LTV lending through the capital regime. This does not promote stability for the Enterprises or (since cheap financing allows buyers to increase their bids) the Multifamily market in general.

Procyclicality

Procyclicality also works against the stability mission. The FHFA has acknowledged this problem since the 2018 Proposed Capital Rule, but only addressed it in Single-Family. In its current state, the Capital Rule charges far more capital for Multifamily assets if a market shock – from which capital is intended to offer protection – is realized. As the FHFA acknowledged, this feature would lead to a prudent manager utilizing a “managerial cushion” to avoid being forced to raise capital during a downturn when it's scarce and expensive – effectively increasing de facto capital requirements today.



*Base Credit Risk based on actual Fannie Mae new originations (1/19 to 5/20)
run through capital grids
MTM sensitivity based on application of prescribed 15%/35% shocks
Stability buffer estimated using 23% market share*

A compounding problem unique to Multifamily is balloon risk. If, in a downturn, the Enterprises already lack sufficient capital due to procyclicality factor, they'll be less able to deploy capital to write new loans, thus impeding refinancing activity and market liquidity.

When queried, the FHFA cited a lack of historical data as a reason to leave this feature for Multifamily, versus the trend approach utilized in Single-Family. The DUS Advisory Council believes that the lack of historical trend data can be easily addressed at a superficial level – but that misses our more fundamental contention that it shouldn't matter if capital meets its stated objective of capitalizing against stated peak-to-trough declines.

The Single-Family approach is internally inconsistent insofar as it does not insulate from the stated peak-to-trough declines, but rather requires capitalization from “current-to-trend” and “trend-to-trough” which may be larger or smaller than the stated decline. In concept, we believe a “trend” has little intrinsic value, and note that shocks are usually understood and stated in peak-to-trough terms – i.e. identifying the level of stress as a Financial Crisis-level decline in nominal terms, but capitalizing for that shock relative to a trend, seems exceptionally onerous. In practice, any “trend” is prone to significant volatility from doing nothing more than adjusting the starting and ending points of a time series which are historically arbitrary. Only with the benefit of hindsight and the flexibility of judgment can one identify the “correct” starting and ending points for a trend, or differentiate between a data point looking high against the trend established by its predecessors, versus marking an inflection point in a trend’s long-term trajectory.

We have detailed in our prior response letters an alternative approach (reproduced here as an Appendix with minimal changes) which was endorsed by Fannie Mae in its response to the 2020 Re-Proposal. The fundamental principle behind our proposal is that if capital is calibrated to absorb shocks of 15% to NOI and 35% to value, then no additional capital should be required until these declines are substantially realized. Our framework includes a mechanism to always capitalize for a minimum additional shock, if desired by FHFA. This framework enhances the predictability of capital planning, while retaining significant roles for a surveillance function and market conditions.

With respect to data, we believe that when indices are used, consistency is important between those selected for calculating MTMLTV and the countercyclical adjustment. The DUS Advisory Council believes that the NCREIF Apartment Price Index meets the FHFA’s requirements for property value / MTMLTV. This data is free and publicly-available, has been published for decades, and contains more than 43 years of apartment data. Moreover, the DUS Advisory Council has confirmed directly with NCREIF that NCREIF would not object to its data supporting the FHFA’s calculations. We note, however, that the selection of specific index could be delegated to the Enterprises (subject to FHFA approval) to the extent the Enterprises are already using an index in the calculation of MTMLTV⁶.

For income / MTMDSCR the Enterprises, either individually or collectively, have sufficient market shares for their portfolio averages to be reasonable proxies for “market.” They could individually use their own data, or the FHFA could use consolidated data, to build a same-store NOI index based on Enterprise investor reporting.

The DUS Advisory Council cannot envision any objections to using this data, and in any event cannot see that any such objections that could be raised would outweigh the risks to the Enterprises’ capacity to lend – and by extension the multifamily market itself – if procyclicality is not specifically, and carefully, addressed.

Incentives and Multipliers

Subsidized Loans

The capital rule does not make any allowance for, or give any “special treatment” to, Low-Income or Very Low-Income units. Conceptually, the DUS Advisory Council supports this position, as we believe that capital should relate directly to risk and should be evaluated empirically and objectively independently from a social mission. Alternatively, a socially-focused business may and should demand more capital to the extent the risks are commensurately higher.

Consistent with this concept, a lower-risk portion of the business should require less capital, and we believe FHFA’s treatment of subsidized loans is a misalignment in the Capital Rule. In the original 2018 proposal, these loans were charged significantly less capital via a multiplier of 0.6x. This was removed in the 2020 Re-Proposal and Final Rule with no explanation.

The DUS Advisory Council recommends that this 0.6x multiplier be reinstated. These loans have historically exhibited low risk – as the FHFA referenced when eliminating the multiplier by citing the few defaults with which to refine its

⁶ Per the MTMLTV definition relating to multifamily exposures, property value can be estimated using the “acquisition property value adjusted using a multifamily property value index” where such index is not specified.

estimates. Per the FHFA, *“Due to the relatively infrequent instances of loss across Multifamily loan programs that include a government subsidy, FHFA has determined that 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.”* (emphasis added). This is not rational for two reasons. First, the presence rather than precise level of subsidy was the primary question, so an inability to fine-tune an assumption should not justify making no assumption at all. Second, it’s the denominator (number of observations) rather than numerator (number of defaults) that matters for establishing low default rates with confidence. To focus on the numerator is like saying we can’t establish low flood risk on a mountaintop because there have been few floods to measure, while ignoring the many dry days.

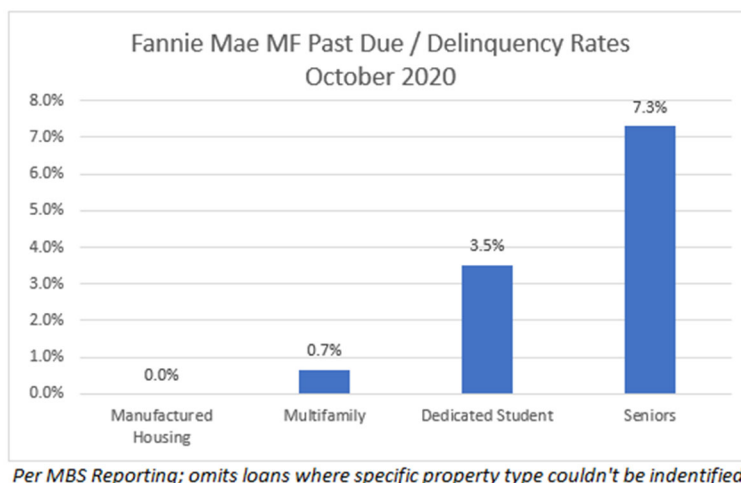
The FHFA has the opportunity to align the three pillars of its mission in this instance. First, reinstating this multiplier will better align capital with risk attributes, creating a relative incentive for low-risk business. Second, it will increase liquidity in a unique portion of the market that is interwoven with other government-affiliated programs. Third, it will fulfill a social need more directly and concretely than do the LI and VLI goals. While LI and VLI units are relatively affordable to average renters in an area, there are no guarantees that the specific renters have a need, or that owners will pass on interest savings and/or maintain real rent levels. These problems are not found in Affordable / Section 8 properties which carry more stringent requirements.

Property Subtypes

The FHFA has cited the performance of the Seniors Housing and Student Housing subtypes as a justification for high credit risk capital factors in the overall Multifamily space. The DUS Advisory Council completely agrees – the risk profiles of these businesses are drastically different than for conventional Multifamily. For Student Housing, risk factors include university enrollment, outsized influence from new deliveries, and competition from both on-campus housing and online learning. Seniors Housing is more of a traditional operating business with high structural costs and thin margins, disproportionately large challenges from staffing, and several health-related sensitivities highlighted by COVID-19 ranging from PPE and vaccines to prohibitions for new move-ins.

The Seniors space showed particular challenges even before 2020, with industry-wide declines in occupancy rates in Independent Living and Assisted Living, and several large Enterprise borrowers struggling to both maintain liquidity and invest in their properties. After the pandemic hit and past due / delinquency rates peaked (notwithstanding forbearance), Seniors showed roughly ten times the rate of impacted loans than did conventional Multifamily.

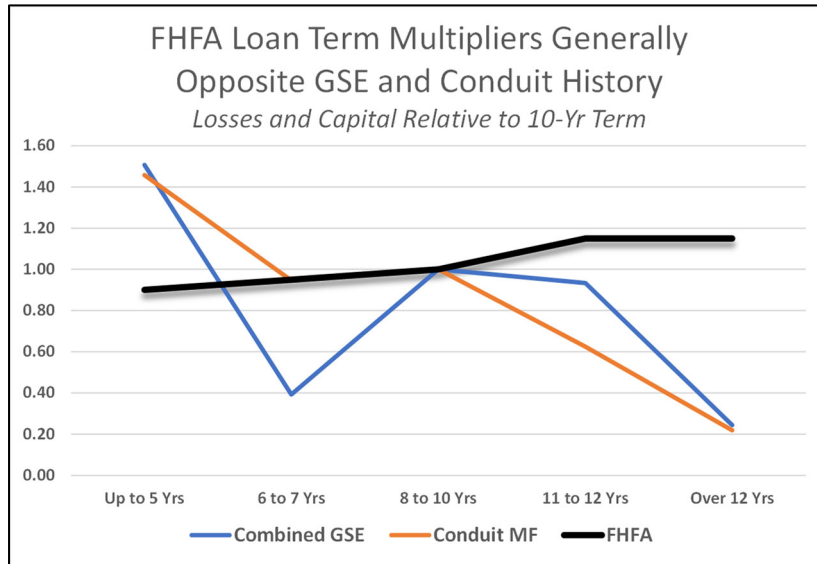
Despite this, the capital rule does not differentiate between Seniors Housing and conventional Multifamily. We ask that the FHFA directly incorporate its concerns – shared by the DUS Advisory Council – into its capital rule by increasing the capital multiplier affixed to these specific loans. We also expect that this would simplify the discussion of conventional Multifamily capital levels relative to the associated risks.



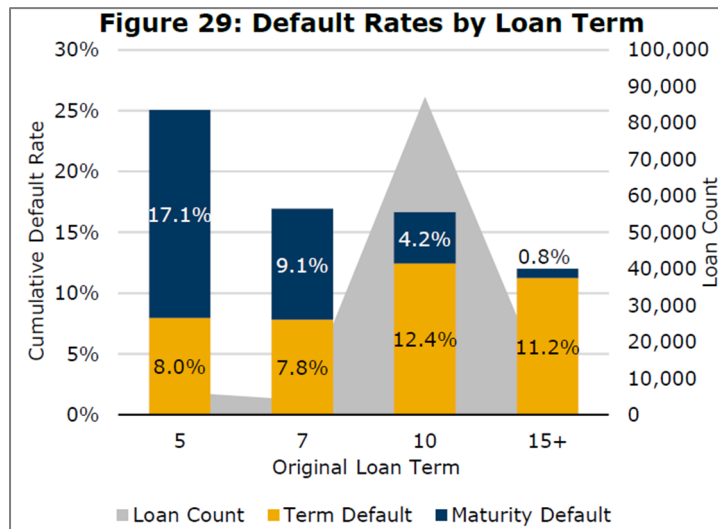
Loan Term

The FHFA also has an opportunity to align its capital with the underlying risk characteristics around loan terms, and in doing so promote its mission of stability in the multifamily market. In its current form, the capital rule charges more capital to long-term loans than to shorter loans. A 12-year loan is charged more than 20% more capital than an otherwise-similar 5-year loan.

This runs counter to the historical record. In both combined Enterprise lending and in CMBS Conduit⁷, losses have generally trended down as loan terms increase. This is demonstrated below. We expect that this is due to maturity risk declining as terms push out, on the back of amortization, inflation, and upward-trending real NOI growth.



This general theme was also echoed by Kroll in its 2021 study of the conduit universe⁸. Their analysis of default rates supports that while term defaults increased with loan term, this was more than offset by reduced maturity risk.



Correcting this would also enhance stability in the market. By needing to access the capital markets less frequently, borrowers are less prone to fluctuations in the market.

⁷ GSE histories built from respective Multifamily Loan Performance Databases with performance through 2019 (Fannie Mae) and 2018 (Freddie Mac). Impact of Fannie loss sharing estimated and grossed up. Conduit based on Trepp data accessed 11/11/2021.

⁸ 2021 “Conduit CMBS Default and Loss Study”; Kroll Bond Rating Agency, November 12, 2021

Conclusion

The DUS Advisory Council is grateful for the FHFA's proposed amendments to the Enterprise Regulatory Capital Framework and considers them significant improvements over the ERCF final rule. Our proposals outlined herein represent areas for further improvement that we believe to be consistent with the FHFA's objectives, the Enterprises' mission, and the historical data and risk profile of the Multifamily business.

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 FHFA and Enterprises themselves.

We would look forward to an open dialogue with the FHFA as it makes further refinements to the capital framework.

Appendix: 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: NCREIF NPI (*such an index is already a permitted method of determining MTMLTV itself*)
- Income: Enterprise investor reporting on same-store basis

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 Capital 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.

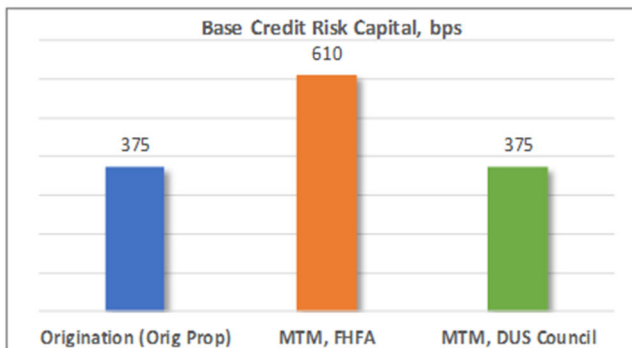
Examples of Our Proposal in Action

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%



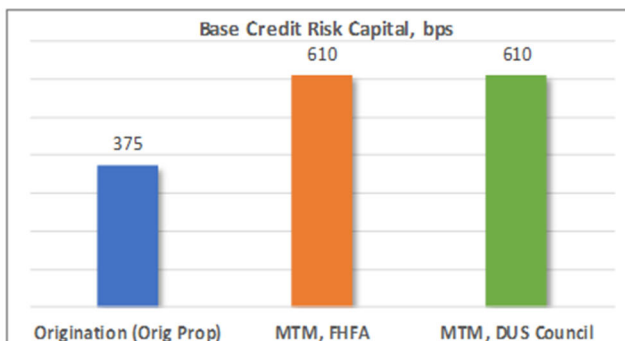
Loan Indicators & Capital			
	Origination	MTM (FHFA)	AdjMTM (DUS C)
LTV	75%	88%	75%
DSCR	1.50x	1.35x	1.50x
Capital	375	610	375

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

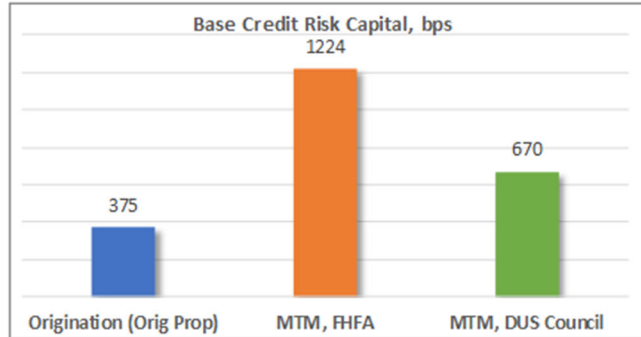
Key Takeaway: Loan surveillance is still important, and if poor performance is unrelated to market forces, no credit should be given

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



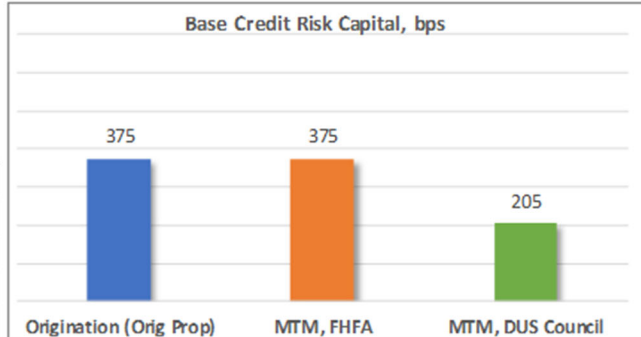
Key Takeaway: Capital should and does increase due to the depth of market’s decline, but unlike FHFA only capturing extent of bands being exceeded

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