HOUSING FINANCE REFORM AND ITS IMPACT ON MULTIFAMILY REAL ESTATE LENDING

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Reforming the government-sponsored enterprises (GSEs), including Fannie Mae and Freddie Mac, is a top priority for the current administration. The U.S. Congress is currently holding hearings to evaluate how to reform these entities, make them less susceptible to tax payer bailouts, or replace them altogether.

Currently, three main proposals are circulating—the Milken, MBA, and Promising Road proposals—and while each shares basic concepts, there are some differences as well. While PGIM Real Estate Finance does not specifically endorse or oppose any of the three proposals, we are watching housing finance reform closely, as it has the potential to impact the multifamily real estate market and access to capital for multifamily real estate investors.

To date, there are still several unknowns concerning how each approach addresses multifamily and affordable housing finance. However, it appears that they all aim to continue the structure and mechanisms currently in place under Fannie Mae and Freddie Mac to stimulate investment in multifamily and affordable properties. As Congress further discusses and evaluates these proposals, the specific elements relative to multifamily and affordable housing finance should become clearer.

In this article, we will examine the main elements of the three reform proposals, explore how each plan could impact multifamily and affordable housing finance, and discuss key questions that must be considered for effective housing finance reform.

In response to the growing concerns from the housing crisis, Congress passed the Housing and Economic Recovery Act of 2008 (HERA), transforming the Department of Housing and Urban Development’s (HUD) Office of Federal Housing Enterprise Oversight into a new, independent regulator, the Federal Housing Finance Agency (FHFA), which had greater oversight and authority over the GSEs than its predecessor.

By September 2008, FHFA put the GSEs into conservatorship and, over the last nine years, enacted several new regulations to reduce risk at Fannie Mae and Freddie Mac, including the creation of the common securitization platform (CSP) and enhanced credit risk transfers (CRT).

In 2012, the U.S. Treasury decided to sweep all profits from the GSEs into the general account, instead of allowing the GSEs to maintain capital against risk. As a result, Fannie Mae and Freddie Mac will have no capital to address losses as of January 1, 2018 and taxpayers will be responsible for any losses incurred. The potential impact on taxpayers has heightened the urgency to reform or replace the secondary mortgage market system with reasonable, balanced public and private risk exposure.

To better understand the role these proposals could play in housing finance reform, including impacts to the multifamily market, we need to examine the proposals individually.

Why Reform and Why Now?

Why does the government have such a keen interest in housing finance reform? Although the GSEs operated as intended throughout the housing crisis of 2008, the enterprises also suffered. Fannie Mae and Freddie Mac held securities backed by tens of thousands of sub-prime single-family mortgages, subjecting the entities to significant market losses, albeit much less than the private sector. It is important to note that financial losses the GSEs incurred were specific to the single-family market; their multifamily investments were profitable throughout the downturn.
The Milken Proposal

The Milken Institute’s proposal aims to reconstitute Fannie Mae and Freddie Mac as lender-owned mutual funds and move secondary market securitization functions into an independent Ginnie Mae platform.

As lender-owned mutual funds, Fannie Mae and Freddie Mac’s previous responsibilities (such as credit enhancements, CRTs, and the securitization of loans from small and mid-sized lenders) would shift to the private market or another government entity, such as HUD’s Federal Housing Administration (FHA), the Department of Agriculture (USDA), or the Department of Veterans Affairs (VA).

The Milken proposal also advocates separating Ginnie Mae from HUD and making it a standalone government corporation. As an independent agency, Ginnie Mae would issue securities on behalf of the mutual funds and other government programs and guarantee the interest rate and timely principle and interest payments to investors.

A mortgage insurance fund would guarantee Ginnie Mae-issued securities. The FHFA would continue to regulate the housing finance system, including securitization and the quantity and quality of private capital standing in front of the government guarantee.

Impacts to Multifamily Lending

The Milken proposal would keep the current structures of Fannie Mae and Freddie Mac’s multifamily business intact but would transition those operations into independently owned and operated private companies, separate from the new Ginnie Mae single-family business unit. Such structures include the loss-sharing arrangements used by Fannie Mae and Freddie Mac in their K-Series and Delegated Underwriter Servicing (DUS) programs.

The Ginnie Mae structure would provide the multifamily mortgage backed securities (MBS) government guarantee, but only for eligible affordable multifamily housing mortgages either issued by the GSE replacements or the private sector. The first loss sharing requirements currently utilized for the GSE multifamily business would also remain in place.

Affordability/Duty to Serve

One of Fannie Mae and Freddie Mac’s objectives is to support the financing of affordable housing and increase liquidity in market segments underserved by primary lenders.

Under the Milken proposal, Ginnie Mae would collect an affordability fee to fund affordable housing efforts, as decided by Congress. This fund could support affordability efforts including affordable rent subsidies, low-income borrower subsidies for first-time home purchases, and loan servicing.

The Milken proposal provides a new “duty to serve” function, different from the existing benchmarks and static goals promulgated by FHFA. All Ginnie Mae issuers above a certain size would be required to serve all borrowers and communities within the areas where they lend and operate, report back on those efforts, and be compared to the market. The proposal also suggests pursuing pilot programs to expand access in minority or rural communities or to issue smaller loans or to enhance credit access for manufactured and micro housing units.

FHFA would be required to work with HUD to ensure that the entire market was being served, including FHA-issued loans.

The MBA Proposal

The Mortgage Bankers Association’s (MBA) proposal* suggests replacing Fannie Mae and Freddie Mac with privately owned independent utilities and FHFA regulated rates of return.

While the re-chartered successors to Fannie Mae and Freddie Mac would likely be the first two guarantors, the regulator could permit additional guarantors to encourage competition. New firms could apply for a guarantor charter that authorizes them to serve either the single-family, multifamily, or both markets.

A new CSP corporation, which would have an explicit government guarantee for MBS, would securitize loans. This CSP corporation would be entitled to insurance premiums from the new utilities to finance a mortgage insurance fund that would provide a backstop for government risk.

The utilities would be responsible for distributing potential credit risk through reinsurance and front-end and back-end CRTs to private investors. The reinsurance and private investors would take a first loss position if any loans fail. The mortgage insurance fund would cover catastrophic risk, and would kick in only in the event of a guarantor failure after all layers of private capital had been exhausted. Should the mortgage insurance fund be exhausted, the taxpayers would be responsible for any losses. If this occurs, the utilities could charge higher insurance premiums to rebuild the mortgage insurance fund and repay taxpayers.

Those utilities with over $50 billion in assets would be labeled as systemically important financial institutions (SIFIs) and could be subject to additional capital requirements, enhanced prudential standards, stress tests, comprehensive capital analysis and review, and oversight deemed appropriate by the primary financial regulator, which would likely continue to be FHFA.

The MBA proposal’s effectiveness could hinge on the number of utilities securing loans. Fannie Mae and Freddie Mac currently operate, report back on those efforts, and be compared to the market. The proposal also suggests pursuing pilot programs to expand access in minority or rural communities or to issue smaller loans or to enhance credit access for manufactured and micro housing units.

FHFA would be required to work with HUD to ensure that the entire market was being served, including FHA-issued loans.
Impacts to Multifamily Lending

Preserving long-term financing for multifamily mortgages (and permitting new options) is a core principle of the MBA proposal. Under the proposal, the utilities would continue to issue multifamily MBS using existing structures, and multifamily operations would continue in their current form.

For the multifamily finance market, the guarantors would utilize current risk sharing and risk transfer structures used as part of Fannie Mae's DUS program, Freddie Mac's K Deals, and other securitization structures to be developed.

Affordability/Duty to Serve

The MBA proposal emphasizes the importance of serving the affordable housing market and suggests the guarantors provide responsible, sustainable access to credit for prospective homeowners, provide liquidity for the development and preservation of affordable rental housing, and improve liquidity for segments of underserved markets.

The MBA proposal also suggests harmonizing federal affordable housing policies between various entities, such as the FHA, the VA, the USDA's Rural Housing Service (RHS), Ginnie Mae, and the GSEs, so they have a consistent affordable housing mission.

The regulator would also be responsible for developing an affordable housing strategy for the utilities to execute. This strategy should address expanding access to credit, preserving and developing affordable rental housing and improving liquidity for underserved markets.

The Promising Road Proposal

The Urban Institute’s Promising Road proposal advocates merging Fannie Mae and Freddie Mac to form a single government corporation, the National Mortgage Reinsurance Corporation (NMRC). The proposal argues that a government corporation would be more flexible than a government agency and would be able to adapt more quickly to the changing demands of the industry.

The NMRC would handle all the operations that the two GSEs perform today. It would purchase conforming single-family and multifamily mortgage loans from originating lenders or aggregators and issue securities backed by these loans through a single issuing platform that the NMRC owns and operates.

The NMRC would also provide an explicit federal guarantee on MBS while syndicating all non-catastrophic credit risk into the private market. It would guarantee the timely payment of principal and interest on the securities and perform master servicing responsibilities on the underlying loans, including setting and enforcing servicing and loan modification policies and practices.

While the NMRC shares many similarities to the current GSEs, it would differ in several important aspects. The new entity would be required to transfer all non-catastrophic credit risk on the securities that it issues to a broad range of private entities. Its MBS would be backed by the full faith and credit of the U.S. government, for which it would charge an explicit guarantee fee to cover any risk that the government assumes.

Multifamily Lending Implications

The Urban Institute has not elaborated on how its proposal would function in the multifamily market. However, since the proposal aims to keep the infrastructure and operations of Fannie Mae and Freddie Mac intact, PGIM Real Estate Finance expects any new multifamily business platform and practices introduced would be similar to what the existing GSEs do today, particularly since the GSEs already engage in risk-sharing for multifamily loans.

Affordability/Duty to Serve

The Urban Institute argues its proposal would better meet the lending needs of underserved communities because instead of incentivizing private guarantors to provide secondary market access to lending, the responsibility would fall to the NMRC.

The NMRC would meet duty-to-serve and affordability goals as defined by the FHFA, the same as Fannie Mae and Freddie Mac do today. To help meet these obligations, the NMRC will price its guarantee fees in a manner that subsidizes lower-wealth borrowers who are creditworthy but who may not be able to afford a mortgage loan otherwise.

In addition to this subsidy, the NMRC will charge an explicit 10 basis points affordability fee that it will use to fund initiatives to support access and affordability for homeownership and rental housing.

Considerations for Congress

While each of the three proposals aims to protect taxpayers, attract capital to guarantors, and ensure borrowers have access to affordable financing, they approach these objectives in different ways. As Congress reflects on the current proposals, the following issues should be considered because of their potential impact on access to capital and market dynamics.

Direct Government Involvement

The Milken proposal suggests spinning off Ginnie Mae from HUD and making it an independent, government-owned securitizer. But how involved should the government be in transactional approvals and individual securitizations? Currently, Ginnie Mae signs off on each individual deal. If this is not structured properly, it could bog down the system and slow access to capital for multifamily real estate investors.
This slowdown could impact the market, as there would be fewer deals and fewer lenders participating, which could in turn raise costs and further restrict access to capital.

Multiple Guarantors and Market Balance
Under the current model, the existence of Fannie Mae and Freddie Mac creates competition that spurs innovation and pricing efficiencies, among other benefits. While competition is good for lenders, Congress must consider the implications of a multi-guarantor environment as outlined in certain proposals and question at what point too many guarantors could disrupt the market balance.

On the one hand, the potential for guarantor expansion and competition incentivizes existing guarantors to innovate and stay efficient. However, at what point does the market reach a point of diminishing returns? There is a delicate balance that Congress will need to strike as they consider how much power they give the FHFA (or another regulator) to charter more guarantors.

Further, if new guarantors with more than $50 billion in assets are designated as SIFIs (as suggested by the MBA proposal), it may create a disincentive for the guarantors to become moderate or large in size. SIFI regulations could have the unintended consequence of creating an unlevel playing field in the market place, subjecting larger companies to enhanced supervision and regulations based on size rather than on risks to the economy. Few guarantors may want to cross that threshold as it could minimize their market competitiveness, forgoing the efficiencies and resources needed to keep costs low and foster innovation in the market. Ensuring the correct mix of guarantors of varying sizes to support the market may be difficult to achieve.

Spinning Off Multifamily Finance into a Separate Platform
Another issue Congress will need to consider is the viability of separating the single-family and multifamily platforms. Currently, there is a tested structure in place to manage both single-family and multifamily finance. Congress will need to consider if these platforms can (or should) stand alone.

Since most of the problems the GSEs encountered were on the single-family side, a multifamily platform could be more stable than a combined platform. Would a standalone multifamily platform be less distracted by the rules and regulations required for the single-family side and thus more focused on multifamily-specific issues? Are there other potential benefits to breaking these apart?

The consequences of separating them also need to be considered. Can Congress ensure a separate multifamily finance platform would enjoy the technology, expertise, skill sets, economies of scale, and infrastructure they benefit from today in the current combined environment?

Ensuring a Smooth Transition
One goal of the current GSEs is to ensure liquidity in the market; too sudden changes to the system could undermine this objective. It is essential that Congress considers how the proposed changes could impact the market on “day one.” This requires clarity on the roles, responsibilities, and players within each of the primary and secondary segments before moving forward. Another consideration is the feasibility of a transition period where a parallel process is managed to effectively wind down existing pipelines and ensure transactions are moving efficiently.

Similarly, the GSEs have all talented individuals working for them, and one goal should be to maintain this expertise. Congress should consider how to best maintain a healthy understanding of risk, credit, client-focus, and transparency within the industry. It should also determine whether, as part of the transition process, key individuals should be incentivized to stay through a particular point in time to ensure a seamless transition.

In addition, the GSEs have extremely effective and efficient operations for both single and multi-family. It would be prudent to preserve as much of the existing structure and operations in any new guarantors, rather than create a whole new framework that will take time to develop and implement. Even then, a new framework will likely have issues that need to be addressed.

Are Taxpayers Sufficiently Protected?
While each proposal considers the liability to taxpayers in the case of a catastrophic event, there is a varying degree of risk associated with each approach. Congress must determine whether the new platform adequately protects taxpayers. Do the fees and premium charges fluctuate based upon current market conditions and signs of duress and delinquency? If these fees are fixed and do not vary, is there a danger that taxpayers would be financially responsible for covering any catastrophic event?

There appears to be consensus, both among the proposals and Congress, that the single-family platform should continue to pursue a mix of front-end and back-end CRTs and reinsurance. However, there has been minimal discussion on the future of the multifamily market. Currently, multifamily utilized both back-end CRTs and reinsurance. It works extremely well for all stakeholders and has proved instrumental in stabilizing the secondary market for multifamily. Should this be maintained in housing finance reform or should Congress be exploring other risk transfer mechanisms for this space?

Limiting Market Disruptions
It’s important that any proposal maintains an efficient review and approval process to avoid market disruption. The review and approval timeline within Fannie Mae and Freddie Mac are very different than that of HUD and Ginnie Mae. Some of this is directly related to the risk profile or loss share position that the lender takes within the construct...
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Creating Affordable Housing Incentives and Goals
Congress should ensure whatever proposal moves forward sufficiently creates affordable housing incentives. Should these incentives be in the form of an affordability fee that aims to fund and protect affordable housing programs? Or, should they instead collect a transaction-by-transaction fee based on specific affordability thresholds? Congress should also explore where there are additional or more effective funding sources available.

Duty to Serve
The “Duty to Serve” rules to ensure lenders are serving all borrowers and communities within their respective markets have always walked a fine line: the rules need to have enough teeth to incentivize lenders to comply, but have, at times, been overly prescriptive in the FHFA’s efforts to achieve that goal. Any new or revised “Duty to Serve” mandate in housing finance reform, and subsequent implementation by the relevant regulator, must also be reasonably balanced; however, this may be difficult to achieve and has been a point of contention in previous Congressional housing finance reform discussions.

A Long Way to Go
Housing finance reform still has a long way to go. As of the publication of this article, both the Senate Banking and House Financial Services Committees have begun holding reform hearings to hear from stakeholders across the GSE, FHA, and private markets. Most stakeholders testifying thus far support some explicit government backing for, at a minimum, MBS. Nevertheless, there is still an incomplete view of how each of these proposals would treat multifamily lending, but we anticipate greater clarity as legislative reform language materializes and will keep readers informed of significant developments.

Because serious consideration of housing finance reform legislation in Congress is not expected until early 2018, the GSEs are facing a pressing problem come January 1, 2018: what to do about the lack of a capital buffer to avoid a draw on the Treasury. We expect Treasury Secretary Mnuchin and FHFA Director Watt will make an announcement in the coming weeks on their plans to deal with the capital buffer issue while Congress continues its evaluation of housing finance reform options.

* PGIM Real Estate Finance participated on the committee that developed the recommendations for the MBA proposal. However, this participation is in no way an endorsement of this proposal.