

State of the Market 32: The GSEs and multifamily

By David A. Smith

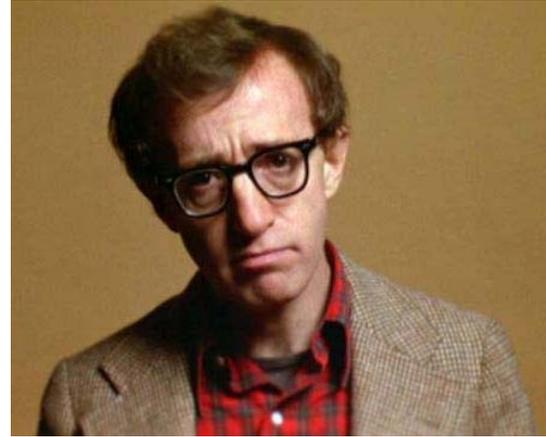
A fellow goes to a psychiatrist and says, "Doc, my brother's crazy, he thinks he's a chicken." The doctor asks, "Why don't you turn him in?" The fellow answers, "I would, but I need the eggs."

– Woody Allen in *Annie Hall*

Recently Recap released a report (available at www.recapadvisors.com/news), *Government-Sponsored Entities and Multifamily Housing Finance: Refocusing on Core Functions*, that will prove to be a landmark in the forthcoming debate surrounding the future of the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac. Written by principal author Ethan Handelman, with support from Recap CEO Todd Trehubenko and myself, the report:

- **Focuses solely on multifamily**, whereas virtually everything written about the GSEs has looked at single-family and overlooked multifamily.
- **Adopts a first-principles approach** to the GSEs' future by asking essentially, "Never mind what the GSEs are today, what do we need them to do – today, tomorrow, and for the indefinite future?" This ground-up functionality approach strips away from the current GSEs anything that can be done by another entity, to make clearer whether they have an essential purpose, and if so what.
- **Identifies core functions required for effective multifamily finance**, and reasons backwards from those to derive necessary roles that any future housing finance entities must play.

Most importantly, the GSEs' multifamily business can exist entirely independent of their single-family business. Multifamily is separately underwritten and operated, and the business is large enough to stand on its own. Whatever form or entity emerges from the rethinking, there is no doubt that the GSEs' multifamily functionalities must be preserved, regardless of what happens to GSE single-family.



We need the GSEs' multifamily functions

Principal findings

As interested and knowledgeable participants active in the marketplace but not directly connected to the GSEs or any GSE-dependent business, we began the investigation with no preconceptions, and built up our recommendations only after making our principal findings of fact, which include these:

1. **Multifamily rental is an essential asset class.** More than 15,000,000 American households live in multifamily rental housing of five units or more, representing 13% of all US households and nearly 43% of all renters. Such properties support American economic competitiveness. Over the last 20 years, the sector has professionalized and become an institutional-class investment.
2. **Multifamily rental requires finance.** As income-producing assets, multifamily rental needs capital that is continuously available on known, market-responsive terms; sufficient diversity of loan products for asset types; standardized execution and scalable capital aggregation; and national availability with local underwriting.
3. **Multifamily financing functions require federal involvement** to assure long-term fixed-rate multifamily permanent debt, credit enhancement for multifamily mortgages, and mortgage products for underserved asset classes including

affordable housing, rural housing, and small-property loans.

4. **GSE multifamily performance has been robust and largely profitable**, even through the severe downturn. Multifamily serious delinquencies are below 0.8% (Fannie Mae) and 0.3% (Freddie Mac), less than one-sixth their single-family delinquency rates, with the entities operating their multifamily business at breakeven or better through the last two years, an interval when their single-family businesses lost over \$160 billion.
5. **Four areas of the multifamily market are under-served today and need continued GSE functional presence:** (a) long-term fixed-rate multifamily permanent loans, (b) credit enhancement for affordable and construction loans, (c) specialized affordable housing loan products to complement state and local agency issues, and (d) small (5-50 apartment) multifamily mortgages.

Implications for the GSEs

Form follows function – thus, if national multifamily finance needs particular functions, with federal involvement as a credit bulwark, there are several necessary consequences:

1. **A permanently-available general liquidity function with a government guarantee**, for as we saw in 2008 and 2009, absent government backstopping credit markets can seize up.
2. **Government liquidity should be countercyclical**, with the GSEs' market share declining naturally in good times and rising in bad times. For extreme increases in liquidity, such as the recent Fed purchases of MBS, it will be useful to have affirmative control by an outside authority, such as Treasury or the Fed.
3. **The federal guarantee should be explicit**, not implicit or ambiguous, both for the market's reliance and for limiting taxpayers' risk. It should be priced, focused on public benefit, junior to originators' own risk capital, and backed by capital at the GSE entity level,

so that any taxpayer guarantee comes only third after the other two sources have been exhausted.

4. **Liquidity requires scalability**, which cannot be replicated in explicit federal lending programs such as FHA which are authorized by program and not by entity and hence cannot flexibly scale when markets move quickly.
5. **Strong government regulation is critical** to prevent runaway risk assumption by taxpayers, including limits that (a) prevent moral hazard risk expansion caused by the government guarantee, (b) avoid simplistic market-share tests, (c) keep the GSEs focused on their core functions, (d) maintain separate control over countercyclical liquidity allowances, and (e) recognize that liquidity and the GSEs' functions generally serve the affordable housing mission.

Conclusion

GSE multifamily lending is not only not a failure, it has been an immense success – it provides essential liquidity, operated without interruption during the most severe credit crunch and recession in half a century, and avoided the catastrophic losses of GSE single-family.

We need the GSEs' multifamily functions in the future as we have successfully relied on them in the past. As our report concludes:

Even were the GSEs not at the center of political controversy, the situation would require a careful and measured transition. This points to a careful readjustment of what has largely been an effective model for supporting multifamily lending—GSEs that provide liquidity to multifamily housing using the basic products of MBS and credit enhancement. Maintaining and expanding that function will support the continued professionalization of multifamily housing, leading to lower-cost, better-quality, more-available rental housing for Americans.

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