REFORMING THE NATIONAL HOUSING FINANCE SYSTEM: WHAT'S AT RISK FOR THE MULTIFAMILY RENTAL MARKET IF FANNIE MAE AND FREDDIE MAC GO AWAY?

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I. INTRODUCTION

It has been over five years since Fannie Mae and Freddie Mac (collectively the Agencies[1]) were put into conservatorship.[2] The two Agencies account for a significant share of the capital used to finance the mortgages that are critical for building and maintaining the U.S. housing stock—both single- and multifamily. Although a general consensus seems to have emerged that the two Agencies, as they currently exist, should be phased out, the debate continues on whether some or all of the functions performed by these two entities are important to maintain.[3]

Scholars generally agree that the combination of private ownership and a government guarantee of debt resulted in what is popularly known as "privatization of the gains and socialization of the losses"[4]—exposing taxpayers to unnecessary

[1] We use "the Agencies," rather than "Government Sponsored Enterprises (GSEs)" because the latter term also includes other institutions such as the Federal Home Loan Banks.

[2] FEDERAL HOUSING FINANCE AGENCY, A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING 2 (Feb. 21, 2012).

[3] *See, e.g.*, Tom White & Charlie Wilkins, AMERICAN ENTERPRISE INSTITUTE, MOVING TOWARD A VIABLE MULTIFAMILY DEBT MARKET WITH NO ONGOING FEDERAL GUARANTEE 4 (2013), *available at* http://www.aei.org/files/2013/03/08/-moving-toward-a-viable-multifamily-debt-market-with-no-ongoing-federal-guarantee_092658334028.pdf; MULTIFAMILY SUBCOMM., CTR. FOR AM. PROGRESS, A RESPONSIBLE MARKET FOR RENTAL HOUSING FINANCE: ENVISIONING THE FUTURE OF THE U.S. SECONDARY MARKET FOR MULTIFAMILY RESIDENTIAL RENTAL MORTGAGES 3–4 (2010) [hereinafter A RESPONSIBLE MARKET] (proposing the creation of "Chartered Mortgage Issuers" that would replace the Agencies), *available at* http://www.americanprogress.org/issues/2010/10/pdf/multifamilyhousingreport.pdf.

[4] *See* Andrea Boyack, *Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac*, 60 AM. U. L. REV. 1489, 1519-20 (2011); Gretchen Morgenson, *Do You Have Any Reforms in Size XL?*, N.Y. TIMES, Apr. 24, 2010, at BU1, *available at* http://www.nytimes.com/2010/04/25/business/economy/25gret.html.

risk.[5] This structure allowed the Agencies' owners and executives to capture (i.e., privatize) extra profits made possible because of an implicit government guarantee on their corporate debt.[6] At the same time, the losses resulting from imprudent risk taking on single-family mortgages were ultimately socialized when the government, and hence the taxpayers, stepped in to prevent the Agencies from defaulting on their obligations.[7]

Most of the discussion on housing finance reform focuses on the single-family mortgage market.[8] Yet the Agencies also play a major role in the multifamily housing market, financing mortgages for apartment buildings with five or more rental units. The multifamily market is critical for rental housing, as the demand for it has spiked and ma well continue to grow faster than the demand for homeownership.[9] Today the Agen-

[5] *See, e.g.*, James B. Lockhart, *Underwater: Are We Drowning or Surfacing?* J. STRUCTURED FIN., Summer 2011, at 46–47; Peter J. Wallison, et al., *Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market*, J. STRUCTURED FIN., Summer 2011, at 49.

[6] Dwight M. Jaffee & John M. Quigley, Housing Subsidies and Homeowners: What Role for Government-Sponsored Enterprises?, Brookings-Wharton Papers on Urb. Aff., 2007, at 103, 122–23.

[7] Another argument often made for phasing out Fannie and Freddie is that the subprime bubble was a direct result of political pressure to increase homeownership, regardless of the riskiness of the loans. Neither the Community Reinvestment Act (requiring banks to help meet the credit needs of low and moderate income communities) nor the Affordable Housing Goals (standards that Fannie and Freddie were expected to meet to serve traditionally underserved communities) has been found to have caused the subprime crisis. *See* Valentin Bolotnyy, The Government-Sponsored Enterprises and the Mortgage Crisis: The Role of the Affordable Housing Goals (Fed. Reserve Bd., Fin. & Econ. Discussion Series No. 2012-25 (2012), available at http://www.federalreserve.gov/pubs/feds/2012/201225/201225pap.pdf.

[8] CAP Hous. Team, Ctr. for Am. Progress, HOUSING FINANCE REFORM: AFFORDABLE RENTAL HOUSING AT STAKE 1 (2013), *available at* http://www.americanprogress.org/wp-content/uploads/2013/10/HousingFinanceReform3.pdf; NAT'L ASS'N OF HOME BUILDERS, HOUSING FINANCE REFORM: QUESTIONS AND ANSWERS ABOUT PROPOSED LEGISLATION 6 (2013), *available at* http://www.nahb. org/fileUpload_details.aspx?contentID=214328; NAT'L MULTI HOUS. COUNCIL & NAT'L APARTMENT ASS'N, KEY PRINCIPLES FOR PRESERVING LIQUIDITY AND STABILITY FOR MULTIFAMILY IN A REFORMED HOUSING FINANCE SYSTEM 5 (2013), *available at* https://www.nmhc.org/uploadedFiles/Articles/Analysis_and_Guidance/NMHC-NAA%20GSE%20Reform%20Principles.pdf.

[9] Residential Vacancies and Homeownership in the First Quarter 2014, U.S. CENSUS BUREAU (Apr. 29, 2014), *available at* http://www.census. gov/

cies own or guarantee about forty-two percent of all outstanding multifamily mortgages.[10]

Reforms to the multifamily side of the Agencies' business require a separate analysis to determine if special treatment is required. In order to do such an analysis, it is important to recognize that multifamily mortgages are neither underwritten, serviced, nor securitized the same as single-family mortgages.[11] Fannie and Freddie each have specialized multifamily business units. While each Agency accesses the capital markets in different ways, both multifamily businesses have experienced low delinquency rates,[12] have generally been profitable through the recent recession,[13] and have been able to con-

housing/hvs/files/currenthvspress.pdf (showing falling homeownership rate while the vacancy rental rate has also decreased).

[10] BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE STATISTICAL RELEASE Z.1, FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS, FOURTH QUARTER 2013, at 104 tbl.L.219 (Sept. 25, 2013) [hereinafter FLOW OF FUNDS] (indicating that GSEs and their mortgage pools account for $386.7 billion in mortgage assets, representing 52% of total multifamily mortgage assets nationwide).

[11] Multifamily properties are each individually underwritten based on their viability as a business, i.e., the sufficiency of the cash flow generated by the property, as well as the value of the property. The income of the borrower may be considered when underwriting the loan but it does not provide a sufficient basis for approving the loan. *See* Vickie Elmer, *Loans for Multifamily Homes*, N.Y. TIMES, Dec. 8, 2011, http://www.nytimes.com/2011/12/11/realestate/mortgages-loans-for-multifamily-homes.html. Servicing of multifamily loans that become delinquent is handled by specialists ("special servicers"). *See* Diana Golobay, *CMBS Delinquencies and Special Servicing Hit Record Highs*, HOUSINGWIRE (Feb. 15, 2010, 12:57 PM), http://www.housingwire.com/articles/cmbs-delinquencies-and-special-servicing-hit-record-highs. Multifamily mortgages tend to be much larger than single-family ones, thus making the effort spent underwriting each loan more cost effective and making it more feasible for investors to do their own analysis of each loan. Multifamily securities may contain as few as a single mortgage while those on the single-family size consist of large pools of mortgages. *See* FREDDIE MAC, MULTIFAMILY K CERTIFICATES (n.d.), *available at* http://www.freddiemac.com/mbs/docs/mf_kcert_fact_sheet.pdf.

[12] For at least the last decade, Fannie Mae's "serious delinquency rate has consistently been well below one percent of multi-family's total book." FANNIE MAE, ANALYSIS OF THE VIABILITY OF FANNIE MAE'S MULTIFAMILY BUSINESS OPERATING WITHOUT A GOVERNMENT GUARANTEE 26 (2012) [hereinafter FANNIE MAE REPORT].

[13] Fannie Mae has been "consistently profitable on an operating cash basis," and, even though it "recorded a pre-tax GAAP loss of $1.8 billion in

tinue to provide capital for new multifamily mortgages even as other sources of capital grew scarce.[14]

Housing finance reform also needs to be placed in the context of the existing housing market and cannot be seen as just a financial markets issue. A large and robust mortgage market already exists. Any disruptions to that market could impair the supply of multifamily housing, just as the need is growing. Changes to the current multifamily mortgage finance structure must be made carefully. This is especially true in light of the multifamily sector's importance as a source of rental housing. The Agencies' involvement in the multifamily market is substantial; any change to them must be made slowly. Great caution and care are required to preserve the ability to add stock as the demand for rental housing grows, and to avoid undermining the viability of existing units.

This article lays out an approach for determining how the government should move forward in the multifamily mortgage market. Part II discusses the importance of multifamily housing in the United States. Part III looks at the roles played by Fannie and Freddie in the multifamily market (both in good and bad times) and explores the ability of other players to serve the market after any phase-out of the Agencies. We also outline the dangers of serious disruption to the multifamily housing market if the Agencies were simply phased out. With these dangers in mind, Part IV looks at options to preserve the key roles played by Fannie and Freddie while eliminating the structure that facilitated the "privatization of the gains and socialization of the losses." Part V offers some thoughts on how to assess the likely impact of tapering the government's involvement over a longer time period and what factors to consider before making such a transition. Part VI concludes the

2009 to boost reserves for future loan losses, . . . annual pre-tax earnings for the core business have been in the range of $200 million to $500 million." FANNIE MAE REPORT, *supra* note 12, at 23. Freddie Mac has similarly earned "$4 billion in net income" from its multifamily business since 2010. FREDDIE MAC, REPORT TO THE FEDERAL HOUSING FINANCE AGENCY: HOUSING FINANCE REFORM IN THE MULTIFAMILY MORTGAGE MARKET 11 (Dec. 2012) [hereinafter FREDDIE MAC REPORT].

[14] Following the 2008 crisis, the Agencies, with the support of the federal government, stepped in to fill the void created by disinvestment in the mortgage market, increasing their combined market share from 25% to nearly 70%. FANNIE MAE REPORT, *supra* note 12, at 21.

article by reiterating the need to be careful in moving forward to reform multifamily mortgage finance.

II.
MULTIFAMILY RENTAL HOUSING IS INCREASINGLY IMPORTANT

Rental housing accounts for more than one-third of the housing units in the United States and multifamily buildings are a major source of rental housing.[15] Moreover, the demand for rental housing is growing faster than the demand for homeownership, especially for low-income households.[16] Multifamily buildings (buildings with more than five units)[17] represent about 41% of the rental market,[18] and make up much of the nation's affordable housing stock.[19] Multifamily rental units generally serve a lower range of income levels with 91.4% of the units in 2009 affordable to households earning 100% or less of the area median income.[20] Nearly two-thirds of low-income households rent their homes.[21] Affordable units are particularly important because incomes have fallen over the past

[15] JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., AMERICA'S RENTAL HOUSING: EVOLVING MARKETS AND NEEDS 1 (2013) [hereinafter JOINT CENTER 2013].

[16] *See supra* note 9; JOINT CENTER 2013 at 2.

[17] As defined in FANNIE MAE REPORT, *supra* note 12, at 13–14.

[18] U.S. CENSUS BUREAU, 2011 AMERICAN HOUSING SURVEY: GENERAL HOUSING DATA—RENTER-OCCUPIED UNITS (NATIONAL), *available at* http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=AHS_2011_C01RO&prodType=table. The remaining portion of the rental market is made up of 1–4 unit buildings and mobile homes. *Id. See also* JOINT CENTER 2013, *supra* note 15, at 30.

[19] CENTER FOR AMERICAN PROGRESS, A RESPONSIBLE MARKET FOR RENTAL HOUSING FINANCE 9 (2010); Drew Schneider & James Follain, *A New Initiative in the Federal Housing Administration's Office of Multifamily Housing Programs: An Assessment of Small Projects Processing*, 4 CITYSCAPE 43, 44 (1998). The most common measure of "affordable" is that rent and utility costs together require less than 30 percent of the income of low- and moderate-income households." JOINT CENTER FOR HOUSING STUDIES OF HARV. U., AMERICA'S RENTAL HOUSING: MEETING CHALLENGES, BUILDING ON OPPORTUNITIES 4 (2011) [hereinafter JOINT CENTER 2011]; *see infra* notes 20–27 and accompanying text.

[20] FANNIE MAE REPORT, *supra* note 12, at 13.

[21] WILLIAM APGAR & SHEKAR NARASIMHAN, ENHANCING ACCESS TO CAPITAL FOR SMALLER UNSUBSIDIZED MULTIFAMILY RENTAL PROPERTIES 3 (2006) (noting that over 80% of renters live in privately-owned, unsubsidized rental housing).

few years for low- and moderate-income workers, while energy prices and rents have continued to increase.[22]

The percentage of renting households is projected to grow as homeownership rates have fallen "across a broad spectrum of the population."[23] As a result, the 2000s saw the sharpest growth in rental housing of any decade in the last half century.[24] About 36.1% of Americans rented their homes in 2012, up from a low of 32% in 2001.[25]

The number of renters is expected to continue to grow because today's young people tend to favor apartments, even after marriage.[26] The nation's increasing diversity is also expected to increase rental demand, since about 45% of rental households are made up of minorities, and black and Hispanic families have much lower homeownership rates than non-Hispanic whites and Asians.[27] Scholars have predicted that the projected increase in rental demand will be a fundamental

[22] JOINT CENTER 2011, *supra* note 19; JOINT CENTER 2013, *supra* note 15 (noting the decrease in affordability).

[23] JOINT CENTER 2011, *supra* note 19, at 17–18. *See also* JOINT CENTER 2013, *supra* note 15, at 1 (noting that the renter share of all households in the United States climbed from 31% in 2004 to 35% in 2012).

[24] JOINT CENTER 2013, *supra* note 15, at 1.

[25] American Community Survey, Selected Housing Characteristics, *available at* http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ACS_12_1YR_CP04&prodType=table (last viewed Mar. 4, 2014); U.S. Census Bureau, American Housing Survey for the United States: 2001 x fig.1 (2002), available at http://www.census.gov/programs-surveys/ahs/data/2001/h150-01. html.

[26] JOINT CENTER 2011, *supra* note 19, at 2. ("Depending on the pace of immigration, the number of renter households is likely to increase by between 4.0 million and 4.7 million in 2013–23."). JOINT CENTER 2013, *supra* note 15, at 2. *See also* Mary Kinney, The Fundamental Role of Multifamily Housing, Mortgage Banking, Jan. 2013, at 64 (noting that the "echo boom generation" has recently begun to move into their own apartments as unemployment decreases). JOINT CENTER FOR HOUSING STUDIES, THE STATE OF THE NATION'S HOUSING 22 (noting that the demand for renter households increased by more than 1.1 million units in 2011–2012, that the median age of renters is lower than the median age for homeowners, and that married couples have contributed to an increasing share of renter household growth over the last five years), *available at* http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2013_chap5_rental_housing.pdf.

[27] Kinney, *supra* note 23, at 64; JOINT CENTER 2011, *supra* note 19, at 3 (45% of renters were minorities in 2011; they also made up 89% of the growth between 2000 and 2010).

shift in the American housing market on the scale of America's post-World War II suburbanization.[28]

Meeting this growth in demand will require both the rehabilitation of existing stock as well as the production of new units. The rental housing stock has a median age of thirty-eight years,[29] and one-third of the occupied stock is over fifty years old.[30] The age of the current supply of multifamily rental housing also increases the importance of the availability of financing to make major repairs and replace major systems (e.g., roofs, electrical, plumbing, heating, etc.). If a significant portion of these buildings disappeared or became dilapidated, much of our affordable housing stock could be lost.[31] Reasonably priced financing for rehabilitation is critical to ensure the continued availability of this source of affordable housing.[32]

Financing is also critical for the production of new, multifamily rental units. While the production of multifamily housing appears to have lagged behind the increase in demand in recent years, it now appears to be coming into balance.[33] Nevertheless, midway through 2013, multifamily starts[34] were on pace to total 294,000 units for the year, still below the 340,000 annual rate averaged in the early 2000s before the housing

[28] Arthur C. Nelson, *The New Urbanity: The Rise of a New America*, 626 ANNALS AM. ACAD. POL. & SOC. SCI. 192 (2009) (predicting that the upcoming shift into rental households will be "as sweeping a change to American's metropolitan landscape as the half century after World War II"); A RESPONSIBLE MARKET, *supra* note 3, at 1.

[29] JOINT CENTER 2011, *supra* note 19, at 6.

[30] JOINT CENTER 2013, *supra* note 15, at 15.

[31] JOINT CENTER 2013, *supra* note 15, at 16. Though it should be noted that "rental housing is in generally good condition, with only 3.1 percent categorized as severely inadequate and 6.7% as moderately inadequate," these shares are "nearly twice those for all housing units."

[32] JOINT CENTER 2013, *supra* note 15, at 21 ("While renovation and improvements might address some of these deficiencies, the costs of upgrading older properties to current building codes are often prohibitive. Still, rehabilitation of older buildings would provide the kind of modest but secure housing that is difficult to add through new construction."). Units for low-income families (those renting for less than $400) are the most vulnerable, and face a loss rate (abandonment) nearly twice as high as that for all rental units. *Id.* at 19.

[33] JOINT CENTER 2013, *supra* note 15, at 5.

[34] The number of new units on which constructions has begun.

bust.[35] The vacancy rate has also been declining since 2009, albeit at a slower rate more recently, indicating a relative shortage of multifamily units.[36] With supply still lagging behind demand, now would seem to be a particularly inopportune time to scale back the government's support to the multifamily market without a full understanding of the consequences.

Fannie and Freddie account for a significant share of the market and their absence could cause a serious disruption of the availability of mortgage finance for multifamily properties. Scaling back the Agencies could result in fewer multifamily units and those that existed would likely rent for more money and be in poorer condition overall. With this in mind, let us look at the role or roles Fannie and Freddie play in the financing of multifamily housing.

III.
Fannie and Freddie Are Critical to the Multifamily Mortgage Market

Long before the privately-owned, but government-regulated, Agencies were placed into federal conservatorship in 2008, Fannie Mae was a formal and integral part of the government. It was created in 1938 by federal charter to purchase Federal Housing Administration (FHA) loans that had been originated by the private sector.[37] With Fannie as an outlet for their mortgage loans, originators were able to free up capital for originating more loans.[38] Fannie would hold these loans

[35] Joint Center 2013, *supra* note 15, at 5. Multifamily construction data includes units for ownership (such as condominiums) in addition to rental units.

[36] *Id.* at 5 fig.4.

[37] Fannie and Freddie were federally chartered to operate as privately-owned, for-profit companies to provide a stable source of funding for residential mortgages across the country. *See Fannie Mae, Freddie Mac & FHA: Taxpayer Exposure in the Housing Markets: Hearing Before the H. Comm. on the Budget*, 112th Cong. 15, 17 (2011) (statement of Deborah J. Lucas).

[38] Ingrid Gould Ellen, John Napier Tye & Mark Willis, Improving U.S. Housing Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options 2 (2010), *available at* http://www.urban.org/uploadedpdf/1001382-fannie-mae-freddie-mac-reform.pdf.

on the government's balance sheet and fund them through the federal budget. The Agency was only privatized in 1968.[39]

In 1968, Fannie Mae was split in two, with the part that retained the name being privatized and allowed to purchase non-government-guaranteed mortgages.[40] The part that remained in the government became the Government National Mortgage Agency (GNMA or Ginnie Mae).[41] While GNMA lacked the ability to hold loans in its portfolio, it could provide a government guarantee on securities backed by pools of government loans.[42] In 1970, GNMA pioneered the modern use of mortgage-backed securities (MBS), in which borrower repayments are "passed through" to the investors.[43] GNMA, with the full backing of the U.S. government, guaranteed that those payments would be made in a timely manner, even if the borrowers defaulted.[44]

In 1970, Freddie Mac was created with a federal charter equivalent to Fannie Mae's.[45] Despite private ownership, investors viewed both of the Agencies as still having, albeit implied, the backing of the U.S. government. This allowed them to attract capital at interest rates only slightly higher than U.S. Treasuries with comparable maturities-securities which are considered to be essentially risk free.[46] As with GNMA, the Agencies also guaranteed the timely payment of principal and interest.[47] Meanwhile, Fannie Mae continued to finance its

[39] David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 HARV. J. ON LEGIS. 437, 456 (2013).

[40] *Id.*

[41] ELLEN, TYE & WILLIS, *supra* note 38, at 2.

[42] *Id.* GNMA can buy, in addition to loans backed by FHA, loans backed by the Department of Veterans Affairs, the Farmer's Home Administration, and HUD's Department of Public and Indian Housing. *See* Min, *supra* note 39 at 456 (2013).

[43] Kenneth A. Snowden, *Mortgage Rates and American Capital Market Development in the Late Nineteenth Century,* 47 J. ECON. HIST. 671 (1987). *See also* GINNIE MAE, http://www.ginniemae.gov/pages/default.aspx (last visited Mar. 25, 2014).

[44] *Our History*, GINNIE MAE, http://www.ginniemae.gov/inside_gnma/company_overview/Pages/our_history.aspx (last modified Dec. 7, 2012, 11:54 AM).

[45] Min, *supra* note 39, at 456.

[46] Min*, supra* note 39, at 457. While ownership was fully private, Fannie Mae and Freddie Mac continued to have call on a line of credit with the U.S. Treasury. 12 U.S.C. § 1719(c) (2012).

[47] Min*, supra* note 39, at 457.

purchases by issuing corporate debt and holding mortgages in its portfolio. Unlike Fannie Mae, however, Freddie Mac looked to the issuance of MBS to fund its purchase of multifamily mortgages.[48] Securitization allowed Freddie to pass the interest rate risk along to investors. By selling the MBS, Freddie Mac was able to avoid having to deal with any mismatch between funding costs and the interest rate earned on the mortgages. Fannie Mae followed GNMA and Freddie Mac in securitizing the majority of its mortgages[49] after short-term interest rates skyrocketed in the early 1980s and Fannie Mae found its funding costs exceeding the interest it was receiving on the mortgages.[50] Both Agencies continued to hold some of their mortgages and MBS in their portfolios.[51]

Prior to the most recent financial crisis, the Agencies' MBS pricing benefitted from the implied backing by the U.S. government. Investors were not concerned about mortgage borrower defaults because they believed that the government would always step in to make the repayments.[52] In all cases, investors received their payments. The only risk that investors had to worry about was the risk that interest rates might go up or down, affecting the market value of the securities.[53] Free from credit risk, securities backed by Fannie and Freddie could be marketed to so-called "rate investors" around the world, ranging from sovereign wealth funds[54] to banks simply

[48] *Id.* at 457 n.104.

[49] FREDDIE MAC, FREDDIE MAC MULTIFAMILY SECURITIZATION 17 (2014), *available at* http://www.freddiemac.com/multifamily/pdf/mf_securitization investor-presentation.pdf (noting that 95% of multifamily mortgages purchased in 2013 are intended for securitization).

[50] Ronald D. Utt, *Time to Reform Fannie Mae and Freddie Mac*, HERITAGE FOUNDATION (June 20, 2005), http://www.heritage.org/research/reports/2005/06/time-to-reform-fannie-mae-and-freddie-mac.

[51] *See, e.g.*, Fed. Nat'l Mortg. Ass'n, Annual Report (Form 10-K) 94 tbl.24 (Apr. 2, 2013).

[52] Min, *supra* note 39, at 457.

[53] Investors holding fixed-rate securities suffer paper, if not actual, losses when interest rates increase since the market value of the security will fall, and the investor will be earning a rate of return less than that being paid for newly issued mortgage loans. *See generally* Dwight Jaffee, *The Interest Rate Risk of Fannie Mae and Freddie Mac*, 24 J. FIN. SERVICES RES. 5 (2003).

[54] Josiane Kremer, *Norway's Sovereign Wealth Fund Sold All U.S. Mortgage Bonds*, BLOOMBERG (Oct. 28, 2011 9:51 AM), http://www.bloomberg.com/news/2011-10-28/norway-s-sovereign-wealth-fund-sold-all-u-s-mortgage-bonds.html.

looking for high quality, fixed-rate bonds that pay a little more than straight government debt.[55] Government-guaranteed MBS offer investors a way to diversify their portfolios with securities offering a slightly higher yield than Treasuries, and treat them as a separate asset class from plain mortgages.

By 2008, however, investors began to question whether the U.S. government was actually going to stand behind Fannie and Freddie[56] when they were hit by huge losses as home prices fell and many borrowers started to default.[57] To calm the markets, the government came to the rescue — as many had expected — and placed the two Agencies in conservatorship under the direction of the newly formed Federal Housing Finance Administration (FHFA).[58] The U.S. Treasury also opened up a line of credit to provide the two Agencies with sufficient capital to meet their obligations.[59] Four years later, and having received nearly $188 billion in capital, Fannie and Freddie appear to have turned the corner and are again making money, having already earned back more than the amount injected by Treasury.[60]

A. *Fannie and Freddie's Current Role in the Multifamily Finance Market*

With the implicit guarantee opening the mortgage market to rate investors, Fannie and Freddie have been able to access a large pool of low-cost capital; to offer mortgages with

[55] *See* Joe D'Allegro, *MBS a Solid Bet—With a Unique Set of Risks*, FOUND. & ENDOWMENT MONEY MGMT., Sept. 2, 2013, at 6.

[56] Diana Hancock & Wayne Passmore, *An Analysis of Government Guarantees and the Functioning of Asset-Backed Securities Markets* 2 (Fed. Reserve Bd., Fin. & Econ. Discussion Series, Working Paper No. 2010-46, 2010), *available at* http://www.federalreserve.gov/pubs/feds/2010/201046/201046pap.pdf.

[57] MARK JICKLING, CONG. RESEARCH SERV., RS22950, FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP 4 (2008).

[58] Min, *supra* note 39, at 440.

[59] Michael Padhi, *Fannie Mae and Freddie Mac at Work in the Secondary Mortgage Market*, FIN. UPDATE (Fed. Reserve Bank of Atlanta), Jan.-Mar. 2001, at 2, *available at* http://www.frbatlanta.org/pubs/financialupdate/financial_update-vol_14_no_1-fannie_mae_and_freddie_mac.cfm.

[60] Jim Puzzanghera, *Fannie Mae, Freddie Mac May Be Too Profitable to Shut Down*, L.A. TIMES, Jan. 2, 2014, http://articles.latimes.com/2014/jan/02/business/la-fi-fannie-freddie-future-20140103; Chris Isidore, *Mortgage Bailout Now Profitable for TaxPayers,* CNNMONEY (Feb. 21, 2014), http://money.cnn.com/2014/02/21/news/economy/fannie-profit-bailout/.

terms longer than typical for banks when originating for their own portfolios;[61] and to fund mortgages even during economic and housing downturns when risk-taking capital becomes scarce (as happened most recently during the financial crisis and Great Recession).[62] They have also been an important source of credit for buildings that offer rents affordable to people at or below 80% of area median income (AMI) and for projects being built under the Low Income Housing Tax Credit program.[63] For example, in 2012, nearly 62% of the units financed by Fannie and Freddie were affordable to those earning 80% or less of AMI.[64]

As a result of being able to offer these products and services, Fannie and Freddie have seen their multifamily business grow over the long run, with their share of multifamily mortgage debt obligations growing from 6.5% in the 1970s to 25% in the 2000s.[65] More recently, as other sources of capital withdrew from the market, Fannie and Freddie's combined share of new multifamily mortgage origination grew, reaching a high of nearly 70% in 2009.[66] This support of new originations has been critical in sustaining the multifamily housing market. Correspondingly, Fannie and Freddie's share of outstanding multifamily mortgage obligations climbed even higher to reach 42.5% by the end of the third quarter of 2013.[67] As over-

[61] Boyack, *supra* note 4, at 1492–93; Min, *supra* note 39, at 482–83.

[62] Min, *supra* note 39, at 477–79.

[63] ELLEN, TYE & WILLIS, *supra* note 38, at 20.

[64] *The Future of Housing Finance—A Review of Proposals to Address Market Structure and Transition: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 14 (2010) (statement of Michael Bodaken, President, National Housing Trust). Note that "affordable" is defined as thirty percent of income. *See supra* note 19.

[65] In the first quarter of 1975, there was $100.586 billion in outstanding multifamily mortgage debt. Fannie Mae held $6.011 billion (or about 6%); Freddie Mac held $0.537 billion (or about 0.5%). In the first quarter of 2005, there was $616.588 billion in outstanding multifamily mortgage debt. Fannie Mae held $103.107 billion, representing almost 17%; Freddie Mac held $53.585 billion representing almost 9%. *Mortgage Debt Outstanding*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/econresdata/releases/mortout stand/current.htm (click "Historical data (CSV)") (last updated Dec. 9, 2013); *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-849, MORTGAGE FINANCING: FANNIE MAE AND FREDDIE MAC'S MULTIFAMILY HOUSING ACTIVITIES HAVE INCREASED 37–38 (2012).

[66] FANNIE MAE REPORT, *supra* note 12, at 20.

[67] FLOW OF FUNDS, *supra* note 10, at 104 tbl.L.219.

all economic and housing conditions continue to improve and other sources of mortgage capital bounce back to more traditional levels, it is reasonable to expect this share to fall back to pre-recession levels.

The increased presence of the Agencies in the market has not been universally welcomed. Critics claim that: 1) the Agencies have crowded out other sources of capital and are not needed to maintain a healthy multifamily mortgage market;[68] and 2) the downsides from government bureaucracy and the potential for political interference[69] inherent in a system with a government guarantee is not worth the benefits (which those same critics are skeptical of in the first place). Let us look at each of these in turn.

B. *Can Other Sources of Capital Fill in If Fannie and Freddie Were Simply Phased Out?*

To answer this first concern of critics, we need to look at the other major sources of multifamily mortgage capital and examine their ability to fill in if Fannie and Freddie were simply phased out over a five year period, as is commonly suggested.[70] In addition to Fannie and Freddie, about 24% of the outstanding multifamily mortgage debt is held by commercial banks, 6% by savings institutions, 6% by life insurance companies, about 9% by GNMA, and the remainder is held by miscellaneous other sources.[71] Each of these sources faces constraints on its ability to respond in a timely manner to a phase out of Fannie and Freddie.

[68] *See* White & Wilkins, *supra* note 3, at 12 (noting that the Agencies "have powerful pricing advantages over private competitors").

[69] *See id.* at 3–4 (noting that the current system is vulnerable to political "meddling").

[70] *See, e.g.*, Kent Hoover, *Bill to End Fannie Mae, Freddie Mac Clears House Committee*, BUS. JOURNALS (Jul. 24, 2013, 11:34 AM), http://www.biz journals.com/bizjournals/washingtonbureau/2013/07/24/bill-to-end-fannie-mae-freddie-mac.html?page=all.

[71] *Mortgage Debt Outstanding*, *supra* note 65. As most recently calculated after the third quarter of 2013, the total outstanding mortgage debt for multifamily residences is $908.108 billion. Commercial banks hold $218.546 billion. Savings Institutions hold $54.838 billion. Life insurance companies hold $52.304 billion. Ginnie Mae holds $0 in portfolio and $79.761 billion in pools or trusts. Fannie Mae holds $186.535 billion in portfolio and $1.341 billion in pools or trusts. Freddie Mac holds $65.268 billion in portfolio and $57.658 billion in pools or trusts.

While Fannie and Freddie have been growing their share of an expanding multifamily mortgage market, these other sources of capital have not kept pace. As a result, banks, insurance companies, pension funds, and private label commercial MBS have all seen their market share fall over time. Banks, insurance companies and pension funds pulled back even further during the recent financial crisis.

In order for banks or others to increase their share in the funding of mortgages, they would have to increase the share of their assets devoted to this asset class. Diversified portfolios are a matter of good financial management, and only a portion consists of mortgages. While banks could increase the share of mortgages within their portfolios, their overall capacity to do so is limited. Prudent management practices call for banks to diversify their assets across asset classes with different risk profiles from those of mortgages. Only 27.8% of bank portfolios are allocated to mortgages. Of the mortgages they hold, only about 6% are multifamily.[72] Already, almost 30% of bank portfolios consist of mortgages (both residential and commercial—a category that includes multifamily).[73] Banks would have to devote their whole portfolios to mortgages in order to replace the funding currently available — an outcome that no prudential bank regulator would allow. Similarly, life insurance companies and private pension funds now devote only about 9%[74] and 0.2%,[75] respectively, of their portfolios to mortgages. Only a fraction of these numbers, however, are multifamily mortgages. Unless these allocations can be significantly increased, their mortgage holdings can only grow roughly at the rate of growth of their overall portfolios.

[72] *Id.* ($218,546,000,000 of multifamily mortgages out of $3,559,344,000,000 of total mortgages held by commercial banks).

[73] FLOW OF FUNDS, *supra* note 10, at 75 tbl.L.109. The precipitous decline of savings banks which traditionally served local mortgage markets has further limited the availability of bank mortgages. In 1980, there were 4,000 thrift institutions. Today, there are just 734. Ben Protess, *Thrift Banks' Long Decline,* N.Y. TIMES DEALBOOK (Dec. 8, 2010, 10:05 AM), http://dealbook.nytimes.com/2010/12/08/thrifts-last-stand/ (noting, however, that there is a "modest earnings resurgence" in the industry, which is "hardly enough to restore thrifts to their formal glory").

[74] FLOW OF FUNDS, *supra* note 10, at 79 tbl.L.115.

[75] *Id.* at 81 tbl.L.117. The percentage for pension funds overall is about 0.17%, because public pensions hold fewer MBSs as a percentage of their portfolios. *Id.* at 80 tbl.L.116.

Another possible source of capital would be a vastly expanded role for conduits, which pool the mortgages and use them to back commercial mortgage-backed securities (CMBS) which are sold directly into the capital markets and lack a government guarantee. While the market for new CMBS business disappeared for a period during the recent economic downturn as private investors exited the market, it had grown significantly before the financial crisis and could bounce back to earlier levels.[76] Even so, its share of the total of multifamily mortgage debt obligations outstanding never exceeded fifteen percent of the market, or about $123.9 billion.[77]

While GNMA multifamily securities also tap the rate-investor market and so could conceivably be expanded, their growth is limited by the capacity of FHA to endorse a larger number of individual loans. Further expansion of FHA's capacity would require an increase in congressional appropriations and would increase the taxpayers' potential exposure to losses, since both FHA and GNMA are backed by the U.S. government.[78]

In summary, it is hard to see how these alternative sources of capital could expand fast enough, either individually or collectively, to substitute for the Agencies, particularly within a five-year timeline. Doing so would require major increases in portfolio allocations of banks, insurance companies, and pension funds, or a fast scale-up of the CMBS market to new highs. The resulting decrease in financing could significantly hurt the multifamily housing market. Developers would not be able to build as many multifamily units.[79] Owners would also have trouble recapitalizing or raising cash to make major repairs

[76] Min, *supra* note 39, at 465–67.

[77] BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE STATISTICAL RELEASE Z.1, FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS, HISTORICAL ANNUAL TABLES 2005–2013, at 99 tbl.L.219 (Mar. 6, 2014), *available at* http://www.federalreserve.gov/releases/z1/current/annuals/a2005-2013.pdf.

[78] The House Financial Services Committee has already approved the Protecting American Taxpayers and Homeowners (PATH) Act, H.R. 2767, 113th Cong. (2013), which seeks to reduce FHA's footprint. Hoover, *supra* note 70.

[79] Denise DiPasquale & Jean L. Cummings, *Financing Multifamily Rental Housing: The Changing Role of Lenders and Investors*, 3 HOUSING POL'Y DEBATE 77, 90 (1992) (noting that "[m]ultifamily financing is characterized by the

and might be forced to abandon their properties as rental income falls or operating cost rise.[80] It could also make the property market less liquid, leaving investors locked into their investments and unable to take cash out. Moreover, the loss of Fannie and Freddie could have a disproportionately negative impact on the availability of longer-term loans,[81] thus leaving borrowers[82] with more interest rate risk.[83] To compensate, owners would have to build higher financing costs into their cost base, resulting in higher rents, higher abandonment, and less supply. All of these changes could very well have a disproportionately large effect on the supply and maintenance of older, privately-owned stock, which is a key part of the Agencies' multifamily business.[84]

C. *What Harm Did the Government Guarantee Cause on the Multifamily Side?*

The second concern requires a look at whether there is something inherent and unavoidable in the structure of Fannie and Freddie that led to the losses following 2008, and whether it is possible to structure the government guarantee in a way that reduces the risk to the taxpayer. The argument generally revolves around the following concerns: moral hazard[85] and political pressure.[86]

need for a large, upfront infusion of capital before the property can begin to produce income").

[80] *See supra* note 32.

[81] This would happen because banks prefer to make shorter-term loans unless they can sell the loans on the secondary market. *Cf.* Min, *supra* note 39, at 482 (noting that long-term, fixed-rate mortgages in the single-family context are only possible because of the secondary market).

[82] *Id.* at 457.

[83] Interest rate risk is the risk that interest rates will rise, causing an investment to be worth less to the investor (who would prefer to lend it at new, higher, interest rates). *See* OFFICE OF INVESTOR EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, PUB. NO. 151, INVESTOR BULLETIN: INTEREST RATE RISK–WHEN INTEREST RATES GO UP, PRICES OF FIXED-RATE BONDS FALL (2013), *available at* http://www.sec.gov/investor/alerts/ib_interestraterisk.pdf; *see also supra* note 53.

[84] Freddie Mac Report, *supra* note 13, at 7.

[85] Min, *supra* note 39, at 483–84.

[86] White & Wilkins, *supra* note 3, at 3.

1. *Moral Hazard*

The first argument is that the combination of private ownership with an implicit government guarantee of corporate obligations creates moral hazard. Under this theory, moral hazard resulted in the two Agencies taking on too much risk, allowing them to earn excess profits because of their unique access to low-cost capital.[87] This dynamic is thought to have led to the "privatization of gain and socialization of losses."[88]

The problem with this argument is that it does not align with the facts, at least on the multifamily side. Judging by the Agencies' low delinquency rates, the two Agencies do not appear to have taken excessive risks.[89] In fact, both multifamily businesses have generally been profitable even through the recent recession.[90] As a result of incurring severe losses in their multifamily businesses around 1990, both Agencies revamped their multifamily programs and have maintained high underwriting standards since.

For example, Fannie Mae instituted a risk-sharing program with a highly selective group of DUS (Delegated Underwriting and Servicing) lenders.[91] Under this business model, the loan originators share in the risk and are, therefore, careful to properly underwrite their loans.[92] This process kept originators' incentives in line with those of Fannie and with acceptable levels of risk. Freddie Mac also works with a highly selective group of "Program Plus" Seller/Servicer lenders but brought underwriting for these loans totally in-house.[93] Even without a risk-sharing program at that time, Freddie maintained its multifamily underwriting standards throughout the housing bubble and was not drawn into a race to the bottom

[87] *Id.*

[88] *See* Boyack, *supra* note 4, at 1519–20; Morgenson, *supra* note 4.

[89] FREDDIE MAC, FREDDIE MAC UPDATE: MAY 2014, at 40 (2014) (on file with authors)

[90] *See supra* note 3.

[91] William Segal & Edward J. Szymanoski, *Fannie Mae, Freddie Mac, and the Multifamily Mortgage Market*, 4 CITYSCAPE, no. 1 (1998), at 59, 69.

[92] *Id.*

[93] *Id.* at 70. There are twenty-four approved Program Plus Seller/Servicers for Freddie Mac. *Program Plus Seller/Servicers*, Freddie Mac, http://www.freddiemac.com/multifamily/sellerservicers/completelist.html (last visited Feb. 7, 2014).

(as can be argued happened to the Agencies on the single-family side).[94]

Another factor that may have counteracted any tendency by the Agencies to lower their multifamily underwriting standards is the very nature of the multifamily mortgage business, which differs in important ways from that on the single-family side.[95] One such difference is the larger size of multifamily loans, which results in securities containing fewer loans, a reality which makes it easier for an investor to review the underwriting of every loan (it is not unusual for a security to consist of just one loan).[96]

Both of the multifamily programs also avoided another problem that seems to have existed on the single-family side — loan originators who thought that they did not need to be concerned about the riskiness of the loans since they were selling them immediately to the Agencies. This principal–agent problem, which may have been inherent in the originate-to-distribute approach, was avoided on the multifamily side by requiring the loan originators to absorb a share of any losses, as was the case with DUS and Fannie, or by taking the underwriting fully in-house and not delegating the responsibility at all, as did Freddie.

2. *Political Pressure*

The second line of thought reflects a concern that the government guarantee opens the system to political pressure, inevitably leading to lower underwriting standards. Politicians have often campaigned on the idea that more Americans should be able to participate in one of the cornerstones of the "American Dream": homeownership.[97] By making mortgages more available, it was hoped that more people would be able to become homeowners and sustain homeownership.

[94] *See* MULTIFAMILY SUBCOMM., CTR. FOR AM. PROGRESS, *supra* note 3, at 11–12.

[95] *See supra* note 11.

[96] *See supra* note 11.

[97] *See* Anne B. Shlay, *Low-Income Homeownership: American Dream or Delusion*, 43 URB. STUD. 511, 511 (2006) (noting that "homeownership has been portrayed as a political right seemingly more popular than voting").

The facts do not back this argument on the multifamily side.[98] While the CMBS market experienced a high level of delinquencies, there does not seem to have been a significant lowering of underwriting standards by the Agencies, let alone for political purposes.[99] Perhaps, a key reason is simply that the multifamily business deals mainly with rental units and not homeownership. Fannie's risk-sharing model also strengthens the resolve not to lower standards, thus helping to account for its low delinquency rates. In addition, Freddie has recently adopted a risk-sharing structure for its multifamily MBS called K-series, where the MBS is divided into tranches, with investors in the "senior" tranches receiving payment first and investors in the "subordinate" tranches being the first to absorb any losses. While the senior tranches benefit from a Freddie guarantee, the subordinate tranches do not. Again, the challenge of finding investors for the subordinate tranches serves to temper any pressure that might otherwise exist for Freddie to lower its underwriting standards.[100]

[98] This argument is used primarily on the single-family side. A number of studies have refuted the argument that the government push for homeownership (by President Clinton) or the ownership society (promoted by President W. Bush) led to lower underwriting standards in the multifamily market. Nor has it been found that either the Community Reinvestment Act (requiring banks to help meet the credit needs of low and moderate income communities) or the Affordable Housing Goals (standards that Fannie and Freddie were expected to meet to serve traditionally underserved communities) caused the subprime crisis. For example, s*ee* Randall Kroszner, *The Community Reinvestment Act and the Recent Mortgage Crisis*, *in* Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act, Fed. Reserve Banks of Boston and San Francisco (2009), *available at* http://www.frbsf.org/community-development/files/revisiting_cra.pdf.

[99] *See* David Brickman et al., *Mysteries Revealed—Why CMBS Multifamily Performance Is So Much Worse Than Agency and Life Company Experience*, CREFC Multifamily Lenders Forum Update 22, 26 (Summer 2011), *available at* https://www.crefc.org/assetlibrary/cab32682-330b-42a6-9ebd-ccdded839422/695509b6e1ab4ab08ef863f0c01761d53.pdf.

[100] Laurie S. Goodman & Landon D. Parsons, *The Case for Alternative Credit Enhancement Structures in GSE Securitizations*, 18 J. Structured Fin., 76, 80 (2012).

IV.
GOALS FOR REFORM: DO NO HARM TO THE MULTIFAMILY MORTGAGE MARKET AND PROTECT THE TAXPAYER

First, do no harm. This maxim should be the starting place for a discussion about reforms to housing finance. The cost and availability of capital is important to the overall health of the indispensable multifamily housing market, and the net impact of any changes must be carefully weighed. Being careful does not preclude phasing out Fannie and Freddie as legal entities or making changes that can increase the availability of capital, improve the mix of products, or address real shortcomings. However, it does counsel caution before moving in the direction of removing a government guarantee from the types of multifamily mortgage-backed securities that are being issued today by Fannie and Freddie. Those who propose such a major change need to show that the existing system is either untenable, or that a better way exists that will not significantly disrupt the supply of multifamily rental housing.[101] As noted in the previous section, the multifamily programs of Fannie and Freddie were able to avoid the dangers of moral hazard and principal–agent relationships that are thought to plague their single-family businesses.[102] Nevertheless, more can be done to protect against these dangers.

A. *Re-Structure the Government Guarantee with Sufficient Private Capital in the First-Loss Position*

One way to reduce the dangers of moral hazard and limit taxpayer exposure without disrupting the market would be to make the guarantee explict and have its provision overseen by a separate government entity.[103] To further protect taxpayers,

[101] For examples of those that propose simply phasing out Fannie and Freddie and with them the government guarantee for non-GNMA MBS, *see* Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. §§ 101-110 (2013); White & Wilkins, *supra* note 3, at 3; James B. Lockhart, *Underwater: Are We Drowning or Surfacing?*, *in* T*he Future of U.S. Housing Finance: Five Points of View*, 17 J. STRUCTURED FIN. 36, 39, 46-47 (2011).

[102] *See* Brickman et al., *supra* note 99, at 24 (noting that "Freddie Mac was more conservative in its underwriting, which we think was true to some extent for all of the lenders with better performance").

[103] To provide the insurance, the Government could create a new entity, or could add it to Ginnie Mae's responsibilities. *See* BIPARTISAN POLICY CTR.,

the guaranteeing entity should charge a premium for providing this coverage, using the proceeds to build a loss reserve.[104] To lower risk in the whole system, this entity should also set standards and monitor performance for the underwriting and servicing of the loans.

An additional step to limit the public guarantor's (and the taxpayer's) exposure to loss would be to increase the amount of private capital required to be at risk ahead of the government guarantee. The current thinking is that this private capital should be sufficient to cover losses during periods of all but the most extreme economic or housing distress, i.e., the government guarantee would only be triggered in the case of catastrophic economic conditions. The responsibility for requiring and monitoring the level of private capital would be under the purview of the public guarantor. In the case of a DUS lender system, it would be necessary to set and monitor the capital levels of both the lenders and the issuer/insurer of the securities. As for the Freddie Mac model, the subordinate tranches need to be large enough and the issuer and insurer

HOUSING AMERICA'S FUTURE: NEW DIRECTIONS FOR NATIONAL POLICY 78—79 (2013), *available at* http://bipartisanpolicy.org/sites/default/files/BPC_Housing%20Report_web_0.pdf.

[104] Determining the amount of the premium is also not without controversy. Some argue that the government is incapable of determining the correct level. *See, e.g.*, ACHARYA ET AL., GUARANTEED TO FAIL: FANNIE MAE, FREDDIE MAC, AND THE DEBACLE OF MORTGAGE FINANCE (2011). Others point to the Federal Credit Reform Act, which lays out rules for determining premium levels and, in the case of the FHA, may well have suficient capital, including loss reserves, to ride out the most recent downturn. Although FHA was mandated to draw down $1.7 billion from the U.S. Treasury in fiscal year 2014, it still had plenty of cash reserves to cover current payments, and the latest actuarial report projects significant net earnings for the most recent cohorts of loans and a rapid rebuilding of its capital position. *See* ANNUAL REPORT TO CONGRESS, U.S. DEP'T OF HOUS. & URBAN DEV. 19 (Dec. 13, 2013), *available at* portal.hud.gov/hudportal/documents/huddoc?id=FY2013RepCongFinStMMIFund.pdf. No additional draw is projected as being to be needed for fiscal year 2015. Jann Swanson, *FHA Fund Doesn't Need Treasury Draw After All; Groups Call for Fee Reduction*, MORTGAGE NEWS DAILY (Mar. 4, 2013), http://www.mortgagenewsdaily.com/03042014_hud_budget_fha.asp. The challenge of setting the premium is further complicated by the debate over methodology: should the rate be set according to the Federal Credit Reform Act (FCRA) which assumes that the government merely needs to cover its expected losses based on its borrowing costs, or so-called fair value accounting which looks to the risk-adjusted rate that the private sector would charge for providing that same level of coverage.

of the senior bonds will have to have sufficent capital to cover losses where a disproportionately large number of defaults occur within a single pool of mortgages.[105]

It may also be possible for legislation to improve on Fannie and Freddie's existing record of serving markets that have been historically underserved. A number of ideas have been proposed that avoid the detailed prescriptions of the Affordable Housing Goals which were required by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.[106] Instead, new legislation might reinforce the importance of serving the affordable rental market by establishing an annual, public process for identifying and addressing underserved market opportunities. In addition, it would make sense to set some minimum requirements for a percentage of units served to have affordable rents. Finally, reform should include funding for the Housing Trust Fund, the Capital Magnet Fund, and the Market Access Fund through a modest annual fee on all guaranteed MBS (single and multifamily) and a surcharge on multifamily projects that contain a high proportion of higher-rent units.[107]

One last danger that should be addressed could come from a lack of competition in the securitizing, insuring, or originating of mortgages. Too few players in any of these areas could allow firms to capture a disproportionately large share of the savings that had been made possible by the government guarantee.[108] The result would be a higher price for mortgage

[105] Laurie Goodman & Jun Zhu, *GSE Reform: Diversification Is Critical in Sizing the Capital Requirement in the New Regime*, URBAN INSTITUTE (Jan. 15, 2014), http://www.urban.org/center/hfpc/capital-requirements.cfm.

[106] Federal Housing Enterprises Financial Safety and Soundness Act of 1992 Pub. L. No. 102-550, § 1337, 106 Stat. 3941 (codified at12 U.S.C. § 4567 (2012)). These goals are overseen by the FHFA. 12 U.S.C. §§ 4511, 4581 (2012).

[107] *See* John M. Quigley, *Federal Credit and Insurance Programs* 31, *available at* http://research.stlouisfed.org/conferences/policyconf/papers2005/quigley.pdf; Housing *Finance Reform: Essential Elements of the Multifamily Housing Finance System: Hearing Before the Subcomm. on Banking, Hous., and Urban Affairs*, 113th Cong. 7 (2013) (statement of Shekar Narasimhan, Managing Partner, Beekman Associates).

[108] Criticism of Fannie and Freddie concluded that having only two entities did not result in enough competition and allowed them to "privatize the gains." David Reiss, *Fannie Mae, Freddie Mac, and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 674 POL'Y ANALYSIS, at 13 ("Fan-

borrowers. The best way to guard against excessive enrichment would be to ensure competition in all of these markets. However, economies of scale or other impediments could limit the number of players at each of these stages. In that case, it may be necessary to limit profits through regulation.

B. *Two Options to Maintain the Key Functions Performed by the Agencies*

Having decided to provide the 'in case of catastrophe' guarantee through a government entity, it would be possible to minimize disruption to the housing finance market in two broad ways: 1) by simply nationalizing all of Fannie and Freddie, or 2) by privatizing the remaining securitization and insurance-type functions.

1. *Make Permanent the Conservatorship by Nationalizing Fannie and Freddie*

The simplest way to minimize short-term disruption in the housing finance market would be to nationalize the two entities. The same functions would be performed by the same entities and the two entities could even be combined into one. By moving these entities formally into the government, this option should preserve the favorable pricing that the MBSs receive in capital markets, the mix of well-priced, longer-term, fixed-rate products now available, and the attention to markets that may not be well-served by the private mortgage market (e.g., properties that are not in pristine condition and not servicing higher income tenants, properties that are in secondary locations, and properties benefiting from government programs). This transfer would, however, add the outstanding liabilities of these two organizations to the government balance sheet, something that conservatorship was able to avoid.

This option also raises other issues. The critical downside to this option is the reality of government ownership. As the experience with FHA has shown, government tends to move

nie and Freddie forgo offering the lowest possible price for mortgages; they do this by retaining a portion of their subsidy, instead of passing it on [to] the borrowers as they would in a perfectly competitive market."), *available at* http://www. realclearmarkets.com/blog/PA674.pdf. Many of the proposals for reform contemplate more competitors, particularly ones that would concentrate on serving smaller originators and smaller markets.

slowly, particularly if legislation is required, and so has a hard time being innovative and responding to evolving market conditions. Furthermore, government pay scales and procurement rules may limit the Agencies' ability to attract and retain staff and to maintain state-of-the-art technology platforms.[109]

2. *Re-Privatize the Remaining Multifamily Businesses Once the Government Guarantee Is Housed in a Separate, Government-Owned Entity*

An alternative approach would be to nationalize only the public guarantor function in order to separate it out from the Agencies and make it clear that the Agency charters do not come with an explicit or even implied government backstop. The remaining multifamily business could also be separated out from their single-family counterparts, spun-off into self-contained subsidiaries, and ultimately sold off to private investors.[110] Initially, these subsidiaries could pay their respective holding companies for continuing to provide the government guarantee. Once the public guarantor is up and running, the now fully explicit guarantee would be purchased from this new entity. Moreover, the government guarantee on qualified MBS would also be available to new entrants in order to encourage more private competitors to the Agencies. While this approach would not be as simple as nationalizing, it should be a relatively easy transition.[111]

[109] Sarah Rosen Wartell & Mark A. Willis, FHA: Reforms to Protect Taxpayers and Borrowers, Housing Policy Debate (forthcoming).

[110] The first step of spinning off these businesses into self-contained subsidiaries could possibly be done now with the authorization of FHFA. *See* Brian Collins, *FHFA: Spin Off Fannie and Freddie's Multifamily Units?*, NATIONAL MORTGAGE NEWS (Feb. 23, 2012), http://www.nationalmortgagenews.com/dailybriefing/2010_543/spin-off-gse-multifamily-units-1029015-1.html. The owners of the holders of the junior preferred stock of Fannie and Freddie have sued to clarify their ownership rights in the existing entities. Complaint, Wash. Fed. v. United States, No. 1:13cv385 (S.D. Fla. June 10, 2013); *see* Richard A. Epstein, *An Unconstitutional Bonanza*, DEFINING IDEAS (Nov. 11, 2013), http://www.hoover.org/publications/defining-ideas/article/161456.

[111] A bill has been proposed by Senators Tim Johnson and Mike Crapo, which would provide a separate public guarantor, based in part on the model of the Federal Deposit Insurance Corporation. *See* Cheyenne Hopkins & Clea Benson, Senate Bill Seeks to Wind Down Fannie Mae in Five Years, BLOOMBERG NEWS (Mar. 17, 2014), *available at* http://www.bloomberg.com/news/2014-03-16/senate-fannie-mae-wind-down-bill-leaves-investor-fate-to-courts.html; S.1217, 113th Cong. (2013 discussion draft before the Sub-

V.
IS MORE FLEXIBILITY POSSIBLE IN THE LONG RUN?

This paper has argued that reform must take into account the potential impact on not only capital markets but also on the housing market. Unfortunately, though, we lack a good understanding of how the rental housing market might be affected by simply phasing out Fannie and Freddie over a period as short as five years. The risk of seriously disrupting the multifamily housing market seems too great a risk given its importance as a source of affordable rental housing. Fannie and Freddie account for a large share of the multifamily mortgage market and serve it through risk-sharing models that have proven to yield high quality loans, low delinquencies, and profitable businesses. However, there may continue to be a call to further reduce the government's direct involvement in the mortgage market. The key question then is whether we could, over a longer period of time, transition smoothly to a world with less reliance on a government guarantee beyond that offered by GNMA for FHA insured multifamily mortgages.

Before we make such a change, we need to understand better the implications of significantly decreasing the share of loans eligible for the government guarantee. One approach would be to find a way to test the waters at relatively low risk to the overall availability of mortgage finance. Such a test might involve increasing, in stages, the guarantee fee for a small subset of securities, such as those that contain properties that serve higher income households. This test would provide evidence of 1) how easy it would be to "crowd-in" more portfolio lending or non-guaranteed CMBS, and 2) the possible impact of such changes on the mix of products that would be available to finance multifamily rental units. If the other sources of capital step up and the impact on the availability and product mix of mortgages for multifamily properties were acceptable (e.g., no significant negative impact on the supply and quality of multifamily units), then the threshold for luxury projects could be lowered or other constraints could be imposed that further limit the mortgages eligible for inclusion in government guaranteed multifamily MBS.

comm. on Banking, Hous., & Urban Affairs), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=512757b1-e595-4b85-8321-30d91e368849.

Two additional considerations need to be taken into account if these tests do open the door for a major reduction in the share of multifamily mortgages eligible for a inclusion in a government guaranteed MBS. The first relates to the possible impact on the ability to attract the private capital needed to privatize the insurance or securitization functions of the Agencies. The more uncertainty over how much of the market these companies may be allowed to serve (or under what terms), the harder it will be to attract investors.

The second consideration is the government's ability to maintain the availability of multifamily mortgages during significant economic declines. The government's backing of Fannie and Freddie was critical for the continued availability of multifamily mortgages during the recent Great Recession. Any reform must be careful not to restrict or otherwise make it difficult to ramp up future countercyclical support for the multifamily mortgage finance market.

VI. CONCLUSION

Reform of the nation's housing finance system needs to be careful not to disrupt unnecessarily the existing multifamily housing market.[112] The near collapse of Fannie and Freddie's single-family business over five years ago resulted in conservatorship and has spawned calls for their termination. While a general consensus has since emerged that Fannie and Freddie should be phased out over time, no consensus exists as to which, if any, of their functions need to be replaced in order to preserve the affordability and availability of housing in general, and multifamily rentals in particular.

On the multifamily side, Fannie and Freddie have built specialized units using financing models that involve private sector risk-sharing (i.e., DUS lender capital at risk or investors holding subordinate tranches of K-series securities) and that have resulted in low default rates and limited credit losses. These units have benefited from an implicit government guar-

[112] For a discussion of the issues on the single-family side, see U.S. DEP'T OF HOUS. & URBAN DEV. & DEP'T OF THE TREASURY, REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS (2011), *available at* http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.

antee of their corporate debt, which has expanded their access to capital and lowered its cost. As a result of the implicit guarantee, Fannie and Freddie have been able to: 1) offer longer term mortgages than generally available from banks, 2) provide countercyclical support to the rental market by funding new mortgages throughout the recent housing and economic downturn, and 3) ensure that the vast majority of the mortgages they fund offer rents affordable to households earning less than even 80% of area median income.

The potential for moral hazard can be reduced without disrupting the multifamily housing market simply by separating out and nationalizing the government guarantee It would then be possible to: 1) spin off the multifamily businesses of Fannie and Freddie into self-contained entities and 2) create an explicit government guarantee, offered by a government entity, and paid for through premiums on the insured MBS. The first step could happen now with FHFA authorization. These new subsidiaries could also begin to pay their respective holding companies for providing the guarantee on their MBS. The second step requires Congressional legislation. Once the public guarantor is up and running, the guarantee would be purchased from it and these subsidiaries could then be sold to private investors. As for other reforms that would explicitly restrict market access to the government guarantee, the best approach would be to first test the private sector's appetite for risk on higher-end deals.