Federal Housing Finance Agency
Office of Inspector General

Enterprise Multifamily Variable-Rate Mortgages

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Executive Summary

Fannie Mae and Freddie Mac (the Enterprises) each acquired record multifamily mortgage volume in 2020. According to the Federal Housing Finance Agency (FHFA or Agency), together they own or guarantee mortgages for approximately 43% of U.S. multifamily units. Multifamily mortgages may have fixed rates or variable rates. The share of Enterprise multifamily mortgage acquisitions with variable rates has varied over time. As of March 31, 2021, 9% of Fannie Mae's multifamily portfolio had variable rates. As of May 31, 2021, 23% of Freddie Mac's multifamily portfolio had variable rates.

Fannie Mae and Freddie Mac use different approaches to manage the credit risk of their multifamily mortgages. For Fannie Mae, lenders generally underwrite the mortgages in accordance with Fannie Mae's requirements and share the risk of loss with the Enterprise. Freddie Mac underwrites multifamily mortgages itself prior to purchase and transfers a portion of multifamily credit risk to third parties. FHFA told us that Fannie Mae retains more of its multifamily credit risk than Freddie Mac.

Fannie Mae considers the portfolio mix of its multifamily mortgages to be one of the top risks to its business, that is, an inherent risk before taking into account the controls the Enterprise has in place to mitigate the risk. Fannie Mae identified several key underlying risks in this area, including the concentration of variable-rate mortgages. However, Fannie Mae told us that both its fixed-rate and variable-rate multifamily mortgages had strong credit performance and that its historical losses had been de minimis. Freddie Mac told us that it considers multifamily mortgage credit risk to be a risk inherent to being in business. The Enterprise added that it believes that the inherent risk of variable-rate loans is essentially mitigated and, as a result, the share of variable-rate loans is not an additional risk factor. Freddie Mac said the delinquency rate of its multifamily mortgages was extremely low, and very few multifamily loans had defaulted, even during the 2008 to 2010 economic downturn and the pandemic. Both Enterprises and FHFA identified mitigants to the risk associated with the variable-rate share of Enterprise multifamily mortgages.

This white paper provides background information on the Enterprises' multifamily programs, FHFA and Enterprise views regarding the risk associated with the variable-rate share of Enterprise multifamily mortgages, and Enterprise actions taken to mitigate the risk.

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ABBREVIATIONS

CRT	Credit risk transfer
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
LIBOR	London Interbank Offered Rate
OIG	Federal Housing Finance Agency Office of Inspector General

BACKGROUND

Multifamily mortgages are loans secured by properties with five or more residential units, including apartment buildings, senior housing, student housing, and manufactured housing communities. Multifamily mortgages may be amortizing or may be interest-only for their full term or a portion of it. Multifamily mortgages typically amortize over a long period, such as 30 years, but have shorter contractual maturities, such as 10 years. As a result, most multifamily mortgages require a balloon payment at maturity. FHFA's guidance to its examiners advises that balloon payments on multifamily mortgages represent a risk to the Enterprises because the borrower may have limited options to refinance or repay the balloon payment at maturity. Multifamily mortgages may have fixed rates or variable rates, that is, interest rates that adjust periodically over the life of the loan.[1]

Fannie Mae and Freddie Mac each acquired record multifamily mortgage volume in 2020, with a combined total of $159 billion for the year.[2] According to FHFA's 2020 Report to Congress, the Enterprises own or guarantee mortgages for approximately 43% of U.S. multifamily units, financing housing for about 8.6 million households. For 2021, FHFA has capped multifamily acquisitions at $70 billion for each Enterprise.

Multifamily credit risk is the risk that the borrower will not repay principal and interest as scheduled. Enterprise multifamily mortgages typically are originated without recourse to the borrower, that is, in the event of default the source of repayment would be the property and cash flows it generates, not the borrower.[3] According to FHFA, factors that affect the level of multifamily mortgage credit risk include vacancy rates, property values, and local economic conditions, among others. FHFA told us that these factors affect the property's debt service coverage ratio and loan-to-value ratio.

According to Fannie Mae, as a multifamily mortgage matures, it generally becomes a more secure credit. Fannie Mae said that rents typically increase and the loan typically amortizes, creating equity in the property. The Enterprise told us that, since 2000, only about 5% of its multifamily defaults occurred at maturity. Freddie Mac also told us that the greatest risk of

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[1] Mortgages with variable rates may be called adjustable-rate, floating-rate, or variable-rate mortgages. According to FHFA, multifamily variable-rate mortgages typically were indexed to the London Interbank Offered Rate (LIBOR), which is being replaced by the Secured Overnight Financing Rate.

[2] For more information about Enterprise multifamily mortgages, see OIG, *Fannie Mae and Freddie Mac in the Multifamily Market* (September 7, 2017) (WPR-2017-002) (online at www.fhfaoig.gov/sites/default/files/WPR-2017-002.pdf).

[3] According to FHFA, borrowers in the Enterprises' multifamily business typically are entities that have the property as their only asset. FHFA also told us that most loans have a guaranty from an individual or entity with an acceptable net worth to cover certain acts within the control of the borrower.

nonpayment for a multifamily mortgage was during the loan term. The Enterprise said very few multifamily loans had defaulted, even during the 2008 to 2010 economic downturn and the pandemic, but most of those defaults occurred during the loan term, not at maturity.

Fannie Mae and Freddie Mac use different approaches to manage their multifamily credit risk. Fannie Mae acquires the vast majority of its multifamily loans through a delegated underwriting and servicing program. Approved lenders underwrite multifamily loans for delivery to Fannie Mae in accordance with Fannie Mae's requirements. The lender shares the risk of loss on the mortgages with the Enterprise. Fannie Mae also had begun transferring some multifamily risk to third parties using credit risk transfer (CRT) transactions. However, Fannie Mae has not entered into any new multifamily CRT transactions since the first quarter of 2020. By contrast, Freddie Mac underwrites multifamily mortgages itself prior to purchase. In addition, Freddie Mac reported that it had transferred the large majority of expected and stress credit risk on its 2020 multifamily volume through securitizations. Although Freddie Mac's single-family CRT transactions fell sharply in the second quarter of 2020 due to the effects of the pandemic, the Enterprise continued certain multifamily risk-transfer securitizations, with modified transaction structures. According to FHFA, considering both CRT and Fannie Mae lender risk sharing, Fannie Mae retains more of its multifamily credit risk than Freddie Mac.

FHFA's 2020 Report to Congress said that the pandemic had a significant negative impact on overall credit quality for the multifamily business at both Enterprises.[4] Fannie Mae and Freddie Mac both reported increases in multifamily delinquencies.[5] The impact of the pandemic varied by loan product. Fannie Mae reported that senior housing loans constituted 4% of its multifamily book of business as of March 31, 2021, but accounted for approximately 40% of the unpaid principal balance of its multifamily loans that received a forbearance and remained in Fannie Mae's multifamily guaranty book as of March 31, 2021. Freddie Mac told us that small balance loans made up the majority of its multifamily loans (by loan count) that had taken forbearance and the majority that were delinquent as of year-end 2020. In July 2021, both Enterprises reported that the multifamily outlook was improving.

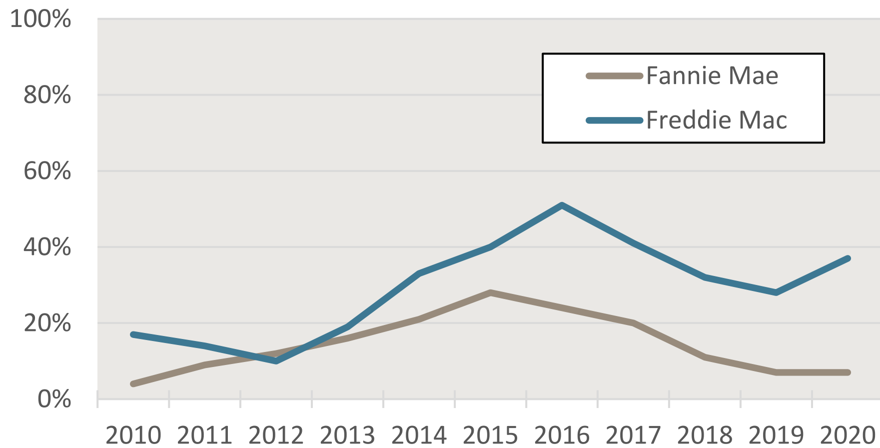
[4] Both Enterprises offered multifamily borrowers forbearance from loan payments under certain conditions. During the forbearance period, property owners receiving forbearance on Enterprise mortgages cannot evict tenants solely for nonpayment of rent. FHFA extended pandemic-related forbearance on Enterprise multifamily loans through September 30, 2021. A separate nationwide eviction moratorium by the Centers for Disease Control and Prevention ended on July 31, 2021, and a moratorium for counties with substantial or high COVID-19 transmission was put in place until October 3, 2021. State and local governments also may have their own eviction moratoriums.

[5] Fannie Mae reports multifamily loans in forbearance as delinquent. Freddie Mac reports multifamily loans in forbearance as current as long as the borrowers are in compliance with their forbearance agreements.

VARIABLE-RATE SHARE OF ENTERPRISE MULTIFAMILY MORTGAGES ....

As of March 31, 2021, 9% of Fannie Mae's multifamily portfolio had variable rates, according to the Enterprise's financial reporting. Freddie Mac told us that 23% of its multifamily portfolio had variable rates as of May 31, 2021. The share of Enterprise multifamily mortgage acquisitions with variable rates has changed over time, as shown in Figure 1.

FIGURE 1. VARIABLE-RATE SHARE OF MULTIFAMILY ACQUISITIONS



Source: Fannie Mae and Freddie Mac.

Fannie Mae told us it believed that some of the variation was due to more aggressive terms others offered for variable-rate loans, as well as to borrower preferences for fixed vs. variable rates depending on relative interest rates at the time. With the pending cessation of LIBOR as well as FHFA's cap on Enterprise multifamily acquisitions, Fannie Mae told us that it was fine with the recent declining percentage of variable-rate mortgages.

Freddie Mac told us it suspected that, after the 2008 to 2010 downturn, borrowers shifted to variable-rate loans because of the greater flexibility they provide to refinance. Additionally, Freddie Mac said that multifamily had shifted toward more sophisticated institutional owners, who tended to choose variable-rate loans. Freddie Mac believed the reduced variable-rate share since 2016 was more a matter of differences in relative interest rates.

FHFA told us that it believed the difference in the composition of the Enterprises' multifamily portfolios was the result of their different business strategies. For example, FHFA said that Fannie Mae lenders may prefer fixed-rate products because of their loss-sharing agreements, while Freddie Mac's securitization model facilitates the acquisition of variable-rate products because the Enterprise transfers credit risk.

Risk Associated with the Variable-Rate Share of Enterprise Multifamily Mortgages

Fannie Mae

Fannie Mae considers the portfolio mix of its multifamily mortgages to be one of the top inherent risks to its business, that is, a risk before taking into account the controls the Enterprise has in place to mitigate the risk. Fannie Mae identified several key underlying risks in this area, including the concentration of variable-rate mortgages. Fannie Mae defines this risk as the risk that the portfolio contains a significant percentage of variable-rate mortgages, which, in an environment of changing interest rates and higher volatility, may result in higher than expected credit losses. However, Fannie Mae told us that, in its experience, the debt service coverage ratio and loan-to-value ratio are the most reliable indicators of future credit performance, not whether a loan is fixed-rate or variable-rate. Fannie Mae said that both fixed-rate and variable-rate multifamily mortgages had strong credit performance based on the Enterprise's analysis of the performance of loans it acquired through its delegated underwriting and servicing program and that its historical losses had been de minimis. In fact, according to Fannie Mae, the credit loss rate of its multifamily variable-rate mortgages was historically slightly below that of its fixed-rate loans. Fannie Mae attributed the better performance to loan sizing, which restricts loan proceeds for its multifamily variable-rate loans to an amount at or below the level for comparable fixed-rate loans.

Fannie Mae views the risk associated with variable-rate multifamily mortgages as stable, neither increasing nor decreasing. The Enterprise noted that its annual share of variable-rate mortgages could increase as interest rates change. Fannie Mae added that it actively monitors and manages its variable-rate share, limiting variable-rate loans to a share with which it is comfortable. Fannie Mae told us that appropriate underwriting standards and loan sizing were mitigants to the risk related to the share of variable-rate multifamily mortgages. Fannie Mae also said that its main multifamily variable-rate mortgage programs either have built-in caps that limit the maximum rate on the loan, or the borrower is required to obtain an external cap from an approved third-party that provides interest-rate protection to the borrower.

Freddie Mac

Freddie Mac told us that it considers multifamily mortgage credit risk to be a risk inherent to being in business. The Enterprise added that it believes that the inherent risk of variable-rate loans is essentially mitigated and, as a result, the share of variable-rate loans is not an additional risk factor. Because Freddie Mac does not consider the share of variable-rate loans to represent additional risk, the Enterprise told us that it considers the direction of this risk to be stable. Freddie Mac said that the delinquency rate of its multifamily portfolio was extremely low, and there were not sufficient delinquencies for a meaningful statistical analysis. Despite limited data, Freddie Mac reviewed its multifamily loan delinquencies for the past three years, excluding small balance loans, and found that there did not appear to be a relationship between loan performance and whether the loan was fixed-rate or variable-rate. In addition, Freddie Mac told us that it sells a portion of the risk on nearly 90% of new loans.

Freddie Mac listed some factors that mitigate the risk of its multifamily variable-rate loans. For example, variable-rate loans provide lower payments than fixed-rate loans early in the loan term, allowing borrowers to build reserves for the future. Freddie Mac's variable-rate loans are sized based upon an equivalent fixed-rate loan. They also are required to have a third-party interest-rate cap provided by a qualified counterparty. According to Freddie Mac, variable-rate loans can be repaid with much lower prepayment premiums than fixed-rate loans, providing borrowers with greater flexibility to refinance. The Enterprise also noted that multifamily properties can increase rents, increasing income when interest rates rise. Freddie Mac added that variable-rate loans generally are requested by more sophisticated institutional borrowers, which have greater access to capital and greater ability to support a transaction in the event of stress during the loan term. The Enterprise told us it believes there is parity in the risk profile between its fixed-rate and variable-rate multifamily loans, and it does not steer borrowers to one or the other.

FHFA

FHFA told us that variable-rate multifamily mortgages generally are considered higher risk than fixed-rate loans. The Agency explained that, in a rising interest-rate environment, a borrower's monthly payment will increase if the interest rate is variable, increasing the probability of default. FHFA added that this is especially the case for multifamily mortgages, which typically have a balloon payment due at the end of the loan term. In light of greater risk for multifamily variable-rate mortgages, FHFA's Enterprise Regulatory Capital Framework assigns higher risk weights to multifamily variable-rate mortgages than to fixed-rate loans.

FHFA highlighted mitigants to the risk associated with the Enterprise share of variable-rate multifamily loans similar to some mitigants noted by the Enterprises. FHFA told us that interest-rate caps on Enterprise multifamily variable-rate loans limit potential payment shock. In addition, the Agency said that Enterprise variable-rate multifamily loans are sized to meet debt service on equivalent amortizing fixed-rate loans. FHFA also noted that the Enterprises' CRT transactions mitigate risk.

CONCLUSION

Fannie Mae considers the portfolio mix of its multifamily mortgages to be one of the top risks to its business, that is, an inherent risk before taking into account the controls the Enterprise has in place to mitigate the risk. Fannie Mae identified several key underlying risks in this area, including the concentration of variable-rate mortgages. However, Fannie Mae told us that both its fixed-rate and variable-rate multifamily mortgages had strong credit performance and that its historical losses had been de minimis. Freddie Mac told us that it considers multifamily mortgage credit risk to be a risk inherent to being in business. The Enterprise added that it believes that the inherent risk of variable-rate loans is essentially mitigated and, as a result, the share of variable-rate loans is not an additional risk factor. Freddie Mac said the delinquency rate of its multifamily mortgages was extremely low, and very few multifamily loans had defaulted, even during the 2008 to 2010 economic downturn and the pandemic. Both Enterprises and FHFA identified mitigants to the risk associated with the variable-rate share of Enterprise multifamily mortgages.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide background on the Enterprises' multifamily programs, provide FHFA and Enterprise views of the risks associated with multifamily concentration, including the share of variable-rate mortgages, and provide Enterprise actions taken to mitigate the risks. To achieve this objective, we reviewed internal FHFA and Enterprise documents as well as publicly available documents. We also interviewed FHFA officials and requested and reviewed information from FHFA and the Enterprises.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

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