An Introduction to Multifamily Agency Mortgage-Backed Securities:

Attributes, Issuers and Opportunities

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Attributes

Many economists expect multifamily construction to increase considerably in 2012 and beyond, allowing the housing market to contribute to growth for the first time in seven years. Homeownership rates continue to decline and, with the struggling economy, more households are choosing renting over buying. The expected jump in multifamily construction will likely result in increased issuance of Multifamily Mortgage-Backed Securities (MFMBS). The $841 billion[1] market still represents tremendous depth and opportunities for investors, especially those investors seeking agency or government issued MFMBS. MFMBS often offer investors more prepayment certainty than MBS backed by single-family loans. Typically, multifamily MBS offer prepayment protection either through lock-outs, prepayment penalty periods or yield maintenance periods.

This white paper will focus on two agency-issued fixed income multifamily investment programs – Fannie Mae Delegated Underwriting and Servicing (DUS) bonds and Ginnie Mae Construction Loan/Project Loan Certificates – with an overview of the programs' histories, amounts issued and outstanding, and the key features and benefits of each program.

Multifamily housing is defined as housing for five or more families, and includes apartment buildings; rural, seniors, student and military housing; manufactured housing communities; and co-operative housing projects. Many multifamily properties qualify as affordable or workforce housing.

Multifamily loans structurely differ from single-family loans as they often have shorter loan terms (typically ranging from 7-, 10- or 15-years) while maintaining a 30-, 35, or even 40-year amortization schedule. Typically, multifamily loans are fixed-rate, though adjustable rate loans are available. There is little amortization of principal over the life of the loan, resulting in a balloon payment at maturity. In addition, MFMBS are often issued with prepayment penalties that protect the investor in case of voluntary repayment by the borrower. Prepayment protections are most frequently in the form of lockout periods, defeasance, prepayment penalties or yield maintenance charges.

LOCKOUT PERIODS

A prepayment lockout is a contractual agreement that prohibits any voluntary prepayments during a specified period of time – the lockout period. After the lockout period, some instruments offer call protection in the form of prepayment penalties. Prepayment lockout and defeasance are the strongest forms of prepayment protection.

DEFEASANCE

With defeasance, rather than loan repayment, the borrower provides sufficient funds for the servicer to invest in a portfolio of Treasury securities that replicates the cash flows that would exist in the absence of prepayments.

PREPAYMENT PENALTIES

Prepayment penalty points are predetermined penalties that must be paid by the borrower if the borrower wishes to refinance. For example, a 5-4-3-2-1 prepayment penalty point structure means if the borrower wishes to prepay during the third year, the borrower must pay a 3% penalty for a total of $103 rather than $100.

YIELD MAINTENANCE CHARGES

Yield maintenance is the most common form of prepayment protection for multifamily DUS loans. Yield maintenance charges are designed to discourage the borrower from voluntarily prepaying the mortgage note. The yield maintenance charge, also called the make-whole charge, makes it uneconomical to refinance solely to get a lower mortgage rate.

[1] *Source: Over Twenty Years of Multifamily Mortgage Financing Through Fannie Mae's Delegated Underwriting and Servicing (DUS®) Program http://www.fanniemae.com/resources/file/mbs/pdf/mbsenger_0412.pdf*

Multifamily loans often do not require the borrower to pay a prepayment premium upon a full or partial prepayment resulting from the receipt of casualty insurance or condemnation proceeds (non-voluntary prepayment). In this case, if a loan is prepaid, investors will receive an early distribution of principal but no prepayment penalty will be passed through.

Both the stable cash flows and positive advantages offered by MFMBS prepayment protection have provided investors with positive convexity versus their single-family counterparties, which contribute negative convexity.

Issuers

Fannie Mae

Fannie Mae is the nation's largest single participant in multifamily mortgage financing. As of the fourth quarter of 2011, Fannie Mae accounted for 21% multifamily mortgage debt outstanding[2]. In 2011, Fannie Mae provided $24.4 billion in debt financing resulting in over 2,700 loans for 422,799 rental units across the country. Approximately 89% of these units were affordable to families earning at or below the median income in their area.

Fannie Mae issued $7.1 billion MFMBS in the first quarter of 2012. Total new issuance for 2011 was $23.8 billion, up from $16.4 billion in 2010[3].

Fannie Mae Delegated Underwriting and Servicing (DUS) Program

Fannie Mae began purchasing multifamily loans in 1998 through their DUS program to hold within their portfolio. The DUS program allows approved Fannie Mae lenders to underwrite and sell loans on multifamily properties without prior Fannie Mae approval. In return for delegation of the responsibility for underwriting and servicing DUS loans, DUS lenders enter into risk sharing arrangements with Fannie Mae throughout the life of the mortgage loan.

Just like single-family Fannie Mae MBS, DUS MBS carry Fannie Mae's guaranty of timely payment of principal and interest. Fannie Mae MBS are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any of its agencies. Fannie Mae alone is responsible for making payments under its guaranty.

DUS MBS are backed by multifamily loan pools that often consist of a single loan to a single property. Loans can be for rented-up and stabilized new construction properties or refinancing of existing projects. DUS MBS can vary significantly in terms of maturities and "lockout" provisions, with the typical structure having a 10-year balloon, 30-years of amortization and 9.5 years of yield maintenance provisions. In 2011, issuance volume for the 30/10/9.5 was over $12.1 billion.

Each DUS loan has one of the following voluntary prepayment provisions:

- Yield Maintenance;
- Defeasance;
- Prepayment fee; or
- Prepayment Lock-out.

Most Fannie Mae DUS bonds are structured with stringent yield maintenance provisions which, in most cases, limits the likelihood of prepayments before expiration of the yield maintenance period (YMP). YMP is not

[2] *Source: Delegated Underwriting and Servicing (DUS®) – The Role of Risk Retention in Multifamily Finance https://www.efanniemae.com/mf/refmaterials/pdf/wprskret.pdf*

[3] *Fannie Mae News Release http://www.fanniemae.com/portal/about-us/media/corporate-news/ 2012/5701.html*

a lock out period. The borrower is permitted to prepay the loan in entirety. However, voluntary partial prepayments are prohibited.

Yield maintenance is a fee equal to a declining percentage of the unpaid principal loan balance. The prospectus supplement will specify: (1) when prepayments will be permitted on the multifamily loans in the pool; (2) whether any prepayment premiums will be assessed; and (3) whether any of the prepayment premiums, if collected, will be shared with the investor, and, if so, will describe the yield maintenance calculation of the share due to the investor. If prepayment premiums are not collected from the borrower, the investor will not receive any prepayment premium.

The borrower must pay the greater of the yield maintenance fee (prepayment premium, or DUS prepay penalty) or 1% of the unpaid principal balance to prepay a DUS loan during the YMP. After the YMP, the borrower is still subject to a 1% prepayment premium on the outstanding principal balance until 90 days prior to the loan's maturity date. Investors do not share yield maintenance fees received by Fannie Mae at the minimum 1% level.

While fixed-rate multifamily loans often require borrowers to pay a prepayment premium as a condition of voluntarily prepaying their loans, adjustable-rate multifamily loans often do not require borrowers to pay a prepayment premium. Moreover, even if a loan requires the borrower to pay a prepayment premium, it may be waived under certain specified circumstances.

Ginnie Mae

The Government National Mortgage Association ("Ginnie Mae"), a wholly-owned corporate instrumentality of the United States of America within the U.S. Department of Housing and Urban Development (HUD), guarantees the timely payment of principal and interest on the securities. Ginnie Mae guaranties constitute general obligations of the United States, for which the full faith and credit of the United States is pledged. Ginnie Mae does not guarantee the payment of any prepayment penalties.

Ginnie Mae's multifamily program was created in 1971 to meet the growing demand for affordable rental housing for low- and moderate-income persons and families. Since its inception, Ginnie Mae has guaranteed more than $103.1 billion MFMBS[4], financing the construction and renovation of multifamily housing including apartment buildings, nursing homes and assisted-living facilities.

Historically, Ginnie Mae has played an important role in providing opportunities in the multifamily housing market. By promoting access to mortgage credit and enhancing the liquidity of mortgage investment, Ginnie Mae has increased the availability of affordable rental housing for millions of Americans.

Ginnie Mae Project Loans & Construction Loan Certificates

Ginnie Mae Project Loans and Construction Loan Certificates are backed by a pool of one or more mortgage loans. Each mortgage must be insured by Federal Housing Administration (FHA) under the National Housing Act or guaranteed by Rural Development under Title V of the Housing Act of 1949. A summary of the FHA and Rural Development insurance programs is provided in Appendix A.

By guaranteeing multifamily pools that are sold to investors in the global capital markets, Ginnie Mae enables lenders to reduce mortgage interest rates paid by developers and property owners of apartment buildings,

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[4] *Source: http://www.ginniemae.gov/issuers/multifamily.asp?Section=Issuers*

hospitals, nursing homes, and assisted-living facilities. Each multifamily mortgage is secured by a completed project, insured by FHA and administered by HUD. Mortgage insurance covers the lender if the borrower defaults on the insured loan.

Ginnie Mae Multifamily MBS increase the supply of mortgage credit available for housing by channeling funds from the capital markets into the mortgage market. Ginnie Mae guarantees the timely payment of principal and interest on the securities. Ginnie Mae securities are full faith and credit obligations of the U.S. Government and carry 0% risk-based capital weightings.

At issuance, Ginnie Mae Project Loans and Construction Loan Certificates often have prepayment provisions that prohibit voluntary prepayment for a number of years following origination. The issuer must specify on a document called the "Annex — Special Disclosure," which is attached to the prospectus, the prepayment provisions of the note (which must include any provision detailing prepayment privileges or penalties). If a prepayment premium or charge is collected, it must be passed through to security holders as an additional payment apart from the amortization of principal of the securities and from required interest.

Notwithstanding the foregoing, FHA guidelines require all of the mortgage loans to include a provision that allows FHA to override any lockout and/or prepayment penalty provisions if FHA determines that it is in the best interest of the federal government to allow the mortgagor to refinance or prepay the Mortgage Loan without restrictions or penalties and any such payment will avoid or mitigate an FHA insurance claim. Additionally, in some circumstances FHA may permit a Mortgage Loan to be prepaid without regard to any statutory prepayment prohibition period.

A Ginnie Mae Project Loan is a pool created under the Ginnie Mae I MBS Program. A Ginnie Mae Construction Loan Certificate consists of a single mortgage on a multifamily project under construction that backs securities created under the Ginnie Mae I MBS Program, with an interest rate that will also be the interest rate on the project loan securities into which the related construction loan securities will be converted. Principal payments cannot be applied and passed through to construction loan security holders. However, principal payments may be passed through if the mortgage has been assigned to FHA, and partial or full claim settlement proceeds have been paid, or if FHA overrides the prepayment lockout and the loan pays off.

Any delay in the conversion of a Ginnie Mae construction loan certificate to a Ginnie Mae project loan certificate will delay the repayment of principal. The conversion of a Ginnie Mae construction loan certificate to a Ginnie Mae project loan certificate can be delayed for a wide variety of reasons, including work stoppages, construction defects, inclement weather, completion of or delays in the cost certification process and changes in contractors, owners and architects related to the multifamily project. The maturity date of construction loan securities that is stated in the prospectus may be set at any date between 200 percent of the construction time as determined by FHA and the permanent loan maturity date.

Construction loan securities are redeemed by the issuance of project loan securities to the security holders of the construction loan securities. When the construction loan securities mature, they must be redeemed by issuance of the project loan securities immediately after FHA's final endorsement of the project loan mortgage. Consecutive pool numbers must be reserved for an issue of construction loan securities and the related project loan securities. The lower pool number is to be used for the construction loan securities.

Opportunities

Given the current historically low interest rates, MFMBS provide investors with varying levels of prepayment protection. Investors should be aware, however, that that these securities may trade to their stated final maturities, instead of to the end of their lock-out or prepayment penalty periods as interest rates rise. For Ginnie Mae projects loans which commonly have 30 to 40-year stated final maturities, this could result in extending the securities duration by 20 years.

Nonetheless, unlike single-family mortgage securities, prepayments on MFMBS with prepayment provisions are generally less sensitive to changes in interest rates. Voluntary prepayments are costly to the borrower. In many cases, prepayments are more of a result of adverse credit situations, such as defaults or delinquencies, than interest rate driven refinancings. Thus, investors seeking stable cash flows from agency-issued securities would benefit from incorporating MFMBS as part of their investment portfolio.

Appendix A

FHA Insurance Programs

FHA multifamily insurance programs generally are designed to assist private and public mortgagors in obtaining financing for the construction, purchase or rehabilitation of multifamily housing pursuant to the National Housing Act of 1934. Mortgage Loans insured under the programs described below will have such maturities and amortization features as FHA may approve, provided that generally the minimum mortgage loan term will be at least ten years and the maximum mortgage loan term will not exceed the lesser of 40 years and 75 percent of the estimated remaining economic life of the improvements on the mortgaged property. Tenant eligibility for FHA-insured projects generally is not restricted by income, except for projects as to which rental subsidies are made available with respect to some or all the units therein or to specified tenants.[5]

The following is a summary of the various FHA insurance programs under which the Mortgage Loans may be insured:

- **Section 207** *(Mortgage Insurance for Multifamily Housing)* provides for federal insurance of mortgage loans originated by FHA-approved lenders in connection with the construction or substantial rehabilitation of multifamily housing projects, which includes manufactured home parks.
- **Section 213** *(Cooperative Housing Projects)* provides for FHA insurance of mortgage loans on cooperative housing projects. Section 213 mortgage insurance enables nonprofit cooperative ownership housing corporations or trusts to develop or sponsor housing projects that will be operated as cooperatives. By using Section 213 insurance, investors can construct or rehabilitate multifamily housing that will be sold to such nonprofit corporations or trusts.
- **Section 220** *(Urban Renewal Mortgage Insurance)* provides for federal insurance of mortgage loans on multifamily rental projects located in federally aided urban renewal areas or in areas having a local redevelopment or urban renewal plan certified by FHA. The mortgage loans may finance the rehabilitation of existing salvable housing or new construction in targeted areas. The purpose of Section 220 is to encourage quality rental housing in urban areas targeted for overall revitalization.
- **Section 221***(d) (Housing for Moderate Income and Displaced Families)* provides for mortgage insurance to assist private industry in the construction or substantial rehabilitation of rental and cooperative housing for low-and moderate-income families and families that have been displaced as a result of urban renewal, governmental actions or disaster.
- **Section 223***(a)(7) (Refinancing of FHA-Insured Mortgage)* FHA to refinance existing insured mortgage loans under any section or title of the Housing Act. Such refinancing results in prepayment of the existing insured mortgage. The new, refinanced mortgage loan is limited to the original principal amount of the existing mortgage loan and the unexpired term of the existing mortgage loan plus 12 years.
- **Section 223***(f) (Purchase or Refinancing of Existing Projects)* provides for federal insurance of mortgage loans originated by FHA-approved lenders in connection with the purchase or refinancing of existing multifamily housing complexes, hospitals and nursing homes that do not require substantial rehabilitation. The principal objective of the Section 223(f) program is to permit the refinancing of mortgage loans to provide for a lower debt service or the purchase of existing properties in order to preserve an adequate supply of affordable rental housing. Such projects may have been financed originally with conventional or FHA-insured mortgage loans.

[5] *Source: Description of Multifamily Programs http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/progdesc*

- **Section 231** *(Mortgage Insurance for Rental Housing for the Elderly)* provides for insurance of mortgage loans to facilitate the construction and substantial rehabilitation of multifamily rental housing for elderly (62 or older) or disabled persons. The mortgage insurance may be used to finance the construction and substantial rehabilitation of detached, semi-detached, walk-up or elevator type rental housing designed specifically for elderly or disabled individuals consisting of 8 or more dwelling units. Section 231 was designed to increase the supply of rental housing specifically for the use and occupancy of elderly and/or disabled persons.
- **Section 232** *(Mortgage Insurance for Nursing Homes, Immediate Care Facilities and Board and Care Homes)* provides for FHA insurance of private construction mortgage loans to finance new or rehabilitated nursing homes, intermediate care facilities, board and care homes, assisted living for the frail or elderly or allowable combinations thereof, including equipment to be used in their operation. Section 232 also provides for supplemental loans to finance the purchase and installation of fire safety equipment in these facilities.
- **Section 241** *(Supplemental Loans for Multifamily Projects)* provides for FHA insurance to finance property improvements, energy-conserving improvements or additions to any FHA-insured multifamily loan. The overall purpose of the Section 241 loan program is to provide a project with a means to remain competitive, to extend its economic life and to finance the replacement of obsolete equipment without the refinancing of the existing mortgage.

Section 538 Guarantee Program

The Section 538 Guaranteed Rural Rental Housing Program is under the United States Department of Agriculture Rural Development. Rural Development operates a broad range of programs that were formerly administered by the Farmers Home Administration to support affordable housing and community development in rural areas. Mortgage loans are provided by Rural Development-approved multifamily lenders, including state and local housing agencies.

Section 538 is designed to increase the supply of affordable rural rental housing, through the use of loan guarantees that encourage partnerships between Rural Development, private lenders and public agencies. Under Section 515 of Title V of the Housing Act, Rural Development is authorized to make direct loans secured by multifamily properties with respect to which the tenants may include very low-, low-and moderate-income families, elderly persons and persons with handicaps and disabilities. Under Section 538, Rural Development subsequently may guarantee new loans, secured by the same properties, made to revitalize the properties. Tenant eligibility for Section 538-guaranteed projects is restricted to persons with income not in excess of 115% of the area median income.

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