A Closer Look:

K-Deal Program Attracts Private Capital, Reduces Risk

Freddie Mac Multifamily’s approach to securitizing mortgage loans backed by multifamily apartment properties nationwide enables us to help keep rental housing affordable, while attracting private capital to the market and minimizing U.S. taxpayers’ exposure to credit risk. Many proposals for reforming housing finance recommend a similar approach to managing credit risk. Only Freddie Mac employs it today.

Known as K-Deals, our securities are commercial mortgage-backed securities (CMBS). Multifamily rental housing is considered commercial – rather than residential – real estate because these properties are developed and purchased for investment only. The property developers/owners (borrowers) are businesses.

The K-Deal program has a consistent record of success. From the program’s start in 2009 through year-end 2013, we funded $71.5 billion in multifamily mortgages through 56 K-Deals. Freddie Mac Multifamily has been the most prolific issuer of CMBS backed by multifamily mortgages since the 2009 market crash. To date, our issuances have been very well received and we have had zero losses on our guarantees on K-Deal securities.

Industry-leading Securitization Program

Freddie Mac Multifamily is charged with helping to keep the rental housing market liquid and stable and promoting access to apartment homes nationwide. In fact, making rental housing available across the United States is our primary purpose. Of the more than 3.6 million rental units that we financed from 2005 through 2013, more than 90 percent are affordable to moderate-income renters (earning area median income or less).

We do this by participating in the U.S. secondary mortgage market. That is, we don’t lend money directly to borrowers; rather, we buy mortgage loans from lenders. With the money that lenders receive from us, they can make mortgage loans to other qualified borrowers.

Today, almost all of our new business is eligible for securitization. This allows us to finance rental housing, while selling virtually all credit risk to private investors. Securitizing loans that we buy from approved lenders reduces our reliance on our retained portfolio and government backstop guarantee.

Innovation that Matters

Freddie Mac Multifamily’s securitization program reflects our leadership, creativity, industry and business acumen, and commitment to promoting rental housing affordability.

Until 2008, Freddie Mac Multifamily held just about all of our purchases in portfolio. When the Federal Housing Finance Agency (FHFA) took government-sponsored enterprises Freddie Mac and Fannie Mae into conservatorship, the implied government guarantee on the companies’ portfolios became an effective guarantee – meaning that U.S. taxpayers would shoulder any losses. Freddie Mac had already been working to pivot away from portfolio lending and toward a securitization business model to reduce our risk and increase liquidity. In fact, we launched a securitization product in April 2008 to enable us to aggregate and securitize new multifamily loans originated through our seller/servicer network. The need and the opportunity for this dramatic, positive change became even clearer with the change in our circumstances.
Our goal: Reduce taxpayer risk, while attracting private capital to the market and increasing market liquidity. Based on our extensive knowledge of the multifamily rental housing industry and the capital markets, the best approach appeared to be a business model that married a CMBS-like structure that would allow us to shift a substantial amount of the credit risk to private investors with features commonly found in portfolio lending that provide flexibility to borrowers.

We issued our first modern K-Deal in June 2009, and fully transformed our business model in just four years.

**Portfolio vs. Securitization**

We went from holding nearly all of the mortgages that we purchased in our portfolio (a storage company) to securitizing most of our eligible purchase volume (a moving company). Today, we securitize about 95 percent of the eligible loans that we purchase.

Each of our security issuances is considered a true sale; that is, after securitization, the underlying loans come off of our balance sheet. Therefore, we don’t have to hold an equivalent amount in capital. This allows us, in effect, to recycle our capital — to reuse the funds from the sale to buy new mortgage loans. This capability is unique in the GSE world to Freddie Mac Multifamily.

Over time, we have expanded the securitization program to include various types of transactions, including the following:

- Five-, seven-, and 10-year term loans
- Floating-rate loans
- Legacy portfolio loans
- Single sponsor
- Seniors, student, military, and targeted affordable housing

We continue to enhance our products in our efforts to anticipate and meet market needs.

**Freddie Mac Multifamily’s Securitization Process**

Our securities typically are backed by loans that have been purchased recently from our network of lenders and directly underwritten, priced, and structured by Freddie Mac underwriting, capital markets, and legal staff members. Loan quality, the size of annual purchase volumes, and investor interest affect our ability to issue CMBS on a regular, predictable schedule. We currently issue a new K-Deal backed by approximately $1.2 billion in multifamily loans about every three weeks.

What and who is involved?
The loans are pooled and sold to a third-party depositor, which deposits the loans into a third-party trust. The pool's diversity in terms of borrowers, property type and location, and loan size and type helps reduce risk.

- Private-label securities backed by the loans are issued by the third-party trust.
- The subordinate bonds and mezzanine bonds, which are not guaranteed by Freddie Mac, are issued by the third-party trust and privately offered to third-party investors.
- Freddie Mac purchases and guarantees all of the senior bonds issued by the third-party trust and securitizes the senior bonds via a Freddie Mac trust. Freddie Mac also purchases and guarantees certain subordinate interest-only bonds related to the senior bonds.
- The resulting Freddie Mac guaranteed structured pass-through certificates (K-Certificates) are then publicly offered by Freddie Mac via placement agents. These transactions are known as K-Deals.
- Investors buy the bonds, which represent slices of the loan pool. In return, investors receive specified portions of the cash flow that the loans generate.

The K-Deal structure contains a shock absorber of sorts in the form of Freddie Mac’s guarantee and structured subordination.
The senior guaranteed bonds (approximately $1 billion of the $1.2 billion in the security) typically carry a AAA rating based solely on the quality of the underlying collateral, and not based on the Freddie Mac guarantee. We sell mezzanine and subordinate bonds (the remaining $200 million) to private capital investors; these bonds are backed by the same pool of loans as the senior bonds are but without Freddie Mac’s guarantee. It is important to note that the unguaranteed mezzanine and subordinate bonds represent approximately the bottom 15 percent of the total offering, although they account for the vast majority of the risk. Investors in the unguaranteed bonds are the last to receive a payout and the first to take any loss.

Following is a simplified illustration of a K-Deal, breaking it down by the various bond classes and the risks/rewards they bear.
In this example, the weighted average coupon we receive on the underlying loan pool is 5 percent and the coupon rate we offer on the issuance – that is, the interest rate paid to bond investors – varies, depending on bond class.

- **Class A** are the senior bonds, which Freddie Mac guarantees. Investors in these bonds receive principal and interest paid on each loan in the pool every month until the bonds are paid off. They are the first to receive payments and would be the last to absorb any credit losses if they weren’t guaranteed. Because these investors bear the least risk, they receive the lowest yield.

- **Class B** and **Class C** are unguaranteed mezzanine bonds. Investors receive interest every month until the bonds are paid off; they receive principal only after investors in the senior bonds have been entirely paid off. Because these investors bear more risk, they receive a higher yield.

- **Class D** are unguaranteed subordinate bonds. These also are the first bonds in the structure to absorb losses. Investors in this class do not receive any interest and only receive principal after Classes A, B, and C have been entirely paid off. Because these bonds bear the most risk in the structure, they have the highest yield in the transaction.

- Interest-only strips, known as **Class X**, reflect the difference between the interest rate on the loan and the coupon rate on each bond class. For Class X bonds, investors only receive interest payments and never receive principal.

For more details on what our securitizations involve, here is a typical timeline, including all process phases and main activities.

**Typical Securitization Issuance Timeline**

<table>
<thead>
<tr>
<th>Internal Pool Preparation 4 weeks</th>
<th>Preliminary Due Diligence 2 weeks</th>
<th>Full Due Diligence 5-6 weeks</th>
<th>Marketing/Placement 2 weeks</th>
<th>Closing/Settlement 1-2 weeks</th>
<th>Surveillance Ongoing</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Identify pool collateral</td>
<td>• Subordinate investors and rating agencies perform preliminary due diligence</td>
<td>• Perform accounting and legal due diligence</td>
<td>• Broker-dealer announces transaction</td>
<td>• Prepare for closing</td>
<td>• Act as guarantor</td>
</tr>
<tr>
<td>• Prepare pool</td>
<td>• Select trustee and master servicer</td>
<td>• Select trustee and master servicer</td>
<td>• Respond to investor inquiries</td>
<td>• Finalize offerings documents</td>
<td>• Monitor</td>
</tr>
<tr>
<td>• Engage rating agencies for preliminary analysis</td>
<td>• Finalize representations and warranties</td>
<td>• Launch and price senior, mezzanine, and interest-only classes</td>
<td>• Settle</td>
<td>• Review and clear exception reports</td>
<td>• Review and clear exception reports</td>
</tr>
<tr>
<td></td>
<td>• Complete subordinate investor confirmatory due diligence and finalize pool</td>
<td>• Finalize preliminary offerings documents</td>
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Securitization promotes market discipline and accountability within Freddie Mac Multifamily because of all of the scrutiny each K-Deal receives. This motivates us to continuously improve our securities program so that we can continue to finance rental housing.

- Upwards of 30 investors participate in each of our issuances. Each investor conducts an independent risk assessment of the securities.

- Senior and interest-only bond investors review the loans and conduct due diligence around Freddie Mac Multifamily’s underwriting and credit approach.

- Rating agencies conduct independent reviews of the loans; typically, each K-Deal is rated by two nationally recognized statistical rating organizations.

- Mezzanine bond investors conduct thorough analyses, which are completed by credit and underwriting professionals.
Subordinate bond investors typically re-underwrite all of the loans in a K-Deal.

The capital markets inherently provide transparency and ensure that information is available.

**K-Deal Investor Profile**

The investor community clearly has an appetite for this type of investment. Our offerings consistently have been highly rated and very well subscribed.

Our investor base is broad, encompassing domestic and international entities. It includes conventional real estate investors that may view our subordinate bonds like other real estate equity investments, life insurance companies and pension fund managers that seek the high yields of our mezzanine bonds, and major financial institutions that treat our senior bonds as an alternative to other Agency CMBS.

Effective June 30, 2014, Freddie Mac Multifamily K-Deals will be included in the Barclays Aggregate U.S. and Global Bond Index – recognition of the growing importance of the Agency CMBS sector. Being in the index will raise our visibility and bring in more investors.

Investors have access to considerable information about the loans within the securitized pools. In fact, Freddie Mac Multifamily offers a web-based tool that allows investors to track the performance of every K-Deal in which they invested.

**Benefits of the K-Deal Program**

Freddie Mac Multifamily’s securitization model enables us to finance rental housing nationwide, while minimizing U.S. taxpayers’ exposure to credit risk.

Benefits of our program:

- **Attracts private capital through a replicable, sustainable structure**
- Transfers significant amounts of risk to private investors
- Allows us to offer lenders and borrowers access to a highly competitive funding source for multifamily mortgages
- Expands Freddie Mac Multifamily’s access to capital, while helping to manage our risk
- Reduces reliance on Freddie Mac’s government guarantee, thereby shrinking the government’s footprint in the housing finance market

Another benefit of today’s K-Deal program is its reliability and dependability. Investors like knowing when the next K-Deal will be issued, its size, and other key characteristics. Our securities have predictable collateral characteristics and investors consistently purchase these securities. This promotes liquidity and competitive pricing and makes Freddie Mac Multifamily a reliable outlet for loans.

**Key Success Factors**

Our in-house expertise, intense focus on quality from end-to-end, and dedication to promoting rental housing contribute to the success of our business model and securitization program.
We purchase loans only from a small network of lenders with demonstrated experience in multifamily lending, knowledge of local market conditions, and close relationships with borrowers. In addition, we maintain specialty lender networks to finance subsidized (targeted affordable), seniors, and student housing. We work with our lenders to allocate specific geographic regions in which they can specialize and source loans eligible for sale to Freddie Mac Multifamily.

To decide whether to purchase particular loans, Freddie Mac Multifamily follows a prior-approval model – that is, we underwrite each multifamily mortgage loan in-house before accepting it for purchase. We do not delegate our due diligence or credit analysis. Our in-house underwriters, in collaboration with our legal and capital markets staff, make credit decisions on each loan based on a number of factors before accepting the loan for purchase. These factors include strength of sponsors, historical property operations, cash equity, the underwriter’s knowledge of markets, and other pertinent information.

After purchasing a loan, we are involved with asset management and servicing, through its maturity. We set servicing standards and, through regular interaction with servicers, actively monitor the loan’s performance and work to ensure that each loan is serviced properly; although we are not directly involved in servicing activities, we strongly influence them.

Importantly, we apply the same credit underwriting and servicing standards to loans whether we invest in them directly through our investment portfolio or securitize them. This consistency and loan quality enables us to attract a high demand for our securities, which in turn allows us to provide a reliable flow of liquidity to our lenders and borrowers.

The Proof Is in Our Performance
Freddie Mac Multifamily’s business results reflect the strength of our strategy and execution:

- We have delivered profits for U.S. taxpayers for at least 16 consecutive quarters.
- Our credit losses are nominal and delinquency rates consistently are among the industry’s lowest.
  - We have experienced zero losses on our guarantee on K-Deal securities to date.
  - Credit losses on our entire $133 billion mortgage portfolio – comprising more than 11,000 loans, held either for securitization or for investment – were just 1 basis point, or 0.01 percent, at year-end 2013.
  - The delinquency rate on our mortgage portfolio has been consistently low. It went no higher than 0.26 percent during the height of the U.S. financial crisis, compared to more than 11 percent for privately funded CMBS. At year-end 2013, the delinquency rate on our portfolio was 9 basis points, or 0.09 percent.
- Repeat borrowers account for 80 percent of our business.

Moreover, the market essentially grades our performance every time we issue a K-Deal. In fact, rating agencies and potential investors often re-underwrite many if not all of the loans in the K-Deal when making decisions about a particular issuance. Our securities are consistently well-received in the marketplace and our underwriting is viewed favorably.

In Conclusion
Policymakers and industry leaders generally agree on the goals of housing finance reform:

- Attract private capital.
- Shift credit risk away from U.S. taxpayers.
- Support the housing market in all economic conditions.
- Promote rental housing to help keep it affordable, especially to lower-income households.

Through our K-Deal securitization program, Freddie Mac Multifamily achieves these goals today – and has achieved them since 2009. We apply our resources, expertise, and innovation every day to help meet the rental housing market’s needs now and in the future. That’s our responsibility and our commitment to those who work with us, invest in us, and rely on us to help make rental housing available nationwide.