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 April 2015, we funded $100 billion in multifamily mortgages through 80 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 four million rental units that we financed from 2005 through 2015, 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 additional 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 in September 2008, 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 rapidly.

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 90 percent of our purchase volume.

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 loans
- Manufactured housing community loans

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?

**K-Deal Securitization Process**

- **Freddie Mac** sells loans to a third-party depositor.
- Loans deposited into the third-party trust by the depositor.
- Freddie Mac acquires guaranteed certificates* and deposits them into a Freddie Mac trust.
- Freddie Mac sells guaranteed K-Certificates backed by the guaranteed certificates.
- Senior certificate investors.
- Mezzanine certificate investors.
- Subordinate certificate investors.
- Unguaranteed mezzanine certificates.
- Unguaranteed subordinate certificates.

*Guaranteed certificates include senior amortizing certificates and/or interest-only certificates off senior and subordinate principal and interest certificates.

- 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 certificates and mezzanine certificates, 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 certificates issued by the third-party trust and securitizes the senior certificates via a Freddie Mac trust. Freddie Mac also purchases and guarantees certain subordinate interest-only certificates related to the senior certificates.
- 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 certificates, 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 structured subordination and Freddie Mac’s guarantee.
The senior guaranteed certificates (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 certificates (the remaining $200 million) to private capital investors; these certificates are backed by the same pool of loans as the senior certificates are but without Freddie Mac's guarantee. It is important to note that the unguaranteed mezzanine and subordinate certificates represent approximately the bottom 15 percent of the total offering, although they account for the vast majority of the risk. Investors in the unguaranteed certificates 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 certificate 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 investors – varies, depending on certificate class.

- **Class A** are the senior certificates, which Freddie Mac guarantees. Investors in these certificates receive principal and interest paid on each loan in the pool every month until the certificates 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 certificates. Investors receive interest every month until the certificates are paid off; they receive principal only after investors in the senior certificates have been entirely paid off. Because these investors bear more risk, they receive a higher yield.

- **Class D** are unguaranteed subordinate certificates. These also are the first 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 certificates 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 certificate class. For Class X certificates, investors only receive interest payments and never receive principal.

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 certificate 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 fixed-rate K-Deal is rated by two nationally recognized statistical rating organizations.

- Mezzanine certificate investors conduct thorough analyses, which are completed by credit and underwriting professionals.

- Subordinate certificate 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 fixed-rate 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 certificates like other real estate equity investments, life insurance companies and pension fund managers that seek the high yields of our mezzanine certificates, and major financial institutions that treat our senior certificates as an alternative to other Agency CMBS.

Since June 30, 2014, Freddie Mac Multifamily K-Deals have been 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 has raised our visibility and brought 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.

What’s the difference between risk transfer and risk sharing?

Risk sharing – Risk is divided among participants, including the entity selling the risk. Each participant is liable for a portion of any and all losses incurred.

Risk transfer – Risk is shifted from the selling entity to other participants.

Through our approach to buying mortgages and securitizing them via the K-Deal structure, Freddie Mac Multifamily transfers more than 90 percent of the credit risk to private investors. Our guarantee acts as catastrophic insurance and would be called on only in the most extreme cases where losses exceed the unguaranteed amounts of the securities.
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 13 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 $143 billion mortgage portfolio – comprising more than 11,000 loans, held either for securitization or for investment – were zero at year-end 2014.
  - 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 the end of March 2015, the delinquency rate on our portfolio was 3 basis points, or 0.03 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.