Today’s Agenda

- Welcome/Agenda: Rich Meyer and Scott Croul
- Executive Sponsor Opening: Michael Lipson
- Environmental Report: Rich Meyer, Scott Croul, Brian Morith
- Lunch
- Credit Perspective on Reports: Ed Hussey and Steve Lansbury
- Market Projections: Kirstin Nelson
- Property Condition Report: Rich Meyer, Scott Croul, Brian Morith
- Closing: Rich Meyer and Scott Croul
Our Speakers

- Executive Sponsor: Michael Lipson, Senior Vice President, Multifamily Asset Management and Operations
- Ed Hussey, Vice President, Multifamily Mortgage Credit Risk Management
- Steve Lansbury, Vice President, Underwriting & Credit, Southeast Region
- Rich Meyer, Director, Real Estate Services
- Scott Croul, Senior Director, Multifamily Underwriting & Credit, Western Region
- Kirstin Nelson, Producer, Central Region
- Brian Morith, Senior Physical Risk Engineer
Overview
The concept of quality is difficult to define, for it is not merely seen, but somehow intuited in the presence of the work in which it is embodied. Quality has little to do with popular notions of beauty, taste, or style; and nothing to do with status, respectability, or luxury. It is revealed, rather, in an atmosphere of receptivity, propriety, and restraint. Paul Rand
"In a conversation, keep in mind that you are more interested in what you have to say than anyone else is."
- Andy Rooney
Corporate Overview

- Freddie Mac is a government-sponsored enterprise (GSE), and we are now in conservatorship as managed by FHFA since September 2008
- Our public mission is to provide liquidity, stability and affordability to the housing market
- We operate in the secondary mortgage market, buying loans through a network of seller/servicers noted on FreddieMac.com
- We serve three business areas:
  - Single-Family
  - Multifamily
  - Investments
Multifamily Overview

- Our Seller/Servicer network delivers conventional loans to our four regional offices in McLean, New York, Chicago and Los Angeles and our new field offices in Atlanta and Austin as well as targeted affordable housing (TAH) loans working with our TAH home office team.

- Our Multifamily Seller/Servicer Guide (Guide), published on AllRegs, outlines our lending parameters and conditions of purchase; all third party report requirements are contained in the Guide.

- We are a prior approval lender and fully underwrite each loan prior to purchase.

- We lend on a non-recourse basis subject to standard industry carve-outs and require environmental carve-outs.

- We began shifting in 2009 from a “buy and hold” to a “buy and sell” model and are currently securitizing more than 90% of the loans we purchase.
We Are Maintaining Responsible Lending Standards

- Promote prudent underwriting standards that support sustainable business practices for the long term
- Continue to review our credit parameters and adjust to reflect risks associated with market conditions
- Champion transparency and core credit principles in our credit changes to provide clear support for every credit decision
- Seek investment-grade loans = sustainable cash flow + quality real estate collateral + market strength and resiliency + viable exit + qualified sponsorship
Importance of Third Party Reporting

Core business principal: Transparent, supportable assessment of risk to promote sustainable lending platform

Mission objective: Promote a safe living environment through the financing of multifamily properties that represent high standards for the applicable property class and market

Need for High-Quality Third Party Reports
General Third Party Report Requirements

- Guide requirements published in AllRegs
- Reports are to be no older than 6 months
- Report results to be provided to appraisers
- Minimum inspection requirements
Updates

- Repair categories: Critical, Priority and Operational
- Seismic requirements
- Vendor management requirements
  - Verify qualifications
  - Maintain files
- New tools for Seller/Servicers
  - Report review aids
  - Consultant certification for alternative qualification criteria
  - Training!
- June Guide Updates
Updates: Seismic

- Portfolio study
  - 23% of portfolio in high risk zones
  - Low insurance coverage
- Former Guide requirement
  - Level 0 evaluation
- Current Guide requirement
  - Level 1 evaluation unless specified building characteristics are verified
- Insurance coverage
  - No changes
Environmental Report Requirements

Primary objectives:

Identify potential pathways of exposure that could threaten the health and safety of the tenants
Understand potential cleanup liability exposure for borrower
Determine conformance with regulatory requirements

ASTM Plus:

Asbestos
Lead-based paint
Radon
Mold
**Primary objectives:**

1. Identify any life/safety issues that could affect tenants
2. Identify all deferred maintenance and current/on-going capital costs required to maintain property quality and provide a safe living environment
3. Determine conformance with regulatory requirements

**Industry standard scope:**

- Complete interior and exterior inspection
- Identify problems and provide remedies with costs
Forward Commitment Requirements

Reporting phases:

1. Pre-construction analysis
2. Construction monitoring
3. Post-construction analysis

Primary objectives:

1. Analyze developer’s plans and capabilities
2. Monitor construction progress and ensure appropriate issue resolution
3. Confirm that the project was completed substantially in conformance with the original plans
"This is not a novel to be tossed aside lightly. It should be thrown with great force."

- Dorothy Parker
Consider the following:

> Shortly after closing a loan with site drainage issues with estimated repair costs of $500K, a study was completed revealing that $24MM would be required to complete the needed work...
Report Issues, continued

» A property that had soils tested due to historical use was determined to require “no further action” despite the fact that contaminant levels exceeded state cleanup criteria and the deal was therefore ineligible for funding by Freddie Mac (without cleanup)
» A recent fire at a property in workout had aluminum wiring as a suspect cause; the property condition report completed at underwriting noted the branch wiring to be copper
A property condition report was completed by a recent graduate with a degree in Environmental Development
Freddie Mac Quality Control Efforts

- Provide ongoing internal technical training to improve underwriting reviews of third party reports

- Strengthen inspection requirements
  - Required training for annual servicing inspections: MBA Inspection Workshop
  - Defined “complete property inspection” for underwriting
  - Adopted MBA inspection format for annual inspections
Freddie Mac Quality Control Efforts, continued

- “Best practices” tools
  - Common Issues and Best Practices document
  - Quarterly customer calls
  - Review guides
  - Training
  - Customer Compliance Management audits

- Report reviews
  - Post purchase
  - Prior to commitment

- Restricted vendor list
Seller Responsibilities

- Retain qualified consultants *with no conflicts of interest*
  - Environmental consultants
    - Degree in relevant discipline
    - 3 to 5 years of experience
    - Specified training
  - Property condition consultants
    - Professional degree in engineering or architecture
    - 5+ years of experience
    - Match skills to required work if special scope is required
- Use Certification of Alternative Criteria sparingly for trusted consultants
**Seller Responsibilities, continued**

- Ensure consultant understands required scope (and Guide changes); provide Guide chapter with contract
- Confirm report conforms with Guide scope and protocols
- Confirm report conforms to Seller’s perception of the property condition
- Ensure identified issues have resolution; **obtain additional studies as needed** and follow up on pending information
- Disclose all property problems to Freddie Mac
- Provide appraisers with relevant report findings
- Be a critical report reader
“I don’t know anything about music. In my line, you don’t need to.”

Elvis Presley
Unit ceilings are 8’ with an aristex coating.

Unit ceilings are 8’ with an aristex coating **with an acoustical decorative finish.**

The masonry cracking was due to rust jacking.

The masonry cracking was due to rust jacking the corrosive expansion of the steel lintels.
Seller Responsibilities, continued

- Manage consultants
  - Evaluate performance and provide feedback
  - Maintain consultant file
    - 3 references for new consultants
    - Current resume
    - Appropriate license(s) (if any)
    - Current insurance certificate
    - Performance evaluations
    - Alternative Criteria Certificate (If any)
- Obtain required information before consultant starts work
- Follow up on outstanding information that was not available when report was issued
Consultant Responsibilities

- Understand required scope
- Assign qualified staff to conduct on site work
- Understand client needs and provide consulting within the context of those needs; know who reviews your reports/monitor client satisfaction
- Understand the client’s business decisions and provide them the information they need to know as well as the information they want to know
- Resolve all issues that are identified
- Be precise and provide adequate detail
Environmental Report: Inspection

- Minimum inspection requirements
  - Fewer than 100 units: the greater of 5 units or 10%
  - 100 units or more: the greater of 10 units or 5%

- If testing is required, sampling protocol requirements may prompt additional unit inspections
Environmental Reports: Asbestos

- Date of construction does NOT eliminate risk
- Friable asbestos is of most concern
  - All suspect friable materials must be tested
  - Concentrations above 10% must be removed
Environmental Report: Asbestos, continued

- If ONLY non-friable materials are suspect, operations and maintenance (O&M) can be recommended in lieu of testing, providing that:
  - Materials are not damaged
  - Materials are non-hazardous in consideration of form, condition and location (accessibility to tenants)

- Testing protocol
  - Greater of 5 units or 10% of all units, not required to exceed 12 units
  - Protocol is a screening tool to identify imminent risk and is not sufficient to determine that the property is asbestos-free
Observed suspect asbestos was in good condition; an O&M is recommended.

Observed suspect asbestos was in good condition and no friable materials were found; an O&M is recommended.
Testing is expected for all properties for the greater of:

» 10% of the lowest habitable units or

» 1 per building

• Locate canisters per Guide protocol

Follow-up testing

» Long-term testing in affected areas must follow all elevated results at a minimum: consultant must determine if more is needed to fully evaluate risk
Due to the property size [800 units in 70 buildings], 50% of the buildings were sampled for radon.

Due to the property size [800 units in 70 buildings] the fact that the property is comprised of small buildings located in close proximity to each other, 50% of the buildings were sampled for radon.
Environmental Report: Mold

- All evidence of mold and/or water intrusion must be identified and the source of the intrusion provided.

- Consultant is to search for visual and olfactory evidence in all areas inspected.

- Inquiries are to be made of knowledgeable parties on site regarding
  - Past evidence of mold or water intrusion
    - Inspect all areas identified by on-site sources
  - Tenant complaints
Environmental Report: Lead-Based Paint

- For pre-1978 property, test or recommend an O&M
- For testing, must use x-ray fluorescence (XFR) or laboratory sampling
- Testing protocol is very prescriptive as a screening tool to identify imminent risks but cannot be used to determine that the property is lead-free
  - Location
  - Number of samples
  - Building elements to be sampled
- If lead-based paint is a concern, paint condition must be identified; damaged surfaces must be repaired
Due to the building age [1972], testing was conducted per the Freddie Mac Guide and no elevated results were found. No further action required.

Due to the building age [1972], testing was conducted per the Freddie Mac Guide and no elevated results were found. No further action required. **As the testing was not comprehensive, an O&M is required to manage potential lead-based paint in place.**
Environmental Report: Polychlorinated Biphenyls (PCBs)

- Brightline date: July 1979; however there is risk from contaminated servicing oils
- Verify utility-owned equipment in writing
- Utility-owned equipment need not be tested; any spills must be reported
- Non-utility equipment installed prior to July 1979 must be labeled or have contents tested
- Non-utility equipment installed after July 1979 need not be tested unless there are signs of leaking around unlabeled equipment
- An O&M is required for any PCB-containing equipment (regardless of ownership)
Environmental Report: Tanks

- Storage Tanks
  - Unused tanks must generally be removed and evidence must be provided to indicate the tank did not leak in the past
  - For all active tanks, provide evidence that the tank has not leaked or test to verify conditions
  - A tightness test is required for all active tanks within 6 months of the property inspection
  - If no tests are available, further investigation must be completed and delivered as part of the full underwriting package
  - Evidence of compliance with all applicable regulations must be provided
  - An O&M is required for all active tanks
Environmental Report: Hazardous Materials

- Hazardous Materials
  - Maximum limits for certain hazards are in the Guide
  - If a conclusion cannot be rendered that there is no risk resulting from suspect hazardous materials, additional investigation is needed
  - Testing must be completed before full underwriting package is delivered
  - Documented contamination that exceeds limits noted in the Guide, or any federal or state cleanup standards, must be remediated
Contamination from an adjacent facility has impacted the subject. The responsible party has been identified and an approved remediation plan is underway. Due to the clean up oversight provided by the environmental regulator, the lack of any pathway of exposure due to the fully developed site, and the fact that water supply is provided by a municipal source, there is no observable risk to tenant health and safety.
Environmental Report: Prior Use

- Prior-use issues must be resolved
- If off-site remediation is ongoing, certain minimum information must be verified:
  - The source has been identified and terminated
  - Extent of the plume has been delineated
  - Responsible parties are known and their capacity to respond has been analyzed
  - Regulatory status is fully explained: a remediation plan has been accepted and remediation target is explained
    - File review
    - Discussion with project manager for environmental authority
Environmental Report: Database

- Evaluate applicable databases
- The regulatory status must be understood at minimum for nearby sites of significance
- Database information may merit further investigation if risk impact cannot be determined:
  - File reviews
  - Project manager interviews
- For any identified site, a conclusion must be provided if it has impacted the subject or is likely to impact the subject
Environmental Report: Residual Contamination

- Most recent test results are understood, found to be sufficiently comprehensive and are related to the relevant clean-up standard
- Impact to tenant health and safety
- Potentially Responsible Parties have been identified
- Regulatory status and ongoing requirements
  - A plan has been accepted by the authority
  - Clean-up requirements are understood
  - No Further Action designation has been obtained or is pending
  - Engineering controls are in place
  - Administrative controls are in place
Environmental Report: “The Rest of the Story”

- Use of previous test results
  - Date
  - Scope
  - Changes to property
- Superlien status
- Form 1103
- Review existing O&M plans
- Follow up on Freedom of Information (FOIA) requests
Environmental Report: “The Rest of the Story,” continued

- Attachments
  - All test results and reference applicable action levels
  - Photos for all issues identified
  - Questionnaires
  - All data and records reviewed, including previous reports
  - Resumes for inspector and report reviewer
Apartment Values are Recovering

In March, apartment prices increased by 1.5% while core commercial prices were flat.

Apartment prices have increased by 12.5% over the last 12 months, driving the 6.2% year-over-year gain in the national all-property index.

Source: Moody’s Investor Service
Vacancies are Down and Effective Rents are Rising

Multifamily Vacancy Rates and Effective Rents

Source: REIS
Rents are in a Third Year of Positive Growth

Rent Growth

Source: REIS
More Capacity is Coming Online

Employment, MF Starts (2+ units), and Completions (2+ units)

MF Starts: 2+ units (thousands)  MF Completions: 2+ units (thousands)  Employment (millions)

Source: Moody’s Economy.com
Delinquency Rates are Falling or are Flat

Source: REIS
Freddie Mac Updates

- 2012 snapshot
- Top 5 states
- Student Housing
- Markets -- what are we seeing now?
Property Condition Report
Property Condition Report: Inspection

- Residential units
  - 10% of the units, to include
    - 50% of the vacant units
    - 50% of the down* units
  - Additional inspections based on
    - Severity of issues identified
    - Lack of condition consistency among units

- Commercial units and common space
  - 100%

* A down unit is any unit that cannot be brought into service with routine maintenance
Property Condition Report: Property Description

- Finishes/Equipment/Appliances
  - Materials described
  - Age noted
  - Quality indicated
  - Condition stated
    - Wear and tear
    - Maintenance and servicing records
    - Excessive exposure to elements
  - “As reported” is not an acceptable form of investigation, particularly in relation to electrical branch wiring
Some garage doors were observed to be damaged.

**How many doors?**  **Extent of damage?**  **Location?**

Carport roofs have significant corrosion in many areas.

**Extent of damage?**  **Replacement or repair needed?**

Sidewalks have trip hazards throughout [15 acres].

**Location?**  **Location?**  **Location?**
Property Condition Report: Problematic Materials

- Electrical issues
  - 60 amp minimum service
  - Circuit breaker protection
  - Aluminum wiring
- Fire retardant plywood
- Problem drywall
- Other issues
  - Product recalls
  - Materials subject to class action lawsuits
  - Inferior siding materials: EIFS, fiberboard, T-111
  - Stab-Lok circuit breakers
  - Problematic plumbing: Galvanized piping, polybutylene piping
  - R-22 air conditioning equipment
Management reported branch wiring to be copper.

**Must be verified by consultant!**

GFI fixtures were not observed during the survey.

**Required by code? Current hazardous condition?**

Due to aluminum branch wiring, CO/ALR fixtures are required.

**Code compliant? Light fixtures? Maintenance?**
Issue resolution

» Understand the industry perspective
  – Manufacturing “generation”
  – Performance standards
  – Typical risks
  – Governmental actions: recalls, lawsuits

» Identify and resolve issues impacting current or historical property specific operations

» Provide justification for leaving material or equipment in place

» Provide measure to manage potential risks going forward
Property Condition Report:
Planned/Completed Improvements

- Summarize recently completed capital improvements
- Analyze ongoing capital improvements
  - Quality of the work
  - Potential impact to residents
  - Budget status
  - Note if any Priority or Operational Repairs are included
Property Condition Report:
Planned/Completed Improvements, continued

- Analyze planned capital improvements
  - Do not assume work will be completed: any Priority or Operational Repairs that are part of the plan should still be identified in the PCR
  - Analyze adequacy of budget to complete proposed work
  - Potential impact to residents
  - Note if any Priority or Operational Repairs are included
Evaluate remaining useful life based on

- Quality of materials used
- Wear and tear
- Level of maintenance
- Exposure to elements/external forces

Any element that has an RUL that will expire within the loan term (or shortly thereafter), MUST be addressed as a Priority Repair, an Operational Repair or be included as a replacement reserve item.

RUL should not equal (or exceed) end of life (EUL) (except for new construction) without an explanation.

Coordinate Replacement Reserve (RR) table (year costs are to be expended) with RUL information (year materials expire).
Priority Repair should be considered for any significant building component at the end of its RUL.

If RULs vary for a particular component, we need more information than “varies” or a broad age spread (e.g., 1-15 years) in Form 1105 (Multifamily Property Condition Form); appliance/equipment RUL information is often effectively conveyed via a table with smaller age spreads quantified; or, for components that cannot be easily quantified, an average age is more informative than a range.

RR, if not Priority Repair, should be indicated for cabinets and countertops at the end of their RULs.
How do borrowers budget for property maintenance and repairs?:

- Equity investment in capital needs: to maintain or improve the property
- Operating budget (underwritten repairs and replacements): to address Routine Maintenance and minor repairs and replacements (Operational Repairs)
- Repair escrows: to address one-time capital needs (Priority Repairs)
- Replacement reserves: to address ongoing capital needs
Property Condition Report: Replacement Reserves

- Capital needs over the term of the loan
- Seeking a representative number vs. seeking an exact number: tell the story for the property inspected
  - Based on age
  - Based on level of past maintenance
  - Based on original quality of construction
  - Based on wear, often associated with tenant profile or external forces
- Repairs identified as Operational should not appear in year 1
- If an Operational Repair needs to repeat during the loan term, the cost should be in later years of the replacement reserve table
Indicate units measured to calculate costs

If costs are combined (e.g., parking striping is included in sealant cost or caulking is included in paint cost), this must be explained

Year that costs are projected to be expended should be tied to RUL and potentially the consultant’s condition rating

Most building components not associated with typical unit turns are capital expenses

Influences of a changing marketplace and changing regulations: e.g., R-22 vs. R-410 refrigerants
Property Condition Report: “The Rest of the Story”

- Code compliance
  - General compliance
  - Building/fire violations
  - Accessibility compliance
    - ADA
    - Fair Housing
- Wood-destroying insects
- Mold
- State-limiting conditions
- Identify deviations from requirements
- Report must be dated within 6 months prior to the date on which the full underwriting package is delivered to Freddie Mac
Property Condition Report: “The Rest of the Story,” continued

- Attachments
  - Questionnaires
  - All data and records reviewed, including previous reports
  - Rehab scope of work and budget
  - Site plan
  - Photographs
    - Convey property condition
    - Show all issues
  - Resume
    - Inspector
    - Report reviewer
"Once the toothpaste is out of the tube, it's hard to get it back in!"
- H.R. Haldeman
Property Condition Report: Repair Categories

- Critical Repairs: Showstoppers
  - Repairs and replacements that significantly impact habitability, value, income or marketability
  - Almost always resolved before consultant engaged
  - Completed work must be verified by consultant
  - All work must be completed before commitment
Priority Repairs: Formerly “Immediate” repairs

» Life safety issues

» Code compliance issues

» Material deficiencies; generally pervasive in nature
  – Conditions leading to component failure within one year
  – Conditions that will lead to an escalation of remedial costs

» Significant deferred maintenance; generally pervasive in nature
  – Postponement of normal maintenance that is significantly impacting condition, operational efficiency, cost to cure or overall property value

» Expected to be completed in the short term (most often within 90 days when possible)

» Must be described in the Repair Rider to the Loan Agreement
Operational Repairs: Generally isolated and of minor cost

- Minor deficiencies
  - Conditions that do not warrant immediate attention, but require repairs or replacements within the next 12 months
  - Conditions that cannot be reasonably addressed by routine maintenance and have a cost of more than $3,000 per item

- Minor deferred maintenance
  - Postponement of normal maintenance that has resulted in minor degradation, some lack of efficiency, and/or a minor increase in the operating budget with a cost of more than $3,000 per item

- Must be incorporated in a Repair Letter issued by the Seller

- Completion will be verified at the first annual servicing inspection
Repair Examples
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temporary repair?
Repair Examples
Repair Examples
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Repair Examples

deteriorated fencing
Repair Examples
Repair Examples

severe termite damage
Repair Examples
Repair Examples

leveling needed
Repair Examples
Repair Examples
Questions