Statement by Peter Donovan
American Enterprise Institute Forum: Multifamily Housing Finance Reform: Eliminating the Federal Guarantee
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Thank you for the invitation and opportunity to discuss the future of Multi Housing finance. As I heard Ed's opening comments I honestly thought he was speaking of the single family market, not the multifamily market. As I read AEI's paper on Multi Housing Finance reform, I couldn't help but think our perceptions of reality and beliefs about the best way to provide liquidity to the multi housing market are heavily influenced by our experiences and personal philosophies. As such, I believe that there is a fundamental difference between AEI's and my sense of reality and philosophy with respect to the future of the multifamily debt market.

Where you see a market threatened by the continued presence of a government guarantee, I see a market that showed discipline and unprecedented performance during the worst recession since the Great Depression, a period which I believe you described as a "mild downturn".

Where you see "A current GSE Multifamily Book that will cause losses to taxpayers during the next bottom of the cycle", I see a portfolio default rate that is currently 25bps on a combined GSE portfolio of over $300 billion that has a 20-25 year history and a business that has generated billions in income.

Where you say that "the objective of liquidity and stability is flawed and dangerous", I say show me a debt market that functions better with illiquidity and instability.

Where you say "The heavy involvement of government sponsored enterprises in multifamily mortgage finance has distorted the market in ways that may lead to serious future problems if not corrected", I see an outperformance by multifamily over the last 20 years in no small part because of the underwriting standards, process discipline, market knowledge, sophistication and funding capacity of the GSEs. In fact, AEI does acknowledge that the GSEs have set the Prime Mortgage standard for multifamily and as such you would expect that we should all see the value in that continuing. The GSE multifamily program is a market based funding source, albeit with a government guarantee. Where you say "the industry's call for liquidity and stability will increase the fragility of the marketplace", I say, show me the evidence of that. Capital scarcity, erratic and undisciplined underwriting creates risks in the market, as we saw in 2007 and 2008. Discipline, liquidity and stability promote a healthy multifamily market.

Where you say that "A centrally managed system will not protect the industry or the economy from market readjustments rather only mask and postpone developing imbalances", I say compare the performance of the centralized GSE model with respect to CMBS default rates of 15% and the S & L crisis of the late 80s that cost taxpayers $125 billion, which were both decentralized financing systems loosely governed with a misalignment of interests.

Where you say "No pressing public interest would be served by facilitating apartment owners' access to capital during periodic financial crises", I say imagine how dysfunctional the apartment market would have been from 2008 to 2011 without the GSEs. This was not a 3 or 4 month liquidity crisis. Without the GSEs the apartment market would have been frozen like the other commercial real estate markets. Development would not be at today's levels, occupancies would be even higher as would rents. How would this serve us well?

Where you say “We have a synchronized (rather than locally differentiated multifamily market) producing excessive leverage”, I say that the 2012 GSE average loan to value for newly originated loans is 65% with a 1.45 debt service coverage and an outstanding balance of 50%-55% at maturity.

Where you say “If the federal guarantee is continued, the risk of downward pressure on multifamily underwriting standards is very high”, I say we have seen no evidence of this under receivership. Your reference to the growth of the aggregate multifamily mortgage debt outstanding is not shown in the context that the average loan to value has gone from 53% in 1992 to 36.5% in 2012 according to the Federal Reserve Board and that values have gone from $545 billion during that time to $2.3 trillion. I ask you where is the bubble in that? Is this your GSE over-allocation of capital to the multifamily sector?

I fail to see the looming crisis and in fact believe that the GSEs have helped us avoid a crisis in multifamily. There is hard evidence and circumstantial evidence but I don’t see either here.

You say that the GSE pricing advantage drives out private competition. I say that there is some truth in this and that the GSEs are widening their pricing. Furthermore we are seeing insurance companies beating GSE pricing and conduits within 15-20bps.

You say that “GSE reform must begin quickly and proceed predictably for private lenders and investors to reenter the multifamily market”. I ask where will the additional liquidity come from? The banks who are floating rate short term lenders? The life insurance companies who provide 10% of multifamily debt with tight capital allocations and limited product and market criteria? For example, I was just on a conference call with 25 of the largest life insurance companies in the country. I asked them if there were an opportunity to lend on 25 to 30 year old class B apartment properties in secondary and tertiary markets at a 50 to 75 bps increase in their standard lending rates for good credits how many would make these loans. The answer was none. Or can we rely on CMBS, which blew up in 2008 and again in 2011 with no substantive changes and with a continued misalignment of interest? And finally, can we really trust the rating agencies given their track record?

The U.S. multi housing market is the most developed and robust apartment market in the world. 85% of institutional quality apartment properties are in the United States. England and Mexico are looking to create a U.S. style apartment market in their countries. Disciplined debt capital consistently available in all market conditions was an essential element. The GSE market discipline, underwriting standards, origination system and alignment of interests are precisely the attributes we need for the future of the multifamily. Housing is just as essential as healthcare and as essential as education. Governments all over the world support housing in a variety of ways. Decent shelter is different from retail, office, hotels, and industrial. We have seen how an over-emphasis on single family homeownership with the best of intentions can have disastrous results.

The elimination of a government guarantee of any sort to avoid a possible crisis, that is not supported by the facts, to be replaced by a private capital market that has not shown itself to be ready, willing, able, disciplined or reliable would truly be a crisis of our own making and for what purpose?

Your final suggestion of the Federal Reserve Bank backstop in lieu of a government guarantee facilitating continued market liquidity rather than to continue a government multifamily guarantee is to my mind the difference between a disaster recovery plan and a disaster prevention plan that will likely lead to more frequent and severe multifamily debt market crisis. During the last recession the government showed little interest in supporting the market. What should be done? As has been proposed by others, if privately recapitalized to promote competition, the GSE successor entities would be competing on service and product, with a raised guarantee fee (if needed to promote an economically sound government guarantee of the bonds) with the government guarantee only utilized after all private equity in the successor firms had been exhausted.

The GSE multifamily experience was not the single family experience. In times of severe economic crisis it worked even better than any of us imagined. It was quite simply the model that needs to be emulated because it works. I don't want successor GSE multifamily to crowd out the private debt market but rather to lead it.