FannieMae

DELEGATED UNDERWRITING & SERVICING (DUS®) – THE ROLE OF RISK RETENTION IN MULTIFAMILY FINANCE

EXECUTIVE SUMMARY

A core component of Fannie Mae's mission is to support the U.S. multifamily housing market to help serve the nation's rental housing needs, focusing on low- to middle-income households and communities. In 2010, the company provided nearly $17 billion in debt financing for rental housing, of which 91 percent of the multifamily units financed were affordable to families earning at or below the median income in their area.

For more than 25 years, Fannie Mae's Multifamily Mortgage Business (Multifamily Business) has successfully and consistently provided a stable, reliable secondary market for participants in the multifamily housing industry. As the nation's largest single participant in multifamily mortgage financing, the Multifamily Business utilizes a shared-risk business model that has proven to be sustainable, scalable, and profitable. Fannie Mae's experience in the multifamily industry, as well as the favorable performance of its $189 billion multifamily guaranty book of business (as of December 31, 2010) – and the more than 43,000 properties and 3.7 million

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"Private credit markets have generally underserved multifamily rental properties that offer affordable rents, preferring to invest in high-end developments. By contrast, Fannie Mae . . . developed expertise in profitably providing financing to the middle of the rental market, where housing is generally affordable to moderate-income families." [1]

housing units financed - offers insight into the benefits of risk retention by lenders and servicers.

Even during the recent economic downturn, Fannie Mae's multifamily mortgage loan portfolio performed well. As of year-end 2010, less than 1 percent of Fannie Mae's multifamily housing portfolio was seriously delinquent (SDQ), which is defined as 60 or more days delinquent, while the SDQ rate of multifamily commercial mortgage-backed securities (CMBS) exceeded 13 percent. Furthermore, the Fannie Mae risk-sharing model is profitable.

This paper highlights the Multifamily Business's Delegated Underwriting and Servicing (DUS) business model. The DUS model utilizes some risk retention concepts similar to those included in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), with additional features that enable Fannie Mae to scale the business in a sustainable manner.

The quality of Fannie Mae's multifamily guaranty book of business is attributable to the DUS model's loss sharing with experienced and financially sound counterparties, supported by industry standard underwriting guidelines and asset management practices, and Fannie Mae oversight. The result is better asset quality at origination and better loan performance over time. Ultimately, lower delinquencies and losses contribute to positive financial returns.

THE DODD-FRANK ACT AND RISK RETENTION

In response to the recent economic crisis, Congress initiated regulatory reform efforts to address perceived market weaknesses in order to prevent another financial crisis. The Dodd-Frank Act was enacted in July 2010 to improve accountability and transparency in the financial system by establishing protections for consumers and investors. Most relevant to the multifamily housing finance industry are mechanisms addressing certain risks inherent in the securitization process. "The financial crisis brought to the surface certain inherent problems in the securitization process, including misaligned incentives of participants and informational asymmetries."[2] In response, the Dodd-Frank Act

contemplates the concept of risk retention as a mechanism to mitigate credit risk by aligning incentives among securitization participants, including lenders, securities issuers, and investors.

Typically, "risk retention" refers to the principal that any party who is responsible for the origination of a loan for securitization (the "investment") – in this case, a mortgage loan secured by a multifamily housing property – cannot transfer the entirety of that investment unless the transferor retains an interest in the investment sufficient to create a continuing material financial risk from subsequent default by the mortgage loan borrower. In other words, throughout the life of the mortgage loan, risk retention requires each party who originates, securitizes, or invests in that loan to retain enough financial risk from the ultimate performance or failure of that loan so that each party will continue to be engaged in the success of the loan as an investment.

The Dodd-Frank Act adopted this concept by, generally, requiring a securitizer[3] of asset-backed securities to retain an unhedged portion of the credit risk (not less than 5 percent) for most assets that the securitizer packages into the securitization for sale to others. By requiring risk retention, Congress acknowledged that investment asset quality may improve when participants are required to maintain an explicit financial stake in the long-term performance of the assets they produce.

According to the Dodd-Frank Act, with respect to a commercial mortgage loan (including multifamily mortgage loans), the accompanying regulation shall provide for permissible forms of risk retention, which may include[4]:

- Retention of a specified amount or percentage of the total credit risk of the asset
- Retention of the first-loss position by a third-party purchaser
- Adequate underwriting standards and controls
- Adequate representations and warranties and related enforcement mechanisms

Following enactment of the Dodd-Frank Act, financial regulators and the Obama Administration issued a number of key studies on and proposals addressing the Dodd-Frank Act's concept of risk retention. Each of these studies bolstered and further refined the risk retention requirements envisioned in the Dodd-Frank Act. In March 2011, several federal government agencies jointly issued a proposed rule to implement the risk retention requirements of the Dodd-Frank Act. While the final form of the Dodd-Frank Act risk retention options is still to be determined and an implementation rule has yet to be promulgated, it is clear that standards for multifamily loan securitizations may be transformed, both from a regulatory perspective and due to investor and other participant demands. This paper does not purport to express any view or comment on the proposed risk retention rule.

FANNIE MAE'S MULTIFAMILY MORTGAGE BUSINESS

Until the recent economic downturn led to a major contraction, multifamily housing projects were financed by a variety of lender types. As the economic downturn continued, most of these institutions (such as life insurance companies, conduits/investment banks, and depository institutions), exited the industry for some time. Notably, many of these lenders and, in particular, the commercial mortgage-backed securities (CMBS) industry, continue to be relatively inactive, leaving Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA) as the primary liquidity providers for the multifamily housing industry since 2008. As noted in a report issued recently by the Harvard University, Joint Center for Housing Studies ("Joint Center"):

> *"The only net additions to outstanding multifamily debt since 2008 have come from the GSEs [together, Fannie Mae and Freddie Mac] and FHA. The volume of outstanding loans held or guaranteed by the GSEs and FHA soared by $71 billion between the first quarter of 2008 and the fourth quarter of 2010, while the volume for all other financing sources combined dropped by $40 billion."* [5]

"...as of the 4th quarter of 2010, Fannie Mae accounted for 20 percent of multifamily mortgage debt outstanding." [6]

In fact, as of the 4th quarter of 2010, Fannie Mae accounted for 20 percent of multifamily mortgage debt outstanding.[6] Furthermore, this is not the first time that Fannie Mae has proven its reliability. As stated in a separate Joint Center report: "Both in the wake of the currency crisis in 1998 and again after 9/11 and the 2001 recession, Fannie Mae … stepped up portfolio purchases and guarantees of multifamily debt."[7]

Given the importance of the Fannie Mae Multifamily Business as a stable, long-term source of financing, it is timely to examine Fannie Mae's DUS business model. As described below, the DUS model parallels some of the concepts embedded in the Dodd-Frank Act. Loss sharing, prudent industry underwriting standards, and adequate contractual representation and warranty mechanisms are in place already and are enhanced by the DUS model's other features. The DUS program has achieved long-term success by applying these concepts to a substantial volume of multifamily mortgage loans over a period of 20 years.

DUS BUSINESS MODEL OVERVIEW

Fannie Mae developed the DUS business model in the 1980s, when a nationwide shortage of both equity and debt financing for multifamily housing resulted from a confluence of events including the thrift crisis, changes in income tax codes, and the retrenchment of federal involvement in multifamily affordable

housing. For example, a U.S. Department of Housing and Urban Development (HUD) privatization initiative – known as "co-insurance" – was curtailed, then terminated, amid mounting financial losses. "After 40 years of public involvement in creating and sustaining the nation's stock of affordable housing, in the 1980s the federal commitment to affordable housing scaled back considerably."[8]

In 1984, Fannie Mae created a separate business division dedicated to purchasing multifamily loans. To fill the nationwide gap in multifamily financing, particularly for affordable rental housing, Fannie Mae sought to enhance underwriting standards and establish product standardization in the multifamily industry. Fannie Mae initiated the DUS program in 1988 to expand its purchases of individual multifamily loans. More than 20 years later, Fannie Mae's Multifamily Business continues to support affordable housing. In 2010, 91 percent of the multifamily units Fannie Mae financed were affordable to families earning at or below the median income in their area. Specifically, more than 212,000[9] housing units were affordable to families with incomes no higher than 80% of the area median income.

DUS is a unique business model in the commercial mortgage industry. The standard industry practice is for a multifamily loan purchaser or guarantor to underwrite or re-underwrite each loan prior to deciding whether to purchase or guaranty the loan. Under the DUS model, lenders are pre-approved and delegated the authority to underwrite, close and service loans on behalf of Fannie Mae. Underwriting and servicing guidelines and standardized loan documents facilitate delegation and create efficiencies in originating and closing loans. In exchange for delegated authority, DUS lenders are required to share with Fannie Mae the risk of loss throughout the life of the loan. Underwriting and asset management delegation enables lenders to respond to customers more rapidly, with the authority to approve a loan or manage the asset (within prescribed parameters). Thus, delegated authority also gives lenders an important benefit in streamlining their own business operations.

"...the success of the DUS model is directly attributable to the alignment of interests among the borrower, lender, servicer and investor over the life of the loan."

Fannie Mae's DUS model provides an example of the successful, large-scale application of risk retention practices (referred to as "loss sharing"). The DUS model incorporates several features that have been proven to benefit all parties involved, including tenants, borrowers, lenders, servicers and investors. These features are described in this paper and are summarized on the next page.

Fannie Mae believes the success of the DUS model is directly attributable to the alignment of interests among the borrower, lender, servicer and investor over the life of the loan.

DUS FEATURES AND BENEFITS

FEATURE	BENEFIT
Industry Continuity	» Countercyclical stability – consistently provides access to credit throughout economic cycles » Promotes confidence that funding and liquidity will be accessible
Published underwriting and servicing guidelines and loan documents	» Sets industry standard for multifamily underwriting and servicing best practices » Promotes standardization and transparency across all industry participants » Facilitates reliable securities disclosures
Delegation and Scalability	» Enables Fannie Mae to scale the business as industry conditions change » Improves efficiency and, therefore, lender responsiveness to customers
Network of Approved Lenders/ Servicers	» Maintains a select group of business relationships based on: • Financial strength • Extensive multifamily underwriting and servicing experience • Strong portfolio performance • Creation of quality branded product
Loss Sharing	» Originators, servicers and Fannie Mae have "skin in the game" throughout the life of the loan » Awareness of risk potential improves processes and performance of all parties » Optimizes outcomes (e.g. profitability, loss mitigation) for all participants
DUS Mortgage Backed-Security (MBS/DUS)	» Transforms a mortgage loan into a more liquid asset, which increases available funds in the financial system » Offers investors highly-rated credit strength due to Fannie Mae's guaranty of timely payment of principal and interest

DUS Lender Network – Counterparty Strength and Experience

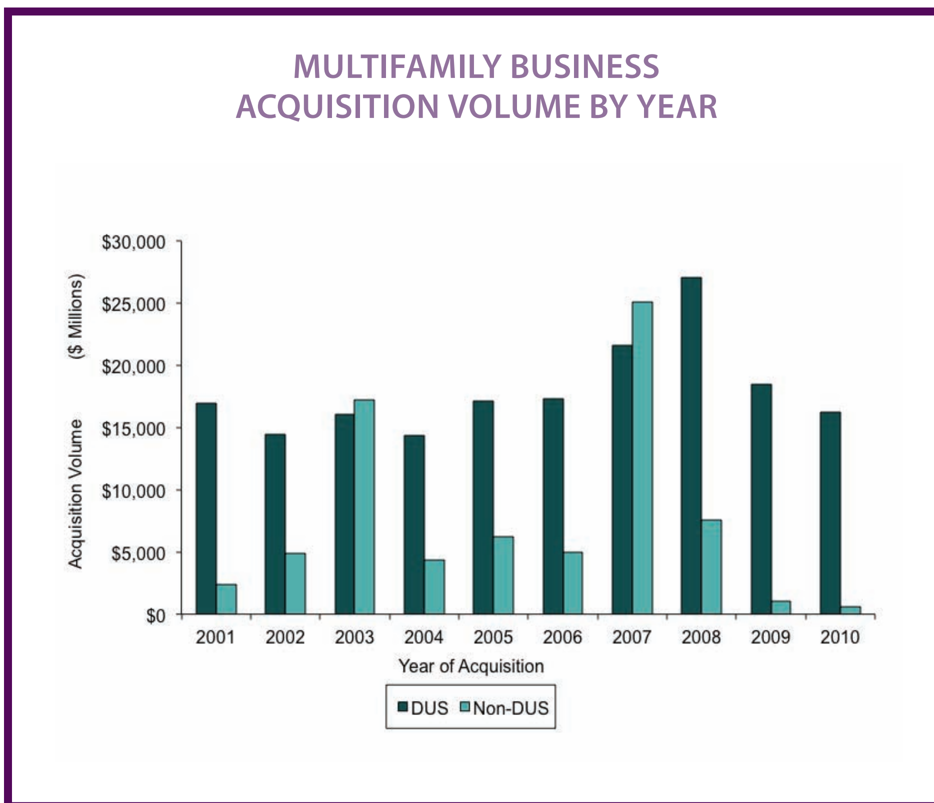
Fannie Mae's Multifamily Business has limited its DUS business relationships to a select group of lenders who are required to possess certain attributes considered crucial to supporting a loss sharing relationship with Fannie Mae. Financial stability, solid credit analysis and underwriting skills, strong infrastructure and technology platforms, and sufficient depth and breadth of management's expertise and knowledge of multifamily lending are essential to becoming an approved DUS lender. To sustain its business relationship with Fannie Mae, each DUS lender must continue to demonstrate the same qualities of financial and operational soundness.

The current 25-member DUS lender network, which is comprised of large financial institutions as well as independent mortgage lenders, is Fannie Mae's primary source of multifamily loan deliveries. In 2010, Fannie Mae executed multifamily transactions with 32 lenders. Multifamily Business 2010 acquisition volume[10] totaled approximately $17 billion, of which 97 percent was delivered by DUS lenders.

DUS LENDERS NETWORK (AS OF 12/31/10)

Alliant Capital Finance, LLC	Deutsche Bank Berkshire Mortgage, Inc.	Oak Grove Commercial Mortgage, LLC
AmeriSphere Multifamily Finance, LLC	Dougherty Mortgage, LLC	Pillar Multifamily, LLC
Arbor Commercial Funding, LLC	Grandbridge Real Estate Capital, LLC	PNC Bank, N.A.
Beech Street Capital, LLC	Greystone Servicing Corporation, Inc.	Prudential Multifamily Mortgage, Inc.
Berkadia Commercial Mortgage LLC	HomeStreet Capital Corporation	Red Mortgage Capital, LLC
CBRE Multifamily Capital, Inc.	HSBC Bank USA, N.A.	Walker & Dunlop, LLC
Centerline Mortgage Capital, Inc.	JP Morgan Chase Bank, N.A.	Wells Fargo Bank, N.A.
Citibank, N.A.	KeyCorp Real Estate Capital Markets, Inc.	
CWCapital LLC	M&T Realty Capital Corporation	

A small portion of the Multifamily Business volume is comprised of non-DUS deliveries, which typically are small balance loans or pools of seasoned loans that were not originated or underwritten in accordance with Fannie Mae standards. Fannie Mae has purchased these non-DUS loans intermittently through the years as illustrated in the following graph:



While delivery volume from DUS lenders varies with industry conditions, it nonetheless has provided steady acquisition volume relative to non-DUS deliveries, which have mirrored the volatility of industry dynamics.

Fannie Mae requires lenders to comply with continuing structural and financial covenants to ensure that each DUS lender will be able to fulfill its loss-sharing commitments. These covenants mitigate Fannie Mae's financial risk exposure to each lender. For example, each lender must establish and maintain a financial position that demonstrates an ability to meet minimum net worth and liquidity requirements.

In addition to showing sufficient on-balance sheet liquidity to satisfy operating expenses and fund expected loan losses, all DUS seller/servicers are required to post collateral to support their loss sharing obligations. In order to insulate the loss sharing entity from additional risk, DUS seller/servicers are permitted to conduct only GSE and FHA business within their corporate DUS structures. Despite the weakened general economic environment and deteriorating credit fundamentals in the commercial lending industry, generally, these requirements have withstood significant testing and Fannie Mae has not experienced any multifamily loss attributable to seller/servicer financial failure during the recent economic recession.

In addition to financial strength, each seller/servicer is assessed for its ability to perform under the business terms of the relationship. This process includes operational due diligence to ensure that the lender:

- Maintains an established business of origination and servicing of multifamily mortgage loans
- Holds a valid license or other authority to do business in each jurisdiction where required, and otherwise operates in compliance with applicable regulatory requirements
- Employs qualified underwriting, originating, and servicing personnel
- Maintains adequate internal audit and management control systems to evaluate and monitor the overall quality of its multifamily loan production and servicing activities

In recognition of DUS lenders' financial, operational and loss sharing responsibilities, Fannie Mae regularly solicits their feedback on underwriting and servicing-related topics, including underwriting standards, servicing and loss mitigation best practices, and potential loan document modifications. These efforts provide lenders with a voice in the development of DUS standards and processes and give Fannie Mae insight into current industry trends.

Loss Sharing – Alignment of Interests

As of December 2010, approximately 78 percent of Fannie Mae's multifamily loans are subject to loss sharing. While DUS loss sharing structures are most prevalent, non-DUS lenders have been subject to loss sharing as well. Fannie Mae has purchased mortgage loans without loss sharing generally in isolated transactions to meet particular business objectives at the time of purchase or when the lender/seller has no long term relationship with Fannie Mae. The most common loss sharing structures are summarized below:

MOST COMMON LOSS SHARING STRUCTURES

DUS	NON-DUS
Pari Passu: Fannie Mae and lender share losses on a pro rata basis with 1/3 to lender and 2/3 to Fannie Mae.	**Top Loss:** Lender bears fixed percent or amount of the original total balance of all loans in a specified pool of loans – lender bears all losses on loans in the pool until specified recourse obligation is exhausted.
Standard: Lender bears a share of losses, calculated using a tiered loss sharing formula (generally involving a first loss position and a cap at 20 percent of original loan amount) based on established risk factors such as loan-to-value and debt-service coverage ratios.	**No Loss Sharing**: Lender bears no risk of loss.

"...lenders are required to retain some form of 'skin in the game'..."

While the loss sharing structures differ depending on the nature of Fannie Mae's various business relationships with lenders, generally lenders are required to retain some form of "skin in the game" for most transactions. Regardless of which loss sharing structure applies, Fannie Mae sees the benefits of loss sharing throughout the life of each loan:

Underwriting: Because an originator makes the initial decision about whether, and on what terms, to extend credit, retaining a material continuing economic interest in the performance of a loan provides an incentive for an originator to evaluate the credit quality of the loan prudently.

Servicing & Asset Management: Typically, once a lender has sold a loan to Fannie Mae, the lender continues to service the loan on behalf of Fannie Mae. The lender/servicer has an additional incentive to monitor the borrower, the mortgaged property, and the geographic area where the property is located in order to identify elevated risk indicators (e.g. cash flow shortfall, deterioration in property condition) that may surface during the term of the loan.

HOW LOSS SHARING WORKS – PARI PASSU

Assumptions:

- Property Value at Origination = $12,500,000
- Original Loan Amount = $8,500,000 (68% loan-to-value)
- Borrower defaults after 4 years, Fannie Mae and lender/servicer proceed with foreclosure
- Property value $3,700,000 at foreclosure per independent appraisal

		SHARED LOSSES		
		Borrower	**Lender**	**Fannie Mae**
Current Unpaid Legal Balance* Due	$8,500,000			
Property Value at Foreclosure	3,700,000			
Realized Loss on Foreclosure	(4,800,000)			
Borrower Equity Loss Since Time of Origination		**(4,500,000)**		
Pari Passu Sharing of Foreclosure Loss			**(1,600,000)**	**(3,200,000)**

**unpaid principal loan balance of $8,000,000 plus any other unpaid amounts – for example, accrued interest income and legal expenses associated with foreclosure, estimated at $500,000.*

Loss Mitigation: The lender and Fannie Mae cooperate to seek alternatives to foreclosure and to reduce costs of defaulted loans in order to minimize potential losses.

Multifamily Selling and Servicing Guide – Transparency and Standardization

Strong underwriting requirements underpin the DUS business model. For the select group of DUS lenders, Fannie Mae offers delegated underwriting authority. DUS lenders evaluate potential loans in accordance with Fannie Mae's proprietary Multifamily Selling and Servicing Guide. During underwriting, the lender is expected to analyze all reasonably identifiable strengths and weaknesses of the proposed transaction, including all factors that could impact the transaction during the term or at maturity of the loan. Among other things, the lender must address:

- The property's financial performance and trends using a standardized template
- The property's current physical condition and expected condition over the term of the mortgage
- The likely ability of the property to be refinanced at the mortgage loan maturity date
- The borrower's and its principal's financial capacity and relevant experience
- The property market's performance and trends

Central to the underwriting standards are the following general parameters:

- Minimum 1.25 Debt Service Coverage Ratio (DSCR) in most markets – DSCR is the primary determinant of the rate of default (incidence), and is based on a 30-year loan amortization period
- Maximum 80 percent loan-to-value (LTV) – LTV is the primary determinant of the loss on the loan after the property has been sold (severity); typically, borrowers are required to have at least 20 percent equity in their properties at origination
- Loan amounts based on actual cash flow, not projected cash flow, with net operating income (NOI) based on current rental income
- Receipt of satisfactory third party reports – appraisal, environmental site assessment, physical needs assessment and, if applicable, seismic risk assessment
- Comprehensive package of standardized loan documents that contain a uniform set of legal rights and remedies regarding compliance with underwriting and servicing standards; standardization results in reliable non-negotiable protections that are strictly enforced to promote the highest quality loan originations

Fannie Mae's proprietary underwriting guidelines set a transparent, prudent industry standard and promotes standardization. Such underwriting standards combined with delegation create a flexible system to respond to borrowers in a measured way so that Fannie Mae is able to scale the level of business activity efficiently and effectively as industry conditions change.

Servicing and Asset Management – Incentives to Monitor Performance

Each multifamily mortgage loan is secured by a property that is an operating business, which requires monitoring of its operational and financial performance. Servicers are required to collect, analyze, and report to Fannie Mae about the operational and financial performance, property physical condition, and compliance with complex commercial loan requirements, including property insurance provisions. These features of the multifamily business require each servicer to develop and maintain systems for frequent collection, processing, and monitoring of large quantities of property and borrower metrics.

DUS mortgage loan servicing typically is performed by the same lender that originated and sold the loan to Fannie Mae. Therefore, Fannie Mae relies heavily on lenders, acting as servicers, to perform many primary asset management duties. The lender/servicer is responsible for evaluating the physical and financial condition of properties and administering various types of agreements (including agreements regarding replacement, completion or repair reserves, and operations and maintenance), as well as conducting routine property inspections. For example, Fannie Mae requires periodic submissions of operating statements and property inspections in order to monitor each property's cash flow and physical condition. If either of these conditions deteriorates, servicing activities increase with additional monitoring, action or remediation plans.

Just as DUS lenders are delegated the authority to underwrite and deliver loans to Fannie Mae, DUS servicers are delegated certain authority in servicing loans. For example, Fannie Mae's Multifamily Selling & Servicing Guide provides guidance on how to process routine asset management requests such as easements, partial releases and condemnations. If such transactions fall within the guidance, then DUS servicers are delegated the authority to process the transaction and complete all required legal documentation. Otherwise, Fannie Mae approval is required.

Fannie Mae pays lenders/servicers a servicing fee throughout the life of each loan to compensate them for the servicing activities, as well as for sharing in the credit risk of the loan. In addition, because of Fannie Mae's on-going loss-sharing requirements, transfers of multifamily servicing rights are rare. Fannie Mae monitors all servicing relationships carefully and enforces Fannie Mae's right to approve all servicing transfers. Because most lenders service each loan throughout the life of the loan, the lender's continuing oversight responsibilities can contribute to improved performance; as the lender/servicer observes a loan's life cycle, the lender gains insight that improves and informs credit decisions on new loan originations.

Special Asset Management – Typically, servicing of a non-performing loan subject to DUS loss sharing is transferred to Fannie Mae, who acts as the special servicer. For loans subject to top loss loss sharing, the lender/servicer acts as special servicer until the lender/servicer's loss obligation is exhausted.

Lender Oversight

Fannie Mae relies on the experience of its DUS lender network to perform many primary underwriting and asset management functions. Because multiple lenders are focused on monitoring Fannie Mae's loans and borrowers, the lenders' continuing financial interest in the performance of each loan allows Fannie Mae staff to devote their attention to all aspects of its business relationship with the lender. Some examples of Fannie Mae's oversight activities are summarized below.

FANNIE MAE OVERSIGHT ACTIVITIES

FUNCTIONAL AREA	OVERSIGHT ACTIVITY
Counterparty Financial Strength & Operational Capabilities	» Lender financial statements reviewed quarterly and annually to confirm compliance with net worth & liquidity requirements » Financial monitoring facilitated by pre-set triggers, rating agency reports, and regulatory filings » Operational reviews conducted periodically, scope of which includes basic corporate governance, loan sourcing, underwriting, commitment, closing and delivery, servicing, asset management, insurance and financial management of each lender
Underwriting / Risk Rating	» Certain loans, such as those secured by properties located in weak or declining areas, are subject to a pre-commitment review by Fannie Mae underwriters » Automated risk-rating model is used as a secondary means of objective surveillance; the model applies data related to collateral type, location, payment behaviors and operating performance characteristics, as reported periodically by the servicers, to generate loan-level risk ratings
Servicing	» Commercially prudent servicing best practices, such as number of loans per servicing/asset management staff, identified and implemented
Asset Management	» Site inspections conducted to validate lenders' effectiveness and calibration of property condition. For example, in 2010, more than 1,600 properties were inspected by Fannie Mae staff throughout Atlanta, Orlando, Phoenix, Jacksonville, Philadelphia, New York City and Los Angeles » Accuracy of property operating statements reviewed and verified in order to assess lender/servicer's monitoring capabilities » Proactive identification of underperforming assets » Continuous risk rating to identify early warning signs of a troubled property and implementation of elevated monitoring plans when necessary
Special Asset Management	» Loss mitigation efforts and decisions are led by Fannie Mae, but lender/servicer remains engaged as both parties seek to minimize lossess
Credit Review Oversight	» Newly originated and delivered loans evaluated on a sample basis to assess underwriting quality and overall credit risk » Remedies may be imposed for failure to meet program requirements or underwriting standards, and may include indemnification, increased loss sharing or loan repurchase by the lender

DUS Mortgage-Backed Securities – Supporting Market Liquidity

Fannie Mae supports liquidity by purchasing whole mortgage loans and mortgage-backed securities, credit enhancing bonds, and securitizing mortgage loans in all economic conditions. In 1994, the company began securitizing DUS loans by creating the DUS Mortgage-Backed Securities (MBS/DUS), each of which is backed by an express Fannie Mae guaranty. From 1999-2009, Fannie Mae DUS lenders issued over $64.8 billion of MBS/DUS[11]. In 2010, the MBS/DUS issuance volume for the most common structure that offers a 10 year loan term with 9.5 years subject to a prepayment premium reached over $10.7 billion.

Creating an MBS/DUS transforms a multifamily mortgage loan into a more liquid asset that is easier to sell than a whole loan. Not only does the MBS/DUS investor receive a share of the cash flow produced by the mortgage loan portfolio that backs the MBS/DUS, each investor also benefits from the credit enhancement provided by Fannie Mae's guaranty. For MBS/DUS or any other Fannie Mae multifamily execution, the DUS loss sharing feature gives Fannie Mae confidence that this unique guaranteed commercial product can be offered to investors without subjecting Fannie Mae to unacceptable guaranty risk.

A wide variety of investors have purchased MBS/DUS, including insurance companies, money managers, commercial banks, and state and local governments. As an investment vehicle, MBS/DUS offer investors highly-rated credit strength due to Fannie Mae's guaranty of timely payment of principal and interest. Additional benefits include:

1. Consistent liquidity enhanced by the large number of dealers engaged in market making,
2. Stable cash flows that are easy to model,
3. Prepayment protection, and
4. Lower pricing (e.g. "spread") volatility relative to other products.

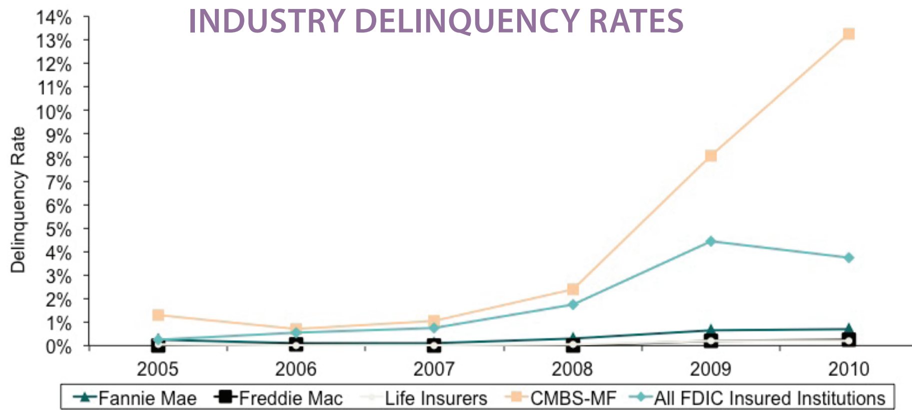
Of particular note is low MBS/DUS spread volatility relative to CMBS. "CMBS spreads spiked to 1,535 basis points [over 10 year] swaps in November 2008, and MBS/DUS reached their wide of 275 basis points to swaps in the same month."[12]

Fannie Mae's DUS experience shows that securitization of loans with a loss sharing component can succeed as an effective, reliable, and prudent liquidity strategy.

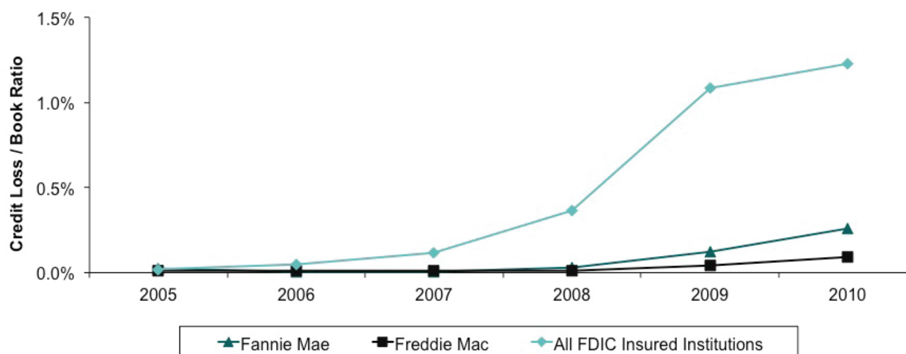
BUSINESS RESULTS

Loan Performance – Peer Comparison

Fannie Mae's Multifamily Business performed well during the current stressed economic environment. While SDQ rates and credit losses have increased, Fannie Mae's multifamily loan performance is better than that of other multifamily investor groups such as CMBS and FDIC-insured banks and thrifts. The share of multifamily loans in CMBS that were 60 or more days delinquent or in some stage of foreclosure, and the 90+ day delinquency rate on loans held by FDIC-insured banks



Note: Fannie Mae, Freddie Mac, Life Insurers and CMBS report 60+ day SDQ; FDIC Insured Institutions report 90 days SDQ + nonaccrual data . Sources: Fannie Mae and Freddie Mac Monthly Volume Summaries, Mortgage Bankers Association, Trepp, and Federal Deposit Insurance Corporation (FDIC)



Note: Credit loss performance metrics are not defined terms within generally accepted accounting principles (GAAP) and are not calculated in the same manner by Fannie Mae, Freddie Mac, and FDIC-insured institutions. Fannie Mae reports credit losses as charge-offs (e.g. the initial write down on the loan when it enters into foreclosure), net of recoveries, foreclosed property expenses, and periodic mark-to-market adjustments on REO properties – data presented is divided by average book balance; Freddie Mac reports credit losses as real estate-owned operations expense plus charge-offs, net – data presented is divided by average book balance; FDIC-insured reports charge-offs net of recoveries – data presented is divided by annual ending balance. Sources: Freddie Mac, FDIC

and thrifts that climbed to over 13 percent and 4 percent, respectively, in 2010. In contrast, Fannie Mae's 2010 SDQ rate was less than 1 percent. Similarly, FDIC-insured banks' and thrifts' credit loss/charge-off ratio was at 1.23 percent compared to Fannie Mae's 0.26 percent.

While various investor groups gather and report delinquency and credit loss data differently, which limits their comparability, the graphs above provide some insight into relative performance.

It is worth noting, given Freddie Mac's better performance relative to Fannie Mae, that Fannie Mae's portfolio is comprised of a significant number of small balance loans[13] primarily acquired from non-DUS lenders. As of December

"...Fannie Mae's 2010 SDQ rate was less than 1 percent."

2010, the current average balance of DUS and non-DUS loans is approximately $7.9 million and $1.8 million, respectively. Over the past ten years, the company has developed and refined a dedicated, small–loan platform and financed $60 billion of small loans during that time. In fact, as of year-end 2010, small balance loans comprised 70% of the multifamily guaranty book of business as measured by loan count. Non-DUS small balance loans have a disproportionately high SDQ rate at 1.47% as of December 31, 2010. Nonetheless, Fannie Mae's Multifamily Business maintains an overall low SDQ rate.

Loan Performance – DUS vs Non-DUS

The benefits of the DUS model are evident in the performance metrics of the Multifamily Business guaranty book of business. By a number of different measures, Fannie Mae's DUS portfolio has consistently out-performed the non-DUS portfolio.

As illustrated by the table below, while both DUS and non-DUS loans may have demonstrated acceptable credit characteristics at origination, the overall performance of the DUS assets over time is significantly better, as evidenced by the level of SDQ rates at various points in time. Non-DUS SDQ rates generally have been at least twice as high as DUS SDQ rates.

Even when accounting for some other variables that may impact loan performance, such as acquisition year or loan size, DUS loan SDQ performance is better as depicted in the following table.

MULTIFAMILY BUSINESS GUARANTY BOOK OF BUSINESS (12/31/2010)

BOOK OF BUSINESS SUBSET	CURRENT UNPAID PRINCIPAL BALANCE ($BILLIONS)	SDQ RATE DEC 2010
Acquisition Year - 2007		
DUS:	$19.7	0.42%
Non-DUS:	$21.7	1.08%
Small Balance Loans*		
DUS:	$14.1	0.55%
Non-DUS:	$19.1	1.47%

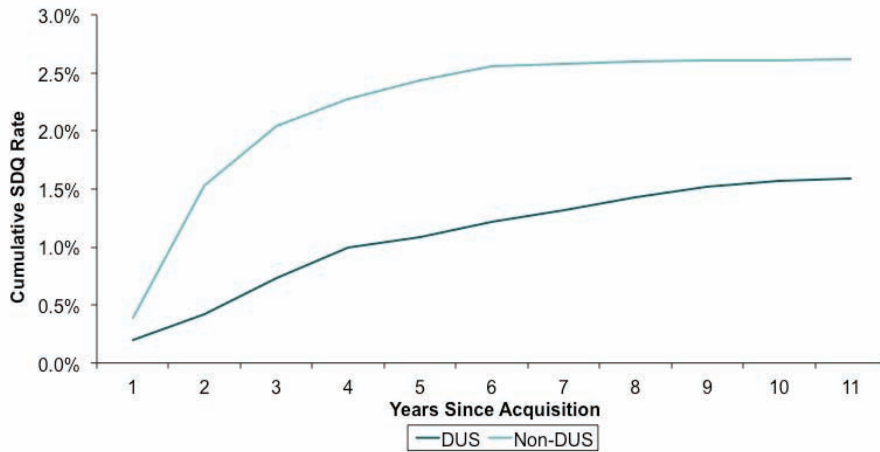
**Small balance loan data as reported in Credit Supplement to 2010 Annual Report Form 10-K*

MULTIFAMILY BUSINESS GUARANTY BOOK OF BUSINESS (12/31/2010)

	CURRENT UNPAID PRINCIPAL BALANCE ($BILLIONS)	WEIGHTED AVERAGE AT ORIGINATION		SDQ RATE DEC 2010	SDQ RATE DEC 2009	SDQ RATE DEC 2008
		LTV	DSCR			
DUS:	$144.9	68.7%	1.45x	0.56%	0.39%	0.24%
Non-DUS:	$ 42.1	58.5%	1.89x	1.20%	1.36%	0.44%

Note: Excludes loans that have been defeased. Defeasance is prepayment of a loan through collateral substitution.

MULTIFAMILY BUSINESS
CUMULATIVE SERIOUS DELINQUENCY RATE (FIRST TIME SDQ)

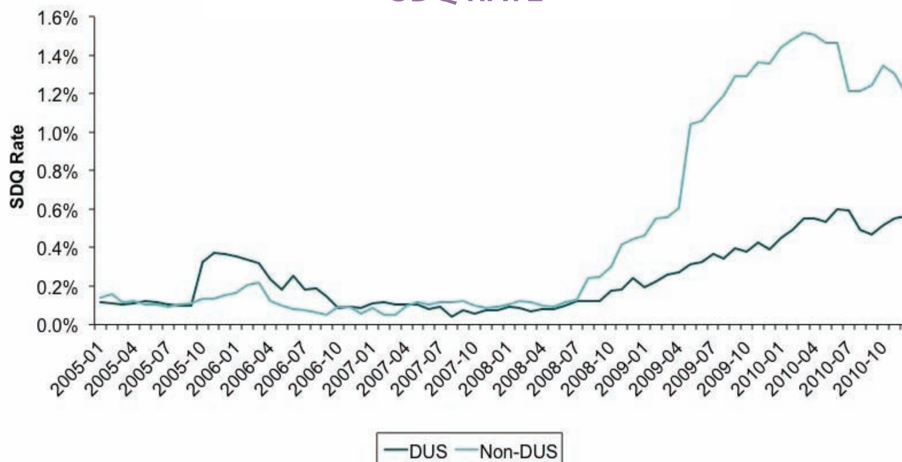


Notes: Multifamily loans are classified as seriously delinquent when a payment is 60 days or more past due. Cumulative serious delinquency rate is calculated for loans acquired from 2000 through 2010 by dividing the UPB of all such loans that become seriously delinquent at any time through 2010, as of the time they first became delinquent, by the UPB of all acquisitions during that period.

As illustrated above, only 1.62 percent of all DUS loans acquired since 2000 have ever been seriously delinquent, while the comparable rate for all non-DUS loans is 2.62 percent.

While both DUS and non-DUS loans have experienced an increase in serious delinquency rates since Q3 2008, the rates are still well below the CMBS and FDIC-insured investor groups. As illustrated below, it is noteworthy that especially since Q3 2008 the economic downturn impacted non-DUS loans to a much greater degree than DUS loans.

MULTIFAMILY BUSINESS
SDQ RATE

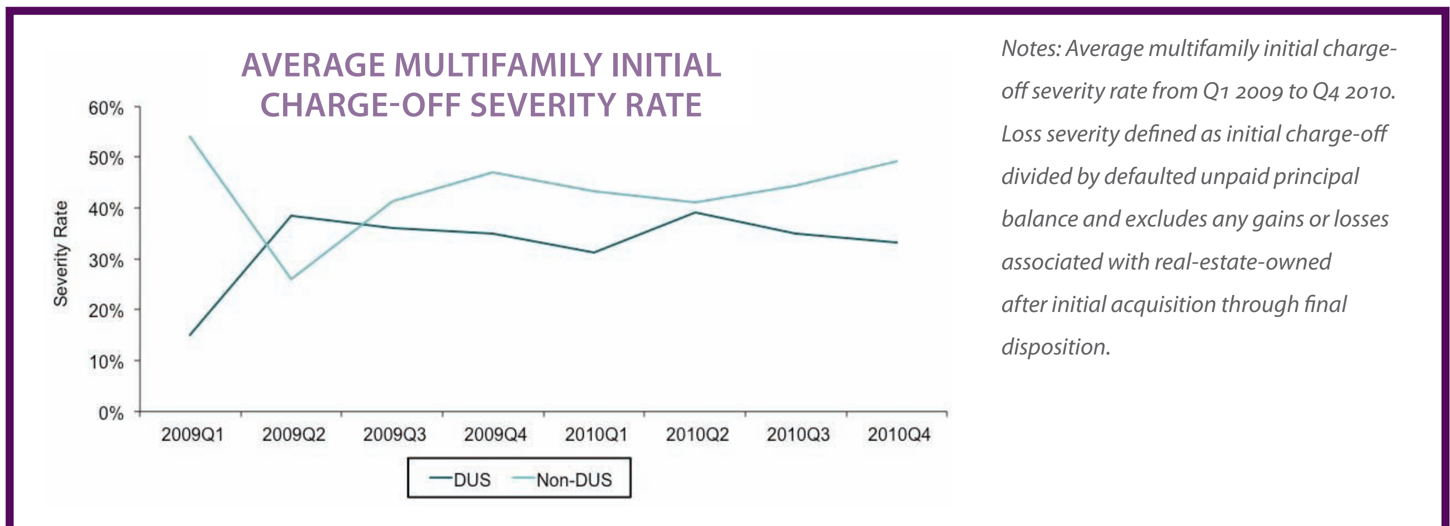


Notes: Periodic SDQ Rate from 1/1/2005 to 12/31/2010. SDQ Rate reflects multifamily loans, including loans underlying securities, for which payments are 60 days or more past due.

These SDQ statistics show the benefit of the prudent underwriting standards, counterparty strength and experience, loss sharing and robust oversight that are a fundamental basis of DUS. Lower SDQ rates translate into lower loss mitigation activities and expenses.

In addition to lower default rates, the DUS portfolio experiences lower losses in comparison with default rates (also known as "loss severity"). The benefits of loss sharing throughout the life of the loan, from prudent underwriting through shared interest in asset management, are apparent during loss mitigation. As detailed below, from 2009-2010, average loss severity for DUS loans was 34 percent, while non-DUS loss severity averaged 45 percent.

Again, all of the many features of the DUS program, anchored by the various parties' alignment of interests, combine to ultimately produce lower financial losses.



Notes: Average multifamily initial charge-off severity rate from Q1 2009 to Q4 2010. Loss severity defined as initial charge-off divided by defaulted unpaid principal balance and excludes any gains or losses associated with real-estate-owned after initial acquisition through final disposition.

Financial Performance

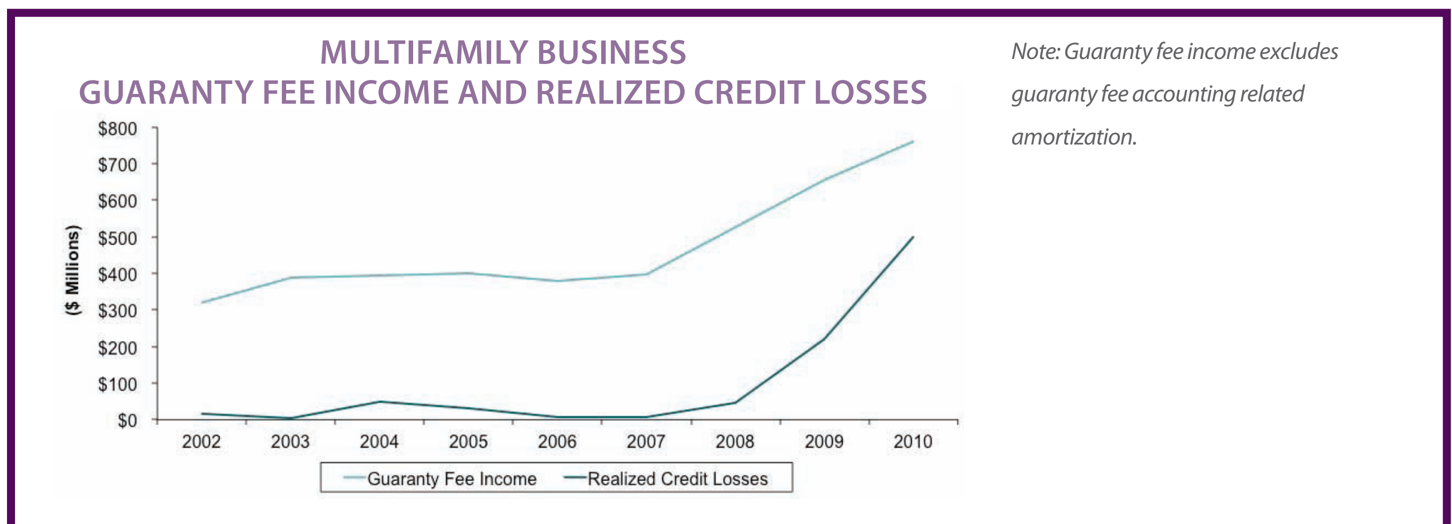
Fannie Mae's Multifamily Business guarantees timely payments of interest and principal to investors. In return for providing this guarantee, Fannie Mae earns a guaranty fee. Guaranty fees are the primary source of revenue for the Multifamily Business. The guaranty fee is priced to compensate Fannie Mae for expected credit losses and administrative expenses, as well as an appropriate return on capital. Each guaranty fee is established at the transaction (individual loan level) and is risk-adjusted based on the debt service coverage, loan-to-value ratio, financing and loss-sharing structures, and other characteristics of the loan.

The relationship of guaranty fee income to realized credit losses has been consistently positive, as depicted in the graph below. Guaranty fee income exceeds credit losses plus direct and certain allocated administrative expenses, which represent the costs associated with running the Multifamily Business. These administrative expenses have averaged $150 million annually over the past few years. The graph below illustrates that Fannie Mae's pricing for and management of credit risk has resulted in guaranty fee income exceeding realized credit losses, even in the stressed economic environments of 2008 – 2010.

Among the factors contributing to profitability is the value of loss sharing. This conclusion is supported by credit loss ratios that are 3 times higher for loans without any loss sharing.

In 2010, the Multifamily Business segment generated net income of more than $200 million related to credit guaranty activities*. This amount excludes more than $800 million in estimated additional net interest income earned on multifamily mortgage loans and mortgage-backed securities in Fannie Mae's mortgage portfolio.

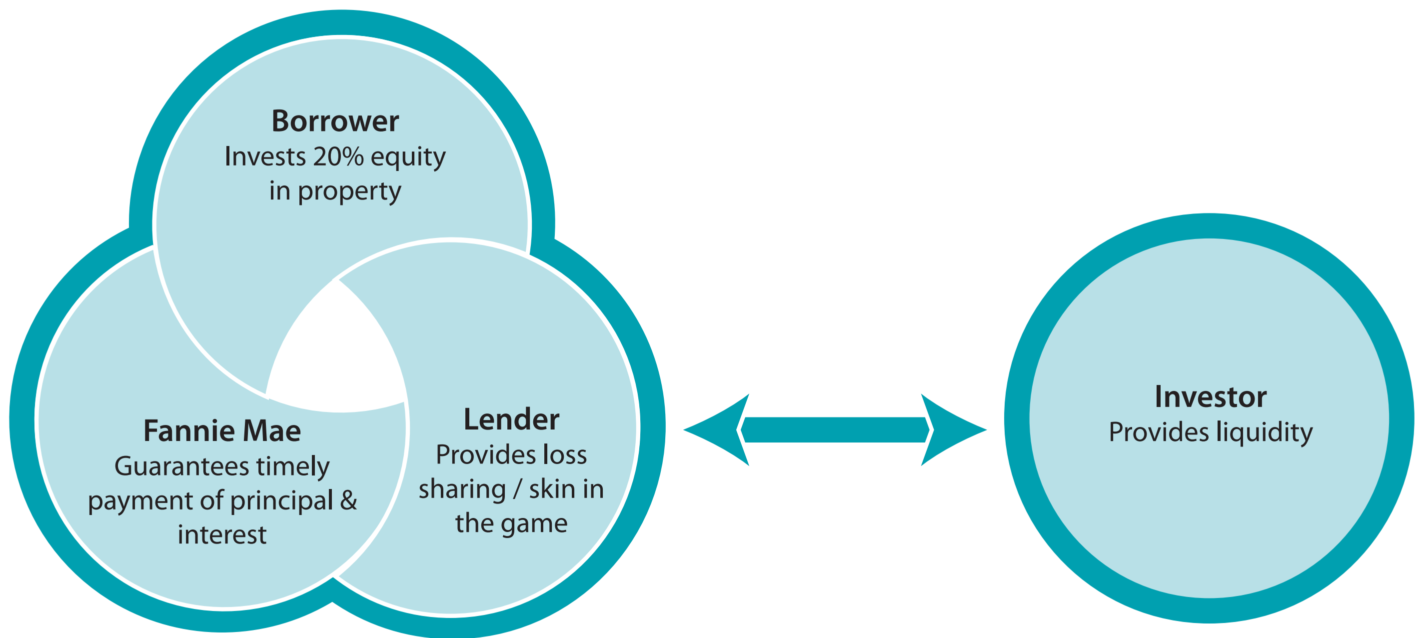
**Note that this segment recorded credit-related expenses of $2.2 billion in 2009, including a $1.9 billion non-cash increase in reserves for future credit losses.*



CONCLUSION

Fannie Mae's multifamily DUS business model has proven to be sustainable, scalable, and profitable. The quality of Fannie Mae's Multifamily Business guaranty book of business is attributable to the DUS model's loss sharing with highly experienced and financially sound counterparties, combined with industry standard underwriting guidelines and asset management practices, as well as robust oversight. An integral component, loss sharing, contributes to the success of DUS as it aligns the interests of the borrower, lender, servicer, and investor over the life of the loan. The DUS business model and business relationship also continues to benefit the DUS lenders, as evidenced by their enduring relationship with Fannie Mae.

ALIGNMENT OF INTERESTS



BENEFITS

BORROWER	LENDER	FANNIE MAE	INVESTOR
» Competitive pricing » Broad range of financing products » Standardized loan documents » Consistent, reliable loan terms » Shorter timelines to loan closing	» Delegated authority » Consistent underwriting and servicing standards » Higher servicing fee income	» Steady guaranty fee income » Scalable » Strong legal protections » Sustainable through economic cycles	» Highly-rated credit strength » Lower spread volatility » Enhanced liquidity » Stable cash flows » Superior call (prepayment) protection

CONTACTS

Multifamily Enterprise Risk Management Team

Kelly Krhounek

Phone: 202-752-6914

Email: kelly_krhounek@fanniemae.com

Caroline E. Blakely

Phone: 202-752-7196

Email: caroline_e_blakely@fanniemae.com

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ENDNOTES

1. "Reforming America's Housing Finance Market-A Report to Congress" The U.S. Department of Treasury and U.S. Department of Housing and Urban Development, February 2011

2. "Macroeconomic Effects of Risk Retention Requirements", Timothy F. Geithner, Chairman, Financial Stability Oversight Council, January 2011

3. Public law 111-203-July 21, 2010, Section 941. The term "securitizer" means either: a) an issuer of an asset-backed security; or b) a person who organizes and initiates an asset-backed securities transactions by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.

4. Public law 111-203-July 21, 2010, "Dodd-Frank Wall Street Reform and Consumer Protection Act", Section 941

5. Harvard University Joint Center for Housing Studies, "America's Rental Housing – Meeting Challenges, Building on Opportunities", April 2011

6. Board of Governors of the Federal Reserve System, Mortgage Debt Outstanding, March 2011 Release

7. Harvard University Joint Center for Housing Studies, "Meeting Multifamily Housing Finance Needs During and After the Credit Crisis: A Policy Brief", January 2009

8. Harvard University Joint Center for Housing Studies, "Multifamily Rental Housing in the 21st Century", January 29, 2001.

9. 2010 housing goals results have not yet been validated by the Federal Housing Finance Agency (FHFA)

10. Includes debt and commercial mortgage-backed securities

11. Includes Discount MBS, (otherwise known as DMBS)

12. Wells Fargo Securities, LLC, Structured Products Research "The Agency CMBS Primer", March 25, 2011

13. Original loan amount of $3 million or less nationwide and $5 million or less in high-income areas.