Cross-Sector – United States Housing and Housing Finance

Changes to Fannie and Freddie mandate will ripple across housing and mortgage markets

Resolving the conservatorships of Fannie Mae (Aaa stable) and Freddie Mac (Aaa stable), the two largest government sponsored enterprises (the GSEs), is the biggest piece of unfinished business from the US financial crisis. Given the lack of consensus in Washington and the complexity and uncertain economic impact of GSE reform, the likelihood of legislation over the next few years is low. However, both the recent Presidential Memorandum on Federal Housing Finance Reform and new leadership at the Federal Housing Finance Agency (FHFA) have raised attention on measures that can be implemented through administrative actions without legislation (See page 2).

The analysis herein is not all-inclusive and does not speak to the likelihood of any particular outcomes, nor to their merits. However, in the event that the role of the GSEs is materially revised or diminished, the most significant implications for rated issuers include:

**Fannie and Freddie:** Reform that materially reduces footprint would likely be credit negative (p. 2)

**Banks:** a reduced role for the GSEs would likely create lending opportunities for banks, a credit positive (p. 3)

**Non-bank Mortgage Companies:** Funding profiles could weaken if GSEs’ footprint diminishes (p. 4)

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**Single-family rentals by institutional landlords:** Reform that increases homeownership costs would be credit positive for the sector (p. 15)

**US Sovereign:** Reform would likely have only a modest impact on the government’s mortgage credit risk contingent liability (p. 15)
Status of housing finance reform open: administrative actions the most likely way forward for now

The conservatorships of Fannie Mae and Freddie Mac have run for more than 10 years and, though new proposals continue to be proffered, the prospects for GSE reform legislation over the next few years is low given the lack of consensus in Washington, the complexity of reform, its uncertain economic impact and, because the GSEs currently have very little capital, the large amount of additional private capital required.

On 27 March President Trump issued a Presidential memorandum directing the Secretary of the Treasury to develop a plan for administrative and legislative reforms of Fannie Mae and Freddie Mac. With the Presidential memo along with new FHFA leadership, there is a lot of attention on administrative actions or reform measures that could be implemented without legislation. But even though administrative actions are easier to accomplish than legislative reform, they would still require navigating the interests of a large number of stakeholders and it is hard to predict their substantive effect on the housing and housing finance markets or the broader economy.

Administrative reform could encompass an array of actions with a wide range of implications for the US housing and mortgage markets, but given the large number of stakeholders and uncertain impact, any changes over the next one to two years will likely be modest. Among the ideas that commentators have mentioned are: reducing the types of eligible mortgages that the GSEs can insure; retaining capital; reducing multifamily volume caps; spinning off or sharing data and technology; increasing guarantee fees possibly on only certain loan types; and more credit-risk sharing transactions.

In the very unlikely event that the market role of the GSEs is materially revised or diminished in the next several years, there is a strong chance of substantial change in the competitive dynamics of housing finance. Some companies could benefit as new opportunities develop or their pricing power improves, while others could face difficulties as the historic drivers of their franchises decline. However, any reform that significantly reduces the GSEs’ size or systemic importance would likely take many years to implement.

Fannie and Freddie: Reform that materially reduces their footprint would likely be credit negative

By Warren Kornfeld

Reform that materially reduces or restricts the market share or scope of operations of Fannie Mae and Freddie Mac (both Aaa stable) or recapitalizes and releases the GSEs from conservatorship, would likely be credit negative for the GSEs. However, given their size and importance to the housing and housing finance market, the GSEs’ current senior unsecured debt and subordinated debt creditors are likely to be protected whatever the nature and timing of the reforms, whether legislative or administrative, including in a complete wind-down of Fannie Mae and Freddie Mac.

The current Aaa senior unsecured debt ratings of Fannie and Freddie reflect effective credit substitution with the government of the United States of America (Aaa stable). Despite a lack of an explicit (formal) guarantee, we assess that there is very strong government support underpinning the GSEs’ senior unsecured debt and subordinated debt obligations. The stable outlook on the ratings for Fannie Mae and Freddie Mac is aligned with that on the US government rating. As such, any rating actions on the US sovereign would likely result in corresponding actions on the GSEs’ long-term senior unsecured debt ratings as well as their subordinated debt ratings, from which these ratings are derived.

A broad political consensus supports the public policy mission of the GSEs; namely, to support the stability of the US mortgage market and promote access to mortgage credit and homeownership. There is no near-term institutional alternative to take up and pursue the GSEs’ mission.

Fannie Mae and Freddie Mac hold or guarantee about 50% of outstanding US mortgages, acting as a linchpin of the housing segment of the US financial system. They have combined total assets of $5.5 trillion (27% of 2018 estimated GDP). By comparison, there is $16.3 trillion in US federal government market debt held by the public.

Housing activity involving fixed investment in residential real estate and consumption spending on housing services is integral to the US economy, although it has been moderating as a share of GDP since the mid-20th century. According to the National Association

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.
of Home Builders (NAHB), housing’s combined share of GDP has declined to about 15% of GDP in 2018 (3.3% for residential fixed investment + 11.6% for housing services) from about 17.5% in 1980. Should GSE reform reduce the accessibility or affordability of prime residential mortgages, it could temper the ongoing cyclical recovery in housing or steepen the long-term decline in such activity.

Our government support assumptions for Freddie and Fannie reflect the critical importance of the GSEs in anchoring the immense US mortgage market, particularly in periods of prolonged economic uncertainty or market turbulence. The GSEs guaranteed around 45% of the estimated $1.3 trillion of US residential mortgages originated during the first three quarters of 2018, and they depend on government support to fulfill this role. Even if Fannie Mae and Freddie Mac completely ceased purchasing and guaranteeing new mortgages, it would take many years for their $5.5 trillion aggregate portfolio to run off.

A severe reduction in the footprint of Fannie and Freddie to, say, 35% or less of new mortgage originations from their current mid-40% share could reduce their perceived centrality to the US housing finance market, which could erode the credit quality of their debt and mortgage backed securities (MBS). How negative this would be for the GSEs’ credit standing would depend on how quickly, and predictably, their market share declined and how clear policymakers were about their objectives and the path forward to a reconstructed US housing finance market, including the level and form of government support. Also important will be the GSEs’ capitalization at the time of reform, their ability to raise required additional capital, as well as market perceptions as indicated by unsecured and MBS bond spreads.

Recapitalizing and releasing the GSEs from conservatorship, as periodic reports suggest the Trump administration is considering, would likely be credit negative for the GSEs because of uncertainty about how privatization would occur. Unless Fannie and Freddie have significant levels of capital, investors in GSE debt and MBS would again have to assess the likelihood and level of implicit government support. As a result, privatization may increase the risk of funding disruptions. We therefore assess the probability that the GSEs will be privatized over the next few years as very low.

Banks: a reduced role for GSEs would likely create lending opportunities for banks, a credit positive

By Warren Kornfeld

Reform that leads to a smaller GSE footprint and higher non-GSE mortgage rates would likely be a net credit positive for banks, according to the scale and nature of their mortgage-related businesses and depending on the scope and details of reform. The prospect of more profitable residential mortgage business would be an incentive for banks to increase their presence in the market, reversing the trend of the last several years, and there are several ways in which they could do so:

Originate and hold mortgage loans in the bank’s loan portfolio. A smaller GSE footprint would increase lending opportunities for US banks, a credit positive. US banks’ are mostly funded by deposits, a comparatively low-cost and stable funding source, giving them an advantage over other financial institutions in capturing the GSEs’ ceded market share. However, to the extent that banks retain more longer-term mortgages on their balance sheets, their asset-liability risk will likely rise. Banks pulled back from the residential mortgage market after the 2008-09 financial crisis for reasons including heightened regulatory and headline risk, but the single biggest driver was the modest profitability. Better profitability prospects will likely draw banks back into the market (Exhibit 1.)
Higher non-GSE mortgage rates will likely result in higher returns for banks’ originate and hold activities over the long run, boosting their net interest income. Initially, however, the benefits of higher interest rates could be offset by increased extension risk, as lower yielding mortgage loans remain on the banks’ books for longer periods, a credit negative if market interest rates rise.

**Originate and sale of mortgage loans (“mortgage banking”) and capital market activities.** GSE reform would likely have a minor net effect on banks’ GSE gain-on-sale margins. Provided that a smaller footprint does not weaken the GSEs’ credit profiles, a reduced supply of GSE MBS will likely lead to tighter GSE MBS spreads. However, spreads on the reduced supply of GSE mortgages are also likely to tighten, with the benefit flowing through to borrowers, not originators. With respect to non-GSE mortgages, private-label residential MBS (RMBS) market activity is likely to increase, providing a growth opportunity for banks with loans the banks’ originate and purchase as well as for capital market activities. However, in addition to being more profitable than GSE mortgage banking, non-agency mortgage banking is riskier because the loans are far less liquid.

**Mortgage Servicing.** Higher mortgage rates would likely reduce the pace of prepayments, thereby increasing the value of banks’ existing mortgage servicer rights (MSRs), a credit positive. However, many banks hedge their MSR rights, which would offset part, if not most, of any gains.

**Hedging.** Should GSE reform result in a smaller and less liquid To-Be-Announced (TBA) market, the cost of hedging banks’ mortgage business would likely increase, a credit negative.

**Fannie and Freddie MBS and debt investments.** Banks are large investors in Fannie and Freddie MBS (Exhibit 2). Tighter MBS spreads would result in short-term gains on the banks’ current GSE MBS portfolios. However, over the longer term, lower spreads on new GSE MBS investments would be credit negative.

**Non-Bank Mortgage Companies: Funding profiles could weaken if GSEs’ footprint diminishes**

*By Gene Berman and Warren Kornfeld*

A smaller GSE footprint will likely have negative credit implications for non-bank mortgage companies. Today, almost all of the mortgages that non-bank mortgage companies originate for sale to the secondary market are guaranteed or insured by the GSEs or the US government. A significant increase in the origination of far less liquid, non-agency mortgage loans would weaken the non-bank mortgage companies’ funding strength, which is already below that of non-bank finance companies more broadly. Moreover, increased competition from banks is likely to reduce the profitability gains that non-bank mortgage companies can reap from increased non-agency mortgage activity.

We assign the non-bank mortgage company sector a B1 industry risk score. Weak funding profiles are a significant rating constraint for companies in the sector, which generally finance their mortgage originations with secured, mark-to-market, warehouse facilities with one-year maturities (and on occasion two-year maturities), exposing the companies to ongoing refinance and market risk. Mortgage market liquidity is highly correlated with its perceived credit risks. During periods of market stress, liquidity for even high-quality non-
agency mortgages can recede quickly. To date, Fannie Mae, Freddie Mac and government-insured mortgages have generally retained their liquidity in most markets.

To offset any decline in GSE originations and maintain market share, non-bank mortgage companies will likely increase the portion of non-agency mortgages they originate. Some may also expand beyond mortgage banking, whereby loans are sold within a couple of weeks after origination, into portfolio lending. Portfolio lending entails materially greater credit risk since loans are typically retained for the life of the loan, and the increased risk would be only partly offset by increased earnings stability. Therefore, unless the non-bank mortgage companies also strengthen their capital and funding profiles, an increase in non-agency mortgages would be credit negative. Lastly, any weakening of the GSEs’ credit profile or reduction in GSE MBS market liquidity would also weaken the funding profiles of non-bank mortgage companies.

If the profitability of residential mortgage origination increases, we expect increased competition from banks, a credit negative for non-bank mortgage companies. Over the last several years, banks have pulled back from the residential mortgage market, largely because they have been able to earn greater risk-adjusted returns in other lines of business, and non-bank mortgage companies have picked up the slack. In 2012, banks made 67% of loans originated and non-banks 27%, with credit unions picking up the remainder (Exhibit 3). In 2017, banks’ share had fallen to just 39% with non-banks’ share doubling to 54%.

A reduction in the GSEs’ footprint combined with a continued high market share for non-bank mortgage originators could result in the FHFA revisiting its 2016 membership rule that excludes captive insurance companies from FHLBank membership. The FHFA’s rule was issued in response to a dramatic increase in FHLBank advances by captive insurers whose parent entities were otherwise ineligible, a practice that the FHFA viewed as circumventing the Federal Home Loan Bank Act. In most cases, the captives primarily served as conduits for their affiliates to access the FHLBank’s stable, low-cost funding, as they typically offered insurance coverage only to related entities. Allowing non-banks access to the FHLBank System would be a strong credit positive for non-bank mortgage companies, providing them a stable funding source, increasing their funding diversity and reducing borrowing costs. FHLBank advances remained readily available to members during the financial crisis at a very attractive cost. For the FHLBanks, on the other hand, expanded membership would be credit negative (see page 9).

RMBS: Credit effects will depend upon prioritization of policy goals and market risk appetite

By Jody Shenn

The credit implications for new private label securitization (PLS) RMBS and GSE credit risk transfer (CRT) transactions from reforms that shrink the GSEs’ footprints, or otherwise revise their unusual status, will depend upon the precise actions taken to address sometimes conflicting policy goals. That’s partly because shrinking the GSEs can be accomplished in numerous ways, including ones that would:

» **Allow private capital to offer stronger competition to the GSEs on higher quality loans**, such as by requiring higher guarantee fees for high-balance conforming loans, while leaving the GSEs’ financing of other loans unaffected.
» **Reduce the GSEs’ ability to finance weaker quality loans**, such as by requiring less cross-subsidization in setting guarantee-fee pricing, inhibiting the GSEs’ ability to introduce new programs or ending the so-called GSE Qualified Mortgage (QM) patch.\(^\text{10}\)

» **Eliminate entirely the GSEs’ ability to finance certain loan products**, such as for second homes, investment properties, all refis or cash-out refis.

Certain actions allowing private capital to offer stronger competition on higher quality GSE loans could reduce the credit quality of both new PLS RMBS and GSE CRT deals compared with today, even if overall origination quality fails to change, depending in part on the risk appetite of RMBS investors and competition from bank portfolio lenders when such actions took effect. For instance, increasing guarantee fees on all high-balance conforming mortgages would likely create adverse selection in the GSEs’ portfolios and hence in their CRT deals because the PLS market would likely end up financing more of the highest quality loans in the category. At the same time, loans shifting to the PLS market could be weaker than recently securitized prime PLS pools, given their strong collateral.

Prime PLS RMBS issuers have already increased the amount of GSE-eligible mortgages in their pools over the past few years, a trend that we described last year as largely credit neutral for the securitizations.\(^\text{11}\) At that point, the GSE-eligible mortgages included so far had strong credit characteristics, more in line with those of prime jumbo loans than with the broader GSE mortgage universe. However, this was primarily a product of market pricing dynamics that made it more profitable for prime PLS issuers to include certain types of GSE-eligible loans with stronger credit characteristics in their deals rather than sell them to the GSEs. Looking ahead, raising GSE guarantee fees on high-balance mortgages would likely allow the PLS market to offer better execution than GSE sales with high-balance loans of even lower quality.

The credit effects of reducing the GSEs’ ability to finance weaker quality loans would similarly depend on the nature and degree of restrictions on the GSEs and the risk appetite of PLS investors, which has been much lower than in the pre-crisis period. The legal risks of non-QM loans may also factor into how active the PLS RMBS market would be in funding such loans, depending on how the looming end of the GSE patch is addressed. In addition, without other changes, FHA and other government programs would continue to offer significant pricing competition for loans with high loan to value ratios (LTVs) and other weaker attributes.

In the event that the GSEs completely stop financing certain types of loans, such as mortgages on second homes or refinance loans, PLS sponsors would not necessarily take on all of those loans, lessening the probability or potential size of credit negative effects on new PLS RMBS. For instance, under credit conditions similar to today, PLS issuers would be unlikely to embrace many of the lowest quality loans in those categories – such as ones with high LTVs and debt-to-income (DTI) ratios or other risk-layering – without significantly higher interest rates. And while higher rates could offset the increased risk, they would also curtail PLS RMBS volumes relative to their potential size. Furthermore, eliminating GSE competition for broad categories of loans would create a surge in potential supply for non-GSE financing sources, reducing PLS market participants’ incentives to continue loosening credit standards.

Because post-crisis mortgage underwriting has been broadly strong, as have the housing and job markets, losses have been very low across most broad categories of GSE-guaranteed mortgages (such as purchase, refinance and cash-out refi mortgages, or loans on owner-occupied, second homes and investor properties.) The widespread strength would also help limit the impact on CRT and PLS credit quality if regulators were to eliminate GSE financing in any of these categories.

Exhibit 4 shows the difference in loss rates across different vintages of Fannie Mae-guaranteed loans by occupancy status. The inset zooms in on post-crisis vintages. GSE investment property loans have generally suffered the biggest losses, though they have outperformed slightly in recent years. Loan attributes aside from occupancy status also differ across these categories, with the relative strength of their borrowers and underwriting changing over time, meaning that occupancy status alone has not driven the differences in performance among these mortgages.
Exhibit 4
Performance has varied across GSE mortgages in various occupancy categories but less in recent years
Net loss rates by vintage for loans tracked by Fannie Mae’s Data Dynamics portal

Source: Fannie Mae’s Data Dynamics information, Moody’s Investors Service

Exhibit 5 shows the difference in cumulative losses across different vintages of Fannie Mae-guaranteed loans by purpose. Cash-out refis have generally suffered the biggest losses, but the relative performance of other types of refis and purchase mortgages has varied under different underwriting and economic conditions.

Exhibit 5
GSE cash-out refis have typically performed worse than mortgages for other purposes
Net loss rates by vintage for loans tracked by Fannie Mae’s Data Dynamics portal

Source: Fannie Mae’s Data Dynamics information, Moody’s Investors Service

Reforms may also result in expanded GSE risk-sharing requirements that lead to more variety in CRT collateral and/or structures. That could include the GSEs’ sharing larger amounts of their initial or more remote loss exposures via their CRT deals. Or it could lead to risk-sharing on low-risk products such as low LTV mortgages (or additional risk-sharing tied to 15-year loans) or certain higher-risk products, such as adjustable-rate mortgages.

More broadly, reducing the GSEs’ footprints would be credit negative for outstanding CRT and PLS RMBS loans to the degree that it reduces support for home prices and homeowners’ ability to refinance. Post-crisis prime PLS RMBS that include mainly jumbo mortgages would likely be less affected than other RMBS because there is less overlap between GSE financing and the segments of property and borrower markets to which jumbo loans are tied. However, those deals would have some exposure because GSE
loan limits typically rise over time, some GSE-eligible loans are present in the transactions, and "move-up" homebuyers need to find purchasers for lower valued homes.

Finally, a very material lessening of the GSEs’ market share could also create significant credit negative ripples because of the variety of benefits that GSE CRT deals and the broader mortgage market derive from their large resources and market power, such as oversight of mortgage originators and servicers to the entire RMBS market and their ability to aggregate large amounts of data on mortgage performance and appraisals.12

**Homebuilders: Higher mortgage costs and lower mortgage availability would be credit negative for homebuilders**

*By Natalia Gluschuk*

A reduced GSE footprint that lowers the availability of affordable mortgage financing would likely reduce demand for homes, a credit negative for homebuilders. Outside the luxury segment, most homebuilders rely on their customers' obtaining mortgage financing to purchase homes. These mortgages are originated either as part of homebuilders' own financial services operations or through third-party lenders, and a large percentage is subsequently sold to the secondary market and guaranteed or insured by the GSEs.

If changes to the GSEs are gradual, the private market should be able to serve the incremental increase in home financing needs. However, home financing costs in the private lending market would likely increase, putting some pressure on potential homebuyers, particularly if the changes occurred in an environment with diminished affordability such as the current market.

The first-time homebuying segment is most at risk from GSE reform because it is most sensitive to cost changes and typically finances the highest proportion of the home purchase price. Much of this market is financed by FHA insurance and other government insurance programs, which if increased could offset the effect of a smaller GSE footprint.

Reduced availability and affordability of mortgages (until replaced by the private market) would affect both the new home and the resale home markets because individuals looking to purchase move-up homes will rely on the potential purchasers of their current homes qualifying for and obtaining mortgages.

To the extent reform leads to a reduction in types of eligible mortgages, such as vacation home and second home financing, it would have modestly negative implications for homebuilders that sell these products. However, these products typically represent only a small proportion of a homebuilder's revenue. Also, should difficulties in obtaining financing for these types of homes persist, homebuilders could shift their product mix away from such offerings.

With a reduced GSE footprint, homebuilders would need to form partnerships with private market lenders to assure that potential homebuyers are able to secure proper and timely financing. To the extent that customers cannot find sufficient financing, homebuilders could look to provide financing themselves. However, committing their own funds to financing would make homebuilders' operations even more capital-intensive, and only well-capitalized companies with strong balance sheets would be able to participate in such business.

**Mortgage Insurers: Reform could reduce GSEs' demand for mortgage insurance, a credit negative**

*By James Eck*

If GSE reform were to shrink the market share of Fannie Mae and Freddie Mac through changes to their current business practices, it would have significant implications for the business and financial profiles of the US private mortgage insurers (PMIs). Because the vast majority of loans insured by the PMIs are purchased by the GSEs, changes to GSE loan limits, guaranty fees, loan-level pricing adjustments (LLPAs) or eligible loan types have the potential to reduce demand for traditional mortgage insurance and gradually erode the profitability of the PMIs. Moreover, to the extent that GSE reform aims to increase private market competition in the mortgage credit risk transfer market, PMIs could face an additional threat to their entrenched market position, forcing firms to adapt in the years ahead.

The PMIs have long benefitted from provisions within the GSEs’ charters that require credit enhancement on mortgages with a loan to value (LTV) greater than 80% at the time the mortgage is purchased. Historically, this requirement has been met predominantly through the use of traditional mortgage insurance, resulting in robust ongoing demand for the product that helps
support the franchises of the PMIs. Even though legislative reform would be required to change this requirement in the GSEs’ charter, administrative reforms could still significantly alter the business prospects of the PMIs.

GSE reforms related to guaranty fees or LLPAs that result in a significant increase in the all-in cost of high-LTV loans for borrowers would lower consumer and lender demand for such loans and lower premium volumes for the PMIs, a credit negative. Furthermore, FHA loan execution would become more cost-effective across a wider range of FICO/LTV combinations, with the unintended consequence of pushing the market for mortgage credit enhancement away from the private market toward the FHA.

Any GSE reforms that reduce the quasi-regulatory demand for traditional mortgage insurance in favor of alternative sources of high-LTV loan credit enhancement would also reduce the PMIs’ core profitability prospects. In recent years, the GSEs have made significant use of innovative structured finance solutions to transfer mortgage credit risk to the private market, including the STACR/Connecticut Avenue securitizations that issue synthetic debt securities referenced to a pool of GSE mortgages and the ACIS/CIRT transactions, which cede risk layers in pools of GSE mortgages to diversified reinsurers.

Likewise, during 2018, both Fannie Mae and Freddie Mac introduced pilot programs designed to cede risk exposure on high-LTV loans to multiline reinsurers as an alternative to traditional mortgage insurance. These programs effectively serve as substitutes for single-premium mortgage insurance policies, which typically make up 15% to 20% of a PMI’s premium volume. The pilot programs are small and should have only a modest immediate effect on the PMIs, but they highlight the evolution of the mortgage credit risk transfer market and signal changes in the competitive dynamics of the mortgage insurance sector.

Other proposed GSE reforms include reducing loan limits or types of eligible loans, such as cash-out refinance and vacation home loans. However, mortgage insurance is primarily a product used by first-time homebuyers for purchase loan transactions. The average insured loan principal balance of around $250,000 is well below the 2019 GSE conforming loan limit of $484,350 ($726,525 in high cost areas). Likewise, cash-out refinance loans and loans on investor properties represent less than 1% of new business volume in the sector. Therefore, restrictions on cash-out refinance and vacation loans or modest decreases in loan limits would likely have only a modest impact on the mortgage insurers.

Despite the threats of declining product demand and increased competition for mortgage insurers that could emerge from GSE reform, the economic impact on the PMIs is likely to be gradual owing to the embedded profitability in their existing insured portfolios, on which they will continue to earn premiums. The greater challenge for PMIs may be how to successfully adapt their business models to the changing US mortgage finance market.

**FHLBanks: Increased mortgage market share for banks would enhance the FHLBanks’ market position**

*By Warren Kornfeld*

A reduced role in the housing market for Fannie Mae and Freddie Mac could drive substantial changes in the competitive dynamics of housing finance that enhance the market position of the FHLBanks, a credit positive. In particular, if US banks begin to originate a larger share of residential mortgages, they will likely take greater advantage of FHLBank advances for cost-effective funding. In addition, a smaller role for the GSEs could reduce the volume of their debt, increasing demand for FHLBanks’ debt and lowering their cost of funding.

The FHLBanks’ secured loans, or advances, outstanding to US banks were over $556 billion as of 31 December 2018. Since 2004 year-end advances to US banks have fluctuated between a low of $300 billion as of year-end 2011 and a high of $794 billion as of year-end 2007 (Exhibit 6).
US banks will most likely need incremental financing should their residential mortgage portfolios increase, which FHLBanks can readily supply. The primary collateral for advances (over 70%) is residential mortgage loans and securities. The FHLBanks have never incurred a loss on an advance in their more than 80-year history because of statutory protections, as well as conservative collateral policies and the ability to call additional collateral as a member bank’s financial condition deteriorates. In addition, FHLBanks require members to purchase more stock as they increase borrowing, which has proved an effective self-capitalizing mechanism.

Aside from boosting the role of the FHLBanks in funding US banks’ housing finance activity, reform that cuts the amount or creditworthiness of Fannie Mae and Freddie Mac debt could compress the FHLBanks’ debt costs until the market adjusts.

One potential credit negative for FHLBanks of a reduced GSE footprint stems from the current high market share of non-bank residential mortgage lenders, which could cause the FHFA to revisit its 2016 membership rule excluding captive insurance companies from FHLBank membership. The FHFA’s rule was issued in response to a dramatic increase in FHLBank advances by these captive insurers whose parent entities were otherwise ineligible, a practice that the FHFA viewed as circumventing the Federal Home Loan Bank Act. In most cases, the captives primarily served as conduits for their affiliates to access the FHLBank’s stable, low-cost funding, as they typically offered insurance coverage only to related entities. Captive insurance companies and their affiliates are financially weaker than traditional FHLBank bank and insurance members. In addition, there is a more limited track record of effective resolutions of captive insurance companies than of banks or traditional insurance companies.

We believe the continued success of the FHLBank System rests on its ability to maintain a consistent advance program with its traditional bank and insurance company membership. We note, however, that expanded membership, though negative for FHLBanks, would be a strong credit positive for non-bank mortgage companies (see page 4).

A number of GSE reform proposals have included a more diverse and expanded role for the FHLBanks. In addition, the 27 March Presidential memorandum directs the Treasury to determine the mission for the FHLBank system and its role in supporting Federal housing finance reform. We would likely view any expanded role of the FHLBanks as credit negative. The few past instances in which FHLBanks incurred financial stress largely related to new products outside their traditional business, particularly those focused on growth.

**Housing Finance Agencies: GSE reform may enhance HFAs’ competitiveness, but increased costs could pose short-term risks**

*By Ferdinand Perrault*

The GSEs are critical partners of state and local Housing Finance Agencies (HFAs) in providing affordable single-family and multifamily housing finance, and reform of the GSEs would therefore have implications for HFAs’ competitiveness and financial strength.

HFAs finance single-family mortgages for low or middle income first-time homebuyers and multifamily mortgages to developers of rental properties for low and middle income renters. Through tax-exempt bond financing, HFAs are able to provide lower mortgage

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**Exhibit 6**

FHLB Advances are an important source of liquidity for US banks

FHLB Advances Outstanding ($ billion)

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Source: FHLBanks Office of Finance, Moody’s Investors Service
rates than conventional lenders. HFAs finance a variety of loans, including loans securitized into GSE MBS, some of which they sell and some of which they retain in their portfolio.

Higher mortgage interest spreads following GSE reform would be positive for HFAs, enhancing their ability to outcompete conventional lenders by offering below-market-rate mortgages. In addition, higher mortgage interest rates will increase HFA margins, though not without some possible drawbacks: for example, should reform also diminish the credit quality of the GSEs, it could force HFAs to change their loan guarantee or mortgage insurance composition, though HFAs may use other loan-enhancement options to mitigate this risk.

If reform causes an increase in GSE guarantee fees, this would raise the cost of mortgages and possibly limit loan production, reducing the HFAs’ revenue and margin on loans securing their bond programs unless there’s an offsetting increase in mortgage rates. But increasing their mortgage rates would reduce HFAs’ competitiveness, so they are more likely to use alternative credit enhancement options to mitigate higher GSE guarantee fees. Another threat to HFA profitability would be reduced upfront premiums from the sale of MBS through the secondary “To-Be-Announced” (TBA) market, which has served as a primary source of down payment assistance for loan applicants in recent years.

If GSE reform substantially diminishes the credit strength of Fannie Mae and Freddie Mac, HFAs may shift further into Ginnie Mae securitizations or whole loan originations, possibly with either government or private mortgage insurance. Nongovernment insured whole loans would carry greater credit risk for HFAs because there is less coverage on defaulted loans, and they would also introduce counterparty risk to HFA programs.

GSE reform that reduces the GSE footprint for multifamily loans would result in either lower HFA volume or greater use of alternative credit enhancement for their multifamily loans. Options include obtaining insurance through various FHA programs or support from participating banks in the form of letters of credit. HFAs may also choose to pledge their own agency resources to cover the loans or alternatively remove their credit risk on the loans by pursuing more conduit financings.

If GSE reform results in new loan limits or restrictions on the types of eligible loans, HFAs are unlikely to be affected since generally their loans are already capped at levels below the GSE conforming limits.

**CMBS: Reform could increase volatility in the sector by reducing capital available to multifamily borrowers**

*By Gregory Ingaglio*

A decreased role for Fannie Mae and Freddie Mac in the multifamily market as a result of reform could have negative long-term effects on the multifamily sector and commercial mortgage backed securities (CMBS). When many private lending institutions cut mortgage loan volumes during the financial crisis, the GSEs continued to provide a steady source of liquidity for multifamily properties. But comprehensive reform could shrink the level of capital available to multifamily borrowers, making it more difficult for CMBS borrowers to refinance loans or transact properties. The reduction of available capital could also result in more volatile valuations for multifamily properties, increasing the likelihood of ratings movement in the CMBS sector.

A decreased role for the GSEs would also have a significant impact on the refinance and recapitalization of workforce housing and smaller affordable multifamily properties in existing CMBS transactions. Under the current format, GSEs are required to meet certain affordable housing goals, which were established to promote a stable and liquid market for mortgages on affordable properties. The current multifamily goals (2018-20) require that Fannie Mae and Freddie Mac finance at least 315,000 units for low-income renters each year, including 60,000 units for very low-income renters and 10,000 units for low-income renters in small multifamily properties (5 to 50 units). Given the GSE focus on creating a platform for affordable housing, reform could significantly reduce sources of funding for CMBS borrowers of workforce housing, including properties classified as Class B and Class C assets. The GSEs also provide critical sources of capital for senior housing, student housing, manufactured home communities and smaller multifamily properties (50 units or less). These types of multifamily properties, including those backing loans that are pooled in CMBS, would be negatively affected by any reduction in the availability of mortgage financing as a result of GSE reform.

Reduced availability of GSE mortgage debt could also impact the refinancing of CMBS properties in secondary and tertiary markets. Multifamily properties in major markets such as New York City, Chicago, Los Angeles, San Francisco and Washington D.C. tend to
attract financing from a greater pool of lending institutions (e.g., REITs, life insurance companies, commercial banks). But underserved markets and rural communities often rely on targeted GSE lending programs, which could be reduced or eliminated with reform. The impact of reform would likely be more substantial for CMBS borrowers with properties outside major metropolitan areas owing to reduced available capital and a smaller pool of institutions willing to refinance multifamily complexes in smaller markets.

In addition to the availability of capital, GSE reform could also increase the cost of capital for the market. For conforming mortgages, the GSEs have typically been able to provide loan coupons at or below those offered by CMBS and other lending institutions. A restructuring of the GSEs could result in higher mortgage rates, which in turn would raise the cost of capital for borrowers. Since property prices are affected by capital costs, more expensive mortgage debt could contribute to a reduction in prices for multifamily properties in any given market.

The aforementioned effects of GSE reform would be more acute during periods of high economic stress. During the last economic downturn, the federal government ensured the availability of liquidity through the market cycle by providing mortgage financing through the GSEs. But reform could significantly reduce the role of GSEs and their ability to provide liquidity to the mortgage market, particularly during high-stress capital market conditions. However, during periods of low and moderate stress, we believe that the negative effects of GSE reform on the multifamily market would be muted. There are several CMBS lenders that compete for the mortgage volume financed by the GSEs during periods of low and moderate economic stress. If GSE reform occurs, CMBS lenders could fill the gap of credit availability during moderate stress periods; however, the cost of capital provided by CMBS lenders would likely be higher. As a result, there would likely be a concomitant modest decline in property values in the multifamily sector, which would increase the volatility associated with outstanding CMBS ratings.

Multifamily REITs: Apartment REITs have financial means to weather GSE reform, which could also create opportunities

By Juan Acosta

Change in the GSEs’ mandate or a reduction in the size and scope of their activities could disrupt the US multifamily market, including the housing REITs, potentially shrinking a significant source of external financing, as well as causing borrowing rates to rise and property values to drop.

While Fannie Mae and Freddie Mac play an important role as guarantors of multifamily mortgages, to which the housing REITs have exposure, they also serve as credit enhancers, in partnership with the HFAs, on tax-exempt bonds that some apartment REITs have issued in the past to finance acquisitions or other business activities. A loss of liquidity or guaranty from the GSEs on these long-term, tax-exempt bonds may cause, among other negative consequences, the REITs to repay these obligations on short notice, impacting their liquidity.

However, the implications of GSE reform for the stronger investment-grade apartment REITs, including those that Moody’s rates, will be more muted than for other constituents of the housing sector. The stronger apartment REITs have lowered their reliance on secured debt and, correspondingly, have less exposure to GSE-guaranteed financing. These firms currently fund growth and other business activities primarily through unsecured borrowings, as part of a strategy to maintain flexible capital structures. Moreover, they have lowered their leverage over the last decade, broadened their capital sources and improved their liquidity buffers, allowing them to absorb the impact of the potential reforms. Lastly, GSE reform may create a competitive advantage for the apartment REITs, because of their superior liquidity and greater access to the corporate debt market compared with smaller, less well-funded apartment investors that rely on traditional sources of mortgage financing. Moreover, a reduced pool of buyers will result in less competition for these REITs.

Apartment REITs’ primary funding source is now unsecured borrowing, and credit metrics have improved

After the liquidity freeze and loss of capital market access during the 2008-10 financial crisis, the major apartment REITs shifted strategy and now fund operations primarily with long-term, unsecured borrowings. Because of their tax structure and capital-intensive business, these firms seek to maintain access to the full spectrum of public and private capital, using a committed unsecured revolving line of credit ("the revolver") as the main source of immediate liquidity. These revolvers can typically range from $500 million to $2.0 billion, with additional borrowing capacity available under an accordion feature. Outstanding balances on the revolver are typically repaid with retained cash, combined with proceeds from long-term unsecured debt offerings in the bond markets, equity issuances, noncore asset sales and, in some instances, capital raised from joint ventures.
Additionally, to optimize their blended cost of capital, these public companies supplement unsecured financings with common equity offerings via their “at-the-market” (ATM) programs, as well as with secured and unsecured bank term loans, securitizations and traditional mortgages. Equally important to note is that because of the institutional investment quality and large “ticket prices” of the properties owned and sold by the apartment REITs, the most active acquirers of these assets (mainly pension funds, life insurance companies, opportunity funds or other real estate firms, including REITs) are “cash buyers”, who also do not necessarily use the GSEs as their main financing source. The effect of the apartment REITs’ shift in funding strategy along with their increase in size over the past decade is evident in the significant decline of their secured debt as a percentage of both gross assets and total debt (Exhibits 7 and 8).

Consequently, the REITs’ exposure to GSE financing or credit enhancements has also declined, as the companies have broadened their access to various sources of long-term unsecured capital to repay or refinance their secured debt upon maturity with unsecured debt (Exhibit 9).

Since 2008, the six investment-grade apartment REITs that Moody’s rates have improved their aggregate credit strength, growing their asset base and cash flow streams, and maintained discipline over their indebtedness levels (Exhibit 10).
Exhibit 10
Improvement in leverage metrics

Source: Companies’ SEC filings and Moody’s Investors Service

Apartment REITs can weather, and perhaps benefit from, GSE reform

As of year-end 2018, the higher-rated multifamily REITs have excellent financial flexibility, supported by a large unencumbered asset base (an average of about 85% of gross assets) and an average fixed charge coverage ratio exceeding 4.0x. These REITs have ample financial cushion against unexpected cash flow declines or a spike in interest expenses (Exhibit 11).

Exhibit 11
Increased financial flexibility

Source: Companies’ SEC filings and Moody’s Investors Service

One potential positive implication for multifamily REITs from the potential reforms is that there may be a smaller pool of well-funded buyers for good-quality multifamily properties, since investors in such properties have typically underwritten their acquisitions based on obtaining GSE-guaranteed loans. A smaller buyer pool may create more buying opportunities for apartment REITs, whose robust liquidity and quick access to capital provide substantial dry powder.

Another positive implication for the apartment REITs is that rental demand could increase if single-family mortgage loan standards are significantly tightened, affordable financing becomes less available, and prospective homebuyers delay or drop the decision to purchase a home.
Single-family rentals by institutional landlords: Reform that increases homeownership costs would be credit positive for the sector
By Thuy Nguyen

A reduction in the GSEs’ footprint could raise the hurdles to qualify for a mortgage, reducing access to credit, increasing homeownership costs, and spurring greater demand for rental properties, a credit positive for the institutional single-family rental market.

One way to reduce the GSEs’ footprint would be to tighten minimum credit requirements, such as by lowering the maximum debt-to-income ratio, increasing the minimum credit score, or lowering loan-to-value (LTV) requirements. Such measures would likely put affordable financing out of reach of some would-be first-time homeowners, especially those with less than stellar credit. Reform that reduces GSE loan limits would likely be a more modest positive for single-family rental companies, since most loans to first-time homebuyers are typically below the GSE conforming limits.

A small but growing portion of the single-family rental market consists of properties owned and operated by institutional market participants, including single-family REITs. Unlike first-time homebuyers, these REITs do not rely on GSE financing. They acquire single-family homes through bulk portfolio purchases or through outlets that are unfamiliar to a typical homebuyer, such as foreclosure auctions and broker sales (multiple listing service and short sales) in all-cash transactions funded primarily by unsecured corporate debt and equity financing. The foreclosure inventory has shrunk as the financial crisis recedes, but the institutional appetite to own single-family rental properties continues to grow. Therefore, single-family rental REITs have looked to other sources of supply, including newly constructed “built for rental” properties that they either acquire from third-party developers or build themselves through their internal construction programs.

A reduction in the types of mortgages eligible for purchase by the GSEs, such as those for financing vacation homes or second homes, would have little impact on most institutional single-family rental companies. For example, the single-family rental REIT that we rate focuses on properties located in middle-class neighborhoods with highly rated school districts to attract tenants with high credit quality and a propensity to stay in the property longer. Substantially all of the leases have a duration of one year.

US Sovereign: Reform would likely have only a modest impact on the government’s mortgage credit risk contingent liability
By William Foster

If the role of Fannie Mae and Freddie Mac is diminished as a result of reform, the US government’s contingent liability would most likely not decline materially but instead transfer from the two GSEs to the parties, such as US banks, that replace them as holders of long-term mortgage credit risk. In this event, unless mortgage risks change appreciably and thereby affect contingent liability risks, the transfer would be credit neutral for the US sovereign.

The government has direct exposure to the two GSEs pursuant to the terms of their amended Senior Preferred Stock Purchase Agreements (SPSPAs), which Fannie Mae and Freddie Mac each entered into with the US Treasury when they were placed into conservatorship in September 2008. Under the terms of the SPSPAs, which have been amended three times, the US Treasury is obliged to recapitalize the GSEs if they register negative equity at the end of any given quarter. A total direct exposure of $189 billion (0.9% of GDP) has been assumed by the government under this facility, with a remaining undisbursed contractual commitment currently standing at $258 billion (1.3% of GDP). Under the terms of the amended SPSPAs, Fannie Mae and Freddie Mac are now each permitted to retain $3 billion in capital.

In addition to the direct obligation, under Moody’s Global Sovereign Bond Methodology the GSEs are considered a major contingent liability of the US government; however, their liabilities are not counted as direct government obligations. Fannie Mae and Freddie Mac hold or guarantee about 50% of outstanding US mortgages, acting as a linchpin of the housing segment of the US financial system. They have combined total assets of $5.5 trillion (27% of 2018 estimated GDP). By comparison, there is $16.3 trillion in US federal government market debt held by the public (Exhibit 12).
The US government’s contingent liability supporting the US housing market would most likely remain even if the role of the GSEs is diminished or eliminated. Given the importance of housing finance to the US economy, the government’s contingent liability would likely transfer from the two companies to their replacements, whether these are US banks or other existing or newly created financial institutions.

Housing activity involving fixed investment in residential real estate and consumption spending on housing services is integral to the US economy, although it has been moderating as a share of GDP since the mid-20th century. According to the National Association of Home Builders (NAHB), housing’s combined share of GDP has declined to about 15% of GDP in 2018 (3.3% for residential fixed investment + 11.6% for housing services) from about 17.5% in 1980. Should GSE reform reduce the accessibility or affordability of prime residential mortgages, it could temper the ongoing cyclical recovery in housing or steepen the long-term decline in such activity.
Endnotes

1 Fannie and Freddie were placed into conservatorship in September 2008.
2 FHFA was established by the Housing and Economic Recovery Act of 2008 (HERA) and is responsible for the effective supervision, regulation, and housing mission oversight of Fannie Mae, Freddie Mac and the Federal Home Loan Bank System, which includes the 11 Federal Home Loan Banks (FHLBanks) and the Office of Finance. Since 2008, FHFA has also served as conservator of Fannie Mae and Freddie Mac.
4 Non-agency loans are loans that are not insured by Fannie Mae, Freddie Mac or the government.
5 Federal Housing Administration (FHA), Veterans Affairs (VA), and the United States Department of Agriculture (USDA).
6 Non-agency loans are loans that are not insured by Fannie Mae, Freddie Mac or the government.
7 See, Key considerations for operating environment, 5 February 2019.
8 Home Mortgage Disclosure Act (HMDA) data.
9 After the financial crisis a number of non-bank mortgage lenders obtained membership in FHLBanks by creating captive insurance companies.
10 The GSE QM “patch” is a temporary measure that will expire on January 10, 2021, or when the GSEs exit conservatorship. It allows mortgages eligible for purchase by Fannie Mae or Freddie Mac to win a safe harbor from QM lawsuits even when they have debt-to-income ratios above 43%.
11 See Inclusion of GSE-eligible loans in private-label pools will likely remain credit neutral, June 22, 2018.
13 Source: FHFA.
14 Equity Residential (A3 stable); AvalonBay (A3 stable), Camden Property (A3 stable); UDR (Baa1 stable) Essex Property (Baa1 stable) and Mid-America Apartments (Baa1 stable). These REITs are among the highest rated corporate entities in Moody’s universe of rated issuers.
15 An accordion is an incremental loan to the revolving credit agreement that allows the borrower to increase the borrowing commitment to a specified amount under certain terms and conditions.
16 This graph does not include the REITs’ joint venture exposure to GSE debt.
17 The perimeter excluding institutions such as the GSEs from the general government balance sheet is similar to that for other sovereigns.
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# Cross-Sector – United States Housing and Housing Finance: Changes to Fannie and Freddie mandate will ripple across housing and mortgage markets

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