Overview of FNMA DUS Securities

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For the vast majority of credit unions, one of the greatest challenges when investing in the MBS market is forecasting prepayment activity, and quantifying call risk (prepayment) and extension risk. Recently, this prepayment uncertainty has been exacerbated due to concerns over HARP and other potential government-sponsored refinancing programs. Obviously with some mortgages trading at significant premiums, being able to quantify the prepayment risk of premium MBS is that much more difficult and critical to managing cash flows and maximizing returns. Likewise, given the recent sharp jump in interest rates, many are now concerned about declining prepayments and extension risk.

Here, we discuss how FNMA DUS MBS could be an attractive investment alternative to traditional MBS securities and Agency debentures. This investment may be suitable for credit unions seeking high quality assets that offer additional yield ***while minimizing prepayment risk and extension risk.***

Background

The Fannie Mae (FNMA) Delegated Underwriting and Servicing (DUS) program started in 1988 with securitization beginning in 1994. These issues have grown in supply and demand in recent years because of the increased demand for rental housing since the housing market crash.

Due to their steady and rapid growth, coupled with greater access to timely data and enhanced analytics, the FNMA DUS market has now achieved a "critical mass." As a result, the liquidity of the market has improved significantly. Fannie Mae is now the nation's largest single participant in multifamily mortgage financing, accounting for 21% of outstanding multifamily mortgage debt. Fannie Mae's multifamily book of business is well over $200 billion.

INVESTMENT SNAPSHOT
FNMA DUS

Aaa/AA+-rated credit strength
Stable monthly cash flows
Limited prepay/extension risk
Greater yield vs. Agencies

Going forward, home ownership rates are expected to continue to decline as more households choose renting over buying. As a result, the expected jump in multifamily construction will likely result in increased issuance of multifamily mortgage backed securities.

DUS Collateral Characteristics

FNMA MBS/DUS loans can be made to purchase, refinance or rehabilitate ***existing income producing multifamily rentals, with a minimum of five residential units' properties***. Residential properties – apartment buildings, rural housing, senior housing, co-operative housing projects, and manufactured housing communities – are eligible collateral for FNMA DUS MBS securities. ***That said, more than 90% of outstanding loans are backed by standard multifamily collateral.*** Loan sizes range from $1 million-$50 million.

Strict Underwriting and High Credit Standards

DUS loans are multifamily mortgages originated by a group of approved private lenders on behalf of Fannie Mae. Currently, Fannie Mae has 25 approved DUS lenders that underwrite, close and service multifamily mortgage backed securities. It is important to note that admission qualifications for consideration to be a DUS lender are stringent. Each lender must maintain acceptable levels of capital and liquidity in relation to its Fannie Mae obligations.

Also, lenders must enter a loss-sharing agreement with Fannie Mae and set aside capital reserves to comply. This loss-sharing element is an incentive for DUS lenders to better manage credit exposure, leading to lower loss and delinquency levels. ***Historically, DUS MBS have been one of the best asset quality products that FNMA securitizes, with delinquency rates as low as 0.52%.***

Types of Multifamily Mortgaged Properties Eligible for DUS MBS

Standard Conventional Multifamily	A multifamily loan secured by a residential property composed of five or more dwelling units and in which generally, no more than 20% of the net rentable area is rented to, or to be rented to, non-residential tenants
Multifamily Affordable Housing and Low-Income Housing Tax Credit	A multifamily loan on a mortgaged property encumbered by a regulatory agreement or recorded restriction that limits rents, imposes income restrictions on tenants, or places other restrictions on the use of the property
Cooperative Blanket	A multifamily loan made to a cooperative housing corporation and secured by a first or subordinate lien on a cooperative multifamily housing project that contains five or more units
Dedicated Student Housing	Multifamily loans secured by multifamily properties in which college or graduate students make up at least 80% of the tenants
Seniors Housing	A multifamily loan secured by a mortgaged property that is intended to be used for elderly residents for whom the owner or operator provides special services that are typically associated with either “independent living” or “assisted living.” Some Alzheimer’s and skilled nursing capabilities are permitted.
Manufactured Housing Community	A multifamily loan secured by a residential development that consists of sites for manufactured homes and includes utilities, roads and other infrastructure. In some cases, landscaping and various other amenities such as a clubhouse, swimming pool and tennis and/or sports courts are also included

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Types of Multifamily Mortgaged Properties Eligible for DUS MBS *(continued)*

Military Housing	A multifamily loan secured by a multifamily property in which more than 20% of the units are occupied by persons serving in, or employed by, the military or which is located in an area where military and military-related employment accounts for 20% or more of the local employment base
Rural Rental Housing	A multifamily loan secured by an affordable multifamily property located within specified rural areas designated by the Rural Rental Housing Guaranteed Loan Program of the USDA. The USDA guarantees up to 90% of any loss incurred upon liquidation of loans it has approved, provided that the loan was underwritten and serviced in accordance with the USDA requirements.

Source: Fannie Mae

Each mortgage is underwritten to a three-tier credit structure. The most favorable interest rates are available loans with higher debt-service-coverage ratios (DSCR) and lower loan-to-value (LTV) ratios.

Tier Level Credit Characteristics

Credit Quality	DSCR	LTV
Tier 2	1.25	80
Tier 3	1.35	65
Tier 4	1.55	55

Source: Fannie Mae

The Fannie Mae Guarantee

Like traditional Agency MBS securities, DUS pools guarantee timely interest and principal payments. This includes monthly interest and the balloon payment. In the event of a loan default that is not cured for four consecutive months (120 days), Fannie Mae will pay the outstanding principal balance at par to investors, regardless of recovery from the mortgagor. The Fannie Mae guarantee on DUS MBS mirrors that provided for single-family Fannie Mae MBS. ***It is important to note that Fannie Mae has never missed a scheduled payment of principal and interest on any of its MBS, single-family or multi-family.*** Any loan that has voluntarily prepaid FNMA would pass on any prepayment penalty collected after deducting its share of the penalty.

DUS – Fixed of Floating

DUS loans can be fixed or floating. Fixed-rate multifamily mortgage loans usually have final balloon maturities of five, seven, 10, 15, 18, 25 or 30 years, while adjustable-rate mortgage loans usually have final balloon maturities of five, seven or 10 years. It should be noted that floating rate DUS bonds typically have a conversion feature that allows the mortgagee to convert to fixed rate without penalty. The bond would be paid at par to investors if executed. There is usually a one-year lockout from the time of issuance before the conversion would be allowed.

Despite the shorter loan maturity, most DUS paper amortizes over a 30-35 year amortization schedule. There is little amortization of principal over the life of the loan, resulting in a balloon payment at maturity. At maturity, the investor is paid a balloon payment equal to the unpaid principal balance.

The most common DUS MBS is a 10/9.5 fixed rate (a 10-year balloon with 9.5 years of yield maintenance). Commonly referred to as 10/9.5 pools, they represent about 67% of the DUS universe. The second most common structure is a “7/6.5,” a seven-year balloon with 6.5 years of yield maintenance.

Top Four Fannie Mae MBS/DUS Pool

Prefix	Definition	Outstanding (Billions)	% of Total MBS/DUS
HY	Conventional, Balloon, Actual/360 interest day basis calculation Multifamily; maturing or due in seven years or more.	**$36.6**	**67%**
HX	Conventional Short-Term, Balloon, Level-Payment Mortgages; Actual/360 interest day basis calculation; Multifamily; maturing or due in seven years or less.	**$11.4**	**21%**
HA	Conventional Adjustable-Rate, Actual/360 interest day basis calculation; Multifamily; maturity dates vary.	**$3.5**	**6%**
MY	Conventional Balloon, Level-Payment Mortgages; Multifamily; maturing or due in seven years or more.	**$1.0**	**2%**

Source: Fannie Mae

Call Protection

Most FNMA DUS loans have a ***yield maintenance*** provision designed to discourage the borrower from voluntarily prepaying the mortgage note and to fully compensate the investor in the event the borrower voluntarily prepays his loan. In essence, yield maintenance is a prepayment penalty that, in the event the borrower pays off a loan before maturity, allows the lender to attain the same yield as if the borrower had made all scheduled mortgage payments until maturity. Yield maintenance premiums are designed to make lenders indifferent to an early prepayment by the borrower. The yield maintenance charge is also called the ***make-whole charge*** making it uneconomical for the borrower to refinance solely to get a lower mortgage rate.

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For example, let's assume a 15-year interest-only $1,000,000 mortgage at 5%. After the fifth year, the borrower decides to refinance. The yield maintenance prepayment penalty would equal the difference between the current 5% rate and the yield that the bank would receive reinvesting the loan proceeds in a 10-year Treasury note (the remaining term of the loan).

Now let's assume that at the time of prepayment, the 10-year Treasury note rate is 3%. The borrower would be required to pay the lender the present value of the 2% difference for each year over the loan's 10 remaining years, or $200,000. This penalty would make the lender "whole" and ensure that the lender would not experience an economic loss as a result of being paid prior to the loan's maturity. Each lender will have a slight variation of this formula, however this example conveys the spirit of the yield maintenance penalty.

While yield maintenance provisions are the most common means of prepayment protection, defeasance, lock-outs and prepayment penalties are also used to a much lesser extent.

- The prepayment lockout is a contractual agreement that prohibits voluntary prepayments during a specified time: the lock-out period. After the lockout period, some offer call protection in the form of prepayment penalties. Prepayment lockout and defeasance are the strongest forms of prepayment protection.
- With defeasance, rather than loan repayment, the borrower provides sufficient funds for the servicer to invest in a portfolio of Treasury securities that replicates the cash flows that would exist in the absence of prepayments.
- Prepayment penalty points are predetermined penalties that must be paid by the borrower if the borrower wishes to refinance. For example, a 5,4,3,2,1 prepayment penalty point structure means that if a borrower wishes to prepay during the third year, the borrower must pay a 3% penalty ($103 versus $100).

Default Risk

Involuntary prepayment from a default is the only situation that would negatively affect a FNMA DUS cash flow because the investor is not compensated for the early prepayment, but is paid off before the intended maturity date at par. Defaults have been rare, and the serious delinquency rate (60+) is only 0.46% of all outstanding loans. ***Once again, the superior performance of FNMA DUS is due to the underwriting criteria required of borrowers and the loss sharing that puts the FNMA DUS lender's own capital at risk on each loan they service.***

The next chart lists prepayment scenarios, prepayment fees and the amount passed to the investor.

Summary of Prepayment Events

Prepayment Event	Prepayment Fee	Amount Passed to Investor
Borrower prepays *during* the Yield Maintenance Period.	The greater of: (a) 1% of the amount of principal being prepaid **OR** (b)the product obtained by multiplying (1) the amount of principal being repaid by (2) the result of a. the interest rate on the mortgage loan ***minus*** the yield rate on the U.S. Treasury security *by* b. the present value factor calculated by using the present value formula.	The investor portion will equal the following: (1) the amount of principal being prepaid, ***times*** (2) the difference between the pass- through rate on the certificates and the yield rate, ***times*** (3) the present value factor.

Summary of Prepayment Events *(continued)*

Prepayment Event	Prepayment Fee	Amount Passed to Investor
Borrower prepays *during* the Prepayment Period.		Investor receives unpaid principal balance at par
Borrower prepays after maintenance period ends AND *prior* to three months before maturity	1%	No Prepayment Fee to the investor. Investor receives unpaid principal balance at par.
DUS loan is in default and is removed from the DUS pool or is in condemnation proceedings against the property or casualty losses occur during the loan term	Not Applicable	No Prepayment Fee to the investor. Investor receives unpaid principal balance at par.

Source: Fannie Mae

Who Buys DUS MBS

Almost all types of fixed income investors – banks, credit unions, insurance companies, pension funds, and money managers – invest in FNMA DUS. Insurance companies, pension funds and financial institutions benefit from the FNMA DUS stable cash flows and strong prepayment protections that permit these institutions to match future liabilities. Money managers like the higher yields (versus similar duration, high grade corporate and Agency bonds) and the positive convexity which helps mitigate the negative convexity of single-family MBS.

Investment Characteristics of FNMA DUS Bonds

Stable Cash Flows

FNMA DUS generate "bullet" like cash flow characteristics and as such, are effective in smoothing out cash flows in portfolios that are heavily front-loaded with traditional residential MBS. This helps to mitigate the reinvestment risk, shrinking book yields and declining net interest margins experienced lately in most credit unions and banks. For financial institutions that foresee a margin squeeze for their institution, as rates stay low or flat, FNMA DUS securities offer an opportunity to lock in attractive spreads now, with limited extension and prepayment risk.

Roll-Down

Also, because of the structure of the loans and prepay protections, these bonds typically roll down the curve better. Although multifamily products tend to have longer initial average lives than most of the traditional MBS, the effect of "rolling down the curve" helps mitigate that risk.

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Limited Extension Risk

FNMA DUS bonds are mortgage-backed securities, but they compare more closely to bullet type Agency debentures. There is very little extension risk due to the balloon maturity, and the yield maintenance feature strongly deters the borrower from early prepayment. These features allow investors to more precisely target when they will receive their principal back. As such, FNMA DUS MBS could be used as alternatives to Agency bullets in laddering fixed income maturities. Also, FNMA DUS typically have wider spreads than comparable bullets.

In the next chart, take a look at the position of a typical new issue FNMA DUS structure (7/6.5 year). The cash flow is based on a 30-year principal amortization schedule, but the bond has a seven-year balloon maturity on 05/01/2020 (6.3 yrs average life at 0 CPY). The yield to maturity is 2.33%, and this translates to a 55 basis point spread to Treasuries and +32 bps to swaps. This bond has yield maintenance protection in effect for 78 months (6.5 years).

The investor will receive monthly principal cash flow (30-year amortization schedule), but the majority of cash flow is expected on 10/01/2018 (the end of yield maintenance, when the borrower can prepay without penalty).

New 7/6.5 Year FNMA DUS

	Market Price	Average Life @ 0 CPY*	Yield	Spread to Treasuries	Spread to Swaps
New Issue 7/6.5	98-08	6.3	2.33	+55	+32

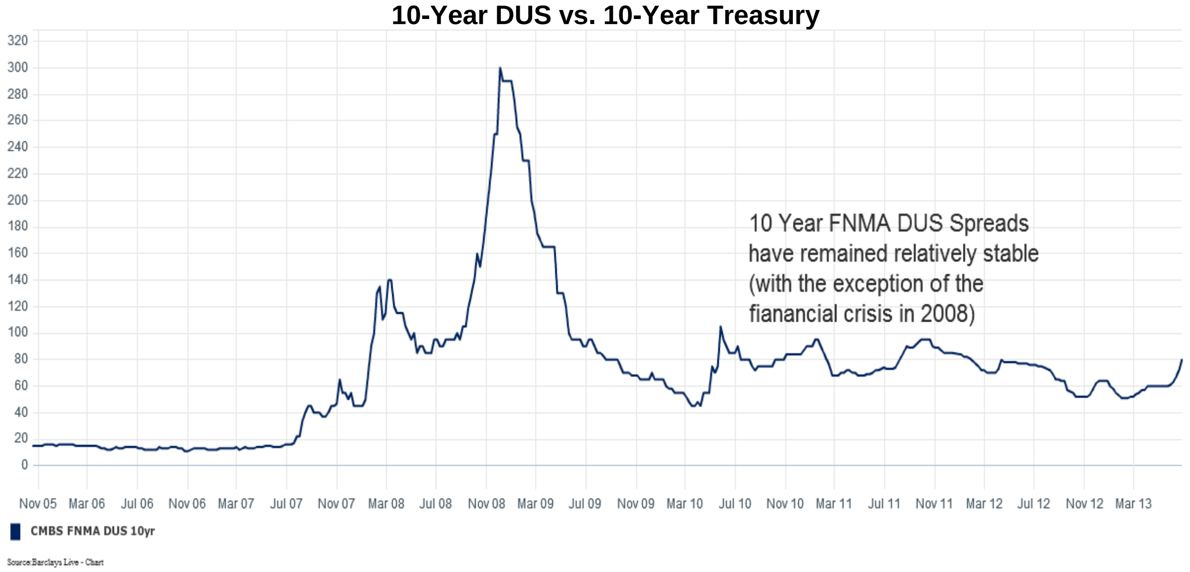
***On more recent issuance FNMA DUS MBS, the pricing convention is to run to 0CPY assumptions. On seasoned premium-priced DUS pools/Megas the convention is to run the collateral at 100CPY, which essentially assumes that all loans pay down at their first open date. For example, 10/9.5 loans this would be at the end of 9.5 years.

Diversification

FNMA DUS collateral is an excellent way to diversify away from traditional, single-family mortgage collateral because the mortgagee reacts differently to changing interest rates and refinancing opportunities. By building a portfolio of DUS MBS pools, investors can diversify by borrower and geography. Or to improve liquidity, reduce the idiosyncratic risk associated with a single loan, and ease operational administration, DUS pools can be pooled together via a Mega or a CMO (under the ACES program).

DUS Spread History

As shown in the next graph, FNMA DUS securities have historically maintained an attractive spread to Treasuries. And, the spread has remained relatively stable (with the exception of the 2008-2009 financial crises).



Conclusion

Historically, DUS MBS has been one of the highest asset quality products that FNMA securitizes. Due to the attractive yields, highly defined principal window and stable predictable cash flows, DUS bonds can be used as an alternative investment to Agency bullets, callables or traditional single family amortizing Agency MBS.

In summary, the highlights of DUS MBS are:

- The Aaa/AA+ rated credit strength is due to Fannie Mae's guarantee of timely payment of principal and interest
- Pools are backed by loans on existing, income-producing multifamily properties
- FNMA DUS lenders required to share risk of loss if default occurs
- Limited prepayment and extension risk
- Stable monthly cash flows that are easy to model
- Wide variety of maturity and amortization options (5-30 years)
- Lower spread volatility relative to other fixed income products
- Greater yield versus similar duration agencies and corporate securities
- Liquidity enhanced from large number of dealers involved in market making

To obtain more information about credit union investment strategy, portfolio allocation and security selection, please contact the author.