AMERICAN ACTION FORUM

Understanding the Multifamily Mortgage Market

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Introduction

Single-family mortgages dominate discussions of the mortgage market and, especially, the housing government-sponsored enterprises (GSEs). But the GSEs have a significant history with the multifamily sector as well. As a paper commissioned for the National Housing Council put it:

> *The debate on the future Fannie Mae and Freddie Mac (the "Government-Sponsored Enterprises" or "GSEs") has focused principally on the role of these entities in financing single-family homeownership. However, the GSEs have also played a major role in financing multifamily housing, including especially multifamily rental housing….The GSEs' proper role deserves evaluation in its own right, apart from any evaluation of the GSEs' activities in single-family housing.*[1]

As it stands, multifamily rental housing accounts for 15 million (13 percent of) households and 43 percent of renters.[2] However, as cities increasingly become the focal points of the country's economic growth potential, multifamily housing will naturally become a centerpiece of the economic landscape of the 21st century. From a policy perspective, growing concerns over the costs of traffic congestion, the beneficial productivity effects of human capital agglomeration when people live in dense urban environments, and the gradual graying of the country's population will necessarily dampen the traditional focus on placing every person into a single-family detached home with a yard.[3] In the immediate future, the fallout of the painful collapse in the single-family mortgage-backed security market will drive a need to consider other housing options.

The U.S. will experience a net growth in population of over 122 million persons from now until 2050. Although the actual population growth rate is projected to decline, it will still remain in the 0.8-1.0 percent change per annum range.[4] This growing population will require significantly more housing, regardless of housing type (single or multifamily), even if we allow for changing patterns in average household size.[5]

Market Linkages: Single Family vs. Multifamily Housing

The relationship between the single-family mortgage market and the multifamily rental market is complicated and dynamic. For example recently, as house prices continued to fall or at best languish, the market for rental housing has heated up. As the homeownership rate fell from its peak of over 69 percent in 2006, nearly two million households were displaced from owner-occupied homes and forced to seek other living accommodations. This increase in demand for rental properties, combined with a general constraint in rental

[1] Ethan Handelman, David A. Smith, and Todd Trehubenko, "Government-Sponsored Enterprises and Multifamily Housing Finance: Refocusing on Core Functions," National Housing Conference, October 2010.

[2] 2009 American Housing Survey Table 1-1. U.S. Census Bureau.

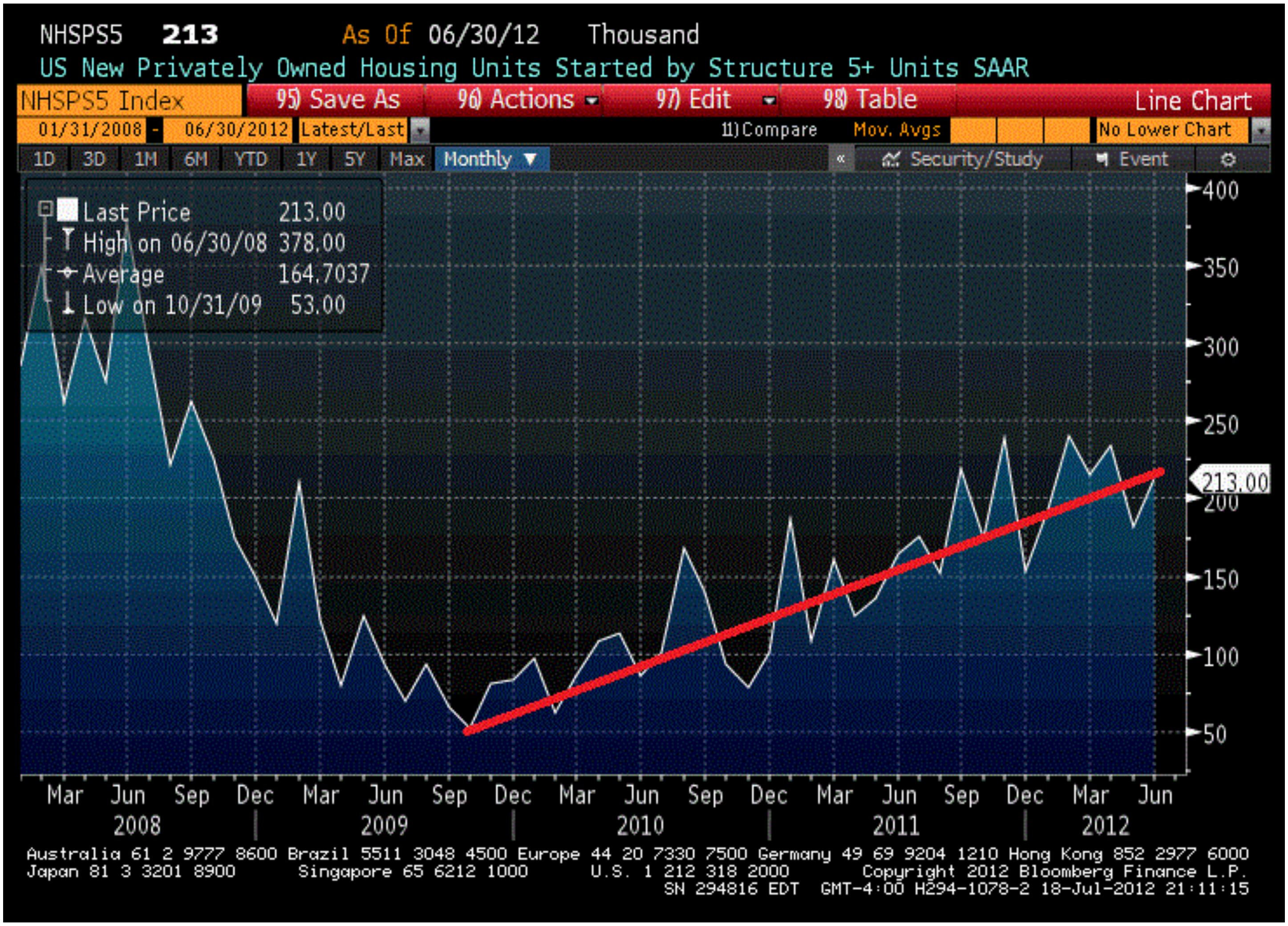
[3] Edward L. Glaeser and Joshua Gottlieb, "The Wealth of Cities: Agglomeration Economies and Spatial Equilibrium in the United States," *Journal of Economic Literature*, vol. 47(4), pp. 983-1028, December 2009.

[4] U.S. Census Bureau, National Population Projections, 2008.

[5] Haya El Nasser and Paul Overberg, "After 50 years of decline, household size is growing," *USA Today*, May 5, 2011, http://www.usatoday.com/news/nation/census/2011-05-04-Census-Households-Demographics_n.htm.

construction, has led to price increases in the rental space far above the prices in single-family purchases.[6] While one might think that low financing costs would tend to offset the pressure of higher prices, the evidence that declines in the mortgage financing costs for multifamily housing are passed onto renters is weak.[7] Shown in Figure 1, multifamily housing starts have been trending upward since 2009 in response to increase demand for rental units.

Figure 1: Multifamily Housing Starts



When house prices drop, especially in a low-interest rate environment like today, one might expect that renters will make the switch to homeownership, thereby acting as an equalizing force on the relative price of the two options. But that simple story is complicated by a pessimistic outlook for home-price appreciation (the expected investment payoff), a growing preference toward renting (especially in urban cores by upwardly

[6] Motoko Rich, "Rents Keep Rising, Even as Housing Prices Fall," *The New York Times*, February 24, 2012, http://www.nytimes.com/2012/02/25/business/homes-arent-selling-but-its-an-apartment-landlords-market.html?_r=1&ref=housing.

[7] Tom White and Charlie Wilkins, "No Federal Guaranty for Multifamily: And Other Ideas for Multifamily Housing Finance Reform," Compass Group, July 28, 2011, http://www.aei.org/files/2011/11/14/-no-federal-guaranty-for-multifamily-by-white-and-wilkins_104859202440.pdf.

mobile individuals and new families), and anemic job and income growth leading to fewer new household formations.[8] In short, a variety of factors may continue to fuel the demand for multifamily housing.

Over the medium term, if there are no dramatic shifts in the relative availability of either single-family or multifamily rental housing stocks, economic growth should lead to price increases in both traditional single-family purchases and the rental market. That is, rents should rise, but the price-rent ratio should be relatively stable. In Figure 1[9], note the real median asking rent (in 2000 dollars), an indicator of rental prices, which stabilized following a slight decrease during the economic downturn. In Figure 3[10], the price-rent ratio, has leveled off following the bubble in home prices.

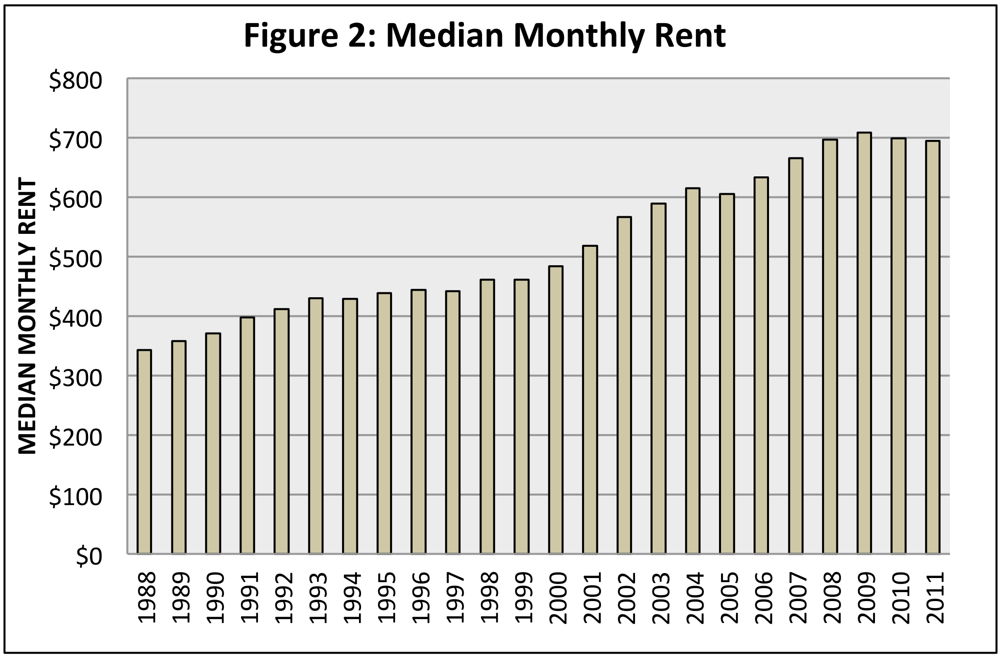


Figure 2: Median Monthly Rent

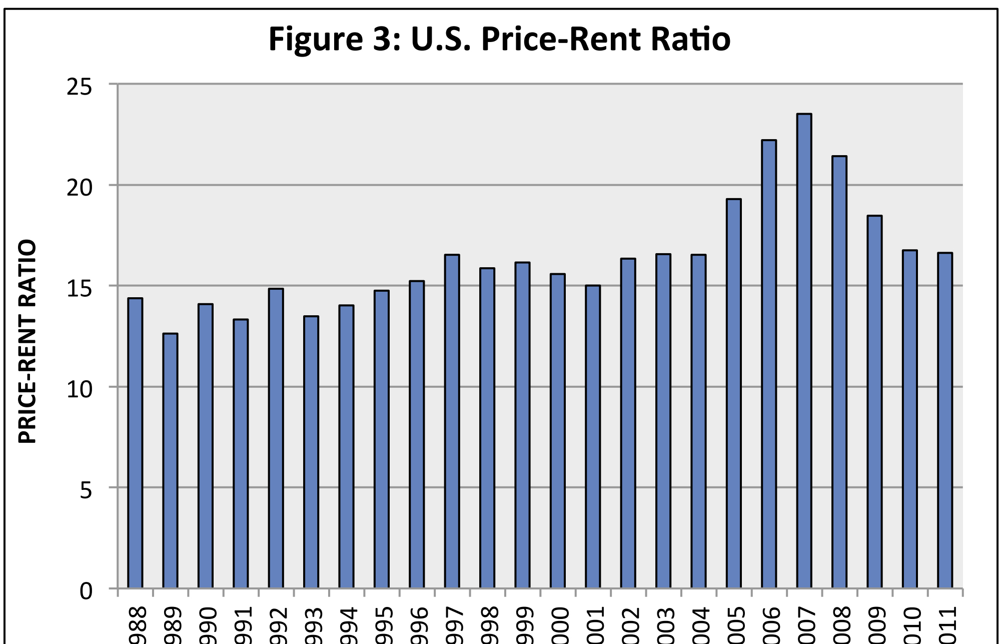


Figure 3: U.S. Price-Rent Ratio

Over a longer horizon, the changing preferences outlined above and the long-term uncertainty regarding residential pricing makes it reasonable to assume rental prices will continue to appreciate faster than the purchase segment.

Notwithstanding the above trends, we have seen in recent years the folly in assuming current trends will continue indefinitely into the future. Thus policymakers should endeavor to shape a policy that does not hinge on overly optimistic projections of price or demand, but instead assumes and thus accommodates the worst-case scenario.

[8] For a discussion on challenges to the traditional rent versus buy model, see "Renting v. Buying: New Evidence Emerges & Informs Housing Policy," e21 Staff Editorial, May 6, 2011, http://economics21.org/commentary/renting-v-buying-new-evidence-emerges-informs-housing-policy. See also, *supra* note 6.

[9] Source: US Census Bureau

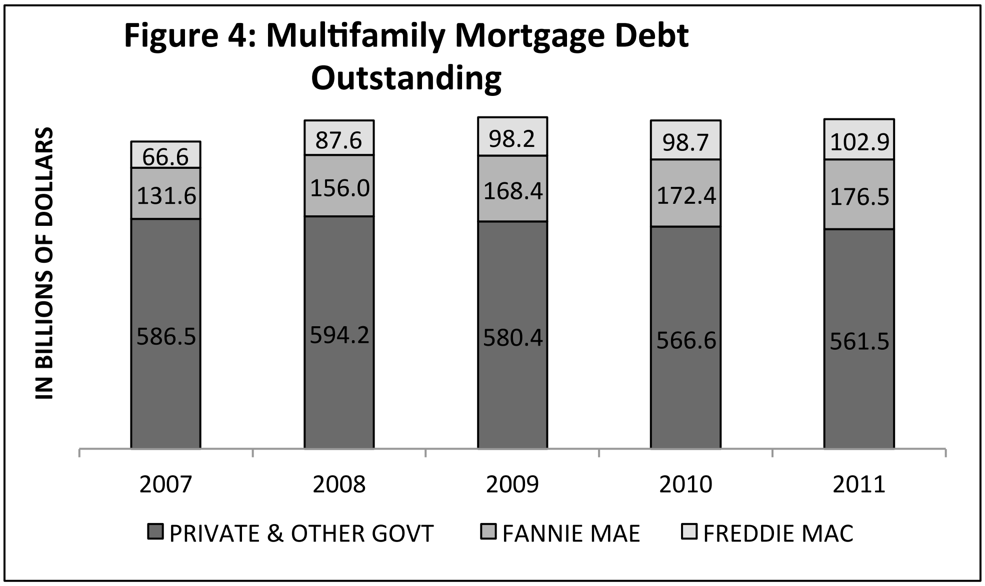
[10] Source: US Census Bureau

Financing Multifamily Housing

Loans secured by a residential property with five or more units are generally considered "multifamily" loans. These properties can be traditional apartment buildings or housing intended for low-income or elderly populations, students, or active duty military personnel or employees. The multifamily mortgage market differs fundamentally from the traditional single-family mortgage market. Indeed, because multifamily mortgages are backed by income-producing properties they are more properly thought of as part of the commercial real estate market.

Multifamily loans have generally performed quite well, with a serious delinquency rate for Fannie Mae and Freddie Mac's portfolio of less than one percent (2010). This compares favorably to the overall commercial mortgage-backed security (MBS) market with distress rates of around 14 percent.[11]

According to the latest Federal Reserve data, Mortgage Debt Outstanding for multifamily residences amounts to $841 billion (See Figure 4).[12]



The changes in the modern multifamily market and its attendant policy responses really begin in the late 1970s. In October 1979, the Federal Reserve raised the discount rate by 100 basis points in an effort to stem rising inflation, leading to dramatic increases in overall interest rates and severely constraining liquidity for commercial real estate markets.[13] The Economic Recovery Act of 1981 allowed accelerated depreciation for commercial real estate construction, which had the expected effect of encouraging building but was ultimately too successful and led to an overinvestment in construction, particularly in the multifamily space. During this time, life insurance companies took advantage of the tax benefits and created a demand for holding this type of lending in portfolio (as well as trading among them), with thrifts and Savings & Loans (S&Ls) as willing suppliers of funds.

The Tax Reform Act of 1986 acted to undo many of the tax advantages of owning commercial real estate. It should be noted that institutions were largely holding in portfolio, rather than securitizing, much of these assets which were at one point relatively high-yielding. The tax reform's change to straight-line depreciation and restrictions on the use of depreciation's write-off value led to reductions in property values. These effects were partially offset by the creation of low-income housing tax credits, as well as the new Real Estate Mortgage Investment Conduit (REMIC).[14] REMICS would "become one of the most utilized multi-class

[11] Joint Center for Housing Studies, Harvard University, *State of the Nation's Housing*, 2011.
[12] Federal Reserve, "Mortgage Debt Outstanding," Table 1.54, December 2011.
[13] Thomas Wratten, "Introduction to Commercial Real Estate Secondary and Securitization Market," Principal Commercial Advisors, Inc., October 1996.
[14] Denise DiPasquale and Jean Cummings, "Financing multifamily rental housing: The changing role of lenders and investors," *Housing Policy Debate*, Vol. 3, Iss. 1, 1992.

mortgage-backed securities" in the residential mortgage space at first, and eventually the commercial real estate space.[15]

The Resolution Trust Corporation (RTC), created in 1989 to dispose of non-performing S&L assets, was the first real test of the secondary market potential of commercial real estate assets. Because the RTC could not sell off whole loans directly to investors, it was forced to turn to securitization. Unfortunately, several headwinds existed for the market at this time:

- No infrastructure, standards, or national servicers;
- No standard underwriting or risk-rating systems;
- Lack of historic performance and national data;
- No standard way to unbundle the seller as an ongoing servicer/guarantor; and
- An already weak commercial real estate market.[16]

Over time, the market has come to develop a fairly robust concept of what the "prime" loan in the multifamily segment means. In much the way that single-family loans are easily categorized as low-risk "prime" loans by meeting easily definable criteria, the nearby table describes the characteristics of a prime multifamily mortgage loan.

A Loan is 'Prime' if All of the Following Are True[17]:

- Property is large enough to achieve economies of scale (50+ units)
- 3+ years of stable operations after lease-up
- 1.20:1+ DSCR, <= 75% LTV *
- Maximum 25 year amortization *
- No secondary must-pay debt
- Prime-quality legal documents
- Prime-quality lending processes
- Reserve adequate to fund 100% of capital needs over the loan term
- Stable market area
- Occupancy not limited by income or age *
- Prime-quality owner and manager
- No office or retail component

** These attributes can be compensated by higher performance in other areas*

Multifamily Housing on the Books

While the GSEs' role in the single-family secondary market has been thoroughly explored (and in some cases maligned), their role in the multifamily space is much less significant. As of the end of 2011, together they held in portfolio approximately 30 percent of the multifamily mortgage debt outstanding in the overall market (See Figure 4). Like the single-family market, the GSEs (Fannie Mae and Freddie Mac) are directly involved in the financing of multifamily loans through their purchases and securitization of originated loans. Though they do not dominate the multifamily market to the extent they do for single-family loans, they are responsible for a non-trivial share overall and have significant involvement in particular sub-segments of the market. For instance:

> *Fannie Mae, the largest government-sponsored enterprise provider of financing for the multifamily market, supports affordable multifamily housing through investments in individual properties or groups of properties, as well as through securitization of loans underlying these properties.*[18]

[15] Only three years earlier, the first secondary market commercial real estate securitization occurs, a "AAA" rated security offered by Fidelity Mutual Life Insurance. Fidelity retained servicing responsibility.

[16] Kimberly Burnett and Linda Fosburg, "Study of Multifamily Underwriting and the GSEs' Role in the Multifamily Market," U.S. Department of Housing and Urban Development: Office of Policy Development and Research, August 2001.

[17] Tom White and Charlie Wilkins, "No Federal Guaranty for Multifamily," AEI Presentation Overview, November 16, 2011, http://aei.org/files/2011/11/18/-event-presentation-on-multifamily-housing-tom-white-and-charlie-wilkins_095030802716.pdf.

[18] FannieMae, "Twenty Years of Multifamily Mortgage Financing Through Fannie Mae's Delegated Underwriting and Servicing (DUS) Program," *MBSenger*, Vol. 4, No. 1, March 20, 2010.

In 2010, Fannie Mae provided more than 50 percent of secondary market funds for multifamily housing finance, as private securitization funds dried up.

Although Fannie Mae's original charter (1938) authorizes financing of rental housing projects, the company created a business division focused on multifamily loan purchasing only in 1984.[19] For Fannie Mae, most of its multifamily business operates through its Delegated Underwriting and Servicing (DUS) program, which it started using to purchase multifamily loans in 1988. From there it grew to be its most important platform in this space. In 2009, 94 percent of its multifamily business volume operated through DUS.

The DUS program creates a pre-approved list of lenders and financial institutions, which can fully underwrite, close, and sell loans on multifamily properties without the need for Fannie Mae review. In other words, DUS effectively outsources its underwriting authority directly to the source, although Fannie Mae still engages in some amount of ongoing monitoring and credit review.

As a tradeoff for delegation of underwriting and servicing authority under the DUS program, lenders participate in a loss-sharing agreement with Fannie Mae. This can range from the lender bearing a first loss share to no loss. A typical arrangement is one where the lender bears one-third of losses, with Fannie Mae responsible for the remaining two-thirds.

These loans are typically non-recourse (i.e., secured by the property and not personal liability of the borrower), in the $1–50 million range, and with a 25 to 30-year amortization schedule. The properties must be already completed and/or in need of modest rehabilitation. Approved mortgages can be described as falling into three tiers of credit characteristics: Tier 2, 3, and 4. Tier 4 represents loans with the highest debt service coverage ratio (approximately 1.5 or higher) and lowest loan-to-value ratio (in the 55 percent range).

The appraisal process is also largely delegated:

1. The DUS lender selects a licensed appraiser who performs appraisal;
2. Environmental assessment (with some allowance for small loans); and
3. Physical needs assessment by DUS designated evaluator

This decentralized approach to underwriting and appraisal leads to a situation in which only the originator (seller) is in a position to know the true quality of the loan. Fortunately there are a variety of ways to mitigate the information asymmetry so that a liquid market can exist:

- *Demonstrated performance.* Sellers can demonstrate satisfactory performance of the good or asset over some initial fixed period.[20]
- *Third party endorsement*. A third party to the transaction which specializes in verifying the quality of the item for sale places its reputational capital at risk by publicly confirming its quality.
- *Guarantee*. Even if the product is defective or turns out to be of lower quality than conveyed, the seller agrees *ex ante* to fix it or buy it back.
- *Retained interest.* The seller retains some ownership share of the product so that they are financially tied to its performance.
- *Standardization*. A strict set of observable characteristics is adhered to as proxies for the unobservable characteristics, with deviations from this standardization resulting in severe price discounts or an illiquid market.

[19] FannieMae, "Fannie Mae's Role in the Small Multifamily Loan Market," First Quarter 2011.
[20] In a sense, the seller himself invests in reputational capital (by virtue of performance).

- *Delegation.* Buyers can delegate responsibility for discriminating among various potential transactions to a third party, perhaps compensated by the ultimate performance of the completed transactions.

In the mortgage market, generally all of them are in effect to some degree. For the multifamily market, complete standardization doesn't work due to the extreme heterogeneity in the underlying collateral. The GSEs also purchase "seasoned" loans – loans that have been held on the books of lenders and are current on payments for at least 12 months. The GSEs purchase these types of loans to varying degrees, as evidence in Figures 5[21] and 6[22], but they point to an important mechanism for minimizing risk as these loans tend to outperform even the fairly low-risk multifamily market altogether.

Freddie Mac's dedicated multifamily business line, Program Plus, goes back to 1993, although it is a decidedly smaller version, consisting of just over two-dozen approved seller/servicers. This is in addition to their Targeted Affordable Housing Program.

The purchases through these programs generally have a maximum 30 year amortization limit, are non-recourse, can be either fixed or adjustable-rates, and have a risk-based pricing structure. The volume usually ranges between $10 – 20 billion per year in available funds, with an explicit push to increase their multifamily loans starting last year.[23] This increase in lending activity has also shown up in an increase in Freddie Mac's K Certificate offerings (their most common pass-through CMBC structuring).[24]

A 2010 Freddie Mac program provides for additional capital and easing the deleveraging process for potentially distressed properties. Under this program, approved lenders originate a mortgage "with a loan-to-value ratio of up to 75 percent," with a mezzanine lender providing up to another 15 percent (the latter piece is backed by borrower equity). Finally Freddie Mac purchases the eligible first mortgages for securitization or portfolio holding.[25] This approach potentially points to an innovative way to solve the negative or low equity problem on multifamily properties, without exposing GSEs to additional direct default risk.

The essential nature of the GSEs in the housing finance market, hotly debated as it is, allows for at least two margins on which reform can happen. That is, the role of the GSEs in the multifamily space stands apart from its role in the single-family space. At the very least, their respective cost-benefit calculations will total to different sums, regardless of whether they net positive totals or not.[26]

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[21] Federal Housing Finance Agency

[22] Federal Housing Finance Agency

[23] Al Yoon, "Freddie to Step Up Multifamily Loans," *The Wall Street Journal*, August 31, 2011, http://online.wsj.com/article/SB10001424053111904332804576540611145353294.html.

[24] Freddie Mac, "Freddie Mac Announces Tenth $1 Billion Multifamily Securities Offering This Year, K-019," press release, July 23, 2012, http://freddiemac.mediaroom.com/index.php?s=12329&item=130752.

[25] Carrie Bay, "Freddie Mac Announces Mezzanine Program for Multifamily Mortgages," DSNews.com, April 5, 2010, http://www.dsnews.com/articles/freddie-mac-announces-mezzanine-program-for-multifamily-mortgages-2010-04-05.

[26] See the discussion in *Housing Policy Debate* (2012) 22:2. In particular, see Ingrid Gould Ellen & Mark Willis (2012): Comments on "Are the government- sponsored enterprises (GSEs) justified?", *Housing Policy Debate*, 22:2, 149-152.

Figure 5: GSE Multifamily Mortgage Loan Purchases

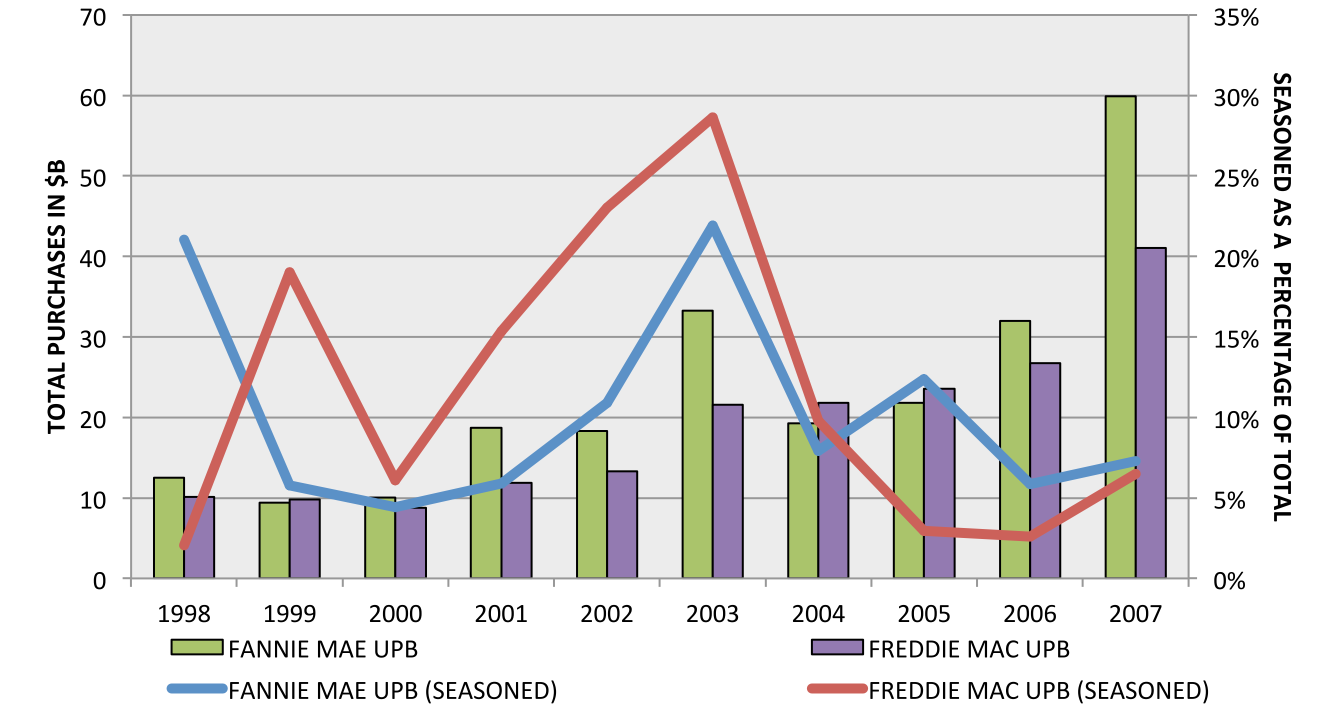

Figure 6: GSE Multifamily Mortgage Loan Purchases