

## CHAPTER V

### BENEFITS, COSTS, AND MARKET EFFECTS OF HOUSING GOALS: MULTIFAMILY AND SINGLE-FAMILY RENTAL PROPERTIES

#### A. Introduction and Main Findings

Extension of the GSE housing goals set in the 2000 Rule will ensure continuation of the GSEs' recently expanded involvement in the multifamily mortgage market. The reason is that multifamily purchases contribute disproportionately to GSE purchases meeting both the low-mod and special affordable housing goals. In 2002, Fannie Mae's multifamily share of all housing units financed was 7.3% decreasing from 10.3% in 2001 [See Table 5.1]. While Fannie Mae's Special Affordable Housing-Multifamily goal for 2002 was \$2.85 billion minimum, the actual result was \$7.22 billion of qualifying investments<sup>1</sup> and total multifamily investments of \$22 billion.<sup>2</sup> At Freddie Mac, the multifamily share of housing units financed was 7.3% decreasing from 9.3% in 2001 [See Table 5.1]. The Special Affordable Housing-Multifamily goal in 2002 was \$2.11 billion for Freddie Mac, their actual result was \$5 billion of eligible purchases<sup>3</sup> and total multifamily mortgage financings were \$13.3 billion, nearly 12 percent higher than 2001 purchase volume of \$11.9 billion. These purchases financed housing for 333,000 families, 93% were affordable to very-low, low- and moderate-income families. Since 1993, Freddie Mac's multifamily activities eligible for goal reporting totaled nearly \$54 billion, financing rental housing for more than 1.6 million families.<sup>4</sup>

#### A.1 Main Findings

##### a. Benefits

- The housing goals have contributed to increased emphasis by both GSEs on the multifamily market in the period since the previous final rule took effect at the beginning of 2001. The expertise and administrative capacity of both GSEs in the multifamily area have continued to grow since HUD's 2000 Final Rule was published.
- The housing goals will promote the availability of credit for affordable rental housing, thereby protecting the affordability of the existing stock of multifamily housing and enhancing the affordability of newly constructed multifamily housing.

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<sup>1</sup> Fannie Mae, 2002 Annual Housing Activities Report, 2003, p. 3.

<sup>2</sup> Fannie Mae, 2002 Annual Housing Activities Report, 2003, p. 5.

<sup>3</sup> Freddie Mac, 2002 Annual Housing Activities Report, 2003, p. 7.

<sup>4</sup> Freddie Mac, 2002 Annual Housing Activities Report, 2003, p. 5.

**Table 5.1****Multifamily Share of All Housing Units Financed**

Year	Units Financed								
	Fannie Mae			Freddie Mac			GSEs Combined		
	Multifamily	Total	Multifamily Share	Multifamily	Total	Multifamily Share	Multifamily	Total	Multifamily Share
1997	253,065	1,888,547	13.4%	99,470	1,213,126	8.2%	352,535	3,101,673	11.4%
1998	394,345	3,707,839	10.6%	221,319	2,718,565	8.1%	615,664	6,426,404	9.6%
1999	294,186	3,109,885	9.5%	191,492	2,328,800	8.2%	485,678	5,438,685	8.9%
2000	289,891	2,293,397	12.6%	163,580	1,677,295	9.8%	453,471	3,970,692	11.4%
2001	503,909	4,893,900	10.3%	315,868	3,381,036	9.3%	819,777	8,274,936	9.9%
2002	461,397	6,362,315	7.3%	333,038	4,552,277	7.3%	794,435	10,914,592	7.3%

Source: GSE Annual Housing Activity Reports, Table 1; figures for 2001 are adjusted for REMIC weights and participations.

- The recently expanded GSE presence has the potential to address underserved segments of the multifamily mortgage market, such as that for properties with 5-50 units and housing in need of rehabilitation.
- The housing goals will promote the liquidity of multifamily mortgages as investments and continued maturation of the secondary market for multifamily loans. This will promote greater stability in the market and will help prevent new credit gaps from forming in the future.

**b. Costs**

- The primary cost of the housing goals with respect to GSE multifamily operations is the risk of increased multifamily defaults, as compared with total “baseline” expected purchases.
- There is ample evidence that both GSEs have the capacity and procedures in place to manage the associated credit risk.
- Multifamily loans have historically been riskier than single-family owner-occupied loans. However, simulations in Section E show that the higher risk can be prudently managed so that the GSEs can earn their investor’s required rates of return under most circumstances. Moreover, as of the end of the 1999 calendar year, both GSEs’ multifamily performance had improved to the point where multifamily delinquency rates were *less* than those in single-family.<sup>5</sup>
- The recent reduction in multifamily default rates to levels below those in single-family by both GSEs is further evidence of their ability to successfully acquire, and manage the credit risk upon, multifamily mortgages. Thus HUD does not consider any increased multifamily acquisition volume relative to baseline projections that will be required under the HUD housing goals to be unrealistic nor to cause safety and soundness concerns.
- Fannie Mae, and to a lesser extent Freddie Mac, makes extensive use of credit enhancements in order to reduce credit losses on its multifamily acquisitions.
- Freddie Mac’s policy of re-underwriting each multifamily loan it acquires has the effect of reducing credit risk.

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<sup>5</sup> Freddie Mac reported delinquency rates of 0.15% for multifamily and 0.41% for single-family in 2001 (2001 *Annual Report to Shareholders*, p. 23.) In 2002, Fannie Mae reported “serious delinquency rates” of 0.05% for multifamily and 0.57% for single-family (2002 *Annual Report to Shareholder*, pp. 75 & 78). Multifamily delinquency rates were also lower than those in single-family for both GSEs at the end of 2000.

- As evidenced by lower default rates and recent published research, multifamily credit risk is better understood today than at the time HUD’s 1995 Final Rule was published. This improved understanding enhances the capability of the GSEs to structure their multifamily purchases in a manner that does not require them to assume an excessive degree of credit risk.

### **c. Market Effects**

The expanded presence of the GSEs in the multifamily mortgage market in recent years has provided other financial institutions with a wider and more attractive set of options for disposing of loans they originate or hold in their portfolios. This enhanced ability to sell multifamily loans likely has promoted the entry of new participants into the market and spurred increased involvement by established players. The current and likely future size of the GSEs’ multifamily operations is large enough to promote standardization and enhance market liquidity, yet the GSEs are not so big as to dominate the market and restrict competition.

This chapter turns next, in Section B, to a general discussion of the role of the GSEs in the multifamily mortgage market. Section C discusses the benefits associated with an expanded GSE presence in multifamily, followed by an analysis of the corresponding costs in Section D. Market effects of GSE multifamily acquisitions are taken up in Section E. Section F concludes with a discussion of GSE purchases of mortgages on small, 1-4 unit rental properties.

## **B. The GSEs in the Multifamily Mortgage Market**

### **B.1 Market Overview**

At the time of the previous GSE rulemaking, in 2000, the multifamily rental housing—or apartment—market was coming off several years of generally positive performance. Vacancies were low in most markets and rent increases were matching or exceeding economy-wide inflation. A key to this strong performance was the volume of new multifamily construction, which was at a level consistent with demand growth. Job growth and income gains helped many renters pay the higher rents without undue burden.

Much has changed in the subsequent three years. The economic slowdown has reduced apartment demand, and with new multifamily construction about unchanged, vacancies have risen and rents have softened. Provision of decent housing affordable to households of moderate or low incomes is a challenge even in strong economic times, and with the unemployment rate up nearly two percentage points since late 2000, affordability problems have increased for many, despite the softness in rents.

Despite the recent weakness in the apartment property market, the market for financing of apartments has grown to record volumes. The favorable long-term prospects for apartment investments, combined with record low interest rates, has kept investor demand for apartments

strong and supported property prices. Refinancings too have grown, and credit quality has remained very high.

Total multifamily mortgage debt outstanding increased 11 percent in 1999 (Q4/Q4), 10 percent in 2000, and 12 percent in 2001, and 8.6 percent in 2002 according to the Federal Reserve's Flow of funds accounts. The dollar volumes were above those of any previous year, and far exceeded the lending volumes of all years other than 1998 and the frenzied period 1985-86. The pace has picked up slightly in 2003, with figures through the first two quarters indicating annualized growth of about 9 percent. The net change in mortgage debt outstanding is defined as loan originations less repayments and chargeoffs. By all accounts originations—for which no single source of estimates is available—are much higher than net change in most years, and appear to have set a new record in 2001.

Multifamily lending has been spurred by new apartment construction, property sales, and refinancings. New multifamily construction was valued at \$32.6 billion in 2002, according to the Census Bureau, up 14 percent since 2000. Sales of existing properties likely have dipped in number since the late 1990s, but rising sales prices may have increased the dollar volume of mortgage financing associated with these transactions. Refinancings have also been strong. Despite the lockout provisions and yield maintenance agreements that constrain early refinancings of many multifamily loans, lenders reported very strong refinancing activity in 2001 and 2002.

The sources of funding of multifamily mortgages have shifted somewhat in the past few years, judging from the Federal Reserve's Flow of Funds accounts. Four categories of lenders have dominated multifamily mortgage lending since the mid-1990s: commercial banks, Fannie Mae/Freddie Mac portfolio holdings, Fannie Mae/Freddie Mac mortgage-backed securities, and private mortgage-backed securities. Of those four, commercial banks have played a lesser, although still substantial, role in the past couple years, providing 20 percent of the net additional funding of multifamily mortgages during 2000 and 2001. The portfolio holdings of the GSEs, by contrast, have recently been much more important than during the last half of the 1990s. Mortgage back securities, both from the GSEs and especially from other issuers, accounted for proportionally less of the growth in 2000-01 than in 1995-99, but between them still accounted for nearly half of all the net credit extensions.

The continuing value of collateral has helped keep loan quality high on multifamily mortgages. Delinquency rates from all major reporters are at or near record lows, and well below the rates reported for single-family mortgages and commercial properties. Multifamily lenders have remained cautious in their underwriting and, together with their regulators, have avoided repeating the mistakes of the 1980s.

## **B.2 GSE Activities**

As the multifamily mortgage market has expanded since 1999, Fannie Mae and Freddie Mac have increased their lending, picked up market share, introduced new programs, and enhanced

others. Fannie Mae is the largest single source of multifamily finance in the United States, and Freddie Mac has made a solid reentry into this market over the last nine years. However, there are a number of measures by which the GSEs lag the multifamily market. For example, the share of GSE resources committed to the multifamily purchases falls short of the multifamily proportion prevailing in the overall mortgage market. HUD estimates that newly-mortgaged units in multifamily properties represented almost 14 percent of all (single-family and multifamily) dwelling units financed between 1999 and 2002.<sup>6</sup> As shown in Table 4.4 in Chapter IV, multifamily acquisitions represented 9 percent of dwelling units financed by the GSEs between 1999 and 2002.

The GSEs added 22 percent to their combined holdings of multifamily loans in 2000, 33.5 percent in 2001, and another 26 percent in 2002. The growth in multifamily MBS outstanding was nearly as dramatic, increasing 13.7 percent in 2000, 25.6% percent in 2001, and another 14.3% in 2002. These gains resulted in the GSE's multifamily purchases (cash and securitizations combined) decreasing by 4.6 percent for 2000 over the previous year, increasing by 74.6 percent in 2001 and decreasing by 4.8 percent in 2002. The combined total of multifamily MBS Issuance for 2000 was an 11 percent decrease over the previous year, for 2001 a 72.2 percent increase over the previous year. The GSEs maintained this high level with just a 1.4 percent decrease over the previous year in 2002 [information from Table 5.2]. For Fannie Mae, the net mortgage portfolio for 2002 included \$28 billion of multifamily holdings.<sup>7</sup>

Despite the substantial pickup in GSE multifamily activity, the GSE's role in the multifamily market is significantly smaller than in single-family. As shown in Table 4.4 in Chapter IV, GSE purchases have accounted for 30 percent of newly financed multifamily units between 1999 and 2002—a market share much lower than their 57 percent share of the single-family-owner market. Stated in terms of portfolio shares, single-family-owner loans accounted for 83 percent of all dwelling units financed by the GSEs during this period, versus 73 percent of all units financed in the conventional conforming market. At the end of 2002, the GSEs' market share of single family debt outstanding was 44 percent, twice the share of multifamily debt held or securitized by these two companies, according to Federal Reserve statistics. Furthermore, the multifamily share of all housing units financed by the GSEs combined has declined from its 1997 level [see table 5.1], although the annual statistics are heavily influenced by the volume of refinancings in the single-family market, which spiked in 1998 and again in 2001 and 2002 in response to the big decline in mortgage rates in those years. Because of lock-out agreements and other loan covenants, multifamily loans are not as prone to rate-induced refinancings as are single-family mortgages. According to Fannie Mae's annual report the total multifamily holdings for 2002 comprised 4 percent of the net mortgage portfolio as opposed to total single-

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<sup>6</sup> Table 4.4 in Chapter IV shows that multifamily represented 14.5 percent of total units financed between 1999 and 2002 (obtained by dividing 7,018,044 multifamily units by 48,270,415 "Total Market" units). Increasing the single-family-owner number in Table 4.4 by 2,817,258 to account for excluded B&C mortgages increases the "Total Market" number to 51,087,673 which produces a multifamily share of 13.7 percent. See Appendix D of the proposed GSE Rule for discussion of the B&C market.

<sup>7</sup> Fannie Mae, Fannie Mae 2002 Annual Report, 2003, p. 39.

**Table 5.2****GSE Multifamily Mortgage Activity, 1998-2002**  
(\$ millions)

	1998	1999	2000	2001	2002
<b><u>Fannie Mae</u></b>					
MF Whole Loans in Portfolio	8,185	7,911	8,361	10,538	13,571
% Change From Previous Year		-3.3%	5.7%	26.0%	28.8%
MF MBS Outstanding	28,535	32,221	35,987	44,909	51,111
% Change From Previous Year		12.9%	11.7%	24.8%	13.8%
MF Purchases (Cash + Securitizations)	11,428	10,012	10,377	19,131	16,611
% Change From Previous Year		-12.4%	3.6%	84.4%	-13.2%
MF MBS Issuance	11,028	8,497	7,596	13,801	12,338
% Change From Previous Year		-23.0%	-10.6%	81.7%	-10.6%
<b><u>Freddie Mac</u></b>					
MF Whole Loans in Portfolio	7,978	12,355	16,369	22,483	28,036
% Change From Previous Year		54.9%	32.5%	37.4%	24.7%
MF MBS Outstanding	N/A	4,462	5,708	7,476	8,780
% Change From Previous Year			27.9%	31.0%	17.4%
MF Purchases (Cash + Securitizations)	3,910	7,181	6,030	9,509	10,656
% Change From Previous Year		83.7%	-16.0%	57.7%	12.1%
MF MBS Issuance	937	2,045	1,786	2,356	3,596
% Change From Previous Year		118.2%	-12.7%	31.9%	52.6%
<b><u>Combined</u></b>					
MF Whole Loans in Portfolio	16,163	20,266	24,730	33,021	41,607
% Change From Previous Year		25.4%	22.0%	33.5%	26.0%
MF MBS Outstanding	N/A	36,683	41,695	52,385	59,891
% Change From Previous Year			13.7%	25.6%	14.3%
MF Purchases (Cash + Securitizations)	15,338	17,193	16,407	28,640	27,267
% Change From Previous Year		12.1%	-4.6%	74.6%	-4.8%
MF MBS Issuance	11,965	10,542	9,382	16,157	15,934
% Change From Previous Year		-11.9%	-11.0%	72.2%	-1.4%

Source: Calculated from tables in OFHEO 2001 Annual Report.

family holdings, which represent 96 percent of the net mortgage portfolio.<sup>8</sup>

Because most of the GSEs' multifamily lending is on properties affordable to households with low- or moderate incomes, financing of affordable multifamily housing by the GSEs has increased almost as much as their total multifamily lending. Approximately 86 percent of Fannie Mae's multifamily lending volume utilizing the *Delegated Underwriting and Servicing* system (DUS), Fannie Mae's principal product line for purchasing individual multifamily loans qualified as affordable to low- or moderate income households in 2002, according to Fannie's Annual Housing Activity Report<sup>9</sup> (approximately 67 percent of Fannie Mae's multifamily mortgage credit book consisted of DUS products or business as of December 31, 2002<sup>10</sup>), as did 93 percent of all Freddie Mac's multifamily units financed.<sup>11</sup> The GSEs increased the volume of their affordable multifamily lending dramatically in 2001, the first year of the new, higher affordable housing goals set for the GSEs. As measured by number of units financed, the total affordable lending more than doubled from a year earlier. Overall, Fannie Mae's 2002 multifamily investments nearly matched its record 2001 performance<sup>12</sup> and Freddie Mac's 2002 multifamily mortgage financings were 12% higher than in 2001.<sup>13</sup>

### **C. Identification and Characterization of Benefits**

Benefits: Lower Financing Costs for Affordable Rental Housing. The affordable housing goals promote the participation of the GSEs as suppliers of credit for multifamily rental housing, most of which is affordable to low- or moderate-income households. By broadening the base of mortgage supply, the availability of credit is improved, and its price is reduced, for at least some borrowers. Ultimately these lower financing costs benefit renters, as market competition drives rents down to the economic "user cost" of providing rental housing, of which debt financing costs are a major component.

The potential for reduced financing costs from GSE involvement in the multifamily market is illustrated by the differences in credit market conditions faced by small properties—those with fewer than five rental units—relative to others. As documented in studies cited in the 2000 Rule, small multifamily rental properties have historically faced a narrower supply and higher cost of credit than have larger properties.<sup>14</sup> Several reasons, largely having to do with the

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<sup>8</sup> Fannie Mae, *Fannie Mae 2002 Annual Report*, 2003, p. 39.

<sup>9</sup> Fannie Mae, 2002 Annual Housing Activities Report, 2003, p. 25.

<sup>10</sup> Fannie Mae, *Fannie Mae 2002 Annual Report*, 2003, p. 77.

<sup>11</sup> Freddie Mac, 2002 Annual Housing Activities Report, 2003, p. 5.

<sup>12</sup> Fannie Mae, 2002 Annual Housing Activities Report, 2003, p. 5.

<sup>13</sup> Freddie Mac, 2002 Annual Housing Activities Report, 2003, p. 5.

<sup>14</sup> One study completed subsequent to the 2000 rule is "An Assessment of the Availability and Cost of Financing for Small Multifamily Properties," prepared by Abt Associates for HUD's Office of Policy Development and Research, August 2001.

high fixed costs of loan originations, inadequate documentation of property income and expense, and the limited opportunities for lender fees for underwriting and servicing small loans.

The GSEs dramatically picked up the volume of their lending on small properties in 2001, outpacing in proportional terms their expansion in multifamily lending generally. In 2000, 3 percent of Fannie Mae's multifamily units financed were in small properties; in 2001 the figure more than doubled to 7 percent. In 2001, Fannie Mae developed the 3MaxExpress Streamlined Mortgage Loan Product to finance loans less than or equal to \$3 million. The product offers flexible amortization, prepayment, and loan terms. This program coupled with efforts from the Delegated Underwriting and Servicing program helped secure \$4.1 billion in financing which assisted over 130,000 families living in small multifamily properties.<sup>15</sup> At Freddie Mac, the jump was from 2 percent in 2000 to 16 percent in 2001. Part of this pickup almost certainly was attributable to the affordable housing goals, which provided additional incentives for lending on small properties. This increased presence likely has resulted in lower rates for many affordable multifamily properties, although no estimates are yet available. In 2002, Freddie Mac's purchase volume of five- to 50-unit multifamily properties was \$1.8 billion which represents more than 44,000 apartment units.<sup>16</sup>

The housing goals also promote changes in the non-rate terms of multifamily loans, further increasing the supply of credit to affordable housing. The GSEs have, in the past, been viewed as conservative in their underwriting practices in the multifamily market.<sup>17</sup> Although both GSEs are recognized by multifamily market participants for their contributions to standardization of loan documentation and loan underwriting, those standards have been seen by many as conservative and somewhat inflexible, especially in application to affordable properties. Instead, banks, thrifts, and lending consortia have been seen as more flexible and innovative in their lending practices.

Benefits: New Products. HUD's housing goals, by encouraging expanded GSE presence in the multifamily mortgage market, have established an environment favorable to innovation not only in underwriting practices but also in product design. The GSEs have introduced a number of new and specialized products in multifamily finance over the years, and most recently since the 2000 Rule was implemented.

These innovations have occurred at both GSEs, notwithstanding the contrasting business models that Fannie Mae and Freddie Mac follow in their multifamily lending. Fannie Mae in the 1990s established its Delegated Underwriting and Servicing (DUS) program, which has since become the mainstay of Fannie Mae's multifamily operation. Under this program, Fannie Mae delegates underwriting responsibilities to designated lenders, and purchases loans originated by

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<sup>15</sup> Fannie Mae, 2002 Annual Housing Activities Report, 2003, p. 25.

<sup>16</sup> Freddie Mac, 2002 Annual Housing Activities Report, 2003, p. 46.

<sup>17</sup> "Study of Multifamily Underwriting and the GSEs' Role in the Multifamily Market: Final Report," prepared by Abt Associates for HUD's Office of Policy Development and Research, August 2001.

these lenders without prior approval if the mortgages are less than \$20 million.<sup>18</sup> Fannie Mae uses loss-sharing agreements with seller-servicers, which protects it from adverse selection on these transactions. The DUS program has enabled Fannie Mae to process multifamily acquisitions more quickly, and to expand its acquisition volume more rapidly than would otherwise be the case. Currently, Fannie Mae has more than \$60 billion of DUS multifamily financing in its portfolio. For the year ending 2002, 92 percent of the DUS loan activity served affordable housing needs; 41 percent of DUS loans were made in underserved markets; and 51 percent of DUS loans addressed “special affordable” needs.<sup>19</sup>

Freddie Mac has taken a different approach to credit underwriting. In the wake of large credit losses on its multifamily business in the late 1980s and 1990, Freddie Mac essentially withdrew from the market. When it re-entered in late 1993, the company elected to retain all underwriting in-house and not delegate this function to the loan originators participating in Freddie Mac’s Program Plus network. Because Freddie assumes the entire credit risk on loans it purchases, some commercial banks and other financial institutions desiring to remove multifamily loans and all related liabilities from their books find Freddie’s program particularly attractive. Freddie Mac has various targeted multi-family initiatives in conjunction with its *Program Plus* network of lenders. For example the *Fixed-to-Float Option* is a conventional mortgage product providing an option to borrowers for a reduced interest rate with an optional one-year extension of the mortgage term at a floating rate in exchange for a yield maintenance provision requiring certain payment upon prepayment that applies during the full mortgage term. In 2002, borrowers used the *Fixed-to-Float option* for more than \$1.4 billion in mortgages. Another example is the *Forward Commitment Pilot*. This initiative provides financing for loans or credit enhancement for bonds with use agreements that preserve the affordability of units in the future. This tool has enabled Freddie Mac to respond to market needs by providing refinancing for properties originally financed with Low Income Housing Tax Credit equity. In 2002, Freddie Mac successfully converted five forward commitments to permanent financing, provided \$94 million in new forward commitments, and provided a variety of innovations to reduce the cost of financing and increase affordability, including variable-rate construction financing, forward starting swaps, forward rate locks and take-outs.<sup>20</sup>

Since the 2000 Rule was established, the GSEs have refined some of their multifamily products and services, and they have also introduced new ones. Each of these innovations enhances the supply of credit in at least one of two ways. First, by tailoring product offerings to the specific financing needs of individual properties and portfolios, and their owners, the GSEs increase the efficiency of credit provided, which in turn reduces its cost to the borrower. Second, by structuring multifamily mortgage-backed securities that better match the investment objectives of potential MBS purchasers, and by increasing the liquidity of those investments, the GSEs’ innovations increase the supply of credit to the multifamily market, again reducing its cost to the borrower and ultimately the rents paid by residents.

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<sup>18</sup> Fannie Mae, Fannie Mae 2002 Annual Report, 2003, p. 77.

<sup>19</sup> Fannie Mae, 2002 Annual Housing Activities Report, 2003, p. 25.

<sup>20</sup> Freddie Mac, 2002 Annual Housing Activities Report, 2003, pp. 44-45.

Among the specialized multifamily products and services of the GSEs, and their recent innovations, are the following:

- Both GSEs purchase pools of loans not meeting their standard underwriting guidelines by means of negotiated transactions.
- Both GSEs provide credit enhancements on tax-exempt bonds issued by state housing finance agencies and local housing authorities.
- Both GSEs offer forward commitment products, which allow developers to lock in a permanent mortgage interest rate at the time of new construction or substantial rehabilitation. Products are offered for both market-rate properties and for affordable properties with tax-exempt bond financing or low-income housing tax credits.
- Both GSEs offer special programs for affordable multifamily properties that serve low- and moderate income families or are located in underserved areas. Program offerings have been expanded in recent years and include both custom-designed programs and modified versions of the GSEs' market-rate multifamily programs.
- Both GSEs have in the past several years introduced products and programs for small multifamily properties with 5-50 units. Fannie Mae's 3MaxExpress, designed for loans of no more than \$3 million, offers flexible amortization and loan and prepayment terms. The product also offers a streamlined underwriting process with reduced transactions costs and the ability to finance those costs. Freddie Mac offers a conventional mortgage program for loans of no more than \$1 million, and also a facility for securitizing pools of small multifamily loans
- Both GSEs offer streamlined refinance programs that reduce documentation and origination costs for refinancing loans that they have already acquired.
- Both GSEs offer permanent financing for multifamily properties in need of moderate renovation, through both their standard programs and negotiated transactions.
- Both GSEs have established programs for mortgages on seniors housing properties to serve a variety of independent living, congregate care, and assisted living properties.
- Fannie Mae has a student housing pilot program for financing stabilized properties that cater to a student tenant base and are not readily convertible to conventional multifamily housing.
- Both GSEs have agreed, in principle, to participate with FHA in a special multifamily risk-sharing program, although program activity has been minimal to date.
- Both GSE's invest in Low-Income Housing Tax Credit mortgages. These investments

combine private sector capital, government incentives and community-based housing expertise for the creation or rehabilitation of rental housing for America's lowest income families.

The need for affordable lending for multifamily properties is no less now than at the time of the 2000 Rule. The number of working families spending more than 50 percent of their income on their rental housing increased 23 percent between 1999 and 2001, according to one recent study.<sup>21</sup> More generally, rents rose 4.7 percent in 2001 (December/December) and a further 3.1 percent in 2002, according to the CPI. Over that same two-year period, the number of jobs nationwide declined 1 percent and the unemployment rate rose from 3.9 percent to 6.0 percent, putting many additional households in an untenable position for meeting the costs of their housing and other necessities. As always, affordability conditions vary greatly from place to place.<sup>22</sup> Although incomes tend to be higher in high-rent markets, the rent differences are proportionally greater, and thus affordability (as measured by the ratio of rent to income) is generally the worst in high-rent markets.

#### **D. Identification and Characterization of Costs**

This section discusses the costs that must be weighed against the benefits of the housing goals with regard to their effects on GSE acquisitions of multifamily mortgages.

It is HUD's position, as it was during the 2000 rulemaking, that the primary cost is the risk of increased multifamily defaults, as compared with total "baseline" expected purchases. The default potential of goals-oriented multifamily loan purchases will drive and dominate all other costs. Therefore, the discussion of costs that follows will focus on the additional mortgage credit risk associated with acquiring additional multifamily loans. The analysis indicates that meeting the housing goals will have little impact on the overall credit risk and the safety and soundness of GSE multifamily operations.

##### **D.1 Findings**

There are several specific findings in this section regarding the credit risk of multifamily purchases:

- The main issue addressed in this chapter concerns the impact of the housing goals on the GSEs' multifamily business. While there are numerous single-family and multifamily purchase strategies that the GSEs could choose in order to meet the proposed housing goals, most are likely to involve an increased focus on "goals-rich" multifamily purchases. The share of total (combined single-family and multifamily) business accounted by multifamily purchases is referred to as the "multifamily mix"

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<sup>21</sup> "America's Working Families and the Housing Landscape 1997-2001" *New Century Housing*, V. 3, issue 2, November 2002, Center for Housing Policy/National Housing Conference.

<sup>22</sup> "The State of the Nation's Housing 2002," Joint Center for Housing Studies of Harvard University, 2002.

and it is an indicator of a GSE's focus on multifamily business. HUD projects that Freddie Mac will continue to increase its multifamily efforts, as a "multifamily mix" of 11 percent is consistent with Freddie Mac's meeting the proposed housing goals under many of the purchase scenarios reported in Section C of Chapter III. Over the past six years, Freddie Mac has fully re-entered the multifamily market, with its purchases (cash plus securitizations) increasing from \$2.7 billion in 1997 to \$11.4 billion in 1998 to \$16.6 billion in 2002; holding a total of \$28.0 billion in whole multifamily loans and \$8.8 billion in multifamily MBS Outstanding in its 2002 portfolio (See Table 5.2.) HUD does not consider the additional multifamily purchases that may be required of Freddie Mac under the housing goals to be unrealistic nor to cause safety and soundness concerns.

- The recent increase in secondary market securitization suggests that multifamily risk is manageable. In addition, market conditions for multifamily lending have improved since the tax-shelter driven overbuilding of the 1980s—multifamily properties now offer less risk of loss than most other commercial property classes.
- Experience from the Low Income Housing Tax Credit (LIHTC) program and other sources indicate that credit risk of affordable rental housing can also be successfully managed.
- Fannie Mae and, to a lesser extent, Freddie Mac make extensive use of credit enhancements in order to reduce credit losses on their multifamily acquisitions.
- Freddie Mac's policy of re-underwriting each multifamily loan it acquires has the effect of reducing credit risk.

## **D.2 Multifamily Default Risk**

On a whole-loan basis, multifamily default rates have historically been higher than those on single-family loans. There are a number of reasons for this. First, owners of multifamily property are considered more "ruthless" with regard to exercise of the default "option" than are owner-occupants subject to moving costs and post-foreclosure deficiency judgments.<sup>23</sup> Second, renter mobility contributes to cash flow volatility. Renters are more mobile than owner-occupants. A third factor is that multifamily loans are typically structured as balloon mortgages or ARMs, resulting in higher interest rate risk to the borrower.<sup>24</sup> While riskier than single-

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<sup>23</sup> Multifamily loans are ordinarily without recourse to the borrower.

<sup>24</sup> This discussion draws on Goldberg and Capone (1998). In addition to these factors, they mention changes in the tax laws regarding depreciation as part of the Tax Reform Act of 1986. Much of the difficulty with creditworthiness in multifamily mortgage investments in recent years was related to the aftermath of wide swings in the tax treatment of multifamily housing. The tax- rather than market-driven overbuilding of the 1980s was followed by the subsequent withdrawal of tax support and a credit crunch in the early 1990s, during which the underwriting of creditworthy multifamily deals was difficult. These conditions have now improved markedly.

family, multifamily properties have been viewed as safer than most other commercial property classes, compared to which multifamily offers less cash flow volatility, lower operating expense ratios, and access to the GSEs for refinancings.<sup>25</sup>

In part, historically higher default rates among multifamily loans as compared with single-family were a consequence of tax-driven overbuilding in the 1980s, compounded by underwriting weaknesses during the same time period. It is significant that Freddie Mac has not experienced a single default on the multifamily mortgages purchased since 1993.<sup>26</sup> As noted previously, both GSEs' multifamily performance have improved to the point where multifamily delinquency rates are *lower* than those for single-family.

Few new studies of multifamily default risk have appeared since the 2000 Rule was promulgated. However, one recent study highlighted the difficulty of accurately identifying the correlates and determinants of loan default, focusing on the role of the loan-to-value ratio (LTV).<sup>27</sup> Option-based models of mortgage default feature the LTV as the key indicator of default risk. The study finds, however, that LTVs are set during the loan origination process in part based on the perceived risk of the loan. Because lenders may require lower LTVs on risky loans, mortgages with low LTVs may be as likely to default as those with high LTVs. The study found that LTV in fact had no relationship to default incidence in a sample of approximately 500 fixed-rate multifamily mortgages. Instead, the strongest predictors of default were property characteristics, including location and initial debt coverage ratio, which were much more important than post-origination changes in the local economy.

### **D.3 Multifamily Risk Mitigation**

#### **a. Techniques for Mitigating Default Risk and Default Losses**

A number of techniques are utilized by the GSEs and other multifamily mortgage market participants to mitigate default risk and default losses.

The GSEs mitigate default risk through the use of relatively consistent underwriting. Maximum loan-to-value ratios of 80 percent and minimum debt service coverage ratios of 1.25-1.30 are applicable to the majority of multifamily transactions.

Fannie Mae also manages multifamily mortgage credit risk throughout the investment life cycle. This cycle begins with the underwriting and servicing policies and procedures, including those delegated to lending partners. Fannie Mae then actively monitors mortgages through post-purchase underwriting reviews. This includes on-site assessments of DUS lenders' servicing and

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<sup>25</sup> "Moody's Reports: Almost One-Quarter of Assets in CMBS Deals Are Relatively Safe Multi-Family Properties," Moody's Investor Services, March 4, 2003.

<sup>26</sup> Freddie Mac, 2001 *Annual Report to Shareholders*, p. 32.

<sup>27</sup> Wayne Archer et al., "Determinants of Multifamily Mortgage Default," *Real Estate Economics* Vol. 30, no. 3 (Fall 2002):445-473.

their financial condition as well as tracking property conditions and financial performance throughout the life of the asset. Fannie Mae also evaluates borrower, geographic, and other types of risk concentrations at the loan and portfolio level.<sup>28</sup>

Fannie Mae further mitigates the adverse effects of any defaults through the extensive use of credit enhancements, including senior-subordinated structures and loss-sharing with seller-servicers. Due to the use of a variety of credit enhancements, Fannie Mae bore the entire credit risk on only 15 percent of multifamily held or guaranteed as of the end of 2002.<sup>29</sup>

Multifamily investments in today's market often involve mortgage pools rather than whole loans. Credit risk remains a concern of investors, but the use of the REMIC and other multiclass securities structures offers an opportunity to mitigate investors' credit risk on multifamily mortgage pools.

Fortunately, a number of alternative credit enhancement vehicles are available. Fannie Mae makes extensive use of loss-sharing arrangements with loan sellers in the DUS program, mentioned previously. Seller recourse is a form of credit enhancement often used by both Fannie Mae and Freddie Mac in their negotiated purchase of pools of seasoned multifamily loans. While the specific provisions and extent of loss-sharing vary between transactions, such credit enhancements are often structured as a first-loss provision covering 15 percent of the unpaid principal balance of the entire pool. This means, for example, that on a hypothetical pool of 100 equal-sized loans, 15 loans would need to default before the GSE would experience any default losses. This would be a fairly remote possibility under normal economic circumstances.

Freddie Mac does not utilize loss-sharing in acquiring mortgages originated to its underwriting standards through its Conventional Cash Purchase Program. Instead, Freddie Mac controls credit risk on these purchases by re-underwriting each prospective acquisition as a condition of purchase.

#### **b. Credit Risk of Affordable Multifamily Housing**

Affordable Rental Housing. The above discussion suggests that credit risk can be successfully managed on market-rate multifamily housing, the great majority of which is affordable to families with incomes less than or equal to the area median. But what about multifamily properties affordable to low-income families? Does credit risk pose a major obstacle to the development of an efficient, liquid secondary market for multifamily mortgages that addresses the full range of multifamily credit needs? There is some evidence that it need not.

Credit Risk in LIHTC Deals. One such source of anecdotal information on the credit risk involved with affordable multifamily housing comes from participants in the low-income

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<sup>28</sup> Fannie Mae, Fannie Mae 2002 Annual Report, 2003, p. 77.

<sup>29</sup> Fannie Mae, Fannie Mae 2002 Annual Report, p. 78.

housing tax credit (LIHTC) program, which was created by the 1986 Tax Reform Act.<sup>30</sup> The tax credit program is the primary Federal assistance program for new or rehabilitated low-income housing that is currently active.<sup>31</sup> Detailed data on the composition and performance of tax credit projects are not yet available. However, both academic and industry experts have been observing the tax credit program since its inception, and some of them have shared their observations with the Department.

According to market observers, tax credit deals typically are financed with 30 to 40 percent equity obtained from investors receiving the tax credits, first mortgage debt of about 40 to 60 percent, and the remaining amount up to 30 percent coming from local subsidies, often in the form of “soft” second mortgages. Market observers indicate the trend in tax credit deals is toward increased equity as a share of the total development cost due to increased competition among tax credit syndicators. A scarcity of local subsidy dollars for soft seconds, particularly in some regions of the country, is also driving up the first mortgage share of total development cost.

The lenders who provide first mortgage financing for tax credit deals tell the Department that they consider loans on these affordable units to be less risky than loans for market-rate multifamily projects. There are several reasons for this conclusion. First, the loan-to-value ratio on these deals is rarely above 60 percent, which gives lenders substantial protection from credit risk. If the lender must foreclose, the tax credits stay with the property, giving the lender the ability to attract equity from new investors. Other reasons that first mortgage financing on affordable tax credit deals is considered less risky are the low turnover rates of affordable units, which keeps project vacancies low, the high potential for future appreciation of the property, and the close scrutiny to initial underwriting by the equity provider or syndicator.<sup>32</sup>

While properties receiving an allocation of tax credits have represented a significant portion of the multifamily new construction market, new construction represents a relatively small portion of the multifamily mortgage market and of GSE purchases. However, the above discussion illustrates that affordability does not necessarily imply an excessive degree of credit risk.

#### **D.4 Default Models**

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<sup>30</sup> Nearly \$500 million in tax credits are allocated to the states annually on a per-capita basis under the Low Income Housing Tax Credit (LIHTC) program. The states are responsible for sub-allocating these tax credits to specific properties. Under LIHTC, equity investors in low-income rental housing receive an annual credit of 9 percent of total construction costs (rehabilitation costs) for newly constructed (rehabilitated) units. The credit drops to 4 percent if the property uses other Federal subsidies, or tax-exempt debt financing.

<sup>31</sup> HUD’s HOME program has funded approximately 340,000 affordable rental units since it was first funded in 1992.

<sup>32</sup> See Stuart J. Boesky, “Tax Credits at Work,” *Mortgage Banking*, September 1995.

In a significant contribution to the literature on multifamily default behavior, Lawrence Goldberg and Charles A. Capone, Jr. (1998) estimate a statistical model of multifamily defaults using data on 7,564 loans acquired by Fannie Mae and Freddie Mac during 1983-1995.<sup>33</sup> They identify loan-to-value ratio (LTV); debt service coverage ratio (DSCR); a measure the present value of tax benefits (principally depreciation); a dummy variable to indicate loans underwritten prior to 1988; and the age of the loan as the principal determinants of default. An innovative feature of their research is that defaults are modeled as a function of *contemporaneous* LTV and DSCR. For the purposes of the model, LTV and DSCR are recalculated each year, taking into consideration changes in rents and operating costs at the MSA level. In their regression analysis, all coefficients have the expected sign and are statistically significant.

The Office of Federal Housing Enterprise Oversight in its risk-based capital regulation for the GSEs developed a multifamily loan performance model as part of its risk-based capital stress test from historical mortgage information provided by the enterprises.<sup>34</sup> The OFHEO stress test projects conditional default and prepayment rates for groups of multifamily loans sharing similar characteristics for each month of the 10-year stress period. Projections of default rates come from a logistic regression model. Multifamily prepayment rates are not generated by a statistical model, but follow a set of prepayment rules that capture the effects of yield maintenance, prepayment penalties, and other mechanisms that may curtail or limit prepayments for specific time periods.

Using the regression model for default rate projections requires information on the loan group characteristics at the start of the stress period. This information is then used along with information about the economics of the benchmark stress period—changes in interest rates, vacancy rates, and rent growth rates—to create values for the explanatory variables for each year of the stress period. Eight explanatory variables are used in the OFHEO multifamily default equation: mortgage age, mortgage age-squared, current debt service coverage ratio, underwater current debt service coverage ratio indicator (this indicator is turned on whenever the net operating income is projected to be less than debt service payment), loan-to-value ratio at origination, a balloon maturity indicator, and two additional indicators that capture underwriting differences in the loans. Some of these explanatory variables in OFHEO’s model vary over time and must be projected over the stress period. Others remain fixed for the entire period. Regression coefficients associated with each of these explanatory variables are applied to the explanatory variable values to produce annual conditional default rates throughout the stress period. These annual conditional default rates are then converted to monthly conditional default rates for use in the stress test’s cash flow model.

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<sup>33</sup> Lawrence Goldberg and Charles A. Capone, Jr. “Multifamily Mortgage Credit Risk: Lessons From Recent History,” *Cityscape: A Journal of Policy Development and Research*, vol. 4, no. 1, pp. 93-113 (1998). Loans in their sample are “cash” transactions, which are originated in compliance with the GSEs’ underwriting standards, as opposed to negotiated transactions, which typically involve pools of seasoned loans held by depositories.

<sup>34</sup>“Risk-Based Capital; Final Rule,” Federal Register, Vol. 66, No. 178, pp. 47730-47875, Thursday, September 13, 2001. OFHEO has subsequently issued several changes, corrections, and amendments to the RBC rule. These documents are available via the internet at <http://www.gpoaccess.gov/multidb.html>.

The multifamily default analysis in Chapter VI is based on the OFHEO model. As noted in Section E of that chapter, the projected return on equity values for loans secured by multifamily properties, are estimated to be slightly higher than for single-family loans. While there is no way to independently verify this result, it is consistent with somewhat higher guarantee fees, extensive loss-sharing arrangements, and the generally conservative approach to underwriting applied to this component of the GSEs guarantee businesses.<sup>35</sup>

## D.5 Conclusions

While it is recognized that the GSEs have been increasing their multifamily purchases, a further enlargement of their role in the multifamily market seems feasible and appropriate, particularly in the affordable (lower rent) end of the market. As noted in Section D.3, market participants believe that the GSEs have been conservative in their approaches to affordable multifamily lending and underwriting.<sup>36</sup> The incentives provided by the affordable housing goals set in the 2000 Rule almost certainly stimulated innovation and additional risk-taking by the GSEs. At the time of the 2000 rule making, HUD's view was that, because of improved market conditions and GSE risk management expertise, the stepped-up goals set for 2001-2003 would not substantially increase the risks and credit losses on the GSEs' multifamily business. To date the GSEs' delinquency rates and losses on their multifamily business have remained minimal. Although these losses likely will increase if the apartment market should weaken further, and continued prudence in underwriting and credit monitoring will be required, there is no reason to expect that extension of the GSEs affordable housing goals will result in excessive risk-taking and credit losses by the GSEs.

Certainly the GSEs face a number of challenges in better meeting the needs of the affordable multifamily market. For example, thrifts and other depository institutions may sometimes retain their best loans in portfolio, and the resulting information asymmetries may act as an impediment to expanded secondary market transaction volume.<sup>37</sup> However, the GSEs have demonstrated that they have the depth of expertise and the financial resources to devise innovative solutions to problems in the multifamily market. The GSEs can build on their recent records of increased multifamily lending and innovative products to make further in-roads into the affordable market. As explained in Section D.3, the GSEs have the expertise and market presence to push simultaneously for market standardization and for programmatic flexibility to meet the special needs and circumstances of the lower-income portion of the multifamily market.

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<sup>35</sup> The projected ROE are generally consistent with the overall ROEs reported by the GSEs in their annual financial disclosures, however the ROE for multifamily properties are not reported separately in these disclosures.

<sup>36</sup> Abt Associates, *op. cit.* (August 2002).

<sup>37</sup> The problem of secondary market "adverse selection" is described in James R. Follain and Edward J. Szymanoski. "A Framework for Evaluating Government's Evolving Role in Multifamily Mortgage Markets," Cityscape: A Journal of Policy Development and Research 1(2), 1995.

## **E. Market Effects**

The expanded presence of the GSEs in the multifamily mortgage market in recent years has provided banks, thrifts, life insurance companies, and other traditional multifamily lenders with a wider and more attractive set of options for disposing of loans they have originated or hold in their portfolios. This enhanced ability to sell multifamily loans likely has promoted the entry of new participants into the market and spurred increased involvement by established players.

The current and likely future size of the GSEs' multifamily operations is large enough to promote standardization and enhance market liquidity, yet the GSEs are not so large as to dominate the market and restrict competition. Banks and other depository institutions likely will continue to see multifamily mortgages as an desirable component of their loan portfolios, and Wall Street will continue, in most financial climates, to demand newly originated multifamily mortgages for inclusion in non-GSE mortgage backed securities.

Lastly, the multifamily mortgage market benefits from the perception that Fannie Mae and Freddie Mac will always be in the market to buy loans, ensuring the liquidity of mortgages to loan originators and other primary market institutions. This perception helps stabilize the market and presumably reduce risk premiums in loan pricing, although this effect has not been quantified. The affordable housing goals help ensure that this perception will be borne out, because without continuous participation as a buyer and securitizer of multifamily mortgages, the GSEs are unlikely to achieve their affordable housing goals.

## **F. Small Single-Family Rental Properties**

Small "single-family" rental properties, containing 1-4 units, represent a significant component of the affordable housing stock, representing 62 percent of all rental housing units in 2001, according the American Housing Survey. The affordability of such units is comparable to that of those in multifamily properties.<sup>38</sup> Expanded GSE acquisition of mortgages on small rental properties can enhance the efficiency of the market for such mortgages. While such loans are typically riskier than those on one-unit owner-occupied mortgages, the GSEs have successfully utilized a number of techniques to mitigate default risk and credit losses, including the acquisition of seasoned loans and loans with low loan-to-value ratios.

Mortgages on small properties contribute to the GSEs' performance on the housing goals, especially for meeting the needs of lower income families. In 2001 approximately 76 percent of single-family rental units backing GSE purchases qualified for the low-moderate income goals, compared with 40 percent of one-family owner-occupied units. This heavy focus on lower income families meant that single-family rental units accounted for 9 percent of the units qualifying for the low-moderate income goal, even though they accounted for around 6 percent

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<sup>38</sup> The 1997 AHS found that 59 percent of such units were affordable to very low-income families, compared with 53 percent for multifamily units.

of the total units (single-family and multifamily) financed by the GSEs. Single-family rentals accounted for 10 percent of the units financed in underserved areas and 13 percent of the special affordable units financed in 2001.

There is not, however, a strong secondary market for single-family rental mortgages. While single-family rental properties comprise a large segment of the rental stock for lower-income families, they make up a small portion of the GSEs' business. The GSEs have not penetrated the single-family rental market to the same degree that they have penetrated the owner-occupant market.

A number of factors have limited the development of the secondary market for single-family rental property mortgages, thus explaining the lack of penetration by the GSEs. Little is collectively known about these properties as a result of the wide spatial dispersion of properties and owners, as well as a wide diversity of characteristics across properties and individuality of owners. This makes it difficult for lenders to properly evaluate the probability of default and severity of loss for these properties. In particular, GSE market share is limited by virtue of the difficulty in determining the property management expertise of the borrower. Smaller, locally-based lenders may have an advantage over large secondary market institutions in this regard.

The GSEs can mitigate risk by purchasing mortgages which are seasoned or refinanced. For the GSEs' mortgage purchases, in general, mortgages on investor-owned properties are more likely to be seasoned than mortgages on owner-occupied 2- to 4-unit properties (based on unit counts). These patterns are consistent with the notion that investor properties are more risky than owner-occupied 2- to 4-unit properties.

In OFHEO's risk-based capital standard for the GSEs, default and prepayment behavior of mortgages on 1-4 unit small rental properties are modeled using regression equations for all single-family mortgages acquired by the GSEs, as described in Chapter VI of this Regulatory Analysis. Occupancy status is included as one of the variables in these models. Default probabilities are greater, and prepayments are lower, on non-owner-occupied than owner-occupied properties.<sup>39</sup>

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<sup>39</sup> Office of Federal Housing Enterprise Oversight (1999), p. 18107