

Financing Multifamily Rental Housing: The Changing Role of Lenders and Investors

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Abstract

A broad consensus exists that there are significant barriers to accessing capital markets for multifamily rental housing, particularly for housing targeted at low- and moderate-income households. While there is a growing secondary market for multifamily mortgages, the market is in the early stages of development and remains quite small. Expanding this market requires increasing standardization of mortgages, increasing credit quality with better underwriting and credit enhancement, and educating investors as to the risks and returns of multifamily investments. In addition, dramatically improved data collection on the performance of multifamily investments and analysis on the determinants of success are needed.

Introduction

Over the past two decades, the U.S. mortgage market has grown from a fragmented set of local credit markets to an important part of the national and international capital markets. The development of this efficient, easy access to the broad capital markets has been primarily the result of increased securitization of single-family mortgages. With standardization and improved marketability, the secondary market for single-family mortgages burgeoned and dramatically increased the flow of capital to homeowners.

The story is quite different, however, when the lens is focused on multifamily rental housing.¹ Although there is a growing secondary market for mortgages on multifamily housing, the market is in the early stages of development and remains quite small; only about one-third of multifamily mortgage originations are sold in the secondary market, as compared with more than three-quarters of single-family originations.

Because the multifamily secondary mortgage market is so small, debt financing for rental housing is still very dependent on depository institutions—particularly thrifts and commercial banks—for

¹ In this paper, “multifamily housing” and “rental housing” are used interchangeably. In all cases the terms refer to rental housing of five units or more.

funding of both construction and permanent loans. However, recent problems facing commercial banks and the crisis in the savings and loan (S&L) industry have significantly limited the participation of these institutions in the multifamily market. As a result, the multifamily market is facing a severe "credit crunch." Finding alternative sources of funding for both short-term construction loans and long-term permanent loans will require opening up access to capital markets and expanding the pool of potential investors.

Yet, in some ways, this could not be a worse time to try to attract new investors to rental housing. A close look at the market right now reveals a rather bleak picture. Much of the tax-favored status of rental housing was eliminated in the Tax Reform Act of 1986. Moreover, the recent slump in the real estate market in general is taking its toll in the multifamily market. Finally, the well-publicized losses in the multifamily programs at the Federal Housing Administration (FHA) and Freddie Mac have sent danger signals to investors in multifamily mortgages.

In trying to understand the causes of the FHA's and Freddie Mac's failures, many have concluded that their experiences had less to do with the inherent risk of rental housing than with lack of expertise in rental housing. Attempts to draw conclusions about multifamily rental housing, however, are stymied by a remarkable lack of data and analysis on the determinants of success. Unfortunately, even for investors who are willing to build expertise in this area, there is very little tracking of data on the performance of and return on investments in rental housing. As a result, investment decisions are often based on perceptions rather than on facts. Despite some indications to the contrary, it is clear that rental housing is an investment many investors view as very risky and few understand.

In this paper, we provide the available data both on the sources of funds for multifamily permanent and construction loans and on

² This paper is derived from DiPasquale and Cummings (1990), a report prepared for the Low and Moderate-Income Housing Finance Task Force created by a group of private, public, and nonprofit organizations. The Task Force consists of high-level private and public participants in the housing finance system. The report includes a complete list of those interviewed as part of this project, as well as a list of Task Force members. This research was funded by Aetna Life & Casualty Company, BankAmerica Foundation, Chase Manhattan Bank/Chase Community Development Corporation, The Equitable Life Assurance Society, Fannie Mae, and the Prudential Foundation. Additional support was provided by The Community Preservation Corporation, Dime Savings Bank, The Enterprise Foundation, Local Initiatives Support Corporation, Neighborhood Reinvestment Corporation, and the Principal Financial Group Foundation, Inc.

delinquencies and foreclosures. Because there has been very little academic research on financing rental housing, much of the research presented here is based on more than 100 interviews conducted with developers; lenders; secondary market actors; federal, state, and local officials; and investors.²

This paper begins with an overview of multifamily mortgage activity over the past decade. The next section examines the economics of rental housing, emphasizing the impact of the federal tax code and bank regulations on both market rate and affordable multifamily rental housing. Next we investigate the structure of financing for both market rate and low- and moderate-income rental housing to uncover any peculiarities in multifamily financing that create barriers to otherwise available capital.³ The following section explores the investors' perspective on rental housing; the market for mortgage-backed securities (MBS); methods of controlling risks, including underwriting and credit enhancement; and actual delinquency and foreclosure experience. Finally, key issues are highlighted that must be addressed to increase access to capital markets for rental housing.

Multifamily mortgage activity

Overview

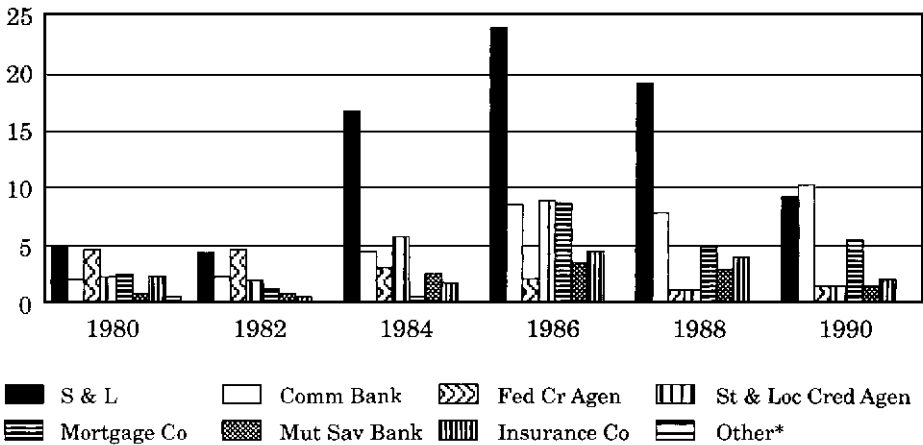
Multifamily loans have historically represented a small portion of real estate loan originations and holdings relative to single-family and nonresidential loans. Multifamily originations peaked at \$59.5 billion in 1986 and declined to a low of \$32.5 billion in 1990, representing 5 percent of all long-term mortgage originations that year.⁴ By comparison, \$458 billion in single-family mortgages have been originated, representing 64 percent of total mortgage originations.

³ In this paper, “low- and moderate-income” or “affordable” housing is defined as housing targeted to households with incomes below a defined threshold. For the purposes of this paper, defining a specific threshold is not required.

⁴ The U.S. Department of Housing and Urban Development (HUD) *Survey of Mortgage Lending Activity* (1980–1990) is the only source of detailed data on multifamily mortgage originations and construction loans. Both HUD and the Federal Reserve Board provide data on multifamily mortgage holdings. Because the Federal Reserve Board data are generally considered more complete, we used those data for mortgage holdings and the HUD survey for originations and construction loans. Percentages of originations, holdings, and construction loans are percentages of the dollar amount, not of the number of loans. All figures are converted to 1990 dollars using the CPI-U-XI.

The story is similar for mortgage holdings. Multifamily loans have consistently accounted for about 8 percent to 10 percent of total real estate mortgage holdings over the past decade. In 1990, \$307 billion of multifamily loans were outstanding, compared with more than \$2.6 trillion for the single-family market. And in that same year, \$29.8 billion in acquisition, development, and construction (AD&C) loans for multifamily housing were outstanding.

Figure 1. Multifamily Mortgage Originations for New and Existing Properties, 1980–1990 (1990 dollars)



*Includes pension and retirement funds and private MBS conduits

Source: U.S. Department of Housing and Urban Development, *Survey of Mortgage Lending Activity*, Annual Tables, table 4.

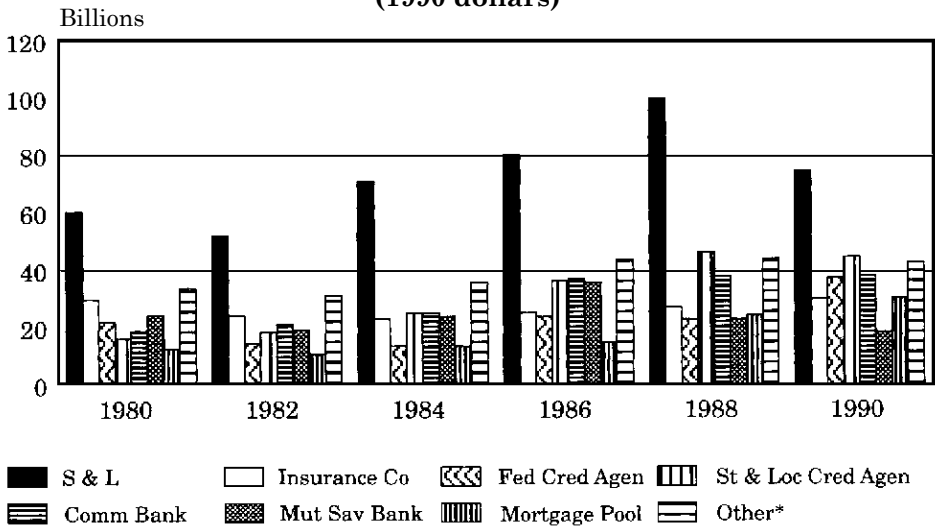
Thrifts and commercial banks have been the largest originators of multifamily mortgages (see fig. 1). Since 1982, S&Ls have accounted for between 30 percent and 50 percent of market originations. In 1990, thrifts and commercial banks originated 28 percent and 34 percent of total multifamily permanent loans, respectively; in 1989, their shares were 37 percent and 25 percent.

In addition, S&Ls have been the largest investor in multifamily mortgages; since 1980, S&Ls have held between 24 percent and 32 percent of the total value of loans outstanding (see fig. 2). Federal,

state, and local credit agencies now account for about 25 percent of outstanding loans. Multifamily mortgage loans held by life insurance companies have dropped over the decade: in 1990, these companies held nearly 10 percent of outstanding loans, down from 14 percent in 1980. Pension funds (part of “other” in fig. 2) held almost 4 percent of outstanding multifamily mortgage loans in the early 1980s but dropped to 0.5 percent by 1990.

Historically, multifamily developers have relied heavily on commercial banks and thrifts for AD&C loans (see fig. 3). In 1990, 50 percent of outstanding multifamily AD&C loans were held by commercial banks; thrifts held 32 percent.

*Figure 2. Multifamily Mortgage Holdings:
Major Investor Groups, 1980–1990
(1990 dollars)*

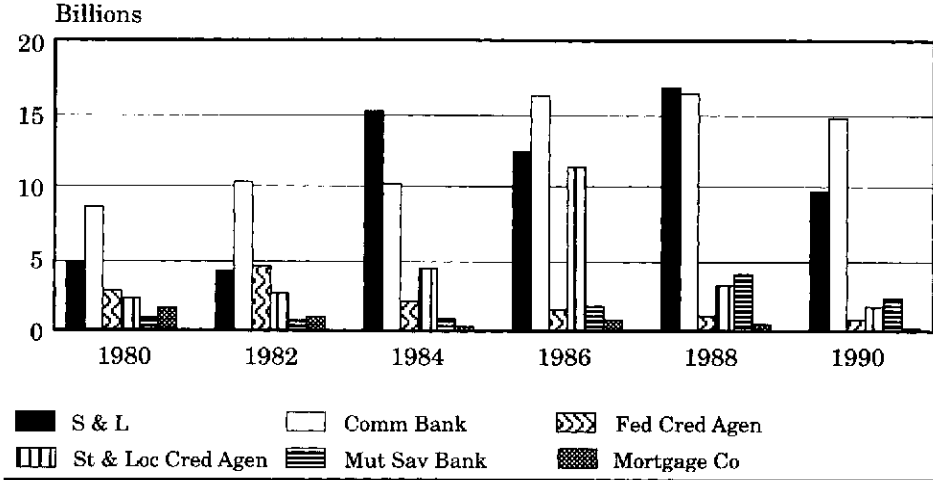


*Includes mortgage companies, private MBS conduits, and pension and retirement funds

Source: Board of Governors of the Federal Reserve System.

Despite substantial growth in the 1980s, the secondary market for multifamily mortgages remains quite small. In 1990, \$9 billion of multifamily loans, representing 28 percent of originations, were sold

*Figure 3. Multifamily Construction Loan Holdings:
Major Investors Groups, 1980–1990
(1990 dollars)*



Source: U.S. Department of Housing and Urban Development, *Survey of Mortgage Lending Activity: Annual Tables*, table 1.

in the secondary market, as compared with \$411 billion of single-family mortgages, or 90 percent of originations.⁵

Finally, the market for multifamily MBS has grown substantially in recent years. Although some of these MBS are privately issued, the vast majority are issued by the federal credit agencies [Fannie Mae, Freddie Mac, and the Government National Mortgage Association (GNMA)]. The federal credit agencies issued \$547 million in multifamily MBS in 1982, \$3.2 billion in 1985, \$7.1 billion in 1988, down to \$5.8 billion in 1989, and up to \$7.3 billion in 1990; this compares with \$225 billion in single-family MBS in 1990.⁶

In the last three years, Fannie Mae’s activity has grown from \$1.4 billion in 1987 to \$4.2 billion in 1988, down to \$3.5 billion in 1989, and back up to \$4 billion in 1990. Freddie Mac’s volume has decreased from a high of \$4.1 billion in 1986 to \$331 million in 1988

⁵ Loans sold include whole loans [from HUD *Survey of Mortgage Lending Activity* (1980–1990), table 33. Taking loans sold as a percentage of originations may overstate secondary market activities, given that loans sold include seasoned loans, which were not originated in the current year. This may have been more of an issue of late as troubled thrifts and banks sell existing portfolios.

⁶ Data on federal credit agency MBS activity is taken from Fannie Mae (1991), *A Statistical Summary*. Figures are in 1990 dollars.

and up to \$1.8 billion in 1990; GNMA issued \$1.5 billion in multifamily MBS in 1990, down from \$2.5 billion in 1988. The decrease in activity at Freddie Mac and GNMA is probably a response to the recent losses in the Freddie Mac and FHA multifamily programs, which have substantially limited activity in both programs.

The outlook for the future

That thrifts account for a large share of originations and holdings in the multifamily market carries some complicated implications in light of the S&L crisis. As a response both to this crisis and to growing problems of the banking sector in general, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which imposed standards designed to reduce risk. These new standards substantially restructure the lending requirements of thrifts and many banks, and they will significantly limit the investment activity of these institutions in multifamily housing.

Alexander (1990, pp. 4–7) anticipates some dramatic changes in the housing market in the 1990s. According to her analysis, the major pieces of FIRREA that affect multifamily financing include the following:

- *Capital requirements.* FIRREA establishes minimum risk-based capital requirements. Multifamily mortgages and AD&C loans are specifically identified as being more risky and are both assigned 100 percent risk weighting. This represents a significant increase in capital requirements from pre-FIRREA practices.⁷ In contrast, single-family mortgages that are not backed by one of the federal credit agencies receive a 50 percent risk weighting.
- *Single-borrower loan limitations.* In an attempt to impose greater portfolio diversification, thrifts are limited to lending a maximum of 15 percent of unimpaired capital to one borrower (with some exceptions), a big reduction from pre-FIRREA practices. This has particularly significant implications for the larger, multifamily loans and for rural areas where a single thrift may serve a large area.
- *Qualified thrift lender tests.* FIRREA raised the portion of thrift portfolio assets that must be housing related from 60 percent to

⁷ Loans on multifamily projects of 5 to 36 units with a loan-to-value (LTV) ratio of 80 percent or less and with stable occupancy of at least 80 percent during the previous year have been defined as “qualifying multifamily housing loans.” These loans receive a 50 percent risk weighting (Office of the Federal Register 1989, p. 46851).

70 percent. Such assets must be “qualified thrift investments” as specifically defined.

- *Loan-to-value (LTV) restrictions.* FIRREA guidelines include an LTV ratio of 95 percent or more for residential loans and of 70 percent for AD&C loans. This inflicts a major blow to AD&C availability in some regions of the country.
- *Direct equity investment restrictions.* In contrast to pre-FIRREA practices, thrifts are now prohibited from making direct equity investment in real estate. (Banks were already prohibited.) AD&C loans structured with low interest rates and some profit sharing by the lender are treated as equity investments and are similarly prohibited.

Based on these changes, it seems certain that thrifts and many banks will step back from their major role in both development and permanent financing of rental housing.

On the other hand, to encourage community mortgage lending, FIRREA did amend the Federal Home Loan Bank Act to mandate that each Federal Home Loan Bank (FHLB) offer a Community Investment program and an Affordable Housing program to member institutions. Under the Community Investment program, financing is provided for home purchases by and rental housing for low- and moderate-income households; the program also offers financing for commercial and economic development in low- and moderate-income neighborhoods. The Affordable Housing program sets aside a portion of net earnings of the FHLBs to subsidize both interest rates on home mortgages for low- and moderate-income home buyers and financing for the purchase, construction, or rehabilitation of affordable rental housing (U.S. League of Savings Institutions 1989, p. 5). Because these programs began in 1990, however, it is still too early to measure their impacts on community lending.

In addition, stepped-up attention to the Community Reinvestment Act (CRA) of 1977 may bring more players to the table. Intended to end discriminatory lending and banking practices, CRA encourages financial institutions to meet the credit needs of their local communities. Recent public outcry for stricter banking regulations and a spate of successful lawsuits against nonconforming banks led financial institutions, Congress, and regulators to take CRA more seriously. In 1989, FIRREA mandated public disclosure of CRA ratings.

The increased enforcement of CRA requirements should bring more banks and S&Ls to the table, either individually or in consortia. This effect is already evident in such cities as Chicago, Los Angeles, and New York, where major commitments to affordable housing and other development projects in poor neighborhoods have been announced.⁸ CXA requirements, however, can be fulfilled entirely with single-family programs, and it is too soon to tell in this new flurry of CRA activity whether investors will make significant commitments to rental housing. To the extent that investors want to meet their CXA requirements with high-visibility projects or with relatively few projects, multifamily housing programs may benefit from CXA activity.

Increased CRA activity and the FHLB programs will provide important resources for affordable rental housing but will not replace the role of thrifts in the multifamily market for AD&C or permanent financing. Whatever the long-run effects of these programs, the investment climate for multifamily is marked by uncertainty and shrinking resources.

The economics of rental housing

The downturn in the rental housing market has received a great deal of attention from housing market analysts and in the popular press. In the first half of the 1980s, multifamily construction was buoyed not only by the overall expansion of the economy but also by extremely favorable treatment under the federal tax code. There is no doubt that construction activity ran well ahead of demand in many parts of the country, and in some places, it oversaturated the market. But although there is an oversupply of rental units in many markets, it is important to note that much of that surplus is at the high end. In many markets, there is a strong demand for but an insufficient supply of good-quality, low-cost units for low- and moderate-income households.

In the 1990s the projected slowdown in household formations and the increases in homeownership rates as the population ages will weaken demand for rental housing. In 1991, multifamily construction hit historically low levels. Current construction levels are insufficient to replace those units being removed from the stock due to

⁸ Efforts include the Rescorp consortium in Chicago, significant commitments by the Security Pacific Bank in Los Angeles, and Chase Manhattan's Chase Community Development Corporation in New York.

conversion, demolition, and abandonment and to meet even modest projections of growth in the number of renter households.⁹

The impact of tax policy

Overview. Because rental housing is an investment asset, the return on investment is an important determinant of the supply of such housing. This return is significantly influenced by federal tax policy, which historically has granted very favorable tax status to rental housing. In fact, particularly in the last decade, federal tax policy has so dominated the underlying economics of rental housing deals that many analysts have concluded that rental housing investments have been tax driven.

Equity investments in rental housing are similar to those in commercial real estate, traditionally taking one of two forms: individual investors or limited partnerships. An individual investor builds or purchases a property and often manages it. Limited partners take no active role in managing the investment but often receive a small, positive cash flow from the project.

Over the past three decades, tax treatment of rental housing has changed significantly. Table 1 provides a summary of the major changes under three tax regimes: pre-Economic Recovery Tax Act (ERTA) of 1981, ERTA, and the Tax Reform Act of 1986 (referred to hereafter as Tax Reform). Under both pre-ERTA and ERTA, the preferred method of depreciation was the double declining balance (DDB) method;¹⁰ Tax Reform mandated straight line (SL) depreciation. The tax life of rental housing has varied widely from 30 to 40 years pre-ERTA to 15 years under ERTA in 1982; under Tax Reform, it was raised to 27.5 years. Maximum marginal tax rates on income for investors ranged from 70 percent in the late 1970s to 50 percent under ERTA to 28 percent under Tax Reform. This lowering of marginal tax rates under Tax Reform has significantly decreased the benefits to investors of investments in rental housing.

The last line of table 1 shows the percentage of historic costs that would be depreciated by year 13 under the different tax regimes,

⁹ For a more complete description of the rental housing market, see Apgar, et al. (1991).

¹⁰ Under ERTA, the Accelerated Cost Recovery System schedule used was approximately equivalent to a 175 percent DDB method in the early years with a switch to straight line in the later years.

given the assumptions made in the table.¹¹ In the pre-ERTA years before 1981, with the DDB method of depreciation and the long tax life, 61 percent of historic costs were depreciated by year 13. Under ERTA, with the DDB method of depreciation and a very short tax life, 88 percent of historic costs were depreciated. Under Tax Reform, with SL depreciation and a longer tax life, 47 percent of historic costs were depreciated.

Another blow to real estate investment under Tax Reform was the provision that “passive” investors (who include most investors in limited partnerships of rental housing) could no longer offset ordinary income with losses from real estate investments. For many investors, this provision substantially eliminated the tax benefits of investing in rental housing, although the actual impact is difficult to measure.

The impact of Tax Reform on the attractiveness of rental housing investment can explain to some degree the historic pattern of multifamily housing starts (see fig. 4). These starts increased during the middle 1980s, due at least in part to the favorable tax rules under

Table 1. Changes in Tax Variables: 1960–1990

	Pre-ERTA	ERTA 1981–1986	Tax Reform 1987–1990
Method	DDB	DDB	SL
Tax life (years)	30–40	15–19	27.5
Tax rate on income on investors	.50	.45	.28
Tax rate on capital gains	.25	.18	.28
Depreciation (13)	.61	.88	.47

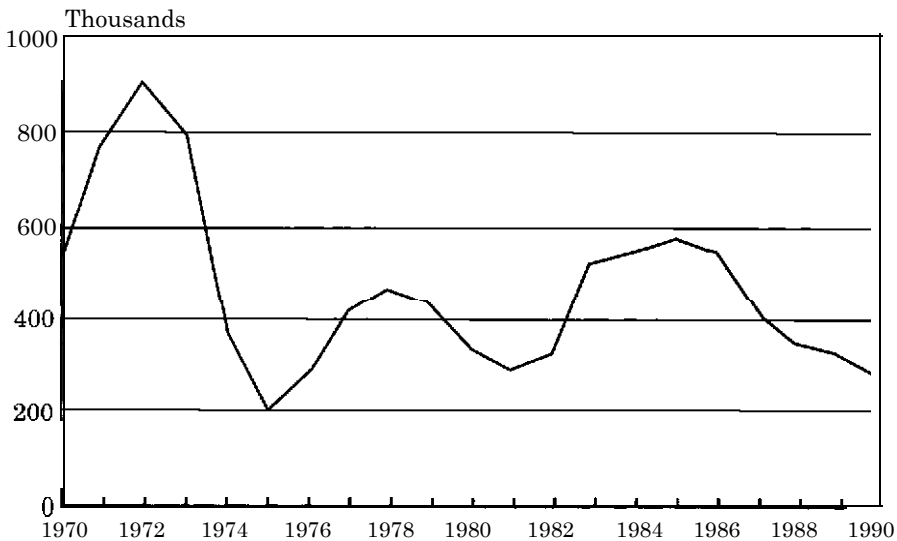
Source: Denise DiPasquale and William C. Wheaton. 1992. The Cost of Capital, Tax Reform, and the Future of the Rental Housing Market. *Journal of Urban Economics*. Forthcoming.

Notes: Method refers to depreciation based on either double declining balances (DDBs) or straight line (SL). Note that the pre-ERTA and ERTA income tax rates for typical investors are assumed to be lower than the maximums. Depreciation (13) is the percentage of historic costs depreciated by the 13th year the property is held. The percentage of historic costs depreciated is based on the tax rate assumptions on income and capital gains for rental housing investors provided in the table.

¹¹ DiPasquale and Wheaton (1992) assume, as do other authors, 13 years to represent the optimal holding period.

ERTA; since the 1986 Tax Reform Act, however, multifamily starts have declined sharply. DiPasquale and Wheaton (1992) forecast that Tax Reform should cause significant long-term declines in multifamily construction, with a resulting increase in rent levels (These estimates of the impact of Tax Reform do not consider the new treatment of passive investors.). Their results suggest that the most dramatic declines in construction (30 to 45 percent) would occur in the first few years but that, from 1987 to 1997, cumulative construction would be 20 percent below levels that would have been sustained had ERTA remained in effect. As a result of Tax Reform, real rents are forecast to climb by 8 percent over the next decade.

Figure 4. Multifamily Housing Starts, 1970-1990*



*Structures with five or more units

Source: U.S. Census Bureau, Census Construction Division, *New Privately Owned Housing Units Started (1959-1990)*, table 1.

The low-income housing tax credit. Although the Tax Reform Act of 1986 dealt a considerable blow to the attractiveness of rental housing as an investment, the Act did introduce the low-income housing tax credit (LIHTC), the de facto federal low-income housing supply program. With the withdrawal of the federal government from housing, except for a few remaining Farmers Home Administration (FmHA) programs, the LIHTC represents the current standard approach to producing low-income housing.

The program provides substantial incentives for investing in low-income housing and often offers the only “equity” found in affordable housing developments. Under the LIHTC program, investors in low-income rental housing projects receive a credit of 9 percent of total construction costs for new construction or rehabilitation costs; the credit drops to 4 percent if the project has federal subsidies or tax-exempt financing. The LIHTC program provides a 4 percent credit for acquisition costs.

LIHTCs are allocated by state. Each state has a maximum volume of credits available set at \$1.25 per capita. Just over \$300 million in tax credits have been available in each of the four years since the program’s inauguration in 1987. A tax credit dollar is available annually for ten years. Hence, the \$300 million in tax credits available in a given year, if fully used, result in \$3 billion in credits over ten years. The four years of the program, at authorizations of \$300 million per year, represent a commitment of \$12 billion over 13 years.

It took some time for the states to gear up to allocating their full credits. In 1987, only 18 percent of the total authorization was actually allocated.¹² By 1989, as developers and financial advisors became more familiar with the program, allocations were up to 98 percent of authorizations.¹³ These credits were allocated to 3,647 projects representing more than 131,000 units, 96 percent of which were low-income units. This works out to roughly \$2,300 in tax credits for each low-income unit per year for ten years. As the volume of LIHTC applications grows, more and more states are hitting their authorization ceilings.

Case (1991) estimates that, under Tax Reform, an investor using 9 percent tax credits can receive implicit tax benefits equivalent to a subsidy of 54 percent of total development costs. The implicit subsidy under the 4 percent credit is 25 percent of development costs. This compares with an implicit subsidy of 15 percent under ERTA and a 6 percent subsidy pre-ERTA. As Case (1991) points out,

¹² Information about the authorization and allocation of tax credits is taken from data compiled by the National Council of State Housing Agencies (NCSHA) (1987–1990).

¹³ According to NCSHA information, allocations of the 1990 program were at 67 percent by mid-1991. This figure is misleading, however, because the unallocated portion will be carried forward into 1991 and eventually a large share will be designated for specific projects. Twenty-five percent of the authorization was not available until the end of the year, when Congress passed the 1990 tax bill.

Congress recognized that the tax credits were lucrative and therefore imposed restrictions on their use, including caps on state allocations, a \$7,000 limit on the credit that an individual taxpayer could take, and a required percentage of low- and moderate-income units in the project.

Costs of the LIHTC program. As with any indirect subsidy program, the LIHTC program has been criticized as inefficient and has become the subject of increased scrutiny. At this relatively early stage in the program's development, the actual costs are difficult to identify, but preliminary analysis suggests that LIHTC deals may be more expensive than comparable investments. A recent U.S. General Accounting Office (GAO) report compared the various fees and expenses associated with real estate partnership offerings that use the LIHTCs (GAO 1989b). The report suggests that partnerships being marketed for LIHTC projects are more expensive than those without tax credits and thereby reduce the amount of equity available for the actual construction and rehabilitation of low-income housing.¹⁴

LIHTC deals bring increased, nonstandardized paper work; the presence of many more players in the deal; and relatively complicated financial arrangements, all contributing to a skyrocketing number of lawyer- and accountant-hours per deal. The low proportion of available tax credits used in 1987 is one indication of how developers and investors have been unable to adapt to the intricacies of the program in a short time. Even in its fourth year, the LIHTC program remains a complicated one with an uncertain future from year to year, which adds to its expense. Stability and predictability could add substantially to the program's efficiency.

Financial structure

Multifamily financing is characterized by the need for a large, upfront infusion of capital before the property can begin to produce income; the large number of parties involved; and the lack of

¹⁴There is some controversy about the interpretation of the data used in the report. In a letter to the GAO about the report, Robert A. Stanger & Co., the data source for GAO's report, argues that the data on fees are, in many cases, "theoretical maximums" that are based on guidelines set by the North American Securities Administrators Association and may overstate actual fees. In addition, they argue that if total fees and expenses are measured against acquired assets rather than equity, low-income housing programs spend 8 percent of their assets as compared with 16 percent for the other partnerships. This is because low-income projects have a considerably lower proportion of equity than do market-rate projects.

standardization of debt instruments or the financing process. The scenario gets even more complicated when subsidies are introduced. Debt financing for rental housing falls into two parts: AD&C and permanent financing.

Acquisition, development, and construction. The consensus among developers and lenders in past years has been that construction financing is readily available from conventional lenders. Construction lending offers banks the clear advantage of being relatively short-term. However, the scenario has changed dramatically of late: AD&C financing for market-rate rental housing has virtually disappeared.

The risk-based capital requirements and single-borrower loan limitations restrict AD&C lending by thrifts. Alexander (1990, p. 8) calculated that, based on the new capital requirements, fewer than 40 thrifts nationwide had the requisite capital to make a \$20 million AD&C loan and only about 15 could extend a \$50 million loan. Further, the practice of profit sharing by the lender has been limited by FIRREA. The National Association of Home Builders (NAHB), in a 1990 survey of builders/developers across the country, confirmed the drying up of AD&C funds (NAHB 1990). Surveyed developers overwhelmingly reported a lack of such funds by conventional lenders and reported that changes in lender practices affected their building or development plans for 1990.

Permanent financing. There are limited data on mechanisms used in permanent financing for multifamily developments. The specific structure of multifamily finance varies widely. The basic components, however, remain constant: equity, mortgage financing, and subsidies for affordable housing.

There are few, if any, reliable data on equity sources for multifamily developments. Equity investment traditionally comes in two forms for rental properties: direct investment by the developer(s) through cash or deferred profit; and investment by an institutional investor, such as a pension fund or insurance company, or by limited partnerships through syndications. Prior to Tax Reform, limited partnerships rather than developers provided much of the equity for rental housing deals. With the provisions for passive investors in Tax Reform, limited partnerships are generally not viable for raising equity for market-rate housing. However, they are used extensively with the syndication of LIHTCs.

As pointed out earlier, syndication of the LIHTCs often provides the only equity for low- and moderate-income housing projects. In

low-cost areas, the combination of the LIHTCs and a conventional mortgage loan can cover total project costs (referred to as a “stand-alone” deal). In many cases, however, the project costs exceed the sum of the LIHTC equity and the maximum conventional mortgage available. The gap is then filled by some combination of state, local, and nonprofit subsidies, direct and indirect.

Currently, there is no single source of information on the financing structure of completed LIHTC projects to identify typical deals or to allow for meaningful comparisons. How the three pieces of permanent financing—the LIHTC equity, the conventional mortgage, and the “gap financing”—break down varies across developments and geographic regions. A “one-third, one-third, one-third” measure is the standard rule of thumb, and many projects we looked at across the country seem to approach that breakdown. Depending on the development costs for the area, 30 to 40 percent of conventional financing is as much as most projects can carry. After putting together the LIHTC equity piece and securing the maximum conventional financing, developers then back into the gap, which typically ranges from 30 percent to more than 50 percent of project costs. One successful private developer in the Midwest reports that he does not have any conventional permanent financing available. Instead, he uses a combination of LIHTCs, state and local direct subsidies, and mortgage money financed through tax-exempt or taxable bonds issued by the state housing finance agency.

Mortgage design. Unlike single-family mortgages, there is little standardization in multifamily mortgage loans. Although some originators with multifamily experience are beginning to standardize at least some features of multifamily mortgages, multifamily mortgage structures do not begin to approach the cookbook standardization that characterizes single-family mortgages. Instead, like commercial mortgages, they are often the result of negotiations between several interested parties trying to accomplish several diverse goals.

To the extent that there is an emerging mortgage standard, it is a fixed-rate balloon mortgage with 7-, 10-, or 15-year terms and 35-year amortization, with some flexibility on the amortization period. Balloon mortgages bring additional risk because the balloon must be paid off or refinanced at the end of the term. Although many argue that balloon risk is a problem only with terms shorter than five years, there are still risks associated with longer term balloon mortgages. One problem is that often the balloon payment is due around the time that the project requires an infusion of cash for capital improvements.

Self-amortizing, 30-year, fixed-rate multifamily loans are relatively rare, although some lenders—particularly those specializing in low- and moderate-income housing—are considering experimenting with these longer term, level-payment, fixed-rate mortgages.

Gap financing. The structure of gap financing is the real wild card in financing affordable multifamily housing. The components are different for every project, and it is often the structure of the gap financing piece in particular that contributes to the problems in finding a market for multifamily mortgages.

Typically, the gap between the project cost and the combination of the first mortgage and total equity is filled by several sources of funds. To the extent that private grants are available, they are tapped quickly. Rural areas rely heavily on FmHA programs. In other areas, developers turn to state and local entities scrambling to fill the void left by the retreat of the federal government.

Subsidies from state and local entities come in several forms. These include “soft second” mortgages, deferred loans, long-term land leases, tax abatements or payment-in-lieu-of-taxes agreements, interest-rate write-downs, and land or buildings at below-market or no cost. Outright grants are used to a lesser extent; they provide too little control over the future of the project while affording government less accountability to the taxpayers. Some increasingly common sources of funds include bond proceeds and funds from “linkage” or dedicated taxes.

There are two important points to make about gap financing from the public sector:

- The structures of gap financing are nonstandard both within a region and across regions. In an era of scarce resources, gap financing often comes from a variety of sources, accounting for some of its nonstandard quality.
- When the public sector enters as a development partner, it typically is looking to achieve several goals at once, including to build housing, to leverage scarce subsidies as far as possible, to deepen affordability, to preserve affordability beyond a few years, and to be accountable for its use of subsidy funds.

Subsidies from state and local entities can be seen by investors as good news. Their presence signals an important political investment in the project: The public sector has made a commitment and will not let the project fail. Yet such subsidies also can signal to

investors that this may be a particularly troubled project, one that needs the extra attention of the public sector to make it appear viable. They further indicate the presence of an additional financial player, one who brings to the table complicated and sometimes costly financial structures and reporting requirements as well as “messy” political demands.

In some cases, to achieve its goals, the public sector structures the gap financing so as to encumber the conventional first mortgage with deed restrictions, rights of first refusal, or special tenant income guidelines. Such restrictions come at a substantial price; lenders are far less willing to provide funds for the first mortgage because the restrictions limit the marketability of the loan.

In summary, there was consensus among the people we interviewed that insufficient permanent financing or subsidies to match the available LIHTCs is the main problem in financing affordable multifamily housing. From a developer’s point of view, public subsidies are the most inexpensive funds in the project. However, in an environment of scarce subsidy dollars, it is important to maximize the size of the conventional first mortgage to increase the leverage of both the subsidies and the tax credit. Hence, a conventional mortgage loan represents the cheapest funds in the project from society’s point of view.

Market for debt from multifamily projects: sorting out the risks

Institutional investors shy away from multifamily housing in part because its management is viewed as difficult. From an investor’s point of view, the easiest real estate ventures to manage are industrial warehouses—large, maintenance-light structures filled with boxes, not people. Although managing commercial real estate is considered troublesome, there is at least a business relationship between management and tenants. Rental housing, however, involves a property manager dealing with individuals and families about something very important to their existence: where they live. In our interviews, many investors who shy away from multifamily housing maintained that management issues are even more difficult in low- and moderate-income housing—that families who live there are harder to manage, require additional services, and are likely to put more wear and tear on the buildings.

Residential management also implies complex legal relationships. Short-term leases, tenant eviction protections, and related issues complicate the management of rental housing. Government regulations such as rent control and restrictions on condominium conversion can limit the future income stream or the ability to sell the investment. Property developed for low- and moderate-income households is viewed as particularly burdened by legal limitations and regulations.

In addition to management issues, the nature of the income stream in low- and moderate-income multifamily housing affects perceptions of risk. On the one hand, successful investors in low- and moderate-income rental housing may argue that rental projects provide a relatively stable income stream. Low vacancy rates—the result of the dwindling supply of low-cost housing—and the tenant-based rental subsidies result in a stable and reliable income stream. In addition, given the short-term leases associated with rental housing, residential rents can be adjusted more often and therefore provide more inflation protection.

On the other hand, low- and moderate-income rental housing may have a greater downside risk because the structures may be in worse condition, be located in distressed neighborhoods, and have higher operating expenses because they are often older and/or rehabilitated buildings. Furthermore, the upside of investment in affordable rental housing is capped by the limit on rents implied by targeting the housing to low- and moderate-income households. This limit on the income stream leads some lenders to view affordable housing as even more risky than market-rate rental housing. For both equity and debt investors, it is important that income keep up with expenses over time. To the equity investor, income growth as well as stability is important; however, investors on the debt side are more concerned with the stability of the income stream over time rather than with its growth.

The role of institutional investors

Much of the reluctance of traditional institutional investors to explore investments in rental housing is due to the incentive structures provided by these institutions. In many instances, there are disincentives for spending time getting up to speed on new, complicated investments. Faced with an investment they either perceive as very risky or know little about, investors have very few reasons to pursue it.

Many pension funds, for example, are legally constrained in their investment options. Some pension funds are prohibited by law from investing in any type of real estate; others are limited as to the kinds of real estate investments they can make. Pension funds have a fiduciary responsibility, which results in a bias against investments that are perceived as risky relative to alternative investments. Corporate pension funds are regulated by the strict provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Although public pension funds are not bound by ERISA, some have developed similar guidelines. Some people argue that public pension funds are even more constrained because they have an extra layer of visibility and accountability to the taxpayers. However, others perceive such funds to be under greater pressure than private pension funds to carry out a “social investment” mission.

In many cases, pension funds and other institutional investors such as life insurance companies relegate rental housing to the social investment branch of their organizations. This decision both reflects and perpetuates certain perceptions of investment in rental housing. Although the social investment branches of these organizations have contributed significantly to providing affordable housing, these branches control a small portion of an institution’s total investment resources. Social investment officers focus on case-by-case projects, are expected to accomplish goals other than bottom-line return on investment, and are therefore judged by different standards than other real estate investors. As a result, traditional mainstream investors within these institutions often know very little about investments in rental housing, and they view these investments as the exclusive domain of the social investment crowd down the hall, which means that—to them—these investments must be messy and unprofitable.

The mortgage-backed securities market

The market for multifamily MBS reflects many of the issues raised here. As noted in the beginning of this paper, the market for multifamily MBS has grown substantially in recent years, but even with this growth, the volume of activity remains relatively small. Many Wall Street traders view multifamily MBS as “story bonds”: traders must explain the financial structure of the security and the underlying properties to potential investors. Describing the underlying properties raises all the issues discussed above regarding investor perceptions of rental housing. Not surprisingly, investors consider multifamily MBS less liquid.

Investment bankers suggest several reasons why the secondary market is less developed for multifamily mortgages than for single-family mortgages. An MBS requires that the underlying mortgages be similar in many respects. Lack of standardization in multifamily mortgages thereby makes it more difficult to package them into securities.

A major problem in selling multifamily MBS is that there is no systematic tracking of the performance of multifamily MBS over time. In the case of single-family MBS, most mortgage research departments on Wall Street have been tracking performance for years and can provide potential investors with their history as well as with comparisons with other investments, such as long-term treasuries. In our interviews, we found almost no tracking of the multifamily MBS market and therefore no history for investors to assess.

As a result of a relatively inactive secondary market, several non-profits and banking consortia across the country are trying to create their own secondary market. These efforts are often targeted at mortgages for low- and moderate-income properties that some lenders perceive are not well served in the existing multifamily secondary market. Even traditional secondary market actors are considering efforts specifically designed for this market. The National Community Development Initiative recently announced a \$100 million commitment from Freddie Mac to purchase long-term mortgage loans from the Local Initiatives Managed Assets Corporation for affordable rental housing projects. However, it is difficult to assess the potential for these efforts, given that most of them are relatively new and there is so little volume to evaluate.

Controlling risks

Investors in rental housing evaluate the projects prior to making the investment to determine if the expected return is sufficient to compensate for the risks. Investors in multifamily mortgages are concerned with three types of risk: interest rate risk, prepayment risk, and default risk. As happens with any long-term, fixed-rate investment, an investor in a fixed-rate multifamily mortgage is concerned with the extent to which the return on the investment keeps pace with alternative investments over time. Adjustable-rate mortgages limit interest rate risk to the investor. In addition, the investor is concerned with the timing of payments of principal. If the investor's principal is returned earlier than expected, this prepayment may decrease the return on the investment.

In the case of default risk, the investor in a mortgage is concerned with the borrower's ability and willingness to make timely payments on the mortgage. Hence, the investor evaluates the potential income stream of the project to be sure it can cover operating expenses and debt service. In addition, the investor is concerned with the chances of loss at foreclosure. Here the investor wants to ensure that the property has a market value sufficient to cover the outstanding mortgage.

The key methods for controlling risk in multifamily mortgage investments include prepayment protection; underwriting guidelines, including lender approval processes and property appraisal standards; and credit enhancements.

Prepayment protection. Multifamily mortgage investors are typically protected from prepayment risk through prepayment protections (or yield maintenance), a standard feature of multifamily mortgages. A schedule of penalties or absolute prepayment lockouts provides the investor with some reliability and predictability of income stream during the yield maintenance period—typically five to ten years. Fannie Mae uses a yield maintenance fee structure tied to the term of the mortgage: prepayment during the yield maintenance period incurs a substantial yield maintenance fee; prepayment after the period carries a prepayment premium of 1 percent of the amount prepaid. Partial prepayments are generally not allowed.

The imposition of substantial fees for full prepayment makes multifamily mortgages a more certain investment than single-family mortgages in the lockout or yield maintenance period. There is still concern about the risk of prepayment after this period. For a multifamily MBS, a single prepayment is likely to have a greater impact on the performance of the security than in the case of a single-family MBS because there are fewer mortgages in the pool, making an individual mortgage a larger portion of the total value of the pool. However, lenders/investors in multifamily housing can ultimately take control over prepayment provisions during initial negotiations; if they are uncomfortable with the risk, they can maintain some penalty for prepayment after the yield maintenance period or even insist on prepayment lockout for the entire term as a condition of lending.

Underwriting. Underwriting guidelines provide a basis for understanding how lenders view the risks associated with multifamily mortgages. To the extent that there are industry standards in underwriting multifamily mortgages, they have been represented by Fannie Mae and Freddie Mac guidelines. As a result of recent losses

in its multifamily programs, which are discussed in detail below, Freddie Mac has largely pulled out of the multifamily market. This has left Fannie Mae as the widely accepted industry benchmark for multifamily underwriting.

Under its Delegated Underwriting and Servicing (DUS) program, Fannie Mae purchases multifamily mortgages, without prior review, from eligible lenders who have obtained special approval from Fannie Mae. Designated local lenders originate, underwrite, and service the loans according to DUS underwriting guidelines provided by Fannie Mae. Fannie Mae sets minimum capital requirements and examines the lender's business practices for approval as a DUS lender; the lender shares the risk of loss. Fannie Mae does not review the loan prior to purchase but does do extensive postpurchase review and lender monitoring.¹⁵

The DUS program allows for mortgages ranging from \$1 million to \$50 million. The underwriting guidelines emphasize examining occupancy levels, rent rolls and lease terms, and the structure of equity participation, as well as detailed studies of the physical condition of the building and neighborhood trends to evaluate the building's long-term economic viability. The project is largely assessed by evaluating the projected income stream. Rent projections are tightly controlled, and limited consideration is given to income other than rent. Repair and replacement reserves are required to be kept in escrow, as are funds for any projected operating losses.

Key variables in underwriting are the LTV ratio, debt service coverage ratio, and recourse or loss sharing with the lender. Typically, the LTV ratio ranges from 60 percent to 80 percent, and the debt service coverage ratio ranges from 1.15 to 1.30. These standards vary somewhat, depending on the level of risk remaining with the lender.

A major element in multifamily underwriting is determining the property's value. Fannie Mae requires that each property be appraised by three methods: (1) the market comparison method (presenting market comparables); (2) the cost replacement method, in which the value is determined by the cost of replacing the

¹⁵ Fannie Mae also purchases multifamily mortgages through two other programs: Prior Approval and negotiated transactions. The Prior Approval program operates using standards similar to the DUS guidelines, with Fannie Mae doing the underwriting of a mortgage before committing to a loan purchase. Negotiated transactions—case-by-case assessments of nonstandard mortgages—account for a substantial portion of Fannie Mae's multifamily portfolio.

building today; and (3) the income capitalization method, in which the value is determined by the building's projected cash flow.

Each of these approaches presents major challenges. Given the diversity of rental housing structures, it is often difficult to find truly comparable properties that have recently sold. The cost of replacing a structure, particularly for rental housing properties that may be older and facing rehabilitation, may have little to do with the structure's current market value. And the income capitalization method raises several mechanical issues, notably projecting the cash flow and selecting the appropriate capitalization rate. As a result, property valuation by any of these methods is not an exact science.

Although Fannie Mae allows for flexibility in the final interpretation of these various assessments, it uses the income capitalization method as the "predominant indicator" in assessing value. Using this assessment method as the predominant indicator significantly affects low- and moderate-income housing. For this housing with a capped income stream, there is often a large gap between value based on capitalized income and value based on project costs. Lenders and developers specializing in low- and moderate-income housing often calculate loan-to-value as loan-to-project cost. This approach may lead the lender to offer a larger loan than if the underwriting was based on a true loan-to-value basis.

Fannie Mae has recently adjusted its guidelines to diminish exposure to default. These adjustments have included increased scrutiny of property condition, increased reserves for replacement funding, and more extensive review of the borrower.

In recent years, Fannie Mae, Freddie Mac, and other multifamily lenders have explored ways of further limiting their exposure to risk. One way of improving underwriting and servicing is to shift more of the risk to the local lenders who do the actual underwriting, thereby making them more accountable. Fannie Mae has been doing this by increasingly using loss-sharing arrangements, under which sellers share the risk of loss at default. Another way is to continue adjusting and tightening its underwriting variables.

Both of these methods have some problems, however. Under the new risk-based capital rules in FIRREA, the loss-sharing requirements threaten the continued participation of banks and thrifts in

Fannie Mae programs because lenders must maintain capital reserves for loans sold when the lender accepts full or partial recourse or risk sharing. These capital requirements limit the value to the lender of selling the loans to Fannie Mae.

Finally, regardless of who is doing the underwriting, it is difficult to set standards for underwriting when there is little known about the actual effects of changing specific variables. For the single-family mortgage market, there has been extensive research over the past two decades on the determinants of defaults. This has resulted in a broad consensus as to the important variables in underwriting single-family mortgages. In contrast, virtually no research has been done on the determinants of multifamily mortgage defaults, so it is difficult to gauge the change in risk associated with small changes in these variables. This continues to be a major problem for all participants of multifamily housing.¹⁶ Those focusing on low- and moderate-income housing often argue that tightening underwriting standards, such as increasing debt service coverage in response to increased defaults, may not be an appropriate response. They claim that their typical successful project would never meet Fannie Mae underwriting standards. There may be better ways for Fannie Mae, Freddie Mac, and others to set underwriting standards to decrease their risk exposure on multifamily mortgages, but the lack of data and analysis makes it difficult to determine what those approaches are.

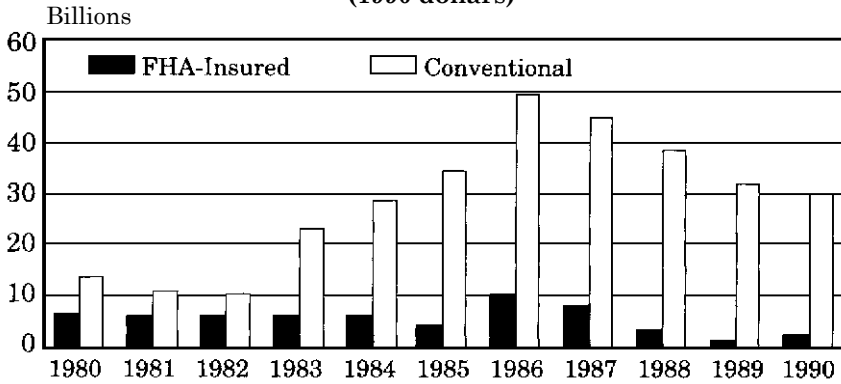
Credit enhancement. HUD has traditionally played a major role in financing multifamily housing. As the only major source of insurance for multifamily mortgages, the FHA insurance program has been a key credit enhancement tool, particularly for low- and moderate-income housing.

However, HUD's activity has dropped considerably, and HUD now seems to be almost entirely out of the multifamily market (see fig. 5). FHA-insured multifamily mortgages (for both new and existing properties) represented only 6.2 percent of total originations in 1990, in sharp contrast to the early 1980s when the FHA's share

¹⁶ The U.S. Comptroller, in looking at problems at HUD and FHA's insurance programs, cited "a lack of up-to-date default information to identify the causes of excessive insurance losses" as a deficiency in monitoring procedures (U.S. General Accounting Office 1989a, p. 9).

was more than 30 percent.¹⁷ For mortgage originations of new properties only, the FHA insured more than 52 percent in 1982 and only 15 percent by 1990. As the FHA reassesses its role in the multifamily market, its activity is likely to remain at these low levels.

Figure 5. FHA-Insured Multifamily Mortgages for New and Existing Properties, 1980-1990 (1990 dollars)



Source: U.S. Department of Housing and Urban Development, *Survey of Mortgage Lending Activity*, Annual Tables, table 4.

With the diminished role of the FHA in this market, there is considerable effort to expand the role of other actors. Unlike the single-family market, there is very little private mortgage insurance offered for multifamily mortgages. Currently, various forms of credit enhancement are provided by some state and local governments and the federal credit agencies, but these efforts do not come close to replacing the large-scale FHA program. In New York State, for example, the Rehabilitation Mortgage Insurance Corporation and the State of New York Mortgage Agency are providing insurance for mortgages underwritten by such organizations as the Community Preservation Corporation (CPC), a private, nonprofit mortgage

¹⁷The share of multifamily originations insured by the FHA in 1990 may be an overstatement of FHA activity. In 1989, the FHA insured only 3 percent of multifamily originations. With the extensive losses in the FHA multifamily portfolio, additional controls were put in place for the coinsurance program in the middle of 1989. As a result, many projects that would have closed in 1989 were actually closed in 1990. With the cancellation of the coinsurance program at the beginning of 1990, the FHA's share in 1991 should decrease considerably.

lender that specializes in financing low- and moderate-income housing (CPC 1991). However, not many states have the capacity to provide insurance. In New York and Maryland, for example, the mortgage insurance programs require 20 percent reserves, a funding level prohibitive to most state and local agencies. In addition, there are proposals that federal credit agencies provide their guarantee on mortgages they do not own for a fee.

Recourse agreements are also seen as an important form of credit enhancement. Recourse agreements and similar tools such as letters of credit are only as good, however, as the parties who sign them. Again, without adequate data, it is unclear what standards for recourse agreements are necessary to afford potential investors sufficient comfort about project risk.

The rating agencies. Obtaining a rating on multifamily investments may be a way to attract more investors to rental housing. A developer or lender could issue a bond or bonds backed by either a single multifamily mortgage or a pool of multifamily mortgages, and then could approach a rating agency for a rating on the bonds. The rating provides useful information and comfort to investors, but it is not a credit enhancement.

To date, the volume of multifamily activity by the rating agencies has been quite small. This is due, at least in part, to their underwriting requirements and the minimum size of transaction necessary given their fee structures. For an AA rating, the rating agencies are looking for debt service coverage ratios ranging from 1.4 to 1.5 and for an LTV ratio ranging from 50 percent to 65 percent; for a BBB rating, the required debt service coverage drops to 1.25 to 1.3 and the LTV ratio rises to 65 percent to 75 percent.¹⁸ In a survey of mortgage activity of life insurance companies, the 1990 average debt service coverage for multifamily mortgages was 1.25 [American Council of Life Insurance (ACLI) 1991]. As described earlier, Fannie Mae's typical underwriting guidelines call for LTV ratios of 60 percent to 80 percent and debt service coverage of 1.15 to 1.3 (Fannie Mae 1988). In our interviews with low- and moderate-income housing specialists, it was clear that the rating agency standards would be very difficult to meet.

¹⁸ These ranges reflect Standard and Poor's and Duff & Phelps guidelines.

In addition, the rating agencies indicated that it would not make sense to seek a rating for a transaction under \$40 million, in part due to the high costs of obtaining a rating. In the multifamily market, however, this volume may be difficult to achieve. Finally, given that there is so little experience with ratings for bonds backed by multifamily mortgages, it is unclear how the market prices the rating. In our interviews with the rating agencies, there was some concern that, in this market, an AA rating was trading like an A rating. If there is too little activity in the market to distinguish among ratings, the value of obtaining a rating is diminished. However, with increased volume, obtaining a rating may be a viable option for at least a portion of the multifamily market.

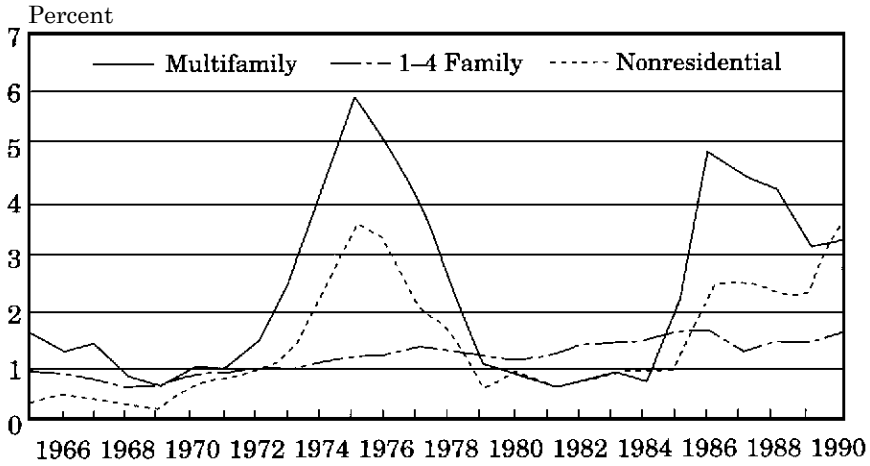
Actual experience

Compared with data on other real estate investments, data on the risks of and returns on rental housing are scarce. Most lenders/investors admit to doing a poor job of tracking the performance of their multifamily housing investments. Because of the relatively small size of most multifamily portfolios and the difficulty investors have in categorizing the loans, data on multifamily housing investments are very hard to obtain. Moreover, the data that are available are not encouraging.

American Council of Life Insurance. An important source of data on multifamily mortgage delinquencies and foreclosures is the ACLI, which tracks multifamily mortgage activity of major U.S. life insurance companies.¹⁹ In the mid-1970s and mid- to late 1980s delinquency rates for multifamily mortgages skyrocketed above those for one- to four-family and nonresidential mortgages (see fig. 6). Although multifamily foreclosure rates did not increase as much during the mid-1970s as might have been expected from the delinquency rates, they did increase dramatically in the late 1980s (see fig. 7).

¹⁹ The ACLI has collected data since the mid-1960s on mortgage activity for multifamily, single-family, and nonresidential properties for major insurance companies. In the ACLI data, delinquent loans are defined as loans with two or more scheduled payments past due; the foreclosure statistics presented here are for completed foreclosures. Delinquency and foreclosure rates are based on dollar amounts rather than on number of loans.

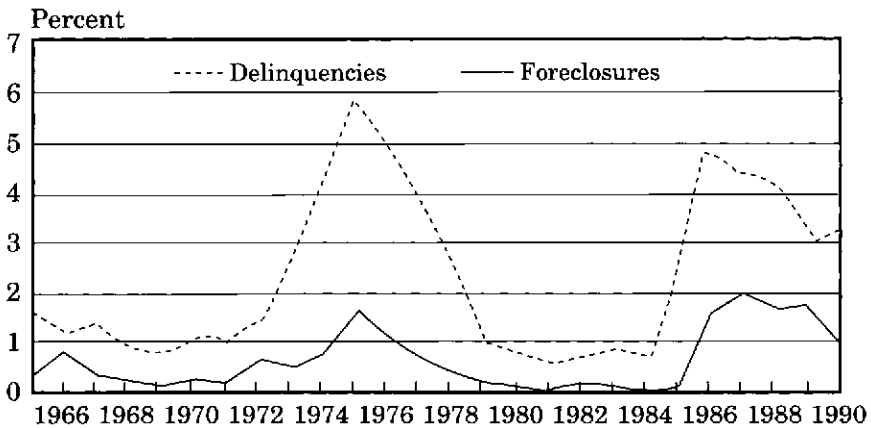
Figure 6. Mortgage Delinquency Rates



Rates by amount of loans; delinquencies include foreclosures

Source: American Council of Life Insurance, *Investment Bulletin: Quarterly Survey of Mortgage Loan Delinquencies and Foreclosures* (1965–1990).

Figure 7. Multifamily Mortgages Delinquency and Annual Foreclosure Rates



Rates by amount of loans; delinquencies include foreclosures

Source: American Council of Life Insurance, *Investment Bulletin: Quarterly Survey of Mortgage Loan Delinquencies and Foreclosures* (1965–1990).

The increase in delinquencies in the mid-1970s may have been due to the downturn in the real estate market and the overall economy during 1974 to 1975. In the rental housing market, real rents fell from 1972 through 1976. The increase in multifamily delinquencies and foreclosures in the late 1980s seems driven by the bust in the oil patch states in their overall economy and their real estate markets. In 1988, for example, the overall multifamily delinquency rate was 4.1 percent, but the delinquency rate was 19.9 percent in the West South Central region of the country, which includes Arkansas, Louisiana, Oklahoma, and Texas. In addition, the favorable tax status of rental housing under ERTA in the early 1980s contributed to overbuilding in many markets, which, in turn, resulted in financial problems for many rental housing projects by the late 1980s.

FHA. The story gets even worse for multifamily programs at the FHA. At this point, the losses in the FHA multifamily mortgage insurance programs, particularly those in the coinsurance program, have been well publicized. The multifamily coinsurance program is part of the FHA's General Insurance (GI) fund. The Price Waterhouse audit of the FHA shows that as of September 30, 1989, the FHA had \$45.4 billion in insurance in force for multifamily housing, of which \$39.1 billion was in the GI fund. As of that same date, the GI fund posted a deficit of \$6.4 billion, up from the deficit of \$3.1 billion on September 30, 1988 (Price Waterhouse 1990). The coinsurance program has since been canceled.

It is difficult to sort out the reasons for the problems in the FHA's multifamily programs. Many people have concluded that the FHA experience illustrates the inherent risks in multifamily mortgages, particularly for housing targeted at low- and moderate-income households. However, there were clearly many problems with the implementation and management of these programs during the 1980s. Price Waterhouse charged that the FHA's multifamily coinsurance program was plagued by "material weaknesses in [its] internal control structure":

Two large programs in FHA's GI fund were structurally flawed and thus exposed FHA to excessive losses. The financial requirements for coinsuring lenders participating in FHA's multifamily coinsurance programs lead to inadequate levels of capital in relation to coinsured risk, and ultimately to a concentration of risk among too few lenders. When one of these large lenders defaulted, FHA incurred substantial losses. (Price Waterhouse 1990, p. 3)

The FHA's 1989 annual report echoed Price Waterhouse's findings in its announcement of the termination of the coinsurance program, labeling the program "structurally flawed and administratively unfixable" (HUD 1991). Thus, the problems with the multifamily insurance programs appear to have had more to do with HUD's inability to manage the programs than with the risks inherent in rental housing.

Fannie Mae and Freddie Mac. As discussed earlier, Fannie Mae's multifamily activity has grown considerably in the last few years.²⁰ At the end of the third quarter of 1990, Fannie Mae's multifamily programs had \$17.9 billion in loans.²¹ Fannie Mae's delinquency rate rose from just over 2 percent in the third quarter of 1986 to a peak of 6.6 percent in the fourth quarter of 1988. By the end of the third quarter of 1990, the delinquency rate had declined to 1.3 percent; at the end of the first quarter of 1991, it had increased to 2.7 percent. In 1990 dollars, losses or charge-offs in the Fannie Mae multifamily programs were \$26.5 million in 1987, \$40.3 million in 1989, and \$32.3 million by the end of the third quarter of 1990.

Interviews with Fannie Mae staff suggest that delinquencies and losses are mainly attributed to their 1984 through 1986 book of business and are geographically concentrated in the oil patch states. In their view, the decline in delinquency rates in recent years is attributed to, at least in part, improvements in underwriting guidelines reflected in their current DUS guidelines, which were initially developed in 1987. In fact, at the end of the third quarter of 1990, the delinquency rate on DUS loans was only 0.2 percent.

²⁰ For both Fannie Mae and Freddie Mac, special detailed reports were issued on their multifamily activities, delinquencies, and losses for the third quarter of 1990. Much of the data presented in these reports have not been updated. Hence, many of the statistics reported here are for the third quarter of 1990. Data on the agencies' multifamily programs are from Fannie Mae (November 1990) and Freddie Mac (October 1990). In this discussion, figures are converted to 1990 dollars.

²¹ Of the total portfolio, \$6.9 billion were conventional loans, \$6.5 billion were conventional loans with recourse, and \$4.5 billion were FHA insured. Fannie Mae delinquency rates are calculated for that portion of the portfolio for which Fannie Mae bears the risk of loss. Hence, the delinquency rates are based on the \$6.9 billion in conventional loans, for which there was no recourse or FHA insurance (referred to as "at-risk dollars"). DUS loans, for which the lender shares the risk of loss with Fannie Mae, were included as at-risk dollars. The figures represent multifamily loans held in Fannie Mae's portfolio as well as loans that were securitized and guaranteed by Fannie Mae (MBS).

For all delinquencies reported in this section, delinquency rates are based on dollar amounts and reflect loans for which payments were more than 60 days late, plus foreclosures.

As mentioned earlier, Freddie Mac has recently experienced significant losses in its multifamily programs. As a result, in 1990, it shut down its cash program, which represented roughly 90 percent of its multifamily business. At that time, its multifamily portfolio totaled \$11 billion.²² Although Freddie Mac currently seems to be testing the waters for reentrance into the multifamily market, for the time being its multifamily mortgage activity remains largely limited to refinancing loans in its current portfolio.

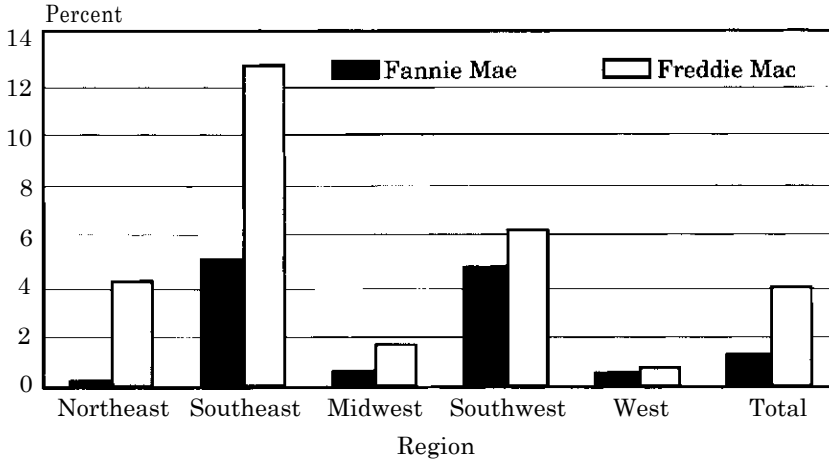
Freddie Mac's delinquency rate rose from 2.2 percent at the end of 1988 to 2.5 percent at the end of 1989. At the end of the third quarter of 1990, delinquencies stood at 3.8 percent; the delinquency rate was 4.2 percent for the cash program and 0.8 percent for the guarantor program. Freddie Mac attributes the strong performance of the guarantor program to the fact that many of these loans were seasoned prior to purchase, which means that their payment histories could be assessed; that most of the loans were originated by depository institutions that intended to hold them and therefore underwrote them as investments; that some of the loans had credit enhancements; and, finally, that many of the loans were on properties located in the West, where property values increased substantially.

Freddie Mac's multifamily losses have risen dramatically from \$3.6 million in 1986 to \$16.1 million in 1987, \$44.2 million in 1988, and \$103.3 million in 1989 (1990 dollars). As of September 30, 1990, multifamily charge-offs were \$122 million. Freddie Mac staff have stated that, in terms of dollars, multifamily mortgages have represented only 3 percent of their business but more than 50 percent of their losses.

Both Fannie Mae and Freddie Mac have indicated that their multifamily problems are geographically concentrated. Delinquencies for 1990 for both agencies were highest in the Southeast and the Southwest (see fig. 8). Within those regions, Georgia and Texas presented the largest problems. Freddie Mac's delinquency rates were higher in all regions, with the most significant differences between the two agencies occurring in the Southeast and Northeast. Freddie Mac's difficulties in those regions were concentrated in Atlanta and New York.

²² Of the \$11 billion, \$9.7 billion was generated through the cash program and \$1.3 billion through the guarantor program.

Figure 8. Fannie Mae and Freddie Mac Delinquency Rates, 9/30/90



Source: Fannie Mae, Investor/Analyst Meeting: Multifamily Housing Program; Freddie Mac, Multifamily Portfolio Analysis, Freddie Mac news release on third-quarter earnings.

Note: 60+ days delinquencies plus foreclosures in process.

The data presented here raise the obvious question of why Freddie Mac's multifamily performance is so much worse than Fannie Mae's. Part of the explanation may reflect the differences in the use of credit enhancement and risk sharing by the two organizations. For Fannie Mae, the "at-risk portfolio" represents only 39 percent of its total multifamily portfolio; 25 percent of the portfolio has FHA insurance, and 36 percent has recourse to the lender for losses. Of the at-risk portfolio, 41 percent consists of DUS loans, for which the lender shares the risk of loss with Fannie Mae. In sharp contrast, a small portion of the Freddie Mac portfolio is credit enhanced. Credit-enhanced loans are part of the guarantor program, which represents only 12 percent of Freddie Mac's multifamily activity. For the cash program, which represents the remaining 88 percent of the multifamily activity, there is virtually no credit enhancement or risk sharing.

Clearly, Fannie Mae's participation in the multifamily market is dominated by activities in which it does not bear the risk of loss, whereas Freddie Mac has taken on the risk for the vast majority of its participation in this market. However, Fannie Mae's at-risk dollar loans clearly perform better than Freddie Mac's cash program.

Thus, underwriting and management must be part of the explanation of the differences in performance. As noted above, a significant portion of Fannie Mae's at-risk portfolio consists of DUS loans. The lender has a real incentive to underwrite these loans carefully, given that it shares the risk of loss. In addition, the approval process for becoming a DUS lender is designed to ensure that the lender uses sound business practices and has the capital to cover the risk. Hence, the program is designed to avoid some of the problems the FHA faced with lenders under the coinsurance program.

The written underwriting guidelines for multifamily mortgage programs for Fannie Mae and Freddie Mac show surprisingly similar criteria. However, the implementation of those criteria seems to have been somewhat different. According to equity analysts at Goldman, Sachs, Freddie Mac focused on the LTV ratio rather than on the debt service coverage ratio (Goldman, Sachs 1990). Although LTV ratios are considered the single most important variable in underwriting single-family mortgages, they are viewed as less important than analyzing cash flows for multifamily loans. Part of the problem with LTVs is the difficulty in determining value, as discussed earlier. While there is no doubt that more formal analysis is required to determine the relative importance of these variables, interviews with underwriters of multifamily mortgages definitely supported the view that debt service coverage was more important than LTV. In addition, equity analysts at Paine Webber argue that Freddie Mac was more lax than Fannie Mae about knowing the lenders who were originating and servicing the loans and auditing the underwriting standards that were being used (Paine Webber 1990).

Interviews with Freddie Mac staff indicate that Freddie Mac did not really develop the special expertise necessary to underwrite and service multifamily loans and was slow to adjust its underwriting guidelines to the softening real estate market of the 1980s. Freddie Mac's relatively large level of activity in the multifamily market at the time made the magnitude of multifamily delinquencies and foreclosures difficult for it to handle.

The data presented above unquestionably paint a rather bleak picture of the performance of multifamily mortgages. The weakness of the real estate market makes this a particularly unfortunate time to examine the multifamily market. The well-publicized problems at the FHA and Freddie Mac have led many to conclude that multifamily mortgages, particularly those on low- and moderate-income housing, are very risky investments.

The divergent experiences of Fannie Mae and Freddie Mac, however, suggest that special expertise in underwriting and servicing can have a significant impact on multifamily loan performance. The FHA and Freddie Mac experiences point to the importance of knowing the business practices of the local lenders who are originating and servicing the loans. As suggested earlier, the scarcity of data makes it difficult to know with certainty the determinants of success in underwriting multifamily mortgages. However, a look at the experience of investors specializing in low- and moderate-income housing may shed some light.

Low- and moderate-income housing specialists. There appears to be a significant divergence between industry default experience for multifamily mortgages in general and the experience indicated by those we interviewed who focus on low- and moderate-income housing (e.g., CRA lenders, social investment departments of life insurance companies, nonprofit lenders, state housing finance agencies, and some private developers). In sharp contrast to the default experience outlined above, specialists in low- and moderate-income housing repeatedly reported to us strong multifamily performance showing few, if any, defaults.

Plausible explanations of this marked difference in performance include the following:

1. *Different definitions and standards of performance.* Specialists in low- and moderate-income housing may, in practice, have different standards of performance. In many cases, these lenders intervene very early when a project is in trouble. They may categorize loans as delinquent or nonperforming later in the process than do traditional market-rate lenders. To the extent that they do, it does not necessarily mean that these specialists are misrepresenting performance. In fact, their categorization may be a more accurate measure of the loan's ultimate performance. As the ACLI data indicate, for example, the life insurance companies' foreclosures were not as high as their delinquency rates might have suggested in the mid-1970s. At the very least, though, investors must develop comparable definitions to compare performances accurately.
2. *Lower vacancy rates in low- and moderate-income projects than in market-rate developments, resulting in less market risk.* In many markets, the rental income streams for low- and moderate-income projects are much more certain than for higher rent

units because low-rent units are in short supply. Hence, the risk of units being vacant for long periods of time is relatively small.

3. *“Creaming” of subsidy-rich deals by specialists in low- and moderate-income housing.* This notion is based on the assumption that taking advantage of the diversity of available subsidy programs requires a significant investment of time and effort that only these specialists are willing to make. This era of scarce resources may create significant barriers to entry for would-be developers; only a few specialists with a proven track record may have the expertise and capacity to gain access to the complicated array of available subsidy programs.
4. *A greater investment in making the project work and a tendency to monitor each project closely on the part of those focused on low- and moderate-income housing.* Arguably, those focused on low- and moderate-income housing watch their projects very closely from the beginning of the development. The specialists are more involved in every step of the process. They may, for example, typically insist on the involvement of community-based organizations as part of their underwriting criteria, seeing this as increasing the likelihood of project success. They may have broader economic development goals tied to the multifamily project and thus may involve themselves more thoroughly in design and management issues. This greater involvement in the project may lead the underwriters and servicers to be more committed and responsive to the project. They may intervene in a troubled project earlier, manage workouts more aggressively, or be more likely to inject additional funds into a troubled project than those involved in conventional market-rate projects.
5. *Special expertise in underwriting and managing low- and moderate-income projects that the industry at large has not developed.* In our interviews, underwriters and servicers clustered in CRA branches of banks, social investment departments of life insurance companies, and nonprofit lenders and developers emphasized the notion that they had a system for underwriting low- and moderate-income housing that was different and more appropriate than the one used by conventional market-rate underwriters. In particular, specialists seemed more likely to tailor their underwriting, property assessment, and management guidelines to the local market conditions. Some of these specialists pointed to specific tools they use, such as letters of credit from developers/contractors. Others said they know the developers they work with, which allows them to judge capacity and track record better.

The divergence between the experience of specialists in low- and moderate-income housing and that of the industry as a whole demands additional attention. Specialists may benefit from an ability to spend more time on project management because they do far fewer projects. Our research suggests, however, that their success also may be due to a special expertise in underwriting and management. The question is to what extent the industry can learn from the specialists and develop more expertise to improve the performance of multifamily mortgages. As stated earlier, we need to improve our understanding of the determinants of default before we can identify with certainty the reasons for the apparent success of these specialists.

Conclusions

The multifamily mortgage market is at a point of transition. Thrifts and commercial banks have been the dominant originators of and investors in both construction and long-term mortgage loans for rental housing. With the S&L crisis and the problems facing commercial banks, these institutions are reassessing their roles in both rental housing and the overall real estate market. Hence, there is pressure to find alternative sources of funding for both construction and long-term mortgage loans. An active secondary market for multifamily mortgages would broaden the pool of potential investors.

Expanding the secondary market requires standardization of multifamily mortgage loans, increased credit quality with better underwriting and credit enhancement, and educated investors with respect to the structure of the underlying mortgage instrument and the performance and risks of multifamily securities. As we learned from the development of the single-family mortgage market, standardization of multifamily mortgage products and documentation should increase the marketability of these loans.

Expanding access to capital for low- and moderate-income housing requires that the financing be structured so that any conventional mortgage is unencumbered by the existence of subsidies and meets industry standards in terms of credit quality. Given the relative scarcity of subsidies, conventional mortgages represent the cheapest funds in the deal whereas subsidies are the most expensive. Hence, the goal should be to maximize the size of the conventional mortgage in the deal within appropriate LTV limits. In many cases, mortgages on projects targeted for low- and moderate-income households require credit enhancement to meet the credit quality

standards of investors. With the current withdrawal of the FHA from insuring multifamily mortgages, it is important to identify alternative sources of credit enhancement. The potential roles of the federal credit agencies, state and local governments, nonprofit organizations, and the private sector in providing credit enhancement must be assessed.

Expanding the potential market for equity investments in multifamily housing requires an increased understanding of the risks of and returns on these investments. For multifamily housing targeted at low- and moderate-income households, LIHTCs are the current fashion for raising equity. As the LIHTC program has become better understood, it has succeeded in attracting investment in low- and moderate-income housing. However, tax laws are subject to change, and such changes increase the costs of building projects. If the goal is to create incentives to provide low- and moderate-income housing through federal tax policy, stability over time in the structure of the incentives would help to achieve that goal.

The surprising lack of any consistent data and analysis on the risks of and returns on investments in rental housing poses serious problems to current participants in the market and raises barriers to attracting new investors. Current participants in the multifamily mortgage market, for example, attempt to manage their exposure to risk by adjusting underwriting guidelines, but they have very little information with which to assess the impact of the adjustments. Analysis of default data to identify the key determinants of risk in multifamily lending is required to develop better underwriting practices for the industry and increase overall credit quality. Both attracting new investors and increasing the activities of the investment banking community are hindered by the investors' lack of experience and expertise with the debt or equity side of rental housing. There needs to be better tracking of rental housing investments—equity, mortgages, and MBS—so they can be compared with alternative investments.

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