MEETING MULTIFAMILY HOUSING FINANCE NEEDS DURING AND AFTER THE CREDIT CRISIS:

A POLICY BRIEF

Joint Center for Housing Studies
Harvard University
January 2009

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Support for this paper was provided by the National Multi Housing Council and the Policy Advisory Board of the Joint Center for Housing Studies.

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The opinions expressed in *Meeting Multifamily Housing Finance Needs During and After the Credit Crisis: A Policy Brief* do not necessarily represent the views of Harvard University, the Policy Advisory Board of the Joint Center for Housing Studies, or the National Multi Housing Council.

The Joint Center wishes to thank Doug Bibby and Mark Obrinsky of the National Multi Housing Council for supporting this paper, and for collaborating on the policy discussion convened by NMHC and JCHS in November 2008 which explored potential opportunities for the reform of multifamily finance as part of a new vision for the nation's housing finance system. Highlights from that immensely valuable dialogue are also summarized herein.

EXECUTIVE SUMMARY

Although multifamily housing finance is not the source of the current credit crisis, it has been disrupted by it. Even though multifamily rental loan performance has held up well, many private sources of multifamily finance have exited the market. Fannie Mae and Freddie Mac, and to a lesser degree the Federal Housing Administration (FHA), have stepped in to make up much of the gap. Thus, the apartment and multifamily development markets are now being heavily supported by federal sources.

With uncertainty about what the reform of Fannie Mae and Freddie Mac will bring, mandatory reductions in their portfolios scheduled for 2010, and questions about the capability of FHA to handle greatly expanded loan volumes, these essential federal supports are at risk. There is a narrow window of opportunity to take steps to ensure the federal government continues to be a liquidity backstop for multifamily property markets before institutional reforms or scheduled portfolio reductions occur. Beyond these immediate liquidity needs, the likely broader reform of the housing finance system provides an additional opportunity to improve government supports for the multifamily finance system of the future.

Multifamily rental housing is important because it meets the housing needs of a range of different types of households. From those who simply find renting more convenient, to those who cannot qualify for a mortgage loan to own a home, to those unprepared to take on the risks of owning a home, to those who have just moved to an area or plan to move again soon, to those who seek the services that are more economically provided in higher density settings (such as seniors and others with disabilities), rental housing is a crucial option.

Multifamily housing is also important because it is better suited than single-family housing to meeting critical national goals like energy independence, sustainable development, and reductions in greenhouse gases. Multifamily housing will only grow in importance as these policy goals take center stage, as the largest generation of children below the age of 20 in the history of the US reaches adulthood from 2000-2020, as the number of frail seniors begins to skyrocket, and as mortgage credit standards tighten.

Although some multifamily market segments have not been as well-served as others by the multifamily finance system, the system has functioned well for years. In no small measure, this is because government supports have typically stepped in to provide liquidity when purely private sources have exited. Fannie Mae, Freddie Mac, and FHA have all expanded their activity

in 2007-08 as purely private sources withdrew or charged untenable interest rates. This is not the first time they have done so. Both in the wake of the currency crisis in 1998 and again after 9/11 and the 2001 recession, Fannie Mae and Freddie Mac stepped up portfolio purchases and guarantees of multifamily debt. This time, in 2007 alone, portfolio purchases surged by fully $29 billion to $56 billion—more than twice as much any previous year.

The system has also functioned well because investors have paid closer attention than single-family investors to their multifamily debt investments. Multifamily loan performance remains quite strong and underwriting standards appear to have remained prudent, unlike in the single-family market. While a severe recession will certainly lead to an erosion in performance, this deterioration will largely reflect economic conditions, not poor underwriting. That said, if as a result of the broader credit crisis existing apartment owners cannot refinance their maturing debt (most multifamily loans are balloon loans of 5, 7, or 10 year terms), default rates could rise. That puts an even greater sense of urgency on preparing plans now to make sure federal sources continue to provide liquidity.

The risks are great. The CMBS market has basically shut down, banks and thrifts are presently not willing to lend for multifamily new construction or rehabilitation, and life insurance companies, pension funds, endowments, and others that have provided permanent financing are standing on the sidelines. Also, with no income tax liability to shelter, Fannie Mae and Freddie Mac have stopped buying low-income housing tax credits. New investors have not yet been found to fill the gap and credit pricing is making most planned projects unworkable. Meanwhile, the public markets for state tax-exempt bonds have been roiled, making it harder to finance the preservation and production of much needed affordable, low-income housing.

One thing is clear: without the federal government as a liquidity backstop for multifamily finance, apartment owners would not be able to buy and sell properties, they would not be able to refinance them when their debt matures, they would not be able to tap equity in their properties to keep them from falling into disrepair, and new construction and rehabilitation could come to a halt even if there is demand for them. States and local governments are not in a position to play this role because they are not seen as the safe haven for investment that the federal government is. And private sources are not stepping in—indeed they are heading for the door.

Federal Reserve Chairman Ben Bernanke in a speech in 2008 concluded that "at least under the most stressed conditions, some form of government backstop may be necessary to

ensure continued securitization of mortgages." There is little disagreement that the size of residential mortgage markets and their importance to Americans demand that the federal government play such as role. There is, though, disagreement over how to achieve this and what other functions are legitimate and important for the federal government to play in support of multifamily markets.

With respect to Fannie Mae and Freddie Mac and their role as liquidity backstops, Chairman Bernanke suggested three alternatives: (1) to fully privatize Fannie Mae and Freddie Mac; (2) to use a covered bond approach (which would take the federal government out of the picture); and (3) to create even closer ties to the government, with or without shareholders.

The risk is that in reforming these institutions or moving forward with planned portfolio reductions, the critical liquidity role of Fannie Mae and Freddie Mac in multifamily finance will be jeopardized. In addition, FHA is now stepping up its activity and is perhaps the only source of lending for new development, though demand has diminished in the face of a broader housing oversupply. But FHA is widely viewed as being too rule bound, inflexible (because it takes an act of Congress to innovate in significant ways to meet new demands), and subject to annual appropriations for staffing and systems. Thus, there is concern that FHA is not prepared to handle a much larger role or could not play such a role effectively.

A wide range of roles beyond liquidity backstop are also possible and, in fact, have been played historically by the federal government in housing finance systems (see body of this paper for additional details). These include:

- Liquidity backstop during periods of extreme credit market stress
- Liquidity source during normal times for housing that would otherwise have trouble attracting funds from purely private sources, or only at unacceptably high costs
- Credit enhancer during periods of stress to increase mortgage liquidity from non-governmental sources
- Credit enhancer in normal times for housing that meets public purposes
- Innovator of new mortgage products aimed at demonstrating market feasibility
- Standard setter for underwriting and pooling loans, managing properties, and servicing and workout practices
- Provider of subsidies and tax incentives for housing that meets public purposes

In thinking through which of these roles the federal government should play and how to play them, several guiding principles have been suggested, though there is surely not full agreement on them (see body of this paper for additional details). These include:

- Start with a clear mission of what public purposes federal agencies or sponsored institutions are serving and what specific functions they will perform to serve them
- Strive to limit federal supports in normal times to activities that serve a public purpose or that the private sector cannot undertake profitably on its own
- Demand appropriate public returns in exchange for government-assumed risks
- Establish adequate reserve requirements for mortgage finance institutions that the federal government sponsors or does business with
- Strengthen the role that the federal government plays in ensuring prudent underwriting by any institution it sponsors, and loans it insures or securities it guarantees
- Establish net worth requirements for counterparties in the housing finance system, require that counterparties have capital at risk, and structure compensation so that counterparties earn returns based on loan performance as well as origination fees
- Develop strong public disclosure requirements to ensure greater transparency to investors, counterparties, policy makers, and public watchdogs
- Establish strong regulators with broad powers to monitor mission and examine for safety and soundness

The housing finance system reform process, including reform of the GSEs, presents a unique opportunity to improve federal supports for the multifamily finance system and to enhance its capacity to meet vital national public policy goals. These goals include ensuring a continuous flow of credit to apartment markets and meeting the nation’s affordable rental housing needs, reducing energy consumption, reducing carbon emissions, and promoting revitalized communities. Also, federal supports for small multifamily finance and lending for land acquisition, development, and construction has been weak and could be strengthened.

This paper briefly describes how the multifamily finance system operates, the federal role in it, the risks ahead, and the potential opportunity to reform multifamily finance as part of a new vision for the nation’s housing finance system.

INTRODUCTION

With credit markets in turmoil, many private sources of multifamily finance have all but withdrawn from the market. Yet, unlike the performance of single family (1-4 unit property) loans, the performance of multifamily (5+ unit property) loans has been holding up well. And while Fannie Mae and Freddie Mac loosened their single-family credit standards to compete against Residential Mortgage Backed Securities (RMBS), they did not do so to compete against Commercial Mortgage Backed Securities (CMBS). Instead, Fannie Mae and Freddie Mac simply lost market share to the CMBS market channel.

Both the availability and pricing of multifamily loans have been negatively affected by the subprime single-family mortgage meltdown. Interest rate spreads in the CMBS market have ballooned and the market all but shut down. Life insurance companies and deposit-taking institutions have sharply curtailed credit. As these and other sources of multifamily finance have seized up, Fannie Mae and Freddie Mac have provided much needed liquidity to the market, especially through portfolio purchases. Although FHA has also stepped up its activity to meet industry need, its multifamily activity has not increased nearly as much as its single-family activity.

More importantly, under a recently passed law Fannie Mae and Freddie Mac will be required to reduce their portfolios after 2009. While it is unclear whether Congress will choose to hold to this plan, especially while the corporations are under a federal conservator, Fannie Mae and Freddie Mac's portfolio purchases are in large part the financing source that has filled the void created by the recent departure of private debt capital sources. Policy makers need to begin to discuss the implications of reducing Fannie Mae's and Freddie Mac's portfolios now so that should these portfolio reductions take place as currently planned, a substitute liquidity backstop will already be in place.

The debate over the broader reform of the housing finance system should not only examine how to ensure liquidity to multifamily housing in the near-to-intermediate term, but also what more fundamental changes would make the multifamily finance system more effective over the long-term. This includes considering how to strengthen federal supports in multifamily market segments in which these supports have traditionally been weaker, including small multifamily rental properties with fewer than 50 units, and land acquisition, development, and construction loans for multifamily properties. It also means considering how the multifamily

finance system can help achieve national goals like energy independence and reductions in carbon emissions by encouraging retrofitting of older properties and building and preserving multifamily housing at higher densities, closer to transit nodes, and in more compact patterns within walking distance of shopping and other amenities. Lastly, it means rethinking the best way to deliver housing subsidies to help low-income Americans afford rental housing and to meet the special housing needs of the growing number of seniors with disabilities.

WHY MULTIFAMILY RENTAL HOUSING IS IMPORTANT

Multifamily rental housing is critical to meeting the nation's housing needs. When looked at from a units-in-structure rather than a units-in-property perspective, multifamily rental housing is home to about 16 million American households.[1] This amounts to 14 percent of all households and 43 percent of all renter households. On a property basis, closer to half of all renter households live in multifamily housing.

Multifamily rental housing serves the housing needs and preferences of many different types of households. These include those who do not want to take on the financial risks of homeownership or the high transaction costs of buying and selling homes, those who prefer the convenience of having others attend to maintenance, those who cannot qualify for a mortgage or afford to own, and those who anticipate moving within a few years.

Multifamily rental housing is an especially important option for those who seek the kinds of services that multifamily rental housing can provide more economically than single family housing. Multifamily housing communities can be built to higher densities that make the delivery of social services and physical infrastructure more efficient and economic than in scattered site single-family housing. Thus, multifamily housing is especially well-suited to serving the needs of seniors and people with disabilities who require special services like medical care, medical attention, preparation of meals and help with other daily activities of living.

Multifamily housing will be even more important moving forward, both for political and demographic reasons. On the political side, multifamily housing will grow in importance because it is better suited than single-family housing to helping achieve the goals of energy independence, sustainable development, and improved environmental quality. It will also

[1] It is important to note that most reporting on multifamily rental construction and households living in multifamily rentals are reported on a *structure* rather than a *property* basis, as further detailed in footnotes to this section.

become more important because of demographic shifts that will favor multifamily rental living. The second fastest growing family type over the next 10 to 20 years will be single persons living alone, nearly half (45 percent) of whom rent. In addition, the native-born population aged 0-19 in 2000 is the largest ever and will be aged 20-39 by 2020. As this population, born 1980-2000, is augmented by young adult immigrants arriving in the country over the next 10-15 years, the young adult population—the group most prone to rent multifamily apartments—is poised to set a record. Also, the fastest growth in the population after 2010 will be among those over 65. While homeownership rates peak at about these ages, they begin to ebb as seniors with disabilities and widows shift increasingly towards rentals. In addition, over and above demographic trends, to the extent that tighter mortgage standards persist into the future, low shares of young renters will be able to make the transition to homeownership and those that defaulted will have a hard time returning to homeownership.

While multifamily housing has the potential to deliver more affordable housing on any parcel of land by economizing on this essential input, without a significant subsidy it is impossible to produce new or rehabilitate existing multifamily rental housing that low-income households can afford. Indeed, the primary program for stimulating the construction and rehabilitation of rental housing that low-income (defined as households with incomes up to 60 percent of area medians) households can afford (at 30 percent of their income) involve tax credits worth up to about 70 percent of the net present value of the property. For any with incomes below 60 percent of area median incomes, even this housing is unaffordable. Indeed, a staggering 79 percent of multifamily renters in the lowest income quartile and 45 percent in the lower-middle income quartile spend more than half their income on housing.

It is even difficult for most low-income renters to afford a modest existing two-bedroom apartment at the federally determined fair market rent. The National Low-Income Housing Coalition reports that there is no county in the nation in which a household earning the full-time equivalent of the minimum wage can afford (at 30 percent of their income) such an apartment, and that in many it takes multiples of the minimum wage to do so. For households fortunate enough to receive a federal rental voucher or certificate, the government makes up the difference between 30 percent of renter incomes and the “fair market rent” for such apartments. The average voucher amounts to around $6,600 annually.

A WELL-FUNCTIONING MULTIFAMILY FINANCE SYSTEM

The multifamily finance system in the United States is effective, credit-worthy, and unlike the single-family system has maintained strong underwriting throughout the decade. The multifamily finance system is composed of a mix of public markets, private markets, and credit supplied or insured by government-sponsored enterprises (GSEs) or insured by government agencies (FHA/Ginnie Mae). While they generally serve different parts of the multifamily housing market, these pieces have fit well together. FHA finances high loan-to-value ratio new construction while life insurance companies and pension funds tend to finance high-end luxury apartments. Fannie Mae and Freddie Mac finance a broad section of the market but concentrate on larger multifamily properties while savings institutions tend to focus on smaller multifamily properties and land acquisition, development and construction loans. Housing finance agencies provide tax-exempt bond financing and federal tax credits to affordable housing development. CMBS markets, until recently, provided liquidity to a range of property types and for a range of financing needs.

The financial institutions and programs that support multifamily rental housing are interconnected. For example, the availability of permanent financing for larger properties from Fannie Mae and Freddie Mac and life insurance companies is critical to the willingness of banks and thrifts to provide land acquisition, development, and construction loans to these properties. In fact, banks and thrifts write construction loans with an eye towards take-out by Fannie Mae and Freddie Mac, and thus conform to their standards.

While the shares of multifamily debt outstanding have shifted around among the different suppliers and insurers of multifamily mortgage credit, multifamily markets have had good access to debt for decades even during difficult economic periods and weak market conditions. When one supplier of credit to apartment properties or multifamily developers was under stress, another would step in to take its place. For example, when the savings and loans crisis occurred in the late 1980s, commercial banks expanded their shares. When FHA temporarily exited from the market in the wake of the failure of the co-insurance program, the GSEs, banks, and others helped to ensure a flow of credit. When Freddie Mac's portfolio of multifamily mortgages was under stress in the late 1980s from loans written in distressed markets (such as in New York City, Los Angeles, and Atlanta), Fannie Mae and other lenders gained share.

Delinquency rates in 2007 for most categories of multifamily and commercial lenders were at historical lows, with only banks and thrifts seeing any increase in rates last year. Some increases in loan defaults, however, did start to crop up for CMBS in 2008. Still, at 0.53 percent of loans 30+ days delinquent or in REO, even CMBS rates are still below the 1.7 percent rate reached in 2003.[2] Relative to other sources of multifamily permanent financing, many believe that underwriting standards have been looser in the CMBS market channel, though it is difficult to judge whether this is true.[3]

WELL-FUNCTIONING FEDERAL SUPPORTS

The primary federal supports for the multifamily finance systems—Fannie Mae, Freddie Mac, and FHA—have been working well. Missteps have been few and largely confined to a period in the late 1980s under the FHA co-insurance program in which proper underwriting controls were not in place, and the early 1990s when Freddie Mac's portfolio performed poorly.

As described below, Fannie Mae and Freddie Mac have repeatedly acted as liquidity backstops when needed. They have also: (1) promoted reasonable underwriting standards that others have emulated; (2) innovated products; (3) promoted uniform mortgage documents; (4) established industry practices for environmental and engineering reviews; and (5) played an important role as key investors and lenders in the tax credit market.

Although the GSEs mostly extend permanent financing for existing properties and for new or redeveloped properties after they have leased up, the fact that the GSEs stand as a take-out of construction financing, and the standards they set, partly drives the availability of land acquisition, development, and construction financing. In addition, the capital the GSEs make available for purchases of multifamily properties plays an important role in creating greater liquidity in the underlying assets, allowing REITS to more easily buy and sell assets and, thereby, to attract equity capital.

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[2] Mortgage Bankers Association, Commercial/Multifamily Mortgage Delinquency Rates for Major Investor Groups.

[3] To the extent that multifamily mortgage performance may deteriorate in the coming quarters, this will likely be a consequence mainly of fast-eroding economic and market conditions rather than poor multifamily underwriting. Loan performance has remained strong in part because rents have continued to rise in many areas. By the broad gauge of the Consumer Price Index, rents increased nationally on average in nominal terms by 3.7 percent from the first half of 2007 to the first half of 2008. But the upward march of rents could soon change as heavy job losses and a flood of foreclosed properties (primarily single-family) put pressure on rental markets. Indeed, through the first 11 months of the 2008 almost 2 million jobs have been lost and over 1.4 million homes have entered foreclosure. In addition, the National Multi Housing Council's measures of rental market conditions have all eroded sharply in recent months and portend a difficult market ahead.

The GSEs are also influential in setting multifamily underwriting standards for the rest of the multifamily permanent loan market. Unlike in the single-family market, Fannie Mae, Freddie Mac, and deposit-taking institutions did not suddenly and significantly relax their multifamily lending standards in the middle 2000s. This is an important reason why multifamily loan performance has held up better. Apart from the two missteps by FHA and Freddie Mac in the late 1980s and early 1990s, the history and performance of FHA and GSE multifamily finance activities have been solid. Since 1998, their 60+day past due delinquency rate has been under 0.5 percent.[4]

Fannie Mae and Freddie Mac have also been active in providing equity to low-income rental housing production through their purchases of low-income housing tax credits. Now that they do not have taxes to offset they have exited the market, leaving a huge gap that other equity providers have not yet filled.

FHA-insured multifamily mortgages (and sales of these mortgages into mortgage-backed pools guaranteed by Ginnie Mae) play a small but critical role in overall market. FHA insurance facilitates new construction and rehabilitation through higher loan-to-value loans for multifamily developments than the private lending market. HUD and Congress budget a credit subsidy for certain multifamily FHA programs. But the primary multifamily program used by for-profits—Section 221(d)(4)—has been a low-risk program for FHA and does not require credit subsidy through the appropriations process. HUD sets premiums based on credit risk, and the premiums have to cover all risk. This eliminated the need to seek additional credit subsidy and temporary program suspensions. The OMB/HUD and Congress have to provide insurance authority that permits the government to take risk (insure loans). The amount that is needed to cover demand has been underestimated from time to time and has had to be addressed. Since this is not a budget item, the Congress has now created adequate authority for FHA to operate and it is closely monitored so that if it is too low to meet demand, the legislative process is now in place to act in a timely manner. On the other hand, the other large program Section 221(d)(3), which provides similar insurance for non-profit sponsors, does require some level of credit subsidy but typically has adequate authority to operate. FHA multifamily has low defaults (outside of skilled nursing homes) and has, from a credit subsidy perspective, been negative (not needing credit subsidy) for years.

[4] Mortgage Bankers Association, Commercial/Multifamily Mortgage Delinquency Rates for Major Investor Groups.

The extent to which multifamily finance now depends on these supports even in normal times is illustrated by the fact more than one-third of all multifamily debt outstanding is held or guaranteed by Fannie Mae and Freddie Mac or in federally-insured mortgage pools (up from a fifth at the beginning of the decade).[5] More precisely, 19 percent of all multifamily debt is held in the portfolios of Fannie Mae and Freddie Mac, and 17 percent is in mortgage pools that they or Ginnie Mae guarantee. These sources of financing are now under the control of the federal government because the Federal Housing Finance Agency is serving as conservator of Fannie Mae and Freddie Mac, and FHA and Ginnie Mae are government agencies. As of the second quarter of 2008, the share of multifamily debt held by savings institutions stood at 31 percent, pension funds and life insurance companies at 6 percent, state and local governments at 8 percent, and CMBS at 14 percent.

MARKET SEGMENTS UNDERSERVED BY FHA AND GSES

Despite the many vital functions performed by Fannie Mae, Freddie Mac, FHA, and Ginnie Mae, there are segments of multifamily finance that have not been well served by them. Most notably, Fannie Mae, Freddie Mac, and FHA have not done especially well in providing debt financing to small multifamily rental properties, which are generally defined as properties with fewer than 50 units. Yet only about two-thirds of multifamily rentals are in larger properties with 50+ units.[6] Reform efforts should therefore consider the need to develop adequate distribution channels for small multifamily mortgage debt on a national scale and expand the capacity of the historical sources of mortgage debt to borrowers for smaller multifamily properties. By most accounts, the GSEs only increased their focus on financing smaller (5-49 unit) multifamily rental properties temporarily when they earned extra points for them in meeting affordable lending goals. This mainly occurred through the purchase of existing loans from depository institutions, which did not lead to appreciable improvement in access to mortgage capital. As banks continue to horde capital, these smaller properties will suffer an especially

[5] All figures in this paragraph are drawn from the Flow of Funds released by the Federal Reserve Board.
[6] Unfortunately, the most recent national data on the distribution of rentals by units in property is the 2001 Residential Finance Survey from which these statistics are drawn. Also, this survey does not provide information on the income of tenants. For that, the American Housing Survey can be used but only for 50+ unit *buildings* not properties. This leads to a severe understatement of the number of renters living in 50+ unit properties because it is common for properties to contain several smaller buildings. Indeed, the 2007 AHS reports that only about one-fifth of renter households, and one-quarter of bottom-income quartile renter households, in multifamily housing were in these larger buildings.

severe credit crunch if the GSEs do not, or cannot, step up to the plate. As with the GSEs, efforts by FHA to bolster the small multifamily rental property market have also been modest and short-lived. Taking an even broader view, one could argue that 2-4 unit properties, which for historical reasons were lumped in with single-family properties even though they have more in common with 5-9 unit properties—in the sense they both involve renting out units—might fit better under a small multifamily finance umbrella.

A second area the GSEs have not been very actively engaged in is lending for land acquisition, development, and construction. This reflects their charters, which severely restrict their ability to provide new construction financing. FHA and savings institutions have played such a role, but the GSEs have done so only indirectly through setting standards for permanent take-out loans. Given the pullback in bank lending, this vital source of financing for new construction and rehabilitation is choked off.

With private sources of lending for development and construction crimped, FHA loan volumes are starting to increase. But FHA is poor at product innovation and does not appear well suited in its current structure or funding to be a liquidity backstop for the broader set of multifamily finance needs.

RECENT DISRUPTIONS OF THE MULTIFAMILY FINANCE SYSTEM

Like other markets, the multifamily finance market has certainly not been immune from the spillover effects of sloppy single-family underwriting, but it is even closer to the center of the storm. This is because the poor performance turned in by single-family subprime loans has led to a retrenchment in all forms of real estate lending. In addition, the oversupply of single-family houses and of condos in multifamily buildings, but financed with single-family mortgages, threatens to lead to a temporary oversupply of rentals as discouraged owners place their properties up for rent.

Capital flows to single-family homes have been severely disrupted in the past year. Subprime mortgage credit is largely unavailable for homebuyers, underwriting standards for homebuyers have been tightened in other ways (including higher downpayment requirements), product offerings have been curtailed, and the spread between interest rates on fixed-rate mortgages and 10-year Treasury bonds stands at high levels.[7]

[7] Mortgage Bankers Association, Mortgage Application Survey.

Disruptions on the multifamily side have not been as dramatic, but they have been significant and are worsening. As on the single-family side, the asset-backed securities market for multifamily loans (which are packaged into CMBS that do not have government insurance or Fannie Mae or Freddie Mac guarantees) has all but shut down. New issuances of CMBS peaked at $75 billion in second quarter of 2007 then fell to zero in the third quarter of 2008.[8] Interest rate spreads have ballooned on sharply reduced volumes of new CMBS issuance. Indeed, the spreads on CMBS relative to 10-year fixed rate Treasuries soared from around 30 basis points in mid 2007 to 600 basis points at the beginning of November 2008.[9]

Though the CMBS market has been roiled before, spreads in the past did not widen nearly as much as they have this time around. During the late 1990s currency crisis and then again just after 2001, spreads rose to only about 100 basis points and 60 basis points, respectively. Since CMBS was a much smaller share of the market in the past, these spikes also mattered less to the overall availability of multifamily mortgage finance. Meanwhile, there are anecdotal reports that banks have all but stopped lending for multifamily land acquisition, development, construction, and permanent financing for multifamily properties has been curtailed and spreads have widened.

In addition, banks are pulling back on lending to multifamily properties. Pension and life insurance companies, which are important sources of multifamily finance, are stepping back from multifamily finance as well—sometimes even selling assets to raise cash or to reduce the real estate exposure in their portfolios.

But perhaps hardest hit by the credit crisis and the losses incurred by Fannie Mae and Freddie Mac have been the markets for low-income housing tax credits and for tax-exempt multifamily bonds. The National Council of State Housing Agencies estimates that as many as about 135,000 units in normal times are placed in service annually with the tax credits, of which about two-thirds are new construction and the other third rehab. This figure includes both apartment buildings that received 9 percent and 4 percent tax credits. With the withdrawal of large purchasers like Fannie Mae and Freddie Mac, tax credits are going begging. Tax credit prices, as estimated by Recap Advisors, have fallen from an average of about 90 cents on the dollar to about 70 cents on the dollar. This means that it takes more credits to deliver the same

[8] Morgan Stanley, http://www.cmalert.com/Public/MarketPlace/MarketStatistics/index.cfm.
[9] Morgan Stanley, http://www.cmalert.com/Public/MarketPlace/MarketStatistics/index.cfm.

amount of equity to the project. Recap Advisors estimates that as much as 40 percent of the developments that have already received allocations might not be able to use them, either because they cannot find investors or because they cannot raise enough equity at today's sharply lower tax credit prices. Meanwhile, tax-exempt bond issuances for multifamily purposes that also receive 4 percent tax credits, which in normal times support the construction or rehabilitation of about 35,000-40,000 units annually, plummeted as yields spiked in the second half of 2008.[10] These developments are a major threat to the production and rehabilitation of affordable, low-income rental housing. In fact, without these markets functioning properly, very little such housing is likely to get produced or preserved. Given the general oversupply of housing, adding to the affordable housing stock through new construction or preservation of existing properties may seem unnecessary or even as exacerbating housing problems. But *affordable low-income* multifamily rental housing is in short supply.

If these interruptions in credit lead to curtailed spending on building and rehabilitating multifamily rental properties in areas where demand remains strong enough and vacancy rates low enough, it will have a material impact on the economy. Multifamily finance disruptions that lead to higher capital costs for existing properties also put landlords under pressure to raise rents and, if unable to pass them along to tenants, under pressure to cutback on improvements. As a result, housing becomes less affordable for tenants and they spend less on other items or residential fixed investment is reduced. Both hurt the economy. Higher capital costs that cause cutbacks in maintenance contribute to disinvestment and deterioration and so have negative neighborhood effects as well. This exacerbates declines in residential fixed investment and causes a drag on economic growth. In addition, reductions in production during periods of growing multifamily demand can place further upward pressure on rents. This not only reduces tenant spending on other goods and services but increases the cost of the voucher and certificate programs which serve nearly 2 million renter households.[11]

[10] This is an estimate of the National Council of State Housing Agencies and the Department of Housing and Urban Development's Low Income Housing Tax Credit database 1995-2005.

[11] These programs make up the difference between 30 (and up to 40 in some cases) percent of tenant incomes and a federally determined fair market rent. If the fair market rent increases more than incomes, the federally required payment per voucher holder goes up. With about 1.8 million renter households currently receiving voucher payments, every $50 a month increase in rent translates into an additional $90 million increase in annual outlays for housing vouchers and certificates. If budget authority is not increased, the growth in rents reduces the number of households served. The HUD budget for housing vouchers has increased by $1.7 billion from 2004 to 2007 (from $14.2 billion $15.9 billion), according to the National Low Income Housing Coalition, even though administrative changes to the allocation procedures of the program caused the loss of 150,000 vouchers over this period. While the

GSEs as Crucial Liquidity Backstops

As in past periods of economic and credit crisis, the multifamily sector has been leaning more heavily on Fannie Mae, Freddie Mac, and FHA/Ginnie Mae. As the multifamily finance system comes under increasing pressure, the credit crunch will likely intensify if these federal supports do not make up for illiquidity of traditional sources of private capital, including depository institutions, life insurance companies, pension funds, and CMBS.

Fannie Mae, Freddie Mac, and FHA/Ginnie Mae will almost certainly have to expand their multifamily lending and guarantee activities even further if they are to fulfill their missions of providing adequate liquidity to housing markets when other sources of capital for multifamily housing dry up or charge too much. Already, the roles of the GSEs and FHA/Ginnie Mae in the multifamily finance market have increased sharply. From just Q3 2007 to Q2 2008, the GSE share of multifamily debt outstanding increased by 3.6 percentage points ($42 billion) and of FHA/Ginnie Mae by 0.3 percentage points ($13 billion).[12] All other holders lost share, with the CMBS share falling the most (1.9 percentage points or over $6 billion). While there is no source of information on the composition of recent multifamily originations, there is no question that the increase in Fannie Mae, Freddie Mac, and FHA/Ginnie Mae multifamily debt holding outstanding is driving much larger and needed shifts in the sources of newly originated multifamily mortgages.

This is by no means the first time that federal supports have had to expand to deal with crises—though in recent cases the crises were triggered by unanticipated and short-lived external events rather than the sort of systemic issues driving both this crisis and the crisis in the 1930s. During the 1998 currency crisis, for example, multifamily GSE purchases for portfolio and MBS issuance rose from $8.8 billion in 1997 to $15.3 billion in 1998.[13] In 2001, in the wake of 9/11 and the recession, the GSEs again increased from around $16.4 billion in 2000 to $28.7 billion in the fourth quarter of 2001. Most recently, Fannie and Freddie doubled their portfolio purchases and MBS issuance of multifamily loans from $33.7 billion in 2006 to $67.0 billion in 2007. Of that $33.3 billion increase, $29.0 billion came from purchases for their retained portfolios.

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probable entry of many foreclosed single-family properties will place downward pressure on rents, over the long run adding to the affordable rental housing stock is important to containing ongoing voucher outlays.

[12] All figures in this paragraph are drawn from the Flow of Funds released by the Federal Reserve Board.

[13] All data in this paragraph and the next are from Freddie Mac and Fannie Mae financials reported in OFHEO annual reports.

FHA has not played as central a role in making up for the loss of other sources of multifamily finance during periods of dislocations. In fact, FHA multifamily endorsements and risk-sharing agreements have fallen from $7.4 billion in 2003 to $3.7 billion in 2008.[14] While FHA is ratcheting up activity and can now do so without requiring appropriation of credit subsidies as it did in the 1990s, it has not fully filled the void.

MANDATED REDUCTIONS IN GSE PORTFOLIOS

Legislation passed in 2008 established a new regulator with the authority to set limits on the GSE retained portfolios. Upon becoming conservator, the new regulator indeed mandated that Fannie Mae and Freddie Mac reduce the size of their portfolios beginning in 2010. This authority provided to the regulator and the ensuing portfolio reduction mandate were put in place because the GSEs have traditionally had a cost advantage in raising funds due to their implicit guarantee, which they used to great advantage by increasingly purchasing rather than guaranteeing mortgage debt. In addition, the sheer size of the GSE portfolios has raised concerns about the risks posed to the federal government by such large portfolios. It is unclear whether or not Congress will suspend these mandated reductions as it focuses on the larger problem of ensuring that housing markets remain liquid.

Regardless of the merits of the case for reducing portfolios, two things are clear. First, multifamily mortgage debt accounts for 35 percent of the overall mortgage debt held in the combined portfolios of Fannie Mae and Freddie Mac. Second, as detailed above, during periods in which other sources of multifamily finance become unavailable or too costly, GSE portfolio purchases provide liquidity. Indeed, there are currently no other lenders supplying any sizable amount of permanent financing to the multifamily rental market and industry, and this includes financing for new developments, rehabilitated developments, land acquisition of existing developments, and refinancing of existing developments. The CMBS market is moribund and banks, thrifts, life insurance companies, endowments, and pension funds are showing little appetite for multifamily lending.

Without the GSEs stepping up to the plate, apartment transactions could come to a near standstill. It would be extremely difficult to buy and sell properties, refinance a property to cash

[14] The source is Department of Housing and Urban Development, Multifamily Initial Endorsements, available from http://www.hud.gov/offices/hsg/mfh/mfdata.cfm.

out on equity needed to upgrade properties, or prevent modest, lower rent properties in need of rehabilitation (which existing regulations would make hard to ever build again new) from being lost from the housing stock.

Furthermore, over the next several years, large amounts of multifamily finance will come due and need to be refinanced. Most apartment properties are financed with short-term loans that must be rolled over every 5-10 years. Without financing, even cash-flow positive projects may not be able to get refinanced and will be pushed towards default. Until recently, the market has been relying in no small measure on the CMBS market to provide liquidity, but it could be a very long time before that market comes back because investor confidence in ratings of this debt has been shaken to its core. That means that investors will likely demand the kind of uniform standards and transparency in underwriting more associated with the GSEs than CMBS. But that could take years to establish in the CMBS market. Life insurance companies, endowments, and pension funds have all suffered extraordinary losses and have to conserve capital. Until they recoup much of those losses, they too are like to remain largely side-lined.

MINIMIZING FURTHER DISRUPTIONS

The multifamily finance system is at risk of further unraveling if Fannie Mae and Freddie Mac, through broader institutional reforms or forced portfolio reductions, pull back from the market before other sources of capital come back. FHA could play an expanded role, but its structure makes it difficult to take on multifamily financing on a much larger scale and to offer products that fit today's needs. Policy makers must consider this looming threat to the multifamily market and take steps to address it. It makes sense to address these short-term issues in the context of a long-term vision for the multifamily finance system and how it fits within the broader mortgage finance system.

Recent events underscore how essential it is for the federal government to serve as the lender or guarantor of last resort to keep credit markets more generally, and mortgage markets in particular, from simply collapsing. Just as the federal government acted swiftly to take Fannie Mae and Freddie Mac into conservatorship to avoid single-family transactions from coming to a stop and to keep the homes Americans own from suddenly becoming illiquid assets that they are unable to refinance, similar action could become necessary on the apartment side if forced portfolio reductions threaten a similar disaster scenario in multifamily finance.

Whatever new set of institutions emerges from the reform of the existing system, the federal government may still want to perform some or all of the following functions (all of which it has in the past):

- Liquidity backstop during periods of extreme credit market stress.
- Liquidity source during normal times for housing that would otherwise have trouble attracting funds from purely private sources, or only at unacceptably high costs.
- Credit enhancer during periods of stress to increase mortgage liquidity from non-governmental sources—Credit enhancements could include loan level insurance and/or pool level insurance or reinsurance.
- Credit enhancer in normal times for housing that meets public purposes—These public purposes might include production and preservation of affordable rental housing, mixed-use developments, mixed-income housing, developments that involve income-targeting and public-private partnerships, and community redevelopment, as well as areas of multifamily finance that lack standardization such as for small multifamily properties and land acquisition, development, and construction (ADC) loans.
- Innovator of new mortgage products aimed at demonstrating market feasibility—Areas today where this might be desirable include small multifamily properties, ADC loans, mixed-use properties, and mixed-income properties with income-targeting.
- Standard setter for underwriting and pooling loans, managing properties, and servicing and workout practices—Areas today where this might be desirable include small multifamily properties, ADC loans, mixed-use properties, and mixed-income properties with income targeting.
- Provider of subsidies and tax incentives for housing that meets public purposes—In the case of multifamily rental finance these supports presently include HOME block grants, tax-exempt bonds, rental depreciation schedules, low-income housing tax credits, vouchers and project-based vouchers, and HOPE VI.

The first step in any wholesale restructuring of the federal supports for the housing finance system is deciding which of the functions listed above ought to be performed by the federal government. These decisions must come prior to considering the specifics of the

organizational arrangements that might be established to perform these functions and the detailed mechanics of how to perform them.

There are a number of existing tools that policy makers could use to help ensure the continued flow of credit to multifamily housing, all of which Congress and the Administration may want to use more actively *at least on a temporary basis*. These include:

- Portfolio lending of Fannie Mae and Freddie Mac—As we have seen in past economic and credit crises, it is especially purchases of multifamily debt for portfolio that have provided prompt and needed liquidity to offset the loss of non-governmental sources.
- Mortgage guarantees of Fannie Mae and Freddie Mac—This is another potential way to provide liquidity and encourage more funding by third parties for multifamily housing.
- Annual affordable lending goals for Fannie Mae and Freddie Mac—These goals, initially established by Congress but reassessed and set every five years by the Administration, have been used to create incentives for Fannie Mae and Freddie Mac to purchase or guarantee more multifamily mortgages. In normal times, the setting of these goals matters, as witnessed by a large increase in small multifamily finance activities of the GSEs when extra points were awarded for these activities. Now that Fannie Mae and Freddie Mac are under conservatorship, the Conservator could impose similar goals.
- Amount of funds appropriated for FHA multifamily insurance activity—Congress can authorize greater FHA insurance volume (a potential key to rehabilitation and new construction) by appropriating more credit subsidy for FHA General and Special Risk Insurance programs.
- Amount of funds appropriated for FHA multifamily risk-sharing arrangements with qualified partners, and the terms of these arrangements—FHA already has risk-sharing agreements with several state and local housing finance agencies, and these could be modified and/or expanded to provide more liquidity.
- On the subsidy side, there are other critical tools that could be mobilized. These include the amount of low-income housing tax credits available for allocation and incentives for investors to purchase them, the amount appropriated for HOME block grants, and the amount appropriated for vouchers.

MULTIFAMILY FINANCE IN THE CONTEXT OF A NEW VISION OF HOUSING FINANCE

Thus far, the multifamily industry has escaped the collapse that threatened the single-family finance system for the same reason that the single-family finance system escaped it: the federal government stepped into to be a liquidity backstop by taking Fannie Mae and Freddie Mac into conservatorship and expanding FHA lending. This has underscored the one function the federal government must play in a debt market as large and crucial as the residential mortgage market: to serve as a liquidity backstop in times of exceptional stress. In a speech delivered at the end of October 2008, Chairman of the Federal Reserve System Ben Bernanke concluded that some form of government backstop might be needed to ensure continued securitization of mortgages during periods of major stress.

To be effective, this backstop must be federal in nature. During the recent crisis, state and local government debt markets were severely disrupted with few investors and skyrocketing interest rates. Federal debt markets, meanwhile, have actually delivered lower interest rates and so far seen sufficient demand to absorb a greatly expanded supply.

Given this, the question becomes how to ensure the federal government continues to play this backstop role *and* what role it should play during normal times. Consideration of what role it should play in normal times is important both because a federal role beyond a backstop may be viewed as desirable for other policy reasons and also so that if a liquidity crisis redevelops, the infrastructure *is already in place* for the federal government to seamlessly step in to keep mortgage credit flowing.

In calling for a federal role as a backstop to mortgage markets, Chairman Bernanke suggested that such government support can take many forms. The three alternatives he proposed are: (1) to fully privatize Fannie Mae and Freddie Mac (which he questioned as to whether the model would be viable without at least an implicit guarantee); (2) to use a covered bond approach (which would take the federal government out of the picture); and (3) to create even closer ties to the government, with or without shareholders. There is little agreement about which of these approaches is more or less desirable and if in fact there may be more than three alternatives.

KEY CONCERNS

At the heart of the debate over the proper role for government are concerns that the sponsorship of Fannie Mae and Freddie Mac gave them an unfair competitive advantage, and "socialized" risks but privatized returns. This has led to calls to alter the size and structure of the GSEs and, in the summer of 2008, led to the creation of a National Housing Trust Fund with the intention of funding it primarily with a portion of the revenues of Fannie Mae and Freddie Mac. FHA has come under criticism for extending mortgage insurance that private mortgage insurers could have been providing. Both have been faulted for taking on too much risk, and in the case of Fannie Mae and Freddie Mac, without adequate reserves. FHA has also long been criticized for being too rule-bound by Congress, reliant on annual appropriations for administration of its programs, and subject to federal pay scales and employment practices.

But proponents of these institutions counter that the presence of Fannie Mae and Freddie Mac has lowered interest rates for mortgage borrowers even if not all of the value of the implicit federal guarantee was passed on to borrowers, and that FHA multifamily insurance, and to some extent FHA single-family insurance too, has met demands that the private sector could or would not meet. Proponents also counter that FHA, Fannie Mae, and Freddie Mac have successfully set standards for the broader market for decades, with Fannie Mae and Freddie Mac only very recently—though fatally—pressured into deviating from its standards by the rapid growth of more lightly regulated asset-backed securities and too little flexibility on how to meet its affordable lending goals. Supporters also point out that in times of stress it is important to have these institutions in place and active well before a crisis occurs if they are to promptly act as a lender and guarantor for mortgage markets of last resort. This is one argument for why these institutions should have scale and operate during normal times as well as times of distress. But none of these arguments speak to whether Fannie Mae and Freddie Mac should be shareholder owned or government owned.

BUILDING BLOCKS

Several principles, or building blocks, have been suggested for how to guide decisions on the structure of institutional arrangements, and how to set up federal programs that draw on past experiences and address these central concerns. However, many are the subject of a spirited debate.

- Be clear about mission—Start with a clear mission of what public purposes federal agencies or sponsored institutions are serving and what specific functions they will perform to serve them. Among the most important are ensuring liquidity (an element of the existing missions of Fannie Mae, Freddie Mac, and FHA), helping stabilize interest rates by providing a supply of credit and charging reasonable risk premiums, and innovating in areas where the private sector is not meeting important needs or not meeting them consistently and well.
- Strive to limit federal supports in normal times to activities that serve a public purpose or that the private sector cannot undertake profitably on its own—There are longstanding beliefs among many that the private sector should provide as much debt and equity to housing, and as many of the risk management tools (such as credit enhancements and interest rate risk management) demanded by the market, as possible. Many feel it is important not to crowd out the private sector with financial institutions sponsored by the federal government unless there is a clear public benefit or gap in the private market. Fears of an expanded federal role are now heightened as the federal government takes extraordinary steps to cure the credit crisis.
- Demand government returns in exchange for government-assumed risks—Decide how to share in the returns of sponsored institutions or other financial institutions that benefit from federal credit enhancements.
- Establish adequate reserve requirements for mortgage finance institutions that the federal government sponsors or does business with—Considerable attention has been paid to the high leverage allowed in financial institutions even on assets that proved highly risky.
- Strengthen the role that the federal government plays in ensuring prudent underwriting by any institution it sponsors and of any loans it insures or securities it guarantees—At a minimum, many are calling for the federal government to focus on safety and soundness in the capital markets. The failure of single-family system is widely viewed as driven by imprudent underwriting and the offering of too-risky mortgage instruments.
- Establish net worth requirements for counterparties in the housing finance system, require that counterparties have capital at risk, and structure compensation so that counterparties earn returns from loan performance as well as origination fees—A primary criticism leveled at the current system is that not enough attention was paid to the financial strength of counterparties

and that many did not have capital at risk, instead earning returns from fees associated with originating and pooling loans before selling them.

- Develop strong public disclosure requirements to ensure greater transparency to investors, counterparties, policy makers, and public watchdogs—Another key complaint about the current system is that not enough information was publicly available to assess risks in the system and safeguard against discrimination and unfair or deceptive treatment.
- Establish strong regulators with broad powers to monitor mission and examine for safety and soundness—For years, there were calls to strengthen the regulator for Fannie Mae and Freddie Mac. Finally in 2008 the Federal Housing Finance Agency was established to do just that. Whether it might have forestalled the current crisis is unknown (after all the Federal Reserve did not strengthen regulations on higher cost lending until 2008 after problems had already become acute), but most agree that it is prudent to have well funded and capable regulatory agencies.

Though not everyone would endorse or agree with all these building blocks, these are among the most commonly cited possible guiding principles for redesigning the federal presence in housing finance.

GSE DESIGN ISSUES

Finally, reforming the system will involve many specific design issues and questions. Clearly there are far more than can be enumerated here, but several are worth mentioning. With respect to the GSEs, these include: should Fannie Mae and Freddie Mac continue to exist in their current form as shareholder-owned corporations? If so, should limits be placed on their portfolios and should more of their profits be diverted to public purposes? How should affordable housing goals be structured or should they even be retained? If not, should there be just one GSE or more than three GSEs (including the Federal Home Loan Bank System)? If they are split up and there are several should they be divided along functional lines (such as single-family and multifamily, loan level insurance and pool guarantees, permanent financing and construction financing) or along regional lines? Should they be restructured along the lines of a cooperative (like the Federal Home Loan Bank System), a utility or a government-owned corporation?

CONCLUSION

Multifamily housing plays a crucial role in housing Americans and its role will become increasingly important moving forward as a result of demographic trends and renewed interest in development patterns that conserve energy and reduce greenhouse gases. An efficient, smoothly functioning finance system is needed to insure the viability of the apartment building market and the multifamily industry. In normal times, multiple sources provide fresh credit to the multifamily market and industry. During this period of extreme distress, however, only federal sources are active in the multifamily finance market.

As lawmakers consider how to reform the housing finance system, it is important that the differences between single-family and multifamily finance not be ignored. The crisis in mortgage loan performance started with, and has thus far largely been confined to, single-family loans. Most of the attention has therefore been on the single-family finance system and what to do it about. But the multifamily finance system—while different because properties sizes are often much larger and because they are income-producing investments—relies on the same set of federally sponsored institutions and agencies as single-family finance to ensure liquidity, bring efficiencies and standards, and innovate in the market.

The recent crisis has made it abundantly clear that both single-family and multifamily finance require some federal supports—especially a liquidity backstop—to function properly in both good times and bad. The portfolio purchases of Fannie Mae and Freddie Mac have been especially important in substituting for private sources of debt financing that have exited the market.

Unfortunately these Fannie Mae and Freddie Mac purchases are at risk of sudden interruption because legislation enacted in 2008 mandates that Fannie Mae and Freddie Mac shrink their portfolios beginning in 2010. If private sources have not come back on line—and there is reason to believe they will not—this could have serious consequences for the nation's multifamily rental markets. Also at risk are the guarantees of mortgage-backed securities that Fannie Mae and Freddie Mac provide if reforms of these institutions lead to a reduction in the availability of such quasi-governmental credit enhancements.

There is a window of opportunity to build a solid foundation for the future of multifamily finance in the context of broader reforms to the housing finance system. Rather than focus only on responses to the current crisis, reformers could consider how to improve the system and have

multifamily housing help achieve a range of other policy goals, including delivering more affordable rental housing, transit-oriented development, and mixed use developments that reduce travel, energy use, and carbon emissions. It also presents an opportunity to rethink the division of the finance system into 1-4 unit and 5+ unit properties, and to look for ways to strengthen those remaining multifamily market segments that remain far from standardized, transparent, and efficient, such as small multifamily properties and land acquisition, development, and construction finance.