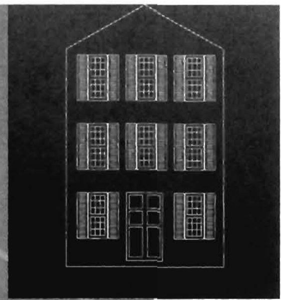

FROM THE NEIGHBORHOODS TO THE CAPITAL MARKETS

REPORT OF
THE NATIONAL
TASK FORCE
ON FINANCING
AFFORDABLE
HOUSING

HOUSING • FINANCE • TASK • FORCE

The National Task Force on Financing Affordable Housing

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CHAIRMEN'S PREFACE

We are pleased to present the report of the National Task Force on Financing Affordable Housing. In this report, we propose the development of a revitalized system for financing multifamily housing for this nation. It is a system that will harness the full power of the private sector to invest in decent, affordable rental housing.

All of us are keenly aware of the desperate need for housing in this country. To meet this need, we must rely not only upon traditional single-family housing, but also upon an adequate supply of multifamily rental housing. Such housing has historically provided affordable shelter for this nation and it can continue to do so.

Yet, the traditional system for financing multifamily rental housing has broken down. From 1985 to 1990—in the wake of changes in government tax, subsidy, and insurance programs—mortgage originations for multifamily housing declined by over one-half to their lowest level in decades.

Our Task Force has attempted to learn from the demise of the old system, as well as from some of the successful models developed in its wake. We have made three essential findings that have guided our efforts in developing a system to replace the old one.

- First, any national system for financing multifamily housing must be locally based. Successful rental projects must be underwritten initially at the local level, by those with full knowledge of the local population and housing markets.
- Second, investments in affordable rental housing, if done properly, can be good business.
- Third, while government plays an indispensable role in any housing finance system, we should maximize the involvement and investment of the private sector.

Accordingly, our Task Force sought to develop a system that would be locally based, profitable, and that would maximize the private sector's investment in affordable housing. We believe the keystone of such a system is a large-scale secondary market for rental housing loans. Through the secondary market, mortgages are originated and then sold to financial intermediaries, who typically turn them into securities and sell them to investors. Because mortgages can be sold to a broad range of investors and do not need to be held in the portfolios of lenders, the secondary market opens up a large, stable supply of capital for affordable housing.

To see the potential benefits of a secondary market in action, one need only look at the success of the system for financing single-family housing. It is difficult to imagine that only thirty years ago, there was no secondary market of any magnitude for single-family mortgages. At that time, banks had their own individual underwriting, appraisal, and performance criteria—not to mention their own documentation. But through a process of standardization—and through the development of effective conduits for securitizing and selling mortgages to the secondary market—the secondary market has grown exponentially. In 1972, only $27 billion of one-to-four family mortgages were sold to the secondary market; in 1990, that number had reached an annual volume of $405 billion. As a result, there is now a large, stable, and relatively inexpensive source of private capital to finance single-family mortgages, which has endured despite the economic and tax cycles of the 1980s.

We believe that it is possible to achieve for multifamily housing what has been achieved for single-family housing, albeit on a more modest scale. We recognize that the single-family system cannot, and should not, simply be transferred to the multifamily housing market. Multifamily housing presents special challenges and opportunities that do not exist in the single-family market. But the experience of the single-family secondary market shows us what we must do to create a successful secondary market for multifamily housing loans. We must create a standardized first mortgage for multifamily housing. We must ensure that government subsidy programs help, rather than hinder, the ability to sell the first mortgage to investors. We must provide for local, consistently expert underwriting and develop a streamlined loan origination process. Moreover, the system for securitizing and

insuring mortgages must be expanded. Finally, there must be a broad effort to educate investors about the performance of multi-family housing. In this report, we make recommendations on how to achieve these necessary changes.

We also recognize that the new system cannot be created overnight. It will require additional research and the continuing work of all of those involved in housing finance—from local developers to pension fund investors. Accordingly, we call for the creation of a Multifamily Housing Institute to press for the necessary changes to bring this new system to fruition.

Before passing on the baton, however, we want to acknowledge the wonderful work of all of the members of the Task Force who have labored so diligently for over two years on this project and, most especially, the contribution of Kirsten Moy, who has been our guiding light and is primarily responsible for making this Task Force, and its report, a reality.

Since the Task Force began its work two years ago, we have witnessed remarkable changes in the world—from the collapse of the Soviet Union to the fundamental restructuring and "downsizing" of American companies. Today, there is widespread agreement that our nation has an historic opportunity—indeed, an historic imperative—to address the domestic needs of our country. There is also a consensus that we must try innovative approaches to these problems. It is in the spirit of offering a practical solution to a pressing problem, as well as adding our voices to this great national debate, that we submit our report.

Respectfully submitted by the Co-Chairmen of the National Task Force on Financing Affordable Housing:

Harry W. Albright, Jr.
Harry W. Albright, Jr.
Chairman, Battery Park City Authority
Of Counsel, Patterson, Belknap, Webb & Tyler

Wayne E. Hedien
Wayne E. Hedien
Chairman and CEO
Allstate Insurance Company

Introduction And Summary Of Recommendations

I

Task Force Mission

To propose a predictable, flexible, accessible, and widely-understood system of long-term financing for multifamily housing, one that extends to serve affordable—including subsidized—housing. More specifically, the Task Force seeks a secondary market for affordable multifamily mortgages that is efficient and liquid, much like that for single-family mortgages.

The National Task Force on Financing Affordable Housing

This report recommends the development of a revitalized system for financing multifamily housing in the United States. The cornerstone of this new system must be a large-scale secondary market that is designed to maximize the private sector's investment in both subsidized and unsubsidized multifamily housing.

The analysis and recommendations put forward here are the product of the National Task Force on Financing Affordable Housing (formerly the Low and Moderate-Income Housing Finance Task Force). The Task Force was formed in 1990 in response to growing evidence of problems in multifamily real estate and mortgage markets. Its members represent key segments of the housing development and finance industry.

Based on its deliberations over the past two years, the Task Force recommends the following measures to revitalize the multifamily housing finance system:

- Standardizing the key elements of the financing of multifamily housing, from the origination of mortgages to their sale to investors
- Exploring new risk-sharing mechanisms between old and new sources of credit enhancement
- Collecting information and providing education regarding the actual, as opposed to the perceived, level of risk of properly underwritten multifamily mortgages
- Streamlining the production process at the local level
- Establishing a Multifamily Housing Institute to pursue the recommendations of the Task Force and, in particular, to create standards for the industry

The Task Force recommendations are presented in detail at the end of this introduction and elaborated in the body of this report.

The Need

There can be little doubt as to the pressing national need for decent, affordable rental housing. According to researchers with the Joint Center for Housing Studies of Harvard University:

> Housing the nation's poor remains a problem because of two broad trends: the persistence of poverty and the loss of low-cost units. . . . The poor . . . face high and rising rents as the stock of low-cost housing continues to dwindle. As a result, millions of low-income households must live in units that are either too costly relative to their incomes, inadequate to their needs, or both.[1]

Other reports have likewise documented both the increasing number of the nation's renters who are inadequately housed and the severe and widening affordability gap they experience. Although rents have flattened recently in response to recession, they remain near historic highs. And the situation, if anything, may worsen, since much of the affordable stock is at risk of loss through abandonment, demolition, or upgrading.

Two-thirds of all poor renter households remain outside the housing assistance network, depending on existing unsubsidized housing for shelter. For those between 60 percent and 100 percent of median income, this portion of the housing stock remains a good choice. It often provides, without rental assistance, rents at no more than 30 percent of income—the definition of affordability used by the U.S. Department of Housing and Urban Development (HUD). Thus, except in certain high-cost markets, much of the existing conventional multifamily stock *is* affordable housing. However, newly constructed or substantially rehabilitated housing frequently must have project-based subsidies to be affordable to this group.

Households with incomes below 60 percent of the median generally require rental assistance, whether they live in existing housing or in new or rehabilitated buildings that also have project-based subsidies.

[1] William C. Apgar, Jr., Denise DiPasquale, Jean Cummings, Nancy McArdle, *The State of the Nation's Housing, 1991*. Cambridge, Mass.: The Joint Center for Housing Studies of Harvard University, 1991.

I

The Problem and the Opportunity

Although direct Federal subsidies for affordable housing in urban and rural America have shrunk dramatically over the last decade, and while the Task Force recognizes fully the essential role that direct subsidies play in making housing affordable, that issue already has many capable advocates. This report focuses, instead, on the manifest difficulties that have emerged in recent years in accessing mortgage financing for the full range of multifamily housing.

Despite the obvious need, traditional first mortgage lending for subsidized multifamily housing—the kind that was previously originated by the private sector and often insured by the federal government—has all but disappeared. Today, even unsubsidized projects are experiencing difficulties in obtaining financing.

One problem is that the secondary market for multifamily housing is relatively new, without the depth or resiliency of the single-family system. As the multifamily finance system has become more fragmented, with a resultant increase in investor confusion and transaction costs and in the overall difficulty of putting projects together, both the availability and the cost of capital have suffered.

The need for a stable, high-volume secondary market that would serve subsidized as well as market-rate multifamily housing is clear; its timely development should not be left to chance. Moreover, broadening financing difficulties present a dual opportunity from the perspective of affordability: both subsidized and unsubsidized multifamily housing could benefit from a restructured financing system. This, in its simplest terms, is the problem—and the opportunity—that prompted the creation of the National Task Force on Financing Affordable Housing.

The Contraction of Mortgage Credit

The Task Force first sought to understand what had happened to the old multifamily mortgage finance system and to identify barriers to the creation and efficient operation of a new one—particularly barriers affecting a secondary market for multifamily mortgages. It commissioned Denise DiPasquale and Jean L. Cummings of the Joint Center for Housing Studies at Harvard University to do this research; the results of their work were published in December of 1990 and are presented in Appendix A. Their study, which included a detailed examination of the problems in accessing multifamily credit, provides a framework for the recommendations in this report.

As the Joint Center report thoroughly documents, mortgage credit has contracted sharply over recent years in response to continually interacting forces—changes in the economic environment and in tax and regulatory policy, the decade-long Federal thrust to extricate government from direct provision of subsidies and to reduce intervention in the market, the collapse of the thrift and real estate industries, and the changed practices of the Federal Housing Administration (FHA).

Particularly as the Federal government has withdrawn from funding standardized subsidy programs for multifamily production, states and municipalities have experimented with a growing number of financing structures and subsidy programs. In addition, the creativity of both nonprofit and for-profit sponsors has blossomed as they have become increasingly sophisticated in financial structuring. Although promising in many respects, this experimentation has had an unfortunate side effect: fragmentation. The current practices in multifamily housing finance increasingly diverge from what uniform practice previously existed: yet for investors, uniformity is the key to understandable credit quality. The disorganization of the current system has limited the growth of the nascent multifamily secondary market, contributing to a more than 50 percent decline in multifamily starts between 1985 and 1990, when they reached their lowest level in decades.

The Importance of a Secondary Market

In sharp contrast to the immobilized state of the multifamily credit system stands a resilient single-family system. The single-family system has actually been growing during the dislocations of the 1980s, protected by the depth of its secondary market. Over the same period that the multifamily market increasingly fell into disarray, the secondary market for one- to four-family mortgages developed rapidly,

providing access to ever-wider capital markets and, consequently, increased liquidity and improved pricing. At the end of this period of rapid development, the single-family secondary market stands as a vivid demonstration and model for a restructured multifamily system.

The volume of single-family mortgage-backed security (MBS) activity grew dramatically in the 1980s. This growth was driven by several forces: an enormous demand for mortgage credit, which could not be satisfied by traditional sources; increasingly sophisticated financial technology; and some of the same deregulation that unsettled the financial system. By 1989, 78 percent of single-family originations were sold into the secondary market and the MBS had become accepted by investors as a legitimate fourth asset class, after stocks, bonds, and cash. The MBS' ability to secure both a lower interest rate for borrowers and a higher return for investors than either could otherwise achieve assures it a permanent place in the capital markets.

The secondary market has been dominated since its inception by the federally-created credit agencies: the Government National Mortgage Corporation (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). These institutions purchase mortgages or provide credit enhancement in the form of direct or implied government guaranties, but their activity has been overwhelmingly in the area of single-family mortgages.

In recent years, two developments have signaled the beginning of a change in this pattern. First, private MBS activity has begun to develop using mortgage collateral not guaranteed by the Federal credit agencies. Second, there is an increasing, though still small, volume of trade in securitized debt other than single-family mortgages—notably commercial and multifamily mortgages, and home equity loans. These promising developments suggest that a fully-functioning secondary market for multifamily mortgages—one with a larger role for the private sector—may well be on the horizon.

The Task Force recognizes the far greater challenge of developing a secondary market for multifamily, as opposed to single-family, housing. However, the benefits of a secondary market are too numerous to allow the challenge to go unmet. The most obvious benefit from the standpoint of the borrower is the lower price and more ready availability of capital, which enhances affordability and stimulates housing production. The secondary market also offers advantages to primary lending institutions, which can sell illiquid assets and replenish their funds, thus allowing them to lend again. For investors, the MBS provides an additional asset type and an opportunity to increase the diversification of portfolios; because of its good return, relative safety, and liquidity, the MBS has made mortgage investment much more attractive to pension funds and other institutional investors.

The Mission of the Task Force

In this context, then, of contracting mortgage credit and an increasingly disorganized market, the mission of the Task Force has been as follows:

To propose a predictable, flexible, accessible, and widely-understood system of long-term financing for multifamily housing, one that extends to serve affordable—including subsidized—housing. More specifically, the Task Force seeks a secondary market for affordable multifamily mortgages that is efficient and liquid, much like that for single-family mortgages.

Why has the Task Force focused its attention specifically on access to the capital markets? As suggested above, the answer is twofold: to gain *better pricing* (lower interest rates), but more importantly, to gain *continuing access* to mortgage credit. These two features are most readily available in the capital markets, a marketplace that is national in scope and where high volume offers liquidity. A housing finance system that reduces the cost and improves the availability of mortgage credit across the entire spectrum of multifamily housing would be a major contributor to affordability.

Findings

Over the course of its more than two years of work, the Task Force has arrived at the following general conclusions.

1) Successful multifamily investing is, and must remain, rooted in local origination and underwriting; at the same time, multifamily investment must be standardized on the national level to gain ready access to the capital markets.

2) There is an essential role for the private sector and for market mechanisms at every level of the system. Affordable housing can be good business. In fact, it *must* be good business if it is to have access to mortgage credit on the scale that it requires.

The Task Force wishes to make it absolutely clear to any private source of capital—whether a bank, thrift, insurance company, or pension fund—that investment in affordable housing is not a philanthropic activity. The Task Force is not recommending that everyone "do their part," with the expectation that write-offs will be taken down the road. Rather, it is suggesting that, although specialized knowledge is necessary to underwrite the risks inherent in affordable housing, it is not impossible to identify these risks, mitigate them, and compensate the private sector appropriately for the level of risk it retains.

3) Despite the necessity for private participation, there will always be an essential role for government at every level. In fact, the private sector can only do its job in the mortgage credit system if government is performing *its* job effectively. Further, maintaining constant and predictable policies is as important as fulfilling a role in the first place. Frequent policy changes and the uncertainty they engender are among the greatest threats to a healthy multifamily finance system.

In addition, there is a connection between direct subsidy dollars and a healthy mortgage credit system. Subsidy dollars are the scarcest and therefore the "most expensive" dollars in a housing project. By maximizing private sector participation through the mortgage credit system, and by providing a readily-available source of long-term permanent financing through access to the capital markets, the system proposed here makes the most efficient use of subsidy dollars. It buys the most subsidized housing per tax dollar expended.

4) Multifamily housing is a separate field that requires its own specialized institutions. One of the gaps in the present system is the lack of a national organization dedicated to making the overall multifamily housing finance system work. Such an organization is needed to develop and promulgate standards, to facilitate data collection and the development of a database on the performance of multifamily housing, and to serve as an information clearinghouse and forum for multifamily financing participants.

Recommendations

It has become clear that developing a new system for financing multifamily housing will require numerous innovations. These include a standardized first mortgage origination process, a standardized subsidy instrument, a new process for securitizing and credit enhancing mortgages, streamlined production at the local level, and a broad effort to involve more investors. In this report, the Task Force has sought to make recommendations that, if implemented, would bring about these necessary changes.

The recommendations that follow reflect the diverse—and balanced—makeup of the Task Force. Because it was designed to include all participants in the housing finance system—lenders, investors, secondary market agencies, credit enhancers and underwriters, nonprofit and for-profit developers, and government agencies—its recommendations represent strategies that have been negotiated and "reality tested" among its members. Since all have an interest in an efficient secondary market, it has been possible to develop mutually agreeable positions.

The Task Force is the first group to examine the entire multifamily finance system since the major changes of the 1980s. The system is still in transition; the market is dynamic and new models continue to emerge. It is the hope of the Task Force that its recommendations will help to organize the market and energize its participants, hastening the time when a stable, high-volume secondary market will serve the full spectrum of multifamily housing.

Summary of Task Force Recommendations

ORIGINATING THE FIRST MORTGAGE

- Create a model first mortgage instrument for multifamily housing loans. This model would include the following key provisions, which meet the needs of investors for predictability of cash flows and liquidity, while accommodating the needs of affordable multifamily housing projects:
  - Fixed rate
  - Standardized term and amortization schedule
  - Standardized prepayment protection
  - Integration of the permanent mortgage with forward funding concepts, to facilitate newly-built and substantially rehabilitated projects
- Gain acceptance for subsidies in the form of gap financing as long as they are properly structured to be fully subordinate to the first mortgage.
- Gain acceptance for a common treatment of equity that accomplishes the following:
  - Requires a sponsor equity investment for acquisition or new construction, which—
    - in the case of a for-profit developer, must include a contribution of the developer/sponsor's own cash
    - in the case of a nonprofit developer/sponsor, may consist of grant funds
  - Accommodates low-income housing tax credit projects by—
    - recognizing the requirements of limited partners
    - recognizing the value of tax credit equity in an appropriate way in the financial structure
- Develop a common approach to underwriting that recognizes the unique strengths and risks of affordable, and especially subsidized, housing—an approach that, while incorporating numerical ratios and guidelines, allows flexibility and discretion on the part of expert originators.
- Create appropriate and rigorous qualifying criteria for seller/servicers of affordable multifamily mortgages. These criteria should emphasize:
  - Specialized competence in multifamily housing, including that which is subsidized
  - Local market knowledge
  - Periodic re-qualification
- Standardize loan documents and forms across the industry.

STANDARDIZING THE SUBSIDY

- Create a standard "soft second" mortgage instrument that—
  - Is fully subordinated to the first mortgage
  - Facilitates production
- Create a manual of acceptable legal provisions for the "soft second" mortgage and for any other subsidy instruments, in order to standardize them as much as possible.

GETTING TO THE CAPITAL MARKETS

- Work with the rating agencies to design a universal risk-weighting system uniquely suited to multifamily housing (from market-rate to subsidized) that will meet with wide acceptance from investors.
- Review and consider revising the risk-weighted capital requirements of the Financial Institutions Reform, Restructure, and Enforcement Act (FIRREA) that discourage multifamily lending and the securitization of multifamily mortgages.
- Investigate the feasibility of new state and local agency roles in providing multifamily credit enhancement, such as:
  - Development of mortgage insurance programs that are capitalized by a dedicated revenue stream and that are designed to provide top loss insurance and a clear loss-recovery mechanism
  - Use of National Affordable Housing Act monies to fund reserves or otherwise support credit enhancement programs

- Development of new risk-sharing arrangements between the Federal mortgage agencies, state housing finance agencies, and others; exploration of reinsurance and other risk-sharing structures should be a top priority

- Expand existing Fannie Mae and Freddie Mac programs to make them more flexible and better able to accommodate subsidized projects.
- Investigate ways that Fannie Mae and Freddie Mac MBS pools can be used to economically securitize subsidized projects in the $250,000 to $2 million range.
- Investigate the feasibility of a system of national, regional, and/or local private conduits that, in conjunction with the Federal mortgage agencies, would help create, pool, credit enhance, and perhaps buy or sell smaller affordable housing mortgages in the secondary market on a larger scale than is presently being done.
- Examine the role of FHA and the issue of why and how the Federal government provides mortgage credit support, focusing on those risks that are appropriate for the Federal government to bear, with a view to restoring FHA as an effective multifamily mortgage financing vehicle. Issues to consider include—
    - The FHA role in risk-sharing and reinsurance and in generally providing credit on a wholesale basis
    - The Federal government role in insuring against political risk, such as that occasioned by 5-year subsidy commitments for projects with long-term financing
    - Whether the mechanics of current insurance programs provide FHA with sufficient flexibility to respond to problems relating to troubled loans

Volume Production

- Encourage local communities to carefully analyze the nature of their production problems before proposing solutions. In modifying existing processes, creating new organizations, calling in new actors, or developing new programs, they should address those problems in a way suited to the local context.
- Make local government subsidy programs dependable and accessible by integrating them with local private-sector financing programs and streamlining the delivery of both.
- Maximize opportunities for private participation on a profitable basis in local affordable housing production systems.

Remaining Barriers

- To provide the information necessary for investors to invest in multifamily housing in much higher volume than they presently do, the industry should:
    - Immediately undertake research and data collection on the past performance of multifamily housing, with a focus on identifying—
        - the determinants of successful lending in affordable housing
        - key underwriting issues associated with delinquency and default
    - Establish a database using common definitions of mortgage characteristics, in an appropriate format and in sufficient detail to be useful to investors in tracking the performance of multifamily loans over time. Such a database should incorporate historical data and track the factors affecting successful lending and underwriting that are identified in the research.
- Develop educational programs and materials for investors and their advisors, consultants, and lawyers to inform them regarding the risks and returns of affordable multifamily mortgages as an asset class, demonstrating that such loans can be profitable and are not necessarily risky.
- Undertake a thorough review of Federal, state, and local laws and regulations affecting multifamily housing investment. This review should focus on dispelling misperceptions of investment risk, identifying actual barriers to investment, and, if necessary, revising or reinterpreting such laws and regulations to permit or encourage investing in prudently-underwritten multifamily mortgages and mortgage-backed securities that provide market-rate returns.

NEXT STEPS

- Create a specialized institution—the Multifamily Housing Institute—to pursue the recommendations of this Task Force and to become a permanent protector and facilitator for the multifamily housing finance system and for affordable housing in particular, by—
  - Providing a forum for participants in the system to solve problems unique to multifamily housing finance
  - Promulgating standards and conventions for underwriting and other aspects of multifamily mortgage lending
  - Serving as an information clearinghouse
  - Facilitating historical research and the maintenance of an ongoing database on the performance of multifamily housing
  - Providing materials for the education of investors

ORIGINATING THE FIRST MORTGAGE: RECONCILING STANDARDS AND FLEXIBILITY

II

RECOMMENDATIONS

- Create a model first mortgage instrument for multifamily housing loans. This model would include the following key provisions, which meet the needs of investors for predictability of cash flows and liquidity, while accommodating the needs of affordable multifamily housing projects:
  - Fixed rate
  - Standardized term and amortization schedule
  - Standardized prepayment protection
  - Integration of the permanent mortgage with forward funding concepts, to facilitate newly-built and substantially rehabilitated projects
- Gain acceptance for subsidies in the form of gap financing as long as they are properly structured to be fully subordinate to the first mortgage.
- Gain acceptance for a common treatment of equity that accomplishes the following:
  - Requires a sponsor equity investment for acquisition or new construction, which—
    - — in the case of a for-profit developer, must include a contribution of the developer/sponsor's own cash
    - — in the case of a nonprofit developer/sponsor, may consist of grant funds
  - Accommodates low-income housing tax credit projects by—
    - — recognizing the requirements of limited partners
    - — recognizing the value of tax credit equity in an appropriate way in the financial structure
- Develop a common approach to underwriting that recognizes the unique strengths and risks of affordable, and especially subsidized, housing—an approach that, while incorporating numerical ratios and guidelines, allows flexibility and discretion on the part of expert originators.
- Create appropriate and rigorous qualifying criteria for seller/servicers of affordable multifamily mortgages. These criteria should emphasize:
  - Specialized competence in multifamily housing, including that which is subsidized
  - Local market knowledge
  - Periodic re-qualification
- Standardize loan documents and forms across the industry.

One of the Task Force's key findings is that multifamily investing—to be successful—must remain rooted in local origination and underwriting, even as it must be standardized on the national level if it is to access the capital markets.

The burden of reconciling the diverse requirements of local projects with national standards falls principally on the mortgage origination process. That reconciliation is embodied in the provisions of the first mortgage instrument, in the way that the other components of the financial structure—gap financing and equity—are treated, in the underwriting standards that are used, and in all other documents connected with a loan origination. It follows that if subsidized projects are to participate in the capital markets, standardization of these aspects of the mortgage origination process must accommodate subsidies as well as other features commonly found in subsidized projects.

Standardization of the mortgage origination process is essential to ensure routine lending and a continuous pipeline of projects. It also contributes to the standardization of credit quality, an essential requirement of investors (see also the discussion in chapter IV, *Getting to the Capital Markets*). Standardization is the key to a large volume of mortgage-backed securities, and it is volume that provides liquidity and entry to the capital markets. Thus standardization must be preserved in the areas where it is critical to success.

However, standardization must not be achieved by sacrificing the essential elements of flexibility required at the local level to address various market conditions, to allow a knowledgeable local underwriter to exercise judgment, and to accommodate unusual but feasible projects. Flexibility must be preserved in those areas where *it* is critical to success.

Reconciling these two conflicting requirements—the need for standardization and the need for flexibility—has been one of the most difficult tasks addressed by the Task Force. In the discussion that follows, we propose a way the necessary reconciliation can be brought about.

Some may find the recommendations that follow surprising and counter-intuitive. We have endorsed standardization to the extent that it is useful; where it is not, we propose reliance on a "common approach" and "expert judgment." A "common approach" means that all originator/servicers have a similar way of looking at affordable housing—that there is, if you will, a common culture—even though specific ratios for loan-to-value, debt service coverage, and reserves will vary with local market conditions and from project to project. Along with a common approach, the "expert judgment" of rigorously-selected underwriters can make good, consistent underwriting possible in the absence of total standardization.

The rest of this chapter elaborates these concepts in discussing the Task Force's recommendations for each aspect of the mortgage origination process: 1) the characteristics of the first mortgage itself, 2) treatment of the other components of the financial structure, 3) underwriting, and 4) project documentation. Also proposed is a new approach to the standards used by secondary market participants to qualify multifamily originators, that is, to underwrite the underwriters. It is in the realm of multifamily originators that local diversity and national standards actually meet.

Standardizing Provisions of the First Mortgage

To accommodate the needs of investors, key provisions of the first mortgage must be standardized. First, investors require that securities backed by pools of mortgages have predictable cash flows. Second, investors require liquidity, which is associated with a large volume of securities. In what is currently a limited market, more than one standard will divide the market, producing an insufficient volume of identical or very similar securities. In the absence of predictability and liquidity, multifamily housing will fail to attract broad investor interest. Standardization of critical features of the underlying mortgages can help meet these two investor needs. At the same time, however, standardized provisions must accommodate the individual needs of the projects themselves.

With these considerations in mind, the Task Force sought to identify those provisions of the first mortgage that it is essential to standardize. They proved to be surprisingly few:

The Task Force recommends the creation of a model first mortgage instrument for multifamily housing loans. This model would include the following key provisions, which meet the needs of investors for predictability of cash flows and liquidity, while accommodating the needs of affordable multifamily housing projects:

- ***Fixed rate***
- ***Standardized term and amortization schedule***
- ***Standardized prepayment protection***
- ***Integration of the permanent mortgage with forward funding concepts, to facilitate newly-built and substantially rehabilitated projects***

1) Fixed Rate. Although a floating rate can work well for some affordable housing projects, a fixed rate is often the most appropriate. In many cases, rents cannot be raised readily without jeopardizing affordability. Conversely, rents need not always drop with the market when they are already below the market. Considering the volume needed for securitization, the Task Force recommends one standard—and that a fixed rather than a floating rate—as the one likely to serve the widest range of projects.

2) Standardized Term and Amortization Schedule. Again, to avoid dividing the market, the Task Force recommends one standard term and amortization schedule. Currently, a variety of both are used, ranging from 25 to 40 years in the case of subsidized projects and from 5 to 40 years in the case of non-subsidized projects.

The ability to refinance a balloon payment that might result from the standard term and amortization schedule selected is a critical consideration. Balloons can be very difficult to refinance for properties that carry rental assistance unless such assistance extends five or more years beyond the balloon date.

In addition, the standard term selected must be long enough to cover tax credit projects, which have a rent restriction period and a minimum holding period.

3) Standardized Prepayment Protection. A standardized lockout or yield maintenance provision is necessary for predictability for the investor, even though the probability of prepayment of this type of mortgage may be lower than in current conventional experience.

4) Forward Funding. Affordable housing projects require integration of permanent financing with forward funding concepts to facilitate new construction and substantial rehabilitation. A forward commitment recognizes the long period often required to bring affordable projects to market and their inability to absorb rate increases.

Gap Financing: The Bells and Whistles

The financial structure of a subsidized housing project typically has three components: the first mortgage, the gap financing, and the equity. The discussions in this and the following section recommend treatments for the gap financing and the equity by the first mortgage lender and by secondary market participants who purchase first mortgages.

The "gap financing" component is the subordinated financing from a subsidy provider that fills the deficiency, or gap, that appears because the first mortgage amount and the equity typically do not cover the entire project cost. (The gap financing may actually be several pieces and may be donated rather than loaned.) Subsidies generally come from the public sector and most carry with them some form of use restriction designed to maintain affordable rent levels over the long term.

The Task Force recommends that subsidies in the form of gap financing be accepted as long as they are properly structured to be fully subordinate to the first mortgage.

Subsidies today most often take the form of a second mortgage. There are a wide variety of such second mortgage instruments. However, the two discussed below—"hard seconds" and "soft seconds"—are general categories into which all others can be classified. In the discussion that follows, the recommended treatments for these two types of subordinated debt illustrate general principles to be

followed with any variation of the two cases. (For a detailed discussion and recommendations on how to properly structure subsidies to protect the salability of the first mortgage, see chapter III, *Standardizing the Subsidy*.)

1) Recommended Treatment of "Hard Seconds." A hard second is a second mortgage as commonly understood: it has a regular payment schedule regardless of project income, and nonpayment will trigger foreclosure, workout, or sale. Generally, the only subsidy offered by a hard second is a below-market interest rate. It should therefore be classified as debt for underwriting purposes and payments should be included in the debt service coverage calculation.

2) Recommended Treatment of "Soft Seconds." With a soft second mortgage, nonpayment will not trigger foreclosure, sale, or workout, nor will it affect payments on the first mortgage. A soft second may have no formal payment schedule (payments being required only when use restrictions are violated) or a payment schedule that is dependent on project income (that is, on residual receipts after debt service coverage reaches a certain level). A below-market interest rate may be only one of several payment concessions. A soft second should be treated differently from hard debt and should not be included in the coverage calculation.

A Common Approach to Equity

Equity is the third component in the financial structure of a project. The equity contributed by for-profits and nonprofits can be expected to differ, reflecting different motivations and sources of funds. For-profit sponsors are presumably motivated by the opportunity to earn profits and by concern for losing their personal cash. A nonprofit sponsor is assumed to be motivated principally by its mission and, in any case, the cash put into a project is not the personal equity of the individuals involved. These distinctions support different treatments: in the case of a for-profit, equity should include a contribution of the develop/sponsor's personal or partnership cash; in the case of a nonprofit, both grants and contributions of the organization's own funds should be considered acceptable equity. However, both for-profits and nonprofits should submit to equally rigorous underwriting standards.

In a tax credit project, where equity up to 40 percent or more of project costs may come from syndication proceeds, the first mortgage (and any subordinated financing as well) must deal with the rights and requirements of limited partners. These generally include the need for nonrecourse financing; the right of the limiteds to change the general partner due to a general partner default; the right to change limited partners so long as the limiteds are not released from their obligation to fund equity; notice and cure provisions for the limiteds in the event of a loan default; various provisions limiting the liability of limited partners when exercising their rights under the partnership agreement; and planned limited partner exit strategies.

It is not possible to address in this report all the potential tax issues encountered in structuring financing for tax credit projects. However, if the low-income housing tax credit is made permanent and thus continues to account for over 90 percent of all low-income units produced. the compatibility of first mortgage provisions with limited partner equity and tax requirements will remain extremely important.

The presence of tax credit equity can also have an influence on the value of the project (see the discussion on determining economic value under *The Art of Underwriting*, below).

In addressing the treatment of equity, the Task Force recommends a "common treatment" rather than specific equity amounts or ratios, which may vary from project to project depending on the circumstances and the judgment of an expert originator. Therefore,

- ***The Task Force recommends a common treatment of equity that accomplishes the following:***
  - ***Requires a sponsor equity investment for acquisition or new construction, which—***
    - ***— in the case of a for-profit developer, must include a contribution of the developer/sponsor's own cash***

- — *in the case of a nonprofit developer/sponsor, may consist of grant funds*
- ***Accommodates low-income housing tax credit projects by—***
  - — ***recognizing the requirements of limited partners***
  - — ***recognizing the value of tax credit equity in an appropriate way in the financial structure***

The Art of Underwriting

Underwriting is the identification and evaluation of risk; as such, it is an art, not a science. In multifamily housing, in fact in commercial real estate generally, there is no such thing as a "no-brainer." Real estate expertise, experience, and judgment must be applied at every turn. Multifamily underwriting cannot be standardized in the same way that single-family underwriting has been; it cannot be reduced to forms and formulas, and there are few rules that cannot be broken in some circumstances.

Even though the present real estate environment is in rapid flux, trending generally toward conservatism, the key to good underwriting of multifamily housing is not likely to change. What is important is that all the factors that bear on the lending risk be examined thoroughly and judged expertly. Therefore,

■ ***The Task Force recommends development of a common approach to underwriting that recognizes the unique strengths and risks of affordable, and especially subsidized, housing—an approach that, while incorporating numerical ratios and guidelines, allows flexibility and discretion on the part of expert originators.***

Ideally, research on the historical performance of multifamily housing (as recommended in chapter VI) would provide the underpinnings of a new underwriting approach. However, until such data are available and the fact-based determinants of default for multifamily housing are better understood, the Task Force decided not to recommend specific numerical ratios or guidelines for underwriting standards. Future research may provide guidance for developing more meaningful loan-to-value and debt service coverage ratios. In the meantime, the outstanding performance of the mortgage portfolios of a number of specialized lending institututions suggests that the art of underwriting affordable multifamily housing can be learned and practiced successfully on a large scale (see *What's Working*, page 22).

Key Underwriting Issues

What is it, then, that appears to foster success in multifamily lending? With a common approach to underwriting in mind, rather than prescribed standards, the Task Force has identified key issues to consider in evaluating projects. These are listed below, with brief comments on how to approach each one. It should be emphasized that if knowledgeable judgment is not exercised, the result will be to miss profitable lending opportunities, on the one hand, and to walk blindly into high-risk situations on the other.

1) Market Analysis. Market analysis matters in underwriting subsidized projects, but it plays a different role than in most conventionally-financed projects. In subsidized projects, rents in many cases will not be the same as, or even derived from, actual market rents; they will be lower, with the overall financial structure and underwriting reflecting this fact. Accordingly, market analysis must focus very specifically on the segment of the market to which the units are restricted and on how permanent these restrictions are. In such cases, the fact that rents are below market may not be particularly relevant; the more important question is how the project compares in price and quality to the alternative housing choices available to the eligible income group.

Rental assistance contracts, the amounts of which vary with tenants' income, are common and need to be understood. Their value should be counted in the income stream for purposes of supporting value and determining the amount of the first mortgage, with due regard for the length of the contract (should it be shorter than the mortgage term) and for any insurance or stand-by mechanism to compensate for a short-term contract.

2) Management. The managers that succeed with subsidized housing projects are different from those that succeed with market-rate projects. On the one hand, subsidized housing projects may have a captive market and therefore low vacancy rates; on the other, they can be difficult to manage and may require the manager to deal with neighborhood issues as well as on-site ones. Although strong and experienced management is essential for success, once it is in place, the risk associated with a subsidized project may be lower than for conventional ones, which continue to be subject to greater market risk. It is evident that the industry needs to develop clear and rigorous criteria for managers of multifamily and especially subsidized projects.

3) Borrower. Nonprofit developer/borrowers are common in subsidized multifamily projects. The lender must be able to evaluate the capabilities and creditworthiness of nonprofits, which, like for-profits, must meet threshold requirements of competence. A number of specialist-originators have developed appropriate criteria for evaluating nonprofit borrowers. For-profit developers of the "mom and pop" variety are also an important customer segment that lenders should learn to evaluate.

What's Working

The conventional wisdom tells us that multifamily housing is an inherently risky investment, and the troubled portfolios of our largest multifamily lenders would seem to bear that out. At this writing, the Federal Housing Administration (FHA) has cancelled its co-insurance program because of high default rates and is reexamining its other multifamily insurance programs as well. Freddie Mac has also experienced severe losses in its multifamily programs and has withdrawn from the multifamily market while it restructures. Horror stories abound in the troubled real estate market, and the increasing insolvency of lending institutions leaves only the hardy—some would say the reckless—to provide financing for affordable multifamily housing.

Thus it is all the more surprising to observe the consistent excellent performance of a number of innovative lending institutions distinguished by their commitment to multifamily housing; the default rates of these institutions are low or nonexistent. Although there are no systematic or comprehensive data on the performance of multifamily housing, there is enough evidence of success in selective cases to suggest that multifamily lending can be profitable.

Among the best-known of these success stories are the Savings Associations Mortgage Company, Inc. (SAMCO), a statewide for-profit lender consortium in California; The Community Preservation Corporation (CPC), a New York City nonprofit lender consortium; the South Shore Bank in Chicago, a commercial bank; and the Fannie Mae Delegated Underwriting and Servicing (DUS) program, begun in 1988, which built upon Fannie Mae's successful 1984 master commitment program with the federally-chartered Neighborhood Reinvestment Corporation and its affiliate, Neighborhood Housing Services of America.

All of these lenders are at risk in the marketplace and all lend at or near market rates; but they have a public purpose as well. Among Federal government programs, the Farmers Home Administration's 515 program, which does multifamily first-mortgage lending at below-market rates in rural areas nationwide, also has an outstanding performance record. Several of these examples are discussed in more detail in the later chapter, *Volume Production* (see chapter V).

All of these organizations or programs have turned in strong performances. Since its creation in 1969, SAMCO has had minimal defaults and delinquencies and has never had a 60-day delinquency in its multifamily portfolio. CPC has never had a loss to its consortium lenders (or to an investor) since its inception in 1974. The South Shore Bank's delinquency rate averages 1-2 percent. The Fannie Mae DUS program to date has an excellent track record, and of the twelve Neighborhood Reinvestment/ Neighborhood Housing Services of America master commitment loans, five have paid in full and the other seven are current. Under the Farmers Home Administration's 515 program, losses stand at less than one percent and delinquencies are only three percent.

These track records suggest that affordable multifamily housing can be a profitable and secure investment. However, there is a need for research to understand better what works and why, as well as a need for a database tracking multifamily loan performance.

4) Neighborhood. Location is evaluated differently for affordable housing projects than for market-rate ones. Because subsidized projects are often located in low-income neighborhoods, this circumstance should not automatically disqualify them from consideration. Lenders must learn to distinguish between neighborhoods that are truly high risk and those that may only appear to be so initially. A supportive network of neighborhood organizations and institutions is particularly important; adequate city services are also important.

5) Mixed-Use Buildings. In certain areas of the country, it is common to find buildings that are primarily residential but with a commercial component. Much affordable housing is developed in older buildings where apartments-over-stores is an historic configuration. Although mixed-use buildings may be difficult for investors to accept initially, maintaining the commercial nature of the street level space is often desirable from the standpoint of neighborhood stability. Lenders should develop standards for such buildings and learn to evaluate the commercial component.

6) Rehabilitation. Rehabilitation characterizes many subsidized housing projects. This is particularly true in urban areas where deteriorated or abandoned buildings are often targeted for fix-up, in many cases as part of larger community development initiatives. The lender must be able to incorporate the value of the rehabilitation into the underwriting.

7) Debt Service Coverage. The default risk of the first mortgage is closely related to the ability of the project to make regular payments and to the income cushion remaining after debt service is paid. What the "correct" debt service coverage or range should be, however, is a point of considerable debate among lenders, credit enhancers, rating agencies, and investors. Minimum ratios range all the way from 1.0 (100 percent coverage) to 1.3 (130 percent coverage) or even higher, with the risk of default generally being seen as diminishing as the level of coverage increases. Debt service coverage is a more important measure of risk than is loan-to-value ratio (discussed further below), especially for subsidized housing projects.

8) Determination of Economic Value. In conventional real estate analysis, the determination of economic value is the real estate professional's bottom-line exercise, the one that determines how much a lender should lend and how much a buyer should pay. If the market is understood and the project properly analyzed, then the economic value of a property can be determined with relative accuracy.

Determining the economic value of a subsidized project is somewhat different. In many projects, rents are restricted and profit is capped or re-sale is constrained; at the same time, such projects are supported by subsidies and below-market financing not available to market-rate projects. The most meaningful measure of value is the capitalization of the income stream, a technique that can incorporate accurately the value of deliberately restricted rents, as well as the value of rental assistance, low income housing tax credits, property tax abatement, and favorable subordinated financing or other subsidies.

By comparison, an approach relying principally on market comparables doesn't provide a dependable basis for calculating value when the universe of similar projects is very limited. Nor is project cost a good measure; in some cases it can be dangerous, leading to overfinancing. In a market-rate project, economic value is generally similar to or greater than project cost. But in many subsidized projects, the economic value derived by capitalizing the income stream is considerably lower than project cost; the usual relationship between economic value and project cost does not hold.

9) The Loan-to-Value Ratio. Once an economic value is determined, the loan-to-value ratio is used by investors, credit enhancers, and rating agencies as a measure of the severity of potential loss in the case of a foreclosure. For those multifamily projects where rents and values are subject to market forces, loan-to-value is a useful concept; accepfable ratios range anywhere from 60 percent to 90 percent. But for affordable housing projects with capped rents, re-sale restrictions, or subsidies, the loan-to-value ratio has less utility. This is so even when value has been determined in a meaningful way; the debt service coverage still has more utility in determining risk.

The need for flexibility and expert judgement in underwriting multifamily housing is illustrated by the following examples, which show how the significance of debt service coverage and loan-to-value ratios may vary depending on the project, particularly in the case of subsidized housing.

One case arises when favorable subordinated financing is provided by a public-interest lender whose main interest is in maintaining the affordability of the housing. Should a default occur, it is likely to lead to a workout rather than a foreclosure and sale. In such cases, the loan-to-value ratio is less relevant, the debt service coverage more relevant.

To take another example, where the subordinated financing is a "soft second" payable out of cash flow, nonpayment does not trigger a default and the subordinated lender cannot initiate a foreclosure. The combined loan-to-value ratio of the first and second mortgages might well be over 100 percent, especially on the basis of an appraisal reflecting restricted rents, without being a signal of high risk. Similarly, the first mortgage could be as high as 90 percent of value and not be highly risky if debt service coverage is adequate and management is strong; given a fixed-rate mortgage and a large supply of tenants, the risk of default is low.

The point being made here is that formulas cannot be substituted for a true understanding of the real estate and its risk, which in turn depends on expertise and local market knowledge. In some cases, debt service coverage of 1.5 might not be enough; other projects may perform flawlessly at 1.1. A large debt service cushion cannot compensate for bad underwriting; if a project is a victim of poor underwriting, it will go through even a large debt service cushion quickly.

Underwriting the Underwriters

In addition to standards for the mortgage lending process itself, qualifying standards are needed for the originator/servicer of the first mortgage. The abilities of the originator/servicer to underwrite successfully, to manage workouts and foreclosures, and to guarantee timely payment, are key considerations in the performance of the mortgage investment. The quality of the originator/servicer will determine to a large extent the quality of the mortgage credit. Further, continuing monitoring of underwriters, perhaps in the form of annual reviews, is necessary to maintain the integrity of the standards, particularly when changes of personnel occur. Therefore,

- ***The Task Force recommends the creation of appropriate and rigorous qualifying criteria for seller/servicers of affordable multifamily mortgages. These criteria should emphasize:***
  - ***Specialized competence in multifamily housing, including that which is subsidized***
  - ***Local market knowledge***
  - ***Periodic re-qualification***

Few housing lenders are well qualified at present in the area of multifamily lending, let alone lending to subsidized projects. Standards for identifying competent and well-capitalized originators in the area of multifamily lending should be developed by the national secondary market participants, with assistance from knowledgeable specialized originators such as those discussed above (see *What's Working*).

It might be productive for the national secondary market agencies, Fannie Mae and Freddie Mac, to re-examine their seller/servicer standards along the lines proposed here. The agencies should review their current standards for appropriateness and—while in no compromising their rigor—adjust them as needed to accommodate successful specialist-originators such as those discussed above and in chapter V (see *Volume Production*). Appropriate standards would probably put somewhat more emphasis on affordable multifamily expertise and somewhat less on capital requirements. Once in place, such standards could become the vehicle for recruiting and training additional affordable multifamily originators and for establishing ongoing relationships with new types of originators such as state housing finance agencies.

It is this process of qualifying originator/servicers that—performed successfully—can make the critical marriage between the flexibility and discretion required at the local level and the standardization of credit quality required at the national level. The goal is a system where national secondary mar-

ket participants can rely more heavily on the ability and record of the (probably small number of) expert originators with whom they deal, in lieu of prescribing overly-restrictive standards. Reliance on prescriptive standards has eliminated many creditworthy projects from consideration, while contributing little to a full understanding of the risk of those that are financed.

Standardized Documents

The effort to standardize the mortgage origination process should be accompanied by efforts to standardize related documentation. Therefore,

- ***The Task Force recommends that the legal documents that formalize the application, appraisal, commitment, mortgage, and any other features of the financing be standardized across the industry.***

As they have done so successfully in the past, Fannie Mae and Freddie Mac should take the lead in setting national standards for sound underwriting and uniform documentation along the lines proposed in this report.

No More "CRA Rocks"

The origination process proposed above would help avoid what bankers refer to as "CRA rocks" (named after the federal Community Reinvestment Act). These are poorly underwritten loans that banks sometimes make under pressure to demonstrate reinvestment in their communities. Such loans are often made on relatively high risk terms, with a mortgage that is not "clean." Since they cannot be sold on a profitable basis, which would allow funds to be recycled for additional affordable housing lending, the CRA rocks must be "thrown in the corner"—that is, held in portfolio and fully reserved for. Instead of creating volume, they act as a disincentive to additional lending. To the extent that poor underwriting results in higher rates of delinquency and default, the effect is to confirm the private sector's common perception that such lending is high risk and low return.

In contrast, the origination approach suggested here assumes competitive risk and return profiles, capable of attracting investors whose interest need not be conditioned on altruistic motives or political or regulatory pressures to invest. Subsidies to projects would be explicit and separate, not hidden by credit mechanisms. Only then can the volume to support a liquid secondary market be achieved. When that happens, regulated financial institutions will have a vehicle for fulfilling their community reinvestment responsibilities without abandoning prudent lending practices. Then the maximum participation by the private sector in the financing of affordable housing can be achieved.

STANDARDIZING THE SUBSIDY: RECONCILING FINANCIAL AND SOCIAL OBJECTIVES

III

RECOMMENDATIONS

- Create a standard "soft second" mortgage instrument that—
  - Is fully subordinated to the first mortgage
  - Facilitates production
- Create a manual of acceptable legal provisions for the "soft second" mortgage and for any other subsidy instruments, in order to standardize them as much as possible.

If multifamily rental housing is to be affordable for low-income people, it must have subsidies. There are few projects and few parts of the country where this generalization does not apply. An important goal of the National Task Force on Financing Affordable Housing is to increase the production of subsidized housing by structuring the financing to permit access to the larger system of multifamily housing finance. This chapter presents recommendations for standardizing the distinguishing feature of such housing—the subsidy—in such a way that it can participate in the larger system, including the secondary market.

The provider of subsidy to a housing project has an interest in the project that is social as well as financial. Typically the subsidy provider is a public-sector agency, but it could be a nonprofit institution such as a foundation, a land trust or other housing organization, or even a university or a hospital. The subsidy provider's interest is to make the housing "affordable," however that is defined. and to keep it affordable for a defined period of time, if not permanently.

Project-based subsidies, as opposed to those such as housing vouchers that travel with the tenant, tie directly to the financial structure of the project; they generally are the piece that makes the project feasible at rents affordable to low-income people. The project-based subsidy may take many forms; but whatever form it takes, it is usually only one component of a complex layered financing structure that often includes a first mortgage from a private lender. Unless the subsidy is properly structured, the conditions that typically accompany it will conflict with the first mortgage lender's requirements and with the terms necessary to make the first mortgage salable to a secondary purchaser. The salability of the first mortgage must be protected if subsidized housing is to participate in a secondary market.

The challenge is to reconcile the financial requirement for salability of the first mortgage with the social goals that almost always accompany the subsidy (usually in the form of use restrictions specifying maximum rent levels or tenant income levels). This balancing act is much more difficult to achieve than if the interests of all parties were strictly financial, as in a conventional business transaction. Furthermore, the balance must be achieved in a practical way that facilitates the project, rather than overburdening it with transaction costs. The project must carry a low enough level of risk and complexity to be acceptable to the developer/sponsor and, in the case of a private developer, must offer a reasonable opportunity for profit as well. These practical considerations are as important to the first mortgage lender as they are to the developer.

Since the surest way for the public-interest entity to enforce use restrictions is to encumber the real estate, a legal instrument—most often in the form of a subordinate mortgage—almost invariably accompanies the subsidy. Ideally, it is the subordinate mortgage loan documents that should be structured to achieve not only long-term affordability, but the financial objective of salability of the first mortgage and the practical objective of facilitating production. In making recommendations for the key provisions of the second mortgage loan instrument, the Task Force sought to support all three of these objectives—the social, the financial, and the practical.

The recommendations assume that the subsidy instrument is a soft second mortgage, the most common form for the subsidy to take. As explained in the preceding chapter, a soft second—unlike a hard second—is generally payable only as cash flow allows and thus should not be included in the debt service coverage calculation. Soft seconds may have long terms (40 or 50 years), and some may even have debt service completely deferred until maturity. Throughout this chapter the term "soft second" applies not only to second mortgages, but also to those that are in an even more subordinated position to the first mortgage.

The development of a simple, predictable, standardized subsidy instrument—one that incorporates use restrictions as well as the specific provisions detailed below with reference to financial and practical goals—is believed by most members of the Task Force to be the single most important requirement for accessing first-mortgage capital for subsidized housing projects. Therefore,

III

■ ***The Task Force recommends that a standard "soft second" mortgage instrument be created that:***

- ***Is fully subordinated to the first mortgage***
- ***Facilitates production***

The recommendations made here are offered in full recognition that subsidy providers' legal considerations may work against complete subordination. However, it should be noted that if the second mortgage documents cannot incorporate substantially all of the financial provisions recommended in this chapter, access to capital through the secondary market will be severely limited if not foreclosed entirely.

The Social Goal: Ensuring Affordability

Subsidized projects must conform to the use restrictions established by the source of subsidy funding. The use restrictions of a soft second typically target rent levels (as a percentage of HUD's fair market rents for the region) and/or tenant incomes (as a percentage of area median household income). In addition, for mixed-income projects, the use restrictions indicate what percentage of total units must meet the use restrictions.

Funds for soft seconds or other project-based subsidies frequently come from HUD's Community Development Block Grant (CDBG) program. For projects to qualify for CDBG funding, rents generally must be affordable to households with incomes below 80 percent of area median income. The HOME Program of the 1990 National Affordable Housing Act will undoubtedly become the source of many project-based subsidies. HOME carries stricter targets than CDBG: on a program-wide basis, 90 percent of the rents must be affordable to households with incomes below 60 percent of median, with the balance affordable to households with income below 80 percent of median. Low-income housing tax credit projects have similar targets.

The Task Force has not recommended specific use restrictions, as these are most appropriately set—or negotiated—in connection with public policy.

Many first mortgage lenders are initially uncomfortable with use restrictions and the need for project compliance; they must come to understand how such restrictions can be made to work with a conventional first mortgage. Use restrictions need not deter the first mortgage lender from lending or hamper the salability of the first mortgage, as long as they are completely subordinate to the first mortgage as described below.

The Financial Goal: Protecting the First Mortgage

The specific provisions necessary to preserve an unencumbered first mortgage so that it can enter the capital markets are detailed here and in the section that follows. To have a "clean" first mortgage means that the soft second is completely subordinate, that it is consistent with and not in conflict with the first, and that the procedures for unravelling the financial structure if the project must be foreclosed are clear. It should be noted that if the real estate is underwritten well, many of these provisions need never be invoked; it is only when the project runs into financial problems that their crucial importance becomes apparent. Therefore,

■ ***The Task Force recommends that the following provisions to protect the first mortgage be incorporated as essential features of a standardized soft second mortgage instrument.***

1) Flexible Use Restrictions. The use restrictions that accompany the soft second should be as broad and as flexible as possible. In the event that the first mortgage is in danger of foreclosure (in "financial distress" in the language of the HOME program), this would allow owners or their successors to propose modifications permitting the first mortgage obligation to be met with the subordinate debt in place. Or, the mortgage instrument might provide for alternative methods of protecting the social objectives of the soft second lender if use restrictions must be modified, such as an ongoing role in oversight of the management plan.

Without such flexibility, a first mortgage lender will be wary of a project that requires below-market rents or tenant income restrictions that could prove

uneconomic and ultimately cause default. Once the financial distress is relieved, the use restrictions should be put back in place or the soft second repaid. Projects in urban renewal areas will always remain subject to some degree of redevelopment authority control.

2) **Clear Default Positions.** If a financing structure must be unwound for nonperformance of either financial or use obligations, then it is essential to have a time frame for response by parties holding soft seconds or other instruments containing use restrictions. Clarification of time-certain actions by all parties allows the first mortgage lender to assess risk up front.

3) **No Permanent Right of Reverter.** Projects in urban renewal areas are conveyed to private developers with deed restrictions that give the redevelopment authority the right to re-enter and take back the property if the project is not developed as promised. To the extent that the city or the redevelopment authority is also the second mortgage lender, these restrictions may be incorporated into the second mortgage itself. The right of the subordinate lender to take back the property in the case of nonperformance should not continue past the certified completion of construction and, in any event, should reflect the continuing priority of the first lien.

4) **Debt Service Payable Only Out of Net Cash Flow.** Nonpayment of debt service on a soft second mortgage should not trigger a default if the cash flow is not available to make the payment. The definition of "net cash flow" should be broad enough to take into account additions to reserves required by senior lenders, as well as cash flow payments required by partnership documents (in the case of tax credit projects). The payment amount and terms should also be clearly defined, even if cash flow is not expected to be available to make the payments. If it is not, payments can be abated or accrued, becoming payable either when cash flow becomes available or out of the net proceeds of a sale.

It should be noted here that unlike a hard second, a soft second requires that the subordinate lender monitor cash flow; thus reporting requirements should be clearly spelled out. Subordinated lenders should be aware that monitoring and enforcing provisions involving net cash flow requires technical sophistication and continual attention to the performance of the property.

5) **The Term of the Soft Second Should Equal or Exceed That of the First Mortgage.** No repayment of principal should be required during the term of the first mortgage, nor should any upward re-sets of payment amounts be allowed.

6) **Right of Reinstatement.** The owner should be able to reinstate a subordinate loan that is in default due to a default on a senior mortgage, once the senior loan default is remedied.

7) **Clearly Defined Terms of Participation in Proceeds.** The terms of participation of the subordinated lender (if participation is required at all) in the proceeds of a sale, syndication, or refinancing should be clearly defined. As in a conventional transaction, this item should be negotiated up front. Again, clarity on this point reassures the first mortgage holder and assists the sale of the first mortgage.

8) **Right to Use Insurance Proceeds to Rebuild.** In the case of fire or other damage, insurance proceeds should be available to rebuild and should not be required to be applied against the soft debt. This is especially important in the case of tax credit projects, to avoid recapture of tax benefits. The same provision should apply to first mortgage debt.

9) **Assumability of Second Mortgage.** In the case of a sale, the soft second should be assumable as long as the loan is not in default and the use restrictions stay in place. However, many subsidy providers will want to exercise some influence over who the new owner is. In such cases, the loan documentation should include either a provision that approval not be unreasonably withheld or a forward definition of an approved purchaser. In the case of a limited partnership where a nonprofit general partner has the right to acquire the property from the limited partners, such a transaction should be explicitly permitted.

In addition, in the case of a refinancing, a new first mortgage should be permitted, provided the subordinate lender's position is not diminished or impaired.

10) **Matching Limited Partner Provisions.** Any provisions of subordinated loans that deal with the rights of limited partners should correspond to those of the first mortgage (see recommendations for originating the first mortgage, chapter II).

The Practical Goal: Facilitating Production

Another group of key provisions can be termed "production provisions." Though not necessarily a factor in balancing a project's financial and social objectives, they are practical considerations that allow the project to happen more easily and to be managed more successfully over time; they may even be necessary to allow it to happen at all. By providing for acceptable levels of risk and return for the developer/sponsor, they facilitate financial structuring, provide flexibility, and reduce negotiation time as well. Therefore,

- ***The Task Force recommends the following provisions to facilitate the production of affordable multifamily housing.***

1) **Designation of a "Lead Subordinate Lender."** The discussion in this chapter anticipates a role in project financing for equity, first mortgage, and soft second participants. However, many affordable housing projects involve additional sources of financing; often subsidy is obtained from three or more sources. All of the subsidy providers, often working in different legal and fiscal contexts, must meet the standards identified here. Designating a lead subordinate lender can simplify the process of financial structuring when a property is initially financed; it can be even more critical in situations of property distress, when quick action is often needed and public policy goals may be in starkest conflict with the need to protect the first mortgage investment. By coordinating communication and decision-making among all participants, the lead subordinate can simplify both of these complicated processes.

2) **Latitude to Tailor the Interest Rate and Amortization to the Requirements of Individual Projects.** The interest rate and amortization schedule of the soft second embody the subsidy that makes it financially feasible to achieve housing affordability. On the one hand, a subordinated lender quite understandably wants the interest rate to be as high as a project can bear; on the other, there should be latitude to set the rate as low as it needs to be. Stated interest rates as low as 1 percent are not uncommon. Principal payments may be limited or deferred until maturity.

3) **Full Asset Coverage Not Required.** The combined amount of the first mortgage and the soft second should be permitted to exceed the appraised value of the property. Because a project's rental income is often constrained by the use restrictions of the soft second, the economic value of the property, as defined by an income-based appraisal, is often less than the development cost. As long as the soft second is fully subordinated as described in the preceding section, the first mortgage holder should not object to this situation. For most tax credit projects, however, appraisals must equal both the first and second mortgage debt. In these cases, appraisals that take into account the value of the credits should be accepted.

4) **Non-Recourse to the Borrower.** The borrower should have no personal obligation to repay the soft second, which is secured by the property only. An exception to this provision may establish the personal liability of a for-profit borrower for fraud, waste, or loss arising under environmental or other indemnities, or for improper diversion of funds.

5) **Reasonable Allowance for Profit and Return on Equity.** There should be clear definitions of allowable profit and overhead for the developer, of allowable return on equity, and of terms of participation in the net proceeds of a sale, syndication, or refinancing. In a tax credit project, requirements for return on equity will be driven by current pricing in the equity markets.

6) **Forward Commitment.** Ideally, the soft second should be a forward commitment for combined construction and permanent financing, with the subordinated lender's funds to precede the conventional construction funds into the project. If the subordinated lender does not participate in the construction financing, a forward commitment is still needed.

7) Partial Releases Permitted. The soft second should provide for partial releases of the mortgage collateral where appropriate, such as in the case of a conversion of some or all of the units to homeownership. Such a provision should correspond to a similar provision in the first mortgage. It should be noted that partial releases are very difficult in cases where the sum of all mortgages exceeds the value of the property. Approaches that address this problem need to be developed.

8) Provisions for Tax Credit Projects. In low-income housing tax credit projects, the need for second mortgages to satisfy certain tax considerations creates additional tension between the social purpose objectives of the public interest entity and the tax structuring needs of the project. The requirement in many tax credit projects that soft second debt be treated as debt for tax purposes limits flexibility in structuring the soft second mortgage instrument; for example, language forgiving the debt is prohibited in many cases. Subsidy providers who seek to facilitate production should make their documents compatible with these tax requirements. If the federal government makes the tax credit permanent, the issue of ensuring the compatibility of tax credit equity and subordinate loans will need to be addressed, perhaps by developing a manual of legal provisions as discussed below.

Ensuring Conformance of Other Legal Instruments

The subsidy (or subsidies) to a particular project can take a form other than that of a soft second. The subsidy may be an outright donation of land, a free or cheap ground lease, a "hard" second mortgage, further subordinated financing, or an outright grant. Almost all subsidized housing projects obtain some form of property tax abatement from the local jurisdiction. Another form of project-based subsidy is the rental assistance contract between a government jurisdiction and a building owner, exemplified by the older Federal Section 8 programs or some state programs that pay the difference between 30 percent of the tenant's income and the rent amount. All of these forms are project-based, whether they are operating or capital subsidies; they therefore are embodied in some type of legal instrument with the potential to encumber the first mortgage.

Whatever the type of subsidy, the financial need to protect the salability of the first mortgage and the practical need to facilitate production remain. Many of the key provisions discussed above will apply and should be incorporated into the applicable legal instrument. That instrument might be a deed restriction, a provision in a ground lease, a covenant, an easement, or a rental assistance contract. Where there is more than one subsidy—for example, donated land, tax abatement, and perhaps a soft second, third, or fourth mortgage all in the same project—not only should all the legal instruments include the appropriate key provisions, but they should not conflict with one another. Therefore,

- ***The Task Force recommends that a manual of acceptable legal provisions be developed for use with soft second mortgages and other subsidy instruments. Such a manual could be drawn on as needed, in a "mix and match" fashion, to standardize these instruments as much as possible.***

To the extent that this and the other recommendations in this section influence common practice, subsidized projects will gain expanded access to the larger system of multifamily housing finance.

GETTING TO THE CAPITAL MARKETS: RECONCILING BORROWER AND INVESTOR NEEDS

IV

RECOMMENDATIONS

- Work with the rating agencies to design a universal risk-weighting system uniquely suited to multifamily housing (from market-rate to subsidized) that will meet with wide acceptance from investors.
- Review and consider revising the risk-weighted capital requirements of the Financial Institutions Reform, Restructure, and Enforcement Act (FIRREA) that discourage multifamily lending and the securitization of multifamily mortgages.
- Investigate the feasibility of new state and local agency roles in providing multifamily credit enhancement, such as:
  - Development of mortgage insurance programs that are capitalized by a dedicated revenue stream and that are designed to provide top loss insurance and a clear loss-recovery mechanism
  - Use of National Affordable Housing Act monies to fund reserves or otherwise support credit enhancement programs
  - Development of new risk-sharing arrangements between the Federal mortgage agencies, state housing finance agencies, and others; exploration of reinsurance and other risk-sharing structures should be a top priority
- Expand existing Fannie Mae and Freddie Mac programs to make them more flexible and better able to accommodate subsidized projects.
- Investigate ways that Fannie Mae and Freddie Mac MBS pools can be used to economically securitize subsidized projects in the $250,000 to $2 million range.
- Investigate the feasibility of a system of national, regional, and/or local private conduits that, in conjunction with the Federal mortgage agencies, would help create, pool, credit enhance, and perhaps buy or sell smaller affordable housing mortgages in the secondary market on a larger scale than is presently being done.
- Examine the role of FHA and the issue of why and how the Federal government provides mortgage credit support, focusing on those risks that are appropriate for the Federal government to bear, with a view to restoring FHA as an effective multifamily mortgage financing vehicle. Issues to consider include—
  - The FHA role in risk-sharing and reinsurance and in generally providing credit on a wholesale basis
  - The Federal government role in insuring against political risk, such as that occasioned by 5-year subsidy commitments for projects with long-term financing
  - Whether the mechanics of current insurance programs provide FHA with sufficient flexibility to respond to problems relating to troubled loans

The journey of a mortgage once it leaves the local bank—a journey through Wall Street and ultimately to the national capital markets—is invisible and perhaps even unknown to the local borrower. But the ability to make a smooth passage is a critical aspect of a healthy multifamily housing finance system.

Although the standardization of first and second mortgage documents and financial structures discussed above are necessary conditions for making the journey, they are not sufficient in and of themselves. For a mortgage to get to the capital markets, both credit enhancement and an efficient system for securitizing multifamily mortgages must be in place; it is these two elements that pave the way.

In past years, a number of entities supplied credit enhancement—banks, insurance companies, and Federal agencies chief among them. However, financial problems at both banks and insurance companies, stemming largely from commercial real estate, have essentially removed them from this market. And, to date, bond insurers have exhibited only a narrow interest in taking real estate risk. These circumstances, combined with the virtual disappearance of Federal mortgage insurance, have obliterated the old route to the capital markets. A satisfactory new one has yet to be mapped out.

The Need for Credit Enhancement

What is credit enhancement and why is it needed? Consider that if the capital markets are to be accessed, then the same first mortgage that works for developers or project sponsors must also be attractive to investors. In theory, the needs of borrowers and investors could overlap exactly, but typically they do not. It is credit enhancement that bridges the gap.

For example, since investors want protection from risk, they will usually seek very conservative loan-to-value and debt service coverage ratios. These compensate for the wide variation in local real estate markets and projects, which an investor in the national capital markets is typically not in a position to assess. However, the extra-conservative ratios required by investors cannot be met by many affordable projects, causing them to fall out of the band of investor interest.

It is here that credit enhancement can reconcile the conflicting requirements. For a fee, the credit enhancer scrutinizes a project and determines acceptable loan-to-value and debt service coverage ratios. It then offers investors its *own* security, which—based on the credit enhancer's capital position and existing risk exposure—has been assigned a specific rating by the rating agencies (in most cases AAA). Investors then need look only to the rating of the credit enhancer, which has assumed the real estate risk.

Thus a credit-enhanced mortgage or pool of mortgages bears a universally-accepted stamp of approval from one of the Federal mortgage agencies—Ginnie Mae, Freddie Mac, or Fannie Mae—or from a well-known bond or mortgage insurer. The investor essentially buys the security of the credit enhancer; in this way, the mortgage or pool of mortgages achieves acceptance in the capital markets.

Credit enhancement may also be needed in the case of some subsidized projects to insure against political risk. Common problems encountered with the government rental assistance contracts currently available are that the term of the contracts may be less than the term of the first mortgage or contract funding constrained by the appropriations or budget practices of a particular jurisdiction. Insurance or some form of credit enhancement is needed to maintain credit quality in case short-term subsidies disappear. Ways to accommodate this risk need to be developed. They might include such things as standby commitments from Federal or state government agencies to cover shortfalls in debt service should rental assistance contracts not be renewed, or provisions that link use restrictions to the rental subsidy stream, so that restrictions can be released if the subsidy should terminate.

To summarize, the market needs credit enhancement to mitigate both real estate risk and political risk. Credit enhancement also addresses the need to standardize credit quality, discussed below.

Standardizing Credit Quality

For a multifamily mortgage or pool of mortgages to obtain credit enhancement, it is essential to be able to determine credit quality. There is currently no

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universal risk-weighting system that can predict accurately the risks of multifamily housing and accommodate the ways in which the project might be subsidized. Consequently, determining credit quality is a time-consuming task.

"Credit quality" is a concept that has developed over decades to a high level of sophistication in the corporate and municipal finance arenas. The techniques of institutional credit analysis, backed by historical data and research, have resulted in highly-quantified standards for rating the risk of bonds or institutional debt.

Commercial real estate, by comparison, is much more difficult to evaluate with reference to uniform standards because of the great diversity of project types, local market conditions, and underwriting approaches used by originators of varying capabilities. Nonetheless, the market demands that evaluation occur. Credit quality standards are essential to the development of a secondary market, because they enable the following to occur:

- Comparison of projects with one another
- Determination of the amount of credit enhancement needed
- Comparison of mortgage-backed securities with other fixed-income investments, and therefore—
- Facilitation of pricing

Just how risky an investment is multifamily housing? The popular perception, and certainly the perception of many investors, is that it is quite risky; indeed, the recent large losses in the FHA and Freddie Mac portfolios suggest the same. The risk-based capital rules for regulated lenders set forth in the Financial Institutions Reform, Restructure, and Enforcement Act (FIRREA) make a similar assumption; they place multifamily housing lending in the highest risk category—a significant disincentive to lend. Yet as noted earlier in chapter II, there are enough examples of consistent strong performance by certain lenders to argue that multifamily housing need not be a risky business. It is especially striking that a number of these successful institutions are active in the same markets where other institutions have experienced heavy losses.

The rating agencies have begun to promulgate credit quality criteria for commercial real estate generally and, in some cases, for multifamily residential specifically; however, the Task Force finds that a rating system uniquely suited to affordable housing—a system that includes subsidized projects—has yet to be developed. Therefore,

■ ***The Task Force recommends that, in cooperation with the rating agencies, a universal risk-weighting system be designed that is uniquely suited to multifamily housing (from market-rate to subsidized) and that will meet with wide acceptance from investors.***

Such a system, reflecting both an understanding of the anticipated types of subsidies and an emphasis on quality management of projects, would enable credit enhancers to accept a wider variety of loans. The requirements of such a system further underscore the need for substantial standardization in the design of subsidies.

Risk-Sharing

The availability of credit enhancement depends upon the willingness of an external party to assume risk. However, no private entity exists today that is willing to fill the role formerly filled by FHA (see *The FHA Role*, below). Nor is there an entity that can regularly and expeditiously provide full credit enhancement to multifamily mortgages, particularly for pools of small subsidized projects.

The Task Force explored the availability of private insurance for multifamily mortgages—insurance that would assume the direct real estate risk of projects. It discovered no active credit enhancers at the present time. The last private mortgage insurers left the business following the 1989 adoption by insurance regulators of prohibitive capital requirements for monoline companies; these requirements, along with the need for expensive and cumbersome licensing in every state, ultimately made the business uneconomic. But even before that time, private insurers had come to view the credit enhancing of multifamily loans as unacceptably risky, principally because of unforeseeable shifts in the economy due to such things as volatile interest rates and changing tax laws. In addition, the labor-intensive nature of multifamily underwriting and the level of expertise

required imposed costs that could not be covered by the fees that could be charged.

Private bond insurers hold only slightly more promise. Bond insurers generally are unwilling to take project-based real estate risk unless the project is backed by some other form of credit enhancement. Rather, they insure the issuer of bonds backed by real estate, the issuer usually being a highly-rated municipality or housing authority. One niche participant that does take project-based risk, Guaranty Risk Services, Inc. (GRS), has recently begun to specialize in commercial real estate projects in the $4-$20 million range, with an emphasis on multifamily housing projects. Using the AAA Duff and Phelps claims-paying ability rating of its affiliate, Asset Guaranty, GRS provides credit enhancement for taxable and tax-exempt bonds issued by public authorities and private trusts. It uses stringent underwriting criteria and typically requires 20-40 percent recourse to the borrower.

For the near term, the prospects for the private insurance industry in providing credit enhancement are not bright. However, GRS is currently working with a major bank and a large state housing finance authority to develop a 15-year product for financing low-income housing tax credit projects. According to GRS, this program has the potential to accommodate small affordable housing projects in pools as small as $30 million on a shared-risk basis between GRS and the bank.

Risk-sharing is not a new idea. However, as a result of the current lack of full-coverage insurance, there is increasing emphasis on developing alternative risk-sharing arrangements. In such arrangements, more than one entity may participate in the risk of a particular project, based on such things as the particular relationship each has to the project or their particular expertise. For example, the developer, the lender, or a municipality—being closest to the project—might be comfortable taking a top- or first-loss portion of the real estate risk; a private or public insurer might take the bottom portion; and a government subsidy provider might cover the political risk of nonrenewal of the subsidy.

Although sharing risk is a way to limit the loss that would be borne by any one party, its more important function may be simply to make all participants more aware at the outset of the nature of the risks involved and more likely to manage and price the risk appropriately. For example, the risk retained by the lender should be designed to promote prudent underwriting and careful loan monitoring and servicing, as well as to provide an incentive for quick loss mitigation in the case of default.

Structured financings, a form of "internal" credit enhancement, are an increasingly common approach to sharing risk. In a structured financing, two or more classes of securities are created, both backed by the same pool of collateral; cash flows are directed in such a way as to increase the probability that investors in the senior class of securities will receive the level of returns promised. The originator may either retain the subordinated class of securities with its higher risk and higher return, as is typical, or seek to sell it.

Such senior-subordinated structures are the most cost-efficient form of internal credit enhancement. More effort to develop such structures is needed and could be helped considerably by standardizing credit quality and by relaxing the risk-based capital requirements that currently hamper banks and thrifts from pursuing this option.

These bank regulations pose a serious impediment to risk-sharing. For example, Fannie Mae's Delegated Underwriting and Servicing (DUS) program utilizes the principle of risk-sharing for multifamily loan purchases. Unfortunately, since that program began in 1988, new regulations have been put in place through the Financial Institutions Reform, Restructure and Enforcement Act (FIRREA). These reforms in effect penalize a financial institution for retaining partial recourse on loans it sells—it must retain 100 percent of the risk (with the attendant impact on its capital requirements), even if it retains only 20 percent recourse on the sold loan. This disincentive penalizes both multifamily origination and securitization and has cut severely into Fannie's DUS business. Therefore,

- ***The Task Force recommends that the Federal government review and consider revising the risk-weighted capital requirements of FIRREA that discourage multifamily lending and the securitization of multifamily mortgages.***

Risk-sharing is a rational and effective alternative or supplement to credit enhancement. It seems not only appropriate but likely that secondary market programs will move increasingly to include various forms of risk-sharing.

Activities of State Government Agencies

One of the more promising avenues to wider availability of credit enhancement may be state government agencies. An interesting and effective statewide program is the mortgage insurance program of the State of New York Mortgage Agency (SONYMA), which provides mortgage insurance on individual projects. SONYMA mortgage insurance has proved to be highly efficient in leveraging public funds for the support of affordable housing.

SONYMA insurance has enabled banks, pension funds, and other institutional investors that otherwise would not be able to invest in affordable housing at acceptable levels of risk to do so prudently. The New York City Employees Retirement System, the Police Pension Fund, the Teachers Retirement System of the City of New York, and the New York State Common Retirement Fund have all invested in affordable housing mortgages originated by the Community Preservation Corporation on a forward-committed basis using SONYMA insurance. Their total commitment now approaches $550 million (see also chapter V, *Volume Production*).

The features of SONYMA's multifamily mortgage insurance program that have been critical to its acceptance among institutional investors include the following:

- **Dedicated Funding.** The program is funded by a dedicated tax, a surcharge on the state's mortgage recording tax, which assures adequate capitalization.
- **Top Loss Coverage.** SONYMA provides top loss insurance for mortgages made in blighted or distressed areas of New York State. Its standard program covers the first loss (including interest arrearages, principal losses, legal fees, etc.) up to an amount equal to 75 percent of the unpaid principal balance of the loan. Where pension fund purchasers are involved, SONYMA covers up to an amount equal to 100 percent of the unpaid principal balance for the same types of losses.
- **Clear Loss Recovery Mechanism.** SONYMA's loss recovery mechanism is clear and certain. It operates with a master mortgage insurance policy to which a participating lender becomes a party. The master policy generally provides for SONYMA to pay out claims once the insured lender has taken title to a property through foreclosure.

Subsequent to the commitment of the public pension funds described above, SONYMA obtained an A- rating from Standard and Poor's and an Aa rating from Moody's in 1989. This rating should eventually enable SONYMA to achieve broader access to the capital markets.

The SONYMA model is a useful one. However, it may not be feasible in all states since it requires state enabling legislation, which may be difficult to get enacted, and it does require some commitment of public funds to create reserves necessary to back the program.

State housing finance agencies are another potential vehicle for state government participation in risk-sharing. Although their programs are being severely curtailed by the current Federal bonding cap and the uncertain future of mortgage revenue bonds—the foundation of their financing activity—many have achieved a level of expertise that equips them for a new role in affordable housing. State housing finance agencies could become more active in countering the disappearance of conventional mortgage credit by exploring new risk-sharing structures that respond directly to the current difficult real estate environment. Using both their taxable and tax-exempt bonding capabilities, and sharing risk with the Federal mortgage agencies, state housing finance authorities are potentially pivotal participants in a revamped housing finance system.

In addition, states could explore creative uses of funds available under the National Affordable Housing Act for credit enhancement. Capitalizing a mortgage insurance agency like SONYMA, for example, or increasing the reserves of a housing finance authority to better position it for a credit enhancement role could provide excellent leverage for pub-

lic funds. Therefore,

- ***The Task Force recommends investigating the feasibility of new state and local agency roles in providing multifamily credit enhancement, such as the following:***
  - ***Development of mortgage insurance programs that are capitalized by a dedicated revenue stream and that are designed to provide top loss insurance and a clear loss-recovery mechanism***
  - ***Use of National Affordable Housing Act monies to fund reserves or otherwise support credit enhancement programs***
  - ***Development of new risk-sharing arrangements between the Federal mortgage agencies, state housing finance agencies, and others; exploration of reinsurance and other risk-sharing structures should be a top priority***

Fannie and Freddie

Fannie Mae and Freddie Mac are the most stable and successful institutions in the otherwise unsettled housing finance system. Despite the temporary withdrawal of Freddie Mac from the multifamily arena while it retools its program, both of these organizations will remain major—if not becoming larger—participants than they have been. In the wake of FHA's shutdown of its co-insurance program, and because of the need for banks and savings institutions to securitize their portfolios to meet new capital requirements, the government-sponsored mortgage agencies have been highly successful in recent years. They have been able to grow their capital to the point where they have come under pressure, particularly from Congress and low-income housing advocates, to step up their support for multifamily housing.

However, as also holds for any other participant in the process, it would be a mistake to expect these for-profit institutions to provide housing subsidies in the guise of loose credit. They should not be expected to compensate for the myriad shocks absorbed by the multifamily mortgage credit system in the last few years—shocks that have included first lax, and then overly-strict, regulation of banks; changes in tax laws regarding the treatment of real estate; curtailment of direct housing subsidies; the cap on tax-exempt bonds; and weakened demand due to overbuilding. Such expectations are a sure recipe for losses and ultimate collapse, as befell FHA.

What the mortgage agencies can do, however, and what they will undoubtedly be mandated to do in 1992, is to work within and build upon their existing multifamily programs. By providing access to the secondary market to unassisted and non-federally insured housing stock, Fannie Mae and Freddie Mac play an essential role. For example, Fannie Mae has created the DUS and Prior Approval programs to serve the multifamily market.

As a general posture the Federal mortgage agencies can be—and indeed already are seeking to be—more flexible and accommodating to smaller projects, which often have one or more types of subsidy, layered financing, nonprofit sponsorship, and tax credit-raised equity. The challenge is to accommodate such projects at reasonable cost and without higher risk. Again, risk-sharing with mortgage originators holds promise, particularly where pooling of smaller projects may obviate the need to underwrite each one. A role in reinsuring local or regional insurers such as SONYMA should be a top priority. Therefore,

- ***The Task Force recommends that Fannie Mae and Freddie Mac expand their existing programs to make them more flexible and better able to accommodate subsidized projects.***

The Mechanics: Pooling and the Need for Conduits

Large, high-quality loans may achieve access to the capital markets through the Federal mortgage agencies or in some cases through private bond insurers. The bigger challenge is to take the mortgages of many small subsidized projects—collateral that couldn't otherwise be sold economically into the secondary market—and to create a bond more acceptable to the market than the underlying collateral. This can be done by 1) pooling loans to create

diversification and 2) credit enhancing the pool to secure a rating or acceptance by the Federal mortgage agencies.

The pooling of multifamily mortgages is impeded, particularly for subsidized projects, by both the lack of credit quality standards and the unpredictable production pipeline. Pooling is also hampered by the number and variety of originators, by the small size of loans (sometimes well below $1 million), and by the need for a high volume of mortgages to achieve efficient securitization. Aggregating a pool of $100 million (the size preferred by Fannie and Freddie) or even $25-$40 million (the minimum to justify the cost of securing a rating) is extremely difficult in light of the long and uncertain lead times for such projects. Not only is there a need for streamlined production, as discussed further in the next chapter, but there is also a need for a mechanism for warehousing loans until enough can be aggregated for an economically viable pool.

Thus, the challenge of securitizing a pool of multifamily mortgages is not just financial; the mechanics are formidable as well. These two functions—that of assuming the real estate risk as financial guarantor or insurer and that of aggregating, warehousing, and securitizing the mortgages to actually effect the sale—should be distinguished. Although they can be performed by the same entity, they need not be.

Whether it is a sale to the public market or a private placement, the associated mechanics may include 1) buying small loans (probably from multiple originators), 2) warehousing them until enough diverse loans are aggregated and market timing is right, 3) pooling them, 4) securing credit enhancement and/or a direct rating, 5) establishing pricing, 6) selling them, and 7) perhaps acting as servicer or master servicer. These steps must be carried out by some entity acting as a conduit for multifamily loans from the neighborhood to the capital markets. In performing this function, the conduit is in a position to exert quality control over loan origination, thereby enforcing loan standardization and engendering confidence in the market.

Currently a number of entities perform part of the conduit function, each for a limited sector of the multifamily mortgage market. Among them are the Federal mortgage agencies (Fannie and Freddie), which also perform the financial function for non-subsidized and tax credit projects, as well as for some subsidized projects. One issue that merits the particular attention of Fannie and Freddie is whether their mortgage-backed securities (MBS) pools could be used to economically securitize subsidized projects in the $250,000 to $2 million range. Such questions as whether investor needs are best met by accommodating such loans in pools of otherwise conventional loans or by aggregating pools of like loans are among those that bear investigation. Therefore,

- ***The Task Force recommends that Fannie Mae and Freddie Mac investigate ways that their MBS pools can be used to economically securitize subsidized projects in the $250,000 to $2 million range.***

A few large originators securitize their own portfolios for sale directly to the market. In addition, a small number of nonprofits, notably the Local Initiatives Managed Assets Corporation (LIMAC) and the Neighborhood Housing Services of America (NHSA) have pooled small subsidized projects. However, there are not currently enough smaller conduits, nor any sufficiently broad single conduit, to meet the needs of subsidized projects. Therefore,

- ***The Task Force recommends investigating the feasibility of a system of national, regional, and/or local private conduits that, in conjunction with the Federal mortgage agencies, would help create, pool, credit enhance, and perhaps buy or sell smaller affordable housing mortgages in the secondary market on a larger scale than is presently being done.***

Such conduits would specialize in bringing mortgages of affordable, including subsidized, multifamily projects to market as described above. With proper capitalization, conduits would be able to provide some recourse as well, easing the way to national credit enhancement and lowering its price.

The question arises of whether a private conduit could operate profitably. Although it should be organized as a for-profit entity and operate in an entrepreneurial fashion to best assure self-sufficiency and longevity, its aim would not necessarily

be to maximize profit. A modest profit or even a break-even performance should be acceptable to a conduit's sponsors, which could be a consortium of institutions with other objectives to be served by bringing it into existence. For example, banks that need to increase liquidity but which would like to retain loan servicing and fee income could benefit from such a conduit. Similarly, nonprofit organizations, utility companies, financial institutions, and state and local governments—all of which have ties to a particular location and therefore a stake in a local or regional economy—are potential sponsors of a conduit.

The FHA Role

The Task Force has not focused on the Federal Housing Administration, nor does it intend to make detailed recommendations in regard to FHA. It does note, however, that government has dominated the housing finance system for years— to a much greater extent than is generally realized—and that the collapse of the principal FHA multifamily insurance program is responsible in large part for the present plight of the system. Although there is an essential Federal government role in making mortgage credit available at a reasonable price, very possibly it should be accomplished in a different manner than in the past. Therefore,

- ***The Task Force recommends that the Federal government examine the role of FHA and the issue of why and how the Federal government provides mortgage credit support, focusing on those risks that are appropriate for the Federal government to bear, with a view to restoring FHA as an effective multifamily mortgage financing vehicle. Issues to consider include—***
  - ***The FHA role in risk-sharing and reinsurance and in generally providing credit on a wholesale basis***
  - ***The Federal government role in insuring against political risk, such as that occasioned by 5-year subsidy commitments for projects with long-term financing***
  - ***Whether the mechanics of current insurance programs provide FHA with sufficient flexibility to respond to problems relating to troubled loans***

Of the range of issues addressed by the Task Force, the problem of structuring credit enhancement is perhaps the one where solutions are least evident. In its review, the Task Force sought to clarify the nature of the problem and to identify promising directions for future work on this critical issue.

VOLUME PRODUCTION V

Recommendations

- Encourage local communities to carefully analyze the nature of their production problems before proposing solutions. In modifying existing processes, creating new organizations, calling in new actors, or developing new programs, they should address those problems in a way suited to the local context.
- Make local government subsidy programs dependable and accessible by integrating them with local private-sector financing programs and streamlining the delivery of both.
- Maximize opportunities for private participation on a profitable basis in local affordable housing production systems.

Even if all the components of the multifamily housing finance system that have been discussed so far—the first mortgage, the subsidy instrument, and the securitization process—were restructured as suggested, the problem of achieving a significant volume of affordable multifamily production would remain. The improvements recommended above would facilitate the acquisition of existing unsubsidized buildings by private investors, particularly if tax laws and bank regulations were revised. But the rehabilitation of deteriorated units and the construction of new units where subsidies are required would still be difficult and erratic.

This problem manifests itself as a lack of continuous volume production—a "pipeline"—even in locations where demand is strong and subsidies are available. Somehow, predictable, high-volume pipelines at the local level—a prerequisite to a secondary market at the national level—must be created.

The Production Problem

Why is there a production problem? Why is the production of affordable multifamily housing cumbersome, time-consuming, and costly? And why does it sometimes break down altogether?

As in all real estate production, affordable housing production has two aspects—the sources of funds and the users of funds. Both have problems that are virtually always present in one degree or another. These can be termed resource delivery problems and developer/sponsor problems.

Resource Delivery Problems

Resource delivery problems are the most difficult obstacle to volume production. The existing delivery system in both the public and private sectors conspires against the ideal of combining funds from both sources to maximize private-sector participation and thereby leverage scarce public subsidy dollars.

Aggregating the resources to buy and rehabilitate or to construct an affordable housing project is an awesome task for a project developer. Assembling a workable financing package—the task of achieving feasibility for a project that is uneconomic in conventional terms—accounts for much of the high transaction and development costs, long processing time, and low volume of subsidized housing projects in the United States.

In the public sector, ignoring for the moment the obvious need for more subsidy dollars, the system is not set up to efficiently deliver those resources that *are* available. The myriad of public sector programs—loan programs, rent subsidies, tax abatement, grant programs, and technical assistance, all intended to spur the production and preservation of affordable housing—are complex and dispersed. The diversity of programs has actually increased in the last 10 years, as state and local housing programs have proliferated to fill the gap left by diminishing Federal funds and reduced standardization.

The bureaucratic procedures and timetables that plague any large institution are magnified for the kind of endeavor that may require programs from several city departments and sometimes from as many as three levels of government. If you combine the complexities of government bureaucracy with the need for construction financing and with the often conflicting requirements of private lenders, then the task of piecing together a resource structure—of necessity much more complicated than for most conventional real estate projects—becomes nearly impossible for any but the experienced and the dedicated.

A somewhat different problem faces developers in rural areas, where credit, local infrastructure, and local government support may be very scarce.

In the private sector, lending institutions face difficulties when they try to fit programs designed for market-rate lending to subsidized projects. Private lenders are unable to evaluate borrowers with weak balance sheets, whether they are for-profit or nonprofit. In addition, lenders' underwriting guidelines are not designed to accommodate the public subsidies that appear in the financing structures of many affordable housing projects, nor are lenders skilled in determining the economic value or evaluating the risk of such projects.

A significant "culture gap" often exists between the banker's world and that of the layered public-private financing structure. The banker may either refuse to finance the project or, under community

reinvestment pressure, throw up his hands and finance it without proper analysis. In short, affordable housing is not a routine event for most private lending institutions. It is perceived as risky and labor intensive; it is seen as not profitable, essentially a civic gesture performed at the expense of the bottom line.

The resource delivery problem described above is a resource *development* problem as well: often the public subsidies or the private financing are not there to be delivered. In this case the solution lies as much in finding or creating resources as it does in streamlining the delivery system.

Further, if private investor equity is part of the project financing—as it is for many subsidized projects—there is an additional layer of complexity. Almost all private equity in subsidized projects now comes from investors who receive Federal low-income housing tax credits in return. Obtaining the credits—through a complicated allocation process administered by states under Federal guidelines—is another exercise in addition to obtaining the public and private sources of debt financing. For large projects, once the credits are in hand and a limited partnership formed to accommodate the investors, the credits must be sold, usually through a syndicator who takes a fee. The funds raised must then be integrated into the financial structure, with the additional possibility of bridge financing if the investors are to pay in over time.

Ironically, despite its complexity, private investor equity—traditionally the highest-risk money and the hardest to come by—today has the most efficient delivery system of the three sources of financing for affordable housing. For large projects, an equity syndication represents yet another complicating factor; however, because of the attractive tax shelter returns afforded by the low-income housing tax credit, syndication has proven an effective market mechanism for raising capital. And many small owner-operated projects can avoid the complications of syndication by raising equity informally among a handful of investors.

Developer/Sponsor Problems

Problems in resource delivery have resulted in a decline in the number of for-profit developer/sponsors of affordable housing. Whereas FHA insurance, tax benefits, and Section 8 subsidies once made for a profitable specialty, all incentives—with the exception of low-income housing tax credits, which have yet to be made permanent—are now gone. With incentives reduced, the production levels of affordable rental housing and thus the number of participating developers have dropped correspondingly.

Although numerous private owners of small apartment houses remain in many urban markets, most are severely stressed by the present recession. Few can obtain financing from conventional lending institutions, nor could they even in pre-FIRREA times. Most are not familiar with construction and its related financing requirements, let alone with public-sector housing programs. Financial vehicles with characteristics suitable for these owners simply do not exist; there is enormous pent-up demand for financing of this type. In New York City alone, over 90 percent of the non-assisted affordable rental housing needs continuous access to the capital markets for refinancing and rehabilitation.

Nonprofit housing developers—community development corporations for the most part—have become important participants in the subsidized housing field in the last decade. They have benefited from the assistance of several national intermediary organizations: the Enterprise Foundation, the Local Initiatives Support Corporation, and the Neighborhood Reinvestment Corporation. These national support organizations have produced an impressive national infrastructure of technical assistance, training, and debt and equity financing vehicles. The Housing Assistance Council has performed many of the same functions in rural areas and small towns.

Nonetheless, nonprofit capacity remains uneven. Most nonprofits are small and undercapitalized and many are inexperienced. Further, nonprofits often have multiple objectives, which make their projects complicated and more costly than those of private sponsors. Moreover, the principal purpose of most community development corporations is not to build housing, but to empower and rebuild their communities.

Hence the circumstances giving rise to the developer problem: nonprofit developers, despite great

strides, generally remain small-scale producers; participation by for-profit developers of affordable housing is down; and small for-profit owners, where they exist, are an endangered species.

The only exception to the otherwise bleak picture painted above is the production of projects using low-income housing tax credits. Of the low-income housing projects being produced, 90 percent are tax credit projects, and of these, 90 percent are produced by private developers. These projects are virtually the only profitable opportunities remaining in the field. Where tax-credit projects can be produced without gap financing, the process is more streamlined. For example, many for-profit developers have shifted from urban to rural areas, where tax credits may be used with the Farmers Home Administration's Section 515 Rural Rental Housing Program, a deep subsidy debt financing vehicle discussed later in this chapter.

The Local Environment

How the resource delivery problem and the developer/sponsor problem get solved, and whether or not they *can* be solved, is largely a function of the local environment—physical, political, and economic. It is also a function of local leadership in both the public and the private sectors. This is not to deny the importance of having more resources and better programs from government at the state and national levels. But without devoting a great deal of time and attention, and without channeling its own resources into affordable housing, a local community will not realize much benefit from changes in the larger system.

The local physical environment is a crucial factor in determining the nature of local solutions to the production problem. The physical environment includes the nature of the housing stock—its scale, density, type of construction, and condition—and, for large projects, the availability of land or buildings in the right location and at an appropriate scale.

The local political environment is a dominant consideration. Public resources come with politics, which may defeat or delay an otherwise worthy project or program. In suburban areas, the zoning, environmental, and regulatory barriers that confront any project are often used as a cover for a not-in-my-backyard or "NIMBY" mindset—a bias against affordable housing. Receptive and supportive local and state governments that give housing a high priority and that are willing to commit public resources and expedite the approval process are essential; political leadership is a must.

Private-sector leadership, equally critical, is important in obtaining construction and first-mortgage financing and in creating partnerships and nonprofit institutions to facilitate production.

The economics of housing in a locality—including local land values and the cost of labor and materials—will determine to a large extent how the problem can be attacked.

In rural areas, the availability of land and, particularly, local politics in the form of NIMBYism may be barriers. In addition, potential rural developers confront a lack of physical and institutional infrastructure.

Approaches to Volume Production

Given the double-barreled production problem of resource delivery problems and developer/sponsor problems, plus the need to address an enormous variety of local environments, some would argue that subsidized housing is by its nature incompatible with volume production. And indeed, as subsidized housing development is currently practiced in most places, this is true. There are some successful examples to the contrary, however, that suggest that production can be streamlined and organized to reduce time and cost and to achieve volume, even without changing other parts of the housing finance system. However, in each case, local intervention of some type was required to make volume production possible; the market did not produce it spontaneously.

Each of the successful approaches discussed below addresses both components of the production problem—the resource delivery problem and the developer/sponsor problem—but with varying degrees of emphasis. They are discussed here, with examples from a number of cities and organizations, because they are potentially replicable if customized for a particular locality. However, these

approaches are principally illustrative; they are not the only solutions. Nor are they mutually exclusive; most communities would benefit from having more than one.

The approaches discussed below are: lender consortia, public/private housing partnerships, and specialist developers. Also presented, by way of contrast to these solutions of the 1980s, is the Farmers Home Administration Rural Rental Housing mortgage program, a wholly government program conceived much earlier.

Lender Consortia

Lender consortia that specialize in affordable housing have developed gradually over the last decade in response to local community demands and to the requirements of the Community Reinvestment Act. CRA calls for federally regulated financial institutions to meet community credit needs. The creatures of local banking communities, lender consortia are focused principally on the problem of resource delivery, often addressing public sector as well as private sector resources. But they also ameliorate the developer/sponsor problem by making financing programs accessible enough to entice developer sponsors to undertake projects or to enter the field in the first place. They are well positioned to reach out to private owners who provide two-thirds of all affordable housing.

As permanent institutions operating on a "wholesale basis" and occupying a pivotal position, lender consortia have the potential to organize the market to increase the reach of financing, to bring about systemic change, and to create an affordable housing industry. They can also maximize the private funds in a financing structure, which maximizes the leverage of public funds.

Lender consortia vary widely in response to the local environment; they are tailored to fit the local politics, housing stock, and housing economics, and they have usually forged at least an informal partnership with local public agencies whose subsidies they use to help project sponsors achieve feasibility.

Some lender consortia are statewide, such as the Massachusetts Housing Investment Corporation (MHIC), the Savings Associations Mortgage Company (SAMCO) of California, and the California Community Reinvestment Corporation (CCRC). Some consortia, such as The Community Preservation Corporation (CPC) in New York City and The Community Lending Corporation (CLC) of upstate New York, are regional. Both CPC and SAMCO have now been in place long enough to be evaluated.

Volume. Lending consortia are capable of volume production over time. One of the most dramatic examples of a volume producer is The Community Preservation Corporation of New York City. Since its creation in 1974, CPC has financed the construction or rehabilitation of more than 29,000 affordable housing units, representing public and private investment of over $800 million.

SAMCO, another volume lender, has financed a cumulative total of $274 million for over 9,000 multifamily units throughout California. In 1990, $52 million in permanent financing made possible 1,800 new or improved housing units.

How They Operate. Capitalized and governed by local banks or thrifts, and sometimes insurance companies as well, lender consortia operate with the flexibility and orientation of private sector organizations. Organized as either for-profits or as nonprofits, all have a public purpose. They have developed specialized expertise in appropriate underwriting for affordable housing and standards that are rigorous, not concessionary. SAMCO, for instance, despite the social nature of its investments, is noted for flexible, expert underwriting and aggressive loan collection. Underwriting is standardized; projects must be economically viable, show evidence of continued affordability, meet income standards, and not exceed conventional loan-to-value ratios.

Lender consortia have the great virtue of being a vehicle for coordinated action by the business community in addressing citywide or statewide problems. They have the potential to carry greater clout than a single institution would and therefore are able to get the attention of government. For example, over the years, CPC has developed a multifaceted partnership with the City of New York—one that has simplified government programs and integrated them with CPC's private funds and origination process. Negotiated up front, partnership policies have insulated individual lending decisions from politics.

By developing a streamlined process that combines government programs with construction and permanent financing from its private-sector sponsors, CPC has made formerly arcane programs accessible to small sponsors and builders. With an up-front equity requirement, CPC has created a sound way to do business with developers whose financial statements alone may not demonstrate their creditworthiness. As a result, competition has been created, volume has risen, and costs have come down.

Lender consortia have demonstrated that affordable housing lending can be a profitable business. As an example, CPC returns 125 basis points on assets and over 13 percent on equity. Its borrowers pay a market rate of interest on the CPC part of the financing, and CPC in turn passes on a market rate of return to its participating lenders.

Since the consortium assumes a key role in obtaining public benefits, it has the ability to reliably incorporate the economic value of those benefits into its mortgage underwriting. It finds the piece of the affordable housing investment that is bankable; using private funds for that portion reduces the need for public subsidies. Under CPC's program, if public subsidies are involved, they are in all respects subordinate to any private first mortgage financing. Should foreclosure become necessary, the first mortgage lender has a "clean" mortgage to foreclose on. Further, the mortgages can be sold into the secondary market; CPC is currently discussing with Fannie Mae the securitization of its portfolio, which would provide CPC with funds for further loans. One of the principal benefits of such consortia is their potential to provide "one-stop financing" for project sponsors, greatly reducing the process-related costs associated with affordable housing. CPC reports, for example, overall costs almost 50 percent lower than comparable projects financed through typically fragmented public and private financing vehicles.

Because they are profitable, or at the very least not money losers, lender consortia are permanent institutions; they stand a good chance of surviving to remain as a permanent streamlined delivery system more stable than government. They have the additional advantages of allowing private lenders to spread risk and to achieve efficiencies by making it unnecessary for them to duplicate specialized expertise. Further, as nondepository institutions, they operate more flexibly than regulated institutions.

Limitations. As is also true for the other approaches discussed in this section, lender consortia are not perfect models. Michael D. Lappin, the president of CPC, notes that whenever the sense of housing crisis that led to CPC's creation abates, so does the participation of government, whose commitment to subsidies and expedited processing makes affordable housing possible in New York City. Further, the consortium itself must be serious and committed if it is to achieve its potential for simplifying and streamlining the system. If its sponsors see it as only a CRA fig leaf, and if the consortium doesn't take on the challenge of using its potential to re-shape the larger environment, then its impact will not be as great as it otherwise might have been.

Housing Partnerships

Public-private housing partnerships are usually citywide affordable housing programs designed to address both the resource delivery and the developer/sponsor problems. In suburban areas, housing partnerships may be informal volunteer organizations, but in urban areas they are more likely to be formally-organized as nonprofit organizations with their own expert staffs and boards of directors drawn from the major business, government, philanthropic, and community organizations within their jurisdictions. Successful housing partnerships are possible only in communities where the political context is highly supportive and leaders in both the public and private sectors are willing to devote considerable time and resources to the partnership.

Housing partnerships bring together existing resources and often raise additional funds, usually on a program basis. The partnerships referenced below work with nonprofit community development corporations (CDCs) to develop CDCs' capacities and to assist their projects by providing technical assistance and financing. Housing partnerships have the ability to pull off some of the most difficult projects in the most difficult neighborhoods. They may work with for-profit developers as well.

The partnerships are not developers themselves and are usually not lenders, although they may be conduits for funds to their member organizations. The national nonprofit intermediary organizations—the Local Initiatives Support Corporation (LISC), the Enterprise Foundation, and the Neighborhood Reinvestment Corporation—often participate in local housing partnerships and sometimes initiate their creation. Housing partnerships are tailored to local conditions and thus show considerable variation.

Among the better-known housing partnerships are the Metropolitan Boston Housing Partnership, the Chicago Housing Partnership, the Cleveland Housing Network, Inc., and the Wisconsin Partnership for Housing Development, Inc.

Volume. Housing partnerships have the potential to increase the volume of multifamily production. During the Metropolitan Boston Housing Partnership's first five years of operation, it was responsible for 860 units and initiated the construction of 925 more units for its second production program. All have been 100 percent affordable to low-income and moderate-income residents and all have been rental; nearly all were produced by nonprofits.

The Chicago Housing Partnership, through its various participants, has supported the production of more than $170 million of affordable housing since 1985. During the first year of the Chicago Equity Fund, an affiliate established to raise equity, participating nonprofits renovated four times as much housing as in the previous year.

How They Operate. The Chicago Housing Partnership (CHP) *has* pioneered corporate equity investments using the low-income housing tax credit. The equity raised has been used to leverage debt financing from a lender consortium and from the city's three largest banks. In addition, the City of Chicago and the Illinois Housing Development Authority have provided considerable subordinated financing.

CHP is an unincorporated entity without a staff that works mainly through a variety of specialized organizations, some already in existence at the time CHP was formed. These include, in addition to the Chicago Equity Fund and the public and private lending sources mentioned above, the Chicago office of the Local Initiatives Support Corporation and nonprofit and for-profit housing development corporations.

The Metropolitan Boston Housing Partnership, in contrast, has a staff of 60 and uses its influential board members to remove obstacles to project implementation. MBHP provides technical assistance, arranges financing, reviews the financial statements of its participating nonprofits, supports their management activities, sponsors resident empowerment initiatives, and administers state rental subsidies. The Community Builders, Inc., a nonprofit forerunner of MBHP and now one of its chief affiliates, provides consulting services to MBHP for syndications and development and also offers fee-based technical assistance and financial packaging services to nonprofits upon request.

Government programs are central to the housing projects supported by the Metropolitan Boston Housing Partnership. The various forms of city assistance—grants and loans, tax abatement, expedited permitting, and assistance with land acquisition, as well as political leadership—are all important, as are state loans, grants, and bonding. In the private sector, foundation grants support both MBHP and its member nonprofits, and corporate contributions, as well as purchases of equity in projects and loans from banks, have been crucial. The financial community has contributed executive time and leadership, along with expertise in syndication.

Limitations. There are drawbacks to public-private housing partnerships. Where they depend on nonprofit producers to achieve volume, as in the foregoing examples, they are constrained by the inherent limitations of organizations that depend heavily on the use of government subsidies rather than on inducing change in private investment patterns. And to a greater degree than the other two approaches, housing partnerships are political creatures and thus subject to the shifting agendas and power struggles of community leaders.

Specialist Development Companies

Specialist development companies attack developer/sponsor problems head-on. Such companies require a relatively large project—perhaps 100 units

or more—to achieve cost effectiveness. They are especially well-suited to communities where there is little developer/sponsor capability in either the public or private sectors to take on projects that are particularly difficult and that require special expertise. As large (by affordable housing standards), expert, and adequately-capitalized real estate development companies, they provide the missing developer/sponsor capacity, at least for selected large projects. They can also, as a byproduct of their activities, help build a community's development capacity by providing a model, by joint venturing with local developers, and by facilitating the development process for smaller and less experienced developers who follow.

Specialist development companies also address the resource delivery problem by aggregating resources themselves just as a conventional developer does, on a project-by-project basis. They achieve acceptance within a local environment—if the community is at all receptive to affordable housing—by forging partnerships with local organizations and governments, again on a project-by-project basis, and by building a quality product. Two examples of this approach are the nonprofit BRIDGE Housing Corporation, which operates in the nine-county San Francisco Bay area, and a for-profit company based in St. Louis, McCormack, Baron & Associates, which operates in 15 cities around the country.

Volume. Specialist development companies can begin to achieve volume because they undertake large projects, because they are single-purpose organizations, and because they begin to organize the market. They are not tied to one neighborhood, but can move to communities where they find an appropriate project. "We are an apolitical production machine," says Don Terner, President of BRIDGE. Frequently communities seek them out.

Both BRIDGE and McCormack Baron produce mixed-income projects that include market-rate units. Even so, they are usually the largest producers of low-income units in the areas where they operate. Although not large by conventional real estate development standards, by affordable housing standards they have achieved large-scale operation.

By 1990, BRIDGE could claim to be the 125th largest home builder in the country and the largest nonprofit builder. Between its founding in 1982 and 1991, it had constructed or helped to construct 5,000 rental and ownership housing units valued at over $400 million. Approximately 60 percent of the units are affordable to BRIDGE's target population of families with incomes between $12,000 and $25,000 per year. The remainder are low-end market-rate units aimed at moderate- and middle-income households.

McCormack Baron, over its 10 years in the development business, has developed over 4,500 housing units and a significant amount of commercial space, with a development cost of about $450 million. It manages its own projects and those of other owners; currently it has about 6,000 units under management.

How They Operate. Both BRIDGE and McCormack Baron find profitable pieces of their projects to induce private-sector participation, whether through the sale of tax credits to investors or through market-rate first mortgages; they then meld these resources with public sector grants and loans. Both look to local government to make significant public improvements in support of their projects.

BRIDGE operates in an entrepreneurial, opportunistic fashion, customizing each project to fit the site, the local subsidies, and the financing structures available. It seeks zoning and density concessions, particularly in suburban communities, to enhance affordability and it aggressively seeks community approvals from neighborhoods often initially hostile to the idea of affordable housing. Its staff is well-versed in all aspects of development; BRIDGE manages construction projects cost-effectively and performs the property management for its completed projects. It works with a small number of construction lenders with which it has established relationships, borrowing funds at both market and below-market rates; its permanent financing generally comes from local tax-exempt bond issues.

McCormack Baron operates much like BRIDGE, specializing in complex public-private financing structures and large affordable housing and mixed-use projects. Unlike BRIDGE, however, it operates exclusively in urban neighborhoods, often in urban renewal areas; many of its projects include historic rehabilitation as well as low-income housing.

Limitations. Specialist development companies are not without their problems, however. Like most real estate development companies, both BRIDGE and McCormack Baron have recently seen their access to capital severely curtailed by recession and by the turmoil in the financial services industry. Consequently, they have been forced to leave their working capital in projects, as equity, and to seek additional capital in a difficult market. The result is fewer projects and much longer gestation periods, with an accompanying increase in the need for—but no source of—high-risk pre-development capital.

As companies that work to a considerable extent through market mechanisms, specialist development companies are subject to the vagaries of the market. In addition, because they address the resource delivery problem indirectly and are often in a pioneering role, they have high transaction costs.

In a sense, specialist development companies have emerged by default, a product of extremely difficult development environments. While they are successful at creating housing, they do not necessarily change the system.

Farmers Home 515 Loan Program

All of the approaches to affordable housing production discussed above are ways—often tortuous ways—of aggregating enough public and private resources to create a program or a project. They are models developed in the 1980s in response to a continuously shrinking Federal commitment to housing.

By contrast, the Farmers Home Administration's Section 515 program is an example from a previous era of a government-sponsored program that was designed (at least originally) to operate virtually without private sources of debt capital, but to provide enough subsidy (and incentive) to attract private producers ;

it has offered in rural areas the constant and predictable government presence that has disappeared in urban areas with the demise of FHA in concert with ever-changing housing programs, tax laws, and bank regulations.

The Section 515 Rural Rental Housing Program is a direct government mortgage program that comprehensively addresses the production problem found almost universally in rural areas—a shortage or complete lack of private investment capital and a deficiency of developer/sponsors. The 515 Program offers loans at 97 percent of value, amortized over 50 years. When combined with low-income housing tax credits as has often been the case in recent years, feasibility can be achieved with only two sources of funds—a relatively streamlined system by today's standards.

Volume. The Section 515 Program achieves multifamily housing volume for sparsely-settled rural areas by operating on a national basis. The annual budget level for the program exceeds $570 million and it is always fully subscribed. The current portfolio stands at $10.6 billion.

How It Operates. The Section 515 program also employs a system of flexible interest assistance, which allows the debt service—currently at 8 ¼ percent—to be written down through interest credits to as low as 1 percent depending on the income of the tenants. In addition, rental assistance (FmHA's version of Section 8) is available to tenants to reduce the 1 percent interest rate so that rents can be set at 30 percent of adjusted income. Some 72 percent of the units in Section 515 projects use rental assistance; about 85 percent use low-income housing tax credits as well. The underwriting and appraisal methods that are used take the subsidies into account in determining economic value.

Under the program, loan administration is decentralized and field employees know their local markets well. FmHA regional offices have low turnover and thus long-time employees service and monitor their own loans, conducting site visits and maintaining oversight of reserve accounts. They are cognizant of acquisition and construction costs, which average under $40,000 per unit.

Limitations. The Section 515 Program has not solved all of the affordable housing needs of rural America. Because renters below 60 percent of median income have first claim on program subsidies, renters above 60 percent of median are rarely served by the program. This situation is com-

pounded in projects using low-income housing tax credits, which require similar targeting. However, those between 60 percent and 80 percent of median income often cannot be served by conventionally-financed rental housing either. Unlike in urban areas, where a substantial stock of existing buildings often provides affordable housing to this income group, rural areas generally cannot support conventionally-financed rental housing affordable to those in the 60-80 percent of median income range. And unlike in many urban areas, where Community Development Block Grant or other city funds provide gap financing, there is usually no source of below-market or gap financing other than the Section 515 program.

Lessons and Recommendations

The Task Force's review of these approaches to subsidized multifamily housing production—to solving the "production problem" and creating volume—suggests that solutions to the production problem lie to a large extent at the local level. The following lessons emerge, leading to several recommendations.

1) Successful local volume production systems are highly customized to the local environment. They require considerable initiative and leadership from both the public and the private sectors. Therefore,

- ***The Task Force recommends that local communities carefully analyze the nature of their production problems before proposing solutions. In modifying existing processes, creating new organizations, calling in new actors, or developing new programs, they should address those problems in a way suited to the local context.***

2) Simplifying and reorganizing the local resource delivery system, that is, streamlining and integrating public and private resources, is the key to volume production because it has the potential to—

- Reduce uncertainty and processing time and thus carrying costs and risk
- Increase return, thus attracting private developers
- Create competition, which reduces costs and stretches subsidies, thus leveraging public-sector resources

If the resource delivery problem can be solved, the developer/sponsor problem will take care of itself, except for unusually difficult projects. Therefore,

- ***The Task Force recommends that local government subsidy programs be made dependable and accessible by integrating them with local private sector financing programs and streamlining the delivery of both.***

3) A system that utilizes market mechanisms wherever possible will achieve the highest volume, the greatest efficiencies, and the most stable and permanent solution. The components of such a system can be organized on either a for-profit or a non-profit basis. Therefore,

- ***The Task Force recommends that opportunities for private participation on a profitable basis be maximized in local affordable housing production systems.***

Previous chapters have identified changes that must take place on a broad national scale to achieve expanded access to capital for multifamily production. But it is clear that in an era of resource scarcity and fragmentation, the problem of achieving continuous volume production must be solved at the local level, where the process of aggregating resources is ultimately played out.

REMAINING BARRIERS VI

RECOMMENDATIONS

- To provide the information necessary for investors to invest in multifamily housing in much higher volume than they presently do, the industry should take the following steps:
  - Immediately undertake research and data collection on the past performance of multifamily housing, with a focus on identifying—
    - the determinants of successful lending for affordable housing
    - the key underwriting issues associated with delinquency and default
  - Establish a database using common definitions of mortgage characteristics, in an appropriate format and in sufficient detail to be useful to investors in tracking the performance of multifamily loans over time. Such a database should incorporate historical data and track the factors affecting successful lending and underwriting that are identified in the research.
- Develop educational programs and materials for investors and their advisors, consultants, and lawyers to inform them regarding the risks and returns of affordable multifamily mortgages as an asset class, demonstrating that such loans can be profitable and are not necessarily risky.
- Undertake a thorough review of federal, state, and local laws and regulations affecting multifamily housing investment. This review should focus on dispelling misperceptions of investment risk, identifying actual barriers to investment, and, if necessary, revising or reinterpreting such laws and regulations to permit or encourage investing in prudently-underwritten multifamily mortgages and mortgage-backed securities that provide market-rate returns.

In preceding chapters, the Task Force has made recommendations to streamline and standardize the mortgage origination process and subsidy instruments, to develop new methods of credit enhancement and securitization, and to facilitate volume production of affordable housing at the local level. If all of these recommendations were implemented, it would represent significant progress toward the creation of a fully-functioning secondary market for multifamily mortgages.

Nonetheless, it is clear from the work of the Task Force and from the appended study by the Joint Center for Housing Studies that more needs to be done before investors, particularly institutional investors, will become regular buyers of multifamily mortgages. Even if all the previous recommendations were implemented, a number of factors would still work against investing in multifamily mortgages and in multifamily mortgage-backed securities.

In some cases, capital market participants have managed to invest prudently in multifamily housing in spite of these barriers, particularly when other considerations weigh in favor of their participation. Union pension funds for example, which have a stake in construction projects built with union labor as well as in housing for union members, have made an extraordinary commitment to housing in the face of numerous regulatory obstacles. One of the key union initiatives, the AFL-CIO Housing Investment Trust, has been able to invest a significant portion of its assets in multifamily housing. Initially, the Trust's investments in multifamily housing included only FHA-insured loans or Ginnie Mae securities backed by individual multifamily projects. Today, the Trust also invests in Fannie Mae- and Freddie Mac-guaranteed projects and it is developing new partnerships with state and local governments to finance affordable multifamily housing.

Public pension funds, which are operated by all levels of government for their employees, have been among the most active pension fund investors in residential mortgages and mortgage-backed securities. Since public funds are regulated primarily by state, and sometimes local, law and are not subject to ERISA (see below), they tend to have more flexibility than private funds to tailor their investments to address the needs of their geographic area. Such investments have become more common in recent years as more of the public funds, particularly the largest ones, have established "economically targeted" investment policies (see, for example, chapter IV's discussion of investments in affordable housing mortgages by New York pension funds). Although information on these types of investments is limited, indications are that their investment performance has been generally positive. Housing has accounted for the largest share of such investments; however, the majority of the funds have been targeted to single-family housing.

The volume of all of these multifamily investments together is minuscule, however, in relation to the magnitude of total investment capital potentially available. Pension funds, for instance, are estimated to have assets of roughly $3 trillion. Currently only a small percentage of these assets is invested in housing, either directly or through mortgage-backed securities, and most of that is in single-family mortgages. In 1989, the top 200 defined-benefit plans had invested less than 5 percent of their assets in real estate (mostly commercial real estate rather than housing) and less than 3 percent in mortgages. If just 5 percent of pension fund assets were invested in multifamily mortgages, the amount of capital available would approximate $150 billion.

Given the breadth of its present mission, the Task Force has not been able to undertake an in-depth review of investor needs and of barriers that face investors considering the purchase of multifamily mortgages. However, it has been able to identify the types of investor barriers that exist and to suggest, in a general way, how they might be overcome. These barriers fall into three broad categories: 1) information gaps, 2) institutional barriers, and 3) regulatory and statutory barriers.

The Information Gap

A general lack of information is one of the primary barriers facing investors who are considering multifamily housing. First, historical data on the performance of multifamily housing is inadequate and second, no uniform system exists to track multifamily performance nationally. Both problems must be addressed to correctly assess credit quality, accurately predict cash flows, compare performance with other types of investments, and precisely price

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mortgages. If these things could be accomplished, mortgages would become more easily tradable and liquidity would follow.

For institutional investors such as pension funds and insurance companies, which are among the largest potential multifamily mortgage investors, such information is absolutely crucial. When faced with a type of investment that they perceive—correctly or not—as very risky, or about which they know little, investors have very few reasons to proceed. The lack of data leads not only to ignorance about multifamily mortgages, but in many cases to misperception of its risks as well, especially in the case of subsidized housing.

The first information problem—the lack of consistent and readily-available data on multifamily housing performance over time—was identified in the Joint Center report as a major problem for investors. The report noted, for example, that research is needed to explain the apparent divergence between the general industry default experience for multifamily mortgages and that of the affordable housing specialists who report few if any defaults (see discussions in chapters II and V). The real risks of multifamily lending need to be identified through a better understanding of the determinants of delinquency and default.

The second information problem calls for constructing a comprehensive database in a format that allows the performance of multifamily mortgages to be evaluated. For such a database to be an effective tool, common definitions of mortgage characteristics must be adopted by all those who supply information. This requirement is a difficult one to impose, as no such definitions currently exist; nor is there any entity presently charged with developing and promulgating them. If such a database were created and were to incorporate historical data, investors could begin to make increasingly fine distinctions regarding credit quality and asset performance. With the passage of time, an overall record of multifamily performance would emerge. This kind of comprehensive and reliable data is an indispensable tool in reducing risk because it allows lenders to underwrite knowledgeably. Therefore,

■ ***The Task Force recommends that, to provide the information necessary for investors to invest in multifamily housing in much higher volume than they presently do, the industry take the following steps:***

- ***Immediately undertake research and data collection on the past performance of multifamily housing, with a focus on identifying—***
  - ***the determinants of successful lending for affordable housing***
  - ***the key underwriting issues associated with delinquency and default***
- ***Establish a database using common definitions of mortgage characteristics, in an appropriate format and in sufficient detail to be useful to investors in tracking the performance of multifamily loans over time. Such a database should incorporate historical data and track the factors affecting successful lending and underwriting that are identified in the research.***

Institutional Barriers

Institutional barriers to investment in multifamily mortgages consist of procedural, as well as what may be termed "cultural," factors. They are most visible in the operation of pension funds, but they operate to some degree with all institutional investors. They include gaps in in-house expertise; the structure of, and disincentives inherent in, the pension fund advisor system; and problems of size and scale.

Staff investment expertise varies widely among institutional investors. A particular fund's staff may lack experts who are fully conversant with mortgages (particularly with affordable housing mortgages) or who can evaluate more arcane investments such as structured financings. This problem is aggravated by the large scale at which most institutional investors invest. The small scale of most mortgage offerings requires as much analysis as significantly larger investments; the mismatch creates an inefficient use of time for the investment staff.

In addition to the lack of staff expertise or knowledge about less common investments, the heavy reliance by pension funds on outside advisors

for investment decisions tends to work against multifamily housing. These outside advisors have little or no incentive to recommend new investments in an area that they may know little about, when there are more familiar alternatives in the marketplace.

To address these problems, education of investors regarding the true risks of multifamily housing should be undertaken once historical data is in hand and a tracking system has been established as recommended above. A broad effort should be made to combat the common misperception that multifamily housing is necessarily a high-risk investment. Therefore,

- ***The Task Force recommends the development of educational programs and materials for investors and their advisors, consultants, and lawyers to inform them regarding the risks and returns of affordable multifamily mortgages as an asset class, demonstrating that such loans can be profitable and are not necessarily risky.***

Regulatory and Statutory Barriers

All institutional investors are governed to some degree by local, state, or Federal regulations or laws. While a detailed review of regulations governing investing was not within the scope of this report, in the course of its investigation the Task Force observed cases where regulations—or the manner in which they are enforced or interpreted—provide disincentives and even outright prohibitions against investing in affordable multifamily housing.

One example is the Employee Retirement Income Security Act (ERISA), administered by the U.S. Department of Labor (DOL), which regulates all private pension funds. It is the feeling of some Task Force members that the low level of investment in affordable multifamily housing by many pension funds has little to do with the underlying economics of the investments themselves. Rather, the low level of ERISA fund activity may be due to the rigid manner in which ERISA regulations are administered and interpreted by DOL. Many believe that the DOL interpretation of ERISA has had a chilling effect on pension investing in affordable housing and that pension funds could readily invest a great deal more in such mortgages without violating the ERISA requirement for market returns.

In addition, the potential liability under ERISA and various state investment laws for imprudent investment decisions—which applies to pension fund trustees, consultants, and advisors—exacerbates the situation. As a result of liability concerns, pension fund trustees rely heavily on legal advice, which tends to be very conservative in light of potential risks to decisionmakers. Plan participants or trustees tend not to challenge their advisors, even in situations where plan participants or trustees would favor investments in multifamily housing.

Other legal impediments include FIRREA capital requirements (discussed in chapter IV) and state and local laws and regulations governing charities, pension funds, and insurance companies. In some states, statutes governing the actions of trustee banks that manage foundation or educational endowment funds could inhibit the purchase of multifamily securities, since such securities may not be included on lists of approved investments for those types of institutions. Therefore,

- ***The Task Force recommends a thorough review of Federal, state, and local laws and regulations affecting multifamily housing investment. This review should focus on dispelling misperceptions of investment risk, identifying actual barriers to investment, and, if necessary, revising or reinterpreting such laws and regulations to permit or encourage investing in prudently-underwritten multifamily mortgages and mortgage-backed securities that provide market-rate returns.***

NEXT STEPS VII

RECOMMENDATIONS

- Create a specialized institution—the Multifamily Housing Institute—to pursue the recommendations of this Task Force and to become a permanent protector and facilitator for the multifamily housing finance system, and for affordable housing in particular. These goals would be accomplished by—
  - Providing a forum for participants in the system to solve problems unique to multifamily housing finance
  - Promulgating standards and conventions for underwriting and other aspects of multifamily mortgage lending
  - Serving as an information clearinghouse
  - Facilitating historical research and the maintenance of an ongoing database on the performance of multifamily housing
  - Providing materials for the education of investors

Each of the preceding five chapters has analyzed one part of the complex multifamily housing finance system. Each chapter has made recommendations to restructure that particular part of the system, with the ultimate goal of making the overall system better serve multifamily housing and subsidized multifamily housing in particular.

Chapter II, *Originating the First Mortgage*, made recommendations for standardizing a limited number of key provisions of the first mortgage instrument. It proposed a "common approach" to the financial structuring of multifamily projects—an approach that accepts subsidies and equity in forms that are common to subsidized housing, but that are also acceptable to investors. To preserve the flexibility of originators, it was also recommended that a "common approach"—rather than rigid prescriptions—be developed for underwriting standards. The Task Force further recommended the development of qualifying standards for originators—standards that can effect the reconciliation of national standards with local flexibility.

In Chapter III, *Standardizing the Subsidy*, the Task Force made recommendations for standardizing the most common form in which subsidies are found today, namely subordinated gap financing. It recommended provisions for standardizing gap financing, both to ensure that such financing is fully subordinate to the first mortgage (thus making the sale of the first mortgage possible) and to facilitate production, while meeting the social goal of preserving affordability. Chapter III also recommended the standardization of other subsidy instruments.

Chapter IV, *Getting to the Capital Markets*, recommended the development of a new risk-weighting system that would standardize credit quality in a way that serves both borrowers and investors. It proposed new risk-sharing arrangements between existing and new participants in the housing financing system, and it recommended revising regulations that presently inhibit risk-sharing. It also recommended exploring the creation of new conduits that would address the mechanics of gaining access to the capital markets for small subsidized projects by buying, warehousing, pooling, and credit enhancing loans.

Chapter V, *Volume Production*, made recommendations to organize the local market and streamline the production process by integrating public and private sector financing and by maximizing opportunities for private-sector participation on a profitable basis. It stressed the importance of creating approaches to production that are customized to the local physical, economic, and political circumstances.

In chapter VI, *Remaining Barriers*, the Task Force recommended actions on behalf of investors: historical research and the creation of a new database for the collection of statistics on multifamily performance, the development of informational materials and programs, and a thorough review of legal and regulatory barriers confronting investors who might consider multifamily mortgages.

In developing these recommendations, the Task Force sought to consider the multifamily finance problem in all its complexity, to identify the specific sub-problems that must be worked on, and to describe what needs to be done. Rather than focusing on the surface manifestations of the problem, the Task Force analyzed the root problems and their interrelationships. Consequently, none of the recommendations represents a finalized standard, document, or formula, much as these are needed. The next steps must be taken by others.

The Next Steps

Of the 21 recommendations made in previous chapters, some can and should be pursued immediately, either because they are the most critical or because they must be implemented before progress is possible on others. These key recommendations are as follows:

- Create a model permanent first mortgage instrument
- Develop a common approach to underwriting
- Create criteria to underwrite and periodically requalify originators
- Standardize documents industrywide
- Create a standard soft second mortgage instrument
- Design a risk-weighting system to standardize credit quality for multifamily mortgages

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- Investigate new state agency roles in credit enhancement
- Investigate the feasibility of new conduits
- Undertake historical research and design and implement a new database on multifamily performance

How might these next steps be taken? Although the tasks themselves are clear cut, it is not at all clear how they will be pursued. Multifamily housing finance is more complicated than even most practitioners appreciate. In particular, the system for financing *affordable* multifamily housing—because of its diverse forms, the multiplicity of participants, and the complicated intertwining of public and private mechanisms in all its aspects—will not be readily restructured or revitalized as a result of the work of this Task Force. Even if the public policy aspects of the system could be instantly relegislated in an ideal form, the private sector aspects of the system would not necessarily fall into line without further action.

Moving the entire system to the point where it has a fully-functioning, high-volume secondary market requires continuing work on each aspect, along with the cooperation of diverse parties who sometimes have little occasion to do business directly, but who nonetheless depend on each other to carry on their work. Yet, with the completion of this report and the dissolution of the Task Force, there will no longer be an industry forum focusing exclusively on the multifamily housing finance system. Thus the Task Force's last recommendation calls for the creation of a new institution to carry on this broad effort.

The First Step: The Multifamily Housing Institute

One of the most important conclusions reached by the Task Force is that multifamily housing is a separate field that requires its own specialized institutions.

The existence of the Task Force has provided an unprecedented opportunity for the housing finance industry to discuss common problems unique to the multifamily system. Remarkably, it has been possible to achieve considerable consensus despite widely varying economic interests and political views from the disparate sectors. It seems clear that because the problems of the system are numerous and affect every participant, no one sector can solve them alone; yet all have an interest in seeing that they are solved. Recognition of these two facts has brought an unusual degree of cooperation.

This experience argues for institutionalizing what has been a very fruitful dialogue, even as the immediate need for a better system lends urgency to the task. Fannie Mae, Freddie Mac, investment bankers, and the rating agencies—the traditional participants in the single-family secondary market—are clearly willing to develop standards for multifamily markets. All are in some manner addressing the issue as this report is presented and they will undoubtedly continue to do so. However, the industry cannot afford to wait for a fully-functioning multifamily secondary market to gradually emerge.

Given the urgency, how does the industry move forward expeditiously to—

- — shorten the time needed for a strengthened multifamily secondary market to develop?
- — ensure a joint effort, rather than an initiative dominated by a limited set of financial institutions?
- — continue to involve the diversity of problem solvers who are now active and interested in seeking long-term solutions to the affordable housing problem?
- — achieve agreed-upon conventions without undermining competition?
- — maintain the momentum that has been achieved so far?

As the Task Force prepares to disband, it seems clear that the answer to these questions is a new national vehicle to effect the changes needed in the industry. Therefore,

- ***The Task Force recommends the creation of a specialized institution—the Multifamily Housing Institute—to pursue the recommendations of this Task Force and to become a permanent protector and facilitator for the multifamily housing finance system and for affordable housing in particular. These goals would be accomplished by—***

- ***Providing a forum for participants in the system to solve problems unique to multifamily housing finance***
- ***Promulgating standards and conventions for underwriting and other aspects of multifamily mortgage lending***
- ***Serving as an information clearinghouse***
- ***Facilitating historical research and the maintenance of an ongoing database on the performance of multifamily housing***
- ***Providing materials for the education of investors***

The primary membership of the Multifamily Housing Institute would consist of those in the business of financing and investing in multifamily housing. A broad and diverse membership is critical; it should include lenders and investors, the Federal mortgage agencies, state and local housing finance agencies, for-profit and nonprofit developers, and other public sector entities. In addition, the participation of FHA and Ginnie Mae would be encouraged. Although a small staff of professionals would be required, the members themselves would be the principal participants.

There is ample precedent for this kind of organization to set industry standards. The Public Securities Association (PSA) and the Financial Accounting Standards Board (FASB) are examples from related fields. The PSA is a trade association representing the Treasuries market, mortgage securities market, municipal bond market, and money market. It represents these groups on all matters where a collective voice is needed; its primary membership is nationwide broker-dealers and commercial banks. FASB, another example, is a consortium of accounting professional organizations that performs research and promulgates concepts and standards for the guidance of the public, including issuers, auditors, and other users of financial information; it is recognized as authoritative by the Securities and Exchange Commission. The Multifamily Housing Institute would function in a manner similar to these two organizations.

The possibility of becoming a government-sanctioned organization such as FASB should be explored by the Multifamily Housing Institute. Another possibility is Congressional chartering. The new organization might seek an appropriation from Congress to carry out research; it might also approach foundations to support some of its work.

In summary, the industry needs to move into the twenty-first century and to find the mechanisms to allow it to do business efficiently. The Multifamily Housing Institute, applying professional expertise and coordination to the field, would provide a reliable private sector authority on which the government and the industry could depend for nationwide standards. The Multifamily Housing Institute would advance the cause of affordable housing much more quickly than would otherwise be possible, hastening the day when the goal of decent affordable housing for all Americans can be achieved.

APPENDIX A

ACCESSING CAPITAL MARKETS
FOR AFFORDABLE RENTAL HOUSING

**A Report to
the Low- and Moderate-Income
Housing Finance Task Force**

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Jean L. Cummings

December 1990
Joint Center for Housing Studies
Harvard University

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PREFACE

In February 1989, a group of private, public and nonprofit organizations created the Low and Moderate-Income Housing Finance Task Force, composed of high-level private and public participants in the housing finance system. Their mission is to bring together the major players in the housing finance system to identify problems in accessing capital markets for affordable rental housing and to develop strategies for increasing access.

As part of the Task Force effort, we were asked to provide an overview of the major issues surrounding the financing of rental housing which would serve as a starting point for Task Force deliberations. Rather than to prescribe final recommendations, our aim was to sharpen the understanding of problems surrounding multifamily rental housing finance and to provide direction for further inquiry.

The lack of data and previous research on financing rental housing made interviewing experts in the field an essential part of our research effort. We visited eleven cities and interviewed over one hundred people as part of this enterprise. Members of the Task Force were an invaluable part of this process. They gave generously of their time both at Task Force meetings and in individual conversations. In addition, they were essential to providing us with a rare opportunity to spend significant amounts of time with leaders in the field. We would like to thank all those who participated in our interviews.

In addition, we would like to thank Larry Bacow, Howard Cohen and Langley Keyes, who served as consultants to the project. Together, they helped provide important perspective and guidance in shaping the themes underlying this report. Their patience and humor through long and somewhat unstructured meetings, particularly at the beginning of this process, are appreciated.

The expert research assistance provided by Melanie Patrick, Mark Curtiss and Shelley Klein at the Joint Center for Housing Studies is most appreciated. In addition, we would like to thank Richard Maier from the American Council of Life Insurance for providing data as well as useful insights on trends in the data.

This project was generously 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.

Finally, we thank Kirsten Moy for her tireless efforts in helping us at every step of this project. Kirsten's high energy and attention to details have been fundamental to the formation and continuation of the Task Force and were crucial to our research.

The support of all those we acknowledge and thank here was essential to this enterprise. However, we are responsible for the analysis, conclusions and any errors in this report.

I. 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 increased standardization and improved marketability of single family mortgages, the secondary market for single family mortgages burgeoned and dramatically increased the flow of capital to homeowners.

The story seems quite different when the lens is focused on multifamily rental housing. While there is a growing secondary market for mortgages on multifamily rental 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 to over three-quarters of single family originations. There is broad consensus that there are significant barriers to accessing capital markets for multifamily rental housing, particularly for housing targeted at low- and moderate-income households.

In this report we try to find out why. We examined the process of building and financing multifamily housing from the perspectives of all the players — the developer, the lender, the investor, the public sector, and the secondary market actors. While data are limited, we analyzed some investor portfolios, developer pro formas, contract documents, underwriting guidelines, and available performance data from public and private lenders and the federal credit agencies. Most importantly, however, we talked to people around the country familiar with developing and financing multifamily housing. The perceptions of these players were our most valuable resource.

It is a timely investigation. On the one hand, a close look at the multifamily rental housing market right now paints a rather bleak picture. Much of the tax-favored status of rental housing was eliminated in the Tax Reform Act of 1986. The recent slump in the real estate market in general is taking its toll in the multifamily market. The striking regional differences in the real estate market caused some areas to have particularly disastrous experiences with multifamily rental housing. The well-publicized losses in the multifamily programs at the Federal Housing Administration (FHA) and Freddie Mac sent danger signals to investors in multifamily mortgages; Fannie Mae, too, struggled with underwriting and servicing issues during much of the eighties. The crisis in the Savings and Loan industry continues to have a major impact. Thrifts have traditionally been leaders in multifamily lending and investment; with the new requirements under the Financial Institution's Reform, Recovery, and Enforcement Act of 1989 (FIRREA) thrifts may need to limit future activities in multifamily housing. Commercial banks have also been major actors in the multifamily market; given the current problems that they face, these lenders have begun to limit their activities and regulatory restrictions are expected.

On the other hand, as the federal government, the federal credit agencies and thrifts reassess their roles in multifamily rental housing. there is growing interest by the other actors. The weakening performance of other real estate investments leads investors to reexamine multifamily housing as an alternative investment. The Community Reinvestment Act is generating increased interest in and available capital for low/mod rental housing. Increased familiarity with the Low Income Housing Tax Credit program draws traditional investors to explore investment in low/mod rental housing.

We begin this report with an overview of multifamily mortgage activity over the past decade. In Section III we examine the impact of the federal tax code and bank regulations on multifamily rental housing. Section IV investigates the structure of financing for both market rate and low- and moderate-income rental housing in an attempt to uncover any peculiarities in multifamily financing which create barriers to otherwise available capital. In Section V we examine the market for debt and equity for rental housing and look at multifamily mortgage performance. In particular, we explore the ways in which underwriters and the market try to evaluate risk for multifamily housing. Finally, we point to key issues that must be addressed to remove barriers and increase access to capital markets for rental housing.

APPENDIX

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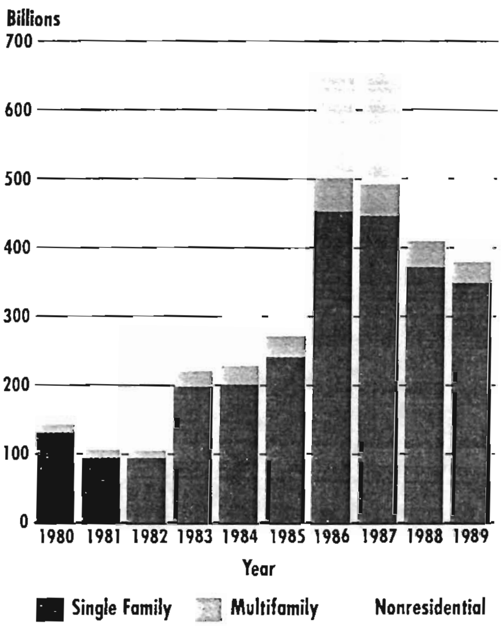
FIGURE 1

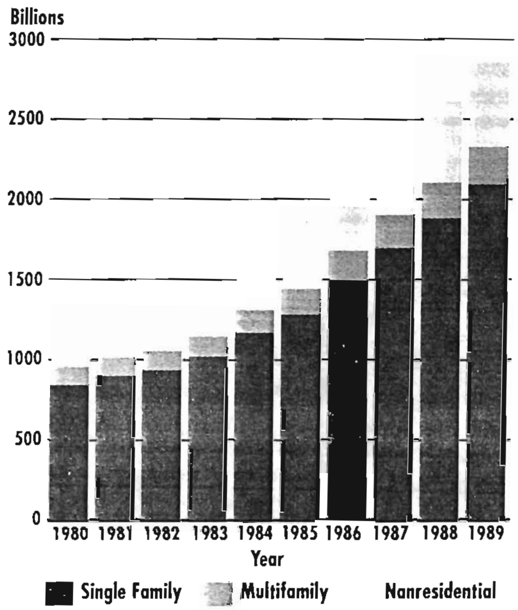
TOTAL REAL ESTATE LOAN ORIGINATIONS 1980–1989



Source: HUD Survey of Mortgage Lending Activity, Annual Tables – Table 3

FIGURE 2

TOTAL REAL ESTATE LOAN HOLDINGS 1980–1989



Source: HUD Survey of Mortgage Lending Activity, Annual Tables – Table 1

II. MULTIFAMILY MORTGAGE ACTIVITY

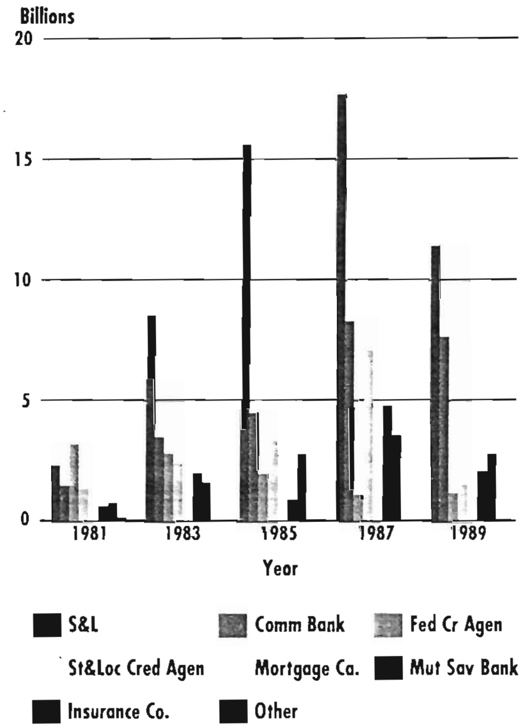
The major source of information available on the mortgage market is the Survey of Mortgage Lending Activity provided by the Office of Financial Management at the Department of Housing and Urban Development (HUD). This survey provides quarterly data on originations, sales and holdings of all mortgage loans.

Figures 1 and 2 provide an overview of originations and holdings of mortgages. While multifamily originations and holdings are substantial, they represent a relatively small share of the overall mortgage market.[1]

[1] Data for all the figures in the report are provided in Appendix C.

FIGURE 3

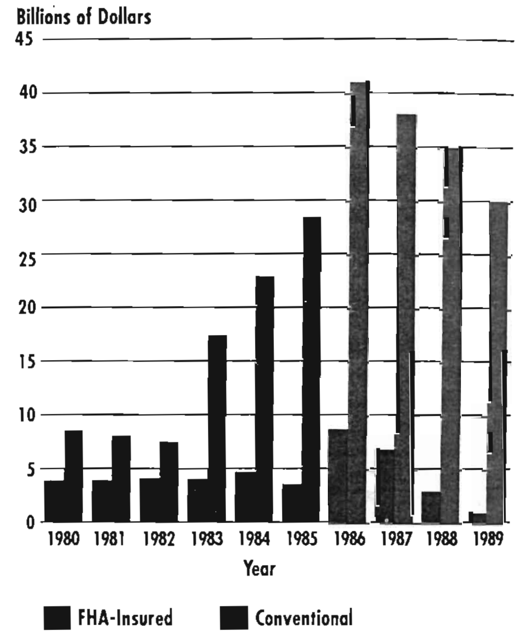
MULTIFAMILY MORTGAGE ORIGINATIONS NEW AND EXISTING PROPERTIES, 1980–1989



Other Includes Pension & Ret Fund and Private MBS Conduit
Source: HUD Survey of Mortgage Lending Activity, Annual Tables – Table 4

FIGURE 4

FHA-INSURED MULTIFAMILY MORTGAGE NEW AND EXISTING PROPERTIES, 1980–1989



Source: HUD Survey of Mortgage Lending Activity, Annual Tables – Table 4

A. Originations

In 1989, $31.1 billion of multifamily mortgage loans were originated, which represents 6% of all long-term mortgages issued that year. In comparison, $352 billion in single family mortgages were issued. While the total dollar amount of multifamily originations increased nearly threefold over the decade, it still remains a small part of the overall mortgage market. Multifamily originations peaked at $49.8 billion in 1986 and have declined since to a low of $31.1 billion in 1989.

Figure 3 shows the distribution of originations on new and existing properties across the major lending groups. Thrifts and commercial banks have clearly been the major originators of multifamily mortgages. Since 1983, the S&Ls accounted for between 35-50% of market originations. In 1989, thrifts and commercial banks originated 37% and 25% of total multifamily loans, respectively.

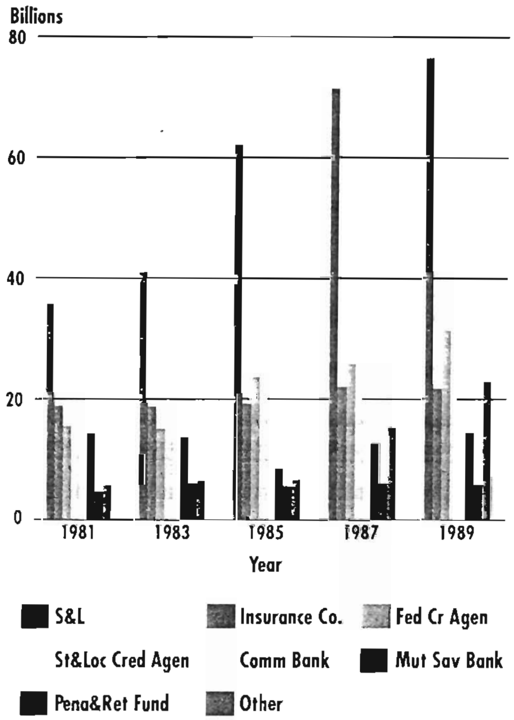
B. Federal Housing Administration Activity

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

As Figure 4 dramatically illustrates, however, HUD's activity recently dropped considerably, and HUD now seems to be almost entirely out of the multifamily market. FHA-insured multifamily mortgages (for both new and existing properties) represented only 3% of total originations in 1989, in sharp contrast to the early 1980s when FHA's share

FIGURE 5

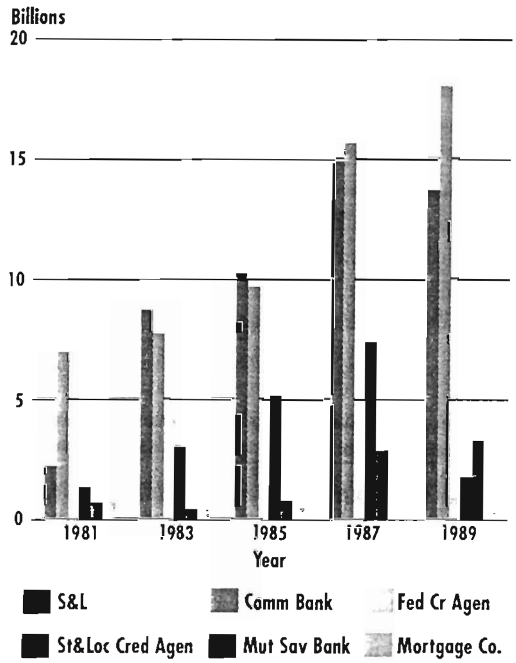
MULTIFAMILY MORTGAGE HOLDINGS MAJOR INVESTOR GROUPS, 1981–1989



Other Includes Mortgage Co., Private MBS Conduit & Mortgage Pool
Source: HUD Survey of Mortgage Lending Activity, Annual Tables – Table 1

FIGURE 6

MULTIFAMILY CONSTRUCTION LOAN HOLDINGS MAJOR INVESTORS, 1981–1989



Source: HUD Survey of Mortgage Lending Activity, Annual Tables – Table 1

was over 30%. For mortgage originations of new properties only, FHA insured more than 52% in 1982 and less than 8% by 1989. As the FHA reassesses its role in the multifamily market, its activity is likely to remain at these low levels.[2]

C. Holdings

In 1989, there were $231 billion of multifamily loans outstanding, compared to over $2 trillion for the single family market. Again, thrift institutions are the major player, holding between 30-40% of the value of loans outstanding throughout the decade (Figure 5). In 1989, thrifts held 33%, state and local credit agencies held 17%, and federal credit agencies held 14%. The share of loans held by life insurance companies stood at 9%, down considerably from 17% in 1980.

The large share of holdings by thrifts carries some complicated implications in light of the S&L crisis. The new risk-based capital requirements of FIRREA may severely limit the extent to which thrifts can invest in multifamily mortgages and must be considered when looking at trends in mortgage holdings.[3]

D. Acquisition, Development and Construction (AD&C)

Overall, multifamily developers rely heavily on commercial banks and thrifts for acquisition, development and construction (AD&C) loans. In 1989, 47% of multifamily construction loans outstanding were held by commercial banks (Figure 6). Thrifts held 36%.

[2] See further discussion in Sections V.C. Performance and V.D. Credit Enhancement.

[3] See Sections III.C. The Changing Role of Lenders and IV.A. Financing Market Rate Rental Housing for further discussion of FIRREA's effects on multifamily investment.

E. Secondary Market Activity

While there was substantial growth in the secondary market for multifamily mortgage loans in the 1980s, the multifamily secondary market is in the early stages of development and remains quite small. In 1989, $10 billion of multifamily loans were sold in the secondary market, which represents 33% of originations. In contrast, there were $274 billion in sales in the secondary market for single family mortgages, representing 78% of originations in 1989.[4]

The market for multifamily MBS has grown substantially in recent years. While there are some privately issued multifamily MBS, the vast majority are issued by the federal credit agencies (Fannie Mae, Freddie Mac, and Ginnie Mae). The federal credit agencies issued $400 million in multifamily MBS in 1982, $2.2 billion in 1985, $7.1 billion in 1988 and $6.1 billion in 1989.

In the last three years, Fannie Mae's activity has grown from $1.2 billion in 1987, to $3.8 billion in 1988 and down to $3.3 billion in 1989. Freddie Mac's volume has decreased from a high of $3.4 billion in 1986 to $600 million in 1989, reflecting the problems in Freddie Mac's multifamily performance which will be discussed in detail later in this report. Ginnie Mae issued $2.2 billion in multifamily MBS in 1989, down from $3.0 billion in 1988.

Even with the growth in multifamily MBS in recent years, the market for these securities is still quite small relative to the market for single family MBS. While the federal credit agencies issued $6.1 billion multifamily MBS in 1989, they issued $195 billion in single family MBS.[5]

[4] Loans sold include whole loans. Source: Table 3, HUD Survey of Mortgage Lending Activity, Annual Tables, Office of Financial Management, U.S. Department of Housing and Urban Development.

[5] Data on federal credit agency MBS activity is taken from A Statistical Summary on Housing and Mortgage Finance Activities, 1970-1989, Tables XIV and XV, Economics Department, Fannie Mae, May 18, 1990.

III. Rental Housing, The Federal Tax Code And Bank Regulations

The data presented in Section II indicate that multifamily originations have declined since 1986 and illustrate the importance of thrifts and commercial banks in originations and investment in multifamily mortgages. In this section we suggest that changes in tax policy explain at least in part the decline in multifamily originations. In addition, new regulations of thrifts under FIRREA, the problems facing commercial banks, and the Community Reinvestment Act (CRA) may significantly alter the current roles played by thrifts and commercial banks in the multifamily mortgage market.

A. Overview of Tax Treatment

Since rental housing is an investment asset, the return on investment is an important determinant of the supply of rental housing. The investment return to rental housing is significantly influenced by tax policy. Historically, the federal tax code granted very favorable tax status to rental housing. In fact, particularly in the last decade, the federal tax treatment of rental housing often so dominated the fundamental underlying economics of rental housing deals that many analysts conclude that such projects have been tax driven rather than market driven transactions.

Private investment in rental housing traditionally takes two forms: individual investor or limited partnership. An individual investor builds or purchases a property and often manages it. Limited partnerships have investors in the project who often receive a small positive cash flow as well as tax benefits from the project; they take no active role in managing the investment. This differs significantly from investment in single family housing and makes multifamily investment appear in many ways more like investments in commercial real estate.

Over the past two decades, there have been significant changes in the tax treatment of rental housing. In order to examine these changes over time, we consider three tax regimes: pre-Economic Recovery Tax Act of 1981 (ERTA), ERTA, and the

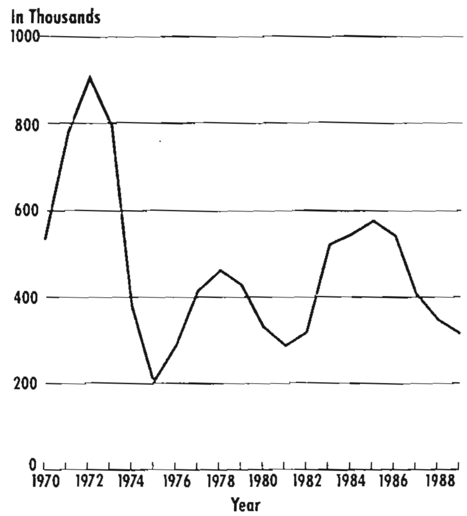
Tax Reform Act of 1986. Under all three tax regimes, rental income and capital gains at sale of the property are fully taxed and depreciation on rental housing is deductible for tax purposes. However, there are major differences in methods of depreciation and tax rates over this time. Until the Tax Reform Act of 1986 mandated straight line depreciation, the preferred method of depreciation was double declining balances. The tax life of the property varied widely over the period from 30 to 40 years prior to 1981, all the way down to 15 years in 1982. Under the 1986 Tax Reform Act, the tax life has been increased to 27.5 years.

These changes in tax treatment significantly altered the speed at which the property could be depreciated. For example, pre-ERTA, with the long tax life and double declining balances method of depreciation, 61% of historic costs would have been depreciated by the 13th year; with the short tax life and the Accelerated Cost Recovery System method of depreciation under ERTA, 88% would have been depreciated by the 13th year.[6] Under Tax Reform, with a tax life of 27.5 years and mandated straight line method of depreciation, the rate of depreciation is slowed considerably; only 47% of costs would be depreciated by the 13th year.

The decreases in marginal income tax rates and the increases in the capital gains tax rate under the 1986 Tax Act significantly lower the after tax return on rental housing. The marginal tax rates of wealthy (shelter seeking) investors dropped sharply. The maximum marginal tax rate in the late 1970s was 70% but under ERTA (1981-1986) was 50%; the maximum marginal rate of 28% under Tax Reform is a significant decline representing a large reduction in the tax benefits of investing in rental housing. Similarly, the rise in capital gains tax rates under Tax Reform from 18% to ordinary income tax rates of 28% further reduces the attractiveness of rental housing as an investment. Perhaps the most significant blow to real estate investment under Tax Reform was the provision that "passive" investors (which include most investors in limited partnerships of rental housing) could no longer offset ordinary income with losses from real estate

FIGURE 7

Multifamily Housing Starts 1970–1989



Structures with five or more units
Source: U.S. Census Bureau

investments. For many investors this provision substantially eliminated the tax benefits of investing in rental housing.

During the debates before passing the Tax Reform Act of 1986, there was considerable concern about the adverse impacts on rental housing of the proposed changes. As shown in Figure 7, multifamily starts increased during the middle 1980s, due at least in part to the favorable tax rules under ERTA; since Tax Reform in 1986 multifamily starts have declined sharply.

This decrease in construction should increase rent levels. DiPasquale and Wheaton (1992)[7] forecast the long run impact of Tax Reform on both construction and rents. Their results suggest that the most dramatic declines in construction (30-45%) would occur in the first few years but that from 1987-1997 cumulative construction will be 20% 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% over the next decade.

[6] During 1981-1986, the Accelerated Cost Recovery System (ACRS) schedule employed was approximately equivalent to a 175% double declining balance method in the early years with a switch to straight line depreciation in the later years.

[7] Denise DiPasquale and William C. Wheaton, "The Cost of Capital, Tax Reform, and the Future of the Rental Housing Market," 1992, forthcoming in the Journal of Urban Economics.

B. Low-Income Housing Tax Credit

In many areas of the country, housing affordable to low- and moderate-income households is produced by the private market and conventionally financed.[8] In these areas, unsubsidized, "market rate" housing can be produced and financed cheaply enough to be supported by rents affordable to low- and moderate-income households.

In many other parts of the country, "affordable" rent levels can only be achieved through some form of subsidy. Over the last five decades, the federal government has provided direct subsidies to stimulate the production and rehabilitation of low- and moderate-income housing.

There is currently no major federal production program, with the exception of the few remaining Farmers Home Administration (FmHA) programs. The Tax Reform Act of 1986 did enact the *de facto* federal housing supply program by creating the Low Income Housing Tax Credit (LIHTC). The LIHTC represents the current standard approach to producing low-income housing. The program provides substantial incentives for investment in low-income housing and often provides the only "equity" found in affordable housing developments.

Under the LIHTC, investors in low-income rental housing projects receive a credit of 9% of total construction costs for new construction or rehabilitation costs; the credit drops to 4% if the project has federal subsidies or tax-exempt financing. The LIHTC provides a 4% credit for acquisition costs.[9]

Just over $300 million in tax credits have been available in each of the three 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 utilized, results in $3 billion in credits over ten years. The initial authorization of $300 million for 3 years, if all credits were allocated, was a commitment of $9 billion over 12 years.

LIHTCs are allocated by state; each state has a maximum volume of credits available set at $1.25 per capita. Only $55 million of the total authorization in 1987 was actually allocated. By 1988, as developers and financial advisers became more familiar with the program, allocations were up to over $200 million. In 1988, the $202 million was allocated to 3,048 projects representing over 95,000 units, 87% of which were low-income units. This works out to roughly $2,500 in tax credit for each low-income unit per year for ten years. As the volume of LIHTC applications increases, the state caps are beginning to impose an additional constraint as several states hit their ceilings.[10]

Case (1991)[11] estimates the present value of tax benefits to investors in low-income housing under the three tax regimes discussed earlier. He points out that projects supported by the earlier federal direct subsidy programs received significant subsidies through the tax system as well.

The tax treatment of low-income housing in the late 1970s prior to ERTA and under ERTA was largely the same as the treatment of other residential real estate. Prior to ERTA, the present value of the tax benefits from each $10,000 of total project costs is estimated at $1,654, which is an implicit subsidy of 16.5%; under ERTA, the implicit subsidy rises to 25% of total project costs.

Under Tax Reform with the LIHTC, Case estimates that the present value of the marketable 9% credits is $5,194 per $10,000 in development costs; when the additional tax benefits from depreciation are added, the present value rises to $5,377 which is equivalent to a subsidy of 54%. The implicit subsidy under the 4% credit is 25% of development costs, which is almost identical to the subsidy under ERTA. In a sense, then, we can think about the 4% LIHTC as a very targeted version of ERTA. As Case points out, Congress recognized that the LIHTC was lucrative and therefore restricted their use. These restrictions include the caps on state allocations, the limit of $7000 on the credit that could be taken by an individual taxpayer, and the required percentage of low- and moderate-income units in the project.

8 We choose to avoid debating here which guidelines to use in defining "affordable housing" and instead recognize "low- and moderate-income housing" as housing which is affordable to lower income households. An "affordable rent" in Boston is not so affordable in St. Louis; a family qualifying as low-income by HUD guidelines in New York can have a much different income than the "low-income family" in St. Paul

9 The 4% and 9% credits have been replaced by a present value credit of 30% and 70%, respectively.

10 From information compiled by the National Council of State Housing Agencies.

11 Karl Case. "Investors, Developers, and Supply-Side Subsidies: How Much is Enough?," Housing Policy Debate, Papers Presented at the Fannie Mae Annual Housing Conference, 1990, Vol. 2, Issue 2, 1991.

C. The Changing Role of Lenders

1. FIRREA

The Financial Institution's Reform, Recovery and Enforcement Act of 1989 (FIRREA) substantially restructures the lending requirements of thrifts and many banks. As a response to the S&L crisis and growing problems of the banking sector in general, Congress through FIRREA imposed standards designed to reduce risk and increase the financial prudence of thrifts. The new risk-based capital requirements will have a dramatic effect on investments by thrifts in multifamily housing.

The major pieces of FIRREA which have an impact on multifamily financing include:[12]

- **Capital Requirements:** FIRREA establishes minimum capital requirements. Multifamily mortgages and acquisition, development and construction (AD&C) loans are specifically identified as more risky and are both assigned 100% risk weighting. In contrast, single family mortgages that are not backed by one of the federal credit agencies receive a 50% risk weighting. This represents a significant increase in capital requirements from pre-FIRREA practices.[13]
- **Single-Borrower Loan Limitations:** In an attempt to impose greater portfolio diversification, thrifts are limited to lending a maximum of 15% of unimpaired capital to one borrower (with some exceptions), which is a big reduction from pre-FIRREA practices. This has particularly significant implications for the larger multifamily-related 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% to 70%. Housing-related assets must be "qualified thrift investments" as specifically defined.
- **Loan-to-Value Restrictions:** The FIRREA guidelines include a loan-to-value ratio (LTV) of 95%+ for residential loans and a 70% ratio for AD&C loans. This represents a major blow to AD&C availability in some regions of the country.
- **Direct Equity Investment:** In contrast to pre-FIRREA, the act now prohibits thrifts from direct equity investment in real estate (banks were already prohibited). AD&C loans structured with low interest rates and with some profit sharing by the lender are treated as equity investments and are similarly prohibited.

2. Community Reinvestment Act

Stepped-up attention to the Community Reinvestment Act (CRA) of 1977 may change the environment for multifamily funding. Intended to end discriminatory lending and banking practices, the Act encourages financial institutions to meet the credit needs of their local communities. Since 1977, bank regulators have conducted "CRA reviews" as part of their routine bank examinations, but CRA ratings were notoriously lax and were not disclosed to the public.

However, the public outcry for stricter banking regulation in the wake of the S&L crisis and a spate of successful lawsuits against non-conforming banks led financial institutions, Congress, and regulators to take CRA more seriously. Last year, FIRREA included a requirement for public disclosure of the 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 cities like Chicago, which has the Rescorp consortium; Los Angeles, where the Security Pacific Bank announced last summer it would commit $2.5 billion over the next 10 years for low- and moderate-income projects, with the bulk going to nonprofit housing groups; and New York, where Chase Manhattan has established a subsidiary, the Chase Community Development Corporation, which has committed $200 million over the next five years to affordable housing and other development projects in poor neighborhoods.

The federal tax code and bank regulations have major impacts on investment decisions for rental housing. As we enter the '90s, the playing field continues to change. The LIHTC remains in practice the only federal production program for low- and moderate-income housing but its future is unclear.

[12] Barbara Alexander, "Will 1990 Signal the End of a Demand-Driven Housing Market?," Salomon Brothers, January 20, 1990.

[13] Loans on multifamily projects of 5 to 36 units with an LTV of 80% or less with stable occupancy of at least 80% during the previous year have been defined as "qualifying multifamily housing loans." These loans receive a 50% risk weighting. (Federal Register, Vol. 54, No. 215,

FIRREA and the reorganization of thrifts seriously threaten the future involvement of the traditional major investors in multifamily rental housing. On the other hand, increased response to CRA requirements may bring substantial new resources and capital to the table, particularly for low- and moderate-income housing. It is not clear what the net effect of these changes in practices will be. What is clear is that this is a time of reexamination and reevaluation, which may present significant opportunities in the quest for increased access to capital.

IV. Financing Multifamily Housing

A close look at the structure of financing multifamily housing and who finances it points to many important ways in which building multifamily housing is different from single family or commercial developments. A better understanding of these differences helps identify barriers to accessing capital markets unique to multifamily development.

Again, there is limited data on mechanisms used in financing multifamily developments. The scale of development, number of parties involved, usual presence of passive investors, and lack of standardization of debt instruments or the financing process lead multifamily deals to resemble the financing for commercial real estate more than arrangements for single family housing. The scenario gets even more complicated when subsidies are introduced.

The ready availability of financing for acquisition, development and construction is particularly important in multifamily development. As with commercial development, multifamily housing requires a large upfront infusion of capital before the property can begin to produce income. Sources of equity and permanent financing for rental housing differ significantly from single family housing not only in their size and scale but in their multiparty financing structures.

A. Financing Market Rate Rental Housing

The financing for market rate rental housing generally involves non-standard, deal-by-deal arrangements. However, the basic components of the financing are clear.

1. Acquisition, Development and Construction (AD&C)

The data presented in Section II illustrate the dominance of commercial banks and thrifts as investors in AD&C loans. In our interviews, we consistently heard from non- and for-profit developers that construction financing was readily available from conventional lenders. Bankers across the country pointed to AD&C financing as their major if not only involvement in development of rental housing. Construction lending offers the clear advantage of being relatively short-term. Staff of the Housing Assistance Council reported that rental construction financing in rural areas is done overwhelmingly by commercial lenders — often representing the only conventional financing in housing deals. In the months since our interviews, the situation has changed dramatically: AD&C financing for market rate rental housing has virtually disappeared.

— FIRREA's Effect on AD&C Financing

Under FIRREA, risk-based capital requirements and single-borrower loan limitations restrict AD&C lending by thrifts. Salomon Brothers calculates that based on the new capital requirements, fewer than 40 thrifts nationwide have the requisite capital to make a $20 million AD&C loan, and only about 15 could extend a $50 million loan.[14] Further, the practice of profit sharing by the lender has been limited by FIRREA.

The National Association of Home Builders conducted an Acquisition, Development and Construction Financing Survey of builders/developers across the country.[15] The survey polled 1142 respondents, 199 of whom identified themselves as multifamily developers. This is a small sample, and one can expect self-selection biases, but the responses are still useful in indicating some national and regional trends.

Nearly 90% of the respondents reported that thrifts have changed their lending agreements or practices, most notably by increasing the amount of

[14] Alexander, p. 8.

[15] "Acquisition, Development & Construction (AD&C) Financing Survey," Economics and Housing Policy Department, National Association of Home Builders, May 16, 1990.

equity required and by reducing the amount of funds available — in some cases to zero. Similarly, about 3/4 of the respondents felt that commercial banks were significantly changing their lending practices in anticipation of regulations, mostly by asking for more equity.

Determining actual thrift and bank practices through these respondents' perceptions is an imperfect science at best, but the survey can be helpful in revealing how some builders view the climate for multifamily development. Seventy-six percent of the multifamily rental developers reported that changes in lender practices have affected their building or development plans for 1990 (even more for developers in the South and Northeast). More than 3/4 of the developers report that they have attempted to make other arrangements for AD&C financing as a result of these changes, with only a third reporting any success.

It will take some time for lenders and regulators to sort out the full implications of FIRREA and to adjust their practices. It is clear, however, that FIRREA will further constrain an already tightening market of AD&C financing. The only question is the magnitude of its effects.

2. Permanent Financing

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 we see in single family mortgages. Instead, like commercial mortgages, they are often the result of negotiations between several interested parties trying to accomplish several diverse goals.

Our interviews revealed that many lenders provide fixed rate, 5-, 7-, or 10-year balloon mortgage loans with 25-, 30-, or 35-year amortization. Balloon mortgages bring additional risk since the balloon must be paid or refinanced at the end of the term. While many argue that balloon risk is only a problem with terms shorter than five years, there are still risks associated with longer-term balloon mortgages. One problem with using balloon mortgages is that often the balloon 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. Some lenders we interviewed are considering experimenting with these longer-term level-payment fixed rate mortgages; many developers were enthusiastic about seeing this happen. The Neighborhood Reinvestment Corporation advocates using 25-year, self-amortizing fixed rate mortgages for low-income housing. The California Community Reinvestment Corporation is planning to build a portfolio of permanent level-payment fixed rate loans of 10-, 15-, and 30-year terms.

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 some reliability and predictability. The prepayment fees typically provide prepayment protection for 5-10 years (the "yield maintenance period"). Partial prepayment of the mortgage is generally not allowed except under special circumstances. The imposition of substantial fees for full prepayment makes multifamily mortgages a more certain investment than single family mortgages during the yield maintenance period. There is some debate on how successfully an investor is protected from prepayment risk in multifamily development even with these lockouts. On the one hand, some argue, after the yield maintenance period or the lockout period, multifamily mortgages become less predictable than single family mortgages because individual investor decisions are even more difficult to predict than the behavior of homeowners. Others argue that this is not true — individual investor decisions are no less predictable than homeowners'. What's more, lenders/investors can ultimately take control over prepayment provisions during initial negotiations — if they are uncomfortable with the risk, they can insist on prepayment lockout for the entire term as a condition of lending.

3. Sources of Equity

There is little if any reliable data on equity sources for multifamily developments. Equity investment traditionally comes in two forms for rental proper-

ties: 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 limited partners through syndications. Prior to Tax Reform, limited partnerships rather than developers provided much of the equity for rental housing deals. Post-Tax Reform, limited partnerships are generally not viable for market rate housing but are used extensively with the syndication of low-income housing tax credits. We were unable to find a reliable source of data on the size and form of equity in rental housing.

B. Financing Low- and Moderate-Income Housing

The use of LIHTC, often combined with additional state or local subsidies, is the current standard approach to financing low- and moderate-income housing.

1. Structure of LIHTC Deals

Syndication of the LIHTCs often provides the only equity for low- and moderate-income housing projects. In low cost areas, the combination of the LIHTC and a conventional mortgage loan can cover total project costs and is 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 filled by some combination of state, local and nonprofit subsidies, direct and indirect.

How these three pieces — the LIHTC "equity," the conventional mortgage, and the "gap financing" — break down varies across developments and geographic regions. 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. The National Council of State Housing Agencies (NCSHA) has begun surveying its member organizations about the nature of their LIHTC deals. Since in almost every case the LIHTCs are allocated and administered by the state housing agency, this would seem an excellent source of data and could prove to be in the future. At present, however, these surveys focus on describing tax credit deals at credit allocation. Since there is a significant time span between credit allocation and project completion and many aspects of the project change, these surveys provide little information on the final financing structure.

Without a major centralized data source, we have to rely on evidence culled through interviews. Around the country we consistently heard that the rule of thumb for the breakdown of finance pieces was something approximating 1/3 equity, 1/3 conventional financing, and 1/3 gap financing. Even though people referred to projects that did not come close to this rule, they still viewed the "one-third, one-third, one-third" measure as a rough standard.

In reality, many projects that we looked at across the country seemed to approach a 30/30/40% breakdown of equity, conventional mortgage and gap financing. Depending on the development costs for the area, 30–40% of conventional financing was as much as most projects could carry. After putting together the LIHTC equity piece, securing the maximum conventional financing, developers then back into the gap, which ranges from 30% to over 50% of project costs. In an environment of scarce subsidy dollars, it is important to maximize the size of the conventional first mortgages in order to increase the leverage of the subsidies. In effect, the conventional mortgage loan represents the cheapest funds in the project. In the Twin Cities, we often heard the 33/33/33% breakdown used as a measure. The San Francisco Mayor's office estimates that their typical low-income projects could get only 20% of total development costs covered through conventional financing, while in nearby Contra Costa County suburbs, conventional financing typically covers 50% 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 LIHTC, state and local direct subsidies, and mortgage money financed through tax-exempt or taxable bonds issued through the state housing finance agency. Rural areas often have the same problem of a lack of conventional financing: instead, these areas rely heavily on Farmers Home Administration programs for permanent financing (discussed more in the section below).

2. Costs of the LIHTC Program

As with any indirect subsidy program, the Low Income Housing Tax Credit 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 of the program are difficult to identify, but preliminary analysis suggests that fees and administrative expenses of the LIHTC may be higher than for comparable investments. These expenses ultimately mean that less of the funds raised through the syndication of the tax credit end up in the project.

A recent General Accounting Office (GAO) report[16] compared the various fees and expenses associated with real estate partnership offerings that use the low-income housing tax credit. The report suggests that partnerships being marketed for LIHTC projects are more expensive than partnerships without tax credits, thereby reducing the amount of equity available for the actual construction and rehabilitation of low-income housing. By their calculations, the low-income housing partnerships devote an average of 27% of funds raised to fees and expenses, while the other types of real estate partnerships use about 21% for this purpose.[17]

Our interviews provided anecdotal support that fees for tax credits deals were significantly higher than fees for other deals. The interviewees cited increased, nonstandardized paperwork, the presence of many more players in the deal, and the relatively complicated financial arrangements as contributing to the skyrocketing number of lawyer- and accountant-hours per deal.

Part of the increase in costs of doing affordable projects results from the constantly changing tax incentive programs. Administrative expenses and legal fees rise considerably each time the playing field changes as the players figure out how to do a deal under the new rules. The low proportion of available tax credits used in 1987 is one indication of the inability of developers and investors to adapt to the intricacies of the program in a short time. Even in its third year, the LIHTC remains a complicated program with an uncertain future from year to year, adding to its expense.

Finally, while it is true that the tax credit partnerships used a greater proportion of funds raised for fees, there is considerable variation across the 19 partnerships examined in the GAO report; fees and expenses as a percent of total funds raised range from 17% to 33.8%. Given this variation, it seems clear that there is considerable room for improvement even within the existing LIHTC program structure. At 17% for administrative costs, a well-structured LIHTC partnership deal is competitive with other real estate partnerships. Stability and predictability of the LIHTC program could add substantially to its efficiency.

3. Rural Areas

In rural areas, developers often match the LIHTCs with Farmers Home Administration (FmHA) programs to meet the costs of building multifamily projects with rents affordable to area residents. Representatives of the Housing Assistance Council and FmHA agree that even with the lower costs relative to urban areas, the tax credits are driving the only low-income housing in rural areas. Even though rental housing projects could be made affordable in some areas without tax credits, the credits provide the only incentive to actually get the housing built. The tax credits provide higher returns to developers and give the necessary incentive for large developers to consider rural areas.

In building affordable, adequate housing in rural areas, however, the problem is usually not the lack of LIHTCs but a scarcity of AD&C and conventional mortgage funds at any price as a result of the harsh impact of the S&L crisis on rural areas. In many cases, one thrift served a large geographical area. As a result, the FmHA programs are very important to rural developments. While some national companies provide construction lending at market rates to rural area developments, there are virtually no private sector funds available for perma-

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16 "TAX POLICY: Costs Associated with Low Income Housing Tax Credit Partnerships," General Accounting Office, July, 1989.

17 There 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" which 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 assets acquired rather than against equity, low-income housing projects spend 8% of their assets as compared to 16% for the other partnerships. This is because low-income projects have a considerably lower proportion of equity than do market-rate projects.

nent financing. According to FmHA officials, about 60% of FmHA's rural projects have deep rental subsidies; the others do not have deep subsidy but have some interest subsidy.

4. Gap Financing

The structure of the 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 which 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, involving several players. Rural areas rely heavily on FmHA programs to help finance projects. Urban areas turn to state and local direct and indirect subsidies. To the extent that private grants are available, they are tapped quickly.

Subsidies from state and local entities come in several forms. Often, local agencies will provide "soft second" mortgages. In San Francisco, the city puts a deferred loan on their projects. In our interviews we consistently heard that state and local agencies are moving away from grants to an increased use of loans as their project contribution. Grants, they feel, provide too little control in the future of the project while loans give them some increased accountability to the taxpayers. Using bond proceeds or funds from "linkage" or dedicated taxes, the public sector often will provide loans at extremely favorable rates as part of their contribution to the project.

In addition to grants and loans, cities and states regularly provide land or buildings at below market or no cost. Long-term tax abatements or payment-in-lieu-of-tax (PILOT) agreements are common in affordable projects.

There are three important points about gap financing from the public sector:

- The structures of gap financing are nonstandard both within a region and across regions.
- From the developer's point of view, these subsidies are the most inexpensive funds in the project. In fact, in many locations, public sector "loans" to affordable projects are implicitly understood to be grants.
- When the public sector enters as a "development partner" it typically is looking to achieve several goals at once — to build housing, to minimize its subsidy cost per unit, to deepen affordability, to preserve affordability beyond a few years, as well as to be accountable for its use of subsidy funds. In addition, the public sector is often trying to achieve these goals with scarce resources. Hence, gap financing often comes from a variety of sources which accounts for some of the nonstandard quality of gap financing. The structure of the gap financing may encumber the first mortgage if, for example, it comes with deed restrictions. The role public sector financing plays in the marketing of multifamily mortgages is discussed further in the section on underwriting later in this report.

V. Multifamily Performance: Sorting Out The Risks

Compared with other real estate investments, data on the risks and returns of multifamily housing are scarce. Multifamily mortgages make up a relatively small portion of most private lenders' portfolios.

Most lenders/investors admit that they do a poor job of tracking the performance of their multifamily housing investments. Originators and holders of multifamily mortgages often have difficulty categorizing these loans, unsure whether to compare them to single family loans or to nonresidential loans. Multifamily loans are residential loans and carry with them many traditional housing-related issues and regulations and therefore are often compared with single family portfolios. However, they are ultimately business loans made to a developer who does not live in the building and are perhaps more comparable to nonresidential loans; in fact, multifamily performance data is often lumped in with commercial investments.

The most consistent time series data on the performance of multifamily mortgage investments is maintained by the American Council of Life Insurance (ACLI). These data track investments made by life companies over the past two decades. Freddie Mac and Fannie Mae, while improving their tracking of multifamily activity, have not been in the multi-

family business long enough to have built meaningful time series data. Perhaps most surprising is the poor data provided by FHA. FHA has been insuring multifamily mortgages since 1934. Yet, it is very difficult to obtain consistent data on the performance of multifamily mortgages insured under these programs.

Finally, in the secondary market, the volume of multifamily activity has been relatively small and the history is short. There has been no systematic tracking of multifamily MBS performance over time.

The scarcity of hard performance data on multifamily investments leaves the evaluation of their relative merits to the perceptions of potential investors. Hence, investment decisions concerning multifamily housing are often based on general impressions.

This section discusses observations on the real and perceived risks and returns of multifamily projects based on our interviews. We also present available data on actual delinquency experience. In addition, we examine underwriting and credit enhancement as a way of understanding how the lenders of multifamily mortgages approach risk. Finally, we discuss multifamily activity and performance in the secondary market.

A. How Investors View the Market

Several themes emerged in discussions with institutional investors:

Management of rental housing is viewed as difficult.

Institutional investors shy away from multifamily housing in part because management of rental housing 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. While commercial real estate is viewed as more difficult, at least there is a business relationship between management and tenants. Rental housing is viewed as a much more difficult management task since property managers are dealing with individuals and families about something very important to their existence — where they live.

Residential management also carries with it complex legal relationships. Relatively 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.

Low- and moderate-income housing is viewed as even more risky than market rate multifamily housing because of several issues related to the targeting of low- and moderate-income households.

1) Management. Investors who shy away from multifamily housing often maintain that management issues are even more difficult for low- and moderate-income housing. Certainly, we heard in some interviews opinions that low- and moderate-income families were harder to manage and likely to put more wear and tear on the buildings. For these potential investors, low/mod management is seen as being more labor-intensive and the management risks greater. In addition, lower-income communities may be burdened by other social issues that affect residential management.

2) Income Stream. On the one hand, successful multifamily investors may argue that low/mod rental projects provide a relatively stable income stream. Compared to commercial investments, the rental net operating income stream is not terribly variable from year to year. In addition, in many markets, vacancy rates among units serving low- and moderate-income households are very low. The low vacancy rates are the result of the dwindling supply of low cost housing.[18] The rental subsidies and contracts that often accompany low/mod housing provide additional stability and reliability of the project income stream.

On the other hand, the upside of investment in low/mod housing is capped by the limit on rents implied by targeting the housing to low- and moderate-income households. The limit on the income stream leads some lenders to view low/mod housing as even more risky than market rate rental housing — although a cap on income should not be

[18] William C. Apgar, Jr., Denise DiPasquale, Jean Cummings and Nancy McArdle, "The State of the Nation's Housing: 1990," Joint Center for Housing Studies, Harvard University, June, 1990.

confused with increased risk. The fact that growth in rental income is limited should be more relevant to equity investors than to investors on the debt side. On the debt side, concern should be focused on the stability of the income stream rather than its growth. For both equity and debt investors, it is important that income keeps up with expenses over time.

However, the downside risk of low/mod rental housing may be larger than for market rate housing because the structures may be in worse condition and located in distressed neighborhoods. Low- and moderate-income rentals are less likely to be new developments. Therefore, the older and rehabbed buildings can be expensive to operate and can complicate planning for future capital needs. This downside risk is a concern for both equity and debt investors.

Recently, institutional investors see multifamily as a viable alternative to other real estate developments.

Whether they have historically viewed multifamily as a stable, steady income-producer or as a hornets' nest of risks, institutional investors seem more willing to consider rental housing recently because of the current downturn in other parts of the real estate market. Most investors want to maintain a portion of their portfolio in real estate investments and are looking to increase portfolio diversification. As office and retail investments continue to perform badly, multifamily investments begin to look better. Seen in this light, rental projects provide a steady, relatively reliable income stream. Residential rental real estate may also be seen as having the most "flexible" income stream: landlords have more year to year control and some lenders assert that residential rents adjust more freely to inflation shifts than do commercial and industrial rents and therefore provide more inflation protection.

Institutional investors have few incentives to take risks.

Faced with an investment they either perceive as very risky or about which they know little, investors have very few reasons to pursue the investment. The structures of investment institutions often inadvertently discourage the exploration of new areas of investment and provide disincentives for spending time getting up to speed on a new, complicated investment.

Pension funds are restricted in their investment options by a network of constraints. 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 ERISA. Public pension funds are not bound by ERISA but some have developed similar guidelines. Some argue that public pension funds are even more constrained because they have an extra layer of visibility and accountability to the taxpayers. On the other hand, public pension funds are perceived by some to be under greater pressure than private pension funds to carry a "social investment" mission.

The lack of strong multifamily investment activity suggests that the price of multifamily investments does not match the investor's perception of their risks.

Do investors shy away from rental housing because these investments are not priced appropriately to compensate for the risks or because the investors do not have the skills or incentives required to properly analyze the risks? This is a difficult question to answer given the lack of data on the performance of multifamily investments. The next sections try to address this issue by looking at performance and underwriting of multifamily mortgages and multifamily activity in the secondary market.

B. Underwriting: Evaluating Risk

Underwriting guidelines provide a basis for understanding how lenders view the risks associated with multifamily mortgages. Guidelines for underwriting multifamily mortgages resemble those for mortgages on commercial properties.

1. Fannie Mae and Freddie Mac Guidelines

To the extent that there are industry standards in underwriting multifamily mortgages, they were until recently represented by the Fannie Mae and Freddie Mac guidelines. Over the last few months, the losses in Freddie Mac's multifamily program have received a great deal of attention. These problems will be discussed in detail in the next section. As a result of these losses, however, Freddie Mac has recently shut down their cash program, which represented roughly 90 percent of their multifamily business. The guarantor program, which represented the other 10 percent of their multifamily business, is still in operation but its activities are largely limited to refinancings for loans already in the portfolio and real estate owned (REO) by Freddie Mac as a result of defaults.

In a recent letter to shareholders, Freddie Mac's chairman and chief executive officer, Leland Brendsel, stated, "[u]ntil I get satisfactory results and resolve these problems, we will not reenter the multifamily cash market. And if we do reenter, our method of operation will be different."[19] Hence, at this point, it is difficult to discuss Freddie Mac's program as part of the current multifamily industry standard. As a result, we will focus our attention on the current programs at Fannie Mae.

Currently, Fannie Mae purchases multifamily mortgages through three programs: Delegated Underwriting and Servicing (DUS), Prior Approval, and negotiated transactions. Under the DUS, local lenders underwrite loans for the program. In order to participate in the DUS program, a lender must be approved by Fannie Mae. Fannie Mae sets minimum capital requirements and examines the lender's business practices for approval as a DUS lender. The approved lender is delegated all underwriting duties; Fannie Mae does not review the loan prior to purchase. However, Fannie Mae does extensive post-purchase review of the loan and lender monitoring. The DUS lender shares the risk of loss with Fannie Mae.

As an alternative, Fannie Mae also provides the Prior Approval program. Under Prior Approval, a lender originates loans with the intention to sell them to Fannie Mae. The lender puts together the paperwork for the loan and submits an application to Fannie Mae for a commitment to purchase. Fannie Mae does the underwriting using guidelines similar to DUS. A lender is reviewed by Fannie Mae in order to participate in the Prior Approval program, but the standards are not as rigorous as for the DUS program. The DUS program does offer an advantage over the Prior Approval program in that DUS loans are purchased at a lower yield than loans under the Prior Approval program. Finally, a substantial portion of Fannie Mae's multifamily business is done through negotiated transactions. These purchases are negotiated on a case-by-case basis.

Fannie Mae's DUS and Prior Approval programs allow for eligible mortgages ranging from $1 million to $50 million. Underwriting guidelines for these programs emphasize examining occupancy levels, rent rolls and lease terms, the structure of equity participation, as well as detailed studies of the physical condition of the building and neighborhood trends to evaluate the long-term economic viability of the building.

Key variables in underwriting are the loan-to-value ratio (LTV), debt service coverage, and recourse or loss sharing with the lender. Typically, the LTV ranges from 60% to 80% and the debt service coverage ranges from 115% to 130%. These standards vary somewhat depending on the level of risk remaining with the lender. To address the risk of prepayment, Fannie Mae uses a yield maintenance fee structure tied to the term of the mortgage.

The appropriate use of recourse is attracting increasing debate as Fannie Mae, lenders, and developers seek to limit risk. Under the new risk-based capital rules in FIRREA, the recourse requirements limit the continued participation of thrifts in Fannie Mae programs since the lender 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 loan to Fannie Mae.

Fannie Mae has made recent adjustments to their guidelines to diminish exposure to risk. These included increased scrutiny of property condition, increased reserves for replacement funding, and more extensive review of the borrower.

[19] Letter to Shareholders of Freddie Mac, October 31, 1990, p.3.

A key element in multifamily underwriting is the determination of the property's value. Fannie Mae requires that each property must be appraised by three methods: i) the market comparison method (presenting market comparables); ii) the cost replacement method, where the value is determined by the cost of replacing the building today; and iii) the income capitalization method, where the value of the building is determined by its projected cash flow. While leaving a lot of room for the eventual interpretation of these various assessments, Fannie Mae indicates that the income capitalization method is the "predominant indicator" in assessing value.

The definition of project value proves to be particularly difficult for low- and moderate-income housing, where the capped income stream often creates a large gap between "project value" based on income capitalization and "value" based on project costs. In our interviews across the country with people focusing on low- and moderate-income housing, we repeatedly heard that they often calculated loan-to-value as loan-to-project cost. This approach would lead the lender to loan more than if the underwriting was based on a true loan-to-value basis.

In recent years, both Fannie Mae and Freddie Mac have attempted to adjust their exposure to risk by periodically making changes in some key underwriting variables. However, given the lack of research on the determinants of defaults, it is difficult to gauge the marginal change in risk associated with small changes in these variables. This is a common theme in multifamily underwriting. The U.S. Comptroller echoed this sentiment in the GAO 1988 Audit of the FHA, stating that "...a lack of up-to-date default information to identify the causes of excessive insurance losses" in FHA's co-insurance program inhibits the agency from knowing how best to respond to the increased exposure to risk.[20] Those focusing on low- and moderate-income housing often argued in our interviews that tightening of underwriting standards such as increasing debt service coverage as a reaction to increased defaults may not be an appropriate response. There may be better ways for Fannie Mae, Freddie Mac and other underwriters to decrease their risk exposure on multifamily mortgages, but the lack of data and analysis makes it difficult to determine what those approaches are.

2. Public Subsidies

Several issues are raised when underwriting low- and moderate-income housing deals that include public subsidies:

- Does the presence of public sector involvement reduce or increase the risk of the project? On the one hand, the presence of the public sector as a "partner" in the development may signal to the underwriter an important political investment in the project. The public sector has made a commitment to the development and will not let the project fail. On the other hand, the involvement of public sector investment may signal to the investor that this may be a particularly "troubled" project, one which needs the extra attention of the public sector to make it appear viable, as well as the presence of an additional financial player who brings to the table complicated and sometimes costly financial structures and reporting requirements as well as "messy" political demands.

  Our interviews reveal that among lenders, developers and underwriters, the group was pretty evenly split as to whether the presence of the public sector was a plus or a minus. For every underwriter who welcomed public sector involvement, there was one who saw it as bad news. What each interviewee had in common, though, was a strong opinion on the subject.
- The structure of the public subsidy can have important implications for underwriting the conventional first mortgage. If the subsidy takes the form of a loan (e.g., a soft second), should that loan be included in debt service coverage? Some argue that public sector "loans" are often understood to be so soft as to be grants — that the public entity will never actually call in the loan or will instead allocate any payments made back into the project. In that case, they argue, including the loan in debt service coverage as underwriters tend to do unduly burdens the low- or moderate-income housing development.

[20] "1988 Financial Audit: Federal Housing Administration," General Accounting Office, September, 1989, p. 9.

Representatives of Fannie Mae explain that if they have documentation that the loan is in fact a subsidy and will be kept in the development, then they will adjust their underwriting to keep the loan out of the debt service coverage. Without that documentation, they will consider it as debt. If it is indeed true that subsidies often take the form of soft seconds, then the actual intended terms of those loans need to be clarified during the underwriting process.

- In some cases, the subsidies are structured so as to encumber the conventional first mortgage, making it difficult to underwrite and sell. In an attempt to achieve additional goals other than simply multifamily production, providers of subsidies often encumber the conventional first mortgage. Deed restrictions, rights-of-first-refusal, or special tenant income guidelines are typical examples of ways in which public and private subsidy providers may attempt to ensure long-term affordability, deepen project affordability, or add broader community economic development goals to a multifamily project. Such restrictions come at a substantial price; lenders will be far less willing to provide funds for the first mortgage since the restrictions limit the marketability of the loan.

C. Performance: Delinquencies and Foreclosures

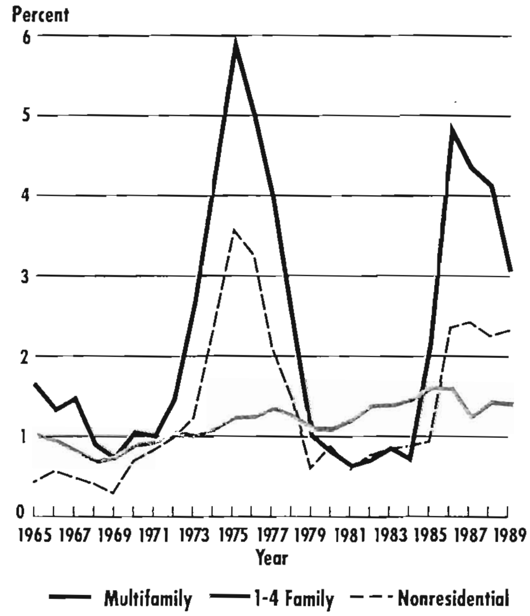
The major sources of data on multifamily delinquencies and foreclosures are the American Council of Life Insurance (ACLI), FHA, Fannie Mae and Freddie Mac.

1. ACLI

ACLI's data, which goes back to the mid-1960s, permits comparisons of multifamily mortgages with 1-4 family and nonresidential mortgages. 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 number of loans. As shown in Figure 8, delinquency rates for multifamily mortgages skyrocketed above

FIGURE 8

MORTGAGE DELINQUENCY RATES



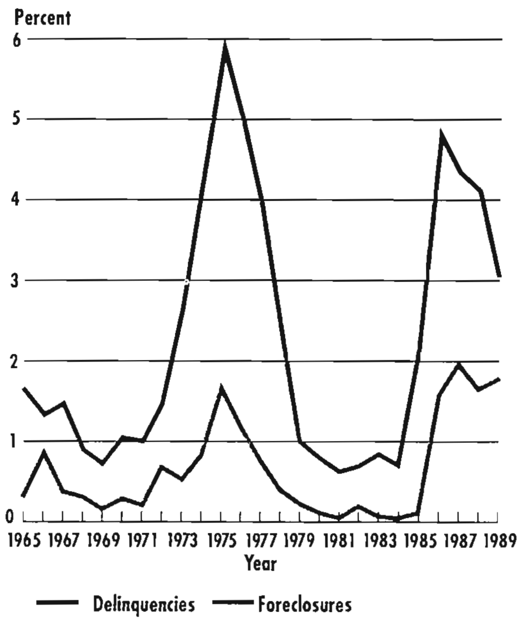
Source: ACLI
Rates by amount of loans; delinquencies include foreclosures

those for 1-4 family and nonresidential mortgages in the middle 1970s and mid- to late 1980s. In both periods, nonresidential mortgage delinquencies also increased but not as dramatically as multifamily delinquencies. As shown in Figure 9, while actual multifamily foreclosures did rise during the mid-1970s, the increase is much smaller than what might have been expected from the delinquency rates. In the late 1980s, foreclosure rates have increased dramatically.

The increase in delinquencies in the mid 1970s may be due to the downturn in the real estate market and the overall economy in 1974-1975. 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% but the delinquency rate was 19.9% in the West South Central region of the coun-

FIGURE 9

MULTIFAMILY MORTGAGE DELINQUENCY AND ANNUAL FORECLOSURE RATES



Source: ACLI
Rates by amount of loans; delinquencies include foreclosures

try, 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.

2. FHA

The story gets even worse when we consider the multifamily programs at FHA. At this point, the losses in the FHA multifamily mortgage insurance programs have been well publicized. In September, 1989, Price Waterhouse issued a report showing that the FHA General Insurance Fund which covers the multifamily co-insurance program would have $62 billion in insurance in force and a deficit of $3.1 billion on September 30, 1988; $2.6 billion of those losses were realized in 1988.[21] The co-insurance program has since been canceled.

It is difficult to sort out the reasons for the problems in FHA's multifamily programs. Many 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. From our interviews, it is clear that many experts believe that the problems with the multifamily insurance programs had much less to do with the design of the programs or the risks inherent in rental housing than with HUD's inability to manage the programs.

3. FANNIE MAE AND FREDDIE MAC

As discussed earlier, Fannie Mae's multifamily activity has grown considerably in the last few years. At the end of the third quarter of 1990, Fannie Mae's multifamily programs had $17.9 billion in loans. Of the total portfolio, $6.9 billion are conventional loans, $6.5 billion are conventional loans with recourse, and $4.5 billion are 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 where there is 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. Delinquency rates are based on dollar amounts and reflect loans for which payments are over 60 days late, plus foreclosures. The figures represent multifamily loans held in Fannie Mae's portfolio as well as loans which are securitized and guaranteed by Fannie Mae (MBS).[22]

Fannie Mae's delinquency rates rose from just over 2% in the third quarter of 1986 to a peak of 6.6% in the fourth quarter of 1988. By the end of the third quarter of 1990, the delinquency rate had declined to 1.3%. Losses or chargeoffs in the Fannie Mae multifamily programs were $23 million in 1987, $29.1 million in 1988, and $38.2 million in 1989. Through the end of the third quarter of 1990, multifamily chargeoffs are $32.3 million.

[21] "Audit of the consolidated statements of the financial position of the Federal Housing Administration," Price Waterhouse, September 15, 1989.

[22] Data on Fannie Mae's multifamily programs from Investor/Analyst Meeting: Multifamily Housing Program (reference materials and slide presentation), Fannie Mae, November 29, 1990.

Interviews with Fannie Mae staff suggest that delinquencies and losses are mainly attributed to their 1984 to 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.

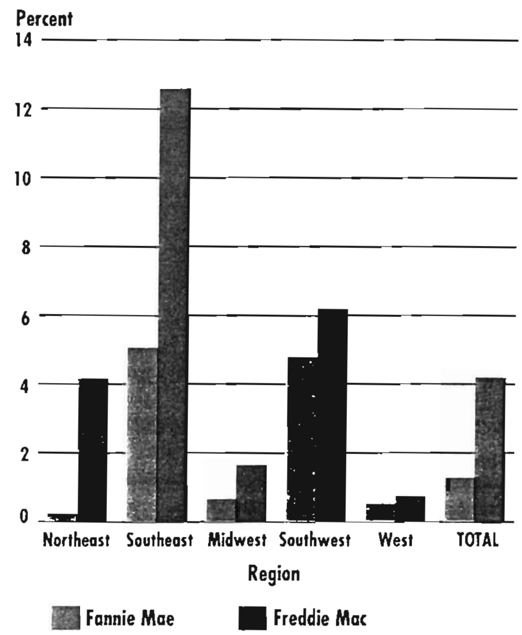
As discussed earlier, Freddie Mac has experienced significant losses in its multifamily programs recently and, as a result, has largely closed its multifamily programs. At the end of the third quarter of 1990, Freddie Mac's multifamily portfolio totaled \$11 billion; \$9.7 billion was generated through the cash program and \$1.3 billion from the guarantor program. Delinquency rates are based on dollar amounts and reflect loans for which payments are over 60 days late, plus foreclosures. Since very few of the loans in Freddie Mac's portfolio are credit enhanced, we assume that Freddie Mac bears the full risk for any losses in their portfolio.[23]

Freddie Mac's delinquency rate rose from 2.24% at the end of 1988 to 2.53% at the end of 1989. At the end of the third quarter of 1990, delinquencies stood at 3.78%. The delinquency rate was 4.19% for the cash program and 0.82% 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 meant that their payment histories could be assessed; most of the loans were originated by depository institutions that intended to hold them and therefore underwrote them as investments; some of the loans had credit enhancements; and, finally, many of the loans were on properties located in the West where property values increased substantially.[24]

Freddie Mac's multifamily losses have risen dramatically from \$3 million in 1986 to \$14 million in 1987, \$40 million in 1988, and \$98 million in 1989. As of September 30, 1990, multifamily chargeoffs were \$122 million. Freddie Mac staff have stated that in terms of dollars, multifamily mortgages represented only 3% of their business but over 50% of their losses.

FIGURE 10

FANNIE MAE AND FREDDIE MAC DELINQUENCY RATES, 9/30/90



60+ days delinquencies plus foreclosures in process

Both Fannie Mae and Freddie Mac have indicated that their multifamily problems are geographically concentrated. As shown in Figure 10, delinquencies for 1990 for both agencies are highest in the Southeast and the Southwest.[25] Within those regions, Georgia and Texas present the largest problems. Freddie Mac's delinquency rates are higher in all regions with the most significant differences occurring in the Southeast and Northeast. Freddie Mac's difficulties in those regions are concentrated in Atlanta and New York.

The data presented in this section raise the obvious question of why Freddie Mac's multifamily performance is so much worse than Fannie Mae's. The Fannie Mae and Freddie Mac performance data presented here were just released and provide an extensive review of multifamily activities. As both organizations continue to analyze their multifamily portfolios and more information becomes available, we will know more about what caused the prob-

[23] Data on Freddie Mac's multifamily programs are from the "Multifamily Portfolio Analysis" in Freddie Mac's new release on Third Quarter Earnings, October 31, 1990.

[24] "Multifamily Portfolio Analysis," p. 4.

[25] These delinquency rates are based on Freddie Mac's definitions of regions. See Table F in Appendix 3 for further details. The Freddie Mac data presented in Figure 10 are for the cash program only.

lems at Freddie Mac. From what we have seen to date, we make the following observations.

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 & Company, both Fannie Mae and Freddie Mac have guidelines concerning debt coverage ratios and loan-to value ratios, but Freddie Mac focussed on the loan-to-value ratio rather than the debt service coverage ratio. While loan-to-value 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. Equity analysts at Paine Webber argue that Freddie Mac was more lax about knowing the lenders who were originating the loans and auditing the underwriting standards that were being used.[26]

Interviews with Freddie Mac staff indicate that Freddie Mac did not really develop the special expertise necessary to underwrite and service multifamily loans. It should be noted that Fannie Mae began to develop more expertise in this area in late 1987 and 1988 after facing some problems in their multifamily portfolio. However, Fannie Mae's problems did not reach the magnitude of Freddie Mac's current situation because their level of activity in the multifamily market was relatively small at the time.

The experiences at Freddie Mac and Fannie Mae suggest that multifamily lending requires special expertise. As suggested earlier, there has to date been very little data collected on multifamily performance. In addition, unlike the single family mortgage market, there has been very little analysis of the determinants of multifamily defaults. More research in this area could improve significantly the underwriting of these mortgages as well as their performance.

There is no question that the data presented above paints a rather bleak picture of the performance of multifamily mortgages. The well publicized problems at FHA and Freddie Mac have led many to conclude that multifamily mortgages, particularly those on low- and moderate-income housing, are very risky investments. In our interviews, many argued that this is an unfortunate time to examine the performance of these mortgages given the problems in the real estate market, particularly in the Southwest, and the deep problems at HUD.

4. 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 companies, non-profit lenders, state housing finance agencies). In sharp contrast to the default experience outlined above, specialists in low- and moderate-income housing that we interviewed repeatedly reported to us strong multifamily portfolios showing few if any defaults.

Plausible explanations of this marked difference in performance include:

1. Differing definitions and standards of performance.

2. Lower vacancy rates in low/mod projects than market rate developments, both because of insufficient supply and tenant subsidy programs, resulting in less market risk.

3. "Creaming" of subsidy-rich deals by specialists in low- and moderate-income housing; these deals, bolstered by the subsidies, have less risk.

4. A greater investment in making the project work, and a tendency to closely monitor each project, on the part of those focused on low- and moderate-income housing. If the project is in trouble they intervene early and manage workouts; their work with the projects may be more labor-intensive.

5. Special expertise in underwriting and managing low- and moderate-income projects that the industry at large has not developed.

There are different definitions of delinquency and default within the industry. 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. These lenders may categorize loans as delinquent or non-performing later in the process

[26] Goldman, Sachs and Company, "Freddie Mac: Multi-Family," October 19, 1990. Paine Webber, "Federal Home Loan Mortgage Corporation," October 19, 1990. See also First Boston, Freddie Mac, November 1,

than do traditional market rate lenders. If there are differences in the way market rate and affordable loans are traditionally considered delinquent or non-performing, is one a more accurate measure of the loan's ultimate performance?

In many markets, the rental income stream 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.

The notion that specialists in low- and moderate-income housing cream the best subsidy-rich deals and hence have fewer defaults is based on the assumption that taking advantage of the diversity of subsidy programs available 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 subsidy programs available.

In our interviews, underwriters and servicers clustered in CRA branches of banks, social investment departments of life 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. Some of these specialists point to specific tools of the trade that they use, such as the use of letters of credit from developers/contractors. Others suggest that the development of a special relationship with developers allows them to better judge capacity and track record.

Arguably, those focused on low- and moderate-income housing watch their project 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, as does the Enterprise Foundation, have broader economic development goals tied to the multifamily project, and thus 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.

The divergence between the experience of specialists in low- and moderate-income housing and the industry as a whole merits additional attention. Our research suggests that the success of these specialists may be due to a special expertise in underwriting and management, and to the fact that these specialists can spend more time on project management since they do far fewer projects. The question is to what extent can the industry learn from the specialists and develop more expertise to improve the performance of multifamily mortgages. Perhaps Fannie Mae has begun this process. As stated earlier, we need to improve our understanding of the determinants of delinquency and default through more data and analysis before we can identify with certainty the reasons for the apparent success of these specialists.

D. Credit Enhancement: Adjusting for Risk

The FHA multifamily mortgage insurance programs have long been the major source of credit enhancement for multifamily mortgages. As already discussed, the financial problems at FHA an d the recent cancellation of the co-insurance program have substantially reduced FHA's presence in the multifamily market. From our interviews it is clear that many experts view poor management by HUD as the major problem with the co-insurance program. However, with the current problems at HUD, it seems clear that FHA insurance will not be a major factor in the multifamily mortgage market in the near future.

Unlike the single family market, there has been very little private mortgage insurance offered for multifamily mortgages. Currently, various forms of credit enhancement are provided by some state and local governments, the federal credit agencies, and the private sector. These efforts do not supply the wide coverage that the FHA programs provided. In many cases, the credit enhancement takes the form of providing a guarantee on the mortgage. For example, Fannie Mae may provide its guarantee on a mortgage that it does not own for a fee. With the diminished role of FHA in this market, there is considerable pressure to expand the efforts of other actors.

E. The Rating Agencies

An alternative approach to providing more comfort to potential investors is to obtain a rating from one of the rating agencies. Essentially, a developer or lender would seek to issue a bond or bonds backed by either a single multifamily mortgage or by a portfolio of multifamily mortgages. The rating agency would provide a rating on the bonds.

To date, few attempts at getting a rating for bonds backed by multifamily mortgages have been successful. Our interviews with the rating agencies suggest several issues with obtaining a rating. For an AA rating, the rating agencies are looking for debt service coverage around 1.5 and an LTV of 50%; for a BBB rating, the debt service coverage required drops to 1.3 and the LTV rises to 65%. In the ACLI data for 1989, multifamily mortgages had an average debt service coverage of 1.24. In our interviews with low- and moderate-income housing specialists, it was clear that the rating agency standards would be very difficult to meet.

In addition, the rating agencies indicated that it would not make sense to seek a rating for a transaction under $40 million. In the multifamily market, 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.

F. The Mortgage-Backed Securities (MBS) Market

As shown in Section II of this report, the market for multifamily MBS has grown substantially in recent years, but even with this growth, the volume of activity remains relatively small. It is not surprising that investors consider multifamily MBS less liquid. 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 of the issues regarding investor perceptions of rental housing discussed above.

In our interviews, investment bankers suggested several reasons why the secondary market is less developed for multifamily mortgages than for single family mortgages. Lack of standard-ization in multifamily mortgages makes it more difficult to package them into a security. An MBS requires that the underlying mortgages be similar in many respects. To the extent that the mortgages are nonstandard, it is difficult to pool them into securities.

Multifamily mortgages are often viewed as less risky to the investor than single family mortgages because they traditionally have had prepayment protection in the form of either a lock- out period during which the borrower cannot prepay, or yield maintenance, which limits the loss to the investor due to prepayment. Even with such protections, however, prepayments may still be perceived as a problem since lockouts or yield maintenance generally cover a relatively short period of time (5-7 years). Since an individual loan is large relative to a mortgage pool, a single prepayment has a greater impact on a pool's performance. However, 5-7 years covers a significant portion of the mortgage term and yield maintenance does provide at least some prepayment protection not available in the single family market.

Many of the investment bankers that we interviewed indicated that 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 this history as well as comparisons to other investments such as long-term Treasuries. In our interviews, we found almost no tracking of the multifamily MBS market. Hence, there is no history for investors to assess.

As a result of a relatively inactive secondary market, several nonprofits and banking consortia across the country are trying to create their own secondary markets. 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. It is difficult to assess the potential for these efforts since most of them are relatively new and there is so little volume to evaluate.

VI. Key Issues To Be Addressed

The issues raised in this report suggest that there are obstacles to accessing capital markets for multifamily housing in general and low- and moderate-income housing in particular. The secondary market for multifamily mortgages is in an early stage of development resembling the single family secondary market of twenty years ago. However, the market is at a point of transition. With the S&L crisis, there is pressure to find alternative sources of funding for multifamily loans. A more active secondary market could provide access to a broad range of alternative sources of funds.

However, expanding access to capital for multifamily housing requires standardization of multifamily mortgage loans, increased credit quality with better underwriting and credit enhancement, and educating investors with respect to the structure of the underlying mortgage instrument and the performance and risks of multifamily securities. The industry should define a small number of multifamily mortgage products and design mortgage documents which would represent the industry standard. 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.

In addition, we need to collect consistent data over time on the performance of multifamily projects in order to increase our understanding of the risks and returns on these projects. On the debt side, we need to analyze default data in order to identify the key determinants of risk in multifamily lending. Part of this effort should focus on understanding the current approaches to underwriting by successful specialists in low- and moderate-income housing. This work will help to develop better underwriting practices for the industry and increase overall credit quality. 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 must be assessed.

Expanding access to capital for low- and moderate-income housing requires that the financing be structured in such a way 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 and 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.

Institutional investors such as pension funds and life insurance companies as well as the investment banking community have very little expertise in either the debt or equity side of rental housing. It is important to provide data on the performance of rental housing as an investment to these players. On the debt side, there needs to be better tracking of the performance of multifamily mortgages and MBS so that investors can compare them to alternative investments. As was the case in the development of the single family market, the investment community must be educated as to the relative merits of investing in multifamily mortgages.

Expanding the potential market for equity investments in multifamily housing requires an increased understanding of the risks and returns of these investments. For multifamily housing targeted at low- and moderate-income households, the LIHTC is the current fashion for raising equity. As understanding of the LIHTC has increased, 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.

♦ ♦ ♦ ♦ ♦ ♦ ♦

Given that the mission of the Task Force is to facilitate access to capital for low- and moderate-income housing, our report suggests four areas of focus:

- Underwriting: What are the key variables in assessing the risk of multifamily mortgages? To what extent do low- and moderate-income projects require different underwriting standards than the current industry standards? What lessons might be learned from the successful underwriting practices of specialists in low- and moderate income housing that can improve underwriting for the industry as a whole?
- Mortgage Design and Development: What are the elements of the mortgage instrument that must be standard in order to increase its marketability? What are the alternative mortgage designs that meet the standardization requirements? Is a fixed rate, level-payment self amortizing mortgage a viable product for multifamily housing? How does the mortgage design influence the design of a mortgage security?
- Financing Structures for Low- and Moderate-Income Housing: To the extent that low- and moderate-income housing requires tenant- or project-based subsidies, how should the subsidies be structured to maintain the marketability of the conventional portion of the financing? Is standardization of the structure of public subsidies required?
- Investor Education: What kinds of information are required by investors to understand the risks and returns of investment in multifamily housing? Who should collect these data?

APPENDIX

A

APPENDIX A: TASK FORCE MEMBERS

LOW- AND MODERATE-INCOME HOUSING FINANCE TASK FORCE

MEMBERS AND DEPUTIES
November 14, 1990

TASK FORCE MEMBER	DEPUTY:
Harry W. Albright, Jr. Chairman The Dime Savings Bank New York, NY	**Paul F. Washington** Assistant to the Chairman and Vice President The Dime Savings Bank New York, NY
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Gregory T. Barmore Chairman, President & CEO GE Mortgage Capital Corporation Raleigh, NC	**Mark E. Goldhaber** First Vice President GE Mortgage Capital Corporation Raleigh, NC
Richard D. Baron President & CEO McCormack, Baron & Associates, Inc. St. Louis, MO	**Stuart A. Davis, Jr.** Executive Vice President McCormack, Baron & Associates, Inc. St. Louis, MO
Gaye G. Beasley President The Patrician Mortgage Company Washington, D.C.	**Eric Stevenson** Senior Staff Vice President Mortgage Bankers Association of America Washington, D.C.
Robert A. Bowman State Treasurer Lansing, MI	**Barry L. Stevens** Director of Investments Michigan Department of Treasury Bureau of Investments Lansing, MI
Barbara A. Cleary President AJ Group, Inc. Boston, MA	**David Ennis** President AJ Group Securities Boston, MA
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* This is not a complete list of everyone we talked with over the course of this project. Those listed have participated in our formal interviews. The titles and organizations represent the position held at the time of the interview. For those whom we know have left their organization or changed positions within their organization, we have included "Former" in their title.

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APPENDIX C: TABLES

TABLE A

TOTAL REAL ESTATE LOAN ORIGINATIONS AND HOLDINGS*

1980–1989 (Millions of Dollars)

	ORIGINATIONS				HOLDINGS			
	Single Family	Multi-Family	Non-Residential	Total	Single Family	Multi-Family	Non-Residential	Total
1980	133,762	12,497	35.923	182,182	857,526	113,945	204,910	1,176.381
1981	98,212	11,971	32.487	142,670	913,940	113,298	217,748	1,244,986
1982	96,951	11,633	34.524	143,108	948,134	117,928	231,692	1,297,754
1983	201,863	21.441	62.448	285,752	1.032,196	125,581	257,602	1,415,379
1984	203,705	27,576	77.348	308,629	1.182,613	145,560	299,436	1,627,609
1985	243,075	31.931	99.360	374,366	1.294,430	160,816	337,265	1,792,511
1986	455,054	49,868	147.374	652,296	1.506,944	190,034	393,447	2,090,425
1987	449,544	44.981	168.652	663,177	1.712,298	207,363	466,110	2,385,771
1988	374,401	37,876	175.754	588,031	1.897,775	222,509	505,468	2,625,752
1989	352,026	31.145	149.950	533.121	2.109,493	230,997	534,122	2,874.612

*Excluding Farm Properties and Land Loans

SOURCE: Tables 1 and 3, Survey of Mortgage Lending Activity Annual Tables, Office of Financial Management, U.S. Department of Housing and Urban Development

TABLE B

HUD-Insured Share of Multifamily Mortgages

New and Existing Properties

1980-1989

Year	TOTAL	Conventional	HUD Insured	% of Total
1980	12,497	8,609	3.888	31.1%
1981	11,971	8.092	3.879	32.4%
1982	11,633	7,552	4.081	35.1%
1983	21,441	17.473	3.968	18.5%
1984	27,576	22.925	4.651	16.9%
1985	31,931	28,449	3.482	10.9%
1986	49,868	41,128	8.740	17.5%
1987	44,981	38,153	6.828	15.2%
1988	37.876	34,927	2.949	7.8%
1989	31,145	30,197	948	3.0%

SOURCE: Table 4, Survey of Mortgage Lending Activity, Annual Tables, Office of Financial Management, U.S. Department of Housing and Urban Development

TABLE C

MULTIFAMILY LOAN ACTIVITY FOR ELEVEN MAJOR LENDER GROUPS

1980-1989 (Millions of dollars)

MORTGAGE LOAN ORIGINATIONS:

		Commercial Banks		Mutual Savings Banks		Savings and Loan Assocs.		Life Insurance Companies		Pension and Retirement Funds*		Federal Credit Agencies		State and Local Credit Agencies		Mortgage Companies		Private MBS Conduits		Mortgage Pools	
Year	Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
1980	12,498	1,247	10.0%	543	4.3%	3,100	24.8%	1,427	11.4%	131	1.0%	2,932	23.5%	1,356	10.8%	1,633	13.1%	129	1.0%	0	0.0%
1981	11,971	1,491	12.5%	593	5.0%	2,339	19.5%	753	6.3%	78	0.7%	3,215	26.9%	1,382	11.5%	2,051	17.1%	69	0.6%	0	0.0%
1982	11,633	1,660	14.3%	561	4.8%	3,171	27.3%	438	3.8%	25	0.2%	3,364	28.9%	1,395	12.0%	960	8.3%	59	0.5%	0	0.0%
1983	21,441	3,517	16.4%	1,968	9.2%	8,521	39.7%	1,597	7.4%	20	0.1%	2,837	13.2%	2,415	11.3%	566	2.6%	0	0.0%	0	0.0%
1984	27,576	3,466	12.6%	2,053	7.4%	13,160	47.7%	1,466	5.3%	18	0.1%	2,407	8.7%	4,563	16.5%	443	1.6%	0	0.0%	0	0.0%
1985	31,931	4,498	14.1%	870	2.7%	15,612	48.9%	2,772	8.7%	71	0.2%	2,000	6.3%	3,362	10.5%	2,746	8.6%	0	0.0%	0	0.0%
1986	49,868	7,176	14.4%	2,892	5.8%	19,877	39.9%	3,723	7.5%	19	0.0%	1,739	3.5%	7,270	14.6%	7,172	14.4%	0	0.0%	0	0.0%
1987	44,981	8,299	18.5%	4,773	10.6%	17,719	39.4%	3,547	7.9%	27	0.1%	1,120	2.5%	7,087	15.8%	2,409	5.4%	0	0.0%	0	0.0%
1988	37,875	6,988	18.5%	2,853	7.5%	17,526	46.3%	3,553	9.4%	116	0.3%	1,155	3.0%	1,158	3.1%	4,526	11.9%	0	0.0%	0	0.0%
1989	31,145	7,669	24.6%	2,059	6.6%	11,410	36.6%	2,786	8.9%	48	0.2%	1,194	3.8%	1,536	4.9%	4,443	14.3%	0	0.0%	0	0.0%

MORTGAGE LOAN HOLDINGS:

		Commercial Banks		Mutual Savings Banks		Savings and Loan Assocs.		Life Insurance Companies		Pension and Retirement Funds*		Federal Credit Agencies		State and Local Credit Agencies		Mortgage Companies		Private MBS Conduits		Mortgage Pools	
Year	Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
1980	113,941	6,482	5.7%	14,711	12.9%	34,327	30.1%	19,017	16.7%	3,966	3.5%	15,768	13.8%	9,979	8.8%	1,697	1.5%	791	0.7%	7,206	6.3%
1981	113,298	7,098	6.3%	14,249	12.6%	35,817	31.6%	18,906	16.7%	4,766	4.2%	15,531	13.7%	11,172	9.9%	1,201	1.1%	0	0.0%	4,558	4.0%
1982	117,928	7,637	6.5%	13,751	11.7%	37,210	31.6%	18,298	15.5%	5,430	4.6%	15,385	13.0%	12,639	10.7%	1,360	1.2%	1,360	1.2%	4,858	4.1%
1983	125,581	9,299	7.4%	13,684	10.9%	41,034	32.7%	18,680	14.9%	6,132	4.9%	15,031	12.0%	15,152	12.1%	638	0.5%	0	0.0%	5,931	4.7%
1984	145,560	10,887	7.5%	13,742	9.4%	51,151	35.1%	18,591	12.8%	5,355	3.7%	18,554	12.7%	19,703	13.5%	169	0.1%	0	0.0%	7,408	5.1%
1985	160,817	11,979	7.4%	8,511	5.3%	62,169	38.7%	19,273	12.0%	5,679	3.5%	23,664	14.7%	22,871	14.2%	449	0.3%	0	0.0%	6,192	3.9%
1986	190,034	15,173	8.0%	9,670	5.1%	68,487	36.0%	20,394	10.7%	6,170	3.2%	25,288	13.3%	32,700	17.2%	1,061	0.6%	0	0.0%	11,091	5.8%
1987	207,363	16,673	8.0%	12,695	6.1%	71,241	34.4%	22,005	10.6%	6,130	3.0%	25,821	12.5%	37,349	18.0%	214	0.1%	0	0.0%	15,232	7.3%
1988	222,509	16,824	7.6%	13,512	6.1%	76,580	34.1%	23,925	10.8%	5,690	2.6%	27,796	12.5%	38,112	17.1%	474	0.2%	0	0.0%	19,596	8.8%
1989	230,997	19,077	8.3%	14,513	6.3%	76,489	33.1%	21,615	9.4%	5,918	2.6%	31,261	13.5%	39,090	16.9%	275	0.1%	0	0.0%	22,729	9.8%

CONSTRUCTION LOAN HOLDINGS:

		Commercial Banks		Mutual Savings Banks		Savings and Loan Assocs.		Life Insurance Companies		Pension and Retirement Funds*		Federal Credit Agencies		State and Local Credit Agencies		Mortgage Companies		Private MBS Conduits		Mortgage Pools	
Year	Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
1980	13,755	5,477	39.8%	613	4.5%	3,032	22.0%	4	0.0%	91	0.7%	1,717	12.5%	1,419	10.3%	1,040	7.6%	362	2.6%	0	0.0%
1981	14,488	6,935	47.9%	708	4.9%	2,156	14.9%	10	0.1%	53	0.4%	2,576	17.8%	1,354	9.3%	696	4.8%	0	0.0%	0	0.0%
1982	17,015	7,472	43.9%	610	3.6%	3,076	18.1%	15	0.1%	37	0.2%	3,399	20.0%	1,792	10.5%	614	3.6%	0	0.0%	0	0.0%
1983	24,624	7,711	31.3%	472	1.9%	8,692	35.3%	34	0.1%	23	0.1%	4,196	17.0%	3,035	12.3%	461	1.9%	0	0.0%	0	0.0%
1984	26,380	8,098	30.7%	697	2.6%	12,206	46.3%	21	0.1%	22	0.1%	1,596	6.1%	3,492	13.2%	248	0.9%	0	0.0%	0	0.0%
1985	27,872	9,636	34.6%	785	2.8%	10,262	36.8%	68	0.2%	21	0.1%	1,426	5.1%	5,174	18.6%	500	1.8%	0	0.0%	0	0.0%
1986	36,699	13,391	36.5%	1,442	3.9%	10,282	28.0%	74	0.2%	19	0.1%	1,378	3.8%	9,600	26.2%	513	1.4%	0	0.0%	0	0.0%
1987	42,323	15,611	36.9%	2,895	6.8%	14,858	35.1%	99	0.2%	25	0.1%	1,215	2.9%	7,446	17.6%	174	0.4%	0	0.0%	0	0.0%
1988	38,856	15,418	39.7%	3,614	9.3%	15,407	39.7%	139	0.4%	22	0.1%	1,055	2.7%	2,946	7.6%	255	0.7%	0	0.0%	0	0.0%
1989	38,081	17,965	47.2%	3,304	8.7%	13,654	35.9%	122	0.3%	12	0.0%	880	2.3%	1,808	4.7%	336	0.9%	0	0.0%	0	0.0%

*Includes Private Non-Insured Pension Funds and State & Local Retirement Funds

SOURCE: Tables 1 and 3, Survey of Mortgage Lending Activity, Annual Tables
Office of Financial Management
U.S. Department of Housing and Urban Development

TABLE D

MULTIFAMILY HOUSING STARTS

Year	Five or More Units
1970	535.9
1971	780.9
1972	906.2
1973	795.0
1974	381.6
1975	204.3
1976	289.2
1977	414.4
1978	462.0
1979	429.0
1980	330.5
1981	287.7
1982	319.6
1983	522.0
1984	544.0
1985	576.1
1986	542.0
1987	408.7
1988	348.0
1989	317.6

SOURCE: Housing Starts — "Table 1. New Privately Owned Housing Units Started: 1959-1989," Census Construction Division

TABLE E

ANNUAL MORTGAGE DELINQUENCY AND COMPLETED FORECLOSURE RATES

	DELINQUENCIES			COMPLETED FORECLOSURES		
	Multifamily	1-4 Family	Non-Residential	Multifamily	1-4 Family	Non-Residential
1965	1.65	1.02	0.43	0.33	0.47	0.06
1966	1.34	0.94	0.57	0.86	0.44	0.08
1967	1.47	0.81	0.49	0.38	0.34	0.07
1968	0.90	0.68	0.41	0.31	0.24	0.18
1969	0.73	0.73	0.30	0.16	0.15	0.14
1970	1.05	0.89	0.70	0.29	0.15	0.13
1971	1.01	0.93	0.83	0.20	0.15	0.13
1972	1.46	1.05	0.98	0.67	0.16	0.15
1973	2.66	1.01	1.23	0.52	0.15	0.09
1974	4.23	1.09	2.33	0.82	0.13	0.13
1975	5.87	1.22	3.56	1.66	0.16	0.68
1976	4.97	1.24	3.26	1.17	0.14	0.55
1977	3.94	1.34	2.10	0.77	0.11	0.59
1978	2.41	1.24	1.48	0.40	0.12	0.38
1979	1.01	1.09	0.61	0.23	0.08	0.20
1980	0.80	1.09	0.88	0.12	0.07	0.06
1981	0.63	1.20	0.60	0.05	0.09	0.05
1982	0.70	1.37	0.77	0.19	0.15	0.09
1983	0.85	1.37	0.85	0.07	0.23	0.10
1984	0.71	1.44	0.88	0.05	0.35	0.24
1985	2.15	1.59	0.94	0.12	0.43	0.29
1986	4.80	1.58	2.36	1.58	0.73	0.71
1987	4.34	1.22	2.42	1.95	0.88	0.81
1988	4.11	1.41	2.25	1.65	0.27	1.65
1989	3.07	1.38	2.32	1.77	0.25	1.77

Rates by amount of loans; delinquencies include foreclosures completed and in process.

SOURCE: Quarterly Survey of Mortgage Loan Delinquencies and Foreclosures, American Council of Life Insurance

TABLE F

FANNIE MAE AND FREDDIE MAC DELINQUENCY RATES, AS OF 9/30/90

(MILLIONS OF DOLLARS)

	FANNIE MAE			FREDDIE MAC		
	Loans Serviced	60+ Delinq	Delinq Rate	Loans Serviced	60+ Delinq	Delinq Rate
Northeast	2,307.2	5.4	0.23%	4,586.9	191.1	4.17%
Southeast	541.8	27.4	5.06%	1,157.4	145.9	12.61%
Midwest	1,345.6	8.8	0.65%	1,576.6	26.2	1.66%
Southwest	758.4	36.2	4.77%	450.6	28.0	6.21%
West	1,962.1	10.1	0.51%	1,917.4	14.8	0.77%
TOTAL:	6,915.1	87.9	1.27%	9,688.9	406.0	4.19%

Freddie Mac figures reflect cash program only and do not include the guarantor program. Fannie Mae figures represent at risk loans only (conventional loans without recourse or FHA insurance).

Delinquency Rates include loans in process of foreclosure.

States are grouped according to Freddie Mac regional definitions:

Northeast: CT, DE, DC, ME, MD, MA, NH, NJ, NY, PA, Puerto Rico, RI, VT, VA, Virgin Islands, WV
Southeast: AL, FL, GA, KY, MS, NC, SC, TN
Midwest (or North Central): IL. IN, IA, MI, MN, ND, OH, SD, WI
Southwest: AR, CO, KS, LA. MO. NB, NM, OK. TX. WY
West: AK, AZ, CA, Guam. HI. ID. MT, NV, OR, UT, WA

SOURCE: "Investor/Analyst Meeting: Multifamily Housing Program" (reference materials and slide presentation), Fannie Mae, November 29, 1990; and Tables 3, 4, and 5, Multifamily Portfolio Analysis in Freddie Mac's new release on Third Quarter Earnings, October 31, 1990.

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