Do FHA Multifamily Mortgage Insurance Programs Provide Affordable Housing and Serve Underserved Areas?[1]

An Analysis of FHA's Fiscal Year 1997 Book of Business and Comparison with the GSEs

I. Introduction and Main Findings

This paper presents the findings from a joint study by HUD's Offices of Policy Development and Research (PD&R) and Multifamily Housing Business Products (MFH-BP) on the affordability of unassisted multifamily rental units financed with mortgages insured by the Federal Housing Administration (FHA).[2] The study also classified each FHA-insured multifamily mortgage by the *served* or *underserved* status of the neighborhood in which the properties are located. The study's primary purpose is to determine whether and to what extent FHA's unassisted, general-occupancy multifamily mortgage insurance programs provide affordable rental housing, and whether these programs serve areas that are identified by HUD as being underserved by the mortgage market. A second purpose is to determine how the FHA programs compare (with regard to affordability and service to underserved areas) to the mortgages purchased by Fannie Mae and Freddie Mac, the two largest government-sponsored enterprises (GSEs) in the housing mortgage markets.

The FHA properties included in the study were all financed with multifamily mortgages initially endorsed for FHA insurance during fiscal year (FY) 1997. The GSE

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[2] Multifamily refers to properties with 5 or more rental units. Unassisted means the units do not receive federal rent subsidies such as Section 8. The FHA is part of HUD.

mortgages included in the study were all purchased during calendar year 1997 by Fannie Mae and Freddie Mac.

The FHA does not collect information on the actual incomes of tenants for unassisted units in its insured portfolio. Similarly, the GSEs generally do not have tenant incomes for multifamily mortgages they purchase. Thus, affordability in this study is determined by formula from the rents of the units relative to the median family income for the area. This methodology for determining affordability is the same one prescribed for use by the GSEs when reporting to the HUD Secretary on their achievement of the affordable housing goals set for them by the Secretary.[3] Using the same methodology allows the rent affordability underlying FHA-insured mortgages to be compared with that of mortgages purchased by the GSEs.

The definition of underserved area used in this study is the same one prescribed for use by the GSEs when reporting to the HUD Secretary on their achievement of the Secretary's affordable housing goals. An underserved area is either:

(1) a middle income area with a high minority population percentage (30 percent or higher), or

(2) a relatively low income area regardless of minority population percentage.[4]

Using the same underserved area definition as the GSEs allows FHA-insured projects to be compared with mortgages purchased by the GSEs.

The FHA's unassisted multifamily mortgage insurance programs are not explicitly targeted to low- or moderate-income occupancy or to underserved areas. FHA insures any application that meets statutory, marketability, and underwriting guidelines on a first-come first-served basis. The GSEs also do not explicitly target their existing housing multifamily mortgage purchases, although the GSEs have more flexibility than FHA (in terms of

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[3] *The Secretary of HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), Final Rule, 60 Fed. Reg. 61646, December 1, 1995, para. 81.19.*

[4] The terms "middle" and "relatively low" are not defined by the rule cited below, but are added here to help readers understand the concepts. Inside a metropolitan area (as defined by the Office of Management and Budget), a middle income area means the median income for the census tract is less than or equal to 120 percent of the median income for the entire metropolitan area. Outside of metropolitan areas, middle income area means the county median income is less than or equal to 120 percent of the state non-metropolitan median income. Inside a metropolitan area, a relatively low income area means the tract median income is less than or equal to 90 percent of the metropolitan area median income. Outside metropolitan areas, relatively low means the county median income is less than or equal to 95 percent of the state non-metropolitan median income (or national non-metropolitan median income, if greater). The precise definition of underserved area can be found in: *The Secretary of HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), Final Rule, 60 Fed. Reg. 61646, December 1, 1995, para. 81.2.*

business strategies such as negotiated purchases of seasoned loan portfolios) in meeting their affordable housing goals.[5]

Existing housing provides the most appropriate comparison between FHA and the GSEs for unassisted multifamily mortgages. Comparisons between FHA and the GSEs which include new construction are not appropriate because the GSEs' new construction business includes income-targeted forward commitment programs, equity investments in tax credit projects, and credit enhancement of state agency bonds, none of which are comparable to FHA's unassisted new construction and substantial rehabilitation programs.

While the similarities between FHA and the GSEs are many with regard to multifamily mortgages on existing housing, there are some notable differences in underwriting terms. Specifically, the GSEs' underwriting is more conservative than FHA's. FHA offers higher loan-to-value ratios, lower debt service coverage ratios, and longer fixed rate mortgage terms under its Section 223(f) program than do the GSEs under their basic lending programs.[6]

The main findings of this study are:

- **FHA's unassisted multifamily mortgage insurance programs do provide affordable rental housing.** For existing housing, 97 percent of the FHA units studied were affordable to families with incomes at the area median income, and 45 percent were affordable at 60 percent of area median income. As one might expect due to the generally higher per unit costs for new construction or substantial rehabilitation, affordability at 100 percent and 60 percent of median income for FHA's new construction/substantial rehab units in the study were somewhat less at 91 and 22 percent, respectively.[7]

[5] Some GSE new construction product lines are explicitly targeted to low-income occupancy. The GSEs (primarily Fannie Mae in 1997) participated in the financing of newly constructed units through income-targeted forward commitment products, equity investments in Low Income Housing Tax Credit projects, and credit enhancements for state and local housing agency tax exempt bonds used to finance multifamily construction. Since it is not possible to distinguish between income-targeted units and non-targeted units in the Public Use Database, and since new construction was a small part of the GSEs' multifamily business in 1997, all new construction units reported by the GSEs are excluded from this study.

[6] The GSEs' basic lending programs are Fannie Mae's Delegated Underwriting and Servicing (DUS) program and Freddie Mac's cash purchases through its Program Plus lenders. FHA's Section 223(f) program offers 85 percent LTV, minimum DSC of 1.0 to 1.175, and 35 year fully amortizing FRM terms. Fannie Mae's DUS program offers 77 percent LTV, DSC no less than 1.25, and balloon loans up to 18 years with 25 year amortization. Freddie Mac offers 80 percent LTV, DSC no less than 1.25, and balloon loans or fully amortizing 25-year FRM terms. See GMAC Commercial Mortgage Corporation, "Mortgage Money Update," 4(1), 1998.

[7] The percent FHA's new construction and substantial rehabilitation units which are affordable at any given percentage of area median income may actually increase by the time the construction is completed, typically 18 to 24 months after initial insurance endorsement. The reason is that the rents are set before construction starts, but area median income may rise during the construction period.

- **FHA's unassisted multifamily programs do serve underserved areas.** About 40 percent of FHA's existing housing units in this study (representing 46 percent of the existing housing projects) were located in underserved areas. Similarly, 36 percent of FHA's new construction or substantial rehabilitation units (representing 34 percent of the NC/SR properties) were in underserved areas.

- **FHA's existing housing endorsements were very similar to the GSEs' multifamily loan purchases for existing housing in terms of affordability and service to underserved areas.** Figure 1 shows the affordability comparison between FHA and the GSEs for existing housing. About 45 percent of FHA's FY 1997 existing housing units were affordable to families with incomes at or below 60 percent of area median income. The corresponding shares for Fannie Mae's and Freddie Mac's 1997 multifamily purchases were 45 and 47 percent, respectively. Figure 2 shows a comparison between FHA and the GSEs on service to underserved areas. For FHA's FY 1997 existing units, 40 percent were located in underserved areas. The corresponding shares for Fannie Mae's and Freddie Mac's 1997 multifamily purchases were 39 and 44 percent, respectively.

- **FHA units located in underserved areas were much more affordable than FHA units in adequately served areas.** Figure 3 shows that 52 percent of FHA's combined new construction and existing units located in underserved areas were affordable at 60 percent of area median income or less. The corresponding figure for FHA units located in served areas is only 26 percent.[8] This difference suggests that rents in the FHA projects studied were relatively lower in underserved areas. An analysis of the reasons for the rent difference that controls for the various factors affecting rent levels was beyond the scope of this study.

The finding of greater affordability for FHA's FY 1997 units in underserved areas compared with those in served areas is a recommended topic for further research. To some extent this may just reflect market differences – that is, underserved areas may be generally characterized by more affordable rents. However, differences in affordability of the magnitudes observed may also be the result of higher usage of state or locally funded subsidies, or low-income housing tax credits in underserved areas. Subsidies and tax credits can lower rents by reducing debt levels that projects need to support.[9] This additional research could also examine the role the GSEs currently play in financing

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[8] The GSEs' existing housing units in underserved areas are similarly more affordable than those in served areas. For Fannie Mae, 53 percent of existing units in underserved areas were affordable at 60 percent of area median income, compared to only 41 percent in served areas. The corresponding percentages for Freddie Mac's existing units were 61 and 35 percent, respectively.

[9] A recent study by the United States General Accounting Office found that FHA's multifamily risk-sharing demonstration programs were able to exceed affordability targets through the use of subsidies and tax credits..United States General Accounting Office, *FHA's Risk-Sharing Programs Offer Alternatives for Financing Affordable Housing*, Washington, DC, 1998, GAO/RCED-98-117.

multifamily properties which receive subsidies or tax credits, and it would support policy debate on the appropriate roles for FHA and the GSEs in this regard.

The remainder of this paper is organized as follows. Section II provides background on FHA's multifamily programs and the GSEs' affordable housing goals. Section III describes the methodology for determining rent affordability and underserved area status. Section IV describes the types of multifamily projects included in the study. Findings are discussed in more detail in Section V, followed by the study's conclusions in Section VI.

Figure 1
1997 Multifamily Unit Comparison: FHA and GSEs
Proportion of Units in Affordability Categories

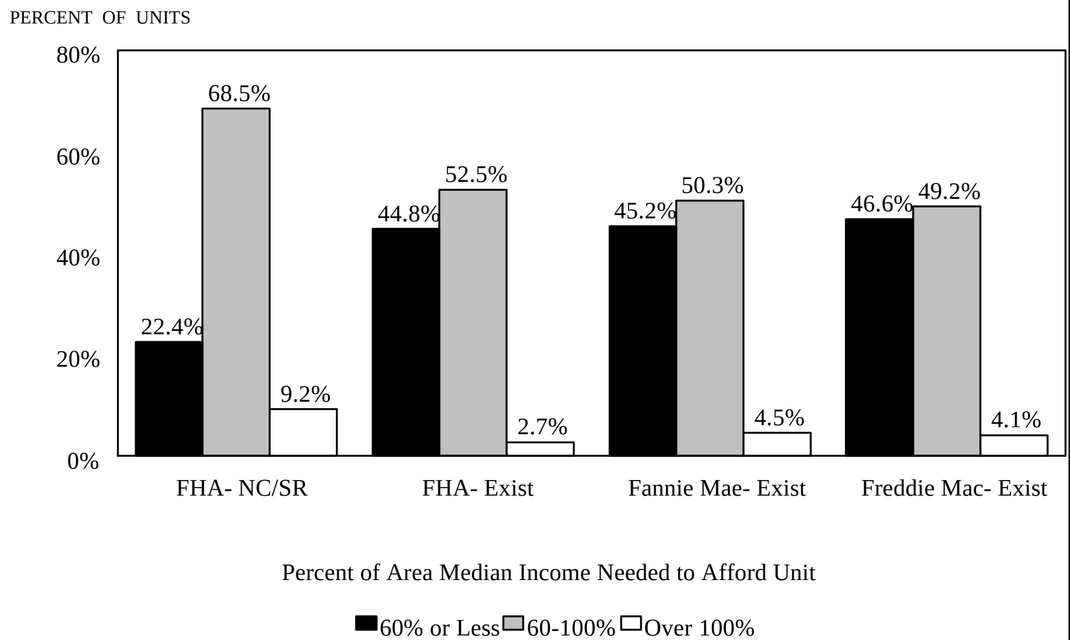


Figure 2
1997 Multifamily Unit Comparison: FHA and GSEs
Proportion of Units in Served/Underserved Areas

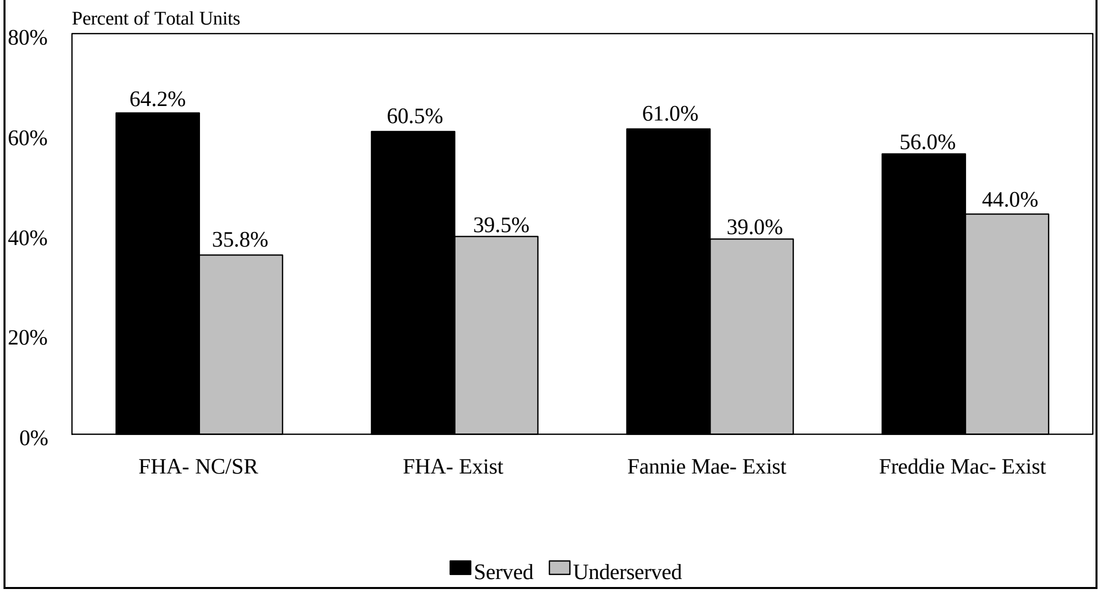
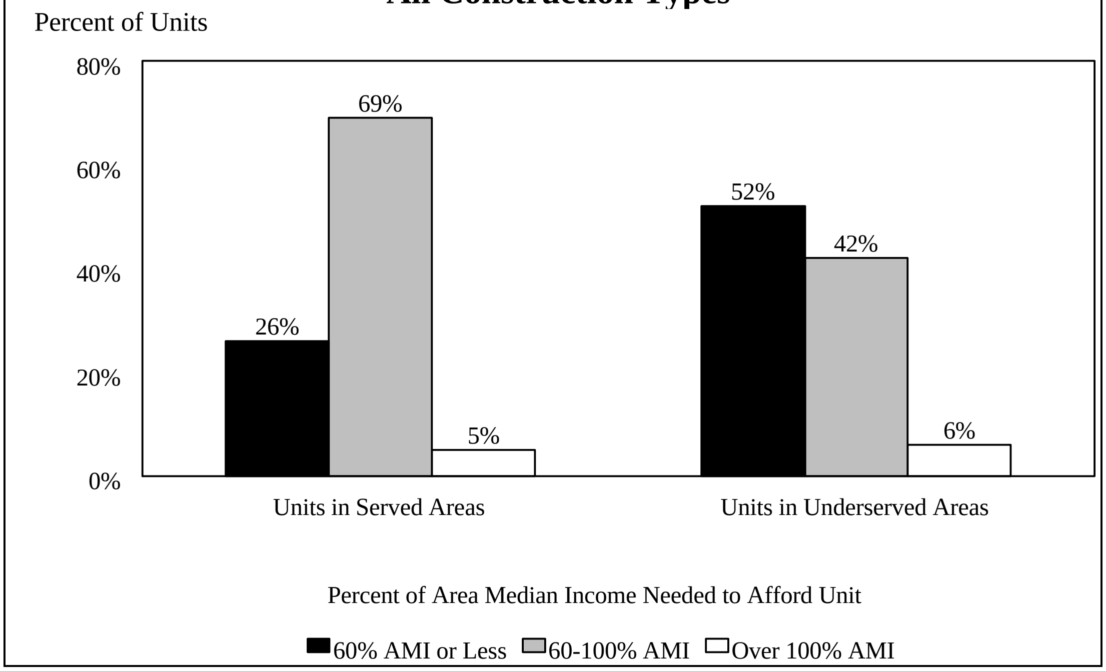


Figure 3
Differences in FHA Affordability by Served/Underserved Areas, 1997
All Construction Types



II. Background

A. Overview of FHA Multifamily Mortgage Insurance

The basic function of FHA mortgage insurance is to encourage lenders to make loans to private sponsors or owners of rental housing by insuring the lender against losses incurred when borrowers default on their mortgages. FHA charges all borrowers an insurance premium to cover the cost of claims it pays out.[10]

The FHA has a long history of insuring multifamily mortgages. FHA's statutory authority to insure multifamily mortgages dates back to the 1930s, although it was not widely used until much later. The statute did not set income guidelines for tenants in FHA-insured multifamily housing and did not provide project- or tenant-based subsidies. Rather, it set ceilings on the per-unit mortgage amount that were intended to keep the program focused on middle-income housing rather than luxury housing. In the 1960s through the early 1980s, FHA multifamily insurance became associated with lower-income occupancy as special programs were developed with interest rate subsidies (for example, Sections 236 and 221d3 BMIR), and standard multifamily insurance products were used with project-based rental assistance (for example, Section 221d4 in combination with Section 8 new construction). In the 1990s these subsidies have not been generally available; thus FHA's recent multifamily production has returned to its middle-income focus.[11] Absent federally-funded interest rate subsidies or project-based rental assistance, FHA-insured multifamily mortgages are often termed *unassisted* even though projects may receive grants, tax concessions, or subsidies from local governments, or federal low income housing tax credits.

B. HUD's Affordable Housing Goals for the GSEs

In 1992 the Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) mandated the GSEs to allocate resources to the affordable sectors of both the single-family and multifamily mortgage markets. Both Fannie Mae and Freddie Mac are private corporations, but they are federally chartered and they receive numerous public benefits. In consideration of the public benefits these two GSEs receive, FHEFSSA directed the HUD Secretary to establish affordable housing and geographically targeted (underserved area) goals for them. Accordingly, the Secretary established interim goals in October 1993, and, based on experience gained between 1993 and 1995, the Secretary

[10] In addition to an upfront premium (paid at initial endorsement) which varies by program, FHA charges an annual premium of 0.5 percent of the mortgage amount on all multifamily programs. Note that FHA multifamily mortgage insurance has several sub-categories which require credit subsidy, which covers projected program costs in excess of projected program revenues. The GSEs do not have fixed pricing for their multifamily products, which affords them much more flexibility than FHA in pricing.

[11] Even though FHA insured unassisted projects throughout the 1960s, 1970s, and 1980s, many still associate FHA multifamily insurance with subsidized housing because of the large volume of subsidized units produced during this period.

published a final rule in December 1995 that set affordable housing goals for both GSEs for the years 1996 through 1999.[12]

C. Comparisons Between FHA and the GSEs

For multifamily housing, a comparison of FHA with the GSEs seems natural: (1) neither the FHA nor the two GSEs restrict occupancy in their multifamily units by tenant income; (2) all operate with per-unit loan ceilings that are sufficiently high to allow a wide range of rent affordability; (3) FHA and the GSEs have public purpose missions.

However, one major difference exists between FHA multifamily insurance programs and the GSE multifamily mortgage purchases. While neither the FHA nor the GSEs include rent affordability restrictions in their respective underwriting standards, the GSEs have more flexibility than FHA in acquiring mortgages with affordable units. For example, FHA insures applications that enter its processing pipeline on a first-come first-served basis, provided the application meets FHA's statutory, marketability, and underwriting guidelines. There has been no FHA policy that gives preference to any project with a higher proportion of affordable rents or with an underserved area location. The GSEs, on the other hand, have more discretion in selecting mortgages to purchase, using various business strategies from time to time to increase their purchases of mortgages that address their affordable housing goals. One such strategy is the negotiated purchase of a seasoned portfolio of multifamily loans from a bank or thrift institution.

D. FHA Risk-Sharing Pilots Are Not Included in This Study

FHA is currently conducting multifamily risk-sharing pilot programs with various state and local housing finance agencies, and with Fannie Mae and Freddie Mac. These programs, authorized under Section 542 of the Housing and Community Development Act of 1992, differ from FHA's full insurance programs in several respects. First, the FHA assumes only a portion of the risk of loss from defaults. Second, the FHA delegates rather than performs the underwriting and asset management responsibilities under these pilot

[12] *The Secretary of HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), Final Rule, 60 Fed. Reg. 61646, December 1, 1995.* The final rule requires that the units backing mortgages the GSEs purchase to meet minimum percentage goals with regard to (1) affordability to low-and moderate income families, (2) geographic targeting in underserved areas, and (3) meeting the *special affordability* needs of low income families living in low income areas, and very-low income families. Except for a minimum multifamily requirement under the special affordable goal, all of the goals may be satisfied by either single-family or multifamily mortgages. Since higher proportions of multifamily units tend to be affordable at any given income level, both the low-mod goal and the special affordable goal are well suited to multifamily mortgage purchases by the GSEs. The special affordable goal is especially suited to multifamily mortgage purchases because the very-low income family definition corresponds to affordability at 60 percent of area median income.

programs. Third, the risk sharing programs, unlike FHA's full insurance programs, are explicitly targeted to affordable housing.[13]

Mortgages insured under the FHA risk-sharing demonstrations are not included in this study because of (1) the pilot status of the programs, and (2) the programs' targeted affordability requirements which make them different than the FHA's full insurance programs or the GSEs' standard multifamily products. It is noteworthy, however, that the properties financed under the risk-share programs have been studied by the United States General Accounting Office and found to contain a high proportion of affordable units. Specifically, of the 12,851 risk-sharing units underwritten by state or local housing finance agencies and completed as of September 1997, 65 percent were reserved for households with incomes at or below 60 percent of area median income, implying that many of these projects exceeded the minimum affordability requirements.[14] The GAO study reports that about three-fourths of the properties which exceed the minimum affordability requirements are able to do so because they also receive some form of subsidy – usually low-income housing tax credits. The GAO report suggests that the FHA risk-sharing pilots have been highly successful in providing affordable housing.

III. Determination of Affordability and Underserved Status

For the FHA-insured units in this study, affordability was calculated using the definition and methodology described below. Underserved area status for the FHA-insured units was also calculated as described below. These methodologies are the same as those used by the GSEs in determining affordability and underserved area status.[15]

For the GSE mortgage purchases, the GSEs themselves make both the affordability and underserved area determinations. The GSEs then submit this information to HUD in support of their achievements toward meeting the Secretary's housing goals. HUD makes some of this data available to the public, and the GSE affordability and underserved area information used in this study comes from the HUD Public Use Database for 1997 GSE mortgage purchases.

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[13] The risk-sharing pilot programs require at least (1) 20 percent of a property's units to be rented to households whose incomes, adjusted for household size, do not exceed 50 percent of area median income, or (2) 40 percent of a property's units to be rented to households whose incomes, adjusted for household size, do not exceed 60 percent of area median income.

[14] United States General Accounting Office, *FHA's Risk-Sharing Programs Offer Alternatives for Financing Affordable Housing*, Washington, DC, 1998, GAO/RCED-98-117. The GAO study found that the GSE risk-sharing programs had not progressed as far as the programs with the housing finance agencies. At the time of the study, six properties financed through the GSE risk-sharing program had reached occupancy, all underwritten by Fannie Mae, and four of the six exceeded the minimum affordability requirements.

[15] The GSEs do have the option of computing unit affordability from tenant incomes, if known. Generally, tenant incomes are not known; hence, the GSEs compute affordability from unit contract rents using the methodology described in the text.

A. Affordability Calculation for FHA Units

Definition of Affordability. A rental unit is considered *affordable* if the annual *gross rent* (twelve times the sum of the monthly contract rent of the unit plus an allowance for tenant-paid utilities) is not more than 30 percent of a family's annual income. For example, for a family with an annual income equal to 60 percent of the area median family income (AMI), an affordable annual gross rent would be 18 percent of AMI (multiply 0.6 times 0.3).

FHA Contract Rents by Bedroom Size. To make the affordability determination of individual rental units in FHA-insured projects, this study used the monthly contract rent for each unit size and type in effect at the time of initial mortgage insurance endorsement. This required researching the FHA case files and manually entering unit rents by bedroom size from the forms HUD 92264, *Project Income Analysis and Appraisal*. The HUD 92264 form that was in effect at the time of initial endorsement was used.

FHA NC/SR – Today's Rents, Tomorrow's AMI. As mentioned above, the contract rent at the time of endorsement for insurance was used in this study to determine affordability for FHA units. For new construction and substantial rehabilitation (NC/SR) projects insured under Sections 220, 221(d)(3), and 221(d)(4), the insurance endorsement generally occurs before the construction or rehabilitation is started. This means that the units will not be occupied until construction is completed – usually 18 to 24 months after the endorsement. FHA rents for new construction and substantial rehabilitation projects are market rents at the time of endorsement and are *not trended* ahead to the expected occupancy date. If area median incomes rise during the construction period, but project rents do not rise over this period, then the affordability calculations for FHA's new construction and substantial rehabilitation projects made today may actually understate the affordability of these units by the time they are ready for occupancy. Affordability calculations in this paper use the area median income at the time of insurance endorsement, not an estimate of future median income for the time of actual occupancy.

Tenant Paid Utilities. Unit affordability calculations are based upon gross rent; thus, the cost of tenant paid utilities must be added to contract rents. Project-specific estimates of the cost of tenant paid utilities are not generally available for FHA-insured mortgages or for GSE mortgage purchases. The Department, therefore, instructs the GSEs to estimate average costs of tenant paid utilities by bedroom size from the most recent American Housing Survey. The same method of estimation is used in this paper to estimate the tenant-paid utility costs for FHA-insured units. To the extent tenant paid utilities differ from these estimates, the affordability calculations may err on individual units, although in the aggregate, the calculations should be reasonably robust.

The table below shows the utility estimates that were added to contract rents for the FHA-insured units in this study.[16] The allowances vary by bedroom size. They are based on data from the 1995 American Housing Survey, and reflect nationwide averages of tenant paid utilities for rental units of the specified bedroom size, excluding units for which the contract rent included all utilities.

No. Bedrooms	AHS- Derived Monthly Utility Allowance
0 (efficiency)	$ 51
1	59
2	78
3 or more	102

Area Median Income. If the project is in a metropolitan area, then the median income for that metropolitan area is used. In non-metropolitan areas, the statewide (or nationwide) non-metropolitan median income is used. In order to determine the appropriate area median income, geographic identifiers, or *geocodes*, for state, county, census tract, and metropolitan area, if applicable, are necessary.[17] For determining affordability, the FHA project geocodes provide a link to the appropriate 1997 area median income as estimated by HUD.[18] The GSEs also use HUD estimates of area median income.

Family Size Adjustment. Affordability at any specified percentage of AMI can be related to units of a given bedroom size by making a family size adjustment. For example, a two bedroom unit is assumed to be occupied by a family of 3 persons. The family size adjustment for a family of 3 is 0.9. Thus a two bedroom unit is considered affordable at 60 percent of AMI if the annual gross rent does not exceed 16.2 percent of AMI (multiply 18 percent from above by the family size adjustment of 0.9).

The following table shows the family size adjustments for the range of bedroom sizes observed in our data. It also shows the maximum annual gross rent for each unit size expressed as a percentage of area median income for the unit to be considered affordable at 60 percent of AMI.[19]

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[16] The GSEs are instructed to add the utility estimates if the unit contract rent does not include all utilities. Non of the FHA-insured projects in this study included all utilities; hence the utility allowances were added in all cases.

[17] Census tract identifiers are necessary in New England where counties may be split between more than one metropolitan area.

[18] HUD estimates of median family income by area are available from HUD USER. See HUD's Income Limit files at http://huduser.org/datasets/il.html.

[19] Maximum gross rent factors for affordability at other percentages of area median income can be found in *The Secretary of HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and*

Affordability Factors: 60 Percent of Area Median Income			
No. of Bedrooms	Assumed Family Size	Family Size Adjustment	Maximum Gross Rent as Percent of AMI for Unit to be Affordable
0 (efficiency)	1.0	0.70	12.60%
1	1.5	0.75	13.50%
2	3.0	0.90	16.20%
3	4.5	1.04	18.72%
4	6.0	1.16	20.88%
5	7.5	1.28	23.04%

B. Underserved Area Determination for FHA Units

Definition of Underserved Area. In metropolitan areas, underserved areas are defined by census tract. In non-metropolitan areas, they are defined by county. An underserved area is either a "middle" income area (tract or county) with a high minority concentration (30 percent or higher), or a "relatively low" income area regardless of minority concentration. Middle income means the median income for the census tract is less than or equal to 120 percent of the median income for the entire metropolitan area. Outside of metropolitan areas, middle income means the county median income is less than or equal to 120 percent of the state non-metropolitan median income. Relatively low income means the tract median income is less than or equal to 90 percent of the metropolitan area median income. Outside metropolitan areas, relatively low income means the county median income is less than or equal to 95 percent of the state non-metropolitan median income (or national non-metropolitan median income, if greater).[20]

Determining Underserved Status. Underserved status of a property is determined as follows. First, the geographic identifiers, or *geocodes*, for state, county, census tract, and metropolitan area, if applicable, are obtained for each property. The geocode information gives the metropolitan area census tract (or non-metropolitan county) associated with each project's address. Then these geocodes are matched with a PD&R file that assigns a served/underserved designation to all metropolitan area census tracts

the Federal Home Loan Mortgage Corporation (Freddie Mac), Final Rule, 60 Fed. Reg. 61646, December 1, 1995.

[20] The precise definition of underserved area can be found in: *The Secretary of HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), Final Rule, 60 Fed. Reg. 61646, December 1, 1995, para. 81.2.*

(non-metropolitan counties) in the nation.[21] This master file of underserved areas uses 1990 Census information, which is the most current data on tract or county minority percentages and median incomes as a percent of area median income, combined with Office of Management and Budget definitions of metropolitan areas.

IV. Properties Included in the Study

A. FHA Properties

FHA insured (initially endorsed) a total of 635 multifamily projects in FY 1997, representing 101,638 total units. Given the purpose of this study to analyze unassisted, general occupancy, FHA-insured multifamily rental units, 244 projects were excluded, leaving a total of 391 out of the 635 total initial endorsements to be included in this study.[22] The following describes the projects that were excluded:

- 179 health care projects insured under Section 232 were excluded because they represent either nursing home beds or rental units with meals or other assisted living services included in the project rents.[23]
- 41 existing FHA projects which were refinanced under Section 223(a)(7) were excluded because many of them receive project-based rental assistance, and all represent existing FHA projects.
- 24 other mortgage endorsements were excluded because they included operating loss, and supplemental loans to improve or preserve the financial and physical condition of existing FHA projects.

After the above exclusions, we were left with a total of 391 multifamily rental properties which were financed with unassisted, FHA-insured mortgages in FY 1997 with a combined total of 67,550 units.[24] The breakdown of the 391 projects by type is as follows:

[21] This file can be downloaded from the HUDUDER website: http://www.huduser.org/datasets/gse.html. Select "geographically targeted goal data".

[22] Not included among the 635 total projects initially endorsed for insurance by FHA in FY 1997 are 357 projects approved by HUD (not insured by FHA) under Sections 202 and 811, and 60 risk-sharing projects which received approval under Section 542. The 202/811 projects are not appropriate for this study because they represent assisted units restricted to occupancy by the elderly or disabled. The risk-sharing projects were not considered for reasons discussed in the text.

[23] FHA also insures capital funding for hospitals, which would have been excluded had FHA insured any hospital loans in FY 1997.

[24] Excluding non-revenue units, there were 67,264 units covered in the study.

Section of Act	Const. Type	# Projects	Total Units
220	NC/SR	3	702
221(d)(3)	NC/SR	5	480
221(d)(4)	NC/SR	153	27,424
223(f)	Existing	230	38,944
Total		391	67,550

Of the universe of 391 FHA-insured project included in the study, we obtained all the data needed to determine rent affordability and underserved status on 377 projects. We were unable to geocode 14 projects representing 2,609 units, all new construction projects insured under 221(d)(4).[25] The data reported in this study therefore, are based on the 377 FHA-insured projects for which we had complete data.

B. GSE Properties

The GSE data used in this study come from a Public Use Database that HUD makes available through its research service called HUD USER. Readers may obtain this data from the HUD USER website (http:\\www.huduser.org). For this study, all GSE loans that were identified in the database as having new construction as the stated loan purpose were excluded, as were loans identified as having government insurance. After these exclusions, the GSE public use data for 1997 provide affordability and underserved area characteristics on 1,011 mortgages purchased by Fannie Mae with a total unit count of 181,546, and 732 mortgages purchased by Freddie Mac with a total unit count of 116,304.[26]

The reasons for excluding new construction from the GSE data are (1) new construction represents a small portion of the GSEs' total business, and more importantly, (2) a large portion of the GSEs' participation in new construction is through product lines with specific low-income occupancy requirements. Excluding risk-sharing pilots with FHA, the GSEs (primarily Fannie Mae in 1997) participated in multifamily new construction through income-targeted forward commitment products, equity investments in properties eligible for low income housing tax credits, and credit enhancements on tax-exempt bonds issued by state and local housing agencies to finance affordable multifamily construction. As a result, in 1997 the GSEs' new construction products financed units that

[25] Generally, it was more difficult to obtain geocodes for new construction projects because the address that is given at the time of initial endorsement for a project that is not yet built often lacks sufficient detail (for example the address may lack a street number, or the street upon which the project is to be located has itself not yet been built and a nearby street name may be given as the project address).

[26] Fannie Mae purchased an additional 147 mortgages representing 17,164 units for which affordability and underserved status could not be determined.

were generally much more affordable and more likely to be located in underserved areas than FHA's FY 1997 new construction and substantial rehabilitation units.[27] Since the Public Use Data does not distinguish between income-targeted and non-targeted units, all new construction reported by the GSEs was excluded from this study.

Because of the many similarities in programs and product lines, existing housing provides the best comparison of FHA's unasssisted multifamily programs with the GSEs' mortgage purchases.[28] Note, however, that FHA's existing housing program, Section 223(f), differs in one respect from existing housing purchases by the GSEs. Section 223(f) requires properties to be at least 3 years old to be eligible, whereas the GSEs may purchase loans on existing properties less than 3 years old if the property meets the GSEs' occupancy requirements. The comparison of FHA with the GSEs, while best using existing housing loans, is nevertheless not entirely comparable.

V. Findings

Exhibits 1-3 provide affordability and underserved area breakdowns for the 377 FHA projects endorsed in FY 1997 by selected project characteristics. Exhibits 4 and 5 provide similar breakdowns for multifamily mortgages purchased by Fannie Mae and Freddie Mac in calendar year 1997.

The affordability categories shown in the exhibits are: 50 percent of area median income and under, 50 to 60 percent of median, 60 to 80 percent of median, 80 to 100 percent of median, and over 100 percent of median. For many purposes, policy analysis with regard to multifamily rental housing focuses on units affordable at 60 percent of area median income or less. Therefore, the percentages of units affordable at this income level are highlighted in the exhibits (shown under the column labeled cumulative) and in the findings below.

- **FHA's unassisted multifamily mortgage insurance programs generally provide modest cost rental housing. Specifically, 94.7 percent of the FHA rental units in the study were found to be affordable at 100 percent of area median income.**

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[27] For example, Fannie Mae participated in the financing of 30,311 new construction units in 1997, of which 74 percent were affordable at 60 percent of area median income, and 63 percent were in underserved areas. Freddie Mac only participated in the financing of 884 new construction units in 1997, of which only 12 percent were affordable at this income level, but 51 percent were in underserved areas. (These numbers for the GSEs exclude equity participation in tax-credit projects and credit enhancements to state housing finance agencies). By comparison, FHA's new construction and substantial rehabilitation programs financed 25,989 units in FY 1997, of which 22 percent were affordable at 60 percent of area median income, and 36 percent were in underserved areas.

[28] Fannie Mae reported about five thousand rehabilitation units in 1997. These units were not excluded because Fannie Mae guidelines generally allow only small amounts of rehabilitation, which makes them comparable to FHA's Section 223(f) existing housing program.

Exhibit 1 shows the FHA totals for all construction types (new, substantial rehabilitation, and existing). Exhibits 2 and 3 break down the totals by construction type. Among the FHA-insured new construction and substantial rehabilitation projects in this study, 90.8 percent of the units were affordable at 100 percent of median income. Among the existing projects studied, 97.4 percent were affordable at 100 percent of median income.

- **FHA's unassisted multifamily insurance programs also produce rental housing affordable to families with incomes at 60 percent of area median income: 35.8 percent of the FHA units studied were affordable at this income level. As one would expect, a greater proportion of the FHA existing units were affordable at 60 percent AMI than the FHA new construction or substantial rehabilitation units.**

  Among the FHA-insured new construction and substantial rehabilitation projects in this study, 22.4 percent were affordable at 60 percent of median income. Among the existing projects studied, 44.8 percent were affordable at 60 percent of area median income. The considerably lower percentage of units affordable at 60 percent of median among FHA's new construction and substantial rehabilitation projects is consistent with the generally higher per unit cost of new construction or substantial rehabilitation compared to the per unit cost of acquiring (or refinancing) existing housing.[29]

  In comparison, the national multifamily housing stock shows similar affordability differences between recently built units and older existing units. The 1997 American Housing Survey shows that about 19 percent of units less than 4 years old were affordable at 60 percent of area median income, and about 56 percent of units 4 or more years old were affordable at this income level.[30] Note that the older existing units in the national stock include units that would not meet FHA's quality standards; thus, the AHS estimate for older existing units may not be a truly comparable benchmark for FHA's existing housing program.

- **161 (43 percent) of the 377 FHA-insured projects in the study could have met the federal low income housing tax credit program's minimum affordability requirement.**

  The low income housing tax credit program requires either (1) at least 20 percent of the project's units to be affordable at 50 percent of area median income, or (2) at least 40 percent of the project's units to be affordable at 60 percent of area

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[29] For existing housing, the rents may include the cost of small amounts of rehabilitation as allowed by FHA's 223(f) existing housing program.

[30] PD&R estimate. Excludes subsidized units, units with government-insured mortgages, and units with no cash rent.

median income. Of the 377 projects studied, 67 projects met the first condition, 159 met the second condition, and 65 met both conditions.[31] 161 projects met one or both conditions for tax credit eligibility. The number of projects which actually used the low income housing tax credit program was not determined by this study.

- **38.0 percent of the FHA units (representing 41 percent of the properties) in the study were located in underserved areas.**

  A slightly smaller share of FHA's new construction or substantial rehabilitation business (35.8 percent of the units, representing 34 percent of the properties) were located in underserved areas. A slightly larger share of FHA's existing housing business (39.5 percent of the units, representing 46 percent of the properties) were located in underserved areas.

- **A substantially higher percentage of the FHA units in underserved areas were found to be affordable at 60 percent of area median income than the FHA units located in other areas.**

  Exhibit 1 shows that 52.0 percent of the FHA units in underserved areas were affordable at 60 percent of area median income, while only 25.9 percent of units in adequately served areas were affordable at this income level. Exhibits 2 and 3 provide similar breakdowns by type: 41.1 percent of new construction/substantial rehabilitation units in underserved areas were affordable at 60 percent of median versus 12.0 percent in other areas; and 58.6 percent of existing housing units in underserved areas were affordable at 60 percent of median versus 35.8 percent in other areas.

- **One might expect a higher share of FHA units in underserved areas to be affordable at 60 percent of area median income than units in adequately served areas (to the extent underserved areas are characterized by more affordable rents than higher income areas). However, the large differences in affordability observed between FHA units in underserved versus served areas may be related to other factors.**

  The finding of greater affordability for FHA's FY 1997 units in underserved areas compared with those in served areas may reflect market differences – that is, underserved areas may be generally characterized by more affordable rents. However, differences in affordability of the magnitudes observed may also be the result of higher usage of state or local funded subsidies, or federal low-income housing tax credits in underserved areas. Subsidies and tax credits can lower rents by reducing debt levels that projects need to support. (The United States General

[31] Note that the tax credit program also requires that these affordable units be occupied by families with incomes at or below the required levels. The actual incomes of families occupying the FHA units in the study are not known.

Accounting Office's 1998 study on FHA's multifamily risk-sharing demonstration programs found that many risk-sharing projects were able to exceed the program's affordability targets through the use of subsidies and tax credits.) However, an analysis of the reasons for the rent difference that controls for the various factors affecting rent levels was beyond the scope of this study.

- **The smaller FHA properties (under 100 units) in the study tended to be more affordable than the larger properties. In the nation's overall stock, smaller properties tend to have lower rents than larger ones; however, as with underserved status, there may be other factors contributing to the observed differences in affordability.**

  About 91 percent of the FHA units studied were in larger (100 units or more) properties. Exhibit 1 shows that 34.4 percent of the FHA units in larger properties were affordable at 60 percent of area median income, but 50.7 percent of the units in smaller properties were affordable at this income level. Similar findings exist by construction type. For new construction/substantial rehabilitation, 21.8 percent of units in larger properties were affordable at 60 percent of area median income, compared to 30.9 percent for smaller properties. For existing housing, 43.2 percent of units in larger properties were affordable at 60 percent of area median income, compared to 59.1 percent of units in smaller properties. See Exhibits 2 and 3.

  These findings are consistent with data on the national housing stock which show units in smaller properties generally have lower rents than units in larger properties. For example, the Bureau of the Census' 1990 Residential Finance Survey shows that the median per-unit rent in small (5 to 49 units) mortgaged properties was $354 compared to $421 for larger mortgaged properties.[32] This rent disparity by property size observed in the overall stock could reflect differences in property amenities and age, among others. However, as with underserved status, the observed differences in the FHA data by property size may be affected by factors beyond the scope of this study.

- **The FHA projects located in metropolitan areas were more affordable than those located in non-metropolitan areas.**

  36.4 percent of the FHA units in metropolitan areas were affordable at 60 percent of median, while only 22.5 percent of the units in non-metropolitan areas were affordable at this level of income. Similar differences persist by construction type. However, only 4 percent of the FHA units studied (3 percent of the new construction/substantial rehabilitation units) were located in non-metropolitan

[32] Drew Schneider and James R. Follain, 1998. "A New Initiative in the FHA's Office of Multifamily Housing Programs: An Assessment of Small Projects Processing," *Cityscape: A Journal of Policy Development and Research*, 4(1): 43-58.

areas. The non-metropolitan volume among the projects in the study may be too small to assign significance to the difference.

- **FHA's FY 1997 existing housing endorsements in this study were similar to calendar year 1997 multifamily mortgage purchases by the GSEs in terms of affordability and underserved status.**

  Exhibits 4 and 5 show calendar year 1997 affordability and underserved area percentages for multifamily mortgages purchased by Fannie Mae and Freddie Mac. The GSE data are limited to existing housing; thus, the appropriate comparison would be to FHA's existing housing loans shown in Exhibit 3. As Exhibit 4 shows, 95.5 percent of Fannie Mae's 1997 multifamily purchases were affordable at 100 percent of area median income, and 45.2 percent were affordable at 60 percent of median. Exhibit 5 shows 95.9 percent of Freddie Mac's 1997 purchases were affordable at 100 percent of area median income, and 46.6 percent were affordable at 60 percent of median.

  FHA's FY 1997 existing housing endorsements (97.4 percent affordable at 100 percent of area median income, and 44.8 percent affordable at 60 percent of median) were similar to the GSEs' multifamily purchases in terms of affordability.

  In terms of underserved area status, 39.0 percent of the units backing Fannie Mae's 1997 purchases, and 44.0 percent of the units backing Freddie Mac's 1997 purchases were in underserved areas. These percentages compare to 39.5 percent for the FY 1997 FHA existing housing endorsements. Thus, FHA's existing housing business was similar to the GSEs' multifamily purchases with regard to underserved status as well.

- **The observation that FHA's FY 1997 units were more affordable in underserved areas was similarly observed in the GSE data for 1997.**

  Exhibit 4 shows that 52.5 percent of Fannie Mae's existing units in underserved areas were affordable at 60 percent of area median income, but only 40.6 percent of Fannie Mae's existing units in served areas were affordable at this income level. For Freddie Mac, Exhibit 5 shows the corresponding percentages to be 61.0 and 35.4 percent, respectively. For the FHA existing housing units, the corresponding percentages were 58.6 and 35.8 percent, respectively. As noted previously, an analysis of the reasons for the rent differences that controls for the various factors affecting rent levels was beyond the scope of this study.

- **The observation that FHA's FY 1997 units in smaller properties were more affordable than those in larger properties was also observed in 1997 Freddie Mac data, but not in 1997 Fannie Mae data, which showed virtual parity in affordablity by property size.**

Exhibit 5 shows that 53.5 percent of Freddie Mac's existing units in small (under 100 units) properties were affordable at 60 percent of area median income, but only 45.4 percent of Freddie Mac's existing units in large properties were affordable at this income level. This is similar to the finding for FHA's existing housing by property size. However, Exhibit 4 shows that affordability differences between Fannie Mae's small and large existing properties were much smaller: the corresponding percentages were 44.6 percent for small properties and 45.3 percent for large properties. The corresponding percentages for FHA's existing housing units were 59.1 percent for small properties, and 43.2 for large properties. As noted previously, an analysis of the reasons for the rent differences was beyond the scope of this study.

Note, however, that the many similarities between FHA's existing housing business and the GSE multifamily mortgage purchases with regard to affordability and service to underserved areas do not extend to other loan or property characteristics. The GSEs are generally more conservative than FHA in underwriting multifamily credit risk.[33] For example, analysis of publicly available data from the GSEs' mortgage-backed security prospectuses indicates that the average LTVs of existing housing multifamily mortgages securitized by Fannie Mae and Freddie Mac from 1995 through 1996 were 71 percent and 55 percent, respectively.[34] A typical LTV on an existing housing mortgage insured under FHA's Section 223(f) would be at or near the program maximum of 85 percent. In addition, FHA's new construction and substantial rehabilitation programs provide insurance for both the construction financing and the permanent financing, which represents more risk than the GSEs generally take.[35]

VI. Conclusions

This study has demonstrated that despite their offering very different underwriting terms, FHA and the GSEs are both providing modest cost rental housing through their

[33] In fact, Standard & Poor's described Fannie Mae's multifamily lending as "extremely conservative" in "Final Report of Standard & Poor's to the Office of Federal Housing Enterprise Oversight (OFHEO)," February 3, 1997, 10.

[34] These estimates include negotiated purchases of seasoned loans by the GSEs. Seasoned loans may have lower LTVs than newly originated loans if property values have increased since the loan was originated. We do not have an estimate of the average LTVs of newly originated loans purchased by the GSEs, although we note that the underwriting guidelines for Fannie Mae's DUS program allow LTVs no higher than 77 percent, while Program Plus lenders may sell loans to Freddie Mac with LTVs of 80 percent or less. Also see William Segal and Edward J. Szymanoski, 1998. "Fannie Mae, Freddie Mac, and the Multifamily Mortgage Market," *Cityscape, A Journal of Policy Development and Research*, 4(1): 69.

[35] The GSEs do not purchase a mortgage until the property has achieved and sustained a minimum occupancy level. For new construction, the GSEs have forward commitment products, equity investments in tax credit projects, and state agency bond credit enhacements – none of which entails the level of risk FHA assumes by providing full insurance at the start of construction. In addition, FHA provides its insurance at a fixed premium, while the GSEs have flexibility in pricing.

unassisted multifamily programs and product lines. The vast majority (about 95 percent) of the units analyzed in this study with mortgages insured by FHA in FY 1997 or purchased by the GSEs in calendar 1997 were affordable at 100 percent of area median incomes.

Both the FHA and the GSEs are providing affordable rental units to families with incomes below the area median income as well. Over forty percent of the units in the study with mortgages insured by FHA or purchased by the GSEs were affordable at 60 percent of area median income. Among the FHA-insured units in the study, 43 percent of the projects could have met the federal low income housing tax credit program's affordability guidelines, although the actual usage of low income housing tax credits was not determined by this study.

Both the FHA and the GSEs are serving underserved areas with their multifamily programs and product lines. About forty percent of the units in the study were located in these areas which are characterized by high minority percentages or low median incomes.

These similarities on affordability and service to underserved areas come despite very different underwriting terms. The GSEs' underwriting is more conservative than FHA's. FHA offers higher loan-to-value ratios, lower debt service coverage ratios, and longer fixed rate mortgage terms.

Noteworthy is the finding that both the FHA and the GSE units located in underserved areas were found to be much more affordable than units located in other areas. This may be partially explained to the extent that underserved areas are characterized by more affordable rents. However, differences in affordability of the magnitudes observed may also be the result of higher usage of state or local subsidies, or federal low-income housing tax credits in combination with FHA or GSE financing in underserved areas. Subsidies and tax credits can lower rents by reducing debt levels that projects need to support. The United States General Accounting Office's 1998 study on FHA's multifamily risk-sharing demonstration programs found that many risk-sharing projects were able to exceed the program's affordability targets through the use of subsidies and tax credits. Thus, the question of what FHA and the GSEs currently do to finance properties which receive subsidies or tax credits is an appropriate topic for further study. Such follow-up research would also support policy discussions on the appropriate roles for FHA and the GSEs in financing multifamily properties which receive state or locally funded subsidies, or federal low income housing tax credits.