

## Two Decades of Multifamily Financing

*Freddie Mac, Fannie Mae, and commercial mortgage-backed securities have changed the face of multifamily property finance.*

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**THE MAJOR INSTITUTIONS** and financial protocols in the multifamily real estate industry are significantly different in 2003 from any time in the past. Since the early 1980s the multifamily rental market has traveled a roller-coaster path of boom, bust, recovery, and slow-down. The changes in financing accompanying this cycle have brought a shift from privately held to publicly traded institutional ownership and financing. On the ownership side, heavily leveraged, privately syndicated partnerships—popular during the 1980s—have given way to the large, publicly traded equity real estate investment trusts (REITs) and other ownership structures. On the

financing side, traditional portfolio lenders—thrifts, commercial banks and life insurance companies—have been replaced by financial intermediaries with lower-cost access to global capital markets: Freddie Mac, Fannie Mae, and Commercial Mortgage-Backed Securities (CMBS).

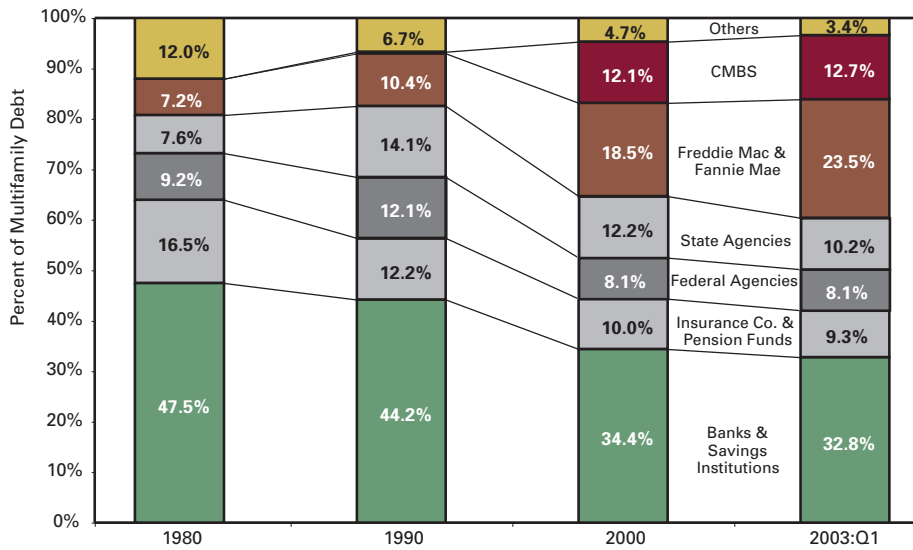
The new financial paradigm that has emerged in multifamily financing is built upon less expensive means of raising funds, economies of scale, access to nontraditional investors, diversity of investments, and the comparative advantage of individual firms that specialize in the various steps of loan production and funding—underwriting, servicing, investing. By injecting a greater flow of capital into the multifamily market, this trend has helped reduce multifamily mortgage spreads, led to the decrease in regional variation in mortgage cost, and reduced the risk of periodic illiquidity. The decoupling of the underwriting, servicing, and investment decisions has put a greater emphasis on standardized underwriting criteria and the greater importance of third-party due diligence. Multifamily properties less amenable to standard multifamily underwriting processes and third-party due diligence procedures, such as smaller properties of 50 units or less, continue to be financed by the traditional multifamily lenders and underwritten in traditional ways.

### THE NEW LEADER

The dramatic change in the nature of multifamily lending is portrayed in Figure 1, which charts the changes in the holders of multifamily mortgage debt from 1980 through the first quarter of 2003. In 1980, depositories (banks and thrifts), insurance companies, pension funds, and private individuals owned more than 70 percent of the mortgage debt outstanding on multifamily properties. Apart from the holdings by government agencies (federal and state combined) of 25.7 percent, the only other significant holders of multifamily mortgage debt were Freddie Mac (which pioneered the first multifamily securitization in the 1970s) and Fannie Mae (with sizable portfolio holdings from its earlier affiliation with the Federal Housing Administration). Even so, Freddie Mac and Fannie Mae held less than 5 percent of the debt outstanding. In short, most of the capital being used to finance multifamily properties was based upon deposits made at banks and thrifts, premiums paid into insurance policies, and retirement accounts at pension funds. Federal agencies and state finance agencies provided financing support only for the privately owned, largely subsidized, lower income apartments.

By 2003 this picture had changed dramatically. The traditional providers of conventional mortgage credit, depositories,

**Figure 1: One-Third of Multifamily Debt is Securitized**



Source: Federal Reserve Board

insurance companies, pension funds, and private individuals had declined to 45.6 percent of the market debt, down 40 percent over the 23 years, while Freddie Mac, Fannie Mae, and the CMBS conduits had increased their share of debt held to 36.2 percent, almost a four-fold increase. CMBS conduits, which did not exist until as late as 1987, had the most rapid growth, increasing from essentially nothing to funding 12.7 percent of mortgage debt on multifamily properties. Government funding of mortgage debt had fallen to 18 percent from over 25 percent in 1980.

Not only have traditional depositories played a smaller role in the multifamily mortgage market since the 1990s, but also their lending has become more specialized.

Although they are still the largest single investment sector in multifamily mortgages, with 33 percent of the total or \$167 billion in holdings (as of the first quarter of 2003), it is likely that much of that investment was in mortgages on smaller properties (those with 50 units or less) and in construction loans. Large property finance has become almost the exclusive province of the national financial intermediaries: Freddie Mac, Fannie Mae, and the CMBS conduits.

Insurance company holdings of multifamily mortgage debt have been stable since 1995 after a net run-off of almost \$5 billion during the previous four years. Since that time, insurance companies have added substantial volumes of mortgage

securities to their investment portfolios as they have reacted to new capital rules that favor holding securities (including MBS) over whole loans. Although they continue to play a limited role as a portfolio lender, they have chosen to participate chiefly as an investor in MBS as a more efficient alternative.

#### A NEW SOURCE OF FUNDS

During the 1980s, traditional lenders such as thrifts, commercial banks, and insurance companies provided all the capital demanded by owners and developers of commercial properties. But the real estate crash in the early 1990s brought the virtual demise of the thrift industry, while banks and insurance companies were too busy mitigating their non-performing and undervalued loans to provide additional capital into the market. The resulting credit crunch caused borrowers to seek new sources of funds, and the capital markets became the primary source of new funds.

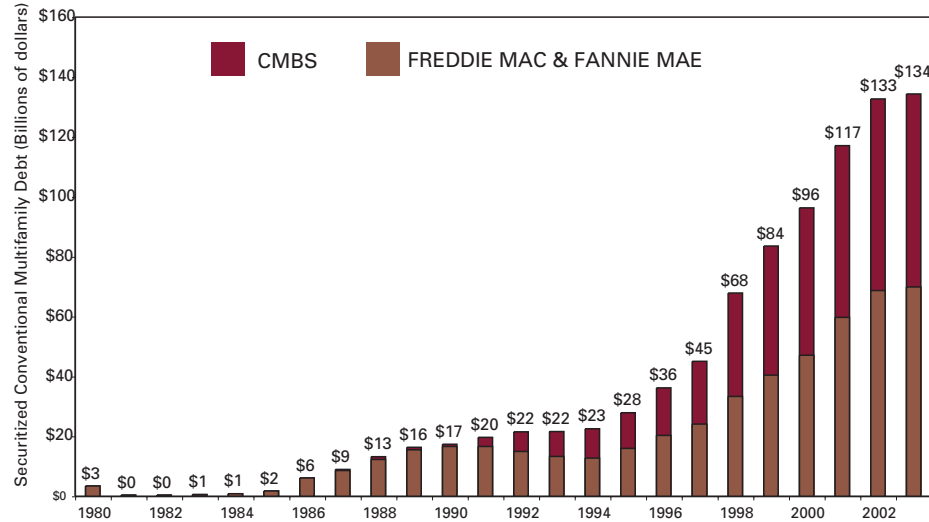
Faced with this collapse of multifamily housing finance, the single-family securitization models of Freddie Mac and Fannie Mae provided useful prototypes for new forms of providing liquidity to the commercial mortgage market. In 1990 and 1991, the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation held nearly \$20 billion of

multifamily mortgages acquired from failed depositories. The securitization model was used by the RTC to dispose of the large number of properties and notes of the failed thrift sector. The success of RTC issuance of MBS containing income-property loans provided the impetus for wider use in the multifamily market and spurred the emergence of the CMBS industry. The RTC was the major issuer of such investment paper until 1992, when the CMBS format became dominant.

The growing sectors of multifamily lending—CMBS, Freddie Mac, and Fannie Mae—all have in common lower-cost access to global capital markets and the ability to offer geographic and product diversification. CMBS conduits offer security pools that are diversified by both the geographic distribution of the properties and the type of property. Moreover, by organizing their securities into different risk tranches, CMBS offer investors more varied and specialized investment opportunities.

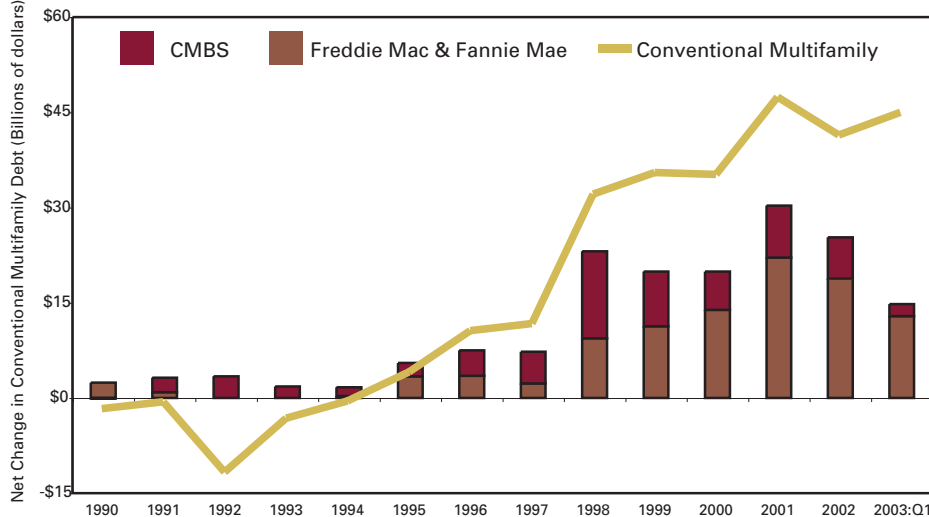
Mortgage securitization volume increased rapidly during the 1990s (Figure 2). In fact, during the 1994 to 1997 recovery of multifamily residential lending, about 90 percent of the net growth in credit was supplied through securitization (Figure 3). About three-quarters of the securitization volume came in the form of private-label activity. From virtual non-existence in 1990 (holding less than 1 per-

**Figure 2: Securitized Debt Tripled in Five Years**



Source: Federal Reserve Board; Data as of year-end except for 2003, which is through March 31.

**Figure 3: Securities Have Financed Most Multifamily Debt Growth**



Source: Federal Reserve Board

cent of the debt outstanding), private-label pools held 12.7 percent of the multifamily debt by the beginning of 2003. Clearly,

CMBS have emerged as the dominant financing vehicle for the last decade.

The reemergence of the commercial

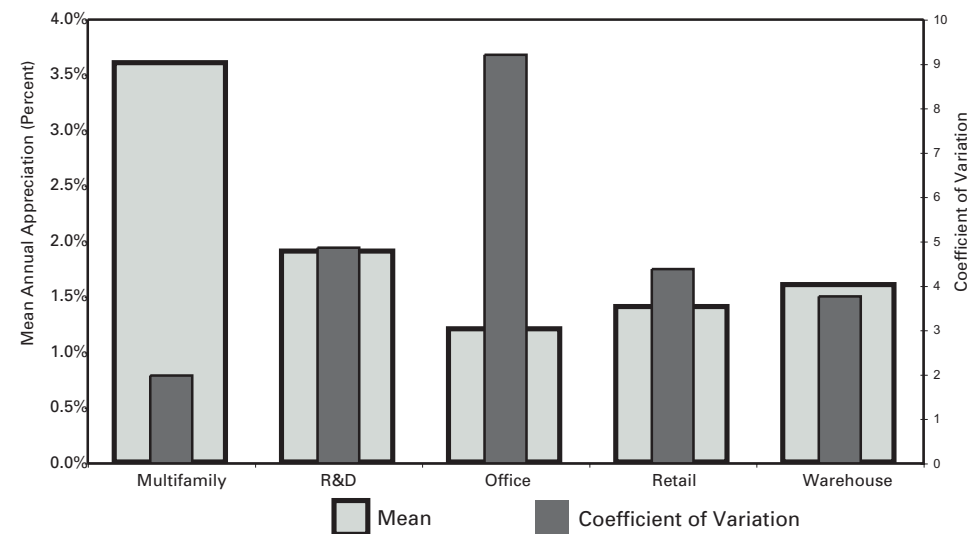
real estate sectors—office buildings, retail space, hotels, and warehouses—from their financial slump in the 1990s provided additional momentum to the private-label conduits. The economic difficulties of other sectors within commercial real estate continued several years after the rebound of the multifamily market. Investor interest in the successful MBS of multifamily properties, however, led to the acceptance of mixed property-type pools, with multifamily mortgages serving as a high-quality anchor. The added diversity of the mixed-asset pool makes them more attractive to investors.

The multifamily sector continues to serve as the mainstay of the CMBS due to its inherent stability. Buttressed by firm demographic demand, the performance

of the apartment sector has been less volatile than other real estate investment types (Figure 4). Over the last decade, multifamily annualized appreciation rates have been positive and relatively stable compared to shopping malls, warehouses, hotels, and offices.

One of the important consequences of the growth of the mixed commercial-multifamily MBS is that the specialized multifamily security issuers (such as Freddie Mac and Fannie Mae) compete actively for the same properties as the mixed pool issuers. Further, by offering a security that is diversified across all types of income-producing properties, investors perceive an overall reduction in the credit risk on the security, allowing mixed commercial-multifamily MBS issuers to

**Figure 4 Multifamily has the Most Appreciation and Least Variance**



Source: NCREIF, 1978:Q1-2002:Q4

offer higher prices than issuers who package multifamily-only securities.

Two of the other main suppliers of multifamily capital have been Freddie Mac and Fannie Mae. An early innovator in securitization, Freddie Mac pioneered the first securitization of conventional multifamily loans in the 1970s. Freddie Mac and Fannie Mae have been an increasingly important source of mortgage financing for rental properties through mortgage purchases for both portfolio investments and security issuance since the mid-1980s. For example, at year-end 1983, Freddie Mac and Fannie Mae held less than 4 percent of multifamily mortgage debt. By year-end 1992 this share had tripled to 11.4 percent. This share has continued to grow despite the intense competitive pressures in the mortgage capital market of the past few years, and stood at 23.5 percent as of the first quarter of 2003. In dollars, Freddie Mac and Fannie Mae's holdings have increased more than five-fold, from \$5.9 billion at the end of 1983 to \$31.2 billion at year-end 1992. In the decade since, Freddie Mac and Fannie Mae's holdings of multifamily mortgages have increased almost four-fold, from \$30.6 billion to \$119 billion as of March 2003.

Freddie Mac and Fannie Mae can access global capital markets not only by creating MBS, but also by issuing debt to fund the purchase of multifamily mortgages for their own portfolios. Conversely,

portfolio lenders, such as commercial banks and savings institutions, rely on deposits for their multifamily funding. Both companies use these capital market investment strategies, with Fannie Mae being a larger issuer of MBS while Freddie Mac's multifamily investments have been primarily portfolio purchases.

#### TRADITIONAL LENDERS ADAPT

Traditional depositories have transformed their multifamily mortgage asset holdings from solely whole-loan portfolios to a blend of whole loans and income-property MBS. Their multifamily loan production operation is viewed as supplying mortgages for both their whole loan portfolio and the secondary market. In particular, depositories are likely to retain those loans that are more costly to securitize while selling the rest, in large part to supply the issuance of additional MBS. Commercial banks are in a unique position to take advantage of fee opportunities at almost all stages of the securitization pipeline because they already possess both organization and servicing. The income-property MBS market allows banks to originate loans without a risk-based capital cost (provided they sell their loans with little or no recourse), while earning origination and servicing fees. The income-property MBS market also allows

banks to earn the fees associated with warehousing multifamily mortgages.

Life insurance companies and pension funds have also responded to this new environment. Both traditionally participated in the real estate market because their long-term investments in apartment mortgages matched their long-term insurance and pension liabilities. Their substantial losses on their real estate investments in the early 1990s, however, encouraged them to seek an alternative investment strategy. Both are finding it more advantageous to pare down their whole loan portfolios in exchange for investment in single-class mortgage-backed securities or REMICs, as these assets offer better liquidity and structured cash flows that better meet their investment needs. They are encouraged in this practice by the fiduciary investment obligations of ERISA and the favorable risk-based capital treatment of MBS allowed by insurance regulators.

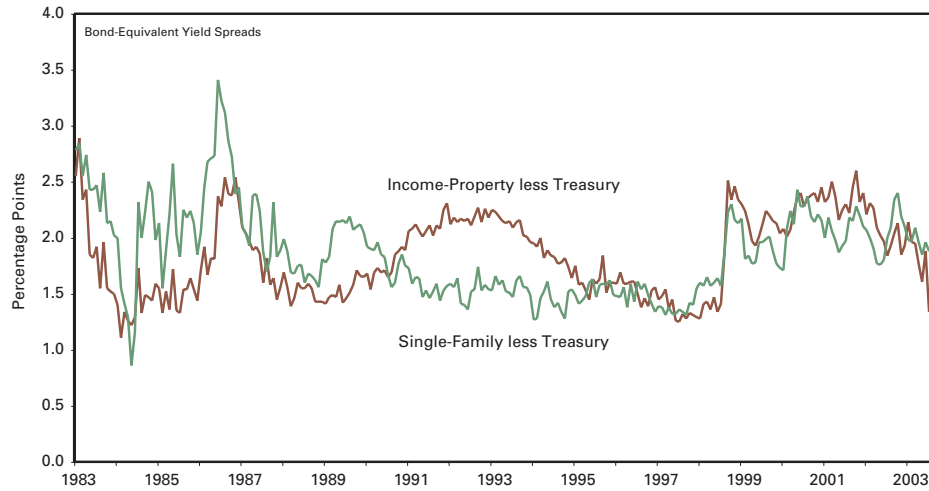
#### BROADENED INVESTOR BASE

Rather than the limited investor base that historically has characterized multifamily finance, today's multifamily market has a plenitude of capital available provided by an increasing variety of willing investors, a characteristic introduced into the single-family market some years earlier. In recent years, greater access to the capital markets

has helped reduce multifamily mortgage spreads and also has reduced regional differences in these interest rates. The spreads between multifamily mortgage rates and comparable term single-family mortgage rates are related to a variety of factors: credit risk on the type of mortgages, prepayment risk, asset liquidity, income taxes, servicing costs, and availability of funds for income-property finance, to name a few. Since the reemergence of the multifamily debt market in the mid 1990s and with the use of new funding sources, the multifamily mortgage rates have tracked single-family rates, while exhibiting much less volatility (Figure 5).

In the case of the single-family market, the advent of securitization reduced regional pricing differences to around 0.1 percent in 2002. While such standardizing effects most likely occurred within the multifamily sector of CMBS, data on regional CMBS note rates are not available. Information is available on apartment whole-loan purchases by life insurers, which indicate average interest rates on new commitments varied by as much as 1.3 percentage points across nine divisions of the nation in 1992. This variation narrowed to about 0.6 percentage points in 2001, but returned to 1.2 percentage points in 2002. Without better data, the single-family model can only suggest that better access to capital markets through the growth in secondary market activity,

**Figure 5: Single- and Multifamily Rates Track Well in Recent Years**



Sources: Barrons/Levy Index and Freddie Mac

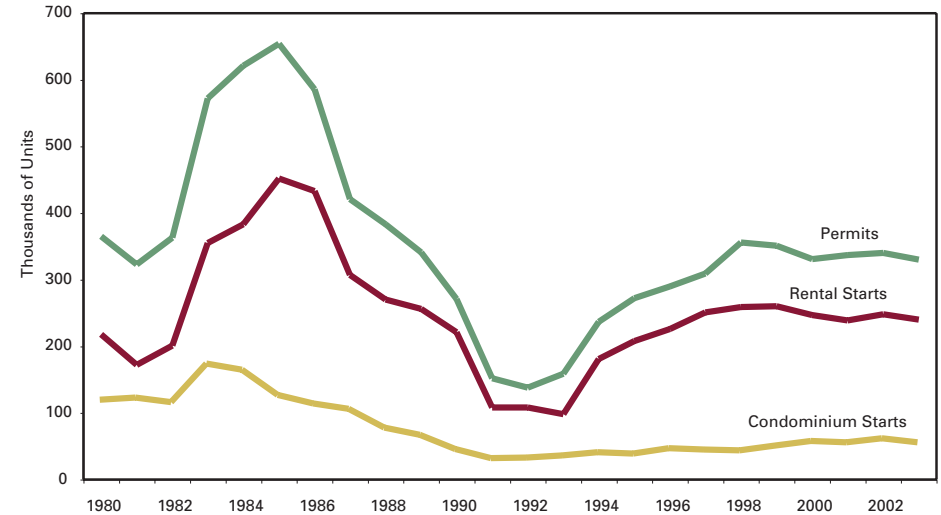
and its accompanying need for greater loan standardization amongst the multifamily industry, will lead to greater uniformity in financing costs.

Such a consequence of the broadening channel through which the capital market funds multifamily lending is the evolution of the underwriting process. The traditional underwriting by local, at-risk lenders who are familiar with the specific performance characteristics of the borrower, the property, and the local sub-market is facing competition from a different process. Increasingly, mortgage loans are scrutinized in turn by the loan originator, mortgage loan purchasers such as Freddie Mac and Fannie Mae, security rating agencies, security traders, and institutional investors.

The multilevel review of these loans has both potential advantages and potential dangers. On the one hand, multiple reviews by independent third parties using different benchmarks help avoid the misjudgments of individual underwriters and lead to better business decisions. On the other hand, over-reliance on fee-based parties without a direct financial interest in the outcome of the investment can lead to mechanistic and cursory reviews. Investment decisions based upon such reviews can lead to inventories with substantial performance problems in the future.

The resurgence of the multifamily market from its nadir in the early 1990s may have reached its business-cycle peak. Rental demand has leveled off in many

**Figure 6: Multifamily Construction Stable in Recent Years**



Source: U.S. Census Bureau

local markets as construction has added new units to the housing stock. Figure 6, however, portrays a market that is exercising some restraint, as new construction seems to be peaking much lower than had been the case in earlier business cycles. Discipline, prompted by the early 1990s experience with market adversity as well as the nature of the new actors in the multifamily sector, may be working.

#### MARKET SEGMENTATION

Changes in multifamily property financing mask market segmentation in multifamily property financing. Although some of the larger small properties have begun to enter securitized pools, small

income properties (fewer than 50 units or less than \$1 million in value) continue to be largely financed by the portfolio-lending activities of traditional depository institutions. A very large proportion of the mortgage debt held in portfolio by the depositories is on these smaller properties. Approximately 49 percent of the outstanding mortgage debt on multifamily properties is on these smaller properties, most of which is financed by depositories. Even while larger property mortgages are increasing funded through securitization instruments, very small rental properties are funded in much the same manner as in earlier periods. Although the financing of smaller multifamily properties has been largely in the domain of depositories, there is evidence

of a growing interest from the broader capital markets in accessing this untapped market. Thus far, however, this property sector has been difficult to securitize under existing models of underwriting and risk assessment.

Over the last several years, standardized approaches to underwriting larger multifamily properties have emerged. Typically mortgage originators perform cash flow analysis, obtain complete commercial appraisals, and conduct full property condition and environmental reviews. This information is available to securitizers and investors as they conduct their due diligence. This standardized approach is quite difficult to adapt to smaller properties because the cost of such underwriting is difficult to justify on low-balance mortgages. Moreover, as loan balance decreases, property value and individual borrowers' credit history rather than property cash flow become more important determinants of loan performance.

Among the factors inhibiting the securitization of smaller multifamily mortgages is the limited information available to assess the profitability of investments in multifamily properties and the default risk associated with their mortgages. Information about gross rents for rental units and the characteristics of tenants in these units is widely available via the Census, the American Housing

Survey, and similar sources. Information at the unit and property level, however, is insufficient for financial institutions or other investors to develop efficient and cost-effective underwriting mechanisms unique to properties of this size. For such purposes, information is also needed about net operating income, expenses, price indexes, and, ideally, the performance of mortgages on such properties.

#### CONCLUSION

A viable secondary market has provided liquidity for single-family mortgages in the United States for many years and has mitigated the effects of cyclical economic downturns, providing consistent funding for home ownership. A secondary market for commercial and multifamily mortgages has emerged during the 1990s that provides that same benefit for income-producing real estate and especially apartment loans (although smaller properties may have been less effected).

Important differences remain between the single-family and multifamily mortgage markets. Underwriting is not nearly as standardized in the multifamily market, and it is doubtful that it can be achieved, given the greater complexity of the financing, heterogeneity of the properties, and legal differences. Uniqueness across properties and loan products

increases the costs of the requisite due diligence, creating limits to overall securitization and creating the market segmentation between large and small property loans. The fixed costs of multi-level loan review increase as a percentage of loan balance as loan size decreases. Further, the dominance of large-balance loans within a pool diminishes the benefits of diversity.

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The views expressed in this paper are those of the authors and do not necessarily reflect those of Freddie Mac.