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A Responsible Market for Rental Housing Finance

Envisioning the Future of the U.S. Secondary Market for Multifamily Residential Rental Mortgages

Prepared by the Mortgage Finance Working Group's Multifamily Subcommittee, sponsored by the Center for American Progress, chaired by CAP Senior Fellow David Abromowitz

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Introduction and summary

Americans rent. Ninety-two million people in America live in rental housing, nearly one-third of our country. Renters on average earn less than homeowners, yet renters spend more on housing each month as a percentage of income than do homeowners. And those who rent their homes are often core members of our communities—our police officers, firefighters, teachers, and other municipal workers among public-sector employees, and our blue-collar workforce in the private sector. All of them perform myriad jobs critical to our economy. It is hardly surprising that this segment of the housing market has come to be known to property professionals as the workforce rental marketplace.

Alas, renters in our economy likely face an expensive future. Our rental housing market today is in trouble. The sharp drop over the past few years in construction of multifamily rental residences—defined as buildings with five or more rental apartment units—because of the larger financial and housing crises means there will be fewer new places to rent over the next few years. This contraction of supply will happen just as the total number of renters will likely rise by some 3.8 million to 5.0 million between 2011 and 2020, depending largely on immigration scenarios, according to Joint Center for Housing Studies at Harvard University estimates.[1]

There are several components to rising demand for rental housing. The so-called "echo boom" generation enters the housing market as first-time (and for many becoming long-time) renters. These roughly 16-to-28-year-olds are likely to enter the housing market variously as roommates or as couples, form families or join extended families—many in multifamily rental housing. In addition, with millions of foreclosed homes coming onto the market, former homeowners with impaired credit will mostly be in search of rental housing. Some may rent foreclosed-on single-family homes but other foreclosed homes will slowly be bought up by the normal increase in homebuyers over the next few years as new housing construction continues to slump due to flat housing prices. And many new renters among the younger generation probably are not looking to live in suburban homes, which comprise many of the current foreclosed properties. Consequently, rents will in all likelihood rise, perhaps sharply, over the next 10 years.

Then there are our elderly renters, more than 6 million households strong, many of whom are now renters or will soon enter the rental markets as the roughly 77 million members of the baby boom generation enter retirement over the coming decade.[2] Finally, as the economy improves, household formation will likely accelerate because more than 1 million households still have adult children living with their parents, many of whom would have long ago moved out on their own in a better job market.

So how can federal policymakers ensure there is adequate rental housing available for more than one-third of our population who will need or want to rent where they live in the coming decades? The answer will determine the kind of shelter available to this large and growing segment of our population, as well as the cost of that shelter to already embattled lower- and lower-middle-class Americans. If supply is diminished and demand grows as expected, then rents will surely be rising on these households at a time when tens of millions of families cannot afford to be paying more for shelter. The answer, in short, will have major economic consequences for decades to come.

The first place policymakers should focus on is a somewhat arcane but nonetheless crucial part of our nation's housing finance system—the so-called secondary mortgage market for multifamily housing finance. For rental housing (as with ownership housing), the secondary market links mortgage lenders to the broader capital markets. Lenders seldom hold mortgages for long periods, instead selling them to investors through the secondary markets. When institutional investors, such as pension funds and insurance companies, buy shares in bundles of multifamily housing mortgages that have been packaged into mortgage-backed securities, or MBS, lenders receive cash and move those mortgages off their books. This enables lenders to make new loans to multifamily housing developers and owners, which in turn enables the rental housing stock nationwide to grow and be maintained.

How well the secondary markets work determines whether mortgages are available at what cost; for what kinds of communities, buildings, owners, and tenants; and on what terms. In short, stable and liquid secondary markets for multifamily mortgages are essential for Americans to have access to decent rental housing at fair and reasonable terms.

Notably, multifamily housing finance was not responsible for the housing and financial crises that beset our nation and the world beginning in 2007. Even today, apartment loans held or guaranteed by Fannie Mae and Freddie Mac, the so-called

government sponsored enterprises, or GSEs, which are both now government-owned, have loan default rates of less than 1 percent. But this market nonetheless has suffered alongside all secondary mortgage markets because private capital for apartment loans has largely retreated from the current private market without government support.

Secondary mortgage markets for multifamily rental housing in the United States provide capital essential to the development and preservation of a wide variety of housing options for American families. The government's role in the secondary markets deserves careful examination to determine if it serves to promote economic security for individuals and families and the continued flow of capital in ways beneficial to society. The involvement of government means that actors in the secondary markets must meet an affirmative duty to provide access to credit on reasonable terms to all communities and types of borrowers as well as ensure that originating lenders, including nonbank lenders, are not engaging in discriminatory practices. These principles should apply to rental housing finance as well as home mortgage finance.

In this paper, we outline a framework for reform that establishes a responsible, necessary, and innovative role for government in maintaining strong financing channels and a safe and secure financing system for all types of multifamily rental property. We explore in detail the multifamily rental housing financing system and how best to achieve the overall goals already articulated by the Mortgage Finance Working Group of the Center for American Progress. (See the box on the inside front cover of this report for a brief description of this working group.)

Our proposals build on a framework put forward by our Mortgage Finance Working Group, which involves establishing a limited number of Chartered Mortgage-backed Securities Issuers, or CMIs, that would issue multifamily mortgage-backed securities with an explicit government guarantee of timely payment on these securities (but expressly not of the debt or equity of the financial institutions that issue the securities). These CMIs could also issue securities on multifamily rental properties as part of their business or entirely as their business. Because such a charter would confer a comparative market advantage, the government guarantee would be paid for by a guarantee assessment on the CMIs. In addition, the CMIs would need to serve at least in part a number of important public purposes that are consistent with their obligations to their shareholders. (See box for an overview of our working group's overarching housing policy proposals.)

Goals of the Secondary Housing Finance System

The Mortgage Finance Working Group at the Center for American Progress proposes that the federal government must continue its carefully crafted support of the U.S. housing market for the following public purposes:

- Facilitating borrowers' access to credit, which requires strong primary lending financial institutions and well-functioning secondary markets for investors to purchase mortgage-backed securities
- Providing countercyclical liquidity, or government financial support for mortgage lending during economic downturns or financial crises
- Ensuring appropriate risk management and oversight of all financial institutions engaged in mortgage finance, including strong underwriting standards at the primary level and adequate risk capital at the secondary level, as well as a level regulatory playing field for all market players
- Requiring standardization of mortgage documents, which promotes market liquidity and stability
- Ensuring transparency and accountability by all market participants, which ensures the housing and financial crises of recent years are not repeated
- Providing systemic stability in the mortgage finance markets—again to avoid repeating the recent crises
- Enhancing consumer protection for all borrowers, which ensures the rights of borrowers are paramount in the mortgage finance markets
- Guaranteeing equitable and fair access to credit, which continues U.S. government policies of giving all Americans the opportunity to live the American Dream

U.S. housing finance policy historically rests on three longstanding core principles: broad and constant liquidity to ensure the availability of mortgage finance; systemic mortgage finance market stability achieved through responsible regulatory risk oversight; and the wide and fair availability of affordable mortgage credit. The Mortgage Finance Working Group believes that these goals should constitute the foundation of any reforms of the secondary mortgage markets.

Our proposal differs from proposals offered by others in at least two fundamental ways. First, it offers a more comprehensive vision of the housing finance system of the future, one that goes beyond mere "GSE reform" (reform of the government-sponsored entities Fannie Mae and Freddie Mac, both of which are now under federal conservatorship). The problems exposed by the recent housing crisis were not limited to Fannie and Freddie, and any reforms that do not address the entire mortgage secondary market are doomed to fail.

Second, while other proposals address primarily the objective of liquidity—attracting investment capital sufficient to meet the needs of U.S. housing—our ideas are designed to fulfill a broader set of public purposes, including systemic stability and affordable housing finance. Federal support for the mortgage markets was never designed simply for the purpose of providing liquidity. Rather, liquidity is sought in order to achieve other priorities, including the wide availability of housing credit that expands access to sustainable homeownership and affordable rental housing over time.

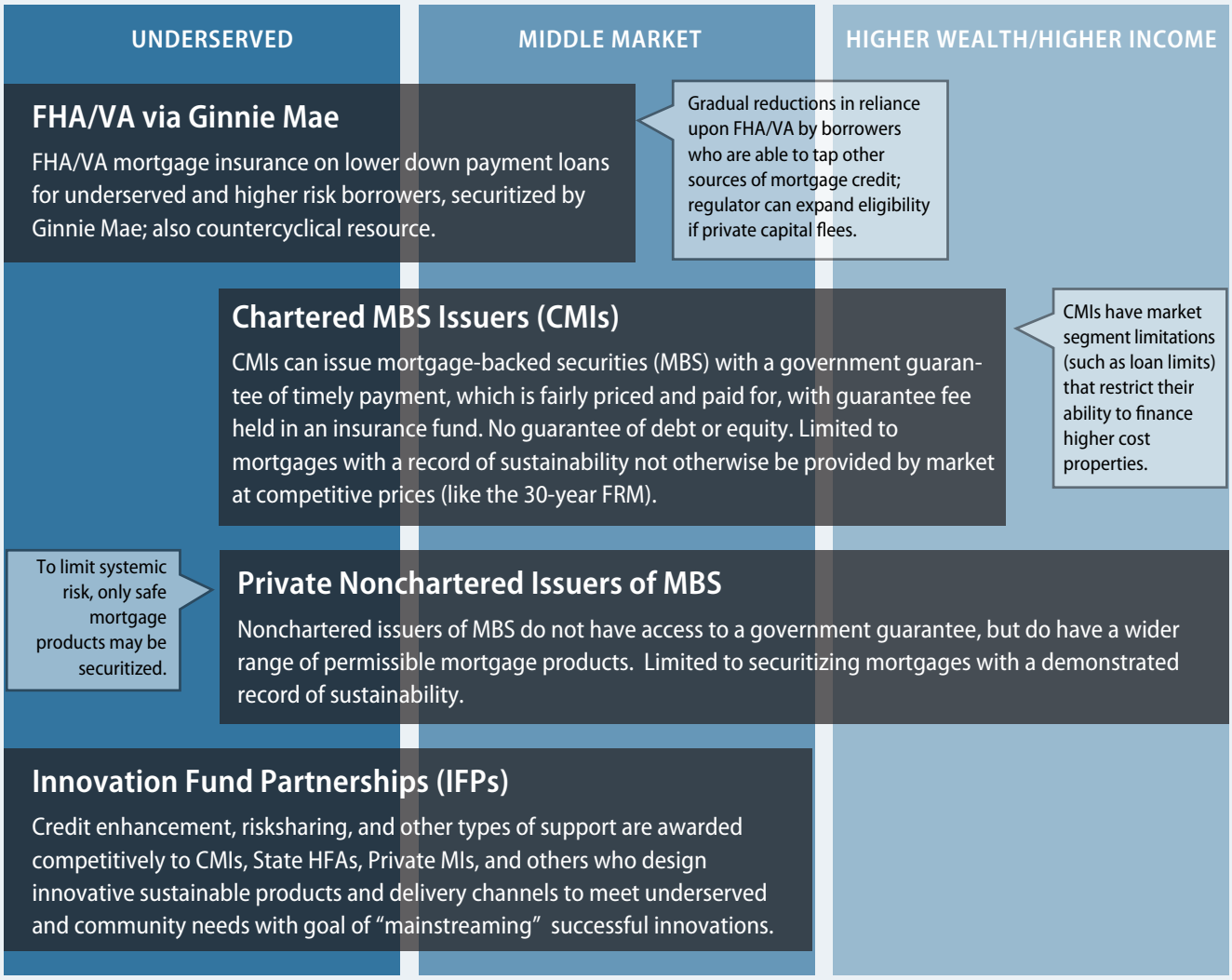
Our proposal offers a new framework in which Chartered Mortgage Issuers, or CMIs, would enjoy some limited governmental backing for their mortgage-backed securities and take on concomitant obligations to serve public purposes. But a key feature of our framework is that it also addresses the relationship between the market served by CMIs and the rest of the market. As a result, we stress the need to consistently oversee and regulate all other financing channels for residential mortgages, including other, nonchartered issuers of mortgage-backed securities. (The existing system of loans insured by the federal government, however, through the Federal Housing Administration, the Veterans Administration, and the Rural Housing Administration, and bundled into securities enjoying a Ginnie Mae guarantee would not be affected by this framework.)

Here's how our proposal would work for:

Chartered Mortgage Issuers

Under our framework, privately owned and capitalized Chartered Mortgage Issuers would be given exclusive charters to issue government-guaranteed, mortgage-backed securities in order to ensure that a deep and liquid market provides capital for mortgages that meet the public-purpose guidelines detailed above. Key features of CMIs include:

Summary of our proposals for single-family mortgage markets



- Explicit government guarantees on these securities. To ensure that mortgages are consistently and broadly available, the government would provide an explicit guarantee on mortgage-backed securities issued by CMIs.

- An FDIC-like regulatory regime. To promote systemic stability and protect the taxpayer against losses, a regulatory regime analogous to that of the Federal Deposit Insurance Corporation would be established. CMIs would hold risk capital and pay into a new Taxpayer Protection Insurance Fund. Regulators would also have FDIC-like resolution authority, allowing them to place a failing CMI in conservatorship or receivership, to minimize losses. Since its creation, the FDIC has resolved thousands of failing banks without costing the taxpayer a dime—thanks to the combination of robust risk oversight, multiple buffers against losses, and resolution authority.

- Strong limitations on eligible mortgages. CMIs would be limited to securitizing mortgages with certain characteristics determined by their primary regulator, with the idea of promoting mortgage products that are safe for the homeowner, advance the goal of expanding sustainable homeownership, and would not otherwise be offered consistently by the private markets.

Goals of the Secondary Housing Finance System (Continued)

- Public-purpose obligations. In return for enjoying exclusive access to a market facilitated by government-backed guarantees on their eligible mortgage-backed securities, CMIs would be required to serve the public good, including by providing countercyclical liquidity (access to credit during market downturns), broad access to affordable mortgage credit, affordable rental housing finance, and contributions to fund affordable housing and innovation efforts.

Taken together, these key features of a new mortgage finance marketplace would ensure that homeowners would benefit from government guarantees on eligible mortgage-backed securities, and the government in turn would be promoting a key marketplace for the broad-based prosperity of our economy and our society. In our main paper, we examine how these same goals can be achieved in our nation's residential rental marketplace.

But there are notable differences between homeownership mortgages and multifamily housing rental mortgages. In the home mortgage markets, the average homeowner benefits from government participation in the secondary market, which happens through the purchase of mortgage loans and guarantees (previously implicit, now explicit) by Fannie Mae and Freddie Mac of these securities. Homeowners benefit from the availability of 30-year fixed-rate mortgages, as well as the facilitation of "liquidity" in the home mortgage market and generally lower interest rates. Liquidity in financial terms means the availability of mortgage credit from various types of lenders, investors, depositors, and other providers of mortgage financing, including when other parts of the financial system are experiencing shortages of capital. This is critical to buyers and sellers of houses in a market with more than 50 million mortgages, and 5 million or more homes bought and sold in normal years.

The question of who benefits from an explicit government guarantee is a more complicated question in the multifamily housing sector. The benefits of government-backed securitization of multifamily housing loans, which include the spreading of risk; access to capital; long-term, fixed-rate mortgage options; and lower interest rates because of government backing of multifamily mortgage-backed securities can in many cases flow to multifamily property owners without necessarily translating into better quality housing or lower rents for the average workforce renter. Accordingly, it is important to clearly define the desired benefits of government participation in the secondary markets for multifamily mortgages.

Our approach attempts to ensure that these benefits accrue to the public generally, and in particular to those individuals, families, and communities that are underserved by a completely unaided multifamily rental financing market. As described in detail further below, we propose that private actors be invited to apply for a charter to issue mortgage-backed securities. Those issued a charter, CMIs, could focus exclusively on multifamily housing or do it as part of broader single-family residential finance business.

We propose that mortgage-backed securities comprised of multifamily mortgages issued by CMIs must meet a standard that takes into account the affordability of rental units financed by CMIs, measured at the time of loan origination. This affordability measure improves over the current use in some circumstances of loan limits to define the public benefit as Federal Housing Administration multifamily mortgage insurance does. In the multifamily context, loan limits can ration the amount of government-aided financing that an owner can borrow per housing unit, but have no correlation with the rent paid by the tenants.

At the same time, we recognize that wide access to multifamily mortgage finance under a range of market conditions—including at times of compromised liquidity like today—is itself of societal benefit. Such financing is necessary to aid the general production, maintenance, and resale of apartment buildings in America, and ensure healthy supply where there is pent-up demand, which helps keep rents more stable. Consequently, we do not believe that CMIs should focus solely on underserved markets.

Nor should CMIs be the only companies able to securitize commercial multifamily housing loans. Under our proposal, private, nonchartered financial institutions—those that operate without any access to government backing—would continue to be a source of mortgage liquidity for multifamily housing through the pooling and securitization of multifamily mortgages into the secondary market, after relevant regulatory standards are met.

We propose that all issuers of multifamily mortgage-backed securities would make a small assessed contribution, which would be used to fund a new Market Access Fund as well as the existing Housing Trust Fund and Capital Magnet Fund.[3] This new Market Access Fund would provide credit enhancement, risk-sharing, and other types of assistance on a competitively awarded basis to CMIs, private nonchartered mortgage securitizers, state housing finance agencies, and other mortgage financing parties who develop innovative products and delivery

channels to address the financing needs of underserved households and communities, including for multifamily housing. We believe such a fund is necessary to foster innovation in the financing of housing for underserved segments of the apartment market, such as rental housing targeted for lower-income residents, special needs communities, smaller multifamily properties, and the elderly.

In the pages that follow, we will first provide some essential background about the state of the current multifamily housing rental marketplace. To frame our analysis, we will then detail the reasons why the following seven goals must be part of any comprehensive rental housing finance policy:

- Market stability
- Affordable rental housing
- Community stability
- Risk mitigation
- Standardization
- Countercyclical liquidity
- Innovation

We then articulate how CMIs would serve some or all of these goals. We identify certain subsets of rental housing that need special attention, in particular small multifamily properties—those 5-to-50 unit properties that cater heavily to workforce renters. e outline ways to begin to establish such a multifamily housing financing system going forward. In the end, we're confident our proposal offers the most pragmatic, progressive way to reform our multifamily mortgage finance marketplace for the common good of all our citizens.

Today's multifamily rental housing market

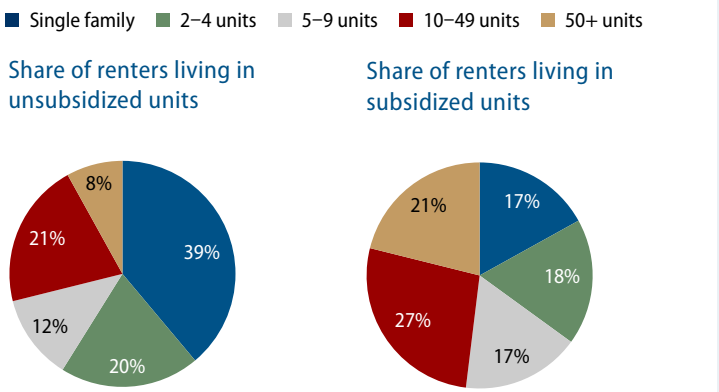
There are approximately 36.7 million apartment rental units in America, of which roughly 30 million are not subsidized in any way by the federal government. Of these 30 million unsubsidized units, about 60 percent are in properties that contain four or fewer units, while the other 40 percent—approximately 12.3 million units—are in multifamily properties comprised of five or more units. The 6.7 million subsidized rental units consist roughly of one third in 1-to-4 unit properties, and another 4.5 million households living in subsidized apartments in buildings of five units or larger.[4]

Our proposal focuses in large part on the roughly 16.7 million households who rent apartments in buildings of 5 units and up—multifamily rental housing that over 40 million Americans rely on everyday for shelter, many of whom are paying more for rent in the private sector than is generally considered affordable. (see Figure 1) Notably, of those 16.7 million households, 78 percent are in smaller buildings of 5-to-49 units. Consistent with current financing practice, rental housing offered in 1-to-4 unit properties is considered to be part of the context of single-family housing finance, which is outside the scope of this paper.

FIGURE 1

Our Nation's Rental Market

Percentage of renters living in different kinds of rental units, 2008



Source: Joint Center for Housing Studies of Harvard University, "America's Rental Housing: The Key to a Balanced National Policy" (2008).

Unfortunately, due to a combination of factors, renters spend a disproportionately higher share of their income to meet their housing needs. According to the Joint Center for Housing Studies at Harvard University, the 33 percent of American households who resided in rental housing in 2008 accounted for 50 percent of the households who spent more than half of their income on housing. In total, 46 percent of renters in 2008 spent more than 30 percent of their income on housing, the threshold for affordability used by most analysts, as compared to only 30 percent of homeowner households.[5] One primary reason for this disparity is that

renters generally have lower incomes than owners. Renter households' monthly median income in 2009 was $2,664, approximately half the $5,172 monthly median income of homeowners.[6]

Furthermore, nowhere in the United States is a household earning the federal minimum wage of $7.25 per hour (or about $1,256 per month for a single wage earner) able to reasonably afford an apartment, as measured by the Department of Housing and Urban Development's so-called fair market rent. The lower income levels of renters can often be exacerbated by the relative lack of supply of affordable rental housing. The imbalance between affordable rental housing supply and demand—particularly in the area of multifamily housing—is unfortunately often overlooked in the national discussion of housing finance policy, which is largely geared toward homeownership in the context of single-family housing.

Over the past few decades, financing for larger multifamily properties has been available through Fannie Mae and Freddie Mac (both through their securitization and their direct-investment activities), state housing finance agencies, and private financial institutions such as banks and insurance companies. Mortgage insurance on multifamily loans originated by private lenders has been available through the Federal Housing Administration, and FHA-insured multifamily mortgages have been pooled by government-owned Ginnie Mae for securitization and guaranteed upon issuance.[7] As discussed below, however, these channels have not served smaller multifamily properties very well.

Notably, during the recent housing crisis and the ensuing retreat of investors from the multifamily mortgage market, Fannie and Freddie accrued a much larger share of multifamily housing finance, purchasing over 84 percent of multifamily mortgages in 2009 for securitization.[8] As of March 2010, just more than half of all multifamily mortgages outstanding were held in the mortgage-backed securities secondary market, with Fannie and Freddie holding 35 percent of all multifamily MBS, Ginnie Mae another 4 percent, and private nongovernmental MBS with 12 percent.[9]

Despite this large role in multifamily finance indicated by this data, there remain significant gaps in the financing of multifamily debt for all critical segments of the rental market. As of March 2010, major financial institutions (commercial banks, savings institutions, and insurance companies) held 37 percent of outstanding multifamily mortgages, but in general they offer loans with short maturities and/or variable interest rates. (See Figure 2 for a breakdown of outstanding multifamily mortgage debt by holder.)

FIGURE 2

Who owns multifamily mortgages?

Multifamily mortgage debt outstanding – by holder, 2006 – 2010 Q1[11]

(in millions of dollars)	2006	2007	2008	2009Q1	2009Q2	2009Q3	2009Q4	2010Q1
Multifamily—total mortgage debt outstanding	707,329	789,527	840,333	842,185	851,494	856,546	850,077	853,801
Major financial institutions								
Commercial banks	157,555	168,407	215,118	216,767	216,790	217,005	211,035	209,657
Savings institutions	95,792	92,705	65,199	65,718	65,843	63,514	59,897	60,055
Life insurance companies	46,078	51,837	51,755	51,182	50,651	50,277	49,938	49,728
Subtotal—major financial institutions	299,425	312,949	332,072	333,667	333,284	330,796	320,870	319,440
Federal and related agencies								
Farmers Home Administration	11,374	11,282	11,069	11,043	11,025	11,004	10,980	10,953
FHA	3,398	3,147	3,287	3,244	3,246	3,277	3,650	3,489
FDIC	1	-	175	134	116	118	37	18
Fannie Mae	60,342	91,746	117,441	119,174	120,794	121,786	120,414	166,657
Freddie Mac	44,993	55,900	70,187	71,637	73,303	75,632	77,319	81,118
Subtotal—federal and related agencies	120,108	162,075	202,159	205,232	208,484	211,817	212,400	262,235
Mortgage pools or trusts								
Ginnie Mae	36,135	37,643	39,406	39,931	40,978	41,763	43,509	44,915
Fannie Mae	44,266	39,815	38,530	39,000	41,551	44,039	47,637	2,019
Freddie Mac	8,415	10,658	14,829	14,887	15,018	15,103	14,263	14,263
Subtotal—mortgage pools or trusts	88,816	88,116	92,765	93,818	97,547	100,905	105,409	61,197
Private mortgage conduits								
Subtotal—private mortgage conduits	103,224	125,350	114,381	112,830	112,081	110,328	108,183	107,257
Individuals and others								
Subtotal—individuals and others	95,729	101,009	98,929	96,611	100,074	102,673	103,190	103,646

Source: Board of Governors of the Federal Reserve System, available at: http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm#fn5r, accessed July 9, 2010.

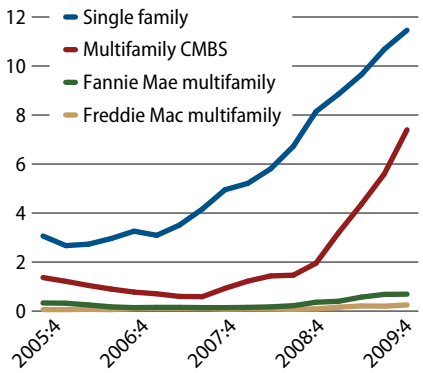
Importantly, Fannie Mae and Freddie Mac have significantly lower delinquency rates on the multifamily mortgages they hold compared to so-called "private label" investors in multifamily MBS—"private label" meaning purely private-sector financial players in the mortgage finance markets—as well as compared to commercial bank loans, and FHA-insured loans over recent years. Specifically, the delinquency rates experienced by Fannie and Freddie were 14 times less than default rates for private-label multifamily MBS, and 11 times less than for the commercial banks (0.45 percent versus 6.5 percent and 5.0 percent, respectively) at the end of 2009.[11] (See Figure 3 for recent loan delinquencies in the multifamily housing market.)

FIGURE 3

Superior performance on multifamily mortgages

Fannie Mae and Freddie Mac multifamily loans outperformed their single-family mortgage portfolio and private MBS mortgages

Share of loans 60 or more days delinquent or in foreclosure (percent)



Notes: Single-family loans include loans for one- to four-unit properties. Single-family delinquency rate is based on number of loans, while other rates are based on volume of loans. CMBS delinquencies include foreclosed properties owned by banks.

Source: Joint Center for Housing Studies of Harvard University, "State of the Nation's Housing 2010" (2010), Figure 25.

Robert E. Dewitt of the National Multi Housing Council in his March 2010 testimony before Congress explained the reasons for this historically strong GSE performance. They include:

- Sound and effective credit policy to ensure the quality of borrowers
- Strong underwriting and loan terms to provide cushions in case of vacancies or falling rents
- Risk-sharing arrangements through third-party insurance
- Agreements with origination and servicing partners that require financial consequences to the loan originators for loans that go bad
- Document standardization to aid transparency and enable securitized mortgages to be packaged and sold to investors more easily
- Portfolio diversification to spread risk and avoid heavy exposure to regional economic downturns

During the housing bubble from 2003 to 2007, the two mortgage financing giants loosened their credit standards on single-family home mortgages after they began to lose market share to private-label MBS issuers.[12] By contrast, in the multifamily area the GSEs generally declined to follow the lead of commercial private-label MBS. What's more, Fannie and Freddie held adequate reserves on multifamily loans to cover the losses stemming from the Great Recession and to remain profitable on their multifamily mortgage business.

This brief review suggests that a governmental guarantee of multifamily mortgage-backed securities is compatible with prudent underwriting and high quality loans. Our proposal aims to build on the strong historical performance and practices of Fannie and Freddie in the multifamily sector and to introduce greater oversight and more robust structures to ensure continued minimal risk to the taxpayer going forward. But first, in the next section we'll address the public-purpose components of our proposal.

Justification for federal government role in rental property finance

The existence of a well-functioning secondary mortgage market benefits the financing of housing in many key aspects. Government involvement can greatly improve the stability and efficiency of a secondary mortgage market but it also comes at a cost to the public because taxpayer resources are devoted to the effort in the form of direct subsidy costs and the payment of claims when federal guarantees are called upon. It is important, then, to be clear about the intended benefits and goals of government involvement.

Overall, any proposed government guarantee of multifamily mortgages securitized by CMIs should demonstrably serve renters at a broad range of income levels and address the general need for what has widely become known as "workforce housing." While there is no formal definition, this term is generally understood to apply to households earning up to 100 percent (and in some high cost areas, 120 percent) of a measure known as Area Median Income. AMI can range from less than $43,000 in poor areas of Mississippi, for example, to more than $103,000, such as in the San Francisco metropolitan area, according to FHFA figures.[13]

Through a combination of federal and state direct subsidies, most households earning less than 60 percent of AMI are able to access affordable rental housing. But because the current system is targeted at promoting affordable rental housing for households with incomes less than 60 percent of AMI, many households find themselves shut out of the market for affordable workforce housing.

With the national median household income approximately $50,000, rental households earning more than $30,000 (or the local equivalent) generally find themselves without access to any form of public subsidy for rental housing.[14] Of those households who spend more than 30 percent of their total income on rental housing, only 25 percent benefit from rental subsidies, signaling a major gap in the system. It is therefore vital that our system going forward works well for both lower- and moderate-income renters, and for the middle-income renters above 60 percent of median who lack any other form of affordability assistance but still has many families squeezed by housing costs.

The insufficiency of rental subsidy programs can be traced, in part, to the government's historic focus on incentives for homeownership. Sheila C. Bair, the chair of the Federal Deposit Insurance Corporation, recently noted:

> *It is estimated that when you add up the mortgage interest deduction, local property tax deductions, and exclusions on capital gains realized on the sale of owner-occupied housing ... the taxpayer subsidies for homeowners are about three times the size of all rental subsidies and tax incentives combined.*[15]

This past policy imbalance not only directed taxpayer subsidies away from renter households, but also contributed to a run-up in housing costs leading to declining affordability generally.

This is one key reason why the federal government's role in the multifamily secondary markets first should ensure availability of multifamily mortgages for properties with units that are affordable to tenants with low or moderate incomes. To facilitate this affordability, these multifamily loans should be provided at competitive interest rates. Because multifamily mortgages on rental properties with rent-subsidized tenants are typically complicated, and because affordable properties are often smaller than multifamily properties that focus exclusively on the higher-income rental market, we believe it is necessary to impose on CMIs an affirmative obligation to provide financing on sound underwriting terms to properties targeted for low- and moderate-income, or LMI occupancy. This affirmative obligation would of course be supported by the federal government's guarantees on the multifamily MBS that include such income targeted mortgages.

Looming debt maturities for multifamily mortgage borrowers pose a further risk to communities already coping with the fallout from the foreclosure crisis. While multifamily rental properties have so far held up relatively well amid the general housing downturn, a major refinancing challenge poses a serious threat to this area of housing. With 20 percent of the $1.45 trillion in nonbank multifamily mortgage debt maturing in 2010 and 2011 (13 percent and 7 percent, respectively), liquidity problems could lead to foreclosures.[16] That is, if there is a shortage of private capital to cover the demand for refinancing such mortgages, many properties could simply find themselves without a way to pay back the maturing loan.

Further, the reduction in property values makes it harder for some properties to refinance, especially when combined with most lenders being willing to lend a lower amount against total valuation when compared to just a few years ago. All this

could further destabilize and displace residents in many working-class communities already hard hit by the Great Recession and further impair economic recovery.

Debt maturities vary significantly by type of holder. Generally, government-assisted loans and loan pools have longer terms than purely private debt. As a result, according to the Mortgage Bankers Association's 2009 Commercial Real Estate/Multifamily Survey of Loan Maturity Volumes, Fannie Mae, Freddie Mac, FHA, and Ginnie Mae collectively face maturing debt of just 2 percent ($4 billion) of the outstanding balance of multifamily mortgages that they hold or guarantee in 2010.[17] Maturity rates are much greater for shorter-term MBS, which include multifamily loans. Loans packaged into these securities face a maturity rate of 12 percent in 2010.[18] Other institutions who are direct holders of multifamily loans, such as credit companies, life insurance companies, commercial banks, and savings institutions, also face comparatively higher rates of maturity for their multifamily loans.

A compelling case for government participation lies at the nexus of the potential imbalance between the demand for refinancing of existing multifamily mortgages and the potential short supply of capital without such government involvement in the secondary market. The potential lack of investors in multifamily housing, particularly during these tenuous times in our financial markets, could lead to a rash of foreclosures or alternatively to a situation in which rental property owners fail to reinvest in their properties, allowing them to deteriorate. The use of limited government support to avoid these outcomes would provide clear benefits to the occupants of multifamily properties as well as to the communities they belong to.

But the most widely recognized public purpose of government involvement relates specifically to underserved groups, including low-income families, young adults, and the elderly. These groups historically experience some degree of market shortage of affordably priced rental housing options. This is particularly the case in low- and moderate-income communities where the underserved tend to live. Public subsidies for rental housing are estimated to serve only 25 percent of those households that are "cost burdened" by their housing costs ("cost burdened" meaning those spending over 30 percent of income on housing).[19]

Even a substantial expansion of direct public subsidies would be unlikely to reach a scale that could provide affordable rental housing for the remaining 75 percent of burdened households not benefiting from current subsidies. In addition, many households whose incomes are above the subsidy eligibility range still find them-

selves cost burdened. Such overspending on rent for housing negatively affects other economic activity, including savings and adequate spending on health care. Consequently, it is critical that the secondary multifamily mortgage market provide capital as much as possible to nonsubsidized properties serving the LMI segment of the market.

We also believe that a modest level of government involvement is appropriate and sometimes necessary in the fully middle-income and even high-rent sectors of multifamily housing to ensure the constant and broad flow of affordable liquidity to rental housing. This is particularly true during recessionary periods, when private sector institutional investors often move to the sidelines, and a government role is necessary to ensure a sufficient supply of capital in the secondary market. Government involvement can also facilitate the supply of workforce rental housing for households that have eschewed homeownership for credit, lifestyle, or cost reasons.

Construction of multifamily apartments requires a relatively long lead time. During recessions, builders find it hard to get loans for construction. And shorter construction loans are only made if a commitment for a longer-term "takeout" loan after completion of construction can be obtained. A credit crunch lasting an extended period of time can halt hundreds of thousands of units of multifamily production annually, as evidenced by the contraction of multifamily housing starts in 2008 and 2009 relative to prior years. Multifamily starts totaled only 109,000 units in 2009, compared to 284,000 units in 2008 and 353,000 units in 2005.[20] This drop of more than two-thirds from normal production levels presumably would have been even more precipitous had Fannie and Freddie not continued to facilitate the secondary market purchase of multifamily MBS.

This sharp slowdown in multifamily housing starts of the past few years will undoubtedly result in rental housing shortages in many local rental property markets even as the economy recovers. A shortage of available market-rate rental housing will put upward pressure on rents for apartments that might otherwise be serving tenants with more modest incomes. Government involvement in ensuring that capital is available during times of credit contraction is a critical factor in mitigating such fluctuations in the supply of market-rate and affordably priced rental housing.

Nevertheless, the core case for government involvement is one where the benefits can be connected as directly as possible to the occupants of the rental housing that is being financed. To accomplish this, we propose a mechanism whereby a

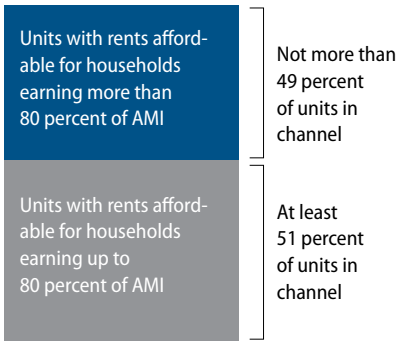
CMI, as part of its government charter, must demonstrate that its overall operations benefit a broad range of income earners. Specifically, we propose that at least 51 percent of the rental housing units financed in the CMI's overall portfolio for a given year have rents affordable to those at or at less than 80 percent of AMI. (see Figure 4)

This approach still permits almost half of the rental units that a CMI finances in any year to be higher-priced rental units targeted at middle- and upper-income households, but it also effectively levies a quid pro quo on CMIs—in exchange for the benefits of a government backing, CMIs must also serve the majority of renters who have incomes less than 80 percent of AMI. We believe it is important that an entity whose securities are publicly guaranteed should not primarily serve the high end of the rental market.

FIGURE 4

Proposed mechanism for government guarantee of CMI multifamily MBSs

Profile of CMI receiving government guarantee of MBS



Source: Mortgage Finance Working Group.

The target we propose appears achievable. According to a National Multi Housing Council review, "90 percent of the apartment units financed by Fannie Mae and Freddie Mac over the past 15 years—more than 10 million units—were affordable to working families at or below their communities' AMI."[21] Moreover, data supplied by Fannie Mae and Freddie Mac show that from 2005 to 2009, at least 62 percent of all the rental units they financed met the threshold proposed here—affordable to persons making no more than 80 percent of AMI—and for some years their percentages were above 80 percent of the units financed.

At the same time, we think it important to view CMIs as vehicles to meet the needs of the broad rental finance market. We need a multifamily mortgage securitization vehicle that can serve a broad range of incomes and properties. If CMIs are simply confined to serving those areas of the rental market that serve households with incomes less than 80 percent of AMI, or if CMIs are otherwise overly burdened with requirements to serve the more affordable end of the market, then their ability to attract private capital could be impaired, thus failing to serve moderate- and middle-income families. Given the government support they would enjoy, CMIs should be asked to target workforce households that are generally well served by the 80 percent of AMI standard we propose, but not necessarily be limited to the lowest-income populations. Consequently, there need to be government rental subsidies available to serve the needs of lower-income renters to fill this gap in the rental financing marketplace.

To ensure CMIs are meeting the public-purpose obligations that accompany their charter and government support, it is important to lay out measuring criteria to ensure CMIs are broadly serving the rental markets. For these purposes, we believe that rental affordability should be measured only at the time a mortgage is underwritten for inclusion in the guaranteed securities, and not require ongoing monitoring and compliance of the affordability of the apartments financed. While in other contexts compliance with a "duty to serve" is monitored over longer periods, we believe that in the context of a secondary market government guarantee for rental housing, initial eligibility should adequately ensure the connection between public involvement and public benefit.

This is in part due to the experience that many rental properties are in neighborhoods where the character and incomes of the community change only slowly over time. In addition, by choosing the 80 percent of AMI standard rather than a higher standard, there is a large cushion of workforce housing affordability before a given property turns into one no longer affordable to residents below full median income, even if rents rise faster than income. As CMIs are primarily intended to attract investor capital, we seek to strike a reasonable balance among all the competing goals.

Under our proposal, it also would be possible over the period of measurement to finance both 100 percent high-rent multifamily rental property developments and 100 percent affordable multifamily rental property developments—rather than "mixed use" rental housing—so long as the 51 percent requirement is satisfied. A structural requirement like our 51 percent threshold might also have a beneficial impact on the persistent problem of providing secondary market loan capital for smaller (5-to-50 unit) multifamily properties, which we discuss in more detail below. Briefly, though, loans on such properties are not often securitized. Yet smaller multifamily properties are more likely to provide a concentration of low- and moderate-income unsubsidized rental housing. Notes Eric Belsky of Harvard's JCHS:

> *In 1995-1996 fully 37 percent of owners of the 5-to-20 unit properties reported that they rented primarily to low-income tenants, compared to 26 percent of owners of large properties. Furthermore, in 2001, only one in five apartments in small multifamily properties was under a subsidy contract compared to more than a quarter of the units in larger properties.*[22]

Portfoliowide measurements of CMIs' multifamily MBS holdings might therefore make such smaller loans more attractive to originators of loan pools seeking to meet their CMI obligations than they have historically proven to be.

Another important dimension in the allocation of the benefits of a government guarantee on multifamily MBS is an analysis of the communities served. In addition to portfoliowide median income measures, a community approach might include targets or benefits for housing for young adults, the elderly, and low- and moderate-income neighborhoods. The community served by loans purchased by a CMI and then packaged into a multifamily MBS could be an additional criterion by which CMIs are evaluated for meeting their duty to serve the public.

We do not propose, however, community-level targets for CMIs based on LMI areas. Final rules and regulations detailing what constitutes an eligible loan might allow for a loan to be counted fully toward the necessary threshold if it finances a property in an LMI area—even if actual occupancy at the requisite AMI level is lower. In addition, we expect that attempts to incentivize affordable housing in the secondary markets would necessarily be complemented by other mechanisms at the local, state, and federal levels.

Structurally, any general government guarantee or other credit enhancement should be directed at the product of securitization, not the multifamily MBS issuer itself. In the context of our general framework for mortgage finance reform, we propose a government guarantee that is limited to mortgage-backed securities issued by our proposed CMIs, and which does not apply to the debt and equity of the CMI. This approach is consistent with our rationale for narrow and targeted government involvement, which focuses primarily on the beneficiaries of the loans themselves rather than the benefits to the companies securitizing them.

The rationale for government involvement in the secondary multifamily market, however, does not itself clarify fully how that involvement would help the intended beneficiaries. In the next section, we discuss in detail key features of the structure of such involvement and the features by which the benefit should be measured.

Benefits of government involvement in the multifamily mortgage secondary market

Government involvement in multifamily housing finance impacts seven key market characteristics: liquidity; market stability; affordability; standardization; innovation; risk mitigation; and community stability. Let's consider each of these in turn.

Liquidity and stability

Government involvement in the multifamily sector plays an important role in creating liquidity by bringing capital to purchase long-term loans or loans that might not otherwise find investors. Government involvement also expands the market during good times by offering long-term fixed rates and creates stability during down cycles by serving as the investor of last resort.

Generally, the availability of a reliable guarantee or source of insurance against a systemic risk brings into a market potential investors who are either risk averse or unable to fully assess the underlying risks of a remote catastrophe. FDIC insurance of bank deposits is one example where the presence of a government guarantee has brought stability in times of economic turmoil. Notably, during the recent economic crisis and market instability of 2008–2009 when secondary market investors for most types of securitized real estate and commercial loans dried up, government-backed multifamily loans attracted a steady flow of investment capital.[23]

Affordability

The government's role in the secondary market also should be to facilitate the owners of multifamily housing to provide affordable housing, meaning rents at levels affordable to average working families. We have articulated that an obligation to serve the full spectrum of the rental market arises from acceptance of a government benefit such as government guarantees of multifamily mortgage-backed securities.

Overall, the government involvement through guarantees for CMI-issued securities merits the affordability standard that at least 51 percent of the rental housing units financed in the CMI's overall portfolio for a given year have rents affordable to those at or at less than 80 percent of AMI. This requirement for maintaining a CMI charter alone will not insure that sufficient loans are available for all affordable housing. Through the Market Access Fund and other actors in the market, such as HFAs, the FHA, and other parties, CMIs can also play a role in meeting the broader affordable needs.

Standardization

Standardization provides benefits to multifamily rental property borrowers, their lenders, and investors in these mortgages via securitization because it enables all three parties to work from the same financing playbook. Standardization also helps ensure the safety and soundness of financial institutions because it simplifies the purchase of loans originated by a wide variety of lenders. Standardization therefore improves the transparency and liquidity of multifamily rental housing finance. Together, these three positive attributes of standardization provide important benefits to the multifamily MBS secondary market.

Innovation

The federal government is uniquely positioned to responsibly push innovation in the rental housing finance market by creating programs and products that the private primary and secondary markets cannot or will not deliver. The 30-year, fixed-rate mortgage for single-family loans, for example, was a major government innovation coming out of the Great Depression. Looking ahead, we anticipate that government guarantees on multifamily mortgage-backed securities packaged from the small multifamily property market may prompt innovations that have yet to emerge or gain traction.

Risk mitigation

The securitization process at Fannie and Freddie in the multifamily mortgage arena was comparatively sound relative to their single-family mortgage operations at the height of the housing bubble in the mid-2000s. The measures we propose

on risk mitigation are based on the better performance of the multifamily MBS portfolios at Fannie and Freddie. Specifically, we propose strong underwriting requirements at the project level, the first level of minimizing the risk of a mortgage loan. The requirement of adequate capital at the CMI level puts another level of protection between project default risk and the ultimate government guarantee. And diversification in the pools of securitized loans spreads risk geographically and by other criteria to the degree possible. The aim: To mitigate structural and market risks to the government and taxpayers.

Community stability

Prudent regulation of the multifamily rental housing market as a whole will ensure that these rental properties are not overleveraged.[24] This will promote preservation of the housing stock in good condition by making capital available to owners who periodically have a need to renovate such properties to preserve their useful life, and ensure that rental housing is safe and sound for tenants. In addition, encouraging the flow of financing for low- and moderate-income rental housing will contribute to community stability. Communities around the country are seeing the negative effects on whole neighborhood of buildings that are deteriorating rapidly in the wake of owners who were allowed to take out too much debt during the boom and now have no expectation of being able to pay off that debt under current conditions. Expanding the availability of securitizable loans in such communities would help to prevent future waves of community destabilization.

Together, then, these seven market characteristics as they relate to the government's role in the multifamily mortgage secondary market illustrate the benefits of government involvement, but it is also clear that government involvement is a more nuanced task than in the single-family mortgage secondary market. For the single-family homeowner, access to affordable mortgage financing involves clear direct and indirect benefits from the government, such as mortgage insurance from FHA or the Veterans Administration, or lower interest rates due to the purchase of individual home loans by Fannie and Freddie for securitization and sale to institutional investors on the secondary MBS market. Figure 5 below outlines some of the direct and indirect benefits for key stakeholders of government participation in the multifamily secondary markets.

FIGURE 5

Benefits of government participation in the multifamily MBS secondary market

All the actors in this rental housing sector gain from government involvement

Tenants and communities	• Supply of affordable rental housing • Lower, more stable rents • Diminished risk of eviction from foreclosed rental properties • Community stability
Owners	• Access to long-term, fixed-rate financing at affordable rates • Liquid markets for property transactions • Funds available to maintain and upgrade properties
Developers	• Expanded development options in underserved communities • Indirect access to affordable construction financing options • Liquid markets that provide reasonable underwriting conditions and exit options
Investors	• Investment options for safe returns at attractive yields • Liquidity of invested capital • Stability and standardization in the secondary markets
Taxpayers	• Protection from exposure to portfolio losses of GSEs • Stability of communities leading to decreased pressure on entitlement programs • Vital communities lead to economic activity, property appreciation, and increased tax revenue

Source: Mortgage Finance Working Group

Our proposed framework for a vital financing marketplace for rental housing rec-

Key features for revitalizing the multifamily housing finance market

ommends targeted direct government involvement in the multifamily secondary markets. Better regulation can minimize both systemic risk and negative community-wide impacts from distressed multifamily properties.

This paper, however, does not attempt to detail a full list of regulatory policies and changes that would be necessary to implement our proposals fully. Instead we suggest a set of key features and principles to govern the development of policy. These key features fall roughly into the following categories, which are explained in detail below:

- Fixed-rate multifamily mortgages
- CMIs and a government guarantee for multifamily MBS
- Support for affordable housing
- Low Income Housing Tax Credits
- Effective government regulator
- Role of Federal Housing Administration
- Role of state housing finance agencies

Let's examine each of these in turn.

Long-term, fixed-rate multifamily mortgages

We believe the government's involvement in the multifamily secondary markets should include exploring how best to expand and encourage greater access to multifamily fixed-rate, long-term mortgages of 15-to-40-year terms. This would expand availability of products that could increase private investor interest in the multifamily MBS secondary market while providing longer periods of financial stability for borrowers, lenders, and investors alike.

Longer-term, fixed-rate mortgages would be especially beneficial for properties with modest rents, including those serving low- and moderate-income tenants, since these properties are less likely to be able to sustain interest-rate adjustments when interest

rates increase. As discussed in detail below, smaller rental properties in particular could benefit from longer term loans. We recognize that this would mark a departure from current terms of 10 years or less that prevail in the private multifamily finance market.

Longer-term loans are already common in the FHA and state housing financing agency/tax exempt bond markets. This provides a base of experience with longer-term, fixed-rate mortgages from which we can potentially expand. Long-term mortgages in the multifamily mortgage market would enhance investor interest for a wider range of multifamily loans while decreasing transaction costs and other risks that have historically made smaller loans less attractive to the Fannie Mae, Freddie Mac, and other institutional investors in multifamily MBS.[25]

We do not suggest that longer-term, fixed-rate loans become mandatory in any sense. But given the negative consequences for communities and tenants of deteriorating multifamily properties when five-year mortgages have to be rolled over into new financing for overleveraged properties, it is important that the multifamily finance system of the future addresses this issue.

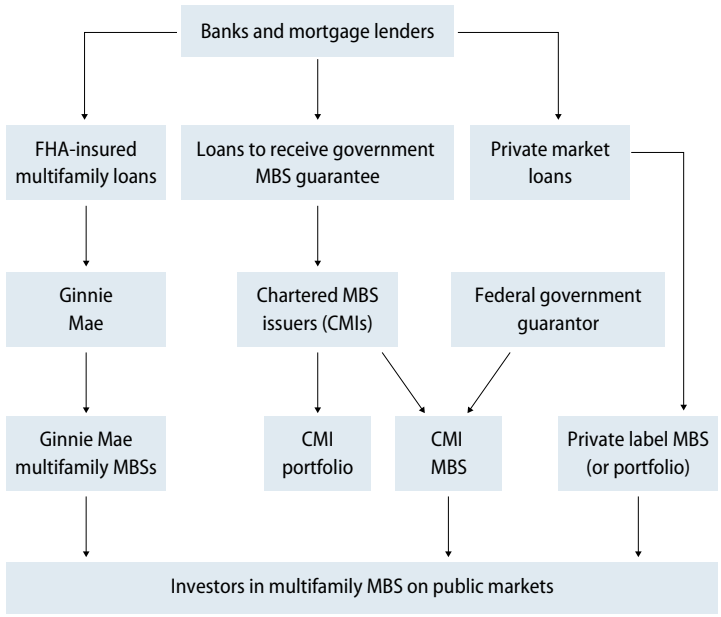
CMIs and a government guarantee for multifamily MBS

The proposed privately owned and capitalized CMIs would, under our framework, be able to obtain government charters permitting them to issue government-guaranteed multifamily mortgage-backed securities. Because the purpose of this government "wrap" is to ensure that a deep and liquid secondary market provides capital for multifamily loans for projects and properties in all communities, CMIs would receive their charters—and the benefits that accrue from access to a government backing—in return for serving certain public purposes. These public-purpose obligations could be met through securitization activities, credit enhancements, direct investments, or a combination of some or all of these actions. (See Figure 6 for a flow diagram of MBS origination in which CMIs would participate under this system.)

FIGURE 6

A new way forward for rental housing finance

How our proposed multifamily mortgage finance system would work



Source: Mortgage Finance Working Group

While there would be an explicit government guarantee on all CMI-issued MBS, this guarantee would be limited to the MBS only, and neither the debt nor the equity of CMIs as companies would be guaranteed in any way. Moreover, CMIs would be required to hold capital against the risk of loss on the MBS they issued, and pay into a taxpayer insurance fund, meant to provide an additional buffer against taxpayer loss. In the event a CMI were to fail, then the government would have a large cushion of protection by the CMI's own capital, and then also by a taxpayer insurance fund. (For more details on the structure of CMIs generally, see the box on page 4)

Additionally, the proposed loan-level protections and risk-sharing structures would further mitigate government risk. An additional protection for the government guarantee is that the number of CMIs needs to be sufficient to ensure competition in the marketplace and to avoid "too big to fail" scenarios in the event one or multiple CMIs become(s) insolvent.

We imagine that all CMIs could participate in both single-family and multifamily securitization activities, but they might elect to focus on only one activity. CMIs electing to engage in multifamily securitization activities would be subject to the same structure, regulation, and purposes of all other CMIs (those focused on single-family, multifamily, or both), but also have additional attributes. The use of a CMI's portfolio of loans it retains would need to be carefully supervised to provide necessary flexibility without exposing CMIs to undue risk. CMIs securitizing multifamily loans would, by definition, serve a majority of apartments with rents affordable to tenants with incomes less than 80 percent of AMI.

CMIs, as well as other players in the housing finance market, could also undertake new products or expand activities with support from the proposed Market Access Fund. MAF, funded by a small assessment on all MBS issuers, would enable innovative products and delivery channels to be tested so as to demonstrate their potential for providing sustainable credit to underserved owners and communities. Such products and other innovations are ones that by definition a for-profit motivated MBS issuer might not undertake without diluting profit margins in the short term. MAF could, for example, assume some of the risk of a new product through a loan loss guarantee approach, thereby minimizing the risk of a startup effort and overcoming a barrier to innovation. MAF would not be a direct funder of housing, but rather would provide credit enhancement or lower-cost seed capital for promising efforts meeting such underserved areas of housing finance.

CMIs that securitize standard multifamily MBS would have to satisfy the basic requirements for renter income levels documented in the individual multifamily mortgages that comprise the MBS. But CMIs with new approaches aimed at meeting a deeper level of renter affordability or addressing additional public purposes could seek MAF support. MAF support would be allocated on a competitive basis among CMIs and others proposing their innovative approaches. The full range of public purposes to be served by an MAF, to be defined by a regulator, might include advances that overcome current obstacles to a steady flow of capital to several underserved segments of the apartment market, among them:

- 5-to-50 rental unit projects
- Rural projects
- Special needs housing for persons with disabilities, veterans, formerly homeless families and individuals, and similar special needs groups
- The preservation of previously assisted housing

The government wrap for multifamily MBS of CMIs and the associated measures we propose all aim to make it profitable and sensible for private-sector capital to fund multifamily rental properties on a consistent basis. We propose these features to incentivize lenders and institutional investors in multifamily MBS to fund attractive rental options for the general apartment property market, as well as the underserved workforce renters and other segments who rely heavily on the private sector to serve their need for affordable rents.

Support for affordable housing

Some in the multifamily field correctly argue that multifamily housing is, for the most part, widely affordable to households at or at less than 100 percent of the AMI. Indeed, one review showed that fully 90 percent of the apartment units financed by Fannie and Freddie since 1995 (some 10 million units), at the time of their origination, were affordable to working families at or below AMI.[26] Yet, as noted above, most renters earn substantially lower incomes and in 2008 more than 46 percent of all renters were paying more than 30 percent of their income toward housing, and nearly 25 percent were paying more than 50 percent.[27]

It therefore appears that the current system is still not achieving affordable options as broadly as it should be, and certainly not in all communities. While the financial markets alone cannot address the gap between incomes and the cost of housing,

when credit flows disproportionally to high-end units it constrains the supply of affordable units and keeps rents high, too.

The record of multifamily finance shows that without government involvement, private-sector lenders originating into the secondary market generally do not provide debt to all sectors of the multifamily market evenly or in sufficient quantity to meet demand. In the past decade, Fannie Mae and Freddie Mac filled some of this gap, with Fannie Mae securitizing mortgages financing more than 542,000 rental units between 2002 and 2008, and Freddie Mac similarly financing 442,000 rental units over the same period—all of the units affordable to low- and moderate-income households.[28] The combination of a government guarantee and long-term, fixed-rate financing options are proposed as part of the way to expand private capital participation in underserved markets.

Government involvement in the multifamily rental finance market would also be countercyclical in nature. The CMIs and FHA would buy or insure more multifamily mortgages for securitization, and for a wider range of groups, during economic downturns. Conversely, their share of the market would likely shrink during economic boom times when capital is flowing more freely into apartment finance.

But for multifamily rental properties affordable to LMI tenants, for smaller rental properties, and for properties in rural or other out-of-the-way local property markets, we believe active participation in the market by the CMIs and FHA will be required no matter what the economic conditions. Very low-income households (those earning 50 percent or less of AMI) often occupy urban properties receiving so-called Section 8 subsidies, which pay the difference between 30 percent of the tenant's income (the standard maximum recommended expenditure on housing) and the market rent. These properties typically have mortgages backed by the FHA, or from a state HFA, which would continue to be the case under our proposal.

In addition, multifamily rental properties serving workforce renters earning 60 percent or less of AMI have a persistent need for assistance in attracting capital. Accordingly, a small assessment levied on all multifamily MBS issuers would be used to finance the Housing Trust Fund and Capital Magnet Fund enacted in 2008.[29] The Housing Trust Fund provides state-administered subsidies to produce and preserve housing for extremely low-income tenants. The Capital Magnet Fund capitalizes certified Community Development Financial Institutions and nonprofit housing developers so they can attract more private financing. These funds complement the secondary mortgage markets but are not duplicative.

But to be clear, we believe that an approach relying entirely on channeling private-sector funds into specialized government administered affordable rental housing funds is neither sufficient nor prudent as the sole or primary approach to meeting the full range of needs of lower-income renters for affordable housing finance. Experience with the Community Reinvestment Act and in other areas shows that when companies meet a duty to serve, they often learn to incorporate more deeply affordable products into a safe, sound, and profitable business line. Our approach, therefore, tries to focus government involvement on creating the incentives and means to attract more private capital into this sector.

Low Income Housing Tax Credits

Even a major increase in debt availability for deeply affordable rental housing is not sufficient to meet the nation's needs. Over the past quarter-century, the nation's most successful affordable housing production and preservation program has been the Low Income Housing Tax Credit. The LIHTC is an indirect federal subsidy used to finance the construction and rehabilitation of affordable rental housing for low-income households. The program incentivizes private investment in low-income housing by offering federal income tax credits to investors. Over the program's history, more than 2 million affordable apartments have been constructed or rehabilitated in urban and rural areas throughout the United States and have been made available to households earning less than 60 percent of AMI. Over its history, the aggregate foreclosure rate on LIHTC equity investments has been less than 0.1 percent annually, better than other real estate asset classes.

Fannie and Freddie have played major roles in this market, both as equity investors and in purchasing mortgages for affordable housing developments financed by the LIHTC program. Fannie and Freddie continue to facilitate, through their loan purchases, 15-year fixed-rate mortgages, which are essential for these tax credits to be attractive to LIHTC investors. We believe the CMIs could replace Fannie and Freddie in providing longer-term debt financing for LIHTC-qualifying rental properties.

The market for LIHTC equity investments has not yet recovered from the withdrawal of Fannie and Freddie, which together comprised some 40 percent of the investment market. Fannie and Freddie were particularly important to LIHTC investments beyond the major metropolitan markets where CRA considerations focused major bank investments. The CMIs could help attract new LIHTC investors by guaranteeing such investments.

Such activities could be one way to meet the "duty to serve" that CMIs would need to fulfill as part of their charter to sell multifamily MBS boasting federal guarantees. But, in general, the problems of revitalizing the market for tax-credit investors in LIHTC-qualifying multifamily rental properties go well beyond the scope of this paper. Constructive proposals have been put forward by a coalition of organizations, providing a sensible basis for addressing the LIHTC capital shortage.[30]

Effective government regulator

Strict and uniform oversight of all MBS issuers is an important component of our proposal, to prevent a "race to the bottom" such as occurred during the recent housing bubble. We believe that all securitizers of mortgage debt should be subject to regulatory review of their products, risk profiles, and capital structures. The recently enacted financial reform law contains some important provisions to ensure such oversight, including a requirement that all issuers of asset-backed securities (including mortgage-backed securities) retain some "skin in the game" proportionate to the volume of the securities they issue, as well as requirements that they hold capital adequate to cover their risk.

In addition, all secondary market participants—from mortgage originators to MBS issuers—should be required to abide by all applicable nondiscrimination and consumer protection laws. To be effective, MBS issuers will need to be responsible for the actions of their originating lenders governed by other laws and regulations. To the extent these latter obligations may apply at the financial holding company level, they may be enforced by the Federal Reserve or the new Bureau of Consumer Financial Protection.

We note that the new Bureau of Consumer Financial Protection will not oversee multifamily rental housing mortgage products, unlike its role in the single-family home mortgage market. Moreover, multifamily mortgage providers, except for commercial banks, have no federal prudential regulation. These factors underscore the importance of sound regulation for the multifamily secondary market.

To prevent repeating practices that in some cases caused rental property owners to defer maintenance or to borrow too much—leading to defaults and foreclosures—multifamily mortgage underwriting should be based on currently available market rents, not on speculative rents that assume dramatic increases or the displacement of current tenants.

Role of Federal Housing Administration

FHA serves a vital function by insuring affordable multifamily loans from approved lenders. These loans finance the construction, substantial renovation, and refinancing of multifamily rental housing. Currently, FHA is serving historically high levels of the multifamily market as evidenced by record monthly issuances of Ginnie Mae multifamily MBS; Ginnie Mae pools approximately 98 percent of FHA multifamily loans for securitization. Unfortunately there is no single source of reliable data on multifamily mortgage originations from which to estimate market share, but Ginnie Mae multifamily MBS issuances exceeded $1 billion in the months of April, May, and July 2010, and constituted 5.3 percent of all multifamily debt outstanding as of the first quarter of 2010.

Clearly, Ginnie Mae and FHA are fulfilling a "last resort" option to ensure multifamily rental property owners can access needed financing during the recent economic downturn. But FHA also at present is exceeding its capacity to meet multifamily mortgage sector demands. As an interim measure, Congress enacted and the president signed the General and Special Risk Insurance Funds Availability Act of 2010 in August 2010, a measure that increases FHA's multifamily loan commitment authority. We propose that FHA's current role be preserved and enhanced.

Specifically, we envision that FHA will continue to provide mortgage insurance to lenders originating multifamily mortgages. Further, we believe that Ginnie Mae should continue to provide multifamily MBS investors with a guarantee of interest and principal payments on pools of federally-insured loans (primarily FHA loans). We also believe that Ginnie Mae should continue to provide a wrap on privately-issued multifamily MBS for an actuarially determined fee.

But FHA also should gradually reduce its market share to regionally adjusted historic levels in parallel with improving economic conditions. FHA's participation in the market should be on an as-needed basis and not constitute competition with the private sector. Eligibility criteria for FHA loans should remain the key lever in ramping up and down FHA participation in the market.

FHA should be doing deals that others are reluctant to do, but still within the guidelines of safety and soundness. FHA should continue to facilitate the preservation and development of affordable housing, but we feel strongly that it should not be the only actor in the affordable market, nor should it be focused exclusively

on affordable rental housing, particularly in the area of providing construction financing. We envision a reformed, innovative FHA functioning as a key component of a broader multifamily finance delivery system.

FHA's current ability to innovate is limited. Many view FHA to be constrained by strict rules and inflexibility arising from the congressional approvals required for making any significant changes in response to new demands.[31] Innovation is an important and incumbent responsibility of government agencies and privately run financial institutions that are able to access government guarantees in the housing market because private sector actors are unlikely to develop new products that these entities are in a position to conceive and experiment with.

Role of state housing finance agencies

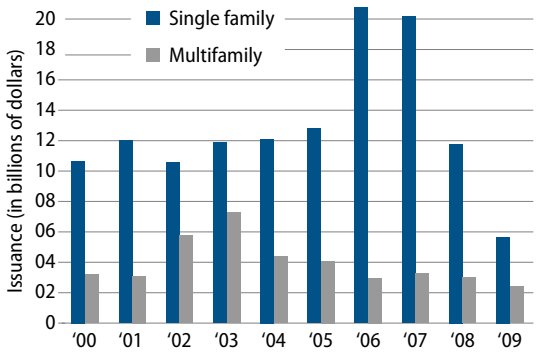
The various state housing finance agencies have for decades played an important role in providing another financing option for multifamily properties serving low-income families, in the form of tax exempt bonds. In brief, tax-exempt bonds issued by state HFAs are sold to private taxpaying investors who are drawn to receiving interest payments tax free while being secured by generally well-performing mortgage loans. These loans are made by state HFAs to finance new or substantially renovated apartment properties providing at least 20 percent of their units at rents affordable to persons making 50 percent or less of AMI (or 40 percent of their units affordable to persons making 60 percent or less of AMI). Tax-exempt bonds typically offer interest rates lower than fully taxable sources of financing.

As state-chartered agencies with local knowledge of each state's housing markets, state HFAs are often in a good position to underwrite loans responsibly and to allocate this limited resource to meet local needs. To date, state HFA-issued tax-exempt multifamily housing bonds have facilitated development of more than 1 million apartments affordable to low-income families.[32] Approximately $2.5 billion in state multifamily housing bonds were issued by various housing finance agencies in 2009, down from nearly $7 billion in 2003. (see Figure 7)

FIGURE 7

State housing finance agency funds are critical

State multifamily housing bond issuance 2000-2009[33]



Source: Thomson Reuters.

The Housing and Economic Recovery Act of 2008 provided an additional $11 billion of funding for housing bonds, but limited demand from private investors for these bonds led to a sharp drop in state HFA activity. Investors in these bonds historically included mutual funds and insurance companies. Fannie Mae and Freddie Mac in the past also purchased state HFA bonds as portfolio investments and, along with Ginnie Mae, continued to offer guarantees on state HFA MBS. But with the Federal Reserve's and Treasury's recent purchases of the GSEs' MBSs in great quantities, and the resulting decline in long-term, fixed-rate loan rates, it has been hard for tax-exempt bonds to compete.[34] The Obama administration's recently launched New Bond Issue Program is intended to alleviate this by using the GSEs to package state HFA bonds for purchase by the Federal Reserve and Treasury.[35]

Nevertheless, in a return to a more normal market for multifamily finance, state HFAs should return to being an important component of the multifamily mortgage market. To facilitate this, we propose that state multifamily housing bonds be eligible for a federal government guarantee if they are structured to meet desired parameters to be worked out in greater detail. For instance, the state HFAs would be required to retain some "skin in the game" and be subject to government review of the loans being made to ensure that they are serving the intended goals.

CMIs would not be required to guarantee state HFA bonds. Nevertheless, facilitating and enhancing the work of the HFAs would represent an important (and likely profitable) means for CMIs to address a duty to serve.

In sum, the key features of our proposal, including long-term, fixed-rate multifamily mortgages, the Chartered MBS Issuers, and the guidelines for pooling of mortgages into MBS that will receive a government guarantee, are intended to establish a responsible framework for government participation in and regulation of a safe and sound market for multifamily finance. The key participants discussed above serve critical roles in facilitating and delivering the benefits of government involvement to those communities and households whose needs are underserved by private markets.

Addressing specific gaps in the current multifamily finance system: Small multifamily rental properties

Small multifamily rental properties (comprised of 5-to-50 units) have long had difficulty accessing mortgage debt on terms comparable to those available to larger properties. Yet more than one-third of the occupied rental units in the United States are in such properties.[36] Moreover, these smaller properties, which in many cities and towns serve as the primary rental housing stock for moderate-income families, can easily become community eyesores when owners find themselves unable to pay off debt or obtain refinancing to pay for necessary capital improvements.[37] And the sheer number of such properties makes them a vital part of America's rental housing stock—there being 473,000 such properties compared to only 71,000 larger properties with 50 or more units, as of last count in 2001.[38]

As the Joint Center for Housing Studies of Harvard University notes, housing finance innovations and securitization in the 1990s brought stability to the financing of larger multifamily properties, but a "dual mortgage delivery system" emerged for smaller multifamily properties. Investors and owners of smaller properties had a different set of lenders and products than did owners of properties with more than 50 units. This led to a situation where 86 percent of the larger properties had a mortgage, and of these, 65 percent of the larger properties with a mortgage had a longer-term, fixed-rate mortgage.

In contrast, only 58 percent of 5–to-9 unit small multifamily properties had a mortgage, and just one-third of these had level-payment, fixed-rate mortgages. The numbers were slightly better in the 10–to-49 unit small multifamily property category: 68 percent had a mortgage, 43 percent of which were level payment, fixed rate.[39] Why does this matter? Long-term, fixed-rate mortgages are especially valuable for smaller properties because such properties tend to command modest rents, and often are unable to raise rents to cover upward interest rate adjustments without causing vacancies. If rents are able to be pushed up in tight markets, then it creates economic hardship for the workforce populations of such properties.

In addition, often owners of smaller properties are "mom and pop" operations that have limited financial resources. Even if they do have substantial reserves, these smaller companies and individuals may not be able to hedge interest-rate risk and other refinancing risks at the maturity of shorter-term loans.

To a certain extent this pattern reflects several legitimate factors that make it more difficult for lenders to offer mortgage products to this sector of multifamily rental properties. Such costs, and higher risks, also increase the difficulty for the lenders in turn to sell these mortgages to issuers of MBS in the secondary market. Individual small multifamily properties, for example, present more risk because the vacancy impact is more pronounced. In a building with fewer units, income losses from a single vacancy will represent a larger percentage of the total property revenues.

Further, many of the transaction costs of multifamily financing are relatively fixed—legal, appraisal fees, environmental/mechanical inspections—and do not vary substantially with the size of the property. As a result, transaction costs in smaller deals represent a higher percentage of the financing. In any sale of these types of multifamily mortgages in the secondary market, these extra costs can erode margins and make a difference in the desirability of the securities among institutional investors. Looking at 2007 data, for example, 7,200 smaller properties containing 138,000 units (or an average of 19 units per property) were financed by Fannie Mae with $7.6 billion of multifamily debt. This represents an average loan size of just $1.05 million.[40] (see Figure 9) An MBS securitizer with a choice between a $10 million loan or a $1 million loan with more or less the same transaction costs for the securitization will naturally gravitate towards the larger loan, with smaller per-unit transaction costs. Not surprisingly, the participation of the GSEs in this segment has been limited compared to their involvement with the financing of larger properties. In 2006, for example, they purchased just 5 percent of multifamily loans of $1 million to $1.9 million, compared to 27 percent of loans of $10 million or more.[42] (see Figure 8)

Perhaps most importantly, the local banks that often make these loans know the customers better, know the properties and the local property markets better, and know the unique property and borrower risks better than investors in the secondary market. Consequently, such loans are harder to standardize. This is reflected in the prices offered by secondary market investors who tend to ascribe a higher risk valuation to such properties than do the bank originator/sellers.

FIGURE 8

Public financing of small multifamily rental properties

Freddie Mac and Fannie Mae financing of small multifamily housing 2002-2008[43]

	2002	2003	2004	2005	2006	2007	2008
Fannie Mae (5-50 units)							
UPB (in millions of dollars)	$3,095	$11,125	$2,619	$4,409	$3,898	$7,646	$5,146
Number of properties	4,768	14,717	2,466	6,535	4,222	7,260	3,778
Number of units	77,535	231,458	54,676	91,328	72,962	138,110	83,398
Fannie Mae small multifamily as share of total multifamily							
Percentage of UPB	17%	33%	14%	20%	12%	13%	14%
Percentage of properties	70%	80%	54%	76%	53%	56%	52%
Percentage of units	17%	29%	12%	19%	10%	12%	12%
Freddie Mac (5-50 units)							
UPB (in millions of dollars)	$1,852	$6,565	$1,889	$857	$1,417	$2,743	$339
Number of properties	3,460	12,598	2,578	562	1,636	2,324	139
Number of units	57,431	188,681	50,358	15,847	39,625	48,721	4,111
Freddie Mac small multifamily as share of total multifamily							
Percentage of UPB	14%	30%	9%	4%	5%	7%	1%
Percentage of properties	54%	81%	48%	20%	32%	37%	8%
Percentage of units	9%	25%	8%	3%	6%	5%	1%

Source: Affordable Housing Activity reports for Fannie Mae and Freddie Mac, available at http://www.fhfa.gov/webfiles/391/HMG

At the same time, the lack of secondary market demand means that some small primary market lenders are able to command attractive profit margins in making smaller multifamily loans. They then hold these loans as assets on their books. Still, these lenders seldom offer long-term, fixed-rate financing precisely because they are holding the entire risk on their books. Overall, the lack of a secondary market outlet in this sector constrains capital and concentrates risk with the institutions originating these loans. In an era when many small and mid-sized banks are facing economic stress, this concentration of risk is unhealthy for the banking system.

One recent effort to overcome this and increase loan purchases by the GSEs in the small multifamily market was the Department of Housing and Urban Development's affordable-housing-goals rule covering the 2001 to 2003 period, which established so-called small multifamily bonus points. Under the rules, Fannie Mae and Freddie Mac received extra credit for the purchase of mortgages secured by properties with 5-to-50 units toward the satisfaction of their afford-

able housing goals. According to a study by a researcher in HUD's Office of Policy Development and Research, Paul Manchester, the bonuses had a positive effect on the GSEs' participation in these markets:

> *Clearly both Fannie and Freddie increased their roles in the [small multifamily finance] market by huge amounts between 2000 and 2003, with Fannie Mae's 2003 purchases 32 times their 2000 level, and Freddie Mac purchases 61 times their 2000 level. Bonus points for the GSE purchases of goal-qualifying mortgages on small multifamily properties had a major impact on the GSEs' role in this segment of the mortgage market in 2001-2003.*[43]

From the data shown in Figure 9, it is apparent that the bonuses on the small multifamily properties made buying outstanding seasoned small multifamily housing mortgage portfolios a cost-effective strategy for achieving their housing goals that year.

Since the bonus points expired in 2004, interest in these loans at Fannie Mae and Freddie Mac diverged. Both showed large drops in small multifamily loan purchases in 2004 relative to 2003 but Fannie Mae continued to provide small multifamily loan financing at elevated levels after 2004 relative to the period prior to the bonus treatment. After financing $2.6 billion in small multifamily mortgages in 2004, Fannie Mae averaged $4.7 billion in small multifamily purchases per year. In contrast, Freddie Mac averaged only $1.5 billion in small multifamily production per year, or less than the $1.8 billion financed in 2004.

With respect to Fannie Mae, at least, it seems that the incentives provided by the Department of Housing and Urban Development helped the company to explore a new business line and figure ways in which to do this type of business profitably, albeit at well below their participation in the market for larger multifamily properties. Consequently, we cannot assume that CMIs under a future system will on their own serve the small multifamily market better than has been done during this most recent period of GSE activity. We believe that the portfolio-based AMI measurement approach for qualifying a multifamily pool for a government guarantee will help stimulate interest in such loans. But we expect that this alone will not be enough.

One part of this gap results from the fact that many community banks and other current sources for loans to small multifamily owners do not have the capital to originate more than a handful of such loans in any given year or time period. With

only a small portfolio of such loans, such institutions are not likely to have formed relationships with MBS securitizers. They therefore have little to no experience with the process of selling such loans into the MBS secondary market.

In contrast, these community banks are often familiar with this process when it comes to single-family mortgages because there is (or was until the housing crisis) a robust channel to move individual home loans from such lenders to institutional investors in the secondary market. Some mechanism for aggregating small multi-family mortgages, perhaps on a state or regional level using existing intermediaries such as the state HFAs would overcome this market barrier. Substantial attention should be put to a detailed study of the barriers at every step of the loan process for smaller multifamily properties.

Conclusion

Multifamily rental properties play an integral role in the vitality and sustainability of our nation's economy, society, and communities. Given demographic and economic trends, demand for rental housing can be expected to increase dramatically, bringing with it even more pronounced strains on affordability among our nation's low- and moderate-income households—our workforce renters. The current crisis gives us the opportunity to build on the historic strengths of the past multifamily finance system while reforming institutions, processes, and relationships in a manner that ensures sustainable liquidity, market stability, affordability, standardization, innovation, risk mitigation, and community stability.

Endnotes

1 Joint Center for Housing Studies of Harvard University, "State of the Nation's Housing 2010" (2010), p. 26.

2 For this reference, elderly households include those of individuals aged 60 and over based on compilations of the 2005 American Housing Surveys by the Joint Center for Housing Studies of Harvard University in: "America's Rental Housing: The Key to a Balanced National Policy" (2008), Table A-3, p. 27; Bureau of the Census, *Selected Characteristics of Baby Boomers 42 to 60 Years Old in 2006*, PowerPoint presentation (Department of Commerce, 2009), available at http://www.census.gov/population/www/socdemo/age/2006%20Baby%20Boomers.pdf.

3 See footnote 30.

4 Joint Center for Housing Studies of Harvard University, "America's Rental Housing: The Key to a Balanced National Policy" (2008), Figure 12, p. 12. Note that throughout much of this paper, we will refer to the size of "properties" rather than "buildings," as some apartment complexes under single ownership and management consist of a number of smaller buildings but are financed by a single mortgage. Most industry data are based on building size, though property-based data are available through: Bureau of the Census, *Residential Finance Survey: 2001* (Department of Commerce, 2005), available at http://www.census.gov/prod/2005pubs/censr-27.pdf.

5 Figures in paragraph above calculated from: Joint Center for Housing Studies of Harvard University, "State of the Nation's Housing 2010," Table A-5, p. 38.

6 Ibid., Table A-1, p. 33.

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19 Joint Center for Housing Studies of Harvard University, "America's Rental Housing," p. 16.

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21 Dewitt testimony, p. 4.

22 Eric Belsky, "Small Multifamily Rental Property Finance: Significant Challenges and Even Greater Opportunities," publication pending, draft date October 7, 2009, p. 4.

23 Diana Hancock and Wayne Passmore, "An Analysis of Government Guarantees and the Functioning of Asset-Backed Securities Markets," Federal Reserve Board, draft, September 9, 2010, p. 5, Figure 1, available at http://www.federalreserve.gov/pubs/feds/2010/201046/201046pap.pdf.

24 The impacts on communities' stability has been particularly apparent in New York City where a City Council Task Force has been formed to address and prevent the problems caused by distressed rental housing, and a special financing program has been launched. Eileen Markey, "Pols Warn Foreclosed Buildings' Mystery Buyer," *City Limits*, August 4, 2010, available at http://www.citylimits.org/news/articles/4132/pols-warn-foreclosed-buildings-mystery-buyer; "Overleveraged Properties Initiative," available at http://www.nyc.gov/html/hpd/downloads/pdf/OPI-Term-sheet.pdf.

25 Weech, "More than Homeownership."

26 Dewitt testimony, p. 4.

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28 Weech, "More than Homeownership."

29 The National Housing Trust Fund and the Capital Magnet Fund were created in the Housing and Economic Recovery Act of 2008, ("HERA"), Pub. L. No. 110-289, but as of this writing have not yet been funded. As one commentator described them, "Section 131 of the Federal Housing Finance Regulatory Reform Act of 2008, later renumbered as § 1131 of the Housing and Economic Recovery Act, establishes two trust funds, a HUD-managed Housing Trust Fund to support production, preservation, and rehabilitation of rental housing and housing for homeownership and a Treasury Secretary-managed Capital Magnet Fund to support a competitive grant program to attract private capital for affordable housing and related economic development and community service activities." See: Peter W. Salsich, "National Affordable Housing Trust Fund Legislation: The Subprime Mortgage Crisis Also Hits Renters," *Georgetown Journal on Poverty Law Policy 16 (1) 2009; Research Paper No. 2009-08 (Saint Louis U. Legal Studies, 2009), available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1444383##.

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About the Authors

This paper is a product of the Multifamily Subcommittee of the Mortgage Finance Working Group organized by the Center for American Progress. The members of the full working group began gathering in 2008 in response to the U.S. housing crisis, in an effort to collectively strengthen their understanding of the causes of the crisis and to discuss possible options for public policy to shape the future of the U.S. mortgage markets. In order to focus more specifically on the multifamily housing market, a multifamily subcommittee was formed. Affiliations are provided for identification purposes only.

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Acknowledgements

Special thanks for the generous support of the Ford Foundation and the Open Society Institute, and to Amy Schnitzer and Griffin James for their work in support of this effort.

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