Center for American Progress

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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.

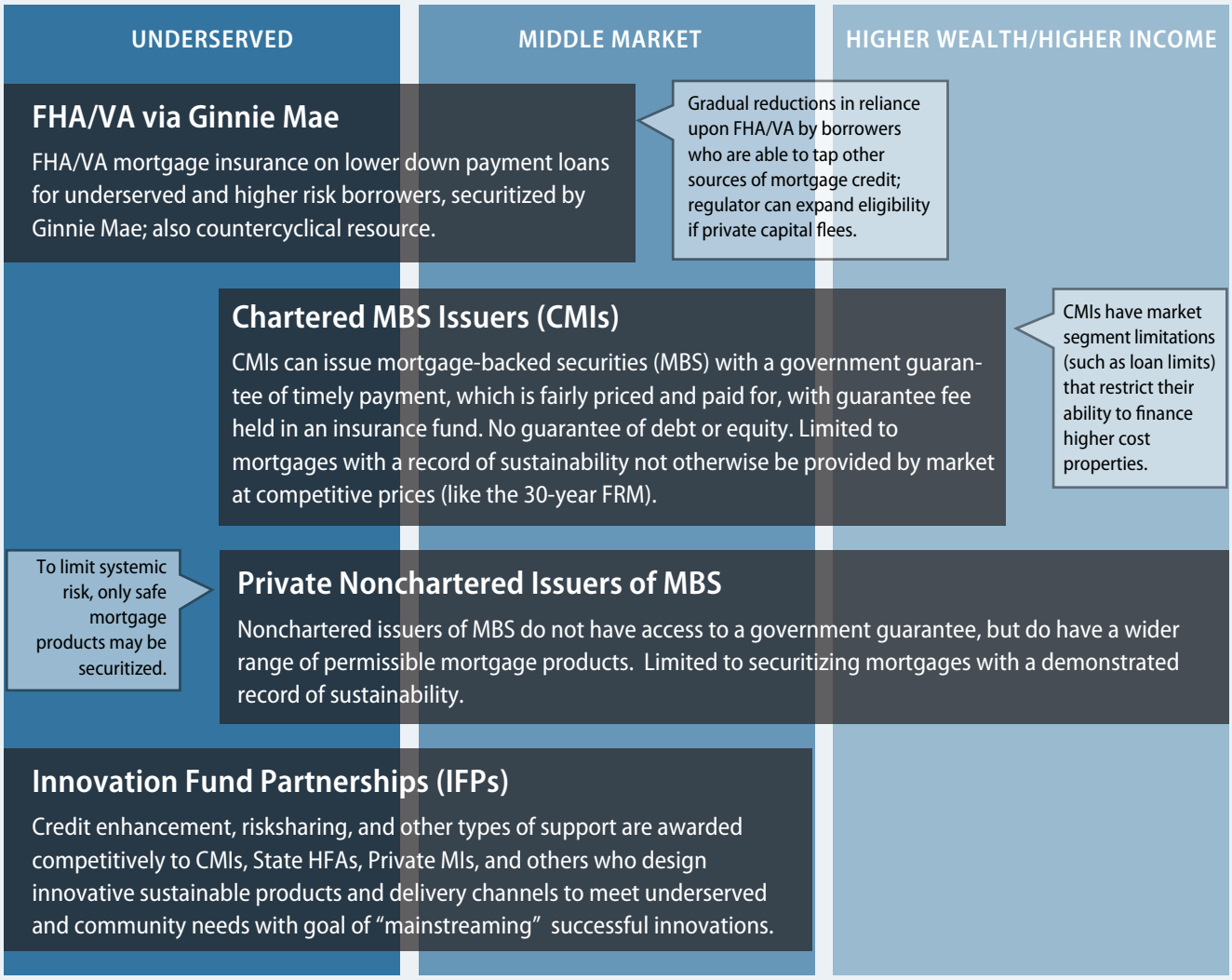
Our proposal offers a new framework in which Chartered Mortgage Issuers, or CMIs, would enjoy some limited governmental backing for their mortgage-backed securities and take on concomitant obligations to serve public purposes. But a key feature of our framework is that it also addresses the relationship 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.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is "of the people, by the people, and for the people."

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