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**THE IMPACT OF CHANGES IN MULTIFAMILY HOUSING FINANCE  
ON OLDER URBAN AREAS**

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## **ABSTRACT**

The multifamily mortgage market has changed dramatically over the last two decades. The relative importance of the thrifts—once the major source of financing for multifamily rental housing—has declined, while commercial banks, the government sponsored enterprises (GSEs) and private conduits have become the dominant players. Government involvement in the market has also devolved to the state and local level, and the nature of its involvement has changed. These developments have transformed a fragmented, localized mortgage market into a highly liquid one with access to capital throughout the world. While these changes have for the most part positive, certain segments of the market—in particular, small rental properties in urban areas—may well be underserved.

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# THE IMPACT OF CHANGES IN MULTIFAMILY HOUSING FINANCE ON OLDER URBAN AREAS

## I. INTRODUCTION

The last two decades have witnessed dramatic shifts in the financing of multifamily apartment buildings. Until the mid-1980s, local thrifts and savings banks were by far and away the largest providers of multifamily mortgages, followed by insurance companies and commercial banks. Since that time, however, the government-sponsored enterprises (GSEs) and private conduits have significantly increased their roles. While the secondary market for multifamily mortgages is not as highly evolved as it is for single-family housing, the gap appears to be closing rapidly. In fact, HUD estimates that in 1999, the extent of securitization in the multifamily mortgage market was close to that of single-family conforming mortgages (58.8 versus 60.8 percent).<sup>1</sup> This rapid increase in securitization has effectively transformed a system of fragmented, localized funding sources into a national mortgage market with access to capital around the world.

The last twenty years have also seen a more subtle, but nevertheless important shift in the government's involvement in multifamily housing finance. Federal subsidies for the construction and rehabilitation of rental housing peaked in the early 1970s, and then virtually disappeared. While FHA and other federal agencies—most notably, the RTC—were active in the disposition of troubled properties in the 1980s and 1990s, the federal government's role as a provider of new financing has been relatively limited for the past two decades. In contrast, state and local housing finance agencies (HFAs) have become increasingly important and now eclipse the federal government in terms of market share. The net result is that the government's direct involvement in the multifamily mortgage market has devolved to the state and local level, and the nature of its involvement has changed. While federal programs such as FHA and Farmers' Home assume the underlying mortgage risk, state and local agencies typically rely on other market participants to play this role.

This paper explores the impact of these trends on the financing of multifamily rental properties in older urban areas. Many of the issues examined here are similar to those raised for the single-family mortgage market,<sup>2</sup> although considerably less is known about the multifamily sector. Due to limitations in existing data, the primary objective of this report is to document trends and identify key policy issues for future research. Whenever possible, however, we piece together a variety of data sources to offer tentative conclusions about the probable impact on urban areas.

The paper begins with a brief discussion of the size and relative importance of the multifamily housing stock. It then addresses three research questions related to the financing of these units:

- What changes have occurred in the financing of apartment buildings over the past two decades?
- How have these trends affected the overall cost and availability of multifamily mortgage credit?
- Has the changing nature of multifamily mortgage finance adversely impacted older urban areas?

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<sup>1</sup> Federal Register, Vol. 65, No. 221, October, 2000, p. 65107.

<sup>2</sup> See, for example, ICF Incorporated, "Community Lending Through Lenders Eyes," 1992.

The paper concludes with a few suggestions for future research.

## II. THE MULTIFAMILY HOUSING STOCK

Multifamily rental housing—defined as properties with five or more dwelling units—represents a relatively small but important component of the nation’s housing stock. Although information on multifamily properties is difficult to obtain, one can estimate the size of the stock by combining several different data sources.<sup>3</sup> Such estimates are presented in Table 1, which shows the distribution of the nation’s housing stock by household tenure and property size.

**TABLE 1**  
**Estimated Distribution of Units by Tenure and Property Size: 2000**

	<u>Number of Units</u> <u>(thousands)</u>	<u>Percent of</u> <u>All Units</u>
Owner-Occupied Units	70,369	67.2 %
Renter-Occupied Units		
Single Family Rentals		
One Unit	11,483	11.0 %
<u>2 to 4 Units</u>	<u>6,168</u>	<u>5.9 %</u>
Total	17,651	16.9 %
Multifamily Rentals		
5 to 19 Units	3,734	3.6 %
20 to 49 Units	2,468	2.4 %
<u>Over 50 Units</u>	<u>10,485</u>	<u>10.0 %</u>
Total	16,687	16.0 %
All Rental Units	34,336	32.8 %
Total Occupied Housing Units	104,705	100.0 %

**Source: Author’s calculations based on US Census Bureau’s March 2000 Population Survey and the 1995-1996 Property Owners and Managers Survey.**

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<sup>3</sup> Most data sources on the housing stock—including the Decennial Census, the American Housing Survey, and the Current Population Survey—provide information on the number of units in the structure, as opposed to the number of units in the property. While the 1995-1996 Property Owners and Managers Survey (POMS) classifies rental properties with two or more units by property size, it does not contain data on one-unit rental properties or on the owner-occupied housing stock. The figures presented in Table 1 were derived by: taking the total number of rental units in one-unit and two-or-more-unit structures from the CPS; assuming that all rental units in one-unit structures were also in one-unit properties; and distributing the remainder of the rental stock according to the property size distribution obtained from POMS.

As shown in the chart, 70 million households—or two out of every three American families—currently own their homes. The 34 million households who rent are about evenly divided between those who live in single family housing (defined as properties with one to four dwelling units) and those who live in multifamily apartment buildings. Multifamily apartment buildings—the focus of this paper—represent about 16 percent of the total housing stock, or about 16.7 million units.

From a policy perspective, the financing of multifamily rental housing is important for several reasons. To begin with, the multifamily rental stock represents a critical source of affordable housing. As shown in Table 2, households living in these properties tend to be younger, smaller, and considerably less affluent than the average American household. They also include a significantly higher proportion of minorities. Since financing costs are the single largest expense for most multifamily properties, issues related to the costs and availability of mortgage funds have important implications for the overall affordability of rental housing.

Multifamily rental housing is also important for the revitalization of older urban areas. About 55 percent of all apartment units are located in central cities, compared to about 46 percent of the total housing stock. The vast majority of these units are more than 20 years old. Without an adequate supply of capital to support the on-going rehabilitation needs of these properties, the ability to maintain and preserve the existing housing stock in older urban areas would be severely limited.

**TABLE 2**  
**Selected Characteristics of Multifamily Rental Units: 1999**

	<u>Multifamily Units</u>	<u>All Housing Units</u>
Median Household Income	\$23,200	\$36,000
Household Size		
One	48 %	26 %
Two	27 %	33 %
Three	12 %	16 %
Four or More	<u>13 %</u>	<u>25 %</u>
	100 %	100 %
Age of Head		
Under 30 Years	31 %	14 %
30 to 44 Years	33 %	33 %
45 to 64 Years	20 %	32 %
65 Years or Older	<u>16 %</u>	<u>21 %</u>
	100 %	100 %
Race of Head		
White	67 %	81 %
Black	21 %	13 %
Other	<u>12 %</u>	<u>6 %</u>
	100 %	100 %
Percent Hispanic	16 %	9 %
Location		
Central City	55%	46%
Suburban	37%	38%
Non-metropolitan	8%	16%
Age of Stock		
Less than 10 Years	9.7%	12.1%
10-20 Years	21.2%	13.7%
20+ Years	69.2%	74.2%

**Source: National Multi-Housing Council calculations based on 1999 American Housing Survey. Data for multifamily housing refers to units in structures with five or more units, which represents an estimated 93 percent of the multifamily rental stock.**

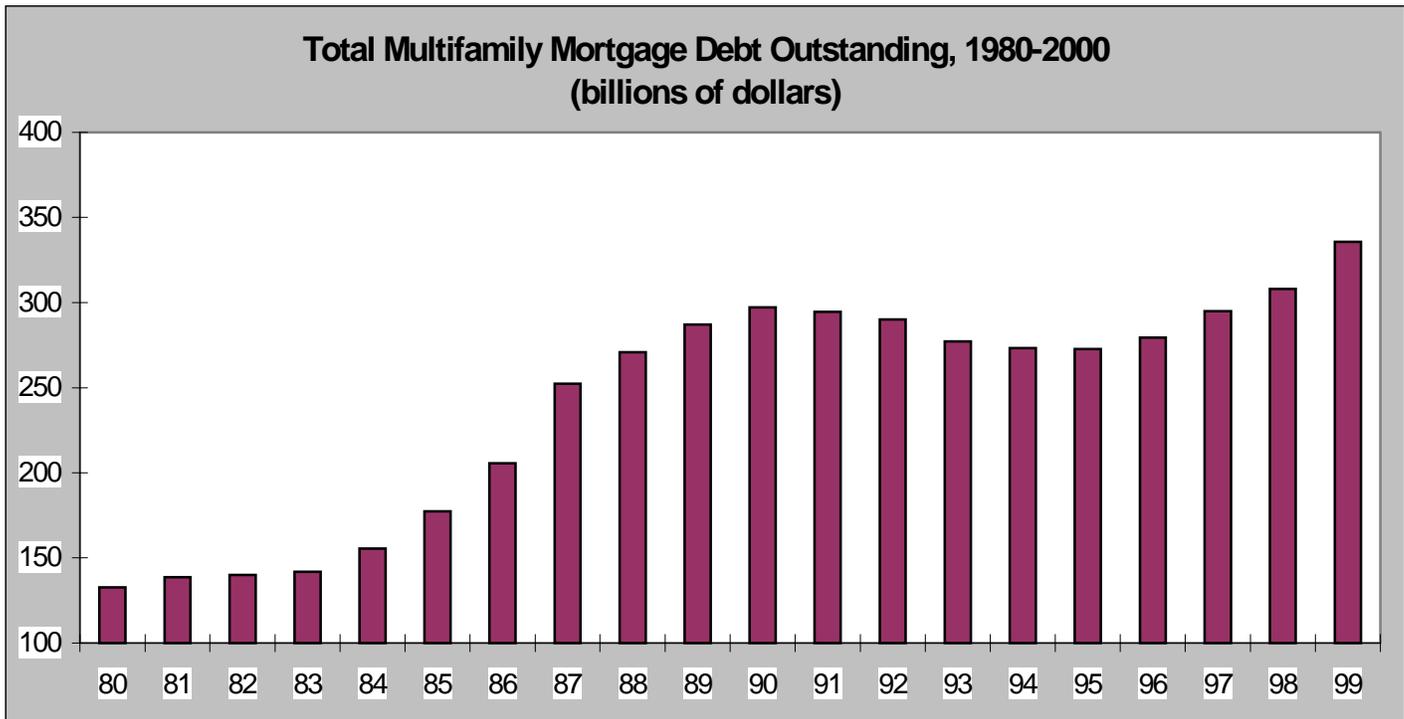
### III. RECENT TRENDS IN THE MULTIFAMILY MORTGAGE MARKET

The financing of multifamily apartment buildings has changed significantly over time.<sup>4</sup> This section examines changes in the outstanding stock of multifamily mortgage debt over the last twenty years. It then considers changes in the underlying sources of these mortgage funds.

#### A. Growth in Multifamily Mortgage Debt Outstanding

Figure 1 shows the overall growth in the stock of multifamily mortgage debt between 1980 and 2000. Over the last twenty years, multifamily mortgage debt has grown by about 185 percent (in nominal terms), from \$133 billion in 1980 to \$378 billion in 2000. Adjusted for inflation, the increase was about 31 percent. According to our estimates, the number of multifamily rental units increased by about 44 percent over the same period of time.<sup>5</sup> Differences in the growth rates of the mortgage and housing stocks could reflect a number of different factors, including: falling loan-to-value ratios; a decline in the percent of properties that are mortgaged; a decline in real property values; or conceivably, measurement errors. Unfortunately, the data needed to distinguish among these different explanations are not available at this time.

**FIGURE 1**  
Source: Federal Reserve Flow of Funds



<sup>4</sup> For an excellent analysis of recent trends, see Donald S. Bradley, Frank E. Nothaft, and James L. Freund, "Financing Multifamily Properties: A Play with New Actors and New Lines," *Cityscape: A Journal of Policy Development and Research*, Volume 4, Number 1, 1998.

The rate of growth in multifamily mortgage debt varied considerably over the last 20 years. Multifamily mortgage debt increased at a relatively rapid rate in the mid-1980s, reflecting the real estate boom that followed the 1981 Economic Recovery Tax Act. Multifamily construction starts rose from about 400,000 units per year between 1980 and 1982 to over 600,000 per year between 1983 and 1986.<sup>6</sup> However, the favorable tax treatment established in 1981 was eliminated by the 1986 Tax Reform Act. Passage of this legislation brought the construction boom to a screeching halt, and triggered a contraction in both the commercial and multifamily real estate sectors that lasted into the early 1990s. Multifamily construction starts fell from about 625,000 units in 1986 to only 162,000 units in 1993. Over the same period of time, the outstanding stock of mortgage debt began to decline, falling by about 8 percent between 1990 and 1994.

As the multifamily real estate market began to recover in the mid-1990s, mortgage debt began to grow. In fact, the annual rate of net mortgage growth increased from about 5 percent in 1996 to over 12 percent in 1999. This rapid increase can not be attributed to construction starts alone. Indeed, while the market has recovered, construction starts are still well below the levels observed in the early 1980s—only about 330,000-340,000 per year. Instead, the growth appears to reflect a significant increase in the average amount of mortgage debt per unit. Either mortgages are getting larger or a higher share of properties are being mortgaged, or some combination of the two.

Most industry experts agree that the multifamily mortgage market was awash in capital in the late 1990s, with large sums of money chasing increasingly scarce returns in many, if not all, sectors of the market. Undoubtedly, the strong economy played a significant role. In addition, the rapid rise of private conduits (see below) may have created an “artificial” demand for multifamily mortgages, since they are typically used to offset the higher risks of commercial loans in structuring Commercial Mortgage-Backed Securities (CMBS).<sup>7</sup> Regardless of the explanation, most observers believe that the current supply of capital for multifamily housing is more than adequate to meet its needs, although some sectors of the market may well be underserved.

## **B. Changes in Financing Sources**

Underlying these broad trends in net mortgage flows are pronounced shifts in the sources of multifamily financing. Table 3 shows the relative share of the outstanding multifamily mortgage debt held or securitized by different entities between 1980 and 2000. Table 4 depicts net changes in the mortgage holdings of these same entities over the same period of time. Net changes in mortgage holdings, roughly defined as acquisitions less sales and payoffs, represent net mortgage flows into

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<sup>5</sup> The estimate is based on Census data showing the increase in rental units in structures with more than five units.

<sup>6</sup> Census Bureau, Construction Starts, Series C-20.

<sup>7</sup> In the late 1990s, the standard “rule of thumb” was that at least 25 percent of a CMBS issuance should consist of mortgages on multifamily properties. Some industry analysts believe that, as the industry gains experience with commercial loans, the inclusion of multifamily mortgages will be less important.

and out of the system. Unfortunately, reliable data on gross mortgage flows, i.e., annual originations, are not available.<sup>8</sup>

Most of the categories presented in the two tables are fairly self-explanatory, although the concept of “mortgage holdings” differs for the different entities.

- Data for thrifts, commercial banks and insurance companies refer to mortgages held in portfolio.
- Data for the two GSEs—Fannie Mae and Freddie Mac—include mortgages securitized by the agencies, as well as mortgages held in their investment portfolios.
- Data for private conduits include mortgages funded through CMBS issuances (and held by a broad range of investors).
- Data for REITS include mortgages held in Real Estate Investment Trusts.
- Data for government-held mortgages refer to foreclosed mortgages held by the different federal agencies.
- Data for government-securitized mortgages refer to mortgages securitized by Ginnie Mae (GNMA) or Farmers’ Home.<sup>9</sup>
- Data for state and local housing finance agencies refers to mortgages funded by tax-exempt multifamily bonds under the private activity cap.
- Data in the “other” category includes mortgages funded by pension funds, as well as a variety of non-traditional mortgage arrangements, such as individual investors or seller-financing.

Note that there is no specific category for FHA loans. While most are securitized through GNMA, some end up with the GSEs or state and local housing finance authorities.

Several broad trends are immediately evident from the data presented in these two tables.

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<sup>8</sup> The only comprehensive survey--HUD’s annual Survey of Mortgage Lending Activity--was discontinued in 1997 due to persistent problems in the sampling frame. While HMDA data includes information on multifamily originations, its coverage is incomplete.

<sup>9</sup> Data for Farmers Home in the 1980s also include mortgages funded directly by the agency.

**TABLE 3**  
**Multifamily Mortgage Debt Outstanding (Percent Share)**

Year	Banks	Thrifts	Insurance Co.	GSEs <sup>10</sup>	Private Conduits	REITS	Federal				Total	State and Local	Other
							Held FHA/VA/ GNMA	RTC/ FDIC	Securitized FMHA	GNMA			
80 <sup>11</sup>	8%	39%	14%	5%	0%	0%	5%	0%	3%	1%	9%	7%	14%
81	9%	38%	14%	5%	0%	0%	5%	0%	3%	2%	10%	7%	14%
82	10%	38%	14%	4%	0%	0%	5%	0%	3%	2%	11%	8%	13%
83	11%	38%	13%	4%	0%	1%	5%	0%	4%	2%	11%	9%	12%
84	12%	40%	12%	4%	0%	1%	4%	0%	4%	3%	11%	10%	11%
85	12%	44%	11%	4%	0%	1%	3%	0%	4%	3%	9%	12%	11%
86	12%	46%	10%	5%	0%	1%	2%	0%	3%	3%	8%	12%	11%
87	12%	38%	8%	6%	0%	1%	1%	0%	9%	2%	12%	12%	10%
88	12%	40%	8%	6%	0%	1%	1%	0%	7%	3%	11%	14%	9%
89	12%	40%	9%	8%	0%	1%	1%	0%	7%	3%	11%	14%	9%
90	13%	37%	9%	9%	0%	1%	1%	0%	6%	4%	11%	14%	8%
91	12%	31%	10%	10%	0%	1%	2%	3%	6%	4%	15%	14%	7%
92	12%	27%	10%	11%	1%	1%	2%	5%	6%	3%	17%	14%	6%
93	13%	25%	10%	11%	2%	1%	3%	3%	7%	3%	16%	15%	6%
94	14%	25%	10%	11%	3%	1%	3%	2%	7%	3%	15%	16%	6%
95	14%	24%	10%	11%	4%	1%	2%	2%	7%	4%	14%	16%	7%
96	16%	23%	10%	13%	4%	1%	2%	0%	7%	4%	12%	16%	7%
97	16%	22%	10%	13%	6%	0%	1%	0%	6%	4%	11%	16%	8%
98	17%	20%	10%	13%	7%	1%	1%	0%	6%	5%	11%	16%	8%
99	17%	18%	9%	15%	11%	1%	1%	0%	5%	5%	10%	15%	8%
2000	18%	16%	9%	17%	12%	0%	1%	0%	5%	5%	9%	13%	8%

Source: Federal Reserve Flow of Funds data.

<sup>10</sup> Procedures used to calculate GSE holdings changed in 1982. Numbers on GSE holdings in 1980 and 1981 are estimates.

<sup>11</sup> Figures represent mortgage holdings at the beginning of each calendar year.

**TABLE 4**  
**Contribution to Total Net Mortgage Growth**

	1980-84	1985-1989	1990-1994	1995-2000 <sup>12</sup>
Banks	20%	15%	0%	30%
Thrifts	48%	25%	-170%	-6%
Insurance	-1%	7%	4%	4%
GSEs	2%	17%	15%	30%
Private Conduits	0%	1%	36%	30%
REITS	2%	1%	-2%	-2%
<i>Federal</i>				
<i>-Held</i>				
FHA/VA/GNMA	-4%	-2%	12%	-4%
FDIC/RTC	0%	0%	18%	-4%
<i>-Securitized</i>				
FMHA	6%	10%	-1%	-1%
GNMA	6%	5%	-2%	7%
<i>Total Federal</i>	<i>6%</i>	<i>14%</i>	<i>27%</i>	<i>-2%</i>
State and Local	25%	16%	15%	5%
Other	-3%	4%	-26%	10%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>-100%</b>	<b>100%</b>

Source: Federal Reserve Flow of Funds

**1. *The declining role of the nation's thrifts in the multifamily mortgage market***

From the 1930s onward, thrifts were the dominant institutional holders of multifamily mortgage debt. However, with the S&L crisis in the 1980s—and the subsequent outflow of capital from the system—the role of the thrifts began to decline. Between 1985 and 2000, thrifts' share of total mortgage debt outstanding fell from 46 to 15 percent. Actual dollar holdings declined by about \$53 billion (or 48 percent) between 1989 and 2000. A number of factors contributed to this outflow of funds, including defaults and write-offs on non-performing assets, the liquidation of failed thrifts, takeovers by commercial banks, and sales to an increasingly active secondary market. However, an analysis by Hamilton Securities concludes that the main explanation was the shrinkage of the thrift industry itself.<sup>13</sup>

In contrast to the thrifts, the market share of commercial banks remained relatively constant throughout the 1980s and then began to rise, increasing from about 12 percent in 1990 to 18 percent in 2000. Most of the increase occurred in the last five years of the decade, when commercial bank activity accounted for 30 percent of the net overall growth of the multifamily mortgage debt. In fact,

<sup>12</sup> Data includes an additional year

<sup>13</sup> This conclusion was based on the fact that multifamily loans as a percent of total thrift assets was fairly stable during the period. See Hamilton Securities, Major Trends in the Multifamily Mortgage Industry.

in the first quarter of 2000, banks were the largest single contributor to the market's growth, accounting for 52 percent of the net increase in mortgage debt.

The increased importance of commercial banks coincided with a widespread consolidation within the industry and bank takeovers of numerous thrifts (and mortgage bankers.) However, the growing role of commercial banks did not offset the declining contribution of the nation's thrifts. Over the twenty year period, the share of multifamily mortgage debt held in the portfolios of the nation's depositories declined from 47 to 34 percent.

The role of insurance companies—the other traditional source of multifamily funding—has also declined. Most of the decline occurred in the mid- to late-1980s, when aggressive underwriting policies on the part of thrifts triggered a 3 to 4 percentage point reduction in their market share.<sup>14</sup> Since that time, however, insurance companies have generally held their own, accounting for about 10 percent of the multifamily mortgage market. For the most part, these companies focus on the upper end of the rental market.

## **2. *The growing importance of the secondary mortgage market***

Fannie Mae and Freddie Mac began issuing securities backed by multifamily FHA loans in 1970, and extended their products to include conventional multifamily passthroughs and participation certificates in the late 1970s. However, GSE purchases and securitization of multifamily mortgage debt remained relatively low in the early years. In 1980, Fannie Mae and Freddie Mac's combined market share was just 5 percent of all multifamily mortgage debt outstanding, and it stayed at about this level until the middle of the decade.

Starting with the thrift crisis in the late 1980s, however, GSE purchases of multifamily mortgages began to accelerate. Between 1985 and 1990, Fannie Mae and Freddie Mac accounted for 17 percent of the net increase in multifamily mortgage debt, bringing their combined market share to 9 percent by 1990. Large losses in Freddie Mac's portfolio—triggered by poor underwriting standards and a soft multifamily market—led that company to suspend its multifamily operations between 1990 and 1993, creating a drag on agency growth. Since that time, however, Freddie Mac has reentered the multifamily market, and both GSEs have continued to grow their portfolios. By 2000, the combined market share of the GSEs had risen to 17 percent. In fact, between 1995 and 2000, Fannie Mae and Freddie Mac combined accounted for about 30 percent of the overall increase in multifamily mortgage debt—roughly the same as commercial banks.

While the two GSEs have become increasingly important players in the multifamily mortgage market, so have private conduits. The non-agency private market did not get into the multifamily mortgage-backed securities business until the mid-1980s, when Standard & Poors developed a ratings system for apartment-backed securities.<sup>15</sup> Although other rating agencies followed, the

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<sup>14</sup> Kerry D. Vandell, "Multifamily Finance: A Pathway to Housing Goals, a Bridge to Commercial Mortgage Market Efficiency," 2000.

<sup>15</sup> Vandell, *op. cit.*

Commercial Mortgage Backed Securities (CMBS) market remained relatively small until the early 1990s, when the Resolution Trust Corporation (RTC) was created to dispose of assets acquired from the nation's ailing thrifts. From the start, the issuance of large scale, privately issued CMBS was a key component of the RTC's overall asset disposition strategy. As investors gained familiarity with these securities—and as Wall Street developed a series of complex derivative products tailored to meet a variety of investment needs—the CMBS market exploded. Growth in privately issued CMBS continued after the RTC closed its doors. At its peak in 1998, CMBS accounted for almost half of the net annual increase in multifamily mortgage debt.

However, the CMBS market was brought to a virtual standstill in the fall of 1998, when a default on Russian bonds shook financial markets here and abroad. The resulting turmoil led to a massive “flight to quality” that caused prices on higher-risk CMBS tranches to collapse. This, in turn, contributed to the demise of two of the largest investors in CMBS—Long Term Capital Management, one of the country's premier hedge funds, and Criimi Mae, a mortgage REIT. Although the CMBS market has recovered to a certain degree, it has yet to return to its previous level, with net growth in 1999 (\$8.3 billion) well below growth in the previous year (\$12.7 billion.) Despite this setback, CMBSs accounted for about 30 percent of the net increase in multifamily mortgage debt over the last five years of the decade—roughly the same as the two GSEs and commercial banks

With declining issuances, the CMBS industry has begun to consolidate, with a smaller number of firms emerging as “top tier” players and providing “brand name” securities.<sup>16</sup> The role of the Wall Street conduits has also declined. Although investment banking firms continue to be the market innovators, conduits sponsored by more traditional real estate lenders are becoming increasingly active. In the first nine months of 1999, loans contributed to CMBS transactions from commercial banks, life insurers and credit companies jumped from 30 to 50 percent of all loans securitized by private conduits.<sup>17</sup> In fact, most commercial banks now underwrite their mortgages to meet secondary market standards, whether or not they continue to hold them in portfolio, making the impact of securitization even more important than the numbers would suggest.

### **3. *The devolution of federal government involvement to the state and local level***

Federal involvement in the multifamily mortgage market traces its roots back to 1934, with the creation of the 207 rental housing insurance program. While production levels never came close to those experienced under the single family program, additional FHA products for targeted segments of the market were developed over the years, although most were limited in scope. The major exception was Section 236, which financed a significant share of multifamily housing starts in the early 1970s.

However, perceived problems with these and other assistance programs at HUD led to a general moratorium in 1973. The Multifamily Coinsurance Program was created in the following year in an attempt to correct some of the deficiencies of earlier programs. This program proved to

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<sup>16</sup> “CMBS Outlook 2000,” *Apartment Finance Today*, Vol. 3, No.6, November/December 1999.

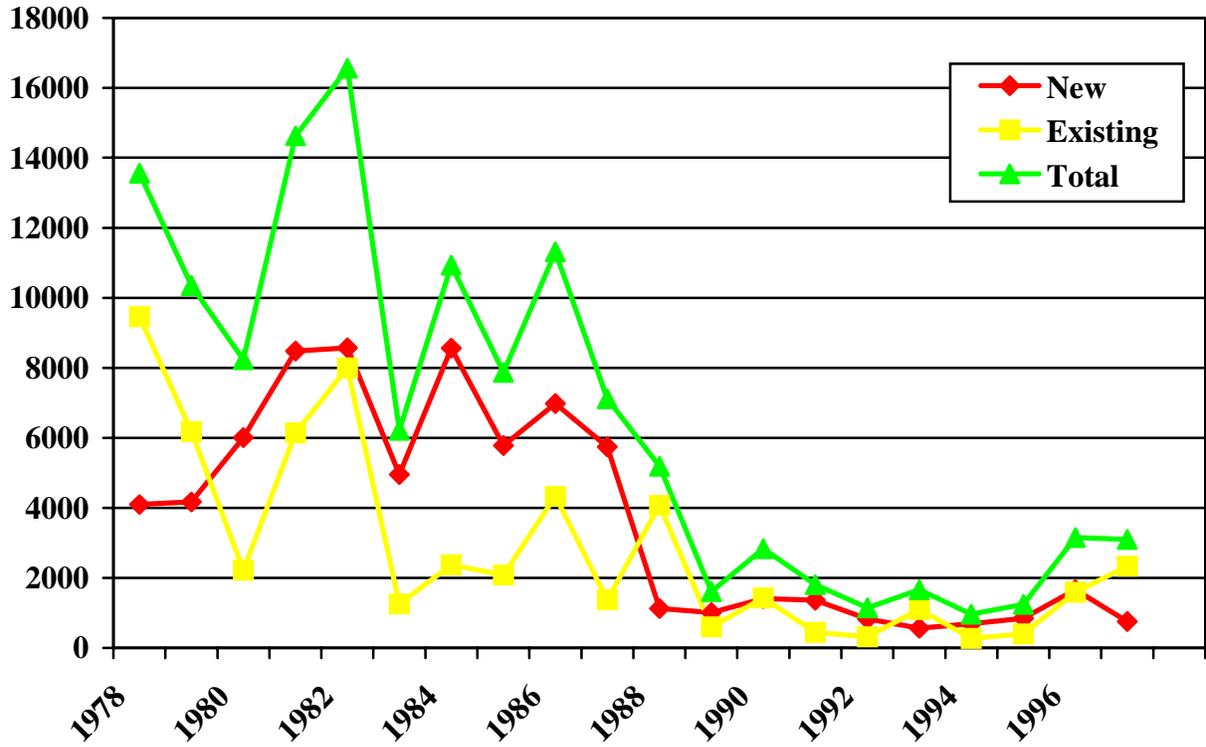
<sup>17</sup> Ernst & Young, *Commercial Mortgage-Backed Securitization Update*, 1999-2000.

be a disaster as well, racking up some \$10 billion in losses within a relatively short period of time. Most observers agree that by the early 1990s, FHA had ceased to be an important player in the multifamily mortgage market. Its primary role in the last ten years has been to refinance its existing portfolio and to offer forward commitments on new developments. While FHA has implemented risk sharing programs with state HFAs and the GSEs, the volume to date has been relatively low—only about \$365 million with HFAs in 2000 and less than \$8 million with the GSEs.

The diminished role of the federal government is reflected in Tables 3 and 4. Although the federal share appears to have grown significantly in the early 1990s, this growth primarily reflects an increase in mortgage holdings by the RTC. These holdings, by their very nature, were temporary, not permanent investments. The subsequent decline in federal holdings in the mid-to late 1990s reflects the disposition activities of the RTC, as well as reductions in the HUD-held inventory.

In contrast, the securitization of new mortgages through GNMA and Farmers Home—the other component of the federal share—has been relatively low throughout the twenty-year period. While GNMA accounted for about 7 percent of the market's growth between 1995 and 1999, much of this growth was associated with the disposition of the HUD-held inventory, which accounted for a 4 percent decline in the overall stock during that same period of time. As noted earlier, GNMA issuances are not synonymous with FHA originations. Since some FHA loans are financed through state and local tax-exempt bonds, the figures in Tables 3 and 4 tend to understate the federal government's role. Nevertheless, as shown in Figure 2, data on FHA originations between 1978 and 1997 (obtained from the Survey of Mortgage Finance) confirms the greatly diminished role of FHA.

**FIGURE 2**  
**Long-term FHA Insured Multifamily Mortgage Volume**  
 (1994 dollars)



Source: HUD Survey of Mortgage Lending Activity, 1978-1997

Although the federal government role has declined, state and local agencies have significantly increased their market share. In 1980, state and local agencies accounted for just 7 percent of the multifamily mortgage stock. By 1990, their share had doubled to 14 percent, about the same as the federal government's. State and local agencies continued to grow in the 1990s, although their contribution to the market's overall growth was considerably lower at the end of the decade than it was in the beginning. The recent decline in the relative share of state and local governments most likely reflects the constraints imposed by the per capita limit on tax credit issuances; this limit, which was increased by 40 percent in 2000, had been in effect since the program's inception in 1986.

Despite the recent slowdown in growth, the stock of mortgages supported by state and local housing agencies today is about 30 percent higher than the total federal share of multifamily mortgage debt. However, it is important to recognize that the nature of state and local agency involvement is fundamentally different from the role of FHA, GNMA or Farmers Home. State and local housing agencies rarely assume the underlying risk of the mortgages that they issue. Instead, they rely on other market players—including FHA, the GSEs, and private insurers—to assume most of the credit risk. In this sense, state and local agencies are more like private conduits and less like the other major investors or insurers of mortgage debt, including depositories, insurance companies, the GSEs and the federal government.

#### **4. *The increased concentration of market power among key providers of multifamily mortgage finance***

The most striking example of increased concentration of market power is the dominant roles of Fannie Mae and Freddie Mac. Although their importance—and comparative advantage—in the multifamily mortgage market is not as pronounced as it is for single family housing, the two agencies combined accounted for over 30 percent of the market's growth between 1995 and 2000, and their overall purchase volume continues to be strong. This has led some industry participants to fear that the continued dominance of the GSEs may ultimately crowd out other investors, leading to fewer financing options and a less competitive mortgage market.

In addition to the increased importance of the GSEs, a number of other factors are contributing to the growing concentration of market power. These factors include:

- the declining role of the thrifts, which have traditionally operated at the local level;
- the consolidation of the financial services industry, which has created a small number of large national (and international) players; and
- the shake-out that is now occurring among private conduits.

Ninety percent of the growth in multifamily mortgage debt between 1995 to 2000 was attributed to three institutional players with more or less equal shares—the two GSEs, private conduits, and commercial banks—and consolidation is occurring within the latter two sectors. Thus,

what was once a highly fragmented, localized market for multifamily mortgages has become increasingly the domain of Wall Street and the country's largest financial institutions.

## IV. MARKET-WIDE EFFECTS

To understand the likely impact of these trends on urban areas, one must first consider their effect on the overall cost and availability of multifamily mortgage credit. This section examines the impact of securitization on mortgage rates and terms, regional differences in financing costs, and market volatility. Extensive research on the single-family side has shown that the growth of the secondary market has had a large and positive effect in each of these areas.<sup>18</sup> Considerably less is known about the probable impact on the multifamily sector.

### A. Financing Costs

At first glance, the data appear to support the hypothesis that the growth of the secondary mortgage market has led to a marked decline in the relative financing costs of multifamily properties. Relative costs are typically measured by the spread between the average multifamily mortgage rate and the rate on a ten-year Treasury bond; the lower the spread, the lower the relative cost of a multifamily mortgage. In the early 1990s, when the secondary mortgage market was relatively small and the multifamily sector was still depressed, multifamily mortgage rates were about 225 basis points higher than the rates on ten-year Treasuries. By 1998, when GSEs and private conduits accounted for about 82 percent of the net increase in multifamily mortgage debt, spreads had fallen to between 130 and 140 basis points.

While the growth of the secondary market is consistent with these falling spreads, a recent analysis by Nothaft and Freund concludes that other factors were at work.<sup>19</sup> Premiums that credit markets required for higher risk investments declined significantly in the mid-to-late 1990s, reflecting the general euphoria produced by a booming economy and a sky-rocketing stock market. When Nothaft and Freund controlled for these lower market risk premiums, the growth of the secondary market *per se* did not appear to explain the relative decline in multifamily mortgage rates. In other words, while spreads to Treasuries declined significantly in the mid- to late 1990s, the market's greater appetite for risk—as opposed to securitization—appears to have been the driving force. The fact that spreads have returned to their earlier levels following the 1998 financial crisis is consistent with this conclusion.

This result most likely reflects the secondary market's relatively early stage of development. To date, application of sophisticated risk assessment and management tools has been severely hampered by the lack of reliable data on the performance of multifamily loans. The use of technology and e-commerce has also been relatively limited. As a result, mortgage underwriting remains a highly labor intensive task involving a fair amount of redundancy and requiring considerable legal and administrative expenses. While the secondary market is making great strides in bringing standardization to the market, transactions costs are still too high to realize the kinds of

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<sup>18</sup> See, for example, *Financing America's Housing: The Vital Role of Freddie Mac*, 1996.

<sup>19</sup> Frank E. Nothaft and James L. Freund, "Recent Developments in Multifamily Mortgage Markets: The Increasing Role of Securitization," Freddie Mac, April 1999.

savings that have been achieved in the single-family market. As described in more detail below, these high costs make securitization a particularly unattractive option for smaller properties.

## **B. Regional Imbalances**

Although significant cost benefits may not have been realized to date, the development of a secondary market for multifamily mortgages—as well as the consolidation of the banking industry—does appear to have had a positive effect on the relative cost and availability of funding in different parts of the country. When the system relied mainly on local depositories, imbalances in the demand and supply of capital in particular markets often led to large regional differences in mortgage rates. Borrowers in high growth areas were particularly disadvantaged, since competing demands for a limited supply of capital typically led to higher interest rates.

However, a recent study by Bradley, Freund and Nothaft found that these regional variations have declined significantly in recent years.<sup>20</sup> For example, in 1992, average interest rates on new multifamily mortgage commitments extended by life insurance companies varied by as much as 1.3 percent across in different regions of the country. By 1997, this variation had narrowed to just 0.3 percent. This finding is consistent with other studies that conclude that the multifamily mortgage market is now fully integrated with the broader capital market.<sup>21</sup>

### **1. Market Volatility**

Integration with the broader capital market may bring costs as well as benefits. On the one hand, it eliminates the type of credit rationing that characterized both the single- and multifamily mortgage markets in the past. On the other hand, it makes the mortgage market more susceptible to competing demands for capital, which can at times be disruptive.

As noted earlier, one such disruption occurred in the fall of 1998 when a default on Russian bonds triggered a massive “flight to quality” that had devastating effects on fixed income securities around the world. During this period of time, the market for CMBS—which had accounted for almost 50 percent of net mortgage flows in the months immediately preceding the financial crisis—all but disappeared. However, the setback to private conduits proved to be an enormous opportunity for the GSEs, who purchased record volumes of loans in late 1998 and early 1999. As a result, capital continued to flow into multifamily housing, keeping mortgage rates relatively low and shielding the multifamily sector from the volatility that shook other parts of the capital market, including commercial real estate.

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<sup>20</sup> Op Cit

<sup>21</sup> See, for example, Richard L. Haney, Donald R. Epley and Kartano Liono, “Comparing Commercial Mortgage Origination Rates to Yields in Other Capital Markets,” October 1997; J. Sa-Aadui, James D. Shilling, and George H. K. Wang, “Deregulation, Financial Innovation and the Integration of Mortgage and National Capital Markets,” November 1997.

To a large degree, the response of the two GSEs reflects their dedicated presence in the mortgage market, as well as their reliance on multifamily mortgages to meet Congressionally-mandated affordable housing goals. However, it also reflects the fact that the broad flight to quality lowered the agencies' relative financing costs and significantly increased their competitive position. Whether or not such a favorable situation will occur again is open for speculation, although the relative cost advantage of the GSEs typically increases during periods of uncertainty. In any event, it seems safe to assume that the presence of the two GSEs serves to dampen, if not eliminate, potential swings in the relative costs and availability of mortgage credit triggered by events in the broader capital market.

## **2. *Mortgage Terms***

The terms of the typical multifamily mortgage have also been affected by the evolving nature of the market, although these changes are not directly related to the increased importance of securitization. While data on mortgage terms are not readily available, most observers agree that the last twenty years has seen a dramatic shift away from long-term, fixed rate financing in favor of short-term, revolving mortgage debt.

Up until the 1980s, multifamily properties were typically financed with long term, fixed rate mortgages amortizing over a period of 20 to 25 years.<sup>22</sup> With the exception of government loans, this form of financing has virtually disappeared. The rapid increase in interest rates that occurred in the early 1980s threatened the financial viability of many major investors, whose costs of funds were well above the returns on their mortgage portfolios. The lending community responded to this crisis by dramatically reducing the term of the typical loan. Within a relatively short period of time, the most common form of new financing for apartment buildings became a five- to ten-year balloon. While some adjustable rate mortgages were also issued, they have not become a dominant financing mode since investors are largely protected by the short maturities of bullet loans.

By 1993, more than 60 percent of outstanding multifamily mortgage debt was variable rate or would mature in less than ten years.<sup>23</sup> More than half of all fixed rate, long term financing was attributed to HUD, FmHA and state and local HFAs. The shift to short-term financing has undoubtedly continued since that time, with maturing fixed-rate mortgages typically replaced with bullet debt. Today, the standard multifamily mortgage—whether financed by depositories, the GSEs or private conduits—is a five- to 15-year balloon mortgage with a lock-in period or another type of prepayment penalty that protects investors in a down-rate period.

The net result has been a transfer of interest rate risk from the holders of mortgage debt to property owners and indirectly, rental households. This stands in stark contrast to the single family mortgage market, where interest rate risk for the most part resides in the broader capital market. To date, this development has been relatively benign, given the declining interest rates that have

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<sup>22</sup> Vandell, *op. cit.*

<sup>23</sup> Hamilton Securities, *op. cit.*

characterized most of the last ten years. Nevertheless, the fact that the multifamily real estate sector now holds the majority of the interest rate risk—and the fact that this risk is not adequately hedged—may have important implications for the rental housing market in the event that the U.S. economy returns to a rising interest rate environment.<sup>24</sup>

### **C. Impact on Urban Areas**

In general, these broad developments in the multifamily mortgage market appear to have been favorable, particularly from the perspective of access to capital. What was once a fragmented, highly localized market has become integrated with capital markets both here and abroad. While the sector as a whole has undoubtedly benefited from the increased access to funds, less is known about the extent to which different segments of the apartment market have been differentially affected by these trends. This section focuses on the likely impact on older urban areas, home to many of the nation's poor.

Although relatively little research has been conducted on this issue, some have argued that the shrinkage of the thrift industry, the growth of the secondary market, and the increased concentration within the industry have disadvantaged older neighborhoods. Large national players are less likely to be familiar with local markets and needs, and may also be less flexible in their underwriting procedures and practices. The devolution of government involvement in the multifamily mortgage market may also be a negative, since FHA has traditionally focused on older urban areas while state and local HFAs have appropriately served a broader constituency. While it is difficult to provide definitive answers to these questions, some inferences can be drawn by examining the extent to which different market investors appear to focus on different segments of the market. This section begins by examining the types of properties characteristic of older urban areas. We then present some preliminary data on differences in the types of multifamily mortgages purchased or originated by the major players in the market place today. Based on this analysis, we assess the probable impact on urban areas of the following trends: the declining role of the thrifts; the growth of the secondary market; and the increased importance of HFAs.

#### **1. Characteristics of Multifamily Properties in Older Urban Areas**

Older urban areas can be defined in many ways, for example, by a central city location; by the income and racial composition of the census tract; and by the age and physical condition of the housing stock. They can also be defined by property type. In general, the kinds of properties that are located in older urban areas differ from those in newer sections of a metropolis due to the timing of development and the difficulties involved in assembling large tracts of land in high density areas. While data on the characteristics of properties (as opposed to units) are difficult to obtain, most observers agree that properties in the older parts of urban areas tend to be considerably smaller

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<sup>24</sup> Even in a down-rate environment, the prevalence of lock-ins and prepayment penalties may expose property owners to a competitive risk since they are less able to take advantage of lower rates.

than other rental developments, typically in the five to 50 unit range.<sup>25</sup> As shown in Table 1, such properties represent about 37 percent of all multifamily rental units and about 6 percent of the total housing stock.

A recent analysis by Bradley, Cutts and Follain uses the 1996 Property Owners and Managers Survey (POMS) to compare key characteristics of small (five to 20 units), medium (21 to 49 units) and large (50+ units) multifamily developments.<sup>26</sup> The authors caution that serious problems with missing data may make their estimates subject to error. However, the study provides one of the few systematic looks at the characteristics of properties of different size.

For the most part, the study confirms a number of common assumptions about the characteristics of small rental properties. Key findings include:

- Small rental properties tend to be considerably older than larger developments. The mean age of properties with five to 20 units (46 years) is 64 percent higher than properties with over 50 units (28 years.)
- Small rental properties tend to have a higher concentration of low and moderate income families. For example, 37 percent of small property owners said that their tenants were primarily “low income,” compared to 24 percent for larger developments.
- Small properties are also less likely to receive direct government assistance, including Section 8, the Low Income Tax Credit, government grants and/or property tax relief. Only 34 percent of small properties reported that they receive some type of government assistance, compared to 56 percent of large developments.
- Smaller properties are more likely to be owned by an individual (as opposed to a partnership, a corporation, a non-profit, or a REIT). Seventy-seven (77) percent of small properties are individually owned, compared to 30 percent for a large developments.
- Small properties are more likely to have a poor financial profile. Nearly 8 percent of small (and medium size) properties have both negative equity and negative cash flow. This compares to about 3.5 percent for properties with more than 50 units.
- Small multifamily properties are less likely to have a mortgage. Thirty-nine (39) percent of small properties reported that they had no outstanding mortgage debt, compared to about 16 percent of large developments.
- Small properties that do have a mortgage tend to pay significantly higher mortgage rates. According to the authors’ estimates, rates on small properties are about 100 basis points higher than rates on large developments. The study was unable to assess the extent to which this premium was justified by differences in the financial characteristics of these properties; however, given the profile described above, such a differential may well be appropriate.

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<sup>25</sup> Largely because of this assumption, Fannie Mae and Freddie Mac will get “extra credit” for any small multifamily mortgages that they purchase under HUD’s recently proposed revisions to the GSEs’ Affordable Housing Goals.

<sup>26</sup> Donald S. Bradley, Amy Crews Cutts, and James R. Follain, “An Examination of Mortgage Debt Characteristics and Financial Risk Among Multifamily Properties,” Freddie Mac, January, 2000.

In general, the study concludes that the underwriting of smaller properties tends to be largely based on the credit history and financial capacity of the owner. Such “signature” loans often require other forms of collateral and thus place more of the credit risk on the property’s owner. This treatment stands in stark contrast to the underwriting of larger developments, which is largely based on the financial viability of the property itself.

## 2. Differences in the Types of Properties Financed

No single data source can be used to describe the types or location of multifamily mortgages purchased or originated by various participants in the market. However, one can piece together information available from HUD, the HMDA files, and the annual reports of the two GSEs to provide at least a partial glimpse of likely differences among multifamily housing’s major funding sources.

Table 5 shows the distribution of loans by mortgage amount, which is a proxy for project size. Table 6 shows the distribution of units financed by their location and affordability. Affordability is measured by the minimum income required to pay the project’s average rent (adjusted for the median income of the metropolitan area.) Project location is measured along two dimensions: location in an underserved census tract; and location in a central city. Underserved census tracts include those with a median income that was less than 80 percent of the local area median in 1990, and/or a minority population of 30 percent or more.<sup>27</sup>

**TABLE 5**  
**Distribution of Multifamily Mortgages by Size of Loan**

	Percent of Total Loans				<u>Total</u>
	<u>&lt;\$1m</u>	<u>\$1-2 m</u>	<u>\$2-4m</u>	<u>&gt;\$4m</u>	
Depositories: 1999 <sup>28</sup>					
Banks	51%	25%	13%	11%	100%
Thrifts	56%	27%	11%	6%	100%
GSEs: 1999 <sup>29</sup>					
Freddie Mac	18%	23%	22%	36%	100%
Fannie Mae	13%	17%	23%	47%	100%
HUD: 1997 <sup>30</sup>	13%	16%	27%	44%	100%

<sup>27</sup> This definition is used by HUD as part of the GSE goals.

<sup>28</sup> 1999 HMDA data

<sup>29</sup> GSE Public User files

<sup>30</sup> Author’s calculations

The data in the chart are drawn from a variety of sources and years. As a result, they are not strictly comparable. However, preliminary analysis of data for other years suggests that the patterns presented in the charts are fairly stable over time. The data are also incomplete. While we were able to get information for the GSEs, commercial banks, thrifts, and the FHA, data on the characteristics of multifamily mortgages funded by private conduits and state and local HFAs were not available.

**TABLE 6**  
**Distribution of Units Funded by Property Characteristics**

	<u>Thrifts</u>	<u>Banks</u>	<u>Fannie Mae</u>	<u>Freddie Mac</u>	<u>New</u>	<u>FHA Existing</u>
Location: <sup>31</sup>						
Underserved Tracts	55%	44%	39%	38%	31%	42%
Central City	63%	64%	56%	52%	62%	50%
Suburban	37%	36%	44%	48%	38%	50%
Percent Affordable to: <sup>32</sup>						
< 60 % of Median	NA	NA	45%	47%	22%	45%
60 to 100% of Median	NA	NA	50%	49%	69%	52%
>100% of Median	NA	NA	5%	4%	9%	3%

<sup>31</sup> Data for Depositories is tabulated from 1999 HMDA data. Data for GSE Underserved Tracts is taken from GSE Public Use Files. Data for FHA is based on 1994-1996 mortgage activity. See William Segal and Edward J. Szymonoski, "Fannie Mae, Freddie Mac, and the Multifamily Housing Market," Cityscape, Volume 4, Number 1, 1998.

<sup>32</sup> Data on rent affordability is based on 1997 mortgage activity. See Edward J. Szymonoski and Susan J. Donahue, "Do FHA Multifamily Mortgage Insurance Programs Provide Affordable Housing and Serve Underserved Areas?" Working Paper No. HF-008, October 1999. Data for GSE affordability is taken from GSE Public Use Files

**a. Project Size**

Differences by project size are quite dramatic. Both banks and thrifts originate relatively high volumes of loans that are less than \$1 million. In 1999, such loans accounted for about 56 percent of originations for thrifts and about 51 percent of originations for banks. While the concentration on smaller mortgages is more pronounced for thrifts, commercial banks are not far behind. This stands in stark contrast to the GSEs and HUD, who each tend to concentrate on larger loans and, presumably, larger properties. In fact, HUD and the two GSEs look almost identical in this regard. Roughly 40 percent of their mortgages exceed \$4 million, while less than 15 percent of their mortgages are below \$1 million.

One reason that the purchases of the GSEs tend to be geared to larger properties is the high administrative and legal fees associated with securitization, in large part driven by due-diligence costs. Since many of these fees are fixed and do not depend on mortgage amount, securitization is a less attractive option for smaller properties. While information on private conduits was not available, knowledgeable observers believe that the same holds true for CMBS. Although the GSEs and private conduits may have a comparative advantage on larger loans, their costs make them relatively uncompetitive for smaller loans. This is consistent with the conclusion, noted earlier, that the securitization of multifamily mortgages has yet to produce the kinds of efficiencies that would lead to a significant reduction in financing costs.

The same basic argument may apply to FHA. In particular, FHA's lengthy and complex processing requirements may be far too cumbersome for smaller property owners. These owners may prefer to deal with their local depositories, who are more likely to underwrite the mortgages based on their existing relationship with the owner, as well as his or her credit history and personal financial resources. Although HUD has attempted to streamline its procedures for smaller properties, such efforts have met with limited success, as have similar efforts by the GSEs.<sup>33</sup>

**b. Property Location**

While differences in location are not as pronounced as they are for project size, thrifts are more likely to lend in underserved neighborhoods compared to the other participants, including commercial banks. About 55 percent of thrift originations are in underserved census tracts, compared to just over 40 percent for the GSEs, commercial banks, and HUD. Both thrifts and banks are also more likely to fund mortgages in the central city, but the differences are not particularly large.

The greater tendency for thrifts to lend in underserved neighborhoods may reflect a comparative advantage stemming from their greater familiarity with local markets. To the extent that such neighborhoods are more difficult to evaluate—and the properties more difficult to underwrite—

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<sup>33</sup> Drew Schneider and James Follain, "A New Initiative in the Federal Housing Administration's Office of Multifamily Housing Programs: An Assessment of Small Projects Processing," *Cityscape: A Journal of Policy Development and Research*, Volume 4, Number 1, 1998.

the more detailed local knowledge of the thrifts may enable them to serve segments of the market that are more difficult for national players to reach. Thrifts' concentration in underserved neighborhoods may also reflect their specialization—and comparative advantage—in smaller loans. In 1999, 62 percent of multifamily mortgages under \$1 million were originated in underserved census tracts, compared to 44 percent of larger multifamily mortgages.<sup>34</sup> Finally, the greater concentration of thrift activity in underserved neighborhoods may also reflect the impact of CRA, although housing goals established for the GSEs encourage the agencies to lend in these areas as well.

### **c. Affordability**

Table 6 also presents data obtained from a recent HUD report comparing differences in the affordability of properties financed by the GSEs and HUD in 1997. In particular, it shows the proportion of units financed that were affordable to moderate, low, and very low-income families, based on reported rents. While newer FHA developments tend to serve somewhat higher income families, the income mix of properties financed by the GSEs—who do relatively little new construction—is about the same as HUD's existing programs. Since rent data are not available for other financing sources, the analysis is obviously limited. Nevertheless, it is consistent with other data suggesting that the GSEs and HUD look remarkably similar in terms of the characteristics of properties financed.

## **D. Implications for Urban Areas**

Drawing implications from these admittedly incomplete data is an inherently dangerous task. At best, the data presented in this report can be used to bolster certain arguments, and shed some doubts on others. While the trends are certainly clear, assessing the impact of these trends on urban areas involves a level of complexity that cannot be supported with the data currently available. Nevertheless, the information presented in this report raises some important policy issues, discussed below.

### **1. *The Declining Role of the Thrifts***

As shown in the previous section, thrifts appear to serve a unique market niche believed to be critical to older urban areas. For example, a much larger portion of their business consists of loans on smaller properties. Thrifts are also more active in underserved neighborhoods. The declining role of the thrifts could thus have implications for urban areas if other market participants are less willing—or less able—to meet their needs.

To some extent, commercial banks may be supplementing the traditional role of the thrifts. However, while they also concentrate on smaller loans, they appear to be less active in underserved neighborhoods. In addition, while commercial banks have increased their market share in recent years—accounting for about 30 percent of the net increase in mortgage debt over the last five years—the overall share of depositories has continued to decline.

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<sup>34</sup>1999 HMDA.

Whether or not this trend has adversely affected older urban areas is difficult to assess. Relatively little evidence exists on the extent to which such markets are being adequately served. Practitioners generally believe that capital is not the problem, at least in the current environment. Rather, the problem appears to be the inability of project rents to carry operating and maintenance costs. Whether or not this conclusion is unique to the current environment—when capital is fairly plentiful—is open to question. At this point in time, however, there is insufficient evidence to conclude that the declining role of the thrifts *per se* has had a negative effect on older urban areas.

## **2. *The Increase in Securitization***

Arguments regarding the probable impact of securitization on older urban neighborhoods are the flipside of those that have been raised with respect to the thrifts. Today, there are many economic barriers (for example, the costs of securitization and the risk of adverse selection) that make properties in older urban areas less suitable for securitization. Both GSEs have initiated programs designed to serve small multifamily properties, but both programs have met with limited success. At this stage of its development, the securitization of multifamily mortgages remains a labor intensive, relatively inefficient process. An increased reliance on technology and further development of sophisticated risk management and underwriting tools may ultimately reduce the cost disadvantages associated with the securitization of smaller properties. However, there are real disadvantages today.

On the other hand, the increased involvement of the secondary market could serve as an invaluable safety valve for older urban neighborhoods, especially in high growth areas. By insuring an adequate flow of capital to financial institutions, urban areas are less likely to be put in a position where they would have to compete with other, more attractive uses of capital. Thus, even in its current stage of development, securitization may be having a positive impact on older urban areas by eliminating the credit rationing that might otherwise have occurred in a heated-up real estate market.

## **3. *The Devolution of Government Involvement***

While FHA has not been a major market player in many years, its absence is undoubtedly felt in many older urban areas. Although older urban areas have always been the primary focus of HUD, FHA programs today are no more targeted to smaller properties or underserved neighborhoods than the GSEs (and, in all likelihood, the private conduits.) While HUD has attempted to develop a special program for small rental properties, the program has met with limited success. At this point, FHA is simply not an effective player in these markets, in large part due to the greatly diminished management capacity at HUD.

Whether or not state and local HFAs have helped to fill the void created by the FHA is difficult to assess. Since the states have historically served a broader constituency than HUD, one might question the extent to which state HFAs are adequate substitutes for FHA in older urban

areas. However, absent reliable information on the characteristics and location of state and locally funded projects, this is a matter for speculation. While the role of the states has grown steadily over the last twenty years, it is difficult to assess the extent to which older urban areas are the beneficiaries of this growth.

In considering the changing role of government, it is again important to recognize the difference between financing and subsidy needs. Most observers believe that, at this point in time, the problem facing urban areas is not an issue of capital supply. Rather, it reflects a fundamental funding gap. Given the relatively low incomes of this nation's renters—and the relatively high costs of operating and maintaining units—there is a real and unmet need for rental subsidies. Rental housing subsidies do not guarantee an adequate housing supply—witness the well-documented failures of the early HUD assistance programs. However, in the absence of such subsidies, it is unlikely that HUD or the HFAs—in their role as financing vehicles rather than their broader role as supporters of affordable housing—can play a major role in revitalizing urban areas.

## V. CONCLUSION

For the most part, broad developments in the multifamily mortgage market appear to have been favorable. The multifamily mortgage market—at least for large multifamily developments—is now fully integrated with national and international capital markets, ensuring a ready supply of mortgage funding and moderating, if not eliminating periodic credit crunches.

Despite this significant progress, there are a number of policy concerns. To begin with, securitization in the multifamily market has yet to produce a significant savings in costs. While the extent of securitization is high—almost as high as it is in the single-family market—the process continues to be labor intensive and inefficient. An increasing reliance on technology will undoubtedly produce further gains. However, real progress continues to be limited by a lack of data on loan performance. To date, industry-wide efforts to create such a knowledge base have been unsuccessful. Until there is a better understanding of the underlying risks, it will be difficult, if not impossible, to achieve the kinds of efficiencies that have been realized for single-family.

The multifamily mortgage market also differs from the single-family sector with respect to interest rate risk. In the single-family market, long-term, fixed rate mortgages serve to protect homeowners in an inflationary environment. Interest rate risk is for the most part borne by institutional investors, who are able to hedge these risks through the use of complex financial instruments. In contrast, interest rate risk in the multifamily sector continues to be held by property owners, who have little, if any ability to hedge their risks. If the economy experiences rising interest rates over an extended period of time, landlords and their tenants will inevitably bear the additional costs.

The fact that small properties in older urban areas are less susceptible to securitization also raises some obvious concerns. Until the costs of securitization drop, smaller properties will continue to be limited in their financing options. Although capital supplies appear to be adequate today, reliance on a single funding source—in this case, local depositories—could well lead to problems in future years. This is particularly compelling in light of the large scale consolidation now underway within the financial services industry.

In addition, smaller properties appear to receive less favorable financing terms than large developments. Rates are higher, and many mortgages are essentially underwritten as “signature” loans, meaning that the property owner holds a significant share of the credit risk. Higher rates may well be justified, given the weaker financial profiles of these properties. However, the use of “signature” loans may make smaller properties more susceptible to economic downturns. Since other forms of collateral can be tapped, the lender’s incentive to conduct a workout in times of stress would presumably be reduced, while at the same time, the ability of the owner to shore up the property would decline. The net result could be a higher foreclosure rate.

Finally, urban areas may be further disadvantaged by the lack of HUD-funded programs and the rise of state and local HFAs, since the latter are less likely to target their activities (and their subsidy funds) to older urban areas.

To understand these issues better, several questions must be addressed. To begin with, we need a fuller understanding of the financing needs of smaller properties and the extent to which they are being adequately addressed. HUD is currently conducting such a study, and its findings should be released within the next few months. Second, we need more information on the activities of state and local HFAs. These agencies are now the major provider of new housing subsidies through the Low Income Housing Tax Credit Program, and their activities need to be better understood. Third, we need to have better data on the characteristics of multifamily mortgage originations. While we can speculate on the extent to which urban areas are being served, one can not understand the multifamily mortgage market without understanding the different activities of its major participants. Finally, we need to have better information on the performance of multifamily mortgages. Such information will be key to further reductions in multifamily financing costs.

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