# Financing Multifamily Properties: A Play With New Actors and New Lines

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## Abstract

*Financing of multifamily properties has evolved dramatically over the past decade with the role of traditional actors overshadowed by the emergence of State finance agencies, publicly traded debt real estate investment trusts (REITs), Freddie Mac, Fannie Mae, and the private-sponsored secondary market conduits. For example, since 1993, increased holdings by Freddie Mac, Fannie Mae, and private-sponsored pools have represented approximately 90 percent of the net increase in conventional multifamily debt in the United States.*

*Changes accompanying this transformation include lower cost access to capital; the decoupling of underwriting, servicing, and investment decisions; and an injection of new capital from investors. Multifamily mortgage rates have fallen relative to single-family rates and U.S. Treasury yields, and regional disparities in loan pricing have narrowed. While the near-term outlook remains bullish, a latent question is whether there is sufficient market discipline to avoid the extreme real estate cycles of the past.*

The key players and financial protocol in the multifamily real estate industry are significantly different in the late 1990s from any time in the past. Since the early 1980s, the multifamily rental market has travelled a roller-coaster path of boom, bust, and recovery. The changes accompanying this latest business cycle have brought with them a shift from privately held to publicly traded or institutional ownership and financing. On the ownership side, heavily leveraged, privately syndicated partnerships—popular during the 1980s—have given way to large, publicly traded equity real estate investment trusts (REITs). On the financing side, traditional portfolio lenders—thrifts, commercial banks,

and life insurance companies—are no longer at the cutting edge. They have been replaced by intermediaries with direct access to national and international capital markets, through State finance agencies, publicly traded debt REITs, and secondary market conduits.

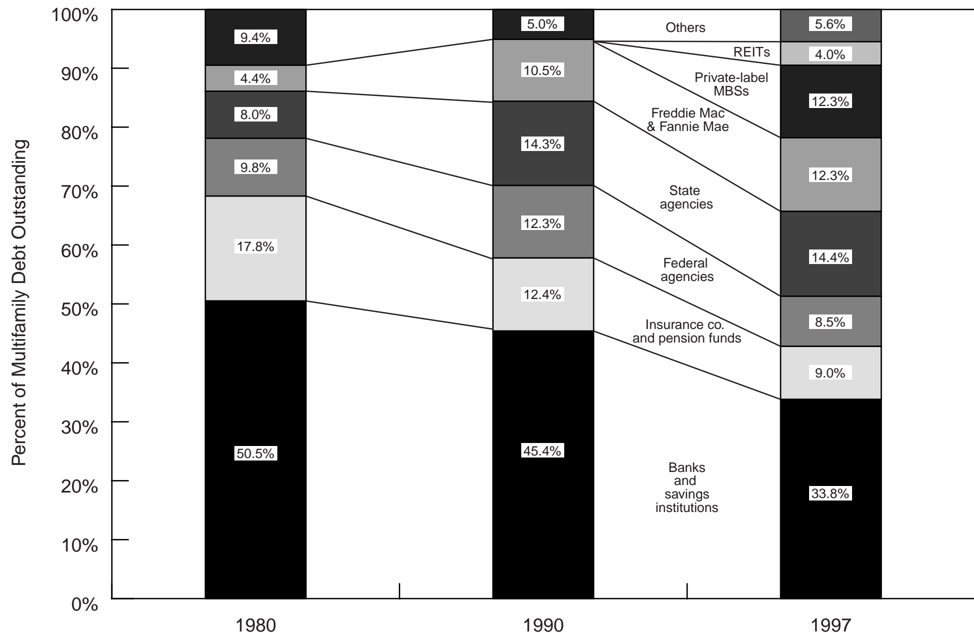
The new paradigm is built on less expensive means of raising funds, economies of scale, access to nontraditional investors, and the comparative advantage of individual firms that specialize in the various steps of loan production and funding—underwriting, servicing, and investing. By injecting a greater flow of capital into the multifamily market, this trend likely has helped to reduce the relative level of multifamily mortgage rates. However, because of the decoupling of underwriting, servicing, and investment decisions, the ultimate investor today may be far removed from the collateral and credit-granting decision, putting greater importance on the third-party due diligence of others. Also, the influx of funds during a prolonged economic expansion raises the specter of capital-chasing projects. This concern is reminiscent of multifamily lending conditions that existed a decade ago, and some lenders have noted that underwriting has become too lax.

## The New Leader of Multifamily Lending

The dramatic change in the nature of multifamily lending is portrayed in exhibit 1, which charts the changes in the holders of multifamily mortgage debt between 1980 and 1997. In 1980, depositories (banks and thrifts), insurance companies, pension funds, and private individuals owned more than 70 percent of the mortgage debt outstanding on multifamily properties.[1] Outside of Federal agencies, the only other significant holders of multifamily mortgage debt were Freddie Mac, which pioneered the first multifamily securitization

### Exhibit 1

Major Holders of Multifamily Debt




Source: Federal Reserve Board

of conventional multifamily loans in the 1970s; Fannie Mae, with sizable portfolio holdings from its earlier affiliation with the Federal Housing Administration (FHA); and State residential finance agencies. Even so, Freddie Mac and Fannie Mae held less than 5 percent of the debt outstanding, and the State agencies held only 8 percent. In short, most of the capital being used to finance multifamily properties was from deposits made at banks and thrifts, premiums paid into insurance policies, and retirement contributions held in pension funds.

By 1997 this picture had changed considerably. The traditional providers of mortgage credit (depositories, insurance companies, pension funds, and private individuals) held less than one-half of the market debt. Freddie Mac and Fannie Mae, the largest government-sponsored enterprises (GSEs), had increased their share of debt held to 12.5 percent, while the State finance agencies' share of the debt had grown to 14.4 percent. Private-sponsored secondary market conduits and REITs, which together had accounted for less than 1 percent of multifamily debt financing as late as 1987, had the most rapid growth. Private-sponsored mortgage-backed securities (MBSs), primarily structured as real estate mortgage investment conduits (REMICs), accounted for 12.3 percent of the mortgage debt outstanding in mid-1997, and mortgage REITs accounted for 4 percent.

Traditional depositories, insurance companies, and pension funds have played a smaller role in the rebounding of the multifamily mortgage market during the 1990s. Savings institutions—which historically have done much of the lending for smaller rental properties—are still the largest single category of investor in multifamily mortgages, with $60 billion in holdings as of mid-1997, or 19 percent of the total. However, the holdings of savings institutions have been declining steadily since 1988, when they held $111 billion in multifamily mortgage debt. Commercial banks have added to their multifamily mortgage portfolios during the recent recovery, in part through acquisitions of savings institutions. While still an important financial pillar in multifamily financing, depository institutions' singular importance has been eclipsed by the emergence of other financial intermediaries. Their role in the market is also changing as they add more fee-based intermediate services—fee origination, loan warehousing, conduit formation, and servicing—to their traditional role as portfolio mortgage originator.

Insurance company holdings of multifamily mortgage debt have been stable since 1995 after a net runoff of almost $5 billion during the preceding 4 years. During the past 5 years, insurance companies have added substantial volumes of mortgage securities to their investment portfolios, as they have responded to new capital rules that favor holding securities, including MBSs, over whole loans.

Of note is the diminishing role of the Federal Government in the multifamily rental markets. In 1990 and 1991, the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation became the holders of nearly $20 billion of multifamily mortgages acquired from failed depositories. During 1992 and 1993, almost all of the mortgages were sold or extinguished. In addition, FHA-insured mortgage debt on troubled projects held by HUD had declined from a high of $7.4 billion in 1992 to $1.9 billion in June 1997.

The Federal role may be even further diminished in the coming years as the function of the FHA insurance program is debated. During the past several years, Ginnie Mae (formerly the Government National Mortgage Association, which is the primary outlet for FHA-insured loans) marginally increased its share of multifamily mortgage debt from 3.8 percent in 1995 to 4.1 percent in 1997. Its continued significance in the market, however, is very much dependent on the future of FHA.

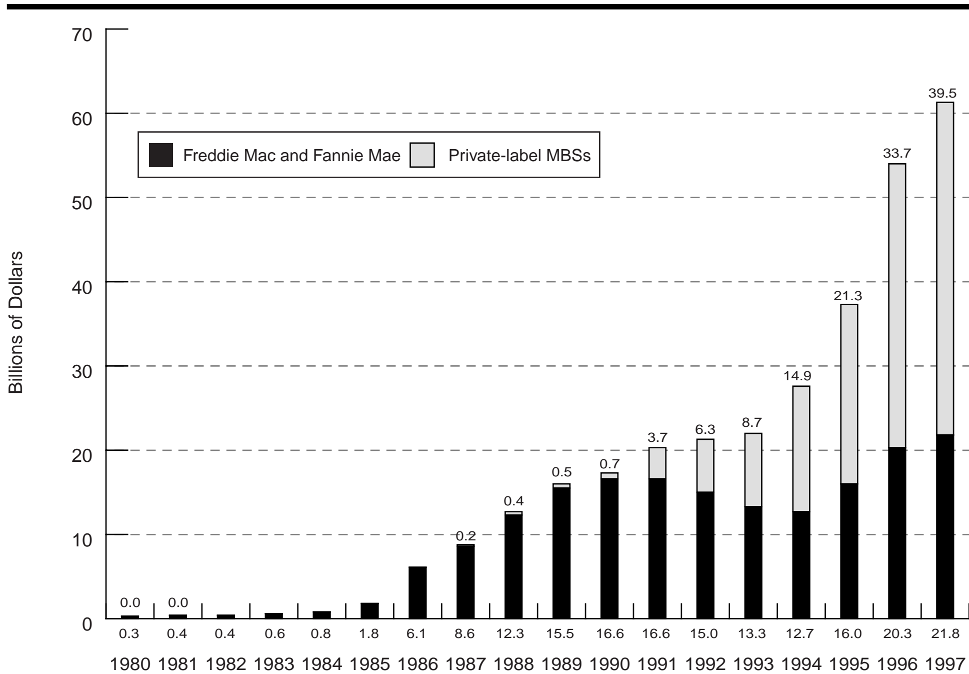
Partly counterbalancing the withdrawal of Federal participation in multifamily housing is the increasing role of State and local housing finance authorities. Through the issuance of multifamily mortgage revenue bonds, State authorities have played an increasing role in financing the supply of affordable rental housing. State finance authorities tripled the amount of multifamily mortgage debt they support, from $10 billion in 1980 to $46 billion in 1997, and they currently account for 14 percent of the mortgage debt on multifamily properties. Statutory limitation, however, on the total amount of their bond issuances effectively caps their role in the mortgage market.[2]

## The New Source of Funds

The growing sectors of multifamily lending—private-sponsored conduits, Freddie Mac and Fannie Mae, and REITs—have in common lower cost access to the national and international capital markets and the ability to offer geographic diversification. Before the 1990s, income-property finance had been characterized by portfolio lenders who held illiquid whole loans backed by regionally concentrated collateral and who raised funds through a costly bricks-and-mortar network of local branch offices. The success of Freddie Mac and Fannie Mae's single-family securitization efforts during the 1980s—by more efficiently intermediating funds between the home mortgage market and the broader capital markets and by accessing nontraditional mortgage investors—highlighted the advantages of loan pooling to reduce costs and better match investor preferences. The success of RTC's issuance of MBSs containing income-property loans provided the impetus for their wider use in the multifamily market. In recent years, improved information flows of income-property markets and acceptance of more standardized mortgage products have facilitated rapid growth in income-property MBSs.

### Exhibit 2

Growth of Securitized Multifamily Debt



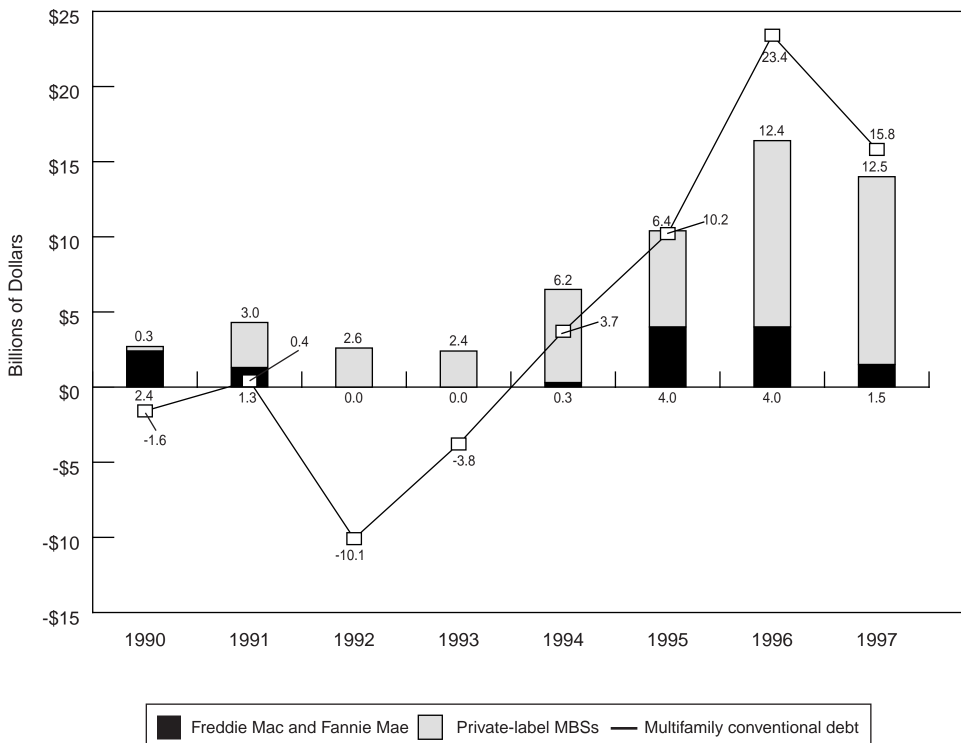

Source: Federal Reserve Board

Mortgage securitization volume has increased rapidly during the 1990s (see exhibit 2). In fact, during the 1994–97 recovery in multifamily residential lending, about 90 percent of the net growth in credit was supplied through securitization (see exhibit 3).[3] About three-fourths of the securitization volume came in the form of private-sponsored activity. From virtual nonexistence in 1990 (holding less than 1 percent of the debt outstanding), private-sponsored pools grew to more than 12 percent of multifamily debt by mid-1997. Clearly, private-sponsored income-property MBSs, which generally include a mixture of multi-family and commercial loans within a pool, have been the dominant financing vehicle during this period.

The recent emergence of the commercial real estate sectors—office buildings, retail space, hotels, and warehouses—from their economic slump has provided additional momentum to the private-sponsored conduits. The economic difficulties of commercial real estate have continued several years after the rebound of the multifamily market, and retail property values remain weak. As the oversupply from the development excesses of the 1980s have been absorbed, investor interest in income-producing properties has returned, with multifamily housing leading the way. Exhibit 4 summarizes peak-to-trough-to-current (third quarter of 1997) valuation changes for income-producing properties. For comparison, valuation changes for single-family homes are shown using the peak-trough quarters for multifamily housing. The value of apartment buildings fell the least of all income properties and began appreciating before any commercial properties.

## Exhibit 3

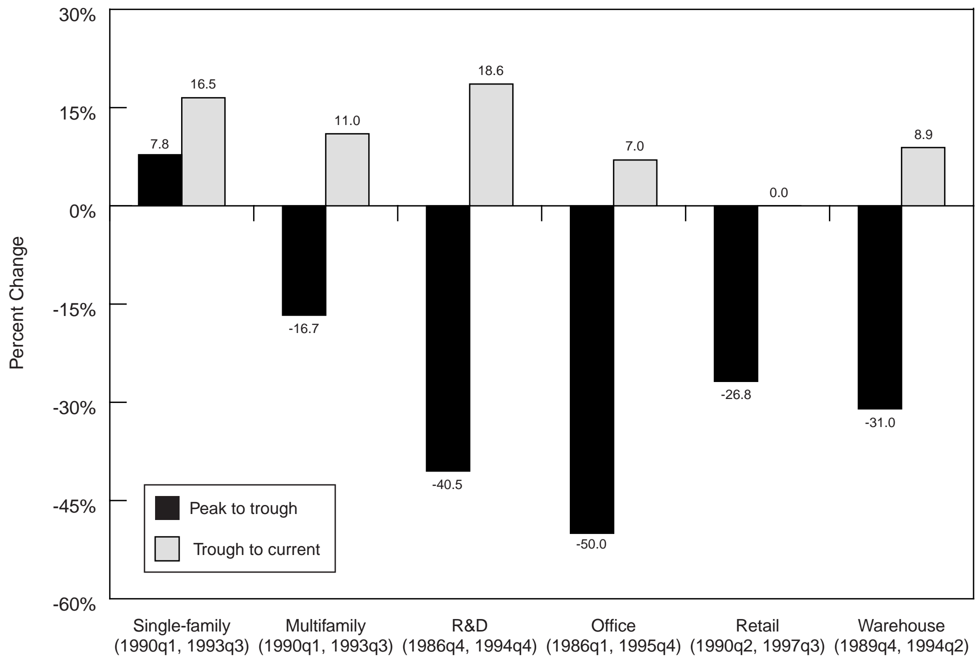
Net Change in Multifamily Mortgage Holdings




Source: Federal Reserve Board

## Exhibit 4

Changes in Property Valuation Over Latest Real Estate Cycle




Source: NCREIF, CMHPI

Multifamily mortgages have served as a high-quality anchor in the mixed mortgage pools that have supplied much of the mortgage capital for the commercial sector during the past several years. The added diversity of the mixed-asset pool makes them more attractive to investors. One of the important consequences of the growth of mixed commercial-multifamily MBSs is that the specialized multifamily security issuers, such as Freddie Mac and Fannie Mae, are in active competition for the same properties as the mixed pool issuers. Further, by offering a security that is diversified across all types of income-producing properties, investors perceive an overall reduction in the credit risk on the security, allowing mixed commercial-multifamily MBS issuers to offer higher prices than issuers that package multifamily-only securities.

Two of the other main suppliers of multifamily capital have been Freddie Mac and Fannie Mae. An early innovator in securitization, Freddie Mac pioneered the first securitization of conventional multifamily loans in the 1970s. The two GSEs have been an increasingly important source of mortgage financing for rental properties through mortgage purchases for both portfolio investments and security issuance since the mid-1980s. For example, at the end of 1983, less than 4 percent of multifamily mortgage debt was held by Freddie Mac and Fannie Mae. By the end of 1992, this share had nearly tripled to 11.4 percent. This share has continued to grow despite the intense competitive pressures in the mortgage capital market of the past few years, and it stood at 12.5 percent as of mid-1997. In dollars, Freddie Mac and Fannie Mae's combined holdings have increased more than sixfold, from $5.9 billion at the end of 1983 to $31.2 billion at the end of 1992 and to $40.1 billion as of June 1997.[4]

The publicly traded REIT is another of the emerging sectors in the multifamily market. Privately owned REITs have been in existence since 1960 and had phenomenal growth in the 1970s. After this initial popularity, REITs (primarily privately issued equity investments) were largely abandoned during the 1980s because of performance problems. In addition, tax treatments of multifamily properties encouraged the use of the syndicated partnership as an alternative investment vehicle.

The creation of the publicly traded version of the REIT, as well as a series of regulatory and tax changes in the early 1990s, brought a rebirth of interest to this form of multifamily investment. The deeper capitalization that public trading created, along with the favorable tax treatment allowed with the elimination of “double taxation” and the removal of many earlier restrictions on institutional investment, has made this one of the more popular investment vehicles.[5] In 1990, debt REITs held less than 1 percent of the multifamily debt outstanding. By 1997, this fast-growing sector held more than 4 percent of the debt outstanding. Between 1990 and 1997, REITs provided a net addition of $11 billion of mortgage capital to rental housing.[6]

## Traditional Lenders Adapt

Traditional depositories are in the early stages of transforming their multifamily mortgage asset holdings from solely whole-loan portfolios into a blend of whole loans and income-property MBSs. As a consequence, their mortgage origination activities supply both whole loans for their portfolios as well as loans for sale into the secondary market. In particular, depositories are likely to retain those loans that are more costly to securitize while selling the rest, in large part to supply the issuance of additional MBSs. Commercial banks are in a unique position to take advantage of fee opportunities at almost all stages of the securitization pipeline because they already have a lending infrastructure in place to undertake loan origination. The income-property MBS market allows the banks to originate loans without a risk-based capital cost (provided they sell their loans with little or no recourse), earning origination fees and, potentially, servicing fees. The income-property MBS market also allows banks to earn the fees associated with warehousing multifamily mortgages.

Multifamily financing was once an industry dominated by banks and thrifts that raised deposits locally and lent to local real estate developers and owners. The multifamily finance system is shifting toward institutions that have low-cost access to the global capital market and to its MBSs and REIT investors.

Life insurance companies and pension funds also have responded to this new environment. Both traditionally participated in the real estate market because long-term investments in apartment mortgages were a good asset match for their long-term insurance and pension liabilities. Substantial losses on their real estate investments in the late 1980s, however, encouraged them to seek an alternative investment strategy. Both are finding it more advantageous to pare down their whole loan portfolios in exchange for investment in single-class MBSs or REMICs because these assets offer more liquidity and structured cash flows that better meet their investment needs. They are encouraged in this practice by the fiduciary investment obligations of the Employees Retirement Income Security Act and the favorable risk-based capital treatment of MBSs allowed by insurance regulators.[7]

## Greater Efficiencies in the Marketplace

Rather than the limited investor base that historically has characterized multifamily finance, today the multifamily market has a plenitude of capital made available by an increasing variety of willing investors. In recent years, greater access to the capital markets

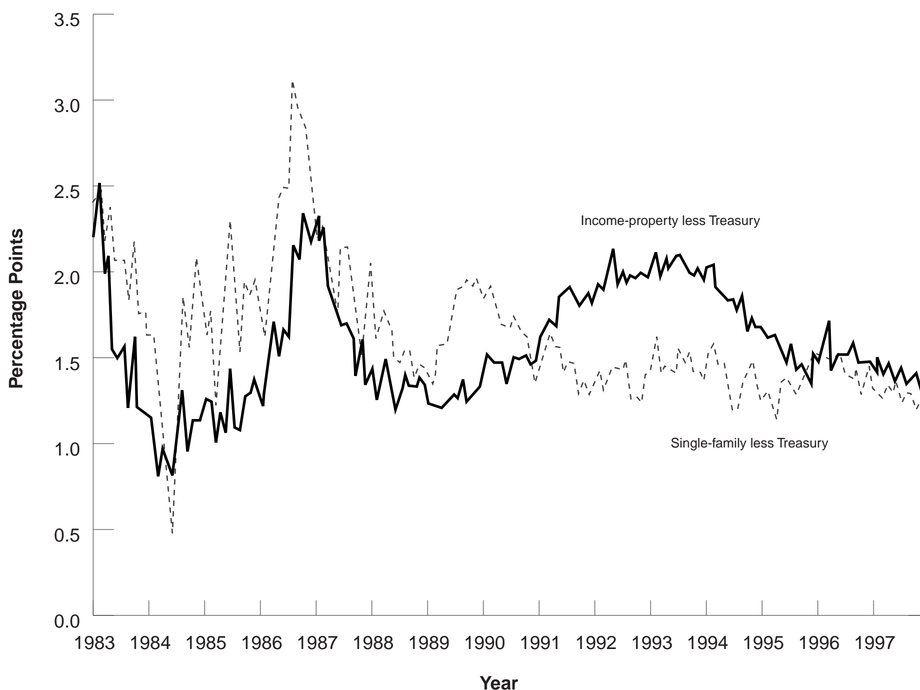
has helped to reduce multifamily mortgage rates generally and also has reduced regional differences in these interest rates. The difference between mortgage rates and, say, comparable-term U.S. Treasury securities is related to a variety of factors: credit risk on multifamily mortgages, prepayment risk, asset liquidity, income taxes, servicing costs, and availability of funds for income-property finance, to name a few (Rothberg, Nothaft, and Gabriel, 1989). Spreads between 10-year income-property mortgage rates and 10-year U.S. Treasury yields have fallen by one-half, from about a 2-percentage-point spread in 1993 to a 1-percentage-point spread today (see exhibit 5). These are the narrowest spreads since 1987 and currently are within 30-year single-family to 10-year Treasury spreads.[8] Analysts note, "Fierce competition in all segments of the [income-property] mortgage market forced lenders to significantly lower spread requirements in order to attract borrowers" (Donaldson, Lufkin, and Jenrette, 1997).

Regional differences in multifamily mortgage rates have also diminished sharply in recent years. For example, average interest rates on new commitments extended by life insurance companies varied by as much as 1.3 percentage points across nine regions of the Nation in 1992. This variation narrowed to about 0.3 percentage points in 1996 and 1997.[9] While several factors led to this reduction in regional rate disparity, part may well be attributable to better access to capital markets brought about by growth in secondary market activity and its concomitant need for greater loan standardization.

Reflecting the large amount of investor interest in income-property MBSs (led by those containing large amounts of multifamily assets), spreads during 1997 continued to narrow for all but the highest rated classes, a pattern that started in 1994 (see exhibit 6). Spreads

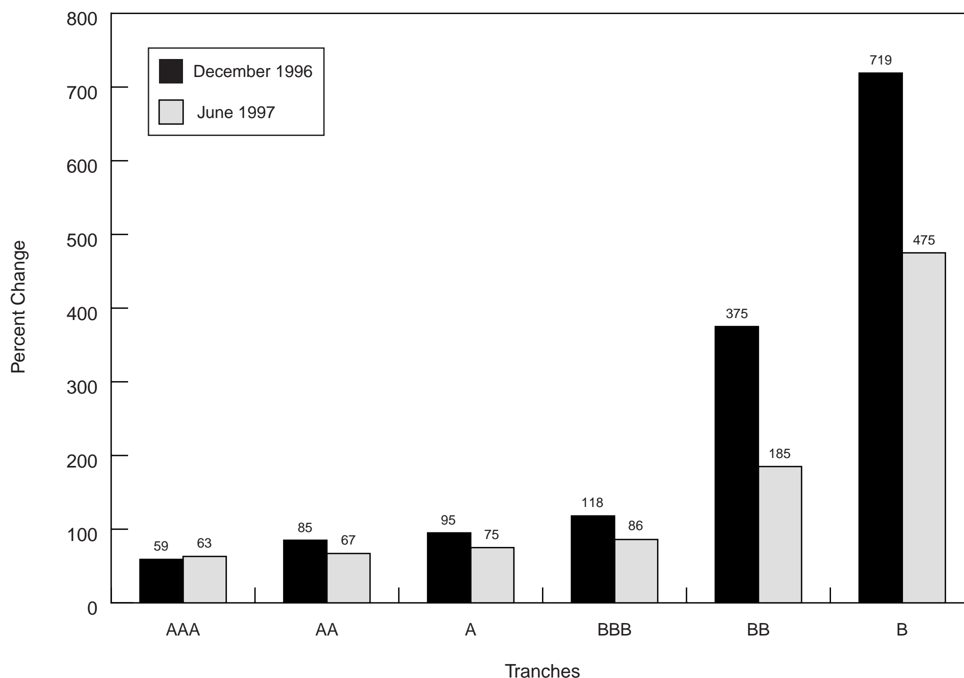
## Exhibit 5

Mortgage Interest Rates Less 10-Year Treasury Yields



## Exhibit 6

Average Income Property MBS Yield Spread to Treasury




on AA-rated classes narrowed by 18 basis points (bps) in 1997, A-rated classes narrowed by 20 bps, and BBB-rated classes (which had been relatively flat throughout 1994 and 1995) narrowed by more than 32 bps. Even spreads on subordinated classes with BB and B ratings experienced significant narrowing. Spreads on BB-rated tranches narrowing by 190 bps between 1996 and 1997, and B-rated classes narrowed by approximately 244 bps during the same period.

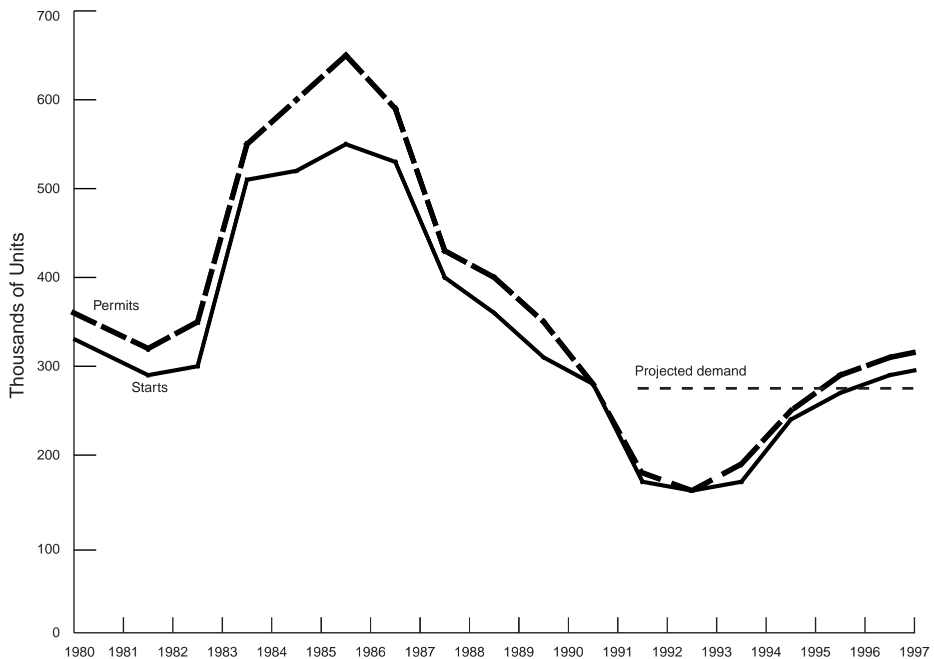
Such narrow spreads are good news for multifamily borrowers. Recently, however, increasing concern has been expressed in the trade press regarding an erosion of underwriting criteria and the possibility of the market overshooting itself. *Barron's* reports that lenders "continue to be concerned about a continuing deterioration in underwriting standards" (Levy, 1997).

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

The multilevel review of these loans has both potential advantages and dangers. For example, multiple reviews by independent third parties using different market benchmarks can avoid the misjudgments of individual underwriters and lead to better business

## Exhibit 7

Indicators of Multifamily Rental New Construction




decisions. Conversely, overreliance on fee-based parties without a direct financial interest in the outcome of the investment can lead to mechanistic and cursory reviews. Investment decisions based on such reviews can lead to inventories with substantial performance problems in the future.

The resurgence of the multifamily market from its lowest point in the early 1990s may be reaching its business cycle peak. Construction has added new units to the housing stock. Exhibit 7, however, portrays a market that is exercising some restraint, for new construction seems to be peaking much lower than had been the case in earlier business cycles.[10] Caution prompted by the early 1990s' experience with market adversity as well as the nature of the new actors in the multifamily sector may well be playing a part.

## Outlook

A viable secondary market has provided liquidity for single-family mortgages in the United States for many years and has lessened the magnitude of cyclical economic downturns, providing consistent funding for homeownership. A broader secondary market for commercial and multifamily mortgages has emerged during the 1990s, which may provide that same benefit for income-producing real estate and especially apartment loans.

Important differences remain between the single-family and multifamily mortgage markets. Nowhere near the standardization of the single-family market has been reached in the multifamily market, and its achievement is doubtful given the greater complexity of

the financing, heterogeneity of the properties, and legal differences across jurisdictions. Special characteristics of properties and loan products increase the costs of the requisite due diligence, creating limits to overall securitization. The wide variation in loan size creates limits as well. The fixed costs of multilevel loan review increase as a percentage of loan balance as loan size decreases. Further, the dominance of large-balance loans within a pool diminishes the benefits of diversity.

Nonetheless, the immediate outlook remains good for the continued growth of securitization and mortgage REITs as net providers of multifamily finance. The current economic climate is uniquely favorable to such growth: Property values are increasing, market volatility is relatively low, and capital market interest rates are low. The business cycle has not been repeated, however, and whether private-sponsored pools and REITs will continue to play a large role in the next cyclical downturn is a question still to be answered.

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## Notes

1. Mortgage debt held by private individuals is the largest component of the *Other* category in exhibit 1, which also includes amounts held by mortgage and finance companies and other small holders. Individuals are playing a smaller role as providers of apartment finance. For example, individuals held 7.8 percent of the multifamily mortgage debt outstanding in 1981 and 4.1 percent in 1991 (U.S. Bureau of the Census, 1980, 1990).

2. In addition, the State authorities administer the low-income housing tax credit (LIHTC) program. LIHTC funds are often used in conjunction with the State finance authority's bond funds. Since its creation by Congress in 1986, the LIHTC program has financed nearly 900,000 apartments for extended low-income use. During 1995, approximately 1,600 properties received tax credit allocations to assist in the funding of more than 88,000 units for lower income families—equal to about 20 percent of all new multifamily construction. (see National Council of State Housing Agencies, 1996).

3. Conventional mortgage debt increased $45 billion between year-end 1993 and mid-year 1997, and private-sponsored MBSs and the total portfolios of Freddie Mac and Fannie Mae increased by $31 billion and $9 billion, respectively, during the same period.

4. Securitized multifamily debt constituted 54 percent of Freddie Mac and Fannie Mae's multifamily holdings in 1997, with an aggregate amount of $22 billion. These GSEs account for 18 percent of the securitized multifamily debt that has been issued by either governmental or private sources.

5. The REIT industry benefitted from the 1986 Tax Reform Act and subsequent changes in tax laws. The 1986 reforms eliminated the incentives of tax-sheltered real estate vehicles and promoted investment vehicles such as REITs whose financial performance is based on property income and price appreciation. The 1986 tax changes also allowed REITs to manage their properties directly. However, a remaining detriment to growth was the "five-or-fewer" rule that restricted the five largest shareholders to owning no more than 50 percent of a REIT's shares. The 1993 tax legislation modified the Federal income tax provisions so that the five-or-fewer rule was no longer an issue for tax-exempt investors.

6. In addition, REITs have provided more than $22 billion of equity investment in rental properties during the past several years. The 35 publicly traded equity REITs collectively own more than 645,000 rental units, 30 percent of which have been acquired in the past 2 years. One consequence of the growth of the large equity REIT is the substantial substitution of equity for debt in a growing portion of the multifamily housing stock.

7. "Regulatory changes—especially risk-based capital requirements—for traditional sources of long-term mortgage debt continue to bolster the growth of securitized markets" (Hart, 1995). For a direct commercial whole loan investment, an insurance company must hold 10 times more capital than for the same dollar investment in an income-property MBS rated A or better.

8. Single-family mortgage rates are from Freddie Mac's Primary Mortgage Market Survey and reflect 30-year fixed-rate, conventional conforming loans with an 80-percent loan-to-value ratio. While the decline in multifamily mortgage rates relative to single-family mortgage rates reflects a number of factors, including the perceived reduction in credit risk from improving apartment property values and relatively less prepayment risk due to prepayment penalties and lockout periods, some of the spread reduction reflects the ability to access the global capital markets better, bringing new, lower cost capital into the apartment market.

9. American Council of Life Insurers (various issues); apartment mortgage interest rates include fees. The regions are the nine census bureau divisions.

10. The projected demand estimate in exhibit 7 is from Goodman (1997).

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