Developing a Secondary Market for Affordable Rental Housing: Lessons From the LIMAC/Freddie Mac and EMI/Fannie Mae Programs

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Abstract

An active secondary mortgage market requires underwriting and mortgage contract standards as well as mortgage performance information for potential investors to assess. These standards and information have been developed in the single-family mortgage market, but not in the secondary market for rental housing mortgages, which is still in the early stages of development. The advances made in the single-family market were largely due to the leadership provided by Fannie Mae and Freddie Mac, both government-sponsored enterprises (GSEs). This article explores the potential role of Fannie Mae and Freddie Mac in the further development of the secondary multifamily mortgage market by examining the LIMAC/Freddie Mac and EMI/Fannie Mae pilot programs. These programs illustrate the challenge of creating industry standards and building an information base and demonstrate that GSEs' participation in this market has been relatively small. Given the public mandate that comes with government sponsorship, we argue that GSEs should take an active leadership role in the development of the multifamily market.

The Federal Government has made a significant and longstanding commitment to the development of the secondary mortgage market. Two key efforts were the chartering of Fannie Mae and Freddie Mac—government-sponsored enterprises (GSEs) charged with creating and taking a leadership role in developing a secondary market for residential mortgage loans.[1] The charter acts of both institutions clearly state that they are to provide stability in and ongoing assistance to the secondary market in residential mortgage loans, including activities related to mortgages on low- and moderate-income housing (U.S.

Congress, 1992a, 1992b). While GSEs have participated in the multifamily (five or more units) mortgage market, particularly over the past decade, their role in that market has been minimal compared with their role in the market for loans on single-family properties (one to four units), where they dominate.

The fundamental idea behind the Federal Government's intervention in building a national secondary mortgage market is that, while housing markets are inherently local in nature, the financing of housing need not be. Mortgage availability should not be a function of local savings; regions that are growing but do not have much savings should be able to obtain mortgage funding from regions with excess savings. An active secondary market increases liquidity, making funds for mortgages more widely available and bringing more players into the market, which should drive down the price of mortgage funds to the borrower.

An active secondary market requires standardization of the mortgage contract, underwriting, and mortgage documents.[2] In addition, a secondary market requires an information base on which market participants can accurately assess the risks and returns of these investments. In many respects, GSEs have succeeded in providing standards and an information base for the single-family mortgage market. The multifamily mortgage market, however, lacks both elements. This market's development is in an early stage, resembling the single-family market of two or three decades ago. GSEs are well positioned to provide a leadership role in developing the secondary market for multifamily mortgages and setting industry standards, as they did in the single-family market.

In this article, we explore some issues surrounding GSEs' potential role in developing this market by examining two recent joint programs that are designed specifically to increase access to the secondary market for providers of affordable multifamily rental housing by bringing GSEs to this market segment. The first program was launched in 1991 by Freddie Mac and the Local Initiatives Managed Assets Corporation (LIMAC), a nonprofit subsidiary of the Local Initiatives Support Corporation (LISC). The LIMAC program set a goal of providing at least $100 million worth of multifamily mortgages to be guaranteed by Freddie Mac. However, the program was suspended after 2 years with only one completed transaction, which was composed of eight existing mortgages totalling $4.6 million. The second program, between Fannie Mae and Enterprise Mortgage Investments, Inc. (EMI), a subsidiary of the Enterprise Foundation, began in November 1994 and is ongoing. In January 1997 the program was significantly restructured to address problems hindering volume. As of June 1997, 15 transactions representing $20.5 million had been completed. The analysis in this article covers the first 31 months of the program through June 1997, the end of our evaluation period.

Both the LIMAC/Freddie Mac and the EMI/Fannie Mae programs received financial support from the National Community Development Initiative (NCDI).[3] We were engaged by NCDI to evaluate both programs, affording us an unusual opportunity to observe closely the program processes from the start and to benefit from participants' candid reflections. The conflicts and tensions that arose shed considerable light on the different perspectives of affordable housing specialists and GSEs. In many respects, the problems faced by the two programs are a microcosm of many broader problems facing the multifamily mortgage market today.

The objective of this article is to present the lessons learned from the two programs to identify some general principles that may be useful in considering new endeavors for the development of a secondary multifamily market, particularly one focused on affordable rental housing. We begin with a discussion of the rationale for greater involvement of

GSEs in developing the secondary market for multifamily mortgages. We then turn to the focal point of the article—an exploration of five important issues arising from the LIMAC/Freddie Mac and EMI/Fannie Mae programs:

- Underwriting.
- Pricing and credit enhancement.
- The availability of an information base and expertise on these types of transactions.
- Capacity.
- The financial viability of a business focused on mortgages for affordable rental housing.

We use these issues and the LIMAC and EMI experiences as a lens through which we can explore the needs in the marketplace and how GSEs can play an important role in developing the market.

Should Freddie Mac and Fannie Mae Have a Role in the Multifamily Market?

Fannie Mae and Freddie Mac were chartered by Congress with a clear mandate to create liquidity in the residential mortgage market by developing a secondary market and setting industry standards. The fundamental aim of Federal Government involvement in the provision of a secondary mortgage market is to increase the funding of mortgages through the capital markets, thereby increasing efficiency and ultimately ensuring that mortgage credit is readily available at lower prices. HUD is charged with establishing annual housing goals for GSEs.[4]

Fannie Mae and Freddie Mac are both federally chartered, private corporations whose stocks are traded on the New York Stock Exchange. Both are prohibited from originating mortgages; they are explicitly limited to purchasing existing mortgages either to hold in portfolio or to package into mortgage-backed securities (MBSs) to sell to investors. Their charter acts limit the maximum size of single-family mortgages that can be purchased (the 1996 limit was $207,000). They are also explicitly charged with providing the industry leadership necessary to make the secondary residential mortgage market operate more efficiently. Securities issues by both firms have the guarantee of the issuing firm. There is no Federal Government guarantee on these securities—unlike those of Ginnie Mae, which are guaranteed by the full faith and credit of the United States Government.

Fannie Mae was created in 1938 to purchase FHA-insured loans; this mission was expanded to include Veterans' Administration (VA) mortgages in 1948, and in 1970 Fannie Mae began to purchase conventional mortgage loans. Freddie Mac was created in 1970 with a focus on providing a secondary market for thrifts but has since broadened its activities to include all conventional mortgages. Together, their impact in the market is huge. In 1995, $3.923 trillion in residential mortgages were outstanding. Fannie Mae held $253.5 billion in mortgages in portfolio and had $513.2 billion in MBSs outstanding. Freddie Mac held $106.9 billion in portfolio and had $459 billion in MBSs outstanding. The mortgage portfolios and guarantees on MBSs of these two firms represent 34 percent of the total residential mortgages outstanding in 1995 (Fannie Mae, 1996).

While Fannie Mae's and Freddie Mac's activities are constrained to include only activities that are directly related to the secondary mortgage market, they enjoy significant benefits in the marketplace as a result of their status as GSEs that give them advantages over other investors. Notably, their securities are exempt from the registration requirements of the Securities and Exchange Commission, they are exempt from State and local taxes, and the Secretary of the U.S. Treasury is authorized to purchase up to $2.25 billion in securities of each firm to enhance liquidity (U.S. Congress, 1992a, 1992b).

Fannie Mae and Freddie Mac also enjoy a substantial benefit because of the widely held view in the marketplace that in the event of financial problems the Federal Government will bail out either institution despite the fact that there is no explicit Federal guarantee on their securities or their overall financial viability. As a result of this perception, both firms can borrow at lower rates than comparable firms, and their securities carry a AAA rating. Given the advantages both organizations enjoy by being GSEs, Congress has established a public-purpose mandate in their charters requiring that both entities provide mortgage credit to a broad range of Americans, including low-income families and residents of underserved areas.

The 1995 HUD rule regulating Fannie Mae and Freddie Mac included setting explicit goals to govern the GSEs' multifamily mortgage activity. The goal for affordable multifamily housing for the 1996–99 period for each GSE is at least 0.8 percent of the total dollar volume of mortgages purchased by the respective GSE in 1994 (*Federal Register*, 1995). In 1994 Fannie Mae's total mortgage purchases were $161.8 billion; $4.8 billion of these purchases were multifamily, of which $2.4 billion met the special affordable goal. As a result, in 1994 Fannie Mae's special affordable multifamily purchases were 1.5 percent of total purchases, significantly exceeding the 0.8 percent goal. By 1996 Fannie Mae's multifamily purchases had grown to $7 billion, representing 4.2 percent of total purchases—the purchases meeting the special affordable goal had fallen slightly. In 1994 Freddie Mac's total mortgage purchases were $123.5 billion. However, only $0.9 billion of these purchases were multifamily, of which $0.5 billion met the special affordable requirements. As a result, in 1994 Freddie Mac's special affordable multifamily purchases were 0.4 percent of total purchases, or one-half of the goal. In 1995 Freddie Mac made the goal with $1.1 billion in special affordable purchases. By 1996 Freddie Mac's multifamily purchases had grown to $2.4 billion, representing 1.9 percent of total purchases, but special affordable multifamily purchases remained at $1.1 billion.[5]

It is clear that with Fannie Mae's higher level of multifamily activity, HUD officials found it difficult to set a goal that would push Fannie Mae and still be within reach for Freddie Mac. Although it certainly could be argued that the goal initially increased Freddie Mac's participation in the affordable multifamily mortgage market, currently the goal does nothing to propel either firm to expand its efforts in this area. As a result, the goal has little impact on today's market.

What is the economic rationale for government sponsorship of Fannie Mae and Freddie Mac? As we argued at the beginning of this article, an active secondary market requires standards and information, both of which have attributes of public goods. Although the overall market reaps substantial benefits from industry standards and information, no individual firm may have sufficient incentive to produce those standards and information if its production is costly and outweighs the benefits to the individual firm. This is a classic case of market failure where government intervention may be warranted to ensure that these public goods—standards and information—are produced.[6]

Virtually all single-family mortgages originated are purchased in the secondary market. In 1995 more single-family mortgages were purchased than originated, meaning some seasoned loans were purchased. From 1990 to 1995, purchases accounted for 97 percent of originations (Fannie Mae, 1996). In 1995 only 40.5 percent of multifamily mortgages were purchased in the secondary market. The traditional focus of GSEs has been on mortgages for owner-occupied housing. Fannie Mae and Freddie Mac played an important role in developing standards and information in the single-family mortgage market. They introduced the standard mortgage application in 1973 and the standard mortgage note for all states in 1975 (Freddie Mac, 1988). These are two important milestones in making mortgages a commodity to investors. According to the Federal Reserve Board, in 1995 Fannie Mae and Freddie Mac portfolio holdings and MBSs accounted for 35.5 percent of the $3.634 trillion in outstanding single-family mortgages. Fannie Mae and Freddie Mac mortgage underwriting guidelines are the industry standard, and the volume and track record of the two GSEs provide a substantial information base for investors to assess (Board of Governors of the Federal Reserve System, 1997).

Yet while their charters clearly cover both single-family and multifamily mortgages, Fannie Mae's and Freddie Mac's contributions to the multifamily mortgage market have been much more limited than their contribution to the single-family market. In 1995, 12.3 percent of the $288 billion in outstanding multifamily mortgages either were held by Fannie Mae and Freddie Mac in portfolio or were in MBSs with Fannie Mae or Freddie Mac guarantees (Fannie Mae had 10 percent and Freddie Mac had 2.3 percent).

The lack of industry standards for these mortgages has been a major obstacle in the development of this market. Some experts have argued that multifamily mortgage loans are inherently more heterogeneous than single-family loans because they are secured by income-producing properties, making them more similar to small-business loans than to single-family mortgages. It is not obvious why this difference necessarily leads to more heterogeneity, nor is it clear that multifamily mortgages cannot be largely standardized. In fact, while single-family mortgage loans are now viewed as commodities, it is important to remember that they were once thought of as inescapably heterogeneous and that standardization of these mortgages took many years. Clearly, leadership is needed in creating industry standards for multifamily mortgages such as those that transformed the single-family market.[7]

This leadership is the kind of role mandated in Fannie Mae's and Freddie Mac's charters. In the 1995 rule for annual housing goals, HUD explicitly argued that the GSEs must focus more on assisting the development of the multifamily secondary market. It could be argued that today the rationale for Federal Government sponsorship of Fannie Mae and Freddie Mac to intervene is stronger in the multifamily mortgage market than in the single-family market. In many ways, the goals of creating standards and an information base have already been achieved in the single-family market. In addition, lower income households tend to live in rental housing often located in urban areas. Given that providing access to capital markets for lower income households in underserved communities, particularly in inner cities, is a policy goal of government sponsorship of Fannie Mae and Freddie Mac, focusing on the rental housing market seems appropriate.

LIMAC/Freddie Mac and EMI/Fannie Mae Programs

LIMAC and Freddie Mac launched a 3-year pilot program in February 1991 to provide at least $100 million for the purchase and securitization of permanent multifamily loans for rental housing targeted at low-income populations and neighborhoods. The program's goal was to provide "a missing piece in the housing puzzle" by making long-term, permanent financing available through an active secondary market.[8] The program was to provide long-term, fixed-rate mortgages for new originations and refinancings of adjustable and shorter term mortgages. In addition, the program planned to purchase existing mortgages held in portfolio by local lenders (see exhibit 1 for a summary of program elements

Exhibit 1

Program Elements

	LIMAC/Freddie Mac	EMI/Fannie Mae
Participant Roles	■ LIMAC acts as an intermediary among lenders (who originate the loans), investors (who buy the securities), and Freddie Mac (who guarantees the securities). ■ Freddie Mac packages mortgages into securities with guarantee. ■ LIMAC has exclusive arrangement with Freddie Mac.	■ EMI is a lender. ■ Fannie Mae is an investor. ■ Fannie Mae purchases collateral trust notes secured by individual mortgages. ■ Structure allows EMI to partner with other originators and investors.
Product	■ Fixed-rate, self-amortizing, long-term, permanent mortgages. ■ Moved to negotiations on 15-year mortgage.	■ Fixed-rate, 25-year, permanent mortgages with forward commitment, focusing on tax-credit projects. ■ Focus on forward commitments for new originations, although may also provide refinancings of existing permanent mortgages.
Underwriting	■ No delegation; LIMAC, Freddie Mac, and lenders all underwrite. ■ Use program Master Agreement standards as guidelines. ■ LIMAC to work with Freddie Mac regional offices and centralized affordable housing staff. ■ Maximum LTV 75 percent, 80 percent with waivers. ■ Minimum debt-coverage ratio 1:1.	■ Intent is to delegate underwriting after initial precommitment review period. ■ Use Fannie Mae's Delegated Underwriting and Servicing Targeted Affordable Housing standards as guidelines. ■ EMI to work with Fannie Mae's regional offices and centralized affordable housing staff. ■ Maximum LTV 90 percent. ■ Minimum debt-coverage ratio 1:1.
Pricing	■ 1-percent initial purchase fee to LIMAC. ■ Return to investor is locked in up front. ■ 50 bps[1] for credit enhancement to LIMAC. ■ Transaction-specific guarantor fee to Freddie Mac (85 bps in the one completed transaction). ■ 25-bps loan-servicing fee to lender.	■ $1,500 application fee to EMI. ■ $1,500 postpurchase fee to Fannie Mae. ■ 2-percent loan-placement and commitment fee to EMI.[2] ■ 2-percent mandatory delivery fee to Fannie Mae, later structured as second lien, refunded on delivery of the loan. ■ Fannie Mae's price, pegged to its affordable housing rate. ■ A forward commitment fee, if applicable, to Fannie Mae, originally 7 bps/month; ultimately waived for first 12 months. ■ 50-bps loan-servicing fee to EMI.

[1] Basis points, or 0.01 percent.

[2] The original terms of the Program's Special Purchase Agreement (SPA) had a 1-percent fee to EMI for loan placement and a 1-percent loan-commitment fee to Fannie Mae. After the SPA was signed, Fannie Mae agreed to waive its commitment fee; EMI elected to continue collecting the fee to boost income.

for both programs). It also planned to target community development corporations (CDCs) and small banks that would not normally work with Freddie Mac. The program would accept Low-Income Housing Tax Credit (LIHTC) and non-LIHTC mortgages.

Pricing included compensation to LIMAC, the lender, the investor, and Freddie Mac. LIMAC was to purchase the loans from approved Freddie Mac multifamily seller/servicers, subject to a risk-sharing arrangement under which LIMAC and the originating lender would share the top 20 percent of loss and Freddie Mac would share the remaining 80 percent with the lender. LIMAC was to combine the loans into pools, swap the loan pools with Freddie Mac for Freddie Mac MBSs, then sell the securities directly to institutional investors. This structure required that LIMAC would either find lenders with enough loans to make up a pool or bear the cost of warehousing the loans until a pool could be formed. Lenders would continue to service the loans they sold in return for a servicing fee.

The program was announced in February 1991. In December of that year, Freddie Mac approved the first loan package: a single transaction totalling $4.6 million, comprising eight existing mortgages from a large, experienced lender. It took another 3 months of pricing negotiations before the transaction was closed in late March 1992. As discussed below, these negotiations were plagued with fundamental disagreements concerning underwriting; pricing; the value brought to the transaction by the lender, LIMAC, and Freddie Mac; and the risks associated with the loans. This first transaction would prove to be the last. In mid-1993, after being unable to reach agreement on other transactions, LISC and Freddie Mac announced that they were suspending the program indefinitely.

The timing of the LIMAC/Freddie Mac program is important. In 1991, as the program was launched, many mortgage lenders, particularly thrifts, were retreating from the multifamily mortgage market. Freddie Mac itself had left the multifamily market because of record losses in its multifamily mortgage business, making it a difficult time to begin the LIMAC program.

By the start of the EMI/Fannie Mae program more than 3 years later, multifamily lending was increasing, with some new entrants into the market. Certainly compared with Freddie Mac in 1991, Fannie Mae was relatively active in the multifamily market. The EMI/Fannie Mae program officially began in November 1994 with a goal of making $150 million available for LIHTC-eligible multifamily housing loans nationwide. At least initially, the program was to focus on long-term, permanent mortgages for smaller, central city, multifamily LIHTC projects being developed by CDCs and other nonprofit organizations—a market segment that program participants felt was underserved. EMI was structured as a subsidiary of the Enterprise Social Investment Corporation (ESIC), the Enterprise Foundation's LIHTC equity syndicator. Unlike the LIMAC program, in which LIMAC was an intermediary between the lender and Freddie Mac and sold Freddie Mac securities to investors, EMI is the lender. EMI originates, underwrites, and services loans while Fannie Mae is the investor, funding the mortgages. Another key difference from the LIMAC/Freddie Mac program is that the EMI/Fannie Mae program structure permits other investors. In 1997 the pension fund for the United Methodist Church committed $10 million to purchase Fannie Mae MBSs backed by EMI loans. The program includes a risk-sharing arrangement, in which EMI takes the first 5 percent of loss on loans it originates and shares the remaining loss with Fannie Mae. EMI's maximum share of the loss is 20 percent.

Pricing was to include compensation to EMI for originating, underwriting, servicing, and bringing the loans to Fannie Mae, and to Fannie Mae for buying the loans and providing a forward commitment. At the program's outset, it was clear that the pricing structure provided a price that was too high for the current market. Fannie Mae agreed to adjust its price through a temporary concessionary pricing structure. EMI had also planned to offer a bridge-financing program to finance tax-credit equity pay-ins to the projects. The revenue from this program was an important part of EMI's projected operating revenue. Fannie Mae, however, was unable to offer a price on the bridge loan product that left room for a fee to EMI and could still be competitive in the marketplace. As a result, EMI became essentially a one-product program: the forward commitment on LIHTC transactions.

By June 1997, more than 2½ years into the program, EMI had made commitments under the concessionary pricing to 13 projects, totalling $18.5 million in mortgages. The start was considerably slower than expected, largely due to sometimes lengthy negotiations between EMI and Fannie Mae over underwriting specifics, particularly concerning some of the special features of affordable projects (such as requirements of various types of subsidies and requests for waivers). In addition, Fannie Mae's documentation requirements were burdensome, particularly for small, nonprofit borrowers. In late 1996 EMI proposed fundamental program changes to Fannie Mae that it felt were necessary for doing business. In January 1997 EMI and Fannie Mae agreed to restructure the program, and Fannie Mae awarded EMI full authority to underwrite, grant provisional waivers for, and commit to loans of less than $3 million, for a total pool of $50 million. EMI was granted the authority to enter into affordable housing transactions of more than $3 million, but EMI is required to compete with other delegated multifamily lenders on their terms; EMI would not receive concessionary pricing on these transactions. The EMI/Fannie Mae program is currently doing business under this new structure, focusing almost exclusively on the forward commitment for transactions under $3 million.

These two efforts have helped in addressing the question of how to involve a GSE in the secondary market for affordable multifamily mortgages. There are some fundamental differences in the programs, but both experienced slow starts and encountered many similar obstacles. The obstacles principally result from wide differences between the GSEs' and their partners' assessments of the risks associated with the loans, as raised in the underwriting and pricing of the transactions. Both programs suffered under the weight of time-consuming negotiations that often resulted in processing costs that were higher than revenues. The discussion that follows provides a detailed description of the five problem areas for these programs: underwriting; pricing; information and expertise; the capacity issues associated with small, startup organizations working with two large institutions; and the financial viability of a business focused on providing mortgages for affordable rental housing.

Underwriting

The mortgage underwriting process is an area in which standards and information are crucial. Underwriting assesses the soundness of the mortgage as an investment. Uniform underwriting guidelines are essential to the operation of the secondary mortgage market because they assure the investor that—regardless of the individual underwriter or the location of the project—the assessment of the investment follows standard guidelines. The LIMAC and EMI experiences reveal several underwriting issues that are fundamental to the successful development of a secondary multifamily mortgage market:

- Delegated underwriting, so that only one party underwrites the transactions.
- Establishing underwriting standards appropriate to affordable multifamily developments, which are often relatively small projects developed by nonprofits.

- Determining a level of documentation that sufficiently ensures the project's soundness, yet does not overburden the borrower or the lender.

Delegated underwriting. Delegated underwriting assigns authority and responsibility for underwriting transactions to one party. Freddie Mac made it clear from the beginning of the LIMAC program that it had no intention of delegating underwriting; this was Freddie Mac's policy, and there was no exception for multifamily transactions. Instead, the LIMAC/Freddie Mac program was structured so that the originating lender, LIMAC, and Freddie Mac all underwrote each transaction. Underwriting for the one completed transaction by the three participants produced quite different results, indicating clearly divergent views of the risks associated with these properties. LIMAC and Freddie Mac tackled underwriting issues for more than a year for the one transaction they closed.

A major principle that was unique to the EMI/Fannie Mae program was that EMI was to be a delegated Fannie Mae underwriter. Because EMI was the lender, it was to be the sole underwriter. Before being granted delegated underwriter status, however, EMI had to qualify in each of Fannie Mae's five regional offices by satisfactorily completing at least three transactions per region under precommitment review, during which Fannie Mae and EMI each underwrote every transaction. Two years into the program, EMI was unable to gain approval for delegated status in any of Fannie Mae's regional offices, and there was no indication that it was to be released from precommitment review soon, even though it had completed eight transactions in one of the regional offices. The lack of delegated underwriting made the program too expensive and time consuming for both EMI and Fannie Mae. In addition, it was difficult to keep prospective customers in the pipeline because EMI was unable to make a clear commitment in a timely fashion.

One of Fannie Mae's concessions in the January 1997 program restructuring was to grant EMI immediate delegated underwriting status for $50 million of qualifying affordable multifamily mortgages of $3 million or less. Fannie Mae removed precommitment review requirements in all regions and granted EMI the authority to issue some waivers for exceptions. Making EMI a fully delegated underwriter was fundamental to testing whether a viable business could be built based on these kinds of transactions. Unfortunately, during the first 6 months of the restructured program, EMI needed to restaff and reorganize, which slowed program progress. It remains to be determined whether the restructuring will allow EMI to shorten its underwriting and processing time, thereby increasing its efficiency.

Establishing underwriting standards for multifamily affordable housing. The LIMAC/Freddie Mac program was guided by a Master Agreement, which, among other things, established a set of underwriting guidelines for the program to anticipate potential problems in underwriting. In practice, however, LIMAC and Freddie Mac usually disagreed on the implementation of those guidelines. Even when both claimed to be following the guidelines as meticulously outlined in the Master Agreement, they often reached different conclusions in their analyses. In addition, the lender for the completed transaction had held the loans in portfolio and had used a different set of underwriting guidelines and documentation requirements when it originated the mortgages.

Freddie Mac and LIMAC placed significantly different values on the properties underlying the loans. Just 3 months before closing, Freddie Mac's appraisals of the eight projects resulted in loan-to-value (LTV) ratios that averaged 91 percent; LIMAC's assessment of LTV ratios for the same projects averaged 71 percent (close to the lender's original assessment of 72 percent, which at the time had sparked criticism by local community development groups for being too high). When the transaction closed, Freddie Mac's final weighted average of the eight LTV ratios was 84 percent.

The discrepancy arose from differences in three assessments:

- The estimation of project income.
- The treatment of soft second mortgages.
- Capitalization rates.

To determine project value, net operating income is divided by a capitalization rate, which reflects current market conditions, including interest rates and an assessment of risks associated with the projected rental income stream. To estimate projected income, LIMAC considered net operating income based on tax-credit-restricted rents as well as the flow of tax credits to the investor, arguing that tax credits were an important part of the return to the equity investor (four of the eight mortgages were for LIHTC projects). Freddie Mac considered unrestricted, or market, rents but did not include the flow of tax credits.

Many projects had soft second mortgages, which Freddie Mac treated as hard loans with fixed payment schedules, and which LIMAC treated more like grants. LIMAC's and Freddie Mac's capitalization rates were also far apart: LIMAC used rates that were between 12 percent and 12.8 percent; Freddie Mac's rates were as high as 16 percent. LIMAC and the lender believed that Freddie Mac undervalued properties located in low-income neighborhoods by failing to consider elements that substantially strengthened the projects, including the benefits of tax credits, the level of commitment of local public officials, and lender and developer histories. From the perspective of LIMAC and the lender, Freddie Mac's approach to underwriting these loans seemed to ignore some essential features of affordable rental housing that influence the risk associated with the projects and may have resulted in its overstating those risks.

The climate for the EMI/Fannie Mae program was considerably different. As the EMI program began, Fannie Mae was completing its new underwriting guidelines for affordable multifamily housing, incorporated in their Delegated Underwriting and Servicing (DUS) program.[9] Fannie Mae's guidelines dealt explicitly with various issues in affordable rental housing. DUS specified guidelines for LTV ratios and debt service coverages (DSCs) appropriate to affordable rental housing, explicitly accounting for various government programs, such as LIHTC. Both EMI and Fannie Mae used the same appraisal. Net operating income was based on the restricted low-income rents, and capitalization rates for completed transactions varied but averaged approximately 10 percent. In recognizing the unique features of tax-credit transactions and that tax-credit and other affordable housing projects are inherently different from standard market-rate transactions, Fannie Mae's guidelines were a significant improvement over those used by Freddie Mac for the LIMAC program. The EMI program's defining document, the Special Purchase Agreement (SPA), revolved around Fannie Mae's new guidelines, making EMI well positioned to test the application and performance of Fannie Mae's new approach to this segment of the market.

In practice, EMI and its borrowers had few complaints about the program's underwriting guidelines. Although Fannie Mae's guidelines could still be a significant challenge for affordable housing, EMI found that a sufficient number of transactions could successfully meet those requirements. Yet continuing disagreements between EMI and Fannie Mae resulted in long processing delays and limited the volume of the program. Although EMI had expected to process applications within 3 months of receiving them, it regularly required 6 months or longer. In some cases EMI and Fannie Mae simply disagreed on the implementation of the guidelines, but the majority of problems originated in areas not explicitly addressed in the guidelines, or in processing waivers or exceptions that can often arise with affordable housing. EMI found that its projects typically required waivers or exceptions, even with Fannie Mae's affordable housing guidelines. Much of the delay in processing arose from negotiating terms and gaining Fannie Mae's consent for waivers. Often EMI staff indicated that Fannie Mae staff did not understand the affordable housing market segment, whereas Fannie Mae staff indicated that EMI did not comply with documentation requirements.

Documentation. Both programs have suffered from burdensome documentation. The initially dense documentation for the LIMAC/Freddie Mac program became increasingly burdensome over time to both LIMAC and the lenders. More than one potential lender dropped out of the program because of the amount of documentation required. The only lender to complete a transaction under the program felt inundated by Freddie Mac documentation requirements and had hoped that LIMAC would do more to push Freddie Mac to simplify the mortgage documents and to assist in their compilation. Because the transaction involved eight existing loans, the lender already had several years' worth of loan origination documentation and servicing records for each loan. However, the information needed to be reformatted to fit Freddie Mac's documents. The lender was frustrated that LIMAC never provided a comprehensive list of what was needed. LIMAC believed that there was no one office or individual within Freddie Mac who was coordinating Freddie Mac's requirements; Freddie Mac's requests were piecemeal and transaction-specific rather than standardized for the program. As a result, the documentation seemed repetitive, disorganized, and endless. As LIMAC considered new transactions, there was no indication that Freddie Mac's documentation requirements would become less complicated or standardized. If anything, the documentation requirements increased over time. For example, Freddie Mac's forward commitment letter on the second, unsuccessful transaction was 22 pages with attachments.

The EMI/Fannie Mae program also required burdensome documentation, although to a lesser degree. From the outset, both borrowers and EMI staff complained of cumbersome documentation requirements. Particularly early on, EMI was aware that some borrowers withdrew preliminary applications because of burdensome documentation, reporting, and due diligence requirements. In our interviews, one borrower with considerable experience in multifamily housing said that she would happily pay a premium to *avoid* working with Fannie Mae. Many EMI borrowers with whom we talked were nervous about the paperwork requirements they faced. The EMI program had considerably more reporting requirements, especially during construction and project management, than those of local lenders. Some forms seemed incompatible with certain characteristics of their projects.

As with LIMAC, some borrowers said that they expected EMI to be more of an advocate for them with Fannie Mae and were disappointed that EMI failed to challenge Fannie Mae's rules. Fannie Mae staff, though, were frustrated early on with EMI's unfamiliarity with their documentation. Staff in one regional office complained that they had to retype EMI documents to get the information in the correct Fannie Mae format.

The restructuring of the program granted EMI the ability to issue some provisional waivers without formally applying to Fannie Mae, which may ease the situation. Although Fannie Mae staff acknowledged that the heavy documentation and due diligence requirements could be problematic and that they would like to ease the burden, as of June 1997 there had been no changes to requirements.

The typical underwriting, documentation, and due diligence requirements of Freddie Mac and Fannie Mae transactions were particularly burdensome for programs targeted at affordable multifamily housing. The smaller, nonprofit, and CDC developers that these programs intended to bring to the market were unprepared, and perhaps unwilling or unable, to meet the high costs of Freddie Mac's and Fannie Mae's due diligence requirements. Certainly our interviews with potential and actual program borrowers indicated that smaller organizations unfamiliar with Freddie Mac and Fannie Mae were most likely to have difficulty meeting the requirements. Given the importance of these smaller borrowers to providing affordable housing in many local markets, streamlined underwriting and documentation requirements are critical to the development of a secondary market for affordable rental housing.

Pricing

As discussed in the introduction, a major benefit of an active secondary mortgage market is increased efficiency in funding mortgages, which should decrease total costs for the borrower. The experiences of the LIMAC/Freddie Mac and EMI/Fannie Mae programs illustrate the difficulty inherent in offering a rate that works for the borrower but still compensates the lender and investor.

Making the price competitive. Exhibit 1 shows that the cost to the borrower consists of upfront fees and other components that make up the rate on the loan. In the LIMAC/Freddie Mac program, the borrower paid an initial purchase fee of 1 percent of the loan amount to LIMAC. The rate on the loan consisted of the rate to the investor, plus 50 basis points (bps), or 0.5 percent, to LIMAC for credit enhancement, plus a guarantor fee to Freddie Mac determined by the risks of the transaction, plus a 25-bps loan-servicing fee to the lender.

Although the pricing of the EMI/Fannie Mae program had more elements, it was somewhat simpler because EMI was the lender and Fannie Mae was the investor. The upfront fees to EMI included a $1,500 application fee and a placement and commitment fee of 2 percent of the loan amount. Fannie Mae received a $1,500 postpurchase fee. In addition, Fannie Mae required a 2-percent mandatory delivery fee to be refunded when the loan was delivered. The loan rate was based on Fannie Mae's published rate for affordable housing, plus a forward commitment fee to Fannie Mae, plus a 50-bps loan-servicing fee to EMI.

For both LIMAC and EMI, generating sufficient income to cover operating expenses was a challenge, given the concentration on small affordable housing loans. As discussed earlier, underwriting these loans is often complicated by many anomalies. However, income is based on loan size. On a $1 million loan, LIMAC would generate $10,000 in fees plus 50 bps of the unpaid mortgage balance (UPB) per year for credit enhancement ($5,000 in the first year). For EMI, a $1 million loan would generate $21,500 in fees plus 50 bps per year in servicing ($5,000 in the first year).

The LIMAC/Freddie Mac program had some unique pricing problems. The rate on the loan had to compensate four participants: the investor, Freddie Mac, LIMAC, and the lender. The rate to the investor was determined first. Because the rate to the investor was locked in, any gap between the time LIMAC locked in the investor's rate and the time the rest of the pieces were in place created exposure to interest-rate risk, which could be expensive. In the one completed transaction, LIMAC committed a return to the investor 20 months before it closed. By that time, decreases in market interest rates meant that the investor seemed to be getting a return that was too high. As a result, the investor agreed to modify its return twice before the loans were delivered. Because Freddie Mac's fee was determined last, its fee was viewed as determining the viability of pricing, leaving Freddie

Mac staff in the position of having their fee break the deal or be less than what they believed to be the market value of their guarantee. In this case, Freddie Mac took less than its assessment of market value.

The EMI/Fannie Mae program faced problems with pricing as well. The base rate on the loan as outlined in the SPA was set at 25 bps below Fannie Mae's required net yield (Fannie Mae DUS Tier II rate, which is its standard rate for affordable rental housing). This rate fluctuates with the market and is published regularly by Fannie Mae. In addition, Fannie Mae was to charge a monthly fee for the forward commitment. When the program began, EMI found that this pricing was not competitive in the marketplace. Fannie Mae's going rate for the forward commitment was approximately 7 bps per month, or 84 bps for a 12-month forward. To get the program started, Fannie Mae offered concessionary pricing for the first $10 million in loans by raising the rate for the loan to its required net yield (that is, eliminating the 25-bps discount) and not charging for the forward commitment. In effect, the cost to the borrower of a 12-month forward went from 84 bps to 25 bps. This pricing has been extended to the first $50 million under the new program structure. EMI's success to date in closing transactions relies heavily on the attractiveness of this pricing of the forward commitment.

While the pricing arrangement represents an important opportunity for EMI to create significant volume, it is an exception to the manner in which Fannie Mae traditionally conducts business transactions. Fannie Mae staff clearly stated that they provided this free forward commitment as a way to start the program but would not offer a free forward commitment indefinitely. It is clear that Fannie Mae has not yet determined how to make this business profitable. The question is, Can Fannie Mae offer a price that appeals to borrowers but still makes a profit for Fannie Mae?

Creating predictable pricing. Part of standardizing a product involves the ability to offer predictable pricing. The two programs approached this issue in very different ways. For the LIMAC/Freddie Mac program, the lack of predictable pricing played a large part in the program's demise. The pricing of Freddie Mac's guarantee—the last step in the process—was dubbed by participants both inside and outside Freddie Mac as a *black box*. It was difficult even for Freddie Mac's regional staff and the staff members in its affordable housing division to be able to predict how these multifamily mortgages would be evaluated by the pricing staff. This uncertainty overshadowed every step of the negotiations. When the final price was set, both LIMAC and the lender felt that the price was too high, and the investor subsequently took a cut in its return to make the transaction feasible.

Two major factors contributed to this uncertainty about pricing. First, although the LIMAC program was managed primarily by Freddie Mac's multifamily group, the pricing of the LIMAC products was determined by a centralized pricing group. The vast majority of the work done by this pricing group was for the single-family portion of Freddie Mac's business. The pricing of LIMAC's transactions was grounded in default models based primarily on assumptions widely used in modelling the single-family mortgage market. These models assume that when the loan amount exceeds its value, the borrower will default on the loan. Investors in rental housing rarely evaluate the market value of their property. Instead, they track income and expenses. As a result, a more appropriate approach would be to consider cash flow by comparing monthly revenues with operating expenses plus debt service to predict default when expenses exceed revenues for a number of months.

Second, Freddie Mac's pricing staff and LIMAC struggled over issues unique to affordable housing. For example, Freddie Mac's pricing staff were concerned about the untested risk to LIHTC projects in year 16 when the compliance period for tax credit-related affordability requirements would end. In addition, Freddie Mac was clearly giving little, if any, credit to the strong lender and community commitments that are typical of affordable rental housing developments and that often keep such projects viable. Despite Freddie Mac's public commitment to the LIMAC program, it seemed unwilling to invest in developing systems and pricing structures that would be appropriate to affordable rental housing.

The EMI program, 4 years later, had far less uncertainty concerning price. The base rate on the loan, both as established in the SPA and under the concessionary pricing structure, was pegged to Fannie Mae's standard affordable multifamily rate. Both EMI and the borrower had immediate access to the current base price for the transaction. In this program, the uncertainty concerning pricing stems from the fact that the program depends on special, temporary, concessionary pricing of the forward commitment. The goal of the program is to bring market-rate financing—not temporary, below-market financing—to affordable housing. As EMI builds volume and experience with Fannie Mae, the program's transactions may affect the way Fannie Mae prices these mortgages. Currently, however, Fannie Mae is still clearly handling EMI's transactions as exceptions rather than as standard products. This program will have only limited impact on the development of a more active secondary market for affordable rental housing unless it generates an acceptable programmatic pricing structure.

Risk sharing: determining the value LIMAC and EMI bring to the table. Both the LIMAC/Freddie Mac and EMI/Fannie Mae programs included risk-sharing arrangements. However, the goals of risk sharing differed for each program. The LIMAC/Freddie Mac program wrote into the Master Agreement a rather complicated risk-sharing arrangement with the lender, LIMAC, and Freddie Mac to reassure potential investors and Freddie Mac. The lender and LIMAC would share the top 20 percent of the risk and Freddie Mac would share the remaining 80 percent with the lender.[10] For the $100 million in mortgages in the initial agreement, LIMAC's potential exposure was $16 million (80 percent of 20 percent). To cover this exposure, LIMAC was to hold $2.5 million in a Freddie Mac-controlled reserve.

Under the program's structure, LIMAC charged 50 bps for its credit enhancement on all transactions, regardless of risk. Clearly it could be argued that a risk-based pricing scheme would be more appropriate. Another issue was that the lender was not compensated for its credit enhancement, retaining risk for the full 30 years. The fundamental issue with the credit enhancement was how it should be valued. In the one completed transaction, Freddie Mac pricing staff indicated that they awarded only 10 to 15 bps for LIMAC's credit enhancement when setting their price for the Freddie Mac guarantee, despite that the lender was being charged 50 bps. Freddie Mac argued that LIMAC was undercapitalized and had much of its capital in reserve for this program. Still, Freddie Mac was reluctant to complete the transaction without LIMAC's credit enhancement.

Another fundamental flaw in the LIMAC program structure was that LIMAC and the lender shared the top 20 percent of risk on each loan, but Freddie Mac had total control over workouts and dispositions in the event of default. In effect, this gave Freddie Mac a blank check on the guarantees provided by LIMAC and the lender.

The EMI/Fannie Mae program has a simpler approach to risk sharing. EMI takes the top 5 percent of loss. Beyond that, EMI and Fannie Mae share the loss according to a formula that alters the distribution as the total loss increases. EMI is not liable for more than 20 percent of the total UPB of the loan. For the $150 million investment in the program, EMI funded a $3 million loan loss reserve with two matching grants.

The fundamental difference between the LIMAC and EMI risk-sharing arrangements is that LIMAC charged the borrower explicitly whereas EMI did not. LIMAC's fee was a given, but Freddie Mac was essentially determining the value of LIMAC's credit enhancement in the pricing of its guarantee, which included an assessment of the financial stability of the source of the credit enhancement. Fannie Mae did not have to place a value on EMI's credit enhancement. Instead, it set a threshold for EMI to enter into the partnership. This difference between the two programs results from a difference in goals.

There are really two goals of credit enhancement: to shield the investor from loss and to create incentives for the mortgage provider (lender or conduit) to bring high-quality loans to the table. If the goal is to shield the investor from loss, the financial soundness and depth of the credit enhancer is crucial. The investor will want assurance that the credit enhancer can safely cover any losses. The fundamental issue is the worth of that reduction in expected loss. While the reduction in expected loss is the same for all purchasers, its value is different for each purchaser. A purchaser with a large, diversified portfolio like those of the GSEs would pay less for the reduction in expected loss on a given loan than a purchaser with a small portfolio that is not diversified. Given Freddie Mac's and Fannie Mae's sheer size and diversification, it is very difficult to provide them with valuable credit enhancement. In fact, Fannie Mae and Freddie Mac may be the most efficient providers of credit enhancement.

Therefore, it seems that for both programs the main goal of credit enhancement was to create incentives to deliver high-quality loans. In this case, the level of capitalization of the credit enhancer or the size and control of a reserve account relative to the potential level of exposure is less important. The matter of concern is that the potential loss to credit enhancers is large, creating an incentive for them to look closely at the loans. The track records of the organizations and, especially, confidence in their underwriting, servicing, and monitoring abilities are key. It was clear that Freddie Mac staff were uncomfortable with LIMAC's limited track record and, therefore, placed a low value on LIMAC's credit enhancement. Fannie Mae staff expressed more confidence with EMI's expertise, in large part because of EMI's explicit connection with ESIC, with which Fannie Mae has extensive experience as a major investor (in ESIC equity transactions).

Generating an Information Base and Expertise

Many underwriting and pricing problems of these programs are due to an insufficient understanding of the determinants of default and loss in the multifamily mortgage industry. This lack of information and analysis contrasts starkly with the quality and amount of data available about the single-family market. The clearer understanding of the risks and returns of the single-family market has led, under the GSEs' leadership, to the creation of industry standards for underwriting and pricing and a very active secondary market.

The lack of documentation about the affordable multifamily market perpetuates an apparent paradox: traditional investors view affordable multifamily housing as a high-risk, low-return investment, yet a considerable amount of anecdotal evidence from affordable housing specialists indicates that this investment has an excellent performance record. The generation of a portfolio that could serve as a reliable information base on these types of transactions was an explicit goal of the LIMAC/Freddie Mac program. One Freddie Mac staff member declared that the best thing about the LIMAC program was that it brought the strong affordable portfolio of the program's sole lender to Freddie Mac's attention. Yet, despite Freddie Mac's acknowledgment of the lender's considerable expertise and excellent track record, when it came to the details of underwriting, Freddie Mac was often uncomfortable with the lender's procedures. In fact, the LIMAC/Freddie

Mac program rejected 75 other loans in the lender's well-performing portfolio before settling on the group of eight because of anomalies that made the loans unsuited to the program's requirements. (The lender was left believing that the program had "creamed" the best transactions out of their portfolio.) The creativity and flexibility that the lender used to evaluate loans often looked unusual to many Freddie Mac staff members. Buying the lender's loans was, as one Freddie Mac staffer put it, like "trying to fit a square peg into a round hole."

Providers of low- and moderate-income housing have long argued that their projects have performed extremely well with virtually no defaults or losses. These providers face a credibility problem, however, because little systematic documentation exists concerning their multifamily activity. In addition, these providers work in the shadow of large industry players such as FHA and Freddie Mac, both of which posted significant losses in their multifamily portfolios in the late 1980s and early 1990s. There is a real need for systematic documentation of the performance of investments in low- and moderate-income rental housing that can inform potential lenders and investors. Increased documentation and understanding of risks and returns paves the way for the standardization of underwriting guidelines and documentation that is necessary to the development of a secondary market. Clearly there will always be uncertainty about these investments—one example was Freddie Mac's concern over the untested risk associated with tax-credit projects in year 16 at the end of the compliance period. LIHTC is only 11 years old, so it is too soon to shed light on this risk.

Capacity

The LIMAC and EMI programs have exhibited David-versus-Goliath qualities. LIMAC and EMI are small, undercapitalized organizations that attempted to negotiate with very large, bureaucratic institutions. Both programs fell considerably short of their goals. Even EMI, despite completing $20 million in transactions and obtaining new terms for a restructured phase, fell well short of its and Fannie Mae's goals for completed transactions: The program did not accomplish in its first 2 1/2 years what it had set as a 1-year goal.

While trying to build a national business to provide access to the secondary market for small affordable housing loans, LIMAC and EMI faced considerable challenges.

Limited track record. Neither organization had significant experience in this business. LIMAC had been established by LISC in 1987 with the goal of establishing a national secondary market for community development loans. LIMAC purchased loans from community development loan originators, pooled them, issued securities, and marketed them to investors. At the start of the LIMAC/Freddie Mac program, LIMAC had issued two bond series of approximately $10 million each. Lending was a new business for EMI and ESIC, although EMI staff had considerable multifamily lending experience.

For both organizations, the lack of experience meant that staff had to spend considerable time becoming familiar with the GSEs' procedures and documentation and gaining the confidence of the GSEs' staff. Freddie Mac and the original lender on the one completed transaction had complained that LIMAC staff also needed training on local markets and affordable housing issues. This issue seemed less important for EMI.

Small organizations. Both organizations were quite small, with only 3 to 4 employees at the start. Staff members of each organization quickly found themselves overworked. Other participants in the programs later expressed surprise when they learned how few people were employed by each organization.

Both LIMAC and EMI contracted some services (property appraisals, for example) with third parties. EMI also received more support from its parent organization, ESIC, whose staff provided help with such tasks as postclosing asset management and servicing. Another advantage EMI had over LIMAC was that it was able to capitalize on the trend toward one-stop shopping for debt and equity for LIHTC transactions that had developed in the market since the LIMAC/Freddie Mac program. EMI stressed one-stop shopping at ESIC/EMI as a program strength. In fact, as part of the January 1997 program reorganization, Fannie Mae sought to formally strengthen the ESIC/EMI tie. Since the LIMAC/ Freddie Mac program did not focus on LIHTC transactions, there was never any intended connection between LIMAC and the National Equity Fund (NEF), LISC's syndicator of LIHTC equity.

Multiple roles. The limited staff at LIMAC and EMI were responsible for a wide range of roles. Both organizations were responsible for marketing to find transactions (LIMAC to lenders and EMI to borrowers) and to perform underwriting. LIMAC was also responsible for marketing the MBSs to investors. EMI does not have to market to investors because it can sell the mortgages directly to Fannie Mae, which is also the investor, although it has brought in the United Board of Methodist Pension and Health Benefits as an investor. EMI staff, however, unlike the LIMAC staff, service the loans.

Focus on small, difficult transactions. By targeting affordable projects, both organizations committed themselves to complicated, labor-intensive transactions, often developed by nonprofits and community development organizations that have few resources for or little experience in dealing with the considerable requirements of Freddie Mac and Fannie Mae. EMI's focus on tax-credit projects placed additional pressure on capacity. The increased popularity and competition for tax credits means that securing financing for tax-credit transactions is becoming a seasonal (winter and early spring) sport. By late spring, tax credits for the year have often been allocated. Staff constraints can result in missing the window of opportunity.

National scope. Both programs were national in scope. Despite the small, centralized staff, neither program wanted to limit itself to a geographic region, even in the startup phase of their programs. This national focus not only added a logistical issue—physically getting to the sites and meeting the participants—but also meant that the staff needed to be knowledgeable about a wide range of local markets and had to negotiate with staff members at Freddie Mac's and Fannie Mae's regional offices. In the EMI/Fannie Mae program, some conflicts arose over due diligence involving EMI's failure to conduct property inspections during construction, which ultimately was due to staffing constraints.

Exclusive arrangement with Freddie Mac/Fannie Mae. Each organization was built, at least initially, around a partnership with one organization. The advantage of this arrangement was the potential benefit of working with a major player. Freddie Mac and Fannie Mae are large, powerful entities that could have an impact on the development of the secondary market for multifamily mortgages. A disadvantage, however, was the exclusivity of LIMAC's and EMI's partnerships. The LIMAC program was an arrangement between LIMAC and Freddie Mac only. The lack of competition put LIMAC at a considerable disadvantage during price negotiations with Freddie Mac. The EMI program was structured so that EMI was free to pursue partnerships with other organizations. Although in 1997 EMI brought the United Board of Methodist Pension and Health Benefits to the program as an investor, its work focused primarily on its efforts with Fannie Mae to get the program started.

Offering a single product. To get the programs started and build volume, both programs focused on a single product—LIMAC focused on a long-term, fixed-rate mortgage; EMI focused on the forward commitment. LIMAC found its mission to be particularly arduous because the 25-year mortgage proved to be difficult to sell as it required the lender to carry the risk for the full mortgage term. LIMAC also abandoned developing a forward commitment product and consistently chose to concentrate its energies and limit its scope.

EMI has also limited its activities. Although EMI has had more programmatic freedom to create new products and new partnerships than LIMAC did, as of June 1997, forward commitment was still the centerpiece of the EMI program.

Viability

Both the LIMAC/Freddie Mac and the EMI/Fannie Mae programs were to be financially self-sustaining. However, revenues never covered costs for the LIMAC program. As of June 1997, revenues had not covered EMI program costs. The experience of these two programs raises the question of whether a business that focuses on mortgages for small, affordable housing projects is financially viable.

Both LIMAC and EMI had the goal of completing approximately 25 transactions per year and projected that at that rate revenues would cover costs after an initial startup period. Interviews with multifamily mortgage market participants suggest that a loan officer handling standard multifamily mortgages can typically complete approximately 10 transactions per year. At that rate, LIMAC's and EMI's production goals seem reasonable. However, neither organization came close to this goal. LIMAC and EMI were not focused on standard multifamily mortgages. Their transactions were small and complicated. The mortgage size meant that they generated less in fees. The complications of rental housing targeted at low-income households meant that these loans were particularly labor intensive.

In addition, each program suffered from having a narrow market niche. LIMAC was committed to one product that, because its structure required lenders to be at risk over the long term, proved to be a poor fit for the market at the time. EMI, although it has had more flexibility, has continued to focus on its partnership with Fannie Mae and its forward commitment product with its temporary pricing. EMI is also limited to loans of $3 million or less. Although EMI can pursue larger loans, it must compete for them with DUS lenders on DUS terms.

Our interviews with affordable housing lenders suggest that some fundamental characteristics of the LIMAC/Freddie Mac and EMI/Fannie Mae programs contributed to their problems in achieving financial viability. One affordable housing lender, who is close to meeting the goal of 25 transactions per year, indicated that his firm's volume would resemble EMI's if it had the presence of Fannie Mae in all of its transactions, a national rather than regional scope, and a small staff. The lender argued that Fannie Mae's requirements would be overwhelming for most of his nonprofit borrowers—his concentration in a single State has permitted him to acquire a detailed understanding of the local markets and his organization has considerable staff to support loan officers.

The LIMAC and EMI experiences suggest that running a national program focused on small, affordable housing transactions with a GSE is a difficult task for a small, understaffed, undercapitalized, startup organization. The LIMAC/Freddie Mac program never moved beyond the startup phase. EMI has closed considerably more transactions but still has not generated sufficient volume to cover costs. However, experience may result in increased efficiency in the program. In addition, the changes in EMI's relationship with

Fannie Mae initiated in January 1997 may decrease staff time required to process each mortgage. EMI's experience during the next year should provide some indication of the magnitude of these efficiency gains.

Lessons and Future Prospects

The experiences of the LIMAC/Freddie Mac and EMI/Fannie Mae programs highlight the need for standards and information in the multifamily mortgage market to facilitate the development of an increasingly active secondary market. The divergent views of the GSEs and their partners concerning underwriting and pricing that have plagued these two programs illustrate the need for industry standards based on an increased understanding of the determinants of risk, return, and default.

The rationale for Federal Government sponsorship of Fannie Mae and Freddie Mac focuses on the provision of standards, information, and industry leadership to the mortgage market, with the explicit public-purpose mandate of serving a broad range of Americans, including low-income families in underserved areas. Fannie Mae's and Freddie Mac's efforts are almost completely focused on the single-family market. These organizations essentially transformed the funding of single-family mortgages from a collection of local lenders funding mortgages with local savings to the national and international capital markets providing funding for these mortgages. Because their activities were limited to the mortgage market, both institutions worked solely on the development of this market. Their efforts standardized the mortgage contract and underwriting procedures, making single-family mortgages commodities that investors can readily trade. This transformation took decades, and during that time few market observers envisioned the efficient capital market funding of home mortgages that exists today.

The dominance of the single-family market in their efforts is not surprising, given the market's size and the history of the Federal Government's housing policy focus on homeownership. At this point, however, the goals of standards and information have largely been achieved in the single-family market. The rental housing market serves poor families, often in inner cities typically underserved by lenders. In today's mortgage market, perhaps one of the best cases that can still be made for continued sponsorship of Fannie Mae and Freddie Mac is to develop the multifamily, secondary mortgage market. Although their charters mandate creating a market for all residential mortgages, GSEs have largely ignored this market segment. Fannie Mae and Freddie Mac could clearly play the leadership role in the development of the multifamily mortgage market.

Given the sheer size and profitability of the single-family market, it is difficult for multifamily efforts, particularly those focused on affordable rental housing, to compete for resources in either GSE. For both organizations, volume is essential. One lesson from the LIMAC/Freddie Mac and EMI/Fannie Mae programs is that these small, undercapitalized organizations have difficulty generating the volume necessary to propel GSEs to be significant players in this market. These boutique-like pilot programs provide GSEs with the opportunity to test some issues and indicate that they are making efforts in this market segment. Yet it is difficult for these efforts to produce programmatic change in the GSEs. The fundamental design of these efforts may be backward, with these small organizations playing the role of David charged with moving Goliath into this market. With their government sponsorship and public-purpose mandate, perhaps GSEs should have the primary responsibility for building the bridge to this market segment.

The experiences of the LIMAC/Freddie Mac and EMI/Fannie Mae programs suggest that, if GSEs are to provide this leadership role, they must develop more expertise in the multifamily market. Freddie Mac's reliance on models from the single-family market to price multifamily transactions indicates that the multifamily market did not receive much of the GSEs' attention or resources. Fannie Mae's inability to offer a competitive price to EMI on the forward commitment or on a bridge loan product is puzzling, given its size and market power. It is difficult to imagine a financial institution that could offer a lower price. Because both the forward commitment on LIHTC transactions and the bridge loan represent new products for Fannie Mae, it may be that its staff find these products difficult to price given their lack of experience with them.

A significant number of private banks provide loans to the affordable multifamily housing market, in part spurred by Community Reinvestment Act requirements. With a more active secondary market, it is very likely that banks would originate more loans, since banks prefer activities that generate fee income but have little interest in holding long-term mortgages. The problem is that GSEs may need to see considerable volume before they make major commitments to this market segment. At the same time, lenders and investors may also require considerable volume before they start entering the market. Generating larger volume in the secondary market will require the participation of larger originators.

The need for industry leadership in fully developing the secondary mortgage market for multifamily mortgages is clear. Given the substantial benefits of government sponsorship to Fannie Mae and Freddie Mac and the terms of their public mandate, they should have the responsibility for building this market. HUD can exert pressure on Fannie Mae and Freddie Mac to invest in this market by setting multifamily goals. To date, however, the goals that have been set have been quite low, requiring little effort to meet them. If GSEs are to become leaders in this market, HUD must set higher goals.

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Notes

1. Fannie Mae was created in 1938; Freddie Mac was created in 1970. In addition to Fannie Mae and Freddie Mac, the Federal Government created the Federal Housing Administration (FHA) in 1934 to encourage homeownership by promoting the 30-year, fixed-rate mortgage to lenders and investors by insuring those loans. In 1968, Fannie Mae was split into two organizations, spawning Ginnie Mae, housed in HUD. Ginnie Mae is responsible for providing a secondary market for FHA/Veterans' Administration loans and other mortgages that support Federal housing assistance efforts.

2. In the case of multifamily rental housing targeted at low- and moderate-income households, standardization in the structure of grants and soft second mortgages is an additional need. These grants and second mortgages often have restrictions that encumber the first mortgage, making it more difficult to sell since there can be wide variation in the nature of the restrictions. (For a broad discussion of the issues related to increasing the secondary market for multifamily mortgages, see DiPasquale and Cummings,1992.)

3. NCDI, a coalition of foundations and private corporations, committed an initial $62.5 million to address urban community development issues nationwide, with a particular emphasis on affordable housing. At that time, NCDI consisted of seven foundations and one insurance company. Together they created a 3-year program providing loans and grants for community revitalization projects to be funneled through the national intermediaries, LISC and the Enterprise Foundation. In 1994 NCDI announced a second 3-year round of loans and grants with an additional $88 million commitment. NCDI II participants consist of nine foundations, two corporations, and HUD.

4. The 1995 HUD rule regarding the regulation of Fannie Mae and Freddie Mac was published in the *Federal Register* on December 1, 1995. It established several new requirements for fair lending, data collection, and reporting; due-process procedures; and new performance goals, including goals targeting affordable housing for low-income households. As part of its effort to develop the requirements for this new rule, HUD brought in several experts to assess various issues. We worked with HUD staff on some of the broad policy issues associated with requirements for multifamily lending.

5. The figures on Fannie Mae and Freddie Mac purchases were provided by HUD and are based on annual reports submitted to HUD by Fannie Mae and Freddie Mac.

6. James R. Follain and Edward J. Szymanoski (1995) present a useful framework for assessing the need for government intervention in the multifamily mortgage market. They identify two possible market failures that might provide a rationale for government intervention: uninsurable risks and prohibitive information costs. Follain and Szymanoski illustrate that these two market failures are prevalent in the multifamily mortgage market. In their analysis, government is defined as the Federal Government and Fannie Mae and Freddie Mac are considered private firms. In this article, we view Fannie Mae and Freddie Mac as quasi-private firms deriving substantial benefits from their status as GSEs. This distinction raises the issue of the rationale for government sponsorship for Fannie Mae and Freddie Mac.

7. In 1993 a group of private actors in the multifamily market formed the Multifamily Housing Institute with the mandate to build a database on the multifamily mortgage market. While this effort may make an important contribution to the market, the Institute has struggled with the fact that its success in building an information base is dependent on the voluntary cooperation of organizations that compete with one another and that are unwilling to provide information to their competitors. The problems associated with obtaining voluntary cooperation are often cited as a rationale for government involvement.

8. “LIMAC/Freddie Mac Joint Venture for Affordable Housing,” Program Description, LIMAC, 1991.

9. EMI staff, in fact, were included in the process of revising Fannie Mae's DUS guidelines for affordable multifamily housing.

10. One consequence of this risk-sharing arrangement was that the lender was on the line for the full mortgage term. This condition proved to be difficult to market in an environment where lenders were accustomed to 5- to 7-year commitments. The EMI program avoids this problem because EMI is the lender and willing to take long-term risk.

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