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Office of Policy Development and Research



Study of Multifamily Underwriting and the GSEs' Role in the Multifamily Market

Final Report

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Study of Multifamily Underwriting and the GSEs' Role in the Multifamily Market

Prepared For

U.S. Department of Housing and Urban Development
Office of Policy Development and Research

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The Department routinely discloses past or current relationships that authors of its funded studies have had with Fannie Mae or Freddie Mac. Kimberly Burnett disclosed that she was briefly employed by Freddie Mac prior to joining Abt Associates. Linda Fosburg disclosed that she previously served as project director in a Freddie Mac-funded study and as a researcher in a Fannie Mae-funded study, both while she was employed by Abt Associates.

The contents of this report are the views of the contractor and do not necessarily reflect the views or policies of the U.S. Department of Housing and Urban Development or the U.S. Government.

Foreword

During the past twenty years the secondary multifamily mortgage market has expanded from a largely local market to a broad national market. During this period, and particularly since the passage of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Fannie Mae and Freddie Mac, the two large Government-sponsored enterprises that function in this market, have increased their involvement in multifamily housing finance. The efficient functioning of this market is important from a public policy perspective, because of the major role of multifamily properties in the provision of affordable housing in the United States.

In the 1992 legislation Congress assigned to the Department of Housing and Urban Development two important regulatory roles that bear on Fannie Mae's and Freddie Mac's activities in the secondary multifamily market, related to the magnitude of their purchases of mortgages for lower-income households and their conformance to fair lending standards. The Department is required to establish numerical affordable housing goals for the two enterprises and periodically to review and comment on the underwriting and appraisal guidelines of each enterprise to ensure their consistency with fair lending laws.

This report supports the Department's fulfillment of both of these statutory mandates. It provides an analysis of credit availability for affordable multifamily properties, credit gaps in segments of the market, and Fannie Mae and Freddie Mac's position in the market. In addition, it discusses the applicability of fair lending laws to the multifamily activities of the two enterprises, and it makes recommendations for the Department's regulatory approach. It should be of value to policy-makers, researchers, financial institutions, and members of the general public interested in multifamily housing finance and the role of the Government-sponsored housing enterprises.

A handwritten signature in black ink, reading "Lawrence L. Thompson". The signature is fluid and cursive, with a long horizontal stroke at the end.

Lawrence L. Thompson
General Deputy Assistant Secretary for Policy
Development and Research

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Executive Summary

The U.S. Department of Housing and Urban Development (HUD) contracted with Abt Associates Inc. to conduct an exploratory qualitative study to examine the multifamily underwriting requirements and standards of the Government Sponsored Enterprises (GSEs)—Fannie Mae and Freddie Mac—and their role in the conventional secondary multifamily mortgage market.¹

The purpose of this study is to aid HUD in understanding the significance of the GSEs' underwriting practices in relation to three issues being examined by the Department:

- The availability of loans on properties affordable to lower income people and in underserved areas;
- GSE capability to help fill identified credit gaps in the affordable segment of the multifamily mortgage market; and
- The possibility that the GSEs' underwriting standards or practices could have a *disproportionate adverse impact*² on one or more groups statutorily protected against discrimination, or that the GSEs' underwriting standards or practices involve consideration of the age or location of the dwelling or the age of the neighborhood or census tract where the dwellings is located in a manner that has a discriminatory effect.

This study addresses the role of the GSEs in providing funding for affordable multifamily properties and the development of liquidity in the multifamily market, thereby reducing costs to lenders, borrowers, and ultimately tenants.

Overview of the GSEs' and HUD's Responsibilities

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) were established as government-chartered private enterprises in 1968 and 1970, respectively. Fannie Mae and Freddie Mac are shareholder-owned corporations, with the following responsibilities:

¹ Multifamily properties are defined as rental property containing five or more units. The multifamily segment of the entire rental market represents approximately 41 percent of the total number of rental units; the subsegments are five to 19 units (24 percent) and 20+ units (17 percent). The other major segment of the rental market is in single-family properties (59 percent); including detached and attached one-unit single-family, two- to four-single-family units, and manufactured housing units (1993 American Housing Survey data).

² See Chapter 5, Exhibit 5-5 for a discussion of the concept of “disproportionate adverse impact.”

- Provide stability in the secondary market for residential mortgages;
- Respond appropriately to the private capital market;
- Provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
- Promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.³

HUD was assigned a role to regulate Fannie Mae in 1968 and Freddie Mac in 1989.

Motivated in part by concern about the GSE's financial safety and soundness, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA). This act:⁴

- Established an independent financial regulator within HUD, the Office of Federal Housing Enterprise Oversight, to be responsible for the financial safety and soundness of the GSEs, under Section 1321;
- Provided the Secretary of HUD with general regulatory power (other than for financial safety and soundness) with respect to the GSEs and the responsibility for making rules and regulations to ensure that the purposes of FHEFSSA and the Fannie Mae and Freddie Mac Charter Acts are carried out;
- Directed the Secretary of HUD to establish three separate housing goals for the GSEs' mortgage purchases of:
 - housing for low- and moderate-income families;
 - housing located in central cities, rural areas, and other underserved areas; and
 - special affordable housing to meet unaddressed needs of very low-income families and low-income families living in low-income areas;

³ Sections 301(b) of the Freddie Mac Act and 301 of the Fannie Mae Charter Act.

⁴ 12 U.S.C. 4501-4641.

- Required the GSEs to submit loan-level data to HUD about their mortgage purchases, including detailed borrower, census tract, and other mortgage characteristics;
- Established new fair lending responsibilities under FHEFSSA Section 1325; and
- Required HUD to review and comment periodically on the underwriting and appraisal guidelines of Fannie Mae and Freddie Mac for consistency with the Fair Housing Act and with specific requirements that they refrain from prohibited discrimination in their mortgage purchases.

The 1995 Final Rule⁵ further articulated the fair lending requirements, related to the Fair Housing Act⁶ and FHEFSSA section 1325(1), that bear on HUD and the GSEs.

The following three sections describe the approach used in undertaking this study, our findings, and our recommendations to HUD for monitoring the GSEs.

Study Approach

The study relied on a combination of review of printed materials and interviews with key players in the field.

Sources of information about the GSEs' business practices in the secondary market used in this study included: published underwriting requirements and standards, as well as policies and practices as implemented by Fannie Mae's Delegated Underwriting and Servicing (DUS) lenders and Freddie Mac's Program Plus lenders. Various source materials were available for the study, including: selected underwriting and appraisal requirements and brochures on the programs offered by the GSEs and FHA. Information on how GSE underwriting requirements were implemented and interpreted were gathered from market participants and from the GSEs themselves.

Two sets of interviews were conducted in April and May 1998. The interviewees included 26 individuals selected as national industry experts, including GSE staff, and 24 lenders who are representatives of various segments of the multifamily financing market and active in one or more of four specific local markets: Atlanta, Boston, Chicago, and Dallas. The interviews examined the informants' impressions of the segments of the multifamily market, the dominant or key players in each of the segments, the GSEs' underwriting requirements'

⁵ HUD, 1995, pp. 61,847-61,848. All references in this report are included in the bibliography in Appendix A.

⁶ 42 U.S.C. 3605

impacts on credit and fair lending, and the GSEs' reputation in the secondary market. Findings from these interviews were updated with two additional interviews in April 2001.

In addition to the interviews, an exploration of the location of loans purchased by Fannie Mae and Freddie Mac in 1993 through 1999 was conducted for the same four sites where the interviews were conducted.

Findings

The following sections summarize the findings of the study based on the fieldwork with national experts and lenders in four markets, supplemented by a review of relevant literature and analysis of data on the GSEs' mortgage purchases, both nationwide and in the same four markets. This information forms the basis for the discussions regarding the GSEs' leadership role in the multifamily mortgage market, affordable lending, credit gaps, and fair lending.

The GSEs' Leadership

The GSE presence in the multifamily mortgage market is less significant than their presence in the single-family mortgage market. At the end of 1999, the GSEs' direct holdings and guarantees were \$63.1 billion, representing 16.9 percent of \$373 billion in outstanding multifamily mortgage debt.⁷ In single-family mortgage markets, the GSEs held or guaranteed 39 percent of \$4.8 trillion in outstanding mortgage debt as of the end of 1999.

According to the informants who function in the primary financing (i.e. origination) market, the GSEs' leadership in the multifamily market is recognized principally in terms of setting the standards for underwriting and financing multifamily properties. In most multifamily segments, however, neither GSE is viewed as "leading the market" especially in improving lending for affordable housing in the multifamily market. Instead, banks and thrifts are viewed as being more flexible in underwriting originations.

Interpreting "leadership" in the context of the multifamily secondary market is complicated. In one sense, the GSEs lead the market by virtue of their volume, size, experience, range of products, and widespread emulation of their underwriting guidelines, which has had a positive effect on standardization. Both GSEs are recognized for their work on common multifamily loan documents. However, the GSEs' underwriting requirements and standards are considered conservative and fairly inflexible, especially with regard to affordable properties. Lending consortia and portfolio lenders have been more innovative with this segment of the multifamily market. In another sense of "leadership," Fannie Mae has more influence than Freddie Mac because of its size, expertise, and track record. Between the two

⁷ *Federal Reserve Bulletin*, March 2001, A 35

GSEs, Fannie Mae is seen as easier to work with and as having a stronger commitment to the affordable market.

Affordable Lending

In the context of the multifamily market, affordable lending can be considered lending for multifamily housing that is affordable to low-income tenants.⁸ Both GSEs have been attaining the housing goals set by the secretary of HUD, including the special affordable housing goal, since 1996 when the 1995 Final Rule (HUD, 1995) became effective. Underlying the GSEs' success in attaining the housing goals has been their mortgage underwriting requirements and standards.

According to the national industry experts and lenders whom we interviewed, both GSEs have adjusted their underwriting standards and practices to support the development of a secondary market for multifamily mortgage loans. These adjustments have sustained the GSEs' progress in increasing their contributions to affordable lending in the multifamily market. The GSEs have also expanded their programs that target the affordable segment of the multifamily market. Fannie Mae and Freddie Mac both offer a targeted affordable housing product. They also offer forward commitment programs that support the construction or rehabilitation of multifamily properties, typically using the Low Income Housing Tax Credit (LIHTC) program. Both also offer bond credit enhancements, thereby supporting tax-exempt bond programs for refinancing, acquisition or rehabilitation of multifamily properties.

However, based on the interviews, there are still differences of opinion on the extent to which the GSEs' underwriting and appraisal requirements support affordable lending. Informants who participate in the GSEs' DUS and Program Plus programs were very familiar with the underwriting requirements and know how to arrange for waivers when needed. In contrast, informants outside the GSEs' sphere consider neither of the GSEs' underwriting requirements flexible, especially for smaller or older properties and any deal with subordinate financing. In comparison with the GSEs, the Housing Finance Agencies (HFAs) and the conduits were viewed as having much more flexible requirements and being much more willing to work out the deals.

As a consequence, although Fannie Mae has a national presence in the affordable secondary multifamily market (and Freddie Mac is developing a presence), the GSEs were rarely viewed as playing a leadership role in the affordable segment of the multifamily market in the four local markets studied. Instead, in the affordable segment of the multifamily market, leadership was perceived as resting with local depositories (banks and thrifts) and conduits. Depending on the market, other influential players mentioned by the interviewees included

⁸ Low-income refers to households with incomes at or below 80 percent of area median.

the state housing finance agencies, lending consortia, and the Federal Home Loan Banks. In several of the markets, lenders with a national presence were mentioned. State housing finance agencies were cited as active players in California and Massachusetts. Moreover, in 30 to 40 markets across the U.S., consortia of large banks, smaller thrifts, and insurance companies are operating in separate, mostly metropolitan (or statewide) markets, and play a large role in the multifamily market. Three markets have very large consortia: New York, Chicago, and the State of California.

Credit Gaps

Are there credit gaps in segments of the multifamily market? The 1995 Final Rule (HUD, 1995) cited anecdotal evidence of credit shortages among several multifamily segments: smaller multifamily properties, multifamily properties in older urban areas, and inner city properties in need of rehabilitation. Without intervention, such as targeting of underserved areas to meet housing goals, the credit gaps could be severe and persistent.

There is evidence that small multifamily properties with five to 50 units have been adversely affected by differentials in the cost of mortgage financing relative to larger properties.⁹ While mortgage loans can generally be obtained for most properties, the financing that is available is relatively expensive, with interest rates as much as 150 basis points higher than those on standard multifamily loans.¹⁰ Loan products are characterized by shorter terms and adjustable interest rates. Borrowers typically incur costs for origination and placement fees, environmental reviews, architectural certifications (on new construction or substantial rehabilitation projects), inspections, attorney opinions and certifications, credit reviews, appraisals, and market surveys.¹¹ Because of a large fixed element, these costs are usually not scaled according to the mortgage loan amount or number of dwelling units in a property and consequently are often prohibitively high on smaller projects. This market segment appears to be dominated by thrifts and other depositories that keep these loans in portfolio. In part to hedge interest rate risk, loans on small properties are often structured as adjustable-rate mortgages.

The GSEs' multifamily purchases do not appear to be contributing consistently to the mitigation of excessive cost of mortgage financing facing small properties with five to 50 units. Based on HUD's analysis of loans originated in 1997 and acquired by the GSEs in

⁹ See Schneider and Follain (1998) and Segal and Herbert (2000).

¹⁰ Schneider and Follain (1998) assert that interest rates on small property mortgages are as high as 300 basis points over comparable maturity Treasuries. Berkshire Realty, a Fannie Mae Delegated Underwriting and Servicing (DUS) lender based in Boston, was quoting spreads of 135 to 150 basis points in "Loans Smorgasbord," Multi-Housing News, August-September 1996. Additional information on the interest rate differential between large and small multifamily properties is contained in Segal and Herbert (2000).

¹¹ These costs have been estimated at \$30,000 for a typical transaction. Presentation by Jeff Stern, Vice President, Enterprise Mortgage Investments, HUD GSE Working Group, July 23, 1998. The most comprehensive account of the multifamily housing finance system as it relates to small properties is contained in Schneider and Follain (1998).

1997, 1998, and 1999, the GSEs have purchased loans backed by 24 percent of units financed in the overall conventional multifamily mortgage market in 1997, but their acquisitions of loans on small multifamily properties have been only 2.3 percent of such properties financed that year.¹² The GSEs' failure to buy significant numbers of loans on small multifamily properties disadvantages the owners of such properties by denying them the benefits of mortgage liquidity provided by secondary market exposure to mortgages on larger properties.

To encourage the GSEs' activity in financing small multifamily loans, the 2000 Final Rule (HUD, 2000a) includes bonus points for purchases of mortgages financing multifamily properties of five to 50 units. Specifically, HUD will assign double weight in the numerator under the low- and moderate-income and special affordable housing goals for each unit financed by GSE mortgage purchases in small multifamily properties.

A recent noteworthy development is Fannie Mae's announcement of a new product through its DUS program for multifamily properties with 5-50 units. Features include a streamlined underwriting process designed, in part, to reduce borrower costs for third-party reports; use of FICO scores to evaluate borrower creditworthiness; and recourse to the borrower in the event of default.¹³

Multifamily properties with significant rehabilitation needs have experienced difficulty in obtaining mortgage financing. Multifamily rehabilitation loans accounted for only 0.5 percent of units backing Fannie Mae's 1998 purchases and for 1.6 percent in 1999. These loans accounted for 1.9 percent of Freddie Mac's 1998 multifamily total (with none indicated in 1999).

Fair Lending

Two sections of legislation provide HUD with authority to oversee the GSEs' underwriting and appraisal requirements with respect to fair housing issues:

- Section 1325 of FHEFSSA, which refers broadly to the underwriting and appraisal requirements and standards of the GSEs and outlines HUD's regulatory responsibility in prohibiting discriminatory impacts of the GSEs' operations (e.g., considering the age or location of dwelling units or age of neighborhood) (see Exhibit 5-2); and

¹² It is assumed that that units in small multifamily properties represented approximately 39.4 percent of multifamily units financed in 1997, per the 1991 Residential Finance Survey, as discussed above. Additionally, it is assumed that 1997 multifamily conventional origination volume was \$38 billion, based on discussions with HUD. An average loan amount per unit of \$ 27,266 is used, the GSE average for 1997 acquisitions.

¹³ "Fannie Mae Announces New 5-50(SM) Streamlined Mortgage for Small Multifamily Properties is Now Available Through DUS Lenders; 10-Year Volume Goal is \$18 Billion," Fannie Mae press release, May 10, 2000.

- The provisions of the Fair Housing Act that relate to the provision of mortgage loans (42 USC 3605).

The provisions of the fair housing and fair lending laws prohibiting discrimination apply to all entities involved in real-estate transactions, including lenders, secondary market purchasers of loans, real estate agents and appraisers, and those offering to sell or rent a dwelling. The fair lending issue raised in this study is whether the GSEs' multifamily underwriting and appraisal requirements are consistent with the Fair Housing Act and FHEFSSA more generally. For example, do the underwriting requirements that include consideration of age or location of dwelling units or age of neighborhood or census tract location have a "discriminatory effect" on protected classes?

As required by FHEFSSA, the GSEs are prohibited from considering the age of a property in purchase decisions in a manner that has a discriminatory effect. Very few of the GSEs' underwriting and appraisal requirements apply specifically to older properties. However, Fannie Mae's subordinate financing requirements for older properties are stricter than requirements for newer properties. Finally, perhaps more important than the GSEs' written underwriting guidelines is the perception in the lending community that the GSEs typically prefer "Class A" properties (which is generally defined as newer housing stock that is less than 10 years old).

Both GSEs have guidelines that indicate market strength as a consideration in multifamily underwriting for their prospective purchase of loans. Market strength factors may be correlated with factors with respect to which discrimination is prohibited, such as geographic areas where members of protected classes reside. The emphasis of these underwriting guidelines on employment, property values, vacancy rates and other characteristics that might adversely affect minority areas may have a discriminatory effect. Although the GSEs are explicit about what is not to be considered (e.g., racial composition of the neighborhood), the issue remains as to how the requirements are actually implemented.

In addition, there is empirical evidence that the GSEs lag in three sectors of the multifamily market that may have fair lending implications:

- Purchases of loans in high-minority tracts;
- Purchases of loans on small multifamily properties, which are disproportionately for minority-owned properties; and
- Purchases of loans for multifamily properties in underserved areas.

Although the GSEs' relative lack of purchasing activity in these areas does not by itself demonstrate that the GSEs are violating fair lending legislation, it does raise the question of

whether some of their underwriting and appraisal guidelines are having a disproportionate adverse impact on protected classes.

Recommendations

Several areas of GSE multifamily activities merit monitoring by HUD. Each of these areas will require data collection

Fair Lending Monitoring. Fair lending analysis of the GSEs' multifamily mortgage purchase activity is governed by a statutory framework similar to that governing the GSEs' single-family activities. A basic issue is whether the GSEs' underwriting or appraisal standards and guidelines have a *disproportionate adverse impact* on protected classes.¹⁴ An underwriting or appraisal standard may have an unfavorable effect on protected classes even if the requirements are imposed impartially. However, a finding of disproportionate adverse impact is not sufficient to support a finding of discrimination as defined by the courts. Follow-up research and analysis would be needed on whether the guidelines have a "business necessity" and whether some other, less discriminatory alternative exists that would also satisfy the business necessity. Protected classes under FHEFSSA include race, color, religion, sex, handicap, familial status, age, or national origin. Also prohibited is any consideration of the age or location of the dwelling or the age of the neighborhood or census tract where the dwelling is located, in a manner that has a discriminatory effect.

A monitoring strategy would include ongoing review of written guidelines and statistical analysis of the GSEs' multifamily mortgage purchase practices.

First, HUD should review GSE underwriting guidelines regularly with attention to provisions of those guidelines governing specific geographic areas, minimum loan amounts, and age of the property. Objectives of the review would be to determine whether there is any indication of disparate treatment, as well as to provide a basis for analysis of the question of disparate impacts.

Second, with regard to GSE underwriting practices, a difficulty in evaluating the potential for disparate impacts is the lack of data on protected-class characteristics of tenants residing in the collateral property, both for GSE multifamily acquisitions and for properties that receive mortgage financing through non-agency secondary market sources or portfolio lenders. However, the data that are available on census tract characteristics may be correlated with race of tenant and/or the age of the property and could be used for a first-stage analysis.

¹⁴ In contrast to disproportionate adverse impact, the issue of *disparate treatment* of borrowers (for multifamily properties) with the same relevant underwriting features is essentially an issue of lender behavior at origination, although it also would be theoretically possible for the GSEs to discriminate if their purchases differed for a member of a protected class from a non-protected borrower with a similarly qualified loan.

Other data sources, such as data from the survey of multifamily properties in compliance with accessibility requirements by HUD's Real Estate Assessment Center, may provide some useful information because this survey also picks up demographic characteristics.

Another approach, requiring new data, would seek to determine whether GSE underwriting practices result in higher credit costs for properties in high-minority areas or for properties where a large proportion of minorities are predicted to reside based on census tract characteristics. Successful implementation of this approach would require that the GSEs provide additional loan-level data to HUD on note rate, origination costs, and prepayment penalties. In order to determine whether differences in the cost of credit are real or apparent, however, HUD would need to control for credit risk, and would therefore also need to be provided with data on LTV and DSC ratio as well.

In addition, HUD could collect information regarding the geographic location of properties where the GSEs have approved waivers to their underwriting guidelines. When the census tract location of such properties has been determined, HUD could analyze whether there is evidence that properties likely to be inhabited by members of protected classes have been approved for waivers less frequently than other properties, representing a potentially disproportionate effect of the GSEs' waiver approvals (although it is not necessarily the case that this would signify adverse impact).

Furthermore, HUD could collect information regarding effects on protected classes of the streamlined GSE approval procedures for DUS and Program Plus lenders. HUD could utilize GSE and HMDA data to analyze whether these lenders are less active in high-minority or inner city neighborhoods, or in areas with an older housing stock, than are other lenders. DUS and Program Plus lenders could usefully be compared with all other lenders active in the multifamily market or with minority-owned thrift institutions identified by the Office of Thrift Supervision.¹⁵ HUD could also evaluate whether the process by which the GSEs approve lenders for the DUS and Program Plus programs has disproportionate adverse effects on minority-owned lending institutions.

HUD could also monitor GSE multifamily transaction volume involving originations by minority-owned thrift institutions. To the degree that loans originated by such institutions are backed by properties in high-minority areas, or owned by African Americans, expanded transactions volume would represent an opportunity for the GSEs to expand the benefits provided by secondary market access to such properties. Conversely, any significant reduction in transactions volume involving such institutions could call into question the GSEs' commitment to fully serving the multifamily mortgage market.

¹⁵ See Office of Thrift Supervision, "Policy Statement on Minority Owned Thrift Institutions," May 25, 1999.

Finally, HUD could request loan-level information on default risk and loan losses as well as factors entering the underwriting process such as LTV and DSC to determine the effectiveness of GSE underwriting standards in controlling credit risk.¹⁶ HUD could also ask the GSEs for any additional information pertaining to validation of their underwriting criteria.

Pilot Programs. The GSEs occasionally offer pilot programs to their DUS and Program Plus lenders to implement. According to the informants, some of these programs gain high visibility in the press but are seldom used in the marketplace. Some of these informants recommend that HUD closely monitor any pilot program, perhaps semi-annually through the first two years of its existence. From this information, HUD could determine whether the program is reaching hard-to-serve segments of the market.

Small Multifamily Properties. The GSEs' treatment of "smaller" loans, in both urban and rural areas, especially for affordable multifamily properties with fewer than 50 units, needs closer examination, especially in light of evidence that such properties are often located in high-minority census tracts and that ownership of multifamily properties by African Americans is concentrated among such properties. The GSEs continue to modify their underwriting approach to these loans and are likely to be further encouraged to do so by the 2000 Final Rule, which gives the GSEs bonus points for their purchases of small multifamily mortgages. HUD should continue to monitor the GSEs' purchases of small multifamily mortgages to determine whether HUD's 2000 Final Rule is effective in creating incentives for the GSEs to become more active in financing these properties.

¹⁶ Information would also need to be collected on credit enhancements in order to isolate the effectiveness of underwriting standards in mitigating loan losses, since credit enhancements may also have the effect of mitigating such losses.

Chapter One

Project Description and Background

The U.S. Department of Housing and Urban Development (HUD) contracted with Abt Associates Inc. through contract DU100C000005978, Task Order 3, and C-OPC-18571, Task Order 6, to conduct an exploratory qualitative study to examine the multifamily underwriting requirements and standards of the Government Sponsored Enterprises (GSEs)—Fannie Mae and Freddie Mac—and their role in the conventional secondary multifamily mortgage market.¹⁷ Under Section 1325 of the Federal Housing Enterprises Financial Security and Soundness Act of 1992 (FHEFSSA), HUD is required to review and comment periodically on the underwriting and appraisal requirements and standards of Fannie Mae and Freddie Mac for consistency with the Fair Housing Act and with specific requirements that they refrain from discriminating in their mortgage purchases because of race, color, religion, sex, handicap, familial status, age, or national origin. This study provides technical support of that objective.

The purpose of this study of multifamily underwriting and the GSEs' role in the multifamily market is to aid HUD in understanding the significance of the GSEs' underwriting standards and practices in relation to three areas of interest to the Department:¹⁸

- The availability of loans on properties affordable to lower income people and in underserved areas;¹⁹
- GSE capability to help fill identified credit gaps²⁰ in the affordable segment of the multifamily mortgage market; and
- The possibility that the GSEs' underwriting standards or practices could have a disproportionate adverse impact²¹ on one or more groups statutorily protected

¹⁷ Multifamily properties are defined as rental property containing five or more units. The multifamily segment of the entire rental market represents approximately 41 percent of the total number of rental units; the subsegments are 5 to 19 units (24 percent) and 20+ units (17 percent). The other major segment of the rental market is in single-family properties. The subsegments are detached and attached one-unit single-family (33 percent), two- to four-single-family units (22 percent), and manufactured housing units (4 percent), including mobile homes and some manufactured housing that is preconstructed and assembled on permanent foundations (1993 American Housing Survey data).

¹⁸ The following areas of interest are presented exactly as stated in HUD's Statement of Work.

¹⁹ A unit is considered affordable if the rent (adjusted for number of bedrooms and including any tenant-paid utilities) is less than or equal to 30 percent of Area Median Income (AMI). A unit is considered "low income" if rent (similarly adjusted) does not exceed 24 percent of AMI.

²⁰ This term is discussed in detail in Chapter 5.

²¹ See Chapter 5, Exhibit 5-4 for a discussion of the concept of "disproportionate adverse impact."

against discrimination, or that the GSEs' underwriting standards or practices involve consideration of the age or location of the dwelling or the age of the neighborhood or census tract where the dwelling is located in a manner that has a discriminatory effect.

Section 1.1 provides background on the GSEs' and HUD's responsibilities. Section 1.2 describes the GSEs' response to multifamily market regulations. Relevant policy and analytic issues are described in more detail in Section 1.3 and Section 1.4 provides an overview of the remainder of the report.

1.1 The GSEs' and HUD's Responsibilities

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) were established as government-chartered private enterprises in 1968 and 1970, respectively. Fannie Mae and Freddie Mac are shareholder-owned corporations, with the following responsibilities:

1. Provide stability in the secondary market for residential mortgages;
2. Respond appropriately to the private capital market;
3. Provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)²² by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and
4. Promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.²³

HUD was assigned a role to regulate Fannie Mae in 1968 and Freddie Mac in 1989.

²² Section 1381(a)(2)(A) of Public Law 102-550, approved October 28, 1992, 106 Stat. 3994, amended this paragraph by deleting "(including mortgages securing housing for low- and moderate-income families involving a reasonable economic return)" and inserting the language in parentheses.

²³ Sections 301(b) of the Freddie Mac Act and 301 of the Fannie Mae Charter Act.

Motivated in part by concern over the contingent liability to taxpayers from the perception of an implicit federal guarantee on the GSEs' debt obligations, Congress passed the Federal Housing Enterprises Financial Safety and Soundness act of 1992 (FHEFSS). This act:²⁴

- Established an independent financial regulator within HUD, the Office of Federal Housing Enterprise Oversight, to be responsible for the financial safety and soundness of the GSEs, under Section 1321;
- Provided the Secretary of HUD with general regulatory power (other than for financial safety and soundness) with respect to the GSEs and the responsibility for making rules and regulations to ensure that the purposes of FHEFSSA and the Fannie Mae and Freddie Mac Charter Acts are carried out;
- Directed the Secretary of HUD to establish three separate housing goals for the GSEs' mortgage purchases of:
 - housing for low- and moderate-income families;
 - housing located in central cities, rural areas, and other underserved areas; and
 - special affordable housing to meet unaddressed needs of very low-income families and low-income families living in low-income areas;
- Required the GSEs to submit loan-level data to HUD about their mortgage purchases, including detailed borrower, census tract, and other mortgage characteristics;
- Established new fair lending responsibilities under FHEFSSA Section 1325; and
- Required HUD to review and comment periodically on the underwriting and appraisal guidelines of Fannie Mae and Freddie Mac for consistency with the Fair Housing Act and with specific requirements that they refrain from prohibited discrimination in their mortgage purchases.

The 1995 Final Rule (HUD, 1995)²⁵ further articulated the fair lending requirements, related to the Fair Housing Act²⁶ and FHEFSSA section 1325(1), that bear on HUD and the GSEs.

FHEFSSA established a transition period of 1993 and 1994 to provide HUD with time to develop interim notices to the GSEs regarding the housing goals, collect and analyze the GSE data, and prepare a proposed rule by February 16, 1995. The housing goals established for the transition period were ultimately extended through 1995 to allow time for public

²⁴ 12 U.S.C. 4501-4641.

²⁵ pp. 61,847-61,848. All references in this report are included in the bibliography in Appendix A.

²⁶ 42 U.S.C. 3605

review of the proposed rule and publication of the Final Rule. In December 1995, HUD issued the Final Rule for regulation of Fannie Mae and Freddie Mac. The Final Rule contained delineation of the three housing goals for 1996 through 1999, FHEFSSA prohibitions against discrimination, new GSE program approval requirements, reporting requirements, access to information requirements, and other provisions. The housing goals were updated in October 2000, when a new Final Rule was issued.²⁷ The 2000 Final Rule specifies the GSEs' housing goals for 2001 through 2003, set at higher levels than those contained in the 1995 Final Rule. Goals for 2000 were maintained at the level set in the 1995 Final Rule. Because the new Final Rule has been in place for a very short period of time, this chapter's discussion focuses on the 1995 Final Rule.

Included in both the 1995 and 2000 Final Rule were three appendices delineating HUD's considerations and studies of issues pertaining to establishing:

- A: Low- and Moderate-Income Housing Goal;²⁸
- B: Central Cities, Rural Areas, and Other Underserved Areas Goal;²⁹
- C: Special Affordable Housing Goal;^{30, 31}

²⁷ HUD, 2000a, pp. 65,044-65,089

²⁸ **The low- and moderate-income goal:** housing for families with incomes at or below 100 percent of the local AMI. This housing goal was set at 40 percent for 1996 and 42 percent for 1997 through 1999. The 2000 Final Rule set this goal at 50 percent for 2001 through 2003. To be qualified under the goal, rental units must have rents (adjusted for unit size) that do not exceed 30 percent of AMI, thereby considered "affordable." The affordability determination is based on the total of rent plus utilities. For example, if the AMI is \$60,000, then the maximum monthly rents (and utilities) are as follows for:

	0BR	1BR	2BR
Moderate income families (100% AMI)	\$1,050	\$1,125	\$1,350

²⁹ **The geographically targeted goal:** "Underserved areas" for Office of Management and Budget-defined metropolitan census tracts (and non-metropolitan counties), with (1) median tract income at or below 90 percent of AMI (95 percent in non-metropolitan area), or (2) minority concentration of at least 30 percent with median tract (or county) or income no greater than 120 percent of AMI. The goals were set at 21 percent for 1996 and 24 percent for 1997 through 1999. In the 2000 Final Rule, this goal was increased to 31 percent for 2001 through 2003.

³⁰ **The special affordable goal:** housing for families with very low incomes (60 percent of AMI) or, if located in a low-income census tract or non-metropolitan county, for families with low incomes (80 percent of AMI). The goals were set at 12 percent for 1996 and 14 percent or 1997 through 1999. This goal was increased to 20 percent for 2001 through 2003 in the 2000 Final Rule. The required minimum affordable multifamily purchase volumes were set at \$1.29 billion for Fannie Mae and \$998 million for Freddie Mac. These levels were increased in the 2000 Final Rule to \$2.85 billion for Fannie Mae and \$2.11 billion for Freddie Mac. These levels represent one percent of each GSE's total mortgage purchases over 1997 through 1999. The affordability determination is based on the total of rent plus utilities. For example, if the AMI is \$60,000, then the maximum monthly rents (including utilities) are as follows for:

	0BR	1BR	2BR
Very low-income families (60% AMI)	\$630	\$675	\$810
Low-income families (80% AMI)	\$840	\$900	\$1,080

³¹ Three additional appendices in HUD's 1995 Final Rule delineate methodology used in preparing the Final Rule:

- D: Estimating the Size of the Conventional Conforming Market for Each Housing Goal;
- E: Required Loan-Level Data Elements; and
- F: Proprietary Information/Public Use Data (U.S. Department of Housing and Urban Development, 1995).

The three housing goals shown in this section are for the sum of single-family and multifamily mortgage purchases by the GSEs.

1.2 GSEs' Response to HUD Housing Goals

The response of the GSEs to the HUD housing goals has been successful from many points of view. Fannie Mae and, especially, Freddie Mac have rapidly expanded their presence in the multifamily mortgage market in the period since the implementation of HUD's interim housing goals in January 1993. Freddie Mac has successfully rebuilt its multifamily acquisition program, as shown in Exhibits 1-1 and 1-2 by the increase in its purchases of multifamily mortgages from \$193 million in 1991 to \$7.6 billion in 1999 and \$6.8 billion in 2000.³² Freddie Mac's presence in the multifamily market is not as large as that of Fannie Mae. Freddie Mac's direct holdings of multifamily mortgages and guarantees outstanding as of the third quarter of 2000, \$19.8 billion, are much smaller than Fannie Mae's \$51.0 billion, not only in absolute terms, but also as a percentage of all mortgage holdings and guarantees. Freddie Mac's multifamily holdings and guarantees are 2.3 percent of its total, compared with 4.3 percent for Fannie Mae.³³ Fannie Mae never withdrew from the multifamily market, but it has also stepped up its activities in this area substantially, with multifamily purchases rising from \$4.0 billion in 1993 to \$9.4 billion in 1999, and \$10.1 billion in 2000, as shown in Exhibit 1-1.³⁴

The rapid expansion of the GSEs' multifamily transactions volume during the 1990s may be related to the multifamily Special Affordable subgoal, set at \$998 million for Freddie Mac and \$1.29 billion for Fannie Mae during 1996-1999, as mentioned above. In particular, Freddie Mac would have been unable to meet HUD's low- and moderate-income special affordable goals without re-entering the multifamily market. The GSEs' multifamily Special Affordable performance for 1993-1999 is shown in Exhibit 1-3.

Growth in GSE multifamily transactions volume is also related to the fact that the multifamily market contributes disproportionately to GSE purchases meeting both the Low- and Moderate-Income and Special Affordable Housing goals generally. In 1999, Fannie Mae's multifamily purchases represented 9.5 percent of its total acquisition volume, measured in terms of dwelling units. Yet these multifamily purchases comprised 20.4

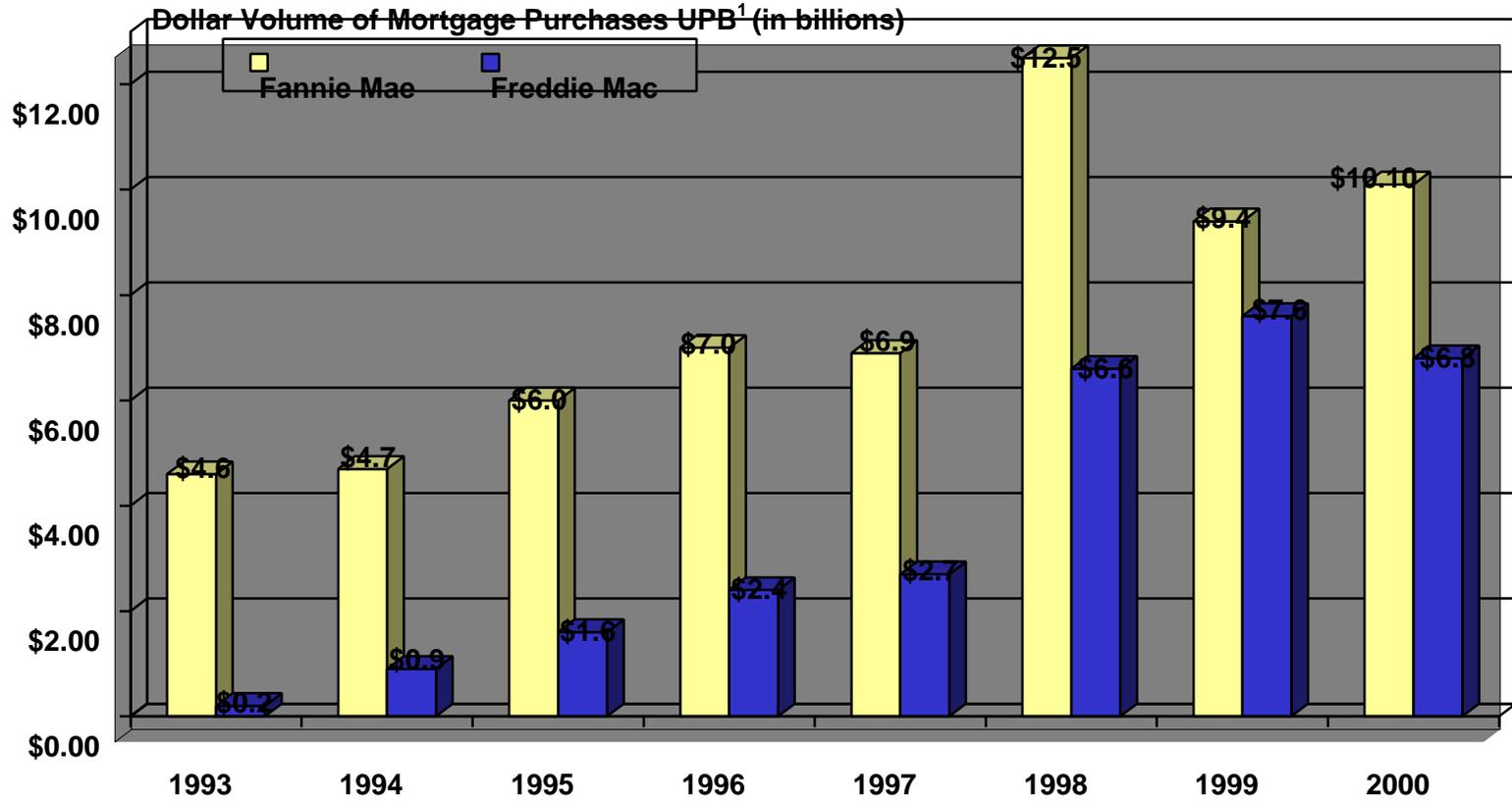
Appendix D in the 1995 Final Rule also has a counterpart in the 2000 Final Rule with the same name, "Estimating the Size of the Conventional Conforming Market for Each Housing Goal" (U.S. Department of Housing and Urban Development, 2000).

³² Corresponding transactions volume as measured in dwelling units is shown in Exhibit 1-2.

³³ *Federal Reserve Bulletin*, June 2001, A 35.

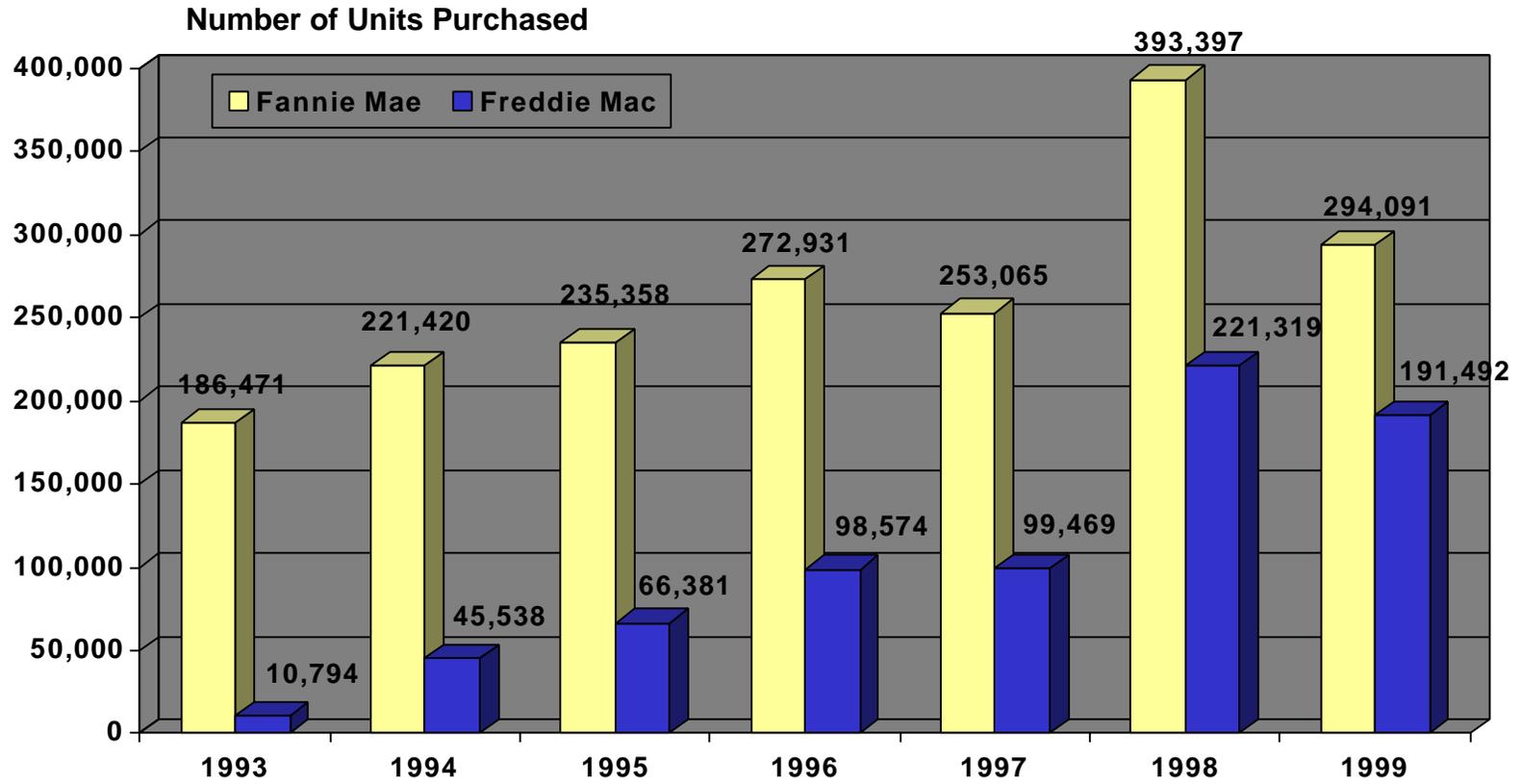
³⁴ Corresponding transactions volume as measured in dwelling units is shown in Exhibit 1-2.

Exhibit 1-1
GSE Multifamily Dollar Volume
1993 - 2000



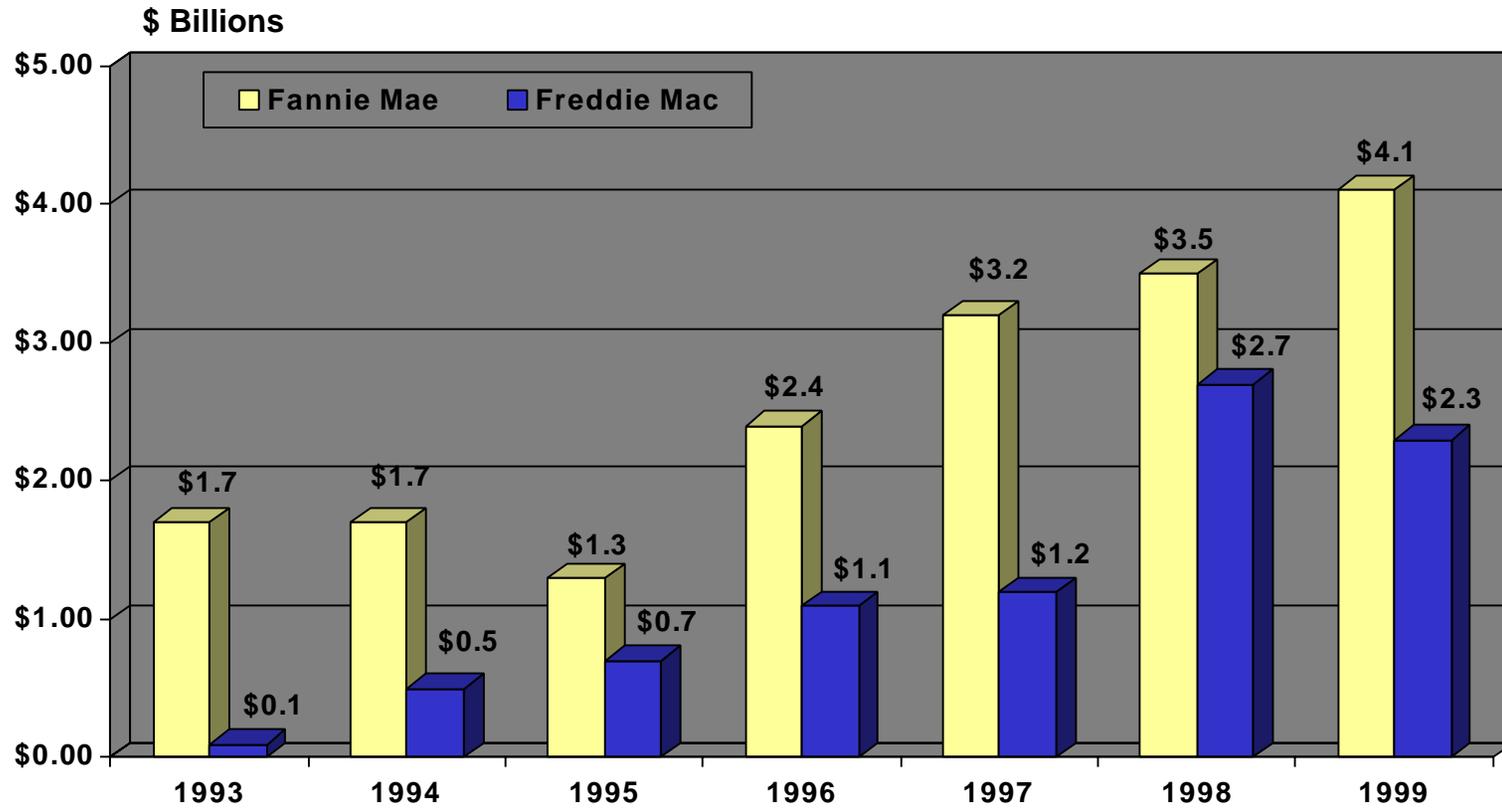
¹ Unpaid principal balance of mortgages purchased.
Source: HUD analysis of GSE loan-level data.

Exhibit 1-2
GSE Multifamily Transaction Volume in Units
1993 – 1999



Source: HUD analysis of GSE loan-level data.

Exhibit 1-3
GSE Multifamily Special Affordable Acquisition Volume
1993 – 1999



Source: HUD analysis of GSE loan-level data.

percent of units qualifying for the Low- and Moderate-Income Housing Goal, and 31.3 percent of units meeting the Special Affordable Goal. Multifamily purchases were 8.2 percent of units backing Freddie Mac's 1999 acquisitions, 16.8 percent of units meeting the Low- and Moderate-Income Housing Goal, and 21.6 percent of units qualifying for the Special Affordable Housing Goal. The multifamily market therefore comprises a significant share of units meeting the Low- and Moderate-Income and Special Affordable Housing goals for both GSEs, and the goals may have contributed to increased emphasis by both GSEs on multifamily in the period since the previous Final Rule took effect in 1996.

The majority of units backing GSE multifamily transactions meet the Low- and Moderate-Income Housing Goal because the great majority of rental units are affordable to families at 100 percent of median income, the standard upon which the Low- and Moderate-Income Housing Goal is defined. For example, 38.5 percent of units securing Freddie Mac's 1999 single-family, one-unit owner-occupied mortgage purchases met the Low- and Moderate-Income Housing Goal, compared with 90.0 percent of its multifamily transactions. Corresponding figures for Fannie Mae were 37.9 percent and 94.8 percent.³⁵ For this reason, multifamily purchases represent a crucial component of the GSEs' efforts in meeting the Low- and Moderate-Income Housing Goal. The share of 1999 GSE multifamily purchases satisfying housing goals requirements is illustrated in Exhibit 1-4.

Both GSEs have met or exceeded each of the housing goals each year since they took effect in January 1996.

Despite the GSEs' success in meeting their goals there is still concern that they are taking a very cautious approach and concentrating their efforts in the middle of the multifamily market segment with regard to affordability (Segal and Szymanoski, 1998; Segal and Szymanoski, 1997). Such an approach could contribute to limits or constraints on availability of credit within some segments of the multifamily market, including properties affordable to low- and moderate-income families.

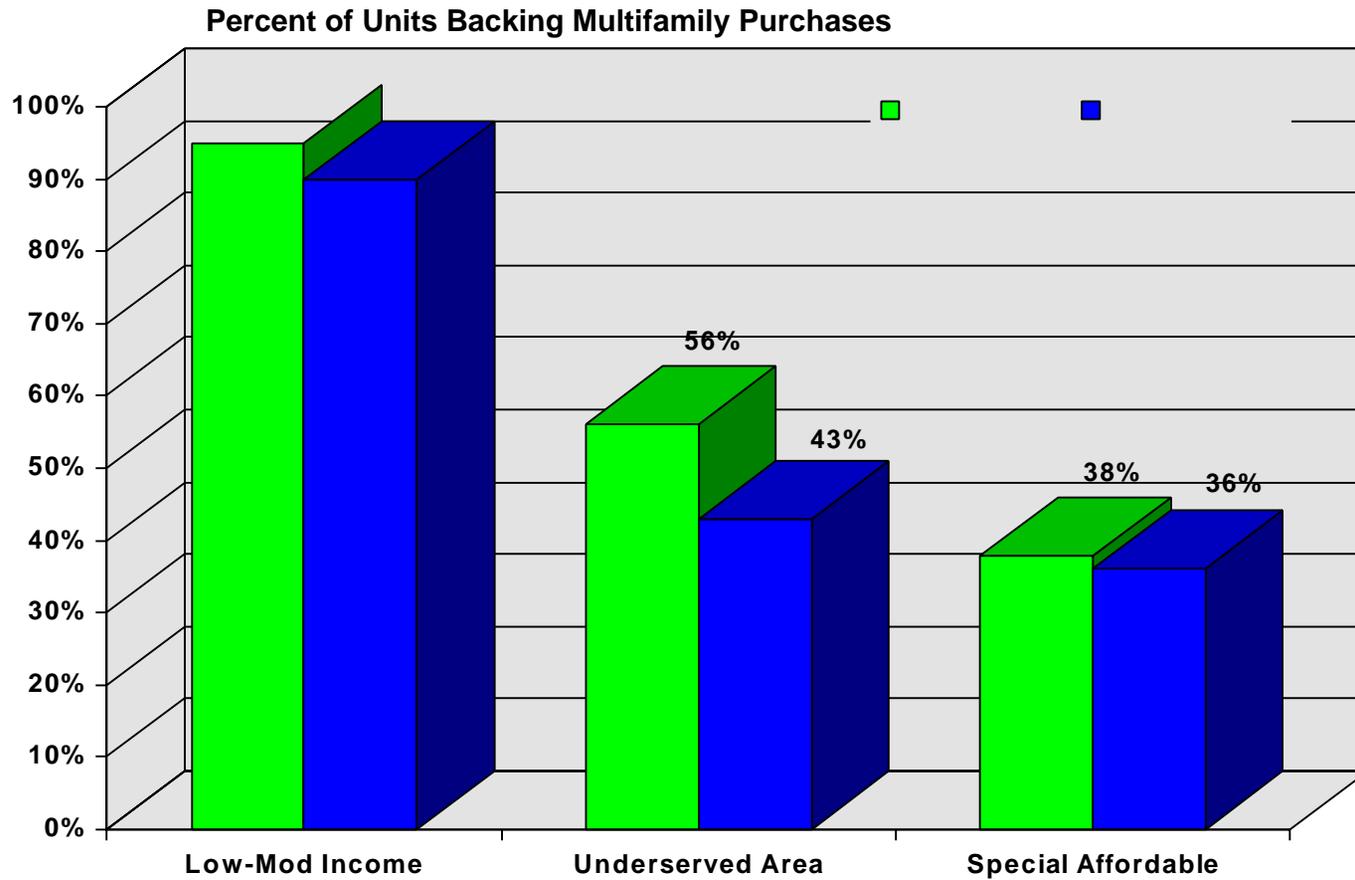
1.3 Policy and Analytic Issues

Policy Issues and Questions

HUD contracted for the Study of Multifamily Underwriting and the GSEs' Role in the Multifamily Market to provide information about a set of policy issues and questions. HUD formulated the following four policy issues:

³⁵ HUD analysis of GSE loan-level data.

Exhibit 1-4
Share of 1999 GSE Multifamily Purchases Satisfying Goals Requirements



Source: HUD analysis of GSE loan-level data.

- **Market Segmentation:** the possibility that segments of the affordable multifamily market receive different levels of pricing and ultimately availability of mortgage credit;
- **Credit Gaps:** the possibility that the demand for credit, especially in some segments of the multifamily market, may exceed the supply;
- **Underwriting Standards:** the possibility that particular GSE underwriting standards or practices affect the availability of mortgage credit in multifamily market segments that are affected by credit gaps; and
- **Fair Lending Issues:** the possibility that the GSEs' multifamily underwriting and appraisal guidelines have a disproportionate impact on protected classes.

The literature review we conducted as part of this study, especially of articles in the trade press, and the commentary provided in interviews with people who are familiar with the multifamily market, led to another issue:

- **Current Competition in the Multifamily Market:** the possibility that the demand for investments in commercial mortgage-backed securities may close potential credit gaps; and

Many specific questions are implied by each of the policy issues. Under each of the policy issues is a series of questions that are addressed by the study as shown in Exhibit 1-5. This exhibit shows the issues covered in the interviews with key informants.

Analytic Issues

HUD's efforts in the preparation of the 1995 Final Rule utilized both quantitative and qualitative methods to understand the role of the GSEs in the multifamily market. These methods included interviews with industry representatives, advocacy groups and other knowledgeable persons; analysis of various GSE and mortgage databases; and a series of contracted studies by various outside experts and academics. HUD has continued to analyze additional data on GSE profitability, to hold background discussions with knowledgeable multifamily industry experts and lenders, and has assembled a GSE Working Group to serve as an advisory board to HUD. HUD continued its multifamily research in preparation for the 2000 GSE Rule. Appendices A and D of that Rule summarize HUD's findings related to the multifamily market.³⁶

³⁶ HUD, October 30, 2000.

Exhibit 1-5
Questions Used to Address the Policy Issues

<p>Market Segmentation Questions:</p> <ul style="list-style-type: none"> • Does the (affordable)³⁷ multifamily market break into any of the following distinct segments: <ul style="list-style-type: none"> - Targeted affordable housing; - Smaller properties; - Inner-city properties; - Properties in need of rehabilitation; and/or - Properties developed with Low Income Housing Tax Credit Program? • Do specific types of lenders dominate any of the market segments above? • Do any of the above segments show evidence of risk-based pricing?
<p>Credit Gap Questions:</p> <ul style="list-style-type: none"> • Are any of the above (affordable) multifamily market segments affected by credit gaps? • Are any financial institutions perceived as market leaders in any of the segments experiencing credit gaps? • Does this phenomenon vary by locality?
<p>Underwriting Questions:</p> <ul style="list-style-type: none"> • Are there any underwriting standards that adversely affect the availability of mortgage credit, especially in areas affected by credit gaps? • Is there any evidence that any of the following are obstacles to GSE activity: <ul style="list-style-type: none"> - Lack of information regarding multifamily market performance; - Lack of owner management expertise; - Borrower net worth requirements; - Property or neighborhood conditions; - Appraisers' opinion of the stability of the market area (e.g., area vacancy and absorption rates, depth and quality of rental market); - Property rehabilitation standards; - Risk sharing on acquisition/rehabilitation projects; and - Presence of partnerships or multiple borrowers.
<p>Fair Lending Question:</p> <ul style="list-style-type: none"> • Is there any evidence that GSEs' multifamily underwriting and appraisal guidelines (e.g., regarding age or location of building, or age of neighborhood or census tract location) have a disproportionate effect on protected classes?³⁸
<p>Current Multifamily Market Competition Questions:</p> <ul style="list-style-type: none"> • What is the current composition of the multifamily lending market; and • How are the GSEs performing in light of current competition?
<p>Improved Multifamily Market Risk Assessment Questions:</p> <ul style="list-style-type: none"> • How is the competition viewing the riskiness of the multifamily market; and • Are there remaining credit gaps?

³⁷ During the implementation of this study using interviews with informants who are considered either national market experts, multifamily lenders, or both, it became necessary to distinguish between the generic multifamily market and the more specific affordable multifamily market. See Appendix B for a more extensive discussion of methodology used in this study.

³⁸ That is, the statistical evidence may demonstrate unequal outcomes across different types of borrowers, even though the guidelines are not explicitly discriminatory. However, a guideline that has a disproportionate effect *and* does not serve a business necessity (or does serve a business necessity but had a substitute with a smaller disproportionate effect) meets the legal definition of **disparate impact** and is discriminatory.

This study is designed to supplement these ongoing efforts. It is an exploratory qualitative study that includes a series of investigations: a review of the GSEs' underwriting and appraisal standards and practices, a review of related studies of the multifamily market, a series of 26 interviews with key national industry experts from a variety of participants in the multifamily market, and a second series of interviews with 24 multifamily lenders and industry participants in four metropolitan markets: Atlanta, Boston, Chicago, and Dallas.

1.4 Overview of the Remainder of the Report

Chapter 2 provides an overview of the multifamily market, beginning with a review of the developments in the multifamily mortgage market since 1979 that have had lasting implications for the development of a liquid secondary mortgage market. This chapter also introduces the key types of multifamily lenders as well as other key secondary market players. Chapter 3 contains an overview of the GSEs' underwriting and appraisal standards and the GSEs' policies and programs. Chapter 4 reviews the literature on the role of the GSEs in the multifamily primary and secondary markets. It also discusses the interface between the GSEs' experiences in the 1980s and early 1990s and the economic and housing conditions in 1995 when the Final Rule was published. Chapter 5 provides background information on three of the policy issues that HUD is considering with respect to the GSEs' multifamily underwriting and appraisal requirements and standards: lending for affordable housing, credit gaps in the multifamily market, and the GSEs' fair lending obligations. Chapter 6 introduces four local housing markets (Atlanta, Boston, Chicago, and Dallas) that were the locations of the interviews with multifamily lenders.³⁹ Chapter 7 presents the combined findings from the interviews with 26 national industry experts and the 24 multifamily lenders on various aspects of the policy issues considered by the study. This chapter provides an analysis and inferences drawn from all aspects of the study. Chapter 8 provides monitoring recommendations to HUD on the housing goals. Following the chapters are five appendices that cover the following topics:

- A. Bibliography;
- B. Research Methodology;
- C. Summaries of Fannie Mae's and Freddie Mac's Multifamily Programs and Guidelines;
- D. Features of Selected Multifamily Finance Programs; and
- E. Provides a glossary of acronyms used in the report.

³⁹ Although these were originally intended to be "local" lenders, of those nominated by the national industry experts, 75 percent represented organizations with a national presence. Therefore, the information the lenders provided was not necessarily restricted to the market where they were located but included their more national perspective. Chicago is an exception where most (but not all) of the lenders focused solely on that market.

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Chapter Two

Overview of Multifamily Mortgage Market

The multifamily mortgage market is a segment of the income-producing or commercial real estate market. In order to understand today's multifamily market, it is important to review its recent history and the fundamental problems that developed during the 1980s. These problems resulted in substantial losses for both primary lenders and secondary market institutions. After the early 1990s, the multifamily market began to recover and new secondary market players began to invest in multifamily and other commercial real estate as described in this chapter. At present, the performance of multifamily mortgages is very important to investors as a segment of the income-producing or commercial real estate market. According to Goldberg and Capone (1998):

Multifamily housing projects are considered very sound investments today, and they generally rate as a lower risk than other commercial property types.... This is a substantial change from just six years ago, when traditional lenders and investors were removing multifamily projects from their portfolios. (p. 93)

Section 2.1 provides a discussion of developments in the multifamily mortgage market since the late 1970s. Section 2.2 describes the key types of mortgage lenders and secondary market players.

2.1 Developments in the Multifamily Mortgage Market Since the Late 1970s

Financial services vehicles for ensuring liquidity and developing a secondary market for the multifamily mortgage and other commercial real estate markets have evolved from the early 1980s and are still evolving. Wratten (1996) has traced a history of the commercial real estate secondary and securitization markets from the late 1970s. Portions of the discussion in this chapter are abstracted from that document. The following history shows the cyclical nature of the multifamily market, the evolution of various secondary market entities, and selected strategies that have emerged to contribute to continuing liquidity of the commercial real estate market.

Federal Reserve Board Actions: October 6, 1979

Since the late 1970s, there has been considerable volatility in the commercial real estate portion of the marketplace. For example, on October 6, 1979—"Bloody Sunday"—the

Federal Reserve Board raised the discount rate by a full 1 percent, in an effort to forestall increasing inflation. During the succeeding 24 months, interest rates climbed to all-time highs, capital available for the commercial and residential real estate markets stopped flowing, and an economic recession with significant impacts on commercial real estate ensued.

Economic Recovery Act of 1981

In 1981, Congress responded with the Economic Recovery Act. This act created tax incentives for commercial real estate construction by providing large and fast depreciation tax write-offs. It succeeded, but fueled excessive building, particularly among multifamily properties. By 1983, interest rates began to fall and commercial real estate syndication sales began to rise.

By 1984, the credit crunch was over. Life insurance companies' portfolio lending responded to the tax-induced building; banks and S&Ls succumbed to the pressure to lend. During 1985, the lending volume increased again. Within the next three years, the volume of commercial real estate debt in portfolios became the largest in history.

Tax Reform Act of 1986

By early 1986, the private markets were holding much of the quality transactions. Former sellers and portfolio lenders held, instead of securitizing, the high yielding commercial real estate mortgages. The 1986 Tax Reform Act substantially decreased the tax advantages of owning commercial real estate.

DiPasquale and Cummings (1992) provide a detailed assessment of the impacts of changes in tax policy on real estate investment. According to their analysis of tax policy changes between 1960 and 1990, when the method of depreciation changed from a double declining balance to straight line depreciation mandated by the Tax Reform Act of 1986, the benefits of multifamily real estate investments decreased substantially. In the same vein, according to Goldberg and Capone (1998), the 1986 Act restrictions on "passive losses" substantially reduced the value of the depreciation write-off (whereby excess depreciation could be used to shelter other income), from \$27 per hundred dollars to \$6.90, and sent property values plummeting.

Ultimately, the cumulative default rate of multifamily properties was just under 9 percent in 1991. These default rates were the product of a number of factors, including the commercial real estate recession as well as the provisions of the 1986 Tax Reform Act.

The Tax Reform Act of 1986 also included some provisions benefiting commercial real estate and multifamily. Specifically, it authorized a new financial investment vehicle, the Real Estate Mortgage Investment Conduit (REMIC). Although authorized initially for the

single-family mortgage market, this securities instrument would ultimately become one of the most utilized multi-class mortgage-backed securities in the commercial real estate market.

The Tax Reform Act of 1986 also authorized the low-income housing tax credit (LIHTC). This program, administered by the states, offered investors in low-income housing projects a 9 percent annual tax credit of the total construction costs for new construction or rehabilitation, or 4 percent of the construction costs if there was other tax-exempt financing or federal subsidy. The 4 percent tax credit also applied to acquisition costs. The life of the tax credits is ten years. The LIHTC legislation stipulated low- and moderate-income units in each project as follows:

- At least 20 percent of all units must be affordable to households with incomes at or below 50 percent of the area median income (AMI), adjusted for family size; or
- At least 40 percent of all units must be affordable to households with incomes at or below 60 percent of the AMI, adjusted for family size.

According to an early assessment of the program by DiPasquale and Cummings (1992), this *de facto* federal program for production of affordable housing was slow to be implemented, and costly in terms of the number of lawyer and accountant hours per deal, but the only tax credit available to developers and investors. A follow-up study by Cummings and DiPasquale (1998a) found that LIHTC had emerged as a very important source of new construction.⁴⁰ Segal and Szymanoski (1997) concur that since 1986, LIHTC has contributed significantly to the affordable multifamily segment of market (i.e., for the construction and substantial rehabilitation of affordable multifamily housing).

Financial Institutions Reform, Recovery and Enforcement Act of 1989

By 1987, the Tax Reform Act of 1986 was beginning to take effect. Within the next two years, the commercial real estate market and the economy were faltering. As the S&L crisis expanded and the banking sector also began to experience problems, Congress responded with the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). As described in detail in Appendix A of the 1992 report of the National Task Force on Financing Affordable Housing, entitled *From the Neighborhoods to the Capital Markets*, major components of FIRREA were designed to reduce insolvency risk and increase the financial cautiousness of the S&Ls.⁴¹ These components included:

⁴⁰ For example, 27 percent of the central-city LIHTC projects were found in census tracts with no other new rental housing construction between 1985 and 1990. Development costs ranged from an average per unit cost of \$65,000 to over \$180,000. The most expensive projects were located in central cities, the northeast, and western regions of the country.

⁴¹ Some provisions of FIRREA have since been modified.

- Capital requirements—Multifamily mortgages and acquisition, development, and construction loans were assigned a 100 percent risk rating (compared to a 50 percent risk rating for single-family mortgages). The risk-based capital requirements also applied to loans sold with recourse; any percentage of recourse had the same risk-based capital requirements as if the loan were still held in portfolio.
- Single-borrower loan limits—Thrifts were limited to lending a maximum of 15 percent of capital to one borrower (with some exceptions). This impacted large multifamily-related loans and rural areas served by a single S&L.
- Qualified thrift lender test—FIRREA raised the minimum for housing-related portfolio assets of S&Ls from 60 to 70 percent of total assets. These housing-related assets had to meet specific requirements to be “qualified thrift investments.”
- Loan-to-value restrictions—Guidelines restricting loans with LTVs of 70 percent or more. Significantly constrained the availability of loans for multifamily acquisition, development, and construction in some regions of the country.
- Direct equity investment—FIRREA prohibited thrifts from direct equity investment in real estate. Multifamily acquisition, development, and construction loans with low interest rates and some profit sharing by the thrift were considered equity investments and prohibited.
- Public disclosure of Community Reinvestment Act (CRA) ratings—Once the CRA ratings were disclosed, the public demand for enforcement of the CRA of 1977, and for stricter banking regulations in general, forced Congress, the non-conforming banks, and the regulators to take CRA seriously. The change in the enforcement of the CRA had the potential of driving new resources and capital to support low- and moderate-level income housing.

Creation of the Resolution Trust Corporation

FIRREA also created the Resolution Trust Corporation (RTC) to market the failed assets of the S&Ls until the expiration of its charter in 1995. The RTC could not directly sell the whole loans to depositories or other investors, so it turned to capital markets, using securitization.

The obstacles for the RTC initiatives in liquidation of assets and commercial mortgage securitization included:

- No infrastructure, standards, or national organizations to service the mortgages;

- No standard underwriting, due-diligence criteria, or risk-rating systems;
- No asset managers with local experience on a nationwide basis;
- No source for local or national data, no historic performance data, and no risk insurance for unknowns (e.g., environmental risks);
- No experience in liquidating non-performing or low quality commercial mortgages, without continuing involvement of the seller as a bundled servicer/warrantor/guarantor; and
- A hostile market for commercial real estate investments.

Overcoming these obstacles required planning and developing an entirely new approach to commercial real estate investment. Research into the components of commercial real estate lending and servicing led to identification of separate functions for which standards could be developed and costs segregated. Unbundling the process was the ultimate key to addressing each of the obstacles listed above. Use of credit enhancements, typically in the form of senior/subordinated structures, enhanced the asset sale process.

With the help of investment bankers, the RTC developed a mortgage disposition plan and a commercial real estate capacity in mortgage servicing and asset management. Gradually, market forces began to respond. Rating agencies increased capacity to rate new RTC commercial mortgage-backed securities (CMBS). Private companies developed their capacity to service loans nationally, and several companies were rated as commercial mortgage-backed servicers. By the end of 1991, master servicing, primary servicing, and special servicing had become recognized specialties.

Commercial Real Estate Recession

Another recession in commercial real estate exacerbated the thrift problems in the early 1990s. Although multifamily housing starts had been gradually declining from the first quarter of 1985 (as a result of oversupply and the Tax Reform Act of 1986), when the latest real estate cycle occurred, multifamily starts declined 47 percent between 1990 and 1991 (Segal and Szymanoski, 1997). The peak to trough decline in property valuation of multifamily real estate stock between the first quarter of 1990 and the third quarter of 1993 was 16.7 percent (Bradley, Nothaft, and Freund, 1998a). Widespread defaults contributed to a decision by Freddie Mac to leave the multifamily market entirely.

During 1993, the commercial real estate investment market bottomed out, and at around the same time Wall Street began to respond to the RTC effort; bidding for RTC assets and servicing CMBS securities became competitive. Portfolio lending by depositories and the remaining thrifts made a weak response as well. Ultimately, the RTC experience helped lead

an expansion of secondary market opportunities for stabilizing and maintaining liquidity in the commercial real estate market.

Commercial Real Estate Recovery through the Present

The expansion phase of the real estate cycle has been well underway for several years now, at least insofar as it pertains to multifamily. Rents have been rising, and vacancy rates have been relatively stable, contributing to a favorable environment for multifamily construction and lending activity.⁴² Delinquencies on commercial mortgages reached an 18-year low in 1997 and multifamily defaults fell further since then.⁴³ As of the end of 1999 both GSEs' multifamily performance had improved to the point where multifamily delinquencies were *less* than those in single-family.⁴⁴

Since the mid-1990s, the multifamily mortgage market has become more closely integrated with global capital markets, approaching the same degree of securitization as the single-family mortgage market by the end of the decade. In 1999, 58.8 percent of new multifamily mortgage originations were securitized, compared with 60.8 percent of single-family originations.⁴⁵

In particular, growth in the multifamily mortgage market has been fueled by investor appetites for CMBS. Nonagency securitization of multifamily and commercial mortgages received an initial impetus from the sale of nearly \$20 billion in mortgages acquired by the RTC from insolvent depositories in 1992-1993. Nonagency issuers typically enhance the credit-worthiness of their offerings through the use of senior-subordinated structures, combining investment-grade senior tranches with high-yield, below investment-grade junior tranches designed to absorb any credit losses.⁴⁶

Because of their relatively low default risk in comparison with loans on other types of income property, multifamily mortgages are often included in mixed-collateral financing structures including other commercial property such as office buildings, shopping centers, and storage warehouses. CMBS volume reached \$30 billion in 1996; \$44 billion in 1997;

⁴² Regarding rents and vacancy rates see Cornwell (1996) and Berson (1998).

⁴³ American Council of Life Insurance data reported in *Inside MBS & ABS* (March 20, 1998).

⁴⁴ U.S. HUD 2000b, p. V-2.

⁴⁵ *The Mortgage Market Statistical Annual for 2000* (Washington, DC: Inside Mortgage Finance Publications), 1, 286. A conventional multifamily mortgage market of \$46 billion is assumed in this calculation. B and C mortgages are excluded from the calculation. Although the degree of securitization is now similar, Schnare (2001) notes that the securitization in multifamily continues to be labor intensive and inefficient and has yet to produce a significant savings in costs.

⁴⁶ On the effects of multifamily mortgage securitization see Bradley, Nothaft, and Freund (1998a) and (1998b).

\$78 billion in 1998; and \$67 billion in 1999. Approximately 25 percent of each year's total is comprised of multifamily loans.⁴⁷

Depository institutions and life insurance companies, formerly among the largest holders of multifamily debt, have experienced a decline in their share of the market at the expense of CMBS conduits (Bradley, Nothaft, and Freund, 1998a). Increasingly, depositories and life insurance companies are participating in multifamily markets by holding CMBS rather than whole loans, which are often less liquid, more expensive, and subject to more stringent risk-based capital standards (Dinsmore, 1998, and Taylor, 1997). In recent years a rising proportion of multifamily mortgages have been originated to secondary market standards. This is a consequence of a combination of factors including the establishment of a smoothly functioning securitization "infrastructure;" the greater liquidity of mortgage-related securities as compared with whole loans; and the desire for an "exit strategy" on the part of investors.⁴⁸

Because of their limited use of mortgage debt, increased equity ownership of multifamily properties by Real Estate Investment Trusts (REITs) may have contributed to increased competition among mortgage originators, servicers and investors for a smaller mortgage market than would otherwise exist. During the first quarter of 1997, REITs accounted for 45 percent of all commercial real estate transactions, and the market capitalization of REITs at the end of January 1998 exceeded that of outstanding CMBS.⁴⁹

During the financial markets turmoil in the fall of 1998, investors expressed reluctance to purchase the subordinated tranches in CMBS transactions, jeopardizing the ability of issuers to provide a cost-effective means of credit-enhancing the senior tranches as well.⁵⁰ When investor perceptions regarding credit risk on subordinated debt escalated rapidly in August and September, the GSEs, which do not typically use subordination as a credit enhancement, benefited from a "flight to quality."⁵¹

Demographic factors will contribute to continued steady growth in the new construction segment of the multifamily mortgage market. The number of apartment households is expected to grow approximately 1.1 percent per year over 2000-2005. Taking into

⁴⁷ CMBS Database, Commercial Mortgage Alert, Harrison-Scott Publications, Hoboken, NJ.

⁴⁸ Board of Governors of the Federal Reserve System and U.S. Securities and Exchange Commission, *Report to the Congress on Markets for Small-Business- and Commercial-Mortgage-Backed Securities* (September 1998).

⁴⁹ "REITs Tally Nearly Half of All Big CRE Deals in First Quarter," *National Mortgage News*, (July 7, 1997); "Will REITs, Mortgage-Backeds Make Difference in Downturn," Jennifer Goldblatt, *American Banker*, (February 18, 1998).

⁵⁰ "New CMBS Headache: B-Piece Market Softens," *Commercial Mortgage Alert* (September 21, 1998); "Criimi Bankruptcy Accelerates CMBS Freefall," *Commercial Mortgage Alert* (October 12, 1998); "Capital America Halts Lending Amid Woes," *Commercial Mortgage Alert* (October 12, 1998).

⁵¹ On CMBS spreads see "Turmoil Hikes Loan Rates" in *Wall Street Mortgage Report* (September 14, 1998). Regarding implications for the GSEs of the conduit pullback see "No Credit Crunch for First Mortgages" in *Commercial Mortgage Alert* (October 12, 1998).

consideration losses from the housing stock, it has been projected that approximately 250,000 - 275,000 additional multifamily units will be needed in order to meet anticipated demand (Goodman, 1997, and Goodman, 1998). This flow is approximately half that of the mid-1980s, but twice that of the depressed early 1990s. In 1999, 291,800 apartment units were completed, and in 2000, 300,000 units were completed.⁵²

The high degree of volatility of multifamily new construction experienced historically is consistent with a view that this sector of the housing market is driven more by fluctuations in the availability of financing than by demographic fundamentals. The stability and liquidity of the housing finance system is therefore a significant determinant of whether the volume of new construction remains consistent with demand.

Past experience suggests that the availability of financing for all forms of commercial real estate is highly sensitive to the state of the economy. In periods of economic uncertainty, lenders and investors sometimes raise underwriting and credit standards to a degree that properties that would be deemed creditworthy under normal circumstances are suddenly unable to obtain financing. Ironically, difficulty in obtaining financing may contribute to a fall in property values that can exacerbate a credit crunch.⁵³ The sensitivity of commercial real estate markets to investor perceptions regarding global volatility was demonstrated by the rise in CMBS spreads in September 1998 (Holusha, 1998).

2.2 Key Types of Mortgage Lenders and Secondary Market Players

There are several types of multifamily mortgage originators in the primary mortgage market. Chief among them are commercial banks and thrifts, mortgage bankers, state housing finance agencies, community lending consortia, and other community-based lenders. Once a mortgage is originated in the primary market, the originator has two choices: keep the mortgage in the institution's portfolio or sell it (and typically retain the servicing) to the secondary market.

Those entities that purchase the originated mortgages are referred to as the secondary market. The secondary market players tend not to originate multifamily mortgages (Fannie Mae and Freddie Mac are prohibited from doing so), but to acquire the multifamily mortgages once they have been originated. In many cases, arrangements for the purchase or acquisition of originated mortgages (or so-called "deals") have been agreed upon before the mortgage is

⁵² *U.S. Housing Market Conditions*, U.S. Department of Housing and Urban Development (May 2001), Table 4.

⁵³ Howard Esaki, a principal in CMBS Research at Morgan Stanley Dean Witter stated recently that volatility in global markets contributed to a 10-20 percent decline in commercial real estate values in late 1998. John Hackett, "CRE Seen Down 10% to 20%," *National Mortgage News*, (November 23, 1998), p. 1.

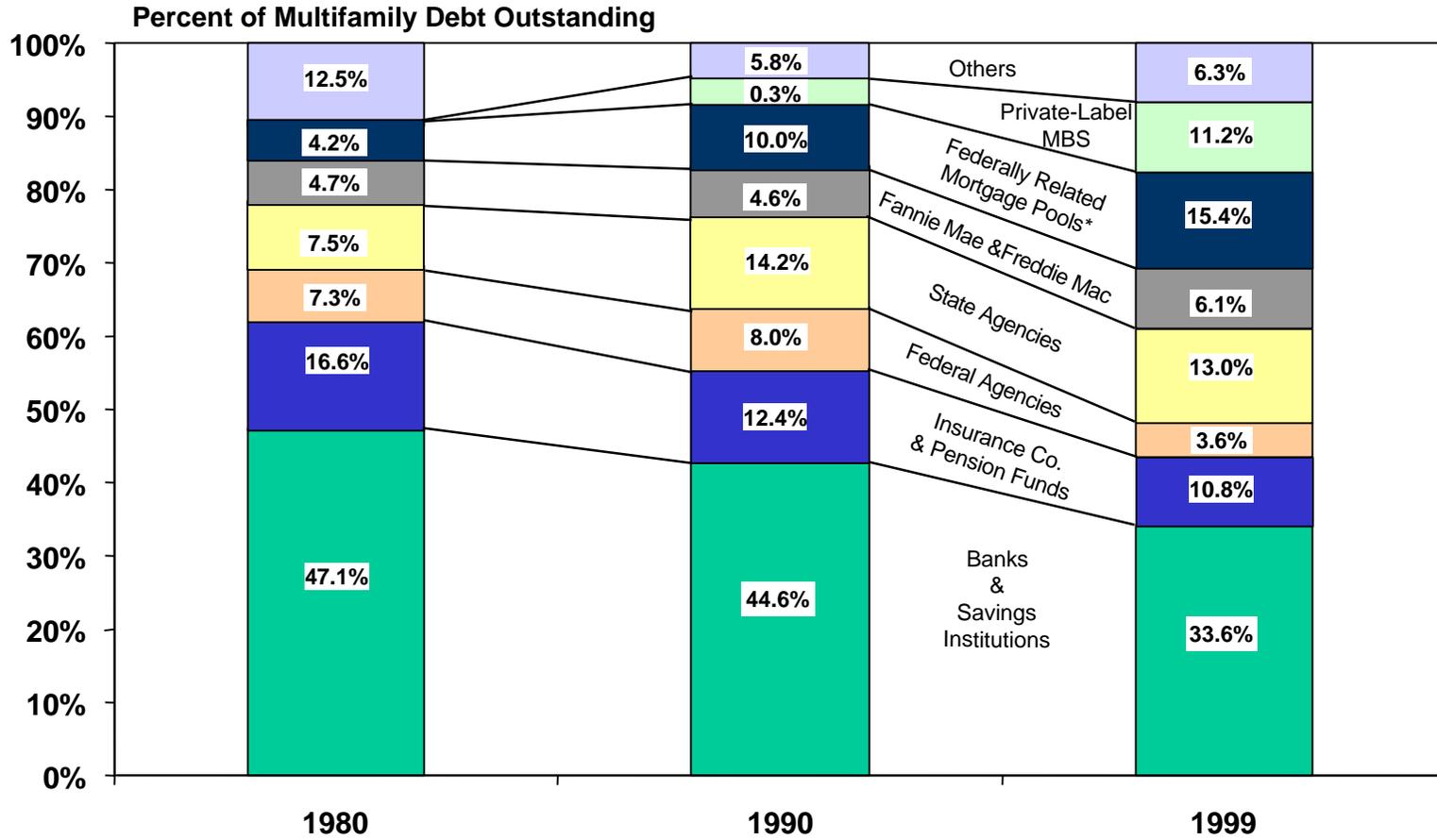
originated. The entities that typically purchase the originated multifamily mortgages include the GSEs, life insurance companies, Wall Street conduits, investment houses, and REITs.

The holders of multifamily debt, as shown in Exhibit 2-1, provide an indication of the competition the GSEs encounter in the multifamily market. Traditionally, the depositories have been the dominant players. This remains true today, as commercial banks held 17.7 percent and savings institutions held 15.9 percent of multifamily mortgage debt outstanding at the end of 1999. However, there has been a considerable decrease in their combined share from 50.5 percent in 1980 to 33.6 percent in 1999. The holders of multifamily debt that have increased their market share are state agencies, the GSEs, and a new player—private-label MBS.

Exhibit 2-2 shows another indication of the growth of competition for the GSEs in securitized multifamily debt. Private label MBS is growing rapidly. Multifamily debt is also being securitized at higher rates than ever before. Although the overall rates of securitization of the multifamily and other commercial real estate (\$1.1 trillion in total) remains at approximately 15 percent (Goldblatt, 1998), industry experts estimate that this is going to increase. Exhibit 2-3 shows the volume of activity in CMBS between 1985 and 1999.⁵⁴

⁵⁴ Rather dramatic turmoil in financial markets followed the financial tumbles in Russia and Asia. This probably contributed to the decline in CMBS issuance in 1999 because of the “flight to safety” that ensued, especially current U.S. Treasury issues – and a consistent increase in returns demanded by CMBS investors (Foong, 1998a). The widening of CMBS spreads relative to those of agency securities benefited the GSEs relative some of their competitors. See “No Credit Crunch for First Mortgages” in Commercial Mortgage Alert, October 12, 1998.

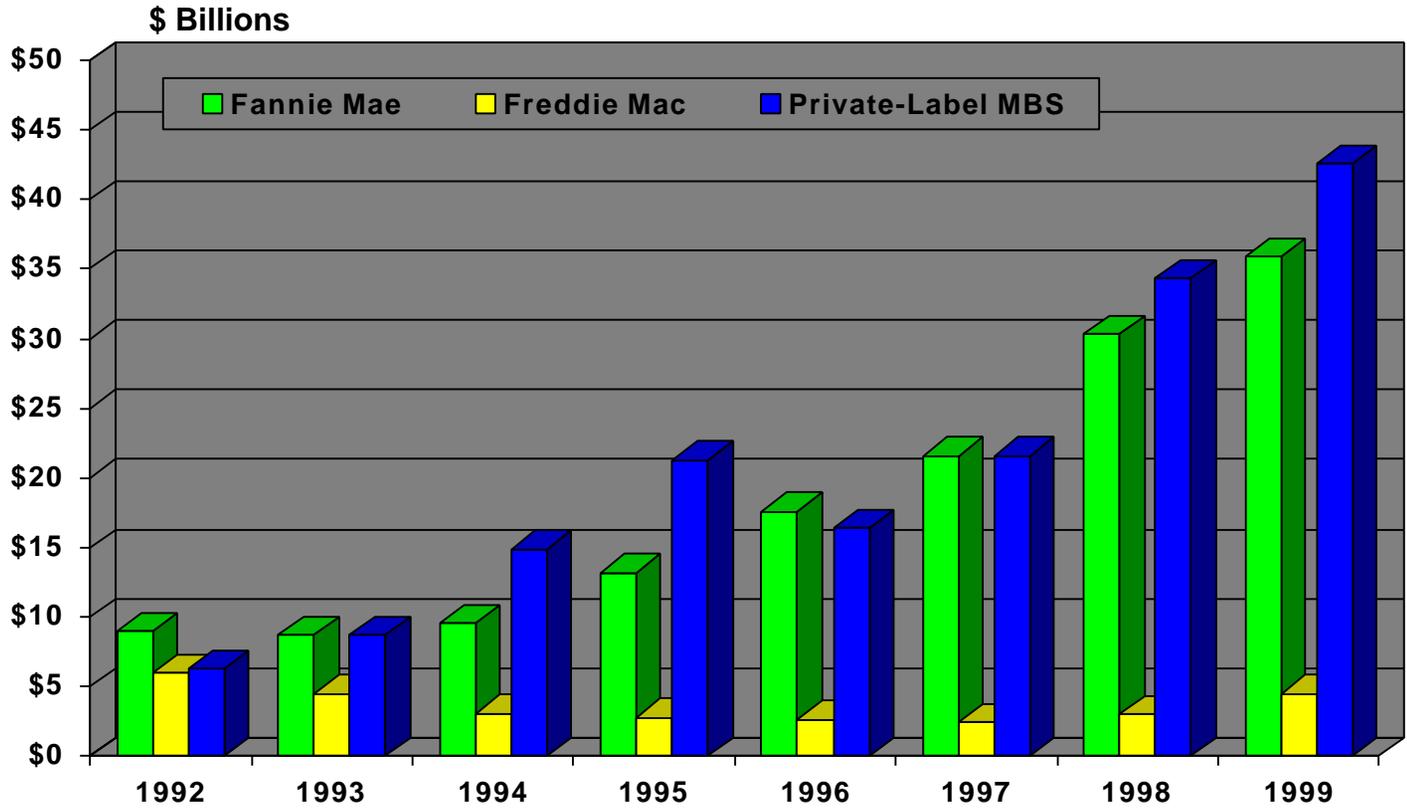
Exhibit 2-1 Major Holders of Multifamily Debt



Source: Table format from Bradley, Nothaft, and Freund (1998a). Data are from analysis of Federal Reserve Board data.

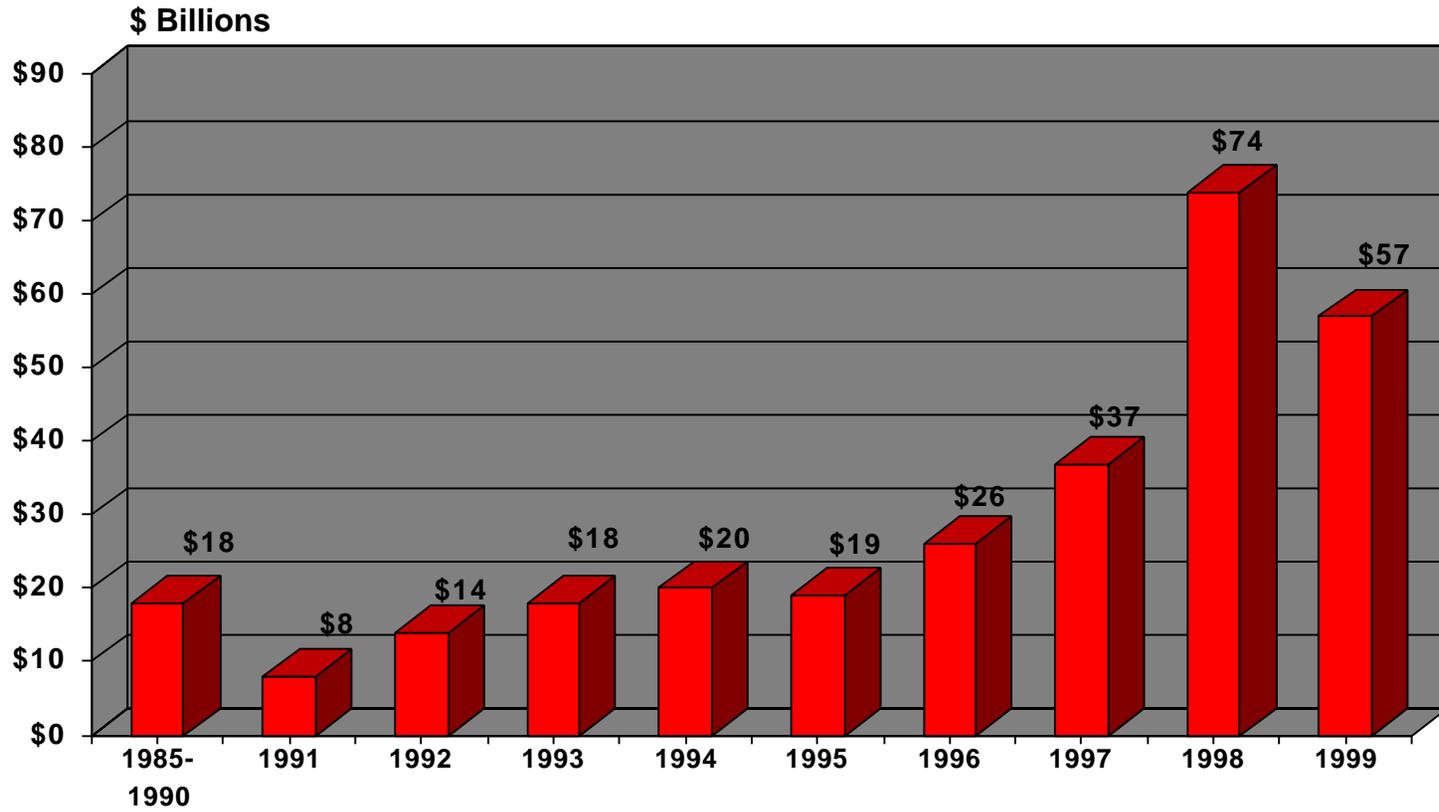
* Includes GNMA, FNMA, FHLMC, and Farmers Home Administration pools. Also includes federally related pools that are used as collateral for federally related agency-issued CMOs and privately issued CMOs. Excludes Federal Financing Bank holdings of pool securities.

Exhibit 2-2
Securitized Multifamily Debt Outstanding



Source: Federal Reserve Bulletin

Exhibit 2-3
Commercial Mortgage Backed Securities Issuance Volume



Source: Lehman Brothers and *Commercial Mortgage Alert*.

Chapter Three

GSEs' Underwriting Requirements, Policies, and Programs

The GSEs' fundamental underwriting standards are relatively similar. Loan-to-value (LTV) ratios of 80 percent and debt service coverage (DSC)⁵⁵ ratios of 125 to 130 percent represent standard thresholds utilized in the Delegated Underwriting and Servicing (DUS) and Program Plus products.⁵⁶ However, underwriting standards differ across a number of special, targeted programs and initiatives sponsored by each of the GSEs.

There are several sources of information about the GSEs' business practices in the secondary market: their published underwriting and appraisal requirements⁵⁷ and standards, their policies and practices as implemented by Fannie Mae's DUS lenders and Freddie Mac's Program Plus lenders, and their product descriptions. This chapter provides an introduction to the GSEs' business practices. In addition to the published underwriting and appraisal requirements, Abt Associates also reviewed the Annual Housing Activities Reports submitted by the GSEs to HUD and spoke with Fannie Mae's and Freddie Mac's representatives. These additional sources of information were invaluable in better understanding the underwriting requirements and how they were to be interpreted.

In contrast to the much larger single-family acquisition volume (in terms of dollars and units), Fannie Mae (1998) and Freddie Mac (1998) characterize the multifamily market as more complex, with:

- More lender expertise and experience required;
- Complex financing, often combined from a number of different sources; and
- Much less standardization.

⁵⁵ DSC is defined as the ratio of net operating income to required debt service.

⁵⁶ Additional details on the GSEs, descriptions of their programs, and required documentation for underwriting are contained in Appendix C. Features of selected multifamily finance programs for the GSEs and FHA are detailed in Appendix D.

⁵⁷ Both GSEs have changed the terminology used to describe their underwriting and appraisal policies and practices. The document specifying their written standards and procedures is called a "Guide." The guide contains (variously) "requirements," "standard eligibility requirements," "special requirements," "underwriting standards," or "general and specific standards." "General mortgage property requirements" include DSC and LTV levels and "specific mortgage requirements" include required years of remaining term to maturity. The term "guidelines" is no longer used because it connotes discretion is permitted. Although the *requirements* in the guide permit no discretion, waivers can be requested on a case-by-case basis, and the GSEs permit documentation of extenuating circumstances that also support certain flexibilities.

The GSEs' response to the complexity of the multifamily market has been to develop an approved seller/servicer lender network and to provide them with detailed underwriting and appraisal standards. For example, Fannie Mae finances most of its multifamily business through its DUS network of 26 lenders. Similarly, Freddie Mac does its multifamily business through a national network of 35 locally based Program Plus lenders. The two approved GSE lender networks overlap. Of Freddie Mac's Program Plus lenders, eight are also Fannie Mae DUS lenders.

The approved lenders in the networks have considerable expertise in originating multifamily mortgages that meet the underwriting and appraisal standards of the GSE with which they do business. There are some differences in the approach taken by each of the GSEs. For example, because of a combination of financial strength, track record, and loss sharing provisions with its DUS lenders, Fannie Mae delegates underwriting authority to them. Fannie Mae does not re-underwrite DUS loans, with the exception of mortgage loans in excess of \$20 million, which are subject to pre-review prior to closing. However, Fannie Mae does conduct some level of post-purchase review of all DUS loans.

Freddie Mac's Program Plus seller/servicers underwrite the loan applications, and Freddie Mac relies on its Program Plus seller/servicers to provide analyses of the property market, borrower, and other characteristics of the loan.⁵⁸ However, Program Plus seller/servicers do not have the final authority on loan originations, nor do they assume any of the loss risk. Instead Freddie Mac re-underwrites all multifamily mortgage originations prior to closing, even though it considers its Program Plus lenders to be the most knowledgeable originators in their "approved geographic areas" and very familiar with the local market trends.⁵⁹

Section 3.1 describes the GSEs' underwriting requirements and standards in more detail. Section 3.2 describes the contents of the GSEs' appraisal requirements and standards. Section 3.3 provides descriptive information on the similarities and differences among the GSEs' and FHA's programs.

3.1 Underwriting Requirements and Standards

The underwriting requirements and standards developed by both Fannie Mae and Freddie Mac provide guidance for lenders and property appraisers, and also serve as a part of the contractual relationship between the GSEs and their seller/servicers. These manuals, thousands of pages in length, provide extremely detailed information on each GSEs' product line.

⁵⁸ Freddie Mac states that it works with the most experienced multifamily commercial lenders in the industry.

⁵⁹ Freddie Mac staff state that Program Plus eligibility requirements for lenders reflect the complexity of the business, and are broadly consistent with those of other institutional capital sources and their correspondents.

The primary objective of the underwriting requirements is to ensure that implementation of the requirements will result in an accurate assessment of whether the mortgage applicant will be willing and able to repay the mortgage. Cummings and DiPasquale (1998b) observe that:

Underwriting assesses the soundness of the mortgages 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. (p. 26)

Similarly, the primary objective of the appraisal requirements and standards is to ensure that the assessment of property value is currently accurate and the property will provide sufficient collateral for the mortgage in the event of borrower default in the future.

Over time, both GSEs have reassessed their underwriting standards to ensure that the standards do not compromise the availability of affordable housing or the requirements of the fair lending statutes (especially for single family mortgages). Both GSEs have conducted extensive loan level data analysis and other experiments⁶⁰ to determine the relative importance of their underwriting requirements and criteria. This research is used to validate their current underwriting criteria, to determine which criteria are most predictive of a variety of risk factors (both individually and in combination), and which are predictive of loan delinquency or default. It is also used to determine whether there are more precise ways to assess credit risks or to permit more flexible product choices for borrowers. These requirements are revised frequently, especially when there is confusion among the selected lenders (DUS and Program Plus) in their interpretation and application to specific multifamily mortgage loans.

During the implementation of this project, HUD selected and provided Abt Associates with major portions of Fannie Mae's and Freddie Mac's Underwriting Guides. Abt Associates also had access to electronic versions of these underwriting guides through a subscription to the Fannie Mae and Freddie Mac modules of AllRegs. These sections were thoroughly reviewed for content and potential relationship to the policy issues under consideration in this project. For example, could the underwriting requirements affect the availability of loans on multifamily properties affordable to lower income people and in underserved areas?

Exhibits 3-1 and 3-2 show selected multifamily underwriting requirements for Fannie Mae and Freddie Mac, respectively. As shown in these exhibits, the requirements are very specific. Most requirements are designed to ensure that the mortgages offered to and purchased by the GSEs are high-quality loans that can be profitably securitized or retained in portfolio. The requirements are designed to achieve the desired goals as well as to prevent

⁶⁰ Experiments are alluded to in some annual reports, but not further described.

unintended consequences (e.g., Fannie Mae's Anti-Redlining Policy⁶¹). Although both GSEs state that the requirements are very specific, considerable training and years of experience are required before DUS and Program Plus underwriters become familiar with all of the underwriting guidelines and possible waivers (e.g., exceptions that may be approved under a specific set of conditions) by the GSE to whom the multifamily mortgage loan is to be sold.

Attention to numerous details is required throughout the underwriting process. As shown in Appendix C (Exhibits C-3 and C-4), there are nearly 40 items or documents (e.g., narratives, third party reports, or verifications) that are required even in the simplest borrower organizational structure (i.e., single borrower, personal financial statement, and schedule for real estate owned). If the borrower entity includes multiple borrowers, each borrower's financial statement and schedule for real estate owned must be included in the application/documentation, thereby expanding the minimum number of documents required.

⁶¹ This policy is articulated in several locations in the Fannie Mae Guide.

Exhibit 3-1
Statements from the Fannie Mae Multifamily Guide

Chapter 1. Mortgage Terms and Loan Documents

Fannie Mae will purchase first lien multifamily Mortgages subject to *specific requirements* [emphasis added] as to the Mortgage Loan amount, payments and term, property condition, performance and value, and other conditions as described in this Guide.

Section 301.01 Anti-Redlining Policy

Fannie Mae does not designate certain areas as being acceptable or unacceptable. In other words, Fannie Mae does not “redline.” Locational factors are fundamental to Property appraising and prudent underwriting, and there is nothing improper about underwriting on the basis of a realistic perception of risk in a given neighborhood. Redlining can occur when perceived property risks are based on improper locational factors (such as the arbitrary imposition of unfavorable loan terms on the basis of geographic area) or when the perceptions of risk are derived from factors that do not predict risk, either reliably or not at all. An example of a factor that is not predictive of risk is race, and racial redlining is illegal under federal law . . . None of Fannie Mae’s Property guidelines [sic] is intended to foster redlining. If any provision is interpreted to do so, it has been misunderstood.

Section 305.07 Market Areas Evidencing Weakness

The lender must carefully evaluate the strength and stability, including trends, of the market area in which each Property is located.

Lenders must exercise extreme caution in considering a loan in markets with poor market indicators or increased market risk factors. Additional analysis and support will be required for markets with any of the following characteristics: current occupancy levels less than 90%; a sustained downward trend in occupancy levels over the prior 12 months; seasonal occupancy; rent levels that are competitive with single-family housing; rent levels that are declining or have not kept pace with inflation over the last two years; markets in which concessions are high or increasing rapidly; markets experiencing unsustainable construction levels coupled with a sustained downward trend in occupancy levels; default and foreclosure rates which are high or rising rapidly; markets with over 15% of employment by a single employer or over 30% in a single industry; shrinking employment base.

Properties located in markets with one or more of the characteristics listed above will be acceptable only if there are exceptional circumstances that have been fully documented by the Lender. Acceptable properties located in such markets typically either receive subsidies from an established program or have very low Loan to Value Ratios, very high Debt Service Coverage Ratios and shortened amortization periods. (Pg. III-3-15 - 16)

Exhibit 3-2
Statements from the Freddie Mac Multifamily Seller/Servicer Guide

Chapter 6 Multifamily Conventional Cash Mortgage Purchase Program

6.1 Overview

Each Mortgage to be delivered to Freddie Mac must have characteristics that demonstrate high investment quality. These characteristics may include

1. Strong market (that is, low vacancy, minimal rental concessions, stable or increasing tenant demand, good balance of housing supply and demand, stable economic base, and employment diversification)
2. Strong property operations (that is, low vacancy, minimal rental concessions, stable or increasing rents, and stable operating and maintenance expenses)
3. Excellent property condition
4. Strong Borrower and Borrower Principals (that is, net worth, liquidity, credit history and experience)
5. Proven management ability of the Borrower, Borrower Principals or third-party property manager (Page 6-1)

Chapter 15 Multifamily Negotiated Transactions Program

15.3 Eligible Sellers

All multifamily Program Plus® Seller/Servicers in good standing are eligible to submit offers under the Multifamily Negotiated Transactions Program.

In addition, offers may be submitted by non-Program Plus entities, such as consortia, pension funds, bank conduits and real estate investment trusts (REITs). The offering entity must complete Freddie Mac's new customer application materials, and be evaluated by Freddie Mac. Freddie Mac will make the determination regarding whether offering entities are qualified on a case-by-case basis. (Page 10-5)

15.4 Eligibility Requirement for Mortgages

To be eligible for purchase under the Multifamily Negotiated Transactions Program . . . The Property must:

1. Have a current minimum occupancy of 90 percent (physical and economic)
2. Have a current Debt Coverage Ratio (DCR) of at least 1.25 on the first Mortgage (as determined by Freddie Mac)
3. Have a current minimum combined DCR of 1.15 (as determined by Freddie Mac)
4. Have a current maximum Loan-to-Value (LTV) Ratio of 80 percent on the first Mortgage (as determined by Freddie Mac)

3.2 GSEs' Appraisal Requirements and Standards

Both of the GSEs have developed appraisal requirements. These requirements are designed to insure that a reliable estimate of the current market value and a complete description of the subject multifamily property are prepared by the appraiser. If the market value estimate is done properly, another appraiser should be able to replicate the market value.

Lenders are responsible for ensuring that the appraiser is qualified to conduct the multifamily property appraisal.⁶² The lender determines whether the appraiser is qualified by reviewing the appraiser's education, experience with and frequency of multifamily appraisals, professional affiliations, and state license or certification. Appraisers, qualified to meet the GSEs' appraisal requirements, must have at least four years of experience appraising multifamily properties and adhere to the Uniform Standards of Professional Appraisal Practice of the Appraisal Standards Board of the Appraisal Foundation. In-service training is offered by the Appraisal Institute, which provides a five-year continuing education cycle for all licensure courses.⁶³

The GSEs' appraisal requirements and standards also provide detailed instructions and lengthy forms, which are designed to ensure a consistent approach to the market value of the multifamily property. The topics covered include the following:

- **Property Identification** e.g., address, legal description, sales price, lender, and lender's address;
- **Required Attachments** e.g., descriptive photographs of subject property; descriptive photographs of the street scene;⁶⁴ sketch of the floor plan of typical units; owners current certified rent roll, or pro forma if proposed or incomplete; and owner's income and expense statement for the current year or pro forma income and expense statement;
- **Summary of Salient Features** e.g., number of apartment units, year built, date of appraised value, forecasted annual income, parking ratio, overall capitalization rate, and forecasted annual income from real property;

⁶² Two organizations provide leadership for the appraisal process: the Appraisal Foundation and the Appraisal Institute. The Appraisal Foundation provides standards about the professional ethics and process. The Appraisal Institute provides guidance on the methodology, especially in terms of "standardized" appraisal forms, training, and procedures.

⁶³ May 1999 conversations with several Appraisal Institute representatives familiar with multifamily appraisals confirm their belief that both single and multifamily appraisals are now "standardized."

⁶⁴ The photographs of the property or the street scene may not include any information about the race, color, national origin, or handicapped status of the persons living in the property nor in the surrounding area.

- **Summary of Neighborhood Features** e.g., employment stability, convenience to employment, protection from detrimental conditions, adequacy of shopping facilities and public transportation **and Property Features** e.g., architectural attractiveness, landscaping, quality of construction, condition of exterior, room size and layout, compatibility to neighborhood, and overall appeal and marketability;
- **Area Data** e.g., area population, growth direction of population, economic base and influence on real estate stability, employment stability, and role of government agencies with respect to apartment development;
- **Neighborhood and Marketing Area** e.g., type [urban, suburban, rural]; direction of property values; present land use; overall property appeal and maintenance level; estimate of neighborhood vacancy rate; unit types and rent ranges in the neighborhood; potential for additional units; and general comments including either favorable or unfavorable elements not mentioned previously;
- **Site Description** e.g., site square footage; zoning; site improvements [public water, public sewer; and/or street lights]; topography; sketch of property; description of improvements [e.g., foundation, basic structural system, and/or roof]; parking; and recommended observable repairs;
- **Value Using the Cost Approach** used for forward commitment or recently completed property, including land value estimate and replacement cost estimate;
- **Comparable Rental Data** competitive market rents on no fewer than three comparables including locational characteristics; tenant user categories [e.g., single people, couples, or elderly]; types of building structures; amenities; and unit mixes;
- **Monthly Rent Schedule** scheduled and economic rental income for the property including premium income units, rent concession units, economic rents for restricted units; and other income from laundry facilities, parking, and commercial space;
- **Value Using the Market Approach** comparison of the subject property with at least three properties that are similar with regard to age, size, condition, amenities, and tenant user profile; located in the same neighborhood or in areas that are physically similar; and have sold recently;
- **Annual Expense Analysis** completed on a line-by-line basis and forecast the succeeding 12 months; it must also consider such items as insurance, utilities; building maintenance, management expenses, payroll, and replacement reserves;

- **Value Using the Income Approach** uses gross annual economic income less the forecasted vacancy and collection loss, less the forecasted annual expenses and replacement reserves, less the return on and recapture of the depreciated value of the furnishings to determine the net annual income from the property which is divided by a local capitalization rate to arrive at market value; and
- **Reconciliation and Value Conclusion** after entering the indicated value using the cost approach (if needed), the market and the income approach to value, the appraiser does a final reconciliation and states a conclusion about the final market value with a rationale for arriving at this valuation. If the property requires moderate rehabilitation, the Conditions and Requirements of Appraisal indicates the “as is” and “as rehabilitated” estimated market value of the subject property.
- **Signature of Appraiser** and date the appraisal was completed. This signature indicates certification of the appraiser’s approach according to stipulated conditions on the appraisal form.

The material requested of the appraiser in the appraisal form is very detailed and specific. The directions to appraisers from the GSEs’ materials and from the Appraisal Institute are very clear with respect to issues that could potentially be discriminatory. Appraisers are clearly instructed to avoid making any conclusions based on the race, color, national origin or handicapped status of either the borrower, prospective occupants of the property or the owners or occupants of the properties in the vicinity of the subject property.

At present the GSEs, HUD and the Appraisal Institute are collaborating to develop a standardized form for all multifamily property appraisals (Fannie Mae, 1999). This form, when approved, will add one more area of standardization to multifamily mortgage financing.⁶⁵

3.3 Comparison of GSEs’ Multifamily Mortgage Programs

Exhibits 3-3 and 3-4 introduce selected products offered by Fannie Mae and Freddie Mac, respectively. The products shown in the exhibits are selected from among the programs/products offered by each agency. Each exhibit shows at least one program that is designed specifically for “affordable” multifamily mortgages.

Broad underwriting parameters established by the GSEs with regard to maximum LTV and minimum DSC ratios are generally similar for the DUS and Program Plus programs, and these represent the bulk of Fannie Mae’s and Freddie Mac’s multifamily purchase activities.

⁶⁵ Fannie Mae does not currently require appraisers who have been designated as Members of the Appraisal Institute to use a standard form.

However, as already noted, in its DUS product line (which accounts for more than half of its multifamily volume), Fannie Mae delegates underwriting and servicing responsibilities to approved seller/servicers. Freddie Mac, in contrast, re-underwrites each of its acquisitions, and negotiates prices for each acquisition individually. Fannie Mae's pricing tiers offer better rates for less leveraged loans (i.e., lower LTVs), reflecting a type of risk-based pricing. Loan amounts, terms, and amortization periods (which pertain more to products and programs than underwriting per se) are generally similar between Fannie Mae and Freddie Mac.

Exhibit 3-5 provides information on FHA multifamily programs, which differ from those of the GSEs in a number of respects. FHA-insured loans can have longer self-amortizing terms; permit up to 95 percent LTV for non-profit borrowers in the FHA 232 program; and allow DSC ratios as low as 111 percent. However, FHA's processing fees frequently exceed those of the GSEs, making the overall cost of some FHA programs less price competitive. More details on these and other features of selected Fannie Mae, Freddie Mac, and FHA programs are shown in Appendix D.⁶⁶

⁶⁶ It should be noted that additional features of the programs are shown in Exhibits D-1 to D-3 of Appendix D. These features are included in the published information on the programs and are subject to change by the offering agencies.

Exhibit 3-3
Selected Multifamily Finance Programs: Fannie Mae

Name of Program	DUS Product Line	Prior Approval Product Line	Targeted Affordable Housing Program	5-50 Streamlined Mortgage
Description	Under DUS, Fannie Mae purchases qualified multifamily mortgages from specially designated lenders. These DUS lenders have been delegated responsibilities for originating, underwriting, closing and servicing. Fannie Mae purchases multifamily mortgages without prior review by Fannie Mae.	Individual transactions are submitted by approved Prior Approval lenders to Fannie Mae regional offices, where they receive full review prior to commitment. Underwriting standards are the same as DUS. Current priority is given to targeted affordable housing transactions.	This program is available through either the DUS or Prior Approval product lines. This program has specific affordability and occupancy restrictions similar to the LIHTC program.	Through this program, available through the DUS product line, Fannie Mae purchases small multifamily properties of five to 50 apartment units. Mortgages purchased through the program are eligible for streamlined underwriting requirements and processing and reduced costs.
Loan Amount	No minimum or maximum loan amount (average is \$5 million)	No minimum or maximum loan amount	No minimum or maximum loan amount	No maximum or minimum loan amount (average is \$750,000)
Term and Amortization	5, 7, 10, 15, 25 years, or others by request; 25- or 30-year amortization or less, by request. ARMs available also.	5, 7, 10, 15, 25 years, or others by request; 25- or 30-year amortization or less, by request. ARMs available also.	5, 7, 10, 15, 25 years, or others by request; minimum 18-year term for LIHTC properties; 25- or 30-year amortization or less, by request. ARMs available also.	5 to 30 years; amortization from 10 to 30 years. ARMs available also.
Maximum Loan-to-Value Ratio	80%.	80%.	Special underwriting, up to 90% for targeted affordable housing transactions.	80% for fixed-rate loans, 77.5% for ARMs.
Debt Service Coverage	125% or higher for most loans	125% or higher for most loans	For properties supported 100% by project-based Section 8 HAP contract is 110%; for other targeted affordable housing properties—115%.	125% or higher for fixed-rate loans; 100% at cap for ARMs.
Subordinate Financing	The combined DSC and LTV of the first mortgage and the subordinate financing must conform with the DSC and LTV limits established for the underwriting tier of the first mortgage.	The combined DSC and LTV of the first mortgage and the subordinate financing must conform with the DSC and LTV limits established for the underwriting tier of the first mortgage.	The combined DSC of first mortgage and subordinate financing must be a minimum of 105%.	The combined DSC and LTV of the first mortgage and the subordinate financing must conform with the DSC and LTV limits established for the underwriting tier of the first mortgage.

Sources: Adapted from Multi-Housing News (August/September 1996), Fannie Mae brochures, and AllRegs.

Exhibit 3-4
Selected Multifamily Finance Programs: Freddie Mac

Name of Program	Conventional Cash Program	Forward Commitment Pilot LIHTC Execution	Senior Housing and Assisted Living Pilot Program
Description	The program is for refinance, acquisition or moderate rehabilitation loans that demonstrate high investment quality.	This pilot provides a single source of construction and permanent first mortgage financing for newly constructed properties or those being substantially rehabilitated that will receive 9 percent credits under the LIHTC program. It provides for a maximum of 36-month interest-only construction financing, followed by an 18-to 30-year amortizing permanent loan upon construction completion, lease-up, and property income stabilization.	This pilot provides a source of first mortgage financing for rental housing that is exclusively for senior residents, including properties that provide assistance for residents with the activities of daily living.
Loan Amount	Small loan program: \$300,00 - \$999,999. Large loan program: \$1 million - \$50 million.	\$1 million to \$15 million per property.	\$3 million to \$15 million per property.
Term and Amortization	5, 7, 10, 15, 25 years, or others by request; 25- or 30-year amortization or less, by request.	18 to 30 year term; 25 to 30 year amortization.	7, 10, 15, 20, and 25 years (loans with terms of 20 years or longer must be self-liquidating). Standard amortization schedule is 25 years or less.
Loan to Value Ratio	80%, based upon Freddie Mac value.	85% maximum; 90% with HUD risk sharing. (See subordinate financing).	75% maximum.
Debt Service Coverage	125% for loans of \$1 million or more; 130% minimum for loans under \$1 million.	115% minimum; 110% with HUD risk sharing. (See subordinate financing).	135% minimum. May be as low as 125% for shorter amortization periods.
Subordinate Financing	Subordinate financing will be considered under certain conditions and circumstances.	Subordinate financing allowed with consent of Freddie Mac: ^a Hard: DSC of 110% minimum LTV of 90% maximum Soft: DSC of 105% minimum LTV of 100% maximum	None.

^a Industry subordinate loan.

Sources: Adapted from Multi-Housing News (August/September 1996), Freddie Mac web page (www.freddiemac.com/multifamily/prodsh01.htm and www.freddiemac.com/multifamily/lowincome.htm), AllRegs, and Freddie Mac brochures.

Exhibit 3-5
Selected Multifamily Finance Programs: FHA

Name of Program	FHA 221(d)(4) Program	FHA 223(f) Program	FHA 232 Program
Description	The program provides mortgage insurance for new construction or substantial rehab of rental or cooperative multifamily housing. (Substantial rehab when cost exceeds \$6,500 per unit adjusted by area high cost percentage, or when more than one major building component must be replaced.)	The program is for acquisition or refinance of existing nursing homes and assisted living facilities.	This program is for new construction or substantial rehabilitation of nursing homes and assisted living facilities.
Loan Amount	No minimum or maximum	No maximum limits.	Up to 90 % (95% for non-profit) of cost. Underwritten at 111% pro forma debt service coverage.
Term and Amortization	Up to 40 years, self-amortizing.	Up to 35 years, self-amortizing. (75% remaining useful life).	40 years, self-amortizing.
Loan to Value Ratio	None for new construction; 90% for substantial rehabilitation.	Up to 85% provided no cash out. Up to 79% with proceeds to the borrower.	Up to 90% (95% for non-profit borrowers).
Debt Service Coverage	111% for new construction. No change from original underwriting for rehab projects; no performance requirements.	117.6%.	No change from original underwriting for rehab projects; no performance requirements.
Subordinate Financing	Subordinate financing will be considered under certain conditions and circumstances.	In certain cases, second mortgages may be permitted where acquisition or refinancing costs are greater than the mortgage amount. The secondary debt may have no foreclosure rights and cannot exceed 7.5% of the project's value, or: a) In a purchase transaction, 7.5% of costs. b) In a refinance transaction, 50% of the difference between total costs and the mortgage amount.	Second mortgages are allowed subject to HUD review and provided that the secondary debt has no foreclosure rights.

Sources: Adapted from Multi-Housing News (August/September 1996); and "a mortgage banker's" brochures.

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Chapter Four

The State of the Multifamily Primary and Secondary Markets

Many discussions of the role of the GSEs in the multifamily mortgage market make some comparison with the role of the GSEs in the single-family mortgage market, where the GSEs are the dominant secondary-market players. In its 1995 Final Rule, HUD recognizes several differences between these markets, but asserts that multifamily mortgages pose a *different level of risk, but not a higher level of difficulty* (HUD, 1995). HUD maintains that the perception that the multifamily market was riskier and more difficult to judge was an impression left from the volatility of the market resulting from wide swings in tax policy, as described in Chapter 2 of this report.

This chapter provides context for Chapter 5, which will discuss policy issues related to multifamily housing finance in both the primary and secondary markets, including affordable housing, credit gaps, and fair lending. Section 4.1 presents an overview of losses by the GSEs and by FHA, which have greatly affected assumptions about the credit risk of multifamily mortgages. Section 4.2 discusses special challenges in multifamily financing, and Section 4.3 concludes with a discussion of the volatility of the multifamily market and the potential impacts of market cycles.

4.1 Multifamily Losses by the GSEs

The appropriate role of the GSEs in the multifamily mortgage market must be understood in the context of their prior experiences with substantial losses. During the 1980s and early 1990s, the GSEs encountered serious challenges to their roles in the multifamily mortgage markets (DiPasquale and Cummings, 1992). Underlying their losses were two important factors: a real estate recession following the Tax Reform Act of 1986 and underwriting requirements and standards that were too lenient to address multifamily market conditions during a recession. One result of the GSEs' experience in the early 1990s was a lasting impression within the secondary mortgage market that multifamily mortgages could be risky investments.⁶⁷

⁶⁷ More recently, multifamily properties are considered sound investments when compared to the risks associated with other types of commercial properties (Goldberg and Capone, 1998).

Fannie Mae

At the end of fiscal year 1990, Fannie Mae's total portfolio of \$17.9 billion in multifamily loans included \$6.9 billion (39 percent) in multifamily mortgages that neither had recourse to the lender nor FHA insurance and were therefore considered "at risk" in the sense that Fannie Mae would itself sustain any loss. At the same time, GSE underwriting practices in the mid-1980s reportedly overstated net operating income by 10 to 20 percent, and underwriters often overestimated property values by failing to gather adequate information regarding property condition.⁶⁸ Fannie Mae's delinquency rates⁶⁹ peaked at 6 percent in the third quarter of 1988 before falling to 2.7 percent in the first quarter of 1991.

In 1987, Fannie Mae developed the Delegated Underwriting and Servicing (DUS) lender program with new underwriting requirements that emphasized risk sharing.⁷⁰ The DUS program built on the concept of delegated underwriting in FHA's co-insurance program, but sought to avoid the risk of defaults and fraud that had plagued FHA co-insurance by redesigning loss-sharing provisions and selecting lenders carefully.⁷¹

Before the co-insurance program was launched, FHA, a major source of insurance for multifamily housing, was the sole guarantor for the loans it insured. Under the co-insurance program, FHA delegated a portion of the risk to private-sector lenders who would originate, underwrite, and service the mortgages. The co-insurance program was a financial disaster for HUD for a number of reasons (Scott, 1992):

- FHA did not focus on ensuring that the private lenders remained financially sound by:
 - Demanding sufficient capital from the lenders;
 - Monitoring the financial condition of the lenders;
 - Requiring reserve accounts in the case of default; and
 - Approving a group of lenders as co-insurers; instead, FHA relied on two lenders for over two years while others were engaged in FHA's laborious approval process.
- FHA focused on what its employees thought they knew how to do better than the private sector—multifamily underwriting—and wrote a 50 page document

⁶⁸ Goldberg and Capone (1998), p. 95.

⁶⁹ Delinquency rates are based on payments that are 60+ days late, plus foreclosures.

⁷⁰ According to Goldberg and Capone (1998), Fannie Mae also required more due diligence and tighter controls over the calculation of the underwriting ratios.

⁷¹ See Scott (1992).

instructing lenders on how to underwrite properties. But FHA did not understand employee reservations about delegation. Thus the program did not:

- Reassure civil servants that the co-insurance program would not threaten their jobs; and
- Provide incentives to employees to implement the co-insurance program in a timely and cost-effective way.

Fannie Mae's DUS program was launched in the light of the HUD risk-sharing experience and in anticipation of the coming impacts of the Tax Reform Act. The DUS program placed more emphasis on prevention of lender failure, not reliance on real estate collateral:

- DUS required higher capital standards for approved originators—\$2.5 million minimum instead of HUD's \$1.5 million;
- DUS required lenders to set up reserve accounts; and
- DUS began with ten approved lenders, compared with two approved lenders in the FHA program.

The DUS strategy was successful in keeping delinquencies low. The delinquency rate on the DUS loans was only 0.2 percent (third quarter 1990).

Freddie Mac

In 1990 Freddie Mac's total portfolio of multifamily loans was \$11 billion. The portfolio included \$9.7 billion (88 percent) generated by their cash mortgage purchase program without recourse or credit enhancement and that was considered "at risk." Only \$1.3 billion (12 percent) was credit enhanced by Freddie Mac.⁷² Freddie Mac's delinquency rate peaked in 1990, later than Fannie Mae's, and at a lower rate (3.8 percent).

The delinquency rate during 1990 was 4.2 percent among the conventional cash mortgage purchase program loans and 0.8 percent within the guarantor program.⁷³ In 1990 dollars, the charge-offs between 1986 and the end of the third quarter of 1990 were \$122 million. By 1991, Freddie Mac's multifamily charge-offs were \$162 million or 51.4 percent of all its credit losses, although multifamily loans were only 2.6 percent of their entire portfolio

⁷² According to Goldberg and Capone (1998), Freddie Mac did not recognize the underwriting deficiencies as soon as Fannie Mae did. "Freddie Mac continued to purchase noninvestment-quality loans through 1990." (p. 95).

⁷³ Freddie Mac has attributed the difference in performance among the guarantor program loans to several facts: they were originated by depositories that expected to retain them in portfolio; they were seasoned (held for at least 12 months prior to sale); some had credit enhancements; and many were in the West, where property values increased substantially during the 1980s.

(Goldberg and Capone, 1998). In 1990, Freddie Mac shut down its cash mortgage purchase program until late 1993; its only activity with multifamily mortgages was refinancing loans in its own portfolio.

DiPasquale and Cummings (1992) attribute Fannie Mae's relatively lower losses to their not bearing the full risk of loss in the vast majority of their multifamily business activities. Although most of the loans in their "at risk" portfolio were DUS lender-originated, the lenders shared the risk of loss and had been carefully screened for sound business practices and capital reserves to cover potential losses. They also believe that although the "written underwriting requirements for multifamily mortgage programs for Fannie Mae and Freddie Mac show surprisingly similar criteria," there were differences in the implementation of the criteria. According to DiPasquale and Cummings (1992), the primary weakness, uncovered later by Goldman, Sachs equity analysts,⁷⁴ was that Freddie Mac was allowing higher property appraisals that over-valued the properties and artificially reduced the loan-to-value (LTV) ratios⁷⁵ (instead of using debt service coverage (DSC) ratios—the ratio of net operating income to debt service payments). Freddie Mac was more lax than Fannie Mae was in originating, servicing, and auditing the underwriting standards that were being used.

In summary, DiPasquale and Cummings (1992) draw the conclusion that many factors influenced the formation of the bleak impression of the credit risks in the multifamily mortgage market, including the overall weakness in the real estate market at the time. They state: *"The well-publicized problems at the FHA and Freddie Mac have led many to conclude that the multifamily mortgages, particularly those on low- and moderate-income housing, are very risky investments."*⁷⁶

Prompted in part by the HUD housing goals, Freddie Mac re-entered the multifamily mortgage market in late 1993. Purchase volume rose rapidly, from \$191 million in 1993 to \$6.6 billion in 1998, \$7.6 billion in 1999, and \$6.8 billion in 2000. Freddie Mac's policy of re-underwriting the loans it acquires, rather than delegating underwriting, may be viewed as motivated in part by the perceived need to minimize the types of risks that contributed to earlier losses.

4.2 Special Challenges in Multifamily Financing

Given the GSEs' earlier losses, the conclusion that multifamily real estate investing was riskier than single-family has seriously impacted the development of the secondary market

⁷⁴ Goldman, Sachs, 1990.

⁷⁵ LTVs were considered the most important variable for underwriting single-family mortgages; Freddie Mac extended LTVs to multifamily properties. Vandell (1992) determined that a high LTV is the principal determinant of default risk in CRA loans. The DSC is the principle measure of credit-worthiness of a multifamily property's financials.

⁷⁶ p.110 [Emphasis added.]

for multifamily mortgages. In 1992, DiPasquale and Cummings observed that the multifamily market was considerably slower than the single-family mortgage market in penetrating the national and international capital markets. They asserted that an increase in the rate of growth in multifamily secondary market capitalization would require:

- Increasing standardization of multifamily mortgages;
- Increasing credit quality with both better underwriting and credit enhancement;
- Educating investors on the underlying structure of multifamily mortgage instruments and on the performance and risks of multifamily securities; and
- Providing access to consistent data for analyzing the risks and performance of multifamily investments.

Some of these requirements have now been addressed, at least in part. For example, various market forces (e.g., large mortgage banks and conduits) have begun increasing standardization of multifamily mortgages. The GSEs have improved underwriting and credit enhancement to more effectively control credit risk and reduce default losses. Wall Street conduits and various rating agencies have participated in the education of investors regarding the multifamily market through the trade press. At least in part as a result of these changes, over the past seven years, the reputation of multifamily projects has changed from risky by traditional lenders and investors to very sound investments (Goldberg and Capone, 1998).

Other changes in the structure of the multifamily mortgage market have also led to increased securitization and a decreased perception of riskiness. According to Szymanoski (1998), the system for financing multifamily properties has expanded from depository lenders (e.g., banks and thrifts) to other lending institutions (e.g., mortgage banks, state housing finance agencies, and community-based lending consortia) that have access to and often sell loans to the secondary markets. Forms of ownership have expanded as well, from individual owners and partnerships to publicly traded real estate investment trusts (REITs). Simultaneously, the Federal government's role has decreased, as FHA's share of the multifamily market has been replaced by non-FHA-insured loan financing, especially for multifamily developments with equity investments from the Low-Income Housing Tax Credits (LIHTC) program.

Nonetheless, according to Cummings and DiPasquale (1998b), the lack of standardization and the lack of complete information for accurate assessment of the risks and returns of investments⁷⁷ in the multifamily market has continued to slow the development of the secondary market for multifamily loans.

⁷⁷ To a considerable extent, the GSEs have contributed to the more rapid development of a secondary market for single-family mortgages by proposing standardization of the:

- Mortgage contract;

Although the GSEs have succeeded in developing these two key elements for the single-family mortgage market—standardization and information—the GSEs’ efforts in the multifamily market lag by two to three decades in the development of these elements. Furthermore, the multifamily market, especially for affordable housing targeted at low- and moderate-income tenants, has additional elements not found in single-family loans that pose special challenges for standardization. For example, they cite the structure of grants and soft second mortgages. These structures often come with restrictions that encumber the first mortgage and make the package (of the first mortgage and subordinate debt) difficult to sell to the secondary market.

Follain and Szymanoski (1995) conclude that special features associated with financing affordable multifamily housing may in fact create uninsurable risks and prohibitive information costs. For example, the increasing reliance on nonprofit organizations to provide affordable multifamily housing contributes to the complexity of financing packages and high costs of obtaining information.

To explore the contribution the GSEs could make to develop the multifamily market, Cummings and DiPasquale (1998b) present two case studies of programs in which a GSE has cooperated with an organization specializing in affordable multifamily housing:

- Freddie Mac and the Local Initiatives Managed Assets Corporation (LIMAC),⁷⁸ an initiative begun in February 1991 and suspended after two years that had a goal of \$100 million and was targeted to low-income populations and neighborhoods; and
- Fannie Mae and Enterprise Mortgage Investments Inc. (EMI),⁷⁹ an initiative begun in November 1994 and still ongoing, with a goal of \$150 million available for LIHTC-eligible multifamily housing loans.

GSE ambivalence regarding the perception of credit risk involved in lending on affordable multifamily properties is evident with regard to the history of both pilot programs. Cummings and DiPasquale (1998) conclude that both initiatives had mixed results, although the Fannie Mae/EMI pilot was more successful in a number of regards. The Freddie Mac/LIMAC initiative was suspended after two years with only one completed transaction, involving eight loans with an aggregate loan amount of \$4.6 million. As of June 1997, 15 transactions comprising \$20.5 million had been completed under the Fannie Mae/EMI pilot, which is ongoing.

-
- Underwriting requirements;
 - Mortgage documents; and
 - An information database for secondary market reassessment.

⁷⁸ LIMAC is a subsidiary of the Local Initiatives Support Corporation (LISC).

⁷⁹ EMI is a subsidiary of the Enterprise Foundation.

Both programs suffered initially from documentation requirements that borrowers perceived as burdensome. Cummings and DiPasquale observe that “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.” (p. 30.)

In addition, the Freddie/LIMAC program had difficulty with predictable pricing because pricing was ultimately determined by a Freddie Mac pricing committee more accustomed to pricing single-family mortgages. During the course of the Fannie/EMI pilot, pricing concessions by Fannie Mae significantly enhanced the competitiveness of the program.

Cummings and DiPasquale (1998b) ultimately conclude that given the size and profitability of the single-family market, the GSEs’ focus remains fixed on this segment of the mortgage market. Small, undercapitalized organizations like LIMAC and EMI can generate neither the volume nor the profits from the affordable multifamily housing segment to gain significant attention by the GSEs. Another conclusion is that both GSEs need to develop more experience and expertise with the multifamily market to understand how to make the affordable multifamily deals work. Finally, they conclude that HUD must set higher multifamily goals if the GSEs are ever to become leaders in the multifamily market.

These case studies by Cummings and DiPasquale (1998b) provide some indications of the barriers and potential solutions that could be implemented by the primary and secondary markets for multifamily mortgages. The case studies also underscore the difficulties that must still be addressed if the GSEs are going to become national leaders in the multifamily market.

4.3 Volatility in the Multifamily Market

The level of liquidity in the multifamily market has changed substantially over the last decade. In the early 1990s, the single family market had higher liquidity: three-fourths of the originated loans had been sold to the secondary market while only one-third of the multifamily mortgages had been sold to the secondary market.⁸⁰ Since then, integration with the capital markets in the multifamily mortgage market has approached that of the single-family market. In 1999, 58.8 percent of new multifamily mortgage originations were securitized, compared with 60.8 percent of single-family originations.⁸¹ However, DiPasquale and Cummings (1998) suggest that there remains a lack of liquidity in particular segments of the multifamily market, such as affordable multifamily housing and multifamily properties in

⁸⁰ HUD, 1995 [p. 61914] and DiPasquale and Cummings, 1992

⁸¹ HUD, 2000 [p. 65107] and *The Mortgage Market Statistical Annual for 2000*.

need of rehabilitation. As described in Chapter 2, since the 1995 Final Rule, the GSEs have increased their acquisition of multifamily loans.

Simultaneously, other players in the secondary market have responded with increased interest in the multifamily market, as well. Although volatility in the financial markets in 1998 (discussed further below) that increased CMBS spreads had a dampening effect on the securitization of commercial mortgages in 1999, securitization of commercial mortgages for 1999 were approximately \$57 billion (Federal Reserve, 2000). The proportion of the CMBS that are backed by multifamily properties ranges from one-quarter to one-half.⁸² Projections for 2000 were that the multifamily market would experience slow, but steady growth in 2000 (Viccaro, 1999).

The international capital markets shifted dramatically in the late summer and early fall of 1998, with significant effects on the CMBS market, as described later in this section. Was there any advance warning? The answer is “yes” from several Wall Street entities and associates. For example, E&Y Kenneth Leventhal Real Estate Group (1998) warned that the CMBS market might be leading to more inherent risk than had been seen since the real estate recession in the early 1990s. They cited competition as the reason that the following chain of business pressures was in evidence:

- Borrowers were pressuring conduits to lower prices and loosen mortgage covenants;
- Conduits were pressuring rating agencies to reduce subordination levels;
- Rating agencies were expressing concerns that the longer amortization periods may have been artificially increasing DSCs, and the special servicers’⁸³ experience was still not thoroughly tested; and
- Investors were expressing concerns that the rating agencies were more concerned with the lending process than with the quality of the loans, the collateral, and underwriting process.

Esaki and Philips (1997), also indicated that the investment market’s appetite for multifamily real estate investment could change if the capital markets change in the future. Other, more optimistic opinions, however, were also continuing to appear. For example, in 1998 the Urban Land Institute’s forecast that in the near term, “profits should continue to rise

⁸² Berton, in a discussion of the role of commercial banks in apartment mortgage securitization, states “as rating agencies prefer multi-housing to represent a third or more of the underlying collateral . . .” Dinsmore (1998) cites an interview with Sally Gordon, KPMG Peat Marwick, in which she says approximately one-half of the total outstanding \$170 billion of CMBS indebtedness is collateralized by multifamily properties.

⁸³ A special servicer assumes servicing responsibilities when a loan goes into default and conducts the “workout” or foreclosure process.

moderately through mid-1999, although increases will be slightly off the 1997 pace.”⁸⁴ The Urban Land Institute forecast said that, although there are signs of a slowdown in the flow of debt and equity capital for real estate, there was no evidence of a shortage through mid-1999. The report did say that between 1999 and 2001, however, some of the commercial real estate market’s excessive behaviors that resulted in the last real estate recession (e.g., overbuilding, overpaying, and lax underwriting) were seen as possibly leading to future reductions in growth of profits, property values, and rent levels.

By late summer of 1998, capital market conditions changed. According to Holson and Bagli (1998), when Russia stopped paying on its bonds and the Asian and Latin American markets reverberated, investors sought less risky investments (e.g., 10-year Treasury securities).⁸⁵ Those who were still willing to invest in CMBS demanded higher spreads (i.e., 80 basis points in June grew to 110 basis points by August 28, 1998). Any investment bank holding commercial (or multifamily) loans in their portfolio was likely to be collecting interest rates that were lower than what they would have to pay investors, “a money-losing equation.” In many cities, the commercial real estate market slowed dramatically after late August 1998; by late 1999, new CMBS issuance was down substantially from 1998’s record high, and developers and investors were still finding it more difficult to finance purchase of new properties (Viccaro, 1999).

The volatility in the CMBS market led to a windfall for some large banks and for the GSEs as well (Berton, 1998). During the fall of 1998, the spreads for the GSEs rose less than the non-GSE rates. The banks with connections to the GSEs (or with strong balance sheets that could hold the newly originated mortgages in portfolio) grew even stronger. For example, Banc One Capital Funding group expected to end the fourth quarter with \$500 million in new originations or three times the level of the first three quarters combined. The source of the volatility was not attributable to perceived increased risks in the CMBS market, but rather to a decrease in investor tolerance for risk. As Berton (1998) writes:

Throughout the tumultuous period, property finance professionals have stressed that the securities and underlying real estate collateral have remained sound assets. As Banc One’s [Ken] Bowen notes, the spread hikes were not precipitated by any losses to bond buyers—nor by any real evidence of a downturn in the relative health of multifamily real estate markets around the country.

The GSEs’ volume of multifamily business in 1998 was unusually large. Fannie Mae volume increased by about 80 percent to \$12.5 billion in 1998 from about \$7 billion in 1997.

⁸⁴ ULI, 1998

⁸⁵ The flight to safety in U.S. Treasury securities has meant the yields for Treasury securities have “fallen through the floor,” to as low as five percent (Foong, 1998a).

Freddie Mac's business increased by about 140 percent to about \$6.5 billion in 1998 from about \$2.7 billion in 1997. In part this increase in GSE activity was a result of less secondary market competition from Wall Street entities (conduits and REITs).

According to Berton's report (1998), the fallout of the volatility in the multifamily market might be lasting. The interest rates on multifamily mortgages that rose during the volatility were expected to remain higher than during mid-1998.⁸⁶ The other reported predictions include:

- Spreads would decrease, but not return to mid-1998 levels;
- Vacancy rates would decline;
- Multifamily building would decrease; and
- Quote of terms would include interest "floors," in addition to spreads.

Changes in the capital markets raise questions about the magnitude and timing of credit gaps in the future:

- Will this lead to credit gaps in the multifamily market?
- If so, in which segments of the multifamily market do credit gaps appear?
- Will the cycle downturn be as severe as in the early 1990s?

The answers to the first two questions have yet to emerge, especially in terms of which segments of the affordable multifamily market will be struck first. It is difficult to compare the current cycle with the early 1990s; the economy is in much better condition and the multifamily housing market is not glutted with oversupply in most markets. The answer to the third question has been addressed in several prior forecasts described below.

In late 1996, Wratten forecast that the credit crunches of 1970, 1974-1975, 1980-1982, and the early 1990s would probably not be repeated. Instead, so much had been learned about the commercial real estate market since the last crunch that many of the danger signals would be recognized earlier. He also forecast that one of the next phases of development for portfolio lenders would be adding an "exit strategy" to their traditional origination and servicing strategies. The exit strategy would encompass a variety of secondary market alternatives to their typical "buy and hold" strategies. This would result in a substantial increase in the

⁸⁶ According to Berton (1998), lenders who previously would quote the minimum spreads were now quoting the absolute interest "floor."

CMBS market. He foresaw it growing to approximately \$200 billion within a few years (of 1996).⁸⁷

Predicting what will happen next with both commercial and multifamily markets depends on where the market is in its historically recurring cycle. Gordon (1997) reports findings on a KPMG study of the commercial real estate lending strategies among commercial banks within the previous year. They found intense competition in the market coming from a variety of sources. The view, from the commercial bankers' perspectives, was that "competition, not risk, is driving pricing." This translates into "lenders are pressed to shave either price—or underwriting standards—or both." Given the historical business cycles of the capital markets, Gordon cautions that although the market appears to be mature, with substantial additional capital in REITs, CMBS and the primary mortgage market, commercial property values did not fully adjust during the last real estate downturn, and commercial lending may enter a slowdown during an adjustment period when values gradually return to "par."⁸⁸

Goldberg and Capone (1998) drew a similar conclusion about a repeat of the early 1980s cycle in their simulations of multifamily mortgage credit risk. Their simulations addressed projections for loans that might be underwritten in 1998. They cited several changes in the multifamily market including the use of greater due diligence, valuation controls, and lower interest rates (that could reduce rental price growth and depreciation allowances) as factors that decrease the overall mortgage credit risk. The most serious risk factors that could negatively impact the market would be another building boom or a rise in interest rates. Repeating the 1983 experience, according to Goldberg and Capone, would require a "significant deterioration in underwriting quality and adverse legislative action." For example, their simulation models show that to keep the ten-year cumulative default rate under 8 percent, even under severe economic conditions, DSCs of 1.30 and LTVs of 0.70 would suffice. If, however, underwriting standards permit DSCs of 1.20 (or 1.10 for special affordable housing loans) and LTVs of .80 (or .90 for special affordable housing loans), then replication of the 1983 experience is possible.

⁸⁷ As a reference, in 1996, the total value of the all stock listed on the American Stock Exchange was approximately \$125 billion. As of 1998, the portfolio of CMBS was over \$170 billion.

⁸⁸ "In property markets, or the market for space, we have become accustomed to thinking of "excess capacity," space that was built in excess of underlying demand. Gradually demand erodes this excess supply, allowing vacancy rates to decline. Perhaps the same model applies to capital markets. "Excess" capital that flowed into commercial real estate in the 1980s is being eroded gradually through repricing of the underlying assets— but the process is not yet over. If we have not really finished with the last cycle yet, then the market is still not "at par." As a result, we might continue to see growth in commercial mortgages at a rate below historical averages or current economic growth rates. At the same time, we might be alert to a potential hidden source of instability." (Gordon 1997, p. 8.)

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Chapter Five

Policy Issues in the Multifamily Market

As discussed in Chapter 3, the purpose of the GSEs' underwriting and appraisal requirements and standards is to ensure that the borrower will have the ability to repay the loan and the property will have sufficient value to recover the loan if necessary. However, it is possible that some of these requirements pose obstacles to the financing of specific types of multifamily property or those located in certain types of neighborhoods. Even if these obstacles are not explicit in the GSEs' requirements, they may result from the way the GSEs' underwriting requirements are being interpreted and applied. The GSEs' underwriting and appraisal standards as they are written were reviewed in Chapter 3.

This chapter presents background information on three important policy issues that HUD is considering with respect to the GSEs' multifamily underwriting and appraisal requirements and standards. Each section examines the GSEs' mortgage purchases for evidence that the actual application of the GSEs' requirements may present obstacles to financing for particular types of multifamily housing. Section 5.1 addresses the GSEs' track record in lending for affordable housing. Section 5.2 describes credit gaps in the multifamily market, particularly for small multifamily properties, for multifamily properties with significant rehabilitation needs, and for multifamily housing for seniors. Section 5.3 discusses potential fair lending implications of the GSEs' business practices. The section first shows that it is reasonable to assume that fair lending laws apply to GSE purchases of loans for multifamily properties. The section then presents two areas where disproportionate adverse impacts on protected groups may result from the GSEs' underwriting and appraisal requirements: how guidelines affect older neighborhoods and the role market strength plays in underwriting. The section concludes with a discussion of GSE lags in purchasing specific types of loans. While these lags do not demonstrate that the GSEs are violating fair lending legislation, they raise the question of whether some underwriting and appraisal guidelines are having a disproportionate adverse impact on protected classes. The views of lenders and national experts on these policy issues are presented in Chapter 7.

5.1 Affordable Lending

The first policy issue that could be affected by the GSEs' underwriting and appraisal requirements and standards is affordable lending within the various segments of the multifamily market. In the context of the multifamily market, affordable lending can be considered lending for multifamily housing that is affordable to low-income tenants.⁸⁹ Segal

⁸⁹ Low-income refers to households with incomes at or below 80 percent of area median.

and Symanoski (1997) have previously examined the secondary mortgage market and the role of the GSEs. They contend that, following the losses experienced by the GSEs and others in the multifamily market in the early 1990s, there has been considerable GSE reluctance to rebuild an active secondary market for multifamily properties, especially in the affordable segments.

HUD's 1995 Final Rule established GSE housing goals for the period 1996 through 1999. Included in these goals were special affordable goals that set minimum annual dollar amounts in affordable multifamily mortgages for each of the GSEs; the goals were set at \$1.29 billion for Fannie Mae and \$998 million for Freddie Mac. The 2000 Final Rule (HUD, 2000a) updated these goals, and set the minimum annual affordable multifamily purchases at \$2.85 billion for Fannie Mae and \$2.11 billion for Freddie Mac for the period 2001 through 2003. Both GSEs have exceeded the Special Affordable goal for multifamily since it became effective in 1996.

The affordability of GSE multifamily acquisitions, expressed in terms of the ratio of rent to income for units covered by GSE mortgage acquisitions, has been relatively constant since the GSEs began providing loan-level data to HUD in 1993, although there has been some year to year fluctuation. This is shown in Exhibit 5-1. The proportion of Fannie Mae acquisitions affordable at or below 60 and 80 percent of Area Median Income (AMI) declined from 1997 to 1998 before rising in 1999. The percentage of Freddie Mac acquisitions affordable at 60, 80, and 100 percent of median decreased noticeably from 1998 to 1999, accompanied by a sharp increase in the proportion of units affordable at more than 100 percent of area median.⁹⁰

⁹⁰ In considering the apparently high level of affordability among Freddie Mac's acquisitions in 1993-1994, it is important to bear in mind that Freddie Mac was re-entering the multifamily market during this time period, and therefore may not be fully representative.

Exhibit 5-1
Multifamily Units by Affordability Level, As Percent of Units Funded*
1993-1999 Acquisition Year

Affordability of Unit	1993	1994	1995	Fannie Mae				Total
				1996	1997	1998	1999	
60% or less of AMI**	43.3%	43.7%	36.1%	40.8%	50.5%	44.0%	48.9%	44.3%
80% or less of AMI	87.1%	85.5%	83.1%	84.5%	89.2%	85.0%	85.8%	85.7%
100% or less of AMI	95.4%	93.8%	94.4%	93.3%	95.9%	94.7%	95.1%	94.6%
More than 100% of AMI	4.6%	6.2%	5.6%	6.7%	4.1%	5.3%	4.9%	5.4%

Affordability of Unit	1993	1994	1995	Freddie Mac				Total
				1996	1997	1998	1999	
60% or less of AMI**	72.8%	54.5%	40.1%	42.1%	46.4%	47.5%	44.9%	46.2%
80% or less of AMI	90.6%	90.0%	88.8%	89.9%	85.1%	88.4%	82.1%	86.5%
100% or less of AMI	94.3%	97.2%	97.2%	97.4%	95.9%	96.3%	92.5%	95.4%
More than 100% of AMI	5.7%	2.8%	2.8%	2.6%	4.1%	3.7%	7.5%	4.6%

* Excludes missing data.

** Area median income.

Source: GSE Public Use Data Base

5.2 Credit Gaps

A second policy issue is credit gaps in various multifamily market segments. In this case, a credit gap refers to a situation where the demand for credit exceeds the supply at market interest rates as a result of disparities in the information available to borrowers and lenders with regard to credit risk.⁹¹ This section reviews the literature on evidence of the existence of credit gaps in both the primary and secondary markets for multifamily lending. It next focuses on three particular segments of the market where credit gaps appear to exist: small multifamily properties, multifamily properties in need of rehabilitation, and housing for seniors.

Literature on the Existence of Credit Gaps

Stiglitz and Weiss (1981) explain how credit rationing can occur in situations where lenders cannot fully evaluate borrowers' credit risk, although borrowers themselves are aware of the level of risk. In theory, interest rates charged will affect the riskiness of their loan pool by sorting potential borrowers (adverse selection effect) or affecting the behavior of the borrowers (incentive effect). Under the adverse selection effect, borrowers who are willing to pay a higher interest rate are those who believe their probability of repaying the loan is low (thereby increasing the riskiness to the bank). Under the incentive effect, the behavior of

⁹¹ Segal and Szymanoski (1998) state that credit gaps are a current policy issue because of the continuing declines in affordable housing units, especially in inner city locations, as reported by the Harvard University Joint Center for Housing Studies (1995).

the borrower is likely to change as the interest rate increases. Borrowers are more likely to undertake projects with a lower probability of success but a higher payoff if successful. In cases where lenders cannot identify the credit risks of otherwise identical borrowers, Stiglitz and Weiss show how lenders will set an interest rate with the highest expected profit given the probability of repayment by borrowers. However, at this profit maximizing interest rate, the demand for credit may exceed supply. But lenders cannot raise interest rates to market clearing levels, as higher interest rates would attract applicants with higher credit risk and lead to lower profits. Thus, the imperfect information available to lenders about credit risk results in credit rationing.⁹²

Stiglitz and Weiss also demonstrate how, in cases where there are distinguishable groups of borrowers, selected groups may face credit rationing while others may be completely “redlined” and unable to secure loans at any interest rate. The groups facing credit rationing or redlining may be characterized by either greater credit risk or greater difficulty in assessing credit risk, either of which would lower the expected profits for the lender. At the same time, credit may be provided to other groups with lower risk or for whom risk is more readily discernible, because expected profits are greater for these groups. If additional investment capital were available, lenders would provide loans to the credit rationed or redlined groups but at a higher interest rate.

This model suggests that credit gaps are most likely to be found in the riskier segments of the market or markets where it is more difficult to discern risk. Market segments such as those with lower housing quality, older properties and properties in poor neighborhoods or rural areas are generally considered riskier. Risk may be more difficult to assess for properties needing rehabilitation or layers of subsidies because of uncertainties about either the construction process or the security of the subsidy source. Since these types of housing represent an important part of the affordable segment of the multifamily market, such credit gaps would be a cause of concern for public policy to ensure that the affordable stock is not adversely affected by a lack of financing.

Lang and Nakamura’s (1990) discussion of the dynamics of the credit market extends Stiglitz and Weiss’s model by including external effects such as the outcomes of previous similar loans in a lender’s own portfolio and in the portfolios of other lenders. They also extend Stiglitz and Weiss (1981) to multiple markets (or geographic areas) where credit gaps could exist for varying lengths of time.

⁹² Stiglitz and Weiss (1981) “reserve the term credit rationing for circumstances in which either (a) among loan applicants who appear to be identical some receive a loan and others do not, and the rejected applicants would not receive a loan even if they offered to pay a higher interest rate; or (b) there are identifiable groups of individuals in the population who, with a given supply of credit, are unable to obtain loans at any interest rate, even though with a larger supply of credit, they would.”

Lang and Nakamura's model considers a theory of alternating periods of growth and contraction in a dynamic credit market. In this model, lender success in the form of profits induces more lending activity and more information about profitability, which can be used for the allocation of future resources. Risk also influences the results within any time period. For example, a bankruptcy will influence future allocation of resources, leading to reductions in lending and thereby reducing the amount of information available for the next decision period. Thus the initial shock is perpetuated into future periods, thereby exaggerating the number of decision periods during which risk aversion will persist until the decision is made to return to a steady state that is more in balance with the actual risks.

Both of these models provide support for the existence of credit gaps. HUD's 1995 and 2000 Final Rules (HUD, 1995, 2000a) cited anecdotal and other evidence of credit shortages among several multifamily segments: smaller multifamily properties in older urban areas and all sizes of inner city properties in need of rehabilitation. Without intervention, such as the housing goal targeting underserved areas, the credit gaps could be severe and persistent.

Credit gaps present in the primary mortgage market can be found in the secondary mortgage market as well. Dinsmore (1998) examined the commercial mortgage-backed securities (CMBS) market⁹³ and reports that the current high levels of capital available in the CMBS market do not benefit all segments of the multifamily market equally. Credit may be more difficult or costly to obtain for:

- Construction loans;
- Small multifamily loans;
- Government-subsidized or regulated properties;
- Mixed-use properties; and
- Any project with unconventional risks.

Dinsmore (1998) explains that construction-financing loans are not currently included in the CMBS market because there are no cash flows from the property until it is completed. The standard CMBS loans are repaid from the property's income cash flow. Small properties, needing loans of less than \$1 million, typically do not have access to the CMBS market, which considers anything less than \$5 million too small.⁹⁴ In general, the CMBS market is

⁹³ In addition to the GSEs, CMBS is an alternative secondary market vehicle for multifamily mortgages. CMBSs consist of all forms of commercial mortgages including about 30 percent multifamily mortgages.

⁹⁴ There are a few exceptions when a company decides to target specific segments of the multifamily market for strategic reasons (e.g., Daiwa Finance Corporation, an investment bank, targets commercial loans ranging from \$250,000 to \$3 million). Dinsmore (1998) also points out that the GSEs treat any loan under \$1 million as small.

looking for “plain vanilla” loans that can be underwritten quickly, which often rules out lending for mixed-use developments and other unconventional risk deals.

Small Multifamily

There is evidence that small multifamily properties, defined as properties with five to 50 units, have been adversely affected by differentials in the cost of mortgage financing relative to larger properties.⁹⁵ While mortgage loans can be obtained for most small properties, the financing that is available is relatively expensive, with interest rates as much as 150 basis points higher than those on standard multifamily loans. Loan products also are characterized by shorter terms and adjustable interest rates. The fixed-rate financing that is available is typically structured with a five to 10 year term, with interest rates as much as 150 basis points higher than those on standard multifamily loans, which may have adverse implications for affordability.⁹⁶ This market segment appears to be dominated by thrifts and other depositories that keep these loans in portfolio. In part to hedge interest rate risk, loans on small properties are often structured as adjustable-rate mortgages.

Borrowers typically incur costs for origination and placement fees, environmental reviews, architectural certifications (on new construction or substantial rehabilitation projects), inspections, attorney opinions and certifications, credit reviews, appraisals, and market surveys.⁹⁷ Because of a large fixed element, these costs are usually not scaled according to the mortgage loan amount or number of dwelling units in a property and consequently are often prohibitively high for smaller projects.

GSE purchases of loans backed by small multifamily properties

The GSEs’ multifamily purchases do not appear to be contributing consistently to the mitigation of the excessive cost of mortgage financing facing small properties. Based on data from the Survey of Residential Finance showing that 39.4 percent of units in recently mortgaged multifamily properties were in properties with five to 49 units, it appears reasonable to assume that loans backed by small properties account for 39.4 percent of multifamily units financed each year. As a share of units backing their multifamily transactions, however, GSE purchases of loans on small multifamily properties are typically

⁹⁵ See Schneider and Follain (1998), pp. 43-58; and Segal and Herbert (2000).

⁹⁶ Schneider and Follain (1998) assert that interest rates on small property mortgages are as high as 300 basis points over comparable maturity Treasuries. Berkshire Realty, a Fannie Mae DUS lender based in Boston, was quoting spreads of 135 to 150 basis points in “Loans Smorgasbord,” Multi-Housing News, August-September 1996. Additional information on the interest rate differential between large and small multifamily properties is contained in Segal and Herbert (2000).

⁹⁷ These costs have been estimated at \$30,000 for a typical transaction. Presentation by Jeff Stern, Vice President, Enterprise Mortgage Investments, HUD GSE Working Group, July 23, 1998. The most comprehensive account of the multifamily housing finance system as it relates to small properties is contained in Schneider and Follain (1998). Herbert (1999) also describes the characteristics of loans on small multifamily properties.

less than 5 percent and have never approached the estimated 39.4 percent market share, as shown in Exhibit 5-2. Based on HUD's analysis of loans originated in 1997 and acquired by the GSEs in 1997, 1998, and 1999, the GSEs have purchased loans backed by 24 percent of units financed in the overall conventional multifamily mortgage market in 1997, but their acquisitions of loans on small multifamily properties have been only 2.3 percent of such properties financed that year.⁹⁸⁹⁹ The GSEs' failure to buy significant numbers of loans on small multifamily properties disadvantages the owners of such properties by denying them the benefits of mortgage liquidity provided by secondary market purchases of mortgages on larger properties.

**Exhibit 5-2
GSE Multifamily Transactions by Size of Property
1994-1999 Acquisition Years**

	1994	1995	1996	1997	1998	1999
Fannie Mae						
Small (5-50 units)	8,717	45,488	5,838	8,111	64,753	12,351
As % FNMA MF Total	3.9%	19.3%	2.1%	3.2%	16.5%	4.2%
Freddie Mac						
Small (5-50 units)	1,165	2,461	4,100	3,963	10,244	4,068
As % FHLMC MF Total	2.6%	3.6%	4.2%	4.0%	4.6%	2.1%

Source: GSE Public Use Data Base.

To encourage the GSEs' activity in financing small multifamily loans, the 2000 Final Rule (HUD, 2000a) includes the use of bonus points for purchases of mortgages financing multifamily properties with five to 50 units. Specifically, HUD will assign double weight in the numerator under the low- and moderate-income and Special Affordable housing goals for each unit financed by GSE mortgage purchases in small multifamily properties.

⁹⁸ It is assumed that units in small multifamily properties represented approximately 39.4 percent of multifamily units financed in 1997, per the 1991 Residential Finance Survey, as discussed above. Additionally, it is assumed that 1997 multifamily conventional origination volume was \$38 billion, based on discussions with HUD. An average loan amount per unit of \$ 27,266 is used, the GSE average for 1997 acquisitions.

⁹⁹ Schnare (2001) p. 22 similarly shows that GSEs' purchases of small loans for multifamily properties (under \$1 million) lagged behind loans financed by depositories. She shows that in 1999 over half the multifamily loans issued by depositories were for under \$1 million, compared with 18 percent for Freddie Mac and 13 percent for Fannie Mae.

GSE underwriting requirements for small multifamily mortgages

Although Freddie Mac purchases loans with principal balances of less than \$1 million under the Conventional Cash Program, the underwriting guidelines used for small loans are more stringent than those for large loans. In particular, the minimum DSC ratio required for large loans is 1.25; for small loans the minimum is 1.30. The maximum LTV allowed for large loans is 80 percent; for small loans it is 75 percent. In addition, the borrower is required to retain recourse liability of at least 25 percent for small mortgages. Borrowers of large mortgages typically are not required to retain recourse.

Fannie Mae introduced the 5-50 Streamlined Mortgage Loan for small multifamily properties as a permanent product in May 2000. The product features streamlined underwriting and documentation requirements, designed to reduce the cost and time to finance multifamily properties with five to 50 apartment units. For example, the appraisal form required for the 5-50 program is half the length of the form required for larger multifamily loans (four pages compared with eight). Additional features include use of FICO scores to evaluate borrower creditworthiness and recourse to the borrower in the event of default.¹⁰⁰

Underwriting standards for the 5-50 product are similar to those for Fannie Mae's multifamily DUS product line in general. Specifically, the minimum DSC ratio and the maximum LTV are the same for loans originated under the 5-50 program and those originated under the DUS product line. In addition to the size requirement, properties obtaining financing under the 5-50 product must be affordable at 100 percent of area median income. Fannie Mae's plans for 2000 were to do \$750 million of small loan volume. Of Fannie Mae's DUS lenders, 19 are currently authorized to provide Fannie Mae's 5-50 Streamlined Mortgage product (Pikramenos, 2000).

Multifamily Properties with Significant Rehabilitation Needs

Multifamily properties with significant rehabilitation needs have also experienced difficulty in obtaining mortgage financing. Properties that are more than 10 years old are typically classified as "C" or "D" properties and are considered less attractive than newer properties by many lenders and investors.¹⁰¹ Multifamily rehabilitation loans accounted for only 0.5 percent of units backing Fannie Mae's 1998 purchases and for 1.6 percent in 1999. These loans accounted for 1.9 percent of Freddie Mac's 1998 multifamily total (with none indicated in 1999).

¹⁰⁰ "Fannie Mae Announces New 5-50(SM) Streamlined Mortgage for Small Multifamily Properties is Now Available Through DUS Lenders; 10-Year Volume Goal is \$18 Billion," Fannie Mae press release, May 10, 2000.

¹⁰¹ On the relation between age of property and quality classification see Jack Goodman and Brook Scott, "Rating the Quality of Multifamily Housing," *Real Estate Finance*, (Summer, 1997).

Housing for Seniors

According to a document prepared for an American Association of Retired Persons White House Conference on Aging Mini-Conference on Expanding Housing Choices for Older People, historically, the flow of capital into housing for seniors has been characterized by a great deal of volatility. A continuing lack of long-term, fixed-rate financing reportedly jeopardizes the feasibility of a number of properties. There is evidence that financing for new construction as well as rehabilitation remains scarce.¹⁰² Both Fannie Mae and Freddie Mac offer Senior Housing pilot programs.

5.3 Fair Lending

The third policy issue considered under the scope of work for this project is the applicability of the fair housing and fair lending legislation to the GSEs' underwriting and appraisal requirements. The section first shows that it is reasonable to assume that these laws apply to GSE purchases of loans for multifamily properties and then explores the potential for disproportionate adverse impacts on protected groups that may result from the GSEs' underwriting and appraisal requirements.

Fair Lending Regulation

Two legislative provisions apply to the GSEs' underwriting and appraisal requirements, as do relevant court cases that demonstrate interpretation of this legislation. The legislative provisions are:

- Section 1325 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA), which refers broadly to the underwriting and appraisal requirements and standards of the GSEs and outlines HUD's regulatory responsibility in prohibiting discriminatory impacts of the GSEs' operations (see Exhibit 5-3); and
- The provisions of the Fair Housing Act that relate to the provision of mortgage loans. (42 USC 3605)¹⁰³

Although the GSEs are not lenders *per se*, they are involved in the lending-decision process through their seller/servicer networks (i.e., DUS lenders for Fannie Mae and Program Plus

¹⁰² W. Donald Campbell. *Seniors Housing Finance*, prepared for American Association of Retired Persons White House Conference on Aging Mini-Conference on Expanding Housing Choices for Older People, (January 26-27, 1995).

¹⁰³ Fair Housing Act-based regulation also specifically covers discrimination in the purchasing of loans or pools of loans. 24CFR 100.125.

lenders for Freddie Mac) and through their business relationships and practices as prescribed in their Guides.¹⁰⁴

Therefore, the Policy Statement on Discrimination in Lending, published on April 15, 1994, applies to the GSEs as well as to primary lenders. This statement was prepared jointly by HUD, Office of Federal Housing Enterprise Oversight, Department of Justice, Department of Treasury, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Board, Federal Trade Commission, and the National Credit Union Administration. The policy statement is based upon the Equal Credit Opportunity Act (enacted in 1974) and the Fair Housing Act (enacted in 1968) as outlined in Exhibit 5-4.

The fair lending issue raised in this study is whether the GSE multifamily underwriting and appraisal requirements are consistent with the Fair Housing Act and with FHEFSSA. For example, do the underwriting requirements that require the consideration of the age or location of a multifamily development or the age of its neighborhood or census tract location have a “discriminatory effect” on protected classes? If so, HUD itself under FHEFSSA 1325 would have a basis for action. Exhibit 5-5 presents the relevant legal concept of “disproportionate adverse impact” based on the Policy Statement and a General Accounting Office report on fair lending issues.

¹⁰⁴ The fundamental statutory references regarding possible discriminatory practices by the GSEs are in the FHEFSSA Section 1325 and in HUD’s Final Rule published on December 1, 1995, which are what defines HUD’s role as a regulator.

Exhibit 5-3

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA): Section 1325. Fair Housing

The Secretary shall:

- by regulation, prohibit each enterprise from discriminating in any manner in the purchase of any mortgage because of race, color, religion, sex, handicap, familial status, age, or national origin, including any consideration of the age or location of the dwelling or the age of the neighborhood or census tract where the dwelling is located in a manner that has a discriminatory effect;
- by regulation, require each enterprise to submit data to the Secretary to assist the Secretary in investigating whether a mortgage lender with which the enterprise does business has failed to comply with the Fair Housing Act;
- by regulation, require each enterprise to submit data to the Secretary to assist in investigating whether a mortgage lender with which the enterprise does business has failed to comply with the Equal Credit Opportunity Act, and shall submit any such information received to the appropriate Federal Agencies, as provided in section 704 of the Equal Credit Opportunity Act, for appropriate action;
- obtain information from other regulatory and enforcement agencies of the Federal Government, State and local governments regarding violations by lenders of the Fair Housing Act and the Equal Credit Opportunity Act and make such information available to the enterprises:
- direct the enterprises to undertake various remedial actions, including suspension, probation, reprimand, or settlement, against lenders that have been found to have engaged in discriminatory lending practices in violation of the Fair Housing Act or the Equal Credit Opportunity Act, pursuant to a final adjudication on the record, and after opportunity for an administrative hearing, in accordance with subchapter II of chapter 5 of title 5, United States Code; and
- periodically review and comment on the underwriting and appraisal requirements of each enterprise to ensure that such requirements are consistent with the Fair Housing Act and this section.

Exhibit 5-4 Policy Statement on Discrimination in Lending

The **Equal Credit Opportunity Act (ECOA)** prohibits discrimination with respect to any aspect of a credit transaction based on:

- Race or Color;
- Religion;
- National Origin;
- Sex;
- Marital Status;
- Age;
- The Applicant's Receipt of Public Assistance; or
- The Applicant's exercise, in good faith, of any right under the Consumer Credit Protection Act.

The **Fair Housing Act** prohibits discrimination in all aspects of residential real-estate related transactions, including, but not limited to:

- Making *or purchasing* loans to purchase, construct, improve, repair, or maintain a dwelling;
- Selling, brokering, or appraising residential real property;¹⁰⁴

The **Fair Housing Act** prohibits discrimination based on:

- Race or Color;
- National Origin;
- Religion;
- Sex;
- Familial Status; and
- Handicap.

Types of Lending Discrimination

- **Overt Evidence of Discrimination:** open discrimination on a prohibited basis.
- **Evidence of Disparate Treatment:** occurs when a lender treats a credit applicant differently based on one of the prohibited bases.
- **Evidence of Disparate Impact:** occurs when a lender applies a policy or practice equally to credit applicants, but the policy or practice has a disproportionate adverse impact on applicants from a group protected against discrimination without business necessity. Even if business necessity exists, the policy or practice would be considered discriminatory if an alternative policy exists that would have less adverse impact. Whether the plaintiff or the defendant bears the burden of proof on the less discriminatory alternative prong of the adverse impact standard has yet to be definitively resolved under the Fair Housing Act.

¹⁰⁵ Concerning appraisals, it is stated that nothing in this title of the Act prohibits a person engaged in the business of furnishing appraisals of real property to take into consideration factors other than the six factors listed below in this exhibit.

Exhibit 5-5

Disproportionate Adverse Impact: The Definition, the Difficulty of Identification, and an Example

According to the Interagency Policy Statement on Discrimination in Lending (1994), evidence of a disparate impact is as follows:

When a lender applies a policy or practice equally to credit applicants, but the policy or practice has a *disproportionate adverse impact* [emphasis added] on applicants from a group protected against discrimination, the policy or practice is described as having a “disparate impact.” Policies and practices that are neutral on their face and that are applied equally may still, on a prohibited basis, disproportionately and adversely affect a person’s access to credit.

According to GAO (1996), disproportionate adverse impact is a type of lending discrimination with the following characteristics:^a

Occurs when a seemingly innocuous policy or practice is applied equally to all credit applicants but with the result that the policy or practice has a disproportionate adverse impact on applicants from a protected group. It must be the case that the policy or practice is not justified by a business necessity and that a less discriminatory alternative does not exist.

Among the three types of lending discrimination (blatant or overt discrimination, disparate treatment, and disparate or adverse impact), the third one is the most difficult to detect and requires several steps to determine its existence. According to GAO (1996), identification requires the following steps:

First, the existence of disparate impact must be established. Frequently this is done by quantitative or statistical analysis. Once a disparate impact has been identified, it must then be determined if the policy or practice is justified by business necessity. If so, it must then be shown that a less discriminatory alternative to the policy or practice existed and that the lender refused to adopt the alternative policy.

The example of disparate/adverse impact in the single-family realm as shown in GAO (1996) is as follows:

A lender’s policy is not to extend loans for single family residences for less than \$60,000. This minimum loan amount policy is shown to disproportionately exclude potential minority applicants from consideration because their income levels or the value of the houses in the areas where they live typically would qualify them only for smaller loan amounts. The lender would be required to justify the business necessity for the policy.

A similar example could easily apply to multifamily properties, especially if the lender set a floor for the loan amount at \$1,000,000. This minimum loan policy could disproportionately exclude from consideration, applications from minority borrowers, especially on small multifamily properties in inner city areas that are disproportionately minority neighborhoods. Furthermore, this policy could disproportionately affect the tenants of the small properties who also could be members of one of the protected classes shown in Exhibit 5-3.

^a The following definition, statement regarding the ease of identification, and the single-family example are drawn from GAO (1996) which adopted this version from the Interagency Policy Statement on Discrimination in Lending (1994).

Recent court cases shed further light on the application of fair lending law to GSE multifamily underwriting standards.¹⁰⁶ For example, in the context of multifamily housing, courts have held that the Fair Housing Act provides a cause of action to white landlords who claim they were denied loans for their apartment complexes because of the racial composition of the tenants and the location of their buildings in predominantly minority areas. *Simms v. First Gibraltar Bank, FSB (now known as First Madison Bank, FSB)*.¹⁰⁷ In *Ring v. First Interstate Mortgage Inc and Federal National Mortgage Association*, a white developer was found to have cause of action under the Fair Housing Act against both the originating lender and Fannie Mae for allegedly refusing to extend credit for seven apartment buildings because of the racial composition of the neighborhoods in which they were located.¹⁰⁸

While the Fair Housing Act prohibits both intentional and effects-related discrimination in multifamily credit transactions, something of a grey area exists regarding the responsibilities of lenders for impacts on members of a protected class (e.g., minority tenants) who are not themselves applicants for credit. Congress intended that the Fair Housing Act protect any “person” who claims to have been injured by a discriminatory housing practice.¹⁰⁹ In *Trafficante v. Metropolitan Life Insurance Company*,¹¹⁰ the Supreme Court held that this provision should be broadly construed so as to promote an important goal of the Act—the replacement of the ghettos and the fostering of “truly integrated and balanced living patterns.”¹¹¹ In *Trafficante* then current tenants in an apartment complex (both white and minority) were allowed to sue their landlord for discriminating against minority applicants for apartments. By parity of reasoning, one might conclude that tenants of an apartment complex who allege they were harmed by the refusal of a lender to provide credit to the owners of their complex on a prohibited basis have a cause of action against the lender and/or secondary market purchaser.

If challenges to credit transactions are brought under the discriminatory impact standard of the Fair Housing Act (whether by the actual credit applicant or aggrieved tenants), it seems clear that the plaintiffs will have to identify a policy, procedure, or practice that is allegedly causing the adverse impact and the extent of the impact. In *Simms v. First Gibraltar Bank supra*, the Fifth Circuit reversed a lower court jury finding that the lender had engaged in an

¹⁰⁶ The information provided in this discussion is based on several communications with Attorney Richard Ritter, formerly the U.S. Department of Justice, and currently a private fair lending consultant (with the Washington Lawyers’ Committee for Civil Rights and Urban Affairs). The information provided by Mr. Ritter does not necessarily reflect the views of the Department of Justice.

¹⁰⁷ 83 F.3d 1546 (5th Cir. 1996)

¹⁰⁸ 984 F. 2d 924 (8th Cir. 1993)

¹⁰⁹ 42 U.S.C. Sec. 3602(I)(1).

¹¹⁰ 409 U.S. 205 (1972).

¹¹¹ 409 U.S. at 211.

unlawful credit practice under the disparate impact standard of the Fair Housing Act because the plaintiff could not point to an underwriting standard, practice, or procedure that had any generalized adverse impact on minorities or residents of minority areas. The only evidence presented was that a loan was denied on an apartment complex occupied by minorities in a predominately minority area. That standing alone was not sufficient to establish a violation of the Act under the disparate impact standard.

Although the defendant prevailed, if the plaintiff in *Simms* had shown that a specific underwriting requirement or standard with adverse effects caused the rejection of his loan application—such as a minimum loan amount that would disproportionately exclude the financing of multifamily housing in minority areas (because developers of properties in those areas were less likely to seek loans above the minimum)—a *prima facie* violation of the disparate impact standard would have been established. At that point, the lender would have had to prove the business necessity for the challenged underwriting practice and the jury could hear evidence of a less discriminatory alternative.¹¹² In cases like *Simms*, plaintiffs could also conceivably challenge the lender’s overall underwriting guidelines under the disparate impact standard if they were subject to discretionary application or interpretation by the bank’s underwriters. *Buycks-Roberson v. Citibank FSB*,¹¹³ permits a class-wide challenge to the lender’s subjective underwriting system under disparate impact theory.

A discrimination case about property insurance for single family housing offers a possible parallel to multifamily properties. In that suit, *NAACP v. American Family Mutual Insurance Company*,¹¹⁴ the underwriting guidelines of single-family property insurers were challenged in eight redlining lawsuits under the Fair Housing Act. The eight suits were combined into a class action suit because a whole neighborhood in Milwaukee was affected by the property insurance underwriting guidelines. Under a consent decree settlement, American Family agreed to changes in marketing, training, and underwriting standards for their insurance policies. They also agreed to increase their marketing and customer service presence in the minority community in Milwaukee and to pay a \$14.5 million settlement. In the consent decree, American Family also agreed *not* to take into consideration the condition of other homes in the neighborhood, the racial composition of the neighborhood, or the age of the home. Instead, they agreed to revise their underwriting guidelines to consider only “objective standards that are directly related to loss or damage.” (p. 12) While a settlement of this kind may not have the same standing as case law, it is relevant to discussions and analyses of fair lending issues in the multifamily mortgage market.

¹¹² Whether the plaintiff or the defendant bears the burden of proof on the less discriminatory alternative prong of the adverse impact standard has yet to be definitively resolved under the Fair Housing Act.

¹¹³ 162 F.R.D. 322 (N.D. Ill 1995)

¹¹⁴ 978 F.2d 287 (7th Cir. 1992), *cert. denied*, 113 S.Ct. 2335 (1993)

These cases provide a strong indication that the fair lending laws apply to multifamily purchases, and how these laws apply. Thus, the GSE underwriting and appraisal requirements must not affect protected classes adversely. If they do affect protected classes adversely, business necessity must be shown, as must the absence of less discriminatory alternatives.

Potential Effects of the GSEs' Underwriting and Appraisal Requirements on Protected Classes

There are two ways in which some of the GSEs' underwriting requirements and standards for multifamily housing may, in fact, have the potential for adverse impact. These areas deserve further examination under HUD's fulfillment of its obligations under FHEFSSA to review and comment on the underwriting and appraisal guidelines of each enterprise to ensure that they are consistent with the Fair Housing Act and FHEFFSA.

- GSE underwriting guidelines may directly affect older neighborhoods by establishing different standards for older properties. These neighborhoods are protected themselves and also may include a disproportionately high concentration of minority residents.
- GSE underwriting guidelines also indicate that market strength should be used as a consideration in multifamily underwriting. Market strength may be correlated with factors with respect to which discrimination is prohibited such as geographic areas where members of protected classes reside.

Factors Relating to Older Properties

FHEFSSA prohibits the GSEs from considering the age of a property in purchase decisions in a manner that has a discriminatory effect. Very few of the GSEs' underwriting and appraisal requirements apply specifically to older properties. Fannie Mae's DUS Guide specifically states that properties in older neighborhoods are eligible for purchase:

A neighborhood analysis should consider the influence of social, economic, government, and environmental forces on property values in the subject neighborhood. However, neither the racial composition nor the age of a neighborhood is an Appraisal factor. A property located in an older neighborhood can be as sound an investment as a property located in a newer neighborhood (Fannie Mae, III, 507.04, 9/30/99)

However, Fannie Mae's subordinate financing requirements for older properties are stricter than requirements for newer properties. The combined DSC for the first mortgage and all subordinate loans must be, at a minimum, the greater of:

- The DSC applicable to the first mortgage at the time of purchase; or
- 1.20 for properties more than 10 years old; or
- 1.15 for properties 10 years old or less. (Fannie Mae, VI, 108.01, 9/30/99)

In addition, lenders must examine the real estate owned by each of the key principals. Fannie Mae underwriting guidelines state that when underwriting a property other properties owned by the key principals must be examined and “older properties or properties in softer markets should be more highly capitalized than newer properties in stronger markets.” (Fannie Mae, III, 605.03, 11/23/99.) This underwriting requirement does not directly affect the property being financed, but may have an important indirect effect. Multifamily property owners who want to finance additional properties through Fannie Mae must either incur greater expense for other older properties they own or they may be discouraged from owning older properties.

Perhaps more important than the GSEs’ written underwriting guidelines is the perception that the GSEs typically prefer “Class A” properties (newer housing stock that is less than 10 years old). This inference is based on the definition of “Class A” properties and the view (published in the press) that the GSEs purchase from the “A” mortgage category. Goodman and Scott (1997) examined several classifications for rating multifamily housing quality. “Class A” quality is most often defined as less than 10 years old. Class B properties are between 10 and 20 years old. While age is not an important variable by itself, and few of the GSEs’ guidelines mention age, it is a covariate of other important variables (e.g., basic structural systems, amenities, location, and rent level).

An article in the Washington Post on risk-based pricing describes the mainstream of the mortgage market, the “A” category, as eligible for sale to Fannie Mae and Freddie Mac (Harney, 1998). However, a few exceptions are offered (e.g. Fannie Mae) for financing of properties in the B+ to B- range, through the DUS lenders who assume the first loss position and 20 to 60 percent of total risk (Goodman, 1997). In a conversation with Freddie Mac regarding issues related to this research project, a spokesman for Freddie Mac confirmed this viewpoint by stating that Class BBB properties are the lowest they consider for investment.

Fannie Mae may be making efforts to change the perception in the industry that they prefer to buy loans on Class A properties. The only reference Fannie Mae’s underwriting guidelines to the classes of properties that are acceptable is in a description of Fannie Mae’s new 5-50 Streamlined Mortgage Loan product:

Fannie Mae prefers property owners with some multifamily management experience, a borrower portfolio that reflects good property maintenance, and affordable B- and C-class properties with stable income, expense and

vacancy histories and that have been well-maintained. (Fannie Mae, 2000-3, Attachment, 5/9/00.)

In this product, which is specifically for small multifamily properties that are affordable at 100 percent of area median income, Fannie Mae's guidelines encourage the delivery of loans on properties that are other than Class A. Because the 5-50 Streamlined Mortgage Loan product was introduced recently (in spring 2000), it is too early to tell whether this product is being widely used or accepted in the market and whether class B and C properties are actually being financed using the product. It is also not clear whether Fannie Mae's encouragement of Class B and C properties extends to other products or to large multifamily loans.

Factors Relating to Market Strength

Both GSEs have guidelines that include market strength as a consideration in multifamily underwriting for their prospective purchase of loans. Although fair lending laws do not prohibit this practice, market strength factors may be correlated with factors for which discrimination is prohibited, such as geographic areas where members of protected classes reside.

Fannie Mae cautions lenders about market areas evidencing weakness: "Lenders must exercise extreme caution in considering a loan in markets with poor market indicators or increased market risk factors. Additional analysis and support will be required for markets with any of the following characteristics:

- current occupancy levels less than 90 percent;
- a sustained downward trend in occupancy levels over the prior 12 months;
- seasonal occupancy;
- rent levels that are competitive with single-family housing; rent levels that are declining or have not kept pace with inflation over the last two years;
- markets in which concessions are high or increasing rapidly;
- markets experiencing unsustainable construction levels coupled with a sustained downward trend in occupancy levels;
- default and foreclosure rates which are high or rising rapidly;
- markets with over 15 percent of employment by a single employer or over 30;
- percent in a single industry; and

- shrinking employment base.

Properties located in markets with one or more of the characteristics listed above will be acceptable only if there are exceptional circumstances that have been fully documented by the Lender.”¹¹⁵

Freddie Mac provides the following instructions on acceptable mortgages: “Each Mortgage to be delivered to Freddie Mac must have characteristics that demonstrate high investment quality. These characteristics may include:

- Strong market (that is, low vacancy, minimal rental concessions, stable or increasing tenant demand, good balance of housing supply and demand, stable economic base, and employment diversification)
- Strong property operations (that is, low vacancy, minimal rental concessions, stable or increasing rents, and stable operating and maintenance expenses)
- Excellent property condition”¹¹⁶

Some of these underwriting guidelines—for example, employment base and property condition—are characteristics that might adversely affect minority areas and, from a fair lending standpoint, may be parallel to the emphasis on age of a property in the underwriting guidelines of property insurers. Although the GSEs are explicit about what is not to be considered (e.g., racial composition of the neighborhood), the issue remains as to how the requirements are actually implemented.

GSE Performance in Segments of the Multifamily Market

Fair lending questions are raised by empirical evidence that the GSEs lag in three sectors of the multifamily market:

- Purchases of loans in high-minority tracts;
- Purchases of loans on small multifamily properties, which are disproportionately minority-owned; and
- Purchases of loans for multifamily properties in underserved areas.

¹¹⁵ Fannie Mae Multifamily Guidelines Section 305.07

¹¹⁶ Freddie Mac Multifamily Seller/Service Guide, Chapter 6

Although the GSEs' relative lack of purchasing activity in these areas does not by itself demonstrate that the GSEs are violating fair lending legislation, it does raise the question of whether some of their underwriting and appraisal guidelines are having a disproportionate adverse impact on protected classes.

*The GSEs lag the overall multifamily mortgage market in purchasing loans backed by properties in high-minority census tracts.*¹¹⁷ Exhibits 5-6, 5-7, and 5-8 indicate that in the overall multifamily market, 35.8 percent of loans originated during 1993-1999 were for properties located in high-minority tracts, compared with 29.9 percent for Fannie Mae and 28.0 percent for Freddie Mac.¹¹⁸

Exhibit 5-6
Multifamily Originations, UPB, by Tract Percent Minority
1993-1999 Origination Year

Tract Percent Minority	1993	1994	1995	1996	1997	1998	1999	Total
All loans								
< 30%	63.0%	61.2%	65.3%	65.3%	64.2%	65.8%	63.6%	64.2%
>= 30%	37.0%	38.8%	34.7%	34.7%	35.8%	34.2%	36.4%	35.8%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
UPB < \$1 m.								
< 30%	54.8%	53.6%	54.1%	57.2%	56.0%	57.7%	54.9%	55.6%
>= 30%	45.2%	46.4%	45.9%	42.8%	44.0%	42.3%	45.1%	44.4%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: HMDA. Excludes loans under \$100,000. Absolute value used for loans with UPB < 0. Excludes missing data.

¹¹⁷ Because HMDA data does not provide information on number of units financed, these comparisons are in terms of unpaid principal balance (UPB). In the GSE Public Use Data Base, UPB is reported in the following ranges because of proprietary considerations: 0- \$500,000; \$500,000 - \$1 million; \$1 million - \$2 million; \$2 million - \$4 million; and more than \$4 million. For loans under \$4 million, UPB is estimated midpoints; e.g., all loans with a reported UPB in the range of \$500,000 - \$1 million are treated as having UPB of \$750,000. The UPB for loans over \$4 million is estimated using the figure which, when multiplied by the number of loans in this range, and added to estimated UPB for loans under \$4 million, equals total GSE acquisition volume. This calculation was performed separately for each GSE for each acquisition year.

¹¹⁸ The HMDA data, which are reported by year of loan origination, are not strictly comparable to the GSE data because of the GSEs' purchases of loans originated in calendar years prior to the acquisition date. However, combining years can reduce the magnitude of any resulting error.

Exhibit 5-7**Multifamily Acquisitions, Estimated UPB, by Tract Percent Minority*
Fannie Mae, 1993-1999 Acquisition Year**

Tract Percent Minority	1993	1994	1995	1996	1997	1998	1999	Total
All loans								
< 30%	73.7%	70.8%	62.7%	76.3%	72.2%	67.0%	70.8%	70.1%
>= 30%	26.3%	29.2%	37.3%	23.7%	27.8%	33.0%	29.2%	29.9%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
UPB < \$1 m.								
< 30%	50.2%	61.5%	38.2%	66.8%	71.1%	38.2%	56.5%	43.0%
>= 30%	49.8%	38.5%	61.8%	33.2%	28.9%	61.8%	43.5%	57.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: GSE Public Use Data Base. Excludes missing data.

* UPB estimated using midpoints of intervals.

Exhibit 5-8**Multifamily Acquisitions, Estimated UPB, by Tract Percent Minority*
Freddie Mac, 1993-1999 Acquisition Year**

Tract Percent Minority	1993	1994	1995	1996	1997	1998	1999	Total
All loans								
< 30%	61.5%	60.6%	71.3%	78.2%	73.3%	70.8%	72.7%	72.0%
>= 30%	38.5%	39.4%	28.7%	21.8%	26.7%	29.2%	27.3%	28.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
UPB < \$1 m.								
< 30%	65.6%	52.1%	63.4%	40.8%	34.9%	50.9%	53.6%	49.8%
>= 30%	34.4%	47.9%	36.6%	59.2%	65.1%	49.1%	46.4%	50.2%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: GSE Public Use Data Base. Excludes missing data.

* UPB estimated using midpoints of intervals.

The GSEs lag the overall multifamily mortgage market in purchasing loans backed by small multifamily properties. As shown in Exhibit 5-2 above, 4.2 percent of Fannie Mae's multifamily purchases were backed by properties with between 5 to 50 units, as were 2.1 percent of Freddie Mac's purchases. In contrast, nearly 40 percent of all units in recently mortgaged multifamily properties were in properties with 5 to 49 units. In addition, using the HUD Property Owners and Managers Survey data, Segal and Szymanoski (1998) show that the average multifamily property mortgaged in 1995 had 33.4 units. In contrast, the average number of units in Fannie Mae's 1996 multifamily purchases was 137, and the average number in Freddie Mac's was 189.¹¹⁹

¹¹⁹ As noted above, Schnare (2001) also showed that the GSEs lagged the market when size is defined as the dollar amount of the loan.

The lag in purchasing loans backed by small multifamily properties has two potential implications for fair lending. First, loans backed by small multifamily properties are more likely than loans backed by larger properties to cover properties in high-minority areas. For example, in the multifamily origination mortgage market 44.4 percent of loans under \$1 million originated during 1993-1999 were located in high-minority tracts, compared with only 35.8 percent overall. (Exhibit 5-6) During 1993-1999, 57.0 percent of Fannie Mae acquisitions of loans backed by small multifamily properties were in high-minority tracts, compared with only 29.9 percent overall. The Freddie Mac data show 52.2 percent of loans backed by small multifamily properties in high-minority tracts, compared with 28.0 percent of overall multifamily transactions volume.

Thus, disparity between the GSEs and the mortgage market in multifamily lending for properties in high-minority tracts can be explained, in part, by their extraordinarily small transactions volume involving small properties.

Furthermore, to the limited degree that multifamily properties are identified as owned by African Americans, such ownership appears to be concentrated among small properties, especially those with 5-19 units. Based on the HUD Property Owners and Managers Survey, conducted during 1995-1996, 59.5 percent of units in multifamily properties identified as owned by African Americans were in properties with 5-19 units, compared with only 32.7 percent of units in properties owned by whites. Of all properties where race of owner was identified, African-American ownership accounted for 4.1 percent of units in properties with 5-19 units, compared with only 2.3 of multifamily units overall. Thus the GSEs' failure to buy significant numbers of loans on small multifamily properties appears especially disadvantageous to African American multifamily property owners.

The GSEs lag the multifamily market in mortgage lending backed by properties in underserved areas, which may include high concentrations of minority residents.¹²⁰ Exhibit 5-9 shows that Fannie Mae's and Freddie Mac's originations in served areas exceed those in underserved areas. The discrepancy is particularly large between suburban served and underserved areas. More importantly, GSE originations in central city underserved areas lag originations in these areas by both banks and thrifts. The GSEs lag thrift institutions and the FHA 223(f) program in originations in suburban underserved areas. A relatively large proportion of the GSEs' originations is in suburban served areas.¹²¹

¹²⁰ "Underserved areas" for OMB-defined metropolitan census tracts (and non-metropolitan counties), with (1) median tract income at or below 90 percent of AMI (95 percent in non-metropolitan areas), or (2) minority concentration of at least 30 percent with median tract (or county) or income no greater than 120 percent of AMI.

¹²¹ A similar point is made in Schnare (2001) Table 6.

Exhibit 5-9

Multifamily Industry Comparisons: Percentage of Unpaid Principal Balance by Central City¹/Suburban Areas and by Served/Underserved² Areas, 1994-96

Metropolitan Statistical Areas Only

	FHA Data ³		Home Mortgage Disclosure Act (HMDA) Data ^{3, 5, 6}		GSE Public Use Data ^{3, 5, 7}	
	221(d)(4) ⁴	223(f) ⁴	Banks	Thrifts	Fannie Mae	Freddie Mac
Central City	62.0	49.8	64.3	63.2	55.7	52.3
Served	37.8	27.2	31.6	25.8	29.6	27.7
Underserved	24.2	22.6	32.7	37.4	26.1	24.7
Suburban	38.0	50.2	35.7	36.8	44.3	47.7
Served	31.1	30.4	24.1	19.2	28.1	33.0
Underserved	6.9	19.8	11.6	17.6	16.2	14.7
Total						
Served	68.8	57.6	55.7	45.0	57.7	60.6
Underserved	31.2	42.4	44.3	55.0	42.3	39.4

¹ *Central City* includes all census tracts, any portion of which is within the boundaries of a central city.

² *Underserved* defined per GSE Final Rule.

³ FHA data for fiscal years 1994-96; HMDA and GSE data for calendar years 1994-96.

⁴ FHA 221(d)(4) is primarily new construction; 223(f) is refinance and purchase of existing construction

⁵ HMDA and GSE data include a mix of new construction and refinance/purchase of existing construction.

⁶ HMDA data exclude FHA-insured loans and GSE current-year purchases. HMDA data subject to significant underreporting by commercial banks.

⁷ GSE data include a small number of FHA-insured loans. GSE unpaid principal balance (UPB) estimated using midpoints of intervals in PUDB.

Sources: FHA fiscal year 1994-96 Multifamily Initial Endorsements Data Base; HMDA data; GSE Public Use Data Base

In summary, our review of the GSEs' underwriting requirements and standards for multifamily housing has identified two aspects that may have the potential for adverse impact. First, GSE underwriting guidelines may directly affect older neighborhoods by establishing different standards for older properties. These neighborhoods are protected themselves and also may include a disproportionately high concentration of minority residents. Second, GSE underwriting guidelines also indicate that market strength should be used as a consideration in multifamily underwriting. Market strength may be correlated with factors with respect to which discrimination is prohibited such as geographic areas where members of protected classes reside.

In addition, there is empirical evidence that the GSEs lag in three sectors of the multifamily market that may have fair lending implications: purchases of loans in high-minority tracts; purchases of loans backed by small multifamily properties, which are disproportionately for minority-owned properties; and purchases of loans for multifamily properties in underserved areas. Although the GSEs' relative lack of purchasing activity in these areas does not by itself demonstrate that the GSEs are violating fair lending legislation, it does raise the question of whether some of their underwriting and appraisal guidelines are having a disproportionate adverse impact on protected classes.

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Chapter Six

Background on Lender Interview Sites and GSE Activity

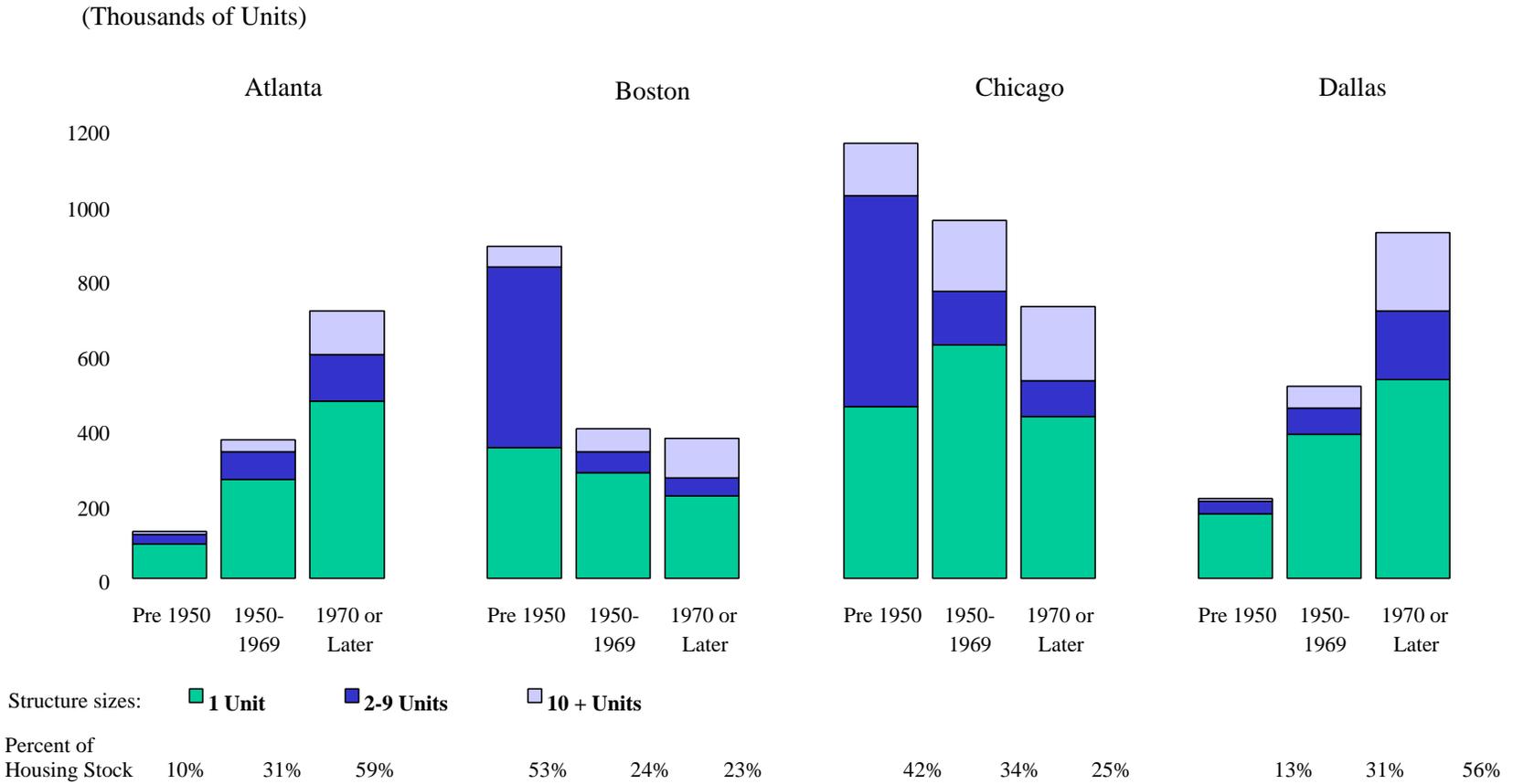
The sites selected for the interviews with multifamily lenders were Atlanta, Boston, Chicago, and Dallas. This site selection was based on analysis of HUD-provided data (Property Operators and Managers Survey (POMS) and GSE data) and was approved by HUD. The sites selected were markets where there was a high level of multifamily market activity (POMS data) and relatively high purchasing activity for both of the GSEs. These sites also provided variation in the types of multifamily housing stock, originating lenders, lending experience in the multifamily market, and age of the housing stock.

Exhibit 6-1 indicates that the housing stock in Boston and Chicago is much older than the stock in Atlanta or Dallas.¹²² As shown in Exhibit 6-1, approximately 75 percent of the housing stock in Boston and Chicago is at least 28 years old and both cities have substantial multifamily stock that is approaching 50 years old. On the other hand, approximately 40 percent of the housing stock in both Atlanta and Dallas is at least 28 years old and approximately 50 percent of their multifamily housing stock was built since 1970. As discussed in Chapter 5, the GSEs typically prefer “Class A” properties (newer housing stock that is less than 10 years old). As a result, the Boston and Chicago markets are more likely to encounter underwriting challenges for purchases of multifamily loans in the older affordable segments of the multifamily housing markets.

As discussed in Chapter 3, the GSEs have a preference for larger multifamily properties. Freddie Mac’s underwriting guidelines for small multifamily properties are explicitly more stringent than those for large multifamily properties, and Fannie Mae only very recently introduced a product designed specifically to reduced transactions costs associated with underwriting small multifamily mortgages. As a result, the GSEs’ multifamily financing activity is concentrated in larger multifamily properties. Exhibit 6-2 compares the GSEs’ purchases of multifamily loans with UPBs of less than \$1 million with non-GSE financing of these loans in each city between 1993-1999. From this exhibit, it is evident that in general, the GSEs’ role in financing small multifamily properties in these cities is minor. In Boston, where only 25 percent of the rental housing stock is in multifamily properties with more than 20 units, the GSEs together financed less than 2 percent of all small multifamily properties in this period. The GSEs’ presence appears to be most significant in Atlanta, where they accounted for 14 percent of small multifamily financing activity in 1993-1993.

¹²² The data in Exhibit 6-1 includes both single family and multifamily housing.

**Exhibit 6-1
Metro Area Housing Stock by Year Built and Structure Size^a**



^aThe housing stock includes both single family and multifamily.

Source: Joint Center Tabulations of 1989, 1990, 1991, and 1992 American Housing Surveys.

Exhibit 6-2**Fannie Mae, Freddie Mac, and HMDA: 1993-1999****Number of Multifamily Loans by Year with UPB less than \$1 Million**

	1993	1994	1995	1996	1997	1998	1999	Total
Atlanta, GA MSA								
Fannie Mae	0	5	5	2	2	17	0	31
Freddie Mac	3	2	1	1	2	13	3	25
HMDA	28	24	27	43	62	99	69	352
Total	31	31	33	46	66	129	72	408
Boston, MA-NH PMSA								
Fannie Mae	8	0	3	4	0	0	4	19
Freddie Mac	0	1	0	2	3	11	8	25
HMDA	147	250	216	320	369	584	647	2533
Total	155	251	219	326	372	595	659	2577
Chicago, IL PMSA								
Fannie Mae	259	15	568	3	1	54	15	915
Freddie Mac	0	2	0	1	0	3	0	6
HMDA	2216	2159	1636	2043	2003	2794	2862	15713
Total	2475	2176	2204	2047	2004	2851	2877	16634
Dallas, TX PMSA								
Fannie Mae	3	5	2	0	3	3	6	22
Freddie Mac	0	3	0	4	2	18	5	32
HMDA	38	40	87	97	105	131	108	606
Total	41	48	89	101	110	152	119	660

Although the GSEs' activity in Chicago in this period accounted for only 6 percent of total activity, in one year, 1995, Fannie Mae financed more than a third of small multifamily mortgages. This appears to have been the result of several purchases of pools of small multifamily mortgages, and activity in following years fell to insignificant levels. In fact, without the unusual activity in 1995, the GSEs would have accounted for only about 2 percent of small multifamily financing in 1993-1999.

As might be expected given the GSEs' preference for newer housing stock and larger multifamily properties, the GSEs' purchase activity in Boston and Chicago represented a very small portion of overall multifamily financing activity in those markets – about 9 percent in Boston and 6.3 percent in Chicago. In contrast, the GSEs' purchases accounted for more than a third of multifamily financing activity in Atlanta and Dallas.

In general, it does not appear that GSE purchases are any more concentrated in low minority areas than non-GSE activity in these four cities. Exhibit 6-3 shows that taken together, the multifamily properties the GSEs financed in 1993-1999 were less concentrated in low-minority census tracts than properties financed by other market participants in every city

examined here except Dallas. The GSEs' low concentration in low-minority areas relative to other market participants is unexpected, because it is in contrast to the GSEs' performance generally. As discussed in Chapter 5, overall, the GSEs' purchases are more concentrated in low-minority areas than are all multifamily originations in the market. Exhibit 5-7, 5-8, and 5-9 show that of the GSEs' multifamily purchases, just over 70 percent are in census where minorities make up less than 30 percent of the population. In contrast, about 64 percent of all multifamily originations are in low-minority census tracts.

Exhibit 6-3

Fannie Mae, Freddie Mac, and HMDA: 1993-1999

Percent of Multifamily Loans Financed by 1990 U.S. Census Tract Percent Minority

	Dallas	Chicago	Boston	Atlanta
Combined FNMA and FHLMC				
less than 10 percent	6.4	10.2	16.8	9.3
10-30 percent	51.1	30.1	38.1	39.9
31-50 percent	20.1	22.3	22.1	12.1
51-80 percent	17.1	17.4	11.5	16.5
greater than 80 percent	5.3	20.1	11.5	22.2
Fannie Mae				
less than 10 percent	6.0	9.9	8.0	10.4
10-30 percent	57.1	29.1	38.0	37.5
31-50 percent	18.2	23.1	18.0	13.9
51-80 percent	13.1	17.8	16.0	16.0
greater than 80 percent	5.7	20.1	20.0	22.2
Freddie Mac				
less than 10 percent	7.2	15.6	23.8	7.7
10-30 percent	39.4	51.1	38.1	43.3
31-50 percent	23.9	4.4	25.4	9.6
51-80 percent	25.0	8.9	7.9	17.3
greater than 80 percent	4.4	20.0	4.8	22.1
HMDA				
less than 10 percent	7.7	16.2	28.2	10.3
10-30 percent	39.5	27.8	31.1	41.0
31-50 percent	18.5	18.3	16.4	13.2
51-80 percent	26.2	19.2	13.9	13.7
greater than 80 percent	8.2	18.4	10.5	21.9

Financing for all market participants was concentrated in low-minority census tracts. In all four cities, at least 60 percent of both GSE activity and non-GSE activity reported in HMDA data was concentrated in census tracts where minorities represent less than half of the

population.¹²³ Forty percent or less of multifamily financing activity in 1993-1999 was in census tracts where minorities accounted for more than half the population.

In comparing the role of the two GSEs, Exhibits 6-6 and 6-7 also show that Fannie Mae played a far greater role in multifamily financing in Dallas and Chicago than Freddie Mac. In Atlanta (Exhibit 6-4), the GSEs' levels of multifamily purchases were more similar than in Dallas and Chicago, although Fannie Mae also played a greater role in this market than did Freddie Mac. Boston (Exhibit 6-5) was the only one of the four markets examined here during 1993-1999 where Freddie Mac purchased more multifamily mortgages than Fannie Mae did.

The following sections describe the four markets based on the comments of both the national experts and the lenders interviewed. Most of the experts and lenders interviewed had a national perspective of the multifamily market. In the Chicago market, however, the majority of interviews with local lenders (who had negotiated unsuccessfully for years with one or both GSEs) focused on the "local" market perspective.

6.1 Atlanta

The multifamily housing stock in Atlanta divides into several sub-markets: the high-rise towers and walk-ups within the city and the sprawling garden apartments (mostly) in suburbia. Among the four sites, Atlanta is the one with the newest multifamily housing stock. Approximately half of the Atlanta multifamily stock was built since 1970, and there has been considerable expansion in the past decade. Despite high levels of multifamily construction in 1999, which threatened to overbuild the market, Atlanta's strong job creation and migration of people to fill those jobs kept vacancy rates low. Through September 2000, vacancy rates in the Atlanta MSA had fallen to 6.55 percent from 1999's level of 7.4 percent (Crawford, 2000).

The map of Atlanta shows the geographic distribution of multifamily loans acquired by the GSEs in Atlanta. The same data is presented by year of purchase in Exhibit 6-4. This exhibit and the map show that between 1993-1999, about 60 percent of the GSEs' acquisitions were in census tracts where minorities accounted for 50 percent or less of the population. HMDA data show that activity for non-GSE participants in the Atlanta market was actually slightly more concentrated in low-minority census tracts than the GSEs' activity.

¹²³ The tract minority population levels are based on the 1990 Census data.

Exhibit 6-4**Atlanta, GA (DeKalb and Fulton Counties), Fannie Mae, Freddie Mac, and HMDA: 1993-1999****Number of Loans by Year and 1990 U.S. Census Tract Percent Minority**

	1993	1994	1995	1996	1997	1998	1999	Total
Fannie Mae								
less than 10 percent	1	2	4	2	0	2	4	15
10-30 percent	6	8	7	9	7	9	8	54
31-50 percent	0	1	3	5	3	5	3	20
51-80 percent	0	4	1	5	3	5	5	23
greater than 80 percent	0	4	12	3	3	3	7	32
Total	7	19	27	24	16	24	27	144
Freddie Mac								
less than 10 percent	0	0	0	1	1	2	4	8
10-30 percent	0	2	5	6	6	12	14	45
31-50 percent	1	0	1	0	0	5	3	10
51-80 percent	1	0	1	0	2	10	4	18
Greater than 80 percent	1	1	2	2	2	9	6	23
Total	3	3	9	9	11	38	31	104
HMDA								
less than 10 percent	2	0	3	3	10	16	11	45
10-30 percent	10	16	21	24	36	49	24	180
31-50 percent	1	1	8	7	10	17	14	58
51-80 percent	3	8	10	11	4	8	16	60
Greater than 80 percent	5	11	8	12	13	26	21	96
Total	21	36	50	57	73	116	86	439

6.2 Boston

The Boston multifamily market is considered a “mature” multifamily market, with most of its stock developed prior to 1950. This is unlikely to change in the near future, as very few new apartments are built in Boston each year. In 1999, Boston ranked 36th among housing markets for the number of multifamily permits issued despite being the sixth largest housing market. This was not a result of lack of demand: in 1999, occupancy rates reached 97.9 percent – the second highest occupancy rate in the nation (Pikramenos, 2000).

In addition to the age of Boston’s multifamily housing stock, according to the lenders interviewed, much of the Boston rental housing stock is small and does not meet Fannie Mae’s and Freddie Mac’s typical scale for an approvable “multifamily” deal. Forty-five percent of the Boston’s rental stock is defined as single family. (Twenty percent of the rental stock is in properties with one to two housing units. Another 25 percent of the rental stock is in properties with three to four housing units.) Thirty percent of the rental stock is in

multifamily properties with between five and 20 units. The remaining rental stock (25 percent) is in properties with greater than 20 units.

There is little GSE activity in the Boston market except for refinances. Exhibit 6-5 and the corresponding map show that more than 75 percent of the GSEs' activity in 1993-1999 in Boston was in census tracts where minorities accounted for 50 percent or less of the population. HMDA data show a similar concentration of multifamily financing activity in low-minority census tracts for non-GSE participants in the Boston market.

Exhibit 6-5
Boston, MA (Suffolk County), Fannie Mae, Freddie Mac, and HMDA: 1993-1999
Number of Loans by Year and 1990 U.S. Census Tract Percent Minority

	1993	1994	1995	1996	1997	1998	1999	Total
Fannie Mae								
less than 10 percent	1	0	0	0	0	0	3	4
10-30 percent	2	4	1	5	0	1	6	19
31-50 percent	0	1	4	2	0	2	0	9
51-80 percent	4	0	2	0	1	1	0	8
Greater than 80 percent	5	0	4	1	0	0	0	10
Total	12	5	11	8	1	4	9	50
Freddie Mac								
less than 10 percent	0	0	0	8	0	3	4	15
10-30 percent	0	0	1	0	0	19	4	24
31-50 percent	0	1	0	1	1	8	5	16
51-80 percent	0	0	0	0	3	2	0	5
Greater than 80 percent	0	0	0	0	1	1	1	3
Total	0	1	1	9	5	33	14	63
HMDA								
less than 10 percent	20	29	39	44	47	75	61	315
10-30 percent	16	36	35	46	40	94	81	348
31-50 percent	15	23	12	27	26	38	43	184
51-80 percent	8	9	11	19	19	43	46	155
Greater than 80 percent	3	8	9	9	21	29	38	117
Total	62	105	106	145	153	276	269	1119

6.3 Chicago

Like Boston, Chicago is another “mature” multifamily market. Neither the housing stock nor the structure of the typical multifamily loan documents are generally consistent with Fannie Mae’s and Freddie Mac’s purchase standards, according to lenders interviewed. The typical affordable multifamily housing property is a three-story walkup that is over 40 years old. These properties neither offer what the GSEs consider “standard” amenities – vanity under the sink, swimming pool and parking on site – nor do the GSEs agree with what local lenders

consider amenities. For example, Chicago developed one of the early (and efficient) public transportation systems. According to the local lenders, the local population considered the rail system an amenity. Even affluent single family property owners considered close proximity to the trains as an advantage. But lenders say that Fannie Mae and Freddie Mac regard this as a negative factor.¹²⁴

Chicago also has several large financial institutions with a long track record of supporting community development lending in the low- and moderate-income neighborhoods. What began as CRA initiatives have taken on a life of their own. After five years, experience has proven that multifamily lending in Chicago is a real and profitable line of business. Chicago lenders have offered borrowers aggressive pricing including “free forward [commitment] rates, construction periods of up to 18 months, ARMs with a 5 percent lifetime cap, 20 to 30 year terms and 25 to 30 year amortization.” In addition they offer “low fees including a \$250 application fee, two points for the entire transaction and no prepayment penalties.”¹²⁵

The aggressive pricing for these community development activities has been satisfactory for the lenders; the loans are performing and the lenders are making the margins they expected. However, the GSEs and the lenders have found it difficult to close deals for the GSEs to purchase the mortgages. Many of the loans are not underwritten to the GSEs standards, nor are the margins sufficient to cover the costs of the transactions with the GSEs.

The map of Chicago shows that the GSEs have found some loans to purchase, mostly along the Lake Michigan shoreline, which is currently being redeveloped. Exhibit 6-6 shows that approximately 63 percent of the GSEs’ purchase activity in Chicago was in census tracts where minorities represent 50 percent of the population or less. HMDA data show slightly greater concentration of multifamily financing activity in low-minority census tracts for non-GSE participants in the Chicago market.

¹²⁴ The GSEs’ perception of proximity to public transportation as a negative factor may be changing. In 1999, Fannie Mae introduced a single-family mortgage product called the Location Efficient Mortgage in several densely populated cities. This product recognizes the savings from the purchase of a home near public transportation and allows a portion of the potential savings to be used as additional borrower income in qualifying for a mortgage. Although the Location Efficient Mortgage is a single-family product, it may be a signal that proximity to public transportation could be a positive factor in underwriting multifamily mortgages as well. (www.fanniemae.com/news/pressreleases/0678.html)

¹²⁵ Correspondence from a consortium of community development lenders in Chicago to Fannie Mae, November 3, 1994.

Exhibit 6-6**Chicago, IL (Cook County), Fannie Mae, Freddie Mac, and HMDA: 1993-1999
Number of Loans by Year and 1990 U.S. Census Tract Percent Minority**

	1993	1994	1995	1996	1997	1998	1999	Total
Fannie Mae								
less than 10 percent	24	1	59	0	2	6	1	93
10-30 percent	78	2	127	17	4	23	22	273
31-50 percent	73	5	129	2	1	6	1	217
51-80 percent	48	5	95	1	1	15	2	167
Greater than 80 percent	33	10	107	0	3	36	0	189
Total	256	23	517	20	11	86	26	939
Freddie Mac								
less than 10 percent	0	0	0	0	0	3	4	7
10-30 percent	0	2	1	3	0	10	7	23
31-50 percent	0	0	0	1	0	1	0	2
51-80 percent	0	1	1	1	0	0	1	4
Greater than 80 percent	0	0	1	5	1	2	0	9
Total	0	3	3	10	1	16	12	45
HMDA								
less than 10 percent	380	352	236	307	299	384	436	2394
10-30 percent	671	565	415	535	490	701	723	4100
31-50 percent	392	374	277	332	364	496	463	2698
51-80 percent	380	378	304	364	352	503	549	2830
Greater than 80 percent	287	288	298	355	366	515	608	2717
Total	2110	1957	1530	1893	1871	2599	2779	14739

6.4 Dallas

The economy of Dallas has been driving expansion in all economic levels of the multifamily market. New construction has been apparent, especially at the luxury end, leading to softness in the Class A market in 2000. Vacancy rates in this market were about 10.4 percent through the first half of 2000, compared with vacancy rates in the Class B segment of about 4.8 percent (Holland, 2000). The demand for affordable multifamily market has continued to expand and ensure high occupancy in the older buildings despite the high turnover rate.

The Dallas multifamily market is currently encountering a shortage of affordable units for housing seniors. The full range of facilities is needed from independent living through assisted living and nursing homes. To date, the housing authority has been the only source for funding. The units needed must reach people whose income levels are such that they can afford approximately \$400 per month. The developers who invest in this opportunity will have to be very patient to recover their investment or find a subsidy for the tenants.

The map of Dallas shows that both Fannie Mae and Freddie Mac have found deals in this rapidly expanding market, especially as the north Dallas area is being developed. Exhibit 6-7 shows that, as in the other markets, GSE purchases in Dallas are concentrated in low-minority census tracts. About 78 percent of the GSEs' purchases in 1993-1999 were in census tracts where minorities represented 50 percent or less of the population. Dallas is the only market of the four examined here where non-GSE activity in the multifamily market was less concentrated among low-minority census tracts than GSE activity. Compared with the GSEs' 78 percent of purchases in low-minority census tracts, about 66 percent of non-GSE activity was in low-minority census tracts (those where minorities represented 50 percent or less of the population).

Exhibit 6-7

Dallas, TX (Collin, Dallas, and Denton Counties),

Fannie Mae, Freddie Mac, and HMDA: 1993-1999

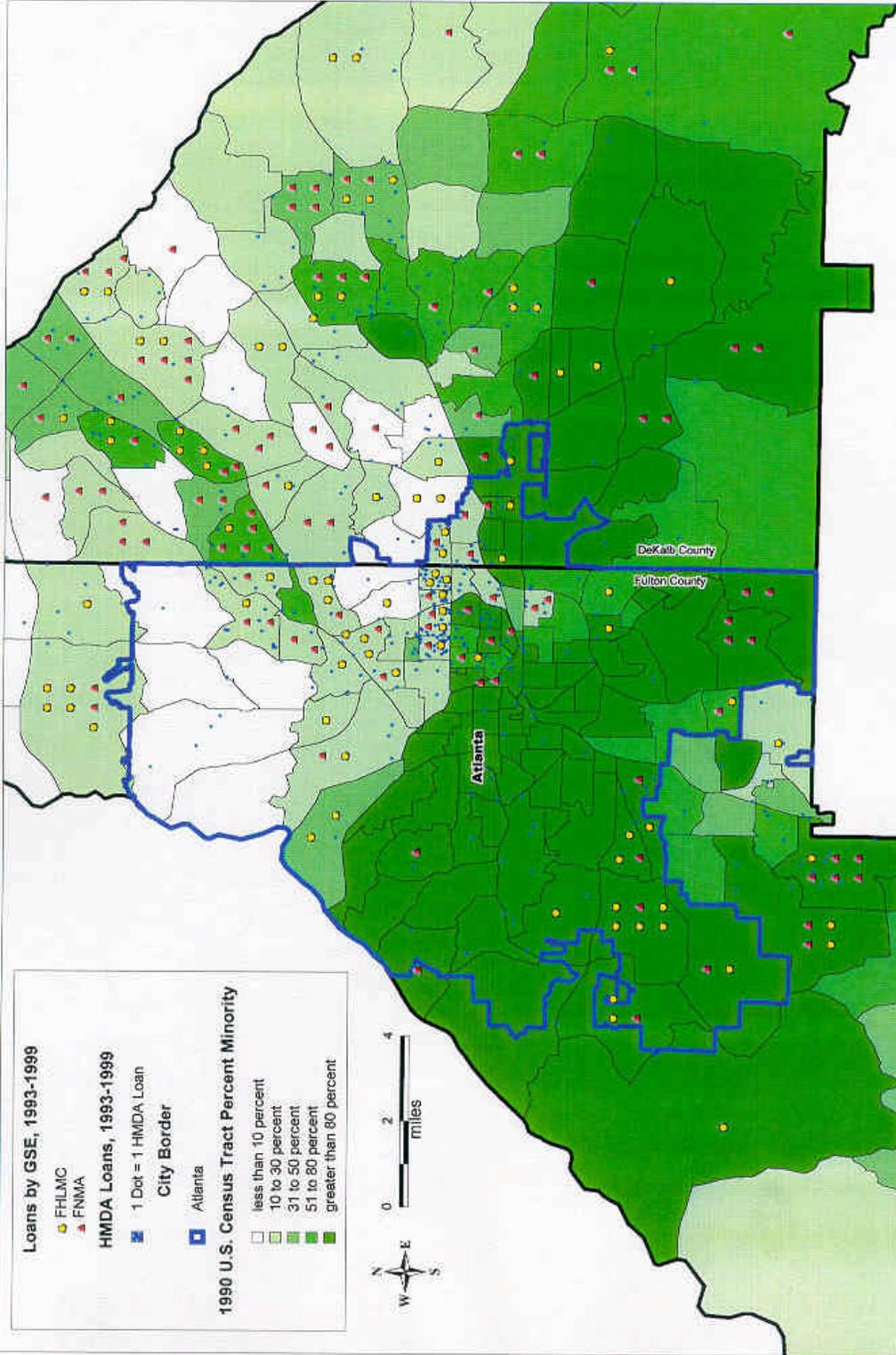
Number of Loans by Year and 1990 U.S. Census Tract Percent Minority

	1993	1994	1995	1996	1997	1998	1999	Total
Fannie Mae								
less than 10 percent	4	3	3	8	3	0	0	21
10-30 percent	16	24	21	45	34	28	33	201
31-50 percent	15	4	5	8	11	12	9	64
51-80 percent	5	7	6	4	11	9	4	46
greater than 80 percent	2	5	2	2	2	2	5	20
Total	42	43	37	67	61	51	51	352
Freddie Mac								
less than 10 percent	0	0	0	2	2	4	5	13
10-30 percent	0	5	5	6	10	28	17	71
31-50 percent	0	3	3	1	7	20	9	43
51-80 percent	1	3	0	3	3	24	11	45
greater than 80 percent	0	0	0	1	2	5	0	8
Total	1	11	8	13	24	81	42	180
HMDA								
less than 10 percent	7	3	6	5	14	16	19	70
10-30 percent	33	19	55	51	70	62	71	361
31-50 percent	7	16	18	20	42	26	40	169
51-80 percent	8	10	25	37	35	82	43	240
greater than 80 percent	5	9	10	3	16	13	19	75
Total	60	57	114	116	177	199	192	915

Atlanta (Fulton and DeKalb Counties, GA)

GSE and HMDA Loans, 1993-1999

Note: Loan symbols show the census tract in which each multifamily property is located but do not necessarily indicate the precise location of the property.

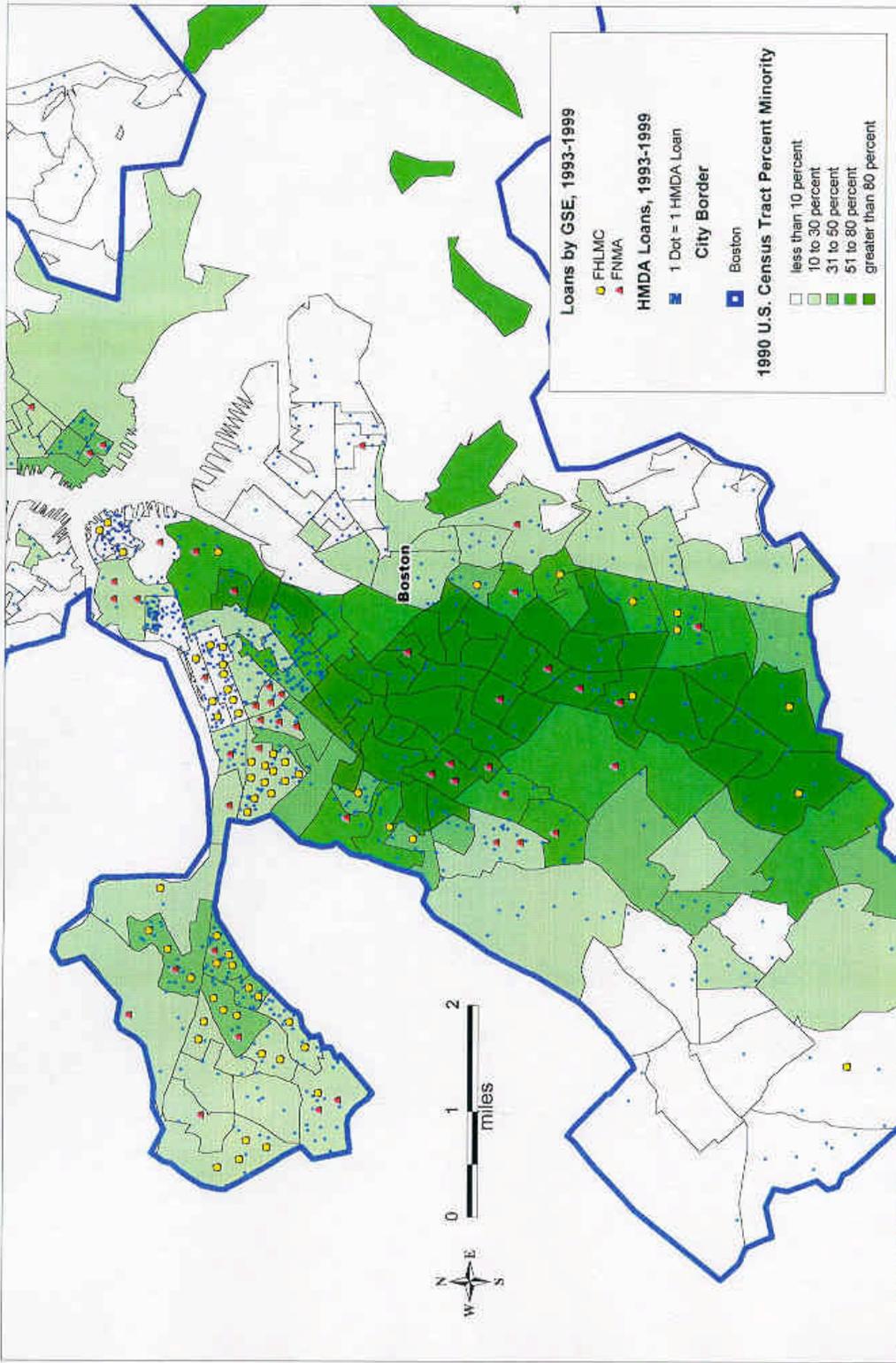


Sources: 1993-1999 GSE Public-Use Database Records; Multifamily Census Tract File Property Records; HMDA Current Year Originations. (Negative loan amounts corrected; loans less than or equal to \$100K were excluded as miscoded single-family loans.)

Alt Associates Inc
04/16/2001

Boston (Suffolk County, MA) GSE and HMDA Loans, 1993-1999

Note: Loan symbols show the census tract in which multifamily property is located but do not necessarily indicate the precise location of the property.



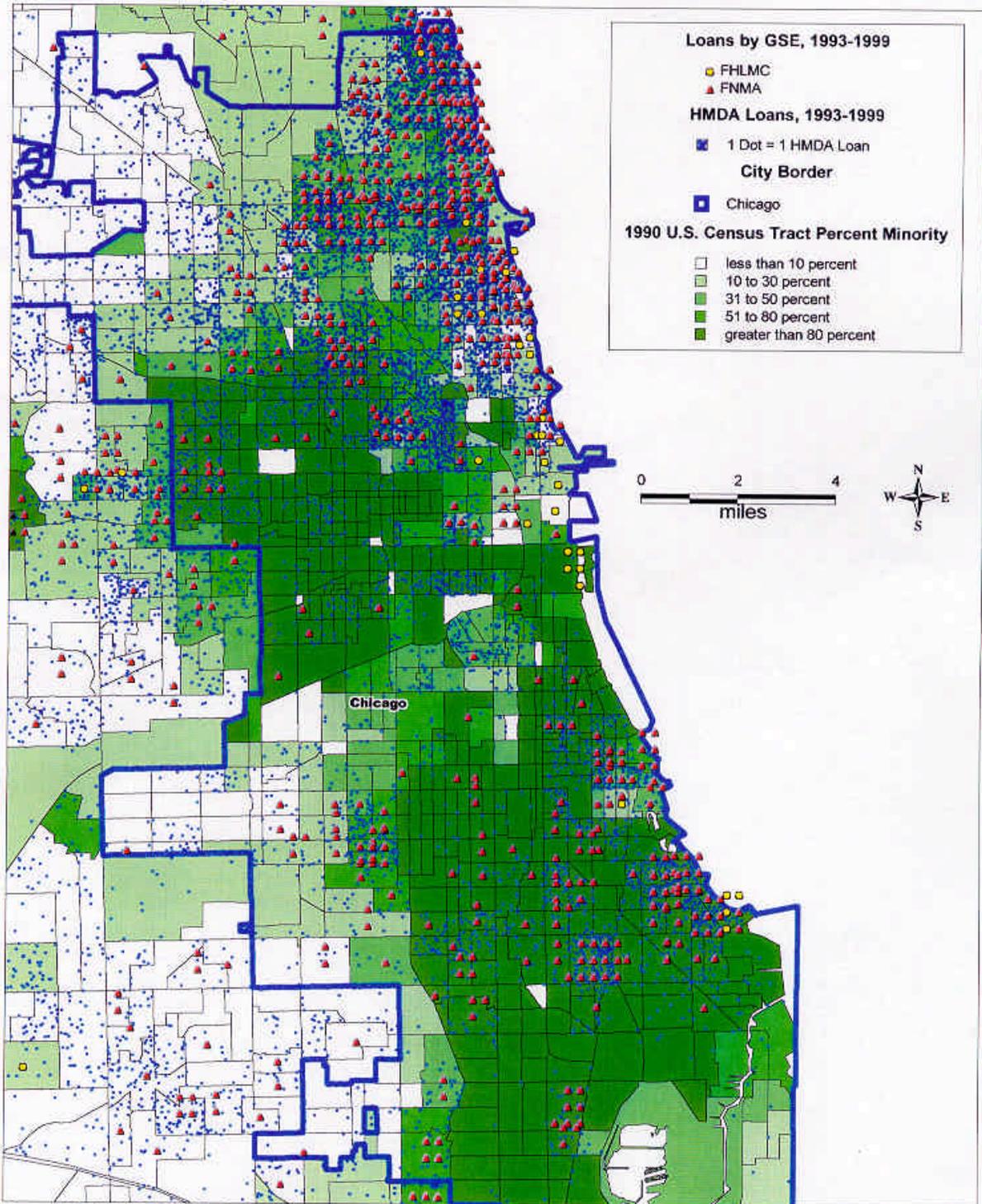
Sources: 1993-1999 GSE Public-Use Database Records, Multifamily Census Tract File Property Records, HMDA Current Year Originations. (Negative loan amounts corrected, loans less than or equal to \$100K were excluded as mis-coded single-family loans.)

Aut Associates Inc.
04/19/2001

Chicago (Cook County)

GSE and HMDA Loans, 1993-1999

Note: Loan symbols approximate the census tract in which each multifamily property is located but do not necessarily indicate the precise location of the property.

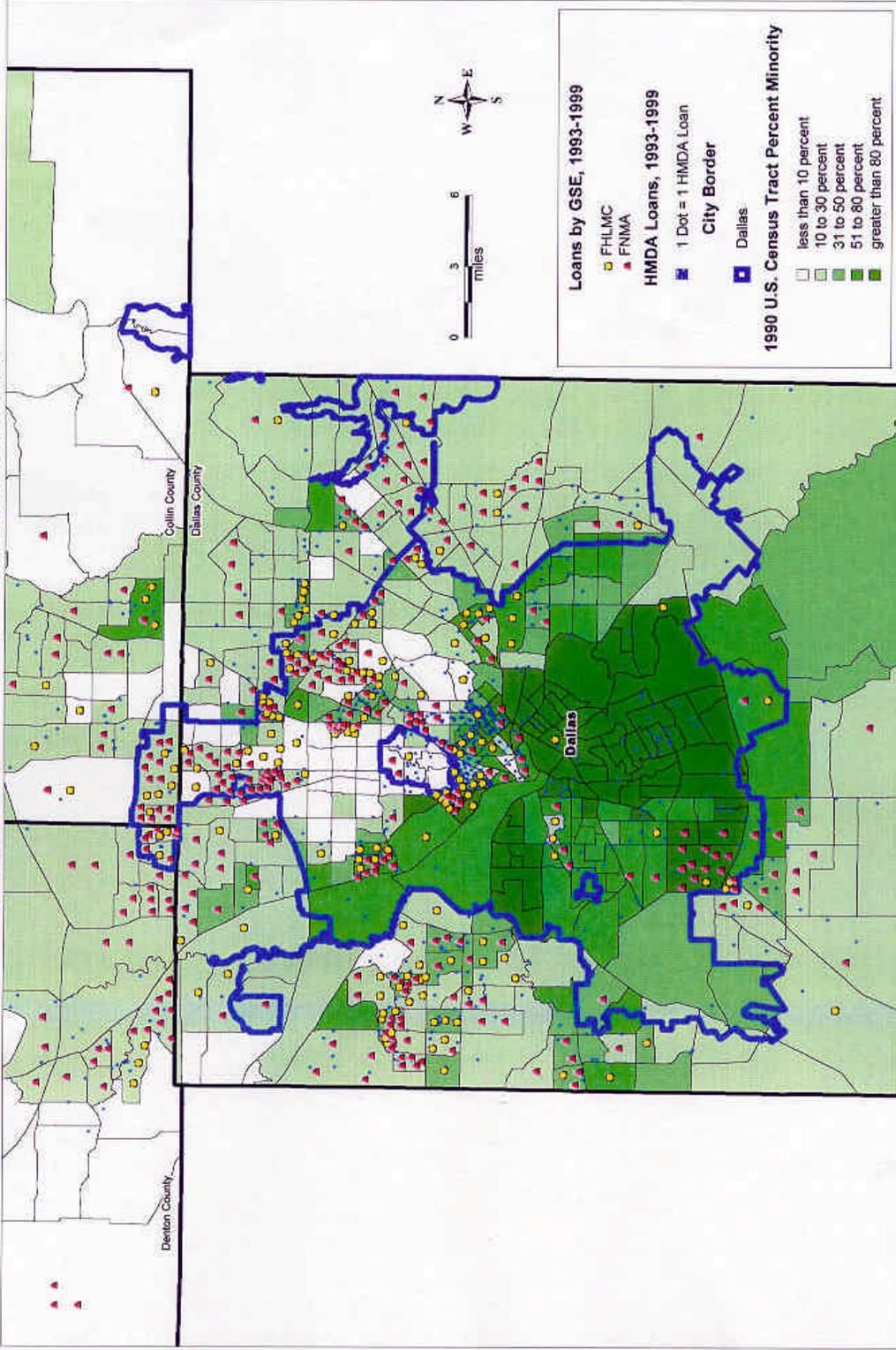


Sources: 1993-1999 GSE Public-Use Database Records, Multifamily Census Tract File Property Records.
 HMDA Current Year Originations. (Negative loan amounts corrected, loans less than or equal to \$100K were excluded as miscoded single-family loans.)

Abi Associates Inc.
04/15/2001

Dallas (Dallas, Denton, and Collin Counties) GSE and HMDA Loans, 1993-1999

Note: Loan symbols show the census tract in which each multifamily property is located but do not necessarily indicate the precise location of the property.



Sources: 1993-1999 GSE Public-Use Database Records, Multifamily Census Tract File Property Records; HMDA Current Year Originations. (Negative loan amounts corrected, loans less than or equal to \$100K were excluded as miscoded single-family loans.)

Abt Associates Inc.
04/18/2001

Chapter Seven

Findings from Interviews with National Experts and Multifamily Lenders in Four Markets

Chapter 3 described the GSE's underwriting requirements, policies, and programs as they are written in the GSEs' written Guides. The goal of this chapter is to shed light on how these requirements, policies, and programs were understood by those who had to implement them, and how they were implemented in practice.

The policy issues considered in the interviews for this exploratory study include investigations into whether there is any evidence of:

- Credit gaps in segments of the multifamily market;
- Impacts of GSEs' underwriting and appraisal requirements and standards on the availability of multifamily mortgage loans;
- GSEs' underwriting and appraisal requirements and standards having a disproportionate adverse impact on protected classes;
- GSEs' underwriting and appraisal requirements pertaining to the age or location of the property or age of neighborhood having a discriminatory effect.

Two sets of interviews were conducted for this study, as described in detail in Appendix B.¹²⁶ The interviewees included 26 individuals selected as national industry experts and 24 lenders who are representatives of various segments of the multifamily financing market and active in at least one of the four local markets described in Chapter 6.¹²⁷

¹²⁶ The discussion below is a compilation of both sets of interviews and reflects the opinions of the informants. Where specific comments (or sets of comments) help to explain the general tenor of the informants' responses, they are set off with bullets. An "N" indicates the response was from the national experts and an "L" from the local multifamily lenders. Most of the comments are paraphrased; quotes are shown with quotation marks.

¹²⁷ It is important to note that most of the interviews with the national industry experts were conducted in April 1998 and the interviews with lenders were conducted in May 1998. During this period, the capital markets were actively seeking multifamily investments. As one lender said, "The competition in the capital markets is the fiercest I've ever seen it. There is just a whole bunch of money out there chasing [investments in multifamily properties], due to the astronomical growth of the conduits in Wall Street." By the end of August 1998, the capital markets changed as the conduits dropped out of investments in multifamily properties due to the increased spreads demanded by investors and substantial losses in their portfolios bulging with loans made at lower spreads. Two additional interviews were conducted in 2001.

Section 7.1 describes the multifamily market segments, the primary and secondary market lenders in each segment of the market, and the views of the informants regarding Fannie Mae's and Freddie Mac's leadership in the multifamily market. Section 7.2 first summarizes the informants' views of whether there are credit gaps in multifamily housing finance and the GSEs' perceived effects on any such gaps. This section also reviews perceived flexibilities and inflexibilities in the GSEs' underwriting practices, and effects on credit availability. Section 7.3 briefly reviews the informants' comments on the GSEs' underwriting requirements and impacts on the intent of the Fair Lending Laws.

7.1 Multifamily Market Segments and Availability of Loans on Affordable Properties

The interviews first focused on the segments of the multifamily market and identifying the dominant players in each segment. Then impressions of Fannie Mae's and Freddie Mac's leadership in this market were discussed.

Market Segments

Informants were asked to discuss the segments in the multifamily market and identify the dominant players within the following segments: affordable housing, small properties, older properties, properties located in urban inner cities, properties in need of rehabilitation, and projects developed under the Low Income Housing Tax Credit Program (LIHTC).

One of the important findings was that interviewees said the key market players varied by segment and region/local area. Each dominant player had had numerous previous experiences with the GSEs—both positive and negative. Therefore, HUD's influence in each of the market segments and markets would ultimately depend on understanding the dynamics between the dominant players and the GSEs. Illustrative experiences for each market segment are presented below:

Affordable Housing Segment. Within the affordable market segment, the definition of “affordable” was very important. Many informants were very careful to separate “affordable housing” from “targeted affordable housing” (a Fannie Mae Multifamily Product).¹²⁸ As some informants indicated (and many of the others agreed):

- (L) “When I say *targeted affordable housing*, it generally means tax credit properties and by Fannie Mae's definition, it is a rent-restricted property.” Fannie Mae's “targeted affordable housing” program has more lenient underwriting standards *that are needed to get these deals done*, e.g., 90 percent LTV, DSC ratio

¹²⁸ Freddie Mac began listing “targeted affordable housing” as a multifamily product in its 1999 web site revision.

of 1.1, and more flexibility on credit requirements. Most of these deals have some proportion of equity investment from Fortune 500 companies (for tax-credit deals).

- (L) Most [targeted] affordable housing is going to have “subordinate debt, tax credits, funny money all over the place, and that’s not necessarily bad.”
- (L) “The *targeted affordable deals* become big negotiations; everyone wants to do it, but everyone has their own lending agenda. These deals can have many layers of subordination, so you have to have everyone around the table. The role of the mortgage banker is as negotiator.”
- (L) There are plenty of other properties that are *affordable* to people who are at or below the median income for the area. These properties do not include tax credits, but can include other forms of subordinate financing.

In the overall affordable segment of the multifamily market, the dominant players are typically local depositories (banks and thrifts) and conduits.¹²⁹ Depending on the market, other players include the state housing finance agencies, lending consortia, and the Federal Home Loan Banks. In several of the markets, lenders with a national presence were mentioned (e.g., ARCS, Bankers Mutual, and Citicorp). State housing finance agencies were cited as active players in California and Massachusetts. In the 1998 interviews, the GSEs were rarely viewed as playing a leadership role in the affordable segment of the multifamily market.

In 30 to 40 markets across the U.S., consortia of large banks, smaller thrifts, and insurance companies are operating in separate, mostly metropolitan (or statewide) markets. These consortia of lenders typically play a large role in the multifamily market. Three markets have very large consortia: New York, Chicago, and the State of California. The Community Preservation Corporation (CPC) has been serving the New York City and several upstate markets since 1974. More recently, CPC has forged relationships with non-profit housing developers to finance affordable multifamily housing. The Community Investment Corporation (CIC), in Chicago, founded in 1974, spent its first decade focused exclusively on the single family market, then changed to focus exclusively on the multifamily market beginning in 1984. The Saving Associations Mortgage Company, founded in 1971, is statewide in California and has 90 members. In the beginning, it provided both construction and permanent financing for single family housing exclusively. Since 1985, it has originated multifamily mortgages exclusively.

Other major contributors to funding affordable housing are the Federal Home Loan Banks (FHLBs). These are large cooperative or wholesale banks that access the capital markets,

¹²⁹ Conduits are entities that pool mortgages and sell interests in these pools to investors.

raise funds by issuing debt instruments (notes and bonds), and then lend funds (“advances”) to their members at favorable rates. The FHLB system funds its members to carry out two community programs—the Affordable Housing Program (AHP)¹³⁰ and the Community Investment Program (CIP).¹³¹ Since 1990, ten percent of the FHLB’s earnings have been available as a subsidy for affordable housing under the AHP. The 12 FHLBs (through approximately 6000 member banks) will have awarded \$639 million in subsidies and completed 4500 projects by the end of 1998.¹³²

Small Properties Segment. Historically, the smaller properties segment (5 to 50 units) was the domain of the savings and loans (S&Ls) and commercial banks that used this market segment to meet their CRA goals. In many markets, mortgage companies, credit companies, small consortia, and conduits are also small multifamily mortgage originators.

Several informants indicated that many of the dominant players are the same as for affordable housing. Another informant indicated that these loans are typically dominated by regional entities. For example, in California, the players include California Housing Finance Agency, Bankers Mutual, and those banks with CRA motivation (Bank of America, Wells Fargo, and Bank of the West). Another informant identified FHA originators like First Maryland Mortgage. Others mentioned TRI and Berkshire Mortgage, Nomura, Daiwa, Countrywide and Citibank. In New York, Apple Bank is a small loan portfolio lender and Key Bank serves the up-state area. In Chicago, LaSalle Talman, Harris Bank, Northern Trust, and Southshore Bank are all players. In Boston, the dominant player is Massachusetts Housing Partnership.

One national lender¹³³ recognized the financing gap in the small property segment and aggressively began advertising a product that was competitive in the following ways:

- Fast (closing in 6-8 weeks);

¹³⁰ The AHP program was authorized by FIRREA in 1989. AHP supports multifamily projects aimed at rental housing development for low-income families with incomes not exceeding 80 percent of AMI.

¹³¹ The CIP program was originally initiated by several of the FHL Banks in 1978 and extended by FIRREA in 1989. The Congressional legislation stated that CIP was to support “community-oriented building” with multifamily loans for:

- Rehabilitation of housing occupied by families with incomes not exceeding 115 percent of area median income (AMI);
- Commercial and economic development activities that benefit low- and moderate-income families or located in low- and moderate-income neighborhoods; and
- Projects that include a combination of these activities.

¹³² See U. S. Department of Housing and Urban Development. (1994). Report to Congress on the Federal Home Loan Bank System, Volume II: Analytic Studies. HUD-6371, April.

¹³³ This lender has recently dropped out of lending in the small properties segment for reasons related to overall business strategy, but unrelated to this segment of the multifamily market.

- Cost effective (total closing costs are \$10,000 on a multifamily property—including all third parties, legal, and underwriting);
- More competitively priced; and
- Doing the deals non-recourse. In mid-1998, they were closing \$10 to \$20 million per month in their small multifamily loan program.

Several of the mortgage bankers indicated that occasionally they receive an application for a loan under \$1 million. These (rare) applications are usually from a current customer and processed as a favor to the customer. If possible, the applications are passed on to a subsidiary that does CRA-type lending and has experience with this segment of the multifamily market. The lender's end strategy for this type of loans is to pool and eventually sell them to Fannie Mae.

Other informants provided comments that explain reasons why this segment of the multifamily market is viewed as difficult to finance and service.

- (L) Small properties are very underserved from the permanent side; it's a lot of work for very little return and it's usually an unsophisticated borrower. There is a huge market here, but it has to be streamlined. These borrowers are accustomed to appraisals (of their own house) that take a week to do, but they are not accustomed to a three-week narrative appraisal with an engineer's report on the gas station next door.

Fannie Mae, Freddie Mac, and FHA have all introduced small loan programs. Freddie Mac offers a small loan program (from \$300,000 to \$999,999) through its Conventional Cash Program. Fannie Mae replaced its small loan pilot in May 2000 with a permanent product, the 5-50 Streamlined Mortgage, offered to DUS lenders. As of 1998, 19 lenders were authorized to provide the product.

According to informants, these small programs have been difficult for the three agencies to implement. The FHA program was created to meet a need, but no one is using it because of processing difficulties. Similarly, Fannie Mae's small loan pilot had not succeeded by May 1998; it was not appealing to the DUS lenders or the borrowers as shown in the examples below:

- (L) We [a DUS lender] declined the invitation to participate [in the small projects program]. With the amount of work required to do Fannie Mae underwriting, and with the pricing offered, we did not think it was competitive, nor could we make any money on it.

- (L) Fannie Mae tried a small program that failed because borrowers did not understand recourse provisions to the borrower. Instead, borrowers are going to their banker down the street, whom they trust will not be as heavy-handed.
- (L) Fannie Mae's loans would have been recourse loans.¹³⁴ In some markets, (e.g., New York City), the savings banks offer the small loans without recourse. This issue would make Fannie Mae's program uncompetitive there.

Fannie Mae's 5-50 Streamlined Mortgage product is too new for lenders to have extensive experience with it, but one DUS lender, who is approved to use the 5-50 product, noted:

- (L) There are lots of attempts to do these great things [in small multifamily financing], but we're still not convinced that it's going to happen. Not because of lack of trying – part of the issue is that this business is just too difficult to do. I see no reason to believe [the 5-50 product] will be more successful [than past attempts to do more small multifamily financing]. I don't know that we will do a lot of [5-50 product] business.

Older Properties Segment. In this segment of the multifamily market, many informants indicated that the profile of lenders was the same as for the affordable segment:

- (L) One informant recalled that a contingent of HFAs through the National Council of State Housing Finance Agencies attempted to develop a risk-sharing initiative/pilot with Fannie Mae that would address many problems, including underwriting older properties. The initiative was never implemented, mainly (as stated by the informant) because of the exorbitant fees that would have to have been charged for each party to feel that the deals were profitable, Fannie Mae's inflexibility in their underwriting standards, and the inability to agree on terms of subordination.
- (L) Another informant indicated that lack of flexibility was not a problem currently with Fannie Mae, under their terms and conditions. Fannie Mae's underwriting standards previously were stricter for properties that were more than ten years old. Today, practically every property in affordable housing areas is a "B" or "C" property between 10 and 30 years old. Fannie Mae is participating in some of these deals but has stricter requirements than for "A" properties.
- (L) A third informant did not believe that the GSEs' underwriting guidelines were biased against older properties. However, he expressed his impression that Freddie Mac's pricing for older properties was more expensive than for newer

¹³⁴ Fannie Mae's permanent small loan program is offered without recourse.

properties. He thought this was a result of the additional competition for mortgages on newer properties, for example from insurance companies.

Inner-city Properties Segment. In the multifamily segment of properties located in urban inner cities, the profile of the dominant players is a combination of those in the affordable housing and smaller property segments, discussed above.

- (L) We handle many properties that have rent control or rent stabilization, (e.g., in New York and New Jersey). Our [mortgage] rates are not contingent on whether the property is affordable or otherwise. It depends on cash flows and on the results of underwriting.

Properties in Need of Rehabilitation Segment. In the multifamily segment of properties in need of rehabilitation, the consortia are the dominant players, but in a limited set of markets. In many markets, banks seeking CRA credits have been the dominant players. The Housing Finance Agencies have also been flexible and willing to take the risk on these transactions. In general, many informants indicated that this segment is still not well served.

Properties Developed with LIHTC Program. For projects developed under the Low Income Housing Tax Credit (LIHTC) Program, the dominant players were originally thrifts that made the loans with subordinate financing provided by state LIHTC programs. Currently, the development community is relying more heavily on deals that include tax-exempt-bond-financing.

In all markets, the LIHTC deals require layered financing. According to informants, these deals vary considerably among market areas (e.g., CPC is not involved in New York,¹³⁵ but CIC is very involved in Chicago). In Boston, the Massachusetts Housing Investment Corporation, a Boston-based affordable housing consortium focuses on the LIHTC projects. More recently, several informants said the dominant players are “anybody and everybody from state HFAs to Wall Street, to non-profits.” There are currently many organizations who are supporting lifting the cap on tax credits set in 1986 as \$1.25 per capita at the state level. Many of the LIHTC loans are sold in the secondary market. According to the informants, investors in the equity side of the LIHTC include many corporations.

Other Special Needs Segments. Within the multifamily market for rental apartments, several of the informants indicated that there were segments of the market that were currently “left out,” with an apparent credit gap in both the primary and secondary multifamily markets.¹³⁶ The following describes the segments that were identified by some informants:

¹³⁵ CPC has developed a successful model using New York State pension funds and state-supplied mortgage insurance.

¹³⁶ This impression was reinforced by informants who speculated which of the multifamily market segments could become “new targets” for the conduits seeking mortgages to securitize (prior to August 1998).

- (L) Seniors housing currently needs considerable attention—the whole range from independent living to skilled nursing.
- (L) One of the biggest needs in the affordable housing area is for the “dispossessed”—the deinstitutionalized (e.g., those with mental health problems, developmental disabilities, physical handicaps, and others who are homeless). Others are vulnerable to becoming homeless—older people with AIDS, abused spouses, and drug abusers.
- (L) Another group that will emerge is the current residents of public housing whose units will be destroyed without one-to-one replacement.

GSE Leadership in the Multifamily Market

According to the national industry experts and lenders whom we interviewed, the GSEs have made progress in their contributions to affordable lending in the multifamily market. Both Fannie Mae and Freddie Mac have forward commitment programs that support the construction or rehabilitation of multifamily properties, typically using the LIHTC and/or other forms of subordinated financing. Both of the GSEs also offer bond credit enhancements, thereby supporting tax-exempt bond programs for refunding, acquisition, or rehabilitation of multifamily properties.

The GSEs’ leadership in the multifamily market is characterized narrowly in terms of setting the standards for underwriting and financing multifamily properties. Depending on the informant, sometimes Fannie Mae is given more credit for this form of leadership than Freddie Mac and sometimes Freddie Mac is recognized for its role, but neither is viewed as “leading the market.” For example:

- (N) Historically, Freddie Mac¹³⁷ claims, and one of the national experts (with years of experience in financial services) concurs, it was viewed as the neighborhood secondary market source for the smaller and older properties, while Fannie Mae was viewed as the secondary market source for the larger, complex-size apartment buildings in the city. Freddie Mac, in the early 1990s, ran into problems with their multifamily portfolio and underwriting practices. After they reduced their commitment to the multifamily market for a few years, they have never fully returned to their previous prominence in the multifamily market.
- (N) Fannie Mae set the early underwriting requirements and standards for the rest of the industry when they developed the Delegated Underwriting and Servicing (DUS) network in the late 1980s. Freddie Mac also developed underwriting requirements and standards that were considered part of the “industry standard.”

¹³⁷ Freddie Mac, 1998.

Other financial institutions followed their lead. Until five years ago, other financial institutions' LTVs and DSCs were similar to those of the GSEs.

None of the informants interviewed in 1998 identified either of the GSEs as leaders in any of the multifamily market segments. Consistent with their generally conservative approach to the multifamily market in general, the GSEs have provided leadership in development of underwriting requirements, but not in developing programs and products especially for the affordable market. Other financial services entities have led the way in affordable lending. The following is a brief summary of the lender informants' perceptions:

- (L) Neither have been leaders. They typically fall way behind the state housing finance agencies in affordable lending.¹³⁸
- (L) Freddie Mac has been super cautious since 1993. At some point, they have to dare to be a leader again.
- (L) We were selling loans to the GSEs years ago. You had to do it their way or not at all.
- (L) They do not work in the same markets that we work in; we do not do swimming pool deals.¹³⁹ That is what I think they do.

One lender we re-interviewed in 2001 believed that the GSEs had substantially increased their efforts to serve the affordable housing market:

- (L) The last couple of years there has been a sea change in [the GSEs'] willingness to work harder to get things done. Freddie Mac is at least trying, and Fannie Mae is making the rhetoric closer to the reality. I think they will eventually achieve leadership in affordable housing.

Differences between the GSEs remain. While Fannie Mae is viewed as being more responsive among many of the informants, there are differences among the market areas. One respondent pointed out that in the New York City market, it is much easier to deal with Freddie Mac, since the regional office is staffed with people who really understand underwriting in that market.

Inferences on Multifamily Market Segments

According to the informants interviewed in April and May 1998, the multifamily market segments were fairly well covered. In each of the four markets visited (Atlanta, Boston,

¹³⁸ The term "affordable lending" used in the multifamily-housing context means loans to support the purchase of multifamily properties with units that are affordable to lower-income families.

¹³⁹ This informant used "swimming pool deals" as shorthand for newer, more costly rental properties.

Chicago, and Dallas), multifamily deals were being made, frequently with competition from several secondary market sources. The informants also provided anecdotal evidence of the extent of the competition with commentary on how close the basis point spreads were among the winners and losers in some of the deals. Three basis point spreads were described on several occasions.

Despite the high level of activity in each of the market segments, Fannie Mae's and Freddie Mac's offers were frequently not the secondary market choice of the borrower. Instead there were numerous examples from the lenders about the slowness of the GSEs' offers, the amount of additional work required of the borrower to meet the preliminary requirements of the GSEs, and the fact that some of the borrowers had prior experience with one or both of the GSEs and did not want to repeat the experience. Given the reports provided by the informants, the GSEs could not be considered leaders in the affordable multifamily lending market in these four markets. At the end of 1998, there has been some increased participation by the GSEs in the multifamily market, after the volatility in the economic conditions in late August 1998.

Lindstrom (1998) quotes Douglas Dear of WMF Washington Mortgage, who comments at the end of the summer of 1998:

“In these market conditions, it's very comforting to have Fannie Mae as one of your investors. Day in and day out, they're in the market. With rates dropping but spreads increasing, a lot of lenders are pulling out of the market.”

The GSEs' both had record years in 1998. Fannie Mae volume increased by about 80 percent to \$12.5 billion in 1998 from about \$7 billion in 1997. Freddie Mac's business increased by about 140 percent to about \$6.5 billion in 1998 from about \$2.7 billion in 1997. This pace was not sustained in 1999, although multifamily volume for both GSEs was the second largest on record that year.

Going forward, the issue for the GSEs will be whether they can continue to increase their level of participation in all segments of the multifamily market.

7.2 GSE Underwriting Requirements: Impacts on Credit Availability

The respective GSEs (and their consultants) periodically scrutinize the GSEs' formal Guides of underwriting and appraisal requirements and standards, especially as they relate to the safety and security of each institution's investments. Generally, the content of the GSEs' underwriting and appraisal requirements and standards appear to us (within the level of

analysis described in the scope of work for this project) to be descriptions of sound and sensible business practices.

The written contents of the Guides do not provide the GSEs' interpretation of the contents of the Guides in practice. For example, the informants who are DUS lenders and/or Program Plus lenders made it clear that all of the required documents (to the extent they exist) must be delivered for underwriting. However, they also indicated that waivers sometimes were permitted and some flexibilities were negotiable and allowed.

Any Presence of Credit Gaps

The issue of GSE underwriting impacts on credit availability can be examined from a broader, more global perspective as well as a micro, business practices perspective. The informants differed in their perceptions of the existence and magnitude of credit gaps. Most insisted that under the then current market conditions (late Spring 1998) no gaps exist, while others identified credit gaps in particular segments of the multifamily market, and still others identified niche gaps that occur under a specific set of conditions within a segment of the multifamily (e.g. for small properties in a state with a weak HFA).¹⁴⁰ Because of capital market cycles, the credit gaps could be alleviated somewhat if there were high investor demand for multifamily mortgages (of any size) and there were conduits purchasing mortgages in that state's market.

Those who saw no current gaps said:

- (L) Lately I have not seen any gaps. When we started doing loans, of anywhere from half a million to two million dollars, I think there were credit gaps. Now there are at least those numbers of interested parties in every deal that we do. They are bidding for the mortgages, so there are no gaps any more.
- (L) Fannie Mae's credit enhancements of tax-exempt bonds have eliminated a gap that was seen when it was no longer possible to get a 9 percent LIHTC. This remains their best execution.
- (L) Take 1991, for example. There was very good coverage during that multifamily mortgage slump. Although the GSEs were not providing secondary market liquidity to the multifamily market, HUD was continuing to lend and insure under several HUD programs. This is one of the reasons that some mortgage bankers value their HUD license; when all else is quiet, HUD will still be there to offer multifamily mortgages.

¹⁴⁰ In this example, the market segment is small properties and the niche is small properties within a geographic area with a weak FHA.

- (L) There's plenty of money to shape the deals; the GSEs are only one source.
- (L) Right now, the market does not need anything. It just doesn't!

Some of those who saw credit gaps still present in the multifamily market, indicated that they were not seen everywhere, but in particular niches of the market segments. For example, one informant questioned whether some rural and smaller metropolitan areas were being denied equal liquidity in the secondary market. Another indicated that there are credit gaps for construction loans for affordable properties for both rehabilitation and new construction.

Others stated the evidence of credit gaps differently, for example:

- (N) [An informant who is very active and aggressive in the small property segment of the multifamily market pointed out that] there might be a gap for unsophisticated borrowers who are unaware of the benefits of refinancing an 11 percent loan for one at 8 percent.
- (N) Although there are no census tracts in this city in which we [a large multi-market bank] do not lend and no census tract in the city that is held back from a pool of loans we sell to Fannie Mae, there are properties that cannot support the required financial ratios, e.g., a loan approved on the LTV ratio but, because of the cash flows, there is a gap between the appraised rentals and DSC requirement. There are a couple of programs in the city where there are soft seconds and gap loan programs to manage the disconnect between the appraised values and the cash flows of the buildings. Whether these deals can survive an economic downturn is unknown.
- (N) There are gaps where there should be; for example in older buildings where there is no value left. In these cases, it's important to reconceptualize the property and add value. Use of the FHA Section 223(f) program, adding services, can reestablish value to support the deal.

Presence of Credit Gaps by Locality

Although there was little evidence of widespread credit gaps as identified by the informants in the national experts and multifamily lenders groups, the presence of credit gaps by locality was also investigated. In response to an inquiry whether there are neighborhoods in the four MSA study areas from which the GSEs do not buy loans, the informants provided a variety of comments.

- (N) On the positive side, rating agencies were said to consider geographic diversity (e.g., Boston, Chicago, etc., markets) and a variety of property types as a positive factor in rating loan pools.

- (N) In some areas, however, there is no “fit” between the area and the GSEs’ regular book of business. For example, Chicago is a market where the Community Investment Corporation and commercial banks tend to make loans that are originated, held in portfolio, and never offered to the GSEs. Loans from commercial banks could be available to the GSEs provided they had a product that is appropriate for the local market. This may or may not apply to all markets. Getting waivers approved to adjust the product to the community can be difficult, especially when the approval process is the responsibility of the GSE headquarters staff who have little or no familiarity with the community.

Many informants pointed out that reluctance to lend in some geographic areas might be transitory and justified because of higher risk. Some of these areas may become more attractive over time with more competition among lenders.

- (N) For example, there have been recent periods when New York City and Portland, Oregon have had little attention from Fannie Mae and Freddie Mac, at least temporarily.

Finally, another secondary market player (not a GSE) indicated that there are few areas where they would not buy loans.

- (N) Among them are properties with serious environmental problems on the property or nearby and properties with 100 percent deferred maintenance. In both cases, it is not worth the high associated risks.

Flexibility in GSEs’ Underwriting Requirements

Both Fannie Mae and Freddie Mac say they have given their underwriting requirements considerable scrutiny to ascertain whether they are clear and applied consistently in similar situations. Despite all of the GSEs’ statements to the contrary, some respondents questioned how flexible the GSEs are.

- (N) A respondent expressed frustration regarding the disparity between GSE claims regarding underwriting flexibility and actual performance. Our [very large] consortium spent one year trying to make a deal work with either Fannie Mae or Freddie Mac, but in the end neither GSE would take the deal because it did not conform—the year’s worth of effort was wasted. The deal either has to fit within the GSEs’ respective boxes or they won’t take it. “Out-of-the-box” deals are unacceptable.

On the other hand, the more experienced and approved DUS lenders have another view.

- (L) There is flexibility with a “whole series” of requirements but it takes experience with the program to know what the important requirements are and which can be waived. As one respondent said of Fannie Mae, “I think they have their own little waiver book somewhere.”

Other informants agreed that it depends on your perspective and size because underwriting is about reputation.

- (N) For the large lenders, who deliver a lot of product, the underwriting specifications of both Fannie Mae and Freddie Mac are requirements, but waivers are possible. For the smaller lenders, whom they do not know, then the standards are closer to requirements that are explained as the GSEs’ way of providing a standard product nationwide. While the public relations position is that the requirements are negotiable, few, if any, multifamily deals are approved that do not fit the standards.

Receiving a firm answer from the GSEs can reportedly be very time consuming. Fannie Mae and Freddie Mac can take a long time to disapprove a waiver request that requires starting over. It can also take a long time to be approved.

- (N) For example, the route to becoming a DUS lender for Fannie Mae is by doing at least three transactions under a precommitment review. However, three may only be the beginning. In some cases, even eight transactions may not be sufficient for qualification, if Fannie Mae is “not quite convinced” that you understand how they do business. (See Cummings and DiPasquale, 1998b for more information).

According to some informants, the time required to sell the loans to the GSEs was only part of the frustration.

- (N) Relative to other options, selling to the GSEs is sometimes not worth the cost or trouble. The GSEs tend to be more rigid in their requirements relative to cash flow requirements, environmental checks, and annual reviews of properties. There is also more bureaucracy in the servicing of the loans (e.g., requiring exhaustive forms and monthly reports), once they are sold.
- (L) First the GSEs will rush out and announce they are going to support the project. But when it comes to really doing the deal, they either back out, back up, or change the terms and conditions of that deal. After the deal is negotiated, someone (usually a regional representative of Fannie Mae or Freddie Mac) will say “Yes, we’ll do it,” and then the next thing you know, it’s still “Yes, we’ll do it, but, we need this, we need that, we need this, and we need that, and we are going to have to change this agreement; otherwise it is no deal.”

Other informants used the time delays to work around the GSEs by doing their own underwriting and servicing. This experience provided an opportunity for lenders to better understand and appreciate the value and economic benefits of the mortgage servicing associated with these loans. Once the internal systems for underwriting and servicing were mastered, and with no shortage of cash to lend for multifamily properties, the lenders decided to hold these loans in portfolio.

Perceptions of High Risks and Pricing. The perceptions of high risks in the multifamily market and the usefulness of risk-based pricing are continuing debates. Several informants insisted that the real problem is agreeing on what constitutes a risk. Numerous examples, cited by the informants, underscore the GSEs' reluctance to take risks. Even in situations where other "experts" were involved, one of the GSEs would "see risk all over the place." Other informants say that high-risk markets occur in areas that have very expansive economies, for example, where multifamily building starts begin before planning is carefully evaluated. Las Vegas is an example where buildings for the elderly quickly outdistanced demand in the last building cycle. In such areas, planning in the real estate market is always two years ahead. By that time, you can easily under- or over-shoot the market.

Because there is no multifamily market database, there is no common agreement on what the determinants of risk are in this market. So the determinants of risk depend on lender's experience in the multifamily market, even by segment. One informant provided the following examples:

- (N) CPC will tell you about their tens of thousands of units that they have already done and they have never had a default. However, someone else will look at what they do and decide "this looks risky." This is similar to a transaction that I watched Freddie Mac price in the early 1990s. A very successful lender had priced a transaction, but when Freddie Mac reviewed it, they saw risk everywhere.
- (N) The Enterprise Mortgage Investments Inc. (EMI) program with Fannie Mae was supposed to be able to deliver to the tax credit market both permanent mortgage loans and a bridge-financing product for the tax credit equity. The latter is a very lucrative business in which EMI would cross subsidize the program on the permanent lending side. However, they could not get a competitive price from Fannie Mae on the bridge loan. When a corporation like Fannie Mae has never done something before and has no experience, the price skyrockets. Others who know the business had been doing bridge financing on tax credit equity for many years, pricing it very differently and making money on it.

Risk-based pricing is built into Fannie Mae's four-tier system,¹⁴¹ but are others using a risk-based pricing system? Not many of the informants offered a comment or opinion on risk-based pricing. However, their best guess was the most sophisticated lenders were probably doing risk-based pricing using various portfolio products.

Risk Mitigation and Recourse Agreements. Fannie Mae's DUS deals have recourse requirements with the originating DUS lender where the lender is responsible for at least up to 11 percent of any loss for the term of the loan. Sometimes the recourse to the lender is higher, depending on decisions made during the underwriting and waiver process. However, not all lenders are sanguine about recourse agreements. Informants express their opinions in a variety of ways:

- (N) Recourse agreements are unacceptable; negotiated transactions under the MBS program with credit enhancements are more acceptable. Other preferable options include direct purchase programs (offered by Freddie Mac) and private placements of securities. This informant stated, "We treat our multifamily portfolio as a mortgage banking portfolio, which we only sell on an opportunistic basis for the best execution (price)."
- (N) The major problem with the recourse agreements is they are costly in terms of the amount of work, the amount of time, and the price. According to one informant, "It just isn't worth it!"
- (L) We sell loans to Fannie Mae non-recourse, with the exception of the usual carve-outs [for fraud]. Almost none of the GSEs' competitors' permanent loans are recourse.
- (L) We do not sell loans to Fannie Mae and Freddie Mac because ours are non-recourse.

Another separate issue is recourse to the borrower. This is most likely to occur when a small multifamily property is involved. Some informants provided the following comments about this situation:

- (L) If you have a borrower who has only dealt with HUD previously, then they don't like recourse. But if you have people who are used to bank loans, it is not an issue. You just have to explain to them what it is, how limited it is, and that it's just an industry standard.
- (L) Recourse helps, but it is hard to get from the borrower. There are times when you could not do the deal otherwise. Even if it is partial recourse for a short

¹⁴¹ See Chapter 4, Exhibit 4-1, for an explanation of Fannie Mae's 4-tier pricing system.

period of time (six to 12 months), it helps a great deal with the lender, at least until the borrower can prove that they can operate the property. On the smaller deals, there may be partial recourse for the entire loan period.

- (L) [There are two points of view. Some think recourse is not bad.] I think there is too much emphasis on the non-recourse loans on the debt side of things.

Inflexibilities in GSEs' Underwriting Requirements

There are other loan structures that are typically unacceptable to the GSEs. Some of the informants illustrated these concerns as follows:

- (L) Subordinate financing is difficult or impossible to place unless the first mortgage has seasoned for two years and the property will underwrite within the original underwriting parameters for the first mortgage (with the first and second mortgages combined). Otherwise, even if we guarantee the FHA share of the risk, Fannie Mae is not interested.
- (L) Borrowing against the 20 percent equity, for some of our very good clients who want to reinvest the capital in another acquisition (in the short term), has not been possible because, as a Fannie Mae servicer, we cannot allow that amount of leverage.
- (L) Fannie Mae developed their conduit program¹⁴² to be competitive with other conduit lending. This program cannot use tax credits deals because the conduits want 10-year terms (and Fannie Mae wants at least a 15- to 18-year term so the borrower does not have to refinance in the middle of the compliance period).

In addition, some loan structures are very costly for lenders:

- (L) Institutions that use Fannie Mae's forward commitment program¹⁴³ feel that the take-out requirements are too onerous (risk-based capital requirements of posting a line of credit during the construction period of 12-24 months is very costly).
- (L) The major issue is the cost of execution; it is very expensive with Fannie Mae.

¹⁴² The Fannie Mae Aggregation Facility is described in Appendix C.

¹⁴³ Both of the GSEs have forward commitment programs. These programs are offered as part of the LIHTC program and provide fixed-rate forward commitments for permanent financing of newly constructed or substantially rehabilitated properties after completion of construction and occupancy at an agreed upon level. This means that the permanent mortgage interest is agreed upon before the beginning of construction.

Yield maintenance premiums or prepayment penalties are also issues according to some of the informants. The purpose of the yield maintenance premium is to protect investors in the event a borrower decides to prepay the entire loan balance before the term of the loan expires. The advantage to the investor is that multifamily securities, as opposed to commercial MBS, include a yield maintenance premium that is accrued and due to the investor if the property is prepaid.

Flexibilities in the GSEs' Competitors' Underwriting Requirements

Several of the informants observed that the GSEs were not in the best position to undertake both risk-based pricing and the necessary flexible underwriting for the small complex deals in some segments of the multifamily market. The inherent conflict is that risk-based pricing implies that risks can be reliably assessed and priced similarly for the same configuration of risks. Flexible underwriting for small complex deals means assessing risks to the extent possible and finding a way to make a one-of-a-kind deal work. Since there may never be another deal exactly like this, the solution found may be unworkable for all other deals. Other examples that informants provided include:

- (N) The consortia and the HFAs are much more successful with the required level of “hand holding” (intensive and personable servicing of the borrower) and they, at the same time, are gaining familiarity with the performance of these types of loans. This may ultimately give them a real advantage with better in-depth insights into loans in certain multifamily segments.
- (N) [From a GSE secondary market competitor] Some still do a standardized credit assessment and make their decision according to requirements, which, in the end, are much more aggressive and more price competitive than the GSEs’.
- (N) [Having explored the conduit market] we have explored the conduit market for their loans and noted that the conduits were more likely to “tweak” a deal to accommodate a difficult transaction. This informant noted that it would be interesting to observe in the future whether the competitors’ strategies in the secondary market will have an impact on changing the GSEs’ strategies with “customers” in the future.

Similarly, the HFAs’ underwriting requirements are viewed as being more flexible with respect to the primary market. For example, to accommodate specific program requirements, some state HFAs, (e.g., the Massachusetts HFA), have modified the “industry standard.” MHFA developed its own standards, which Fannie Mae allowed them to keep as a “DUS-like lender.”¹⁴⁴ Although the loans originated under this program were sold to Fannie Mae, the final negotiations on the deal were very protracted.

¹⁴⁴ A “DUS-like lender” uses many of the requirements and standards included in Fannie Mae’s Guide, but not all.

- (N) 30 out of 48 HFAs currently participate in HUD’s risk-sharing program.¹⁴⁵ The program is voluntary, and the insurance/credit enhancement is allocated based on a “demand basis.” Most are the “Top-tier” or rated HFAs who participate mainly because the premiums are cheaper and the Delegated Underwriting Process is comprehensible.
- (N) One state HFA prefers to use FHA’s risk-sharing program versus other GSE credit enhancements because:
 - It’s less expensive in terms of fees and other third party costs;
 - The underwriting is more flexible based on the amount of risk the HFA is willing to take; and
 - HFAs in general like the “partial payment of claim”¹⁴⁶ component of the risk-sharing program in terms of mitigating loan defaults or if the loan gets into some “other” trouble, like market downturn, partnership problems, etc.

According to one informant, more recently, HFAs have offered debt products for long-term, low-income multifamily housing debt. They have adjusted the features of their products to address the needs of the multifamily market.

- (N) The HFAs have been willing to originate 30-year mortgages for affordable multifamily housing and the terms are more lenient: HFAs approve a debt service coverage ratio (DSC) of 1.1 and rely on operating subsidies (such as the SHARP program in Massachusetts) to apply to income. HFAs may also allow zero coupon bonds to leverage debt.¹⁴⁷ As this informant stated emphatically, “This is unheard of at Fannie or Freddie!” In addition, HFA staff also seem to better understand the needs of affordable housing developers.

Another GSE competitor, the FHLB, is another source of multifamily market liquidity (available to small banks and thrifts).

- (N) It [FHLB] is following the CRA model with its Community Investment Program (CIP). The CIP program is less expensive than those offered by Fannie Mae or Freddie Mac. The FHLB also has a grant program that makes subsidized advances that can cut the CIP loan rate. The FHLB has been criticized for being more conservative than the GSEs with respect to collateral requirements.

¹⁴⁵ This refers to a specific risk-sharing program between the FHA and the state HFAs that was developed to help the HFAs undertake a multifamily demonstration program without incurring all of the risk.

¹⁴⁶ FHA has a policy of making “partial payment of claim” for each claim when filed. The amount of the partial payment is typically 90 percent, with the remainder paid after other mitigating factors are taken into consideration.

¹⁴⁷ A “zero coupon bond” requires no payments for principal or interest until specified maturity date, much like Treasury notes. The GSEs require payments to subordinate financing to be paid on schedule.

More recently, growing competition has led some institutions to lower underwriting standards, allowing higher LTVs and lower DSC ratios, for example. While the GSEs are not competing on these dimensions, they are lowering their spreads relative to comparable maturity Treasuries on mortgage loans they are willing to purchase.

Inferences on Credit Availability

As discussed earlier, a credit gap refers to a situation where the demand for credit exceeds the supply at market interest rates because of disparities in the information available to borrowers and lenders with regard to credit risk. Under normal competitive-market circumstances, lenders would be expected to respond to excess demand for funds by raising interest rates to a market clearing equilibrium. However, because of their inability to fully evaluate borrowers' credit risk, lenders cannot raise interest rates, as higher interest rates would increase the credit risk of applicants and lower profits.

Evidence on the presence or absence of credit gaps in the primary mortgage market is inconclusive, from our interviews with national industry experts or multifamily lenders. Some informants stated that in the current market, there are no credit gaps. Other informants said there are still niches within multifamily market segments with credit gaps, but these are typically limited to specific geographic areas. Among the credit gaps mentioned by the informants are the following:

- Mortgage loans in rural areas;
- Mortgage loans in small metropolitan areas;
- Loans for rehabilitation; and
- Loans for construction projects for seniors or other special needs populations.

At the secondary market level, according to Dinsmore (1998), market segments that are typically not included in CMBS are:

- Construction loans;
- Small multifamily loans;¹⁴⁸
- Government-subsidized or regulated properties;
- Mixed-use properties; and

¹⁴⁸ There are a few companies targeting small multifamily mortgages (e.g., Daiwa Finance Corporation, an investment bank), with the intention of securitizing these loans and selling the securities.

- Projects with unconventional risks.

Much of the current rationale for excluding such loans from CMBS may be based on the lack of expertise of lenders and developers, who need assistance from experienced project managers to ensure the success of certain development projects. However, other organizations (e.g., Neighborworks® organizations in the single-family market) have hired the expertise (e.g., from architects, engineers, and project managers) to oversee rehabilitation construction for the majority of the single-family projects they undertake. Such experience may also be applicable to multifamily.

In the segments of the multifamily market that are well served by the secondary market, which primarily include the purchase and refinance of larger multifamily properties, the GSEs have been subject to strong competitive pressures from conduits and other national lenders. Consequently, the underwriting requirements and standards of the GSEs do not limit financing opportunities for properties in these market segments. The competitive pressure facing the GSEs is evidenced by the fact that both GSEs have reevaluated their underwriting requirements and reduced some standards for specific and limited products, in terms of LTV and DSC ratios. According to one lender with a nationwide market:

“Fannie Mae has been very reactive to the competition. They have lowered their prices a lot in the last couple of years in order to keep up with the competition. . . . In the financing of the affordable housing what they have done in the forward commitment program I think has been very significant.”

Freddie Mac has eliminated the requirement for funding replacement reserves in connection with loans to creditworthy borrowers. That is, their underwriting requirements and standards have changed but only in very minor ways. Freddie Mac has been willing to compete on price. According to a respondent:

“Since their prices were generally higher than those of their competitors, this was a reasonable place to compete without changing the risk profile.”

In contrast, the origination costs for small multifamily properties are still substantially different when comparing the GSEs and their chief competitors. Although the GSEs have made an effort to reduce origination costs, they have been unwilling to modify the third-party reports required.¹⁴⁹ Thus per unit costs, especially for a small multifamily property, are still substantially greater than for a single family property with one- to four- units, where third-party reports are not required.

¹⁴⁹ The third party reports include engineering reports, environmental report, appraisal, credit investigation, and management review.

7.3 GSE Underwriting and Appraisal Standards: Fair Lending Issues

Fair lending is a complex subject, as evidenced by the discussion in Section 5.2. In the interviews conducted for this research, most of the informants were reluctant to express an opinion in response to an explicit question about whether the GSEs' underwriting and appraisal requirements have a disproportionate impact on protected classes.¹⁵⁰

A few of the informants could express an opinion in response to a question of whether there were geographic areas where the GSEs do not buy mortgages. These few informants could identify areas in which the GSEs were "inactive" or where their product was not attractive (due to terms and pricing). These areas included the inner city, low-income areas (especially areas below 60 percent of median income), places where there were a lot of small and affordable apartments, rural areas, and small metropolitan areas. The remainder of the informants either claimed having no knowledge or a preference for making no comment.

The areas identified by the informants were likely to be the neighborhoods in a community that offered the most affordable rents and were therefore housing some of the persons with the lowest incomes. If those with low incomes were also in a protected class (e.g., minority), then the GSEs' inactivity in those areas could be said to have a disproportionate adverse impact on the (protected class) residents in those neighborhoods. However, this would not, by itself, amount to legal discrimination, which also involves issues of business necessity for the GSEs' actions and the possibility of less discriminatory alternative business practices that would satisfy the GSEs' business objectives. Section 5.2 discusses this, and Chapter 8 presents suggestions for ongoing HUD monitoring.

¹⁵⁰ Only three of the informants, who were familiar with the Fair Lending Laws and implications for protected classes, responded. It was clear to these three respondents that the laws apply to borrowers. They did not understand, however, that the laws could cover either the effects of the GSEs' underwriting on tenants in the multifamily properties or the residents of the neighborhood who were in protected classes, and they answered accordingly.

Chapter Eight

Monitoring Recommendations

There are several areas of GSE activities that HUD could monitor to become better informed about the progress being made in the multifamily mortgage market, given HUD's regulatory responsibilities. Each of these areas will require data collection. The recommendations for data collection and monitoring take account of informants' comments as well as trade press commentary.

8.1 Fair Lending Monitoring

Fair lending analysis of the GSEs' multifamily mortgage purchase activity is governed by a statutory framework similar to that governing the GSEs' single-family activities. A basic issue is whether the GSEs' underwriting or appraisal standards and guidelines have a *disproportionate adverse impact* on protected classes.¹⁵¹ An underwriting or appraisal standard may have an unfavorable effect on protected classes even if the requirements are imposed impartially. However, a finding of disproportionate adverse impact is not sufficient to support a finding of discrimination as this term has come to be defined by the courts. Follow-up research and analysis would be needed on whether the guidelines have a "business necessity," and whether some other, less discriminatory alternative exists that would also satisfy the business necessity. Protected classes under FHEFSSA include race, color, religion, sex, handicap, familial status, age, or national origin. Also prohibited is any consideration of the age or location of the dwelling or the age of the neighborhood or census tract where the dwelling is located, in a manner that has a discriminatory effect.

A monitoring strategy would include ongoing review of written guidelines and statistical analysis of the GSEs' multifamily mortgage purchase practices.

First, HUD should regularly review GSE underwriting guidelines with regard to special provisions governing specific geographic areas, minimum loan amounts, and age of property. Objectives of the review would be to determine whether there is any indication of disparate treatment, as well as to provide a basis for analysis on the question of disparate impacts.

Second, with regard to GSE underwriting practices, a difficulty in evaluating the potential for disproportionate adverse impacts is the lack of data on protected-class characteristics of

¹⁵¹ The issue of *disparate treatment* of borrowers (for multifamily properties) with the same relevant underwriting features is essentially an issue at origination, by the lender, although it also would be theoretically possible for the GSEs to discriminate if their purchases differed for a member of a protected class from a non-protected borrower with a similarly qualified loan.

tenants residing in the collateral property, either for GSE multifamily acquisitions or for properties that receive mortgage financing through non-agency secondary market sources or portfolio lenders. However, the data that are available on census tract characteristics may be correlated with race of tenant and/or the age of the property and could be used for a first-stage analysis. Other data sources such as data from the survey of multifamily properties in compliance with accessibility requirements, by HUD's Real Estate Assessment Center may provide some useful information. Given the limitations of the existing data, there are two main ways that HUD could monitor the GSEs in this regard:

- Use of data at the *census tract level* to compare the demographic characteristics of the tenant population in census tracts where GSEs have purchased multifamily mortgages with the characteristics in tracts where multifamily properties have received mortgage financing through other sources.¹⁵² Relevant demographic characteristics include race of head of household and median family income. Characteristics of the neighborhood tenant population would be utilized as a proxy for the characteristics of multifamily tenants.
- Use of data at the *property level*, to compare the characteristics of the properties collateralizing multifamily mortgages purchased by the GSEs with those held by portfolio lenders or purchased by non-agency (i.e., non-GSE) secondary market players. A predictive model would be built upon observed statistical relationships between property characteristics (such as age and affordability of property) and race of tenant.

For the analysis of *census tract level* information, HMDA data would be utilized to identify the tract location of loans not sold on the secondary market, and the loan-level data provided to HUD by the GSEs would be utilized to identify the tract location of GSE purchases. Census data would be utilized to evaluate demographic characteristics of tracts in which such loans are located. Research should attempt to determine whether the racial composition of the tenant population in census tracts where GSE purchases are located differs significantly from that of multifamily loans not sold on the secondary market.

For the analysis of *property level* information, a predictive model could be built using data from the American Housing Survey. The predictive model could be applied to data from the Multifamily Housing Institute in order to determine whether the “predicted” race of tenant in properties backing GSE multifamily purchases differs significantly from those of portfolio lenders.

Another approach, requiring new data, would seek to determine whether GSE underwriting practices result in higher credit costs on properties in high-minority areas or in properties

¹⁵² While the population of the *overall* tenant population may differ somewhat from that of the tenant population residing in *multifamily* structures, characteristics of the tenant population may need to be used due to limitations of the data.

where a large proportion of minorities are predicted to reside based on property characteristics, as discussed above. Successful implementation of this approach would require that the GSEs provide additional loan-level data to HUD on note rate, origination costs, and prepayment penalties so that HUD could calculate an annual percentage rate. In order to determine whether differences in the cost of credit are real or apparent, however, HUD would need to control for credit risk, and would therefore also need to be provided with data on LTV and DSC ratio as well. Ultimately, loan performance data would need to be analyzed, to address the issue beyond disproportionate impact.

In addition, HUD could collect information regarding the geographic location of properties where the GSEs have approved waivers to their underwriting guidelines as discussed in Chapters 3 and 7. When the census tract location of such properties has been determined, HUD could analyze whether there is evidence that properties likely to be inhabited by members of protected classes have been approved for waivers less frequently than other properties, representing a potentially disproportionate effect of the GSEs' waiver approvals (although it is not clear whether a positive finding would signify an adverse impact).

HUD could also collect information regarding effects on protected classes of the streamlined GSE approval procedures for DUS and Program Plus lenders. HUD could utilize GSE and HMDA data to analyze whether these lenders are more or less active in high-minority or inner city neighborhoods, or in areas with an older housing stock, than are other lenders. DUS and Program Plus lenders could usefully be compared with all other lenders active in the multifamily market, or with minority-owned thrift institutions identified by the Office of Thrift Supervision.¹⁵³ HUD could also evaluate whether the process by which the GSEs approve lenders for the DUS and Program Plus programs has disproportionate adverse effects on minority-owned lending institutions.

Furthermore, HUD could request loan-level information on default risk and loan losses as well as factors entering the underwriting process such as LTV and DSC to determine the effectiveness of GSE underwriting standards in controlling credit risk.¹⁵⁴ HUD could also ask the GSEs for any additional information pertaining to validation of their underwriting criteria.

Finally, HUD could monitor GSE multifamily transaction volume involving originations by minority-owned thrift institutions. To the degree that loans originated by such institutions are backed by properties in high-minority areas, or owned by African Americans, expanded transactions volume would represent an opportunity for the GSEs to expand the benefits

¹⁵³ See Office of Thrift Supervision, "Policy Statement on Minority Owned Thrift Institutions," May 25, 1999.

¹⁵⁴ Information would also need to be collected on credit enhancements in order to isolate the effectiveness of underwriting standards in mitigating loan losses, since credit enhancements may also have the effect of mitigating such losses.

provided by secondary market access to such properties. Conversely, any significant reduction in transactions volume involving such institutions could call into question the GSEs' commitment to fully serving the multifamily mortgage market.

8.2 Pilot Programs

The GSEs occasionally offer pilot programs to their DUS and Program Plus lenders to implement. According to the informants, some of these programs gain high visibility in the press but are seldom used in the marketplace. Some of these informants recommend that HUD closely monitor any pilot program, perhaps semi-annually through the first two years of its existence. From this information, HUD could determine whether the program is reaching hard-to-serve segments of the market.

8.3 Small Multifamily Properties

The GSEs' treatment of "smaller" loans, in both urban and rural areas, especially for affordable multifamily properties with fewer than 50 units, needs closer examination, especially in light of evidence that such properties are disproportionately located in high-minority areas and that ownership of multifamily properties by African Americans is concentrated among such properties. The GSEs continue to modify their underwriting approach to these loans, and are likely to be further encouraged to do so by HUD's 2000 Final Rule, which gives the GSEs bonus points for their purchases of small multifamily mortgages. HUD should continue to monitor the GSEs' purchases of small multifamily mortgages to determine whether the 2000 Final Rule is effective in creating incentives for the GSEs to become more active in financing these properties.

Appendix A

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Appendix B

Research Methodology

Research Methodology

The research strategy that Abt pursued for the Study of Multifamily Underwriting and the GSEs' Role in the Multifamily Market has included four phases of data collection:

- A review and summary of the *existing related research studies* and trade press accounts of financial services activities undertaken in the multifamily market;
- A brief analysis, using the Property Owner and Managers Survey (POMS) and the GSE data supplied by HUD, of the *major metropolitan markets* where Fannie Mae and Freddie Mac have been purchasing multifamily loans, as well as the major metropolitan markets where multifamily loans are being originated regardless of GSE purchases. The four markets selected are: Atlanta, Boston, Chicago, and Dallas;
- Telephone interviews with *key national industry experts* to assess potential impacts of the multifamily underwriting and appraisal standards and practices; and
- In-person and telephone interviews with *multifamily lenders* (recommended by national experts), in the four selected markets, to probe in more depth the impacts of the GSEs' underwriting and appraisal standards on the liquidity of the multifamily market as well as the potential impacts of the rapidly changing secondary market for commercial mortgages.

The first two phases of data collection included an intensive review of the related research studies and the trade press and analysis of information supplied by HUD on the top 25 metropolitan areas with multifamily market activity. Simultaneous with the second phase of data collection, Abt assembled a potential list of national industry experts and submitted it to Kerry Vandell (a project consultant) for his recommendations. Those recommended were contacted for a telephone interview.

Prior to conducting the national expert interviews, we prepared an interview guide to assist the Abt team to capture similar issues about multifamily mortgage finance on four key issues: multifamily market segments and financing, underwriting and appraisal standards and practices, GSEs' secondary market activities in various geographic areas, and recommendations for local lenders to interview during the next phase of data collection.

Ultimately, 26 individuals nominated as national industry experts were interviewed. Those included in the telephone interviews of national industry experts were representatives of the following multifamily financing market segments:¹

- Community and advocacy groups (n=8);
- Lender Consortia (n=5);
- Mortgage bankers (n=3);
- Investment houses (n=3);
- Developers (n=2);
- Housing finance agencies (n=1);
- Rating agencies (n=1);
- Academics (n=1); and
- HUD Field Office representative (n=1).

After conducting the first round of 26 interviews with national experts and prior to conducting the lender interviews, we revised the interview guide to capture similar issues about multifamily mortgage finance on four key issues: multifamily market segments and financing, underwriting and appraisal standards and practices, GSEs' secondary market activities in various geographic areas, and recommendations for HUD and the GSEs.

During the second phase of interviews (using in-person and telephone interviews with multifamily lenders), 20 interviews were conducted with 24 lenders² who were representatives of the following multifamily financing market segments:

- Wall Street conduits (n=5);
- Depository institutions (n=5);
- Mortgage bankers (n=7); and

¹ During the telephone interview phase with the national industry experts, we determined that most of the experts were willing to participate and be forthright in their comments as long as they remained anonymous. Since some also requested to not be listed in the report, we have applied that request to all experts. As a consequence, some of the comments used in this report are very close to verbatim, but we do not identify either the individual or the organization.

² Two interviews were held with more than one person participating.

- Federal Agency Representatives (n=3).³

Most of the interviews in both phases of the interviews were between 30 and 120 minutes long. The average was approximately 55 minutes. During these interviews, we also collected some background information to assist in understanding the context of the comments. Some of the experts were less knowledgeable about certain topics, so those interviews focused in more depth on topics related to their expertise.

³ All three representatives are very involved with and knowledgeable about multifamily lending activities.

Appendix C

Summaries of Fannie Mae's and Freddie Mac's

Multifamily Programs and Guidelines

Introduction

Congress chartered the Government-Sponsored Enterprises (GSEs) — the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) in 1938 and 1970, respectively. Currently both GSEs are chartered as shareholder-owned corporations (since 1968 for Fannie Mae and 1988 for Freddie Mac), as specified in Sections 301(b) of the Freddie Mac Act and 303 of the Fannie Mae Charter Act.

The following summarizes information by and about the GSEs:

C.1 Fannie Mae

Fannie Mae's goal is to provide a constant source of multifamily financing in the nation's urban, suburban and rural areas, targeting low- and moderate-income housing, underserved communities, and special affordable housing.⁴ In 2000, Fannie Mae exceeded the goals set for it by HUD for each of these targeted areas. In 2000, Fannie Mae financed \$13.5 billion in multifamily housing, providing affordable renting housing for more than 266,000 families. (Fannie Mae 2000 Annual Housing Activities Report, March 16, 2001, p. 23.) Of loans delivered to Fannie Mae by its Delegated Underwriting and Servicing (DUS) network in 2000 (described below), 65 percent served affordable housing needs, 20 percent were extended to underserved markets, and 40 percent addressed special affordable needs. Fannie Mae plans to expand availability of affordable multifamily housing through \$16 in financing activities in 2001. (Fannie Mae 2000 Annual Housing Activities Report, March 16, 2001, p. 23, 30.)

Fannie Mae's Multifamily Programs

DUS - Since 1988, Fannie Mae has delegated loan origination, underwriting, closing, and servicing responsibilities to approved and experienced lenders with expertise in financing multifamily properties, without prior review by Fannie Mae. Currently 26 DUS lenders originate and service on Fannie Mae's behalf. Under this risk-sharing partnership, DUS lenders can sell multifamily loans outright or swap multifamily loans for Fannie Mae MBS. Typically, DUS conventional loans:

- Are either fixed-rate balloon mortgages with 5-, 7-, 10-, or 15-year terms or fixed-rate fully amortizing loans with 25- or 30-year terms;
- Are secured by income-producing, multifamily rental or cooperative buildings with at least five units and with occupancy rates of at least 90 percent; and

⁴ *Urban Land*, 1997.

- Are on buildings, existing or recently completed, or may require moderate rehabilitation;
- Contain a loss sharing agreement between Fannie Mae and DUS lenders in case of default; and
- Are on loans originated within six months prior to Fannie Mae’s purchase.

Fannie Mae categorizes DUS loans into one of four credit ‘tiers’ based on debt service coverage (DSC) ratios and loan-to-value (LTV) ratios. Tier 4 loans have the highest credit quality, while Tier 1 loans have the lowest. Most DUS loans fall with in Tiers 2 and 3. DUS Underwriting Tiers are shown in Exhibit C-1. Tier 1 is seldom used because of its pricing.

Exhibit C-1

Tier	Minimum DSC Ratio	Maximum LTV Ratio
1	1.15	80%
2	1.25	80%
3	1.35	65%
4	1.55	55%
Source: Fannie Mae Guide III, 403 (2/20/01)		

A main advantage found in Fannie Mae’s multifamily securities over other residential MBS is the prepayment protection. Most include a yield maintenance premium, in the event of early prepayment. Common yield maintenance terms are shown in Exhibit C-2:

Exhibit C-2

Balloon Term (years)	Yield Maintenance Term (years)
5	3 or 4.5
7	5 or 6.5
10	7 or 9.5
15	10
30	10
Source: Esaki and Philips, p. 9	

After the end of the yield maintenance period, Fannie Mae still requires the borrower to pay a 1 percent premium in the event of prepayment. During the last 90 days of the loan period, this premium is not charged in order to give the borrower a window to refinance. If the premium were charged during the last 90 days, the borrower would be required to make a choice between repaying the entire loan balance at maturity or paying a prepayment premium to Fannie Mae.

Most DUS loans have recourse to the lender. The level of recourse varies with the “Loss Level,” or loss-sharing regime, entered into by Fannie Mae and the lender. Under the most common loss-sharing arrangement, Loss Level I, if a DUS loan defaults, losses up to the first 5 percent of the unpaid balance are carried solely by the lender. Fannie Mae and the lender share losses in excess of 5 percent; however, the lender’s total loss share is limited to 20 percent of the unpaid balance. Fannie Mae reported that as of year-end 2000, there had been 88 defaults of the more than 7,000 DUS loans originated to that point. (Burnett, Herbert, and Maris, 2001, pp. 6.) In 2000, almost 65 percent of the multifamily units financed by Fannie Mae came through the DUS lender network. Of the loans that came through the DUS network in 2000, 65 percent served affordable housing needs, 20 percent were extended to underserved markets, and 40 percent addressed special affordable needs. (Fannie Mae’s 2000 Annual Housing Activities Report, p. 23.)

Alternative Credit Enhancement Structures (ACES) - The ACES program allows non-DUS lenders to swap multifamily loans for Fannie Mae securities. The collateral in ACES deals may be from seasoned portfolios or from new conduit originations. Two basic ACES structures are:

- The Real Estate Mortgage Investment Conduit (REMIC)⁵ structure which includes:
 - Wisconsin Avenue Securities (WAS) REMIC⁶ – allows the lender to swap multifamily loans for senior (A) and subordinated REMIC certificates (B).
 - MBS REMIC – allows the lender to first swap multifamily loans for Fannie Mae MBS, which are then placed in a REMIC. A portion of the MBS certificates are held in a custodial account to provide first-loss protection (B) to senior securities (A).
- The A/B grantor trust - lender swaps loans for MBS but a portion of the MBS (B) is set aside in a custodial account to cover losses. Only the interest cash flows of

⁵ A REMIC is a pass-through vehicle created by the Tax Reform Act of 1986 to issue multiclass mortgage-backed securities. REMICs offer issuers more flexibility; issuers can separate mortgage pools not only into different risk classes but also into different maturity classes as well.

⁶ The WAS REMIC is more efficient than the MBS REMIC because the loans do not need to be first securitized before being put into the REMIC. In addition, it permits the creation of more liquid subordinate classes of loans.

the “B” piece are sold, and Fannie Mae retains its principal flows for a designated period of time. The “A” piece is sold in its entirety to investors and principal payments are guaranteed to be distributed monthly.

MBS Swaps – Under this program, the lender swaps multifamily mortgages for Fannie Mae MBS with full, partial or no recourse to the lender. Recourse obligations must be collateralized with Fannie Mae approved collateral or backed by a corporate guarantee.

Fannie Mae Aggregation Facility – This conduit-like lending program, begun in 1996, permits lenders to sell individual loans to Fannie Mae for cash on an ‘as originated’ basis. This program is available to approved DUS and Aggregation Facility lenders. Lenders participating in this program originate loans under standardized underwriting and origination requirements utilizing Fannie Mae Loan documents. Although Fannie Mae initially accumulated loans under the Aggregation Facility and issued WAS REMICs, Fannie Mae has subsequently held them in portfolio. (Burnett, Herbert, and Maris, 2001)

Other Fannie Mae programs include equity investments in properties eligible for the ***Low-Income Housing Tax Credits (LIHTC)***, which have expanded access to equity capital for developers and community development organizations. These investments help to revitalize distressed urban areas and develop housing for homeless families and individuals. In 2000, Fannie Mae closed on over \$1.3 billion in LIHTC commitments. (Fannie Mae’s 2000 Annual Housing Activities Report, March 16, 2001, p. 26.)

Targeted Affordable Housing finances housing with affordability and occupancy restriction that meet or exceed the Federal LIHTC requirements of:

- At least 20 percent of all units must have restricted rents affordable to households earning no more than 50 percent of area median income, adjusted for family size; or
- At least 40 percent of all units must have restricted rents affordable to households earning no more than 60 percent of area median income, adjusted for family size.

Under this program, Fannie Mae offers greater flexibility:

- LTV ratios may be as high as 90 percent (compared to 80 percent)
- DSC can be 110 percent (compared with 125 percent)
- A wider range of subordinate financing is acceptable.

Fannie Mae/HUD Risk-Sharing Program - Under this program, Fannie Mae reduces its guaranty fee to participating lenders by 10-20 basis points, which improves affordability. Fannie Mae uses the Targeted Affordable Housing product line with this program for newly constructed properties or substantially rehabilitated properties.

Fannie Mae introduced the ***5-50 Streamlined Mortgage Loan*** for small multifamily properties as a permanent product in May 2000. Fannie Mae reported that the product features streamlined underwriting and documentation requirements, designed to reduce the cost and time to finance small multifamily properties of five to 50 apartment units.⁷ Fannie Mae plans to increase its investment in small multifamily housing by at least \$1 billion in 2001, at least in part through the 5-50 Streamlined Mortgage Loan product. (Fannie Mae's 2000 Annual Housing Activities Report, March 16, 2001, p. 30.)

Fannie Mae's Underwriting Guidelines

Following is a list of the minimum documentation required by Fannie Mae for underwriting a loan. The lender must maintain these documents for each mortgage.

⁷ Burnett, Herbert, and Maris, 2001, p. 14.

Exhibit C-3
Fannie Mae's Required Documentation

A. Borrower Structure and Experience
<ol style="list-style-type: none"> 1. Description of the borrower entity and for each borrower, key principal and principal, a copy of their certified multifamily ownership and loan history statement. 2. Results of the experience checks for each borrower, key principal and principal. 3. Organizational documents of the borrower and each principal that is not an individual and of any entity which owns an interest in the principal. Resumes for each key principal and each individual principal.
B. Borrower Credit
<ol style="list-style-type: none"> 1. Signed financial statements to include name and location of property, property age, number of units; ownership interest, estimated value, amount and terms of debt and debt secured by property; maturity date of debt on secured property; property annual net operating income; and, income after debt service. 2. Federal income tax returns as required by Section 605.01 of this Part. 3. Credit reports. The credit reports must include a search of the public records 4. Verification of significant deposits and noncash assets. 5. Verifications of bank and trade references. 6. The borrower's mortgage loan payment record for the last two years, if the property is being refinanced. 7. Appropriate borrower's certificate regarding creditor's rights and UCC filings.
C. Property Management
<ol style="list-style-type: none"> 1. A property management plan. 2. List of all property staff, their salaries and benefits, including any fee or discounted units. 3. Statement indicating what costs, if any, are shared with other properties.
D. Property Location and Condition
<ol style="list-style-type: none"> 1. Certificate of building code compliance or the results of recent code inspections. 2. Evidence of compliance with zoning and land use laws and regulations. 3. List major repairs and capital replacements for the property for the year to date and the previous three years. 4. Termite inspection report, termite bond or other evidence of adequate coverage. 5. For moderate rehabilitation and recently completed properties, an architect's or engineer's report. 6. Aerial photograph of property.

Exhibit C-3
Fannie Mae's Required Documentation
(Continued)

<p>E. Underwriting Documents</p> <ol style="list-style-type: none">1. Certified project rent roll, certified by borrower, the management agent, and the lender.2. Appraisal with all attachments.3. Original operating statements, including profit and loss statements and balance sheets for the last three years, certified by borrower for any property to be refinanced.4. Copies of historical bills or assessments, as required by the lender.5. Copies of any reciprocal use agreements relating to recreational facilities, parking areas, or private streets, etc.6. Copies of laundry leases, if applicable.7. Copies of all material service contracts.8. If the property is subject to any federal, state, or local rent, occupancy and/or resale restrictions, a copy of the applicable laws or regulations.9. Ground lease analysis and copies of any ground lease.10. Lender's commitment to the borrower.11. Underwriter's narrative.12. Underwriter's recommendation to the lender's loan committee.13. Evidence that the loan was approved by the lender's loan committee.
<p>F. Other Documents</p> <ol style="list-style-type: none">1. Lender's form application from the borrower.2. Title insurance policy for this transaction and if obtained, any historical title insurance policies.3. Survey and surveyor certificate.4. Copies of the property sales contract, including all addenda, if the property was acquired during the 12-month period preceding the date of the borrower's loan application.5. All documents, not listed here, that are part of the mortgage loan delivery documents, including closing documents and documents contained in the mortgage loan delivery package and the monitoring package.

C.2 Freddie Mac

Freddie Mac provides a range of financing products for the acquisition, construction, refinance or moderate rehabilitation of apartment buildings. In contrast to Fannie Mae, Freddie Mac reduced its role in multifamily market for nearly three years beginning in 1990. Since 1993, Freddie Mac has purchased more than \$29 billion in multifamily mortgages, financing housing for 900,000 families. In 2000, Freddie Mac purchased \$7.1 billion in multifamily loans, a 10 percent decrease from their 1999 record purchase activity. Ninety-

two percent of the units in mortgages funded in 2000 were affordable to families with incomes at or below their area medians.⁸

Freddie Mac Programs

Freddie Mac ensures national coverage through a carefully selected network of lenders called Program Plus lenders (banks, pension funds, insurance companies, lending consortia, foundations, state and local housing agencies and low-income housing tax credit intermediaries). These lenders are pre-approved to sell and service loans in geographic territories where the lender has proven expertise. Freddie Mac works with these lenders to develop permanent financing for rental properties that are home to low-income families as well. To be eligible for purchase under Freddie Mac's conventional cash purchase program, loans must be between \$300,000 and \$50 million⁹ and have the following characteristics:

- Terms of 7, 10, 15, 20, 25 or 30 years
- Maximum amortization period of 30 years
- Maximum LTV of 80 percent
- Minimum DSC of 1.25

In an effort to expand the availability of properties with affordable rent for low-income families, Freddie Mac also purchases multifamily mortgages either for cash or through its *Negotiated Transactions Program* in which it exchanges mortgages for Freddie Mac Multifamily Participation Certificates (PCs), a pass-through security where the principal and interest on each pooled mortgage is "passed-through." The borrower pays the debt service, (principal and interest) to the lender, and the lender passes the remaining (after the servicing fee) principal and interest on to Freddie Mac. After Freddie Mac removes its guarantee fee for management and guarantees, it passes the remaining principal and interest on to the PC holder.¹⁰ In addition to the PC swap transactions, Freddie Mac Multifamily Negotiated Transactions includes the purchase of mortgages with credit support provided by the seller or borrower and/or credit enhancement of multifamily housing bonds on a pool basis and other non-standard mortgage purchase transactions.

Freddie Mac's Pilot Programs and Initiatives

Senior Housing Program - provides long-term financing for rental housing that meets the needs of elderly residents. Eligible properties include rental housing accommodations that provide any combination of independent living, congregate care, and assisted living. (Freddie Mac's Annual Housing Activities Report, March 16, 2001, p. 51.) In 2000, Freddie Mac

⁸ www.freddiemac.com/news/archives2001/mfyearend.htm

⁹ Waivers are required for loans larger than \$50 million.

¹⁰ www.freddiemac.com/function/fm-multi/prodlio1.htm

financed \$529 million, for 5,900 units, in seniors apartments, congregate care and assisted living housing.

Forward Commitment Pilot LIHTC Execution - provides mortgage financing for multifamily properties that qualify for low-income housing tax credits. It provides a single source of construction and permanent financing for tax credit properties that are affordable to low-income families. The financing is fixed-rate during construction and provides a Freddie Mac commitment to buy the permanent loan upon construction completion and lease-up.

Multifamily Housing Bond Credit Enhancement Program – announced in February 1998, provides credit enhancement for both fixed-rate bonds and variable-rate bonds. The credit enhancement can be used as a replacement of existing credit enhancement facility for tax-exempt bonds for refundings, acquisition, and acquisition/rehabilitation (minimum rehabilitation only). Freddie Mac guarantees payment of mortgage principal and interest that is used to pay the bond investors. The minimum loan size per property is \$3 million; the maximum loan size is \$50 million.

Low-Income Housing Tax Credit Investments - in 2000, Freddie Mac invested more than \$272 million in LIHTC properties. By working with for-profit and nonprofit partnerships, its total low-income housing tax credit investments have surpassed \$1.4 billion. (Freddie Mac's Annual Housing Activities Report for 2000, March 16, 2001, p. 2.)

Tax-Exempt Bond Investment - in 2000, Freddie Mac purchased \$592 million in newly-issued multifamily mortgage revenue bonds that had been issued by state, county or city government agencies to finance mortgages for nonprofit borrowers or property owners who agree to keep rents at affordable levels. These bonds will finance approximately 12,800 units of affordable housing.¹¹

HUD/Freddie Mac Risk-Sharing Program - provides lender financing for up to 5,000 units of affordable rental housing through a unique risk-sharing partnership between Freddie Mac and HUD.¹² Two projects have been funded through this program to date, a total of \$14 million for 652 units.

Freddie Mac's Underwriting Guidelines

To be eligible for Freddie Mac's programs, the lender must follow Freddie Mac's underwriting requirements provided in Exhibit C-4 and Freddie Mac will re-underwrite these mortgages.

¹¹ Freddie Mac's Annual Housing Activities Report 2000, p. 2.

¹² www.freddiemac.com/function/fm-multi/prodlio1.htm

Exhibit C-4
Freddie Mac's Required Documentation

A. Delivery Location
The seller must deliver to Freddie Mac, at the seller's expense, the required documents and any required fees, subject to Freddie Mac's approval. The seller must deliver the required documents to the applicable Freddie Mac Multifamily Regional Office serving the State where the Property is located.
B. Organization of Underwriting Packages
With respect to each delivery, the seller/servicer must: <ul style="list-style-type: none">• deliver the documents simultaneously.• adequately secure the documents at the top right inside of a legal-sized manila folder.• arrange the documents in the order listed below, with the first item on top.
C. Changes to Forms
The seller may not make changes to any forms prescribed by Freddie Mac without prior written authorization from Freddie Mac.
D. Copies of Forms and Documents; Delivery of Original Documents.
The seller must submit only originally executed forms and documents unless otherwise noted.
E. Certification
Documents for which Freddie Mac requires certification must bear the following statement, executed by an individual who is authorized to legally bind the borrower or borrower principal: I hereby certify that the information contained in this documents is complete and accurate as of <i>(Date)</i> <i>(Name of Entity)</i> and <i>(Signature)</i> .
F. Financial Statements
Financial statements must include, at a minimum, a balance sheet and an income statement. If the financial statements are audited, a statement of changes in financial position and all notes must also be included. If audited financial statements are not available, the party whose finances are summarized by the statement must certify that the statements are complete and accurate.

Exhibit C-4
Freddie Mac's Required Documentation
(Continued)

G. Cooperative Analysis

If the property is owned by a cooperative housing corporation, a cooperative analysis must include:

1. Documentation required in Section C of Schedule IX of Form 506, Multifamily Risk Assessment.
2. Current financial statements for any one owner that holds 20% or more of the Cooperative's shares. If an owner of 20% or more is a corporation, partnerships or other legal entity, the seller must deliver financial statements for each officer, general partner or trust beneficiary, including sponsors and beneficiaries that hold unsold shares.
3. Maintenance fee delinquency report for the previous 12 months showing the number of units delinquent for each month and the corresponding dollar value.
4. Analysis of the sponsor's current cash flow from unsold units (rent roll detailing rent and maintenance for each unit).
5. Analysis of the sponsor's ability to support negative cash flow from unsold units, if applicable.
6. Analysis of pro forma Income and Expense Statements showing the economic results if the property were operated as a rental.
7. Analysis of the estimated value of the Property as a Cooperative (Co-op) and as a rental project.
8. Information on loans secured by unsold shares.

H. Mortgage Transaction Narrative Analysis

A Mortgage transaction narrative analysis is a narrative analysis by the seller describing the mortgage transaction and containing a discussion of the:

1. Characteristics of the proposed mortgage that make it an investment quality mortgage, risk factors and the reasons the seller recommends the mortgage.
2. Property's physical description.
3. Property's financial analysis (profile and trend).
4. Evaluation of balloon risk that includes the borrower's ability to pay the unpaid principal balance (UPB) of the new mortgage at maturity.
5. Surrounding property uses and physical condition, public facilities, shopping facilities and sources of employment.
6. Market analysis (occupancy, supply and concessions).
7. History of the borrower's equity investment in the property and the borrower's proper use of mortgage proceeds.

Exhibit C-4
Freddie Mac's Required Documentation
(Continued)

I. Rent Schedule

Must be current and dated and include:

1. Unit number or identification
2. Tenant's name
3. Unit type
4. Monthly rent
5. Subsidies, if applicable (specify)
6. Rent controlled or rent stabilized, if applicable
7. Concessions, rebates or discounts given to tenant
8. Furnished or unfurnished status
9. Lease commencement date
10. Lease expiration date
11. Arrearages owed by tenant, if any
12. Amount of security deposit held

J. Credit Report

Current credit report on the borrower and each borrower principal must:

1. Be issued by an independent credit reporting agency acceptable to Freddie Mac
2. Be dated within 60 days before delivery of the full underwriting package
3. Verify debts listed on the financial statement submitted with the full underwriting package, including terms, balances and ratings
4. List any other debts
5. List all legal actions that involve the borrower or borrower principal and are disclosed by a search of public records

K. Real Estate Schedule

A real estate schedule (Form 1116) for all real estate in which the borrower or any borrower principal currently has a direct or indirect interest must be dated with 60 days of the submission and certified by the borrower as complete and accurate.

For each parcel identified, the schedule must contain:

1. Name of owner of each property identified on the schedule
2. Role and ownership interest of each owner of the property
3. Property name and address, including city, county, and state
4. Property type
5. Acquisition date of each property
6. Identity of lenders, if any
7. Freddie Mac loan number
8. Current mortgage balance or balances
9. Current market value as estimated by the borrower
10. Date of the borrower's value estimate
11. Income and expense information for the property

Exhibit C-4
Freddie Mac's Required Documentation
(Continued)

L. Incomplete or Improper Packages

If the delivery is incomplete, if the documents have not been properly prepared, or if the documents do not, or the delivery does not, otherwise conform to Freddie Mac requirements, Freddie Mac cannot process the underwriting package.
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Appendix D

Features of Selected Multifamily Finance Programs

Exhibit D-1
Selected Multifamily Finance Programs: Fannie Mae

Name of Program	Delegated Underwriting and Servicing (DUS) Product Line	Prior Approval Product Line	Targeted Affordable Housing Program	5-50 Streamlined Mortgage
Description	Under DUS, Fannie Mae purchases qualified multifamily mortgages from specially designated lenders. These DUS lenders have been delegated responsibilities for originating, underwriting, closing and servicing. Fannie Mae purchases multifamily mortgages without prior review by Fannie Mae.	Individual transactions are submitted by approved Prior Approval lenders to Fannie Mae regional offices, where they receive full review prior to commitment. Underwriting standards are the same as DUS.	This program is available through either the DUS or Prior Approval product lines. This program has specific affordability and occupancy restrictions similar to the LIHTC program. Current priority is given to targeted affordable housing transactions.	Through this program, available through the DUS product line, Fannie Mae purchases small multifamily properties of five to 50 apartment units. Mortgages purchased through the program are eligible for streamlined underwriting requirements and processing and reduced costs.
Loan Amount	No minimum or maximum loan amount (average is \$5 million).	No minimum or maximum loan amount.	No minimum or maximum loan amount.	No maximum or minimum (average is \$750,000 ¹³)
Term and Amortization	5, 7, 10, 15, 25 years, or others by request; 25- or 30-year amortization or less, by request. ARMs available also.	5, 7, 10, 15, 25 years, or others by request; 25- or 30-year amortization or less, by request. ARMs available also.	5, 7, 10, 15, 25 years, or others by request; minimum 18-year term for LIHTC properties; 25- or 30-year amortization or less, by request. ARMs available also.	5 to 30 years; amortization from 10 to 30 years. ARMs available also.
Interest Rates	Priced daily; best prices to most conservative transaction on a four-tier basis. Wall Street access.	Priced daily; best prices to most conservative Transaction on a four-tier basis. Wall Street access.	Special pricing available for targeted affordable housing transactions. Wall Street access.	80% for fixed-rate loans, 77.5% for ARMs.
Rate Lock	Option to lock at commitment	Option to lock at commitment	Option to lock at commitment	125% or higher for fixed-rate loans; 100% at cap for ARMs.

¹³ Burnett, Herbert, and Maris, 2001, p. 14.

Exhibit D-1 (continued)
Selected Multifamily Finance Programs: Fannie Mae

Name of Program	Delegated Underwriting and Servicing (DUS) Product Line	Prior Approval Product Line	Targeted Affordable Housing Program	5-50 Streamlined Mortgage
Prepayment	Numerous yield maintenance options depending upon execution chosen. 1% after yield maintenance term; last 90 days open.	Numerous yield maintenance options depending upon execution chosen. 1% after yield maintenance term; last 90 days open.	Numerous yield maintenance options depending upon execution chosen. 1% after yield maintenance term; last 90 days open.	The combined DSC and LTV of the first mortgage and the subordinate financing must conform with the DSC and LTV limits established for the underwriting tier of the first mortgage.
Assumability	Yes, under the conditions of the mortgage documents.	Yes, under the conditions of the mortgage documents.	Yes, under the conditions of the mortgage documents.	The combined DSC and LTV of the first mortgage and the subordinate financing must conform with the DSC and LTV limits established for the underwriting tier of the first mortgage.
Maximum Loan-to-Value Ratio	80%	80%	Special underwriting, up to 90% for targeted affordable housing transactions.	80% for fixed-rate loans, 77.5% for ARMs.
Debt Service Coverage	125% or higher for most loans.	125% or higher for most loans.	For properties supported 100% by project-based Section 8 HAP contract is 110%; for other targeted affordable housing properties--115%.	125% or higher for fixed-rate loans; 100% at cap for ARMs.
Fees	Vary with DUS lender, 2% Fannie Mae fee refunded at closing (except \$10,000, which is refunded when legal documents are cleared).	Vary with transaction size.	See DUS and Prior Approval product lines.	Minimum of 1% of the original loan amount in origination fees; servicing fees for loans under \$3 million may be higher than those for DUS pricing.
Timing	Varies with DUS lender, workload. No Fannie Mae review required.	Depends on complexity of transactions and regional workload.	See DUS and Prior Approval product lines.	See DUS product line.
Eligible Properties	From premium to moderate, wide age range, central city or suburban, high rise or garden.	Wide range, with priority to targeted affordable housing. Rental and co-op, new to moderate rehab.	Wide range, with priority to targeted affordable housing. Rental and co-op, new to moderate rehab.	Multifamily mortgages with 5 to 50 units that are affordable under HUD guidelines.

Exhibit D-1 (continued)
Selected Multifamily Finance Programs: Fannie Mae

Name of Program	Delegated Underwriting and Servicing (DUS) Product Line	Prior Approval Product Line	Targeted Affordable Housing Program	5-50 Streamlined Mortgage
Escrow	May need escrow for repairs if not completed by closing.	May need escrow for repairs if not completed by closing.	May need escrow for repairs if not completed by closing.	Escrow funds may be required to ensure the timely completion of repairs, replacements, and/or improvements to the property.
Replacement Reserves	Depends on structure, but not automatically required for under 10-year transactions; may be waived for certain transactions with over 1.35 DSC.	Depends on structure, but not automatically required for under 10-year transactions; may be waived for certain transactions with over 1.35 DSC.	Full funding of replacement reserves at a minimum of \$150 per unit per year.	Funding of replacement reserves may be required if property condition is declining or taxes or insurance are unpaid or if Borrower fails to file operating statement. For Tier 2 loans over \$3 million, 50% funding of replacement reserves is required.
Subordinate Financing	The combined DSC and LTV of the first mortgage and the subordinate financing must conform with the DSC and LTV limits established for the underwriting tier of the first mortgage.	The combined DSC and LTV of the first mortgage and the subordinate financing must conform with the DSC and LTV limits established for the underwriting tier of the first mortgage.	The combined DSC of first mortgage and subordinate financing must be a minimum of 105%.	The combined DSC and LTV of the first mortgage and the subordinate financing must conform with the DSC and LTV limits established for the underwriting tier of the first mortgage.
Main Advantage	Cash-out, 80% LTV, 30-year amortization. MBS/DUS provides access to Wall Street pricing.	Because of direct review by Fannie Mae's Prior Approval, can handle a greater range of complexities than other product lines.	LTV ratio up to 90%; DSC can be 110%; a wider range of subordinate financing acceptable.	Reduced transaction costs for third-party reports; reduced out-of-pocket costs to the borrower; streamlined underwriting requirements; simplified business processes; reduced data submission requirements.
Main Disadvantage	N/A	N/A	N/A	N/A

Sources: Adapted from Multi-Housing News (August/September 1996), AllRegs, and Fannie Mae brochures.

Exhibit D-2
Selected Multifamily Finance Programs: Freddie Mac

Name of Program	Conventional Cash Program	Forward Commitment Pilot LIHTC Execution	Senior Housing and Assisted Living Pilot Program
Description	The program is for refinance, acquisition or moderate rehabilitation loans that demonstrate high investment quality.	This pilot provides a single source of construction and permanent first mortgage financing for newly constructed properties or those being substantially rehabilitated that will receive 9 percent credits under the LIHTC program. It provides for a maximum of 36-month interest-only construction financing, followed by an 18- to 30-year amortizing permanent loan upon construction completion, lease-up, and property income stabilization.	This pilot provides a source of first mortgage financing for rental housing that is exclusively for senior residents, including properties that provide assistance for residents with the activities of daily living.
Loan Amount	Small loan program: \$300,00 - \$999,999. Large loan program: \$1 million - \$50 million.	\$1 million to \$15 million per property.	\$3 million to \$15 million per property.
Term and Amortization	5, 7, 10, 15, 25 years, or others by request; 25- or 30-year amortization or less, by request.	18 to 30 year term; 25 to 30 year amortization.	7, 10, 15, 20, and 25 years (loans with terms of 20 years or longer must be self-liquidating). Standard amortization schedule is 25 years or less.
Interest Rates	Fixed for term of loan. Competitive rates based on risk-based pricing for each loan's quality; Wall Street access for PC One Program. Rate reset mortgages fixed for each 5-year term.	Fixed for term of the construction and permanent loan.	Permanent fixed rate.
Rate Lock	Option to lock at commitment.	Option to lock both the project loan and permanent loan rates at commitment.	Option to lock at commitment.
Prepayment	Yield maintenance or fixed fee schedule.	The standard yield maintenance period is 15 years. The minimum prepayment premium due during and after the yield maintenance period is 1% of the amount prepaid. There is no prepayment premium during the last 90 days of the term of the permanent mortgage.	Fully prepayable with payment of applicable prepayment fee.

Exhibit D-2 (continued)
Selected Multifamily Finance Programs: Freddie Mac

Name of Program	Conventional Cash Program	Forward Commitment Pilot LIHTC Execution	Senior Housing and Assisted Living Pilot Program
Assumability	One time transfer allowed with consent of Freddie Mac.	Yes, under the conditions of the mortgage documents.	“Due on sale” with a waiver for independent living and congregate care properties.
Loan to Value Ratio	80%, based upon Freddie Mac value.	85% maximum; 90% with HUD risk sharing. (See subordinate financing).	75% maximum.
Debt Service Coverage	125% for loans of \$1 million or more; 130% minimum for loans under \$1 million.	115% minimum; 110% with HUD risk sharing. (See subordinate financing).	135% minimum. May be as low as 125% for shorter amortization periods.
Fees	0.10% application fee.	Application fee is the greater of \$3000 or .10% of loan amount. Commitment fee of 2% of loan amount (refundable). Delivery assurance fee of 5 percent of loan amount (refundable). Conversion fee of .1% of loan amount.	Application fee is the greater of \$2000 or .10% of loan amount.
Timing	An average of 23 days between receipt of application and commitment issuance	Freddie Mac will issue an indication quote within 10 working days of receipt of a complete preliminary underwriting package. Then the Seller/servicer has 90 days to prepare the Construction Loan underwriting package.	An average of 23 days between receipt of application and commitment issuance
Eligible Properties	5+ units, garden, mid-rise, high-rise and cooperative properties in good condition with minimum occupancy of 90% for 90 days.	To-be-built or substantially rehabilitated garden or mid-rise apartments that have received a 9% tax credit allocation under Section 42 if the Internal Revenue Code.	Independent care, congregate care, assisted living properties. Because of the need to support properties that allow for each resident to age in place, eligible properties may contain a mix of resident care with a limited amount of skilled nursing care. Private pay rental only.
Escrow	Tax and insurance escrows required.	Tax and insurance escrows required.	Tax and insurance escrows required.
Replacement Reserves	Replacement reserve escrows typically required.	Replacement reserve escrow required.	Replacement reserve escrow required.

Exhibit D-2 (continued)
Selected Multifamily Finance Programs: Freddie Mac

Name of Program	Conventional Cash Program	Forward Commitment Pilot LIHTC Execution	Senior Housing and Assisted Living Pilot Program
Subordinate Financing	Subordinate financing will be considered under certain conditions and circumstances.	Subordinate financing allowed with consent of Freddie Mac: Hard: DSC of 110% minimum LTV of 90% maximum Soft: DSC of 105% minimum LTV of 100% maximum	None.
Main Advantage	Competitive terms, conditions, process and rates. Early rate lock delivery option.	25- to 30-year amortization.	Long-term financing, nationwide program, flexible term, short turn-around time, and competitive rates.
Main Disadvantage	DSC is high compared with other conduit programs. Small loans have a 25% recourse.	DSC is high compared with other conduit programs.	N/A

Sources: Adapted from Multi-Housing News (August/September 1996), Freddie Mac web page (www.freddiemac.com/multifamily/prodsh01.htm and www.freddiemac.com/multifamily/lowincome.htm), AllRegs, and Freddie Mac brochures.

Exhibit D-3
Selected Multifamily Finance Programs: FHA

Name of Program	FHA 221(d)(4) Program	FHA 223(f) Program	FHA 232 Program
Description	The program provides mortgage insurance for new construction or substantial rehab of rental or cooperative multifamily housing. (Substantial rehab when cost exceeds \$6,500 per unit adjusted by area high cost percentage, or when more than one major building component must be replaced.)	The program is for acquisition or refinance of existing nursing homes and assisted living facilities.	This program is for new construction or substantial rehabilitation of nursing homes and assisted living facilities.
Loan Amount	No minimum or maximum	No maximum limits.	Up to 90 % (95% for non-profit) of cost. Underwritten at 111% pro forma debt service coverage.
Term and Amortization	Up to 40 years, self-amortizing.	Up to 35 years, self-amortizing. (75% remaining useful life).	40 years, self-amortizing.
Interest Rates	Fixed for term of loan; based upon current market conditions; and set at the closing of the construction loan.	Fixed for term of loan. Competitive rates based on risk-based pricing for each loan's quality; access to Wall Street. Rate reset mortgages fixed for each 5-year term.	Fixed for term of the construction and permanent loan.
Rate Lock	The rate lock is arranged with the security (GMAC) purchaser by payment of a reservation fee of 50-100 basis points (refundable).	The rate lock, after acceptance of the HUD commitment and (up to 60 days) prior to closing, is arranged with the security (GMAC) purchaser by payment of a reservation fee of 50-100 basis points (refundable).	The rate lock, after acceptance of the HUD commitment and (up to 60 days) prior to closing, is arranged with the institutional investor who purchases the whole loan or a GMAC security and usually requires a commitment fee of 50-100 basis points (refundable).
Prepayment	Negotiable, usually locked for 5 years then 5%, 4%, 3%, 2%, 1% thereafter, at par.	Negotiable, usually locked for 5 years then 5%, 4%, 3%, 2%, 1% thereafter, at par.	Negotiable, usually locked for 5 years then 5%, 4%, 3%, 2%, 1% thereafter, at par.
Assumability	Yes, subject to HUD approval with a nominal fee of 0.05%.	Yes, subject to HUD approval with a nominal fee of 0.05%.	Yes, subject to HUD approval with a nominal fee of 0.05%.
Loan to Value Ratio	None for new construction; 90% for substantial rehabilitation.	Up to 85% provided no cash out. Up to 79% with proceeds to the borrower.	Up to 90% (95% for non-profit borrowers).

Exhibit D-3 (continued)
Selected Multifamily Finance Programs: FHA

Name of Program	FHA 221(d)(4) Program	FHA 223(f) Program	FHA 232 Program
Debt Service Coverage	111% for new construction. No change from original underwriting for rehab projects ; no performance requirements.	117.6%.	No change from original underwriting for rehab projects; no performance requirements.
Fees	Loan fee: none--included with construction loan. HUD application fee of .3% of mortgage amount. Initial processing fee of \$15,000 to \$20,000 upon acceptance of application. HUD mortgage insurance premium of .5% of mortgage amount. HUD inspection fee of .5% of mortgage amount. Financing and Permanent Placement Fees of up to 3.5% plus 1.5% of mortgage amount.	Loan fee of 1-2% depending on loan size. HUD application fee of .3% of mortgage amount. Initial processing fee of \$15,000 to \$20,000 upon acceptance of application. HUD mortgage insurance premium of 1% of mortgage amount due at closing, then .5% per annum paid monthly with principal and interest. HUD inspection fee of 1% of required repairs or \$30/unit. Financing and Permanent Placement Fees of up to 3.5% plus 1.5% of mortgage amount.	Loan fee: none--included with construction loan. HUD application fee of .3% of mortgage amount. Initial processing fee of \$15,000 to \$20,000 upon acceptance of application. HUD mortgage insurance premium of .5% of mortgage amount. HUD inspection fee of .5% of mortgage amount. Financing and Permanent Placement Fees of up to 3.5% plus 1.5% of mortgage amount.
Timing	Although it can vary by specific office, processing time from HUD's receipt of a complete submission ranges from 1-3 months for site appraisal and market analysis to 3-12 months for a firm commitment..	Although it can vary by specific office, processing time for a 223(f) loan is generally within 90 days of HUD's receipt of a complete submission. In most offices, this submission is under the Fast Track program.	Although it can vary by specific office, processing time from HUD's receipt of a complete submission ranges from 1-3 months for site appraisal and market analysis to 3-12 months for a firm commitment.
Eligible Properties	Multifamily properties. Units must have kitchens and baths and comply with local building codes. The program is geared toward market rate housing; however, subsidized, tax credits and moderate-income properties are not excluded.	The project must be at least 3 years old and contain 8 or more apartment units for long-term residential use. Moderate rehabilitation is allowed, however, the total construction costs must not exceed HUD's estimate of replacement cost upon completion by more than 15%.	The project must contain five or more units for long-term residential use and nursing homes must have at least 20 beds.

Exhibit D-3 (continued)
Selected Multifamily Finance Programs: FHA

Name of Program	FHA 221(d)(4) Program	FHA 223(f) Program	FHA 232 Program
Escrow	Tax and insurance escrows required. Initial operating deficit escrow, if any. 2% working capital escrow, 4% GNMA escrow if required during construction	Tax and insurance escrows required. Initial operating deficit escrow, if any. 2% working capital escrow (unused portion released after sustaining occupancy has been reached for three months.	Tax and insurance escrows required. Initial operating deficit escrow, if any. 2% working capital escrow (unused portion released after sustaining occupancy has been reached for three months.
Replacement Reserves	Deposited monthly commencing with amortization and based on a percentage of structural costs.	Replacement reserve escrows typically required.	Replacement reserve escrow required.
Subordinate Financing	Subordinate financing will be considered under certain conditions and circumstances.	In certain cases, second mortgages may be permitted where acquisition or refinancing costs are greater than the mortgage amount. The secondary debt may have no foreclosure rights and cannot exceed 7.5% of the project's value, or: a) In a purchase transaction, 7.5% of costs. b) In a refinance transaction, 50% of the difference between total costs and the mortgage amount.	Second mortgages are allowed subject to HUD review and provided that the secondary debt has no foreclosure rights.
Main Advantage	1.00-1.11 DSC. Long-term, fixed rate, full amortization, non-recourse, and competitive interest rates. Construction and permanent financing.	Financing up to 35 years self-amortizing, assumable, no net worth minimums.	Financing up to 90% (95% for non-profit borrowers) of cost. Construction and permanent loan in one. Amortization up to 40 years, assumable, and no net worth requirements.
Main Disadvantage	Processing time in some offices; prevailing wage rates.	N/A	N/A

Sources: Adapted from Multi-Housing News (August/September 1996); and Berkshire Mortgage Finance brochures.

Appendix E

Acronyms

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AMI – area median income

CIP – Community Investment Program

CMBS – commercial mortgage-backed securities

CRA – Community Reinvestment Act of 1977

DSC – debt service coverage

DUS – Delegated Underwriting and Servicing Program

EMI – Enterprise Mortgage Investments Inc.

FHEFSSA – Federal Housing Enterprises Financial Security and Soundness Act of 1992

FHLBs – Federal Home Loan Banks

FIRREA – Financial Institutions Reform, Recovery and Enforcement Act of 1989

GSEs – government-sponsored enterprises

HMDA – Home Mortgage Disclosure Act

LIHTC – Low Income Housing Tax Credit Program

LIMAC – Local Initiatives Managed Asset Corporation

LTV – loan-to-value

O&M – Operations and Management Plans

POMS – Property Owners and Managers Survey

REITs – real estate investment trusts

RTC – Resolution Trust Corporation

S&Ls – savings and loans