c. Economic and Housing Conditions: Multifamily Market

(1) *The Secondary Mortgage Markets: Multifamily Differs from Single-Family*. Over the past two decades, the single-family mortgage market has evolved from a fragmented set of local markets to an efficient, national market that is well integrated into the broader capital markets. In particular, the development of the secondary market for single-family mortgages has increased the flow of capital available to homeowners and lowered its cost.

The same cannot be said of multifamily rental housing. The secondary market has increased its purchase volume for multifamily mortgages in recent years, but remains much less of a factor in providing capital for multifamily housing than it does for single-family housing. About one-third of multifamily mortgage originations are sold to the secondary market, compared to about three-fourths of single-family mortgages in some years. The GSEs do not dominate the multifamily mortgage market like they dominate the single-family market—the GSE's purchases of multifamily mortgages in 1994 were $5.7 billion out of a total market estimated to be in excess of $30 billion.

(2) *Multifamily Continues to Rely on Portfolio Lenders*. As a result, debt financing for multifamily mortgages remains very dependent on portfolio lenders, many of whom are depository institutions (banks and thrifts). Yet several institutional changes in the past two decades have made it increasingly difficult for depository institutions to originate and hold multifamily mortgages.

These changes include a significant downsizing of the thrift industry after the savings and loan (S&L) debacle of the 1980s, and the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 which imposed new risk standards for depository institutions to prevent a recurrence of the S&L scandal.[36]

(3) *A Role for the GSEs in Multifamily Housing.* In addition to institutional changes, the difficulty with multifamily lending in recent years was also related to market conditions. The tax-driven overbuilding of the early 1980s was followed by a credit crunch due to the Tax Reform Act of 1986, FIRREA, and the soft market conditions for all properties (both new and existing properties) caused by the overbuilding. As a result, underwriting creditworthy multifamily deals was difficult in the early 1990s, especially for portfolio lenders. These conditions have now improved markedly.

Currently, multifamily properties offer less risk of loss than most other commercial property classes according to Moody's Investors Service.[37] In overbuilt markets, vacancies have declined due to depressed construction levels in the early 1990s. Accordingly, competition for multifamily loans has increased and spreads over Treasury rates of these loans have declined in the past year.

Credit risk remains a concern of investors, but new techniques in multiclass securitization have helped mitigate credit risk on multifamily mortgage pools.[38]

Much of the benefit of increased competition for multifamily mortgages results from reduced spreads on these mortgages, which lower capital costs for owners, and ultimately reduce rents for borrowers. As discussed in background section (7) below, the recent market upturn has not been equally beneficial to multifamily properties affordable to lower-income households. Among these are smaller, inner-city properties, which comprise a significant portion of the existing affordable stock, as well as larger redevelopment projects, seniors' housing, and affordable new construction in faster-growing markets.

By sustaining a secondary market for multifamily mortgages, the GSEs can extend the benefits that come from increased mortgage liquidity to many more lower-income families while helping private owners to maintain the quality of the existing affordable housing stock. That is, greater liquidity and stability in the secondary market due to a significant presence by the GSEs will benefit lower-income renters without the need for subsidy—much as the GSEs now provide benefits to homebuyers without subsidies. Providing liquidity and stability is the main role for the GSEs in the multifamily market, just as in the single-family market.

(4) *The Current Availability of Credit is not the Key Issue Regarding the Role of the GSEs*. As described above, an important consideration in determining the appropriate role for the GSEs in the multifamily housing market is the potential benefit from increased liquidity in the long term. The current ''snapshot'' of market conditions and recent trends in the availability of mortgage credit are temporary features of the mortgage market.

Today's ample supply of credit for certain multifamily properties and credit gaps for other classes of properties (see part vi of Section 7 below) are temporary features of a changeable market. For example, the current return to multifamily lending by banks and thrifts may be driven in part by a desire by these institutions to maintain loan volume and fee income following the single-family refinance boom of 1993–1994, and in part by Community Reinvestment Act considerations.

Portfolio lenders may eventually feel the burden of FIRREA standards or other portfolio management pressures and seek to reduce their holdings of multifamily mortgages. This could rather rapidly reverse many of the private investment decisions that have contributed to current market conditions. In such circumstances, the liquidity of an efficient secondary market for multifamily mortgages would help these lenders and other lenders maintain a presence in the primary market during such shifts in investment strategy.

(5) *The Importance of Increased Liquidity*. Anecdotal information available to HUD indicates that lack of liquidity, rather than credit risk, is a major obstacle preventing lenders from holding more affordable housing investments in portfolio. HUD examined the current sources of multifamily capital to determine if mortgages originated were available for purchase by the GSEs, including institutional mortgage originators and holders such as life insurance companies and pension funds.

Investors in multifamily mortgages make their investment decisions based on how well the characteristics of an asset matches their portfolio objectives. Increasing the liquidity of an asset like multifamily mortgages would increase the interest of all investors in holding these assets.

Life insurance companies report, for example, that it is generally true that they buy mortgages with the original intent of holding them. However, life insurance companies do sell multifamily mortgages from time to

[36] Two specific changes instituted by FIRREA that affect multifamily mortgages are risk-based capital requirements under which most multifamily mortgages are assigned 100 percent risk weights (compared to 50 percent risk weights for single-family loans which are not backed by a federal credit agency), and a lending limitation to a single borrower of 15 percent of an institution's unimpaired capital.

[37] ''Moody's: Multifamily Offers Less Loss Risk,'' *National Mortgage News*, May 1, 1995.

[38] For example, Fannie Mae ''swap transactions'' in which Fannie Mae swaps its securities for the top 85 percent, or the ''A'' piece, of a multifamily mortgage pool, leaves the riskier ''B'' piece, which absorbs the first credit losses from the pool, to be sold at discount on the market. Recently there has been considerable investor interest in these higher yielding B pieces.