construction weakness will be offset by a growing demand associated with the existing stock. Specifically, mortgage demand in the remainder of the decade will include refinancings of long-term loans to reduce interest rates, rollover of shorter-term balloon loans coming due, refinancings to rehabilitate buildings, and existing property sales. Some observers expect that the \$33 billion origination volume in 1994 to increase to over \$35–\$40 billion in 1996 and 1997.

(v) Interpreting the Trends. These trends have been interpreted by some as evidence that the private capital markets in the mid-1990s are capable of providing the necessary liquidity to the multifamily market. However, there are other considerations to be weighed.

Despite the upturn in lending for new construction and the increased participation by banks, private conduits and REITs, there are indications that the private credit markets may not be meeting the full range of multifamily credit needs. The loans most likely to be originated by banks or sold to private conduits and real estate investment trusts (REITs) are not secured by affordable rental units. One market observer noted, "* * * while Wall Street has recently sought to fill multifamily lending gaps through conduits, these conduits barely nick the surface of affordable housing, concentrating primarily on market-rate multifamily properties." 48

There are several reasons for the continued gap in multifamily finance. First, multifamily mortgages, like small business loans, lack standardization. This is particularly true for affordable housing loans because the developments often require a mix of financing sources in order to make the project affordable to low-income households. Second, multifamily loans are also relatively large, making multifamily mortgage pools more difficult to diversify than single-family pools. Third, there is far less information about the performance of multifamily mortgages than there is for single-family mortgages, particularly those secured by affordable developments.

(vi) Current Credit Gaps: Property Types. HUD has anecdotal evidence that credit shortages exist currently for certain classes of existing affordable properties: smaller multifamily properties (i.e., 5 to 20 unit properties) in older urban areas, and properties of all sizes in inner cities in need of rehabilitation.⁴⁹ While some may consider these to be market "niches," they are not insignificant markets. For example, small multifamily properties actually comprise a major component of the nation's affordable housing stock: the 1991 Residential Finance Survey shows that there were about 470,000 properties in the U.S. with between 5 and 19 units, but only 150,000 with 20 or more units.

Affordable housing for seniors is another class of properties that the conventional market has had difficulty financing. The primary reason for this difficulty appears to be uncertainty by the market over the nature of seniors' housing. ⁵⁰ Compared to other multifamily rental housing, seniors' housing is more specialized and non-homogeneous. It is a currently evolving product, and investors are especially uncertain of its financial performance.

Finally, there is inadequate capital to finance construction of new affordable units, which usually involve lowincome housing tax credits, in highergrowth markets.

(vii) Current Credit Gaps: Lending Terms. Terms of conventional financing can also restrict access to credit for units intended for lower-income families. For example, an obstacle to the financing of new construction or substantial rehabilitation of housing for lower-income families is the inability to lock-in an interest rate (without payment of an exorbitant fee) for the permanent loan. Over 60 percent of outstanding multifamily debt either carries a variable interest rate, or will have a balloon payment due in less than 10 years.

The construction financing for most new construction or substantial rehabilitation projects covers both the actual construction and the initial rentup periods, while the interest rate usually floats until the project has reached the required occupancy level and is ready for permanent loan takeout and possible securitization. The inability to lock-in permanent rates without paying prohibitive lock-in fees, makes it much more difficult to finance affordable housing because a rate increase during construction and rent-

up can make an affordable project infeasible.⁵¹ If the GSEs are able to provide new financial instruments that include forward rate commitments at reasonable cost, for example, the credit gaps for affordable units can be reduced.

(viii) The Impact of Credit Gaps. A major problem facing low-income households is that low-cost housing units continue to disappear from the existing stock.⁵² The ability of the nation to maintain the quality of the affordable housing stock and to stabilize inner city neighborhoods depends on the availability of adequate capital for small existing properties, redevelopment projects, and senior housing.

The current availability of multifamily credit for certain types of multifamily mortgages is not a valid argument that the GSEs are unneeded in the multifamily credit markets. Rather, the current competition for multifamily mortgages on amenity-rich apartments and the tightening spreads between the yields of privately issued multifamily MBS and comparable maturity Treasury bonds demonstrate the benefits that increased liquidity in multifamily markets could provide to the affordable rental housing market. That is, the GSEs' participation in the market can reduce the cost of capital and ultimately improve housing quality and/or decrease rents paid by low-income families.

(ix) Rentals in 1- to 4-Unit Buildings. HUD is also aware that a significant portion of the demand for rental housing is satisfied by rental units in properties containing 1 to 4 units. In 1993, about 57 percent of the rental housing in the nation was in buildings with fewer than 5 units. However, there is considerable variation across local markets in the portion of the rental stock that is contained in 1- to 4-unit properties. The New York area, for example, has only 30 percent of its rental units in 1- to 4-unit properties, while Chicago has 46 percent and

⁴⁷ Robert Dunsky, James Follain, and Jan Ondrich, "An Alternative Methodology to Estimate the Volume of Multifamily Mortgage Originations," Report prepared for the Department of Housing and Urban Development, September 1995.

⁴⁸ Stuart J. Boesky, "Tax Credits at Work," *Mortgage Banking*, September 1995.

⁴⁹ Participants at numerous industry forums and working group meetings sponsored by the Department have attested to the existence of these credit gaps.

⁵⁰ Campbell, W. Donald. 1995. "Seniors Housing Finance." Paper prepared for AARP/White House Mini-Conference "Expanding Housing Choices for Older People," January 26–27, 1995, in Washington,

⁵¹ Another example of the terms of conventional financing that restricts access to credit for affordable units is the lack of long-term fixed rate loans. About 60 percent of conventional multifamily loans are adjustable rates or fixed rate balloon loans with terms of 10 years or less. The rollover of a balloon loan generally resets the interest rate. In either case, if the rate increases at a scheduled adjustment period, the higher debt service expense may be more difficult for an affordable property to absorb.

⁵² The Joint Center's *State of the Nation's Housing* for 1995 finds that the number of unsubsidized low-cost units in the Northeast has fallen by half since 1974. In the Midwest the addition of new subsidized units has offset the loss of unsubsidized low-cost units, but in every other region the total low-cost stock (subsidized and unsubsidized) is below 1974 levels.