

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

Jean L. Cummings
City Research

and

Denise DiPasquale
University of Chicago
and
City Research

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I. INTRODUCTION

The federal government has made a significant and long-standing commitment to the development of the secondary mortgage market. Two key steps were the chartering of Fannie Mae and Freddie Mac, government-sponsored enterprises (GSEs) charged with creating and taking a leadership role in developing a secondary market for residential mortgage loans.¹ Today, the charter acts of both institutions clearly state that they are to provide stability in and ongoing assistance to the secondary market in residential mortgage loans, including activities related to mortgages on housing for low- and moderate-income housing (U.S. Congress, 1992a and 1992b). While the GSEs have participated in the multifamily (5 or more units) mortgage market, particularly over the last decade, their role has been minimal compared with their role in the market for loans on single-family properties (1-4 units), where they dominate the market.

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

An active secondary market requires standardization of the mortgage contract, underwriting, and mortgage documents.² In addition, a secondary market requires an information base upon which market participants can accurately assess the risks and returns of these investments. In many respects, the GSEs have succeeded in providing standards and an information base for the single family mortgage market. The multifamily mortgage market,

however, lacks both. It is in an early stage of development resembling the single family market of two or three decades ago. The GSEs are well-positioned to provide a leadership role in developing the secondary market for multifamily mortgages and setting industry standards, as they did in the single family market.

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

Both the LIMAC/Freddie Mac and the EMI/Fannie Mae programs received financial support from the National Community Development Initiative (NCDI).³ We were engaged by NCDI to evaluate both programs, affording us an unusual opportunity to observe closely the program processes from their start and to benefit from the participants' candid reflections. The

conflicts and tensions that arose shed considerable light on the different perspectives of specialists in affordable housing and the GSEs. In many respects, the problems faced by the two programs are a microcosm of many of the broader problems with the multifamily mortgage market today.

The purpose of this article is to lay out the lessons learned from the two programs in order to build some general principles that may be useful in considering new endeavors for the development of a multifamily secondary market, particularly one focused on affordable rental housing. In the next section, we begin with a discussion of the rationale for greater involvement of the GSEs in developing the secondary market for multifamily mortgages. In Section III, we turn to the main focus of our article: an exploration of five important issues arising from the LIMAC/Freddie Mac and EMI/Fannie Mae programs: (1) underwriting, (2) pricing and credit enhancement, (3) the availability of an information base and expertise on these types of transactions, (4) capacity, and (5) the financial viability of a business focused on mortgages for affordable rental housing. We use these issues and the LIMAC and EMI experiences as a lens through which we can explore the needs in the marketplace and how the GSEs can play an important role in developing the market.

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

Fannie Mae and Freddie Mac were chartered by Congress with a clear mandate to create liquidity in the residential mortgage market by developing a secondary market and setting industry standards. The fundamental aim of government involvement in the provision of a secondary mortgage market is to increase the funding of mortgages through the capital markets, thereby increasing efficiency and ultimately ensuring that mortgage credit is readily available at lower prices. The Department of Housing and Urban Development (HUD) is charged with establishing

annual housing goals for the GSEs.⁴

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

Fannie Mae was created in 1938 to purchase FHA-insured loans; this mission was expanded to include Veterans Administration (VA) mortgages in 1948, and in 1970 Fannie Mae began to purchase conventional mortgage loans. Freddie Mac was created in 1970 with a focus on providing a secondary market for thrifts, but also has since broadened its activities to include all conventional mortgages. Together, their impact in the market is huge. In 1995, there were \$3,922.8 billion in residential mortgages outstanding. Fannie Mae held \$253.5 billion in mortgages in portfolio and had \$513.2 billion in MBS outstanding. Freddie Mac held \$106.9 billion in portfolio and had \$459 billion in MBS outstanding. Together, these two agencies held 34% of total outstanding mortgages in portfolio or in MBS (Fannie Mae, 1996).

While Fannie Mae's and Freddie Mac's activities are constrained to include only activities that are directly related to the secondary mortgage market, they enjoy significant benefits in the

marketplace as a result of their status as GSEs that give them advantages over other investors. Notably, their securities are exempt from registration requirements of the Securities and Exchange Commission, they are exempt from state and local taxes, and the Secretary of the U.S. Treasury is authorized to purchase up to \$2.25 billion in securities of each firm in order to enhance liquidity (U.S. Congress, 1992a and 1992b).

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

The 1995 HUD rule regulating Fannie Mae and Freddie Mac included setting explicit goals to govern the GSEs' multifamily mortgage activity. The goal for affordable multifamily housing for 1996-99 for each GSE is at least 0.8 percent of the total dollar volume of mortgages purchased by the respective GSE in 1994 (*Federal Register*, 1995, p. 61891). In 1994, Fannie Mae's total mortgage purchases were \$161.8 billion; \$4.8 billion of these purchases were multifamily, of which \$2.4 billion met the special affordable goal. As a result, in 1994, Fannie Mae's special affordable multifamily purchases were 1.5% of total purchases, significantly exceeding the 0.8% goal. By 1996, Fannie Mae's multifamily purchases grew to \$7.0 billion, representing 4.2% of total purchases; the purchases meeting the special affordable goal fell

slightly. In 1994, Freddie Mac's total mortgage purchases were \$123.5 billion; only \$0.9 billion of these purchases were multifamily, of which \$0.5 billion met the special affordable requirements. As a result, in 1994, Freddie Mac's special affordable multifamily purchases were 0.4% of total purchases or half the goal. In 1995, Freddie Mac made the goal with \$1.1 billion in special affordable purchases. By 1996, Freddie Mac's multifamily purchases grew to \$2.4 billion, representing 1.9% of total purchases; special affordable multifamily purchases remained at \$1.1 billion.⁵

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

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

Virtually all single family mortgages originated are purchased in the secondary market. In

1995, more single family mortgages were purchased than originated, meaning some seasoned loans were purchased; from 1990-95, purchases accounted for 97% of originations. (Fannie Mae, 1996, Table XII.) In 1995, only 40.5% of multifamily mortgages were purchased in the secondary market. The traditional focus of the GSEs has been on mortgages for owner-occupied housing. Fannie Mae and Freddie Mac played an important role in developing standards and information in the single family mortgage market. They introduced the standard mortgage application in 1973 and the standard mortgage note for all states in 1975 (Freddie Mac, 1988, p. 36). These were two important milestones in making mortgages a commodity to investors. According to the Federal Reserve Board, in 1995, of the \$3,634 billion in single family mortgages outstanding, Fannie Mae and Freddie Mac portfolio holdings and MBS accounted for 35.5%. Fannie Mae and Freddie Mac mortgage underwriting guidelines are the industry standard, and the volume and track record of the two GSEs provide a substantial information base for investors to assess. (Board of Governors, 1997.)

Yet, while their charters clearly cover both single family and multifamily mortgages, Fannie Mae and Freddie Mac contributions to the multifamily mortgage market have been much more limited. In 1995, of the \$288 billion in outstanding multifamily mortgages, 12.3% were either held by Fannie Mae and Freddie Mac in portfolio or were in MBS with Fannie Mae or Freddie Mac guarantees (Fannie Mae had 10.0% and Freddie Mac had 2.3%).

The lack of industry standards for these mortgages has been a major obstacle in the development of this market. Some experts have argued that multifamily mortgage loans are inherently more heterogenous than single family loans because they are secured by income-producing properties, making them more similar to small business loans than to single family

mortgages. It is not obvious why this difference necessarily leads to more heterogeneity, nor is it clear that multifamily mortgages cannot be largely standardized. In fact, while single family mortgage loans are now viewed as commodities, it is important to remember that they were also once thought of as inescapably heterogeneous and that standardization of these mortgages took many years. There is a clear need for the kind of leadership role in creating industry standards for multifamily mortgages that transformed the single family market.⁷

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

III. The LIMAC/Freddie Mac and EMI/Fannie Mae Programs

LIMAC and Freddie Mac launched a three-year pilot program in February 1991 to provide at least \$100 million for the purchase and securitization of permanent multifamily loans for rental housing targeted at low-income populations and neighborhoods. The program's goal was to provide "a missing piece in the housing puzzle" by making available long-term permanent

financing through the development of an active secondary market.⁸ The program intended to provide long-term, fixed rate mortgages for new originations and refinancings of adjustable and shorter-term mortgages. In addition, they planned to purchase existing mortgages held in portfolio by local lenders (see Table 1 for a summary of program elements). They also planned to target community development corporations (CDCs) and small banks that would not normally work with Freddie Mac. The program would accept Low-Income Housing Tax Credit (LIHTC) and non-LIHTC mortgages.

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

The program was announced in February of 1991. In December of that year, Freddie Mac approved the first loan package: a single transaction comprised of eight existing mortgages from a large experienced lender, totaling \$4.6 million. It took another three months of negotiations on pricing before the transaction was closed at the end of March 1992. As discussed in detail below, these negotiations were plagued with fundamental disagreements concerning underwriting, pricing, the value brought to the deal by the lender, LIMAC, and Freddie Mac, and the risks

associated with the loans. This first transaction would prove to be their last. In mid-1993, after being unable to reach agreement on any more transactions, LISC and Freddie Mac announced that they were suspending the program indefinitely.

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

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

the first 5% of loss on loans it originates and shares remaining loss with Fannie Mae; EMI's maximum share is 20%.

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

By June 1997, more than 2 ½ years into the program, under the concessionary pricing, EMI had made commitments to 13 projects representing \$18.5 million. The start was considerably slower than expected, largely due to sometimes lengthy negotiations between EMI and Fannie Mae over underwriting specifics, particularly concerning some of the unique features of affordable projects, such as requirements of various types of subsidies and requests for waivers. In addition, Fannie Mae's documentation requirements were burdensome, particularly for small nonprofit borrowers. In the Fall of 1996, EMI proposed fundamental changes in the program to Fannie Mae that they felt were necessary in order for them to continue doing business. In January 1997, EMI and Fannie Mae agreed to restructure the program and Fannie Mae awarded EMI full authority to underwrite, grant provisional waivers, and commit to loans of less than \$3 million, for

a total pool of \$50 million. EMI also was granted the authority to do affordable transactions over \$3 million, but they must compete with other delegated multifamily lenders on their terms, including using their non-subsidized price. The EMI/Fannie Mae program is currently doing business under this new structure, focusing almost exclusively on the forward commitment for transactions under \$3 million.

The unique value of these two efforts lies in their willingness to address head on how to involve a GSE in the secondary market for affordable multifamily mortgages. While there are some fundamental differences in the programs, both had slow starts and encountered many similar obstacles. The obstacles principally result from wide differences between the GSEs' and their partners' assessment of the risks associated with the loans, as raised in the underwriting and pricing of the transactions. Both programs suffered under the weight of time consuming negotiations that often resulted in processing costs that were higher than revenues. In the sections that follow, we provide a detailed description of the problems in five key areas for these programs: underwriting, pricing, information and expertise, the capacity issues associated with small start up organizations working with two large institutions, and the financial viability of a business focused on providing mortgages for affordable rental housing.

A. UNDERWRITING

The mortgage underwriting process is an area where standards and information are crucial. Underwriting assesses the soundness of the mortgage as an investment. Uniform underwriting guidelines are essential to the operation of the secondary mortgage market because they ensure the investor that regardless of the individual underwriter or the location of the project, the assessment of the investment follows standard guidelines. The LIMAC and EMI experiences

reveal several underwriting issues fundamental to successfully developing a secondary multifamily mortgage market: 1) delegated underwriting, so that only one party underwrites the transactions, 2) the establishment of underwriting standards appropriate to affordable multifamily developments, which are often relatively small projects developed by nonprofits, and 3) determining a level of documentation which sufficiently ensures the project's soundness yet does not overburden the borrower or the lender.

1) Delegated Underwriting. Delegated underwriting is the assignment of the authority and responsibility of underwriting transactions to one party. Freddie Mac made it clear from the beginning of the LIMAC program that there was no intention of delegating underwriting; this was Freddie Mac's policy on which there was no flexibility for any multifamily transactions. Instead, the LIMAC/Freddie Mac program was structured so that the originating lender, LIMAC, and Freddie Mac were all underwriting each transaction. Underwriting for the one completed transaction by the three participants produced quite different results, indicating clearly divergent views of the risks associated with these properties. LIMAC and Freddie Mac tackled underwriting issues for over one year for the one transaction they closed.

A fundamental principle of the EMI/Fannie Mae program that distinguished it from the LIMAC program was that EMI was to be a delegated Fannie Mae underwriter. Since EMI was the lender, EMI was to be the sole underwriter. Before being granted delegated underwriter status, however, EMI was to qualify in each of Fannie Mae's five regional offices by satisfactorily completing at least three transactions per region under Precommitment Review, during which Fannie Mae and EMI each underwrote every transaction. Two years into the program, EMI was not able to gain approval for delegated status in any of Fannie Mae's regional offices, and there

was no indication that they were to be released from Precommitment Review soon, even though they had completed eight transactions in one of the regional offices. The lack of delegated underwriting made the program too expensive and time consuming for both EMI and Fannie Mae. In addition, it was difficult to keep prospective customers in the pipeline because EMI was unable to make a clear commitment in a timely fashion.

With the January 1997 program restructuring, one of Fannie Mae's concessions was to grant EMI immediate delegated underwriting status for \$50 million of business for qualifying affordable multifamily mortgages under \$3 million. Fannie Mae removed Precommitment Review in all regions and granted EMI the authority to issue some waivers for exceptions. Making EMI a fully delegated underwriter was fundamental to testing whether a viable business could be built based on these kinds of transactions. Unfortunately, during the first six months under the restructured program, EMI needed to restaff and reorganize, which slowed program progress. It remains to be seen if this restructuring allows EMI to shorten significantly its underwriting and processing time, increasing their efficiency.

2) Establishing Underwriting Standards for Multifamily Affordable Housing. The LIMAC/Freddie Mac program was guided by a Master Agreement, which, among other things, established a set of underwriting guidelines for the program in an attempt to anticipate potential problems in underwriting. In practice, however, LIMAC and Freddie Mac usually disagreed on the implementation of those guidelines; even when both claimed to be following the guidelines as meticulously outlined in the Master Agreement, they were still often far apart in the analyses. In addition, the lender for the completed transaction, who had held the loans in portfolio, had used a different set of underwriting guidelines and documentation requirements when it originated the

mortgages from those set out for the program.

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

The discrepancy arose from differences in three assessments: 1) the estimation of project income, 2) the treatment of "soft second" mortgages, and 3) capitalization rates. To determine project value, net operating income is divided by a capitalization rate, which reflects current market conditions, including interest rates and an assessment of risks associated with the projected rental income stream. In estimating projected income, LIMAC considered net operating income based on tax credit restricted rents as well as the flow of tax credits to the investor, arguing that tax credits were an important part of the return to the equity investor (four of the eight mortgages were for LIHTC projects). Freddie Mac considered unrestricted, or market, rents but did not include the flow of tax credits. Many of the projects had soft second mortgages that Freddie Mac treated as hard loans with fixed payment schedules and LIMAC treated more like grants. LIMAC's and Freddie Mac's capitalization rates were also far apart: LIMAC used rates between 12-12.8%, Freddie Mac's were as high as 16%. LIMAC and the lender felt that Freddie Mac undervalued properties located in low-income neighborhoods by failing to take into account elements which substantially strengthened the projects, including the benefits of tax credits, the level of commitment of local public officials, and lender and developer track records.

Freddie Mac's approach to underwriting these loans seemed to ignore some essential features of affordable rental housing that influence the risk associated with these projects, and may have resulted in their overstating these risks.

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

In practice, EMI and its borrowers had few complaints about the program's underwriting guidelines. Although Fannie Mae's guidelines could still be a significant challenge for affordable housing, EMI found that a sufficient number of transactions could successfully meet the requirements. Yet, there were still significant disagreements between EMI and Fannie Mae that

resulted in long delays in processing transactions and limited the volume of the program. Although EMI had hoped to process applications within three months of receiving them, they were regularly taking six months or longer. While in some cases EMI and Fannie Mae simply disagreed on the implementation of the guidelines, the majority of problems came in areas not explicitly addressed in the guidelines, or in processing waivers or exceptions that can often arise with affordable housing. EMI quickly found that its projects typically required waivers or exceptions, even with Fannie Mae's affordable housing guidelines. Much of the delay in processing arose from negotiating terms and gaining Fannie Mae's consent for waivers. Often EMI staff indicated that Fannie Mae staff did not understand this market segment, while Fannie Mae staff indicated that EMI did not comply with documentation requirements.

3) Documentation. Both programs have suffered from burdensome documentation. For the LIMAC/Freddie Mac program, the initially dense documentation for the program became increasingly burdensome over time to both LIMAC and the lenders. More than one potential lender who dropped out of the program pointed to the high level of documentation. The lender on the only completed transaction felt inundated by Freddie Mac documentation requirements, and had hoped that LIMAC would do more to push Freddie Mac towards simplification and to assist in the compilation of the mortgage documents. In this lender's case, because they were using eight existing loans, the lender already had loan origination documentation and servicing records for several years for each of the loans. However, all of the information needed to be reformatted to fit Freddie Mac's documents. The lender was frustrated that LIMAC could never give them a comprehensive list of what was needed. For LIMAC's part, they felt that there was no one office or individual within Freddie Mac who was coordinating Freddie Mac's

requirements; Freddie Mac's requests came piecemeal and were transaction-specific, rather than standardized for the program. As a result, the documentation seemed repetitive, disorganized, and endless. As LIMAC began looking at new transactions, there was no indication that Freddie Mac's documentation requirements would become simpler or follow a standard format. If anything, the documentation continued to expand over time. Freddie Mac's forward commitment letter alone on the second, unsuccessful, transaction was 22 pages with attachments.

The EMI/Fannie Mae program also has endured burdensome documentation, although to a lesser degree. From the outset, both borrowers and EMI staff complained of overly heavy documentation requirements. Particularly early on, EMI was aware that some borrowers withdrew preliminary applications because of the burdensome documentation, reporting, and due diligence requirements. In our interviews, one borrower with long experience in multifamily housing said that she would happily pay a premium to *avoid* working with Fannie Mae. Many of EMI's borrowers whom we talked with were nervous about the paperwork requirements ahead of them--the program had considerably more reporting requirements, especially during construction and project management, than they were used to with their local lenders. Some of the forms seemed unworkable to them given the particulars of their projects.

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

With the restructuring of the program, EMI gained the ability to issue some provisional

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

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

B. PRICING

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

1) Making the price competitive. In Table 1, the components of the price to the borrower are outlined for the LIMAC/Freddie Mac and EMI/Fannie Mae programs. As shown in

the table, the cost to the borrower consist of upfront fees and the various components that make up the rate on the loan. In the LIMAC/Freddie Mac program the borrower paid an initial purchase fee of 1% of the loan amount to LIMAC. The rate on the loan consisted of the rate to the investor, plus 50 bps (basis points--one one-hundredth of a percent) to LIMAC for credit enhancement, plus a guarantor fee to Freddie Mac determined by the risks of the transaction, plus a 25 bps loan servicing fee to the lender.

The pricing of the EMI/Fannie Mae program was somewhat simpler due to the fact the EMI was the lender and Fannie Mae was the investor. The upfront fees to EMI included a \$1,500 application fee and a placement and commitment fee of 2% of the loan amount. Fannie Mae received a \$1,500 post-purchase fee; in addition, Fannie Mae required a 2% mandatory delivery fee that is refunded when the loan is delivered. The rate on the loan was based on Fannie Mae's published rate for affordable housing, plus a forward commitment fee to Fannie Mae, plus 50 bps servicing fee to EMI.

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

The LIMAC/Freddie Mac program had some unique pricing problems. The rate on the loan had to compensate four participants: the investor, Freddie Mac, LIMAC, and the lender.

The rate to the investor was determined first. Since the rate to the investor was locked in, any lag between when LIMAC locked in the investor's rate and when the rest of the pieces were in place created exposure to interest rate risk which could be expensive. In the one completed transaction, LIMAC committed a return to the investor 20 months before it closed. By that time, decreases in market interest rates meant that the investor seemed to be getting too high a return. As a result, the investor agreed to modify its return twice before the loans were delivered. Since Freddie Mac's fee was determined last, their fee was viewed as determining the viability of pricing, leaving Freddie Mac staff in the position of having their fee break the deal or be less than what they believed to be the market value of their guarantee. In this case, Freddie Mac took less than their assessment of market value.

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

the attractiveness of this pricing of the forward commitment.

While the pricing arrangement represents an important opportunity for EMI to create significant volume, the pricing is an exception to how Fannie Mae does business. Fannie Mae staff were frank in saying that they provided this free forward commitment as a way to start the program but will not offer a free forward commitment indefinitely. It is clear that Fannie Mae has not yet determined how to make this business profitable. The question is, can Fannie Mae offer a price that works for borrowers but is still profitable to Fannie Mae?

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

There were two major factors contributing to this uncertainty about pricing. First, although the LIMAC program was mostly managed by Freddie Mac's multifamily group, the pricing of the LIMAC products was made by a centralized pricing group. The vast majority of the work done by this pricing group was for the single family portion of Freddie Mac's business. The pricing of LIMAC's transactions was grounded in default models that were based primarily

on assumptions widely used in modeling the single family mortgage market. These models assumed that as soon as the loan amount exceeded value, the borrower would default on the loan. Investors in rental housing rarely evaluate the market value of their property; instead, they track income and expenses. As a result, a more appropriate approach may be to consider cash flow by comparing monthly revenues with operating expenses plus debt service, and predicting default when expenses exceed revenues for a number of months.

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

The EMI program, four years later, had far less uncertainty concerning price. The base rate on the loan, both as established in the SPA and under the concessionary pricing structure, was pegged to Fannie Mae's standard affordable multifamily rate. Both EMI and the borrower had immediate access at any time to the current base price for the transaction. In this program, the uncertainty concerning pricing stems from the fact that the program depends on special concessionary pricing of the forward commitment that is temporary. The goal of the program is to bring market rate financing, not temporary below market financing, to affordable housing. As EMI builds volume and experience with Fannie Mae, the program's transactions may effect the

way Fannie Mae prices these mortgages. However, at this point Fannie Mae is still clearly handling EMI's transactions as exceptions rather than as standard products. This program will have only limited impact on the development of a more active secondary market for affordable rental housing unless it generates an acceptable programmatic pricing structure.

3) Risk Sharing--Determining the Value LIMAC and EMI Bring to the Table. Both the LIMAC/Freddie Mac and EMI/Fannie Mae programs included risk sharing arrangements. However, the goals of risk sharing varied. The LIMAC/Freddie Mac program wrote into the Master Agreement a rather complicated risk sharing arrangement between the lender, LIMAC, and Freddie Mac to provide comfort to potential investors and Freddie Mac. The lender and LIMAC would share the top 20% of the risk and Freddie Mac would share the remaining 80% with the lender.¹⁰ For the \$100 million in mortgages in the initial agreement, LIMAC's potential exposure was \$16 million (80% of 20%). To cover this exposure, LIMAC was to hold \$2.5 million in a Freddie Mac-controlled reserve.

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

enhancement.

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

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

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

There are really two goals of credit enhancement: *(1) to shield the investor from loss*, and *(2) to create incentives for the mortgage provider (lender or conduit) to bring high quality loans to the table*. If the goal is to shield the investor from loss, then the financial soundness and depth of the credit enhancer is crucial. The investor will want to be sure that the credit enhancer can safely cover any losses. The fundamental issue is the worth of that reduction in expected loss.

While the reduction in expected loss is the same for all purchasers, its value is different for each purchaser. A purchaser with a large, diversified portfolio like the GSEs' would pay less for the reduction in expected loss on a given loan than a purchaser with a small portfolio that is not diversified. Given Freddie Mac's and Fannie Mae's sheer size and diversification, it is very difficult to provide valuable credit enhancement to them. In fact, Fannie Mae and Freddie Mac may be the most efficient providers of credit enhancement.

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

C. GENERATING AN INFORMATION BASE AND EXPERTISE

Many of the underwriting and pricing problems facing these programs are due to a lack of a clear understanding of the determinants of default and loss in multifamily mortgages in the industry. This lack of information and analysis is in stark contrast to the depth and breadth of data about the single family market. The clearer understanding of the risks and returns of the single family market has led to, under the GSEs' leadership, the creation of industry standards for

underwriting and pricing and a very active secondary market.

The lack of documentation about the affordable multifamily market perpetuates an apparent paradox: on the one hand, traditional investors view affordable multifamily housing as a high risk, low return investment, yet there is considerable anecdotal evidence from specialists in affordable housing that this investment has an excellent performance record. Generating a portfolio that could serve as a reliable information base on these types of transactions was an explicit goal of the LIMAC/Freddie Mac program. One Freddie Mac staff member declared that the best thing about the LIMAC program had been that it had brought the lender's strong affordable portfolio to their attention. Yet, despite Freddie Mac's acknowledgment of the lender's considerable expertise and excellent track record, when it came down to the specifics of underwriting, Freddie Mac was often uncomfortable with the lender's procedures. In fact, the LIMAC/Freddie Mac program rejected 75 other loans in the lender's well-performing portfolio before settling on the group of eight because of anomalies which made them unsuited to the program's requirements. (The lender was left feeling that the program had "creamed" the best transactions out of their portfolio.) The creativity and flexibility that the lender used in evaluating loans often looked foreign to many Freddie Mac staff members. Buying the lender's loans was, as one Freddie Mac staffer put it, like "trying to fit a square peg into a round hole."

Providers of low- and moderate-income housing have long argued that their projects have performed extremely well with virtually no defaults or losses. These providers face a credibility problem since there is little systematic documentation of their multifamily activity. In addition, these providers work in the shadow of large industry players such as the FHA and Freddie Mac, both of which posted significant losses in their multifamily portfolios in the late 1980s and early

1990s. There is a real need for systematic documentation of the performance of investments in low- and moderate-income rental housing to inform potential lenders and investors. Increased documentation and understanding of risks and returns paves the way for standardization of underwriting guidelines and documentation so necessary to the development of a secondary market. Clearly, there will always be some uncertainty about these investments. One example was Freddie Mac's concern over the untested risk associated with tax credit projects in year 16 after the compliance period ends. Since the LIHTC is only eleven years old, there is no experience to analyze that can shed light on this risk.

D. CAPACITY

Both the LIMAC and EMI programs have had a "David and Goliath" quality to them. LIMAC and EMI are small, undercapitalized organizations, both attempting to negotiate with very large bureaucratic institutions. Both programs fell considerably short of their goals. Even EMI, despite its progress in completing \$20 million of transactions and obtaining new terms for a restructured phase, fell well short of Fannie Mae's or its own goals for completed transactions: the program did not complete in its first two and one-half years what it had set as a one-year goal.

In trying to build a nationwide business around providing access to the secondary market for small affordable housing loans, LIMAC and EMI faced considerable challenges:

CLittle if any track record. Neither organization had a significant track record in this business. LIMAC had been established by LISC in 1987, with the goal of establishing a national secondary market for community development loans. LIMAC purchased loans from community development loan originators, pooled them, issued securities, and marketed them to investors. At the start of the LIMAC/Freddie Mac program, LIMAC had issues two bond series of about \$10

million each. Lending was a new business for EMI and ESIC, although EMI staff had considerable multifamily lending experience.

For both organizations, the lack of track record meant that staff had to spend considerable time early on getting up to speed on the GSEs' procedures and documentation as well as gaining the confidence of the GSE staff. Freddie Mac and the original lender on the one completed transaction had some complaints that LIMAC's staff also needed training on local markets and affordable housing issues; this seemed to be less of an issue for EMI.

CSmall organizations. Both organizations were quite small, with 3-4 employees at the start. Both staffs quickly found themselves overworked. Some other participants in both programs later expressed surprise when they found out how few people each organization had.

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

CMultiple roles. The small staffs at LIMAC and EMI were responsible for a wide range of roles. Both organizations were responsible for marketing to find transactions (LIMAC to

lenders and EMI to borrowers), and performing underwriting. LIMAC was also responsible for marketing the mortgage-backed securities to investors. EMI does not have to market to investors since they can sell the mortgages directly to Fannie Mae, who was also the investor, although they have brought in the Methodists pension fund as an investor. EMI staff, however, unlike the LIMAC staff, service the loans.

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

CNational scope. Both programs were committed to a national scope. Despite the small, centralized staff, neither program wanted to limit itself to a geographic region, even in the start-up phase of their programs. This national focus not only adds a logistical issue--physically getting to the sites and meeting the participants--but also means that the staff needed to be well-versed in a wide range of local markets and had to negotiate with several separate staffs at Freddie Mac's and Fannie Mae's regional offices. In the EMI/Fannie Mae program, there were some conflicts over due diligence involving EMI's failure to conduct property inspections during construction, which ultimately was due to staffing constraints.

CExclusive arrangement with Freddie Mac/Fannie Mae. Each organization was built, at

least initially, around a partnership with one organization. The advantage in this arrangement was the potential benefit of working with a major player. Freddie Mac and Fannie Mae are large, powerful forces that could truly have an impact on the development of the secondary market for multifamily mortgages. A disadvantage, however, was in the exclusivity of both LIMAC's and EMI's partnerships. The LIMAC program was explicitly an arrangement between LIMAC and Freddie Mac only. The lack of competition put LIMAC at a considerable disadvantage in negotiating with Freddie Mac on price. The EMI program was structured so that EMI was free to pursue partnerships with other organizations. Although in 1997 EMI brought the Methodists pension fund to the program as an investor, its main focus was on its efforts with Fannie Mae to get the program started.

Offering a single product. Both programs were essentially one-product programs. In an attempt to get the programs started and build volume, both programs ended up focusing on a single product--for LIMAC, it was a long-term fixed rate mortgage and for EMI it was the forward commitment. For LIMAC this was particularly troubling because they were never able to get their product off of the ground. The 25-year mortgage proved to be difficult to sell since it required the lender to carry risk for the full mortgage term. LIMAC also abandoned developing a forward commitment product. LIMAC consistently chose to limit their initial scope in order to concentrate energies and not spread themselves too thin.

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

E. VIABILITY

Both LIMAC/Freddie Mac and EMI/Fannie Mae programs were created with the goal that they would be self-sustaining financially. For the LIMAC program, revenues never covered costs; as of June 1997, the revenues were not covering costs in the EMI program. The experience of these two programs raises the question of whether or not a business focused on mortgages on small, affordable housing projects is financially viable.

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

In addition, each program has had a narrow market niche. LIMAC was committed to one product that, because of its structure requiring the lender to be at risk long term, proved not to be a good fit for the market at the time. EMI, although it has more flexibility, has continued to focus on its partnership with Fannie Mae and its forward commitment product, with its temporary pricing. EMI is also largely limited to loans \$3 million or less. Although they can pursue larger loans, they must compete for them with DUS lenders on DUS terms.

Our interviews with lenders focused on affordable housing suggest that some fundamental characteristics of the LIMAC/Freddie Mac and EMI/Fannie Mae programs contributed to their problems in achieving financial viability. One affordable housing lender, who is close to meeting

the goal of 25 transactions per year, indicated that his volume would look more like EMI's if he had 1) the presence of Fannie Mae in all of his transactions, 2) a national scope instead of a regional one, and 3) a small staff. He argued that Fannie Mae's requirements would be overwhelming for most of his nonprofit borrowers, his focus on a single state has permitted him to build a detailed understanding of the local markets, and his organization has considerable support staff to back up his loan officers.

The LIMAC and EMI experiences suggest that running a national program focused on small, affordable housing transactions with one of the GSEs is a difficult task for a small, understaffed, undercapitalized, start up organization. The LIMAC/Freddie Mac program never really moved beyond the start up phase. EMI has closed considerably more transactions but still has not generated sufficient volume to cover costs. However, with experience there may be efficiency gains in the program. In addition, the changes in EMI's relationship with Fannie Mae initiated in January 1997 may decrease the staff time required per mortgage. EMI's experience in the next year should provide some indication of the magnitudes of these efficiency gains.

F. LESSONS AND FUTURE PROSPECTS

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

The rationale for government sponsorship of Fannie Mae and Freddie Mac focuses on the

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

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

Given the sheer size and profitability of the single family market, it is difficult for

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

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

There is a significant presence of private banks who are lending on affordable multifamily

housing, in part spurred by CRA requirements. With a more active secondary market, it is very likely that banks would originate more loans, since banks prefer activities that generate fee income but have little appetite for holding long term mortgages. The problem is the GSEs may need to see considerable volume before they will make major commitments to this market segment, while at the same time, lenders and investors need to see considerable volume before they start entering the market. Generating larger volume in the secondary market will require larger originators participating in this market.

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

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ENDNOTES

1. Fannie Mae was created in 1938; Freddie Mac was created in 1970. In addition to Fannie Mae and Freddie Mac, the federal government created the Federal Housing Administration (FHA) in 1934 to encourage homeownership through promoting the 30-year fixed rate mortgage to lenders and investors by insuring those loans. In 1968, Fannie Mae was split into two organizations, spawning Ginnie Mae (Government National Mortgage Association), housed in the U.S. Department of Housing and Urban Development. Ginnie Mae is responsible for providing a secondary market for FHA/VA loans and other mortgages supporting federal housing assistance efforts.
2. In the case of multifamily rental housing targeted at low- and moderate-income households, there is an additional need for standardization in the structure of grants and soft second mortgages. These grants and second mortgages often come with restrictions that encumber the first mortgage, making it more difficult to sell since there can be wide variation in the nature of the restrictions. For a broad discussion of the issues related to increasing the secondary market for multifamily mortgages, see DiPasquale and Cummings (1992).
3. NCDI, a coalition of foundations and private corporations, committed an initial \$62.5 million to address urban community development issues nationwide, with a particular emphasis on affordable housing. At that time, NCDI consisted of seven foundations and one insurance company, which together created a three-year program providing loans and grants for community revitalization projects, to be funneled through the national intermediaries LISC and The Enterprise Foundation. In 1994, NCDI announced a second three-year round with an additional \$88 million commitment. NCDI II participants consist of nine foundations, two corporations, and the Department of Housing and Urban Development.
4. The 1995 HUD rule regarding the regulation of Fannie Mae and Freddie Mac was published in the Federal Register on December 1, 1995. It established several new requirements for fair-lending, data collection, and reporting, due-process procedures, and new performance goals for Fannie Mae and Freddie Mac, including goals targeting affordable housing for low-income households. As part of their effort to develop the requirements for this new rule, HUD brought in several outside experts to assess various issues. We worked with HUD staff on some of the broad policy issues associated with requirements for multifamily lending.
5. The figures on Fannie Mae and Freddie Mac purchases were provided by HUD and are based on the annual reports submitted to HUD by Fannie Mae and Freddie Mac.
6. Follain and Szymanoski (1995) present a useful framework for assessing the need for government intervention in the multifamily mortgage market. They identify two possible market failures that might provide a rationale for government intervention: uninsurable risks and prohibitive information costs. Follain and Szymanoski illustrate that these two market failures are prevalent in the multifamily mortgage market.

In Follain and Szymanoski's analysis, government is defined as the federal government and

Fannie Mae and Freddie Mac are considered private firms. In this article, we view Fannie Mae and Freddie Mac as quasi-private firms deriving substantial benefits from their status as GSEs. This distinction for us raises the issue of the rationale for government sponsorship for Fannie Mae and Freddie Mac.

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

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

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

10. One consequence of this risk sharing arrangement was that the lender was on the line for the full mortgage term. This proved to be difficult to market in an environment where the lenders were used to commitment of only 5-7 years. The EMI program avoids this problem since EMI is the lender and is willing to be in long term.