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Congressional Recipients

This report, mandated by the Cranston-Gonzalez National Affordable Housing Act, examines (1) the problems that have led to the shortage of mortgage financing for affordable multifamily housing, (2) the factors limiting the expansion of opportunities for financing multifamily housing, (3) alternative forms of federal credit enhancements, and (4) ways to estimate and limit the federal government's exposure to risk in adopting specific credit enhancements.

The report contains recommendations aimed at facilitating the implementation of the credit enhancement demonstration programs authorized in the Housing and Community Development Act of 1992 and the development of a national data base on multifamily housing.

We are sending copies of this report to congressional committees and subcommittees interested in housing; the Secretary of Housing and Urban Development; the Chairman, Federal Housing Finance Board; the Director, Office of Management and Budget; and other interested parties. We will make copies available to others on request.

This work was performed under the direction of Judy A. England-Joseph, Director of Housing and Community Development Issues, who can be reached at (202) 512-7631. Major contributors to this report are listed in appendix X.

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Executive Summary

Purpose

One of the nation's most critical housing problems today is the shortage of decent and affordable multifamily rental housing.[1] The Congress has recently focused attention on expanding the availability of capital to finance such housing through credit enhancements—mechanisms for transferring credit risk from one party to another—such as mortgage insurance. The Cranston-Gonzalez National Affordable Housing Act directed GAO to, among other things, examine alternative federal credit enhancements. In April 1992 congressional testimony, GAO outlined four credit enhancement options.[2] Subsequently, the Congress authorized the Federal Housing Administration (FHA) to develop and conduct risk-sharing demonstration programs to test the effectiveness of new forms of federal credit enhancements for multifamily housing loans.

To be effective, these demonstration programs must be designed to overcome current barriers to financing multifamily housing. This report provides information aimed at increasing the utility of the demonstration programs and related initiatives by examining (1) the problems that have led to the shortage of mortgage financing for affordable multifamily housing, (2) the factors limiting the expansion of a secondary market for such housing, (3) alternative forms of federal credit enhancements, and (4) ways to estimate and limit the federal government's exposure to risks in adopting specific credit enhancements.

Background

Credit enhancements encourage primary lenders, such as commercial banks, to make long-term, fixed-rate mortgage loans, and investors, such as pension funds, to buy these loans in what is known as the secondary market. The sale of individual loans, or securities backed by pools of loans, returns funds to primary lenders, creating liquidity and allowing the lenders to make additional loans or otherwise reinvest the funds. Credit enhancements can also serve as incentives for savings and loan associations and commercial banks to originate and retain in their portfolios additional loans for affordable multifamily housing by helping these institutions meet certain regulatory requirements for banks.

[1] In this report, affordable multifamily rental housing means housing in which at least 20 percent of the units in a building are affordable to households with incomes at or below 50 percent of the area's median income, or at least 40 percent of the units are affordable to households with incomes at or below 60 percent of the area's median income, once these households' incomes have been adjusted for family size. For units to be considered affordable, households are expected to pay no more than 30 percent of their income for rent and utilities.

[2] Mortgage Credit Enhancement: Options for FHA in Meeting the Need for Affordable Multifamily Housing (GAO/T-RCED-92-52, Apr. 3, 1992).

Secondary markets have long been a critical element in financing single-family housing, but they are less widely used in financing multifamily rental housing. The Congress addressed this issue in the Housing and Community Development Act of 1992, which calls on FHA to conduct demonstration programs of federal credit enhancements for affordable multifamily housing and authorizes the formation of a task force to make recommendations for establishing a national data base on the performance of all multifamily mortgages. The legislation also sets specific goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) to achieve in purchasing multifamily housing mortgages. In addition, the Federal Credit Reform Act of 1990 requires that the costs of any federal credit enhancements adopted be (1) projected and (2) financed by federal appropriations. The federal government, because of its high credit rating and strong public policy objectives, is in a unique position to provide credit enhancements for both secondary market investors and portfolio lenders. Nevertheless, while credit enhancements are important, affordable multifamily housing projects, particularly those targeted to households with very low incomes, often require other subsidies to be viable. These subsidies may be direct (e.g., rental assistance) or indirect (e.g., second mortgages or tax credits).

Results in Brief

The financing available for multifamily housing has been declining since the mid-1980s, largely because of (1) changes in federal policies and regulations on housing subsidies, taxation, and banking; (2) the poor performance of multifamily mortgages purchased or insured by major financial institutions; and (3) overbuilding in certain housing markets. There is a broad consensus among market experts that a significant gap exists between the need for and the availability of financing for affordable multifamily housing.

Federal credit enhancements can help increase the availability of capital by promoting an expanded secondary market for multifamily mortgages, particularly affordable multifamily mortgages. However, such a market has not evolved for several reasons. First, FHA has reduced the credit enhancements it provides, partly because of losses exceeding $2 billion. Second, few credit enhancements are available from private insurers. Third, the key secondary market institutions, Fannie Mae and Freddie Mac, have limited their purchases of mortgages for smaller subsidized affordable multifamily housing projects, both because of known and unknown risk and because of the difficulty of standardizing these

mortgages. Fourth, without a data base on the past performance of affordable multifamily housing loans, it has been difficult for lenders and investors to evaluate and price the risks of such loans. Some successful affordable multifamily housing developments have been financed through partnerships between nonprofit organizations and local lenders. However, capital and bank regulatory constraints have restricted the volume of these efforts.

Because affordable multifamily housing often requires multiple layers of financing and subsidies and different kinds of originating lenders, no single federal credit enhancement can meet all financing needs. Nevertheless, a broad segment of this market could be served by credit enhancement options that (1) delegate responsibility—primarily for processing, underwriting, and monitoring individual loans—to state and national financial intermediaries, such as housing finance agencies (HFA), Fannie Mae, Freddie Mac, and Federal Home Loan Banks, or (2) insure pools of loans, either directly or indirectly. To ensure the effectiveness of the options chosen, the FHA demonstration programs will require risk-sharing arrangements between FHA, key financial intermediaries, and local lenders. These parties must also reach consensus on the most useful options and the policies that will guide their implementation.

A data base on the performance of affordable multifamily housing loans could help determine the real credit risks by providing the information needed to refine risk-sharing agreements between FHA and participating financial institutions. Such a data base could also permit accurate estimates of any subsidy costs of providing federal credit enhancements, as required by the Federal Credit Reform Act of 1990. The Congress authorized, but did not appropriate funds for, the creation of a task force to develop recommendations for establishing a national data base on multifamily housing loans. Once the task force is created, choosing a single organization or agency to manage and maintain the data base could help ensure its ongoing utility.

Principal Findings

Supply of Capital for Multifamily Housing Has Decreased

Since the mid-1980s, lending for multifamily housing has been declining in response to changes in government policies and regulations on banking, taxation, and housing subsidies and to overbuilding in the multifamily

housing market in several regions. Specifically, regulations aimed at maintaining the financial soundness of depository institutions made lending for multifamily housing less attractive to these institutions. Also, federal tax policies incorporated in the Tax Reform Act of 1986 eliminated tax incentives that had contributed to overbuilding in many housing markets. In addition, under a new federal policy, housing subsidies shifted from long-term, project-based commitments to short-term, tenant-based housing certificates. While the new policy provides individuals with greater mobility and freedom of housing choice, it has discouraged lenders from financing affordable rental projects because of uncertainty about the level of subsidies that will be available to such projects over the life of the mortgage. Finally, FHA, which has long been the principal source of federal credit enhancements for multifamily mortgages through mortgage insurance, reduced its coverage from over 30 percent of new multifamily mortgages in the early 1980s to only about 6 percent in 1991.

Secondary Market for Smaller Loans for Affordable Multifamily Housing Is Limited

A secondary market provides access to alternative sources of capital, primarily from large institutional investors such as pension funds. These investors have longer-term investment plans than most depository institutions, which depend primarily on short-term, variable-rate deposits. The secondary market thus potentially increases the volume of long-term, fixed-rate mortgage loans for affordable multifamily housing and possibly results in lower interest rates by providing access to more efficient national capital markets. However, the development of such a market has been limited, primarily because of the difficulty of standardizing loans and the risks, both known and unknown, of lending capital for housing targeted to lower-income households.

Private insurers today are generally not providing credit enhancements to affordable multifamily housing projects. The efforts of Freddie Mac and Fannie Mae, the key institutions that can potentially expand the secondary market in affordable multifamily mortgages, have been mixed. Since mid-1990, Freddie Mac has substantially reduced its multifamily housing activities, following major losses incurred during the late 1980s. In the past, Fannie Mae generally supported large unsubsidized projects or purchased large pools (usually exceeding $50 million) of existing loans from large depository institutions. While the projects financed by these loans were normally affordable to a wide range of low- and moderate-income tenants, lenders with smaller projects that lower-income tenants could afford found that they could not readily obtain financing from Fannie Mae. Recently, however, Fannie Mae has negotiated

purchases of loan pools from bank consortia and is seeking smaller loan pools from smaller individual lenders and bank consortia. It has also developed a new Forward Commitment product that allows lenders to "lock in" interest rates up to 2 years before construction is complete. This program is particularly important for new construction and substantial rehabilitation projects. Such projects take up to 2 years to complete and need stable, permanent financing before construction begins.

Despite the regulatory and market barriers that have affected both lenders and secondary market participants, successful local initiatives have helped provide limited financing for some affordable multifamily mortgages. Many of these initiatives have been led by nonprofit community development corporations and local lenders. However, small and medium-sized lenders in particular have been handicapped by their limited ability to commit large amounts of their capital when making multifamily housing loans, as required by banking regulations.

Various Credit Enhancement Options Can Improve Financing for Affordable Multifamily Housing

Financing needs for affordable multifamily housing are diverse, and no single federal credit enhancement option can work in all situations. GAO has proposed the following four credit enhancement options, two of which provide insurance on individual loans and two of which provide insurance on pools of loans:

- Delegated processing. FHA would delegate loan processing and origination to selected HFAs and lenders certified by "qualified financial institutions."[3] FHA would retain final underwriting approval but would be required to make a decision within a specified period of time.
- Delegated underwriting. FHA would delegate underwriting to more experienced HFAs and lenders selected by qualified financial institutions. This authority would be limited to specific types of loans and loan amounts, depending on the capability of the participant. Substantial risk sharing among the participants would be required.
- Primary bond insurance. FHA would provide primary bond insurance for pools of loans issued by qualified financial institutions. Risk would be shared between FHA and the bond issuer.
- Bond or pool reinsurance. Either a private bond insurer or a state mortgage insurance agency would provide the primary bond insurance. FHA would provide up to 50-percent reinsurance.

[3]Under the demonstration program, "qualified financial institutions" include HFAs, Fannie Mae, Freddie Mac, and Federal Home Loan Banks.

Currently, there is no mechanism for bringing together the financial institutions that are critical to financing affordable multifamily housing to reach consensus on the best options and the policies needed to implement them effectively.

Data Base Could Address Actual Credit Risk by Providing Better Performance Data on Loans

The federal government and investors need accurate information on the performance of multifamily loans in order to price risk. Also, the costs of implementing new federal credit enhancement options must be projected and funded to cover expected losses throughout the duration of the coverage. Without accurate data, funding of reserves could be too low, impeding compliance with the Federal Credit Reform Act of 1990, or too high, making the price of federal credit enhancements excessive. The task force authorized by the Congress in 1992, to be chaired jointly by the Secretary of the Department of Housing and Urban Development (HUD) and the Chairman of the Federal Housing Finance Board (FHFB), is to develop recommendations for establishing a national data base on multifamily housing loans. Funding for the task force was authorized for fiscal years 1993 and 1994 but not appropriated. As a result, the task force has not been formed. Important issues for the task force to address are standard definitions for data and ongoing maintenance of the data base.

Matter for Consideration by the Congress

To establish a national data base on multifamily housing loans, the Congress may wish to consider reauthorizing and appropriating funds for the task force authorized by the Housing and Community Development Act of 1992.

Recommendations

To facilitate the implementation of the credit enhancement demonstration programs, GAO is recommending, among other things, that the Secretary of HUD, in cooperation with the Commissioner of FHA, convene a conference of senior officials from the financial institutions authorized to participate in the programs. The purpose of the conference would be to guide the implementation of the demonstration programs by beginning to reach consensus on the underlying policies and options for providing credit enhancements on individual loans as well as loan pools.

Because of the ongoing need for accurate data on the performance of loans for affordable multifamily housing, GAO is also recommending that the Secretary and the Chairman of the FHFB designate one institution to

maintain and manage the data base resulting from the task force's recommendations.

Agency Comments and GAO's Evaluation

HUD, the Office of Management and Budget (OMB), Fannie Mae, Freddie Mac, FHFB, and the National Council of State Housing Agencies (NCSHA) were given an opportunity to comment on a draft of this report. (See apps. VI to IX.) HUD, Fannie Mae, Freddie Mac, and the NCSHA were in general agreement with the report's findings and conclusions. Each of the respondents agreed that credit enhancements could assist in improving financing for properly underwritten affordable multifamily housing projects. Moreover, HUD, Fannie Mae, and NCSHA support GAO's recommendation that FHA convene a conference as a starting point for implementing the demonstration programs. Freddie Mac did not explicitly address this point. Fannie Mae and NCSHA agreed with GAO's conclusion and related recommendation on the need to improve the quality of data on the performance of affordable multifamily loans. Freddie Mac and HUD, in discussions with GAO, also concurred on the need to improve the data base on the performance of these loans. OMB and the FHFB declined to comment on the draft of this report.

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Abbreviations

AHP	Affordable Housing Program
CDC	community development corporation
CHAS	Comprehensive Housing Assistance Strategy
CIC	community Investment Corporation
CIP	Community Investment Program
CPC	Community Preservation Corporation
CRA	Community Reinvestment Act
DSCR	debt service coverage ratio
DUS	Delegated Underwriting and Servicing
ERISA	Employee Retirement Income Security Act
Fannie Mae	Federal National Mortgage Association
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
FHFB	Federal Housing Finance Board
FHLB	Federal Home Loan Bank
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
Freddie Mac	Federal Home Loan Mortgage Corporation
GAO	General Accounting Office
Ginnie Mae	Government National Mortgage Association
GSE	government-sponsored enterprise
HFA	housing finance agency
HUD	Department of Housing and Urban Development
LIMAC	Local Initiatives Managed Assets Corporation
LISC	Local Initiatives Support Corporation
LTV	loan-to-value ratio
MBS	mortgage-backed security
NCSHA	National Council of State Housing Agencies
NRC	Neighborhood Reinvestment Corporation
OMB	Office of Management and Budget
OTS	Office of Thrift Supervision
PA	Prior Approval
RTC	Resolution Trust Corporation
SAMCO	Savings Associations Mortgage Companies, Inc.
SONYMA	*State of New York Mortgage Agency*
S&L	savings and loan institutions
S&P	Standard & Poor's

Introduction

Decent and affordable housing for every American has been a national goal since 1949. The 1990 National Affordable Housing Act reaffirmed this goal with its statement that every American family should be able to afford a decent home in a suitable environment. However, several recent studies have concluded that millions of low- and very-low-income[1] Americans pay too much for and/or live in substandard housing. Many of these families rent units in buildings with multiple units.

Over the last 10 years, the multifamily housing finance system in general and the affordable multifamily housing subsystem in particular have experienced significant tax, regulatory, housing subsidy, and market changes. These changes have contributed to a considerable decline in the availability of long-term, fixed-rate mortgage financing for both subsidized and unsubsidized multifamily housing.

Mortgage lenders and institutions that buy mortgage loans (called secondary market institutions) often perceive long-term mortgage loans for low-income multifamily rental housing as risky. This perception results partly from the changes mentioned above and partly from concerns that low-income families may not be able to afford the rents needed to cover the cost of operating the project, reserves for capital improvements, and profits. This concern can be reduced by the use of credit enhancements—mechanisms for transferring the credit risk of an individual loan or pool of loans from one party, such as the lender, to another entity, such as a public or private mortgage insurer. Credit enhancements can thus make more capital available to finance affordable housing at lower long-term fixed rates by substituting the creditworthiness of the credit enhancement provider for that of the project and/or lender. Thus, capital can be attracted from large institutional investors who have long investment horizons but who are unwilling to or incapable of assuming even modest credit risks.

With the expectation that credit enhancements could help provide more families with decent and affordable housing, the Cranston-Gonzalez National Affordable Housing Act directed GAO to identify and recommend legislative or administrative actions that could lead to the use of credit enhancements to improve the availability of mortgage finance for affordable housing. On April 3, 1992, GAO presented four credit enhancement options in testimony before the Senate Subcommittee on

[1]Low-income households are those with incomes of 80 percent or less of the area's median income adjusted for family size, while very-low-income households are those with incomes of 50 percent or less of the area's median income adjusted for family size.

Housing and Urban Affairs.[2] The Congress subsequently enacted the Housing and Community Development Act of 1992, authorizing the Federal Housing Administration (FHA) to establish credit enhancement demonstration programs for multifamily housing loans. This report provides information aimed at increasing the utility of these demonstration programs.

Defining Affordable Housing

Affordable rental housing has no standard definition. However, a widely accepted measure for individual households in government programs is when housing costs are no greater than 30 percent of household income (as adjusted by household size) for rent and utilities. This measure is consistent with the rent payment standard in the two major Department of Housing and Urban Development (HUD) rental housing programs—public housing and section 8 housing assistance.

Determining whether an individual multifamily rental building or project provides affordable housing is more difficult because the number of its residential units that are occupied by lower-income families is likely to vary over time. However, Internal Revenue Code provisions for two programs (tax-exempt bonds that can be used to finance multifamily housing and the low-income housing tax credit) have established minimum standards for affordable multifamily rental housing. Both programs provide assistance for multifamily housing when (1) at least 20 percent of the units are affordable to households with incomes at or below 50 percent of median income for the area or (2) at least 40 percent of the units are affordable to households with incomes at or below 60 percent of median income for the area (adjusted for family size). In this report, our definitions of housing affordable to households and affordable multifamily projects are consistent with the HUD and Internal Revenue Code definitions.

The Shortage in Affordable Rental Housing

A critical housing problem today is the shortage of decent and affordable rental housing. According to HUD data, millions of lower-income families pay too much for housing, and too often the housing they occupy is substandard. Furthermore, the supply of affordable housing is shrinking.

Lower-income renter families (those with incomes 80 percent or less of the area's median income) have great difficulty finding decent, affordable

[2] Mortgage Credit Enhancement: Options for FHA in Meeting the Need for Affordable Multifamily Housing (GAO/T-RCED-92-52, Apr. 3, 1992).

housing, as five recent studies have pointed out.[3] The studies typically used the 1989 American Housing Survey (supplemented by other data) as the source of their findings.[4] While these studies used different income groupings to measure the need for decent affordable housing, their findings on the severity of the problem were consistent.

For example, according to HUD's 1991 report, about 11.6 million (58 percent) of the nation's 20 million lower-income renter households paid 30 percent or more of their income for housing. HUD also estimated that about 5.5 million (28 percent) of these households paid more than 50 percent of their income for housing. This problem is particularly acute for very-low-income families (those with incomes 50 percent or less of the area's median income); more than 40 percent of these families had rent burdens exceeding half their income. These results contrast starkly with the percentage of income paid by middle- and upper-income renters (households with incomes of 81 percent of the area's median income or more). HUD's report estimated that almost none of the middle- and upper-income households paid 50 percent or more of their income for rent.

Lower-income families are also more likely than higher-income families to live in inadequate housing. HUD's study estimated that about 3 million (15 percent) of the nation's 20 million lower-income renter households live in housing that is in inadequate condition—about double the percentage of middle- and upper-income renters who live in inadequate housing.

The Government's Tools for Making Affordable Housing More Available

Making housing affordable for lower-income households often requires governmental involvement through subsidies and other forms of assistance. The basic economic explanation for the need for governmental involvement is that a gap exists between the rents that lower-income families can afford to pay and what it costs an owner to make mortgage payments, pay operating expenses, set aside reserves for major repairs or rehabilitation, and earn a profit.

[3] A Place to Call Home—The Low Income Housing Crisis Continues, Center on Budget and Policy Priorities and the Low Income Housing Information Service (Washington, D.C.: Dec. 1991); Cushing N. Dolbeare, Out of Reach: Why Everyday People Can't Find Affordable Housing, Low Income Housing Information Service (Washington, D.C.: 1991); Priority Housing Problems and "Worst Case" Needs in 1989, A Report to the Congress, Department of Housing and Urban Development (Washington, D.C.: June 1991); The State of the Nation's Housing, 1991, Joint Center for Housing Studies, Harvard University (Cambridge, Mass.: 1991); Margery Austin Turner and John G. Turner, Dynamics of the Low-Cost Rental Stock, The Urban Institute (Washington, D.C.: 1991).

[4] The American Housing Survey is a national sample of households. Its results can be generalized nationally and regionally. The survey is conducted biennially by the Bureau of the Census for HUD.

Aside from public housing there are at least three approaches to making housing more affordable. First, governments (federal, state, or local) can provide tenant-based subsidies that make up the difference between what a landlord charges in rent and the amount a tenant can afford to pay (the "affordability gap"). Second, governments can provide owners of lower-income rental housing with subsidies and favorable tax treatment to lower the cost of building or operating the housing, thus allowing them to charge lower rents. Finally, governments can make housing credit cheaper and more available by providing credit enhancements. Credit enhancements induce lenders to make loans and investors to buy loans by transferring default risk to the credit enhancer—as a result, making credit more available at fixed rates, for longer terms, and possibly at reduced costs. It is important to note that the federal government can price its credit enhancements to cover expected costs or price them below expected cost to support a public policy objective such as facilitating the financing of affordable multifamily housing. When very-low-income households are being assisted, multiple housing subsidies may need to be combined to make the housing affordable.

The lack of sufficient subsidies is the principal constraint on serving more low-income families that have housing problems. However, well-designed credit enhancements can complement housing subsidies by reducing the cost to borrowers and increasing the availability of fixed-rate debt financing. As a result, rents can be reduced.

While the discussion below highlights the critical importance of housing subsidies and the way credit enhancements can complement these subsidies in making financing available for projects serving low-income families, other issues, not addressed in this report, are also important in the nation's ability to provide adequate housing for those in need. These issues include general economic conditions in the country, discrimination in housing, restrictive zoning codes and building codes, environmental hazards, and a lack of social services such as job counseling and day care for the target population.

Subsidies Are Used to Decrease the Affordability Gap

At present, the federal government's primary tool for decreasing the affordability gap is HUD's section 8 program, which serves about 2.8 million households. This program provides lower-income families with housing vouchers or certificates that they can use to rent housing of their choice. Generally, the section 8 program pays a private landlord the difference between 30 percent of a family's income and the "fair market rent" for an

apartment in the area. However, because this program costs about $6.5 billion each year for every 1 million families served, any significant program expansion is likely to be difficult given persistent federal budget deficit pressures.

Favorable Tax Treatment and Other Subsidies Can Lower Owners' Costs

Governments can also provide favorable tax treatment or other subsidies that lower owners' costs, allowing owners to charge lower rents and thus making rental housing more affordable to lower-income families. One often-used subsidy is the Internal Revenue Code's low-income housing tax credit. Under the tax credit, people who own or invest in the development of qualified low-income rental housing receive a credit or reduction in tax liability each year for 10 years in exchange for providing a specified amount of cash equity to the development. Other subsidies that reduce costs to owners include "soft seconds" (i.e., second mortgages that do not require regular payments or whose payments are deferred); grants from the Community Development Block Grant Program,[5] state and local governments, foundations, or religious institutions; and local tax abatements.

Credit Enhancements Can Increase the Flow of Capital

As noted, credit enhancements, such as mortgage insurance, transfer the credit risks of a mortgage loan from the lender to another entity, in this case the insurer. FHA, within HUD, has for many years provided this kind of credit enhancement through programs insuring individual mortgage loans for both single-family and multifamily housing. Credit enhancements are also used to provide higher credit ratings for pools of loans sold as mortgage-backed securities. One such credit enhancement is a guarantee of timely payment of principal and interest to the investor, who then relies on the creditworthiness of the entity providing the credit enhancement rather than the credit quality of the pool of loans underlying the security. If the insurer or the credit enhancement provider is the federal government—the Government National Mortgage Association (Ginnie Mae), for example—the cost (interest rate) of the security should decline, while the availability of capital should increase, particularly from risk-adverse institutional investors such as pension funds.

As mentioned above, credit enhancements are a complement to—not a substitute for—other subsidies needed to make rental housing affordable to very low-income families. Moreover, it is important to note that while

[5]Community Development Block Grants are provided by HUD to entitled communities to carry out a wide range of community development activities directed toward neighborhood revitalization, economic development, and improved community facilities and services.

credit enhancements can increase the financing available for providing affordable housing, additional credit enhancements will expose the federal government to possible costs. Appendix I describes the credit enhancements most commonly used for multifamily housing.

The Multifamily Housing Finance System in Brief

The multifamily housing finance market has three principal participants: (1) primary lenders, which originate mortgage loans; (2) secondary market institutions, which purchase mortgage loans from primary lenders; and (3) investors in securities issued by secondary market institutions that are backed by mortgage loans and often include credit enhancements. All three participants contribute to the efficient flow of funds to the multifamily borrower.

Lenders originate mortgages, which they may either retain as an income-earning asset (an approach called portfolio lending) or sell to a secondary market institution. The sale of these mortgages provides the lender with funds to make additional loans. A secondary market institution, in turn, purchases a mortgage and may retain it as a portfolio asset or pool it with similar mortgages that serve as collateral for a security, such as a housing bond or a mortgage-backed security. Investors then buy these securities from the secondary market institution.

Organizations most often associated with the multifamily secondary mortgage market are Ginnie Mae, FHA, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Other organizations, such as large banks, mortgage bankers, and state and local housing finance agencies, are also participants.

Because Ginnie Mae, Fannie Mae, and Freddie Mac were chartered by the federal government, the financial community perceives that their securities are backed by the government. Ginnie Mae is a federal agency, and its debt is backed by the full faith and credit of the federal government. However, Fannie Mae and Freddie Mac are private organizations without explicit federal government guarantees. Nevertheless, both of these corporations enjoy a special relationship with the federal government because they are federally chartered and, in the view of the investment community, have an implicit federal guarantee.

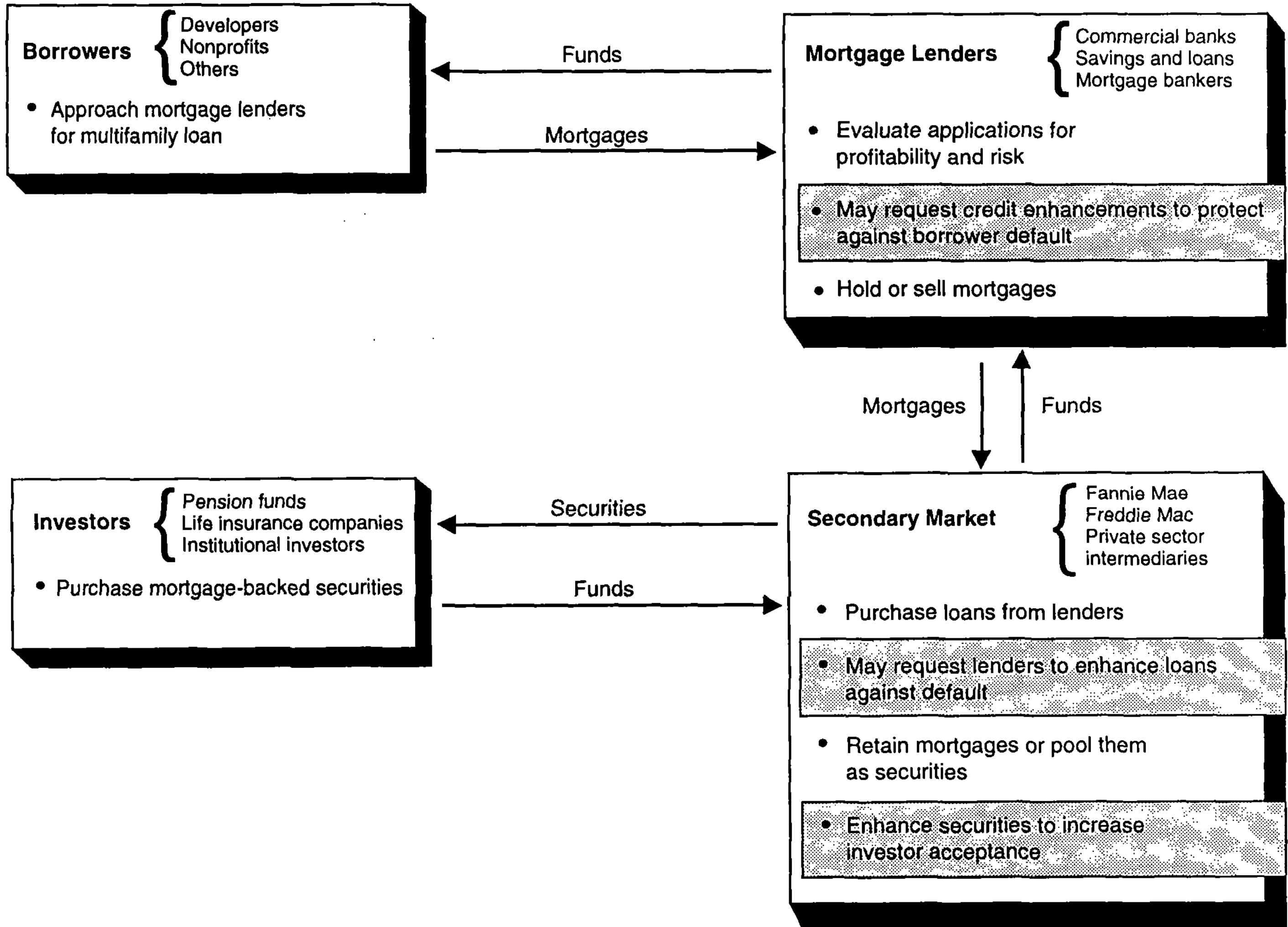
Another important component of the housing finance system is the Federal Home Loan Banks (FHLB), which are regulated by the Federal

Housing Finance Board (FHFB). Although the FHLBs are not technically secondary market intermediaries, they perform a similar function by selling combined obligation bonds in the national capital markets. These bonds are used to finance mortgage loans originated and held by member institutions.

Credit enhancements are used both when a loan is originated and when it is converted into a mortgage-backed security[6] (see fig. 1.1). For example, lenders may require credit enhancements—typically mortgage insurance—on the loan itself. Secondary market institutions, in turn, may require that lenders provide some type of enhancement, such as those cited in appendix I, on the loans or loan pools that they sell. Finally, investors may require a credit enhancement, such as a guarantee of timely payment of principal and interest, on the securities they purchase.

[6]Mortgage-backed securities are created when individual loans are pooled and pledged as collateral to insure payment for the security.

Figure 1.1: Overview of the Multifamily Housing Financing System



Objectives, Scope, and Methodology

Consistent with the requirements of section 271 of the Cranston-Gonzalez National Affordable Housing Act, this report primarily addresses problems in securing long-term financing for affordable multifamily rental housing and actions that might be taken to improve access to this capital through credit enhancements. More specifically, the act asked GAO to assess

- the need for HUD or other federal agencies to provide partial credit enhancement to make financing for affordable housing available efficiently and at the lowest possible cost;
- ways in which HUD could provide any needed credit enhancement;
- ways in which HUD or other federal agencies could help government-sponsored enterprises (i.e., Fannie Mae, Freddie Mac, and the FHLBS) finance mortgages on affordable housing through the development of standardized mortgage-backed securities that are readily traded in the capital markets; and
- ways in which the capacities of existing agencies of the United States could be used to provide mortgage financing for affordable housing more efficiently through government-sponsored mortgage finance corporations.

The act requires that any proposals protect the interests of the federal government and minimize the risks of loss to the government through requirements for fees, mortgage insurance, risk-sharing, secure collateral, and guarantees by other parties as well as through standards for minimum capital and previous experience with mortgage loan underwriting, origination, and servicing on the part of the originating lenders.

In response to section 271, this report examines (1) the problems that have led up to the shortage of mortgage financing for affordable multifamily housing, (2) factors limiting the expansion of opportunities for financing multifamily housing, (3) alternative forms of credit enhancements, and (4) ways to estimate and limit the federal government's exposure to risks in adopting specific credit enhancements.

To provide this information, we reviewed financial and housing literature and congressional testimony and interviewed more than 200 top- and mid-level officials from about 75 institutions. Federal agencies and government-sponsored enterprises at which we conducted interviews included HUD, FHA, Ginnie Mae, bank regulatory agencies, FHFB, Fannie Mae, and Freddie Mac. National associations and institutions we contacted included the National Council of State Housing Agencies, National Association of Home Builders, Mortgage Bankers Association of America, National Low Income Housing Coalition, Neighborhood Reinvestment Corporation (NRC), Enterprise Foundation, Local Initiatives Support Corporation (LISC), and Joint Center for Housing Studies at Harvard University. Financial institutions and other organizations at which we held interviews included Standard & Poor's (S&P), Moody's, several bond insurers, and various lending institutions, including several bank

consortia. At many of these institutions we gathered internal documents, studies, and analyses related to our work.

We also followed the progress of a similar effort by a National Task Force on Financing Affordable Housing (representing public and private sector institutions) to study problems in multifamily affordable housing. The task force's mission was to propose a predictable, flexible, accessible, and widely understood system of long-term financing for multifamily housing, including affordable housing. The task force issued its report, entitled From the Neighborhoods to the Capital Markets, in June 1992.

We contracted with James A. Vitarello to provide advice on various aspects of job design, execution, and reporting. Mr. Vitarello has extensive experience in community development finance as well as secondary markets and has provided advice to a wide variety of commercial banks; nonprofit organizations; pension funds; and federal, state and local governments. He is the principal author of over 20 articles in this area.

We performed our work between March 1991 and August 1993 in accordance with generally accepted government auditing standards.

Policy, Regulatory, and Market Factors Have Contributed to a Decrease in Financing for Affordable Multifamily Housing

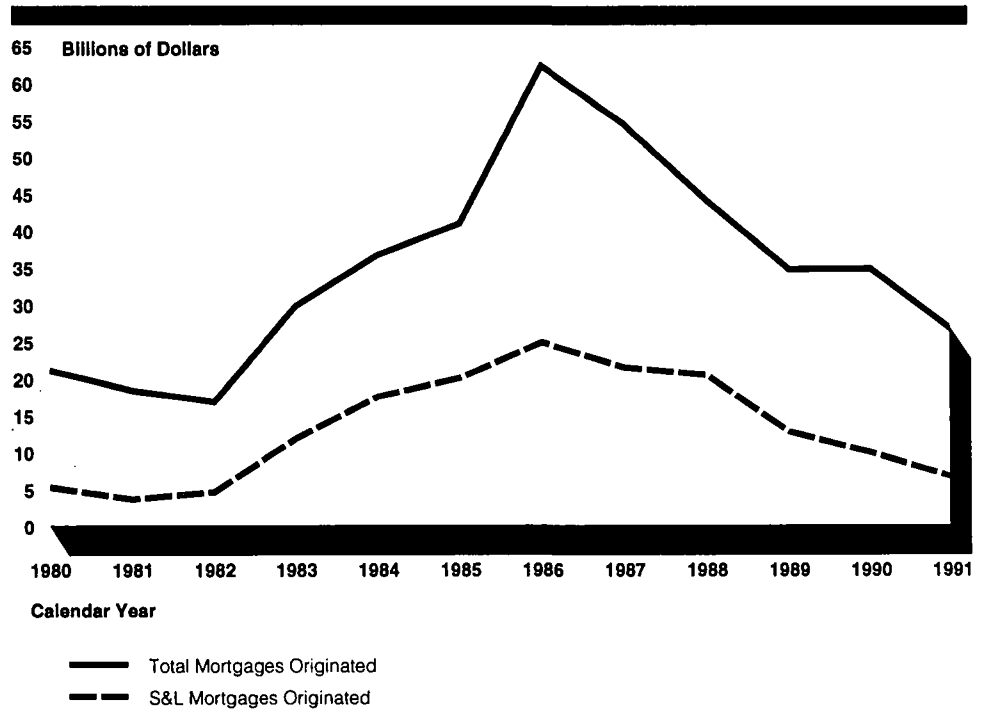
To function efficiently, this nation's multifamily housing finance system depends on the effective interaction of various institutions, made possible partly by supportive public policies. However, changes in governmental regulations and policies during the 1980s, along with the poor performance of multifamily loans held by key institutions, had negative repercussions for financing multifamily housing. Although these changes have had some positive effects, including promoting safety and soundness within the banking industry, they have generally worked to discourage investment in multifamily housing, including affordable multifamily housing.

Lending for Multifamily Housing Is Declining and Sources Are Shifting

Lending for multifamily properties has steadily decreased since the mid-1980s.[1] Several key factors were responsible for this decline. For example, overbuilding in certain markets that led to high vacancy rates, low rent increases, falling property values, and failing loans combined to decrease the ability of properties to qualify for financing. In addition, other changes, including significant revisions to the tax code in 1986, removed incentives for developing multifamily housing. Figure 2.1 shows the decline in the total value of multifamily mortgage loans originated.

[1]Currently available data on multifamily housing generally do not separate out affordable multifamily loans as a subset of all multifamily loans.

Figure 2.1: Multifamily Mortgage Loan Originations, 1980 Through 1991, in Constant 1992 Dollars



Source: GAO's analysis of data from HUD's Survey of Mortgage Lending.

The decline in total mortgage volume shown in figure 2.1 has been accompanied by a marked shift in the relative market share of the four primary lenders. Savings and loan associations (S&L) were the leading originators and holders of multifamily mortgage loans throughout the 1980s. At the height of their domination in 1985, there were 2,857 federal- and state-chartered S&Ls with assets totaling nearly $890 billion. In that year, these S&Ls originated 49 percent of all multifamily mortgages that year (see fig. 2.2), while their largest competitor, commercial banks, originated only 14 percent of total mortgages. However, by 1991 the number of S&Ls had declined by more than 50 percent, to only 1,353, and their total assets had declined by about 55 percent, to only $406 billion. Also, commercial banks replaced S&Ls as the market leader, with 44 percent of the market share. S&Ls dropped to second with 25 percent of the market share, mortgage bankers had 8 percent, and housing finance agencies (HFA) had 6 percent (see fig. 2.3).

Figure 2.2: Share of Multifamily Mortgage Originations by Institution, 1985

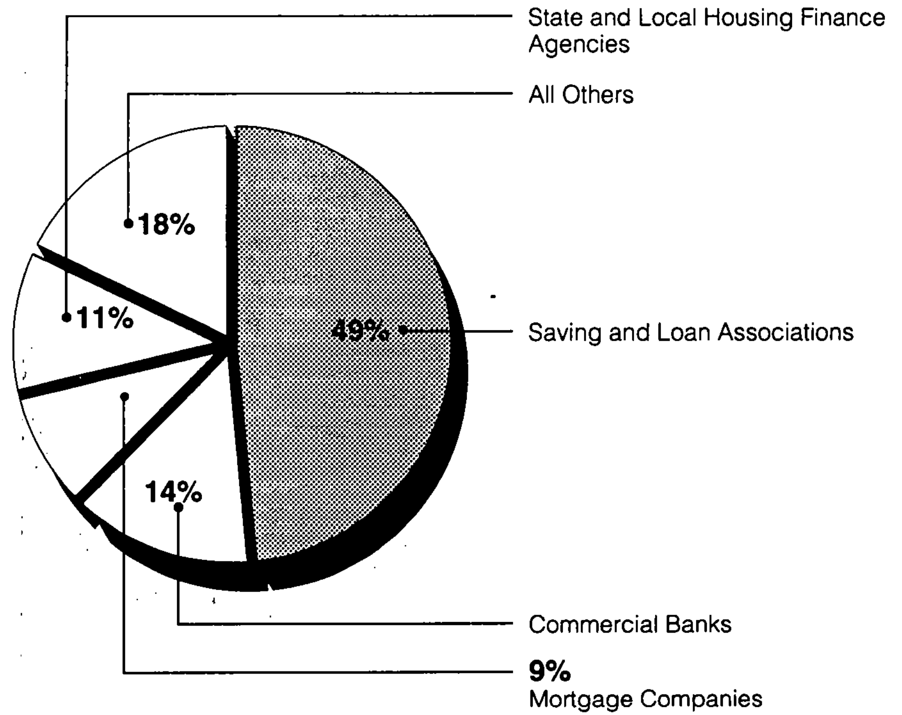
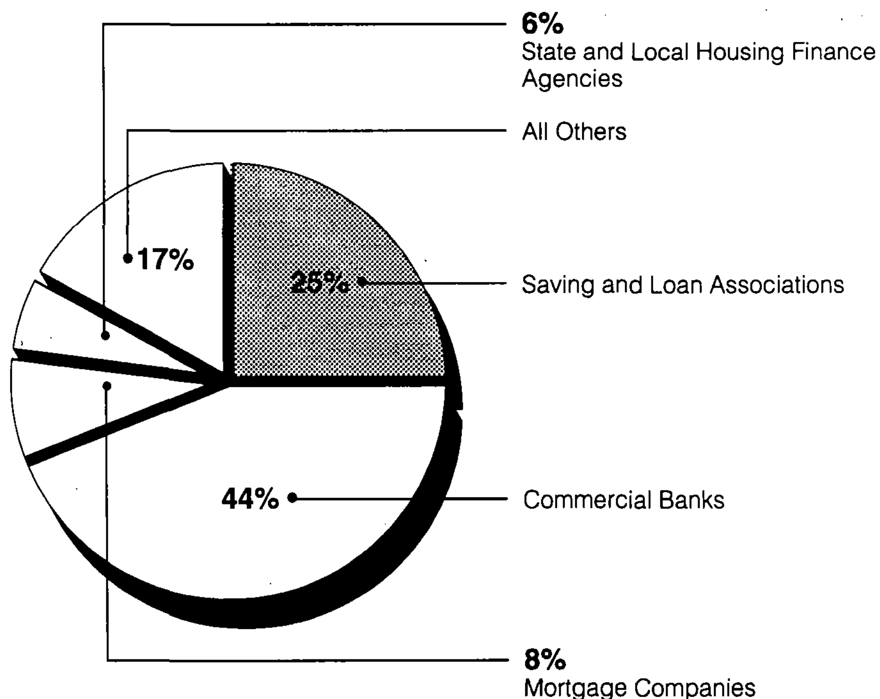


Figure 2.3: Share of Multifamily Mortgage Originations by Institution, 1991



Note: Mortgages originations were for new and existing properties. "All Others" includes mutual savings banks, insurance companies, pension and retirement funds, and private issuers of mortgage-backed securities.

S&Ls and commercial banks—called depository institutions because they historically obtained their capital from deposits made by individuals and corporations—either retain the mortgages they originate as income-earning assets or sell them and use the proceeds, possibly to make additional loans. Mortgage bankers, on the other hand, obtain their capital by borrowing from other financial institutions and typically sell their loans to repay the borrowed funds. HFAS sell tax-exempt and taxable bonds to raise capital to make multifamily loans; they repay these bonds with the principal and interest payments borrowers make on the loans.

While a shift has occurred from S&Ls to commercial banks as loan originators, both continue to be heavily involved in multifamily loan originations. This prolonged involvement can be attributed, at least in part,

to the Community Reinvestment Act (CRA). Enacted as part of the Housing and Community Development Act of 1977, CRA applies exclusively to federally insured banks and S&Ls. Under CRA, banks and S&Ls covered by this law have "a continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered."

While federal banking regulators[2] are responsible for enforcing compliance with CRA, community organizations have used CRA's requirements to successfully negotiate agreements with local lenders and bank holding companies to include affordable multifamily housing loans among their targeted loans. For example, three Chicago banks that have CRA agreements are First Chicago, Harris Bank, and Northern Trust. Each bank has originated multifamily mortgages totaling between $30 million and $50 million and averaging about $500,000 per loan for affordable multifamily housing.

While CRA has provided an impetus for affordable multifamily lending, other public policies have discouraged such lending. It is these other policies that partly explain both the decline and the shift in mortgage originations for multifamily housing.

Public Policy Reforms Have Contributed to a Decrease in the Availability of Multifamily Financing

Over the last 10 years, changes in government policies and regulations have contributed to decreases in the amount of financing that primary lenders have provided for affordable multifamily housing. Among the more notable were changes to (1) banking laws, (2) tax policies, and (3) HUD's method for providing housing subsidies.

The ability of depository institutions to originate long-term financing for affordable multifamily housing was sharply altered by interest-rate deregulation and changes in other government regulations aimed at better ensuring these institutions' financial solvency following widespread losses within the S&L industry. While banking reforms have largely affected depository institutions, changes in tax policies have affected all multifamily mortgage originators by generally making such mortgages less profitable and riskier. Finally, HUD's shift from project-based housing subsidies to subsidies not tied to specific housing projects has increased the risk to lenders who originate loans that rely on subsidies to make the projects financially viable.

[2]Federal agencies with regulatory responsibility are the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision.

Wide Swings in Interest Rates Have Affected Institutions' Lending Environment

Beginning in 1978, the Congress initiated a series of laws that eventually deregulated the interest rate that federally insured S&Ls and commercial banks could pay their depositors. This action was taken to allow these financial institutions to compete with a variety of new investment options (e.g., money market funds) that were offering more competitive rates and consequently drawing funds away from depository institutions. Before interest-rate deregulation (and the advent of alternative money market investments), S&Ls and commercial banks maintained fixed-rate deposits (including non-interest-bearing checking accounts) at a low cost to the institution. They used these deposits to finance long-term, fixed-rate mortgage loans. The capital reserves required under federal regulations for these loans were very low and flexible, particularly for larger institutions.

In this environment, S&Ls and commercial banks held multifamily mortgage loans in their portfolios. Consequently, the need for a secondary market supported by credit enhancements (except for individual mortgage insurance for high-risk loans) was minimal or nonexistent. Interest-rate deregulation ended this protected environment. S&Ls and commercial banks shifted to variable-rate loans to minimize the exposure to interest-rate risk resulting from the need to pay higher interest rates on deposits.

More recently, both the federal banking regulatory agencies and the Congress have focused more attention on the potential effect that interest-rate risk could have on the capital adequacy of S&Ls and commercial banks. In 1990, banking agencies began issuing advisory letters to their respective institutions, urging them to develop comprehensive systems to manage interest-rate risk and to limit their exposure to changes in interest rates. Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 requires all federal banking agencies to revise their risk-based capital requirements[3] by June 1993 to take interest-rate risk into account. Because variable-rate multifamily mortgage loans have longer adjustment periods (3 to 5 years) than other variable-rate loans (1 year), this recent federal banking action appears to make it less desirable for S&Ls and commercial banks to hold loans for multifamily housing in their portfolios.

[3]Risk-based capital requirements set the amount of equity capital a depository institution must hold against specific classes of assets under banking regulations.

Financial Reform Legislation Increases Costs of Multifamily Mortgages

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was enacted to promote safety and soundness in depository institutions by restructuring the lending requirements of S&Ls and many commercial banks. However, an unintentional result has been to reduce the flow of financing for multifamily housing by reducing the profitability and increasing the cost of such financing. Two of FIRREA's provisions, in particular, have adversely affected lending for multifamily housing.

First, in an attempt to impose greater portfolio diversification, FIRREA established limits on the amount of funds that S&Ls may lend to a single borrower. S&Ls are generally limited to lending a maximum of 15 percent of their capital to one borrower. This 15-percent limit can make it unlikely that smaller lending institutions will be able to finance larger multifamily housing projects. Also, in rural areas where there may be only a limited number of developers, a lender who makes several smaller loans to the same developer may quickly exceed the 15-percent limit.

Second, FIRREA established risk-based capital requirements for S&Ls that make multifamily housing loans much less attractive than some other investments. The four federal banking agencies adopted risk-based capital requirements for the institutions they supervise under a 12-nation international agreement known as the "Basle Agreement." As noted earlier, risk-based capital requirements indicate the amount of equity capital that an institution must maintain for a particular class of assets, such as multifamily mortgages. The higher the risk "weight" (i.e., the percentage of minimum capital that must be assigned to an asset), the higher its equity capital requirement. Under the Basle Agreement and FIRREA, the banking agencies have placed nearly all multifamily loans in the highest-risk category, carrying a 100-percent risk weighting.[4] As a result, for every $100 loaned in this category, an institution must hold $8 in equity capital. Most single-family loans and guaranteed mortgage-backed securities, on the other hand, are identified as less risky investments and carry 50-percent and 20-percent risk weightings, respectively, requiring the institutions to hold $4 and $1.60 in equity capital for every $100 loaned. Thus, to originate multifamily mortgage loans, S&Ls and commercial banks must usually hold twice as much capital as they would to originate single-family loans and five times as much as they would to hold guaranteed mortgage-backed securities. This difference is significant because of the added costs associated with raising equity capital.

[4]The Office of Thrift Supervision (OTS), which regulates S&Ls, determined that smaller multifamily projects (with 36 or fewer units) are less risky than larger projects. It has therefore reduced the risk weighting to 50 percent for these smaller projects.

In 1991, in section 618(b) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvements Act of 1991, the Congress amended the risk-based capital requirements for certain multifamily mortgage loans, reducing the risk weighting for qualified multifamily loans from 100 percent to 50 percent. To qualify for this reduced capital requirement, the multifamily housing loan must have

- a first lien with a minimum debt service coverage ratio (1.2 for fixed-rate loans or 1.15 for variable-rate loans),[5]
- a maturity between 7 to 30 years, and
- a maximum loan-to-value ratio[6] of 80 percent for fixed-rate loans or 75 percent for variable-rate loans.

In addition, timely interest and principal payments must have been made on the loan for at least 1 year.

In April 1992, the Federal Deposit Insurance Corporation (FDIC) was the first federal banking agency to issue proposed regulations to implement this act. The act also authorized the federal banking agencies to include any other underwriting standards that are consistent with the purposes of the act. The proposed regulations include the following additional criteria:

- Loan-to-value ratios are to be determined at the time of the loan's origination,
- the loan may not be more than 90 days past due or carried in another nonperforming category,
- the building must have had an average annual occupancy rate of at least 80 percent for at least 1 year, and
- the loan must have been made in accordance with prudent underwriting standards.

As of August 1993, none of the federal banking agencies charged with implementing this act had issued final regulations. This delay was caused by (1) a freeze placed on all new regulations by the Office of Thrift Supervision and the Office of the Comptroller of the Currency and (2) a decision by the four federal banking agencies to promulgate uniform regulations. The banking agencies are expected to issue final regulations by the end of 1993.

[5]Debt service coverage ratio is calculated by dividing the total income from the property minus the operating expenses by the annual mortgage payment.

[6]Loan-to-value ratio is calculated by dividing the amount of the mortgage by the appraised value of the property.

Risk-based capital requirements affecting loans sold with recourse or standby letters of credit are also significant because they determine the percentage of each loan sold that the bank regulators require be retained as capital in the bank's portfolio. As noted earlier, federally insured institutions are now required to maintain a percent of capital on a risk-weighted basis.

The issue of recourse was also addressed in section 618 (b) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991. Specifically, the act required the federal banking agencies to amend their risk-based capital standards to distinguish between loans sold "subject to a pro rata loss sharing agreement" and "other loss sharing arrangements" (such as recourse). Although existing banking regulations do not explicitly state how these two risk-sharing arrangements are to be treated, the FDIC's instructions to banks for preparation of the Consolidated Reports of Condition and Income[7] direct banks to report both types of arrangements as follows:

- Pro rata loss-sharing arrangements. "If the risk retained by the seller is limited to some fixed percentage of any losses that might be incurred . . . the maximum amount of possible loss for which the selling bank is at risk . . . shall be reported as a borrowing and the remaining amount of the assets transferred reported as a sale."
- Other risk-sharing arrangements (recourse). The loan sale shall be reported as a transferred asset only if the selling institution "(1) retains no risk of loss from the assets transferred resulting from any cause and (2) has no obligation to any party for the payment of principal or interest on the assets transferred."[8]

The three federal banking agencies that regulate commercial banks do not distinguish between limited and full recourse arrangements. In contrast, the Office of Thrift Supervision allows S&Ls to sell loans with partial recourse and maintain less capital if the dollar amount of the recourse coverage falls below the capital that would be required for the total asset. For example, if the required capital is 8 percent but the recourse arrangement only requires that the first 5 percent of losses be covered, then the lender will have to hold only 5 percent in equity capital.

[7]These reports are quarterly financial reports submitted by all commercial banks. They include assets and liabilities as well as income and expenses.

[8]Federal Register, vol. 57, no. 63, Apr. 1, 1992, pp. 11012-3.

Risk-based capital requirements also affect letters of credit. Banks that provide credit enhancements through standby letters of credit that assist in the securitization of mortgages are required to hold capital reserves up to 100 percent against the related credit exposure. Before 1986, banks did not have to maintain any capital reserves for standby letters of credit, a practice widely criticized by investment analysts.

Tax Reform Act of 1986 Changes Benefits of Investing in Multifamily Mortgages

The Tax Reform Act of 1986 reduced the general tax incentives for building multifamily housing that had been provided by the 1981 tax act and that had encouraged the growth in multifamily mortgage originations (see fig. 2.1). By making investments in multifamily housing financially attractive, these incentives contributed to an oversupply of rental housing in some markets. The 1986 act made the following changes to reduce tax benefits:

- The depreciation period for residential structures was increased from 19 years (15 years for low-income housing) to 27.5 years. In addition, only straight-line depreciation was permitted; the previous law had allowed accelerated depreciation. These changes substantially reduced the current cash flow owners receive from newly built or purchased rental properties.
- Individuals who do not earn their living primarily in real estate (called "passive" investors) were prohibited from deducting any real-estate-related losses, including depreciation, from income not earned from real estate until the year the property is sold. This change postpones the investors' tax deduction and thus increases the present value of their tax liability. The increased tax liability reduces the investors' yield on multifamily investments, making them less attractive than other investment opportunities.
- Special treatment of capital gains from the sale of real estate (as well as other property) was terminated, significantly reducing the after-tax benefits of real estate investments.

While these provisions of the Tax Reform Act of 1986 worked to suppress tax-driven investment in multifamily housing, the act created a new program—low-income housing tax credits—that was intended to encourage investment in low-income multifamily housing. This program provides up to $9 in tax credits to investors each year for 10 years for each $100 invested in low-income housing.

Although the net effect of these changes in tax law on investments in affordable multifamily housing was outside the scope of this review, state

HFAS attributed part of the decline in affordable multifamily loan originations to these and other tax code revisions, including tighter restrictions on income-targeting and subsidies placed on multifamily tax-exempt bonds. In 1987, the HFAS' market share of multifamily loan originations stood at about 16 percent; by 1991, it had eroded to about 6 percent. This drop reflects not only the changes in tax policies mentioned above but others as well. For example, HFAS frequently raise capital through the sale of bonds that are exempt from federal taxes. Under the tax code, the total amount of credits provided is limited to $4 rather than $9 for each $100 of investment when proceeds raised through tax-exempt bonds are combined with equity capital raised through the sale of tax credits. This limitation on credits was included in the tax code to prevent excessive subsidies for any one project.

Other factors have required HFAS to find new subsidy sources in order to develop economically viable multifamily housing projects. These factors—particularly the loss of project-based section 8 subsidies and the need to pay higher yields on tax-exempt bonds because of a decline in FHA mortgage insurance—are discussed in detail in the following sections.

Taken together, these tax and other policy changes have virtually eliminated tax-exempt financing by HFAS for new rental properties or acquisitions. The overwhelming volume of tax-exempt financing today is used to refinance existing bond issues, either to take advantage of lower interest rates or to restructure loans for properties in financial difficulty. Bond market participants agree, with virtual unanimity, that "new money" issues—that is, bonds that raise capital to expand the supply of affordable housing—are very rare.

Shift to Tenant-Based Subsidies Increases Difficulty of Obtaining Multifamily Financing

In the 1980s, federal housing policy shifted away from section 8 subsidies tied to specific housing projects to subsidies tied to individual tenants. Under the previous approach, project-based subsidies were typically provided for 15 years. If these subsidies covered all or most of the units within a project, the owner was virtually assured of a long-term rental income stream sufficient to meet the debt obligation on the mortgage and other operating costs. Largely because the federal government provided a long-term financial commitment and its section 8 contracts were standardized, financing was generally readily available from both primary and secondary market institutions. As the section 8 program has moved to a tenant-based approach and to shorter commitments (5 years versus 15 years), its role in attracting long-term financing has diminished. We

discuss the importance of this shift in chapter 3, in which we describe how risk is evaluated and factored into lenders' and investors' decisions.

State and local government programs have attempted to fill some of the financing void resulting from the changes in the section 8 program by providing project-based subsidies. However, the financial markets do not consider these subsidies as attractive as the project-based subsidies provided by the federal government because (1) the time commitments are relatively short (5 years or less) and (2) the state and local government programs are not standardized.

Recent Losses by Key Financial Institutions Have Resulted in Financing Cutbacks

As the principal originators of loans for multifamily housing have reordered their lending priorities in reaction to changes in governmental regulations and policies, so too have secondary market institutions undergone change. Two institutions, FHA and Freddie Mac, have significantly reduced their activities in multifamily housing finance, partly in response to substantial losses.

FHA Has Dramatically Reduced Its Multifamily Mortgage Insurance

FHA's multifamily mortgage insurance programs have long been the major source of federal credit enhancement for multifamily mortgages. However, FHA substantially reduced its presence in the multifamily market following losses that were approaching $1.5 billion by the end of 1991. In the early 1980s, FHA insured over 30 percent of multifamily mortgages (for both new and existing properties); in 1991, FHA-insured mortgages represented only about 6 percent of total loan originations.

FHA's decreased activity in the multifamily market can be explained by the public policy changes incorporated in the Tax Reform Act of 1986 and from the shift from section 8 subsidies tied to specific housing projects to subsidies tied to individual tenants, as discussed above. The poor performance of FHA's coinsurance program further contributed to the decrease in activity. Under coinsurance, FHA authorized approved lenders (primarily mortgage bankers) to assume many of the functions traditionally borne by HUD's field offices. Lenders were given the power to originate, process, and underwrite mortgage loans and to issue firm commitments that bound FHA to coinsure these loans.

FHA also made lenders responsible for servicing current loans and for disposing of defaulted projects. Lenders shared in the risks of insuring mortgages by assuming the first 5 percent of any losses on loans they

originated. Losses in excess of this amount were to be split in the ratio of 15 percent and 85 percent between the lender and FHA, respectively. In return for assuming the additional responsibilities and this portion of the risk, coinsuring lenders collected various fees for applications, financing, and placement, and shared the initial and annual mortgage insurance premiums with FHA.

Throughout most of the 1980s, FHA operated the coinsurance program to meet the market's demand for multifamily mortgage insurance. The program enabled FHA to share the risk of insuring a multifamily mortgage with participating lenders. FHA's coinsurance program provided mortgage insurance for (1) the purchase or refinancing of existing multifamily housing that required limited rehabilitation (section 223(f)) and (2) new construction or substantial rehabilitation (section 221(d)). As shown in tables 2.1 and 2.2, both programs insured a significant number of housing units from 1983 to 1992. That is, insurance under section 223(f) covered 319,758 units and insurance under section 221(d) covered 61,595 units. During that period, over $10 billion worth of loans were insured. However, as the tables show, the average insured project was large (generally exceeding 200 units). The average insured loan was correspondingly large: $7 million in the section 223(f) program and $11.1 million in the section 221(d) program.

Table 2.1: FHA Insurance for HUD's 223(f) Program

In base year 1992 dollars

Fiscal year	Total loan amount	Total number of units	Total number of projects	Average units per project	Average loan amount per project
1983	$ 311,772,677	13,289	47	283	$6,633,461
1984	719,917,264	25,980	103	252	6,989,488
1985	928,404,738	32,197	115	280	8,073,085
1986	2,086,084,769	68,150	276	247	7,558,278
1987	2,391,475,212	78,497	340	231	7,033,751
1988	1,663,802,648	53,823	244	221	6,818,863
1989	941,292,865	31,957	148	216	6,360,087
1990	201,239,829	9,489	38	250	5,295,785
1991	120,900,930	6,089	33	185	3,663,665
1992	14,700,000	287	1	287	14,700,000
Total	**$9,379,590,931**	**319,758**	**1,345**	**238**	**$6,973,674**

Source: GAO's analysis of data provided by FHA.

Table 2.2: FHA Insurance for HUD's 221(d) Program

In base year 1992 dollars

Fiscal year	Total loan amount	Total number of units	Total number of projects	Average units per project	Average loan amount per project
1986	$396,126,342	6,191	25	248	$15,845,054
1987	1,069,895,405	16,583	76	218	14,077,571
1988	739,777,532	14,907	86	173	8,602,064
1989	698,467,559	12,311	69	178	10,122,718
1990	398,921,627	7,820	42	186	9,498,134
1991	153,181,508	2,955	14	211	9,655,822
1992	40,519,300	828	2	414	20,259,650
Total	**$3,478,889,273**	**61,595**	**314**	**196**	**$11,079,265**

Source: GAO's analysis of data provided by FHA.

HUD terminated FHA's coinsurance program in January 1990 because of significant losses. Specifically, losses related to these programs through September 30, 1992, totaled in excess of $2.4 billion. According to a congressional report (Senate Print 101-124) that summarized findings from hearings on the coinsurance program, the program's problems resulted from deficient conceptual design and failures in administration. Among the major problems cited both at the hearings and in the congressional report were the following:

- From 1983 through July 1986, no FHA staff were specifically assigned to monitoring coinsurance.
- Because lenders were allowed to pool coinsured mortgages into securities guaranteed by Ginnie Mae,[9] FHA's exposure on these coinsured loans could increase from approximately 80 percent to 100 percent.
- FHA's capital requirements for coinsuring lenders were inadequate, and the fee structure created strong incentives for coinsurers to focus on originating a high volume of loans rather than on ensuring loan quality.
- FHA did not establish a limit on the number of loans that one lender could coinsure. As a result, a few lenders approved as coinsurers early in the program were able to monopolize the coinsurance business and accounted for a significant proportion of the program's losses.

[9]As a government-owned and -operated corporation, Ginnie Mae guarantees the timely payment of principal and interest on securities issued by private lenders and backed by pools of FHA or Department of Veterans Affairs mortgages.

It is important to note that the coinsurance program was never targeted as an affordable housing program. The program involved primarily large national and regional mortgage bankers rather than the local commercial banks and S&Ls that tend to work primarily with smaller borrowers. In fact, according to the president of one of the three major support organizations for community development corporations,[10]

"FHA [insurance . . . was] a uniform national system that could not easily accommodate the problems and opportunities of diverse low-income communities. Moreover, the complex program requirements, high transaction costs, and lengthy processing periods have made FHA insurance workable for only the most specialized lenders and the largest, most conventional projects. The system has favored national or regional mortgage banks over local commercial banks or thrifts . . . . Among low-income projects, only a large project with Section 8 rents far in excess of what a typical low-income neighborhood can support could carry a mortgage large enough to justify the time and cost of obtaining FHA insurance."

In our opinion, losses within the coinsurance program have (1) increased investors' perceptions of multifamily investments as very risky and (2) heightened concerns within FHA about entering into new credit enhancement options such as those discussed in chapter 4.

Freddie Mac Withdrew From the Multifamily Market

Freddie Mac was a major source of permanent financing for multifamily housing during the 1980s, purchasing over $12 billion in multifamily mortgages from 1983 to 1990. However, in September 1990, Freddie Mac suspended new business activities for its multifamily cash purchase program—its primary vehicle for purchasing multifamily mortgages—effectively removing itself from that market.

Industry observers generally agree that Freddie Mac's cash purchase program had several management problems. Specifically, Freddie Mac did not carefully select its loan originators and appraisers, did not evaluate the underwriting performance of these lenders, and did not adequately service its loans. In our 1991 report on 35 multifamily loans purchased by Freddie Mac in the Bronx, New York, we confirmed some of these problems.[11] For example, we found that 27 of the 35 properties received, in total, mortgages about 20 percent higher than the market value of the properties.

[10]Community development corporations are discussed in ch. 3.

[11]Federal Home Loan Mortgage Corporation: Abuses in Multifamily Program Increase Exposure to Financial Losses (GAO/RCED-92-6, Oct. 7, 1991).

Also, none of the 35 loan originators were headquartered either in the Bronx or elsewhere in New York City. Most originators were from out of state—several from as far away as Florida—raising a concern about whether the loan originators had adequate knowledge of the housing market in the Bronx.

Losses from this program ranged from $3 million in 1986 to $179 million in 1990. Freddie Mac's departure from the multifamily market created a significant gap for loans of between $500,000 and $3 million. Freddie Mac reentered the multifamily market in a somewhat limited capacity in July 1992, as we discuss in chapter 3.

Observations

A public policy of supporting affordable multifamily housing—through section 8 subsidies, favorable tax policies, and the risk-reducing credit enhancement that FHA's mortgage insurance provides—has prevailed in the United States for many years. But the goals of this public policy have been made more difficult to attain because of changes that have affected certain principal components of the multifamily housing finance system.

Changes to the regulations governing savings and loan institutions in the wake of the S&L crisis, for example, while laudable for improving the soundness of depository institutions, have made investment in multifamily housing less attractive to the institutions that were previously its principal loan originators. Even the most traditional means by which the federal government has reduced risk to investors—FHA mortgage insurance—has decreased for multifamily housing in the wake of public policy reforms and FHA's significant losses. Furthermore, the Tax Reform Act of 1986 eliminated the liberal tax incentives that had led to overbuilding and generally reduced investors' interest in developing additional housing units unless tax credits were available. Without alternative means to attract capital for multifamily housing, such as expanding the secondary market for loans that depository institutions can no longer hold in their portfolios, what many observers perceive as very serious problems in obtaining long-term financing for affordable multifamily housing could persist.

An Efficient Secondary Market Could Increase Financing for Affordable Multifamily Housing

The secondary market for financing multifamily mortgages has taken on increased importance as a result of the policy and regulatory changes discussed in the previous chapter. Yet, for several reasons, the secondary market serving multifamily housing is much smaller than the secondary market serving single-family housing. Among the more important reasons are (1) the difficulty of standardizing multifamily mortgages; (2) the risks, both known and unknown, of lending capital for housing targeted to lower-income households; and (3) the absence of reliable information on borrowers' performance in repaying affordable multifamily housing loans.

Historically, the federal government has played a major role in facilitating financing for multifamily housing through the credit enhancement offered by FHA insurance. Yet industry participants have questioned FHA's ability to supply efficient credit enhancement, in part because of insufficient staff. Moreover, the public policy changes discussed in chapter 2, combined with losses in the multifamily coinsurance programs, have constrained FHA's willingness to expand activity in this area or to participate in new credit enhancement programs.

Various efforts have been made to increase capital for affordable multifamily housing. Public-private partnerships have been formed between local lending institutions, state or local governments, and nonprofit community development corporations—generally referred to as CDCs. Programs to facilitate financing for affordable multifamily housing have also been set up within the Federal Home Loan Bank (FHLB) system. These efforts have made some headway and are beginning to demonstrate that loans for such housing are viable when properly underwritten. But, in the opinion of a broad range of market participants, these programs would be complemented by a more active secondary market for affordable multifamily mortgages.

A Secondary Market Is a Way to Expand Capital Sources

A secondary market for loans, including affordable multifamily housing loans, gives local financial institutions access to additional long-term, fixed-rate capital from national institutional investors. For reasons discussed in chapter 2, local depository institutions are limited in their ability to originate long-term, fixed-rate multifamily mortgage loans without a secondary market. Selling such loans and securities in a secondary market returns funds to the lender, creating liquidity and providing the lender with funds to make additional loans. How much additional capital would be made available by expanding the secondary

market depends on the extent to which loans can be standardized and the nature of the risks associated with affordable multifamily housing.

The secondary market has several other advantages. It spreads credit and interest-rate risks among the market participants and makes additional long-term, fixed-rate loans available to qualified borrowers. In addition, the secondary market allows investment in securities, backed by a pool of loans, that have liquidity and are readily marketable.

Conversely, the lack of a fully functioning secondary market can limit (1) the number of local lenders willing to bear the entire credit and interest-rate risk associated with affordable multifamily housing loans and (2) the dollar volume of loans that participating local lenders are willing to originate and retain in their portfolios.

While the secondary market for multifamily mortgages grew in the 1980s, it was still much smaller than its single-family counterpart. For example, in 1989, $10 billion worth of multifamily mortgages—about 33 percent of such loans originated—were sold in the secondary market. In the same year, by contrast, $274 billion worth of single-family mortgages—or 78 percent of such loans originated—were sold in the secondary market.

A discussion paper prepared for the National Association of Affordable Housing Lenders underscored the usefulness of an effective secondary market for affordable multifamily loans.[1] The paper concluded that "among the factors which contribute to a national shortage of long-term, fixed-rate financing for low- and moderate-income housing, the lack of an effective secondary market stands out."

Private market participants with whom we spoke broadly supported another of the discussion paper's conclusions—that the lack of a secondary market both increases the cost of loans to borrowers and potentially increases the credit risk to lenders resulting from variable-rate mortgage loans. The paper concluded that

> "the lack of a fully functioning secondary market for multifamily loans also works indirectly to raise the costs of borrowing. Having to keep the loans in portfolio contributes to a mismatch between the terms on which lenders are willing to lend (shorter terms, variable rate) and those which are sustainable for this type of borrower (longer term, fixed rate). The resulting exposure of projects to interest-rate risk and refinancing uncertainties

[1]N. Lynne Jones, "Addressing Policy Obstacles to Affordable Housing Lending," National Association of Affordable Housing Lenders (Sept. 1990).

means that fewer affordable housing projects are developed, and more run into trouble than would be the case if lenders were encouraged to lend on terms more appropriate to this type of project and borrower."

Key Barriers Impede Development of an Efficient Secondary Market

There are several key barriers to developing a viable secondary market for multifamily housing: lack of standardization, added risks, and a lack of information on the performance of loans for affordable multifamily housing. Unless these barriers are addressed and resolved, it is doubtful that the multifamily housing sector will have the same access to financing and associated benefits that the single-family housing sector has enjoyed through the secondary market system.

Multifamily Mortgages Are Not Standardized

Lack of standardization in multifamily loans has impeded the expansion of a secondary market for these mortgages. Particularly for projects serving low-income families, complex financial structuring results in variations in mortgage terms, conditions, and underwriting criteria. Yet standardization of mortgages is critical to developing a large volume of mortgage-backed securities, as the single-family loan market has shown. These securities provide entry into the capital markets and thus liquidity for the underlying mortgages. Nevertheless, while greater standardization of multifamily mortgages is desirable to provide access to capital markets, it must be balanced against the need for local lenders to exercise their judgment in underwriting individual mortgages. As noted in chapter 1, providing housing for lower-income families frequently requires not only debt and equity capital but also additional subsidized financing, usually referred to as "gap financing." The report by the National Task Force on Financing Affordable Housing recognized the importance of attempting to standardize, to the extent practical, the first mortgage, the gap financing, and the equity contribution.[2]

The task force found that the first mortgage, to accommodate both the needs of investors for predictable cash flows and the needs of affordable multifamily housing for fixed costs, should have a (1) fixed rate, (2) standardized term and amortization schedule, and (3) yield maintenance provision to provide prepayment protection. Information we obtained during this review confirmed this finding.

[2]From Neighborhoods to the Capital Markets, National Task Force on Financing Affordable Housing (Washington D.C.: June 1992).

The task force and market participants we interviewed also expressed concern that gap financing should be fully subordinate to the first mortgage. This means that in the event of a mortgage default, holders of the first mortgage would receive full payment before payments were made to subordinate mortgage holders. If the gap financing is not subordinate, investors may require a much higher yield on the first mortgage or decline to purchase it altogether. Subordinating gap financing should not pose any serious problems in obtaining such financing. Most gap financing for affordable multifamily housing projects today is in the form of subordinated second mortgages provided by the public sector.

Regarding equity, the task force recognized that individual project circumstances and underwriting should dictate the proportion of equity invested in a property. Accordingly, the task force did not recommend a minimum equity investment for each project. Rather, the task force recommended that real equity—cash contributions—be invested in the project regardless of whether the project's developer or sponsor was a for-profit or nonprofit entity. The rationale for this recommendation was, in part, to ensure that property owners have a monetary incentive in seeing a project succeed and to provide lenders with some security in the event the project defaults.

We agree with the task force on both the desirability and suggested method for standardizing the first mortgage as well as its suggested approach to gap and equity financing. Expert originators must be allowed flexibility and discretion to recognize and respond to unique conditions of individual housing markets and projects. Along these lines, we understand that Fannie Mae and Freddie Mac are involved in a joint effort to develop revised standard loan documents that should lower transaction costs and make multifamily mortgages more easily understood by, and acceptable to, investors. In chapter 4 we discuss how establishing qualifying standards for sellers and servicers of affordable multifamily mortgages could help promote individual flexibility in mortgage underwriting.

Multifamily Lending Presents Several Added Risks

Underwriting is evaluating a borrower's loan request in terms of its potential profitability and risk. It involves the assessment of various risk factors to determine whether a lender should make a loan and what price (interest rate) the lender should charge the borrower for that loan. Unlike single-family mortgages, multifamily mortgages do not have standard underwriting procedures because of the complexity of evaluating these loans, the diversity of the projects, and the lack of reliable information on

loan performance. Lenders therefore face added challenges and risks in providing financing for multifamily properties.

Risks in Originating Loans

In general, multifamily loans are underwritten on the basis of the premise that the underlying property will be able to generate sufficient income to cover the building's operating expenses and debt service. In addition, if the loan should default, there will be adequate value in the property to cover any outstanding loan principal. According to underwriting standards developed by Fannie Mae, multifamily loans should assure lenders safe principal, a reasonable return, and eventual recapture of their initial investment.

To determine if multifamily loans meet these criteria and to limit risk exposure, lenders evaluate certain risk factors related to the physical condition of the property, such as its age and structural integrity. They also evaluate characteristics of the area in which the property is located, including the vacancy rates of surrounding properties and trends in the areas real estate values, employment level, and crime rate. In addition, lenders must evaluate the ability of the property to generate sufficient income to cover the mortgage obligations. They look at such factors as projected rents, operating expenses, vacancy rates, and loss reserves to help them determine the property's debt service coverage ratio (DSCR)—the degree to which the income from the property is expected to exceed the mortgage payments. DSCR is one of the most important underwriting ratios used by mortgage originators.

The continued availability of government assistance is often a key variable in evaluating the financial viability of multifamily housing targeted to low-income households. As stated in chapter 1, most affordable housing transactions could not be completed without some type of housing subsidy or other form of government assistance. However, the lender must consider the risk that future changes to government assistance may affect the housing's value. For example, changes in tax policies may alter the underlying viability and/or profitability of multifamily housing, changes in either the amount or duration of government subsidies can jeopardize the property's viability or profitability, and changes in government policies may limit the owner's options for disposing of the properties when the subsidies expire.

In addition to evaluating the financial aspects of a property, the lender must also consider the borrower's creditworthiness. In general, a

borrower must demonstrate a history of timely repayment of debt and must be financially able to meet the new mortgage obligation.

Finally, since multifamily rental properties are purchased as investments, the lender must be concerned about the attractiveness or value of the property to future potential investors should the loan default and a forced sale become necessary. Value is also used to determine the loan-to-value ratio (LTV), another critical underwriting ratio used by both primary and secondary market institutions. Lenders base the loan amounts they are willing to originate primarily on a project's LTV. For example, most multifamily lenders will not approve a loan with an LTV above 80 percent, even if the loan meets the other underwriting criteria. Lenders may reduce the loan amount to match their LTV requirement, but the borrower will then be required to find other acceptable financing to fill this gap, such as a second mortgage, a grant, or equity.

Risks in Holding Mortgages

Aside from the risk factors of the property itself, lenders face market risks associated with multifamily housing. Among the more important are risks related to changing interest rates, lack of liquidity, geographic concentration, and possible prepayment. While these risks exist for other types of lending, those associated with liquidity and geographic concentration can be more troublesome for multifamily loans.

Interest-rate risk is the possibility that changes in interest rates will result in losses. Lenders face interest-rate risk when they originate and retain long-term, fixed-rate loans, including those for affordable multifamily housing, because the interest rates they pay on short-term deposits can be higher than those they receive on long-term, fixed-rate loans.[3] When interest rates on deposits rise, they cannot be offset by adjusting rates on long-term loans with fixed interest rates. Depository institutions can therefore face large losses in their portfolios. To avoid this risk, these institutions write variable-rate mortgages that shift most of the interest-rate risk to the borrower because the interest rate on the loan is adjusted at specified intervals on the basis of prevailing interest rates.[4] However, as noted in chapter 2, shifting interest-rate risk to the borrower can also increase the credit risk to the lender (or investor if the loan has been sold). A more technical discussion of this increased credit risk is

[3]Since 1978, the Congress has enacted several laws that removed the interest-rate ceiling (Regulation Q) on federally insured short-term deposits.

[4]Variable-rate mortgage loans are generally not adjusted as often as other loans, such as commercial and consumer loans, and therefore usually retain greater interest-rate risk than those loans. In addition, variable-rate mortgages for multifamily housing are generally not adjusted as frequently as variable-rate mortgages for single-family housing.

found in chapter 5, where we review Standard & Poor's loan pool loss matrix.

Interest-rate risk can also greatly affect the market value of securities. For example, when market interest rates increase, the value of lower-interest-rate securities held by investors decreases. Because potential investors have the option of buying new higher-interest-rate securities, all other things being equal, they would purchase the older securities from the current holders only if the securities were discounted, i.e., reduced in price, to provide the same yield as the new securities. Investors holding the lower-interest-rate securities who decided to sell when interest rates are high would lose money on their investments. On the other hand, large institutional investors such as pension funds have long-term liabilities, allowing them to retain long-term, fixed-rate investments such as securities backed by affordable multifamily housing mortgages.

Liquidity risk refers to the ability to convert individual mortgages or mortgage-backed securities into cash quickly. Investors take the risk that they will not be able to sell a loan or security at any time they choose. In general, the lack of standardization increases the liquidity risk. A secondary market in which these types of mortgages are actively traded can reduce liquidity risk.

Concentration risk refers to a pool of mortgages on properties that are all located within a fairly restricted geographical area, increasing the risk that all the mortgages can be affected by the same conditions. For example, if a commercial bank makes a number of loans in a particular city and that city experiences an economic downturn, the bank that holds the loans in its portfolio will sustain great losses. Concentration risk can be minimized by establishing pools of mortgages for properties that are not concentrated in particular geographical areas and selling these pools to investors through a secondary market.

Prepayment risk is the risk that borrowers will make early principal payments on mortgages or pay the entire principal before the loan matures. For example, as interest rates decrease, a borrower with a fixed-interest-rate loan is more likely to pay off the mortgage—thereby removing it from the pool of loans—more quickly and refinance the property at a lower rate. In this case, the lender is repaid all the principal but forfeits future interest payments. If interest rates have declined, the lender may be forced to reinvest any prepaid funds in a security that pays

a lower rate of return. In multifamily housing, prepayment risk is often minimized by including in the mortgage (1) prohibitions of prepayment for a certain period of time or (2) yield-maintenance agreements that, in essence, require cash penalties if the mortgage is prepaid.[5]

Information on Multifamily Loan Performance Is Scarce

The general lack of information on how affordable multifamily housing loans perform is one of the greatest impediments to the development of a more active and efficient secondary market in these loans. Investors do not have the information they need to quickly and cheaply evaluate risk and set interest rates accordingly. As a result, multifamily housing is at a disadvantage compared with single-family housing. Lenders need highly reliable information in order to correctly assess credit quality, accurately predict cash flows, compare loan performance with other types of investments, and appropriately price mortgages. If lenders could accomplish these tasks, mortgages for affordable multifamily housing would become more easily tradeable and more liquid investments. In chapter 5, we discuss legislative action the Congress has recently taken to address the current scarcity of information and the additional benefits of having reliable information on the performance of affordable multifamily housing loans.

Secondary Market Institutions Can Expand Their Purchases of Smaller Mortgages for Affordable Multifamily Housing

Following the withdrawal of Freddie Mac from the multifamily market in September 1990, its reentry has been limited primarily to refinancing its own portfolio of multifamily loans and purchasing a very small pool of affordable multifamily housing loans from a Chicago lender. Fannie Mae, which has had a sustained presence in the multifamily housing market, has traditionally focused on purchasing larger, unsubsidized multifamily mortgages and very large pools of relatively smaller mortgages from very large lenders. Recently, however, Fannie Mae has taken a more proactive role in negotiating purchases of smaller affordable multifamily housing loans, primarily from experienced loan consortia. This initiative was reenforced by the Congress in October 1992, when it included specific affordable multifamily housing goals for Fannie Mae and Freddie Mac as part of overall legislation designed to insure the financial soundness of these institutions.

[5]Single-family mortgages rarely have any prepayment penalties. They are thus less attractive to institutional investors, who generally avoid the uncertainties that result from early loan prepayment.

Freddie Mac's Current Multifamily Housing Programs Are Limited

As noted in chapter 2, Freddie Mac suspended new business in its program for purchasing multifamily mortgages in September 1990 after suffering large losses as a result of poor underwriting and other factors. According to Freddie Mac, from 1986 through 1992, the cash purchase program accounted for 86.6 percent of the number of multifamily loans purchased and 90.9 percent of the total dollar amount of loans purchased. However, less than 2 percent of the mortgages purchased secured newly constructed multifamily projects. Instead, the program has supported the refinancing and acquisition of existing properties.

From 1986 through 1992, Freddie Mac's cash purchase multifamily program has tended to serve medium-sized projects (averaging about 61 units) with mortgages averaging about $1.1 million. During this time, the program provided over $9 billion in support of approximately 487,000 multifamily units. Using data collected on its 1990 purchases, Freddie Mac estimates that over 95 percent of the dollar amount of these purchases financed properties with average rents affordable to families earning 100 percent of the area's median income, and over 90 percent were affordable to those earning 80 percent of the area's median income.

In July 1992, Freddie Mac announced its return to the multifamily market, with plans to make available up to $1.5 billion in purchase commitments in 1993. Freddie Mac also announced its long-range goal of providing $10 billion in multifamily financing by 1997.

Aside from the cash purchase multifamily program, Freddie Mac entered into a joint venture with a national community development secondary market intermediary to purchase up to $100 million worth of affordable multifamily housing loans. As of December 1, 1992, it had purchased a $4.6 million pool of "seasoned" affordable multifamily mortgages from Harris Bank in Chicago as part of this commitment. Freddie Mac is currently working with this intermediary's parent company to reorganize and enhance this joint venture.

Fannie Mae Is Expanding Its Purchases of Smaller Multifamily Mortgages

Fannie Mae has retained a dominant role in the multifamily housing secondary market, consistently purchasing loans since the inception of its conventional loan purchase "product" in 1984. Historically, Fannie Mae's products have been used primarily to purchase loans on unsubsidized projects that serve tenants with a broad range of incomes. Recent initiatives have specifically targeted the purchase of smaller loan packages originated by major affordable housing lenders. However, we believe a

sizeable need remains for the secondary market in general to purchase smaller subsidized mortgages that primarily serve very low-income households.

Fannie Mae either purchases mortgage loans (financed by corporate bonds) for its own portfolio or enhances the credit of mortgage loans for purchase by other investors. When it enhances the credit of these mortgages, Fannie Mae guarantees the timely payment of principal and interest. The primary vehicle that Fannie Mae uses to do this is mortgage-backed securities. Fannie Mae reports having purchased or enhanced the credit of over $30 billion worth of conventional and FHA-insured multifamily loans. According to Fannie Mae, its total activity in multifamily housing in 1992 amounted to over $3.5 billion.

Fannie Mae supports different needs within the multifamily mortgage market, primarily through its Delegated Underwriting and Servicing (DUS), Prior Approval (PA), and Negotiated Mortgage Backed Securities (MBS) products. All these products principally finance properties with rents that are affordable to a large percentage of lower-income households. (See table 3.1).

Table 3.1: Fannie Mae's Multifamily Loan Purchases Under DUS, PA, and MBS Products, 1992

Units by affordability to tenants with different income levels	Number of units (percents in parentheses)	
	DUS and PA	MBS
Total number of units financed for which affordability data are reliable[a]	78,500	26,432
Number of units affordable at 100 percent of median income[b]	75,177 (96)	25,495 (96)
Number of units affordable at 80 percent of median income[b]	69,087 (88)	20,930 (79)
Number of units affordable at 60 percent of median income[b]	42,315 (54)	12,921 (49)
Number of units affordable at 50 percent of median income[b]	19,253 (25)	4,497 (17)

[a]The total number of units financed with these products was 80,664 for DUS and PA and 32,809 for MBS.

[b]Actual rents were calculated as annual rents and divided by 0.3 to test affordability to tenants. Local median incomes were adjusted for household size.

Source: Fannie Mae.

Under DUS, Fannie Mae buys mortgages from a small group of approved lenders (between 25 and 30) without prior review or approval of the underwriting. These lenders are required to have significant financial net worth and must contribute to a reserve established to support recourse obligations in case of default. DUS has generally served large projects (averaging approximately 200 units), with mortgages averaging close to $5 million between 1990 and 1992. During these 3 years, Fannie Mae financed about $5.1 billion worth of multifamily mortgages with this product. Since its inception, DUS has primarily been a vehicle for refinancing existing mortgages rather than mortgages supporting new construction, substantial rehabilitation, or acquisition. Under PA, Fannie Mae reviews and approves the underwriting for each loan but does not require lender recourse. PA also serves large projects (averaging about 150 units), with mortgages for 1990-92 averaging between $3 and $5 million. Using this product, Fannie Mae provided over $1 billion in financing between 1990 and 1992. Like DUS, PA has primarily been used to refinance existing mortgages.

As noted, DUS and PA have not been extensively used to purchase loans on smaller subsidized housing projects. Less than 2 percent of the mortgages purchased by Fannie Mae under these two products included any kind of direct housing subsidies supporting the properties. However, mortgages for these smaller subsidized housing projects are the type originated by community development corporations. For example, the average first mortgage for properties assisted with tax credits through the Enterprise Social Investment Corporation[6] is about $875,000. The National Task Force on Financing Affordable Housing recommended that Freddie Mac and Fannie Mae expand their existing products to make them more flexible and better able to accommodate subsidized projects.

Under Fannie Mae's MBS, bundles of loans are typically "swapped" for one or more mortgage-backed securities. Using MBS, Fannie Mae purchases smaller existing loans from relatively large lending institutions and typically relies heavily on recourse pledged by the lender. Until recently, a mortgage pool of $50 million or more was required from individual lenders.[7] This requirement created a substantial barrier to participation for all but the largest lenders. Since 1987, Fannie Mae has swapped over

[6]The Enterprise Social Investment Corporation is a subsidiary of the Enterprise Foundation. The Enterprise Foundation, Local Initiatives Support Corporation, and Neighborhood Reinvestment Corporation are the three primary support organizations for CDCs. These organizations are discussed later in this chapter.

[7]Unlike single-family MBS, multifamily mortgage pools cannot commingle loans from more than one lender.

$11 billion using its MBS. The median loan size was $750,000 and the median property contained just under 26 units. As with DUS and PA, most of Fannie Mae's loans in this portfolio are unsubsidized. The national task force recognized this condition and recommended that Fannie Mae expand its MBS pools to include subsidized projects in the $250,000 to $2 million range. As of 1993, MBS has not served relatively smaller lenders with limited loan volume. Fannie Mae will likely have difficulty serving this market segment unless it either lifts its restriction on single-lender MBS pools or creates a new product targeted to smaller lenders with limited loan volume. As multifamily loan standardization becomes more developed, a major impediment to multiple lender pools should be overcome.

Fannie Mae is expanding its three basic products to accommodate new transactions that better serve special housing needs. Some of the newer products that the company has introduced are negotiated cash purchases, enhancements of HFA bonds, and the Forward Commitment, FAME, and Resolution Trust Corporation (RTC) Multifamily Affordable Housing Disposition products.

Under negotiated cash purchases, Fannie Mae has recently purchased, on a nonrecourse basis, negotiated investments in smaller loan pools that serve special needs. For example, Fannie Mae recently announced a commitment to invest $50 million in loans originated by the Chicago Investment Corporation, a nonprofit organization that supports low-income housing in that city. Fannie Mae also recently purchased a package of 12 loans originated by the California Community Reinvestment Corporation. These loans have a total remaining balance of $14 million and are secured by 14 properties serving low-income tenants throughout that state.

Fannie Mae has also enhanced both taxable and tax-exempt housing bonds, including those produced by state HFAs and local issuers. Fannie Mae's "AAA" rating provides a highly favorable market interest rate, thereby reducing debt coverage requirements and possible government subsidies. According to Fannie Mae, through 1992 it had enhanced over $1.2 billion in bonds. Reportedly, the transactions have ranged from a $584 million section 8 transaction with the Massachusetts HFA to transactions of less than $1 million with rural bond issuers.

Under its Forward Commitment product, initially authorized at $300 million, Fannie Mae makes an advance commitment to provide

permanent financing for affordable multifamily projects before construction or substantial rehabilitation begins. Fannie Mae expects that most of these projects will include allocations of low-income housing tax credits. Through November 1992, Fannie Mae had executed seven forward commitments totaling approximately $31 million as a pilot demonstration during the product's development phase. Currently, 15 new projects totaling almost $95 million in value await commitments. Fannie Mae has stated that this product is designed for mortgages of $2 million to $10 million, with an expected minimum of $1 million. However, the average mortgage amount through November 1992 was between $4 million (commitments that have been executed) and $6 million (projects awaiting approval). Thus, this product too is apparently serving projects that are generally larger than many subsidized housing projects such as those partially funded by low-income housing tax credits and sponsored by the Enterprise Social Investment Corporation referred to earlier. However, Fannie Mae's Forward Commitment product serves a very important credit need for new construction and substantial rehabilitation by "locking in" the interest rate for the permanent mortgage loan before construction or rehabilitation begins. A stable interest rate is particularly important for nonprofit developers and projects serving very-low-income households. The capacity of these projects to absorb increases in financing costs are likely to be limited.

Under the FAME product, a lender exchanges a fixed-rate first mortgage for cash or mortgage-backed securities while retaining a fixed-rate or adjustable-rate second mortgage. For these mortgages, the loan-to-value ratios should not exceed 65 percent and the debt service coverage ratio should be between 1.0 and 1.25. Through November 1992, no lenders had used this product.

The RTC Multifamily Affordable Housing Disposition product was introduced as a joint initiative between Fannie Mae and the RTC in November 1992. Fannie Mae has allocated $100 million to this initiative. The product allows Fannie Mae, through its network of approved multifamily lenders, to provide permanent first-mortgage financing for properties being sold by the RTC. No financing transactions had been completed under this initiative as of November 30, 1992.

Recent Legislation Establishes Affordable Housing Goals for Fannie Mae and Freddie Mac

Concern that Fannie Mae and Freddie Mac were not adequately supporting affordable housing was captured in a report of the Senate Committee on Banking, Housing, and Urban Affairs:[8]

> ". . . there has been a growing doubt among a large number of lenders—for-profit and not-for-profit developers, tenant advocates, state and local governments and other housing organizations—that Fannie Mae and Freddie Mac are not doing enough to serve the housing needs of low- and moderate-income families."

This concern was addressed by the Congress in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, whose primary purpose was to revise the regulation of Fannie Mae and Freddie Mac. The act includes a comprehensive framework of affordable housing goals, data collection and reporting requirements, and enforcement provisions. Section 1333, entitled "Special Affordable Housing Goal," for the first time specifically requires Fannie Mae and Freddie Mac to purchase multifamily rental housing loans that benefit low-income residents.

In 1993 and 1994, Fannie Mae must purchase at least $2 billion worth of affordable housing loans, divided evenly between single-family and multifamily housing. Freddie Mac's minimum goal for the same period is $1.5 billion worth of loans divided evenly between single-family and multifamily projects. The act also places specific limits on the income of the residents of the multifamily units: 45 percent of the mortgages are to be for housing affordable to low-income families (with 80 percent or less of the area's median income), and 55 percent of the mortgages must meet one of two minimum requirements:

- At least 20 percent of the units must be affordable to families whose incomes do not exceed 50 percent of the area's median income, or
- at least 40 percent of the units must be affordable to families whose incomes do not exceed 60 percent of the area's median income.

Also for the first time, the Congress is requiring Fannie Mae and Freddie Mac to collect data on the income of the perspective or actual tenants of each property financed when such data are available. Only when such data are not available are Fannie Mae and Freddie Mac authorized to substitute the rent levels affordable to low- and very-low-income families in determining whether the multifamily housing goals mentioned above are being met. Moreover, the legislation restricts "the purchase or refinancing

[8]Report of the Committee on Banking, Housing, and Urban Affairs, United States Senate, no. 102-282, May 15, 1992.

of existing, seasoned portfolios of loans" toward the achievement of these goals unless the originating lender satisfies two conditions:

- The lender must be engaged in a specific program to reinvest the funds to originate additional loans that meet the special affordable housing goals and
- the purchases or refinancing must actually support additional lending that meets these goals.

In passing this legislation, the Congress considered that Fannie Mae and Freddie Mac can and should expand the secondary market for affordable housing lending by making long-term, fixed-rate mortgage financing available to serve the needs of low- and moderate-income households.

FHA Faces Problems in Providing Federal Credit Enhancements

In 1991, HUD replaced FHA's coinsurance program with a new, full mortgage insurance program—the Delegated Processing Program. Under this program, approved processors perform the technical underwriting functions for FHA but are not authorized to issue insurance commitments; FHA must approve these transactions. However, current and former HUD officials have identified problems that may impede the agency from effectively providing credit enhancements, and industry representatives have criticized delays and processing inefficiencies in the Delegated Processing Program.

Programs' Poor Performance and Limited Scope Reduce Effectiveness

A former FHA Commissioner and a former Deputy Assistant Secretary for Multifamily Housing have publicly expressed their lack of confidence in the future ability of FHA to manage its own portfolio and to continue to serve as a "retail" insurer. Moreover, HUD's Inspector General found that insufficient staffing and computer resources at FHA have directly contributed to problems in monitoring and servicing loans in its multifamily housing portfolio.

A comprehensive audit conducted by Price Waterhouse of FHA's original multifamily loan insurance programs, which was submitted to HUD in June 1992, showed the outcome of these problems. The audit found cumulative failure rates of about 17 percent in the section 223 (f) program for the purchase or refinancing of existing apartment projects; about 23 percent in the section 221 (d)(4) program for financing the construction or substantial rehabilitation of multifamily rental housing for moderate-income families; and about 42 percent in the section 221

(d)(3) program, which also provides financing for the construction or substantial rehabilitation of multifamily rental housing for moderate-income families. These three programs have insured a total of $27.6 billion worth of loans and have insured an average of 320 loans per year. The average loan size has been $2.8 million.

Our analysis of loans insured under the Delegated Processing Program through December 1992 showed that FHA only insured 24 projects with an average loan size of approximately $5.3 million. Furthermore, not all of the loans financed were for multifamily housing. As shown in table 3.2, 10 loans totaling about $58.5 million were for nursing homes.

Table 3.2: Loans Insured Using FHA's Delegated Processing Program Through December 1992

Program	Number of projects	Number of units	Total mortgage amount	Average mortgage amount
New construction				
Section 221(d)(4)	2	264	$ 14,227,700	$7,113,850
Section 232[a]	6	974	50,792,500	8,465,417
Existing construction				
Section 207[b]/223(f)	4	658	15,019,500	3,754,875
Section 232	4	273	7,694,500	1,923,625
Substantial rehabilitation				
Section 207/223(f)	8	1,909	40,467,200	5,058,400
Total	**24**	**4,078**	**$128,201,400**	**$5,341,708**

[a]Section 232 loans are for nursing homes.

[b]Section 207 loans are to finance construction or rehabilitation of a broad cross section of rental housing.

Source: GAO's calculations of data provided by FHA.

Industry Officials Cite Delays in Approving Applications

Senior officials in the financial community have consistently said, both in interviews with us and at congressional hearings, that a vigorous and effective FHA is needed to serve the multifamily housing market. However, these officials expressed concern about what they perceive to be staffing inadequacies at FHA that, in turn, have led to excessive delays in approving insurance commitments.

Industry officials also believe that the number of delegated processors has been too low for the volume of loans. Initially, the selection of delegated processors was legislatively restricted to companies that were approved FHA lender-servicers. As a result, FHA approved only 13 delegated processors nationwide; one processor located in California had to serve eight western states. This restriction was lifted in 1992, but no additional processors have been added to improve FHA's processing efficiency and, as of July 1993, two of the previously approved processors had dropped out. FHA is currently seeking to expand the number of approved delegated processors.

Innovative Local Initiatives Have Financed Affordable Multifamily Housing

Despite the regulatory and market barriers that affected both primary and secondary market multifamily housing programs in the 1980s, many successful and innovative local initiatives—including private-public partnerships—have helped provide financing and servicing for affordable multifamily mortgages. Some of these partnerships have been operating successfully for almost 20 years.

In addition, the Congress created, under FIRREA, an Affordable Housing Program within the Federal Home Loan Bank system. This program gives member banks an opportunity to provide long-term financing for affordable multifamily projects at below-market interest rates. The system encourages flexible local credit origination, supports holding loans (i.e., portfolio lending), and serves as an important alternative to the secondary market as a source of capital for affordable multifamily housing.

Local Initiatives Have Resulted in Successful Multifamily Financing

Local initiatives for financing affordable multifamily housing have evolved despite regulatory changes and other market impediments. Bank and S&L consortia led the way in the early 1970s, largely in response to the economic recession. During the 1980s, these initiatives expanded to public-private partnerships, often led by nonprofit community development corporations (CDC), in response to the Community Reinvestment Act cited in chapter 2.

State and Local Lender Consortia

The first successful affordable multifamily housing lenders were bank and S&L consortia in New York City, Chicago, and California. The largest banks and thrifts in each location provided the leadership for the funding and management of these specialized consortia. By pooling their resources and skills, the consortia were able to diversify the credit and interest-rate risk among several institutions.

These lender consortia include the Community Preservation Corporation (CPC) in New York City; Savings Associations Mortgage Companies, Inc., (SAMCO) in California; and Community Investment Corporation (CIC) in Chicago. Although each consortium's loan programs have been adapted to serve the credit needs of the local marketplace, they share two important results: high volume (the three have collectively originated over $1 billion worth of loans) and very low default and loan-loss rates. Appendix II provides greater detail on the three consortia.

One critical feature has distinguished CPC from the other two groups: its ability to establish a secondary market for its long-term, fixed-rate mortgages through private placements to the New York City pension fund. A credit enhancement—state mortgage loan insurance provided through the State of New York Mortgage Agency (SONYMA)—has ensured an ongoing source of capital for CPC loans. Each CPC loan has a 100-percent mortgage guarantee backed by SONYMA's extensive reserves (not the full faith and credit of the state of New York). These reserves accrue annually through a special surtax on all commercial mortgage loans. The revenue stream produced by this surtax amounts to between $35 million and $42 million annually and is held by SONYMA in an interest-bearing account to cover future losses. SONYMA maintains reserves of at least 20 percent of all its outstanding mortgage insurance.

SONYMA's default rate has been very low throughout the state. Nevertheless, SONYMA has been limited by two major obstacles:

- The credit rating agencies[9] have not increased its rating above A+, largely because of the lack of geographic diversification in its guaranteed loans. This problem is inherent in any state-financed credit enhancement program.
- The existing credit enhancement is limited by law to individual mortgage insurance and is not used to insure loan pools.

Despite the significant benefits to the lender, the state, and the investor, the New York State legislature has not authorized SONYMA to insure loan pools originated by high-volume lenders like CPC. (The advantages of this kind of credit enhancement are discussed in detail in ch. 4.)

Since the mid-1980s, several other cities—including Cincinnati, Ohio; Miami, Florida; and Des Moines, Iowa—and states such as Delaware, California, and Washington have formed their own lender consortia that

[9]Standard & Poor's, Moody's, and Dun and Phelps.

primarily specialize in affordable multifamily housing loans. Because of the complexity and perceived higher risk associated with affordable multifamily lending, there is a trend by local financial institutions to form lender consortia. Despite the advantages of these consortia, including having a highly skilled and dedicated staff to originate and service affordable multifamily loans, several important issues will need to be addressed before Fannie Mae and Freddie Mac or FHA may be willing to provide credit enhancements for their loans. For example, these lender consortia may be reluctant to provide even partial recourse agreements to secondary market investors, because their organizational structure may lack sufficient net worth to support such a commitment.

Community Development Corporations

In addition to lender consortia, CDCs took on increasing importance in the development of affordable multifamily housing during the 1980s. At the national level, three major nonprofit intermediaries have played a critical role in building the capacity of CDCs and in both equity and debt financing for multifamily housing projects. These groups are the Local Initiatives Support Corporation (LISC), Enterprise Foundation, and Neighborhood Reinvestment Corporation (NRC). Together, these organizations have formed a national network of CDCs, foundations, churches, insurance companies, local financial institutions, and government at all levels to facilitate the exchange of information, technical assistance, and financing that have led to the development and management of many multifamily housing projects.

In most large and middle-sized cities, CDCs have become major developers of affordable multifamily housing, often in partnership with private developers and/or in limited partnerships. A 1991 national survey of CDCs showed the following:[10]

- Housing development is the predominant activity of the approximately 2,000 CDCs nationwide. About 88 percent of these CDCs created almost 87,000 affordable housing units between 1988 and 1990.
- Between 1988 and 1990, the number of CDCs that developed 100 or more housing units increased from 244 to 421, a 75-percent increase.
- CDCs also increased the proportion of rental housing they developed between 1988 and 1990, from 54 percent of the total units in 1988 to 61 percent in 1990.

[10] Changing the Odds—The Achievements of Community-based Development Corporations, NCCED (Washington, D.C.: Dec. 1991).

Affordable multifamily mortgage loans made to CDCs and originated by local lenders have, to date, performed very well. In fact, according to the report of the National Task Force on Financing Affordable Housing, the default rate of these institutions is "low or non-existent." Our interviews with federal bank regulators, many of the nation's most active lenders for affordable multifamily housing, and two major national housing equity funds[11] that include mortgage financing as part of most of their deals, uniformly confirmed the task force's findings.

FHLB System Has Renewed Role in Meeting Capital Needs of Affordable Multifamily Housing

As noted earlier, the Federal Housing Finance Board (FHFB) was created by the Congress in 1989 to regulate the 12 Federal Home Loan Banks (FHLB), which are treated as government-sponsored enterprises. The FHLBS, in turn are owned and controlled by their member institutions in each district. Member institutions were historically only S&LS, but membership has been broadened to include commercial banks that have at least 10 percent of their assets in residential mortgage loans. With the approval of the FHFB, FHLBS raise funds on the national capital market by issuing consolidated obligation bonds. They then relend these funds to their members as "advances," and the members, in turn, make residential and multifamily mortgage loans to their customers. The banks' combined obligation bonds have a AAA rating, allowing them to provide financing for multifamily housing at very competitive rates.

Under FIRREA, two new programs were created within the FHLB system that should help meet part of the capital needs of affordable multifamily housing. These programs are the Affordable Housing Program (AHP) and the Community Investment Program (CIP), both of which are funded through long-term (10-15 years), fixed-rate bonds collectively issued by the 12 FHLBS. The AHP is designed to provide subsidized affordable housing financing, primarily to people with low to moderate incomes. The CIP allows for funding of both housing and economic development activities located in low- and moderate-income neighborhoods. (App. III contains a more detailed discussion of these programs.)

The financing approach of the FHLBS differs in an important way from those of the more traditional secondary market institutions discussed earlier, because the participating lenders retain the entire loan in their portfolios and, therefore, the entire credit risk as well. These mortgage

[11]The two funds are the National Equity Fund, affiliated with LISC, and the Enterprise Social Investment Corporation, an affiliate of the Enterprise Foundation.

loans also serve as collateral for the advances borrowed from individual FHLBs. These long-term, fixed-rate advances, however, eliminate most interest-rate risk to the originating lender, since the lender is borrowing these funds on a quasi matched-funding basis from the FHLB in its district.[12]

Observations

Financing for affordable multifamily housing would benefit from an active secondary market. Such a market could expand the number of loan originators willing to enter the market, increase the volume of long-term, fixed-rate mortgage loans and potentially lower interest rates by providing access to national capital markets, particularly to large institutional investors with long-term liabilities and sizeable assets to invest. An improved secondary market would also increase lenders' liquidity and thus increase the funds available to make loans.

The two principal secondary market institutions—Fannie Mae and Freddie Mac—have the potential to expand the secondary market, particularly for smaller affordable multifamily housing loans. However, since mid-1990, Freddie Mac has largely withdrawn from the multifamily housing market and is no longer the major purchaser of loans that it was in the 1980s. While Fannie Mae has remained in the market, it has generally purchased mortgages on larger, unsubsidized projects. More recently, Fannie Mae has taken several initiatives to increase its purchases of smaller mortgages for affordable multifamily housing. This action is consistent with legislation enacted in 1992 requiring Fannie Mae and Freddie Mac to expand the secondary market for affordable housing lending. Compliance with this mandate should result in additional support for affordable multifamily housing.

At the federal level, FHA has the potential to offer a credit enhancement that could make multifamily housing loans more attractive to secondary market buyers. However, problems with program management and design have historically led to significant cumulative losses in FHA's multifamily insurance programs. Moreover, FHA's current Delegated Processing Program has experienced substantial processing delays and, again, is not serving a significant portion of the market because its average loan size is higher than the typical mortgage for affordable multifamily housing. HUD noted, in commenting on a draft of this report, that it is (1) contracting for

[12]Since many of the AHP-funded mortgages are amortized on a 30-year basis but are only funded for a 10-15 year term, these mortgages do not always represent matched funding. Both interest-rate and credit risks could be incurred in the future if interest rates rose significantly at the refinancing period and the project could not afford the increased interest cost.

a study to streamline FHA's underwriting process to make FHA insurance more attractive to both lenders and project sponsors and (2) pursuing opportunities to make FHA-insured financing more readily available for small projects.

No private or public agency has taken a leadership role in developing the underwriting standards needed to make multifamily mortgages more attractive to investors or to consolidate the information necessary to evaluate the multiple risk factors associated with multifamily mortgages. Lacking such leadership, some public-private partnerships and community development corporations have attempted to meet the financing needs of affordable multifamily housing in their states and localities. Under both approaches, loan default rates have been very low, suggesting that in some circumstances multifamily housing mortgages can perform successfully and profitably.

Federal Credit Enhancement Options Could Make Financing for Affordable Multifamily Housing More Available

Few credit enhancements for affordable multifamily housing are available from the private sector. Those enhancements that are available tend to be both costly and designed primarily for low-risk undertakings, limiting their utility for affordable multifamily housing. This lack of affordable credit enhancements in the private sector, coupled with the decline in FHA's activity in credit enhancements, has limited the ability of developers of affordable multifamily housing to obtain financing at rates and terms that would allow more projects to be viable. It has also reduced the willingness of secondary market institutions and investors to purchase affordable multifamily loans or securities backed by such mortgages.

The Congress recently responded to this situation by passing legislation providing for the development of several innovative credit enhancement demonstration programs. These programs offer an opportunity to alter and expand the traditional method by which the federal government has provided credit enhancements. The actual risks and benefits to the federal government of new credit enhancements cannot be quantified at the outset; however, collecting adequate data on their costs and results should make such an assessment possible in the future. It is important that credit enhancements be offered only to viable projects that are properly underwritten and not used in lieu of housing subsidies (i.e., section 8 subsidies). Also, the costs to the federal government of such demonstration programs will depend, in part, on whether the credit enhancements provided are priced to cover expected costs or whether they are priced below these costs to achieve added social benefits.

An underlying assumption of these demonstration programs is that no single federal credit enhancement can meet the diverse financing needs of affordable multifamily housing. To address this diversity, we proposed, in our April 1992 testimony,[1] that four options be considered. These options are (1) delegated processing, (2) delegated underwriting, (3) primary bond insurance, and (4) bond or pool reinsurance. Several uniform principles for all the programs—including flexibility in underwriting and pricing, together with strong management oversight—can help ensure that demonstration programs based on these options are consistent with the risk the federal government assumes and the social objectives to be achieved.

[1] Mortgage Credit Enhancement: Options for FHA in Meeting the Need for Affordable Multifamily Housing (GAO/T-RCED-92-52, Apr. 3, 1992).

Private Sector Credit Enhancements Are Limited

The private sector has provided three kinds of credit enhancements—mortgage insurance, bond insurance, and securities with a senior-subordinated structure, in which risk is unequally shared. However, a number of regulatory and risk-related factors have limited or eliminated the use of these credit enhancements for affordable multifamily housing. State initiatives to fill the need for credit enhancements have been limited without federal incentives.

Private Companies Have Left the Multifamily Mortgage Insurance Market

Private mortgage insurance has existed for nearly a century, but the overwhelming majority of this insurance has been written for single-family housing loans. A fledgling subindustry to guarantee multifamily loans existed in the 1970s and early 1980s. According to a study made by an economic consulting firm for one of the three commercial mortgage insurance companies insuring multifamily mortgage loans,[2] this subindustry insured between $89 million and $115 million worth of multifamily mortgage loans annually between 1978 and 1980. By the mid-1980s, however, the three commercial mortgage insurance companies had dissolved.

The National Task Force on Financing Affordable Housing concluded that no private entity today can "regularly and expeditiously provide full credit enhancement to multifamily mortgages, particularly for pools of small subsidized projects." The task force researched the availability of private insurance for multifamily mortgages—that is, insurance that would assume the direct real-estate risk of multifamily projects. It found that the last private mortgage insurers left the business after insurance regulators, in 1989, adopted what the task force termed "prohibitive capital requirements."

As the task force's report points out, however, even before these requirements were established, private insurers had come to view credit enhancements for multifamily loans as unacceptably risky. This risk is primarily due to unforeseeable shifts in the economy caused by, among other things, volatile interest rates and changing tax laws. Furthermore, underwriting of multifamily mortgage insurance is labor-intensive and requires a high level of expertise, imposing costs that may not be covered by the fees charged. As a result, the private sector is basically reluctant to insure the real-estate risks of multifamily loans.

[2] Commercial Mortgage Insurance Prospects, Gladstone Associates (Washington, D.C.: Mar. 1981).

Bond Insurance for Housing Revenue Bonds Has Declined

Bond insurance, another privately provided multifamily credit enhancement that has been used by HFAs to improve their credit ratings and thus lower their cost of capital, has increased in general but declined for housing revenue bonds. The bond insurance industry began only in 1970 and has performed very successfully over the past 20 years. Between 1988 and 1990, the volume of municipal and corporate bond insurance written increased by 50 and 100 percent, respectively. At the same time, however, insurance for housing revenue bonds—a submarket of municipal bonds—declined. For these bonds, insurance coverage decreased from $4.4 billion in 1988 to $2.2 billion in 1989 and only $1 billion in 1990. Most of this decline has been attributed to the reduced use by state and municipal HFAs of tax-exempt bonds as a means of financing affordable multifamily housing. Bond insurers have reportedly also increased collateral requirements for housing revenue bonds. Bond insurers assume little, if any, economic risk because they require substantial collateral on any bond issue they insure. HFAs told us they could not afford to provide this collateral.

Reinsurance companies can purchase some of the financial guarantee risks from the primary bond insurers. The reinsurance market is comparable to the secondary loan market, in which the original lender sells all or some of the loan to a secondary market institution like Fannie Mae. In the case of reinsurance, the primary insurer sells part of the risk to the reinsurance company, compensating that company with part of its premium. Only two financial guarantee reinsurance companies currently participate actively in the bond reinsurance market.

The private sector is little disposed to providing bond insurance on issuances whose primary collateral is first mortgages on multifamily properties. The report of the National Task Force on Financing Affordable Housing confirmed information provided to us by major bond insurers: They are generally unwilling to accept real-estate risk for a project unless the project is backed by some other form of credit enhancement. Rather, bond insurers generally provide their credit enhancement only to bond issuers that (1) are highly rated by one of the recognized national credit rating agencies and (2) agree to provide substantial recourse on any losses incurred. The task force's report does identify one company that has begun to specialize in bond insurance backed by commercial real estate projects that emphasize multifamily housing. However, the company reportedly uses stringent underwriting criteria and requires 20-40 percent recourse to the lender.

Capital Requirements Discourage Use of Senior-Subordinated Securities

Another credit enhancement that can be used to facilitate the financing of multifamily housing is the senior-subordinated structure. In this type of financing, two or more classes of securities are created, both backed by the same collateral pool. Cash flows are set up to ensure that holders of the senior class of securities receive their expected cash flow before the holders of the subordinated securities. Thus, the subordinated securities are a higher-risk investment. Originators of multifamily mortgages may retain the subordinated class of securities or attempt to sell them. (Fannie Mae's DUS product uses this principal of risk-sharing for multifamily loan purchases.) However, as noted in chapter 2, bank regulatory agencies are applying new risk-based capital requirements that discourage depository institutions from retaining partial recourse on loans they sell. Because depository institutions must retain 100 percent of the risk on loans sold even if they retain only 20 percent of the recourse, they are disinclined to use the credit enhancement provided by senior-subordinated securities.

Further State Initiatives Are Unlikely Without Federal Incentives

As discussed in chapter 3, New York State has adopted a multifamily mortgage insurance program. Maryland has had a similar insurance program for nearly 20 years, but the program has been limited to insuring state HFA bonds and has generally not been available to local financial institutions. No other state governments, to our knowledge, have enacted multifamily mortgage insurance programs. Given both the fiscal crisis faced by many state governments and the inherent difficulty for state insurance programs to obtain the highest credit rating, as noted in chapter 3, it is unlikely that any state government initiatives will take place without specific federal government incentives. The multifamily demonstration programs that the Congress has recently authorized, discussed in detail below, offer FHA the opportunity to provide such incentives and encourage the formation of new partnerships with interested state governments. This approach may lead to more permanent state credit enhancement programs in the future.

The Congress Has Taken Action to Support Innovative Credit Enhancements

In October 1991 and again in April 1992, the Senate Subcommittee on Housing and Urban Affairs held hearings on problems associated with financing affordable multifamily housing. Similar hearings were held by the House Subcommittee on Housing and Community Development in July 1992. These hearings brought together representatives of the public and private sectors, including primary and secondary market participants. The overriding consensus was that the multifamily housing sector is experiencing serious difficulties in obtaining permanent financing for

either new construction, substantial rehabilitation, acquisition, or refinancing. The participants consistently cited the factors discussed in chapters 2 and 3 as the underlying causes of this problem. Moreover, almost all participants felt that, as a major part of the solution, the federal government would need to assume a leadership role in providing innovative mortgage credit enhancements.

Following these hearings, the Congress enacted legislation in October 1992, as part of comprehensive amendments to the National Affordable Housing Act of 1990, to address this concern. The Housing and Community Development Act of 1992 authorizes FHA to create federal credit enhancement demonstration programs and also authorizes the establishment of a task force to develop recommendations for a national data base on multifamily housing loans.[3] The establishment of pilot programs and the national data base are consistent with the testimony we presented at the April 1992 Senate hearing.[4]

FHA Is to Create Multifamily Mortgage Credit Demonstration Programs

The act directs FHA to create risk-sharing programs that will demonstrate the effectiveness of a variety of new forms of federal credit enhancements for multifamily loans. The demonstration is to have two major components: (1) a program, to begin within 8 months after the passage of the act, to evaluate the effectiveness of FHA's entering into partnerships or other contractual agreements with state or local HFAS, the FHLBS, Fannie Mae, Freddie Mac, qualified financial institutions, and other state or local mortgage insurance companies or bank lending consortia and (2) a program, to begin within 3 months after the passage of the act, limited exclusively to credit enhancement agreements between FHA and HFAS.

In the first program, FHA is authorized to enter into risk-sharing agreements and other forms of credit enhancements such as reinsurance on pools of multifamily housing loans. The act directs FHA to develop and assess a variety of risk-sharing alternatives or options, including arrangements under which FHA would assume an appropriate share of the risk related to long-term mortgage loans on newly constructed or acquired multifamily rental housing, mortgage refinancing, and other forms of multifamily housing mortgage lending.

[3]Housing and Community Development Act of 1992, title V, subtitle C, Improvement of Financing for Multifamily Housing.

[4]GAO/T-RCED-92-52.

To limit the federal government's liability, the act requires that credit enhancement options be designed to

- ensure that other parties bear a share of the risk—in percentage amount and in order of payment—sufficient to create strong, market-oriented incentives for them to maintain sound underwriting and loan management practices;
- develop credit mechanisms, including sound underwriting criteria, processing methods, and credit enhancements, by which FHA can assist in increasing multifamily housing lending to meet the expected need in the United States;
- provide a better supply of mortgage credit for sound multifamily rental housing projects in underserved urban and rural markets;
- encourage major financial institutions to expand their participation in mortgage lending for sound multifamily housing by, for example, mitigating uncertainties about federal government actions (including the possibility that the government will not renew short-term subsidy contracts);
- increase the efficiency and lower the costs to the federal government of processing and servicing FHA-insured multifamily housing mortgage loans; and
- improve the quality and expertise of FHA staff and other resources to ensure sound management of reinsurance and other forms of credit enhancement.

Under the act, FHA can collect appropriate fees to compensate for the risks and administrative costs associated with the credit enhancements it provides.

The act limits the size of the first component of the demonstration to risk sharing on not more than 15,000 housing units in fiscal years 1993 and 1994. Before the program can be expanded, reports on its effectiveness must be submitted to the Congress. These reports are to be prepared by Fannie Mae, Freddie Mac, HUD, the FHFB, and GAO.

The demonstration's second component is similar to the first but limited to HFAS. FHA would provide credit enhancements for affordable multifamily housing originated by or through qualified HFAS and establish risk-sharing agreements that would reimburse FHA for either all or a portion of any losses FHA incurred.

Under the act, HFAS that enter into risk-sharing agreements with FHA must provide evidence of their capacity to fulfill any reimbursement obligation made. The act also states explicitly that FHA is to accept the underwriting criteria used by HFAS and that multifamily housing qualifying for FHA insurance must be occupied by families with very low incomes. Premiums charged by FHA must be sufficient to cover the percentage of expected losses assumed; lower or nominal premiums are permitted if HFAS assume a greater share of the risk.

In this second program, the number of housing units that can be insured is limited to no more than 30,000 units in fiscal years 1993 through 1995. Again, the program cannot be expanded until mandated reports on its effectiveness have been completed and submitted to the Congress. These reports are to be prepared by the same agencies.

Task Force Is to Create a Data Base on Multifamily Housing Loans

The act also directs that an interagency task force be established to develop recommendations for establishing a national data base on multifamily housing loans. Chaired by the Secretary of HUD and the Chairman of the FHFB, the task force is to include representatives from bank regulatory agencies, Fannie Mae, and Freddie Mac. In addition, HUD is to appoint representatives from HFAS, the building industry, and the life insurance industry, and the Chairman of the FHFB is to appoint representatives from the financial services industry, the nonprofit housing development sector, and one nationally recognized credit rating agency.

The task force's principal responsibility is to develop recommendations for establishing a comprehensive national data base on the operation and financing of multifamily housing to provide reliable information to lenders, investors, sponsors, property managers, and public officials. The importance of creating a reliable data base, both in connection with any new credit enhancement demonstration and for purposes of complying with provisions of the Credit Reform Act, is the subject of chapter 5.

Four Credit Enhancement Options Could Form Basis for Demonstration Program

As noted above, in giving FHA the authority to create new credit enhancements and risk-sharing agreements with qualified HFAs and other qualified financial institutions,[5] the Congress was concerned that the other financial institutions maintain sound underwriting and loan management practices. The act therefore stipulates that the Secretary of HUD ensure that their share of the risk—in terms of both percentage and exposure—provide strong, market-based incentives to do so. This stipulation is important because the federal government is also exposed to risks.

In our testimony before the Senate Subcommittee on Housing and Urban Affairs on April 3, 1992, we presented four options for providing federal credit enhancements for both HFA individual mortgage loans and loan pools. At that time, we proposed that these options be limited to qualified HFAs. However, with the Congress's enactment of more comprehensive legislation, we support the application of these options to all qualified financial institutions authorized by the act. We believe that with some modification, these options could become the basis for implementing the credit enhancement demonstration programs. Furthermore, these options provide FHA with the flexibility of structuring risk-sharing agreements with participating institutions that would provide the incentives needed to encourage sound underwriting and loan-servicing practices.

The options described below provide a starting point for the development of credit enhancements with which FHA can assist in increasing the supply of mortgage credit for sound, affordable, multifamily rental housing projects. In developing these options, we drew on the expertise of a wide range of senior and mid-level officials representing private financial institutions, including commercial bankers, mortgage bankers, and savings and loan officials; bond insurers; credit rating agencies; government-sponsored mortgage finance corporations; for-profit and nonprofit housing developers; government regulatory organizations; state and local housing finance agencies; and community development organizations.

Option 1: Delegated Processing

Under this option, FHA would allow certain HFAs and lenders certified by qualified financial institutions to originate and process individual loans and submit these loan packages directly to FHA for final approval for 100-percent loan insurance. The HFAs and other lenders could be selected

[5]Qualified financial institutions specifically cited in the Housing and Community Development Act of 1992 are Fannie Mae, Freddie Mac, and the FHLBs. Other institutions generically defined in the act include state or local mortgage insurance companies and bank lending consortia.

directly by FHA after it reviewed their affordable multifamily housing loan performance and experience. Selected HFAS and other lenders would be allowed to originate and service only those types of mortgage loans for which they have a proven record. FHA would be required to either approve or disapprove the loan insurance within a specified period of time (e.g., 60 to 90 calendar days). This option is likely to benefit larger and/or more complex loans that may not fully follow accepted underwriting standards. These loans also tend to be more difficult to pool because their size can disproportionately affect losses within the pool if the loan goes into default. Less experienced affordable multifamily lenders could also benefit from this option by being given the opportunity to increase their capacity to originate more affordable multifamily housing loans. Under this option, only minimal risk-sharing between FHA and the participating HFAS and other approved lenders should be necessary, since FHA would retain final underwriting and approval authority.

Option 2: Delegated Underwriting

Under this option, selected HFAS and qualified financial institutions, including Fannie Mae and Freddie Mac, would be delegated authority to underwrite loans and make decisions on individual FHA mortgage loan insurance without prior approval by FHA. This authority would be limited to loans up to a certain size and type, depending upon the capacity of the HFA or qualified financial institution. FHA and qualified financial institutions, including HFAS, would need to determine and commit to substantial risk-sharing agreements, since each qualified financial institution would be allowed to follow its own underwriting criteria and procedures. Moreover, since each qualified financial institution would have the exclusive authority to select more experienced lenders to use this option, the qualified financial institution would also be responsible for any outstanding risk-sharing liability agreed to by those lenders it selected. FHA would also conduct audits on selected loans after origination to ensure that the qualified financial institutions were adhering to agreed-upon criteria for delegated underwriters.

Option 3: Primary Bond Insurance

Under this option, FHA would provide primary bond insurance on HFAS' or qualified financial institutions' bond or mortgage-backed security. Since Fannie Mae, Freddie Mac, and the Federal Housing Finance Board already have AAA credit ratings, the more likely users of this option would be some of the most experienced HFAS. This option would be used to insure pools of loans rather than individual loans. Thus, HFAS or other qualified financial institutions would be encouraged to originate smaller loans and

adopt "loan-to-lender" programs with experienced local mortgage lenders—a procedure currently used extensively for single-family loans.[6] This option should only be used in cases for which FHA determines that private bond insurance is either not available or too costly for the loans in the pool. Under this option, FHA should enter into risk-sharing agreements with the financial institutions that issue the bonds or mortgage-backed securities commensurate with the projected credit risks of the loan pool.

Option 4: Bond or Pool Reinsurance

Under this option, FHA would provide reinsurance when private bond insurers agree to provide the primary bond or pool insurance to an HFA or other qualified financial institution. For the private insurer, FHA's participation would provide a means of sharing part of the credit risk of the underlying bond or pool of mortgages. To best ensure sound underwriting and loan management on the part of the private insurer, FHA should provide reinsurance on no more than 50 percent of the insured risk. Moreover, any risk-sharing agreements between the primary bond insurer and the qualified financial institution should also apply equally to the FHA-reinsured portion of the transaction. The availability of this kind of federal reinsurance could encourage private bond insurers to offer credit enhancements for affordable multifamily bonds and mortgage-backed securities.

Appendix IV provides details on how the four options originally proposed for HFAs in our April 1992 testimony would be implemented as well as (1) eligibility criteria for HFAs, (2) the size and type of loan most likely to be affected, (3) underwriting criteria, (4) access to local financial institutions, and (5) the advantages and disadvantages of each option. We emphasized the HFAs because they have twice as many authorized housing units as all the other qualified financial institutions combined (30,000 versus 15,000).

However, in appendix V we also expand these options beyond the HFAs, providing abbreviated examples of how three other major participating institutions (Fannie Mae, Freddie Mac, and the Federal Housing Finance Board) could apply one or more of these options to help meet their specific needs and goals in affordable multifamily housing financing.

No single credit enhancement option will meet the diverse needs of all market participants, including local lenders, developers, loan pool issuers,

[6]In a loan-to-lender program, the local lender serves as an agent for the HFA, thus avoiding any loan sales transactions.

institutional investors, and secondary market institutions. The Congress recognized this diversity in providing FHA with appropriate broad authority to create credit enhancements and risk-sharing agreements that address the different needs of the participants.

Recognizing that FHA's legislative authority is intentionally broad, we nevertheless believe that the following principles should guide the development and implementation of each new credit enhancement option:

- Wholesale credit enhancement. FHA should consider moving from being a "retail" to being a "wholesale" credit enhancer. That is, rather than underwriting individual loans, FHA could increasingly rely on the processing and underwriting capacity of major financial institutions such as Fannie Mae, Freddie Mac, HFAS, and others identified in the legislation. Limiting the number of loans that need to be underwritten and monitored by FHA staff would presumably improve FHA's service quality.

  The National Task Force on Financing Affordable Housing recognized the benefits of this approach and suggested that it be considered as part of an effort to restore FHA as an effective credit enhancer for multifamily financing. However, FHA should continue to underwrite larger multifamily mortgage loans that can not be readily pooled by the major secondary market institutions and/or that are inherently more risky because of their size and exposure to loss.

- Flexible underwriting standards. On the basis of empirically derived performance data, the federal government should consider developing flexible underwriting standards that allow local adaptations and rely more on the capacity of the local lender and borrower to underwrite, service, develop, and manage similar projects included in the loan pool.

  The national task force also proposed this concept in its report. As that report notes, the purpose of this approach is to develop a system in which national secondary market participants can rely more heavily on the ability and record of the expert originators with whom they deal, rather than prescribing overly restrictive standards.

- Flexible pricing. If not detrimental to project feasibility, the federal government could price its reinsurance policies closely parallel to those of either the loan pool issuer or the retail insurer, if one agrees to participate. In addition, in determining pricing and the degree of risk exposure, FHA could consider (1) the credit risks projected for the originating lenders and

loans included in the loan pool; (2) the percentage of very-low, low- and moderate-income residents actually residing or expected to reside in each project financed by the loan pool; and (3) the extent to which the projects included in the loan pool address the priority housing needs of their respective communities as demonstrated in the HUD-approved Comprehensive Housing Assistance Strategy for that community.[7] Moreover, FHA could, provided it complied with the provisions of the Credit Reform Act we will discuss in chapter 5, consider lowering the price for its credit enhancement when there are offsetting public benefits that warrant setting the price below the risk-based level.

- Reinsurance of other credit enhancers. When other insurers—such as state or local mortgage loan guarantee programs, private bond insurers, or private mortgage insurers—are also involved in a transaction as retail insurers or credit enhancement providers, the federal government should, after assessing the associated risks, consider reinsuring the primary insurer's credit risks. Such reinsurance—not to exceed 50 percent of the assumed risk—would ensure that the primary insurer's economic risk was large enough to encourage effective oversight. Federal reinsurance could both encourage these other providers to enter this market and reduce the federal government's long-term exposure to risk.

Critical Issues Could Impede Development and Implementation of Options

Aside from specific advantages and disadvantages with each of the options outlined above, several overriding issues could impede the implementation of a successful credit enhancement demonstration. While the legislation provides for the new demonstration programs to be tested and evaluated, their long-term success can only be achieved through cooperation between the federal government and the institutions the Congress authorized to participate. Yet fostering such a cooperative environment presents real challenges. The federal government has divergent goals of promoting social objectives (i.e., ensuring an adequate supply of affordable multifamily housing) while at the same time limiting its exposure to losses. Virtually all of the participating institutions have similarly divergent—and competing—goals. The ability to balance these goals through effective compromise by all parties will greatly influence the success of the demonstration programs.

Aside from this potential conflict between promoting affordable housing and minimizing risk, certain institutional barriers to investing in affordable

[7]The Comprehensive Housing Assistance Strategy (CHAS) was required by the National Affordable Housing Act of 1990. Localities and states that receive federal housing funds are required to file a CHAS application and have it approved before receiving those funds.

multifamily housing will also have to be overcome. For example, the investment community lacks expertise in evaluating the risks of investing in affordable multifamily housing. Also, the investment system tends to favor larger investments rather than the relatively smaller-scale investments typical of affordable multifamily housing. Finally, in addition to the regulatory barriers discussed in chapter 2 that affect originators of affordable multifamily loans, regulatory barriers to investing in these loans could adversely affect the success of the credit enhancement demonstrations.

Market Participants in Demonstration Programs Have Competing Objectives

Because participants in the credit enhancement demonstration programs have competing objectives, qualifying financial institutions may have to make adjustments and compromises on certain issues to take full advantage of the programs. Among the participants affected are Fannie Mae and Freddie Mac, CDCS, state and local HFAS, the FHLBS, and local depository institutions.

Fannie Mae and Freddie Mac have historically been cautious about investing in affordable multifamily mortgages. In fact, financial market participants have criticized Fannie Mae and Freddie Mac for using underwriting criteria they consider too restrictive, eliminating what they consider to be economically viable loans made in low-income neighborhoods. In its report From the Neighborhoods to the Capital Markets, the National Task Force on Financing Affordable Housing recommends that both Fannie Mae and Freddie Mac "expand their existing programs to make them more flexible and better able to accommodate subsidized projects." As discussed in chapter 3, the Congress also recognized and reacted to this concern by establishing specific goals for Fannie Mae's and Freddie Mac's purchases of affordable multifamily housing mortgages.

As we also noted in chapter 3, CDCS have become a major provider of affordable multifamily housing. CDCS, which are nonprofits, usually do not have the capital or land holdings of large private developers and must, therefore, be able to settle on a property very quickly. If Fannie Mae and Freddie Mac are to effectively serve this market segment, it will be important that their procedures are streamlined enough to allow lenders to be able to make timely loan commitments to CDCS.

Many state and local HFAS, while having successfully used local lenders to originate mortgages for their bond-backed, single-family mortgage

programs, have been reluctant to use local lenders for their multifamily mortgage programs. However, our discussions with state HFAS indicate that they might benefit from using local lenders who are familiar with the local housing market and are also capable of properly underwriting and servicing smaller, more complex multifamily housing loans. Therefore, to take full advantage of the credit enhancement demonstration programs, state and local HFAS may wish to expand their lending activity through local lenders.

Similarly, if the FHLBS are to take advantage of the credit enhancement demonstration programs, they may be required to modify their current method of doing business. Historically, the FHLBS have not taken any underwriting responsibility for loans financed by their advances to local lenders. Rather, local lenders receiving advances have been required to pledge collateral equal to 125 percent of the outstanding advance. This requirement may act as a disincentive for some lenders to request advances from the FHLBS.

However, the Congress has required that the FHLBS assist in providing financing for affordable housing by establishing the Affordable Housing and Community Investment Fund programs (described in app. III). The credit enhancement demonstration programs offer the FHLBS an opportunity to join in a risk-sharing agreement with FHA, under which selected lenders could receive advances without having to pledge the 125-percent collateral, since FHA would guarantee a portion of the outstanding principal. Such a program, by shifting some risk to FHA, could help FHLB members meet financing needs for affordable multifamily housing within their respective markets.

Many local depository institutions are holding affordable multifamily housing loans in their portfolios, in part to meet the requirements of the Community Reinvestment Act. To encourage these institutions to originate additional affordable multifamily housing loans, the credit enhancement demonstration could be used to either eliminate or reduce the recourse requirements that secondary market purchasers impose on originators. To illustrate, Fannie Mae requires lenders in its Delegated Underwriting and Servicing (DUS) product to absorb the first 5 percent of any losses on loans that the lender originates and sells to Fannie Mae. Because of the risk-based capital requirements, this recourse provision limits the value to lenders of selling their affordable housing loans to Fannie Mae. However, the credit enhancement demonstration programs provide an opportunity for a new risk-sharing arrangement between the lender, Fannie Mae, and

FHA that strikes a balance between the different institutions' social and financial goals.

Institutional Barriers Could Impede Credit Enhancement Demonstration

Most major purchasers of long-term bonds and mortgage-backed securities—mainly pension funds, insurance companies, endowments, and trusts—require that the bonds and securities have credit enhancements. These institutional investors, particularly pension funds, tend to be risk-adverse and, as such, seek investments that mirror this risk position. Asset-backed securities and bonds are attractive investments for several reasons. First, they are considered relatively safe as a result of credit enhancements. Second, the return on mortgage-backed securities and housing revenue bonds is typically higher than that on U.S. Treasury securities with comparable maturities. Third, these investments allow investors to diversify their portfolios by purchasing securities from different geographical areas. Highly rated bonds and mortgage-backed securities also offer the added benefits of conforming to the "prudent man rule" incorporated in most pension funds laws such as the Employee Retirement Income Security Act of 1974 (ERISA)[8] and providing liquidity to pension fund managers interested in the future marketability of these investments.

A GAO study of pension investments in affordable housing[9] found that the overwhelming majority of the pension fund investments studied (13 of 15),

> "reduced the risk associated with the housing by investing in insured mortgages or guaranteed federal or state government bonds. Without such safeguards, most pension fund managers said they would not have invested in affordable housing, perceiving the risk of borrower default to be too great regardless of the interest rate."

While credit enhancements can address investors' concerns about risk, it was the conclusion of the National Task Force on Financing Affordable Housing that many institutional investors lack the staff expertise to adequately evaluate investments in affordable multifamily housing. As a consequence, the task force found that many institutional investors tend to rely on outside advisers, who themselves may have little knowledge of such investments and thus have little incentive to recommend them. To address this problem, the task force recommended that educational

[8]Although ERISA only applies to private-sector pension funds, many of its administrative and judicial rulings defining the scope of the prudent man rule are followed by most public and church pension funds.

[9]Pension Plans: Investments in Affordable Housing Possible With Government Assistance (GAO/HRD-92-55, June 12, 1992).

programs and materials be developed to inform investors of the risks of and returns on investments in affordable multifamily housing.

Conclusions

Because of its regulatory responsibilities, high credit rating, and strong public policy objectives, the federal government is in a unique position to influence those institutions that are critical to the expansion of the secondary market for affordable multifamily housing. However, because of the limitations on FHA's activities discussed previously, the federal government has been without an effective mechanism for evaluating the potential viability of credit enhancements for affordable multifamily housing. In our view, until the federal government provides credit enhancement options that are responsive to investors' needs, the secondary market for affordable multifamily housing is unlikely to expand significantly. However, appropriate caution needs to be exercised so that federally provided credit enhancements are not used to support poorly underwritten projects.

The Congress, recognizing the need to expand capital for affordable multifamily housing, has authorized FHA to enter into credit enhancement demonstration programs that provide for risk-sharing arrangements with private and public institutions that originate mortgages for such housing. We believe the effective implementation of these programs will offer a basis for evaluating whether properly underwritten affordable multifamily mortgages can be economically viable. If these mortgages are shown to be economically viable, investors, in turn, may be more willing to purchase affordable multifamily mortgages, assisting in the development of a broader secondary market.

Monitoring the costs and benefits of the new credit enhancement demonstration programs is critical to evaluating their effectiveness. In this regard, the costs of these programs could be affected by whether the credit enhancements provided are priced to cover expected costs or whether part of these costs are subsidized to achieve desired social benefits.

Because of the diversity of the institutions, lenders, and borrowers that participate in financing affordable multifamily housing, it is important that the demonstration programs provide options for individual loan insurance and loan pool insurance. Individual loan insurance would likely be needed for above-average-size loans and/or for projects with special characteristics. This kind of insurance would also be useful to

participating institutions who wish to share the credit risk of individual loans with FHA rather than to achieve a higher credit rating on securities backed by these loans. Conversely, loan pool insurance could be very important to institutions requiring a credit enhancement to market their securities at the lowest possible yield, thereby improving the affordability of their projects.

Moreover, we believe that for the credit enhancement options to have the greatest utility, they should be guided by certain principles. If adopted, the following principles could allow FHA to serve a broader segment of the affordable multifamily housing market, while also encouraging participating institutions to enter into risk-sharing agreements with FHA. First, FHA could shift from being a retail insurer to being more of a wholesale insurer. Second, FHA and participating financial institutions could place greater reliance on the underwriting capacity and experience of local lenders and borrowers rather than on less flexible national underwriting standards. Third, FHA, in pricing its credit enhancements, could consider the expected social benefit of each loan or pool of loans as well as the credit risk. To the extent that greater social benefits are achieved (i.e., increased targeting of housing to lower-income households), FHA, provided it complies with the provisions of the Credit Reform Act, may choose to subsidize the cost of its credit enhancement premium by pricing it below expected losses. Finally, FHA could work to maximize opportunities for involving private and state government credit enhancers by reinsuring their credit risk. In our opinion, the development of a strong private market to provide reasonably priced credit enhancements for affordable multifamily housing could lessen the dependency on FHA. Determining the likelihood that this will happen should be a key objective of the demonstration programs.

We believe that FHA could serve as the catalyst for implementing the credit enhancement demonstration programs by holding a conference that brings together the institutions specified in the legislation in order to develop additional credit enhancement products. Such a conference would both signal FHA's commitment to the demonstration programs and begin to develop the required agreement among the participating institutions on the policies needed to implement them.

Beginning to reach consensus at such a conference could allow HUD to promulgate proposed instructions or regulations to implement the demonstration programs. Such instructions or regulations could, at a minimum, (1) specify the policies and procedures for approaching FHA to

participate in the demonstration programs, (2) incorporate and define different credit enhancement options for both individual loan and loan pool insurance, and (3) state the guiding principles for all credit enhancement options. The instructions or regulations should also describe how FHA will monitor each of the financial institutions participating in the demonstration in order to ensure compliance with program objectives and requirements and to facilitate future program evaluations by outside organizations, as required under the act. In addition, FHA may wish to design its credit enhancements so that participating institutions will be encouraged to adopt new operating procedures for affordable multifamily housing. For example, HFAs could chose to use experienced local lenders as delegated originators of HFA loans rather than relying only on their own capacity to originate loans. As another example, Fannie Mae and Freddie Mac could explore opportunities to accept more flexible underwriting standards, thus enabling them to better serve the affordable multifamily housing market.

We are aware, as noted in chapter 3, that FHA has been hampered in past programs by inadequate staffing and management information systems. Assessing its resources in both of these areas and making any necessary staff realignments or requests for additional resources could help FHA ensure that it has adequate internal capacity to lead in the effort to carry out the demonstration programs.

Recommendation to the Secretary of HUD

To facilitate the implementation of the credit enhancement demonstration programs, we recommend that the Secretary of HUD, in cooperation with the Commissioner of FHA, convene a conference of senior officials representing each of the financial institutions referred to in the authorizing legislation. The conference should begin to (1) draft policies and procedures for participating in the credit enhancement demonstration programs, (2) develop options for providing credit enhancements on individual loans as well as loan pools, and (3) formulate principles to guide the implementation of the credit enhancement options.

We further recommend that, following the conference, the Commissioner of FHA incorporate in draft instructions or regulations the policies and procedures agreed to. These regulations should specify (1) the data that must be collected in the demonstration programs to ensure that thorough evaluations of the costs and benefits of these programs can be made and (2) the way FHA will monitor participating institutions' compliance with the objectives and requirements of the demonstration programs, including any

provisions requiring the participating institutions to adopt new operating procedures for improving the financing of affordable housing. Requiring lenders and borrowers that benefit from federal credit enhancements to provide information on loan performance over the life of the credit enhancement would also contribute to the establishment of a data base on affordable multifamily housing loans (see chapter 5).

Finally, we recommend that FHA reassess its staffing and management information systems and make any necessary staff realignments or requests for additional resources necessary to help ensure that it has adequate capacity to successfully implement the credit enhancement demonstration programs.

Agency Comments

HUD, Fannie Mae, Freddie Mac, and the National Council of State Housing Agencies (NCSHA), in commenting on a draft of this report, agreed that federal credit enhancements can assist in obtaining financing for properly underwritten affordable multifamily housing loans. (Their complete comments are reproduced in apps. VI, VII, VIII, and IX.) Moreover, HUD, Fannie Mae, and NCSHA explicitly endorsed our recommendation that FHA convene a conference as a means of facilitating implementation of the credit enhancement demonstration programs. HUD and Freddie Mac also commented specifically on the need to have adequate staff to implement an effective credit enhancement demonstration program.

Better Data Are Needed on Performance of Affordable Multifamily Housing Loans

For the secondary market in multifamily housing to substantially expand, financial institutions need access to information that will enable them to quickly and economically evaluate, price, and manage risk. Currently, limited information is available on loans for multifamily housing in general and affordable multifamily housing in particular. Without such information, financial institutions and investors are handicapped in evaluating and pricing the risks associated with lending for affordable multifamily housing.

Also, to the extent the credit enhancement options discussed in chapter 4 are implemented, their costs will have to be projected and financed as required by the Federal Credit Reform Act of 1990. To meet these requirements, reliable data are needed on the past performance of multifamily housing loans. Until such data are developed, it will be necessary to rely on approximations made on the basis of the limited information now available.

The Congress recognized and responded to this problem by authorizing the creation of an interagency task force that is to develop recommendations for establishing a national data base on multifamily housing loans. However, the Congress has yet to appropriate funds to carry out the mandate of the task force. If and when funds are appropriated to develop this data base, the task force will need to research and address several issues. First, ensuring the confidentiality of, and providing standard definitions for, the data base would greatly increase its effectiveness and utility. Second, identifying an agency or organization that could take ongoing responsibility for collecting, analyzing, and reporting on the performance of multifamily housing loans could help ensure the continuing availability of the needed data on multifamily housing financing.

Absence of Data on Loan Performance Creates Numerous Problems

The lack of standardized data on the current and past performance of affordable multifamily housing loans has restricted investor confidence and interest in investing in these loans and, in doing so, has impeded the development of a secondary market. Lack of data may also have resulted in the bank regulatory agencies' classifying all multifamily housing loans in the highest risk category. Moreover, without accurate data, agencies must rely on approximations of risk to set the prices of federal credit enhancements.

As the National Task Force on Financing Affordable Housing noted in its report, the general lack of information is one of the primary barriers facing investors who are considering multifamily housing. Our review confirmed the report's finding that historical data on the performance of multifamily housing loans are inadequate.

Investors need data on loan performance to correctly evaluate credit quality and compare risks among investment alternatives. Without this information, institutional investors—pension funds and insurance companies, for example—and other investors have a weak analytical basis for deciding whether to purchase affordable multifamily housing mortgages unless credit enhancements are provided to protect against the unknown credit risks. Collecting and analyzing these data may also lead to an explanation of the low default rate on loans made by some community-based affordable housing lenders compared with the default rate of the industry overall.

The participation of an array of investors helps create a robust secondary market. But data limitations constrain such participation and are thus a major barrier to the expansion of the secondary market for affordable multifamily housing loans. Establishing a high-quality data base should provide investors with the information they need to make prudent decisions about the credit quality of such investments.

Finally, without actual data on the performance of multifamily loans, there is little basis for evaluating whether the current risk weighting assigned to these loans is appropriate or in need of change. According to bank regulatory agency officials we interviewed, the risk-based weighting factor (100 percent) assigned to multifamily housing was not derived through a rigorous analysis of the past performance of such loans. Rather, this weighting reflects a combination of some consideration of past loan performance with certain intuitive perceptions of the risk of these loans as compared with, for example, single-family housing loans. The different weightings initially assigned to multifamily housing with between 5 and 36 units by the Office of Thrift Supervision and the other regulators suggest the absence of creditable data necessary to properly assess and price risk. As a result, the risk-based capital requirements have placed loans for multifamily housing in the highest risk category, increasing their costs over loans in lower risk categories.

Data Limitations Impede Compliance With Federal Credit Reform Act

The lack of comprehensive data on the performance of affordable multifamily housing loans precludes the accurate pricing of any subsidies associated with federally supported credit enhancements. However, until these data can be systemically collected and analyzed, approximations will have to be made of subsidy costs associated with any credit enhancement options to comply with the provisions of the Federal Credit Reform Act.

The federal government intervenes in credit markets to assist certain borrowers and to increase market efficiency. These interventions are intended to further various social and economic objectives. By providing more favorable terms than those available from private lenders, federal credit programs assist borrowers, including some who could not obtain funds otherwise. By creating secondary or resale markets for loans, federal programs also help increase the liquidity of the loans.

Federal credit programs include (1) direct loans, (2) federal guarantees of loans made by private lenders, and (3) loans to and by government-sponsored enterprises.[1] Unequal budgetary treatment of these three federal credit programs led to passage of the Federal Credit Reform Act of 1990. This act established budget parity—that is, a consistent and comparable basis for measuring the costs of cash and credit transactions. The government's loss on the exchange of cash for a promise to pay is the subsidy cost to the government. It is this loss that is relevant for budgeting.

Under the Federal Credit Reform Act, subsidy costs must reflect the full cost to the government of providing credit assistance. These costs include loan defaults, delayed repayments, and below-market interest rates, but not administrative expenses. Changes in the terms of loans—by, for example, forgiving loans or waiving penalties—also result in subsidy costs. However, subsidy costs are reduced by any fees and premiums borrowers pay for credit assistance. To avoid bias and inconsistency in measuring the subsidy, the Federal Credit Reform Act made the Office of Management and Budget (OMB) responsible for prescribing methods for calculating the subsidy cost of credit.

Federal credit enhancements provide subsidies to the extent the losses paid exceed the premiums charged. For example, if the federal government provides a credit enhancement through a loan guarantee, it usually pays the private lender or investor if a borrower defaults. The

[1]As previously noted, the three government-sponsored enterprises that promote housing are the FHLBs, Fannie Mae, and Freddie Mac.

extent to which this payment exceeds the fees collected for the credit enhancement is considered a subsidy. The Federal Credit Reform Act requires that these subsidies be calculated and allocated to the budget for the year in which the credit enhancement is given. The subsidies must be reestimated and adjusted every year until the credit enhancement has ended. The aim of this procedure is to recognize the costs of providing credit enhancements at the time the credit enhancement commitments are made. No new federal credit enhancements can be extended without an appropriation of budgetary authority to cover any anticipated subsidy costs for the credit enhancement.

Credit Enhancement Options Can Be Priced on the Basis of Risk

Risk-sharing agreements and premiums priced to cover expected costs can be designed for any of the credit enhancement options discussed in chapter 4. Pricing for these premiums will depend on both the type of credit enhancement being offered, the nature of the risk-sharing agreement, and whether any federal subsidy is intended.

Data on the past experience of multifamily loans, together with forecasts of future economic conditions, should be used to accurately price any federal credit enhancement. However, as noted earlier, adequate data on the performance of multifamily loans do not exist. In lieu of such data, private industry has developed alternative methods for evaluating and pricing the risk for both individual and pooled multifamily mortgages. Standard & Poor's—one of the principal credit rating agencies—uses a method based on two real-estate based indicators, the debt service coverage ratio (DSCR) and the loan-to-value ratio (LTV). As previously mentioned, the DSCR is calculated by dividing the total income from a property minus operating expenses by the annual mortgage payment, and the LTV is calculated by dividing the amount of the mortgage by the appraised value of the property. While we did not perform a rigorous analysis of private industry's approaches, Standard & Poor's method was the most comprehensive of those we reviewed and could be useful in pricing credit enhancements for both individual and pooled mortgages.

Standard & Poor's Pricing Is Based on a Real-Estate Approach[2]

Standard & Poor's (S&P) uses a real-estate approach in pricing and evaluating risk, using DSCR and LTV as its primary indicators. This approach assumes that multifamily housing loans are underwritten on the basis of the property's ability to generate sufficient cash flow to cover operating

[2] Information in this section was obtained from Standard & Poor's publications Credit Review (Mar. 25, 1991) and Special Report: Multifamily Mortgage Securitization to Rise (Oct. 1991).

expenses and debt service. Although an owner may temporarily cover a cash flow shortfall of a property, long-term shortfalls indicate a troubled property. A decrease in revenue (e.g., an increase in vacancies), an increase in operating costs (e.g., an increase in utility expenses), or a combination can lead to a decrease in net operating income. If a decrease occurs, the DSCR will fall, weakening the investment value of the mortgage. The DSCR is S&P's primary indicator of foreclosure frequency, while the LTV is its primary indicator of loss severity. For any given multifamily loan, other factors being equal, these two indicators tend to move in opposite directions.

S&P has developed loan-loss matrices for both individual and pooled multifamily loans on the basis of its review of a wide variety of data sources. These sources include aggregate data from the early 1970s through 1990 from Fannie Mae and Freddie Mac, life insurance companies, S&Ls and commercial banks, and 200 of the largest bank holding companies, including their mortgage banking subsidiaries. The data also include a study sponsored by the National Bureau of Economic Research of multifamily loan losses between 1920 and 1946, a period that included the Great Depression. These data are useful in developing the worst-case loss scenarios during depression conditions. While these sources provided only aggregated performance data, the data do reflect losses by DSCR and LTV. Interpretation of the data, however, requires professional judgment, since the data definitions are not standard. For example, some of the data report DSCR and LTV at the time of loan origination, while other data report these ratios at the time of foreclosure.

Rating Individual Multifamily Loans

In rating individual loans, the primary focus is on the DSCR; the LTV is a secondary factor. Table 5.1 shows S&P's assumed LTV ranges for the four investment grades used in rating individual mortgages (AAA is the highest and BBB is the lowest).

Table 5.1: Standard & Poor's Loan-To-Value Ratios and Implied Equity Requirements for Rating Individual Multifamily Loans

Desired credit rating	Required LTV (percent)	Implied equity required (percent)
AAA	5-40	95-60
AA	10-45	90-55
A	20-55	80-45
BBB	25-60	75-40

Source: Standard & Poor's.

As table 5.1 shows, an individual mortgage requires a minimum of 40-percent equity to receive a BBB rating and a minimum of 60-percent equity to receive a AAA rating. Another major factor for rating individual loans is the quality of the property and the property manager. As illustrated in table 5.2, the highest-quality markets, properties, and managers require a lower DSCR than do poorer-quality markets, properties, and managers. In addition, loans that pay only interest (i.e., for which there is no amortization of principal) require higher DSCRs than loans that are fully amortized over 20 years. The higher ratio reflects the risks associated with refinancing after 10 years.

Table 5.2: Standard & Poor's Estimate of Debt Service Coverage Ratios for Individual Multifamily Housing Loans

Quality of market, management, and building	Desired rating	Minimum DSCR given 20-year amortization	Minimum DSCR given 10-year, interest-only loan
Excellent	AAA	1.55	1.60
	AA	1.50	1.55
	A	1.40	1.45
	BBB	1.35	1.40
Good	AAA	1.65	1.75
	AA	1.60	1.70
	A	1.50	1.60
	BBB	1.45	1.55
Fair	AAA	1.80	1.95
	AA	1.75	1.90
	A	1.65	1.80
	BBB	1.60	1.75
Poor	AAA	2.00	2.50
	AA	1.95	2.45
	A	1.85	2.35
	BBB	1.80	2.30

Source: Standard & Poor's.

Tables 5.1 and 5.2 show the minimum DSCR and LTV that a multifamily housing loan would need to obtain the desired credit ratings. These tables can be used in pricing credit enhancements for individual loans. Since the DSCR is the primary factor in determining the probability of defaults on individual loans, the DSCR for each loan for which a credit enhancement is being considered should first be compared with the DSCR for the desired credit rating (shown in table 5.2). If this ratio is the same or higher than the DSCR of the desired credit rating, there would be no need for any credit enhancement, provided the loan's LTV is within the suggested LTV range for the desired credit rating (shown in table 5.1). However, if the DSCR for the loan is below the minimum DSCR for the desired credit rating, the

difference should be calculated and multiplied by the loan's annual debt service payment. The resulting amount would equal the credit enhancement required to achieve the desired credit rating. This figure would be reviewed annually to determine the need to either increase or decrease the amount of the credit enhancement. The purpose of the annual review would be twofold: first, to update information on the quality of the building and its management, and second, to update the DSCR in order to make any adjustment to the amount of the credit enhancement needed.

Although a loan's LTV is a secondary factor, adjustments to the amount of the credit enhancement would be necessary if the loan's LTV were substantially higher than the LTV range for the desired credit rating (shown in table 5.1).

The following is a hypothetical example of how these calculations would be applied to an individual loan. Assume an individual loan with a 20-year amortization, a $100,000 annual debt service payment, a DSCR of 1.15, and an LTV of 70 percent for a newly constructed building with excellent property management. A cash reserve would need to be established to achieve a BBB rating for this loan. According to table 5.2, the required DSCR for this type of loan would be 1.35. The cash reserve is calculated by subtracting the loan's actual DSCR (1.15) from the required DSCR (1.35), which equals 0.20. This number is then multiplied by the annual debt service payment ($100,000) to yield a required reserve of $20,000. In this example, while the LTV (70 percent) is slightly outside the required LTV range for the desired rating (shown in table 5.1), because of the excellent quality of the building and its management, adjustments to the reserve would probably not be necessary. However, a poorer quality building with poorer management and an LTV outside the desired range could require a significant adjustment. Underwriting judgment would be necessary to establish the degree of adjustment required.

Rating Multifamily Loan Pools

For multifamily loan pool ratings, S&P has developed a more sophisticated loan-loss matrix. As a starting point, S&P establishes a baseline for expected losses over several economic cycles. This baseline is equivalent to a BBB security rating. This baseline rating also includes an assumption of a 3-year depression beginning in the first year of the pool, including the default of the largest loan in the pool. While S&P's officials acknowledged that such an occurrence would be unlikely, they included it at an early stage in order to offset the probability of more frequent but less severe economic recessions during the life of the loan pool. Since the frequency

and the severity of these recessions are impossible to predict over 20-30 years, S&P decided to use the 3-year depression scenario to test the pool's vulnerability at a time when the DSCR would normally be at its lowest and the LTV would normally be at its highest.

As shown in table 5.3, a security with a BBB credit rating, backed by a pool of mortgages with a DSCR of 1.15 and an LTV of 80 percent, would have an expected foreclosure rate of 9 percent and expected losses of 32 percent on foreclosed loans.

Table 5.3: Standard & Poor's Estimate of Loss of Principal Due to Mortgage Foreclosure

Rating level desired	DSCR	LTV (percent)	Expected foreclosure frequency (percent)	Loss of principal on loans foreclosed (percent)
AAA	1.70	50	9	12
	1.55	55	10	20
	1.45	60	12	27
	1.30	65	13	32
	1.25	70	15	37
	1.20	75	16	41
	1.15	80	18	45
AA	1.70	50	8	6
	1.55	55	9	15
	1.45	60	10	22
	1.30	65	12	28
	1.25	70	13	33
	1.20	75	14	38
	1.15	80	15	42
A	1.70	50	6	2
	1.55	55	6	5
	1.45	60	7	13
	1.30	65	8	20
	1.25	70	9	26
	1.20	75	10	31
	1.15	80	11	35
BBB	1.70	50	5	2
	1.55	55	5	2
	1.45	60	6	9
	1.30	65	7	16
	1.25	70	8	22
	1.20	75	8	27
	1.15	80	9	32

Note: The loss severity equals the loss of principal plus 2 years' interest. The total loss coverage is equal to the expected loss on the largest loan plus the amount computed by multiplying the foreclosure frequency times the loss severity for the remainder of the pool.

Source: Standard & Poor's.

For pricing credit enhancements, these percentages translate into the reserves needed to cover expected losses over several economic cycles. For example, assuming that the baseline mortgages were originated with a DSCR of 1.15 and an LTV of 80 percent, the level of reserves needed to cover expected losses for a pool of 100 mortgages, each with an outstanding balance of $1 million, would be calculated as follows:

- The expected foreclosures on the entire pool (9 percent) would amount to $9 million.
- The loss of principal on the foreclosed loans (32 percent) would amount to $2.88 million.
- The loss of 2 years' interest at 10 percent would amount to $1.8 million.[3]
- The required reserves to pay expected losses on the pool would be $4.68 million ($2.88 million plus $1.8 million), or 4.7 percent of the original outstanding balance of $100 million.

Higher-rated pools are structured to withstand greater economic distress. As a result, Standard & Poor's requires higher reserves for securities that receive higher credit ratings. To receive a AAA rating, securities must have reserves sufficient to cover the losses that would be experienced during the most severe economic depression. For example, assuming a 1.15 DSCR and an LTV of 80 percent, the level of reserves required for a pool of 100 mortgages, each with an outstanding balance of $1 million, for which an AAA rating is desired would be calculated as follows:

- Expected foreclosures on the entire pool (18 percent) would amount to $18 million.
- The loss of principal on foreclosed loans (45 percent) would amount to $8.1 million.
- The loss of 2 years' interest at 10 percent would amount to $3.6 million.[4]
- The required reserves to pay expected losses on the pool would be $11.7 million, or 11.7 percent of the original outstanding balance of $100 million.

Credit enhancements cannot, however, be properly priced simply by using matrices like tables 5.1 through 5.3. Each individual loan or mortgage pool should be evaluated separately for the actual and unique risks involved, with appropriate adjustments made to any credit enhancement prices that

[3]This example assumes that it will take 2 years to foreclose on the loan, during which time interest payments accrue but are not received by the lender.

[4]This example, like the preceding example, assumes that interest payments accrue but are not received during the 2 years it takes to foreclose on the loan.

might be derived by using such tables. Specific credit enhancement requirements depend on features that are specific to the loans or to the pool, including payment structure, DSCR, loan seasoning, loan size and pool concentration, geographic concentration, loan rates (fixed versus variable), underwriting quality, real estate quality, and pertinent legal issues. Adjustments to the price of the credit enhancements depend on how these features affect expected default rates and related losses.

Payment Structure

Mortgage payments can be structured in various ways, each with different implications for default risk. For example, according to a study of the portfolios of major life insurance companies from 1920 to 1946, multifamily housing loans that are not amortized default just over twice as often as fully amortized multifamily loans, on average. S&P has reported that more recent data tend to support that statistic. Moreover, if loans are maturing at a time when refinancing is not readily available, greater levels of risk may be experienced for balloon mortgages—mortgages that require full payment of principal on a specified future date.

Debt Service Coverage Ratio

As previously discussed, the DSCR is S&P's primary indicator of the probability that multifamily loans will default. S&P relies more heavily on this ratio than on the LTV because the DSCR is a more precise number, based on current debt service and a project's net operating income. Conversely, it is more difficult to precisely determine property values and therefore LTVs. When there is a bona fide discrepancy between the two ratios (for properties with significant equity raised through the sale of tax credits but a DSCR near 1.15, for example) the expected foreclosure frequency, as shown in table 5.3, will correspond to the DSCR, while the loss of principal will correspond to the LTV.

Seasoning

Before any adjustments (positive or negative) are made for loan seasoning, it is necessary to review the local and regional economy where the properties are located. Seasoned loans are normally considered less likely to default than newly originated mortgages, but this may not be true for seasoned loans in economically depressed areas.

Loan Size and Pool Concentration

Loan size concentration refers to pools in which certain loans in the pool are disproportionately large in comparison with others. A default on such a loan would have serious implications for the entire pool. S&P believes that concentration in a pool makes probability theory, such as that used in table 5.3, less useful for pricing credit enhancements. Therefore, S&P would assume an increased default frequency for pools of this type.

Geographic Concentration

Many pools of loans will be representative of the lender's normal market areas. For most lenders, this will lead to pools concentrated in one state or region. However, pools that are distributed over multiple regions often achieve reduced risk and loss coverage from this geographic diversification. According to S&P, well-diversified pools may be able to substantially reduce the amount of credit enhancement needed.

Fixed Versus Variable Rates

Variable-rate loans are inherently riskier for an investor. Investors may benefit as the yield rises with the rising cost of funds, but the risk that the borrower will default is greater. The potential for payments to rise lessens the importance to the investor of an established payment history for the borrower, since there is less certainty that a borrower, or a property, will have the capacity to meet higher future debt service payments. S&P expects variable-rate loans to default 1.25 times more frequently than fixed-rate loans, not only because the variable rate affects the periodic payments but also because the changing payment stream affects the DSCR.

Underwriting Quality

The quality of underwriting used to purchase loans is another important factor to consider in evaluating the quality of individual loans or loan pools. According to S&P, individual loans or loans being pooled should be representative of the originator's portfolio with regard to location, LTV, appraisal, and credit approval processes. In S&P's view, the servicer should also have at least 5 years' experience with multifamily mortgages and should provide the institution purchasing the loans with financial statements, portfolio data, and delinquency and foreclosure data for the past 5 years.

In addition, in underwriting individual loans or loan pools, the quality of the underlying property will affect the level of loss coverage needed. Loans secured by poor-quality properties are more likely to default because a borrower in financial difficulties may have less incentive to keep paying.

For lenders and/or secondary market institutions with superior loan performances, adjustments in both the DSCR and LTV assumptions could be considered to reflect this performance. For example, if a lender with a 20-year record can document that its losses for loans with a 1.15 DSCR has only been 3 percent instead of 9 percent (as assumed in table 5.3), a partial downward adjustment in the price of the credit enhancement could be made to reflect this improved performance. On the other hand, the lender's limited geographic diversity could require an increase in the price

of the credit enhancement, possibly cancelling out the adjustment for the superior loan performance of its portfolio.

Real Estate Quality

When credit enhancements are provided for specific property transactions, the quality of the real estate may require adjustments to the price of the credit enhancements. Among the factors that affect the quality of specific properties are location; the diversity of the local economy; competition from other rental properties; zoning requirements; vacancy rates; length of existing leases; property history; quality of the property management; construction quality and energy efficiency; and access to schools, shopping, and other services. Because of the influence of these factors on pricing, local lenders are often in the best position to evaluate the risks associated with each factor.

Legal Issues

The minimum legal issues to be reviewed in pricing credit enhancements are the financial status of the originator who is requesting the credit enhancement, the existence of appropriate liens on all pledged properties, and the validity of all leases for properties pledged as collateral for credit enhancements.

OMB May Price Credit Enhancements Using Yield Differentials

OMB discussed with us two ways of calculating the subsidy costs to the federal government of providing credit enhancements, as required by the Federal Credit Reform Act. OMB's preferred method would be to build an econometric model using reliable data on multifamily loan performance. OMB would then be able to predict expected losses on the basis of its expectation of future economic conditions. Such an econometric approach could produce a matrix similar to that of Standard & Poor's.

However, OMB officials stated that if adequate performance data are not available, they could use an alternative approach, based on comparing the yield differentials—that is the different interest rates—between securities with AAA ratings and the rating that securities backed by multifamily loans would have received without federal credit enhancements. Under this approach, the difference in yields is the implied federal credit enhancement subsidy. Because yield data can be readily obtained, OMB officials say they are considering using this approach until adequate data become available for econometric modeling of subsidy costs.

In this approach, the cost of the federal credit enhancement can be illustrated by the following example: A $100 million pool of multifamily mortgages receives a federal credit enhancement, giving the pool a AAA

rating. With the credit enhancement, these loans will have an average interest rate of 8 percent and will be fully amortized over a 30-year period. These factors would require a yearly payment of principal and interest of about $8.9 million. The same mortgage pool, without a federal credit enhancement, may have a BB rating and require an interest rate of 11 percent. To calculate the cost of the federal credit enhancement, the payment stream at the AAA rate is discounted using the BB interest rate of 11 percent. The present value of 30 yearly payments of $8.9 million, discounted at 11 percent, is $76 million.

The difference in present values represents the value of the federal credit enhancement. In the above example, the subsidy resulting from the federal credit enhancement is $24 million ($100 million minus $76 million), which is the amount the Congress would need to appropriate to meet the requirements of the Federal Credit Reform Act. This difference of $24 million is the amount that would have to be raised in premium fees to avoid the need for any congressional appropriation.

Approaches Chosen Significantly Affect Costs of Federal Credit Enhancements

As the above examples show, the different approaches result in large differences in the estimates of the reserves needed to meet the funding requirements of the Federal Credit Reform Act. Depending on the estimating procedure, the premium or reserve requirement could be so large that the cost of credit enhancement would be prohibitive.

Credit rating agencies like Standard & Poor's use a BBB rating to estimate losses over several economic cycles and a AAA rating to determine losses under "stress test" conditions. In our example, the BBB rating resulted in a reserve requirement/premium of 4.7 percent. However, if Standard & Poor's model is applied to a pool for which a AAA rating is desired, reserve requirements must be adequate to cover catastrophic losses—those likely to occur in a severe economic downturn. In our earlier example, this approach results in a reserve requirement/premium of 11.7 percent—about 2.5 times greater than the reserves projected to be needed for a BBB rating. However, using the yield differential approach, our example would require a reserve of 24 percent—about 5 times greater than the reserve needed for a BBB rating.

We did not evaluate the data set Standard & Poor's used to develop tables 5.1 through 5.3. However, to the extent that OMB could initially use these data to develop an econometric model—to be refined as better data become available—the reserve requirements appear to be lower than

those resulting from the yield differential approach. The yield differential approach results in higher reserve requirements because it requires reserves sufficient to withstand catastrophic losses.

Several Issues Must Be Addressed in Developing an Effective Data Base

In passing the Housing and Community Development Act of 1992, the Congress reaffirmed the need for a national data base on the performance of affordable multifamily housing loans. Accordingly, it authorized the establishment of an interagency task force on multifamily housing and charged it with developing recommendations for establishing a national data base on multifamily housing loans, as described in chapter 4. However, as of August 1993, the Congress had not appropriated funds to carry out the task force's activities.

Among the critical functions that the legislation directs the task force to complete to improve the availability and efficiency of financing for multifamily rental housing are to

- "prepare a comprehensive national database on the operation and financing of multifamily housing that will provide reliable information appropriate to meet the projected needs of lenders, investors, sponsors, property managers, and public officials;
- "identify important factors that affect the long-term financial and operational soundness of multifamily housing properties, including factors relating to project credit risk, project underwriting, interest rate risk, real estate market conditions, public subsidies, tax policies, borrower characteristics, program management standards, and government policies; and
- "develop common definitions, standards, and procedures that will improve multifamily housing underwriting and accelerate the development of a strong, competitive, and efficient secondary market for multifamily housing loans."

In discussions with individuals from the institutions to be represented on the task force, we found that all agreed on the benefits of having improved data. However, as we pointed out in our April 1992 testimony,[5] aside from determining the organizational forum for collecting and analyzing data on affordable multifamily loan performance, it is also important that several critical policy and technical issues be resolved. In our testimony, we cited the following issues, which we continue to believe are important:

[5]GAO/T-RCED-92-52.

- Confidentiality and public access to the data. Our review showed that lenders and secondary market institutions are particularly concerned that their data remain confidential. They pointed out that any federal agency, or possibly any federally funded institution, that creates and administers the data base may be subject to the Freedom of Information Act and could be required to reveal confidential information from its sources. However, those we interviewed agreed that summaries of the data should be publicly available to provide a better understanding of many of the economic and social questions affecting loans for both conventional and affordable multifamily housing.
- Procedures for using prospective versus past loan performance. Requiring lenders and secondary market institutions to complete questionnaires for new loans is much less costly and time-consuming than requesting them to reconstruct data for their existing loans. However, limiting the data base to new loans will mean that it may only be useful 3 to 5 years in the future. Market participants with whom we spoke proposed possible hybrid solutions. For example, information on past loan performance might be required for only a small percentage of each institution's loan originations or purchases, either by random or representative sampling. However, because previous loans were originated without uniform standards or definitions of loan terms, amortization schedules, and the treatment of soft second mortgages, the utility of information on their performance would have to be carefully evaluated.
- Data and underwriting standards. There are no uniform definitions for many of the items that may be included in the data base, for example, debt service coverage with multiple mortgages. Underwriting standards also vary among lenders, particularly those who finance affordable housing projects. Broad consensus would be needed on the kinds of data to include in the data base and a common definition for each item.
- Cost and potential revenues of the data base. The task force will need to estimate the costs of developing the data base, both for the data providers and the data assembler, as well as the amount of these costs that could realistically be offset by fees charged to potential users.
- Voluntary versus mandatory status of the data base. The task force will need to determine whether supplying data should be voluntary or required by federal law. Legal issues related to mandatory participation as well as probable compliance with a voluntary data base will have to be reviewed.
- Public subsidy risk. Most market participants we interviewed favor standardization of the public subsidies that many affordable multifamily housing projects depend on. Performing such a complex task, particularly for the wide variety of local and state government subsidies in use today, will require a fundamental understanding of their effectiveness and

shortcomings. The national data base is perhaps the only vehicle that could be used for such an undertaking, because it would gather data across institutional and program lines.

Aside from addressing these policy and technical issues, the task force will have to address the clear need for a mechanism to ensure that data collection continues into the future. In our opinion, it is desirable if not essential for the task force to identify the agency or institution that it believes can best maintain data on, and serve as a clearing house for, multifamily mortgage lending. In this regard, the National Task Force on Financing Affordable Housing believed that a specialized institution—the Multifamily Housing Institute—should be created to pursue the recommendations made in its report and to serve as a permanent data clearinghouse on the performance of multifamily mortgages. Having an entity responsible for collecting and analyzing these data could help overcome many of the problems discussed here. Whether that entity should be a newly created institution or an existing federal agency is a matter we believe the interagency task force could appropriately address.

To establish the task force, the Congress authorized funding of up to $6 million for fiscal year 1993 and up to $6.2 million for fiscal year 1994. Funding for the task force, however, was not appropriated. As a result, neither the FHFB nor FHA has acted to undertake the task force's activities. Important first steps for the task force to address are standard data definitions and ongoing maintenance of the data base.

Conclusions

An improved data base on the performance of multifamily housing could provide investors with the information they need to consider increasing their investments in affordable multifamily housing, allow risk-based capital requirements to be set on the basis of statistical analysis of loan performance, and meet the requirements of the Federal Credit Reform Act. Such a data base could also help identify the key factors that affect the long-term financial and operating soundness of multifamily properties, leading to standards and other procedures that would improve multifamily underwriting and accelerating the development of a strong, competitive secondary market for multifamily loans. The October 1992 legislation creating a National Interagency Task Force on Multifamily Housing should help in developing recommendations for establishing a national data base on multifamily housing loans. However, as of August 1993, the task force had yet to be created because its funding had not yet been appropriated.

The need for improved data is particularly critical to meet the requirements of the Federal Credit Reform Act. Without accurate data, estimates of required reserve levels rely on approximations that could be in error, leading to reserves that could be either too low or excessive. The yield differential approach under consideration by OMB, for example, results in reserve requirements that are much higher than other estimates. While insufficient reserves would violate the Federal Credit Reform Act, excessive reserves could make the cost of federal credit enhancements prohibitive.

Finally, once created, we believe that the task force, in developing its recommendations for establishing a national data base, has several related policy and technical issues to address if the data base is to be effective and accepted by all participants. Among the more important issues are ensuring confidentiality and public access to the data, determining whether to include data on prospective as well as past loan performance, defining data and underwriting standards, estimating the cost of the data base to both the data providers and the data assembler, determining if supplying the data should be voluntary or required, and determining how the public subsidy risk should be handled. Because it is also clear that the data needs for multifamily housing investment will continue into the future, it is desirable that the task force include, as part of its report on establishing a multifamily housing data base, its recommendation on the agency or institution that should be permanently charged with maintaining and managing this data base.

Matter for Congressional Consideration

To establish a national data base on multifamily housing loans, the Congress may wish to consider reauthorizing and appropriating funds for the task force authorized by the Housing and Community Development Act of 1992.

Recommendation to the Secretary of HUD and the Chairman of the FHFB

We recommend that the Secretary of HUD and the Chairman of the Federal Housing Finance Board, in their capacity as cochairpersons of the interagency task force on multifamily housing, direct that the task force, once created, research and resolve several critical policy and technical issues in developing a national data base on multifamily housing. These issues concern (1) the confidentiality of and access to the data, (2) the inclusion of performance data on prospective as well as past loans, (3) the definition of items and underwriting standards to be included in the data base, (4) the question of who should bear the cost of developing and maintaining the data base, (5) the question of whether the required data

should be provided voluntarily or required by federal law, and (6) the standardization of the public subsidy risk associated with affordable multifamily housing.

Because of the ongoing need for these data, we further recommend that the Secretary and Chairman direct that the task force recommend in its report which agency or institution should be given the authority and responsibility for maintaining and managing the data base in the future.

Agency Comments and Our Evaluation

Fannie Mae and the NCSHA both agreed in their written comments on a draft of this report (see apps. VIII and IX) on the need to improve the quality and availability of data on the performance of affordable multifamily housing loans. HUD and Freddie Mac, in various meetings with us, also concurred on the need to improve the quality and availability of data on the performance of these loans. However, reportedly because of the lack of funding, neither HUD nor the FHFB has initiated actions relating to their joint responsibility as the cochairpersons of the National Interagency Task Force on Multifamily Housing. Given the critical importance of reliable data, we encourage that this effort be undertaken as soon as funding becomes available.

Predominant Forms of Mortgage Credit Enhancement

Mortgage Insurance

Mortgage insurance can be used by itself or in conjunction with other enhancements to transfer risk in case of defaults. Insurance for multifamily mortgages is primarily provided by the Federal Housing Administration (FHA) within the Department of Housing and Urban Development (HUD). Unlike single-family mortgage insurance, private multifamily mortgage insurance is generally not offered by U.S. insurance companies.

Guarantees

Guarantees are promises by a third party to pay security holders when the issuer of the security fails to do so. One government agency—the Government National Mortgage Association (Ginnie Mae) and two government-sponsored enterprises—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—provide guarantees. These guarantees are preferred by investors because the government promises to stand behind Ginnie Mae securities in the case of default on underlying mortgages and because investors perceive that the government also stands behind Fannie Mae and Freddie Mac.

Recourse Agreements

Recourse provisions are agreements made between originators and secondary market institutions that require the originator to cover losses on a loan or loan pool up to an amount contractually agreed upon. Recourse agreements can also require an originator to repurchase a nonperforming loan at full face value. Rather than making a cash payment, originators may be allowed to replace a nonperforming mortgage with a performing one.

Spread Accounts

Spread accounts occur when interest earned on loans in the underlying pool is higher than the interest paid on securities issued by the secondary market participant. These excess amounts are accumulated in an escrow account and are used to cover any losses that may occur.

Overcollateralization

In overcollateralization, a lender or investor requires that an individual loan or security be backed by collateral that exceeds the market value of the loan or security in order to minimize the risk of loss through default. For example, mortgage-backed bonds issued by some private entities may be collateralized by a pool of mortgage loans or mortgage-backed

securities that may range between 125 and 240 percent of the bonds' total face value.

Examples of Successful Lender Consortia for Affordable Multifamily Housing

Local initiatives have evolved for financing affordable multifamily housing despite the regulatory changes and other market impediments noted in chapters 2 and 3. This appendix describes the records of successful housing lenders for this market in New York City, Chicago, and California.

Community Preservation Corporation

One of the largest and perhaps best-known of the bank consortia is the Community Preservation Corporation (CPC), established in New York City in 1974 by some of the largest banks and savings and loan institutions (S&L). Today, CPC's investors include 47 commercial and savings banks and 7 insurance companies.

CPC has financed the construction and rehabilitation of more than 28,000 affordable rental units in the city's low- and moderate-income neighborhoods; its total public and private investment through June 1991 amounted to over $780 million. As of this date, CPC had incurred no loan losses. CPC has worked to help New York City's housing agency streamline its procedures and better target its public subsidies. At the same time, CPC has kept its sponsoring institutions informed about public housing programs and has encouraged these institutions to invest in viable housing projects.

According to the President of CPC, the corporation discovered a new market of small owners "who had little or no access to financing"—a market that had not been anticipated by CPC's founding institutions. More recently, CPC has established relationships with several nonprofit housing developers to finance affordable multifamily housing.

Saving Associations Mortgage Company

The Savings Associations Mortgage Company (SAMCO), a consortium of S&Ls in California, was established to provide both construction and permanent financing for low- and moderate-income housing throughout the state. When SAMCO began in 1971, it focused only on single-family housing loans. In 1985, SAMCO stopped providing single-family loans; it has since originated exclusively multifamily mortgage loans.

A typical SAMCO mortgage loan has a 10-year adjustable rate with monthly payments based on a 30-year amortization schedule. The mortgage interest rate is set at the San Francisco Federal Home Loan Bank's 10-year rate, plus 2 percent for projects with 36 units or fewer and 2.25 percent for projects with more than 36 units. The adjustable rate has a combined 4-percent interest rate cap; each borrower is charged a 2-point origination

fee. About 75 percent of SAMCO's borrowers are nonprofit organizations. Through July 1991, SAMCO had originated 101 mortgages totaling over $90 million.

None of these loans has ever been sold on the secondary market because SAMCO's Board of Directors prefers that each participating S&L hold a pro rata share in its own portfolio. The rationale for this decision appears to be partly that the yields are above average, making it attractive for the institutions to keep the loans, and partly the belief that the loans would probably not meet Fannie Mae's or Freddie Mac's national underwriting criteria. According to SAMCO's new Executive Director, however, the board has decided to begin selling seasoned SAMCO loans, largely because of the new risk-based capital requirements.

SAMCO has never had any loan defaults or workouts. Two borrowers did fail to pay their real estate taxes but did not go into foreclosure. SAMCO's Executive Director attributes most of this success not only to sound underwriting at the beginning of the loan but also to monitoring after the loan is closed. For each property it invests in, SAMCO receives quarterly and annual financial reports and conducts annual physical inspections.

Community Investment Corporation

Although the Community Investment Corporation (CIC) began operations in Chicago in 1974 as a single-family housing lender, it began to focus exclusively on multifamily housing in 1984. Today, a total of 37 banks and S&Ls and the Methodist Church Board of Pensions are investors in CIC.

Since 1984, CIC has loaned more than $146 million to 282 multifamily housing projects, totaling about 8,000 units. Over 25 percent of these buildings were vacant before CIC acquired them. The need for affordable multifamily housing finance in Chicago is reflected in the age and condition of the current housing stock. Specifically, over 70 percent of the city's apartment buildings are more than 50 years old, an age at which buildings frequently require major repairs and systems upgrades.

Despite the recession in real estate, 1991 was CIC's best year. Investments totaling $33 million helped rehabilitate 1,829 units. As of December 1992, CIC's loan-loss ratio (actual losses) was 0.21 percent for total loans approved and 0.55 percent for projected losses.

Affordable Housing and Community Investment Programs

Created by the Federal Financial Institutions Reform and Recovery Act of 1989, the Affordable Housing and Community Investment programs operate within the Federal Home Loan Bank (FHLB) system. One purpose of the programs is to encourage member institutions of the FHLB system to finance affordable multifamily housing.

Affordable Housing Program

The Affordable Housing Program (AHP) subsidizes the interest rate on loans or provides direct subsidies to FHLB system members engaged in long-term lending for owner-occupied and affordable rental housing targeted to households with very low, low, or moderate incomes. Subsidies—which are allocated semiannually through a competition—are designed to encourage member institutions to increase their support for affordable housing.

AHP subsidies must be used to finance the purchase, construction, and/or rehabilitation of

- owner-occupied housing for households whose income does not exceed 80 percent of the area's median income or
- rental housing, in which at least 20 percent of the units are occupied by and affordable to very-low-income households—earning 50 percent or less of the area's median income—for the remaining useful life of such housing or the mortgage term.

AHP regulations (12 C.F.R. 960) identify seven priorities for AHP subsidies. Each application is evaluated on how well it meets these priorities.

The level of AHP subsidies was set by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) at a percentage of the net income of the FHLBs in the previous year: For 1993 and beyond, those subsidy amounts are

- 5 percent of net income for the FHLB system or an aggregate total of $50 million, whichever is greater, through 1993;
- 6 percent of net income for the FHLB system or an aggregate total of $75 million, whichever is greater, through 1994; and
- 10 percent of net income for the FHLB system or an aggregate total of $100 million, whichever is greater, thereafter.

The allocations in 1991 and 1992 were $59.5 million and $50 million, respectively.

According to an April 1993 study by the Federal Housing Finance Board (FHFB),[1] since 1989 AHP subsidies have been used to assist in financing about 52,900 housing units, of which 69 percent were renter-occupied and 31 percent were owner-occupied. Moreover, 60 percent of the units went to very-low-income households—those with incomes at or below 50 percent of the area's median income.

Community Investment Program

The Community Investment Program (CIP) provides funds for community-oriented mortgage lending; that is, loans to

- finance home purchases by families whose incomes do not exceed 115 percent of the area's median income,
- finance the purchase or rehabilitation of rental housing to be occupied by families whose incomes do not exceed 115 percent of the area's median income, and
- finance commercial and economic development activities that benefit low- and moderate-income families (with incomes at 80 percent or less of the area's median) or activities that are located in low- and moderate-income neighborhoods.

Unlike the AHP, the CIP is not a competitive program, and the loans made by the FHLBS to member institutions are generally not subsidized. Individual FHLBS are encouraged, however, to charge only "reasonable" administrative costs for CIP loans.

According to the April 1993 FHFB study, since 1989 the CIP has lent over $2.7 billion. Reportedly, these loans have financed about 78,400 units: 72 percent home-ownership units and 28 percent rental units.

[1] Report on the Structure and Role of the Federal Home Loan Bank System (Apr. 28, 1993).

Credit Enhancement Options

This appendix discusses in greater detail the four options described in chapter 4 for providing federal credit enhancements for housing finance agencies' (HFA) loans and loan pools for affordable multifamily housing. GAO developed these options through discussions with officials representing the major state HFAs and the Federal Housing Administration (FHA).

Each option would require that HFAs agree to assume the expected losses on loans they originate, based on the HFAs' history of performance for affordable multifamily housing loans they originate. The federal government would cover losses beyond those expected. As we pointed out in our April 1992 congressional testimony,[1] in all four options, there is a trade-off between the risk to the federal government and the impact on the supply of affordable housing.

Option 1: Delegated Processing

To implement this option, FHA would delegate loan processing authority to each eligible HFA. FHA would be required to either approve or deny the completed loan application within a specified number of days (e.g., 60 or 90 days) of its submission, or the individual loan would be automatically approved. If FHA denies a loan, the agency would be required to explain in writing why and explain what, if any, changes should be made to make the loan acceptable. This written explanation would be provided to the HFA within 30 days after the denial. If FHA approves the loan, the agency would provide a 100-percent guarantee. However, the HFA would be required to provide a risk-sharing agreement, under which it would assume the anticipated losses of any insured mortgage loans and the first 50 percent of losses for any construction loans during the construction and leasing periods.

The anticipated losses to be assumed by each HFA would be based on the loan-loss performance record of each HFA and the specific risks of each insured loans (determined by considering, for example, the debt service coverage ratio, loan-to-value ratio, operating reserves, etc.).

Eligibility Criteria for HFAs

Any HFA with an acceptable multifamily performance record for comparable loans (size and type) over a specified number of years would qualify.

Loans Most Likely to Be Affected

Mostly larger, more complicated loans that require individual loan guarantees would be affected. Any new construction and substantial

[1] GAO/T-RCED-92-52.

rehabilitation loans would also be likely to benefit, because they require more detailed underwriting analysis than, for example, acquisition, moderate rehabilitation, and refinancing loans.

Underwriting Criteria

For HFAS with exceptional records (a highly trained staff and superior performance for a specified number of years in handling loans), FHA would defer to the underwriting criteria and local building codes of that state. For all other HFAS, modified versions of FHA's underwriting criteria and building codes would apply.

Access to Local Lenders

There would be no access to local financial institutions. It is assumed that either the HFAS will be too inexperienced to select and monitor local lenders or the loans will be too large and complex for experienced HFAS to delegate to someone else.

Advantages

- Delegated processing would be available to a larger number of HFAS than the other options.
- This option would minimize FHA's staff time and allow staff to concentrate on actual underwriting decisions.
- The specific turnaround time (i.e., 60 or 90 days) would provide HFAS with an incentive to participate in the program, while encouraging FHA to speed up its decision-making.
- The additional requirement for FHA to provide within 30 days a written explanation of why a loan has been denied and how the loan could be restructured to improve its chances for approval would also facilitate greater understanding and cooperation between FHA and individual HFAS.
- Since HFAS would remain responsible for the anticipated first losses of mortgage loans and 50 percent of losses on construction loans, the HFAS would have a strong incentive to select projects carefully and conduct their own underwriting before applying to FHA.
- Because HFAS with superior records would be allowed to use their own underwriting and state building code standards, other HFAS could be encouraged to develop a similar record that would enable them to use their own standards.

Disadvantages

- Delegated processing would require FHA to develop the capability and procedures to administer this kind of program, which, although flexible, includes deadlines for decision-making.
- This option would also require FHA to analyze each HFA's performance record (although using reviews by credit rating agencies would facilitate such an analysis) and developing standards that would distinguish those

HFAS with "superior" records. Staff expertise to carry out these responsibilities is essential; otherwise risks to FHA would be increased.

- Those HFAS that would be required to follow FHA's underwriting and building code standards may not be interested in participating in the program because of the complexity of the standards (although it is assumed that FHA would be required to be more flexible).
- The lack of participation by local lenders would limit the number and diversity of loans available to the HFAS.

Option 2: Delegated Underwriting

To implement this option, FHA would delegate underwriting to eligible HFAS for loans up to specific limits and for specific types of loans (e.g., new construction, substantial rehabilitation, and refinancing loans). These loan limits and the types of loans eligible would increase over time as HFAS demonstrate their ability to originate and monitor larger, more complex loans. FHA would provide a 100-percent loan guarantee for individual loans. However, HFAS would be required to assume the top percentage of anticipated losses for permanent loans (depending upon the loan's debt service coverage ratio, loan-to-value ratio, and operating reserves and the HFAS' performance record for comparable loans) and 100 percent of the risk on construction or rehabilitation loans until the project achieved a break-even occupancy rate. If HFAS used local lenders in this program, the lenders could be required to assume 100 percent of the risk during the construction and leasing period, but only minimal risk during the permanent mortgage, because of federal risk-based capital requirements.

Eligibility Criteria

Only those HFAS with successful multifamily performance records for comparable sizes and types of loans, a specified number of years of underwriting experience, and a strong staff with experience in underwriting and monitoring these types of loans would be eligible.

Loans Most Likely to Be Affected

The size and type of loan most likely to be affected would depend on the size and type of loans HFAS (and participating local lenders) had successfully originated and serviced.

Underwriting Criteria

The underwriting criteria and state building codes applicable to participating HFAS would be used.

Access to Local Lenders

Access to local financial institutions would be limited, depending upon their record for underwriting and servicing loans comparable to those the HFAS specialized in originating. Access would vary according to the size

and diversity of each state and the potential demand for comparable loans throughout the state.

Advantages

- Participating HFAS would be authorized to commit FHA to insuring 100 percent of the loan amounts without prior approval by FHA (it is assumed that FHA would conduct annual audits on a sample of loans to determine the HFAS' compliance).
- The percentage of the top risk the HFAS would assume would vary with each loan, depending upon its risk characteristics and each HFA's record of originating comparable loans.
- HFAS would apply their own underwriting criteria, including applicable state building codes, instead of federal standards, which should greatly encourage HFAS to participate in this program.
- HFAS would be encouraged to specialize in particular types and sizes of loans and to develop a good record in order to participate in this program. FHA could remove a participating HFA whose performance begins to deteriorate from this program after a hearing to determine the HFA's record.
- Experienced local lenders with a successful record of originating and servicing comparable loans would be given access to permanent mortgage loans that are generally not available today. For projects involving loans for construction or substantial rehabilitation that use local lenders, the lenders could be required to provide construction loans directly and assume 100 percent of the risk during the construction and leasing period. In exchange, HFAS would provide a permanent mortgage loan with no recourse. Local lenders could also continue to service these loans for the HFAS for a fee.

Disadvantages

- FHA would have to carefully select participating HFAS. These HFAS would have to develop reliable projections of losses for different types and sizes of loans to determine the top percentage of losses that would be assumed for each loan.
- The quality of each HFA's staff may change with the departure of one or two senior persons, significantly affecting the performance of the HFA's program for multifamily housing loans. FHA's early detection of this and other potential problems associated with specific HFAS is needed for proper implementation of this kind of risk-sharing program.
- The number of HFAS that would be eligible to participate in this program would be limited.
- A deterioration in a particular state's economic conditions could seriously affect the viability of this program and increase FHA's risk exposure beyond anticipated losses.

Option 3: Primary Bond Insurance

To implement this option, FHA or the Government National Mortgage Association (Ginnie Mae) would provide primary bond insurance on HFA bonds, involving a minimum loan amount and number of loans. No single loan would be greater than about 10 to 20 percent of the total bond. The insurance would also cover timely payments of interest and principal to investors. An HFA would be required to assume the top portion of the projected losses in the loan pool. A procedure similar to the Standard & Poor's (S&P) loan pool loss matrix described in chapter 5 could be used to calculate expected losses. However, the actual losses for each HFA could be substituted for S&P's data if it is determined that there is sufficient loan volume and seasoning to rely on the HFA's past performance for comparable loans. The HFA would be responsible for 100 percent of the risk during the leasing period for new construction and substantial rehabilitation loans. HFA bonds would only be eligible if they covered buildings with at least 50 percent of the units serving households with 60 percent or less of the area's median family income. It is likely that HFA bonds rated internally as BBB or lower (without any additional insurance, but including normal reserves) would be the primary beneficiaries of this option.

If HFAs otherwise eligible to participate in this program lacked the loan volume (including participation by local lenders) to create bonds large enough to justify normal bond expenses, either FHA or Ginnie Mae could be given the authority to provide a credit enhancement to pool the loans from several participating HFAs. Such a "multistate" HFA security would have to be (1) issued by a qualified financial intermediary like an investment banking firm and (2) certified by FHA or Ginnie Mae.

Eligibility Criteria

Only those HFAs that have had superior performance records for comparable loans for a specified number of years and that maintain a high-quality staff and loan performance record for multifamily mortgages would be eligible. FHA or Ginnie Mae would be required to monitor each HFA's performance at least annually and certify that the HFA continues to meet performance and staffing requirements.

Loans Most Likely to Be Affected

Mostly small- to medium-sized loans ($250,000 to $2 million) involving a broad range of financing, including projects receiving tax credits, would be affected.

Underwriting Criteria

Underwriting criteria would be the same as those under option 2, delegated underwriting.

Access to Local Lenders

This option would be available to local financial institutions with relatively large loan volumes that the HFA otherwise could not directly serve. Participating lenders would be required to meet specific minimal standards before becoming eligible (such standards and decisions would be the exclusive responsibility of each participating HFA).

Advantages

- Primary bond insurance should generate a high volume of loans for affordable housing that either are not being originated today or are being offered with short terms and variable rates that increase credit risks.
- This option should provide faster and more extensive access to HFA financing through local participating lenders for small- and medium-sized loans with minimal risk to the HFAs and local lenders. (The former take the long-term credit risk and the latter the short-term market and construction risk.)
- The federal government would not be involved in the underwriting process. Only minimal audits after loans have been originated would be needed as long as the HFAs' loan performance remains high and there is no decline in their credit rating. The federal government's major responsibility would be to select "superior" HFAs with excellent performance records for comparable loans and to determine whether to allow the HFAs to substitute their loan performance data for that of S&P.
- HFA bonds with credit enhancements from FHA or Ginnie Mae would receive AAA+ credit ratings and provide liquidity to investors, particularly state pension funds that have been reluctant to purchase HFA bonds without this type of credit enhancement.
- The availability of insured mortgage-backed securities with a AAA rating would significantly increase the access of these HFAs to public capital markets that are otherwise closed to them.
- This option would yield the same advantages in underwriting as option 2.
- FHA would not compete with private bond insurers since they are rarely interested in bonds with BBB ratings or lower.

Disadvantages

- New responsibilities would require the entity providing the credit enhancement to have the trained staff to do the required reviews. FHA and Ginnie Mae would have to work cooperatively to establish new risk-based performance data systems to determine the eligibility of different HFAs and HFA loan pools. Once these systems were established, they would have to be monitored regularly to detect any potential problems at an early stage.
- HFAs with small staffs could have serious problems monitoring loans by local lenders with substantial loan volume.
- This option would present regional market problems similar to those discussed under option 2.

- Investment banking firms' ability to create multistate loan pools by purchasing small loans from several HFAS could be hampered by problems in logistics and interest-rate risk.

Option 4: Bond Reinsurance

To implement this option, private bond insurers would provide the primary bond insurance to HFAS, and FHA or Ginnie Mae would provide reinsurance on their policies. This option would work for HFA bonds with credit ratings of A or better that do not cover buildings with the 50-percent minimum affordability test discussed in option 3. This reinsurance would not cover more than 50 percent of the primary insurers' losses and assumes that private bond insurers would provide the primary credit enhancement.

Eligibility Criteria

Eligibility criteria would be the same as for option 3, except that smaller HFAS with lower loan volumes would probably not be able to participate unless a regional or national investment banking institution was willing to issue a regional or national bond involving several HFAS.

Loans Most Likely to Be Affected

This option would probably result in fewer new construction and substantial rehabilitation projects and somewhat larger loans, because private bond insurers tend to be averse to risk.

Underwriting Criteria

Underwriting criteria would be same as those under option 2, delegated underwriting.

Access to Local Lenders

Access to local financial institutions would be more limited than for option 3 and possibly even option 2, because bond insurers may be reluctant to delegate underwriting to local lenders with whom they are not familiar.

Advantages

- The government reinsurance that characterizes this option should give HFAS with larger loan volumes and previous credit rating experience much easier access to private bond insurers. This credit enhancement should also increase market acceptance of these bonds, again because of the federal government's involvement. Government involvement should interest private bond insurers that may want to increase their housing bond business with less additional risk (and therefore lower capital reserves).
- Advantages are similar to those of option 3 except that local lenders' participation may possibly be limited.
- The federal government would have less risk exposure and responsibility for monitoring loan pools because of the private sector's increased

involvement. Less federal risk will also mean lower congressional appropriations needed to offset possible losses, as required by the Federal Credit Reform Act.

Disadvantages

- HFAS would depend on private bond insurers' willingness to provide primary credit enhancement for these bonds on the condition that the federal government commits to provide reinsurance. The relationship between each of these bond insurers and either FHA or Ginnie Mae would have to be worked out in detail before such a program could operate nationally.
- Some HFAS may find it too difficult to provide the reserves and collateral that bond insurers require, even with government reinsurance.
- If a private bond insurer experienced serious financial difficulty (and therefore a lower credit rating), the federal government might be required to assume some of the bond insurer's liability to maintain the bond's economic viability. (Lower credit ratings usually cause a technical bond "default," which would require that the bond be refinanced.) Since bond insurers are only regulated by state governments, FHA or Ginnie Mae may have little control over such situations unless their control is agreed to by all participating parties as a condition of the federal government's commitment to provide reinsurance.
- The premiums charged by the bond insurers may be too high for some housing projects to afford.

How Credit Enhancement Options May Be Used by Federal Home Loan Banks, Fannie Mae, and Freddie Mac

This appendix briefly describes how the Federal Home Loan Banks (FHLB), Fannie Mae, and Freddie Mac might choose to use the credit enhancement options discussed in chapter 4. The examples cited in this appendix are not meant to be all inclusive, but rather are intended to illustrate the flexibility of the options proposed.

Federal Housing Finance Board and Federal Home Loan Banks

Currently, the FHLBS make loans to member institutions under the Affordable Housing Program (AHP) and Community Investment Program (CIP). These loans, in turn, can be used by the member institutions to originate mortgages, as described in appendix III. These mortgages are then held in the institutions' portfolios.

To help mitigate the credit risk and thereby reduce the institutions' risk-based capital and collateral requirements on these mortgages, under option 2 (delegated underwriting), FHA could provide insurance for up to 50 percent of the mortgages on individual multifamily housing loans approved by the regional FHLBS and the Federal Housing Finance Board (FHFB). To be consistent with other federal housing programs, FHA may want to limit its insurance on loans under the Community Reinvestment Act to those projects targeted to serve lower-income households.

To maintain a "wholesale" position, it would be preferable for FHA to have separate mortgage insurance agreements with each FHLB. These banks in turn could execute separate agreements with individual lenders. It may also be desirable to limit these agreements to lenders that (1) satisfy minimum capital standards established by their respective regulatory agency, (2) are not on the regulatory agency's "watch list" of troubled institutions, and (3) have a multifamily loan portfolio whose performance is at or above average. Participating lenders who meet these qualifications could benefit because their credit risks would be lower and their risk-based capital and collateral requirements should also be lower. This option could be particularly beneficial to small lenders that may be reluctant to assume the full credit risks of affordable multifamily housing loans.

Fannie Mae

The Community Preservation Corporation (CPC)—the New York-based bank consortium described in appendix II—and Fannie Mae recently agreed to exchange $50 million worth of newly originated multifamily mortgages for $50 million in mortgage-backed securities using a senior-subordinated note structure. In this arrangement, CPC agreed to

retain exposure for the top 10-15 percent of potential losses. As an additional credit enhancement, CPC agreed to establish a loan-loss reserve fund for each loan. The reserve will be funded by increasing the mortgage interest rate by one-tenth of a percentage point.

The senior portion of the mortgage-backed securities will be guaranteed by Fannie Mae and is therefore likely to be priced between 85 and 95 basis points[1] above comparable U.S. Treasury securities. Since the subordinated notes are higher-risk debt instruments, they will be priced at 350 basis points above comparable U.S. Treasury securities. The yield requirement on the mortgages originated will be the blended rate on the mortgage-backed security plus Fannie Mae's insurance premium, the fee to establish the loan-loss reserve, and any insurance premium required by the credit enhancer.

The required interest rate on the underlying mortgages could potentially be reduced by applying option 3 (primary bond insurance) to this arrangement. Specifically, FHA could provide bond insurance for the subordinate notes in exchange for a risk-sharing agreement from CPC. Under such an agreement, CPC would agree to pay 50 percent or more of any losses incurred on the subordinated mortgage-backed securities. With this FHA credit enhancement, these subordinated notes should be priced at lower interest rates, because the market places the highest value on federal insurance. Thus, interest rates could be reduced for each multifamily housing project receiving this type of credit enhancement for its financing.

Freddie Mac

Under Freddie Mac's original agreement with the Local Initiatives Managed Assets Corporation (LIMAC),[2] LIMAC provided a credit enhancement by assuming the top 20 percent of losses for each loan included in each Freddie Mac mortgage-backed security. Also, each originator shared in any losses that might occur by assuming a 20-percent pro rata share of the risk for all loans it originated. Freddie Mac officials have suggested that it would be more beneficial to apply a credit enhancement on a loan pool basis. In their view, a credit enhancement absorbing the first 5-10 percent of any loan pool losses may be preferable to having a 20-percent credit enhancement on individual loans. The

[1]Each basis point is the equivalent of one one-hundredth of a percentage point. For example, 75 basis points equal three-quarters of one percent.

[2]LIMAC is a subsidiary of the Local Initiatives Support Corporation (LISC), which is one of the three primary support organizations for community development corporations.

principal rationale for this approach is that individual mortgage insurance, which under the LIMAC arrangement is limited to the top 20 percent of losses, does not protect Freddie Mac against catastrophic losses on individual loans. In addition, losses can be more accurately projected for a pool of loans than for individual loans.

Under the loan pool approach, FHA could agree to reinsure 50 percent of LIMAC's exposure under option 4 (bond reinsurance). As previously noted, the market places the highest value on government insurance. Consequently, FHA reinsurance could result in a lowering of the interest rate on the underlying mortgages. In addition, FHA reinsurance would allow LIMAC to obtain greater leverage on its existing funds and thus provide credit enhancements for more multifamily housing.

Comments From the Department of Housing and Urban Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

U. S. Department of Housing and Urban Development
Washington, D.C 20410-8000

May 19, 1993

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Ms. Judy A. England-Joseph
Director, Housing and Community Development Issues
U.S. General Accounting Office
441 G Street, N.W. - Room 1842
Washington, DC 20548

Re: GAO Draft Report-Housing Finance: Improving Financing for Affordability Multifamily Housing (GAO/RCED-93-93)

Dear Ms. England-Joseph:

This is in response to your request for comments on the subject report:

See comment 1.

1. Section 8 - As I indicated in our meeting, the primary reason for the lack of affordable rental housing is not the multifamily "credit crunch" but a limited supply of rental subsidies. Other major reasons for the decline in FHA market share, particularly in affordable housing, include the termination of the Section 8 New Construction and Substantial Rehabilitation Programs in 1983, and public policy reforms, particularly the Tax Reform Act of 1986. Over the last 30 years, FHA's share of the multifamily business sharply increased when the Department combined mortgage insurance with significant appropriations of project-based assistance (Section 236, Section 8 New/Sub Rehab).

2. The report suggests several risk-sharing options for FHA for producing affordable rental housing in partnership with HFAs, FNMA, FHLMC and others. We are aggressively pursuing these options; in fact, we plan to begin a new risk-sharing effort with HFAs in September.

3. Small projects - FHA is contracting for a study to streamline FHA processing of small, less than 50-unit project mortgages. We believe that this streamlining, in addition to new program partnership efforts with the secondary market, the Federal Home Loan Banks and others, will assist us in financing smaller project loans.

4. National Interagency Task Force on Multifamily Housing - this task force is supposed to make recommendations for establishing a national data base on multifamily loans. GAO asked about this in the meeting but we are not aware of anyone in the Department who was given the assignment to work on setting up the task force.

5. Specific comments:

Now on p. 35.
See comment 2.

p. 39 - As noted herein, poor performance of the coinsurance programs contributed to FHA's decreased activity. More important, however, were the public policy reforms, particularly the Tax Reform Act of 1986, and the termination of HUD's Section 8 new construction and substantial rehabilitation programs.

Now on p. 39.
See comment 3.

p.45 - While it is true that FHA activity has declined for reasons noted above, in recent times, full insurance applications have increased dramatically - approximately 30 percent since April of 1992. We also point out that staffing cutbacks of the 1980s and loss of experienced personnel made processing full insurance applications more difficult.

Now on p. 41.
See comment 4.

p. 49 - The paper mentions the lack of an effective secondary market for affordable multifamily loans. The report should consider the beneficial role of GNMA as a secondary market for FHA insured loans. Please note, however, that the GNMA $500,000 minimum for project mortgage securities inhibits small projects.

Now on p. 54.
See comment 5.

p.66 - We will review the claims information presented with our Comptroller's Office. We have several concerns. The first loans under Section 223(f) were not endorsed until 1975. The Section 221 program started in approximately 1962. The failure rates cited by Price-Waterhouse for the Section 221(d)(3) program probably include the subsidized Section 236 Program in 1968. We concur that insufficient FHA staffing and computer resources have been long-standing problems. With regard to small project loans, please note that FHA is contracting for a study to streamline our procedures and to make such financing more attractive to small projects. Again, the GNMA $500,000 minimum is also a problem in connection with small project loans.

Now on p. 54.
See comment 6.

p. 67 - HUD Regional Offices are currently reviewing responses to the Request for Proposals for Delegated Processing II which we hope will expand the number of delegated processors nationwide and also streamline the selection process for each application.

Now on p. 60.
See comment 7.

p. 74 - We have noted that FHA is contracting for a study to streamline the underwriting process and make FHA insurance more attractive to both lenders and sponsors. We are also aggressively pursuing new program partnerships with the secondary market, FHLBs and others to make FHA insured financing more readily available to small projects.

Now on pp. 69-71.

p. 86-89 - Options for FHA

1. Delegated Processing - You suggest that HFAs and other lenders can originate loans and submit them to FHA to either approve or deny within a specified period of time. Our only comment is that the processing times would have to be more realistic (60-90 days) to give FHA time to complete statutory mandated reviews like the environmental. You correctly note that these loans would be more complex and difficult. We believe implementation would require multifamily development responsibilities and staffing in the Field Offices to be significantly modified. Deadlines of 30 days for market approvals in coinsurance were a major problem in some offices.

See comment 8.

2. Delegated Underwriting - This option is similar to our risk-sharing demonstration except that the HFAs take the top portion of the risk and 100 percent of the risk on construction loans until the project reaches break-even. We will investigate this option further. Again, we have some staffing concerns to be addressed in implementation.

3. Primary Bond Insurance - This option would require that HUD evaluate HFAs' loan pools and establish risk-based performance data systems. We are currently considering such options; however, there are similar staffing and training issues.

4. Bond Reinsurance - Under this option FHA or GNMA would reinsure private bond insurers who provide primary bond insurance to HFAs. We will consider this option and the specific staffing needs for development and implementation. Options 3 and 4 may require use of outside contract personnel.

Now on p. 72.
See comment 9.

p. 90 - We would be pleased to work with you in development of flexible underwriting standards that reflect local adaptations and rely on the capacity of the lender. If you have any specific suggestions, I hope you will share them with us.

Now on p. 77.
See comment 10.

p. 97 - Conclusion - While the "limitations on FHA's activities" are very real, I hope that GAO's report would also indicate the significant adverse effect of inadequate staff and automation on HUD's ability to move forward on the development, implementation and administration of efforts recommended. Over the next year, we will pursue many of the options indicated, looking to assistance from our partners in these efforts and making increased use of consultants and contractors.

Now on p. 78.

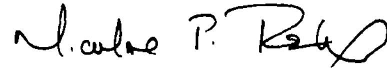
p. 99 - We concur with your suggestion that HUD convene one or more conferences of institutions specified in the risk-sharing legislation to develop the required consensus among the participating institutions on the policies needed to implement the demonstration programs. HUD Headquarters has already

conducted such a meeting with State and local HFAs on Section 542(c).

Now on pp. 97-98.

p. 125 - FHA already has extensive data on FHA insured loans on Form 92410, and we will be happy to discuss sharing such information. Currently, we are struggling to obtain the staffing and computer capacity needed to enter it into our system.

Sincerely,



Nicolas P. Retsinas
Assistant Secretary for Housing-
Federal Housing Commissioner

The following are GAO's comments on the Department of Housing and Urban Development's letter dated May 19, 1993.

GAO's Comments

1. We agree with FHA that the limited supply of rental subsidies and major changes in public policies have been the primary causes for the lack of affordable rental housing. These impacts are discussed in chapters 1 and 2 of our draft and final reports.

2. We have revised the report to include HUD's point on the public policy reforms that have been the primary reasons for FHA's reduced role in multifamily mortgage activity (see ch. 2).

3. HUD's observation regarding staffing problems is consistent with the findings of HUD's Office of Inspector General and the concerns expressed by industry officials. These findings and concerns are discussed in chapter 3 of our draft and final reports.

4. Neither the draft nor the final report highlights the beneficial role of Ginnie Mae in facilitating a secondary market for FHA-insured loans given FHA's recent limited activity. Should FHA's activity increase in the future, as envisioned in the demonstration program, we agree that Ginnie Mae could assist in the establishment of a more efficient secondary market for affordable multifamily housing loans.

5. The figures presented in our report are consistent with those contained in the June 18, 1992, Price Waterhouse study on the General Insurance Fund and have been characterized as such.

6. In this report, we have updated the number of delegated processors through July 31, 1993.

7. HUD's recent efforts to make FHA insurance more readily available are reflected in this final report.

8. The draft and final reports recognize the need for sufficient staff and staff expertise within FHA to carry out each of the four options. Assuming such staffing is made available, and in consideration of HUD's comments, we have revised our report to suggest that FHA's goal for rendering a decision under the delegated processing option be between 60 and 90 calendar days.

9. We believe that to a large degree, flexible underwriting standards will need to be developed through negotiations between FHA and other institutions that participate in the credit enhancement demonstration programs. FHA concurs with the desirability of convening a conference with future participants in these programs. Such a conference would be a logical place to begin these negotiations.

10. We have revised our report to further emphasize the importance of adequate staff and automated systems to HUD's ability to develop and implement the demonstration programs.

Comments From the Federal Home Loan Mortgage Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

1771 Business Center Drive
P.O. Box 4180
Reston, Virginia 22090-4180

Freddie Mac

June 3, 1993

Ms. Judy A. England-Joseph
Director, Housing and Community
Development Issues
Resources, Community and Economic
Development Division
General Accounting Office
Washington, DC 20548

Dear Ms. England-Joseph:

On behalf of the Federal Home Loan Mortgage Corporation ("Freddie Mac"), I would like to thank you for this opportunity to offer our comments on the GAO's draft report entitled Housing Finance: Improving Financing for Affordable Multifamily Housing.

It is clear from the draft that the GAO has spent a considerable amount of time and effort in attempting to address a complex and difficult issue, so we offer only a few comments for the GAO's consideration as it finalizes its recommendations to Congress.

Freddie Mac supports the establishment of and would participate in a well-structured and well-managed federal credit enhancement program for affordable multifamily housing. Credit enhancements are a useful and often necessary tool to execute affordable housing deals, and in many cases such a federal program could attract financing that otherwise might not be available. But credit enhancements alone cannot address many of the challenges involved in financing affordable multifamily housing, so it should be kept in mind that practical limits exist to the ability of any federal credit enhancement program to attract additional financing.

See comment 1.

Additionally, and more importantly, while federal credit enhancements can bring more participants to the table and help improve the credit quality of economically viable loans, they cannot transform a poorly underwritten loan into a quality loan. Sometimes the distinction between credit enhancements and subsidies is not understood, so we believe it should be made clear that credit enhancements are no substitute for credit quality, nor should they be used to encourage lending that fails to meet reasonable underwriting standards.

See comment 2.

Freddie Mac's experiences with losses in its multifamily portfolio has taught us that the prerequisites to a successful multifamily program include not only high mortgage credit quality but also proper program design, an adequate number of experienced staff to operate the program, and appropriate management and reporting controls. With this in mind, we recommend the GAO's report more fully consider the administrative weaknesses that were a major factor behind the failure of the Federal Housing Administration's (FHA's) coinsurance program in the 1980s. While the draft report

See comment 3.

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page two

does discuss the problems with the design and execution of the program, we believe more attention should be paid to the FHA's failure to assign enough trained and qualified staff to adequately manage the program and to establish effective management controls. Had the FHA properly staffed and managed the program, it would have addressed or least detected earlier the problems GAO identified, which would have substantially limited the program's financial losses.

Since the GAO's recommended four options for risk-sharing insurance arrangements depend upon the participation of the FHA, the GAO's report should specifically address these questions:

See comment 4.

- For each of the four programs, what are the staffing requirements and what management and reporting controls need to be in place to ensure its successful operation?
- Given these requirements, is the FHA currently capable of implementing and managing these programs?
- If the FHA is found to lack such capability, what corrective actions must be taken to ensure these programs are managed in a safe, sound, and effective manner?

See comment 5.

Additionally, for any credit enhancement program to work properly, it is vital for every player in a deal, no matter how major or minor its role, to think of itself as a full participant. Each must understand not only its role but also the roles of every other participant and how they interrelate. Likewise, each must fully understand not only its own risk but the total risk of the deal and how it is divided among the participants. The GAO should consider how its recommended programs can be structured to ensure that all players act as full participants.

See comment 6.

The GAO's call for flexible underwriting guidelines for multifamily mortgages is another issue we believe could be discussed more fully in the draft report. We agree in principle with the GAO, but we would add that the term "flexible underwriting guidelines" tends to mean different things to different people and thus should be more clearly defined. Flexibility should not be interpreted as meaning acceptance of multifamily mortgages that are of poor credit quality or otherwise are not economically viable.

See comment 7.

Finally, we offer some comments on the subject of developing a secondary market for multifamily mortgages. While Freddie Mac is in the process of reentering the multifamily market and intends to help create a stable secondary multifamily mortgage market, it should be kept in mind that such a market is unlikely to become as dominant in multifamily mortgage finance as it has become in single-family mortgage finance. The reason may be seen in reviewing why the single-family secondary market grew so dominant in the financing of single-family homes and determining if these same factors are present in the multifamily market.

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page three

During the 1980s the secondary market emerged as the most efficient and least expensive way to fund single-family mortgages. Freddie Mac and Fannie Mae were able to access a virtually unlimited supply of funds from the capital markets for single-family housing finance because they provided investors with guarantees against credit risk at low cost by standardizing underwriting guidelines and relying on the primary market to originate, sell, and service high-quality mortgages.

This in turn was possible because of the highly similar characteristics of single-family loans. They can be purchased without re-underwriting each loan individually and without recourse arrangements or other forms of credit enhancements (except, as required by the charters of Freddie Mac and Fannie Mae, on mortgages with loan-to-value ratios of over 80 percent). Credit quality is ensured by monitoring of sellers and quality control sampling checks to ensure loans meet published standards. The control systems themselves are straightforward because credit quality can be assessed with relatively little information (primarily loan-to-value and payment-to-income ratios) that is generally easy to verify. Finally, because the majority of borrowers occupy the houses they own, they have strong incentives against default.

In contrast, measuring and quantifying the risks of multifamily mortgages are far more difficult. Far fewer multifamily mortgages exist, and their characteristics are far less homogeneous than those of single-family mortgages. But more importantly, multifamily lending is fundamentally different than single-family lending. A multifamily property is owned for business purposes, so a multifamily loan must be regarded as a business loan that will be repaid out of the cash flow generated by the business. This requires a multifamily mortgage lender to pay particular attention to the condition of the local rental market (i.e., average rent levels, vacancy rates) and make some long-term guesses about the economic viability of the property. Additionally, because multifamily properties are investor-owned, borrowers do not have as much incentive to make payments should cash flows and equity become negative.

These characteristics make it virtually impossible to replicate for a multifamily secondary market the role the primary market plays in originating, selling, and servicing mortgages in the single-family secondary market. Indeed, Freddie Mac now acts more like a primary lender in its multifamily mortgage program than as a secondary market player; we look at each loan individually before purchase rather than buy all loans that meet objective and predetermined underwriting standards.

What all of this means is that a multifamily secondary mortgage market cannot successfully operate in the same manner as the single-family secondary mortgage market. It has to address the greater risks of the multifamily markets by doing some combination of the following: changing its operations to include more direct

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page three

During the 1980s the secondary market emerged as the most efficient and least expensive way to fund single-family mortgages. Freddie Mac and Fannie Mae were able to access a virtually unlimited supply of funds from the capital markets for single-family housing finance because they provided investors with guarantees against credit risk at low cost by standardizing underwriting guidelines and relying on the primary market to originate, sell, and service high-quality mortgages.

This in turn was possible because of the highly similar characteristics of single-family loans. They can be purchased without re-underwriting each loan individually and without recourse arrangements or other forms of credit enhancements (except, as required by the charters of Freddie Mac and Fannie Mae, on mortgages with loan-to-value ratios of over 80 percent). Credit quality is ensured by monitoring of sellers and quality control sampling checks to ensure loans meet published standards. The control systems themselves are straightforward because credit quality can be assessed with relatively little information (primarily loan-to-value and payment-to-income ratios) that is generally easy to verify. Finally, because the majority of borrowers occupy the houses they own, they have strong incentives against default.

In contrast, measuring and quantifying the risks of multifamily mortgages are far more difficult. Far fewer multifamily mortgages exist, and their characteristics are far less homogeneous than those of single-family mortgages. But more importantly, multifamily lending is fundamentally different than single-family lending. A multifamily property is owned for business purposes, so a multifamily loan must be regarded as a business loan that will be repaid out of the cash flow generated by the business. This requires a multifamily mortgage lender to pay particular attention to the condition of the local rental market (i.e., average rent levels, vacancy rates) and make some long-term guesses about the economic viability of the property. Additionally, because multifamily properties are investor-owned, borrowers do not have as much incentive to make payments should cash flows and equity become negative.

These characteristics make it virtually impossible to replicate for a multifamily secondary market the role the primary market plays in originating, selling, and servicing mortgages in the single-family secondary market. Indeed, Freddie Mac now acts more like a primary lender in its multifamily mortgage program than as a secondary market player; we look at each loan individually before purchase rather than buy all loans that meet objective and predetermined underwriting standards.

What all of this means is that a multifamily secondary mortgage market cannot successfully operate in the same manner as the single-family secondary mortgage market. It has to address the greater risks of the multifamily markets by doing some combination of the following: changing its operations to include more direct

The following are GAO's comments on the Federal Home Loan Mortgage Corporation's (Freddie Mac) letter dated June 3, 1993.

GAO's Comments

1. We agree with Freddie Mac that credit enhancements alone cannot address many of the challenges of financing affordable multifamily housing. We discuss in chapter 1 of our draft and final reports the importance of other subsidies in making housing available and affordable to lower-income households.

2. Again, we agree with Freddie Mac that credit enhancements should only be provided to properly underwritten loans and not be used as a substitute for credit quality. This point is made in both chapters 3 and 4 of the draft and final reports.

3. Freddie Mac's observation that administrative weaknesses were a major factor behind the failure of the Federal Housing Administration's (FHA) coinsurance program is included in chapter 2 of this report.

4. Chapter 4 of this report further emphasizes the importance of adequate staff and automated systems for FHA to successfully develop and implement the demonstration programs. Moreover, FHA recognizes the importance of these issues, as reflected in its comments on the draft of this report (see app. VI).

5. We agree with Freddie Mac that for any credit enhancement program to work properly, each participant must understand its role, the roles of the other participants, and how they interrelate. We further agree that each participant must also fully understand its risk, the total risk of the transaction, and how risk is shared among all participants. We believe that a starting point for reaching this understanding is the conference recommended in chapter 4 of this report.

6. We believe that our discussion of flexible underwriting guidelines in chapters 3 and 4 of the draft and final reports provide a balanced perspective on the merits and drawbacks of this concept. We have further clarified in the final report that we intend credit enhancements to be used to support only economically viable projects.

7. Many of the concerns raised by Freddie Mac regarding the development of an expanded secondary multifamily mortgage market are compatible with issues raised in chapter 3 of the draft and final reports. However, we

believe the demonstration programs, together with vastly improved data on multifamily housing loan performance, can be used to significantly expand the multifamily secondary market.

Comments From the Federal National Mortgage Association

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Larry H. Dale
Executive Director
National Housing Impact Division

September 8, 1993

Ms. Judy A. England-Joseph
Director, Housing and Community
Development Issues
Resources, Community and Economic
Development Division
U.S. General Accounting Office
441 G Street, N.W., Suite 1842
Washington, DC 20548

Dear Ms. England-Joseph:

Thank you for the opportunity to review and comment on your Report, "Housing Finance: Improving Financing for Affordable Multifamily Housing" (GAO/RACED-93-93). The Report is a thoughtful analysis of technical and policy issues surrounding credit enhancements for affordable multifamily housing.

We appreciate the GAO's acknowledgement of our major role in the industry. Fannie Mae is proud of its record of being a leader in the secondary market for multifamily loans. We are consistently in the market offering competitive prices on loans with reasonable terms -- indeed, we have purchased or credit enhanced over $3.9 billion annually between 1988 and 1992. Working with our lenders and other partners, we have carefully, over time, created the underwriting discipline and business infrastructure necessary for a sound, viable industry. And we are ready to move forward from a position of strength to expand even further the scope of our business.

The Report challenges all participants in the secondary market to do more in support of affordable housing. It is Fannie Mae's objective to further serve all segments of the affordable housing market. Indeed, Fannie Mae created its National Housing Impact Division (NHID) to focus and accelerate the company's efforts toward this goal. This challenge is also consistent with the Federal Housing Enterprises Financial Safety and Soundness Act in 1992, which, among other things, creates housing goals for both Fannie Mae and Freddie Mac. Fannie Mae is committed to meeting those goals, and we will bring all available resources to this task.

Fannie Mae The USA's Housing Partner

Judy A. England-Joseph
September 8, 1993
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One mission of the NHID is to develop specific products to finance affordable housing. As appropriate, these products may be variations of existing offerings or they may be entirely new structures. What is most important is meeting the need. Working with our partners in both the public and private sectors, we will pursue a variety of approaches and actively incorporate the most successful in the mainstream of our business.

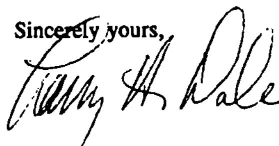
We are very interested in the potential of federal credit enhancements as a means to promote affordable housing. We are analyzing and consulting with HUD on potential creative financing structures and partnerships. The GAO's findings will greatly assist our analyses of possible uses of credit enhancements including risk sharing.

We are pleased that GAO notes the importance of consistent, reliable data for the promotion of markets for affordable housing. We fully support the call for a centralized data facility and are currently active members, along with other key players, in the development of the Multifamily Housing Institute. We look forward to working with Secretary Cisneros and other industry leaders to create and support this industry database.

We are also in complete agreement with GAO's statement that credit enhancements should be offered only to viable projects that are properly underwritten and not used in lieu of subsidies to obtain financing for marginal projects. We believe that underwriting and pricing decisions must be actuarially sound in order to ensure the long-term stability of markets for affordable multifamily housing.

Finally, we support the GAO's proposed conference of senior officials of financial institutions authorized to participate in the credit enhancement demonstration. Consensus from such a group on underlying policies and options on individual loans as well as loan pools would be most useful.

Sincerely yours,



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Comments From the National Council of State Housing Agencies

September 14, 1993

Ms. Judy A. England-Joseph
Director, Housing and
Community Development Issues
U.S. General Accounting Office
441 G Street, N.W., Room 1842
Washington, D.C. 20548

Dear Ms. England-Joseph:

The National Council of State Housing Agencies (NCSHA) thanks you for the opportunity to review and comment on GAO's proposed report, "Housing Finance: Improving Financing for Affordable Multifamily Housing." The availability of financing for multifamily housing for lower income households is among NCSHA's principal priorities.

NCSHA is a national, nonprofit organization created in 1970 to assist its members in advancing the interests of lower income people through the financing, development, and preservation of affordable housing. NCSHA is the only representative of state or local government exclusively devoted to the full range of affordable housing issues.

NCSHA's members are the state agencies which finance affordable housing in all 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands. State Housing Finance Agencies (HFAs) have issued $74 billion in Mortgage Revenue Bonds (MRB) to finance more than 1.5 million lower income families' home purchases and $26 billion in bonds to finance over 500,000 rental apartments for such households.

NCSHA's members also allocate the Low Income Housing Tax Credit (Tax Credit), which, since 1987, has financed over 500,000 apartments for low income families. In 35 states, NCSHA's members administer $675 million in HOME funds to support a wide range of affordable housing programs for low income families. In additional states, HFAs contribute to HOME administration through project evaluation and underwriting. Collectively, HFAs operate more than 600 affordable housing programs, which range from homeownership to homeless initiatives.

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HFAs are substantial players in the housing finance market with combined assets of over $78 billion. Although they are state-chartered, HFAs are required to be self-sufficient and receive no operating funds from their state governments.

We commend you on the draft report, which offers a lucid discussion of recent developments in multifamily housing finance and an excellent summary of recent legislative events in this area. We enjoyed meeting with GAO on several occasions as you examined the multifamily housing finance system and prepared recommendations for increasing the availability of capital for affordable housing activities.

NCSHA supported your April 3, 1992 testimony to the Senate Subcommittee on Housing and Urban Affairs. It contributed to the establishment of the multifamily mortgage credit demonstration programs contained in the Housing and Community Development Act of 1992 ("the '92 Act"). The options cited in the draft report, including delegated underwriting and risk sharing for HFAs, are consistent with that testimony and provide a solid framework for moving forward with the demonstration programs. In congressional hearings on multifamily housing issues, NCSHA also advocated that the Federal Housing Administration conduct a risk sharing program with HFAs.

We were very pleased that these programs were included in the '92 Act. We have been working with HUD actively for several months to implement the HFA Pilot Program, which we expect HUD will implement through an interim rule in October. This program will leverage HFAs' proven ability to finance and operate affordable multifamily housing by providing full FHA mortgage insurance on loans originated by participating HFAs which will agree to accept ranging from ten to ninety percent of the risk of loss.

We agree with your recommendation that FHA convene a conference of senior officials from financial institutions interested in the credit enhancement demonstrations. In fact, HUD has actively sought HFA involvement in the development of the HFA Pilot Program. It participated in a roundtable discussion with NCSHA and other interested parties to discuss the Risk Sharing Pilot Program which authorizes the Secretary to enter into reinsurance agreements with qualified financial institutions, including HFAs, Fannie Mae, and Freddie Mac. HUD should continue to seek aggressively and consider the comments made by HFAs and other experts in the housing finance system to make these programs as effective as possible.

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We also agree that a national effort to improve the quality and availability of information regarding the performance of multifamily loans would improve the efficiency of housing finance markets and may lead to an increase in the amount of capital invested in housing. We look forward to the efforts of Secretary Cisneros and the Chairman of the Federal Housing Finance Board to form and administer the National Interagency Task Force on Multifamily Housing established in the '92 Act.

Thank you for the opportunity to comment on GAO's report on housing finance. We commend you on an excellent and high quality effort. We look forward to continued work together to improve the financing of affordable multifamily housing.

Sincerely,

John T. McEvoy
Executive Director

Major Contributors to This Report

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Related GAO Products

Housing and Community Development Issues (GAO/OCG-93-22TR, Dec. 1992).

Pension Plans: Investments in Affordable Housing Possible With Government Assistance (GAO/HRD-92-55, June 12, 1992).

Mortgage Credit Enhancements: Options for FHA in Meeting the Need for Affordable Multifamily Housing (GAO/T-RCED-92-52, Apr. 3, 1992).

Housing and Community Development Products (GAO/RCED-92-111, Mar. 1992).

Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

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Federal Agricultural Mortgage Corporation: Secondary Market Development and Risk Implications (GAO/RCED-90-118, May 4, 1990).

Federal Agricultural Mortgage Corporation: Underwriting Standards Issues Facing the New Secondary Market (GAO/RCED-89-106BR, May 5, 1989).

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