Federal Housing Finance Agency
Office of Inspector General

Fannie Mae and Freddie Mac in the Multifamily Market

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Executive Summary

Fannie Mae and Freddie Mac (collectively, the Enterprises) provide an important source of financing for America's housing, purchasing both single-family and multifamily mortgages. They are known for their single-family businesses and support of homeownership. Their multifamily businesses and support for multifamily rental housing may be less well known and understood.

According to the Federal Housing Finance Agency (FHFA or Agency), the Enterprises' regulator and conservator, "[t]he multifamily lending businesses of Fannie Mae and Freddie Mac are fundamentally different from their single-family business lines." FHFA recognizes that multifamily mortgages are much larger and more complex to underwrite than single-family loans, and the Enterprises operate their multifamily businesses differently from one another.

The Enterprises' multifamily business programs weathered the 2008 financial crisis, generating positive cash flows. In recent years, both market-wide multifamily originations and Enterprise purchases of multifamily mortgages have grown to record levels.

During the same period, different proposals have emerged to reform the housing finance system, and there is heightened interest in the future structure of the housing finance system and the Enterprises' role in it. Much of this discussion has focused on the single-family market. In light of heightened public interest in the future structure of the housing finance system, FHFA's Office of Inspector General (OIG) prepared this white paper to explain the Enterprises' role in the multifamily market, a critical aspect of the housing finance system.

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ABBREVIATIONS

Enterprises	Fannie Mae and Freddie Mac, collectively
Fannie Mae	Federal National Mortgage Association
FHA	Federal Housing Administration
FHFA or Agency	Federal Housing Finance Agency
Freddie Mac	Federal Home Loan Mortgage Corporation
Ginnie Mae	Government National Mortgage Association
OIG	Federal Housing Finance Agency Office of Inspector General

BACKGROUND

Established by Congress, Fannie Mae and Freddie Mac perform an important role in the nation's housing finance system. They provide liquidity (ready access to funds on reasonable terms) to the thousands of banks, savings and loans, and mortgage companies that make loans to finance housing, and are tasked with the mission of providing stability and liquidity to the secondary market for residential mortgages. In carrying out this mission, the Enterprises purchase single-family and multifamily mortgages from banks and other mortgage originators.

DIFFERENCES BETWEEN SINGLE-FAMILY AND MULTIFAMILY HOUSING AND FINANCING

Single-family housing refers to properties with one to four units. While roughly 70% of single-family housing in the United States is occupied by owners, the remaining 30% is rented. Multifamily housing refers to properties with five or more units. Multifamily properties primarily are rental apartment communities, whether high-rise, mid-rise, garden-style, or walk-up. Multifamily properties also may include senior independent or assisted living properties, student housing, cooperatives, and manufactured housing communities. Multifamily properties provide rental housing for more than 18 million households in the United States. (Of occupied U.S. rental housing units, approximately 60% is in single-family structures and 40% is in multifamily structures.)

Mortgages for multifamily housing represent a substantially smaller share of the U.S. mortgage market than single-family mortgages. Of the $11 trillion in residential mortgage debt outstanding at the end of 2016, $10 trillion—90%—was single-family and $1 trillion was multifamily.

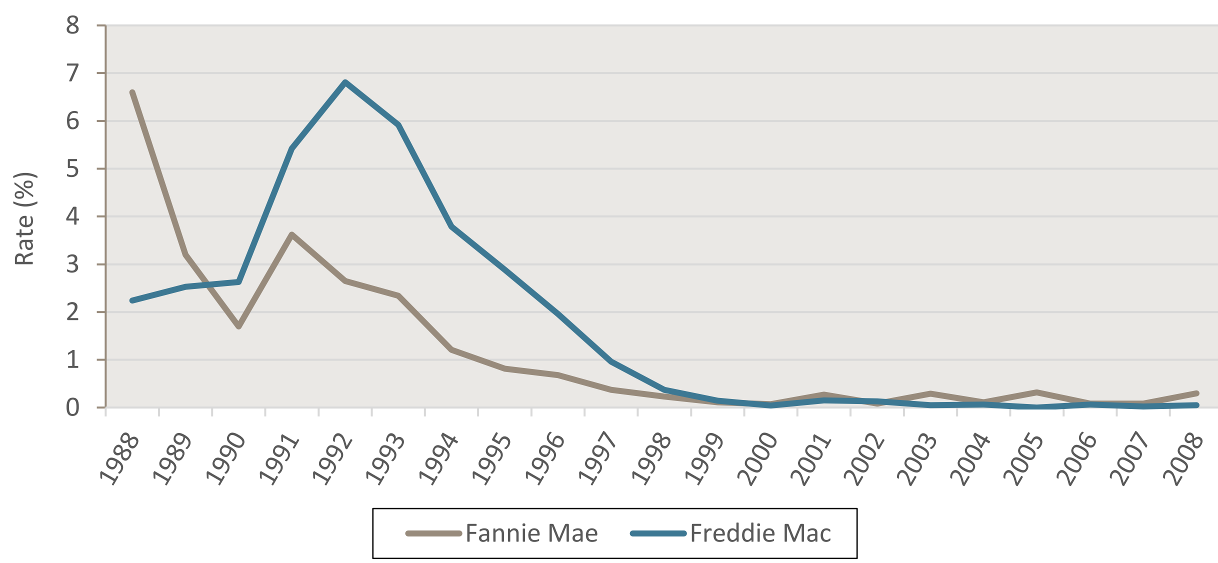
Multifamily mortgages usually have short terms (five, seven, or ten years), with a balloon payment due at maturity, which can be sizable. As a result, they may need to be refinanced at that time, subject to the availability and cost of a new loan. Multifamily mortgages often have prepayment penalties. One multifamily loan may be collateralized by a number of multifamily properties. Conversely, one multifamily property may be financed by multiple loans.

Generally, multifamily mortgages are more complex than single-family mortgages to underwrite. For most multifamily mortgages the primary source of repayment is the cash flow from the rental units. Underwriters of multifamily loans must understand the business and local market conditions, including occupancy rates and demand for apartment rentals, to project future cash flows and assess whether they will be sufficient to service the mortgage. Multifamily mortgages also are more complex to service because of the greater complexity of the collateral, borrowers, and loan structures. For example, they require ongoing property monitoring beyond that typically performed by single-family servicers, and periodic reexamination of financial statements.

HISTORICAL INVOLVEMENT OF FANNIE MAE AND FREDDIE MAC IN THE MULTIFAMILY MORTGAGE MARKET ....

Over the past 30 years, the level of the Enterprises' participation in the multifamily mortgage market has varied. After experiencing significant default losses from multifamily mortgages, Freddie Mac largely withdrew from the multifamily market from about the fall of 1990 to late 1993 (though it continued to fund the refinancing of loans in its portfolio). By way of example, Freddie Mac's multifamily mortgages represented less than 3% of its portfolio and 51% of its credit losses in 1991. While Fannie Mae remained in the multifamily market during this period, its multifamily mortgages represented almost 6% of its portfolio and 30% of credit losses. Freddie Mac returned to the multifamily market with a revamped program in late 1993. The share of its multifamily mortgages that were seriously delinquent fell sharply, as shown in Figure 1.

FIGURE 1. FANNIE MAE AND FREDDIE MAC MULTIFAMILY SERIOUS DELINQUENCY RATES. 1988-2008



Source: FHFA, 2016 Report to Congress.

The volume of multifamily mortgages purchased by the Enterprises began to climb, beginning in the late 1990s. From 1997 to 2007, the Enterprises' share of multifamily mortgage debt outstanding increased from 14% to 25%, while the private-market share decreased from 77% to 69%—though the private share remained much larger than the Enterprise share. During the two years leading into the financial crisis (2006-2007), multifamily mortgage originations averaged about $140 billion per year, according to data published by the National Multifamily Housing Council, of which the Enterprises purchased roughly one-quarter.

Multifamily mortgage originations collapsed with the financial crisis, falling about 40% to approximately $88 billion in 2008 and another 40% to approximately $53 billion in 2009, as multifamily housing starts hit a historic low in 2009. As other sources of credit dried up, the Enterprises' share of the multifamily mortgage market increased in 2008 and 2009. For 2009, the Enterprises purchased roughly two-thirds of all multifamily mortgages originated during that year. The share of multifamily originations insured by the Federal Housing Administration (FHA) also increased during these two years, but not as significantly as the Enterprises' purchases.[1]

In September 2008, FHFA, the then newly created regulator of the Enterprises, placed them into conservatorships after mounting losses from single-family mortgages and risky business practices had depleted the Enterprises' capital and threatened their ability to continue to provide liquidity to the secondary mortgage market.

As private sources of credit began to return to the multifamily market by 2011, the percentage of multifamily mortgages purchased by the Enterprises declined, although the Enterprises' overall dollar volume of multifamily mortgage purchases grew by more than $25 billion from 2009 to 2012.

In 2012, FHFA, as conservator, established a strategic goal for the Enterprises to contract their overall operations. To evaluate how to achieve that goal, it tasked the Enterprises with analyzing the viability of their multifamily businesses without government guarantees. The Enterprises found that, based on certain assumptions, they could continue to operate their multifamily businesses (at least in the short term), but their volumes would fall, they would serve a smaller niche of the market, their market presence would be less consistent, and they would likely provide less support for affordable housing. According to the Enterprises, their

[1] Along with its support of the single-family market, FHA, a government agency within the U.S. Department of Housing and Urban Development, provides mortgage insurance to approved lenders to facilitate the construction, substantial rehabilitation, refinancing, and purchase of multifamily housing. FHA-insured multifamily mortgages may be packaged into multifamily Ginnie Mae securities.

multifamily businesses in this scenario would likely focus on non-prime lending and secondary and tertiary markets,[2] and their cost of funds and lending rates would be higher.

The following year, FHFA set a goal for the Enterprises to reduce their purchases of multifamily mortgages by at least 10% from the volume of 2012 purchases. While FHFA recognized that the Enterprises played a significant role in the purchase of multifamily mortgages, it understood that the Enterprises did not dominate this market (as they did in the single-family market). Further, it saw their multifamily business as more akin to commercial real estate lending and had concluded that their footprint could be reduced. Seeking information on further contracting Enterprise operations, in August 2013, FHFA sought public input on strategies to reduce the Enterprise footprint in the multifamily market. The Agency received more than 60 responses, many of which cautioned against further reductions.

Under the leadership of a new FHFA Director, the Agency revised its strategic plan for conservatorships of the Enterprises in 2014. Its announced 2012 goal of contracting overall Enterprise operations was reformulated to focus on reducing taxpayer risk through increasing the role of private capital in the mortgage market. The Agency directed the Enterprises, in 2014, 2015, and 2016, to place caps on the dollar amount of the Enterprises' purchases of multifamily mortgages. According to FHFA, the caps were intended to limit the Enterprises' participation in the multifamily market: the Enterprises would serve as a backstop for that market, while not impeding the participation of private capital.

Some mortgage purchases were allowed without counting against these limits, including certain affordable housing loans. As the Enterprises' business volumes approached the caps in 2015 and 2016, FHFA modified the caps by increasing the amount or changing the exclusions.[3]

Multifamily financing may pose various potential risks to the Enterprises. Those risks may include:

- **Credit risk**: the risk that multifamily mortgages could default during the term of the loan, or default at maturity in the event the borrower cannot refinance to make a balloon payment.

[2] Fannie Mae has defined primary metropolitan areas as those with a population greater than 1 million, secondary metropolitan areas as those with a population of 500,000 to 1 million, and tertiary metropolitan areas as those with a population less than 500,000.

[3] Caps for 2017 currently remain at the 2016 level ($36.5 billion for each Enterprise), with future increases possible based on FHFA's review of the size of the multifamily origination market. (See below for information on the Enterprises in the multifamily market today.)

- **Counterparty risk**: the risk that multifamily loan sellers or servicers could decline to meet their contractual obligations. For example, the Enterprises note the risk that, if their multifamily servicers come under financial pressure, it could potentially cause a decline in the quality of the loan servicing they provide. Fannie Mae also faces the risk that the multifamily lenders it has risk-sharing agreements with might not meet their obligations should a mortgage default.

- **Spread risk**: the risk that market conditions change in the period between an Enterprise's commitment to purchase a multifamily mortgage and its securitization of that mortgage, causing a potential reduction in the value of the loan.

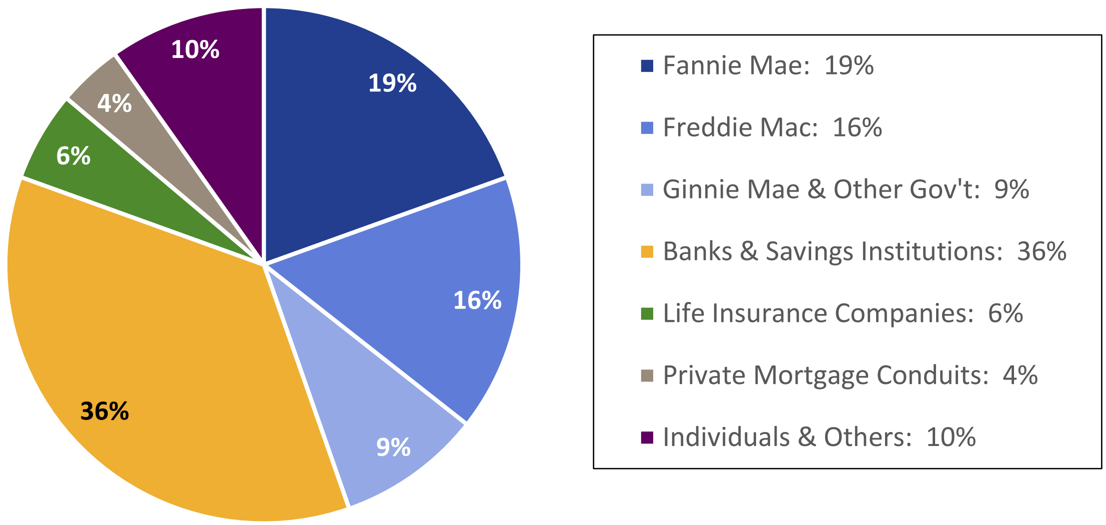
Beginning in 2014 and continuing in place today, FHFA has sought to transfer some risks inherent in the multifamily mortgage business to the private sector. FHFA directed the Enterprises to assess the feasibility of adopting additional types of risk transfer structures or increasing the amount of risk transferred. For 2017, FHFA expects that the Enterprises will transfer a meaningful portion of credit risk on at least 80% of the unpaid principal balance of newly acquired multifamily mortgages to the private sector and that they will continue efforts to evaluate—and implement if economically feasible—further ways to transfer additional credit risk.

ENTERPRISE PARTICIPATION IN THE MULTIFAMILY MARKET TODAY...

During 2016, estimated multifamily mortgage originations nationwide reached more than $260 billion. Combined, the Enterprises purchased $112 billion in multifamily mortgages in 2016, and purchases by Fannie Mae and Freddie Mac set new records. Together, the Enterprises back 35% of the $1 trillion of multifamily mortgage debt outstanding as of the end of 2016, just under the 36% held by banks and savings institutions, as shown in Figure 2 on the following page. While multifamily remains a fraction of the mortgage debt backed by the Enterprises—roughly 10% compared to 90% for single-family mortgages—the Enterprises continue to play a significant role in the multifamily mortgage market.[4]

[4] The single-family and multifamily mortgages purchased by the Enterprises have notable differences. Their average multifamily mortgage is much larger than their average single-family mortgage. For example, Fannie Mae reported that the average loan size for its conventional guaranty single-family book of business was $163,200 compared to $8 million for its multifamily book of business.

FIGURE 2. MULTIFAMILY MORTGAGE DEBT OUTSTANDING BY HOLDER. YEAR-END 2016



Source: FHFA Office of Inspector General analysis of Federal Reserve Board data.

The multifamily programs run by the Enterprises primarily finance multifamily rental housing, but also include other housing types. Of Fannie Mae's $55 billion in multifamily acquisitions in 2016, for example, 87% financed conventional and cooperative housing, 5% financed manufactured housing, 5% financed student housing, and 3% financed seniors housing.

Both Enterprises have counterparty concentrations in their multifamily business. The Enterprises purchase multifamily mortgages from a limited number of lenders compared to single-family mortgages. In 2016, Fannie Mae executed multifamily transactions with 30 lenders; Freddie Mac also has about 30 approved multifamily sellers. By comparison, approximately 1,200 lenders delivered single-family mortgages to Fannie Mae in 2016. Fannie Mae and Freddie Mac each have ten lenders that accounted for more than three-quarters of the respective Enterprise's 2016 multifamily volume.

The Enterprises purchase multifamily mortgages from metropolitan areas of different sizes. For example, Fannie Mae reported that it financed about 15% of units in the multifamily market nationwide and a similar share in primary (15%), secondary (17%), and tertiary (13%) markets. The Enterprises also provide financing for a range of property and loan sizes. In 2016, for example, approximately 15% of Fannie Mae's multifamily purchases by loan count were for small (5- to 50-unit) properties. Enterprise financing also can be used for large-scale properties and apartment communities. In December 2015, Fannie Mae announced $2.7 billion in financing for a 110-building apartment community with 11,241 units in New York City. The transaction will help maintain 5,000 rental units that are affordable to moderate-income residents.

Although there are various ways to define affordability, generally most of the Enterprises' multifamily purchases support affordable rental housing. For example, according to Freddie Mac, in 2016, nearly 90% of the multifamily units it financed were affordable to low- to moderate-income renters earning 100% or less of area median income.

Serious delinquency rates—the share of unpaid principal balance that is 60 or more days past due or in the process of foreclosure—on Enterprise multifamily mortgages have fallen from their post-crisis peaks. For Fannie Mae, the rate fell from 0.71% at the end of 2010 to 0.05% at the end of 2016. For Freddie Mac, the rate fell from 0.26% to 0.03% over this period.[5] In addition, Fannie Mae held for sale 13 foreclosed multifamily properties as of December 31, 2016, and Freddie Mac had no multifamily real estate owned properties.

Demand for rental housing has expanded at a rapid rate over the past decade, and multifamily prices have now surpassed the peak from before the financial crisis. For 2017, Freddie Mac's outlook is for the multifamily market to remain strong, though growing at a more moderate pace; Fannie Mae also predicted slower momentum. Both Enterprises have noted that the strength of the multifamily market varies by metropolitan area.

Notwithstanding the numerous similarities in these multifamily programs, there are significant differences between them. For example, Fannie Mae delegates underwriting multifamily mortgages to the originating lenders, rather than underwriting multifamily mortgages in-house. Fannie Mae requires the lender to share in the loss if a mortgage defaults, which aligns its interests with those of the lender. Typically, Fannie Mae securitizes multifamily mortgages and guarantees the payments on the securities. Fannie Mae's 25-member delegated-underwriting network is comprised of large financial institutions and independent mortgage lenders. Given the risk-sharing nature of the mortgages, Fannie Mae sets lender eligibility standards, such as minimum capital and liquidity levels and the posting of collateral, and monitors their financial condition. Fannie Mae estimates that, from 2006 to 2016, lenders have assumed 31% of losses associated with Fannie Mae's multifamily loans.

Conversely, Freddie Mac performs in-house underwriting for every multifamily loan it purchases. Freddie Mac then sells much of the mortgage default risk to investors in security form in transactions known as K-Deals (or, since 2015, SB-Deals for small balance multifamily mortgages). From 2009, when the program began, through year-end 2016, Freddie Mac did not realize any credit losses on K- or SB-guarantees. Security investors lost $12 million on K-Deals, representing less than one basis point (1/100th of 1%) of the securities issued.

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[5] By comparison, for single-family mortgages, CoreLogic has reported that 2.6% of homes with a mortgage were in serious delinquency at the end of 2016, compared to the serious delinquency peak of 8.6% in January 2010.

CONCLUSION……………………………………………………………………………

The Enterprises' multifamily business lines are complex and growing. The Enterprises have played a substantial role in financing multifamily housing, and the future of the U.S. housing finance system is under consideration. The multifamily market merits ongoing attention from FHFA and policymakers.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide background information on the role of Fannie Mae and Freddie Mac in the multifamily mortgage market. To achieve this objective, we reviewed publicly available documents such as FHFA, Enterprise, and other publications. We reviewed and conducted analysis of publicly available data series such as for multifamily mortgage debt outstanding and Enterprise multifamily mortgage purchases. We also received data from FHFA on multifamily mortgage originations and the share financed by various sources from 2005 to 2016. We noted some differences among data sources. We did not independently test the reliability of the data.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

ADDITIONAL INFORMATION AND COPIES……………………………

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