An Assessment of the Availability and Cost of Financing for Small Multifamily Properties

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Prepared by:
Abt Associates Inc.
Christopher E. Herbert

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Foreword

In 1992 legislation, Congress directed the Department of Housing and Urban Development to institute a system of quantitative affordable housing goals for Fannie Mae and Freddie Mac, the two large Government-sponsored enterprises that provide a secondary market for home mortgages. The goals first went into effect in 1993, were raised and re-formulated through regulations issued in 1995, and were further raised and refined through regulations issued in 2000. Since their establishment, these goals have stimulated Fannie Mae and Freddie Mac to increase their involvement in financial markets for both single-family and multifamily affordable housing.

In its regulations in 2000, the Department highlighted the market for mortgages on small multifamily properties as an area of substantial unmet need, where Fannie Mae and Freddie Mac could play a constructive role. To encourage them to increase their mortgage purchase activity in this area, the Department instituted a system of bonus points for mortgages on small multifamily properties under each of the goals.

This study analyzes the cost and availability of financing for small multifamily properties and barriers to financing. The study synthesizes the analysis of these issues that was utilized by the Department in its 2000 rulemaking and which is discussed in the technical appendixes to the published regulation. It includes both analysis of data on mortgage financing for multifamily properties of different sizes and findings from interviews with lenders, developers, and others involved in the market. The study was prepared by Abt Associates Inc. under a contract with the Department for analytical support to the 2000 rulemaking work.

The Department acknowledges with thanks the work of the study's author, Dr. Christopher Herbert. Thanks are also extended to representatives of government agencies, industry organizations, housing developers, and lending institutions who provided information to Dr. Herbert during the course of his work, and to Dr. William Segal, who served as the Department's Government Technical Monitor for the study.

Lawrence L. Thompson
General Deputy Assistant Secretary for Policy
Development and Research

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Executive Summary

Purpose and Approach of the Study

Small multifamily properties account for a large share of the unsubsidized, affordable rental housing stock. Given the importance of small properties in the supply of affordable rental housing, the availability and cost of financing for small properties is a matter of concern for public policy. Previous research has found that small multifamily properties have greater difficulty gaining access to mortgage financing than larger properties and that, when credit is secured, the cost (in terms of the interest rate charged) is generally higher than that facing larger properties. The purpose of this study is to examine the cost and availability of financing for small multifamily properties at present. To the extent that there are difficulties in obtaining financing for small properties, we were to investigate the reasons for these difficulties. This study was intended to support HUD's reconsideration of the housing goals for the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac.

This study is best characterized as exploratory in nature. This effort is intended to update and supplement the substantial work that was done on this subject by HUD in 1996. There were three principal tasks to add to this previous work:

- An analysis of data from the Property Owners and Managers Survey (POMS) to provide an empirical grounding about the cost and availability of financing for small properties relative to larger properties;
- Interviews with government agencies, national industry organizations, housing developers, and lenders engaged in providing mortgage finance to explore the current state of the market for financing for small properties; and
- A review of the literature including industry publications related to financing for small multifamily properties.

Barriers to Financing Small Properties

There are several barriers to providing financing for small multifamily properties using the standard commercial mortgage underwriting process. The standard process, which is used extensively in loans on larger commercial properties, typically mandates the use of a recent appraisal by a state-certified appraiser, environmental reviews, and attorney opinions and certifications. The high fixed costs associated with this process make the standard approach prohibitively expensive for smaller properties. A related problem is that even in cases where

a lower cost underwriting process has been developed, many small property owners do not keep sufficient documentation of the properties' income and expenses to provide the type of information needed for commercial underwriting. Finally, the revenues generated by these loans for underwriting and servicing, which are based on a percentage of the loan balance, are too low to make these loans profitable for many commercial mortgage originators.

One factor that does not seem to be a barrier to serving this market is higher credit risk associated with smaller loans. Lenders generally expressed the view that these loans did not present any greater risk than larger properties. In fact, recent studies on multifamily loan performance have found that smaller loans are less likely to default. It is true that it can be more difficult to assess the credit risk of smaller loans due to a lack of documentation of the properties' financial condition and less information about the small property managers' abilities. However, depositories have demonstrated that these problems can be remedied by requiring a credit check on the borrower and personal recourse to support the loan.

The principal source of financing for small multifamily properties has been depository institutions. These lenders have been able to circumvent the barriers described above by employing an underwriting process that is best described as a hybrid between the approach used to underwrite residential mortgages and that used to underwrite commercial mortgages. Depositories rely as much on the creditworthiness of the borrower as the value of the asset securing the loan. By only making loans to creditworthy borrowers and by requiring personal recourse, depositories are able to rely on a much less costly process to evaluate the property. This approach also means that borrowers are not required to provide the level of documentation of property income and expenses that is required by secondary market investors.

The Availability and Cost of Financing for Smaller Properties

Data from the Property Owners and Managers Survey (POMS) indicates that small multifamily properties, in fact, are less likely than larger properties to have mortgage financing. About two-thirds of properties with fewer than 20 units have existing debt. This share climbs to nearly 80 percent for properties with between 20 and 49 units, and about 90 percent for properties of 100 units or more. Smaller properties are also found to be somewhat less likely to have obtained a new first mortgage during the 1994-95 period.

Data from the POMS reveals the extent to which depositories have been the principal source of funding for this market segment. Among properties with fewer than 50 units, about 70 percent of those with mortgage debt report depositories as the loan servicer. In comparison, about 45 percent of properties with 100 or more units have loans serviced by depositories. For these larger properties, loan sources such as mortgage bankers, secondary market loan

pools, the GSEs, pension funds, insurance companies, and other government lending programs account for slightly more than half of all mortgages. For small properties, these sources account for only 15 percent of existing mortgages. In fact, small properties are about as likely to be financed by individuals or estates as these non-depository lenders. The relatively sizable share of loans made by individuals may be indication of a dearth of financing from lenders for these properties.

The POMS also shows that smaller properties do tend to have higher interest rates. Compared to properties with 100 units or more, the average interest rate was 1.1 percentage points higher on properties with fewer than 20 units and 0.7 percentage points higher for properties with between 20 and 49 units. This estimate is consistent with the findings from interviews with conduits serving both the small and large property markets where the price differential between these segments ranged from 0.2 to 1.2 percentage points.

Through interviews conducted for this study, industry representatives reported that local depositories are in many cases the only source of loans for small properties, especially in small markets and rural areas, limiting borrowers' ability to find favorable interest rates. Industry participants observed that in areas where there is not significant competition from other lenders, depositories are able to command higher interest rates. Lenders acknowledged that a higher interest rate was needed to compensate for the fixed costs of underwriting and servicing these loans. But many lenders indicated that a lack of competition in the market segment and a lack of sophistication by borrowers allowed lenders to charge higher rates than would otherwise be needed.

The interviews also revealed that the lack of competition in the small multifamily mortgage market constrains borrower choices with regard to loan product. Small properties are more likely to have the choice of loan type limited to adjustable rate financing. Adjustable rate loans are often less desirable because of the interest rate risk that owners bear with this type of loan. Our analysis of POMS data confirms that ARMs are more common among smaller properties (accounting for about a third of existing mortgages) than on larger properties.

The image that emerges from our interviews and our analysis of the POMS data is that of two market segments. For larger properties, there are a variety of sources of funding available. This diversity in funding sources results in greater choice of loan type and more competitive interest rates. Because standard commercial lending programs are not generally well-suited to smaller properties, such properties are largely confined to local depositories as a source of financing. The result is less choice in the type of loan and higher interest rates than might otherwise be available.

Recent Market Trends

There are important ways in which the market for small multifamily financing has evolved in recent years. As secondary market conduits have grown in importance in commercial mortgage financing in the 1990s, these firms have been exploring ways to expand their markets. Because small properties are seen to represent a potentially large, untapped market, this segment has attracted a fair amount of attention. An industry publication in early 1999 identified 12 conduits that had introduced small loan programs in addition to a Fannie Mae program offered through 3 of its affiliated lenders.

But the underwriting approach used by the conduits, a streamlined version of the standard commercial underwriting approach, is not appropriate for many small properties. Many owners of small properties cannot adequately document their financial condition to meet underwriting requirements or the property quality is too low for these programs. In essence, the conduit small loan programs are serving the cream of the small property market—more sophisticated owners of "B" quality properties. Only 1.8 percent of loans securitized in Commercial Mortgage Backed Securities consist of small loans.

The majority of small multifamily borrowers are still largely left with depositories as a source of funding, but there are some favorable trends in this market niche as well. Depositories appear to be expanding their lending operations. LaSalle Bank states that it has taken its small multifamily program to all 48 continental states. Other depositories interviewed also noted that they are looking to develop new lending opportunities in nearby markets. Perhaps the most interesting development is a program being launched by the residential lender Countrywide to begin originating small multifamily loans using an underwriting approach that relies as much on borrower creditworthiness as the property's valuation. This underwriting is essentially the same model that the depositories have perfected and so seems to offer good possibilities for success. However it is not yet clear whether Countrywide will be successful in this market.

A key question is whether the new lending programs have made a noticeable contribution to the availability of financing. Representatives of one industry group reported that, in contrast to several years ago, there is no longer a lack of available financing. This change was attributed to the expansion of lending programs aimed at the small property market. But given the scale of these new and expanded lending programs relative to the size of this market niche (several hundred thousand properties), it would appear that there is still room for substantial expansion of lending activity. Most of the small loan programs have been concentrated in major market areas. Interviews conducted for this study found that financing options in small markets and rural areas are few.

Another question is whether the expansion of lending programs has helped to lower interest rates for small loans. Absent systematic information on interest rates and other loan terms it is particularly hard to evaluate this issue. Discussions with lenders and a review of interest rate information available on the lender web pages suggest that interest rates available through conduits may not be lower than those available from depositories. The main advantage of these lending programs may be the availability of fixed-rate financing. One indication that interest rates have not come down much is that depositories expanding their activities report being drawn to this market by the higher profits these loans offer compared to residential lending. Many lenders noted that rates were higher in the small property segment not only because of higher costs of underwriting and servicing these loans, but also because a lack of deep competition made higher rates feasible. But if lending programs targeted at this niche continue to grow, over time any interest rate premiums in this market not attributable to higher costs or risks would decline.

Secondary Market Access for Small Loans

For the most part, small multifamily properties have accounted for a relatively small share of the multifamily units involved in GSE transactions. For Freddie Mac, small multifamily properties have consistently accounted for less than 5 percent of their multifamily units. Fannie Mae has had similarly low shares accounted for by small properties with the notable exceptions of 1995 and 1998 when there were significant numbers of small properties in their transactions. These shares fall well below the share of the mortgage market accounted for by small multifamily properties. The 1991 Survey of Residential Finance (RFS) found that small multifamily properties accounted for 39 percent of recently financed multifamily units. Small multifamily properties have not come close to this share of GSE acquisitions—even in years when Fannie Mae's share of small multifamily units was unusually high. In an attempt to better tap this market niche, Fannie Mae has introduced a new product for multifamily properties with 5-50 units. This product features a streamlined underwriting process designed, in part, to reduce borrower costs for third-party reports; use of FICO scores to evaluate borrower creditworthiness; and recourse to the borrower in the event of default.

It is also important to note that the limited volume of small multifamily properties in secondary market transactions is not a unique characteristic of the GSEs. Information regarding non-GSE securitization of small loans is quite limited, but in commenting on a Commercial Mortgage-Backed Security (CMBS) offering backed by commercial loans with a balance of less than $1 million, *Commercial Mortgage Alert* noted that such offerings are rare.[1] The article reported that from the beginning of 1998 through the first quarter of 1999,

[1] Commercial Mortgage Alert, 1999a

only 1.8 percent of CMBS issued involved small balance loans. Thus, the GSEs' shares in the 2 to 4 percent range are actually higher than in the non-agency CMBS market.

One of the issues of concern for this study is whether this low level of secondary market activity involving small multifamily loans may be indicative of impediments to the sale of small multifamily loans by originators in the primary market to secondary market investors. One of the principal reasons that small multifamily loans have not been prevalent in secondary market transactions appears to be that the detailed underwriting requirements used by the rating agencies and the GSEs to ensure loan quality are prohibitively expensive for small balance loans. Fannie Mae and a number of conduits have developed small loan programs to streamline the origination process to address this barrier, but it is not clear whether these programs will succeed in generating a very large volume of small loan originations. Among the challenges facing these programs are the lower fees earned by originators on small loans, which make this niche less attractive than the market for large multifamily loans. In contrast, depositories have been successful in serving the small property market by employing a simpler underwriting process that is financially attractive to both borrower and lender and provides adequate screening for loan quality. However, this process is not well suited to the types of safeguards employed by secondary market actors to ensure loan quality. It would appear that both the problems of employing these safeguards with depositories as well as the focus of depositories on originating loans primarily to be held in portfolio contribute to the dearth of small loans sold to secondary market investors.

Chapter 1
Introduction

1.1 Background

Small multifamily properties account for a large share of the unsubsidized, affordable rental housing stock. According to the Bureau of the Census' 1991 Survey of Residential Finance (RFS), 557,000 of the 633,000 multifamily properties in the U.S. contain 5 to 49 units. These smaller properties also tend to be more affordable. The RFS found that the median monthly rent among mortgaged properties with 5 to 49 units was $354, compared to $421 for larger properties.[2] Given the importance of small properties in the supply of affordable rental housing, the availability and cost of financing for small properties is a matter of concern for public policy. Previous research has found that small multifamily properties have greater difficulty gaining access to mortgage financing than larger properties and that, when credit is secured, the cost (in terms of the interest rate charged) is generally higher than that facing larger properties.[3] This raises the concern that inadequate access to mortgage financing may contribute to higher default risk, insufficient maintenance, or less affordable rents among these properties. Inadequate investment in these properties is not only a threat to the supply of affordable housing, it is also a threat to the stability of neighborhoods where these properties are located.

The purpose of this study is to examine the cost and availability of financing for small multifamily properties at present. To the extent that there are difficulties in obtaining financing for small properties, we were to investigate the reasons for these difficulties. This study was intended to support HUD's reconsideration of the housing goals for the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Given this context, a particular concern for this study is the potential for the secondary market to increase the availability and lower the cost of financing for small properties. The specific questions to be addressed include:

- What do available data indicate about the availability and cost of mortgage financing for small properties relative to larger properties? What does available empirical evidence indicate regarding the access of small multifamily properties to the secondary market compared to larger properties?

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2 These figures are cited by Schneider and Follain (1998), pages 44-45.

3 In 1996 HUD conducted market research on financing for small multifamily properties to help develop a pilot program aimed at this market niche. The findings from this research are reported in HUD (1996) and Schneider and Follain (1998).

- What are the principal barriers to financing small properties? Have there been any developments in the mortgage markets in recent years to overcome these barriers?
- What do interviews with industry participants indicate about the current availability and cost of mortgage financing at present?

1.2 Methodology

This study is best characterized as exploratory in nature. This effort is intended to update and supplement the substantial work that was done on this subject by HUD in 1996.[4] There were three principal tasks to build on this work. First, analysis of data from the Property Owners and Managers Survey (POMS) is used to provide an empirical grounding about the cost and availability of financing for small properties relative to larger properties. Also included in this analysis is information from the GSEs about their purchases of small properties to gauge the relative access of small properties to the secondary market. Second, interviews were conducted with government agencies, national industry organizations, housing developers, and lenders engaged in providing mortgage finance to explore the current state of the market for financing for small properties.[5] Finally, we reviewed the recent academic literature and industry publications related to financing for small multifamily properties.

1.3 Report Outline

Chapter 2 presents our analysis of the POMS and GSE data on financing for small properties. Chapter 3 describes the potential barriers to providing financing for small properties and presents our findings regarding the importance of these barriers at present. Chapter 4 then discusses our impressions on the availability and cost of financing for small properties based on interviews with industry experts and housing developers.

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[4] See HUD (1996) and Schneider and Follain (1998) for reports on this research.

[5] It is important to note that while we believe these interviews provide useful insights into the state of the market, the relatively small number and non-random selection of interviews subjects (representing 28 organizations) means that the findings do not provide systematic information about the market.

Chapter 2
Empirical Evidence on the Availability and Cost of Financing for Small Properties

This chapter presents an analysis of data from the Property Owners and Managers Survey (POMS) on the availability and cost of financing for small multifamily properties. The POMS was conducted during 1995-96 on a sub-sample of the rental housing units included in the 1993 American Housing Survey (AHS). This data set is one of few sources of systematic, property-level information at a national level on the use of debt financing by multifamily properties. In the sections that follow we will examine the degree to which the use of mortgage debt, the mortgage interest rate, the sources of funding, and the type of loan vary with property size. In the last section, the GSEs' purchases of mortgages backed by small properties are compared to the estimated share of the primary market accounted for by small properties to evaluate the extent to which the GSEs have managed to reach this market segment. However, before turning to the analysis, the first section discusses the issue of how small properties are to be defined.

2.1 Defining "Small"

In using the POMS to evaluate differences in the availability and cost of financing for small properties compared to larger ones, we have to begin by defining what is meant by "small." In consulting both the existing literature and industry standards we find that there is no shortage of competing definitions for what constitutes a 'small' property. The principal distinction is that small may be defined in terms of the number of units in the property or the value of the loan. In terms of number of units, small properties are generally defined as those with between 5 and 49 units (properties with fewer than 5 units are considered single family properties). However, a variety of distinctions are made within this size range. For example, FHA defined small as between 5 and 20 units for its Small Projects Processing (SPP) initiative, while Schneider and Follain (1998) defined 'very small' as properties with between 5 and 12 units and 'small' as those with between 13 and 50 units. Lenders, however, generally define small loans in terms of the loan value, not the number of units in the property. Schneider and Follain (1998) found lenders setting maximum amounts for small loans that ranged from $1 million to $3 million, while a few lenders contacted for this study employed a maximum of $750,000. In establishing rating criteria for small loans, the rating agency Duff & Phelps has set different underwriting requirements for loan values in $250,000 increments up to $1 million (Duff & Phelps, 1998).

With regard to the question of whether small is most usefully defined in terms of the number of units in the property or the value of the loan, there are good justifications for either definition. As will be discussed in Chapter 3, many of the principal obstacles to financing smaller properties are related to the value of the loan. For example, the cost of meeting the underwriting standards for secondary market investors generally represent a prohibitive share of the loan value for smaller loans. In addition, the fees earned by lenders and servicers that are a percentage of the loan balance become too low to be profitable. The distinction between property size and loan value is important to the extent that in high-priced markets, smaller properties may support higher value loans. But in most market areas this distinction may not be critical as loan value will largely be a function of the size of the property.

Another significant barrier to financing small properties relates to the sophistication of the property owners, as properties that do not maintain adequate records on income and expenses will not be good candidates for many lending programs. The number of units in the property may be the best proxy for the likely degree of owner sophistication. For this study, we will define small in terms of the number of units in the property since this information is available for all properties in the POMS sample.[6] But given the strong correlation between loan value and property size, it should be remembered that smaller properties also generally represent smaller balance loans.

With regard to the precise cutoff for what defines "small," as the multitude of definitions cited above suggests, there is no clear, single point at which financing becomes more difficult to obtain. As a result, it seems reasonable to establish more than one category for small properties to examine how the availability and cost of financing varies with size. In broad terms, it seems reasonable to define small as properties with between 5 and 49 units. This definition is in keeping with many common definitions of small properties in terms of the number of units. This size class is also consistent with loan values of less than a $1 million, which is the most common definition of small in terms of loan value used by lenders.[7] However, we will subdivide small properties into two groups, those with 5 to 19 units and those with between 20 and 49 units, to examine how circumstances may differ between these size classes. Large properties will also be divided into several categories to examine how availability and cost varies within this group. The large categories will be 50 to 99 units, 100 to 249 units, and 250 units and larger.

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[6] In the POMS, loan amount is only available for properties with an existing mortgage.

[7] The POMS indicates that newly financed properties in 1995 had an average loan balance of slightly more than $20,000 per unit. This average indicates that most loans of less than $1 million are for properties of less than 50 units.

Exhibit 2-1 shows the number of properties in each size category as well as the total number of units in these properties. Multifamily properties with fewer than 50 units account for the vast majority of multifamily properties (88.5 percent), with most (74.9 percent) having fewer than 20 units. But while large properties comprise a small share of properties, they account for a large share of units. Small properties contain only slightly more than a third of total multifamily units (37.2 percent). In contrast, properties with 100 or more units account for only 6.4 percent of properties, but nearly half (49.5 percent) of all multifamily units.

Exhibit 2-1

Distribution of Multifamily Housing Stock by Number of Units in Property

Property Size (Units)	No. of Properties	Percent of Properties	No. of Units	Percent of Units
5-19	388,667	74.9%	3,362,229	22.4%
20-49	70,597	13.6%	2,223,786	14.8%
50-99	26,583	5.1%	1,998,896	13.3%
100-249	24,734	4.8%	4,071,128	27.1%
250+	8,260	1.6%	3,372,962	22.4%
Total	518,840	100.0%	15,029,001	100.0%

Source: Tabulations of Property Owners and Managers Survey (HUD, 1996).

2.2 The Availability of Mortgage Financing

The POMS provides information on whether properties have any outstanding mortgage debt and the year the first mortgage was originated. This information can be examined to determine whether smaller properties are less likely to be financed than larger properties. Of course, whether a property has mortgage financing is a function of factors related to both the demand and supply of mortgage debt. For a variety of reasons, owners of smaller properties may be less interested in financing. For example, individual owners may prefer to own properties without debt and use the monthly cash flow as a source of income. Thus, a finding that smaller properties are less likely to be financed does not prove that financing is more difficult to obtain. Nonetheless, such a finding is certainly consistent with this hypothesis.

Exhibit 2-2 shows the share of properties with outstanding mortgage debt and the share of properties with mortgages that had loans originated during the most recent time period covered by the POMS.[8] Smaller properties are, in fact, less likely to have mortgage debt than larger properties. Among the smallest category, about two-thirds of properties have some debt. The share financed increases with property size up to about 100 units. Among the largest properties about 90 percent of properties have debt financing. While smaller loans are also somewhat less likely to have obtained financing in the 1994-95 period, the disparities are somewhat less pronounced. Properties with between 20 and 49 units were least likely to have obtained a new first mortgage during 1994-95 (19 percent), while those with 250 or more units were most likely (27 percent).

Exhibit 2-2

Share of Multifamily Stock with Mortgage Debt by Number of Units in Property

Property Size (Units)	Share Mortgaged	Share with Mortgage Originated in 1994-95
5-19	66%	22%
20-49	79%	19%
50-99	86%	23%
100-249	90%	24%
250+	88%	27%

Source: Tabulations of Property Owners and Managers Survey (HUD, 1996).

2.3 The Cost of Mortgage Debt

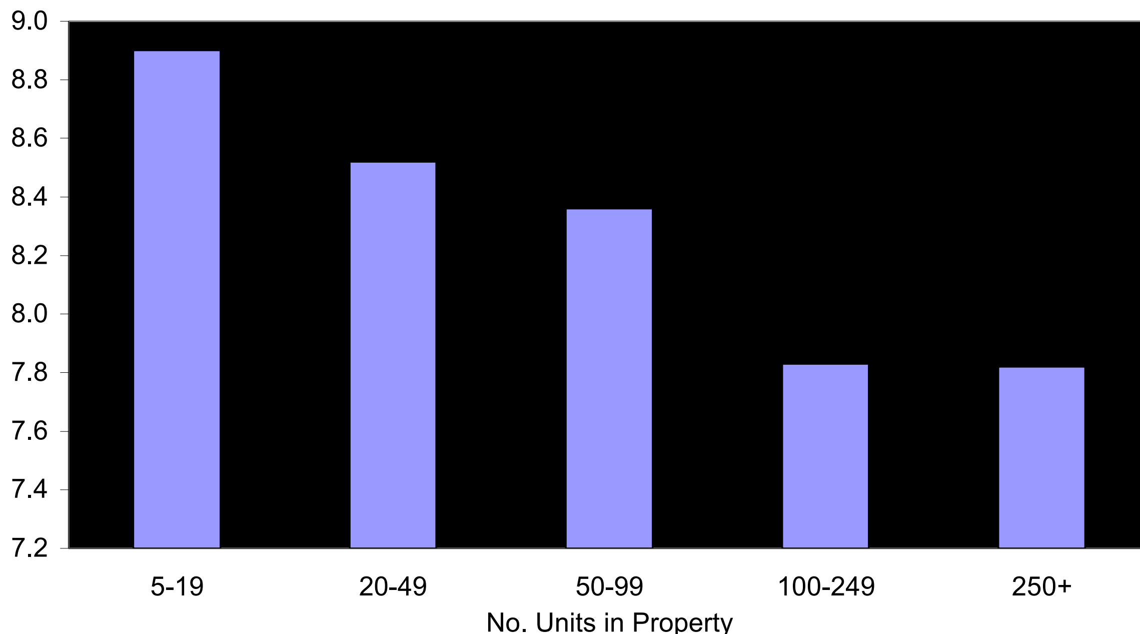
The POMS includes information on the current interest rate on first mortgages which can be used to examine whether there are differences in the cost of mortgage finance associated with property size. Of course, the current interest rate is only part of the cost of mortgage finance. Points paid at origination are another important component of costs about which POMS does not include information. In addition, for adjustable rate loans, the current

[8] The two-year period 1994-95 is used to examine newly originated mortgages since focusing on 1995 alone produces sample sizes for some size categories that are quite small (fewer than 30 observations).

interest rate may differ from the average interest rate that will prevail over the life of the loan. Despite these deficiencies, the interest rate does provide some indication of whether small loans face higher costs and the magnitude of this difference.

Exhibit 2-3 illustrates the average interest rates by property size for properties with outstanding mortgage debt.[9] The highest interest rates are found on properties with between 5 and 19 units, averaging 8.9 percent. In contrast, the average interest rates among the two largest property categories is 7.8 percent, more than 1 full percentage point lower. Interest rates are found to decline systematically with property size up to 100 units. Properties with 20 to 49 units have average interest rates that are about 40 basis points lower than the smallest property category, while those with 50 to 99 units are about 50 basis points lower.

Exhibit 2-3
Average Mortgage Interest Rate by Property Size



Source: Tabulations of Property Owners and Managers Survey (HUD, 1996).

[9] It is important to note that the interest rates shown include all outstanding mortgages, and not just recently originated mortgages. As a result, some of the difference in interest rates by property size may reflect differences in the average age of mortgages by property size. Given the small sample sizes in the POMS, estimates of average interest rates are less precise when only recently originated mortgages are considered. But even when only recently originated mortgages are considered, the average interest rate on the smallest property size category is about one percentage point higher than for other properties.

2.4 Loan Servicer

Participants in POMS were asked for the type of institution servicing the first mortgage on the property they owned or managed. This variable provides an indication of the source of financing. In the wake of the 1980s Savings and Loan crisis, there have been significant changes in the sources of financing for multifamily properties. Most notably, mortgage banking companies and real estate investment trusts (REITs) have grown in importance as sources of funds, while depository institutions have seen their market share decline.[10] One explanation for the decline in market share by depositories is that new risk-based capital rules adopted by bank regulators in the late 1980s required banks to hold more capital against multifamily loans than other assets.[11] The decline in depositories' market share also reflects innovations in the commercial mortgage backed securities market that opened the multifamily mortgage market to new sources of capital through mortgage banking intermediaries or conduits.[12] But while larger properties have increasingly obtained financing through mortgage banking conduits, it is generally believed that depository institutions have continued to be the principal source of funding for smaller properties. The greater access to broader capital markets for larger properties is thought to provide advantages in both the interest rate obtained and in the types of loan terms that are available (most notably products offering fixed interest rates over the loan term).

Exhibit 2-4 shows the distribution of the type of loan servicer by property size. As expected, a large majority of loans for small properties are serviced by depositories. The share declines from 70 percent for those with 5 to 19 units to less than half for properties with more than 250 units. It is noteworthy, however, that such a significant share of larger properties obtain financing from depositories. Depositories clearly are able to compete in large-property markets.[13] On the other hand, small properties are much less likely to have loans serviced by mortgage bankers, a mortgage pool, or one of the GSEs. Less than 10 percent of small properties report that their loans are serviced by one of these entities,

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10 See Bradley, et al (1998) for a discussion of changes in the source of financing for multifamily properties.

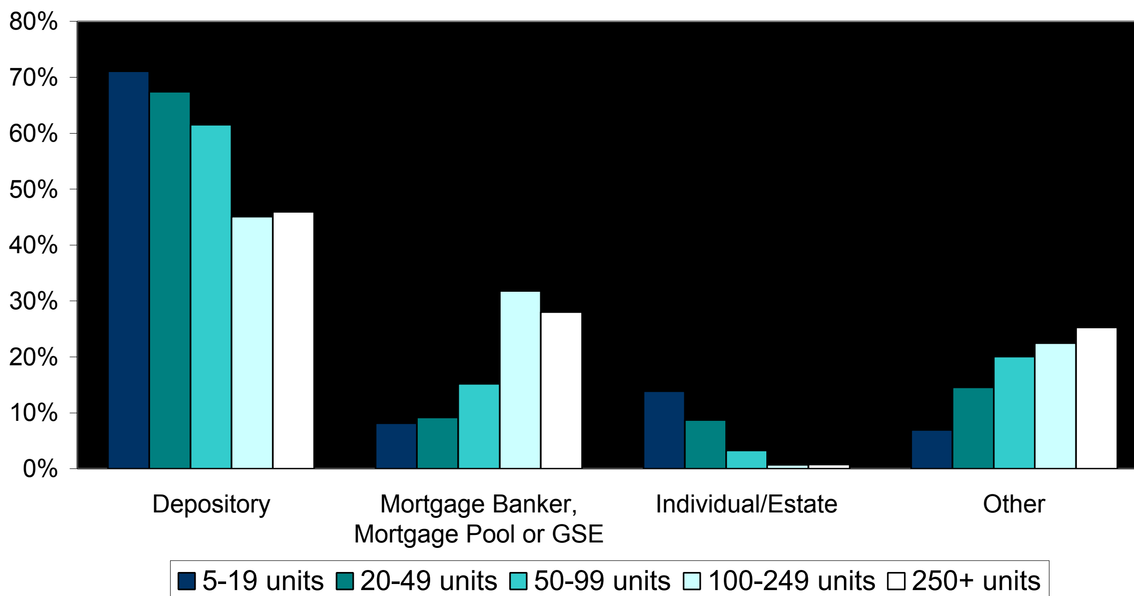
11 Prior to adoption of the risk-based capital rules developed as part of the Basel Accord, bank capital adequacy guidelines did not include differential treatment of bank assets. Under the new risk-based capital rules, multifamily loans generally required higher levels of capital than assets such as single-family mortgages, MBS, or government securities. See FDIC (1997) for a rich discussion of the evolution of bank captial adequacy requlation during the 1980s, and Segal and Szymanoski (1998) for a discussion of the chilling effect of these changes on banks' investment in multifamily mortgages.

12 See Bradley, et al (1998) for a discussion of the factors associated with the growing importance of secondary market intermediaries during the 1990s.

13 Since this chart includes all outstanding mortgage debt, it may not accurately reflect changes in the sources of new loans during the 1990s. However, tabulations of the sources of loans for recently issued loans also find that slightly less than half of new loans for larger properties are serviced by depositories.

while about 30 percent of large properties report this source. Smaller properties are also more likely to report individuals or estates as the source of financing, while this source of funding is negligible for larger properties. The prevalence of this non-institutional source of financing for small properties may be because the smaller size of these loans makes it more feasible to use these sources. On the other hand, this source of funds may be an indication that more traditional sources of financing are more difficult to secure so that sellers are forced to finance the sale of their properties.

Exhibit 2-4
Share of Properties Reporting Given Loan Servicer by Property Size



Source: Tabulations of Property Owners and Managers Survey (HUD, 1996).
Note: "Other" includes federal agencies, state or municipal government, life insurance companies, REITs, and pension funds.

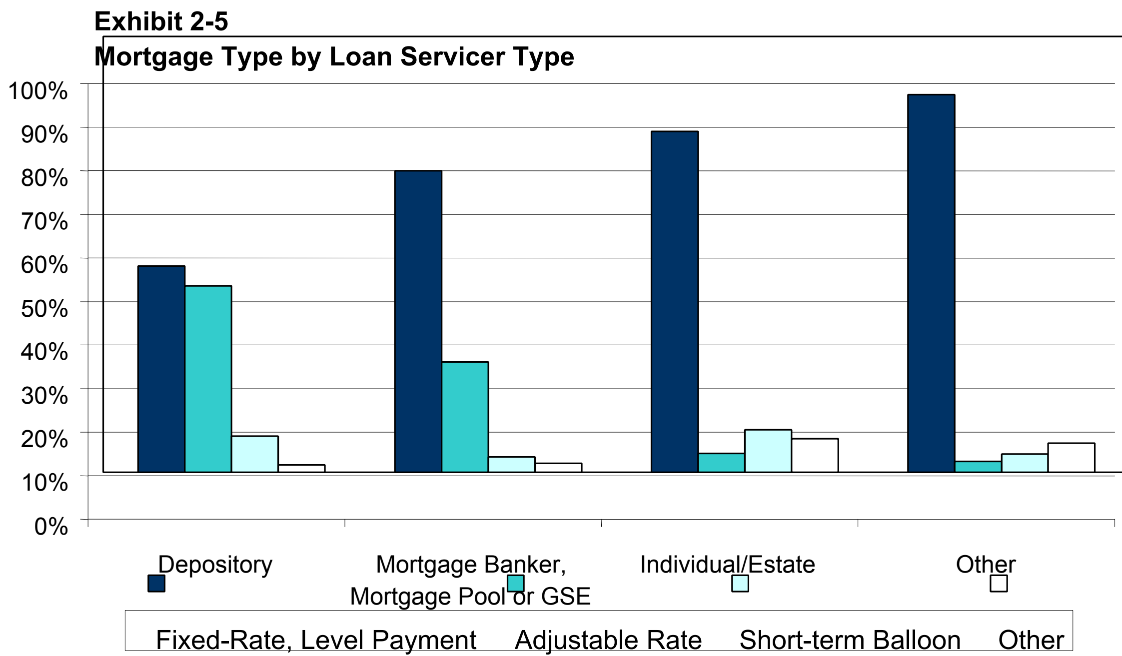
Finally, larger properties are more likely to have “Other” sources of financing, which include life insurance companies, pension funds, real estate investment trusts (REITs), or federal, state or municipal government agencies. This source accounts for nearly a quarter of mortgaged properties with 250 units or more, and less than 10 percent of properties with only 5 to 19 units.

In sum, small properties are very reliant on depositories for mortgage financing. In fact, individuals and estates are a more important source than either mortgage bankers or other sources such as pension funds and insurance companies. The broader financing options for larger properties no doubt provide greater competition to keep interest rates low and to make a broad range of loan types available.

2.5 Mortgage Type

With short-term deposits a key source of funds for depositories, they are more sensitive to interest rate risk than other lenders. As a result, mortgage financing from depositories is more likely to be in the form of adjustable rate mortgages than other types of mortgages, in order to protect depositories from the interest-rate risk associated with long-term fixed-rate mortgages (see Exhibit 2-5). While there are some advantages to this type of loan for borrowers, it also exposes owners to greater risk from rising interest rates.

Exhibit 2-5
Mortgage Type by Loan Servicer Type



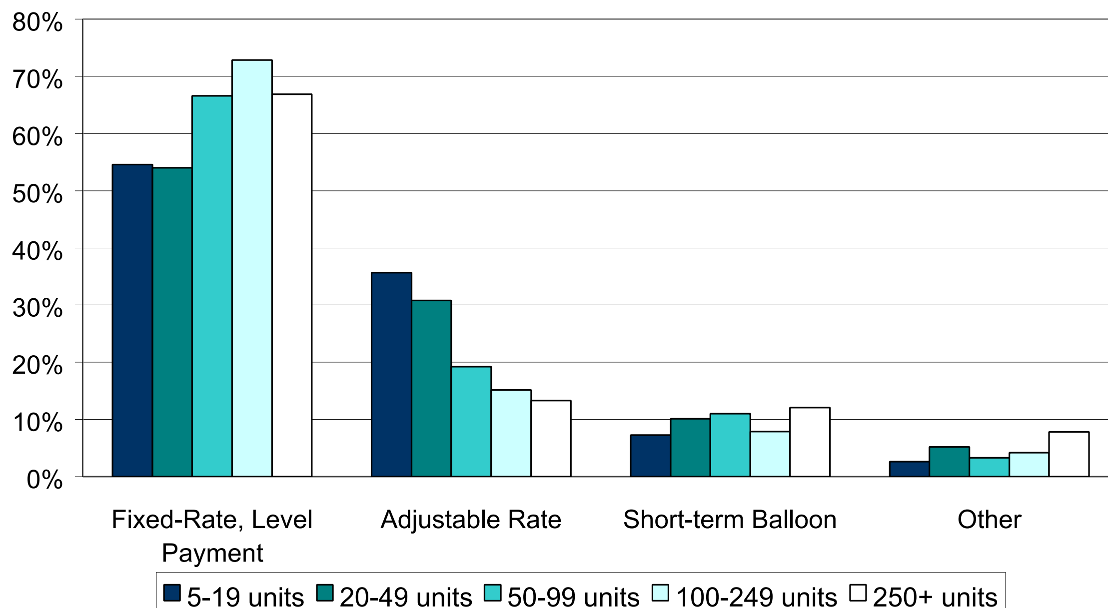
Source: Tabulations of Property Owners and Managers Survey (HUD, 1996.)

Note: "Other" includes federal agencies, state or municipal government, life insurance companies, REITs, and pension funds.

Exhibit 2-6 presents the distribution of loan type by property size. As shown, smaller properties are somewhat less likely to be financed with fixed-rate, level payment loans and more likely to have an adjustable rate mortgage. The greater likelihood of small properties to have an adjustable-rate mortgage is in keeping with the fact that these properties are more likely to be financed by depository institutions. However, for all property types, including small properties, fixed-rate loans account for the majority of loans. But for larger properties this share reaches about 70 percent. Adjustable rate loans account for a third of loans among properties with 5 to 19 units, and only slightly more than 10 percent of loans for properties in the largest size category. Thus, while small properties are, in fact, much more likely to have adjustable rate financing, these loans are not the predominant form of loan for small properties. Somewhat surprisingly, there is little variation across

loans sizes in the share of mortgages that are short-term balloons (loans that do not fully amortized before the loan term expires). Such balloon mortgages are common in secondary market loan pools and so it might have been expected that the share of these loans would be higher for larger loans. However, these loans are also marked by a fixed interest rate and so respondents may have chosen to report the fixed-rate, balloon payments as fixed-rate loans.

Exhibit 2-6
Property Size by Type of Mortgage



Source: Tabulations of Property Owners and Managers Survey (HUD, 1996).

2.6 Purchases of Small Loans by the GSEs

Each year the GSEs provide HUD with information on their mortgage purchases during the preceding year as part of HUD's oversight of the GSEs' efforts to meet their housing goals. Exhibit 2-7 shows the trends from 1994 through 1999 in the number of multifamily units in small properties backed by mortgages acquired or guaranteed by the GSEs. For the most part, small multifamily properties have accounted for a relatively small share of the GSEs' multifamily units. For Freddie Mac, small multifamily properties have consistently accounted for less than 5 percent of their multifamily units. Fannie Mae has had similarly low shares accounted for by small properties with the notable exceptions of 1995 and 1998 when there were significant number of small properties in their transactions. These shares appear to fall well below the share of the mortgage market accounted for by small multifamily properties. The Survey of Residential Finance (RFS) found that small

multifamily properties accounted for 39 percent of recently financed multifamily units in 1991.[14] Small multifamily properties have not come close to this share of GSEs acquisitions—even in years when Fannie Mae's share of small multifamily units was unusually high.

Exhibit 2-7
GSE Multifamily Transactions by Size of Property
And Acquisition Year
(in Units)

	1994	1995	1996	1997	1998	1999
Fannie Mae						
Small (5-50 units)	8,717	45,488	5,838	8,111	64,753	12,351
As % FNMA MF Total	3.9%	19.3%	2.1%	3.2%	16.5%	4.2%
Freddie Mac						
Small (5-50 units)	1,165	2,461	4,100	3,963	10,244	4,068
As % FHLMC MF Total	2.6%	3.6%	4.2%	4.0%	4.6%	2.1%

Source: HUD tabulations of GSE Public Use Data Base (HUD, 2000, page 65109).

However, a recent noteworthy development is Fannie Mae's announcement of a new product for multifamily properties with 5-50 units. Features include a streamlined underwriting process designed, in part, to reduce borrower costs for third-party reports; use of FICO scores to evaluate borrower creditworthiness; and recourse to the borrower in the event of default.[15] While it is too early to tell whether this new product will result in a significant increase in Fannie Mae's transactions involving mortgages for small multifamily properties, this effort is aimed at increasing Fannie Mae's activity in this market segment.

It is also important to note that the limited volume of small multifamily properties in secondary market transactions is not a unique characteristic of the GSEs. Information regarding non-GSE securitization of small loans is quite limited, but in commenting on a CMBS offering backed by commercial loans with a balance of less than $1 million,

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[14] HUD (2000), page 65109.

[15] "Fannie Mae Announces New 5-50(SM) Streamlined Mortgage for Small Multifamily Properties is Now Available Through DUS Lenders; 10-Year Volume Goal is $18 Billion," Fannie Mae press release, May 10, 2000.

Commercial Mortgage Alert noted that such offerings are rare. The article reported that from the beginning of 1998 through the first quarter of 1999, only 1.8 percent of CMBS issued involved small balance loans.[16] Thus, the GSEs' shares in the 2 to 4 percent range are actually higher than in the non-agency CMBS market.

2.7 Summary and Conclusions

This chapter presents an analysis of data from the Property Owners and Managers Survey (POMS) on the availability and cost of financing for small multifamily properties. According to the POMS, multifamily properties with fewer than 50 units account for the vast majority of multifamily properties (88.5 percent), with most (74.9 percent) having fewer than 20 units. But small properties account for a smaller share of units, encompassing only slightly more than a third of all multifamily units (37.2 percent). Consistent with the view that smaller properties have a more difficult time obtaining mortgage financing, smaller properties are less likely to have mortgage debt than larger properties. Among properties with fewer than 20 units, about two-thirds of properties have outstanding mortgage debt. This share climbs to nearly 80 percent for properties with between 20 and 49 units, and about 90 percent for properties of 100 units or more. Smaller properties are also found to be somewhat less likely to have obtained a new first mortgage during the 1994-95 period.

The POMS also reveals that the mortgages on smaller properties tend to have higher interest rates than those on larger properties. The highest interest rates are found on properties with between 5 and 19 units, averaging 8.9 percent. Interest rates are found to decline systematically with property size up to 100 units. Properties with 20 to 49 units have average interest rates that are about 40 basis points lower than the smallest property category, those with 50 to 99 units are about 50 basis points lower, while properties with more than 100 units have average interest rates that are more than 100 basis points lower.

Data from the POMS also reveals the extent to which depositories have been the principal source of funding for this market segment. Among properties with fewer than 50 units, about 70 percent of those with mortgage debt report depositories as the loan servicer. In comparison, about 45 percent of properties with 100 or more units have loans serviced by depositories. For these larger properties, loan sources such as mortgage bankers, secondary market loan pools, the GSEs, pension funds, insurance companies, and other government lending programs account for slightly more than half of all mortgages. For small properties, these sources account for only 15 percent of existing mortgages. In fact, small

[16] Commercial Mortgage Alert, 1999a

properties are about as likely to be financed by individuals or estates as these non-depository lenders. Mortgages serviced by depositories are less likely to be fixed-rate, level-payment loans than loans from other sources. Consistent with the fact that smaller properties are more likely to have mortgages with depositories, these properties are also more likely to have adjustable-rate financing than larger properties.

This chapter has also examined the extent to which loans for small multifamily properties have been purchased by the GSEs. For the most part, small multifamily properties have accounted for a relatively small share of the multifamily units involved in GSE transactions. For Freddie Mac, small multifamily properties have consistently accounted for less than 5 percent of their multifamily units. Fannie Mae has had similarly low shares accounted for by small properties with the notable exceptions of 1995 and 1998 when there were significant numbers of small properties in their transactions. These shares fall well below the share of the mortgage market accounted for by small multifamily properties. The 1991 Survey of Residential Finance (RFS) found that small multifamily properties accounted for 39 percent of recently financed multifamily units. Small multifamily properties have not come close to this share of GSE acquisitions—even in years when Fannie Mae's share of small multifamily units was unusually high.

However, small multifamily loans have also comprised a very small share of loans in non-agency CMBS. In commenting on a Commercial Mortgage-Backed Security (CMBS) offering backed by commercial loans with a balance of less than $1 million, *Commercial Mortgage Alert* noted that such offerings are rare.[17] The article reported that from the beginning of 1998 through the first quarter of 1999, only 1.8 percent of CMBS issued involved small balance loans.

[17] Commercial Mortgage Alert, 1999a

Chapter 3
An Assessment of the Barriers to Financing Small Properties

This chapter describes the potential barriers to providing financing for small properties and presents our findings from interviews with industry participants regarding the importance of these barriers at present. We have identified five reasons why it may be more difficult to finance small multifamily properties, leading to situations where small properties are less likely to have a mortgage, may have higher mortgage costs, or may be more likely to have adjustable rate financing compared to larger properties. These five arguments are:

- The origination process is too costly or otherwise burdensome for small properties;
- Small loans are not profitable to originate or service;
- The credit risk of small loans is higher or more difficult to assess;
- Market imperfections limit the sale of small loans to secondary market investors; and
- Small loans are common in small cities and rural areas where market risk is higher.

Each of these arguments will be discussed in turn below, along with a summary of our findings regarding the evidence supporting or contradicting these arguments.

3.1 Origination Cost

One of the principal findings of the previous HUD study on financing for small properties was that financing activity for small properties was constrained by "the burden of origination and up-front fees on the financial resources of typical small project owners and developers."[18] This view was substantiated in the interviews that were conducted for this study. This issue primarily arises with regard to what has been described here as the standard commercial underwriting process.[19] The underwriting process in these cases requires so-called "third-party reports" for property appraisals, structural (or engineering)

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18 HUD (1996) page i.

19 The standard commercial underwriting approach is similar to what is typically required for loans originated for secondary market investors or FHA-insured loans.

assessments, and environmental assessment. The combined cost for these third-party reports is typically from $10,000 to $15,000.[20] These costs, combined with other origination fees, become prohibitively expensive for small loans.

One reason that depositories have been able to serve the small loan market is that they utilize a different approach. The appraisal is a much simpler process, and the engineering and environmental reports may be skipped entirely unless the appraisal inspection reveals evidence that such reports are warranted. Lenders offset the potentially greater risks from this lower due diligence by requiring personal recourse to the borrower. Thus, in the typical depository approach to underwriting small loans, the creditworthiness of the borrower is as important as the value of the asset. This approach to underwriting is more like the process used for residential mortgages than for commercial mortgages.

In contrast to standard commercial underwriting, the depositories' approach to underwriting also does not require as extensive documentation of income and expenses. In the standard commercial underwriting approach, owners must also provide certified rent rolls and have up-to-date leases. In many cases, small property owners are not sophisticated property managers, so their record keeping practices make it difficult to provide the type of documentation that is required by the rating agencies. These borrowers may be unable or unwilling to develop the documentation that is needed for the underwriting process. So even a simplified version of the typical commercial mortgage underwriting process may not be well suited for many borrowers in the small property market. In contrast, depositories will often accept annual income tax statements to document historical financial performance. The depositories will also rely on their understanding of local market conditions to assess the property's financial soundness. If lenders have concerns about the property's financial stability, one approach is to offer a lower loan-to-value ratio than would otherwise be required. Also, as with the reduced third-party report requirements, an important part of the depositories' risk mitigation strategy is to rely on the creditworthiness of the borrower.

3.2 Profitability of Loan Origination and Servicing

Another barrier to serving the small loan market is that these loans are viewed as unprofitable to originate and service. The previous HUD study found that "mortgage bankers typically have been unable to operate small project lending programs profitably because of the projects' high transaction costs relative to anticipated financing revenues." [21] The problem arises because lenders are compensated for originating and servicing loans

[20] See Foong (1999) for a discussion of the costs of third-party reports.

[21] See HUD (1996) , page 3.

by fees that are set as a percentage of the loan balance. However, many of the steps involved in the underwriting and servicing of loans require as much effort for small properties as for large properties. As a result, mortgage bankers using the standard commercial underwriting approach have found it unprofitable to originate and service these loans. The interviews conducted for this study also found that the fees earned on small loans cannot easily support the traditional underwriting and servicing approach of mortgage bankers.

There are several reasons why depositories are not similarly hampered. First, as described above, the underwriting process generally employed by depositories is not as complex as that used by mortgage bankers in the commercial mortgage market. Similarly, the servicing requirements for CMBS usually require annual on-site inspections by servicers, whereas depositories only conduct on-site inspections when projects fail to meet their financial obligations. Additionally, HUD's 1996 study of the small multifamily market also found that depositories active in the small property market generally had salaried staff dedicated to serving this niche. In contrast, commission-based staff of mortgage bankers have a strong incentive to devote their attention to larger loans for which there is greater compensation.[22] Finally, depositories interviewed for this study noted that they are able to compensate for higher costs by charging slightly higher interest rates on smaller loans.

All of these elements of the depositories' approach are also evident in the approach used by mortgage banking conduits developing small loan programs. The simplified underwriting process used by conduits (described in detail in Chapter 4) both helps to make the program more attractive for borrowers *and* less labor-intensive for lenders. The more successful firms also generally have staff dedicated to this product line, so there is no competing incentive to devote attention to larger projects. Lenders serving this market note that it is essential to have a very streamlined underwriting process to keep per loan costs low. It is also important to generate a substantial volume of loans to be able both to cover staff and other overhead costs and to earn a profit.[23] Finally, the interest rates on these loans are generally somewhat higher than for larger loans from the same lender to provide greater compensation for underwriting and servicing.

Mortgage bankers who have started small-loan programs report that this product line can be profitable with the right approach. However, given the goal of streamlining the underwriting process, properties that for one reason or another are more difficult to

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[22] See Schneider and Follain (1998) page 48.

[23] One lender who was among the most active originators under FHA's Small Project Processing (SPP) initiative had hired staff dedicated to originating loans under this program. The lender had anticipated sufficient demand for loans under this program to be able to support this staff. However, problems with the program, most notably the long time periods from application to closing, meant that the lender was not able to achieve the expected loan volume. As a result, they found this product line to be unprofitable, so the staff was laid off and the program discontinued.

underwrite will not be good candidates for these programs. For example, if property owners do not have good financial records, lenders will not be willing to spend the time that would be needed to help owners develop the necessary records.[24] Similarly, for programs that require credit checks on borrowers, lenders will avoid situations where there are multiple owners requiring multiple credit checks, because of the effort involved.

3.3 Credit Risk

Another explanation that has been proposed for why small properties have had difficulty obtaining financing is that the credit risk of these properties is greater. One argument for greater risk is that the small number of units in the properties makes cash flows more volatile—two empty units in a 10-unit building would create a 20 percent vacancy rate. Another reason for greater risk is that small property owners are not as sophisticated as larger property managers and so may be less effective managers. Finally, even if default rates were not higher for small loans, the expected loss from default rate may be higher because the fixed costs associated with foreclosure represent a larger share of the outstanding loan balance.

However, neither a review of the literature nor interviews with lenders found any support for the view that small properties represent greater credit risks. The previous HUD study found that a "majority of lenders interviewed felt that small projects were comparable to other multifamily properties in terms of historical loan performance."[25] Interviews conducted for this study revealed similar sentiments. In fact, many lenders viewed these loans as less risky because of the greater motivation of owners to retain ownership of their properties. Many small property owners are individuals for whom these assets represent a significant share of their personal wealth. As a result, they are much more motivated to retain ownership of the property. In addition, in many cases small loans also entail personal recourse to the borrowers, which provides additional motivation to meet their financial obligations on the loan.[26]

There have also been several recent articles that have examined the default risk of multifamily loans that have included the size of the property or loan as an explanatory variable. Follain, Huang and Ondrich (1999) model the performance of FHA-insured loans

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[24] One exception would be a situation where a property owner has a substantial portfolio of small properties. In such a case, one lender reported that they would be willing to organize the necessary information because of the payoff in a large volume of loans.

[25] Schneider and Follain (1998) page 49.

[26] A recent offering of a CMBS backed by portfolio of small loans by Bank of America achieved a lower level of subordination than is typical of conduit deals. This lower subordination was attributed in part to the fact that virtually all of the loans have full recourse to the borrowers (Commercial Mortgage Alert, 1999b).

and find that loan size is consistently significantly and positively related to the probability of claim. Thus, smaller loans are less likely to end in a claim. Archer, et al (1999) examines the performance of loans securitized by the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC) during 1991-96. They also find that larger properties have a significantly higher probability of default.

While small properties may not generally be riskier, in some cases it may be harder to assess the risk of an individual property. There are several reasons why this may be true. First, as was described above, poor record keeping by some small property owners makes it difficult to evaluate the financial condition of the property. Second, the fact that small property owners are often not professional property managers with a proven track record may make it more difficult to evaluate the effectiveness of their management practices. However, in other respects, the process of evaluating risk for small properties is identical to that of larger properties. A non-trivial issue, however, is the question of how much it costs to undertake this process. As described above, the cost of underwriting small loans using the standard approach required by secondary market investors is often too costly for borrowers and lenders alike.

However, depositories do not appear to have any difficulty assessing the credit risk of smaller properties. As will be discussed in Chapter 4, depositories are generally quite willing to provide funding for small properties and view these as among their more profitable assets. One explanation for depositories ability to serve this market niche may be that they have an informational advantage in assessing the credit risk of these properties compared to other lenders. For example, depositories might make loans to borrowers with whom they have had a long-standing relationship. This relationship would provide them with information on borrower credit risk that is not evident to other lenders. Another informational advantage might be due to the depositories' intimate knowledge of local market conditions. Given the concentration of their lending in markets in which they are located, depositories may not need as much documentation from borrowers to assess the risk of a property in a given area.

But it is not clear how well this explanation actually describes the depositories' situation. The depositories interviewed indicated that borrowers were not necessarily individuals with whom they had a long-standing relationship. And while depositories often do specialize in lending in local markets where they have branches, in some cases they have extended lending to nearby states, and the largest depositories have expanded lending programs to all regions of the country. Thus, not all depositories need to be located in markets where they lend. In addition, even local lenders require documentation of income and expenses and undertake appraisals and physical inspections of some kind. And, as described above, a lower level of due diligence on the property is mitigated by a through check of the borrower's creditworthiness and a requirement of personal recourse

agreements. Thus, while depositories indicate that knowledge of the local market is helpful, it is not absolutely necessary. Countrywide's initiative to create a small loan program that employs an underwriting process that is similar to the approach used by depositories is another indication that lenders do not have to be locally based to serve the small property market.

In short, it does not appear that differences in the level of credit risk or difficulties in assessing credit risk are critical factors in explaining why small properties may have greater difficulty obtaining mortgage financing. Available evidence suggests that the credit risk of smaller properties is most likely lower than for larger properties. While it can be more difficult to assess the credit risk of smaller properties, depositories are able to deal with the problem by relying more heavily on the creditworthiness of the borrower than on the financial condition of the property.

3.4 Potential Barriers to Secondary Market Access for Small Loans

One of the issues of concern for this study is whether there may be factors that impede the sale of small multifamily loans by originators in the primary market to secondary market investors. As discussed in the previous chapter, small multifamily loans have comprised a disproportionately small share of multifamily loans purchased by the GSEs and loans securitized in CMBS pools, compared to estimates of the share of multifamily loans accounted for by small properties in the primary mortgage market. This section will explore possible explanations for this apparent lack of access to the secondary market by small multifamily loans.

One problem that is endemic to secondary market transactions is that of asymmetric information between originating lenders and secondary market investors. Originators are generally thought to be in a better position to assess the risk of loans due, for example, to a long-standing relationship with the borrower or intimate understanding of the local market. Lacking this inside information, secondary market investors cannot fully assess the risk of these loans. The problem is further exacerbated when the lender is primarily originating loans to hold in portfolio. In this case, when loans are offered for sale to secondary market investors the concern is that the originator has selected loans for sale that it knows are higher risk for reasons that are not readily apparent to the investor. Akerlof's classic article (Akerlof, 1970) on this subject has shown how such a problem of asymmetric information between buyers and sellers can impede the development of a market because the uncertainty about the quality of goods offered for sale results in only "lemons" being brought to market.

A related, but separable, issue is that secondary market investors have to rely on lenders to act in their interest in originating loans. To the extent that lenders are largely compensated by fees earned at origination, they will have an incentive to originate as many loans as possible and so may not be as prudent as investors would like them to be in underwriting loans. This situation is a classic example of a principal-agent problem in economics where the principal must establish incentives to ensure that the agent acts in the principal's interest. This issue is separable from the market for lemons problem in that the concern is not necessarily that the agent is *only* passing on lower quality loans as is the case in the market for lemons, rather that the agent may include lower quality loans among those it originates.

The problems of both asymmetric information leading to adverse selection and the principal-agent problem affect essentially all secondary market transactions. However, a variety of methods to address these problems have been developed and are widely used in secondary market transaction involving residential and commercial mortgages. Riddiough has summarized the four most commonly used approaches.[27] First, secondary market investors specify required loan origination guidelines ("bright line" tests) that are designed to screen out loans of unacceptable quality.[28] Second, secondary market investors will review lenders' activities to ensure that they are adhering to the underwriting criteria and will monitor ongoing loan performance as a further check on the adequacy of the underwriting process. Third, secondary market investors may require originators to enter into loss sharing arrangements to retain responsibility for some share of losses to align the interests of the originator with those of the investor. Finally, the desire for repeated business transactions between originators and investors provides an incentive for originators to behave in a responsible manner over time.

While Riddiough was describing the approach used by conduits in non-agency transactions, all four of these safeguards are evident in the approach used by Fannie Mae to obtain multifamily loans. The principal avenue by which Fannie Mae purchases multifamily loans is through its Designated Underwriter and Servicer (DUS) program. Under this program, lenders are granted authority to originate loans to be purchased by Fannie Mae without prior approval. Lenders are required to follow detailed underwriting guidelines established by Fannie Mae. Lenders are also subject to on-site reviews to verify that they are following established policies and procedures to ensure that the underwriting guidelines are implemented as intended. In addition, the DUS program requires lenders to enter into loss sharing arrangements so they will bear some losses in the event borrowers fail to meet

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[27] Riddiough, 2000.

[28] For non-agency transactions, rating agencies undertake the steps outlined in this discussion to to protect the interests of investors in mortgage-backed securities.

their loan obligations. Finally, participation in the DUS program is limited to a select group of lenders who will have repeated dealings with Fannie Mae.

In contrast, Freddie Mac's approach is much more cautious. After experiencing significant losses on multifamily loans it purchased from lenders in the 1980s, Freddie Mac withdrew from the multifamily market entirely during the early 1990s. When it reentered the market, Freddie Mac's approach to ensure high quality loans was to re-underwrite all multifamily loans that it purchases. Like Fannie Mae, Freddie Mac has established a network of lenders (Program Plus lenders) whom they have selected as being eligible to provide them with multifamily loans. Freddie Mac has also developed detailed underwriting guidelines that these lenders are required to use to screen loans for sale to Freddie Mac. However, even given these safeguards, Freddie Mac does not rely on the underwriting review of the originating lenders but rather re-underwrites each loan itself. Because of its involvement in re-underwriting loans, Freddie Mac does not require the additional protection of loss sharing with originating lenders.

While the concern about adverse selection is a serious problem, the approaches described above have been sufficient to support a great deal of activity during the 1990s involving multifamily loans in CMBS securitizations and in purchases by the GSEs. Nonetheless, as detailed in Chapter 2, the volume of secondary market activity involving small multifamily loans has been quite small. A key question for this study is why the approaches used to ensure the quality of large multifamily loans sold on the secondary market might not work for small multifamily properties.

As described earlier in this chapter, one important factor is that the underwriting guidelines used by the GSEs and the rating agencies to ensure loan quality can be prohibitively expensive for small loans. Fees for appraisals, engineering and environmental reports can represent a prohibitively large share of the loan balance for small properties. As will be described more fully in Chapter 4, a number of conduits and Fannie Mae have developed small loan programs which reduce the types of third party reports required in order to lower origination costs. While lenders developing these approaches report they are having success in tapping the small property market, no systematic information is yet available to indicate whether a significant volume of small loans are being originated under these programs.

One challenge facing these conduit small loan programs is in quickly generating a sufficient volume of small loans to support the issuance of a security. Rating agency guidelines for evaluating pools of small loans indicate that the lower information gathered from streamlined origination processes is acceptable if loan pools are large enough so that

benefits of diversification offset the lower information available.[29] For example, Duff & Phelps' criteria indicate that pools of at least 500 loans are needed in order to support statistical rating techniques commonly used in rating residential mortgage backed securities. This approach requires that lenders have the ability to originate a large number of small loans quickly. The loans must be originated quickly in order to minimize the credit and interest rate risks faced by originators while the loan pool is developed. However, most commercial mortgage firms have been geared toward originating a smaller number of large balance loans. In part, the focus on large balance loans is driven by the fact that these loans can be more profitable to originate, since fees are tied to loan balance and the underwriting process can be as time consuming for smaller loans as for larger loans. Large balance loans also have the advantage of allowing firms to more rapidly accumulate a large enough loan pool to support the issuance of a security. It is not yet clear whether commercial mortgage firms are well suited to producing a high volume of small loans.

While commercial mortgage firms do not have a track record of originating loans for small multifamily properties, depositories have succeeded in serving this market niche. Why is it that these loans have not made their way into the secondary market? Undoubtedly one important factor is that depositories are primarily originating loans to hold in their portfolios and only occasionally seek to sell loans on the secondary market in order to re-balance their portfolios. But in addition, many of the safeguards employed by the secondary market to ensure the quality of loans purchased do not work well with the depositories' underwriting approach or financial needs.

To begin with, depositories appear to have succeeded in serving the small multifamily market niche by employing a process for property inspections and appraisals that is much less costly that that required by the rating agencies or GSEs. In interviews conducted for this study, depositories reported that in reviewing property conditions and values they relied on the expert judgement of local agents whose opinions they have come to trust. This more informal underwriting process and reliance on relationships does not fit well with the secondary market's need to establish "bright line" tests for underwriting guidelines. Another important limitation is that risk-sharing provisions, such as those used by Fannie Mae's DUS program, are not financially attractive for depositories. Regulators generally require that depositories hold as much risk-based capital against loans sold with risk sharing or other forms of recourse as for loans that were not sold. As a result, depositories are unlikely to be attracted to sales requiring risk-sharing requirements.[30]

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[29] See for example "Rating of Transactions Backed by Small Multifamily and Commercial Mortgage Loans" Duff & Phelps Credit Rating Co., February 1998.

[30] Perhaps not surprisingly, Fannie Mae's DUS lender network does not include a single depository. In contrast, Freddie Mac, which does not require risk sharing because it re-underwrites each loan it purchases, has several depositories in its Program Plus network of lenders.

Finally, since depositories may seek to sell loans from their portfolios only occasionally, the discipline provided by the need to protect their reputation for providing quality loans to support repeated transactions is less evident.

In sum, it appears that one of the principal reasons that small multifamily loans have not been prevalent in secondary market transactions is that the detailed underwriting requirements used by the rating agencies and the GSEs to ensure loan quality are prohibitively expensive for small balance loans. Small loan programs have been developed by Fannie Mae and a number of conduits to streamline the origination process to address this barrier, but it is not clear whether these programs will succeed in generating a very large volume of small loan originations. Among the challenges facing these programs are the lower fees earned by originators on small loans, which make this niche less attractive than the market for large multifamily loans. In contrast, depositories have been successful in serving the small property market by employing a simpler underwriting process that is financially attractive to both borrower and lender and provides adequate screening for loan quality. However, this process is not well suited to the types of safeguards employed by secondary market actors to ensure loan quality. It would appear that both the problems of employing these safeguards with depositories as well as the focus of depositories on originating loans primarily to be held in portfolio contribute to the dearth of small loans sold to secondary market investors.

3.5 Market Risk in Areas Where Small Properties are Prevalent

The prior HUD study on the market for financing small properties found that markets where there was a large stock of small properties generally had a number of lenders actively serving this market. San Francisco and Boston were specifically cited as areas with an active network of lenders operating in this market niche.[31] The New York metropolitan area has also been identified as an area where large demand has fostered the development of a competitive market. In fact, mortgage brokers are reported to bring borrowers from nearby states to depositories in New York to take advantage of their lending programs.[32] However, the HUD study also found that outside of large market areas, particularly in rural areas, there were fewer lenders active in multifamily lending.

The interviews conducted for this study largely corroborate this finding. Housing developers who were identified by the National Association of Homebuilders (NAHB) as having trouble obtaining financing were all located in rural market areas. These developers reported being limited to local depositories for financing, as mortgage bankers were not

[31] See HUD (1996) page 9.

[32] See Foong (1999).

active in these areas. Interviews with mortgage bankers found that they were generally reluctant to enter these markets. One reason for this reluctance is that small and rural market areas are believed to be riskier because sharp fluctuations in the supply or demand for rental housing are more likely. Mortgage bankers also reported to be unwilling to originate these loans because of the added costs associated with travel to these market areas from their offices in larger metropolitan areas. These costs would be particularly prohibitive for smaller properties.

While the developers interviewed did not report that they were unable to secure any financing, they did note that the terms offered by the small, local depositories had higher interest rates and were more likely to be limited to adjustable rate products than loans available in larger market areas. Developers largely attributed the less favorable loan terms to a lack of competition in these markets. But while developers were able to obtain financing when needed, they did note that they often had to work hard to find lenders who were willing and able to make these loans. Bank regulations limit the value of loans held in portfolio from a single borrower to 15 percent of a bank's portfolio. In some cases, developers in small markets had reached this limit with local lenders. Developers also reported having to coax depositories to make this type of loan, as many very small banks were not engaged in real estate lending. This lack of experience with this type of loan may also contribute to the conservative loan terms offered by these lenders.

3.6 Summary and Conclusions

There are several barriers to providing financing for small multifamily properties using the standard commercial mortgage underwriting process. The standard process, which is used extensively in loans on larger commercial properties, typically mandates the use of a recent appraisal by a state-certified appraiser, environmental reviews, and attorney opinions and certifications. The high fixed costs associated with this process make the standard approach prohibitively expensive for smaller properties. A related problem is that even in cases where a lower cost underwriting process has been developed, many small property owners do not keep sufficient documentation of the properties' income and expenses to provide the type of information needed for commercial underwriting. Finally, the revenues generated by these loans for underwriting and servicing, which are based on a percentage of the loan balance, are too low to make these loans profitable for many commercial mortgage originators.

One factor that does not seem to be a barrier to serving this market is higher credit risk associated with smaller loans. Lenders generally expressed the view that these loans did not present any greater risk than larger properties. In fact, recent studies on multifamily loan performance have found that smaller loans are less likely to default. It is true that it

can be more difficult to assess the credit risk of smaller loans due to a lack of documentation of the properties' financial condition and less information about the small property managers' abilities. However, depositories have demonstrated that these problems can be remedied by requiring a credit check on the borrower and personal recourse to support the loan.

The principal source of financing for small multifamily properties has been depository institutions. These lenders have been able to circumvent the barriers described above by employing an underwriting process that is best described as a hybrid between the approach used to underwrite residential mortgages and that used to underwrite commercial mortgages. Depositories rely as much on the creditworthiness of the borrower as the value of the asset securing the loan. By only making loans to creditworthy borrowers and by requiring personal recourse, depositories are able to rely on a much less costly process to evaluate the property. This approach also means that borrowers are not required to provide the level of documentation of property income and expenses that is required by secondary market investors.

Multifamily properties located in rural areas and small markets tend to be small. As a result, there is a correlation between property size and the size of the market area where the property is located. One barrier to obtaining financing for properties in these areas is that there may not be many depositories engaged in multifamily lending. Furthermore, interviews with mortgage bankers found that they were generally reluctant to enter these markets. One reason for this reluctance is that small and rural market areas are believed to be riskier because sharp fluctuations in the supply or demand for rental housing are more likely. Mortgage bankers also reported to be unwilling to originate these loans because of the added costs associated with travel to these market areas from their offices in larger metropolitan areas. These costs would be particularly prohibitive for smaller properties.

One of the issues of concern for this study is whether this low level of secondary market activity involving small multifamily loans may be indicative of impediments to the sale of small multifamily loans by originators in the primary market to secondary market investors. One of the principal reasons that small multifamily loans have not been prevalent in secondary market transactions appears to be that the detailed underwriting requirements used by the rating agencies and the GSEs to ensure loan quality are prohibitively expensive for small balance loans. Fannie Mae and a number of conduits have developed small loan programs to streamline the origination process to address this barrier, but it is not clear whether these programs will succeed in generating a very large volume of small loan originations. Among the challenges facing these programs are the lower fees earned by originators on small loans, which make this niche less attractive than the market for large multifamily loans. In contrast, depositories have been successful in serving the small property market by employing a simpler underwriting process that is financially attractive

to both borrower and lender and provides adequate screening for loan quality. However, this process is not well suited to the types of safeguards employed by secondary market actors to ensure loan quality. It would appear that both the problems of employing these safeguards with depositories as well as the focus of depositories on originating loans primarily to be held in portfolio contribute to the dearth of small loans sold to secondary market investors.

Chapter 4
Qualitative Findings on the Current Availability and Cost of Mortgage Financing for Small Properties

To gather qualitative information on the availability and cost of financing for small multifamily properties, we conducted interviews with representatives from national industry organizations representing multifamily developers and owners, specifically, the National Association of Homebuilders (NAHB) and the National Multi Housing Council (NMHC). After getting the perspective of these national organizations on the state of the market, we then sought referrals to members of the organizations to further explore this issue. In addition, we conducted interviews with lenders to gather information about the type of properties served by their lending programs, the terms and rates of their loans, and the degree and nature of competition they faced in their market areas. Finally, information on loan terms and rates was also gathered from the lenders' web pages on the Internet. This chapter will summarize our findings and tentative conclusions based on the information gathered from these sources. Given the nature of this investigation, the findings are not conclusive. Nonetheless, we believe the findings do provide some interesting insights into the current state of the market and identify some trends that bear watching.

4.1 Availability of Financing

Representatives from NAHB reported that their members continued to have difficulties in obtaining financing for smaller properties. They noted that this problem was most acute in rural areas where there were few lenders active in this market segment. For the most part, however, developers were able to obtain financing, but the interest rates and loan terms were not as favorable as in larger market areas. NAHB representatives also reported that their members had hoped that FHA's Small Project Processing (SPP) initiative would provide greater financing opportunities, but the continued high costs and long time frames associated with FHA underwriting meant that this program was not really a viable source of funds. However, some members noted that GMAC had developed a small loan program that was quite attractive in the rates and terms available. This comment indicates that the efforts of conduits to develop small loan programs was becoming evident to NAHB members.

NAHB then provided referrals to seven members who were developers of smaller properties. Of these developers, several reported being able to rely on affordable lending

programs through local bank consortia or programs offered through the Federal Home Loan Bank. Only three builders reported difficulty obtaining financing. In each case, the builder reported that with some effort they could obtain a loan through local depository institutions, but the loan rates and terms were not as favorable as in larger metro areas with which they were familiar. In general, the local banks would offer only adjustable rate mortgages, with fairly short adjustment periods (one to three years). One developer reported having to continually seek new lenders to make loans as he ran into constraints on the volume of loans these small institutions could make to one entity.

In contrast, a representative of NMHC reported that they have been monitoring the market for small property financing for a number of years and for the last two years they have not observed any problem obtaining financing for these properties. During the organization's annual meetings they host a roundtable discussion about current concerns and problems. In neither of the last two meetings was a lack of financing mentioned as a concern. They feel that the improvement has come about because lenders have gotten better at serving this market. The improvements include both the development of small lending programs by conduits, such as DLJ and ValuExpress, and the expansion of lending operations by depositories, such as Apple Savings and Key Bank. NHMC also noted that Fannie Mae has made a concerted effort to develop a small loan program and has had some success in getting originators to become more focused on this market segment. NMHC acknowledged that small loans generally do face higher interest rates, but that these higher rates are warranted by the higher costs of originating and servicing these loans. NMHC also noted that small property owners are reluctant to take the steps required to meet the documentation requirements of the secondary market. But these borrowers appear to be willing to accept higher interest rates and other less desirable loan terms in exchange for a simpler underwriting process from depository lenders.

Interviews with lenders and a review of industry publications found a great deal of interest in the small property market. In recent years, as competition has increased among secondary market conduits in the commercial mortgage markets, a number of firms have been attempting to tap into the small multifamily market as this niche seems to offer a large potential demand for financing. An article in *Multi-Housing News* from early 1999 indicated that 12 conduits were serving the small property market as well as 3 Fannie Mae DUS lenders (Foong, 1999). The approach followed by these firms has been to streamline these third-party reports to reduce costs for borrowers. A streamlined appraisal form is used, rather than requiring the more costly narrative report. An environmental transaction screen process is used rather than the more elaborate "Phase I" protocol. And a structural "review" is called for rather than a full-blown structural report. These simpler requirements can reduce the costs to borrowers to as low as $3,500.

As interest has grown in small properties by conduits, the rating agencies have begun to develop criteria for rating transactions backed by small loans where lower levels of due diligence are allowed. Duff & Phelps issued a report in February 1998 which describes three tiers of third-party report requirements for loans under $1 million (Duff & Phelps, 1998). For the lowest tier (loans under $250,000), the originator does not have to engage outside experts to conduct the inspections, and the required reviews entail fairly simple inspection reports. For the next tier ($250,000 to $750,000), a single third-party expert (most likely an appraiser) is required to conduct the inspections, although the same simplified inspection process used in the first tier is still allowed. For the third tier ($750,000 to $1 million), a qualified engineer must complete abbreviated Phase I and engineering reports. For loans of $1 million or more, the normal underwriting requirements for a CMBS transaction are required.

In 1997 FHA initiated its SPP program to serve the small property market. The intended approach of this program was also to reduce the up-front costs of origination to better serve the small market by requiring more economical versions of the third-party reports. The design of this program followed directly from the findings of HUD's 1996 study. However, interviews conducted in early 1999 with lenders who had been active in the program found that in some cases HUD field offices were still requiring more expensive third-party reports. In addition, FHA's review process has proven to be much too slow to retain borrower interest. As a result, the SPP program had not generated as much lending activity as had been hoped. In the spring of 1999, FHA announced that they were making revisions to the program to address these shortcomings.

While the development of a more economical underwriting process by the conduits has enabled these lenders to begin tapping the small property market, there are still other aspects of their underwriting process which make it difficult for some borrowers to take advantage of these lending programs. In order to assess a property's financial condition, the rating agencies require very complete documentation of income and expenses over the previous three years, including monthly statements for the previous year. Owners must also provide certified rent rolls and have up-to-date leases. In many cases, small property owners are not sophisticated property managers so their record keeping practices make it difficult to provide the type of documentation that is required by the rating agencies. These borrowers may be unable or unwilling to develop the documentation that is needed for the underwriting process. So even a simplified version of the typical commercial mortgage underwriting process may not be well suited for many borrowers in the small property market.

A new entrant into the market for financing for small multifamily properties is Countrywide, a large, nationwide residential mortgage originator and servicer. This firm has recognized that it is well positioned to build on its residential lending expertise to tap

the small multifamily property market. The underwriting approach developed by Countrywide is essentially the same as that used by depositories. A very low-cost approach (reportedly as low as $1,000) is used for appraisal and property inspection. Personal recourse is required of borrowers and credit checks are an important part of the underwriting process. In addition, income tax records are accepted to assess the property's income and expenses, avoiding onerous documentation requirements. By applying standard underwriting criteria, a maximum loan value is determined. Countrywide representatives describe this approach as being in contrast to the standard conduit process where the loan amount is an important variable in the negotiation process. In Countrywide's model, there is little room for negotiating on loan amount.

Unlike other conduits' small loan programs, Countrywide's approach is to develop loan pools that are more like residential pools than commercial pools. Duff & Phelps' report presenting their rating criteria for small loans discusses how they will employ statistical models derived from their residential pool models to evaluate small loan pools. However, for such an approach to work, a minimum of 500 loans is needed for a pool. For many originators, this loan volume is difficult to achieve. However, a lender such as Countrywide, with a broad residential loan origination network is well suited to develop such high volume origination. One obstacle for residential lenders seeking to enter this market has been to find investors willing to purchase these loans for pooling and securitizing. Residential lenders like Countrywide have established relationships with the GSEs for purchasing their residential loans on a flow basis, but did not have a similar outlet for these small commercial loans. Countrywide has developed a relationship with a Wall Street investment banking firm to fund these loans on a trial basis. If Countrywide proves successful at this approach, other residential lenders may also seek to enter this market.

But while non-depository lending programs are growing, depositories are clearly still the dominant force in this market. Mortgage bankers entering this market niche view depositories as the principal competition. On the other hand, the depositories interviewed also noted other banks as their principal competition and generally did not find mortgage bankers to be important competitors. In part, this lack of perceived competition from mortgage bankers may reflect the small volume of these lending programs. But it may also reflect a division in the small property market. While the simpler underwriting approach developed by conduits is creating greater opportunities for some small property owners, less sophisticated borrowers with poor documentation of their properties' financial condition are not good candidates for these programs. One depository noted that while they will lend to some "B" quality properties, these borrowers have more opportunities to choose from and so are not their principal clients. Instead, they focus on "C" and "D" quality properties that do not have the option of obtaining financing from mortgage

bankers. Conduit small loan programs appear to be aimed at the "B" quality properties that may not be the most significant segment of the depositories market.

While conduit loan programs may be beginning to expand financing opportunities for "B" quality properties, there is also evidence that some lenders are expanding loan programs aimed at lower quality segments. One example of such an expansion is LaSalle Bank. They have expanded their small multifamily loan program to all 48 continental states and believe that they can originate over $1 billion annually of this product. Smaller depositories that were interviewed also noted that they have slowly expanded their small loan programs into neighboring market areas. Then, as the lenders become comfortable with these new markets, they will expand their presence and consider other markets to enter.

In sum, it appears that small properties are generally able to obtain financing, but the available options are often limited. The opportunities for profitable lending in both higher and lower quality segments of the small property market appears to have spurred expanded lending programs by both conduits and depository lenders. Some market areas, with a large stock of small apartment buildings, are reported to have fairly competitive markets. But the number of lenders supplying funds is particularly thin for properties in smaller areas and those lacking good documentation of income and expenses. In these less competitive market segments, the interest rate of these loans may be higher and other loan terms may not be as favorable. The next section presents our findings on the issues of loan costs and other terms.

4.2 Interest Rates

Virtually all of the lenders interviewed acknowledged that small loans carry somewhat higher interest rates than larger loans. Among conduits offering small loan programs, the magnitude of the difference in rates offered on small and large loans was reported to be as small as 20 basis points[33] and as large as 120 basis points. This premium was justified on several grounds. Lenders attributed at least part of the higher rate to a need to be compensated for the fixed costs associated with underwriting and servicing these loans. But many lenders acknowledged that higher rates were also due in part to less competition in this market segment and less sophistication by borrowers.

The depositories interviewed generally do not offer separate small loan programs, so it is harder to gauge the magnitude of the interest rate differential faced by smaller loans from these sources. But in terms of a comparison of the rates available from conduits and

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[33] A basis point is 1/100th of a one percent.

depositories, it appears that the rates may be similar. The most common pricing spread quoted by depositories interviewed was 250 basis points over Treasuries of a comparable term. In comparison, the web site for ValuExpress, a conduit known for its small loan program, reports spreads for its small loans to be in the range of 200 to 300 basis points above Treasuries. Based on this example, it does not appear that the conduits' small loan programs necessarily offer significant interest rate advantages over depositories. One depository noted that in early 1998 when conduit spreads over Treasuries reached a low point, these lenders had a clear interest rate advantage. But once spreads widened again after the financial turmoil of the summer and fall of 1998, the depository's interest rates were again competitive with the conduits. Also, one lender active in FHA's SPP program noted that the program had a difficult time competing with LaSalle's small loan program because the rates offered by LaSalle were as good or better than the rates available with FHA insurance.

Given the context for this study, it is worth noting that the GSEs' borrowing advantages allow them to offer the most attractive interest rates for borrowers. Thus, while conduits and depositories may offer similar rates, loans made through the GSEs will generally have somewhat lower rates.

One indication that the interest rates on small loans are higher than would prevail under more competitive market conditions is that many of the depositories interviewed commented that these loans are among the most profitable assets in the banks' portfolios. Several commented that because of the great competition for residential loans, the returns on residential loans were generally not as attractive. In general it seems that small loan market is viewed as offering profitable opportunities which are spurring the development of new small loan programs by depository and non-depository lenders alike.

4.3 Other Loan Terms

Another consideration in assessing the availability of financing for small properties is the type of loan products available. Depositories are known to favor adjustable rate mortgages to better align the interest rate risk of these assets with the risk of their liabilities. The secondary market conduits, in contrast, generally offer fixed-rate loans. Our interviews with depositories generally supported this perception, although lenders reported several different options for the periods between adjustments that did offer borrowers some degree of choice.
For borrowers, adjustable rate loans are generally not preferable because of the risk of facing higher interest rates. One of the potential advantages of gaining access to conduit lenders is that more fixed-rate financing might be available.

On the other hand, a typical conduit loan will include prepayment penalties and will be a ten-year balloon note (although some lenders offer a range of options on the loan term, the terms are usually less than 20 years). Borrowers thus largely forfeit the option of refinancing and face the prospect of having to obtain a new loan in ten years under unknown market conditions. In contrast, depositories are more likely to offer fully amortizing loans and generally do not include yield maintenance provisions.

Thus, the typical loan products of depositories and conduits each have their advantages and disadvantages. With depositories the primary financing option for many small properties, borrowers do not generally have the choice of fixed-rate loans. An expansion of the number and type of lenders serving this market would create greater choice of loan type, allowing borrowers to select loans which are best suited for their tastes and circumstances.

4.4 Summary and Conclusions

There are important ways in which the market for small multifamily financing has evolved in recent years. As secondary market conduits have grown in importance in commercial mortgage financing in the 1990s, these firms have been exploring ways to expand their markets. Because small properties are seen to represent a potentially large, untapped market, this segment has attracted a fair amount of attention. An industry publication in early 1999 identified 12 conduits that had introduced small loan programs in addition to a Fannie Mae program offered through 3 of its affiliated lenders.

But the underwriting approach used by the conduits, a streamlined version of the standard commercial underwriting approach, is not appropriate for many small properties. Many owners of small properties cannot adequately document their financial condition to meet underwriting requirements or the property quality is too low for these programs. In essence, the conduit small loan programs are serving the cream of the small property market—more sophisticated owners of "B" quality properties. Only 1.8 percent of loans securitized in Commercial Mortgage Backed Securities consist of small loans.

The majority of small multifamily borrowers are still largely left with depositories as a source of funding, but there are some favorable trends in this market niche as well. Depositories appear to be expanding their lending operations. LaSalle Bank states that it has taken its small multifamily program to all 48 continental states. Other depositories interviewed also noted that they are looking to develop new lending opportunities in nearby markets. Perhaps the most interesting development is a program being launched by the residential lender Countrywide to begin originating small multifamily loans using an underwriting approach that relies as much on borrower creditworthiness as the property's valuation. This underwriting is essentially the same model that the depositories have

perfected and so seems to offer good possibilities for success. However it is not yet clear whether Countrywide will be successful in this market.

A key question is whether the new lending programs have made a noticeable contribution to the availability of financing. Representatives of one industry group reported that, in contrast to several years ago, there is no longer a lack of available financing. This change was attributed to the expansion of lending programs aimed at the small property market. But given the scale of these new and expanded lending programs relative to the size of this market niche (several hundred thousand properties), it would appear that there is still room for substantial expansion of lending activity. Most of the small loan programs have been concentrated in major market areas. Interviews conducted for this study found that financing options in small markets and rural areas are few.

Another question is whether the expansion of lending programs has helped to lower interest rates for small loans. Absent systematic information on interest rates and other loan terms it is particularly hard to evaluate this issue. Discussions with lenders and a review of interest rate information available on the lender web pages suggest that interest rates available through conduits may not be lower than those available from depositories. The main advantage of these lending programs may be the availability of fixed-rate financing. One indication that interest rates have not come down much is that depositories expanding their activities report being drawn to this market by the higher profits these loans offer compared to residential lending. Many lenders noted that rates were higher in the small property segment not only because of higher costs of underwriting and servicing these loans, but also because a lack of deep competition made higher rates feasible. But if lending programs targeted at this niche continue to grow, over time any interest rate premiums in this market not attributable to higher costs or risks would decline.

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