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MOBILIZING THE MULTIFAMILY SECONDARY MARKET

BY

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Securitization has been the hallmark of the 1980s mortgage market, at least for single-family mortgages. By the end of 1988, approximately 37 percent of the $2.1 trillion of single-family mortgages outstanding had been securitized, in forms ranging from simple passthrough securities to complicated structured financings.

But progress in securitizing the multifamily and commercial mortgage market has been much slower. Of the $1 trillion in income property mortgages outstanding, only 4 percent has been securitized. Even in the multifamily market, where securitization efforts have been fairly intense, only a small percent of the $295 billion in mortgages outstanding have been transformed into securities (see figures 1 and 2).

Why is there such a gap between securitization activity in the single-family and multifamily mortgage markets, and is the gap likely to close?

**Barriers to Multifamily Securitization**

Several factors have constrained the securitization of multifamily loans. Private mortgage insurance, for example, is not available for multifamily loans. Thus, except for Federal Housing Administration insured loans, primarily on subsidized building projects, multifamily mortgages are not insured. Multifamily properties also are subject to risks that single-family properties can largely escape -- business risks, for example, especially those related to development, marketing, and management. Zoning issues and legal restrictions on rents and evictions can add uncertainty to an otherwise straightforward project. These factors increase the risks of securities collateralized by multifamily loans.

A relative lack of standardized documentation and underwriting also has slowed multifamily securitization. In the single-family market, standard practices have
FIGURE 1
COMMERCIAL MORTGAGES OUTSTANDING
BY PROPERTY TYPE

$ Billions, Year-End 1988

Source: U.S. Dept. of Commerce, Board
of Governors of the Federal Reserve
System, and Salomon Brothers, Inc.
FIGURE 2
MORTGAGE MARKET SECURITIZATION
YEAR-END 1988

SINGLE FAMILY MORTGAGES
OUTSTANDING - $2,103 BILLION

COMMERCIAL AND MULTIFAMILY MORTGAGES
OUTSTANDING - $1,007 BILLION

Source: Bd. of Governors of the Federal Reserve System, U.S.
Dept. of H.U.D., Ginnie Mae, Fannie Mae, Freddie Mac,
Securities Data Corp. and Salomon Brothers, Inc.
greatly eased the work of reviewing and rating a mortgage portfolio. Homogeneous documentation also makes both securitization and servicing much easier across large numbers of mortgage loans.

The dearth of historical market data for multifamily mortgages is another problem. Scores of statistical measures of defaults, delinquencies, prepayment rates, and other characteristics are available for single-family mortgages; there is no such uniform set of statistics for multifamily mortgages. The available data for multifamily mortgages are limited and difficult to use confidently across different mortgage products, originators, and servicers. That makes assessing credit risk and interest-rate risk on multifamily mortgages more difficult.

These factors, plus the fact that multifamily pools typically contain fewer, and larger, loans than comparable single-family pools, makes it difficult for underwriters and investors to apply actuarial methods to evaluate the credit quality of multifamily pools. In contrast, single-family pools contain many relatively small loans, and we have better historical information about how they perform, which enables underwriters and investors to use actuarial methods to rate these portfolios with greater confidence. Those actuarial techniques, which substantially lighten the task of reviewing mortgage collateral, have been almost indispensable to the growth of single-family mortgage-backed securities.

Making Multis Work: Ratings

Successful securitization of mortgages, including multifamily mortgages, depends on the issuer’s ability to raise the credit rating of the securities relative to the underlying collateral, broaden the investor base, and make it unnecessary for investors
in the securities to review the underlying collateral. Credit rating agencies now have techniques for evaluating pools of income property mortgages. The availability of ratings has been key in improving the liquidity of income property mortgages in recent years and, for nonagency securities, an investment-grade rating from one of the national rating agencies is crucial to success.

The major rating agencies -- Standard & Poors Corporation (S&P), Moody's Investor Service, and Duff & Phelps -- have introduced rating criteria for many types of securities and properties. However, if a letter of credit or other guarantee of principal and interest is provided as full credit support, the rating will be based on the credit quality of the insurer rather than on these standard criteria.

Standard & Poor's rates multifamily and other commercial mortgage property-specific financings (secured by a single property), as well as securities backed by pools of mortgages. In rating property-specific financings, S&P applies a worst-case scenario to the property's projected cash flows. To determine the amount of credit support needed for an A, AA, or AAA rating, S&P looks at how far the cash flow would fall below required debt service in this worst case.

In rating securities backed by pools of mortgages, S&P uses its own actuarial model to estimate foreclosure frequency and loss severity. The model considers a number of variables, including the number of loans in the portfolio, their geographic distribution, and their loan-to-value ratios, along with the lender's underwriting experience, which is of key importance. For both property-specific and pool financings, third-party credit support and overcollateralization can be applied to meet expected shortfalls and to achieve a rating as high as AAA.

Moody's rating system is similar to S&P's and employs substantially similar variables. Moody's, like S&P, applies worst-case assumptions to project the
properties' cash flows. However, Moody's puts greater emphasis on local market data and uses market-specific economic variables in its worst-case assumptions, while S&P applies a national scenario.

Duff & Phelps' criteria are based on quantitative and qualitative factors that affect the subject properties, their cash flows, and their local markets. Unlike S&P and Moody's, Duff & Phelps does not use an actuarial model in rating mortgage pools. It evaluates each loan individually, so the number of loans within a pool is not a major consideration in determining how much credit support is needed. Like S&P and Moody's, Duff & Phelps sets credit enhancement requirements to cover possible cash flow shortfalls and ensure timely payment of principal and interest.

Credit Support

Issuers can use either a market value or a cash flow structure in securitizing income property mortgages. The structure determines whether the issue is evaluated according to the adequacy of the market value of the collateral or the adequacy of the collateral cash flows to support the payments to investors. Regardless of the structure, however, issuers of multifamily mortgage securities generally need some type of credit enhancement to obtain an investment-grade rating. Nearly all of the transactions rated by the three major agencies have included some form of credit support.

The simplest form of credit support is a guarantee of bond or passthrough payments, provided by the issuer, the issuer's parent company, or an affiliate. A third party can also supply a guarantee; for example, insurance companies offer surety bonds and banks issue letters of credit.
Guarantees differ. Some promise ultimate principal repayment rather than, or in addition to, timely payment. They may guarantee to meet all cash flow shortfalls fully or only those up to a specified dollar amount.

A guarantor that guarantees bond or passthrough payments essentially assumes the credit risk of the supported financing in exchange for fees paid by the financing's issuer. Such guarantees may merely backstop the payment of principal and interest by the issuer, or they may be the first line of credit (if the guarantor makes payment directly to the bondholder and then is reimbursed by the security issuer).

Overcollateralization is an increasingly popular form of partial credit support that enhances the likelihood of timely and complete payment. Overcollateralization can be achieved either by providing excess cash flow to support principal and interest payments (for cash flow structures), or by providing collateral whose market value exceeds the principal balance on the security (for market value structures).

The securities can be structured as bonds, giving the issuer financing treatment for accounting purposes, or as passthrough certificates, which often means that the transaction can be accounted for as a sale. Overcollateralized commercial mortgage-backed bonds have either preset payment schedules or payment schedules that mirror actual mortgage payments received. Overcollateralized passthrough securities are typically structured as senior/junior (also called senior/subordinated) transactions. In this type of transaction, the senior certificates have priority with respect to interest and scheduled principal payments as well as principal prepayments. The junior certificates, on the other hand, take a "first loss" position, and typically have been retained by the issuer. By manipulating the size of the subordinated interest in a mortgage or mortgage pool, the rating agencies can assign high ratings to the senior
classes. Senior/junior transactions are an increasingly popular way of securitizing multifamily and other commercial mortgages.

In a commercial mortgage bond that is overcollateralized by excess market value, the posted collateral is replenished as necessary to maintain a specified collateral-market-value-to-bond-principal ratio. This structure is common for single-family mortgage-backed securities, but it has been little used for multifamily securities because multifamily properties are more difficult to value. In fact, market value structures for commercial mortgage-backed securities first appeared only in 1988.

The idea behind credit support, of course, is to assure the rating agency or guarantor that the mortgage pool will support full and timely payment on the security even under stressful economic conditions, and so deserves a high rating. A high rating can transform a relatively illiquid mortgage pool into a liquid capital market instrument that appeals to a broader universe of investors.

But an even broader set of investors will participate in multifamily securities that carry a guarantee from the US government or a government-related entity. A top rating significantly reduces investor concern over collateral quality, but the governmental (or quasi-governmental) guarantee essentially removes all concern with credit on the properties and allows investors to focus on the characteristics of the mortgage pool.

In fact, government-sponsored enterprises -- Freddie Mac, Fannie Mae, and Ginnie Mae -- have accounted for the bulk of securitization in the multifamily mortgage market. Largely because of their efforts over the past decade, multifamily mortgages have become much more liquid than before, and are considerably more liquid than other commercial mortgage products.
Agency Involvement

Freddie Mac began purchasing multifamily mortgage loans for cash in 1972, Fannie Mae in 1983; by the later 1980s, these two agencies held substantial portfolios. Ginnie Mae also has played an important role, but has focused on FHA-insured project loans. This program allows issuers to convert single-property project loans into Ginnie Mae passthroughs.

Freddie Mac and Fannie Mae have been involved in the secondary multifamily mortgage market in three basic ways. First, both Freddie Mac and Fannie Mae have cash programs under which they will purchase multifamily mortgage products meeting specific requirements. Second, both agencies have swap programs through which they issue guaranteed passthrough securities in exchange for multifamily mortgage pools. Finally, Freddie Mac has securitized loans from its own portfolio by issuing participating certificates (PCs) representing interests in specific pools of multifamily mortgage loans.

In 1984, Fannie Mae executed the first multifamily mortgage securitization in a swap transaction with Midwest Federal Savings and Loan of Minnesota. Midwest Federal swapped approximately $140 million in multifamily mortgages for Fannie Mae Mortgage Backed Securities (MBSs). These MBss were then used to support the first collateralized mortgage obligation (CMO) backed by income property mortgages. Three months later, Freddie Mac entered into a swap transaction exceeding $800 million with Financial Corporation of America.

These swap transactions marked a significant turning point for the multifamily market; for the first time mortgages from the illiquid income-producing sector of the market were packaged as tradable mortgage securities. The swaps also transformed
unrated multifamily mortgage whole loans into collateral -- agency passthroughs -- that could be used to secure borrowings in other sectors of the capital markets.

Despite this aggressive beginning, the business of exchanging agency passthroughs for multifamily mortgage portfolios developed slowly. Between 1985 and 1986, Fannie Mae entered into only three swap transactions, aggregating approximately $358 million, and Freddie Mac entered into only two swaps that totaled only $17 million. But during this period, Freddie Mac was busy securitizing multifamily loans from its own portfolio. Between 1985 and 1987, Freddie Mac issued $6.6 billion in PCs from its portfolio. Fannie Mae has not, to date, pooled its portfolio for passthrough issuances.

In 1987, however, Fannie Mae renewed its efforts in the multifamily swap market. By the end of the first quarter of 1989, Fannie Mae had entered into almost 50 swap transactions totaling $6.5 billion. Fannie Mae has executed nearly 82 percent of the swap volume and Freddie Mac has issued 100 percent of the auction volume through PC sales from its portfolio. Between 1984 and the first quarter of 1989, these two agencies securitized approximately $14 billion in multifamily mortgages.

In developing the multifamily secondary market, the greatest challenge to Freddie Mac and Fannie Mae lies in understanding real estate risk. Unlike portfolios of single-family loans, multifamily pools do not lend themselves to purely statistical analysis of risk; typical multifamily portfolios contain fewer and much larger loans, and much less historical prepayment, delinquency, or default data are available on which to base statistical estimates of performance.

Fannie Mae has sought to control the risk by requiring sellers to pledge full or partial recourse against portfolio losses. This means that the seller assumes
responsibility for default losses. The recourse obligation often has been accompanied by pledged collateral, depending upon the credit and potential volume the selling institution represents. Consequently, analyzing the selling institution is generally as important as analyzing the real estate. Fannie Mae charges a fairly standard guarantee fee to large volume issuers providing full recourse.

Until recently, all Freddie Mac swap transactions carried full or partial recourse. Freddie Mac engaged in transactions with a variety of institutions and exchanged PCs for various types of multifamily products. In July 1988, Freddie Mac unveiled its Multifamily Guarantor Program, which offers an important innovation: financial institutions can adjust the indicated guarantee fee based on a desired level of recourse, the loan-to-value ratios, and the quality of the mortgage portfolio submitted for the swap. Some recent swap transactions under this program have been fully nonrecourse deals.

Fannie Mae does not yet enter into non-recourse swap transactions, but it has recently developed a nonrecourse cash purchase program. Under this program, portfolios of $25 million and above, containing loans of at least $5 million, can be sold for cash without any recourse obligation. Freddie Mac will also purchase multifamily loans for cash on a nonrecourse basis. Freddie Mac and Fannie Mae continue to develop their programs to meet the ever-shifting demands of the marketplace. Little by little, the liquidity of the multifamily market grows.

What Risk-based Capital Will Mean

Risk-based capital regulations for banks and thrifts are likely to have significant effects on both agency and private multifamily mortgage security issuance. First, the
regulations require considerably less capital against agency securities than against multifamily mortgage loans. The rules assign each asset to a risk category, with capital requirements varying depending on the presumed level of risk. For example, Fannie Mae and Freddie Mac securities are assigned to the 20 percent risk basket, while multifamily mortgage loans are assigned to the 100 percent risk basket. For thrifts, this implies capital requirements of 1.2 percent for agency passthrough securities and 6 percent for multifamily mortgage loans. Thus, the new regulations will give thrifts an incentive to securitize in order to reduce capital requirements.

The proposed thrift regulations could severely affect recourse transactions with the agencies and senior/subordinated issues in the nonagency passthrough market. Under current rules, thrift institutions providing recourse in a multifamily mortgage transaction may treat the transaction as a sale, and need hold capital only against the amount of recourse actually retained. Under the proposed rules, a retained recourse obligation will disallow sales treatment for regulatory capital purposes, and the thrift must hold capital against the entire transaction. Thus, an institution that sells $100 million in mortgages with full recourse will still need to hold $6 million in capital, just as if it retained the mortgages in portfolio.

The pending rules have markedly slowed recourse trading by the thrift industry and have clearly affected the multifamily swap programs calling for recourse obligations. Several large institutions are already looking for ways to eliminate the recourse obligations, and some may try to unwind recourse obligations already made. The incentive to develop nonrecourse programs is clear.

In the nonagency passthrough market, similar factors are at work. The thrift regulations treat retained subordinated portions of senior/subordinated transactions similarly to recourse: the issuer must hold capital against the entire transaction
(unless the retained piece is less than that capital requirement). As a result, issuers are now hesitant to enter into senior/subordinated transactions. If the guidelines are adopted as proposed, issuers will need to sell the junior interest to avoid the capital requirement. The junior-class investor market has just begun to develop; in the past year, several institutions have traded subordinated interests in commercial mortgage transactions. The proposed capital guidelines will impose new pressures to create this needed liquidity.

The proposal is also encouraging thrifts to turn to whole loan sales instead of securitizing multifamily mortgages in order to avoid the recourse issue and reduce capital requirements. Traditional whole loan trading, however, requires a solid understanding of real estate risk, locally and nationally, and the associated due diligence can be both costly and time-consuming. Nonetheless, many institutions will prefer to spend that time and effort rather than face the large capital requirements attached to credit-enhanced transactions.

In the past, the secondary market for multifamily mortgages has depended on a variety of credit-boosting techniques to attract investors. By forcing investors to consider whole loan trading more often, the proposed guidelines may help to educate the market about multifamily assets. This could lead to a market place that better understands and accepts these investments — and thus greater liquidity for multifamily mortgages.