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# Multifamily Housing Finance and Selected Policy Issues

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A *mortgage* is a loan secured by the underlying real estate collateral being financed by the loan. *Single-family mortgages* are loans secured by a residential dwelling having at least one and no more than four separate units. A single-family mortgage borrower is typically the homeowner using the loan to purchase the residence. By contrast, *multifamily mortgages* are loans secured by a residential dwelling, such as an apartment building, with at least five or more separate units. Multifamily real estate frequently refers to properties used as residential dwellings, including traditional apartment buildings, subsidized housing, housing for seniors (age-restricted, independent and assisted living), and housing for students (dormitories). Developers that want to purchase, construct, or rehabilitate these structures are likely to seek multifamily mortgages from financial institutions.

Developers are generally attracted to multifamily properties because of the potential profitability they generate in the form of rental income. Lenders also treat rental income as a key determinant when evaluating requests for multifamily mortgages. Financing may be limited for certain multifamily projects that are unlikely to generate the cash flows commensurate with the greater financial risks. Low- and moderate-income (LMI) tenants, for example, may not be able to pay rents that would generate sufficient revenues for developers to repay their multifamily mortgage loans and meet targeted profitability levels. Lenders specialize in pricing default risk, and they typically increase the financing costs linked to riskier loans to receive compensation for assuming the greater levels of risk. If, however, raising rents on some LMI tenants would not be a viable option to recover higher lending costs, then some affordable rental housing investments may be less attractive for developers to pursue.

Congress has provided financial incentives to develop certain multifamily projects that face challenges sustaining adequate cash flow levels to secure credit at affordable terms, which arguably may increase net social benefits. Such federal support may help reduce the amount of funds that affordable housing developers would need to borrow. For example, the Low Income Housing Tax Credit (LIHTC) can be used to cover some portion of acquisition and rehabilitation costs or state and local fees, thus facilitating some affordable housing financing. Federal entities may also provide mortgages with favorable terms, which make the loans more affordable for developers and transfer the additional financial risks to the government. Federal agencies, such as the Federal Housing Administration (FHA) and U.S. Department of Agriculture (USDA), can offer fixed-rate mortgages with long maturity terms and guarantee the default risk. Congress chartered government-sponsored enterprises (GSEs), specifically Fannie Mae and Freddie Mac, to provide liquidity for both the single- and multifamily mortgage markets. The GSEs have mission goals to promote affordable housing for underserved groups and locations. The GSEs also offer multifamily mortgages with more affordable terms and retain more financial risk, increasing the attractiveness for developers to invest in affordable rental housing.

Investing in the higher-end rental market may be considered more profitable as the demand for and the costs to supply rental properties increase. State and local growth management regulations, for example, provide developers with greater incentive to construct mixed-use developments, and many costs may be passed on to tenants in the form of higher rents. In some locations, developers can combine the various financial support provided by FHA, USDA, tax credit incentives, and GSEs' financial risk-sharing programs to increase the profit margins, thus increasing the attractiveness for certain affordable housing investments. This strategy, however, may be less effective particularly in densely populated areas where land is scarce and more expensive to develop. Hence, investments in certain rental markets may become less attractive should nonfinancial costs grow more important despite the various forms of federal support that reduce multifamily financing costs.

The GSEs' primary regulator, the Federal Housing Financing Agency (FHFA), limited their multifamily activities after placing them under conservatorship on September 6, 2008. (FHFA is authorized to make all financial business and operations decisions for the GSEs until they are financially sound to exit conservatorship.) These limitations were established to minimize further losses to taxpayers and to prevent the GSEs from controlling a large share of the multifamily mortgage market at the expense of private lenders. The effect of these limitations on the supply of multifamily mortgage credit, however, is unclear. Prior to conservatorship, the GSEs had developed their own proprietary multifamily business models and niche markets. The limitations on the GSEs' multifamily activities are likely to force them to adapt their business models, and perhaps it may be possible to observe over time some of the affected niche markets.

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## Introduction

Multifamily properties—structures designed to house five or more family units—include traditional apartment buildings, subsidized housing, housing for seniors (age-restricted, independent and assisted living), and housing for students (dormitories). Multifamily real estate frequently refers to properties used as residential dwellings.<sup>1</sup> By contrast, commercial properties include buildings used for offices, retail businesses, hotels and motels, industrial warehouses, and special purposes (e.g., self-storage facilities, churches, car washes).<sup>2</sup> Multifamily real estate may be considered either a separate or a subset category of commercial real estate; different industry participants may classify certain structures, such as medical and healthcare facilities, as either multifamily or commercial properties.<sup>3</sup>

Developers (or investors) are generally attracted to multifamily and commercial properties because of the profit potential generated in the form of rental income.<sup>4</sup> Lenders also treat rental income as a key risk indicator of whether a multifamily or commercial loan would be repaid. Hence, expensive financing costs may discourage investments in riskier multifamily projects. For example, properties occupied by low- and moderate-income (LMI) tenants, who are more likely to experience frequent income disruptions, may not generate the rental income streams necessary to sustain acceptable profitability levels and repay loans.<sup>5</sup> Such multifamily properties regularly include small residential structures (5-50 units) that generate low volumes of rents, structures in older urban areas, and inner city structures in need of rehabilitation.<sup>6</sup> Charging higher loan rates commensurate with the higher credit (default) risks may not be a viable solution if property developers cannot offset higher financing costs by raising rents on LMI tenants. This conundrum may result in affordable rental unit shortages, contributing to a reduction of net social benefits.<sup>7</sup>

<sup>1</sup> As of 2021, an estimated 46% of renters were living in apartment buildings. See National Multifamily Housing Council (NMHC), “Quick Facts Data Download: Resident Demographics, Household Characteristics, What Type of Structure Do Renters Live In?” at <https://www.nmhc.org/research-insight/quick-facts-figures/quick-facts-data-download/>.

<sup>2</sup> Residential condominiums are typically sold in units and financed by single-family mortgages rather than multifamily mortgages. Commercial condominiums that are used for small businesses are financed by commercial mortgages.

<sup>3</sup> Federal banking agencies define *commercial real estate* as a real estate-related transaction that is not secured by a single 1-to-4 family residential property. Office of the Comptroller of the Currency (OCC), Treasury; Federal Reserve System; Federal Deposit Insurance Corporation (FDIC), “Real Estate Appraisals,” 83 *Federal Register* 15019-15036, April 9, 2018. Although people do not live in hospitals, meaning that these could be classified as commercial properties, the Department of Housing and Urban Development (HUD) classifies mortgages to hospitals as one of its multifamily programs. See HUD, “Office of Healthcare Programs,” at [https://www.hud.gov/federal\\_housing\\_administration/healthcare\\_facilities](https://www.hud.gov/federal_housing_administration/healthcare_facilities); and HUD, “Office of Hospital Facilities,” at [https://www.hud.gov/federal\\_housing\\_administration/healthcare\\_facilities/section\\_242](https://www.hud.gov/federal_housing_administration/healthcare_facilities/section_242).

<sup>4</sup> In this report, the terms *developers*, *investors*, and *multifamily borrowers* are used interchangeably as demanders of financing; by contrast, *lenders* (e.g., banks) are discussed as intermediaries that supply financing. Although discussions about multifamily finance in many instances refer to banks as partners or investors, this report avoids that convention to clearly distinguish between the demand and supply sides of the multifamily mortgage market.

<sup>5</sup> The term *low- and moderate-income* (LMI) can be used to refer to those households earning below certain thresholds such as 50% or 80% of median household income; it may refer to certain eligibility requirements in the context of certain assistance programs. This report uses the term LMI broadly and will note when referring to more specific contexts.

<sup>6</sup> For a discussion of historical credit gaps in the multifamily mortgage market, see HUD, “The Secretary of HUD’s Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac),” 60 *Federal Register* 61846-62005, December 1, 1995.

<sup>7</sup> James R. Follain and Edward J. Szymanoski, “A Framework for Evaluating Government’s Evolving Role in Multifamily Mortgage Markets,” *Cityscape: U.S. Department of Housing and Urban Development*, vol. 1, no. 2 (June

Likewise, financing costs that correspond with the level of credit risk may also discourage certain commercial investments. For example, some health facilities face challenges obtaining finance for construction or renovation due to the inability to maintain sufficient or consistent levels of operating cash flows. Such facilities may include hospitals that frequently treat uninsured patients and receive little or no cost reimbursements.<sup>8</sup> Although lenders can charge higher loan rates commensurate with higher levels of default risk, such risk-based pricing strategies may not be affordable for hospitals with thin profit margins. Consequently, this impasse may contribute to shortages of adequate health care facilities in LMI communities.

Since the Great Depression, Congress has facilitated access to credit in the single-family, multifamily, and certain commercial mortgage markets to promote quality affordable housing and sustainable communities. To facilitate the construction of affordable multifamily rental units, the Federal Housing Administration (FHA) and the U.S. Department of Agriculture (USDA) Rural Development provide financial support in the form of mortgage loan guarantees.<sup>9</sup> Congress also created Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) to facilitate market liquidity; these entities distribute to the private sector various amounts of the credit (default) risk linked to the underlying multifamily mortgages they help finance. In addition, Congress provides subsidies to developers to reduce the costs to develop affordable rental units, which fosters the attractiveness of such investments.

Despite competing investment opportunities in the higher-end multifamily market segments, developers can overlay multiple forms of federal support to reduce financing costs such that investment in affordable housing in certain areas remains attractive. This strategy, however, may be less effective particularly in densely populated coastal areas where land is scarce and more expensive to develop. Furthermore, since their conservatorships, Fannie Mae's and Freddie Mac's multifamily businesses have also been curtailed by their primary regulator to minimize potential risks to taxpayers. Hence, investments in certain rental market segments may become less attractive to developers should various forms of federal multifamily financing support fail to keep pace with the rising trend in nonfinancial costs.

This report provides an overview of the multifamily mortgage market and selected policy issues pertaining to the development of multifamily residential structures for affordable housing. It explains investors' financing demands for distinct classes of multifamily properties, along with a description of lenders' typical underwriting requirements and mortgage terms. It then summarizes various forms of federal government support to facilitate the financing of affordable rental housing. Finally, the report discusses selected trends and policy issues pertaining to affordable housing finance.

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1995), pp. 151-177.

<sup>8</sup> For more information, see CRS In Focus IF10918, *Hospital Charity Care and Related Reporting Requirements Under Medicare and the Internal Revenue Code*, by Marco A. Villagrana et al.

<sup>9</sup> In 1998, Congress passed the Veterans Programs Enhancement Act (P.L. 105-368, 38 U.S.C. §2051), which authorized the Department of Veterans Affairs (VA) to establish a pilot loan guarantee program for the construction or rehabilitation of multifamily transitional housing projects specifically designed to provide housing for homeless veterans. For information pertaining to program implementation, see U.S. Government Accountability Office (GAO), *Veterans Affairs Homeless Programs: Implementation of the Transitional Housing Loan Guarantee Program*, GAO-05-311R, March 16, 2005, at <https://www.gao.gov/products/gao-05-311r>; and VA, "Notice of Funds Availability (NOFA): Inviting Applications for Section 601 Loan Guarantees for Multifamily Transitional Housing," 71 *Federal Register* 18813-18821, April 12, 2006.

## The Basics of Multifamily Financing

A *mortgage* is a loan secured by the underlying real estate collateral that is being financed by the loan. *Single-family mortgages* are loans secured by a residential dwelling having at least one and no more than four separate units. A single-family mortgage borrower is typically the homeowner using the loan to purchase the residence. By contrast, *multifamily mortgages* are loans secured by a residential dwelling, such as an apartment building, with at least five or more separate units. Developers that want to purchase, construct, or rehabilitate these structures seek multifamily mortgages from financial institutions. This section provides an overview of the demand and supply side mechanics of the multifamily mortgage market.

### The Demand for Multifamily Credit

Multifamily properties that generate stable revenues (via collection of rents from tenants) have predictable profitability levels, which can make them attractive investments. By contrast, the profit potential of riskier properties, such as those experiencing above-normal vacancy rates and rental income declines (e.g., due to neighborhood location, poor management, or upkeep), may be less predictable yet still be attractive investments. After substantial rehabilitation, a rental property may appeal to tenants with more stable and higher incomes and possibly fetch a higher resale value—or it may still fail to generate the anticipated rental income, resulting in substantially greater losses. Thus, riskier financial investment opportunities may translate into greater profits or greater losses.

Real estate properties are categorized as Class A, Class B, and Class C, which provides developers and lenders with the financial risk characteristics of the prospective investment properties (defined in more detail in the text box below). Restating the preceding investment strategy, acquiring a riskier Class C property may initially be less expensive and have greater profit potential than a less risky Class A property investment. If, however, a Class C property after rehabilitation would continue to generate low or below-market rents, the losses are likely to be significant. In short, developers decide whether to invest in low- or high-risk multifamily projects.

One criterion for determining whether to invest in Class A, Class B, or Class C income-generating properties is current and expected future performance of rents. Anticipated rent growth is a favored metric developers use to evaluate a prospective investment's profitability.<sup>10</sup> Occupancy rates also provide information about anticipated rent increases or decreases. As multifamily properties' occupancy rates increase (decrease), the overall rental income the properties generate is more likely to increase (decrease).<sup>11</sup> A related concept, the property *capitalization* (cap) rate, is the annual net operating income generated by the property divided by its purchase price. In other words, the cap rate measures a property's *yield*, the annual return in the form of (rental) income generated by the investment. (The cap rate does not account for any outstanding debt such as a mortgage amount.) The interpretation of a high cap rate, however, may be ambiguous. Although a higher cap rate may be indicative of higher profit potential, it may also be indicative of a limited ability to raise future rents on some tenants (e.g., the elderly, those with higher delinquency rates, and those currently with long leases). In the latter case, the expected

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<sup>10</sup> See Peter J. Elmer and Anton E. Haidorfer, "Prepayments of Multifamily Mortgage-Backed Securities," *The Journal of Fixed Income*, vol. 6, no. 4 (March 1997).

<sup>11</sup> The vacancy rate, which equals 100% minus the occupancy rate, can be used instead of the occupancy rate.

profit potential would be lower if rent hikes would not be a viable option to recover some of the financing costs.

### Multifamily and Commercial Property Classifications<sup>12</sup>

#### Multifamily Properties

- Class A properties generally have one or more of the following characteristics. They tend to be newly constructed or less than 10 years old; located in a geographical area with at least 2 million in population;<sup>13</sup> and have 200 or more units. They often include luxury-styled apartments. Class A properties are considered investment grade because they are more likely to generate the rental income to give developers profitable returns and reduce the likelihood of defaults on multifamily mortgages. Class A properties tend to be inhabited by high-income earning tenants, have low vacancy rates, and be professionally managed.
- Class B properties generally have one or more of the following characteristics. Class B properties are older than Class A properties, but they have been well-maintained; may have some auxiliary renovations that could result in upgrading these properties to Class A; may be located in geographical areas consisting of 500,000 to 2 million in population; and may have 100-200 units. Class B properties tend to be considered somewhat riskier than Class A because tenants may have relatively lower incomes than tenants who rent Class A properties.
- Class C properties, also referred to as properties that fall in the Naturally Occurring Affordable Housing (NOAH) category, generally have one or more of the following characteristics.<sup>14</sup> Class C properties may be more than 20 years old; may need some major renovations to meet more updated standards; and may be located in geographical areas consisting of fewer than 500,000 in population. Properties with one or more of these characteristics may be considered below investment grade because they are more likely to generate relatively lower market rents, thus increasing the likelihood of mortgage default. In the context of affordable housing for low- and moderate-income tenants, a new property may be designated as Class C if the monthly rents are lower than Class A and Class B properties within a geographical proximity.<sup>15</sup>

#### Commercial Properties

Commercial real estate properties are also categorized as Class A, Class B, or Class C.

- Class A properties are newly built or extensively renovated buildings located in areas with easy access to amenities.
- Class B properties are similar to Class A but may need minor repairs and upgrades.
- Class C properties are in poor locations, require major capital investments to improve dated infrastructure, and are likely to have higher vacancy rates.

<sup>12</sup> See Joint Center for Housing Studies of Harvard University, *Rental Market Stress: Impacts of the Great Recession on Affordability and Multifamily Lending*, July 2011, at <https://www.urban.org/sites/default/files/publication/27011/1001550-Rental-Market-Stresses-Impacts-of-the-Great-Recession-on-Affordability-and-Multifamily-Lending.PDF>; “What is Class A, Class B, or Class C Property,” *Realty Mogul*, at <https://www.realtymogul.com/knowledge-center/article/what-is-class-a-class-b-or-class-c-property>; and Commercial Real Estate Finance Company of America, “Multifamily Property Classifications,” at <http://www.crefcoa.com/property-classifications.html>.

<sup>13</sup> A primary multifamily market may be loosely defined as having approximately 5 million or more people; a secondary market having approximately 2 million-5 million people; and a tertiary market having fewer than 2 million people. See Les Shaver, “Defining the Market,” *Multifamily Executive*, May 1, 2011, at [https://www.multifamilyexecutive.com/business-finance/defining-the-market\\_o](https://www.multifamilyexecutive.com/business-finance/defining-the-market_o).

<sup>14</sup> See Fannie Mae, Multifamily Market Commentary: 2018 Multifamily Affordable Market Outlook—A Long Way to Go, February 2018, at <https://www.fanniemae.com/media/23056/display>.

<sup>15</sup> As well as being in a class all by itself, Class D properties may also be considered a subset of Class C properties. Class D properties are older, not well-maintained, and may even need to be demolished and rebuilt. Class D properties may be located in high-crime areas and have far more neglect than Class C. For more information, see Les Shaver, “Defining the Market,” *Multifamily Executive*, May 1, 2011, at [https://www.multifamilyexecutive.com/business-finance/defining-the-market\\_o](https://www.multifamilyexecutive.com/business-finance/defining-the-market_o); and Commercial Real Estate Finance Company of America, “Multifamily Property Classification,” at <http://www.crefcoa.com/property-classifications.html>.

Developers commonly seek financing for their multifamily investments. Some lenders, however, may not be willing to assume added or above-normal credit (default) risk of not being repaid, usually associated with loans secured by riskier multifamily investments. In these cases, some lenders may be willing to provide loans at higher financing charges commensurate with the higher risk levels. After factoring in the higher financing costs, some developers may consider the potential profitability to be less attractive and, therefore, consider other investments. Multifamily financing sources along with typical lending requirements, which may factor into developers' investment decisions, are described in the next section.

## The Supply of Multifamily Credit

Commercial banks have historically been the principal source of credit for commercial and multifamily finance, particularly for Class A and some Class B properties.<sup>16</sup> Multifamily financing, in the form of direct loans or debt security issuances, may also be obtained through some credit unions, life insurance companies, pooling structures such as bank participations and syndications, commercial mortgage-backed securities (CMBS), and institutional investors either directly or via real estate investment trusts (REITs). Private-sector lenders are more willing to provide financing for Class A and some Class B investments because properties in higher-end neighborhoods can fetch higher rents and experience lower vacancy rates and, therefore, fewer disruptions to rental income streams. Consequently, a broader array of private-sector funding arrangements exists for the less risky Class A and Class B properties, which may translate into more competitive multifamily mortgage rates. Lenders use various arrangements to fund multifamily loans for investment-grade properties; some are summarized in the text box below.

Not only are underwriting requirements for multifamily and single-family mortgages different, but lenders can also shift more financial risk to multifamily borrowers. For the sake of comparison, single-family mortgage underwriting typically requires borrowers to have acceptable credit scores, loan-to-value (LTV) ratios, and debt-to-income ratios.<sup>17</sup> Furthermore, a typical single-family mortgage is a 30-year fixed-rate loan that can be repaid prior to maturity term if, for example, a borrower wants to refinance to a lower interest rate. A fixed-rate loan over several decades combined with the ability to prepay the loan ahead of schedule without penalty ensures that borrowers' mortgage payments remain fixed or can be lowered. Single-family mortgages, therefore, shift the risk of sudden changes in cash flow to lenders. A lender risks a sudden loss in cash flow if, after a fall in mortgage interest rates, a single-family borrower refinances to the lower rate. After a rise in mortgage interest rates, a lender would lose the opportunity to earn a greater rate of return if a borrower continues to repay the loan as scheduled at the lower rate.<sup>18</sup>

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<sup>16</sup> A commercial bank is an institution that obtains either a federal or state charter, which allows it to accept deposits insured by the Federal Deposit Insurance Corporation (FDIC), which can subsequently be used to fund multifamily and commercial mortgage loans.

<sup>17</sup> Credit scores and loan-to-value ratios (which are lower if borrowers make acceptable downpayments) are better predictors of borrower default in the single-family mortgage market. Lenders, however, have also adhered to minimum debt-to-income requirements. For more information, see Karan Kaul, Laurie Goodman, and Jun Zhu, *Comment Letter to the Consumer Financial Protection Bureau on the Qualified Mortgage Rule*, Urban Institute, September 17, 2019, at <https://www.urban.org/research/publication/comment-letter-consumer-financial-protection-bureau-qualified-mortgage-rule>; and CRS In Focus IF11761, *The Qualified Mortgage (QM) Rule and Recent Revisions*, by Darryl E. Getter.

<sup>18</sup> For more on the components of a consumer loan, see CRS In Focus IF10993, *Consumer Credit Markets and Loan Pricing: The Basics*, by Darryl E. Getter. For more on how the Fannie Mae and Freddie Mac isolate the prepayment and default risk components of a single-family mortgage, see CRS Report R45828, *Overview of Recent Administrative Reforms of Fannie Mae and Freddie Mac*, by Darryl E. Getter.

### Funding Multifamily Loans

Funding loans refer to how lenders acquire funds that are subsequently lent to borrowers. The following describes selected options lenders use to fund multifamily and commercial loans.

- **Lending Spreads and Rollovers.** Lenders that retain loans in their portfolios may fund their longer-term mortgage assets via *rollovers*, a continuous series of shorter-term borrowings. Banks employ this funding method with deposits, repaying depositors in periodic intervals. Rather than rely solely on their funders, some banks may also acquire short-term loans from other banks or short-term money markets. The profits, also called lending spreads, from loans held in portfolio are generally computed as the difference between the higher rates and fees charged by the lender for the mortgage loans and the lower interest rates that are paid on the successive sequences of shorter-term borrowings.
- **Private placement.** After a multifamily loan is originated, a private placement occurs when a broker finds financiers to directly purchase it. Financiers may consist of banks, finance companies, insurance companies, hedge funds, foundations, pension plans, university endowments, and other high-net-worth individuals or entities. The Securities and Exchange Commission (SEC) promulgates the regulatory guidance for private placement activities. The SEC exempts securities from standard registration requirements that are not offered to the public; however, only *accredited investors* may purchase private placement offerings. An accredited investor includes anyone who has (1) earned income exceeding \$200,000 (or \$300,000 joint income) or (2) a net worth of \$1 million (excluding the value of the person's primary residence). Funding via private placement reduces costs and delays associated with sponsoring securitizations, SEC registration, or compliance with prudential requirements for depository institutions. Funding via private placement has reportedly risen, particularly among bank and nonbank lenders.<sup>19</sup>
- **Participations.** Other loan funding structures allow for the coordination of multiple financial institutions such as banks to jointly fund a set(s) of pooled loans. For example, suppose a regional real estate developer goes to a local bank for a loan. If the small bank is unable to offer the loan, rather than surrender the developer to a larger bank, the small bank may offer to coordinate with other local banks to jointly provide the loan using a loan *participation (syndication)* structure. The local bank would originate the loan, thus acting as the *sponsor* or lead bank of the participation arrangement. The sponsor typically retains the largest portion of the loan and sells smaller portions (shares) to other institutions. This structure allows the sponsor to maintain control of the customer relationship and overcome funding limitations. The other banks in the participation may use their shares to diversify geographical concentration risks in their lending portfolios.
- **Structured Financing.** Another type of joint funding structure initially creates a trust to hold pooled assets (e.g., mortgage loans) and subsequently issues securities to fund the trust's assets. The funding structure's lead arranger or sponsor selects the assets to place in the trust and then determines how many shares to issue to investors. Two structures typically used to fund multifamily mortgages are *commercial mortgage-backed securities (CMBSs)* and *real estate investment trusts (REITs)*, which are discussed in the section entitled "Joint Lending: Privately Sponsored Pools and Conduits." Despite their functional equivalence, a CMBS is treated as a lending arrangement (i.e., loan participation) in which participating shareholders have no ownership or equity interests in the borrower's primary business, whereas a REIT is treated as equity shares to investors that are principally engaged in a profit-sharing venture with ownership interests.<sup>20</sup>

By contrast, multifamily and commercial mortgages are underwritten based on the current and anticipated cash flows (predominantly in the form of rental income) generated by the properties,

<sup>19</sup> Financial technology (fintech) firms frequently refer to nondepository firms that use various technological formats to deliver financial services to customers. For more information about recent private placement trends, see Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Securities and Exchange Commission (SEC), August 2018, at [https://www.sec.gov/files/DERA%20white%20paper\\_Regulation%20D\\_082018.pdf](https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf).

<sup>20</sup> Loan participation shares and investment securities are functionally equivalent structures to fund assets and share financial risks. Because participation shares and investment securities receive different regulatory and tax treatments, legal criteria are applied to determine whether issuances used to fund longer-term assets should be construed as part of a large lending transaction or investment (ownership) securities. For more information, see Dennis Scholl and Ronald L. Weaver, "Loan Participations: Are They 'Securities'?" *Florida State University Law Review*, vol. 10, no. 2 (Spring 1982), pp. 215-234; Securities Exchange Commission (SEC), "Real Estate Investment Trusts (REITs)," at <https://www.sec.gov/fast-answers/answersreitshtm.html>; Nareit, "Guide to Mortgage REITs," at <https://www.reit.com/>

the primary collateral source to back the loans.<sup>21</sup> Rental income streams vary extensively by geographical location in light of the surrounding jobs and businesses, meaning that the underlying risks of multifamily mortgages cannot be standardized. For this reason, lenders evaluate the default risk of multifamily mortgages using the following metrics.

- The *debt service coverage ratio* (DSCR) is the annual net operating income divided by annual total debt service (principal and interest). A lender typically requires a DSCR of 1.25 or higher because it indicates that a borrower has the ability to service the mortgage obligation.<sup>22</sup>
- The initial amount of equity that a developer has invested in the property is reflected by the LTV ratio. A mortgage becomes underwater when the current property value declines far below the outstanding loan balance amount, which provides a borrower with the financial incentive to default. Therefore, the dollar amount of a multifamily mortgage tends to be 80% or less of the property value—or have a LTV ratio of 80% or less—forcing the developer to have an ownership stake of at least 20% in the financed property.

Empirical research has shown that the DSCR and LTV ratio are key factors to predict default. Specifically, developers are far more likely to default on their multifamily mortgages if they simultaneously experience negative cash flows and negative equity (underwater) positions, which usually occur after substantial declines in property values.<sup>23</sup>

Multifamily and commercial mortgage terms essentially shift the risk of sudden cash flow disruptions that can result from interest rate movements to borrowers. Multifamily mortgages are also much larger in size than single-family mortgages. For this reason, interest rate fluctuations have even greater cash flow implications for lenders: (1) actual and large cash flow losses if borrowers refinanced into cheaper loans, or (2) foregone cash flows if borrowers repay loans for numerous years at below current market rates. Multifamily (and commercial) mortgages—unlike most single-family mortgages—offered by private-sector lenders typically have shorter maturities (e.g., five years), prepayment penalties (i.e., the risk of losing yield if the borrower repays the loan ahead of schedule), and adjustable (floating) rates.<sup>24</sup>

Multifamily mortgages are also likely to include *loan covenants*, which are contractual requirements to assure that a borrower's initial financial standing at underwriting remains in place over the life of the loan.<sup>25</sup> Loan covenants may require a borrower to provide audited financial statements, maintain a minimum cash reserve, maintain a constant DSCR or debt-to-net assets

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what-reit/types-reits/guide-mortgage-reits; and CRS In Focus IF10736, *Collateralized Loan Obligations (CLOs) and the Volcker Rule*, by Darryl E. Getter.

<sup>21</sup> Similarly, lenders require single-family property borrowers who intend to rent their dwelling units to show proof of anticipated streams of income the property would generate, such as tenant rental agreements.

<sup>22</sup> Economists have found that cash flow may be a more significant determinant of default risk in the multifamily mortgage market. See Kerry D. Vandell, "Multifamily Finance: Pathways to Housing Goals, Bridge to Mortgage Market Efficiency," *Journal of Housing Research*, vol. 11, no. 2 (2000), pp. 319-356.

<sup>23</sup> For more information, see Lawrence Goldberg and Charles A. Capone, "A Dynamic Double-Trigger Model of Multifamily Mortgage Default," *Real Estate Economics*, vol. 30, no. 1 (2002), pp. 85-113.

<sup>24</sup> In some cases, lenders may initially offer balloon mortgages (i.e., mortgages with interest-only payments except for the final payment, which consists of the last interest and total principal payments), and subsequently offer more favorable terms following increases in occupancy rates.

<sup>25</sup> See Richard K. Green, "Multifamily Mortgages," in *Introduction to Mortgages and Mortgage-Backed Securities* (Elsevier, 2014).

ratio, limit new acquisitions or asset sales, or some or all of the above.<sup>26</sup> Some loan covenants may explicitly or implicitly require borrowers to raise tenants' rents to avoid breaching contractual requirements. In short, loan covenants (as well as collateral requirements) allow lenders to monitor changes in borrowers' financial conditions and, therefore, better anticipate changes in default risk.

In sum, single-family mortgages face both default and cash flow risks if borrowers prepay loans after interest rates fall. Federal support for the single-family mortgage market is generally in the form of default guarantees; lenders typically can transfer default risks to the federal government and retain cash flow risks. By contrast, multifamily and commercial loans have default risks. Lenders monitor default risks using loan covenants and shift interest-rate risks to borrowers via loan terms. For higher-risk multifamily investments, the federal government may assume greater financial risks that would be passed on to developers, which is discussed in the next section.

## The Federal Role in the Multifamily Credit Market

In some niche rental markets, the ability to raise rents commensurate with current market rents on low-income tenants is limited. Furthermore, estimating property cap rates and DSCRs is more challenging if tenants are likely to have higher delinquency and turnover rates.<sup>27</sup> Mortgages that finance higher-risk multifamily property investments are likely to have higher interest rates and more stringent loan covenants and LTV requirements than less risky property investments. Higher financing costs may reduce the potential profitability and, therefore, the attractiveness of higher-risk investment opportunities.

## Federal Incentives to Finance Affordable Multifamily Structures

The federal government encourages developers and lenders to invest in affordable, higher-risk multifamily properties by offering various incentives, such as those included in the list below.<sup>28</sup>

- The Federal Housing Administration (FHA), which is part of the U.S. Housing and Urban Development (HUD), is a federal government agency that insures the default risk for single-family residential mortgages and multifamily mortgages.<sup>29</sup> FHA-insured structures include multifamily rental or cooperative housing for low- and moderate-income individuals, nursing homes, assisted living facilities, and hospitals.
- Congress chartered Fannie Mae and Freddie Mac, government-sponsored enterprises (GSEs), to provide liquidity for mortgage markets, thus promoting homeownership for underserved groups and locations.<sup>30</sup> The Federal Housing

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<sup>26</sup> See Charles Zimmerman, "An Approach to Writing Loan Agreement Covenants," *Journal of Commercial Banking Lending*, vol. 58 (1975), pp. 2-17.

<sup>27</sup> Predicting the income generated by some properties, such as dormitories or nonprofit institutions (e.g., churches, shelters), may also be more difficult under certain circumstances.

<sup>28</sup> For information about federal programs that would also include financial support given directly to tenants, see CRS Report RL34591, *Overview of Federal Housing Assistance Programs and Policy*, by Maggie McCarty, Libby Perl, and Katie Jones.

<sup>29</sup> See HUD, "Multifamily Housing," at [https://www.hud.gov/program\\_offices/housing/mfh](https://www.hud.gov/program_offices/housing/mfh). With some exceptions, most FHA-insured multifamily mortgage programs do not have explicit affordability requirements.

<sup>30</sup> In single-family mortgage markets, the GSEs purchase mortgages from loan originators and retain the default risk (for a fee). They subsequently issue bond-like securities (i.e., mortgage-backed securities) to private-sector investors who assume the risk that borrowers may choose to repay their mortgages ahead of schedule (prepayment risk). Since

- Finance Agency (FHFA), the federal agency that regulates the GSEs for prudential safety and soundness, sets and ensures that the GSEs meet affordable mission goals for LMI households as mandated in their congressional charters.<sup>31</sup> Specifically, the FHFA sets both single- and multifamily housing goals for the GSEs (including a new “duty-to-serve” three underserved markets: manufactured housing, affordable housing preservation, and rural housing) in addition to the affordable housing goals previously established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.<sup>32</sup>
- Fannie Mae and Freddie Mac are also statutorily required to contribute a portion of their profits to the Housing Trust Fund (HTF) and the Capital Magnet Fund (CMF), which are permanent funding streams that do not rely on annual congressional appropriations and are dedicated to affordable housing activities for low-income households.<sup>33</sup> Specifically, the GSEs must set aside 4.2 basis points (0.042%) of the unpaid principal balance of new single- and multifamily mortgage purchases for the funds, in which most of the funding by statute must be used for rental housing. HTF funds are subsequently awarded to state and state-designated entities for developing or maintaining affordable housing.<sup>34</sup> CMF funds provide competitively awarded grants to Community Development Financial Institutions and nonprofit housing developers for affordable housing and community economic development.<sup>35</sup>
  - The Low Income Housing Tax Credit (LIHTC) subsidizes construction costs for developers of affordable housing for low-income renters. The tax credits are claimed over a 10-year period. Because developers need upfront financing to complete construction, they typically sell the 10-year stream of tax credits to financiers (e.g., corporations, financial institutions) in exchange for financing. By reducing the total amount of financing that developers would otherwise have to secure, tenants can be offered units in these properties at more affordable rents.<sup>36</sup>

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2012 under the direction of their primary regulator, the Federal Housing Finance Agency (FHFA), the GSEs developed programs that transfer to the private sector some of the credit risks linked to their single-family mortgage purchases. See CRS Report R45828, *Overview of Recent Administrative Reforms of Fannie Mae and Freddie Mac*, by Darryl E. Getter; and CRS Report R44525, *Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions*, by Darryl E. Getter.

<sup>31</sup> FHFA was created by P.L. 110-289, the Housing Economic and Recovery Act of 2008.

<sup>32</sup> P.L. 102-550, Title XIII; see 12 U.S.C. §§4561-4564.

<sup>33</sup> See CRS Report R40781, *The Housing Trust Fund: An Overview*, by Katie Jones.

<sup>34</sup> See HUD, “About the Housing Trust Fund,” at <https://www.hudexchange.info/programs/htf/about/>.

<sup>35</sup> See U.S. Department of the Treasury, *Community Development Financial Institutions Fund: Capital Magnet Fund*, at <https://www.cdfifund.gov/programs-training/Programs/cmf/Pages/default.aspx>; CRS Report R47217, *Community Development Financial Institutions (CDFIs): Overview and Selected Issues*, by Darryl E. Getter; and CRS Report R47169, *Community Development Financial Institutions (CDFI) Fund: Overview and Programs*, by Donald J. Marples and Darryl E. Getter.

<sup>36</sup> Investor may refer to developers, as used in this report, or to financial firms such as banks and other entities that want exposure to multifamily investments. To reduce confusion, the term *financier* in this report refers to lenders and financing companies that want exposure to multifamily investment risk. For example, a developer may be able to sell a \$1.00 tax credit to a financier for \$0.90 of financing. The developer subsequently uses the \$0.90 to finance construction of the property. The financier yields the difference between what it paid for the tax credit (\$0.90) and the reduction in its tax liability, which equals the tax credit’s face value (\$1.00). The financier also often receives tax benefits related to any tax losses generated through the project’s operating costs, interest on its debt, and deductions such as depreciation. See CRS In Focus IF11335, *The Low-Income Housing Tax Credit: Policy Issues*, by Mark P. Keightley; and CRS Report RS22389, *An Introduction to the Low-Income Housing Tax Credit*, by Mark P. Keightley.

- The U.S. Department of Agriculture (USDA) supports multifamily rental housing in rural areas through programs such as the Section 515 Rural Rental Housing Loans, a direct lending program for nonprofit or for-profit rural housing developers, and the Section 538 Guaranteed Rural Rental Housing Program, a loan guarantee program that focuses on partnerships between the USDA and qualified lenders.<sup>37</sup>
- The Federal Home Loan Bank (FHLB) system is a cooperative GSE created to provide liquidity to its membership, which consists of mortgage lenders—such as banks, credit unions, and insurance companies—that retain mortgages in their lending portfolios that are engaged in housing finance and some agricultural and small business lending. Each FHLB must set aside 10% of net income for affordable housing and community investment.<sup>38</sup> The funds are subsequently awarded to each FHLB’s member financial institutions as grants on a competitive basis to support the acquisition, construction, or rehabilitation of affordable single- and multifamily housing.

The federal government can encourage investments in higher-risk properties in underserved areas by reducing developers’ financing costs and assuming some or all of the interest rate risks that otherwise would be borne by lenders.<sup>39</sup> Federally backed multifamily mortgages (e.g., purchased by the GSEs, insured by FHA, or insured or loaned by the USDA) have some terms and features similar to those of single-family residential mortgages. For example, Fannie Mae and Freddie Mac offer fixed-rate loans that amortize (i.e., the principal amount declines over the life of the loan) for up to 30 years, which reduces the monthly payment compared to borrowers with multifamily mortgages of shorter maturities. FHA-insured multifamily mortgages are fully amortizing with 40-year maturities, and developers are allowed to refinance an existing multifamily loan into a lower interest rate.<sup>40</sup> Such mortgage terms, which may also allow for refinancing into lower market interest rates, can help sustain profitability of various multifamily projects that otherwise might be bypassed due to the higher financing costs.

## Commercial Financing: Limitations and Exemptions

The private sector generally provides funding for commercial and higher-end multifamily properties. By contrast, the federal role in the multifamily and commercial credit markets is primarily limited to properties that support specific mission goals. The federal presence in the

<sup>37</sup> See U.S. Department of Agriculture (USDA), “Multifamily Housing Programs,” at <https://www.rd.usda.gov/programs-services/all-programs/multi-family-housing-programs>; USDA, “Multifamily Housing Direct Loans,” at <https://www.rd.usda.gov/programs-services/multi-family-housing-direct-loans>; and USDA, “Multifamily Housing Loan Guarantees,” at <https://www.rd.usda.gov/programs-services/multi-family-housing-loan-guarantees>.

<sup>38</sup> See Federal Housing Finance Agency (FHFA), “FHLB Affordable Housing and Community Development: Affordable Housing Program,” at <https://www.fhfa.gov/PolicyProgramsResearch/Programs/AffordableHousing/Pages/Affordable-Housing-Home-Loan-Banks.aspx>.

<sup>39</sup> Commercial banks may be awarded credits stemming from the Community Reinvestment Act (P.L. 95-128, 12 U.S.C. §§2901-2908), which are taken into account when banks apply for charters, branches, mergers, and acquisitions, among other things. For more information, see CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter.

<sup>40</sup> Ginnie Mae sells, in the form of mortgage-backed securities, the prepayment risk for FHA- and USDA-insured multifamily mortgages.

higher-end single-family mortgage market, which includes nonconforming residential and non-owner occupied and investment mortgages, is also uncommon (see the textbox below).<sup>41</sup>

### Limited Federal Support for Certain Single-Family Mortgages

Federal support for single-family mortgages used to acquire secondary homes or investment rental properties is limited. FHA's single-family program is limited to owner-occupied principal residences.<sup>42</sup> FHA generally insures only one principal residential mortgage per borrower. FHA does not insure investment property mortgages. Likewise, veterans are required to personally occupy their VA-insured properties.<sup>43</sup> Federal and federally related entities provide financial support for condominium projects that are built primarily to house residents, keeping with their mission goals, rather than for the benefit of investors (landlords). For example, HUD has established an owner-occupancy range with a floor of 30% and a cap of 75%, allowing for the flexibility to set limits to address different project circumstances.<sup>44</sup> Fannie Mae and Freddie Mac require a minimum of 50% owner occupancy for condominium projects.<sup>45</sup>

Although federal intervention in the multifamily mortgage market is conducive to developing more traditional multifamily structures, the demand for mixed commercial and residential real estate developments has grown over several decades. Mixed-use real estate typically refers to three or more uses in the same or adjoining structures to allow residents, tenants, visitors, and patrons to live, shop, work, and interact in public recreational spaces.<sup>46</sup> As construction boomed in 2017, reaching an all-time high of \$1.26 trillion in construction spending, mixed-use walkable community developments made up a substantial portion of this spending.<sup>47</sup> Mixed-use developments, unlike single-purpose developments, provide more diversification of revenue streams for investors' portfolios because tenant diversity reduces the likelihood that they would simultaneously become delinquent paying rent or vacate.

Because federal intervention is largely stipulated for affordable residential housing, certain mixed-use properties may pose challenges for some federal entities to provide financial support.

<sup>41</sup> Nonconforming mortgages exceed the conforming loan limit, which is the maximum mortgage amount that Fannie Mae's and Freddie Mac's charters allow them to purchase. The conforming loan limit is adjusted annually.

<sup>42</sup> See HUD, *Mortgage Credit Analysis for Mortgage Insurance on One- to Four-Unit Mortgage Loans Handbook (4155.1)*, Chapter 4, Section B, at [https://www.hud.gov/program\\_offices/administration/hudclips/handbooks/hsg/4155.1](https://www.hud.gov/program_offices/administration/hudclips/handbooks/hsg/4155.1).

<sup>43</sup> See VA, *Lenders Handbook: VA Pamphlet 26-7*, Chapter 3, at [https://benefits.va.gov/warms/pam26\\_7.asp](https://benefits.va.gov/warms/pam26_7.asp).

<sup>44</sup> See HUD, "Project Approval for Single-Family Condominiums," 84 *Federal Register* 41846-41877, August 15, 2019. The Housing Opportunity Through Modernization Act (HOTMA; P.L. 114-201, 130 Stat. 782) required FHA to establish an owner-occupancy requirement by October 27, 2016. Prior to 2008, FHA required the owner-occupancy rate to be as high as 80%; the rate was lowered after the passage of P.L. 110-289. See FHA Mortgagee Letter 2016-15, October 23, 2016, at <https://www.hud.gov/sites/documents/16-15ML.PDF>. The current floor was set to accommodate newly constructed projects in which units have not been sold. The cap, however, was set to limit the credit risk to the Mutual Mortgage Insurance Fund (MMIF), which holds the proceeds collected in the form of insurance premiums that are used to reimburse lenders after defaults on FHA-insured single-family mortgages. If HUD determines that a lower owner-occupancy rate is causing distress to the MMIF, then it will raise the requirement for certain projects closer to the 75% cap. For more information about the MMIF, see CRS Report R42875, *FHA Single-Family Mortgage Insurance: Financial Status of the Mutual Mortgage Insurance Fund (MMI Fund)*, by Katie Jones.

<sup>45</sup> See Fannie Mae, *Fannie Mae Selling Guide*, at <https://singlefamily.fanniemae.com/media/21821/display>; and Freddie Mac, *Freddie Mac Single-Family Seller/Servicer Guide PDF*, at [https://guide.freddiemac.com/ci/okcsFattach/get/1002095\\_2](https://guide.freddiemac.com/ci/okcsFattach/get/1002095_2).

<sup>46</sup> See Adam Ducker, "How to Invest in Mixed-Use Real Estate Projects," *Real Assets Adviser*, vol. 5, no. 1 (January 1, 2018), at <https://irei.com/publications/article/invest-mixed-use-real-estate-projects/>; and Federal Reserve Bank of Minneapolis, *What Does "Mixed-Use Development" Mean?* December 1, 1998, at <https://www.minneapolisfed.org/article/1998/what-does-mixed-use-development-mean>.

<sup>47</sup> See Adam Robinson, "Why Is Mixed-Use the Newest Gem in U.S. Development?" *National Real Estate Investor*, May 3, 2018, at <https://www.nreionline.com/development/why-mixed-use-newest-gem-us-development>.

For example, a horizontal mixed-use arrangement consists of multiple buildings each with a single use.<sup>48</sup> Horizontal mixed-use developments may be easier for federal entities to provide financial support because many multifamily structures can be isolated from the other adjoining commercial structures. By contrast, a vertical mixed-use structure combines different uses in the same building, such as a storefront on the ground level and apartment units above. For vertical property arrangements, it may become more difficult to determine what percentage of federal financial support is being applied to finance affordable housing versus commercial space.

The restrictions on financing commercial and other nonresidential spaces vary by type of federal entity, as summarized below.

- By their federal charters, Fannie Mae and Freddie Mac are not authorized to receive cash flows from mixed-properties mortgages, thus limiting their purchases of commercial or multifamily mortgages with a large percentage of commercial or nonresidential space.<sup>49</sup> For this reason, certain older (Class C) small-unit (typically 5-50 units) properties, usually eligible for GSE mortgages, may occasionally conflict with their multifamily mission requirements and commercial lending restrictions when designed for vertical mixed-use with one or more noncontiguous commercial components.<sup>50</sup> In response, Fannie Mae's and Freddie Mac's guidelines currently cap the amount of space that a project may use for commercial or other nonresidential purposes to 35%.<sup>51</sup>
- HUD established a range—a floor of 25% and a cap of 55%—for the percentage of space that a mixed-use property development can allocate for commercial or other nonresidential uses and still be eligible for mortgage insurance.<sup>52</sup> The Housing Opportunity Through Modernization Act (HOTMA; P.L. 114-201, 130 Stat. 782) gives HUD greater flexibility (than that of the GSEs) to set higher commercial and nonresidential caps as long as it considers the prevailing economic conditions in the locality, property's location, and number of family

<sup>48</sup> See Howard Blackson, *Don't Get Mixed Up on Mixed-Use*, PlaceMakers, PlaceShakers and Newsmakers, April 4, 2013, at <http://www.placemakers.com/2013/04/04/mixed-up-on-mixed-use/>.

<sup>49</sup> In the past, the GSEs' regulator has required them to disinvest from pools that contain both multifamily properties and nonresidential commercial properties based on permissible activities as described in the Federal Home Loan Mortgage Corporation Act of 1970 (P.L. 91-351, 84 Stat. 450). See Office of Federal Housing Enterprise Oversight, *Report to Congress*, June 16, 2006, at [https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/OFHEO\\_Report\\_Congress-2006.pdf](https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/OFHEO_Report_Congress-2006.pdf); and John Zipperer, "Fannie, Freddie Have Limited Appetite For Mixed-Use," *Affordable Housing Finance*, January 1, 2006, at [https://www.housingfinance.com/policy-legislation/fannie-freddie-have-limited-appetite-for-mixed-use\\_o](https://www.housingfinance.com/policy-legislation/fannie-freddie-have-limited-appetite-for-mixed-use_o).

<sup>50</sup> The GSEs' multifamily mortgage products used to provide financing for small-unit properties (e.g., 5-50 units) arguably fills a credit market gap that exists because private-sector lenders are unwilling to assume the credit risk for a property that may not generate a sufficient volume of rental income. See Philip Langdon, "Yes, You CAN Finance Mixed-Use Development," *Public Square—Congress for the New Urbanism*, July 31, 2017, at <https://www.cnu.org/publicsquare/2017/07/31/yes-you-can-finance-mixed-use-development>; "Freddie Mac Small Balance Multifamily Loans," *Multifamily Loans—Capital Markets Advisors*, at <https://www.multifamily.loans/freddie-mac-small-balance-apartment-loans>; and "Optigo Small Balance Loans Program," *Freddie Mac Multifamily*, at <https://mf.freddiemac.com/product/sbl.html>.

<sup>51</sup> See Fannie Mae, *Fannie Mae Selling Guide*, at <https://singlefamily.fanniemae.com/media/21821/display>; and Freddie Mac, *Freddie Mac Single-Family Seller/Servicer Guide PDF*, at [https://guide.freddiemac.com/ci/okcsFattach/get/1002095\\_2](https://guide.freddiemac.com/ci/okcsFattach/get/1002095_2).

<sup>52</sup> See HUD, "Project Approval for Single-Family Condominiums," 84 *Federal Register* 41846-41877, August 15, 2019.

- units in the project. For this reason, HUD stated that it established a cap of 55% to accommodate more mixed-use developments.
- The USDA’s Rural Business Cooperative Service Agency has the authority to insure commercial loans to finance private agriculturally related businesses located in rural areas, among other restrictions.<sup>53</sup> In addition, the Farm Credit System is another GSE authorized to provide a secondary market for agribusiness real estate mortgage loans, rural housing loans, and rural cooperative loans.<sup>54</sup> These exemptions address the difficulty that agricultural commercial businesses may encounter while trying to borrow under certain circumstances when lenders face greater challenges predicting the potential revenues that certain collateral (i.e., agricultural products) could generate.<sup>55</sup>

As mixed-use development growth trends continue, the GSEs, FHA, and other federal entities arguably may need to periodically evaluate the extent to which their federal commercial lending restrictions may affect their ability to achieve affordable housing objectives.

## Affordable Housing Finance: Selected Trends and Policy Issues

This section reviews multifamily investment trends as they pertain to affordable housing,<sup>56</sup> resulting in challenges for various federal agencies and the GSEs (since their conservatorships) to achieve mission goals that address housing cost burdens. A *cost-burdened* household is one with a monthly housing cost—either to own or rent—that exceeds 30% of its monthly income.<sup>57</sup> A household is *moderately cost burdened* if the ratio of monthly housing costs divided by monthly income is greater than 30% but less than 50%; it is *severely cost burdened* if the ratio exceeds 50%. The share of the population falling into one or more of these categories may increase as rents or prices of smaller entry level single-family homes rise. Increases in the percentages of cost-burdened households is indicative of a shortage of affordable housing.

### Combining Federal Incentives to Minimize Financing Costs

Prior to more contemporary urbanization trends, differences in rents among the various property classes reflected more segmentation between higher-end and LMI rental markets.<sup>58</sup> Between 2004

<sup>53</sup> The Consolidated Farm and Rural Development Act of 1972 (P.L. 92-419) authorized the Business and Industry (B&I) Guaranteed Loan Program. See Department of Agriculture: Rural Business-Cooperative Service and Rural Utilities Service, “Guaranteed Loanmaking and Servicing Regulations,” 81 *Federal Register* 35984-36027, June 3, 2016; and USDA, Business & Industry Loan Guarantees, at <https://www.rd.usda.gov/programs-services/business-industry-loan-guarantees>.

<sup>54</sup> See Farm Credit Administration, at <https://www.fca.gov/>.

<sup>55</sup> See Timothy Besley, “How Do Market Failures Justify Interventions in Rural Credit Markets?” *The World Bank Research Observer*, vol. 9, no. 1 (January 1994), pp. 27-47.

<sup>56</sup> For more information on the wider range of federal programs aimed at affordable housing, please see CRS Report RL34591, *Overview of Federal Housing Assistance Programs and Policy*, by Maggie McCarty, Libby Perl, and Katie Jones.

<sup>57</sup> See HUD, “Defining Housing Affordability,” HUD USER, *PD&R Edge*, August 14, 2017, <https://www.huduser.gov/portal/pdredge/pdr-edge-featd-article-081417.html>.

<sup>58</sup> See Kim Parker et al., *What Unites and Divides Urban, Suburban, and Rural Communities*, Pew Research Center, May 22, 2018, at <https://www.pewsocialtrends.org/wp-content/uploads/sites/3/2018/05/Pew-Research-Center->

and 2016, HUD reports that an unprecedented 10 million households became renters.<sup>59</sup> Following a rise in the demand for rentals, average monthly rents increased and national vacancy rates declined in certain regions and metropolitan areas.<sup>60</sup> Class A apartment rents and occupancy rates subsequently increased nationwide.<sup>61</sup> As more renters were priced out of the Class A market, middle- and upper-income renters sought lower rents. Consequently, the demand and rents subsequently increased for Class B and Class C apartments, meaning that these properties did not experience a *filtering down* to the affordable segments of the market.<sup>62</sup> Filtering down is the process in which LMI households inherit older properties to own or rent, which are expected to be less expensive than when they were newly constructed.<sup>63</sup> Instead, some research has demonstrated that rising rents (and housing prices) in densely populated urban areas has resulted in the *filtering up* of Class C properties.<sup>64</sup> The convergence of rents may also indicate that market segmentation among property classes is fading in certain localities.

Rising construction costs and lack of scale (i.e., volume of tenants paying rent) may also sway greater investment toward the higher-end rental markets where aggregate revenues from rents are sufficient and more sustainable. (For details on some of these factors influencing multifamily developments, see the text box at the end of this section.) As multifamily development costs have risen at a faster pace than low and moderate incomes, more Class C properties are being repurposed for higher-end renters or owners rather than being filtered down into affordable rental properties.<sup>65</sup> Specifically, some developers have demonstrated greater willingness to convert Class C structures to condominiums rather than rehabilitate rent-controlled apartments.<sup>66</sup>

Consequently, developers frequently rely on a variety of strategies to foster the investment in or construction of affordable rental units.<sup>67</sup> For example, developers may combine an LIHTC with

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<sup>59</sup> See HUD, “America’s Rental Housing 2017,” *PD&R Edge*, February 5, 2018, at <https://www.huduser.gov/portal/pdredge/pdr-edge-featd-article-020518.html>.

<sup>60</sup> See HUD, “Spotlight on First Quarter Regional Rental Market Conditions,” *PD&R Edge*, July 11, 2016, at <https://www.huduser.gov/portal/pdredge/pdr-edge-spotlight-article-071116.html>; HUD, “Apartment Demand for the Next 15 Years: Can We Meet the Need?,” *PD&R Edge*, September 25, 2017, at <https://www.huduser.gov/portal/pdredge/pdr-edge-featd-article-092517.html>.

<sup>61</sup> For more information, see Tanya Zahalak, *Multifamily Economic and Market Commentary*, Fannie Mae, February 2020, <https://www.fanniemae.com/media/33271/display>.

<sup>62</sup> See Swapnil Agarwal, “Five Steps to Smart Multifamily Investments,” *National Real Estate Investor*, October 10, 2018, at <https://www.nreionline.com/multifamily/five-steps-smart-multifamily-investments>; Yuen Yung, “2017-2018 Forecast: Class B and C Apartments Will Rule,” *Business & Finance*, June 21, 2017, at [https://www.multifamilyexecutive.com/business-finance/20172018-forecast-class-b-and-c-apartments-will-rule\\_o](https://www.multifamilyexecutive.com/business-finance/20172018-forecast-class-b-and-c-apartments-will-rule_o); Kim O’Brien, “Occupancy Gains Largest Among Class C Apartments in Current Cycle,” at <https://www.realpage.com/analytics/occupancy-gains-largest-among-class-c-apartments-current-cycle/>; and Jeremiah Jensen, “RealPage: Class-C is now the Cream of the Multifamily Crop,” *Housing Wire*, at <https://www.housingwire.com/articles/43847-realpage-class-c-is-now-the-cream-of-the-multifamily-crop>.

<sup>63</sup> See Stuart S. Rosenthal, “Are Private Markets and Filtering a Viable Source of Low-Income Housing? Estimates from a ‘Repeat Income’ Model,” *American Economic Review*, vol. 104, no. 2 (2014), pp. 687-706.

<sup>64</sup> See Lena Edlund, Cecilia Machado, and Maria Micaela Sviatschi, *Gentrification and the Rising Returns to Skill*, National Bureau of Economic Research, Working Paper no. 21729, January 2019, at <https://www.nber.org/papers/w21729.pdf>.

<sup>65</sup> See Joint Center for Housing Studies of Harvard University, *America’s Rental Housing 2017*, at [http://www.jchs.harvard.edu/sites/default/files/harvard\\_jchs\\_americas\\_rental\\_housing\\_2017\\_0.pdf](http://www.jchs.harvard.edu/sites/default/files/harvard_jchs_americas_rental_housing_2017_0.pdf).

<sup>66</sup> See Mark Noack, “Condos to Replace rent-Controlled Apartments,” *Mountain View Voice*, May 18, 2018, at <https://www.mv-voice.com/print/story/2018/05/18/condos-to-replace-rent-controlled-apartments>.

<sup>67</sup> The LIHTC program serves households that make an average of 60% of area median income (AMI); however, it still does not serve extremely low-income households without relying on additional federal rental assistance programs. See

an FHA-insured multifamily mortgage, which lowers both the initial loan amount and the financing costs and, therefore, enhances an investment's rate of return.<sup>68</sup> Mixed-income multifamily projects can target renters with a range of incomes so that the higher rents paid by higher-income renters cross-subsidize the lower rents paid by LMI-renters, and still meet the eligibility requirements for LIHTCs.<sup>69</sup> Such strategies combined with various federal incentive programs may increase the viability of affordable multifamily construction in some locations; however, they may be less effective in densely populated areas where land is scarce and more expensive to develop.<sup>70</sup>

Given the difficulty of raising rents on some tenants to generate more revenue, lowering some of the nonfinancial costs—particularly various regulatory costs—may increase the attractiveness to invest in housing for LMI renters.<sup>71</sup> The 117<sup>th</sup> Congress considered measures to increase incentives to develop affordable housing.

- On December 29, 2022, Congress passed H.R. 2617, which included some provisions from the Yes In My Back Yard Act (H.R. 3198 and S. 1614), which would have established a competitive grant program to be administered by HUD. The provisions would have required state and local governments that apply for federal housing development funds through the Community Development Block Grant (CDBG) program to develop policies to improve inclusionary zoning practices and reduce regulatory costs and fees for developers, thus reducing obstacles to the production of affordable housing.<sup>72</sup>
- The 117<sup>th</sup> Congress also debated modifications to the LIHTC program that would have expanded financial support for affordable housing investments. Those provisions may be reintroduced in the 118<sup>th</sup> Congress.<sup>73</sup>

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Corianne Payton Scally, Amanda Gold, and Nicole DuBois, *The Low-Income Housing Tax Credit: How It Works and Who It Serves*, Urban Institute, July 2018, at [https://www.urban.org/sites/default/files/publication/98758/litc\\_how\\_it\\_works\\_and\\_who\\_it\\_serves\\_final\\_2.pdf](https://www.urban.org/sites/default/files/publication/98758/litc_how_it_works_and_who_it_serves_final_2.pdf).

<sup>68</sup> FHA has reported that approximately 30% of the transactions related to its insured-multifamily mortgage portfolio consists of borrowers that also rely on the LIHTC. See HUD, "FHA Expands Pilot Program to Accelerate Financing of Low-Income Housing Tax Credit Projects," press release, February 21, 2019, at <https://archives.hud.gov/news/2019/pr19-014.cfm>.

<sup>69</sup> See Testimony of Katherine M. O'Regan, "America's Affordable Housing Crisis: Challenges and Solutions," U.S. Congress, Senate Committee on Finance, *Increasing Access to Affordable Housing*, 115<sup>th</sup> Cong., 1<sup>st</sup> sess., August 1, 2017, at <https://www.finance.senate.gov/imo/media/doc/01aug2017OReganSTMNT.pdf>.

<sup>70</sup> See Urban Land Institute and Enterprise, *Bending the Cost Curve: Solutions to Expand the Supply of Affordable Rentals*, 2014, at [http://uli.org/wp-content/uploads/ULI-Documents/BendingCostCurve-Solutions\\_2014\\_web.pdf](http://uli.org/wp-content/uploads/ULI-Documents/BendingCostCurve-Solutions_2014_web.pdf).

<sup>71</sup> See Office of Policy Development and Research, "Why Not In Our Community?": *An Update to the Report of the Advisory Commission on Regulatory Barriers to Affordable Housing*, HUD, February 2005, at <https://www.huduser.gov/portal/Publications/wnioc.pdf>; and Joseph Gyourko and Raven Molloy, *Regulation and Housing Supply*, National Bureau of Economic Research, Working Paper no. 20536, October 2014, at <https://www.nber.org/papers/w20536.pdf>.

<sup>72</sup> See Brian Schatz, "Schatz Secures \$85 Million to Address National Housing Crisis, Help Build More Affordable Housing," press release, December 20, 2022, at <https://www.schatz.senate.gov/news/press-releases/-schatz-secures-85-million-to-address-national-housing-crisis-help-build-more-affordable-housing>; and Yonah Freemark, "How Federal Policymakers Can Promote Affordable Housing Production in Exclusionary Communities," Urban Institute, January 20, 2023, at <https://www.urban.org/urban-wire/how-federal-policymakers-can-promote-affordable-housing-production-exclusionary>. For more information about the CDBG program, see CRS Report R43520, *Community Development Block Grants and Related Programs: A Primer*, by Joseph V. Jaroscak.

<sup>73</sup> For more information, see CRS Insight IN12070, *The Low-Income Housing Tax Credit: Lowering the 50% Bond Threshold to 25%*, by Mark P. Keightley.

### Some Factors Arguably Influencing Multifamily Investment Decisions

The bullets below summarize some of the costs, which have been rising for several decades, and other factors arguably influencing multifamily developers' investment decisions.<sup>74</sup>

- According to the National Association of Home Builders, regulations account for 32% of the total cost of developing multifamily housing.<sup>75</sup> State and local governments impose regulations on property developments and *impact fees*, which are collected to pay for some or all of the public services provided to the new development. Developers may gravitate toward the higher-end purchase and rental markets to recoup costs.
- Many state governments and local municipalities encourage (and some require) construction of more mixed-use developments.<sup>76</sup> Many states generate property tax revenues from these communities, thus they have passed legislation mandating their cities and counties to develop plans for rising population growth. Such requirements encourage developers to construct mixed-use properties, which incorporate parking, open space, housing, and public transportation, among other essentials to accommodate growing populations.<sup>77</sup> Some economists have found evidence to suggest that these laws may lead to increases in development costs that are subsequently passed on to consumers in the form of higher house or rent prices, thus creating a challenge to supply residential units for certain segments of cost-burdened renters.<sup>78</sup>
- Certain multifamily construction projects may be less likely to occur if a low population density is not expected to generate a sufficient volume of rental income necessary to cover development costs.<sup>79</sup> The number of USDA-supported rental homes via its Section 515 program has declined, and no new properties have been financed in the past several years. Furthermore, many of the remaining Section 515 loans are reaching maturity and projected to leave the portfolio in the next few decades.<sup>80</sup> Once a Section 515 loan is fully repaid, the tenants are no longer eligible for USDA rental assistance, and in some instances, the homes may no longer be affordable for the current tenants. Developers may not find rural apartment investments as profitable as other alternatives particularly when the population density is too low to generate a sufficient volume of tenants to maintain below-market rents.<sup>81</sup>

## Recent Developments in Fannie Mae's and Freddie Mac's Multifamily Financing Activities

In the multifamily mortgage market, Fannie Mae and Freddie Mac purchase mortgages and transfer a portion of (or share) the default risks to the private sector, although they have different underwriting and risk-sharing business models.

<sup>74</sup> See HUD, Office of Policy Development and Research, *Preserving Affordable Rental Housing: A Snapshot of Growing Need, Current Threats, and Innovative Solutions*, Evidence Matters, Summer 2013, at <https://www.huduser.gov/portal/periodicals/em/summer13/highlight1.html>.

<sup>75</sup> See U.S. Congress, House Committee on Financial Services, *Housing in America: Assessing the Infrastructure Needs of America's Housing Stock*, 116<sup>th</sup> Cong., 1<sup>st</sup> sess., April 30, 2019.

<sup>76</sup> See Kim Slowey, "Building a 'Sense of Community': Why Mixed-Use Developments Are Sprouting Up Across the U.S.," *Construction Dive*, June 23, 2016, at <https://www.constructiondive.com/news/building-a-sense-of-community-why-mixed-use-developments-are-sprouting-u/421386/>.

<sup>77</sup> Various states, including Florida, Maryland, Virginia, and Washington, have passed their own versions of growth management regulations.

<sup>78</sup> For more information and a literature survey, see Jerry Anthony, "The Effects of Florida's Growth Management Act on Housing Affordability," *Journal of the American Planning Association*, vol. 69, no. 3 (Summer 2003).

<sup>79</sup> See Timothy Besley, "How Do Market Failures Justify Interventions in Rural Credit Markets?" *The World Bank Research Observer*, vol. 9, no. 1 (January 1994), pp. 27-47.

<sup>80</sup> See Housing Assistance Council, *Rural Housing for a 21<sup>st</sup> Century Rural America: A Platform for Preservation*, September 2018, at [http://www.ruralhome.org/storage/documents/publications/rrreports/HAC\\_A\\_PLATFORM\\_FOR\\_PRESERVATION.pdf](http://www.ruralhome.org/storage/documents/publications/rrreports/HAC_A_PLATFORM_FOR_PRESERVATION.pdf); Michael Feinberg, *Rural America Is Losing Affordable Rental Housing at an Alarming Rate*, Housing Assistance Council, March 2, 2022, [https://ruralhome.org/wp-content/uploads/2022/03/rural\\_research\\_brief\\_usda\\_rural\\_rental\\_housing.pdf](https://ruralhome.org/wp-content/uploads/2022/03/rural_research_brief_usda_rural_rental_housing.pdf); and CRS Report RL31837, *An Overview of USDA Rural Development Programs*, by Tadlock Cowan.

- Fannie Mae primarily relies on its Delegated Underwriting and Servicing (DUS) business model when purchasing multifamily mortgages.<sup>82</sup> Under the DUS process, Fannie delegates to its pre-approved group of lenders (that sell multifamily mortgages to Fannie Mae) the responsibility of assessing borrowers' creditworthiness (i.e., the likelihood of loan delinquency or default). The lenders, following Fannie Mae's standardized underwriting and servicing guidelines, close and service the approved loans on Fannie Mae's behalf. The lenders are also required to enter into mortgage default loss sharing agreements with Fannie Mae, which fosters alignment of their incentives to perform prudent underwriting. Fannie Mae offers two types of loss sharing agreements. A *pro rata* loss sharing agreement requires the lender to assume one-third of the losses and Fannie Mae assumes the remaining two-thirds.<sup>83</sup> A *tiered-basis* loss sharing agreement requires lenders to bear the initial 5% of the unpaid principal balance and then share any remaining losses up to a prescribed limit.<sup>84</sup> On October 24, 2019, Fannie Mae introduced *Multifamily Connecticut Avenue Securities* (MCAS), a multifamily credit risk transfer program that has similarities to Freddie Mac's multifamily risk-sharing approach.<sup>85</sup>
- Freddie Mac relies on its pre-approval business model that consists of its own team of in-house underwriters.<sup>86</sup> Freddie Mac internally re-underwrites and approves multifamily mortgages prior to purchasing them from lenders. Freddie Mac subsequently issues and sells certificates referred to as *K-Certificates* (or *K-Deals*), thus offloading various amounts of default loss risk to private-sector investors (e.g., REITs, pension funds, hedge funds).<sup>87</sup> Freddie Mac's K-Deals have similarities to Fannie Mae's MCAS.

FHFA, as the GSEs' conservator, currently has the powers of management, boards, and shareholders.<sup>88</sup> FHFA issues annual *scorecards*, which communicate the annual priorities and

<sup>81</sup> See Audrey Johnston, *A Review of Federal Rural Rental Housing Programs, Policy and Practices*, National Rural Housing Coalition, April 2017, at <http://ruralhousingcoalition.org/wp-content/uploads/2017/05/Rental-Housing-Report-FINAL-04.18.17.pdf>.

<sup>82</sup> See Fannie Mae, *Delegated Underwriting & Servicing (DUS)*, Fourth Quarter 2011, at [https://multifamily.fanniemae.com/sites/g/files/koqyhd161/files/migrated-files/content/fact\\_sheet/wprskret.pdf](https://multifamily.fanniemae.com/sites/g/files/koqyhd161/files/migrated-files/content/fact_sheet/wprskret.pdf).

<sup>83</sup> In some isolated cases, Fannie Mae has purchased non-DUS mortgages (e.g., small balance loans or pools of seasoned loans) from lenders without a loss sharing agreement to meet various objectives and in situations where it may not have a long-term relationship with the lender.

<sup>84</sup> See Fannie Mae, *Form 10-K*, For the Fiscal Year Ended December 31, 2018, December 31, 2018, p. 100, at <https://www.fanniemae.com/sites/g/files/koqyhd191/files/migrated-files/resources/file/ir/pdf/quarterly-annual-results/2018/q42018.pdf>.

<sup>85</sup> See Fannie Mae, "Fannie Mae Price Inaugural Multifamily Connecticut Avenue Securities Deal: Landmark \$472.7 Million Transaction Complements Fannie Mae's Multifamily Credit Insurance Risk Transfer and Delegated Underwriting and Servicing Loss-Sharing Programs," October 24, 2019, at <https://www.fanniemae.com/portal/media/financial-news/2019/multifamily-connecticut-avenue-securities-6947.html>.

<sup>86</sup> See Freddie Mac, *Multifamily Securitization Overview*, June 30, 2019, at [https://mf.freddiemac.com/docs/mf\\_securitization\\_investor-presentation.pdf](https://mf.freddiemac.com/docs/mf_securitization_investor-presentation.pdf).

<sup>87</sup> See Freddie Mac, *Multifamily Securities*, at <https://mf.freddiemac.com/investors/securities.html>. In addition to K-Deals, Freddie Mac offers a variety of certificates that back the performance of specific types of multifamily structures to appeal to investors with varying appetites for risk. Freddie Mac may retain in its portfolio some of the multifamily default risk, such as any losses resulting from extremely unfavorable macroeconomic conditions, which is referred to as *catastrophic risk*. See CRS Report R44525, *Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions*, by Darryl E. Getter.

<sup>88</sup> In September 2008, the GSEs experienced losses that exceeded their statutory minimum capital requirement levels

expectations that it sets for the GSEs with respect to both of their single-family and multifamily mortgage businesses while under conservatorship.<sup>89</sup>

FHFA has issued various directives for the GSEs' multifamily programs, initially to reduce financial risks while under conservatorship and more recently to sharpen the focus on mission goals. FHFA's 2013 Conservatorship Scorecard reduced the GSEs' new multifamily purchase volumes by 10% from the 2012 caps to shrink their multifamily operations and risks to taxpayers.<sup>90</sup> FHFA subsequently directed the GSEs to limit their 2014 multifamily purchase volumes at or below the 2013 caps.<sup>91</sup> In addition, FHFA excluded mission-driven purchases from counting toward the cap to encourage GSE support in the affordable housing and underserved market segments.<sup>92</sup> In 2016, FHFA began specifying the types of multifamily loans that would count toward the annual caps to retain the GSEs' focus on mission goals. Furthermore, by purchasing mission-driven multifamily mortgages that support affordable rental housing, the GSEs are less likely to *crowd out* (impede) private-sector lender participation by offering cheaper borrowing rates for multifamily loans. In other words, the GSEs' multifamily programs have been tailored to promote the availability of affordable rental units for LMI and other historically underserved renters—while making a *reasonable* economic return—rather than crowd out multifamily loans that private-sector lenders might be willing to originate.<sup>93</sup>

The GSEs must still satisfy their annual mission-driven goals, which are also established by FHFA.<sup>94</sup> The FHFA establishes three multifamily housing mission-driven goals for the GSEs with a benchmark amount of rental property purchases. A benchmark goal is established for a *low-income family*, defined as having an income of less than or equal to 80% of area median income (AMI);<sup>95</sup> for a *very low-income family*, defined as having an income of no greater than 50% of AMI; and for *small multifamily properties*, defined as a property with five units to 50 units. FHFA

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due in part to above-normal mortgage defaults. See CRS Report R44525, *Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions*, by Darryl E. Getter.

<sup>89</sup> See FHFA, "Conservatorship," press release, at <https://www.fhfa.gov/Conservatorship>.

<sup>90</sup> See FHFA, "FHFA Seeks Public Input on Reducing Fannie Mae and Freddie Mac Multifamily Businesses," press release, August 9, 2013, at <https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/MultifamilyInput080913Final.pdf>; and FHFA, *Conservatorship Strategic Plan: Performance Goals for 2013*, at [https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2013EnterpriseScorecard\\_508.pdf](https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2013EnterpriseScorecard_508.pdf).

<sup>91</sup> The 2013 volume that became the 2014 cap for Fannie Mae was \$30 billion; the 2013 volume that became the 2014 cap for Freddie Mac was \$26 billion. See Karan Kaul, *The GSEs' Shrinking Role in the Multifamily Market*, Urban Institute, April 2015, at <https://www.urban.org/sites/default/files/publication/48986/2000174-The-GSEs-Shrinking-Role-in-the-Multifamily-Market.pdf>.

<sup>92</sup> See FHFA, "Fact Sheet: New Multifamily Caps for Fannie Mae and Freddie Mac," press release, at <https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/newmultifamilycaps-9132019.pdf>.

<sup>93</sup> The GSEs' statutory public purpose includes an "affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return." See 12 U.S.C. §4501(7). Both GSE charters authorize them to perform "activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities." See 12 U.S.C. §§1451, 1716 note.

<sup>94</sup> The GSEs' primary regulator is required by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (P.L. 102-550, title XIII, §1302, October 28, 1992, 106 Stat. 3941) to establish annual housing goals for mortgages purchased by the GSEs. See FHFA, "Federal Housing Finance Agency Charter: Federal Housing Enterprises Financial Safety and Soundness Act of 1992," at <https://www.fhfa.gov/Government/Documents/Federal-Housing-Enterprises-Financial-Safety-and-Soundness-Act.pdf>.

<sup>95</sup> FHFA uses HUD-published area median incomes (AMIs) to determine affordability for the GSEs' single-family and multifamily mortgage acquisitions. AMI is a measure of median family income derived from the Census Bureau's American Community Survey.

previously stated these goals in terms of thousands of rental units. However, it has made revisions to this framework. On December 14, 2022, FHFA finalized a rule to establish the benchmark levels for multifamily housing goals using a new percentage-based methodology.<sup>96</sup> The three subgoals will each be established as a percentage of the total number of affordable multifamily properties financed by the GSEs each year. Because new developments may occur over the period that can increase the infeasibility to meet a housing goal defined in terms of units, the percentage-based methodology lessens the need to amend the benchmarks after publication of the final rule.

The FHFA also provided an updated comprehensive definition of mission-driven multifamily purchases.<sup>97</sup> Examples of additional eligible mission-driven mortgage purchases for the GSEs include properties subsidized by the LIHTC program; loans on properties covered by a Section 8 Housing Assistance Payment contract, which limits tenant incomes to 80% or below of AMI; and loans of properties in which a Public Housing Authority or nonprofit affiliate is the developer (borrower) that reserves units for occupancy by tenants with limited income or the rents that may be charged for those units.<sup>98</sup>

For calendar year 2023, the FHFA has established the multifamily volume caps for both Fannie Mae and Freddie Mac at \$75 billion each, for a total of \$150 billion.<sup>99</sup> At least 50% of the multifamily business must be mission driven according to the definitions established by the FHFA.<sup>100</sup> The FHFA established three multifamily housing mission-driven goals for the GSEs' 2023-2024 purchases:<sup>101</sup>

1. The annual benchmark percent of all goal-eligible units in multifamily properties financed by mortgage purchases by the GSEs that would be affordable for *low-income* (less than or equal to 80% of AMI) families is set at 61%.
2. The annual benchmark percent of all goal-eligible units in multifamily properties financed by mortgage purchases by the GSEs that would be affordable for *very low-income* (of no greater than 50% of AMI) families is set at 12%.
3. The annual benchmark percent of all goal-eligible units in multifamily properties financed by mortgage purchases by the GSEs that would be considered *small multifamily properties* affordable to low-income families is set at 2.5%.

Limiting the GSEs' multifamily activities to market segments with more apparent credit gaps is intended to reduce the likelihood of crowding out private lenders' activities in market segments with less apparent credit gaps.<sup>102</sup> From an economics viewpoint, however, a lending cap arguably

<sup>96</sup> FHFA, "FHFA Finalizes 2023-2024 Multifamily Housing Goals for Fannie Mae and Freddie Mac," press release, December 14, 2022, at <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Finalizes-2023-2024-Multifamily-Housing-Goals-for-Fannie-Mae-and-Freddie-Mac.aspx>.

<sup>97</sup> FHFA, "FHFA Revises Multifamily Loan Purchase Caps for Fannie Mae and Freddie Mac—Appendix A: Multifamily Definitions," press release, September 9, 2019, at <https://www.fhfa.gov/Conservatorship/Documents/AppendixA-Revisions-to-2019-FHFA-Conservatorship-Scorecard.pdf>.

<sup>98</sup> See CRS Report RS22389, *An Introduction to the Low-Income Housing Tax Credit*, by Mark P. Keightley; and CRS Report RL34591, *Overview of Federal Housing Assistance Programs and Policy*, by Maggie McCarty, Libby Perl, and Katie Jones.

<sup>99</sup> See FHFA, "Fact Sheet: 2023 Multifamily Caps for Fannie Mae and Freddie Mac," at <https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/2023-Multifamily-Caps-Factsheet.pdf>.

<sup>100</sup> See FHFA, "Appendix A: Multifamily Definitions," at <https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/2023-Appendix-A-11102022.pdf>.

<sup>101</sup> See FHFA, "2023-2024 Multifamily Enterprise Housing Goals," 87 *Federal Register* 78837-78846, December 23, 2022.

<sup>102</sup> See FHFA, "Fannie Mae & Freddie Mac Multifamily Businesses," at <https://www.fhfa.gov/>

may be considered an arbitrary policy tool that might exacerbate any existing shortage of multifamily lending if set at levels that are retrospectively found to be “too low” or overly restrictive. The extent to which the GSEs crowd out private lenders may be difficult to determine without sufficient data.<sup>103</sup> To address the potential crowding out of private-sector lending opportunities, one policy option might be to require multifamily developers to demonstrate the inability to obtain credit elsewhere, similar in manner to the “credit elsewhere” requirement placed on applicants for loans insured by the Small Business Administration.<sup>104</sup> Another policy option might be a tax on the GSEs’ net income derived from multifamily lending, which could be applied to increase the cost to originate multifamily loans that the private sector arguably might have originated.<sup>105</sup> Such a tax could take a variety of forms, such as increased GSE contributions to the Housing Trust and Capital Magnet Funds, higher capital requirements, additional fees to Treasury for an explicit guarantee, or other arrangements as determined by policymakers. Should the GSEs be restored to well-capitalized, profit-maximizing firms, a tax on profitability—as opposed to a cap on profitability—may allow greater flexibility for them to address both profit (duty to shareholders) and mission-driven objectives that on occasion may be in conflict.<sup>106</sup>

## Conclusion

Investors typically borrow when acquiring financial or physical assets, thus to be attractive, their expected returns must be greater than their financing (borrowing) costs. It follows that developers, when considering multifamily property investments, evaluate whether the expected rental income streams would exceed the costs to finance their purchases, construction, or rehabilitation. For this reason, achieving affordable housing policy objectives is challenging because LMI tenants may not be able to pay market-level rents, which in turn translates into higher financing costs commensurate with the higher lending risks. The federal government supports the financing of affordable housing by sharing various amounts of credit and interest rate risks with lenders, which lowers developers’ financing costs. Nevertheless, nonfinancial costs (e.g., rising construction costs particularly those associated with mixed-use development trends) may be rising at a faster pace relative to financial costs, thus dampening the impact of existing

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PolicyProgramsResearch/Policy/Pages/Reducing-Fannie-Mae—Freddie-Mac-Multifamily-Businesses.aspx.

<sup>103</sup> For example, some banks argue they would not enter the space. See PNC Real Estate, “Comment Letter: Request for Input on Reducing Fannie Mae and Freddie Mac Multifamily Business, October 8, 2013, at [https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/Reducing-Fannie-Mae-and-Freddie-Mac-Multifamily-Businesses/PNC\\_Real\\_Estate.pdf](https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/Reducing-Fannie-Mae-and-Freddie-Mac-Multifamily-Businesses/PNC_Real_Estate.pdf). Business models, however, differ by institutions; for example, insurance companies may be in favor of lending caps. See Mortgage Bankers Association, *MBA Survey: Life Insurance Companies Could Fund an Additional \$10 Billion in Multifamily Lending in 2020*, September 16, 2019, at <https://newslink.mba.org/mba-newslinks/2019/september/mba-newslink-tuesday-9-17-19/mba-survey-life-insurance-cos-could-fund-additional-10b-in-multifamily-lending-in-2020-2/>.

<sup>104</sup> See CRS Report R45878, *Small Business Credit Markets and Selected Policy Issues*, by Darryl E. Getter.

<sup>105</sup> Using a price incentive to raise the cost of multifamily lending activities that may not be mission driven is equivalent to applying a *Pigouvian tax*, a tax applied to mitigate the negative effects of an activity that imposes a cost to society. For discussions regarding the strengths and weaknesses of a Pigouvian tax, see William J. Baumol, “On Taxation and the Control of Externalities,” *The American Economic Review*, vol. 62, no. 3 (June 1972), pp. 307-322; Earl A. Thompson and Ronald Batchelder, “On Taxation and the Control of Externalities: Comment,” *The American Economic Review*, vol. 64, no. 3 (June 1974), pp. 467-471; and Dennis W. Carlton and Glenn C. Loury, “The Limitations of Pigouvian Taxes as a Long-Run Remedy for Externalities,” *The Quarterly Journal of Economics*, vol. 95, no. 3 (November 1980), pp. 559-566.

<sup>106</sup> For more information regarding the proposed rule to increase the GSEs’ capital requirements, see FHFA, “FHFA Releases Re-Proposed Capital Rule for the Enterprises,” press release, May 20, 2020, at <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Releases-Re-Proposed-Capital-Rule-for-the-Enterprises.aspx>.

federal government programs. As nonfinancial costs continue to rise, the expected rental income factor is likely to have a large influence on multifamily investment decisions.

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