

Community Developments *Investments*

May 2015

Small Multifamily Rental Property Financing



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SMALL MULTIFAMILY RENTAL PROPERTY FINANCING

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A Look Inside...

Barry Wides, Deputy Comptroller, Community Affairs, OCC

As the Bipartisan Policy Center's Housing Commission recently observed, the next 10 years will most likely see a significant increase in the number of renters as the Echo Boom generation, the children of post-World War II baby boomers, form first-time households and the baby boom generation downsizes from its current homes. This pressure for additional rental units may soon push rents to unaffordable levels for those least able to afford them.

Small multifamily rental properties are one of the most important affordable housing resources that make up our nation's existing housing stock. According to the [U.S. Department of Housing and Urban Development](#), these small rental properties provide units for almost a third of the nation's renters—more than 20 million households. Buildings with five to 49 units are common in our nation's urban centers and rural areas. And the rents charged at these small properties are typically more affordable to low- and moderate-income families than those of larger properties.¹ According to Harvard University's [Joint Center for Housing Studies](#), unsubsidized rental units account for three-quarters of all low-cost rental units. In fact, a [study by John C. Weicher](#), Senior Fellow and Director of the Hudson Institute's Center for Housing and Financial Markets, indicates that most affordable rental properties have no government subsidies.²



Source: Thinkstock
This photograph shows a street front scene with three buildings: a four-story brick apartment building, a single-story brick building; and a six-story, multi-unit apartment building.

This edition of *Community Developments Investments* describes the small multifamily rental housing market, some of the challenges the market faces, and the ways that national banks and federal savings associations (collectively, banks) are active players in the market. This newsletter focuses on this topic because, as Elizabeth La Jeunesse from the Joint Center for Housing Studies points out, these small rental properties are less likely to obtain institutional financing because of the constriction of the secondary market and are more likely to be financed by community bank portfolio lenders. Further, Ms. La Jeunesse notes that loans to this market segment are more likely to be located in low-income communities.

According to the community bankers interviewed by the OCC's William Reeves and Letty Shapiro for this edition of *Community Developments Investments*, these small loan lenders are actively engaged in the small multifamily rental space. These lenders have learned to carefully underwrite these rentals, and they prefer to keep these loans in their portfolios under the current interest rate environment. Because these properties are often affordable to low-income households and in low- and moderate-income areas, these loans can often be qualified as affordable housing under Community Reinvestment Act guidelines if properly documented. Vonda Eanes, an OCC District Community Affairs Officer, [describes](#) how this can be accomplished.

In addition, this edition of *Community Developments Investments* provides a look at many of the risk management issues related to commercial real estate lending and small multifamily property lending. The OCC recently issued an updated version of its "[Commercial Real Estate Lending](#)" booklet of the *Comptroller's Handbook*, so the time is right to look at many of the risk management issues related to small multifamily property lending.

This edition of *Community Developments Investments* also highlights some of the [partnerships](#) that banks have formed with community development financial institutions and other community partners to

facilitate financing for these small properties and to reduce risks and costs by forming lending pools and consortiums. Finally, this newsletter looks at the rental financing programs of government-sponsored entities—namely, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—and where the secondary market might be heading. [Shekar Narasimhan](#), Managing Partner at Beekman Advisors and a well-known and highly respected practitioner in the affordable housing field, shares his thoughts with us in a Q&A.

For banks interested in learning more about financing smaller multifamily properties, this newsletter includes a [resource guide](#) with Web links to recent research on the topic and other helpful resources.

¹ American Housing Survey, 2010.

² Some articles in this newsletter refer to the universe of small multifamily properties as containing “five to 50 units” to describe the size of these buildings.

How Affordable Housing Qualifies for Community Reinvestment Act Consideration

Vonda Eanes, District Community Affairs Officer, OCC

Affordable housing is a core component of community development under the Community Reinvestment Act (CRA). National banks and federal savings associations (collectively, banks) may receive CRA consideration for loans, qualified investments, and community development services related to affordable housing (including multifamily housing) if the primary purpose is for community development.

Under the CRA, the OCC evaluates banks’ records of helping to meet credit needs in communities where the banks have deposit-taking facilities. This includes the number and dollar amount of bank loans used to purchase, develop, refinance, or improve multifamily residential properties. Unlike loans for other purposes, loans related to multifamily housing that primarily benefit low- or moderate-income individuals or families may be considered as retail loans under the Lending Test and as community development loans. For banks evaluated using large bank procedures, community development loans are considered under the Lending Test. For intermediate small banks, community development loans are considered under the Community Development Test.

Community development loans include loans that support affordable housing that primarily benefits low- or moderate-income persons. Community development loans also include those that help to revitalize or stabilize low- or moderate-income areas, designated disaster areas, or areas defined by the agencies as [underserved or distressed nonmetropolitan middle-income areas](#).³ A bank may receive consideration for a community development loan if the loan benefits the bank’s assessment area or the broader statewide or regional area that includes the bank’s assessment area.

[Interagency Questions and Answers on Community Reinvestment \(Q&A\)](#), dated March 11, 2010, provides guidance on how to determine whether a project is affordable housing for low- or moderate-income individuals.⁴ The Q&A notes the concept of “affordable housing” for low- or moderate-income individuals hinges on whether low- or moderate-income individuals benefit, or are likely to benefit, from the housing. Giving CRA consideration to a project that exclusively or predominately houses families that are not low- or moderate-income simply because the rents or housing prices are set according to a particular formula would be inappropriate.

Examiners review demographic and economic factors as well as market data to determine the likelihood that the housing primarily accommodates low- or moderate-income individuals. Such a review is useful for projects that do not yet have occupants and for which the income of potential occupants cannot be determined in advance—or for projects involving unverifiable income for occupants. For example,

examiners may look at median rents of an assessment area and a project; the median home value of the assessment area, low- or moderate-income geographies, or the project; the low- or moderate-income population in the area of the project; or the past performance record of the organization or organizations undertaking the project. Such a project could receive CRA consideration if its bona fide intent of community development is expressly stated, for example, in a prospectus, loan proposal, or community action plan.

Banks can partner with or invest in organizations that target low- and moderate-income populations. CRA guidance explicitly recognizes loans and investments in community development financial institutions (CDFI) as community development activities. For loans and investments in a CDFI to receive CRA consideration, the CDFI must primarily lend or facilitate lending to promote community development. Banks may receive CRA consideration based on the amount of an investment or a pro rata share of the loans made as a result of that investment. An institution may choose to receive partial consideration under both tests: a portion of the investment under the investment test, and a portion of its pro rata share of loans under the lending test.⁵

Technical assistance for CDFIs, including developing loan application and underwriting standards, lending employees, or serving on boards and committees of CDFIs, is eligible for CRA consideration. Other examples of community development services with CDFIs include developing secondary market vehicles or programs, assisting in marketing financial products, furnishing financial services training for staff, contributing accounting or bookkeeping services, and assisting in fund-raising. Loan referrals may receive CRA consideration if the bank reviews the borrower's eligibility for bank financing and it is bank policy to refer "second chance" loans to the CDFI.

Loans and investments supporting an organization that covers an area larger than the bank's assessment area(s) may also receive CRA consideration. The bank's assessment area(s) need not receive immediate or direct benefit, provided that the purpose, function, or mandate of the organization includes serving geographies or individuals within the bank's assessment area(s). Examiners may also consider activities in the broader statewide or regional area even if the activities do not serve the assessment area as long as the bank has been responsive to assessment area needs. In evaluating "responsiveness," examiners consider all activities that serve the assessment area as well as opportunities available to the bank in their assessment area.⁶

Bankers should consult with their supervisory office if they have questions about specific projects, loans, investments, or services and types of documentation needed to demonstrate the benefit to low- or moderate-income individuals.

For more information, [e-mail](#) Vonda Eanes.

³ See [12 CFR 25.12\(g\)](#) for national banks or [12 CFR 195.12\(g\)](#) for federal savings associations.

⁴ See [Q&A 12\(g\)\(1\)—1](#).

⁵ "[Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; Notice](#)," 75 Fed. Reg., 11659, Q&A section __.23(b)-1, March 11, 2010.

⁶ "[Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; Notice](#)," 78 Fed. Reg., 69678, Q&A section __.12(h)-6, November 20, 2013.

Small Multifamily Resource Guide

America's Rental Housing: [Evolving Markets and Needs](#), Joint Center for Housing Studies of Harvard University, December 9, 2013.

America's Rental Housing: [The Key to a Balanced National Policy](#), Joint Center for Housing Studies of Harvard University, April 30, 2008.

The [Center for Community Lending](#) conducts and sponsors research about community lending, promotes the revitalization of distressed and underserved neighborhoods, works to eliminate discrimination in lending, and promotes the equality of opportunity for access to credit.

“[Commercial Real Estate Lending](#),” *OCC Comptroller's Handbook*, August 2013, focuses on commercial real estate lending activities, including the analysis of project financing.

“[CRA: Community Development Loans, Investments, and Services](#),” *Community Developments Fact Sheet*, OCC.

Enhancing Access to Capital for Smaller Unsubsidized Multifamily Rental Properties, Joint Center for Housing Studies of Harvard University, [William Apgar and Shekar Narasimhan](#), March 2007, RR07-8.

[Fannie Mae](#) and [Freddie Mac](#) are government-sponsored enterprises whose public mission is to support liquidity and stability in the secondary market, where existing mortgage-related assets are bought and sold, and to increase the affordable housing supply.

[Fannie Mae's Role in the Small Multifamily Loan Market](#), Fannie Mae, first quarter 2011.

Federal [Home Loan Banks](#) are 12 U.S. government-sponsored banks that provide low-cost funding to American financial institutions (not individuals) for home mortgage loans and small business, rural, agricultural, and economic development lending. Membership in the Federal Home Loan Bank system is available to insured depository institutions and certain other financial institutions.

Housing America's Future: [New Directions](#) for National Policy, February 2013, Economic Policy Program, Housing Commission, Bipartisan Policy Center. This report provides a detailed blueprint for a reformed housing finance system that promotes the uninterrupted availability of affordable mortgage credit.

[HUD Reports Continued Increase in "Worst Case Needs" in 2011](#), U.S. Department of Housing and Urban Development, February 22, 2013.

The Institute for [Housing Studies](#) is a research center based at DePaul University, Chicago, Ill., that provides analysis and data to inform affordable housing policy and practice.

The [Joint Center](#) for Housing Studies of Harvard University is a collaborative unit affiliated with the Harvard Graduate School of Design and the Harvard Kennedy School. The center produces reports, working papers, research notes, and other research publications.

A Long Look at Affordable Rental Housing, [John C. Weicher](#), Hudson Institute, video: [Realtor University Speaker Series: Affordable Rental Housing in the U.S.: Where does it come from and what happens to it?](#)

In this video, Dr. Weicher, Director, Center for Housing & Financial Markets at the Hudson Institute, takes a 20-year look at affordable rental housing. His analysis spans 1985-2005, and he discusses how that housing availability has changed and why.

Meeting Multifamily Housing Finance Needs During and After the Credit Crisis: [A Policy Brief](#), Joint Center for Housing Studies of Harvard University, 2009.

Multifamily Rental [Resource Directory](#), OCC.

[Preserving Affordable Rental Housing: A Snapshot of Growing Need, Current Threats, and Innovative Solutions](#), U.S. Department of Housing and Urban Development, January 28, 2014.

[Public Welfare Investments](#), Resource Directory, OCC. National banks and federal savings associations may make direct or indirect investments designed primarily to promote public welfare through community development activities, affordable housing, small business development, and other community needs. This directory provides information concerning these investment authorities.

Small Multifamily Building Risk-Share Initiative: Request for Comment, [Notice](#) by the U.S. Department of Housing and Urban Development, November 4, 2013, Notice for Public Comment.

[Realities and Possibilities in Preserving Unsubsidized Affordable Rental Housing](#), Minnesota Preservation Plus Initiative and One Roof Global Consulting, April 2012.

U.S. Department of Agriculture, “[Section 538 Guaranteed Rural Rental Housing \(‘538’\) Loan Program](#).”

Addressing the Affordability Challenge: Rental Housing

Judy Kennedy, former member, Board of Directors, Center for Community Lending

The Center for Community Lending (CCL) conducts and sponsors research about community lending, promotes the revitalization of distressed and underserved neighborhoods, works to eliminate discrimination in lending, and promotes the equality of opportunity for access to credit.

Mission-driven, multifamily affordable rental housing lenders, serving areas as diverse as New York, Alabama, Massachusetts, California, and the Carolinas, have stepped up to help address the need for financing of small multifamily properties. In [figure 1](#), states highlighted in blue illustrate where mission-driven lenders have financed community economic development, including affordable housing, schools, and community centers. These lenders provide financing for multifamily apartment complexes across the nation. These buildings are often developed by independent “ma and pa” developers who live in the communities where they build.

Figure 1: States With Center for Community Lender Member Organizations Financing Multifamily Affordable Housing



Many of the mission-driven lenders are 501(c)(3) nonprofit groups, and others are for-profit organizations. All have financed the construction or substantial rehabilitation of thousands of homes, with 97 percent of the units affordable to low- and moderate-income renters. These lenders are at the forefront of financing affordable and sustainable housing for low- and moderate-income individuals.

Mission-driven lenders have successful track records of pooling private capital to finance the expansion of affordable rental housing. These lenders make loans, which are the building blocks of community development. They often combine multiple federal subsidy programs, such as Low Income Housing Tax Credits, Community Development Block Grants, and the HOME Investment Partnerships Program.

For more information, refer to CCL's [list](#) of mission-driven, nonprofit multifamily lenders, or contact Paul Haaland at (202) 293-9850.

Articles by non-OCC authors represent the authors' own views and not necessarily the views of the OCC.

Surprise! Most Affordable Rentals Are in Small Buildings

John G. "Jack" Markowski, President and CEO, Community Investment Corporation

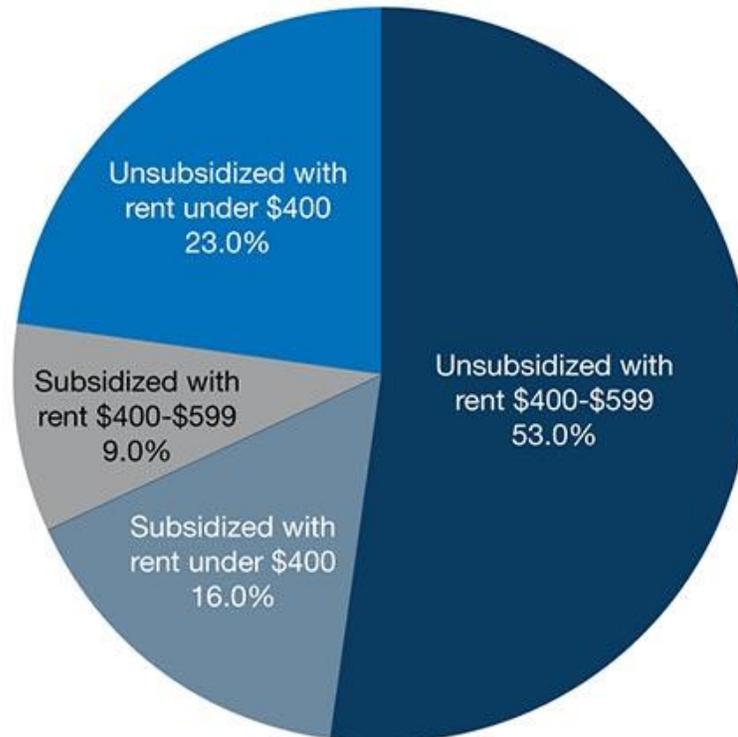
When most people hear the term "affordable housing," they may think of housing built or made affordable by various forms of government financial assistance. They may think of public housing, project-based section 8 developments, or housing built with financing provided by low-income housing tax credits, tax-exempt bonds, and HOME Investment Partnerships Program funds. To many, it comes as a surprise that 76 percent of the low-cost rental housing in the United States is privately owned and privately financed with no form of public assistance, not even section 8 rental vouchers, for its residents (see [figure 2](#)).



Source: Community Investment Corporation, Chicago. This property is an example of the small multifamily properties that Community Investment Corporation finances.

Figure 2: Unsubsidized Units Account for Three-Quarters of Low-Cost Rental Units

Share of units renting for under \$600 (2009)



Source: America's Rental Housing: Meeting Challenges, Building on Opportunities, Harvard Joint Center for Housing Studies (April 26, 2011).

Note: Subsidized renters include those who reported living in public housing or other government-subsidized housing, receiving a rent voucher, or being required to certify income to determine their rent. Rent does not include tenant-paid utilities.

Overall, about 90 percent of rental housing in the United States is privately owned and privately financed. Another surprise is that nearly 90 percent of rental housing is contained in buildings with fewer than 50 units. The irony of this last point is that the programs and entities created to provide financing for rental housing (i.e., Fannie Mae, Freddie Mac, and the Federal Housing Administration) are largely focused on developments with more than 50 units.

For the most part, buildings with fewer than four units are adequately addressed by the existing financial system—owner-occupied one- to four-unit properties can be underwritten as single-family properties, originated by local lenders, securitized, and sold into the secondary market.

But buildings with five to 49 units are left to fend for themselves. Neither fish nor fowl, they are not pooled with owner-occupied housing in mortgage-backed securities and do not have significant access to the secondary market. Instead, they have largely been financed by local lenders who underwrite each building as a unique business transaction and then hold the loan in portfolio. It is exactly this kind of portfolio lending that has declined most precipitously since the financial crisis in 2008, particularly in low- and moderate-income communities.

Why It’s Important

Buildings with five to 49 units account for more than one-third of the rental housing in the United States (see [table 1](#)). Generally privately owned and without government assistance, rent restrictions, or income restrictions, these buildings nevertheless provide a major portion of our affordable rental housing supply. Clean, secure, and well-maintained apartment buildings help set the tone for entire neighborhoods. These buildings protect property values, including those of single-family homes, and they contribute to a safe environment where families can sit outside and children can walk to school.

Table 1: Role of Small Multifamily Properties in Rental Market (Rental Units by Building Size, 2012)

Number of units	United States	Cook County, Ill.	Chicago
Single-family	33.5%	13.2%	9.4%
2 to 4	18.8%	33.2%	38.8%
5 to 49	31.5%	34.1%	29.4%
50 or more	11.5%	18.9%	22.1%
Other	4.7%	0.5%	0.3%

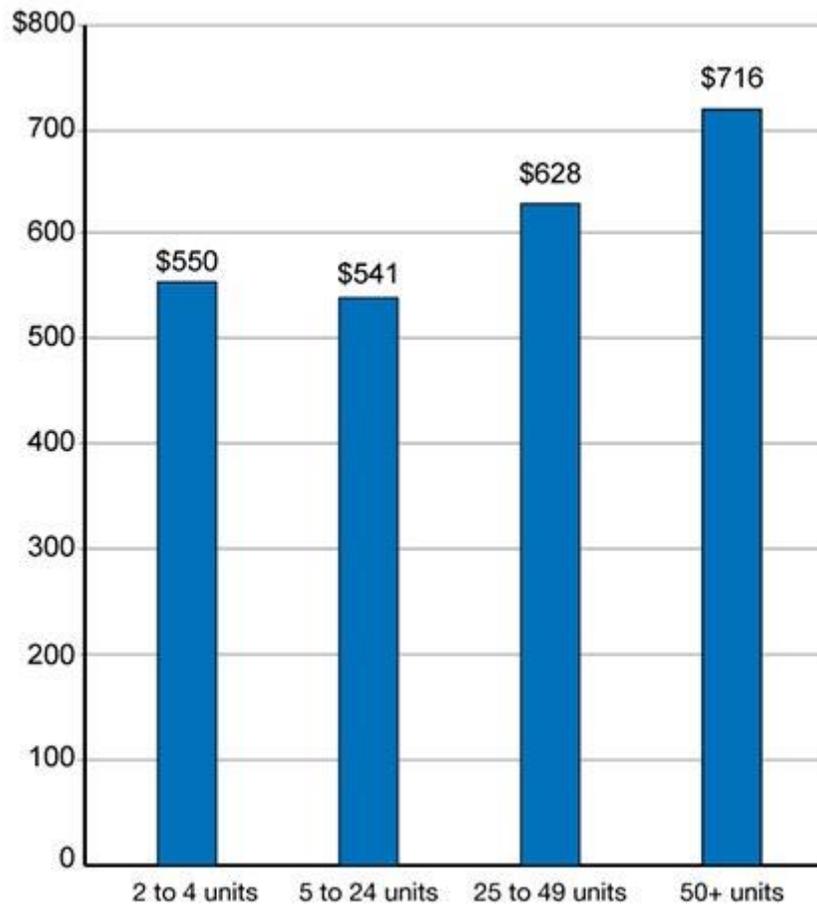
Source: 2012 American Community Survey, (5-Year Estimates) Tenure by Units in Structure, 2008–2012, Data Element B25032; Institute for Housing Studies at DePaul University.

The people who live in five- to 49-unit buildings are typical of the renter population in the Chicago area. Renters are usually younger and less affluent than the population at large. In Cook County, Ill. (the county in which Chicago is located), 68 percent of the people younger than 35 are renters. (Overall, 43 percent of the households are renters.) The median income for renter households in Cook County is \$33,000; for owner-occupied households, that figure is \$72,000. Renters fill a wide variety of positions in our workforce, including teachers, construction workers, health care professionals, drivers, and retail clerks.

Small rental housing is economical for renters and owners. Across the country, rents in small rental

housing tend to be lower than rents in larger buildings (see [figure 3](#)). In the Chicago area, the all-in costs for acquisition and rehabilitation of a small rental property are about \$40,000 to \$60,000 per unit in many communities compared with \$300,000 to \$400,000 per unit to create new rental housing with low-income housing tax credits.

Figure 3: Median Monthly Rents per Unit by Development Size



Source: *Rental Housing Finance Survey*, tables 2a, 2b, 2c, and 2d (August 5, 2014).

Small rental housing is generally owned by “mom and pop” entrepreneurs. According to the 2012 Rental Housing Finance Survey, 58 percent of five- to 49-unit properties are owned by individuals, households, or estates, compared with just 8 percent of larger properties. These small property owners may own five units or 1,000; they may be pursuing real estate ownership as a side venture or as a full-time career. Generally motivated by cash flow, the potential for property appreciation, and the opportunity to be their own boss, these “hands-on” entrepreneurs are classic small business owners. They provide a valuable service, they invest their own time and money, they typically hire and buy materials and supplies locally, and they are committed to their community. In many neighborhoods, the owners of apartment buildings are among the strongest and most stable local businesses.

Challenges of Financing

It is relatively easy to bundle and sell loans for owner-occupied one- to four-unit housing to the secondary market because there are only a few variables to consider in the underwriting: appraised value of a property; borrower’s income, assets, and credit score; and debt-to-income ratio.

Underwriting multifamily rental transactions, however, is much more complex, and every building is unique. While it is important to evaluate a borrower’s financial strength and creditworthiness, it is even more important to fully understand and evaluate the business transaction being proposed, including the following:

- “As-is” value of the building from both a market sales perspective and from a cash flow perspective.
- “After rehab” value of the building (from both perspectives as previously noted).
- Scope of work and the cost of construction to meet building code requirements and provide good living conditions.
- Ability of a proposed contractor to complete construction on time, within budget, and with good quality.
- Market rents in a neighborhood and likely vacancy rates.
- Projected operating costs (including repairs, maintenance, management, taxes, insurance, utilities, security, etc.).
- Track record and experience of the owner and manager, their familiarity with the type of building and the neighborhood, their ability to manage all aspects of construction and operations, and their ability to meet income and expense projections.

These underwriting considerations are essentially the same for a six-unit building or a 600-unit development. The analysis is somewhat subjective and requires specific knowledge of the neighborhood, the building, and the people involved (and their capabilities). Because every transaction is unique, loans for small multifamily buildings cannot be easily bundled and sold to the [secondary market](#). Instead, each loan stands on its own merit and pro forma.

The typical pro forma components for a 20-unit rental apartment building in Chicago are shown in tables 2, 3, 4, and 5. [Table 2](#) shows the sources and uses of funds. [Table 3](#) lists the value before and after rehabilitation. [Table 4](#) shows typical rents for various-sized apartments. [Table 5](#) shows the loan profile and cash flow of such an investment.

Table 2: Sources and Uses of Funds for a 20-Unit Apartment Building

<i>Sources</i>	<i>Financing</i>		<i>Uses</i>	<i>Cost</i>
Loan	\$800,000		Purchase	\$500,000
Owner equity	\$200,000		Rehab	\$425,000
			Fees, escrow, other	\$75,000
Total	\$1,000,000		Total	\$1,000,000

Source: Community Investment Corporation.

Table 3: Appraised Value

As is	\$500,000
After rehabilitation	\$1,000,000

Source: Community Investment Corporation.

Table 4: Affordable Rents in Chicago and Cook County

<i>Size</i>	<i>Units</i>	<i>Rent*</i>	<i>Monthly total</i>
Studio	3	\$550	\$1,650
1 bedroom	7	\$650	\$4,550
2 bedrooms	7	\$750	\$5,250
3 bedrooms	3	\$850	\$2,550
Total	20		\$14,000

Source: Community Investment Corporation.

*Rents affordable in Chicago/Cook County.

Table 5: Loan Profile and Property Cash Flow

Loan characteristics			Annual cash flow	Value
Amount	\$800,000		Gross income	\$168,000
Interest rate	5%		Vacancy (10%)	(16,800)
Term	20 Years		Effective gross income	\$151,200
Amortization	25 Years			
			Expenses** (\$4,050/unit/year)	(81,000)
Loan to value	80%		Net income	\$70,200
Loan to cost	80%			
			Annual debt service on loan	\$56,121
Monthly payment	\$4,677		Cash flow	\$14,079
Annual payment	\$56,121		Debt coverage ratio	1.25

Source: Community Investment Corporation.

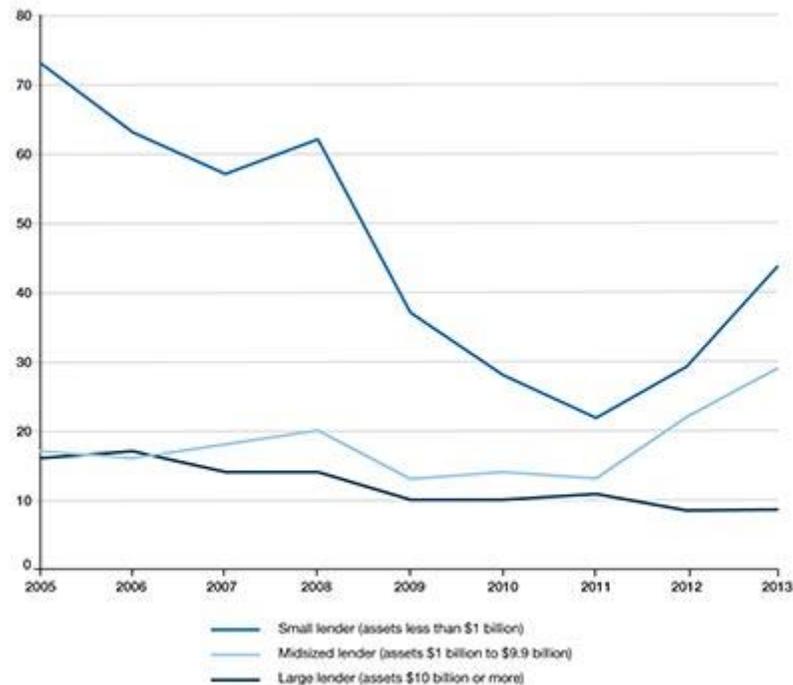
**Expenses include repairs, maintenance, taxes, insurance, utilities, management, miscellaneous, and reserves.

Over time, loan originators have typically found that it is generally too costly and too time consuming to underwrite multifamily loans less than \$3 million (typically about 100 units in a low- or moderate-income neighborhood in Chicago) for individual presentation to the secondary market. As a result, local banks—with an immediate knowledge of the properties, neighborhoods, and individuals involved—have typically been the primary source of financing for small rental housing, and these banks have held the loans for the long term in their portfolios.

In general, the pre-2008 housing bubble was caused by ill-advised single-family lending, not by lending for multifamily properties. But when the crash occurred, the repercussions spread throughout communities. Many lenders were caught with outstanding loans on multifamily properties that had suffered great devaluation. They had to re-value their portfolios and pull back on their lending operations. Many banks were forced to close because of losses in this sector. Cook County had more than 40 percent

fewer active small lenders in 2013 than in 2005 (see [figure 4](#) illustrates the shift in the number of small lenders).

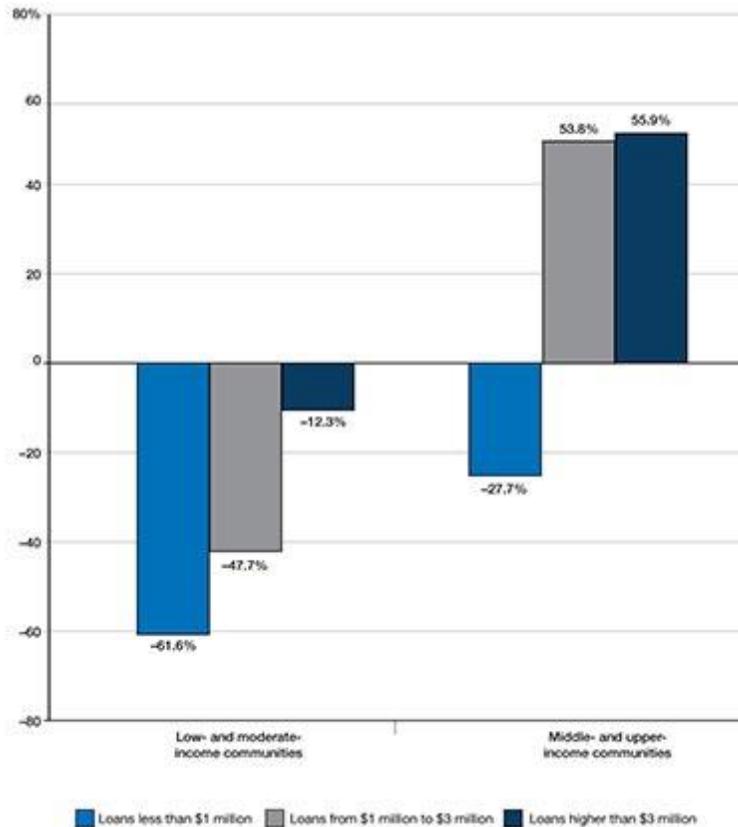
Figure 4: Change in Number of Active Multifamily Lenders in Cook County, 2005–2013



Source: Institute for Housing Studies at DePaul University analysis of Home Mortgage Disclosure Act (HMDA) Loan Application Register Data, 2005–2013.

As the real estate market has begun to recover, some return to normalcy in lending for small multifamily buildings has occurred. In Chicago, some banks are making short-term loans to strong borrowers in strong neighborhoods. But in the low- and moderate-income communities of the city, multifamily lending has continued to lag. According to DePaul University’s Institute for Housing Studies, lending for small multifamily buildings (loans under \$3 million) in these low- and moderate-income communities has dropped from its peak by up to 61 percent (see [figure 5](#)) at the same time that lending to middle- and upper-income communities has increased by more than 55 percent for loans greater than \$3 million.

Figure 5: Change in Cook County Multifamily Loan Dollars by Loan Size and Neighborhood Income Level, 2005-2013



Source: Institute for Housing Studies at DePaul University analysis of Home Mortgage Disclosure Act (HMDA) Loan Application Register Data, 2005–2013

Is it because lenders, chastened by the recent experience of the real estate crash, no longer want to hold long-term real estate debt, especially in low- and moderate-income communities? Is it because lenders still perceive great risk in these communities? Is it because recent legislative and regulatory requirements regarding capitalization and reserves that were intended to strengthen our financial system have inadvertently discouraged lending for small multifamily properties? Is it because these markets are still very depressed with very little borrower demand?

The truth lies somewhere in the midst of these questions. It is clear, however, that without an adequate supply of credit, it is impossible to rehabilitate and preserve multifamily housing and reinvigorate communities across the country.

Financing Solutions

To fully address the credit needs of small rental housing and to begin to approach the level of credit available before the real estate crash, progress needs to occur on many fronts. Here are some of the ideas that are being discussed or implemented in housing circles across the country.

- **Lending consortiums:** An idea that [dates to the 1970s](#), a [lending consortium](#) is a way for banks

to pool their risks and resources to address areas of need that the banks recognize but do not want to address alone. In Chicago, Community Investment Corporation (CIC) was formed by local financial institutions in 1974 and is now capitalized by more than \$400 million in commitments from 40 [banks](#). CIC's unique niche is privately owned rental housing. CIC is able to offer more resources and expertise than a small bank and more personal attention than a big bank. As the Chicago area's leading multifamily rehabilitation lender, CIC has provided more than \$1.2 billion in financing for buildings containing more than 55,000 rental units since 1984. CIC has provided its investor banks with a reasonable rate of return and has suffered very few losses in its portfolio. (Community Investment Corporation of the Carolinas has more recently formed a bank loan pool that you can read about in this [newsletter of Community Developments Investments](#).)

- **Community development financial institutions (CDFI):** U.S. Department of the Treasury certified community development financial institutions (CDFI) are organizations dedicated to financing community development. Many local banks and lending consortiums are CDFIs. Investments in CDFIs by the Treasury Department's Community Development Financial Institutions Fund and other sources of "social capital" help CDFIs attract private capital to meet local financing needs.
- **Risk sharing:** The U.S. Department of Housing and Urban Development has proposed an expansion of its section 542(b) Risk-Sharing Program to work with experienced affordable housing lenders to make risk-share loans to refinance, rehabilitate, and recapitalize small rental properties (properties with five to 49 units). The idea is that the agency would underwrite the affordable housing lender and its lending policies and procedures rather than individual buildings, then take 50 percent of the risk on the lender's loans, thereby facilitating and expanding access to capital. See [sidebar](#) on the proposed program.
- **Community Reinvestment Act:** Since the financial crisis, most regulatory attention has been directed at ensuring the safety and soundness of banks. With the firming of the recovery, however, many believe that the time is right for a renewed emphasis on the Community Reinvestment Act. Banks should be encouraged to participate in lending consortiums and invest in CDFIs to meet the credit needs of low- and moderate-income communities. Most importantly, banks should be encouraged and given the latitude to make loans for small rental housing and hold the loans in their portfolios for the long term.

Ideally, there is a combination of responses that together ensure readily available credit for small rental housing to preserve affordable housing and revitalize communities across the country.

For more information, [e-mail](#) Jack Markowski.

Bank Consortium Financing

Jack Markowski, President and Chief Executive Officer, Community Investment Corporation

Through Community Investment Corporation (CIC), a CDFI Fund certified community development financial institution, banks in Chicago have formed a consortium to provide financing for otherwise difficult-to-serve needs. Since 1984, [CIC](#) has specialized in financing the acquisition and rehabilitation of multifamily rental housing in low- and moderate-income communities throughout the Chicago area. With more than \$417 million in commitments from 40 banks, CIC has developed resources and expertise to fully serve the multifamily marketplace, but it has also retained a



Source: Community Investment Corporation. The Community Investment Corporation finances small rental properties like this one through its bank consortium.

close, personal relationship with its borrowers. Since 1984, CIC has provided more than \$1.2 billion to finance more than 55,000 units of affordable rental housing.

Banks participate in the CIC consortium by purchasing Limited Recourse Collateral Trust Notes that are issued by CIC and secured by individual mortgages on properties. To facilitate loan servicing and collections, CIC retains ownership of the loans and mortgages with individual borrowers.

A multiyear Note Purchase Agreement, signed by CIC and all of the bank investors, governs operations of the CIC loan facility. All loans are approved by a loan committee, the members of which must represent at least 51 percent of overall investor commitments.

The loan committee sets the interest rate and terms for the loans. A loan becomes eligible for sale to investors when construction is complete and rent-up has achieved a 1.1 debt service coverage ratio. Approximately once every three months, CIC pools eligible loans and conducts a note sale, in which each investor purchases a portion of the notes equal to its overall share of outstanding investor commitments. (Investor commitments currently range from \$1 million to \$72 million.)

Loan servicing is performed by CIC for a fee of 0.375 percent. Each month, CIC remits to investors their proportional share of loan repayments less the charge for loan servicing and a payment into the Investor Loan Loss Reserve (currently set at 1 percent). CIC reports to investors on a regular basis regarding delinquencies and the overall condition of the loan portfolio. Any loan loss is covered first by the Investor Loan Loss Reserve. To the extent that a loss exceeds the balance in the Investor Loan Loss Reserve, the loss would be borne proportionately by the investors on the specific loan. Since 2001, however, CIC has not passed on any losses to participating investors.

Currently, CIC is servicing a portfolio of \$230 million in loans with notes sold to investors. In fiscal year 2014, the portfolio generated a net return of 2.6 percent (2.0 percent above the rolling three-year average for three-year U.S. Treasury securities). Investing in a consortium like CIC is a very effective way for banks to pool resources and prudently meet the financing needs of affordable housing and low- and moderate-income communities.

For more information, [e-mail Tom Hinterberger](#).

Community Preservation Corporation: Growing New York Neighborhoods

By Sadie McKeown, Chief Operating Officer and Executive Vice President, Community Preservation Corporation

In 1974, David Rockefeller and the NYC Clearing House Banks founded the Community Preservation Corporation (CPC) to be an active multifamily housing lender in New York City neighborhoods on the verge of abandonment. Over our 40-year history, our lending has generated over \$8.4 billion in public and private investment in 157,000 units in New York state.

Today, the CPC is a leading not-for-profit affordable housing and neighborhood revitalization lender. In 2014, the CPC closed on a \$400 million construction lending



Source: Ronald L. Glassman for the Community Preservation Corporation. This 28-unit rental apartment building in Greenburgh, N.Y., received financing from the Community Preservation Corporation as well as private capital and public subsidies.

facility from a group of financial institutions led by Citi. This capital will be used for the acquisition, construction, rehabilitation, and preservation of affordable multifamily properties across New York City and state.

The CPC's financing differs from standard bank financing because we look for difficult-to-finance properties, such as small properties and properties that may need a variety of complex financing sources.

Based on its success financing small and large properties across the city, the CPC expanded to cover all of New York state starting in 1988. Since that time, the CPC has provided a consistent source of capital to finance multifamily properties in the state's underserved housing markets. The CPC's investment in neighborhoods including Washington Heights, Harlem, and Crown Heights in New York City, and in the cities of Syracuse, New Rochelle, and Buffalo, has driven significant revitalization.

An essential part of the CPC's mission is helping local developers build and preserve smaller multifamily properties. The CPC specializes in providing loans to owners of buildings with fewer than 50 units, the small buildings where most New Yorkers live. In New York state, 53 percent of the multifamily housing stock is in buildings with five to 49 units. The CPC's success in this market is driven largely by access to the State of New York Mortgage Agency (SONYMA) insured 30-year fixed-rate permanent mortgage product, which is unique in the housing finance market for small properties. This fixed-rate product provides stability for owners and is critical for subsidized properties, where rent increases are restricted.

The CPC's longstanding partnership with SONYMA has enabled a secondary market for its 30-year mortgages. The New York City Employee Retirement System and the New York State Common Retirement Fund have purchased over \$1.5 billion in 1,350 SONYMA-insured loans. This investment financed over 43,000 units of housing. These pension funds offer a 24-month forward interest rate commitment so that the CPC can provide short-term construction financing for properties in need of construction or repair with the certainty of a take-out upon completion and lease-up.

Unlike other conventional lenders, which focus on all housing markets, the CPC's approach is to identify the capital needs of the multifamily stock in distressed communities. Cities and towns across the state have government-sponsored community development offices, which share this common goal. The CPC uses its private capital, in conjunction with public subsidies available through these offices, to address particular goals of cities and towns for affordable housing and community redevelopment. The CPC's collaborative approach is consistent in every market it serves.

During the 1990s, the CPC created a for-profit arm to do development and place equity in neighborhoods to complement its lending business. CPC Resources (CPCR) developed owned-occupied housing in emerging markets, took on large-scale deals that were difficult to develop, and worked to create mixed income communities. When the housing market collapsed, some of these projects were especially risky and difficult to sustain in the ensuing market conditions. As a result, CPCR had to slow down its business while the CPC has refocused on its core lending for rental properties.

The CPC's lending in Beacon, N.Y., is an example of the organization's success with small multifamily lending. Over an eight-year period starting in 1990, the CPC financed 20 small multifamily properties in the east end of the city totaling just over 80 residential units and 25 stores. The private investment of just under \$5 million leveraged \$2.3 million in subsidies and transformed the area into a thriving retail district. The average CPC loan was only \$250,000. Conventional lenders don't typically finance small properties at this scale, but such a targeted investment has significant impact in communities and draws

in other investment afterwards.

In addition to providing private financing, the CPC serves as a “one-stop shop” that offers its project owners extensive technical assistance when needed to help them understand tax benefits, rent subsidies, and other public incentives. The CPC works with its customers to coordinate financing with government and other low-interest subsidy providers, as well as review the scope of work on rehabilitation projects and cost estimates. Bank members continue to support the CPC’s work with financial resources, and new partnerships with banks are always welcome.

As the CPC looks toward its future, the approach remains the same. The organization continues to be an important presence in the state and a crucial partner in the effort to build and stabilize healthy neighborhoods.

For more information, [e-mail](#) Sadie McKeown.

A Bank Loan Consortium: Putting Private-Sector Equity to Work

David Bennett, Executive Vice President, Community Investment Corporation of the Carolinas

Nearly 25 years ago, the North Carolina Bankers Association (NCBA) determined that it could play a role in addressing the critical shortage of affordable housing across North Carolina. It was 1990, just a few years after the comprehensive tax reform efforts that created the Low Income Housing Tax Credit (LIHTC) Program. This legislation created a new method of attracting private-sector equity into the affordable housing development process. As a new housing industry began to take shape, NCBA hoped to leverage the financial capacity of its member financial institutions to provide a complementary source of loan capital for affordable multifamily housing developers.



Source: Community Investment Corporation of the Carolinas.

This 60-unit residential property for seniors in Goldsboro, N.C., was financed by the Community Investment Corporation of the Carolinas.

The result was a new lending consortium, which has evolved over the years from a single-state lender to the multi-state entity now known as Community Investment Corporation of the Carolinas (CICCAR). Since its inception, CICCAR has operated as a mutually beneficial partnership of banks, with impressive results—\$260 million in loans financing more than 300 properties to date, providing quality housing opportunities for 16,000 households across the Southeast.

Financing Partnerships

CICCAR loans provide first-lien, permanent financing for multifamily communities with rents that are affordable to residents with incomes at or below 60 percent of area median income. Funding capital for CICCAR’s loans comes from its members, with membership open to any financial institution operating within the six-state operating footprint. With over 100 members, CICCAR is one of the largest affordable housing loan consortiums of its kind in the nation. The membership base is very diverse, ranging from some of the largest national and regional banks down to the smallest community savings institutions.

Members provide funding for each CICCAR loan on a voluntary, loan-by-loan basis. CICCAR staff members take applications from affordable housing developers, perform the initial underwriting, and submit requests to the consortium board for approval. Once a loan application has been approved by the board, all CICCAR members are provided an opportunity to review the request and decide if a particular loan is right for them.

Participation is never mandatory; members can select the loans and participation levels that best support their own particular lending goals. Because CICCAR loans meet the definition of community development under the Community Reinvestment Act (CRA), some institutions are motivated to lend primarily by a desire to meet CRA goals in the markets they serve. Other institutions choose to participate in CICCAR loans because they offer a relatively low-risk source of loan growth—with CRA eligibility providing a secondary benefit to the bank.

Following origination, CICCAR provides ongoing loan servicing, financial analysis, and asset management services that further ensure the successful operation of each property securing the loan portfolio. In addition to collecting and disbursing monthly payments to the participating banks, this means that CICCAR staff members perform a quarterly analysis of rent rolls and internal financial statements, an annual review of audited financial statements, and annual site inspections at all properties.

Benefits of Consortium Membership

The consortium model enables member financial institutions of all sizes to participate in community development lending efforts in a direct and meaningful way. Although loans financing LIHTC properties have a strong performance track record and an extremely low default history nationwide, the longer terms and other non-traditional loan characteristics that accompany these deals present a degree of credit risk that many banks are unwilling to take by themselves. By spreading that risk among a broad pool of banks, this critical source of affordable housing finance is sustained while limiting the risk exposure to each participating bank.

For more information, [e-mail](#) David Bennett.

Massachusetts Housing Investment Corporation: Filling the Financing Gap

Joe Flatley, President and CEO, Massachusetts Housing Investment Corporation

Massachusetts Housing Investment Corporation (MHIC) was founded by a consortium of banks in 1990 as a private nonprofit organization. MHIC began filling a critical gap in meeting the credit needs of affordable housing developers at a time when the real estate market was in turmoil.

Initially, MHIC focused on attracting investor capital for low-income housing tax credit properties and a loan pool for construction and acquisition lending. Its product lines expanded in 2000 to include the New Markets Tax Credit (NMTTC) program, and again in 2008 with the



Source: Massachusetts Housing Investment Corporation.

Canal Bluffs is in Bourne, Mass., a town known as the “gateway to Cape Cod.” It is the second of a three-phase development and consists of 45 units of affordable rental housing in a three-story building. The project was financed with a \$3.75 million construction loan from Massachusetts Housing Investment Corporation.

Massachusetts Neighborhood Stabilization Loan Fund to address the mortgage foreclosure crisis.

Supported by an experienced and dedicated staff, MHIC has taken on difficult and complex projects with rigorous underwriting, attentive asset management, and timely reporting to provide investors with high asset quality and competitive returns. As of December 31, 2013, MHIC had raised more than \$2.08 billion from over 37 institutional investors to finance the development of affordable housing and community development throughout New England.

Examples of these developments include [Canal Bluffs](#), [Saunders School](#), and [Torrey Woods](#).

Under its lending program, MHIC provides construction financing, acquisition loans and pre-development loans, and bridge loans for historic tax credits to sponsors of low-income housing tax credit and NMTC properties. MHIC also offers lines of credit on a selective basis to customers with whom it has long-standing relationships. MHIC works with both for-profit and nonprofit developers and community-based organizations to finance property acquisition and new construction or rehabilitation of multifamily rental, homeownership, or mixed-use projects. MHIC has no minimum or maximum size of loans. Over the past few years, MHIC's loans have ranged in size from \$219,000 to \$13.3 million.

Over the past 23 years, MHIC has lent over \$592.5 million for multifamily projects, and the default rate has been under 1 percent. MHIC receives the financing it needs to operate its multifamily lending programs through the support of investors who commit long-term equity capital. This capital is then leveraged with lines of credit to increase lending capacity. Current lending capacity exceeds \$60 million. MHIC typically lends only in situations where an investor member has not expressed an interest in providing a direct loan.

For more information, [e-mail Joe Flatley](#), or visit [MHIC's Web site](#).

Articles by non-OCC authors represent the authors' own views and not necessarily the views of the OCC.



Source: Massachusetts Housing Investment Corporation.

The Torrey Woods project in Weymouth, Mass., includes 20 new units of affordable rental housing for families. The project, a three-story building on 5.78 acres of wooded land at the Weymouth/Abington border, was built with a \$1 million construction loan from Massachusetts Housing Investment Corporation. This was a joint venture between South Suburban Affordable Housing and Preservation of Affordable Housing.



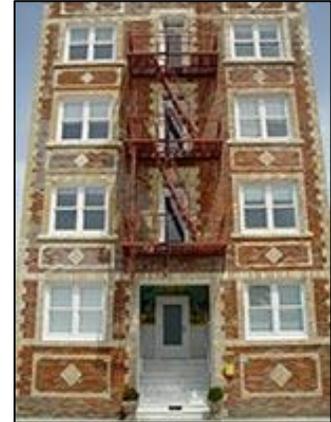
Source: MHIC.

The Saunders School project in Lawrence, Mass., for which Massachusetts Housing Investment Corporation provided a \$2.1 million construction loan, involved the adaptive reuse of a vacant three-story historic school building to create 16 two-bedroom units of affordable rental housing. The development includes on-site and collaborative services to help families integrate into the community and achieve self-sufficiency.

Small Multifamily Property Ownership, Management, and Financing Issues

Elizabeth La Jeunesse, Research Analyst, Joint Center for Housing Studies of Harvard University

The housing finance system in the United States has long defined multifamily housing as properties with five or more residences under single ownership. Financing for multifamily properties is handled by separate divisions of Fannie Mae, Freddie Mac, and the Federal Housing Administration. For this reason, national banks and federal savings associations also tend to organize their operations and segregate their accounting into loans on single family (with single ownership of fewer than five residential units) and multifamily properties.¹

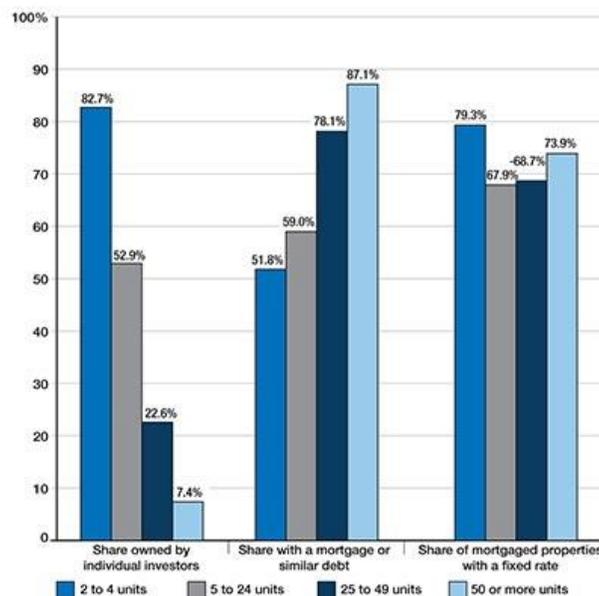


Source: Thinkstock.
This photo shows a four-story, brick apartment building.

For many years, policy makers and industry analysts have observed that small multifamily properties, defined either by loan size or number of units, are less likely than larger properties to (1) carry debt, (2) carry longer-term fixed rate debt when they do carry debt, (3) be professionally managed, and (4) be sold into the secondary market. Smaller properties are also more likely to be owned by individuals.

Unfortunately, 2001 was the last year a dependable survey of ownership, management, and financing of multifamily properties was done. Thus, there is currently no way to know how much the character of ownership and financing may have changed. In addition, no formal, commonly accepted definition exists for what constitutes the dividing line between larger and smaller multifamily properties. Most commonly, analysts consider properties with five to 49 units “small” and 50 or more “large,” though there is no such sharp dividing line in the average characteristics of multifamily properties tabulated by size. That said, differences seem to widen as the number of units in a property increases. [Figure 6](#) illustrates two areas of difference, single-investor owners and share of properties with a mortgage or similar debt.

Figure 6: Multifamily Property Ownership and Lending Characteristics by Property Size



Source: 2012 Rental Housing Finance Survey, U.S. Department of Housing and Urban Development; Joint Center for Housing Studies of Harvard University.
Note: Fixed-rate mortgage information pertains to current first mortgage only and includes about 4 percent nonresponses.

Fortunately, we do have more up-to-date information on small multifamily properties from two sources that measure financing by loan size: the Home Mortgage Disclosure Act (HMDA) and the Mortgage Bankers Association (MBA), which draws on HMDA data and data for firms that service loans for larger originators. Neither data set, however, gives complete coverage of financing for multifamily properties, and neither provides information on the number of residences per property. Relying on loan size alone clouds conclusions about small multifamily properties somewhat because loan size is an imperfect proxy for units per property. Fannie Mae considers any loan up to \$3 million to be a loan for a small multifamily property. But loans under this threshold skew strongly toward \$1 million or less, and it is among these even smaller loans in particular that levels of secondary market securitization are extremely low.

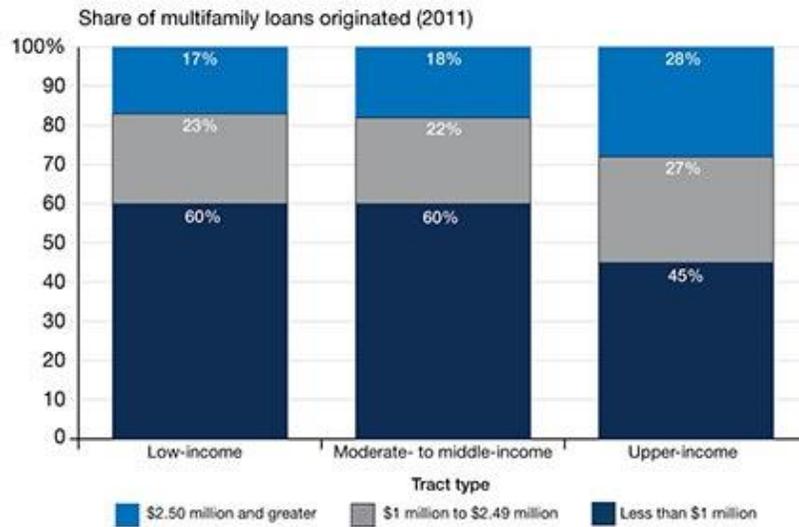
Despite these data limitations, loan size data provide recent information on loan volumes and the channels through which the financing to small multifamily properties is being delivered. And HMDA data provide meaningful geographic detail on the loans of reporting entities. These data reveal that the smaller the loan size, the greater the drop-off of lending between 2006 and 2011, the sharper the withdrawal of secondary market funding, and the sharper the contraction of purchases by Fannie Mae and Freddie Mac (see [table 6](#)). Thus, the small multifamily loan market has been left increasingly to portfolio lenders and remains at levels that are significantly below 2006 volumes. In addition, smaller loans are a larger proportion of multifamily lending in low-income communities than other communities (see [figure 7](#)). While the incomes of the tenants are not reported by HMDA, Fannie Mae has stated that 86 percent of the unit rents in small-sized multifamily building loans it finances are affordable to people at or below the median income in their areas.

Table 6: The Smaller the Loan, the Greater the Falloff in Activity From Boom to Bust

Loan size	All loans			Sold to secondary market in calendar year			If secondary market, sold to GSE		
	2006	2011	% change	2006	2011	% change	2006	2011	% change
Less than \$500,000	17,662	9,374	-46.9%	3,482	291	-91.6%	515	58	-88.7%
\$500,000–\$999,000	9,486	5,880	-38.0%	1,797	151	-91.6%	250	64	-74.4%
\$1 million–\$2.49 million	7,251	6,069	-16.3%	1,510	392	-74.0%	460	279	-39.3%
\$2.5 million–\$24.9 million	5,181	4,979	-3.9%	1,734	1,335	-23.0%	869	1,197	37.7%
More than \$25 million	289	342	18.3%	126	177	40.5%	69	167	142.0%
All	39,869	26,644	-33.2%	8,649	2,346	-72.9%	2,163	1,765	-18.4%

Source: Joint Center for Housing Studies of Harvard University.

Figure 7: Smaller Loans Are a Smaller Share of Multifamily Lending in Upper Income Census Tracts



Source: Joint Center for Housing Studies of Harvard University.

The broader MBA data, which include reporting from larger specialized multifamily lenders, show that while just 10 lenders dominate total multifamily loan volume (with a 45 percent share), smaller lenders dominate as a share of loans originated (see [table 7](#)). Indeed, the roughly 2,600 lenders that individually supply \$500 million or less in multifamily finance account for just more than half of all originations (based on number of loans). Although these figures cannot be broken down by loan size, it is almost certain that smaller multifamily lenders dominate the small multifamily loan market even more. The small multifamily loan market is highly fragmented.

Table 7: Large Firms Dominate the Multifamily Lending Landscape

Size of lender, by multifamily lending volume	Lenders		Multifamily originations		Multifamily loans		Average multifamily loan size (in millions of dollars)
	Number	Share	Amount	Share	Number	Share	
More than \$2.5 billion	10	0.4%	\$49.9 billion	45.3%	8,503	27.3%	\$5.9 million
\$1.0 billion–\$2.5 billion	12	0.5%	\$21.4 billion	19.4%	2,123	6.8%	\$10.1 million
\$500 million–\$1.0 billion	19	0.7%	\$13.3 billion	12.1%	3,409	10.9%	\$3.9 million
\$1 million–\$500 million	51	1.9%	\$12.5 billion	11.4%	3,663	11.8%	\$3.9 million
Less than \$1 million	2,561	96.5%	\$13.0 billion	11.8%	13,446	43.2%	\$1.0 million
All	2,653	100.0%	\$110.1 billion	100.0%	31,144	100%	\$3.5 million

Source: Mortgage Bankers Association Annual Report on Multifamily Lending, 2011; Joint Center for Housing Studies of Harvard University.

While the reasons for the differences in ownership, management, and financing of smaller multifamily properties relative to larger ones remain uncertain, most analysts ascribe the differences to the following:

- The high fixed costs of originating multifamily loans and packaging the loans into publicly traded securities reduce securitization of smaller property loans (costs cannot be spread over as large a mortgage).
- The relative ease of entry for individual owners because the required equity investment is so much lower.
- The tendency for individuals to rely more frequently on their own sweat equity to manage properties.

Although there is a lower level of securitization in the financing of small versus large multifamily properties, a significant share of such loans are held in portfolio by banks. Because depository institutions' loan portfolios are funded by short-term liabilities, bank lenders have reasons to favor serving this market with shorter-term adjustable rate loan products. Still, it is unclear whether the dominance of adjustable rate products in the smaller loan market reflects these supply-side concerns or whether small multifamily property owners choose adjustable rate loans because they may be disinterested in taking on the steep yield maintenance requirements (prepayment premiums) that typically accompany fixed-rate multifamily loan products. The fact that even in low-rate environments, however, fixed-rate small multifamily loan products are not that common suggests more a supply than demand side explanation. (See [sidebar](#), "Challenge of Capital Access," by Rebecca Cohen and Dennis Shea.)

In terms of loan performance, the only detailed information by loan size comes from Fannie Mae and Freddie Mac. Among their loans, performance deteriorates as the size of the loan declines. As of June 30, 2013, Fannie Mae reported a 0.7 percent serious delinquency rate for its smaller multifamily loans of less than or equal to \$750,000. This was twice the rate of delinquency of its larger loans of \$5 to \$25 million and over five times that of its largest loans over \$25 million. Freddie Mac's smaller multifamily loans had a lower delinquency rate of 0.38 percent, but this too was over four times the delinquency rate experienced on its \$5 million to \$25 million loans, and over seven times the delinquency rate on its loans larger than \$25 million.

Fannie Mae observed that small multifamily loans are more likely than larger multifamily loans to rely upon the borrower's own financial strength and repayment history. In addition, Fannie Mae looked to the strength of the property cash flow. Cash flow in small properties is critical because the margin for error is very tight. Even one vacancy for more than 30 days could affect a borrower's ability to repay the mortgage without tapping into personal self-worth. A recent examination by Fannie Mae of its loan portfolio found that 6 percent of all small multifamily loan delinquencies were directly related to borrower credit issues. It is possible that the loans that banks opt to hold in their own portfolios have very different performance characteristics. But there is no broad database that offers insight into any possible differences.

What emerges from this brief summary of what we know, do not know, and can only speculate about small multifamily properties is that available data permit only a partial picture to emerge when it comes to channels serving the market, products offered and used, and loan performance. And when it comes to information on ownership and management, only a dated picture emerges.

What does seem clear from the figures and tables in this article is that the anecdotal conclusions about small multifamily properties ring true. Most dramatically, the data reveal just how small a share of loans of up to \$1 million and even of loans \$1 million to \$3 million are sold into the secondary market. Furthermore, the data show the degree to which all smaller loan originations fell in the wake of the financial crisis, but especially how dramatically secondary market purchases of these loans collapsed.

Lastly, it reveals the importance of small multifamily properties in low-income communities as a source of rental housing for lower income Americans.

For more information, [e-mail Elizabeth La Jeunesse](#).

¹The OCC also follows this organization for periodic call reporting and Home Mortgage Disclosure Act reporting purposes.

²See [Fannie Mae's Role in the Small Multifamily Loan Market](#) (first quarter of 2011).

Challenge of Capital Access

Rebecca Cohen, Senior Policy Analyst, Bipartisan Policy Center, and Dennis Shea, Principal, Shea Public Strategies and adviser to the Bipartisan Policy Center Housing Commission

One of the most perplexing issues in housing finance is how to improve capital support for small multifamily properties (those with fewer than 50 units). Contrary to popular understanding, most rental housing is not situated in large apartment complexes, nor is it in urban areas.³ In addition, private individuals, not large multifamily developers, are the owners of most rental homes in America today. According to the 2001 Residential Finance Survey, more than 80 percent of rental units in properties with one to four units are individually owned, while more than 70 percent of units in properties with five to nine units have individual owners.⁴

A significant share of this individually owned rental stock is affordable to low- and moderate-income Americans.⁵ Yet most of these units receive no government subsidies.

Historically, smaller rental properties have had limited access to long-term, fixed rate financing and funding from the capital markets.

One reason for this capital access issue is that the process of underwriting smaller properties is typically more expensive for both the lender and the borrower. In some cases, good information about individual owners is not available to help lenders assess credit risk. The difficulties associated with underwriting are compounded by the fact that many of these smaller properties are in neighborhoods with weaker housing markets. Smaller rental properties are also generally older than their larger counterparts and change owners less frequently, often making it harder to establish resale values.

Access to capital through the secondary market for mortgage-backed securities is hampered by the fragmentation of the lender base serving smaller rental properties and the lack of loan standardization. Yet securitized lending offers the type of financing these properties often need: fixed rate, non-recourse, and longer term.⁶ Instead, owners of smaller rentals who have mortgages often have loans with variable rates and shorter terms (e.g., five years) with a “bullet” payment due at maturity. Operating on thin margins, in weaker markets that leave little room to increase rent levels (and therefore, cash flow), owners may find themselves unable to make larger payments when rates re-set and increase.

There are no magic solutions to these challenges, but improving access to capital financing for smaller rental properties is critical in the coming decade. The Urban Institute estimates that from 2010 to 2020, the number of renter households will expand by as many as 6 million. Preserving the millions of existing small rental properties in our nation’s housing stock can be a key component of a broader strategy to respond to this increase in rental demand.

As Congress considers proposals to reform our nation’s housing finance system, the Bipartisan Policy Center’s Housing Commission strongly believes there should be a greater focus on understanding the mortgage market for smaller rental properties and examining ways to facilitate financing to smaller

properties. In its February 2013 report, *Housing America's Future: New Directions for National Policy*, the commission also makes the following specific recommendations.

Explore opportunities to provide financing to small, scatter-site rentals on a bundled basis. The commission believes there may be untapped opportunities for the bundling of several non-contiguous properties into a single multi-site, multifamily property for purposes of financing the development and acquisition of these properties. To the extent that the [Federal Home Loan Banks](#) or [Fannie Mae and Freddie Mac](#) have experience with multi-site, multifamily finance, each government-sponsored enterprise (GSE) should use this experience to inform development of future financing products.

Review the impact of passive loss rules for small rental properties. The Tax Reform Act of 1986 disallowed the practice of using losses from “passive activities”—including investment in rental properties—to offset “active income” from other, unrelated areas. The limitation on passive losses, however, permits taxpayers with incomes under \$100,000 (phased up to \$150,000) to deduct as much as \$25,000 of losses from rental property they actively manage. The federal government should assess the potential to attract greater investment in affordable rental homes by exempting rental properties with fewer than 50 units from the \$25,000 limit and indexing the limit to inflation.

Pursue additional research to enable improved decision-making and underwriting. The Federal Housing Finance Agency, in conjunction with Fannie Mae and Freddie Mac, should conduct a thorough review of the two [GSEs'](#) experience in supporting the five- to 49-unit multifamily rental market to see what lessons can be learned. The aim of these studies would be to identify factors that may have contributed to the poorer historical performance of these properties in terms of underwriting, valuation methods, product features, and other factors.

Facilitate partnerships with mission-driven lenders. A new system of rental housing finance should support and enhance the role of community development financial institutions (CDFI) and other mission-driven lenders. Such a system should encourage traditional financial institutions to work in partnership with CDFIs on risk sharing and other arrangements to expand capital support to small multifamily properties. While CDFIs typically provide pre-development and construction financing, access to long-term permanent financing—through direct issuance of securities or sale to an aggregator—would enable them to better support affordable rental housing of all sizes. The U.S. Department of Housing and Urban Development's [Small Multifamily Building Risk-Share Initiative](#) presents a good opportunity to explore the potential of these partnerships.

Finally, there is a tremendous need for more comprehensive and timely data, including information on small rental loan originations, servicing, and performance. Better information is the critical first step in helping policy writers make informed decisions about how to meet the capital needs of this important segment of the rental market.

For more information, [e-mail](#) Grace Campion.

³ See Joint Center for Housing Studies of Harvard University (JCHS), *America's Rental Housing: Meeting Challenges, Building on Opportunities* (2011), p. 21.

⁴ Ibid., p. 22 (information based on JCHS tabulations of U.S. Census Bureau, 2001 Residential Finance Survey).

⁵ Ibid. In 2009, more than 10 million privately owned units had monthly rents of \$599 or less. See also U.S. Department of Housing and Urban Development, [Preserving Affordable Rental Housing: A Snapshot of Growing Need, Current Threats, and Innovative Solutions](#), (summer 2013).

⁶ For a summary of the unique financing challenges faced by small rental properties, see *Enhancing Access to Capital for Smaller Unsubsidized Multifamily Rental Properties*, Joint Center for Housing Studies of Harvard University, [William Apgar and Shekar Narasimhan](#), March 2007.

Federal Home Loan Bank Advances

MaryBeth Wott, Community Investment Officer, Federal Home Loan Bank of Indianapolis

Chartered in 1932, the Federal Home Loan Bank System (the system) comprises 12 banks and the Office of Finance, which provide funds for mortgages and community lending. Each bank is in a different region of the country, and each has individual program goals based on local market conditions. Each Federal Home Loan Bank (FHLB) is a government-sponsored enterprise, federally chartered but privately capitalized and independently managed.



Source: Federal Home Loan Bank of Indianapolis. The Federal Home Loan Bank of Indianapolis financed this series of 12-unit multifamily rental properties with multiple advances.

Each FHLB is a cooperatively owned membership organization. Community banks, national banks and federal savings associations, commercial banks, credit unions, community development financial institutions, and insurance companies are eligible for membership. FHLBs and their members represent the largest collective source of home mortgage and community credit in the United States.

One benefit of FHLB membership is access to low-cost secured borrowings, known as advances, which are funded by the FHLBs in the capital markets from the issuance of discount notes or term debt, collectively known as consolidated obligations.

In addition to providing on-demand liquidity to member financial institutions, the system also promotes community development through the Affordable Housing Program (AHP) and the Community Investment Program (CIP). According to the FHLB, “AHP subsidizes the interest rates for loans to member financial institutions, and provides direct subsidies to members making loans for the purchase, construction, or rehabilitation of very low- to moderate-income owner-occupied or rental housing. The CIP provides funds for community-oriented mortgage lending for families whose incomes do not exceed 115 percent of the area median. The CIP also directs lending towards economic development activities that are located in low- to moderate-income neighborhoods.”

Community Investment Program in Action

Berne is a small, picturesque community in northeastern Indiana founded by Swiss Mennonite immigrants in 1852. On the east side of Berne, Quad Properties, a local enterprise, has been building and managing small-scale apartment buildings since 2007. Over the last seven years, Quad Properties has completed and rented multiple new 12-unit properties. The apartment complex has five individual buildings. Each building was fully occupied, with a waiting list in place, before construction on the next building was started. The most recent building was completed in 2012. All units contain two bedrooms and feature a dishwasher, washer and dryer, and either a patio or a deck.

Thanks to affordable financing provided by First Bank of Berne, Quad Properties built each building without federal subsidies or tax credits. The \$500 monthly rents are well within the 115 percent of area median income calculation required to qualify for a CIP advance from the Federal Home Loan Bank of Indianapolis (FHLBI). Along with owner equity, CIP advances funded several of the development phases, covering both construction and permanent financing. A 10-year, \$760,000 CIP loan financed the most recently constructed building. The CIP advance allowed the bank to offer a longer-term loan at a rate of 0.75 basis points less than it would typically offer. Joe Caffee, Senior Vice President and Head of Lending for First Bank of Berne, said, “CIP is a wonderful opportunity to give back to the community by providing lower cost and longer term loans to local businesses to invest in projects like this housing. There are a lot of families living in these units. They’re very popular.” He said that First Bank of Berne

has also used CIP for operating funds for a local boat manufacturer to save jobs during the economic downturn. Caffee reports that the boat company is doing quite well these days.

CIP provides FHLBI members with a continuous, favorably priced source of funds for a variety of uses, including affordable rental housing, first-time home buyer loans, small business loans, and community and economic development loans. CIP is designed to support FHLBI members' efforts to undertake community-oriented mortgage lending and economic development in the communities they serve.

For more information, [e-mail](#) MaryBeth Wott.

Articles by non-OCC authors represent the authors' own views and not necessarily the views of the OCC.

Financing the Survival of Small Rental Properties

Carl Jenkins, Managing Director, Community Investments, BMO Harris Bank N.A.

As a region built over the past two centuries to house millions of immigrants, job seekers, and the poor, metropolitan Chicago is heavily reliant on the availability of quality affordable rental housing. For Chicago-based BMO Harris Bank N.A., [Community Investment Corporation](#) (CIC) provides a highly effective tool for financing the preservation of such housing. Much of this rental housing exists in the form of apartment buildings with 50 units or less, and is owned and maintained by small entrepreneurs. While the new construction and maintenance of subsidized affordable housing in the Chicago region is critical to meet the continually growing need, the preservation of naturally occurring affordable housing in the unsubsidized private ownership market is critical to stabilizing many of the area's communities.



Source: Community Investment Corporation. This building is an example of a small multifamily property in Chicago. BMO Harris invests in buildings like this through the Community Investment Corporation loan pool.

Market Need

In 2012, DePaul University's Institute for Housing Studies (IHS) completed an analysis of renter-occupied apartment buildings in Cook County, Illinois. Cook County, the most populous county in the region, and Chicago, within Cook County, contain a significant share of the housing stock. Nearly 38 percent of all residential units in Cook County and 52 percent in Chicago alone are in multifamily rental buildings. When categorized by building size, according to IHS, multifamily rental buildings with five to 49 units account for 15 percent of the housing units in Cook County and 19 percent in Chicago. Even more prominent in Chicago are two- to four-unit buildings (these are financed in the same manner and with the same tools as single-family residences), which account for 26 percent of the total housing units and 50 percent of multifamily rental units in the city. Combined, these small buildings play an outsized role in the rental markets of the region's low- and moderate-income communities. In some neighborhoods, these building account for up to 70 percent of the overall housing units. Many first-time owners and potential investors looking to acquire and rehabilitate these properties have a customer and property profile that falls outside the standard underwriting framework of a traditional commercial real estate financing product offered by a bank. This is where CIC steps in.

BMO Harris's Partnership With CIC

CIC, formed in 1974, is a 501(c)(3) nonprofit corporation certified as a community development financial institution by the U.S. Department of the Treasury. The organization was formed by Chicago's major financial institutions (including BMO Harris) as a separate, self-sustaining nonprofit mortgage lender that allows local banks to pool their capital to effectively target underserved Chicago neighborhoods. These neighborhoods contain a significant number of what we call "naturally occurring affordable housing."

While BMO Harris typically offers commercial real estate loans with five-year terms to qualified borrowers, CIC offers more flexible loan terms with maturities of up to 20 years. The mission, to provide long-term credit products for rental apartment buildings, requires a long-term, sustainable source of capital. Although many loan funds capitalize their lending activity using multiple sources of subordinate debt, this model is not scalable, and the maximum capacity for loan origination is quickly reached. To

address this challenge, CIC, in partnership with local financial institutions, created a financial instrument to attract investors and provide the organization with a long-term source of capital that could work to expand its lending activity. The instrument, branded as the Resource Apartment Lending program (RAL), has allowed CIC to originate approximately 2,000 loans and finance the rehabilitation of over 50,000 rental units. Launched in 1984, CIC's RAL program provides a unique and effective investment product for BMO Harris to finance naturally occurring affordable housing. In 1991, thanks in part to the success of its RAL program, CIC expanded beyond Chicago to the six-county metropolitan area.

Effective Community Reinvestment Act Investment Test Tool for BMO Harris

To meet its goals under the Community Reinvestment Act (CRA), BMO Harris must commit resources to qualified investments to achieve its goals under the Investment Test. Typical qualified investments available to banks are unsecured, involve economic returns in the form of a tax credit, or do not regularly amortize. The RAL allowed BMO Harris to make a \$30 million commitment to purchase a series of notes collateralized by mortgage loans to independent property owners for the acquisition and rehabilitation of rental apartment buildings in low- and moderate-income census tracts. Essentially, the program is a privately placed mortgage-backed security that allows investors to share in the risks of a pool of mortgages.

With the BMO Harris purchase of a security backed by loans and not the direct purchase of whole loans, the bank can treat the instrument as an equity investment on its books, instead of as a loan. The original loans issued by CIC to apartment building owners remain on CIC's balance sheet and are simply pledged as collateral to the investor's security. Additionally, the RAL investor program is unique to a loan fund not only because of its collateral structure but also because the program provides a cash return in the form of monthly principal amortization and interest payments.

The RAL program has performed exceptionally well with manageable delinquencies, defaults, and charges-offs, despite a challenging real estate market. Since the RAL program's inception, charge-offs in the RAL pool have been covered by the loan loss reserve, and no charges have been passed through to investors since 2001.

Partnership Continues to Grow to Meet Neighborhood Needs

As the recent IHS study highlights, many poorer neighborhoods in Chicago contain a disproportionate share of two- to four-unit buildings. The recent economic downturn has had a particularly devastating effect on these rental buildings and their communities. The two- to four-unit properties, according to IHS, "have been disproportionately impacted by foreclosure and become highly distressed." These buildings typically do not qualify for credit products designed for commercial buildings (five units or greater) and owners of these small rental properties face a number of challenges. CIC has recently offered a new pilot collateralized note program designed exclusively to target capital to buyers of one- to four-unit rental properties. The program is designed to support investors willing to buy distressed one- to four-unit buildings. Loans under this program are made only to investors willing to buy at least nine units that are located close together. BMO Harris understands the importance of getting capital to these properties and the important role these properties play in stabilizing many communities in Chicago. To date, BMO Harris has made a \$4 million commitment to this program.

In addition to the CRA and economic benefits BMO Harris receives in exchange for its investment in CIC, the bank also leverages CIC's ability to provide property rehabilitation training and technical assistance to first-time rental property investors. BMO Harris also works directly with CIC through board and loan committee participation. Furthermore, CIC provides a valuable resource for BMO Harris to

direct potential investors who may be ineligible for traditional banking credit products but may be able to achieve their objectives with a loan from CIC. Finally, CIC clients often use BMO Harris for their cash management and operating account needs.

For more information, [e-mail](#) Carl Jenkins.

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What Community Banks Are Saying—A Review of Four Community Banks’ Small Multifamily Lending Programs

William R. Reeves, Community Development Lending Manager, OCC, and
Letty Ann Shapiro, PhD, Community Development Expert, OCC

Our district community affairs officers (DCAO) provide a conduit between OCC Headquarters staff, local bankers, and examiners. These colleagues support the OCC’s mission to ensure a safe and sound banking system. DCAOs help national banks and federal savings associations (collectively, banks) to become better leaders in providing financing, investments, and retail services to underserved communities and consumers; provide community development expertise to support examiners; and help bankers and examiners better understand community development financing needs in communities across the country.



Source: Shutterstock.
This photo shows three small, brick, tenement-style apartment buildings.

Through the DCAOs, the authors have heard about issues related to small multifamily rental properties that may be limiting the bank financing available to preserve these valuable affordable housing units. The authors also have heard similar concerns voiced by community development financial institutions in areas that were hard hit by the economic downturn of 2008 and that have experienced increased pressure on rental housing and high unemployment.

What’s the Story?

Small rental properties with five to 50 units provide the largest source of unsubsidized multifamily rental units in the country. Anecdotally, over the past 12 months, we have heard conflicting stories about a lack of financing available for these small multifamily affordable rental properties. One story line described frustrated borrowers unable to find loans to purchase, refinance, or improve these small rental properties. This was supported by a nonprofit lending consortium telling us how large bank lenders once active in this line of business have since left it, leaving many neighborhoods with financing gaps. In contrast, we also have heard that community banks are increasingly interested in making loans to small multifamily affordable rental properties.

To sort out the details, we decided to go to entities that we readily can access—community banks—to hear what they had to say.

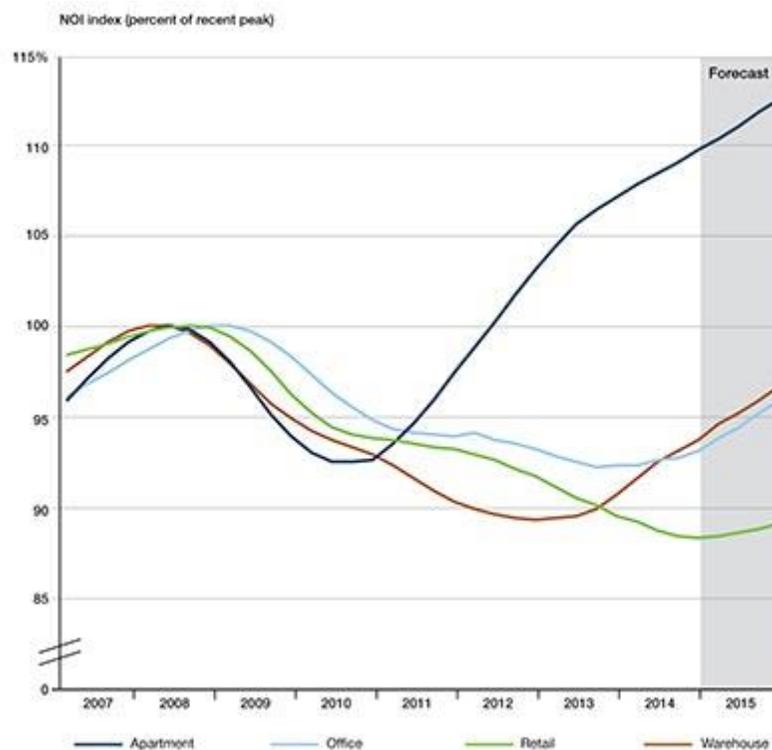
To determine whether community banks have an appetite for small multifamily rental financing (SmMF), which is a subset of commercial real estate (CRE) lending, we contacted four community banks to gauge their level of interest and involvement in this product, and if they offered SmMF loans, to learn about their respective products. We limited our interviews to community banks because we knew that while many large banks continue to be significant players in financing the CRE industry, they typically look for loans on larger properties that can be sold in the secondary market, usually in amounts greater than \$3 million. For more information about this product line, see the [article](#) by Elizabeth La Jeunesse titled “*Small Multifamily Property Ownership, Management, and Financing Issues.*”

The community banks we interviewed were not scientifically selected, nor do they reflect a national survey or picture. The banks are lending in the SmMF niche in different urban areas, and they are in markets that have a substantial stock of small multifamily properties.

What We Learned

In response to our fundamental question as to whether these community banks have a healthy appetite for SmMF loans, all four indicated that they were actively seeking out this type of business. The banks reported that the SmMF loans in their portfolios were well matched with their funding sources and performed as well as or better than other types of CRE loans. The banks all reported significant competition for these loans. This information matches our understanding of how the overall multifamily rental property market is generally performing. As [figure 8](#) illustrates, multifamily rental properties (the dark blue line) are outperforming the three other CRE asset classes: office, retail, and warehouse.

Figure 8: Net Operating Income Index at All-Time High for Apartments



Source: Property and Portfolio Research, third quarter 2013 baseline forecast.

Note: The net operating income index (NOI) represents the change in the total net operating income for each property type over time. The NOI is simply the cash flow generated by properties (rents) minus expenses but before payments of principal and interest. The indices are set to 100 at the pre-recession high. In 2014, net operating incomes were at an all-time high for apartment properties and projected to continue moving upward, while the other property types were bringing in 90–95 percent of what they were before the recession.

As a starting position, all four banks that we interviewed offered an initial five-year fixed-rate loan with amortization periods stretching out over 20 to 30 years. After this initial five-year term, however, the products' terms varied. In fact, two of the banks we interviewed described their loan product as having a 10-year maturity with the interest rate being reset at the end of the initial five-year fixed-rate period and a

balloon payment at maturity. The other two banks indicated that the second five-year term would be a variable interest rate based on an index. One of these two banks indicated that, in some cases, it would extend the initial fixed-rate term to seven years. Both of these banks also required a balloon payment at the end of the term. All of the banks indicated a willingness to entertain loan refinancing at maturity.

All four banks utilized an index, either from the start of the loan, in the case of the variable rate loans, or at the initial fixed-rate reset. The indexes mentioned ran the gamut: the Federal Home Loan Bank advance rate; the five-year Treasury bond rate; a swap index; and the prime rate or the London Interbank Offered Rate. Each of the banks then added a margin, from as low as 200 basis points to as high as 350 basis points, depending on the index used and the loan's term. Three of the banks hedged their interest rate risk with various prepayment premium schedules that reduced as the loans seasoned.

Loan-to-value (LTV) ratios were fairly standard, with all four banks reporting a maximum range of 75 to 80 percent. One bank indicated that its LTV ratio was 80 percent, while another indicated that it had the authority to go up to 80 percent, but typically kept its loans at a 75 percent LTV. Likewise, debt service coverage ratios were standard, with the four banks reporting their minimum coverage requirements range from 1.20x to 1.25x of the annual debt payment, with higher coverage ratios required for larger properties.

The banks indicated that they offered loans in amounts ranging from \$250,000 to \$1 million or more.

From an underwriting perspective, all four banks agreed that the following are fundamental to the success of this line of business: operating cash flow, collateral value, and borrower guarantees. Because the debt service on these loans is supported by only a small number of units, just one or two vacancies in a five- to 25-unit property can be the difference between a performing and a nonperforming loan. While adequate (or appropriate) collateral value (supported by documented appraisals) is always considered the second source of repayment, all of the banks noted that the recession had confirmed that what goes up (like a property's value), can, and will, come down. The banks indicated that they were looking for borrowers with deep pockets to support the guarantees and reserves required.

Most SmMF loans are secured by properties located in older metropolitan neighborhoods. The properties themselves are typically older; in many cases they were built in the 1920s and 1930s, and in almost all cases, they were built before the 1970s. Therefore, asset management and unit maintenance also are important factors for bankers to consider when making loans secured by these buildings.

When we asked the banks to tell us what they were looking for in a quality borrower, some spoke about borrower character and pride of ownership. They also said that no "slumlords" need apply and that investor owners needed to show proper maintenance, which results in satisfied tenants and more consistent cash flow. Some banks indicated a desire to lend to experienced rental property owners who knew what is expected of them both on the asset preservation side as well as the banking relationship side. To reinforce what was said earlier, each of the banks sought borrowers with good liquidity to help themselves and the bank if the property rent rolls needed support.

During our interviews, we asked how the banks performed their own asset management due diligence. The bankers all indicated that they conducted annual account reviews in some manner. Most frequently, the reviews relied on financial statements (business and personal) and rent rolls to indicate the financial stability of the properties. Additionally, the banks reported that they conducted site visits and inspections prior to closing. And most of the banks indicated that they completed a site inspection at least annually, and more often when the borrowers' financials raised concerns.

We learned from these banks that the SmMF borrowers do not have typical profiles. Depending on the property size, borrowers could be full-time professional real estate investors, or alternatively, could be young professionals with full-time jobs who are investing in real estate on the side. In all cases, however, the banks were cautious when it came to borrowers who indicated they would be doing their own plumbing and electrical repairs. Not surprisingly, the banks looked more favorably on borrowers who had appropriate experience, and whose portfolios reflected that they could afford to hire appropriate management teams to keep their properties in good condition.

When we asked the banks to describe how they originate these loans, we again heard a variety of answers. One bank relied heavily on commercial real estate brokers to bring in business. Other banks indicated that their branch system, reputation, and word of mouth were sufficient to gain a good market share. With intense competition for this business, all four banks indicated a willingness to be aggressive if the transaction offered the chance to establish a new business relationship, or if approving it was important to maintain an existing customer relationship.

All of the banks that we interviewed keep their SmMF loans in portfolio. The banks indicated that the structure and pricing of these loans worked well for them as a portfolio asset.

It has been suggested that the availability of an established secondary market for these SmMF loans could further the availability of credit to this market by providing liquidity and long-term fixed-rate financing. Importantly, all of the banks that we spoke with indicated that they are highly liquid and do not need to look for opportunities to sell the product in the secondary market. They also valued the shorter-term loans and the fees these loans generate.

What Does It Mean?

As the economic downturn put many former homeowners out of their homes and into the rental market, the demand for rental properties increased. In addition, new data on the younger population cohort, the older baby boomer cohort, and the new wave of immigrants forecasted, indicate that these groups are likely to expand over the next 10 to 20 years and are more interested in rental housing than previous generations. Pressure from these groups is likely to lead to an increasing demand for rental units, especially affordable rental units. In addition, the aging of these properties increases the need for renovation, including energy efficiency and structural improvements. Thus, the demand for loans on SmMF properties is likely to continue to gain traction. And, as we reported earlier in this article, competition for this business is high.

These bankers also indicated that if the economy weakened, or their liquidity positions changed, an established secondary market might be helpful to them, such as when credit is tight or long-term fixed-rate financing is the preferred loan product. Based on our interviews, for now it appears that community banks specializing in SmMF financing appear willing to make loans to creditworthy borrowers.

For more information, [e-mail](#) Letty Shapiro.

Articles by non-OCC authors represent the authors' own views and not necessarily the views of the OCC.

Underwriting Challenges of Financing for Small Multifamily Rental Properties

James A. Stiel, CRC, Risk Specialist, OCC

Small multifamily rental properties fill an important need in many communities; such properties provide housing that is affordable and offer relatively short-term housing solutions when needed. The OCC encourages national banks and federal savings associations (collectively, banks) to make soundly underwritten and prudently administered loans, including loans to finance smaller multifamily properties, that help provide needed affordable housing and promote economic development in the communities the banks serve.

Good loan underwriting and seasoned judgment help minimize a lender's losses and help ensure that the borrower is successful and that the property continues to serve the community's housing needs. The OCC's "[Commercial Real Estate Lending](#)" booklet of the *Comptroller's Handbook* provides supervisory guidance to examiners for commercial real estate lending, which includes multifamily housing. This article is not intended to provide [supervisory guidance](#), but instead discusses a few of the unique challenges the financing of smaller multifamily properties (five to 49 units) can present.



Source: Thinkstock.
This photo shows a four-story brick apartment building.

Although the underwriting for loans that finance these smaller properties is similar in many respects to the underwriting for loans that finance larger properties, there are important differences that are useful to consider. The biggest difference is often the borrower. These borrowers often have less experience and fewer resources than investors in larger properties. The available financial information may also be quite different for these borrowers, with financial statements prepared by the borrower or bookkeeper, rather than prepared, reviewed, or audited by a certified public accountant. Adequate and clear financials are what an examiner or banker needs to be confident in the financial information and borrower. The property and its condition are other considerations. Maintenance of smaller properties is commonly performed by the owner or a trusted hired helper rather than a dedicated maintenance staff who may have access to more resources. The ultimate tests of the property are its condition on inspection and whether the borrower has adequate resources to maintain property quality.

The Borrower

In some cases, those who borrow to invest in smaller properties may have only one or possibly a few properties, and these borrowers often manage the properties themselves. Effective management is critical to the success of multifamily properties, and poor management is a primary cause of failure. Particularly where the primary source of repayment is the income from the property, it's important to understand how well prepared the borrower is to successfully manage the investment and the collateral.

If the borrower has other properties, a review of these properties' performance helps to gauge his or her management ability. If the borrower is relatively new to being a landlord, assessing his or her ability requires some additional sensitivity. A lender can use the interview with the borrower to assess how well prepared the borrower is. How well does the borrower understand the business? Has the borrower analyzed all the important factors, such as rental and vacancy rates for similar properties? How does he or she plan to screen tenants? Is he or she prepared for the challenge of collections (those of us who are

former newspaper carriers remember that delivering newspapers was the easiest part of the job—it was collecting that determined if you made any money)?

Does the borrower have another full-time job that requires his or her attention? If so, how will the borrower handle urgent calls from tenants about a stopped-up toilet or leaky roof? Will the borrower have the time to manage and maintain the property if he or she performs these duties?

If the borrower's plans are to turn an underperforming property into a successful one, experience becomes even more critical. The lender will want to know if the borrower has done this before and make sure that he or she has a plan that is well supported. What are the borrower's plans and expectations? Are they realistic? How will the borrower improve the property? Will he or she reduce vacancies? Increase rents? Increase collections? How will the borrower make the property successful? A new owner sometimes comes to understand why the previous owner couldn't do this only once the borrower is in the previous owner's shoes—when it's too late.

Financial Information

A careful review of the financial information that the borrower presents tells the lender a lot about the borrower's understanding of the business in addition to the performance of the property.

Has the borrower included all likely expenses in the pro forma? Small property borrowers may do a lot of the work, such as management and maintenance, themselves. Although borrowers may sometimes view this work as “free,” it still represents an investment of time and materials that should be accounted for in the pro forma.

Has the borrower made realistic assumptions about vacancies and credit and collection losses? These are items that inexperienced borrowers and lenders may underestimate. What kind of resources does the borrower have? Does he or she have some source of liquidity aside from retirement funds that can be used to pay for unexpected repairs or other expenses?

For a small multifamily property, maintenance, repairs, and the replacement of capital items require a larger share of a property's cash flow than most other property types. The borrower's assumptions about required capital replacements should be reviewed, and the pro forma and historical information should demonstrate that the property can be reasonably expected to generate sufficient cash flow to maintain the property and fund replacements over time.

Is the income expected to provide an adequate rate of return or, instead, does the borrower plan to forgo income and expect to receive his or her return through appreciation? In the latter case, such properties may be unable to absorb inevitable fluctuations in income and thus be more likely to face default. The borrower or guarantor needs sufficient wherewithal to support the property. Properties should generate sufficient cash flow to cover expenses and upkeep.

If the borrower owns other properties, a review of these properties' statements can tell the lender not only how the properties are performing but how good a manager the borrower is. Does the borrower maintain current rent rolls and collection records, and can he or she show month-by-month or quarter-by-quarter what his or her profit or loss is? Or is the borrower a “seat-of-the-pants” type who waits until April 15 to find out how much he or she has made or lost when giving checking statements and receipts to an accountant to figure out the taxes? While tax returns can be useful to verify information, they are not sufficiently detailed or current to provide a good basis to manage a multifamily property or underwrite a loan.

Revenue should be closely analyzed. Comparing rent rolls with deposit records helps to determine the true revenue and effectiveness of the borrower's tenant screening and collection programs. Expense statements should be carefully reviewed to ensure that all appropriate expenses are included in the statements and that the expenses are reasonable. Statements prepared on a cash basis show only the expenses that have been paid; they do not show the expenses that should have been paid but were not. The same is true of tax returns prepared on a cash basis. Items such as real estate taxes and maintenance are commonly deferred when cash flow is tight. For this reason, the tax returns should be carefully evaluated. Expenses presented in appraisals of similar properties can provide useful comparisons. A cash-basis income statement that shows positive cash flow may actually be hiding negative cash flow if necessary expenses were not paid and were therefore excluded from the statement. It's not enough to determine if the borrower can pay the lender; the lender needs to be assured that the borrower can, and does, pay everyone else too.

The Property

Property condition is a major factor in a property's ability to attract and retain tenants, and this is particularly true with residential properties. It's critical for the lender and the borrower to have a good understanding of the condition of the property. When financing the purchase or refinance of smaller properties, it's tempting to forgo having a professional inspection done in order to keep the borrower's transaction costs down. Most of us would, however, never think of purchasing a home without an inspection; the same should be true of investment properties. In addition to describing the property and its overall condition, the inspection report should identify any deferred maintenance that may have accrued and estimate the cost to remedy it. A good practice is to make sure that any needed work is done before closing, or to hold back sufficient loan proceeds to ensure the work is done. Postponing work that needs to be done now to fund it out of future cash flow is rarely a good idea. The inspection report should also note major repairs or replacements that are not needed now but will be needed in the near future, and a realistic plan should be developed to pay for them.

When new improvements are part of a plan to improve property performance and the improved performance forms the basis for the underwriting assumptions, the construction budget should be closely reviewed to ensure that it accurately represents and includes all costs. The expenditures should make a commensurate contribution to the overall value of the property and be supported by the prospective (as-complete or as-stabilized) value. The "[Commercial Real Estate Lending](#)" booklet of the *Comptroller's Handbook* provides examiner guidance for underwriting and administering loans that finance construction.

It is a good practice to inspect the property at least annually to determine whether it is being adequately maintained. Monitoring the condition of the property can be as important as monitoring the cash flow; doing so helps determine if the property is generating enough cash flow to cover all of the expenses, since maintenance is one of the first items to be cut if the property or borrower is experiencing difficulty. Regular inspections can also help to protect the value of the lender's collateral.

For more information, [e-mail](#) James Stiel.

The OCC's 'Commercial Real Estate Lending' Booklet of the *Comptroller's Handbook*

James A. Stiel, CRC, Risk Specialist, OCC

The OCC recently revised the “[Commercial Real Estate Lending](#)” booklet of the *Comptroller's Handbook* to replace the “Commercial Real Estate and Construction Lending” booklet issued in 1995. The revised booklet also replaces sections 210, “Income Property Lending,” and 213, “Construction Lending,” of the former Office of Thrift Supervision’s Examination Handbook, issued in 2009 and 1994, respectively. The revised booklet provides guidance to examiners for multifamily as well as other types of properties.

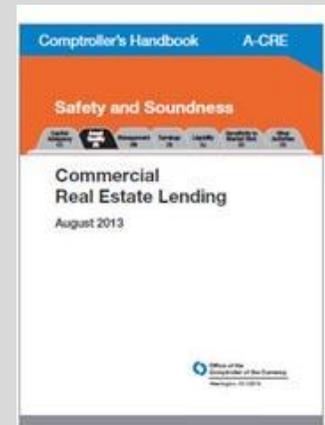
The “Commercial Real Estate Lending” booklet reflects examiner guidance issued subsequent to the release of the now replaced 1995 booklet. The new guidance includes a variety of topics, including prudent loan workout strategies; management of concentrations; stress testing; updated interagency appraisal guidelines; and statutory and regulatory developments in environmental risk management. Discussions of statutes and regulations governing federal savings associations have also been incorporated in the revised booklet.

In addition, expanded examiner guidance addressing acquisition, development, and construction (ADC) lending is found in the revised booklet. Issues unique to ADC and income-producing real estate lending are discussed in separate sections. Other topics found in the booklet that are either new or expanded include project feasibility, investor-owned residential real estate, amortization, debt yield, owner-occupied real estate, and specific underwriting considerations for various property types, including multifamily and affordable housing.

The booklet also enhances the agency’s guidance for supervisory loan-to-value (SLTV) limits that were established in appendix A to subpart D of 12 CFR 34, “Interagency Guidelines For Real Estate Lending.” The limits under the updated guidelines for multifamily properties are 80 percent for construction financing and 85 percent for completed properties. The guidelines do not prohibit loan-to-values in excess of these limits. Rather, they provide that the sum of these loans in excess of the limits at origination should be no greater than 100 percent of a bank’s capital. Within that aggregate limit, total loans to finance commercial, agricultural, multifamily, or other non-one- to four-family residential properties should not exceed 30 percent of the bank’s total capital.

For a loan exceeding SLTV limits, the entire outstanding balance should be included in the bank’s nonconforming basket, not just the portion exceeding the limit. If the bank holds a first and second lien on a parcel of real estate and the combined commitment exceeds the appropriate SLTV limit, both loans should be reported in the bank’s nonconforming loan totals. Further, the bank should include all loans secured by the same property if any one of those loans exceeds the SLTV limits. A loan need no longer be reported as part of aggregate totals when reduction in principal or senior liens, or additional contribution of collateral or equity (e.g., improvements to the real property securing the loan), brings the LTV into compliance with SLTV limits.

The booklet also provides examiner guidance in selecting the proper value for measuring SLTV. The value used in calculating the SLTV can be as-is, the prospective market value as completed (“as-completed”), or the prospective market value as stabilized (“as-stabilized”). An as-is value would be



Source: OCC
Thumbnail-sized cover of the OCC's *Comptroller's Handbook* booklet titled “Commercial Real Estate Lending,” published August 2013

appropriate for calculating the SLTV for raw land or stabilized properties. For an owner-occupied building or a property to be constructed that is preleased, the as-completed value should generally be used. An as-stabilized value would be appropriate for an existing property that is not stabilized or a property to be constructed that is not preleased to stabilized levels. For a further discussion of as-completed and as-stabilized values, see the “prospective market value” entry in the booklet’s glossary (page 124).

The LTV ratio is only one of several important credit factors to be considered when underwriting a real estate loan. Additional credit factors to be taken into account are discussed in the “Underwriting Standards” section of the booklet (pages 8–10). In light of these additional factors, the establishment of the SLTV limits should not be interpreted to mean that loans underwritten to these limits are automatically considered sound.

The booklet also provides property-specific underwriting considerations for various property types, including multifamily. The booklet stresses that management ability is critical to the success of multifamily properties; inept or inexperienced management is a major cause of difficulty for loans financing multifamily dwellings. Mitigating tenant turnover requires a constant marketing effort, and management must retain tenants when possible by being attentive to their needs. In addition to attracting and retaining tenants, management must do an effective job of collecting rents. Although a review of the rent roll might indicate a high rate of occupancy, actual collections should be examined to determine the true economic occupancy and to evaluate the competency of management and the effectiveness of its collection efforts. Whether properties are self-managed or managed by a third party, the manager’s ability and experience should be carefully evaluated.

Lack of proper maintenance can pose a significant risk to the viability of multifamily properties. Undercapitalized borrowers may neglect needed maintenance when cash flows are inadequate, which can result in increased turnover and vacancies. Deferred maintenance can significantly affect loan losses and expenses in the event of foreclosure. An inspection of the property should determine how many of the vacant units are rentable in their current condition; cash-strapped borrowers sometimes “cannibalize” vacant units of appliances, heating units, and other items when replacements are needed. It is important that banks monitor property maintenance and improvements to ensure they are timely and appropriate. Banks should ensure that the property’s cash flow is adequate to provide for necessary replacements and upgrades over time. In addition, the property’s operating expenses should be carefully analyzed to ensure that replacements and upgrades actually were made.

Multifamily rental properties fill an important need in many communities; they can be more affordable than owner-occupied housing and offer relatively short-term housing solutions. These properties have historically been one of the most stable property types, and, when prudently underwritten, and properly managed and maintained, they can provide profitable opportunities for lenders while improving the communities they serve.

For more information, [e-mail](#) Jim Stiel.

Articles by non-OCC authors represent the authors’ own views and not necessarily the views of the OCC.

Secondary Market Options to Finance Small Multifamily Properties

Sharon Canavan, Community Relations Expert, OCC

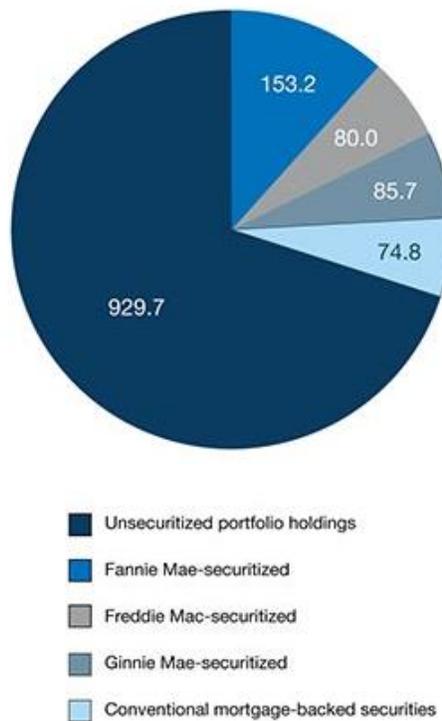
One-third of all multifamily units are in small multifamily properties, which are an important component of the affordable rental housing stock for low- and moderate-income individuals.¹ Although many small multifamily properties receive some form of government subsidy, unsubsidized units account for three-fourths of units with rents below \$600. This article discusses the role of Fannie Mae and Freddie Mac in financing small multifamily properties.



Source: Thinkstock.
This photo shows a four-story apartment building

Multifamily mortgage debt origination and investment is highly fragmented—although a handful of institutions holds about one-third of outstanding multifamily debt, the remainder is held in portfolio by almost 6,000 Federal Deposit Insurance Corporation-insured institutions.² [Figure 9](#) shows that although securitization plays an important role in supporting multifamily finance, unsecuritized portfolio holdings remain a significant source of multifamily investment. Commercial multifamily mortgage securitization, which virtually halted in 2008, is slowly recovering, and life insurance companies play a measurable role as multifamily investors.

Figure 9: 2014 Multifamily Mortgage Debt Outstanding (in Billions)



Source: Mortgage Bankers Association.

There is less fragmentation in the multifamily housing lender segment that is focused on originations above \$3 million. In contrast, small multifamily housing lending is much more highly dispersed among institutions, many of which view this business line as a complement to their broader banking business relationship with customers.³

Although small multifamily properties are commonly defined as those with five to 50 units, both Fannie Mae and Freddie Mac define small multifamily properties by loan size, ranging from \$1 million to \$5 million. Smaller properties with two to four units are also an important source of affordable rental housing, but are not the focus of this article; loans for these smaller properties are originated using Fannie Mae and Freddie Mac single family underwriting guidelines. (The [sidebar](#) to this article provides more information.)

In recent years, small multifamily housing loans have represented a limited segment of the total multifamily business activities of Fannie Mae and Freddie Mac, the two large government-sponsored enterprises (GSE), that provide a secondary market for residential mortgages. In 2013, Fannie Mae provided \$28.8 billion in financing to the multifamily market, and small loans accounted for \$2.3 billion, or 8 percent, of the total multifamily investment activity. In 2013, Freddie Mac provided \$25.9 billion in multifamily financing on 1,600 loans. Freddie Mac's total volume of loans in amounts of less than \$3 million, or \$5 million in high-cost areas, was \$1 billion, or approximately 4 percent of its total multifamily production.

Challenges to GSE Participation in Small Multifamily Housing Finance

As secondary market investors, the GSEs' role in providing liquidity to the multifamily market is an important one; however, they face a number of challenges in financing multifamily properties. These hurdles are particularly acute for small multifamily loans.

The characteristics of small multifamily properties make financing more challenging. More than half of the small multifamily housing stock is more than 30 years old and tends to have higher maintenance costs than larger properties. Although vacancy rates for smaller properties are only marginally higher than those for properties with more than 50 units, losses due to vacancy are higher for smaller properties. To manage these concerns, adequate reserves to cover temporary liquidity problems and meet anticipated capital expenses are even more critical for smaller properties.

Although individual borrowers are important contributors in the small multifamily arena, they have unique characteristics that present challenges to financing. In small multifamily properties with less than 25 units, borrowers tend to be individual property investors or smaller commercial enterprises that invest in just a few properties. Typically, in small properties with more than 25 units, the ownership structure involves more formal legal arrangements, such as limited liability partnerships, limited liability companies, or other types of corporate entities.

Individual small multifamily borrowers operate on thinner cash flow margins than larger property owners, and are exposed to higher income fluctuation risk when vacancies occur. Many individual borrowers do not have the resources to outsource the management of their properties; instead, they manage their properties themselves, which can impact the maintenance of the units or the speed of filling vacancies.

Accessing the secondary market is particularly difficult for individual small multifamily borrowers who often lack the deep pockets to meet secondary market underwriting requirements for minimum net worth,

liquidity reserves, or escrowed reserves for capital expenditures. In addition, individual borrowers may not have audited financial statements to meet reporting requirements.

Evaluating these multiple factors not only adds to the complexity and cost of underwriting small-balance multifamily loans, but also limits the field of investors willing to purchase these loans. Due to a combination of unique factors that are typical of small multifamily loans, investors view the market as highly heterogeneous. In every loan transaction, all of the distinctive characteristics of both the property and the borrower must be considered. In many instances, these characteristics render a loan to a particular borrower, or on a small multifamily property, ineligible for purchase by the GSEs.

Variability in the small multifamily market segment runs counter to many of the inherent strengths of the GSEs' securitization business model. The widely divergent characteristics of small multifamily loans make standardization, which is the hallmark of the GSEs' secondary market securitization model, extremely challenging. It is far more difficult to securitize non-homogeneous loans. Credit rating agencies face the same hurdles in assessing a mortgage-backed security (MBS) offering that is secured or backed by small multifamily loans. Also, MBS investors expect the underlying assets to conform to specified standards, generate predictable revenue streams, and reflect a high level of credit performance.

Lenders operating in narrower local or regional markets may safely and soundly offer more flexible underwriting to small multifamily borrowers than the GSEs because their geographic focus helps them gain a considerable understanding of their communities and borrowers. Lenders in these communities, such as national banks and federal savings associations (collectively, banks), may actively originate small multifamily loans and then hold them in their portfolios. In 2013, multifamily originations by banks represented 39 percent, or \$67.9 billion, of total multifamily originations. Bank and thrift institutions' portfolio holdings totaled 30 percent, or \$281 billion,⁴ of outstanding multifamily mortgage debt.⁵

GSEs' Multifamily Business Model

The GSEs support multifamily lending needs generally by offering standardized multifamily underwriting on a nationwide basis. In particular, the GSEs' multifamily programs provide a critical source of financing in smaller and regional markets that may not attract adequate sources of funding.

Before 2009, the GSEs' multifamily business strategy relied heavily on purchasing multifamily loans, intending that they be held in portfolio. After the GSEs entered conservatorship in September 2008, however, they were directed to reduce their portfolio holdings by 10 percent per year. As a result, the GSEs rapidly shifted their emphasis to securitizing multifamily loans. Fannie Mae, which had an existing securitization product at the time, scaled up rapidly, so its multifamily securitization jumped from 17 percent in 2008 to 81 percent in 2009. Freddie Mac's issuance of multifamily mortgage participation certificates and structured securities rose from \$700 million in 2008, to \$2.5 billion in 2009.

Today, securitization is still the primary way that the GSEs provide liquidity to the small multifamily market. In their roles as credit guarantors, the GSEs assure timely payment of principal and interest to investors. In 2013, virtually all of Fannie Mae's multifamily financing was structured as MBSs. Similarly, Freddie Mac relies heavily on securitization—since 2012, less than 5 percent of its multifamily new loan volume has been held in its portfolio for investment purposes. Despite the shift in strategy from portfolio investment to securitization, the GSEs continue to support liquidity in the multifamily market, as demonstrated by the number of multifamily mortgages that they securitize each year.

Fannie Mae and Freddie Mac maintain business relationships with a small set of approved multifamily lenders that are capable of meeting capital and infrastructure requirements. The GSEs also manage their

multifamily credit risk exposure by usually requiring their lender partners to assume a portion of the credit risk.

Even if a bank generally originates multifamily loans for its portfolio, from time to time an institution may need to manage its balance sheet for capital purposes or other reasons, so a secondary market execution for seasoned loans serves a valuable purpose. On a limited scale, both Fannie Mae and Freddie Mac purchase multifamily loans from other lenders on a negotiated basis. Freddie Mac evaluates the purchase or guarantee of bulk pools consisting of one or more seasoned multifamily loans. Similarly, Fannie Mae does a small amount of negotiated business with non-delegated underwriting and servicing (DUS) multifamily lenders. The GSEs' credit loss risk sharing requirements, however, often dissuade lenders from partnering with the GSEs.

Fannie Mae

DUS lenders are approved by Fannie Mae based on an analysis of financial strength, experience with underwriting and servicing multifamily loans, and past loan performance. Once approved, DUS lenders are delegated the authority to underwrite, close, deliver, and service multifamily loans, in adherence with Fannie Mae's credit and underwriting standards. The delegated authority results in streamlined loan processing. Fannie Mae oversees its DUS lenders on an ongoing basis.

Two dozen multifamily lending firms are currently approved under the DUS program, and these lenders deliver most of the multifamily loans financed by Fannie Mae. Any DUS lender is eligible to participate in Fannie Mae's Small Loans Program, but only a small number of the DUS lenders actively participate. One DUS lender helps to expand access to secondary market solutions for non-DUS lenders by acting as a small loan facilitator. Although most DUS lenders are non-bank institutions, one-third of the DUS lenders are regulated financial institutions, and these banks provide 35 percent of Fannie Mae's guaranty book of multifamily business.

A national bank or federal savings association that is not a DUS lender, but is interested in originating or selling small multifamily loans, can work with a DUS lender, either as a broker or correspondent. As a broker, an institution can negotiate a fee for referring a potential borrower to a DUS lender. A correspondent relationship with a DUS lender could be a better fit for institutions with a more robust multifamily presence. A DUS lender can negotiate the level of loan processing work that a correspondent lender does and the compensation, but the DUS lender always remains the counterparty to Fannie Mae.

When multifamily loans are delivered, Fannie Mae creates an MBS supported by the underlying multifamily mortgage or mortgages. A DUS MBS is typically backed by a single mortgage loan. A DUS MBS offers advantages for investors, including prepayment protection and competitive yields.

Fannie Mae's DUS model is based on a shared risk approach. As a safeguard to ensure high-quality origination and servicing, Fannie Mae requires DUS lenders to share a portion of the credit loss in the event of default. "Pari passu" is the most common loss-sharing structure, in which the agreement requires the DUS lender to absorb one-third of the first loss on a pro rata basis, with Fannie Mae absorbing the remainder. The "standard" approach uses a tiered loss-sharing formula (that incorporates factors such as loan-to-value [LTV] and debt service coverage ratios) in which the DUS lender assumes the first loss, up to a cap of 20 percent of the original loan amount. In transactions with non-DUS lenders, agreements to share or absorb credit losses are negotiated on a percentage of the loan or the pool balance.

Fannie Mae's Small Loans Program offers financing for multifamily loans up to \$3 million in most areas and up to \$5 million in eligible high-cost areas.⁶ Although small multifamily properties are frequently

defined as having five to 50 units, Fannie Mae uses loan size as a proxy for small multifamily properties, even if a smaller balance loan is made on a project with more than 50 units.

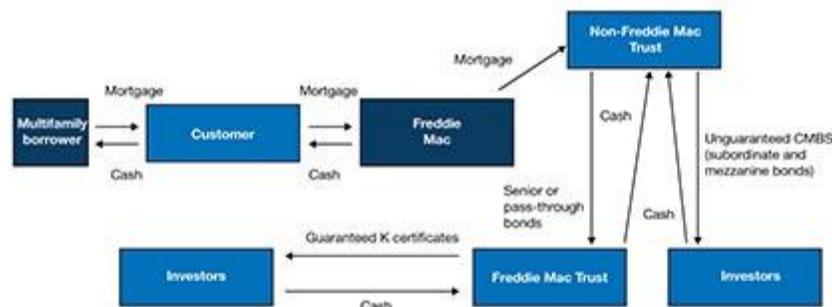
Fannie Mae’s Small Loans Program offers acquisition and refinance loan options for existing, stabilized properties. Loan terms can range from five to 30 years, with an amortization period of up to 30 years. Borrowers can choose either fixed or variable interest rate options, as well as yield maintenance or other graduated prepayment options. The maximum LTV ratio for an acquisition loan is 80 percent, and the minimum debt service coverage ratio is 1.25. Because many small multifamily borrowers, such as partnerships or corporate entities, are more like single family borrowers than traditional multifamily borrowers, Fannie Mae requires increased underwriting scrutiny of individual borrowers’ personal creditworthiness under the Small Loans Program.

Freddie Mac

In contrast with Fannie Mae’s delegated underwriting approach, Freddie Mac relies on a prior approval lending model. Freddie Mac purchases multifamily mortgages through its Program Plus network, which consists of about two dozen lenders that are approved as correspondents.⁷ These multifamily lenders submit multifamily loan packages to Freddie Mac, which performs a complete underwriting evaluation and credit review before issuing a final approval.

Once the multifamily loans are approved and delivered, Freddie Mac packages them into securities. Freddie Mac works with its network of securities underwriters to structure and issue private label securities backed by pools of multifamily loans. As illustrated in [figure 10](#), Freddie Mac issues a guarantee on the senior portion of the structured security and then issues pass-through certificates, known as K Certificates, which are publicly offered by placement agents to investors. Subordinate bonds and mezzanine bonds covering the balance of the structured pool of these commercial mortgage backed securities (CMBS) are not guaranteed by Freddie Mac and are sold by Freddie Mac through its placement agents to private investors.

Figure 10: K Certificate Transaction



Source: [Form 10-K](#) for the fiscal year ended December 31, 2013, Freddie Mac, page 12.

Freddie Mac recently announced a new Small Balance Loan (SBL) program designed for multifamily loans ranging from \$1 million to \$5 million on properties with five or more residential units.⁸ Six Program Plus lenders are approved to sell small multifamily loans to Freddie Mac.

Borrowers must be one of the following: a U.S. citizen, a limited partnership, a limited liability company, a single asset entity, a special purpose entity, an entity that holds as tenancy-in-common with up to five unrelated members, or a trust (irrevocable trusts and revocable trusts with a “warm body” guarantor). The borrower must have a net worth equal to the loan amount with liquidity equal to nine months of principal and interest.

Fixed-rate loans are available with five-, seven-, or 10-year terms and amortization up to 30 years. For fixed-rate and hybrid adjustable rate mortgage (ARM) loans, the maximum LTV for small balance loans is 80 percent, but the required minimum amortizing debt coverage ratio (DCR) varies depending on location of the property. The minimum amortizing DCR for loans in specified top small balance loan markets is 1.20x, and the DCR is a higher 1.25x for loans in all other markets.⁹ Full-term interest-only loans are available with a minimum amortizing DCR of 1.40x and a maximum LTV of 65 percent. Loans are available for existing properties with a minimum 90 percent average occupancy rate over the trailing three-month underwriting period. Yield maintenance provisions governing prepayment penalties apply to both fixed-rate and hybrid ARMs. Small balance multifamily loans are non-recourse with standard carve-out provisions (e.g., fraud).

SBLs are securitized using the K-Deal securitization technology. In the case of SBLs, however, the lenders agree to buy the unguaranteed slice of the security or place it with another investor, taking a first-loss position to absorb any credit losses.

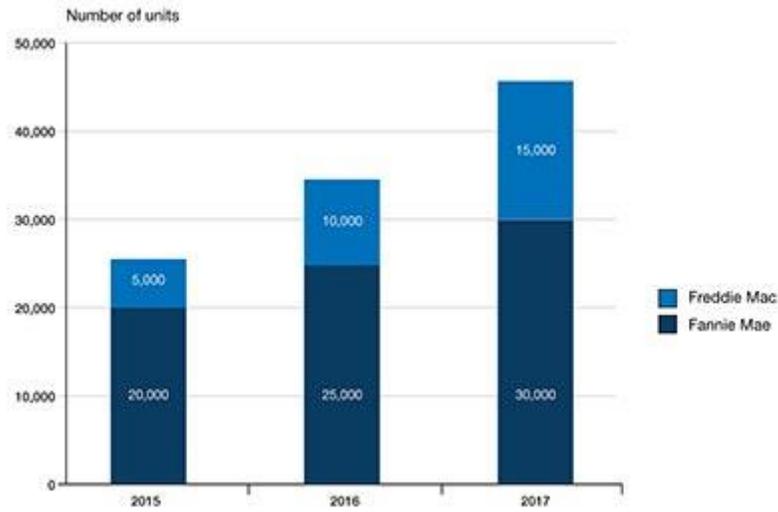
Depository institutions that are not Program Plus correspondents but would like to sell small multifamily loans can approach Freddie Mac to evaluate a seasoned pool of multifamily loans. Freddie Mac evaluates the loans, which generally must be seasoned for at least a year. If Freddie Mac approves the loans, it purchases, credit enhances, or swaps a security for the pool of mortgages.

Providing Liquidity to Small Multifamily Finance: the Future Role of the GSEs

In the past several years, the Federal Housing Finance Agency (FHFA), which regulates the GSEs, has held divergent views on how much support these institutions should offer in the multifamily market. In 2013, the FHFA directed the GSEs to reduce multifamily volume by at least 10 percent. FHFA Director Melvin Watt, however, included no plans to reduce multifamily production levels as part of FHFA’s “The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac.” Although Director Watt noted that the FHFA expected less GSE multifamily activity in 2014, he stressed that the “FHFA will not mandate that the Enterprises [i.e., the GSEs] prematurely shrink their multifamily footprint.” Watt added, “Consistent with safety and soundness, our affordability focus will include multifamily lending for small properties.”

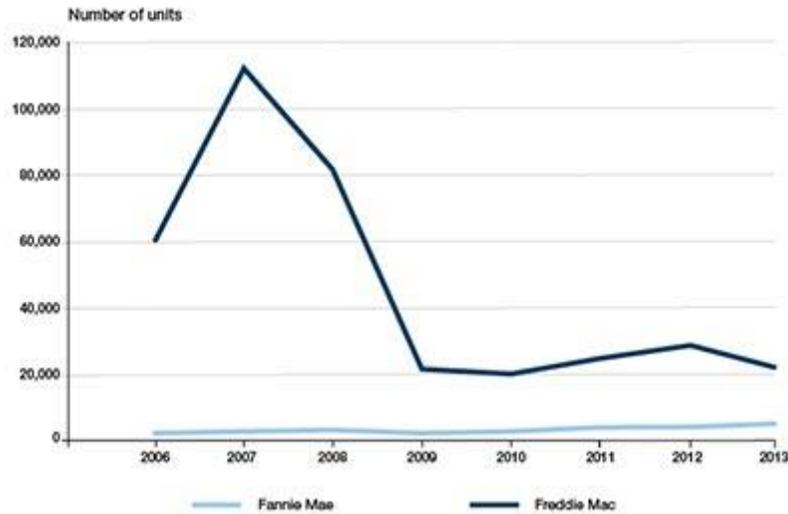
In fact, the FHFA has proposed regulation requiring that the GSEs increase their future small multifamily residential property financing activity. For the first time, the FHFA has proposed a specific sub-goal target for small multifamily properties serving low-income individuals (defined as having incomes of 80 percent or less of area median income) in the GSEs’ 2015 through 2017 affordable housing goals (see [figures 11](#) and [12](#)). In the proposal, the FHFA defines small multifamily property as five to 50 units.

Figure 11: Proposed GSE Low-Income Small Multifamily Housing Goals 2015–2017



Source: [Federal Housing Finance Agency 2015–2017 Enterprise Affordable Housing Goals](#) , 79 Fed. Reg. No. 176, pages 54481 and 54498, September 11, 2014.

Figure 12: GSE Funding of Low-Income Units in Small Multifamily (Five- to 50-Unit) Properties



Source: [Proposed GSE Low-Income Small Multifamily Housing Goals 2015–2017](#) , table 4, Federal Housing Finance Agency 2015–2017 Enterprise Affordable Housing Goals, 79 Fed. Reg. No. 176, pages 54481 and 54497, September 11, 2014.

Lenders interested in learning more about the GSEs' small multifamily programs can visit [Fannie Mae](#) and [Freddie Mac's](#) Web sites.

For more information, [e-mail Sharon Canavan](#).

¹ Monthly rents in properties with fewer units tend to be lower, so smaller multifamily properties offer a more affordable housing option for lower income individuals. The mean monthly rent receipts per housing unit on mortgaged properties are \$658 for five- to 24-unit properties, \$826 for 25- to 49-unit properties, and \$919 for properties with more than 50 units. See the 2012 U.S. [Rental Housing Finance Survey](#), U.S. Department of Housing and Urban Development and U.S. Census Bureau, Selected Characteristics by Mortgage Type, Tables 2b, 2c, and 2d at pages 39, 57, and 75.

² Wayne Archer and David Ling, "Toward an Understanding of Fannie Mae's Penetration of the Multifamily Housing Market," University of Florida, September 2012, at page 3.

³ ["Fannie Mae's Role in the Small Multifamily Loan Market,"](#) first quarter 2011, page 7.

⁴ Mortgage Bankers Association, "Annual Report on Multifamily Lending," 2013.

⁵ Ibid.

⁶ Fannie Mae, "[Multifamily Term Sheet, Small Loans Program](#)."

⁷ Freddie Mac provides a list of [Program Plus lenders](#).

⁸ Freddie Mac, "[Multifamily: Small Balance Loan At-a-Glance](#)," December 2014.

⁹ Ibid, page 2. The top small balance loan markets include the following Metropolitan Statistical Areas: New York, Newark, Jersey City; Boston, Cambridge, Newton; Philadelphia, Camden, Wilmington; Washington, Arlington, Alexandria; Chicago, Naperville, Elgin; Los Angeles, Long Beach, Anaheim; San Francisco, Oakland, Hayward; San Jose, Sunnyvale, Santa Clara; and San Diego, Carlsbad.

GSE Financing for Two- to Four-Unit Properties

Sharon Canavan, Community Relations Expert, OCC

Both Fannie Mae and Freddie Mac offer financing options for two- to four-unit properties, which are underwritten using single family guidelines. The eligible loan amount depends on both the number of units in the building and the location of the property; in high-cost areas, loan purchase limits are appreciably higher.

Fannie Mae

Fannie Mae's standard single family eligibility and underwriting guidelines treat two- to four-unit properties as single family properties. Financing for two- to four-unit properties accounted for 3 percent of Fannie Mae's single family conventional guaranty book of business in 2013 and through June 2014. Moreover, Fannie Mae financed almost 32,000 owner-occupied two- to four-unit properties in 2013, totaling about \$8.7 billion.

Depending on the loan type, certain additional eligibility requirements apply to two- to four-unit properties, such as a more stringent loan-to-value (LTV), debt-to-income ratio, and credit score, and minimum reserve requirements. A 1 percent loan-level price adjustment applies to two- to four-unit properties. Owner-occupant borrowers can use rental income from the other units to qualify for the loan. Under standard underwriting guidelines, Fannie Mae permits up to four loans to the same borrower/investor. Borrowers holding five to ten properties must meet additional eligibility, underwriting, and delivery requirements.¹⁰

Freddie Mac

A number of Freddie Mac products expand financing options to include two- to four-unit properties.¹¹ Additional eligibility requirements apply to these properties, such as a more stringent down payment, debt-to-income ratio, and credit score, and minimum reserve requirements. Although more stringent LTV requirements apply to two- to four-unit properties,¹² the Home Possible and Home Possible Neighborhood Solutions products allow down payments as low as 5 percent for two- to four-unit properties.¹³ Rental income from the other units can be used to qualify the owner-occupant borrower. Post-settlement delivery fees ranging from 1 to 2 percent, depending upon the LTV, apply on two- to four-unit properties.

For more information, [e-mail](#) Sharon Canavan.

¹⁰ [“Fannie Mae Announcement 09-02, Updates to Multiple Mortgages to the Same Borrower Policy, Reserve Requirements, Reserves Definition, and Form 3170”](#) (February 6, 2009).

¹¹ See Freddie Mac information on [“Mortgages for 2- to 4-unit Primary Residences.”](#)

¹² See [“Super Conforming Mortgages.”](#)

¹³ See Freddie Mac, [“Home Possible Mortgages,”](#) [“Home Possible at a Glance,”](#) and [“Home Possible Neighborhood Solutions Mortgages.”](#)

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An Interview With Shekar Narasimhan: Financing Small Rental Properties

Shekar Narasimhan, Managing Partner, Beekman Advisors

Shekar Narasimhan, Managing Partner at Beekman Advisors, McLean, Va, provides strategic advisory services to companies and investors involved in real estate, mortgage financing, affordable housing, and related sectors. He serves on many boards, including those of Enterprise Community Investment and the Community Preservation and Development Corporation. He is on the executive committee of the National Housing Conference and is a fellow at the Joint Center for Housing Studies of Harvard University. In the past, he served on the Mortgage Bankers Association of America Board of Directors, and was elected the first Chair of the Fannie Mae Delegated Underwriter and Servicer Advisory Committee.



Source: Shutterstock
This photo shows the upper three stories of a brick apartment building.

To share more information about how to best finance the small multifamily rental market, the Community Developments Investments staff recently sat down with Mr. Narasimhan to talk about financing for small multifamily rental properties. Here is a portion of the conversation.

OCC: Can you please tell us your thinking about the availability of financing for small multifamily properties and where any gaps exist?

Narasimhan: First, let me say that this small multifamily rental property market seems to be getting much of the credit it needs from portfolio lenders and is not capital starved. But I would like to point out that there is still a need for a secondary market for small multifamily loans. When you look at it purely from the perspective of a lender, access to a secondary market at some point in time, to be able to offload assets that don't meet your asset liability requirements or have a duration mismatch or have seasoned and can extract profits from it, is a very, very valuable thing to have. The other reason is that under certain circumstances, securitizing loans can result in lower regulatory capital requirements for the lender.

For example, let's say you have a three-year seasoned small loan that has met certain requirements: say a 10-year duration, 25-year amortization, and it has performed well for three years in a row. If that loan can get a Federal Housing Administration (FHA) insurance wrap, it could be kept by the lender in portfolio. The insurance would then reduce the regulatory capital requirements from, say 100 percent to 20 percent or something like that, depending upon structure. The institution may then decide to keep these newly insured loans for the duration, or alternatively, it would have the ability, if the loan didn't fit the lender's profile on its liability side, to be able to offload the insured loan in the secondary market. This could be done because there's a ready market for government guaranteed paper.

[Editor's note: Under the regulatory capital rule certain multifamily mortgage loans receive a preferential capital charge of 4 percent (risk weight of 50 percent) pursuant to the provisions pertaining to statutory multifamily loans in the regulatory capital rules. Other multifamily mortgages receive 8 percent capital charge (a 100 percent risk weight). The risk weighting would depend on whether the FHA "wrap" would qualify as an eligible guarantee under the capital rule. If the "wrap" did qualify, it is likely to be treated as a conditional government guarantee, which would reduce the capital charge to 1.6 percent (risk weight of 20 percent).]

OCC: How are Fannie Mae and Freddie Mac factored into the small multifamily market?

Narasimhan: Many have suggested that Fannie Mae and Freddie Mac, or their successor entities, should play a larger role in financing small multifamily properties. I guess my perspective has been that square pegs don't fit in round holes, and this is a square peg. This is also the reason why we should clearly define what we're trying to achieve on the capital side. And I would argue that what we're trying to achieve is the ability for these loans to be sold in the secondary market at some point in some manner rather than create a cookie-cutter securitization product. This would support the free flow of capital. As a lender, I can replenish my balance sheet. I can reduce my reserve requirements. I can address an asset liability mismatch. I don't necessarily need to be able to standardize each loan to securitize them through a CMBS [commercial mortgage-backed security] conduit or through a federally guaranteed agency that puts it into a mortgage-backed security.

OCC: So you're saying that this small multifamily loan product is a square peg, not fitting the round holes of the government-sponsored enterprises (GSE). Please tell us more about your thinking here.

Narasimhan: An idea I've had for a very long time is that banks want and need to make these loans. Probably the right loan for this marketplace is actually a 10-year fixed-rate loan with a 25-year amortization. Most of the property owners do not need or want a much longer duration. After 10 years, banks tend to need to recycle capital. After 10 years, the properties themselves need renovation or capital improvements, probably because of the age. What if you could create an instrument so that after three years of seasoning this loan on your books, you could take it to [the] Federal Housing Administration? FHA, of course, would automatically give you 100 percent government guaranteed insurance. You insure that loan and ideally make it into a Ginnie Mae security. Or, after a period of seasoning where the loan actually performed and you maintained the servicing, and you then could keep that loan on your books or you could offload it directly into the secondary market with that government insurance or that government wrap. But you're not forcing the bank or institution to sell. You are reducing their risk weighting for regulatory capital and you're enabling them to continue to serve the same borrower base. That's what I mean by access to the secondary market. The ability to sell a loan can be differentiated from the ability to create pools of loans, to create a security and sell it. Most smaller financial institutions are never going to have the ability to create pools of loans.

OCC: So, is it really just a question of a lack of longer-term, fixed-rate financing that the small multifamily property sector needs?

Narasimhan: You put your finger on it. One product in the market is offered by J.P. Morgan Chase (which was formerly a WAMU [Washington Mutual] product), and it was a five-year instrument, fixed rate for the first five years, with one five-year rollover option.

We in the affordable housing community (especially nonprofits and advocates) have our own value system about how we think the market should operate. We think that a longer-term, fixed-rate mortgage would be better for these properties. We think non-recourse is better. When a commercial bank makes this loan, it tends to do it as a relationship borrowing exercise, which makes complete sense. The loan will tend to be at a floating rate and have the advantage of optionality in prepayment terms. So the bank is giving the borrower a lot of optionality. The securitization market requires less optionality, non-recourse, reserves being pledged, and, you know, significantly higher fixed underwriting costs.

So we, in the affordable housing community, have tried to push our value system on these loans, and it doesn't make sense. This is more driven by people saying, "We have a section of the market that is diminishing in size," which it is. "There is more attrition of units here. This is a valuable resource. We should do something about it, and we think the answer is to somehow figure out a way to do 10-year, fixed-rate loans for this market, and it'll become more stable." I think that may be the right product for this market if you could do a 10-year fixed-rate loan which could have limited prepayment optionality and then is open for prepay or very limited prepay restrictions after five years. But I don't know anybody who's going to buy that particular loan product in the securitization market. It doesn't fit, and it doesn't price very well. So that's why I keep saying the disconnect is we think we know an answer, but I'm not sure we've thought through what the problem is.

OCC: But the downside of a 10-year, fixed-rate product for our community banks is duration risk. And perhaps we need to acknowledge that some parts of this small multifamily market are not going to be served with longer-term financing since they are too small for the GSEs and thus not securitizable. Would you agree?

Narasimhan: Right. So, let me make two points here. One is the proposed FHA risk-sharing pilot, [which] requires 50 percent risk taking by a qualified community development financial institution [CDFI] will have difficulties becoming operational if the loan cannot be securitized with Ginnie Mae. Under the program [described elsewhere in this publication] if the CDFI makes a loan under the program, they get FHA insurance. And if the loan defaults, the CDFI would pay 50 percent of the claim.

However, legislation is needed in order for these loans to be able to be securitized with Ginnie Mae. I don't believe that legislation is likely to pass, at least in the near term, and there wouldn't be liquidity for the loan itself. These are not going to be held in a nonprofit sector, particularly by CDFIs, either because of the risk-sharing or because of the duration risk and because of the fact that they're not liquid instruments.

My other thought is that we should look more carefully at the 538 program that Rural Housing Service runs ([see sidebar 3, below](#)). The 538 program is the rural rental program. It's also largely small loans. It's a program with a 90/10 pari passu risk-share [90 percent of the loan is covered by a government guarantee, 10 percent is retained by a lender]. Reminds me of the old Freddie Mac 95/5 program, for single-family mortgage loans made by S&Ls.

OCC: Anything else you want to cover that we haven't talked about yet?

Narasimhan: Only to assert that this small multifamily market needs to become more professionalized. This will have a terribly positive effect on the small multifamily space by proving wrong all the people I've talked to who say, "No, no, it can never be made efficient." But those are the same people that said you can never do single family rental housing either. So if it works, which I strongly suspect it will, given the players and given the impetus and given the fact that this is core housing for the United States, it will help preserve this very important housing stock that is desperately needed. If the stock did not exist, it would create even more rent increases than we have seen, and people would then have no choice but to rent a large garden apartment in the suburbs. And that's why I keep suggesting the same thing, which is to give lenders access to the secondary market. Let them be the drivers of the decision. Give them the template for getting there so that when they load up, they can take appropriate action.

Some of these banks have billions of dollars of these loans. At some point in time, they will notice the extent of these loans and hear their boards and your [OCC] examiners say, "You're loaded up." They need an exit strategy when this time arrives. So I would say the rationale for a secondary market is very

solid. The rationale for using banks as the front lines to originate and service this product and make money off of it is fantastic.

For more information, [e-mail](#) Shekar Narasimhan.

HUD's New Multifamily Risk-Sharing Program

Theodore Toon, Director of the Office of Production, Office of Multifamily Housing Development, U.S. Department of Housing and Urban Development

Small buildings house a disproportionately large share of the nation's low-income renters and provide housing at rents more affordable than large buildings.¹ Yet this segment of the market is disproportionately underfinanced, even through U.S. Department of Housing and Urban Development (HUD) programs.² In addition, a disproportionately small percentage of the Federal Housing Administration (FHA) insured loans have been for small buildings. In FY 2012, just 5 percent of loans in the FHA new construction/substantial rehabilitation program (section 221[d][4]) were for small multifamily properties, and just 16 percent of FHA's loans in the refinance/moderate rehabilitation program (section 223[f]) were for small properties.³

Small buildings are home to more than 30 percent of the nation's renters, approximately 20 million households.⁴ Many of these properties are "naturally affordable," meaning that rents without rental assistance are typically more affordable to low- and moderate-income families than the rents in larger buildings.⁵ By supporting the financing of these kinds of properties with mortgage insurance, the FHA ensures that more affordable housing is available for these renters and their families and that rents can remain affordable into the future.

HUD's Office of Multifamily Housing has a long-standing history of supporting the development, preservation, and operation of market rate and affordable housing. In the past, HUD has supported affordable housing with FHA insured loans, and in some cases, with grants and subsidies to owners or tenants (often referred to as "assistance"). But now, HUD is embarking on a new strategy, focusing on financing for small multifamily buildings of between five and 49 units each. In late 2013, HUD published a Federal Register [notice](#) for public comment, announcing its intent to implement a Small Multifamily Building Risk-Share Initiative. This initiative expands support for small building financing, utilizing existing authorities within HUD's FHA. Corresponding legislation has been proposed by the Obama administration that would allow these risk-share loans to be securitized in Ginnie Mae mortgage backed securities. HUD received over 40 comments, which it has been aggregating, and expects to publish a final Housing Notice in 2015.

The majority of small multifamily properties are owned by individuals, and many others are owned by small businesses. Small owner entities, rather than institutional investors, own 77 percent of small buildings. In many cases, small multifamily properties are small businesses, creating jobs and opportunity in all kinds of communities. Generating more accessible financing streams for these owners preserves and creates more affordable units of housing—a priority for the Obama administration. With the lack of access to low-cost long term fixed rate financing, new investors are rarely drawn to play in this space, and owners are less likely to have access to conventional financing to make needed repairs and improvements.

Other than Fannie Mae and Freddie Mac to some degree, the federal government is largely absent in this space (see the [article](#) in this edition entitled "Secondary Market Options to Finance Small Multifamily Properties" by Sharon Canavan). This is one reason that HUD introduced the concept of a Small Multifamily Building Risk-Share Initiative that is a proposed extension of the FHA's existing Multifamily Risk-Sharing program authorized under section 542(b) of the National Housing Act. This initiative would

allow 50/50 risk sharing with community development financial institutions, mission-motivated lenders, or lending consortiums that originate and service mortgages on properties that have between five and 49 units or loan balances under \$3 million. The ultimate goal is to provide better access to financing to create more affordable rental housing for Americans.

For more information, [e-mail](#) James Carey, Office of Multifamily Housing Production.

¹ American Housing Survey, 2010.

² William Apgar and Shekar Narasimhan, “[Enhancing Access to Capital for Smaller Unsubsidized Multifamily Rental Properties](#),” March 2007.

³ HUD data.

⁵ American Community Survey, 2010.

⁵ Ibid.

Asset Management Training Opportunities for Rental Property Owners

David A. Fromm, Senior Curriculum Manager, Training, NeighborWorks America

Asset management has become a recognized housing industry term for the function provided to owners by skilled, experienced housing professionals who provide a critical connection between owners’ goals for their properties and the various operational challenges that confront owners. As has been discussed elsewhere in this publication, owners of small multifamily properties often seek to manage properties themselves. NeighborWorks America, in conjunction with Enterprise Community Partners and Local Initiatives Support Corporation, provides asset management training which may be useful to owners of small multifamily properties.



Source: NeighborWorks America. NeighborWorks America provides training for small property owners on asset management.

An Asset Management Designation

In 1994, NeighborWorks America joined with Enterprise Community Partners and Local Initiatives Support Corporation to create the Consortium for Housing and Asset Management (Consortium). The Consortium recognized that nonprofit asset management, like for-profit asset management, is difficult work and requires managers to be particularly skilled and sophisticated. Over time, to support all industry managers, the Consortium developed a designation program, the Certified Housing Asset Manager (CHAM). This CHAM program trains and recognizes professional capacity and benefits both professionals and their organizations. In addition, NeighborWorks/CHAM sponsors an annual conference focusing on cutting-edge asset management issues for property owners. These resources are available to help owners provide high quality, sustainable, and affordable rental housing that is a true community asset, whether the asset consists of small apartment buildings, usually defined as having five to 50 units, or much larger developments.

NeighborWorks America has also developed a series of other asset management courses designed to meet the developing needs of our national network of members, roughly 240 nonprofit organizations spread

across the country. These courses are also available for independent small property owners. The courses teach owners how to apply the basic concepts of asset management to their housing portfolios no matter how large or how small. Owners of small, medium, and large housing properties are trained to understand and apply the basic principles of asset management to meet the established ownership goals for a property.

The Curriculum

Overall, the NeighborWorks asset management curriculum identifies opportunities and systems for owners to provide proper oversight of the property manager through implementation of industry-accepted property performance standards. The curriculum teaches the basics of real estate financial analysis for owners to analyze the current financial status of a multifamily property and identify options for improving the property's financial performance. The curriculum includes a range of techniques to measure the profitability of multifamily real estate and options for refinancing a property's debt.

Through case study analysis and discussion of best practices, participants learn to identify and examine the different property management options available to best meet their organization's needs. Approaches to keep multifamily affordable rental stock healthy and energy efficient are provided. Special modules cover the specifics of managing real estate owned (REO) properties. REOs are usually owned by an investor, usually a bank.

Access to the Training

To meet the needs of our network members as well as to provide opportunities for training to the broader market, NeighborWorks America offers four National Training Institutes a year where participants can network and learn with peers at various locations across the country. In addition, sponsors may request specific locations and times for training events. We deliver place-based training events held anytime throughout the year depending on the request of the sponsor.

In addition to these events, we offer self-paced eLearning and virtual classroom courses that provide the opportunity to learn from the convenience of a home or office. (Only certain courses are available in this format.) And we are beginning to expand these online learning opportunities by building skills efficiently and cost-effectively through NeighborWorks eClassroom Express webinar training sessions.

As lenders to owners of small multifamily rental properties, banks may want to refer borrowers who may require additional training as asset managers to the NeighborWorks training program. Likewise, investor owners may want to increase their asset management skills by participating in this training.

For more information, [e-mail](#) David A. Fromm. Visit [NeighborWorks](#) for more information on accessing training.

USDA Section 538 Guaranteed Rural Rental Housing Loan Program

Description: This program seeks to increase the supply of affordable multifamily housing in rural areas through partnerships between the U.S. Department of Agriculture (USDA) Rural Development program and major lending sources, including national banks and federal savings associations. The program provides federal credit enhancement, in the form of 90 percent (maximum) guaranteed loans, to encourage lenders to make new loans for affordable rental properties that are located in rural geographies

and that meet the program's standards.

Lender eligibility: Lenders must be approved by the USDA to participate in the 538 program. Eligible lenders are typically already approved HUD/FHA, Fannie Mae, or Freddie Mac multifamily lenders, or Ginnie Mae. Or they could be state or local housing finance agencies. Members of the Federal Home Loan Bank System and other lenders also may be able to participate if they have demonstrated satisfactory multifamily lending experience and financial strength.

Project eligibility: 538 program funding can be used for multifamily projects with five or more units. The project must be located in a rural area. Loans can be used for (1) construction of new rental housing or (2) acquisition and rehabilitation of existing rural rental housing when there is at least \$6,500 of rehabilitation per unit involved. In connection with construction of new rental housing, the loan proceeds can be used for a variety of purposes, including land acquisition costs, landscaping, parking, and appliances. When the funds are used to rehabilitate existing housing, the proceeds can be used to cover loan fees and costs (including USDA fees), professional services, market study costs, developer fees, and construction interest. Acquisition or rehabilitation projects covered by the 538 program would include revitalization of existing rural rental housing projects under the USDA Rural Development's Section 515 loan program (which provides affordable rental housing to seniors, people with disabilities, and families).

Affordability restrictions: The USDA Rural Development program includes required tenant affordability criteria that must be established as a deed restriction for the full term of the loan, even if the loan is prepaid. First, tenants may not have incomes in excess of 115 percent of the area's adjusted median income (determined when the tenant is admitted). Second, the average monthly rent plus utility allowance cannot exceed 30 percent of the area's adjusted median income. Third, the maximum rent plus utility allowance cannot exceed 30 percent of 115 percent of the area's adjusted median income.

Loan size: This program does not establish a minimum loan size. Maximum loan size is the lesser of (1) for for-profit borrowers, up to 90 percent of the project's appraised value or 90 percent of the total development cost and (2) for nonprofit borrowers, Indian tribes, or public borrowers, up to 97 percent of the appraised value or 97 percent of the total development cost.

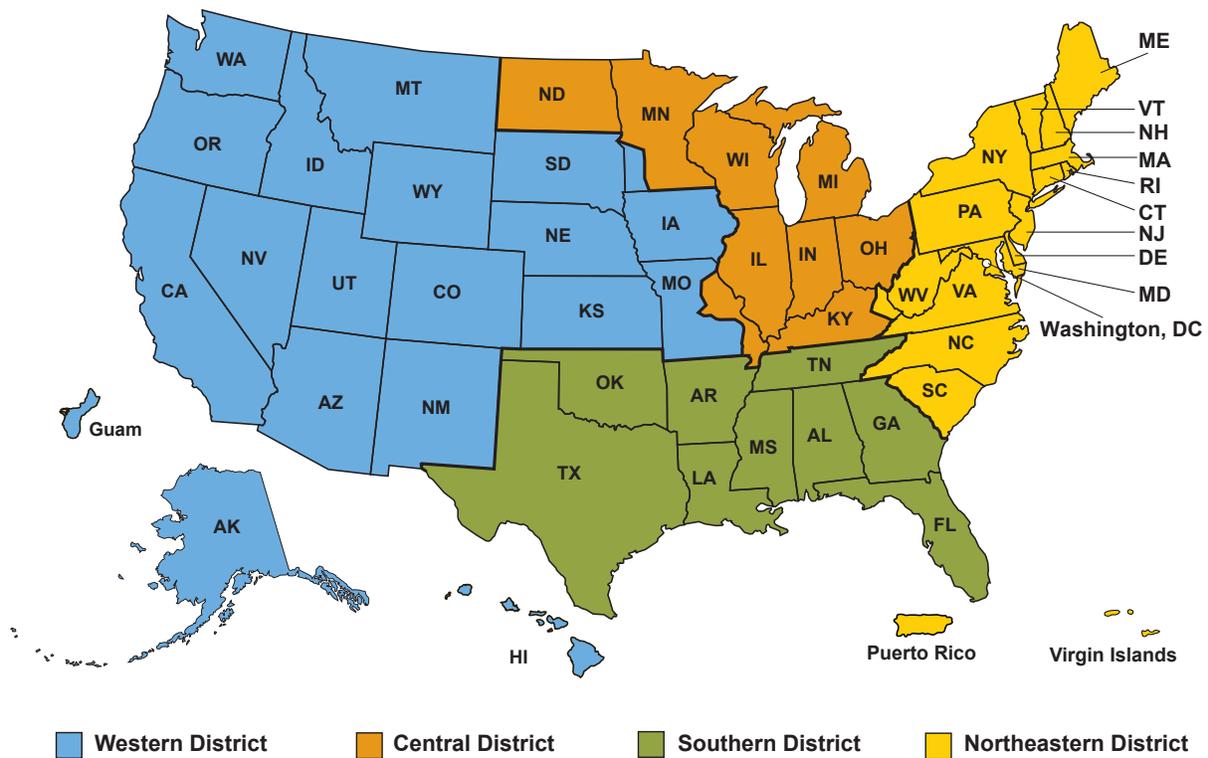
Lender benefits: Lenders may use their own forms, loan documents, and security instruments. Importantly, a secondary market exists for 538 guarantees through Freddie Mac, Fannie Mae, and Ginnie Mae. Additionally, the guaranteed portion (up to 90 percent) of the loan is protected against loss by a federal guarantee. Further, the guaranteed portion of the loan does not count against the lender's legal lending limits and can help lenders satisfy their Community Reinvestment Act requirements.

For more information, visit

[10.438—Section 538 Rural Rental Housing Guaranteed Loans](#)

Articles by non-OCC authors represent the authors' own views and not necessarily the views of the OCC.

Community Affairs supports the OCC's mission to ensure a vibrant banking system by helping national banks and federal savings associations to be leaders in providing safe and sound community development financing and making financial services accessible to underserved communities and consumers, while treating their customers fairly.



E-mail and telephone information for the OCC's District Community Affairs Officers is available at www.occ.gov/cacontacts.

Community Affairs

Office of the Comptroller of the Currency
Washington, DC 20219
(202) 649-6420
www.occ.gov/communityaffairs
www.occ.gov/cacontacts