- The multifamily rental vacancy rate in the third quarter of 2009 was 13.1 percent, up from 12.1 percent in the previous quarter and 11.0 percent in the third quarter of 2008. In contrast, the rental vacancy rate for single-family units was 9.9 percent in the third quarter of 2009, the same as in the second quarter but up from 9.4 percent in the third quarter of 2008. The vacancy rate for all rental units in the third quarter of 2009 was 11.1 percent, up from 10.6 percent in the second quarter and 9.9 percent in the third quarter of 2008.

Eye on Multifamily Housing Finance

Throughout what is likely to be known as the recession of 2007–09, much attention has been focused on the single-family housing market. This focus on single-family housing, in large part, is due to the economic distress that followed the rapid rise of subprime mortgage defaults to unprecedented levels, precipitating a loss of confidence in the nation's credit and finance markets that brought on declines in economic activity, wealth, and home prices, eventually increasing prime mortgage defaults and foreclosures to generational highs. Although the second and third quarters of 2009 have shown signs of recovery in single-family housing and the economy as a whole, it might surprise some to know that the multifamily housing sector has been subject to many of the same stresses that could bring on comparable difficulties in the coming quarters.

The 2007 American Housing Survey estimates the U.S. occupied housing stock to be 110.7 million units, composed of 78 percent single-family, 16 percent multifamily, and 6 percent manufactured or mobile homes.[1] Of the 110.7 million U.S. housing units, 68 percent are owner occupied, while 32 percent are renter occupied, with renters occupying primarily multifamily units (43 percent) followed by one- to four-family attached units (27 percent), single-family detached units (25 percent), and manufactured or mobile units (4 percent). Policymakers are concerned about the multifamily housing finance market because, among other reasons, a disproportionate share of people occupying multifamily housing units are households living below the poverty line, minority populations, and people with disabilities; thus, if multifamily housing conditions deteriorate, these populations may suffer disproportionately.[2]

During the years of rapid home price appreciation from 2004 through 2006 (and possibly into 2008 for multifamily housing), the aggressive underwriting standards that characterized the subprime home mortgage market were mirrored in the multifamily mortgage market. While subprime lenders used hybrid adjustable-rate mortgages (ARMs) and option ARMs to increase the ability of borrowers to afford higher priced single-family homes, some multifamily lenders employed pro -forma underwriting based on aggressive estimates of future earnings and 5- to 10-year, interest-only balloon and other short-term mortgages to support rising property prices in similarly overheated multifamily housing markets.[3]

U.S. multifamily mortgage debt totaled $914.3 billion and U.S. home mortgage debt totaled $10,951.1 billion at the end of the second quarter of 2009.[4] In the 3 years at the height of the subprime boom and home price bubble, 2004 through 2006, the dollar value of single-

family home debt grew at an annualized rate of 13.0 percent, while multifamily debt grew at an annualized rate of 9.6 percent. In the subsequent period, 2007 through 2008, however, single-family home debt grew at an annualized rate of 2.7 percent, while multifamily debt continued to grow at an annualized rate of 10.3 percent. The housing-price bubble, fueled in part by aggressive underwriting in the single-family market, continued in the multifamily sector even after the underwriting standards tightened in the single-family market in 2007.

As the economy contracted during the period from 2007 through 2009, home property prices declined and many single-family borrowers found themselves under water[5] and unable to refinance, which has led to an increase in foreclosures, repossessions, and distressed sales. The looser underwriting of home mortgages during the 2003–06 period did an abrupt turnaround beginning in 2007 as underwriting standards tightened and credit available from the conventional market became restricted to only the most creditworthy borrowers. This credit tightening occurred just as many adjustable rate subprime loans were resetting to higher rates. Unlike in previous years, borrowers were unable to refinance into new loans with similar low initial rates; thus, many borrowers were forced into default as their payments rose to unaffordable levels.

A parallel situation is now emerging in the multifamily mortgage market. Multifamily markets are now experiencing rising delinquencies and defaults as many multifamily property owners are unable to refinance their mortgages at today's tighter underwriting standards. Aggressively underwritten 5-year balloon mortgages that were originated from 2004 through 2007 and are maturing from 2009 through 2012 will face very tight credit markets. As happened in the single-family market, tight credit conditions have reduced demand by narrowing the pool of potential buyers, putting additional downward pressure on prices and valuations, and exacerbating the difficult refinancing conditions.

Evidence of the multifamily credit tightening is shown in Exhibit 1, which presents multifamily residential mortgage flows as seasonally adjusted annual rates through the second quarter of 2009, as reported in the Federal Reserve Board's Flow of Funds Accounts. The lowest rate of credit flows into the multifamily housing sector since 2005 occurred in the first and second quarters of 2009. Exhibit 1 shows that the highest flows by issuers of asset-backed securities and commercial banks occurred in 2007 and 2008, respectively, and, by the second quarter of 2009, the commercial bank share of flows was less than 1 percent and the asset-backed securities share was -18 percent. The total federal government share (federal government's share plus government-sponsored enterprises' [GSEs'—Fannie Mae's and Freddie Mac's] share) of flows was at its highest levels in the fourth quarter of 2008 and the first quarter of 2009, at 166 and 104 percent of total

Exhibit 1. Federal Reserve Board Flow of Funds Accounts

	2004	2005	2006	2007	2008	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2
All sectors multifamily	**53.2**	**70.7**	**55.4**	**99.0**	**58.0**	**71.8**	**65.3**	**61.4**	**33.6**	**11.2**	**25.6**
Households and nonprofit organizations	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Nonfarm nonfinancial corporate business	0.0	0.0	– 0.1	– 0.3	– 0.3	– 0.3	– 0.3	– 0.3	– 0.3	– 0.3	– 0.3
Nonfarm noncorporate business	1.6	1.9	– 0.5	2.0	0.8	1.4	0.8	0.8	0.1	– 0.8	– 0.9
State and local governments, less employee retirement funds	3.3	4.3	5.8	4.2	– 1.7	– 1.0	– 2.4	0.9	– 4.5	1.7	7.6
Federal government	0.4	0.0	– 0.2	– 0.3	1.8	– 0.5	1.1	2.7	3.7	– 7.3	– 0.1
Commercial banking	14.2	20.0	18.9	10.9	42.2	18.1	12.8	136.3	1.6	6.6	0.1
Savings institutions	9.6	10.8	– 2.6	– 3.1	– 27.5	7.5	9.3	– 126.9	0.0	2.1	2.5
Life insurance companies	1.9	2.0	3.6	5.8	– 0.1	0.3	0.2	0.2	– 1.0	– 2.3	– 1.7
Private pension funds	0.0	0.0	– 0.1	0.1	0.3	0.9	0.4	1.0	– 1.2	0.6	0.5
State and local government employee retirement funds	– 1.6	0.4	– 0.6	– 0.5	– 0.1	0.0	– 0.1	– 0.2	0.0	– 0.1	– 0.1
GSEs	14.3	10.5	12.4	42.3	40.4	40.1	40.8	46.0	34.8	12.9	13.1
Agency- and GSE-backed mortgage pools	2.9	3.9	2.1	15.7	13.6	13.7	13.0	10.4	17.4	6.0	11.5
Issuers of multifamily asset-backed securities less securitized REIT	6.5	16.6	14.0	22.1	– 11.0	– 10.3	– 11.5	– 9.8	– 12.2	– 6.2	– 4.6
Finance companies	– 0.1	0.0	– 0.5	– 0.1	0.8	1.8	1.7	2.8	– 3.3	– 0.8	– 0.4
REITs	0.1	0.3	3.1	0.2	– 1.3	– 0.1	– 0.5	– 2.7	– 1.8	– 1.0	– 1.6

GSE = government-sponsored enterprise. REIT = real estate investment trust.

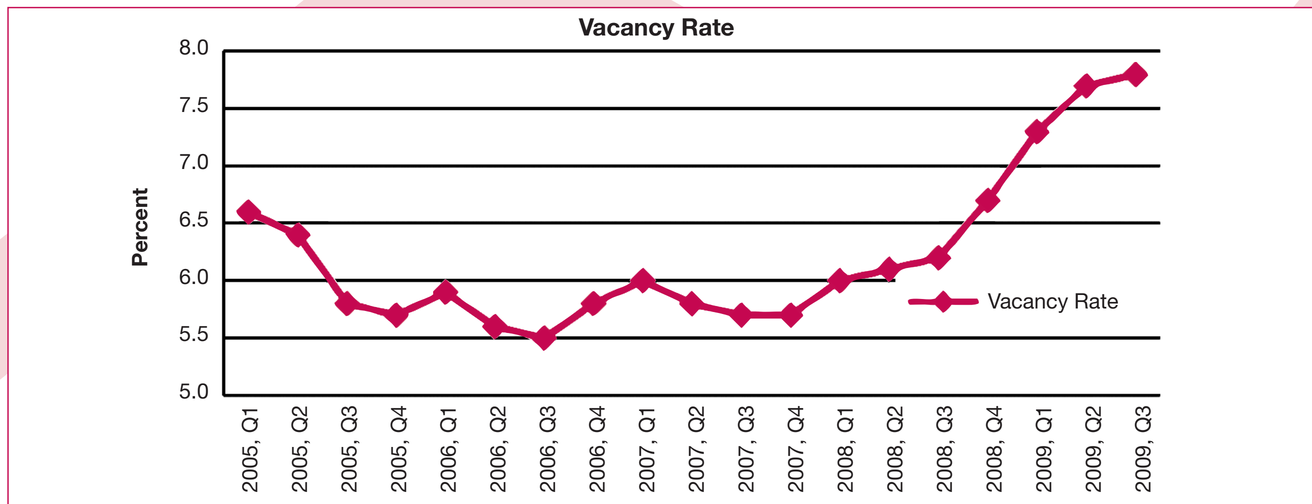
Notes: Billions of dollars. Quarterly figures are seasonally adjusted annual rates.

Source: Federal Reserve Board Flow of Funds Accounts

multifamily flows, respectively, at a time when other lenders were reducing multifamily credit.[6] Although multifamily housing is clearly constrained by the credit tightening and reduced flows, multifamily credit markets would be significantly tighter without the liquidity being provided by federal government institutions.

In addition to creating tight credit conditions, the deterioration in the U.S. economy has led to a decline in multifamily market fundamentals. Declining property cash flows and rising market capitalization rates are causing multifamily property values to decline.[7] Exhibits 2 and 3 show trends in multifamily vacancy rates and changes in multifamily rents. From 2005 through the first part of 2008, vacancy rates were stable and rents were rising. Since the end of 2008, however, vacancies have risen to record 20+ year highs and rents have fallen. The multifamily vacancy rate in the third quarter of 2009 was 7.8 percent, an increase of more than one-third over the vacancy rate in the fourth quarter of 2007. Exhibit 3 presents trends in the quarter-to-quarter change in asking rents and effective rents.[8] Asking and effective rents were increasing from the first quarter of 2005 through the third quarter of 2008; however, the quarterly change in rents has been declining since the third quarter of 2008 and, since the fourth quarter of 2008, the quarterly change in both asking and effective rents has been negative. The rising vacancies and declining rents have combined to reduce property cash flows (net operating income).

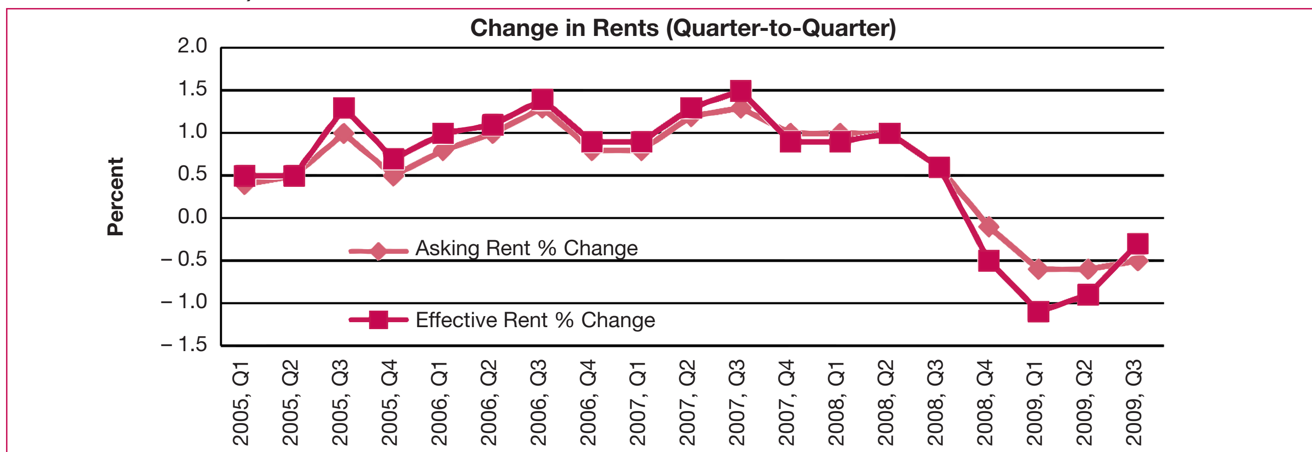
Exhibit 2. Multifamily Vacancy Rates



Note: The Reis database includes competitive rental apartment properties in complexes with 40 or more units (20+ units in California and Arizona). Although the database also may contain selected condominium, co-operative, student apartment, senior housing, rent-stabilized, and subsidized properties, these are excluded from inventory, completions, and all other Reis rental apartment statistics.

Sources: Reis, Inc.; U.S. Department of Housing and Urban Development

Exhibit 3. Multifamily Rents



Sources: Reis, Inc.; U.S. Department of Housing and Urban Development

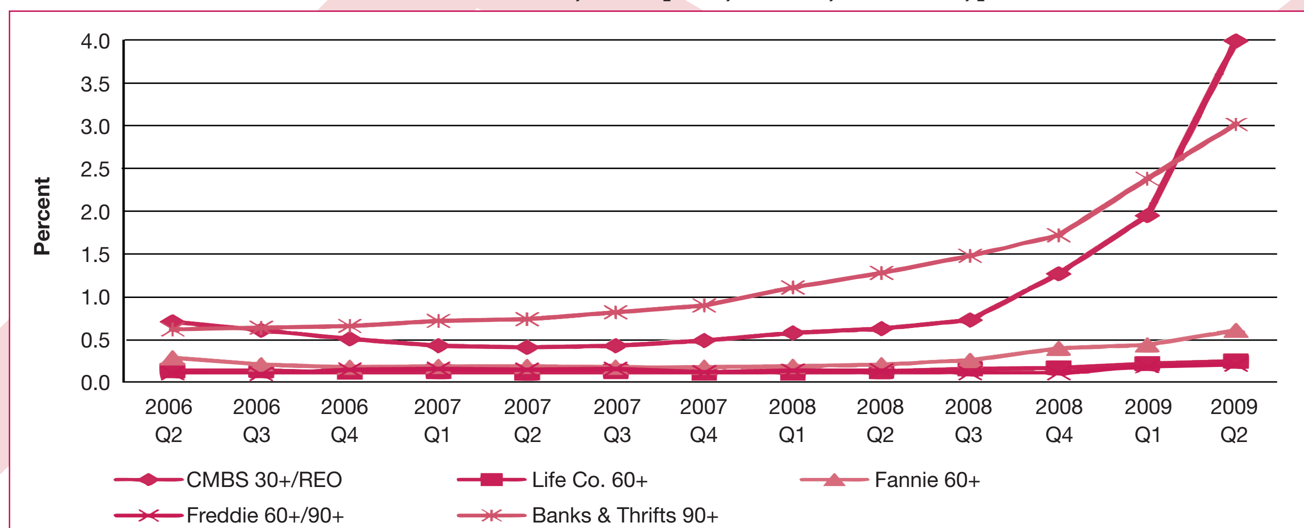
Along with the falling cash flows, the decreased demand for properties, due to tighter underwriting and uncertainties about the future of the economy, has caused investors in the small number of sales that have occurred to demand higher yields, raising market capitalization rates. The result has been estimated price declines of commercial real estate/multifamily properties of 25 to 45 percent, according to Deutsche Bank AG, Mortgage Bankers Association (MBA), and Moody's Investors Service. The only good news in Exhibits 2 and 3 is that, in the most recent quarter, the vacancy rate grew at a slower pace than in the previous three quarters, the percent change in asking rents declined less than in the previous two quarters, and the percent change in effective rents declined less than in the previous three quarters.

The tight underwriting, rent declines, vacancy increases, and price declines have, unsurprisingly, led to an increase in multifamily mortgage defaults. Exhibit 4 presents commercial real estate and multifamily delinquency rates from the second quarter of 2006 through the second quarter of 2009 for five investor types—commercial mortgage-backed securities (CMBS), Life Insurance Companies, Fannie Mae, Freddie Mac, and banks and thrifts—as reported in the MBA Commercial Real Estate and Multifamily Quarterly Data Book for the second quarter of 2009.[9] Delinquency rates, which are reported differently for the five investor types, are not comparable across investor class. The trend in delinquency rates, however, is clear. From 2006 through 2007, delinquency rates remained below 1 percent for all investor types. Beginning in 2008, however, delinquencies turned sharply higher for CMBS and banks and thrifts, rising from 0.61 to 3.89 percent for CMBS and from 0.52 to 2.92 percent for banks and thrifts. The GSEs' delinquency rates remained low over the entire period. At the end of the second quarter of 2009, Freddie Mac had a 0.11 percent, 90+ day delinquency rate and Fannie Mae had a 0.51 percent, 60+ day delinquency rate.

Rising multifamily delinquencies cause concern for a number of reasons. Similar to delinquencies in the single-family housing market, multifamily properties that become delinquent on their mortgages and/or are foreclosed upon often have postponed maintenance, meaning that tenants' living conditions deteriorate relative to tenants living in properties that are current on their mortgage debts. While foreclosure of a single-family home creates hardships for one family in terms of loss of home, multifamily foreclosures create hardships of a different nature for many families.

The current tight credit markets and the difficult refinancing environment that many multifamily property owners face also cause concern that multifamily properties may continue to operate for long periods of time under the cloud of potential default, foreclosure, extended periods of deferred maintenance, and deteriorating property conditions. This additional concern has arisen from an increasing incidence of loan servicers extending the maturity dates of multifamily mortgages for property owners who are unable to refinance maturing balloon loans, rather than initiating foreclosure. Even when foreclosure is initiated, the foreclosure process can take 6 months to a year, or longer, to be completed. Exhibit 5 presents performance metrics for multifamily loans in CMBS tracked by the firm of Trepp, LLC, at the

Exhibit 4. Commercial Real Estate and Multifamily Delinquency Rates by Investor Type



Note: Delinquency is defined as follows: Commercial mortgage-backed securities (CMBS)—30+Days Delinquent or Bank Real Estate Owned (REO); Life Insurance Companies—60+Days Delinquent; Fannie Mae—60+Days Delinquent; Freddie Mac—60+Days Delinquent before June 2008, 90+Days Delinquent in June 2008 and thereafter; banks and thrifts—90+Days Delinquent.

Sources: Mortgage Bankers Association; U.S. Department of Housing and Urban Development

end of the third quarter.[10] Exhibit 5 has four sections: (1) overall portfolio performance (delinquencies by category), (2) foreclosure starts, (3) bank real estate owned (REO), and (4) watchlisted loans. Of the 24,194 multifamily loans in the Trepp database, nearly 96 percent are current, but 1.32 percent are 90 or more days delinquent, 0.84 percent are in foreclosure, 0.49 percent are REO, and 14 percent are on the watchlist.[11] The stable foreclosure and REO numbers in conjunction with the rapid growth of loans on the watchlist in first three quarters of 2009 may be evidence of future problems or evidence of servicers extending maturity dates on loans that mature and are unable to refinance.

The trend toward extending maturing loans unable to refinance is also an issue for loans held in bank portfolios, particularly for small- to medium-sized regional banks. Due to a smaller share of short-term balloon loans held by the GSEs, Fannie Mae and Freddie Mac, maturity defaults and term extensions are less of a problem for these two agencies. They are not an issue for the Federal Housing Administration (FHA) because FHA multifamily loans are typically long-term (30- to 40-year), fully amortizing loans.

Although the multifamily housing market clearly has many stresses to contend with, the sector may get some relief from the recovery of the U.S. economy. On November 24, 2009, the Bureau of Economic Analysis released the second estimate of third quarter 2009 real gross domestic product (GDP) growth, which was estimated to have increased by 2.8 percent, as compared with the GDP in the second quarter of 2009, which decreased by 0.7 percent.[12] The robust GDP growth may signal that the economic recession that began in December 2007 is nearing its end. Although economic output has resumed positive growth, nonfarm payroll employment continued on a downward trend through October 2009. On November 6, 2009, the Bureau of Labor Statistics reported that nonfarm payroll employment declined in October (down 190,000 jobs), the ranks of the unemployed rose to 15.7 million, and the unemployment rate rose to 10.2 percent.[13] Thus, the growing ranks of the unemployed and the growth in labor underutilization reported through October 2009 will likely suppress housing demand over the next few quarters.

The economic recovery appears to have reached the single-family housing market, which received a boost from the many federal government efforts to support housing demand, including the American Recovery and Reinvestment Act of 2009's $8,000 first-time homebuyer tax credit, continued low interest rates, and the Federal Reserve's quantitative easing policies that

Exhibit 5. Trepp Multifamily Loan Performance for the Third Quarter of 2009

Trepp Multifamily Loan Data								
Overall Portfolio Performance								
	Total	**30–59 Days DQ**	**60–89 Days DQ**	**90+ Days DQ**	**Nonperforming Matured Balloon**	**In Foreclosure**	**REO**	**Current**
Loan count	24,194	186	87	320	74	203	118	23,206
Percent share	100.00%	0.77%	0.36%	1.32%	0.31%	0.84%	0.49%	95.92%
Foreclosure Starts								
	Total	**Prior to 2008**	**2008**	**2009 Q1**	**2009 Q2**	**2009 Q3**		
Loan count	287	25	81	58	61	62		
Percent share	100.00%	8.71%	28.22%	20.21%	21.25%	21.60%		
Bank Real Estate Owned (REO)								
	Total	**Prior to 2008**	**2008**	**2009 Q1**	**2009 Q2**	**2009 Q3**		
Loan count	118	16	53	18	16	15		
Percent share	100.00%	13.56%	44.92%	15.25%	13.56%	12.71%		
Watchlist								
	Total	**Prior to 2008**	**2008**	**2009 Q1**	**2009 Q2**	**2009 Q3**		
Loan count	3,401	854	880	285	614	768		
Percent share	100.00%	25.11%	25.87%	8.38%	18.05%	22.58%		

DQ = delinquent. REO = Real Estate Owned.
Sources: Trepp, LLC; U.S. Department of Housing and Urban Development

included purchases of $1 trillion in Fannie Mae- and Freddie Mac-issued mortgage-backed securities (MBS). As of September 2009, the S&P/Case-Shiller® 10- and 20-city composite Home Price Indices recorded annual declines of 8.5 percent and 9.4 percent, respectively, continuing the trend of improvements over the previous month that has occurred in each month since the beginning of the 2009.[14] In addition, the NATIONAL ASSOCIATION OF REALTORS® (NAR) reported that existing home sales increased to a seasonally adjusted annual rate of 6.10 million units in October 2009, an increase of 23.5 percent over the 4.94 million-unit pace in October 2008 and the highest level in more than 2 years since it hit 6.55 million in February 2007.[15] NAR also reported that distressed homes accounted for 30 percent of October transactions and that first-time homebuyers accounted for one-third of October home sales. Conversely, the third quarter 2009 MBA Survey of Commercial/Multifamily Originations reported that commercial and multifamily mortgage originations were 12 percent lower than they were during the second quarter of 2009 and were 54 percent lower than in the third quarter of 2008. Multifamily originations declined 40 percent year-over-year and declined 17 percent quarter-over-quarter.[16] Many housing analysts have noted that a key to the recovery of the single-family and multifamily housing markets is increasing demand and liquidity in the market and decreasing excess supply, both of which appear to be happening in the single-family market but not yet in the multifamily market. In fact, the American Recovery and Reinvestment Act of 2009's $8,000 tax credit for qualified first-time homebuyers has been credited with helping the single-family housing market begin to recover and may have hindered the multifamily recovery by reducing demand for rental units.

In addition to the support housing markets will receive as the economy continues to grow, several government agencies are currently providing liquidity for multifamily rental housing. At a time when the CMBS market has shut down and banks and insurance companies have sharply curtailed credit, the FHA and Ginnie Mae continue their respective multifamily programs that combine to insure multifamily loans and to guarantee MBS backed by these loans. FHA-insured multifamily loans typically have terms of 30 years or longer. In addition, Fannie Mae and Freddie Mac continue to purchase multifamily loans, primarily for their portfolios. Most GSE multifamily loans are 10-year term loans amortizing on a 30-year schedule, but many GSE-held multifamily loans have longer terms. The agency multifamily portfolios should perform relatively well due to underwriting standards, which remained relatively constant, and from the lower share of their business projected to mature during the next several years, requiring refinancing in this tight credit market.

Conclusions

Multifamily housing provides approximately 16 percent of the occupied housing units in the United States, with households living below the poverty line, minority populations, and people with disabilities occupying a disproportionate share of the multifamily housing stock. The pressures on multifamily property owners and property managers—tight credit markets, rising vacancies, falling rents—mean that policymakers at local, state, and federal levels must carefully monitor developments in multifamily housing markets and possibly increase government initiatives that support multifamily housing to ensure that tenants are fairly treated and continue to have high-quality rental options. Although there is reason for concern, there is also cause for optimism, both attributed to the signs of economic recovery that are now appearing and to the stability that the federal government provides through the Federal Reserve Board, the FHA, and the GSEs.

Notes

[1] Note: Single-family home is defined as any structure with one to four housing units and multifamily home is defined as any structure with five or more housing units.

[2] http://www.census.gov/hhes/www/housing/ahs/ahs07/ahs07.html.

[3] Hybrid ARMs were predominantly 2-28 (3-27) mortgages that had a fixed rate for 2 years (3 years), generally at a relatively low interest rate, which reset and became adjustable after the introductory period to a higher rate that fluctuated. Option ARMs are mortgages that offer the borrower several payment options that often include (1) a fully amortizing mortgage payment, (2) an interest-only mortgage payment, and (3) a minimum payment that covers only part of the accrued interest and adds the unpaid portion to the principal balance. An interest-only balloon mortgage is a mortgage on which the borrower pays only interest for the term of the mortgage and repays the entire original principal balance at maturity.

[4] http://www.federalreserve.gov/releases/z1/Current/.

[5] A property is under water when the owner owes more on his or her mortgage obligations than the property is worth.

[6] The total government share of multifamily mortgage flows can be greater than 100 percent because 7 of the remaining 12 funding sources had negative multifamily mortgage flows in the second quarter. That is, 7 sources sold or disposed of more multifamily mortgage debt than they purchased.

[7] The capitalization rate on a property sale is the ratio of net operating income (NOI) to sales price (value). Investors seeking higher yields on equity invested will reduce the portion of NOI devoted to debt service and thereby reduce the price they are willing to pay for a property. Market capitalization rates are averages based on actual sales that have been observed in the market. Dividing any multifamily property's NOI by the market capitalization rate provides a contemporaneous estimate of that property's value. Thus, rising market capitalization rates put downward pressure on property values.

[8] Asking rents are the advertised rental rates. Effective rents are the actual rents received by the property manager net of concessions, such as waived security deposit or free first month's rent: that is, asking rent – rental concessions = effective rent.

[9] http://www.mortgagebankers.org/files/Research/DataBooks/2Q09QuarterlyDatabook.pdf.

[10] http://www.trepp.com/.

[11] The master servicer for each CMBS pool adds and removes loans from the watchlist based on an assessment of whether a loan has failed to satisfy certain triggers, which include financial conditions, property conditions, and maturity.

[12] http://www.bea.gov/.

[13] http://www.bls.gov/.

[14] http://www.standardandpoors.com/.

[15] http://www.realtor.org/.

[16] http://www.mortgagebankers.org/tools/FullStory.aspx?ArticleId=8780.