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The Federal Role in the Financing of Multifamily Rental Properties

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Notes

Unless otherwise indicated, all years referred to in this report are federal fiscal years, which run from October 1 to September 30 and are designated by the calendar year in which they end.

Numbers in the text and tables may not add up to totals because of rounding.

Cover photograph by Maureen Costantino.

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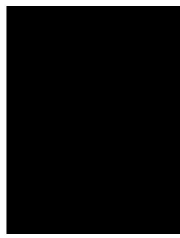


The Federal Role in the Financing of Multifamily Rental Properties

Summary

Multifamily properties—those with five or more units—provide shelter for approximately one-third of the more than 100 million renters in the United States and account for about 14 percent of all housing units. Mortgages carrying an actual or implied federal guarantee have been an important source of financing for acquiring, developing, and rehabilitating multifamily properties, particularly after the collapse in house prices and credit availability that accompanied the 2008–2009 recession. According to the Federal Reserve, the share of outstanding multifamily mortgages carrying such a guarantee increased by 10 percentage points, from 33 percent at the beginning of 2005 to 43 percent at the end of the third quarter of 2014. (A slightly larger increase of about 16 percentage points occurred in the federal government's market share of the much larger single-family market.) Such guarantees are made by a variety of entities, and some policymakers are looking for ways to make the federal government's involvement more effective. Other policymakers have expressed concern about that expanded federal role and are looking at ways to reduce it.

What Are the Pros and Cons of Federal Support of the Multifamily Mortgage Market?

The federal government's support of the multifamily mortgage market is one of many federal policies aimed at providing support for rental housing for low- and moderate-income families. Mortgage guarantees made by the Federal Housing Administration (FHA), the Rural Housing Service (RHS), and Fannie Mae and Freddie Mac—the two large government-sponsored enterprises (GSEs) that have been operating under federal control since 2008—increase the availability of mortgage credit. They do that primarily by insuring investors who buy mortgage-backed securities (MBSs) against losses that they would incur if the mortgage borrowers—whose mortgage loan payments provide the cash flows for those securities—defaulted. Those loan guarantees help to provide liquidity and stability to the market for those mortgages, particularly during periods of stress. They also lower the cost of financing multifamily housing projects slightly, because the fees the borrowers pay for their guarantees are lower than what a private guarantor would charge.

Providing such benefits through federal credit guarantees has several drawbacks, however. Loan guarantees could expose the federal government to potentially large losses if many multifamily loans defaulted. In addition, actual or implied federal loan guarantees may encourage excessive risk taking by insulating lenders and investors from losses on investments they would not make without the guarantee. Such guarantees slightly increase the large subsidies that favor housing over other types of investment, resulting in a slightly less productive allocation of capital resources in the economy. Furthermore, although the lower development costs made possible by government guarantees may be passed along to renters in the form of lower rental rates, the reduction is probably small.

What Are the Budgetary Costs of Federal Guarantees of Multifamily Mortgages?

Federal loan guarantees can generate very different budgetary effects depending on the accounting method used to value them. The Congressional Budget Office estimates that new loan guarantees issued by FHA and RHS in 2016 for multifamily mortgages will generate budgetary savings of about $386 million over their lifetime if the projected budgetary effects are calculated

using the procedures delineated in the Federal Credit Reform Act of 1990 (FCRA) or costs of about $334 million if they are calculated on a fair-value basis.[1]

Both estimates are based on the same projections of cash flows for those credit programs; the difference between them stems from the discount rates used to convert the projected cash flows to a present value.[2] FCRA requires that a program's cash flows be discounted using the rates on Treasury securities of comparable maturity to the cash flows of the program. Fair-value estimates also include the cost of market risk, which can be expressed as an adjustment to the discount rate to reflect the premium one would have to pay an investor to take on the market risk of a loan guarantee.[3] The fair-value estimate approximates the price that the federal government would need to pay a private insurer to make loan guarantees on the same terms as FHA's and RHS's. Because those fair-value estimates incorporate a charge for market risk, they provide a more comprehensive measure of the costs of guarantees than do FCRA estimates.

CBO also projects federal budgetary costs for Fannie Mae and Freddie Mac. Since 2008, when those two GSEs were placed into conservatorship by the government, CBO has treated them as governmental for budgetary purposes and estimated the cost of their credit guarantees as if they were provided directly by the federal government. Unlike explicitly federal credit programs, whose budgetary effects are estimated under FCRA, the budgetary effects of the GSEs' activities are estimated on a fair-value basis in CBO's budget projections.[4]

On that basis, the GSEs will generate a budgetary cost to the government of about $129 million in 2016 for their multifamily loan guarantees, CBO estimates, reflecting a subsidy rate (the loans' lifetime cost divided by the amount of credit extended) of 0.2 percent. In comparison, CBO projected a fair-value subsidy rate of 0.4 percent for the GSEs' single-family guarantee operations for 2016 in its August 2015 baseline. The fair-value subsidy rate for the GSEs' multifamily loan guarantees is smaller because the fees they charge are estimated to be closer to those charged in comparable private transactions. In addition, in their multifamily operations, the GSEs require private lenders and investors to assume a larger share of any losses incurred on the mortgages they guarantee through a variety of risk-sharing mechanisms.

How Might the Federal Role in the Multifamily Mortgage Market Be Changed?

Policymakers could attempt to make the federal role in the multifamily market more efficient or reduce it by shrinking or eventually closing the GSEs' multifamily operations and modifying the federal government's explicit credit programs for that market. In a previous report, CBO identified four broad approaches to modifying the federal role in the single-family mortgage market.[5] Those same approaches could be applied in the multifamily market.

1. The subsidy costs provided in this report are based on estimates of expected future cash flows from loan guarantees. The actual cash flow from a loan guarantee cannot be determined until the loan subject to that guarantee has been repaid fully or the costs associated with paying a claim against the guarantee have been realized. Those cash flows will be the same regardless of the procedure used to estimate subsidy costs, as will the net impact of those programs on the federal debt. When subsidy estimates are used in the budget, as they are for federal credit programs under FCRA, the difference between projected costs and realized cash flows is reconciled through reestimates (which appear as federal outlays) or other means of financing (which are not federal outlays). For more details of how those amounts appear in CBO's budgetary projections, see Congressional Budget Office, *Federal Debt and Interest Costs* (August 2015), pp. 11–12, www.cbo.gov/publication/21960.
2. The present value of a flow of revenues or outlays over time is a single number that expresses that flow in terms of an equivalent lump sum received or paid at a specific time. The present value depends on a rate of interest (the discount rate) that is used to translate past and future cash flows into current dollars.
3. Market risk, which is one component of financial risk, is the risk that remains even after a portfolio has been diversified as much as possible. Loan guarantees have market risk because borrowers tend to default more frequently when the economy as a whole is weak and, hence, their risk cannot be eliminated through diversification. For further discussion, see Congressional Budget Office, *Fair-Value Accounting for Federal Credit Programs* (March 2012), www.cbo.gov/publication/43027.
4. For an explanation of CBO's budgetary treatment of the GSEs, see the testimony of Deborah Lucas, Assistant Director for Financial Analysis, Congressional Budget Office, before the House Committee on the Budget, *The Budgetary Cost of Fannie Mae and Freddie Mac and Options for the Future Federal Role in the Secondary Mortgage Market* (June 2, 2011), www.cbo.gov/publication/41487. As discussed later in this report, the Office of Management and Budget does not consider the GSEs to be governmental entities and thus records their transactions with the Treasury on a cash basis.
5. For a discussion of options for modifying the GSEs' role in the single-family mortgage market, see Congressional Budget Office, *Transitioning to Alternative Structures for Housing Finance* (December 2014), www.cbo.gov/publication/49765.

- *Fully Federal Agency.* A federal agency would replace the role played by the GSEs and provide an explicit federal guarantee for all credit losses on the mortgages that it insures.
- *Hybrid Public/Private Approach.* Private firms would cover initial losses and a federal agency would absorb the remainder of losses by providing a partial guarantee on some of the mortgages issued in the multifamily market.
- *Federal Guarantor of Last Resort.* A federal agency would provide a full credit guarantee to a small share of the market during normal economic conditions and to a larger share of the market during periods of economic stress.
- *Largely Private Approach.* A federal agency would provide a full guarantee on only a portion of FHA's and RHS's loan guarantees projected under current law; all other multifamily mortgages would be provided by private firms without federal guarantees.

In each of those approaches, Fannie Mae and Freddie Mac could have the multifamily portion of their operations made either explicitly public under the aegis of a federal agency or explicitly private, through privatization or liquidation. The remaining federal agencies (some of which might be consolidated) could target some or all of their guarantees toward multifamily rental properties for households with low incomes, as they do today. Because the single-family and multifamily loan guarantees offered by FHA, RHS, and the GSEs are designed to support different policy objectives—homeownership in the case of single-family guarantees and adequate, affordable rental properties for multifamily loan guarantees—policymakers might modify the two markets differently.

The impact of the four approaches on the availability of mortgage credit during periods of economic stress would depend largely on the degree to which each relied on a federal guarantee. A fully federal agency would provide the most federal support to the market, and the largely private approach would provide the least. The effect of a government guarantee on credit availability under the hybrid public/private and federal guarantor of last resort approaches would be more complex. In normal economic conditions, the government guarantor in a hybrid public/private approach would offer guarantees on more loans than a guarantor of last resort. However, as the guarantor of last resort, the government would increase its share of guarantees in times when that guarantee could be most valuable to the market and most costly to the government.

What Would Each Approach Cost?

The cost of each approach relative to what would be expected under current law could vary considerably depending on the details of its implementation and the budgetary treatment used. To provide illustrative estimates of the cost of each approach, CBO analyzed the budgetary effects in 2020, by which time CBO assumed the transition would be complete (see Figure 1). CBO estimated the costs of mortgage guarantees under two approaches: using a fair-value basis consistently for all guarantees and using current budgetary procedures (a FCRA basis for all explicitly federal programs and a fair-value basis for the GSEs).[6]

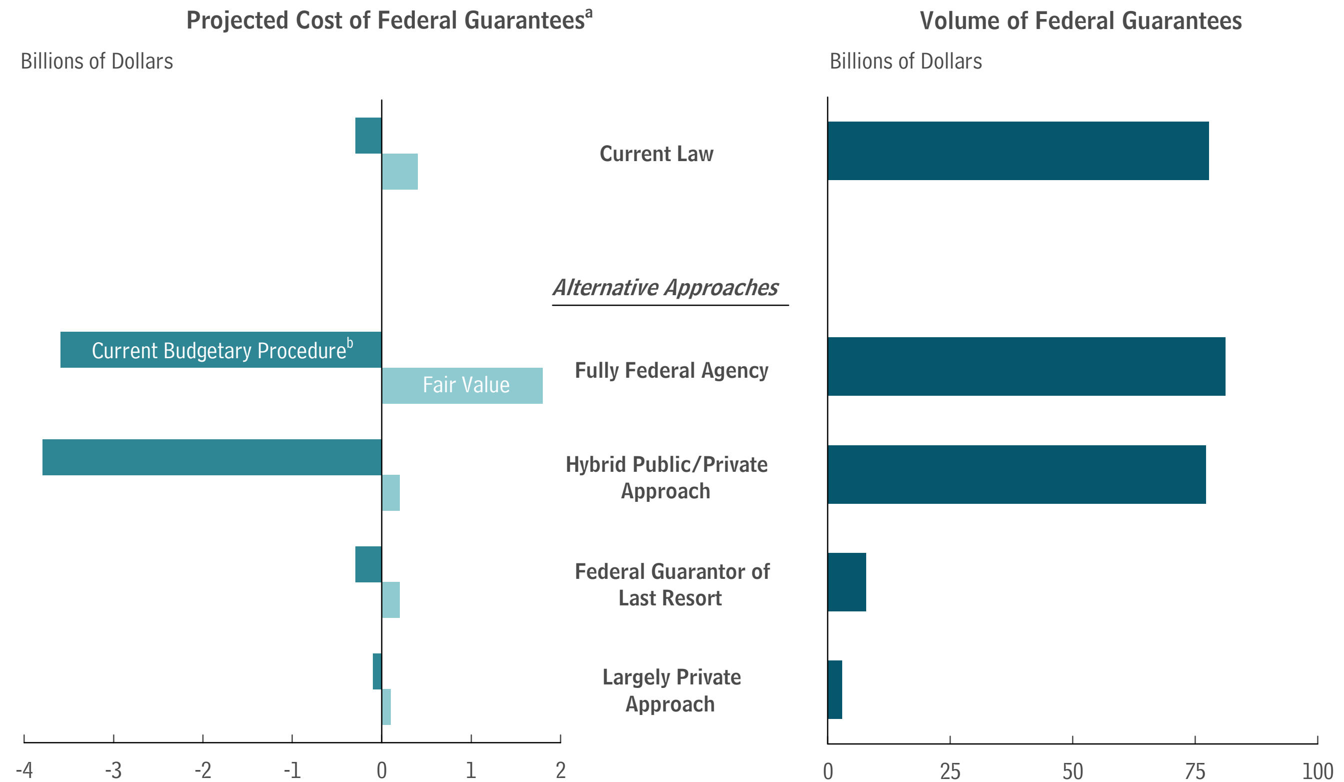
For the implementation of the *fully federal agency*, CBO assumed that mortgages that formerly carried a partial guarantee from the GSEs would instead carry a full federal guarantee with loan terms and subsidy rates similar to those of a representative loan in one of FHA's programs. The higher subsidy rate and the availability of longer-term fixed-rate financing would increase the market share of mortgages carrying a federal guarantee. Thus, on a fair-value basis, estimated total federal costs would increase relative to estimated costs under current law. However, if the costs of existing federal agencies and the new agency were estimated under FCRA, total estimated budgetary costs under the new system would be lower than under current law, primarily because GSE-guaranteed mortgages that have a cost on a fair-value basis would be replaced with federal mortgage guarantees that produce projected savings under FCRA.

For the *hybrid public/private* approach, CBO assumed that guarantee fees and loss coverage on loans formerly guaranteed by FHA and RHS would be reduced to match those for the GSEs' existing partial guarantee, which offers recipients a less generous subsidy. That change would slightly reduce the projected dollar volume of mortgages carrying a government or GSE guarantee. The change would produce estimated savings under both

6. When CBO prepares cost estimates for legislative proposals related to those programs, it includes not only estimates that reflect its current budgetary procedures but also estimates calculated on a fair-value basis. The latter estimates are required by section 3105 of the Concurrent Resolution on the Budget for Fiscal Year 2016, S. Con. Res. 11.

Figure 1.

Cost and Volume of Federal Guarantees for Multifamily Mortgages Under Current Law and Alternative Approaches, 2020



Source: Congressional Budget Office.

Notes: Under current law, FHA offers a full guarantee on credit losses, RHS offers a 90 percent guarantee, and the GSEs offer a partial guarantee on credit losses.

Under the approach that would create a fully federal agency, that agency would offer guarantees on credit losses like those currently provided by FHA or RHS. Fees would be set to yield a target subsidy rate equal to that of FHA's existing development and refinancing programs. The volume of loans at a new federal agency would increase by 5 percent of the GSEs' volume as a result of offering a full guarantee on longer-term fixed-rate loans with a higher subsidy.

Under the hybrid public/private approach, a new federal agency would offer a partial guarantee on credit losses. Fees would be set to yield a target subsidy rate equal to that of the GSEs' existing guarantees. The volume of loans at a new federal agency would decrease by 5 percent of FHA's and RHS's volume as a result of offering a partial guarantee on generally shorter-term and variable-rate loans with a lower subsidy.

Under the approach that would make the federal government the guarantor of last resort, a new federal agency would offer a full guarantee on credit losses. Fees would be set to yield a target subsidy rate equal to that of FHA's existing development and refinancing programs. Ten percent of the loans guaranteed by FHA and RHS would be fully or 90 percent guaranteed by a new federal agency. Ten percent of the loans guaranteed by the GSEs would be converted to full guarantees of the new federal agency (similar to FHA's).

Under the largely private approach, a new federal agency would offer a guarantee on credit losses, and fees would be set to yield a target subsidy rate equal to that of FHA's existing development program. Twenty-five percent of the loans guaranteed by FHA and RHS to finance the development of new multifamily units would be fully or 90 percent guaranteed by a new federal agency. The federal government would no longer offer FHA guarantees to refinance existing units and GSE guarantees.

FCRA = Federal Credit Reform Act; FHA = Federal Housing Administration; GSE = government-sponsored enterprise; RHS = Rural Housing Service.

a. Positive values indicate budgetary costs; negative values indicate budgetary savings.

b. The projected budgetary cost of guarantees issued by FHA, RHS, or a new federal agency is based on FCRA methodology. The projected cost of guarantees issued by Fannie Mae and Freddie Mac is based on fair-value methodology.

budgetary treatments, but the savings under FCRA would be considerably larger because of the switch in treatment for loans formerly guaranteed by the GSEs.

For the *federal guarantor of last resort* and the *largely private* approaches, a significantly smaller share of mortgages would carry a federal guarantee. The fees and terms on those guarantees would be similar to those in existing credit programs under current law. That reduction in federally guaranteed mortgages would produce estimated savings on a fair-value basis but estimated net costs under the current budgetary treatment, because the FCRA savings from loans guaranteed by FHA and RHS under current law would be reduced. For the guarantor of last resort, CBO's estimates of the dollar volume and cost include the potential effect of an increase in the share of mortgages that may be guaranteed by the agency in a crisis; the government would increase its share of guarantees significantly once every 40 years and moderately once every 10 years, CBO projects. In all other years, CBO projects, the agency would maintain a 5 percent share of the total market. On average, the government would maintain a 10 percent share.

Overview of the Multifamily Rental Housing Market

Properties with five or more units, called multifamily properties, provide shelter for more than one-third of the renters in the United States. They include apartment buildings, condominiums, housing for senior citizens, and housing cooperatives. The federal government supports rental housing, including multifamily housing, through payments made to renters and property owners and tax incentives for developing low-income housing.[7] The federal government also supports rental housing, and housing more broadly, through federal credit programs administered by the Federal Housing Administration (in the Department of Housing and Urban Development) and by the Rural Housing Service (in the Department of Agriculture) that increase the availability and lower the cost of financing. In addition, Fannie Mae and Freddie Mac—two large government-sponsored enterprises that have been in federal conservatorship since September 2008—guarantee mortgages for single-family and multifamily housing against losses from default and are an integral part of the federal support for housing finance.

The guarantees offered by federal credit programs and the GSEs are designed, in part, to provide incentives for private developers and owners to build, rehabilitate, and acquire properties that have rental units for low-income households. Those incentives include less stringent loan underwriting requirements and lower borrowing rates than would be available in the private market. But how effective those incentives have been is difficult to determine because their effect on the cost and availability of low-income housing is hard to measure.

Composition of the Market for Rental Housing

Since the beginning of the financial crisis of 2008 and 2009, more families have moved to rental housing—either by choice or by circumstance. The share of housing units occupied by renters has increased from a low of approximately 30 percent in 2005 to nearly 36 percent by 2015, according to the American Community Survey.

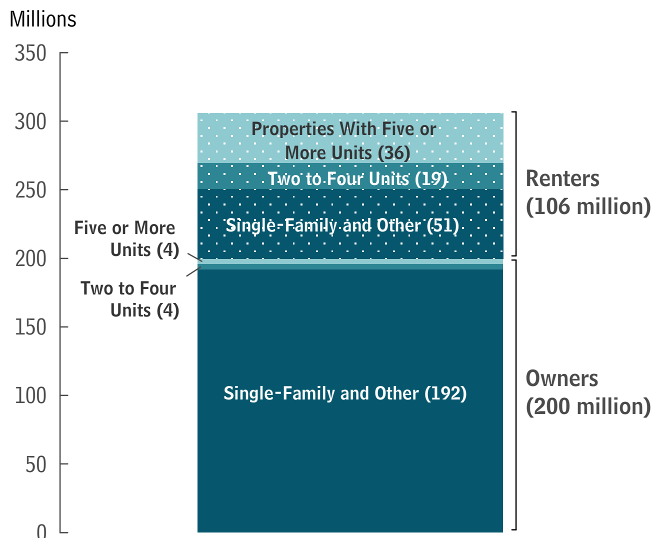
The composition of properties for rent has also changed in the wake of the financial crisis. Single-family properties have become a larger segment of the rental market, as foreclosed homes have been converted to rentals. According to the Census Bureau's American Housing Survey, single-family properties made up about 55 percent of occupied rental units in 2005; that number increased to nearly 59 percent by 2011. Although the number of multifamily properties that were rented also increased over that period, single-family properties accounted for more than 80 percent of the total increase in housing units occupied by renters. That change has helped to alleviate some of the upward pressure on rental costs from the growth in the number of renters.

The demographics of renters are changing as well. More households headed by individuals over the age of 60 and more married couples are renting than before the crisis. Although some of that shift has occurred because borrowers who have lost their homes to foreclosure have become renters, some probably results from changing attitudes

7. Unless otherwise noted, the term "low-income" as used in this report does not have a specific definition and refers to households targeted for housing support programs. The Department of Housing and Urban Development defines low-income families as those whose income does not exceed 80 percent of the median family income in their area, families with very low income as those whose income does not exceed 50 percent of the median family income in their area, and families with extremely low income as those whose income does not exceed the greater of the federal poverty guidelines (as published by the Department of Health and Human Services) or 30 percent of the median family income in their area.

Figure 2.

U.S. Population, by Property Type and Ownership Status, 2012



Source: Congressional Budget Office based on the 2012 American Community Survey (one-year estimate).

Notes: Renters in five-or-more-unit properties may include those renting a condominium or cooperative property. Those properties are not eligible for multifamily guarantee programs.

The property category "Single-Family and Other" includes mobile homes, boats, and recreational vehicles.

toward home ownership, with potential homeowners recognizing the risk of home price declines and therefore choosing to rent instead.

In total, multifamily properties provide shelter for 36 million renters in the United States, which represents 34 percent of the total population of 106 million renters (see Figure 2).[8] The remaining renters reside in single-family properties or properties made up of two to four units. In urban areas, 45 percent of rental units are in multifamily properties, versus just 20 percent in rural areas; the difference results partly from the fact that multifamily properties are more cost-effective in densely populated locales.[9]

Multifamily properties are either publicly or privately owned and operated. In public multifamily housing, a housing authority at the federal, state, or local level owns the building and typically acts as the landlord. Housing authorities do not rely on multifamily mortgages to fund their development; instead they are developed, operated, and maintained from federal, state, and local government revenues. Tenants in those properties are typically households with very low income who are charged below-market rents based on their income. According to the Department of Housing and Urban Development, 1.2 million households (or 3 percent of the 43 million households who rent in the United States) live in some form of public housing.[10]

Privately owned multifamily properties are most often owned by institutions that hold a portfolio of real estate investments, which may include other commercial buildings (such as hotels, shopping malls, and office space). In 2013, the 10 largest holders of multifamily real estate owned 126,000 units each, on average.[11]

Financing for Multifamily Housing

Privately owned multifamily properties are typically financed with bank-issued loans. Unlike mortgages for single-family properties (which have a standard 30-year repayment period with regular payments of principal and interest), multifamily mortgages tend to have shorter terms to maturity (often 7 or 10 years) and require a single large (or "balloon") payment at maturity. Multifamily loans have many of the same underwriting terms and conditions as loans for other types of commercial properties, and the way the loans are serviced is also similar. An important difference is that loans made to finance multifamily properties often have federal or GSE guarantees, whereas most loans made to finance retail and office buildings, hotels, industrial buildings, and hospitals are provided without federal loans or loan guarantees.

8. Those figures are one-year estimates from the Census Bureau's 2012 American Community Survey. According to the Census Bureau's 2011 American Housing Survey, 41 percent of rental households were in properties with five or more units. The discrepancy between the two surveys (34 percent versus 41 percent) is mostly attributable to what is being counted: American Community Survey counts individuals, whereas the American Housing Survey counts households. Because multifamily rental households average fewer people than single-family rental households, the percentage of households in multifamily rentals is larger than the percentage of individuals. Renters in five-or-more-unit properties may include those renting a condominium or cooperative property. Those properties are not eligible for multifamily guarantee programs.

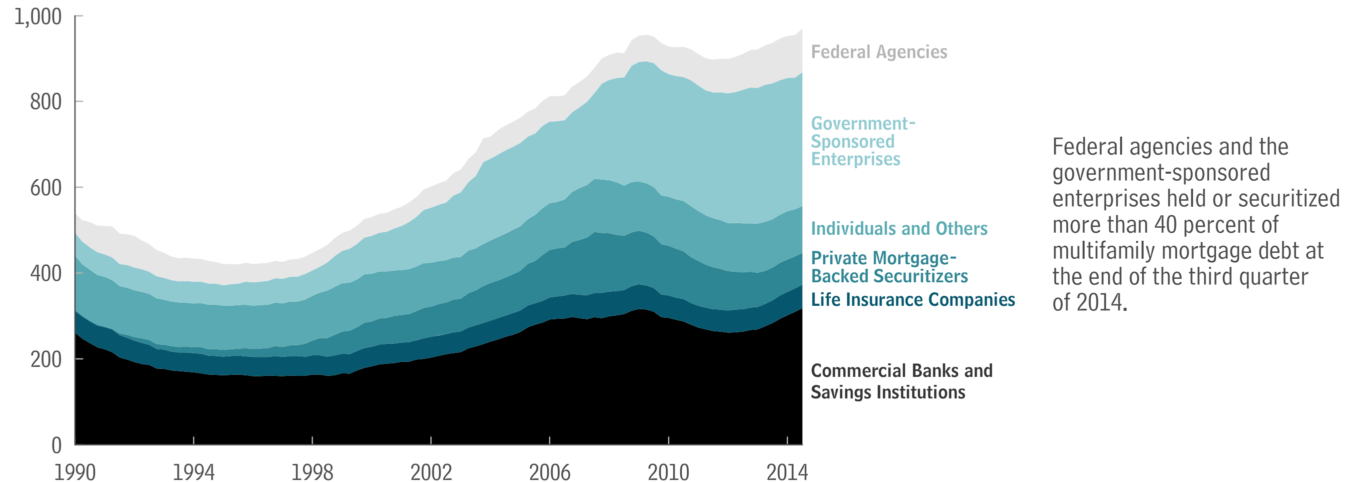
9. Those data come from the 2011 American Housing Survey. An urban area is the core within a metropolitan statistical area.

10. See Department of Housing and Urban Development, "HUD's Public Housing Program" (fact sheet, accessed August 2015), http://go.usa.gov/cgnCA.

11. Multifamily Executive, "2014 NMHC 50 Owners" (list, accessed July 10, 2014), http://tinyurl.com/pwzt6zy.

Figure 3.

Holders and Securitizers of Multifamily Mortgage Debt, 1990 to 2014



Sources: Congressional Budget Office; Federal Reserve.

Note: The category "Government-Sponsored Enterprises" comprises the loans and securities of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The "Federal Agencies" category is made up of the loans and securities of the Federal Housing Administration and Ginnie Mae (both part of the Department of Housing and Urban Development), the Department of Veterans Affairs, and the Department of Agriculture's Rural Housing Service. The category "Individuals and Others" includes mortgage companies, real estate investment trusts, state and local credit agencies, state and local retirement funds, noninsured pension funds, credit unions, and finance companies.

Multifamily mortgages that carry a federal guarantee are used to create mortgage-backed securities. Fannie Mae and Freddie Mac purchase mortgages that meet certain standards from banks and other originators, pool those loans into MBSs that they guarantee against losses from defaults on the underlying mortgages, and sell the securities to investors—a process referred to as securitization. (The multifamily loans that FHA guarantees are also securitized, but by a separate governmental entity, Ginnie Mae.)

In contrast, multifamily loans that are issued without a GSE or federal guarantee are most commonly held directly by banks and life insurance companies. A smaller fraction are pooled into privately issued commercial securities and sold to individuals and institutions looking to invest in commercial real estate without owning the properties or underlying loans directly.

The cash flows of most securitized loans are more predictable than those of individual mortgages and thus easier to value. Through securitization, investors with different appetites for risk can purchase different securities based on the same pool of loans. Those features of securitization expand the number of potential investors and increase the liquidity of the underlying loans. According to the Federal Reserve, the GSEs and federal agencies held or securitized nearly 43 percent of $969 billion in outstanding multifamily mortgage debt at the end of the third quarter of 2014 (see Figure 3). By contrast, the share that was securitized by private firms was around 8 percent. Private mortgage-backed securitizations financed a larger part of the market in the years preceding the recent financial crisis, representing 16 percent of the outstanding multifamily mortgage debt in the second quarter of 2007.

The reduction in private securitizations may partly reflect investors' increased appreciation of the risk of mortgage investments, but other factors may also be discouraging banks and other firms from issuing those securities. Some observers argue that new rules and regulations stemming from the 2008 financial crisis, such as those implemented pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203), have discouraged private financing for multifamily mortgages. However, other observers argue that the problems with the private mortgage-backed securitization market are more fundamental: Investors' confidence in that market was shaken by losses experienced during the financial crisis, and investors continue to be wary of the market for several reasons, including a lack of transparency about the mortgages underlying private securities, unreliable credit

ratings, and the fact that the companies servicing the securitized mortgages have incentives that conflict with those of the investors when loans are delinquent.

Federal Support for Multifamily Housing

The U.S. government supports multifamily rental housing through a collection of federal programs and tax incentives. The largest programs, in terms of budgetary cost, provide rental assistance to low-income households in both publicly and privately owned buildings and provide tax credits to developers to build or rehabilitate low-income rental housing units.[12] Through those programs, the federal government provided an estimated $43 billion in housing assistance in 2015—$29 billion in rental assistance for privately owned housing, $6 billion in assistance for public housing, and $8 billion in tax credits.

Credit assistance, in the form of mortgage loan guarantees, supplements those programs. Around $72 billion in mortgage loans, or 7 percent of the total value of all new mortgages insured by the GSEs and federal agencies, will be made to owners of multifamily properties in 2016, CBO estimates. In total, by CBO's estimate, those guarantees will generate $0.3 billion in budgetary savings in 2016, because the present value of the guarantee fees paid to the government exceeds the estimated present value of the payments the government will make to satisfy its obligations when borrowers default.

Although the amount of rental assistance provided through noncredit programs has remained relatively stable despite the budgetary stress created by the 2008 recession, the number of low-income renters has increased sharply and remains elevated. As a result, the percentage of renters with very low income receiving such assistance declined from 27 percent in 2007 to 24 percent in 2011.[13]

The pressure on federal programs has been exacerbated by a reduction in the amount of private capital available from the housing finance market, including the multifamily mortgage market, which reduced the availability of financing for new development. Some of that reduction was offset by an increase in GSE and federal guarantees—in 2009, more than 65 percent of new multifamily mortgages carried a GSE or federal guarantee (see Figure 4). Although the share of the market without those guarantees has since recovered, it remains below the 80 percent share observed in 2005 and 2006, primarily because of the failure of the market for commercial mortgage-backed securities (securities backed by multifamily mortgages and other commercial loans and issued without a government guarantee) to recover in the wake of the financial crisis. That source of financing plummeted to near zero in 2008 and remained below 5 percent of new multifamily mortgages through 2013.

Federal guarantees provide liquidity to the mortgage market for large rental properties by protecting investors from losses; that protection makes mortgage-backed securities safer and easier for investors to value and trade. Federal guarantees also help stabilize the market during a crisis by improving the availability and lowering the cost of credit for the acquisition and development of multifamily properties. That increased liquidity and stability may, in turn, reduce borrowing costs for owners and developers of multifamily properties. Those lower borrowing costs may increase the supply of multifamily properties, which could slightly lower rental rates overall and support the development of properties with units that provide below-market rents. When guarantee fees are set at fair-market levels, the net impact on owners' and developers' borrowing costs tends to be small and reflects only the effect of greater liquidity.

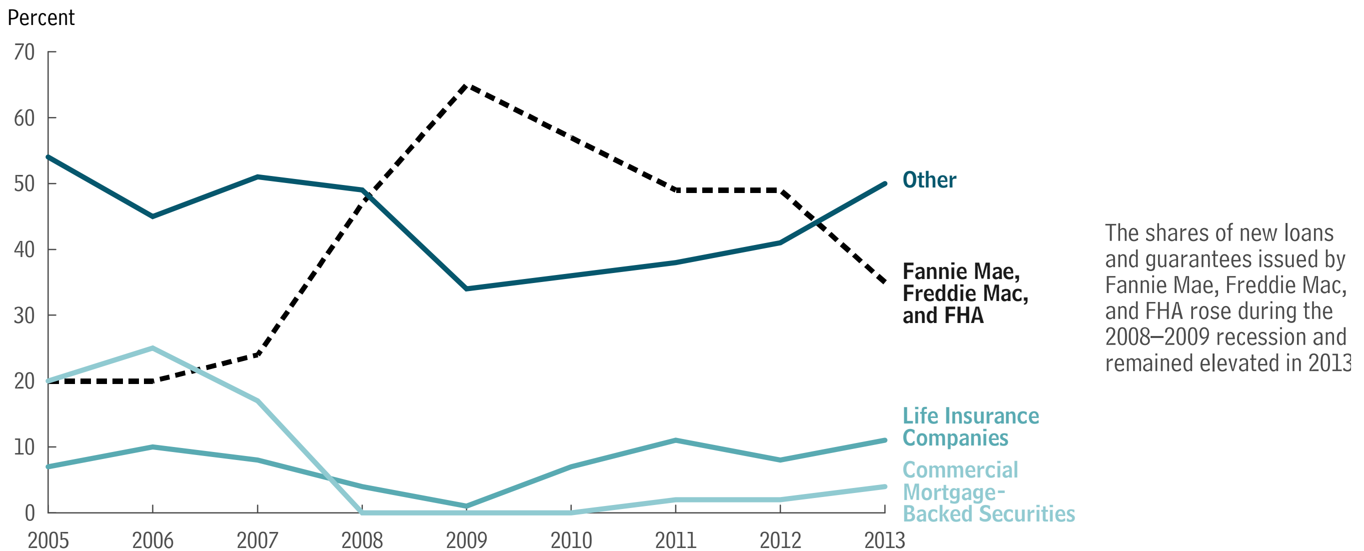
Federal guarantees have several drawbacks, too. Despite those possibly lower rental rates, CBO's estimates suggest that federal guarantees, even when their full benefit is passed through from the owners and developers in the form of lower rents, have little or no effect on rental affordability for low-income households. Federal guarantees also create risk for taxpayers by exposing the federal government to potential losses through defaults on the loans. Although the multifamily operations of the GSEs did not experience accounting losses during the housing crisis that arose from the 2008 recession, the multifamily housing sector has experienced an increase in defaults, foreclosures, and accounting losses under other circumstances. For example, Freddie Mac reported losses of $278 million in its multifamily program for 1989 and 1990, representing more than 50 percent of its total losses

12. For additional information, see Congressional Budget Office, *Federal Housing Assistance for Low-Income Households* (September 2015), www.cbo.gov/publication/50782.

13. See Barry L. Steffen and others, *Worst Case Housing Needs 2011: Report to Congress* (Department of Housing and Urban Development, August 2013), www.huduser.org/portal/publications/affhsg/wc_HsgNeeds11_report.html.

Figure 4.

New Loans and Guarantees for Multifamily Properties, by Source of Capital



Source: Congressional Budget Office based on data from Mortgage Bankers Association, Fannie Mae, Freddie Mac, Federal Housing Finance Agency, Trepp, and American Council of Life Insurers.

Notes: The category "Other" includes banks, savings and loan companies, and mortgage companies.

FHA = Federal Housing Administration.

for those two years.[14] The losses stemmed from a failure to adjust underwriting standards to react to a deteriorating multifamily property market, inadequate servicing standards, and insufficient resources to handle the number of delinquencies and foreclosures that occurred.[15] Federal and GSE loan guarantees also may encourage excessive risk taking by lenders and investors, who are insulated from losses on investments they would not make in a purely private market. Those incentives may increase the large subsidies that favor housing over other types of investment, resulting in a slightly less productive allocation of capital resources in the economy.

Multifamily Mortgage Guarantees Under Current Policy

FHA, RHS, and the GSEs provide guarantees to investors against losses on multifamily loans. Those guarantees differ in important ways, including the type of financing they cover, the structure of the guarantee, and their budgetary treatment (see Table 1).

Guarantees Provided by FHA and RHS

The Federal Housing Administration and the Rural Housing Service offer various programs to support the multifamily mortgage market, although most guarantees are issued through three large programs operated by FHA. FHA offers a full guarantee against losses from defaults on the underlying loans, setting fees in those programs to offset the projected budgetary cost of their loan guarantees. However, the fees charged and other lending terms available in those programs typically are more favorable to borrowers than what would be available from private lenders or the GSEs.

Loans guaranteed under FHA's *Multifamily Development* program, which guarantees loans for the construction or rehabilitation of multifamily housing units, can finance up to 90 percent of a building's replacement cost and have a term as long as 40 years. Developers using this program to finance buildings are not required to make units available for rent to low-income families. According to FHA, the Multifamily Development program insured

14. See General Accounting Office (now the Government Accountability Office), *Federal Home Loan Mortgage Corporation: Abuses in Multifamily Program Increase Exposure to Financial Losses* (October 1991), www.gao.gov/products/RCED-92-6.

15. See Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises* (April 1991), Chapter 4, p. 150, www.cbo.gov/publication/19583.

Table 1.

Federal Loan Guarantees for Multifamily Properties

Program Name (Agency)	Type of Financing	Structure of Guarantee	Budgetary Treatment
Multifamily Development (FHA)	For construction or substantial rehabilitation of multifamily properties	Full guarantee against credit losses Loans are eligible for Ginnie Mae securitization, which provides an additional guarantee for investors in multifamily mortgage-backed securities	FCRA
Apartments Refinance (FHA)	For purchase or refinancing of existing multifamily properties	Full guarantee against credit losses Loans are eligible for Ginnie Mae securitization, which provides an additional guarantee for investors in multifamily mortgage-backed securities	FCRA
Tax Credit New Construction (FHA)	For new, rehabilitated, or existing multifamily properties assisted with tax credit programs	Full guarantee against credit losses Loans are eligible for Ginnie Mae securitization, which provides an additional guarantee for investors in multifamily mortgage-backed securities	FCRA
Other Programs (FHA)	Risk sharing with state housing finance agencies, Fannie Mae, Freddie Mac, and other qualified entities	Risk-sharing programs allocate a portion of credit losses to other entities	FCRA
	For existing multifamily manufactured housing, senior housing, and housing located in urban areas	Some programs provide a full guarantee against credit losses	

Continued

$2.3 billion in mortgages for 172 projects in 2014.[16] The program will guarantee approximately $1.4 billion in new loans in 2016, CBO estimates.

FHA's *Apartments Refinance* program guarantees loans to purchase preexisting multifamily buildings or refinance existing loans against those properties. The program provides mortgages with terms of up to 35 years and allows for refinancing of up to 90 percent of a property's appraised value. Loans can be insured under the program regardless of whether they are already backed by FHA. The program grew markedly after the recent financial crisis—annual guarantees of loans increased from approximately $1.7 billion in 2009 to more than $15 billion in 2013—because low interest rates spurred refinancing and because private capital was less available during the crisis. The dollar volume of guarantees issued under the Apartments Refinance program then began falling, as interest rates rose and private investors began showing signs of returning to the multifamily mortgage market. Those guarantees totaled $7.6 billion in 2014 and are expected to total $6.3 billion in 2016, CBO estimates.

Loans that are eligible for guarantee under the two programs described above and that are associated with projects using tax provisions (such as the low-income housing tax credit, or LIHTC) are instead guaranteed

16. Results for 2015 were not available for all programs when this report was published.

Table 1. **Continued**

Federal Loan Guarantees for Multifamily Properties

Program Name (Agency)	Type of Financing	Structure of Guarantee	Budgetary Treatment
Rural Housing Insurance Fund (RHS)	For construction, acquisition, or rehabilitation of multifamily housing in rural areas	Up to a 90 percent guarantee (or 97 percent for nonprofit entities) against credit losses	FCRA
	For units that rent for no more than 30 percent of 115 percent of an area's median income	Loans are eligible for Ginnie Mae securitization, which provides an additional guarantee for investors in multifamily mortgage-backed securities	
Fannie Mae Multifamily (GSE)	For existing multifamily properties, including conventional rental housing, cooperative housing, manufactured housing, senior housing, and student housing	Lenders agree to bear a portion of the credit risk on either a prorated basis or a tiered basis under the Delegated Underwriting and Servicing program	Fair Value
	Primarily for units that rent for no more than 30 percent of an area's median income		
Freddie Mac Multifamily (GSE)	For existing multifamily properties, including conventional rental housing, cooperative housing, manufactured housing, senior housing, and student housing	Investors purchase a portion of bonds issued without a guarantee under K-Series Multifamily Pass-Through Certificates	Fair Value
	Primarily for units that rent for no more than 30 percent of an area's median income		

Source: Congressional Budget Office.

Notes: Fair value approximates the price that the federal government would need to pay a private insurer to make a loan guarantee on the same terms.

FCRA = Federal Credit Reform Act; FHA = Federal Housing Administration; GSE = government-sponsored enterprise; RHS = Rural Housing Service.

under FHA's *Tax Credit New Construction* program. By design, loans guaranteed under that program support a higher concentration of low-income multifamily rental units than similar loans guaranteed under FHA's other programs. The LIHTC encourages the development of low-income housing by reducing the tax liabilities of private developers in exchange for developing low-income rental housing units. Developers can sell those tax credits, raising money for their projects and reducing the amount of debt needed to complete construction. Lower debt-service costs enable developers to maintain the expected return on their projects while offering the lower rents required to receive the LIHTC. The Tax Credit New Construction program is expected to guarantee $2.5 billion worth of loans in 2016, CBO estimates, up slightly from $2.0 billion in 2014.

Smaller programs that support multifamily housing are offered by both FHA and RHS. FHA has programs tailored to support certain segments of the multifamily market (such as housing for the elderly) or designed to share risk with other institutions (such as the GSEs or state housing finance agencies). RHS guarantees multifamily housing in rural areas. Its Rural Housing Insurance Fund 538 program finances the construction, improvement, or purchase of housing for low- and moderate-income renters in eligible rural areas, providing mortgages with terms of up to 40 years. The program also allows for refinancing

of up to 97 percent of a property's appraised value. Rents for individual units are capped at 34.5 percent of an area's median income. In 2016, the program is expected to guarantee approximately $200 million in loans, CBO estimates.

Default and recovery rates vary across the multifamily programs, according to the Office of Management and Budget's *Federal Credit Supplement*.[17] FHA expects approximately 8 percent of the Multifamily Development loans guaranteed in 2016 to default over their lifetime; default rates for the Apartments Refinance and Tax Credit New Construction programs are estimated to be approximately 1 percent and 4 percent, respectively. For each of those programs, FHA expects to recover about 70 percent of the defaulted loan balances. RHS expects default and recovery rates of roughly 8 percent and 25 percent, respectively, under the Rural Housing Insurance Fund 538 program. Guarantees for rural multifamily housing are typically made on loans for smaller properties—the average loan size is projected to be about one-tenth as large as FHA's loans—and the smaller loan balances may yield lower net recoveries because of fixed costs in the recovery process.

Activities of Fannie Mae and Freddie Mac

In September 2008, the federal government assumed control of Fannie Mae and Freddie Mac in an effort to keep mortgage credit available. The government committed to providing ongoing financial assistance to the entities, which outside investors view as an effective federal guarantee of their operations.

The perception that the for-profit activities of the GSEs are federally guaranteed—because of their federal charters—existed even before the entities were placed into conservatorship.[18] That perception gave the GSEs lower funding costs than private entities, which allowed the GSEs to offer more favorable terms on mortgage guarantees than other private entities. In exchange for those advantages, the GSEs were required to allocate a certain portion of their guarantees to low-income households and in areas traditionally underserved by privately financed mortgages (such as those with large minority populations and residents with low income). Their placement into conservatorship has led many analysts to question the viability of the GSE model, particularly for their single-family guarantee operations, which suffered large losses during and after the government assumed control. Although the GSEs did not suffer losses on their multifamily guarantee operations during that period, they have done so in past economic downturns. (See Box 1 for a comparison of loan performance in the GSEs' single-family and multifamily portfolios.)

Fannie Mae and Freddie Mac have comparable multifamily operations stemming from their similar federal charters that require them to provide liquidity to the mortgage markets but prohibit them from originating loans themselves. They operate in the multifamily mortgage market by purchasing whole loans originated by private lenders. Some of those loans are retained in their investment portfolios and others are securitized—placed in trusts to create mortgage-backed securities that the GSEs sell to private investors. The GSEs guarantee investors against losses from default on loans they securitize and, hence, bear the risk of default on all loans that they acquire. Since their federal conservatorships began, the GSEs have moved away from portfolio investments in favor of securitization. According to Freddie Mac, about 29 percent of the loans it acquired in 2009 were intended for securitization. That amount increased to more than 95 percent in 2013. The GSEs' guarantees on multifamily loans, as opposed to their portfolio investments, are the focus of the alternatives analyzed later in this report.

An important difference between Fannie Mae's and Freddie Mac's multifamily operations is the way in which they share credit losses on the loans with private investors. Both enterprises use some form of risk sharing, but the partners who share that risk and the structure of the risk-sharing agreements differ. Since 1988, Fannie Mae has purchased multifamily loans from lenders under the terms of its Delegated Underwriting and Servicing program. Lenders in that program are preapproved to underwrite and service loans on the basis of criteria established by Fannie Mae, which will in turn purchase the loans without performing its own, separate, underwriting. In exchange for their delegated authority, the lenders agree to bear a portion of the credit risk on loans sold to Fannie Mae. The lenders share risk with the GSE either on a prorated basis (for example, they would cover one-third of all losses and Fannie Mae

17. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2016: Federal Credit Supplement* (February 2015), www.whitehouse.gov/omb/budget/Supplemental.

18. For a more detailed discussion of those issues, see Congressional Budget Office, *Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market* (December 2010), www.cbo.gov/publication/21992.

would cover the remaining two-thirds) or on a tiered basis (they would cover the first 5 percentage points of losses and some portion of all losses beyond that point, for example, or the first 10 percentage points of losses with no exposure beyond that point).

In contrast, Freddie Mac fully underwrites and approves multifamily loans before acquiring them. Once Freddie Mac has acquired those loans, the lenders are no longer responsible for future credit losses. For Freddie Mac, risk sharing is created through the securitization process, which produces securities known as K-Series Multifamily Mortgage Pass-Through Certificates, or K-deals. In the K-deal structure, Freddie Mac transfers loans to a third-party trust, which issues two classes of bonds—senior and subordinated—backed by those loans. Freddie Mac then purchases the senior bonds and reissues them to investors with its own guarantee against future credit losses. The third-party trust sells the subordinated bonds to investors without Freddie Mac's guarantee. In the event of a default on the multifamily mortgages that underlie both classes of bonds, losses are allocated first to investors who hold the subordinated bonds. If losses exceed the value of those securities, Freddie Mac is responsible for all remaining credit costs and holders of the senior bonds for none.

For multifamily loans acquired by Fannie Mae and Freddie Mac, delinquencies and defaults have been few, even during the financial crisis that started in 2008.[19] Multifamily loans guaranteed by the GSEs have lifetime default rates of approximately 2 percent, CBO estimates—lower than the rates for loans guaranteed under FHA's Multifamily Development program and RHS's Rural Housing Insurance Fund 538 program but higher than the rates for loans guaranteed under FHA's Apartments Refinance program.[20] Those generally lower default rates for loans guaranteed by the GSEs could result from several factors, including underwriting differences between GSE and non-GSE multifamily loans; differences in the location, size, and quality of the underlying properties; and the potential benefits of risk sharing between the GSEs and lenders.

Support for Low-Income Rental Housing

FHA, RHS, and the GSEs attempt to ensure that a large share of guaranteed mortgages finances properties with some units for low-income renters—but their success is difficult to measure.[21] (See Box 2 on page 16 for an overview of trends in rental housing.) FHA's programs do not require that properties financed with a federal guarantee have a minimum number of low-income housing units. Also, FHA does not publish data on the number of units it finances that charge rents that are affordable for households at certain income levels.

The GSEs, in contrast, publish information about the extent to which their guarantees meet a series of "housing goals"—targets established by their regulator, the Federal Housing Finance Agency, for the share or number of their guarantees that promote access to mortgage credit for certain households on the basis of their income or location. According to the GSEs' 2014 annual reports, approximately 65 percent of the units they financed in 2013 charge rents that are 30 percent or less of gross income—a threshold widely described as affordable—to households earning no more than 80 percent of an area's median income, and 15 percent charge rents that are affordable to households earning no more than 50 percent of an area's median income. The Department of Housing and Urban Development designates a household with income below 80 percent of the area median as a household with low income and a household with income below 50 percent of the area median as one with very low income.

The proportion of units financed by GSE mortgages that would be deemed affordable for households with very low income falls short of the proportion of such households in the overall population of renters. According to the

19. Although delinquencies and defaults are correlated, it can be difficult to predict which delinquent loans will proceed to default. Some borrowers with delinquent loans never resume payments and proceed directly to default. Other borrowers may resume payments, either by resolving a temporary cash shortfall or negotiating a modification to the terms of their loan.

20. That finding is based on CBO's analysis of performance data provided by Fannie Mae and Freddie Mac. See Fannie Mae, "Multifamily DUS Prepayment History Report," www.fanniemae.com/portal/funding-the-market/mbs/multifamily/dusprepayment-history.html; and Freddie Mac, "Securities," www.freddiemac.com/multifamily/investors/securities.html.

21. Metrics based on incomes and rents are benchmarks that policymakers and housing industry analysts often refer to, but assessing the effectiveness of any particular housing policy, including credit programs, is more complicated. For a detailed discussion of those broader issues, see Robert Collinson, Ingrid Gould Ellen, and Jens Ludwig, *Low-Income Housing Policy,* Working Paper 21071 (National Bureau of Economic Research, April 2015), www.nber.org/chapters/c13485.pdf (1.2 MB).

Box 1.

GSE Guarantees During and After the Financial Crisis and the Potential Implications for Mortgage Finance Reform

During the financial crisis of 2008 and 2009, delinquencies increased for single-family and multifamily loans guaranteed by Fannie Mae and Freddie Mac, but the pattern of those increases and the performance of the loans as the economy recovered have differed greatly. For Fannie Mae's single-family loans, the average delinquency rate (three or more missed payments) was 0.54 percent from January 1999 to December 2006, but it rose by more than 2.50 percentage points, to 3.10 percent, from January 2007 to December 2013 (see the table). For Fannie Mae's multifamily loans, average delinquency rates (two or more missed payments) for those same two periods were 0.14 percent and 0.37 percent, respectively, representing an increase of only 0.23 percentage points. Results for Freddie Mac's single-family and multifamily loans followed a similar pattern.

Delinquency rates for multifamily loans have returned more quickly to their levels before the financial crisis than have delinquency rates for single-family loans. In September 2014, delinquency rates for Fannie Mae's and Freddie Mac's multifamily loans were below their average from 1999 to 2006, whereas delinquency rates for single-family loans remained well above their 1999–2006 average (see the figure, top left).

Although the increase in delinquencies of multifamily loans during the financial crisis was relatively modest, those loans are not immune to distress. In 1991, when a severe downturn in the multifamily property market happened, Freddie Mac's multifamily credit losses were more than 50 percent of its total credit losses, despite the fact that multifamily loans represented less than 3 percent of its guarantees.[1] One explanation for those losses was the failure to adjust underwriting standards to react to a deteriorating multifamily property market created by overbuilding before the crisis: From 1983 to 1986, for example, multifamily housing starts exceeded 500,000 units per year, according to the Census Bureau, far more than typical levels (see the figure, top right). Other explanations for the credit losses include inadequate servicing standards and insufficient resources to handle the increase in the volume of guarantees.

The differences in performance between single-family and multifamily loans have led some people to view the multifamily housing finance system as a model for reform of the single-family mortgage market.[2] Specifically, the heavy reliance on risk sharing between the originating lender and Fannie Mae or Freddie Mac as the guarantor of loans for multifamily housing is cited as a mechanism for promoting better underwriting and fewer defaults.

Although adopting a risk-sharing model for the single-family housing finance system might better align interests between lenders and guarantors, it is uncertain whether that feature alone would prevent a spike in single-family mortgage defaults in future economic downturns. Other variables might also contribute to differences in loan performance during and after future recessions. For example, how the underlying loans are underwritten and serviced might affect loan performance. In addition, broader economic factors (such as the size of the housing inventory and the amount of overbuilding or underbuilding, as well as the impact of housing starts, household formation, interest rates, and employment on vacancy rates, rental rates, and house price appreciation) might have an effect.

1. Lawrence Goldberg and Charles A. Capone, Jr., "Multifamily Mortgage Credit Risk: Lessons From Recent History," *Cityscape: A Journal of Policy Development and Research*, vol. 4, no. 1 (Department of Housing and Urban Development, 1998).

2. See Sarah Mulholland, "Fannie-Freddie Elimination Model in Apartments: Mortgages," *Bloomberg* (April 28, 2014), http://tinyurl.com/pszxmmr; and Shekar Narasimhan and James B. Lockhart, "Make Multifamily the Starting Point for Housing Reform," *American Banker* (February 18, 2014), http://tinyurl.com/oe4euyn.

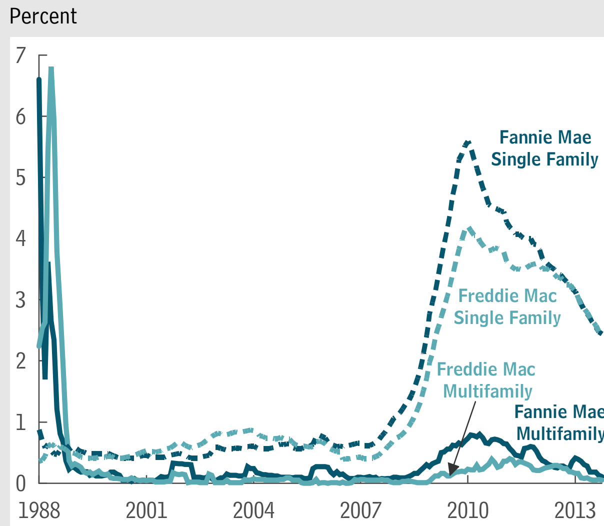
Continued

CBO

Box 1. **Continued**

GSE Guarantees During and After the Financial Crisis and the Potential Implications for Mortgage Finance Reform

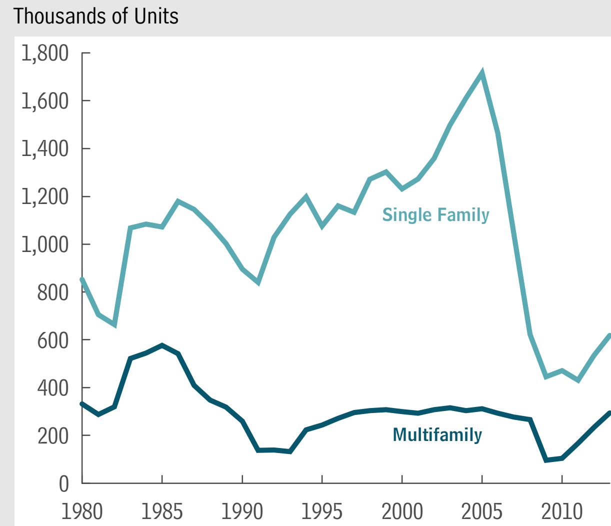
Delinquency Rates for Properties Insured Through Fannie Mae and Freddie Mac



Source: Congressional Budget Office based on data from Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency.

Note: A single-family loan is delinquent if three of more consecutive payments have been missed. For multifamily loans, delinquency is determined after two or more missed payments. Data before 1999 are annual.

Housing Starts



Source: Congressional Budget Office based on data from the Census Bureau.

Delinquency Rates for Properties Insured Through Fannie Mae and Freddie Mac, Selected Periods

Percent

	Delinquency Rates			
	Fannie Mae		Freddie Mac	
	Single Family	Multifamily	Single Family	Multifamily
January 1999 to December 2006 (Average)	0.54	0.14	0.60	0.07
January 2007 to December 2013 (Average)	3.10	0.37	2.61	0.16
January 2007 to December 2013 (Peak)	5.59	0.80	4.20	0.40
September 2014	1.96	0.09	1.96	0.03

Source: Congressional Budget Office based on data from Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency.

Note: A single-family loan is delinquent if three or more consecutive payments have been missed. For multifamily loans, delinquency is determined after two or more missed payments.

Box 2.

Trends in the Market for Rental Housing

The financial crisis that took hold during the 2008 recession brought many changes to the rental housing market. One significant change was the decline in the home ownership rate and the commensurate increase in the number of households renting their primary residence. According to the Census Bureau, the share of housing units occupied by someone other than the owner, most of which are occupied by renters, was 36 percent in the first quarter of 2015, up from a low of approximately 30 percent in the first quarter of 2005 and at the highest level since the fourth quarter of 1989.

The influx of new renters, many of whom have lost significant income as a result of the recession, has had a negative effect on various measures of rental affordability:

- The share of renters paying more than 30 percent of their income toward housing increased from 41 percent in 2001 to 49 percent in 2013, according to the Joint Center for Housing Studies at Harvard University (see the figure, top left). Those shares increase substantially for renters with annual income below $30,000.
- The supply of rental units available to renters with income of less than 50 percent of the median income in their area has declined from 80 units per 100 renters in 2003 to 65 units per 100 renters in 2013, according to the Department of Housing and Urban Development.
- The number of renters with worst-case housing needs grew from 5.0 million in 2001 to 7.7 million in 2013 (see the figure, top right).[1] Most of that increase occurred between 2007 and 2011, when the number shot up by nearly 2.6 million.

A shortage of affordable rental housing available to people with low income has further worsened the situation. According to the Census Bureau, fewer than 200,000 multifamily units were started each year from 2009 to 2011; in 2009, only 97,000 units were started. (Typically, multifamily housing starts averaged around 295,000 per year between 1995 and 2005.) That amount of new construction was insufficient to keep up with the loss of existing units from obsolescence and the influx of new renters. As a result, rents have been rising nationwide, further lowering rental affordability for low-income households.[2]

1. Renters with worst-case housing needs have income of less than 50 percent of the median income in their area, do not receive federal housing assistance, and have either a severe rent burden (paying more than 50 percent of their income for rent and utilities) or severely inadequate housing (living in a unit with one or more serious problems related to heating, plumbing, electrical systems, or maintenance). See Barry L. Steffen and others, *Worst Case Housing Needs: 2015 Report to Congress* (Department of Housing and Urban Development, April 2015), www.huduser.org/portal/publications/affhsg/wc_HsgNeeds15.html.
2. According to Zillow's rent index, median national rents per square foot increased by 12 percent from January 2011 to January 2015.

Continued

Department of Housing and Urban Development's *Worst Case Housing Needs* report to the Congress in 2015, 65 percent of all households that rented in 2013 were households with low income, but 46 percent of all households were ones with very low income.

Any benefits that renters with low income receive from federal support of the multifamily mortgage market are likely to be very small compared with the total costs of acquiring, developing, and operating rental properties. According to Mercy Housing, a national nonprofit housing organization, the average annual operating costs of its properties are approximately $6,400 per unit.[22] To cover only those operating costs, households paying 30 percent of their gross income toward their housing expenses would need to earn over $21,000 per year. That amount exceeds the annual average amount earned by a family of four designated as extremely low income by the Department of

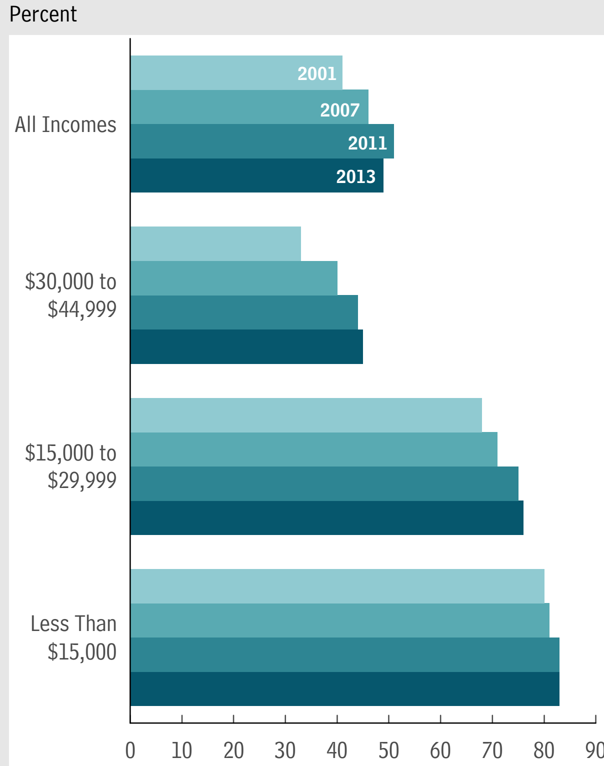
22. Data provided by Barry Zigas, Chairperson of the Board of Trustees for Mercy Housing and Director of Housing Policy for the Consumer Federation of America.

CBO

Box 2. Continued

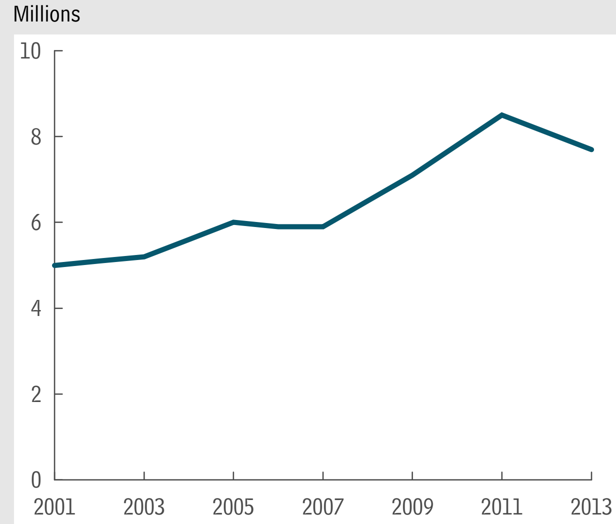
Trends in the Market for Rental Housing

Share of Renters Paying More Than 30 Percent of Their Income for Housing, by Annual Income



Source: Congressional Budget Office based on the Joint Center for Housing Studies at Harvard University's tabulations of data from the American Community Survey.

Renters With Worst-Case Housing Needs



Source: Congressional Budget Office based on the Department of Housing and Urban Development's tabulations of data from the American Housing Survey.

Note: Renters with worst-case housing needs have income of less than 50 percent of the median income in their area, do not receive federal housing assistance, and have either a severe rent burden (paying more than 50 percent of their income for rent and utilities) or severely inadequate housing (living in a unit with one or more serious problems related to heating, plumbing, electrical systems, or maintenance).

Housing and Urban Development in most states in 2014. Therefore, a multifamily loan guarantee, which typically subsidizes development and acquisition costs but not operating costs, could not reduce the rent low enough—even if there was no guarantee fee and the resulting subsidy was fully passed through to renters—for a household with extremely low income to spend less than 30 percent of its income on rent.

The Budgetary Cost of Multifamily Loan Guarantees

CBO uses two approaches to estimate the costs of credit guarantees. One approach reflects the procedures currently used in the federal budget as prescribed by the Federal Credit Reform Act of 1990; as required by FCRA, CBO applies that approach to FHA's and RHS's programs. The other approach shows estimated costs that reflect the market value of the federal government's obligations; CBO applies that fair-value approach to the operations of Fannie Mae and Freddie Mac.

FCRA and Fair-Value Approaches. Under FCRA, the estimated lifetime cost of a loan guarantee—the subsidy cost—is recorded in the budget when the loan is made. The subsidy cost is the net present value of the estimated claim payments that the government must make minus recoveries and fees over the life of the loan guarantee. To compute the subsidy cost, a program's projected future cash flows are discounted to the date of disbursement using an interest rate for each year of cash flow corresponding to the interest rate on Treasury securities of corresponding maturity. For example, the projected yield on Treasury securities maturing in two years is used to

discount cash flows two years from the disbursement date, a three-year Treasury rate is used for cash flows three years from disbursement, and so on. Federal administrative costs are accounted for separately and do not affect estimated subsidy costs. Those estimates of subsidy costs may be revised over time as actual cash flows are realized or as expectations about remaining future cash flows change.

Under the fair-value approach, a program's costs are likewise estimated on a present-value basis. Fair-value subsidy costs are computed using the same cash flows as under FCRA, but the Treasury rates used under FCRA are replaced with market-based discount rates. Those rates are inferred from the prices charged by private providers of mortgage credit.[23] Thus, the fair-value subsidy cost can be interpreted as the competitive market price that an investor would charge to take on the government's mortgage guarantees.

The two approaches differ in their treatment of the cost of market risk, which is one component of financial risk. Most of the risk of financial investments can be avoided by diversifying a portfolio; market risk is what remains after a portfolio has been diversified as much as possible. It arises because most investments tend to perform relatively poorly when the economy is weak and relatively well when the economy is strong. People value income from investments more when the economy is weak and incomes are relatively low, so they assign a higher cost to losses that occur during economic downturns. The higher cost of losses in bad times (as well as the lower cost in good times) is captured in the cost of market risk.

The FCRA approach essentially treats future cash flows subject to market risk as having the same value as Treasury securities that promise the same average payments with no risk. In other words, the market risk of federal credit assistance is treated implicitly as having no cost to the government.

The usefulness of each approach depends on the purpose for which it is used. FCRA estimates are less comprehensive measures of cost because, by discounting using Treasury rates, they treat expected outcomes as being equivalent to certain outcomes. However, if the realized cash flows do indeed match the expected cash flows, then the addition to the federal debt caused by the loan or loan guarantee will more closely correspond to the FCRA estimate. Thus, FCRA estimates are more useful than fair-value estimates for projecting the average effect of loans and loan guarantees on federal debt in the long run. However, projecting effects on debt is not the only—or necessarily even the primary—purpose of cost estimates. Those estimates are also tools that policymakers can use to make trade-offs between policies that work toward a policy goal. By taking into account the cost of financial risks as expressed through market prices, fair-value estimates are generally more useful than FCRA estimates to help policymakers understand trade-offs between policies that involve market risk.

In total, the multifamily programs of FHA and RHS and the operations of the GSEs will guarantee approximately $72 billion in loans in 2016, CBO projects. The fair-value budgetary cost of those guarantees in that year will be $462 million, CBO estimates. However, in CBO's official projections, FHA's and RHS's programs are estimated under FCRA; on that basis, the overall effect of the government's and the GSEs' multifamily loan guarantees is estimated to be budgetary *savings* of $257 million.

FHA's and RHS's Programs. CBO (in its baseline budget projections) and the Office of Management and Budget (in federal budget documents) record the costs of FHA's and RHS's multifamily loan guarantee programs using the procedure prescribed by FCRA. For its baseline estimates, CBO used the FCRA subsidy costs for the multifamily programs of FHA and RHS that were reported by the Office of Management and Budget in the *Federal Credit Supplement*.[24] For 2016, the agencies are projected to guarantee a combined total of approximately $11 billion in multifamily loans, and those loans are estimated to generate budgetary savings under FCRA of $386 million (see Table 2). The average subsidy rate across all programs is projected to be -3.6 percent.

23. CBO's approach to calculating the fair value of a loan guarantee relies on determining the difference between the fair value of the loan with and without the guarantee, using discount rates that incorporate appropriate premiums for market risk. For more information, see Congressional Budget Office, *Fair-Value Estimates of the Cost of Federal Credit Programs in 2013* (June 2012), www.cbo.gov/publication/43352.

24. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2016: Federal Credit Supplement* (February 2015), www.whitehouse.gov/omb/budget/Supplemental.

Table 2.

Projected Budgetary Effects of New Federal Multifamily Loan Guarantees, 2016

Percent

	Program Name (Agency)						
	Multifamily Development (FHA)[a]	Apartments Refinance (FHA)[a]	Tax Credit New Construction (FHA)[a]	Other Programs (FHA)[b]	Rural Housing Insurance Fund (RHS)[b]	GSE Multifamily[c]	Total
Volume (Millions of dollars)	1,408	6,277	2,500	437	200	61,200	72,022
			FCRA Subsidy Components[d]				
Defaults, Net of Recoveries	2.4	0.3	1.0	2.3	5.4	n.a.	0.9
Fees	-5.2	-5.0	-2.7	-3.7	-8.4	n.a.	-4.5
Subsidy Rate	-2.7	-4.7	-1.7	-1.4	-3.0	n.a.	-3.6
FCRA Cost (Millions of dollars)	-39	-293	-42	-6	-6	n.a.	-386
			Fair-Value Subsidy Components[d]				
Defaults, Net of Recoveries	9.0	6.5	7.2	8.6	11.7	5.3	5.5
Fees	-4.7	-4.6	-2.3	-3.3	-8.0	-5.0	-4.9
Subsidy Rate	4.3	1.9	4.9	5.3	3.7	0.2	0.6
Fair-Value Cost (Millions of dollars)	60	120	123	23	7	129	462

Sources: Congressional Budget Office; Office of Management and Budget.

Note: FCRA = Federal Credit Reform Act; FHA = Federal Housing Administration; GSE = government-sponsored enterprise; RHS = Rural Housing Service; n.a. = not applicable.

a. Loan volume and FCRA subsidy costs and rates are from CBO's August 2015 baseline and Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2016: Federal Credit Supplement*. Fair-value subsidy costs and rates are based on cash flows used to derive FCRA results and a risk premium of 78 basis points. (A basis point is one one-hundredth of a percentage point.)

b. Loan volume and FCRA subsidy costs and rates are from CBO's August 2015 baseline and Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2016: Federal Credit Supplement*. Fair-value subsidy costs and rates include estimates of fixed and variable costs from the Multifamily Development, Apartments Refinance, and Tax Credit New Construction programs.

c. Loan volume is based on CBO's August 2015 baseline, reflecting the Federal Housing Finance Agency's 2015 strategic plan for Fannie Mae and Freddie Mac to maintain new business volume near $30 billion in calendar year 2015 with a 2 percent increase for 2016. Fair-value subsidy costs and rates are derived from CBO's subsidy cost calculations for the multifamily mortgage business.

d. Positive values indicate budgetary costs; negative values indicate budgetary savings.

CBO has also analyzed the FHA and RHS credit programs using the fair-value approach. In doing so, CBO used a projection of cash flows but added a risk premium to the discount rate used in the valuation process. (The risk premium was estimated from the default projections underlying the cash flows and the market risk premium associated with private loans with similar default rates.)[25] Under that fair-value approach, FHA's and RHS's multifamily loan guarantees in 2016 are estimated to have a lifetime budgetary cost of $334 million and an average subsidy rate of 3.1 percent.

GSEs' Operations. CBO has incorporated the projected credit activity of the two GSEs in its projections of the federal budget since Fannie Mae and Freddie Mac were placed into conservatorship in 2008. In effect, CBO treats the loan guarantees of the two entities as federal loan guarantees. However, unlike most other federal credit programs, whose budgetary effects are estimated

25. For this analysis, CBO used program cash flows for 2015 to estimate the FCRA and fair-value subsidy rates. The difference of approximately 6.5 percentage points between those two rates was added to 2016 FCRA subsidy rates to estimate 2016 fair-value rates. The 2015 fair-value subsidy rates for all of FHA's and RHS's multifamily programs were calculated by adding a risk premium of 0.78 percent to the FCRA discount rates used in the valuation process. CBO did not have sufficiently detailed information about the market pricing of loans by their risk characteristics to make program-specific risk premium estimates. Varying the risk premium between programs according to the characteristics of the loans in each program would result in different estimates of the cost and subsidy rate for each program. However, in CBO's judgment, the average risk premium used is representative of the programs in total; using an alternative measure would not materially alter the policy analysis provided in this paper.

following the procedures prescribed by FCRA, CBO has estimated the costs of the GSEs' guarantees on a fair-value basis.[26]

In contrast, the Office of Management and Budget does not consider the GSEs to be federal entities and has not adopted a fair-value budgetary treatment for them. It does not use the FCRA approach either. Rather, it considers the GSEs' operations nongovernmental and includes in the budget only the net cash payments exchanged between the GSEs and the Treasury. (Those payments stem from the contractual agreements for the government to support the two GSEs that were entered into after the GSEs were placed into conservatorship.)[27] CBO estimated, in its August 2015 baseline, that the GSEs' multifamily mortgage business will account for approximately $61 billion in loans in 2016; the fair-value cost of those guarantees is expected to be nearly $129 million and the subsidy rate, 0.2 percent. (In contrast, CBO estimated a fair-value subsidy rate of 0.4 percent for the GSEs' single-family guarantee operations in 2016.)

26. CBO's decision to include the operations of the GSEs in its budget projections and to account for the costs of their activities on a fair-value basis was made in conjunction with the House and Senate Budget Committees. That treatment is consistent with the view that the government's conservatorship and large financial stake in the enterprises convey effective ownership and control; the fair-value approach is consistent with the budgetary treatment specified in law for the Troubled Asset Relief Program. One rationale for the use of fair-value accounting instead of FCRA accounting is to provide lawmakers with more comprehensive measures of the cost of legislative proposals. For further discussion, see Congressional Budget Office, *CBO's Budgetary Treatment of Fannie Mae and Freddie Mac* (January 2010), www.cbo.gov/publication/41887, and the testimony of Deborah Lucas, Assistant Director for Financial Analysis, Congressional Budget Office, before the House Committee on the Budget, *The Budgetary Cost of Fannie Mae and Freddie Mac and Options for the Future Federal Role in the Secondary Mortgage Market* (June 2, 2011), www.cbo.gov/publication/41487.

27. From 2008 (when their conservatorships began) through September 2015, the GSEs have paid $239 billion to the Treasury. Those payments have reduced the budget deficit in each year. Going forward, both CBO and OMB project that the GSEs will continue to make payments to the Treasury. However, CBO treats those payments as intragovernmental transfers and not a source of budgetary savings. For more information on the differences between CBO's and OMB's budgetary treatment of the GSEs, see Congressional Budget Office, *Transitioning to Alternative Structures for Housing Finance* (December 2014), p. 14, www.cbo.gov/publication/49765.

CBO estimates that Fannie Mae and Freddie Mac are incurring budgetary costs on a fair-value basis because they are charging less, on average, for their guarantees than even the most efficient private financial institution would charge in a liquid market. The two GSEs' guarantee fees are projected to be high enough to cover expected losses and administrative expenses but not high enough to cover all of the market risk associated with the guarantees that a fully private entity would need to recover. (That situation is why analysts expect that Fannie Mae and Freddie Mac will continue to report accounting profits even if they earn lower returns than private investors would require to bear the same risks.)

Alternative Approaches to Guaranteeing Multifamily Mortgages

Policymakers are considering alternatives for the single-family and multifamily mortgage markets that would have more explicitly defined public and private roles in providing loan guarantees than the current GSE-dominated structure. Those approaches vary in the degree of federal involvement in the mortgage markets, ranging from a fully federal agency that would guarantee and securitize qualifying mortgages to a largely private secondary (or resale) mortgage market.

In a previous analysis of alternative arrangements for the single-family mortgage market, CBO examined four approaches that would change the federal government's role.[28] The first approach would create a fully federal agency that would bear all the credit risk on guaranteed mortgages. The second approach—a hybrid public/private structure—would institute a federal guarantee against catastrophic losses, with a structure that could be similar to the loss-sharing arrangement now used by Fannie Mae and Freddie Mac in which private investors take losses ahead of the government. Under the third approach, the federal government would bear the entire credit risk, as in the first approach, but the total dollar volume of guaranteed mortgages would vary with economic conditions. Under the fourth approach, the current structure would evolve into a largely private mortgage market in which the federal government's guarantee was targeted toward a limited number of loans with specific characteristics.

28. See Congressional Budget Office, *Transitioning to Alternative Structures for Housing Finance* (December 2014), www.cbo.gov/publication/49765.

CBO considered only approaches that would explicitly delineate federal and private roles in the multifamily mortgage market and, consequently, did not consider a return to the precrisis GSE model with its inherent weaknesses.[29] Before the GSEs' conservatorship, most investors believed that the government would not allow Fannie Mae and Freddie Mac to default on their obligations. That perception of an implicit federal guarantee stemmed from their federal charters and the very prominent role the two entities played in the housing market and in the broader financial market. Because of their implicit federal guarantee, Fannie Mae and Freddie Mac could borrow at much lower interest rates than fully private financial institutions, and investors valued the GSEs' credit guarantees more highly than those issued by fully private guarantors. Some of the benefits from federal support flowed to mortgage borrowers in the form of greater availability of credit and somewhat lower interest rates. However, the advantages of implicit federal support allowed Fannie Mae and Freddie Mac to grow rapidly and dominate the secondary market, which increased risk to the overall financial system. Because the federal subsidy arising from the implicit guarantee was not reflected in the federal budget, the size of the subsidy was not readily apparent to policymakers and the public. Conservatorship has made the federal support explicit and has reduced, but not eliminated, the challenges of trying to balance competing public and private goals.

To evaluate the relative merits of applying the four approaches to the multifamily mortgage market, CBO focused on three main criteria (see Table 3):

- How would each approach affect the availability of mortgage credit for multifamily properties?
- To what extent would taxpayers be exposed, implicitly or explicitly, to the risk of losses on mortgage guarantees?
- And how would each approach affect the availability of low-income multifamily rental housing?

Under any of the approaches, the extent of the federal government's involvement in the multifamily mortgage market would not need to match the extent of its involvement in the single-family market. Although the loan guarantees offered by FHA, RHS, and the GSEs are designed to provide liquidity and stability to mortgage markets, federal support for the single-family and multifamily markets has different policy objectives. Single-family mortgages support home ownership by enabling individuals to purchase a home or refinance an existing loan for a lower monthly payment. Multifamily mortgages provide the financing necessary to develop and maintain rental properties, which helps to supply rental housing to people who are not willing or able to own their own home. Those differing objectives might cause policymakers to adopt different structures for the two markets.

Alternatively, policymakers might want to restructure the markets for single-family and multifamily loans in broadly consistent ways. If policymakers' primary objective was to limit the government's exposure to mortgage credit risk, creating a largely private single-family market but leaving a large government role in the multifamily market would not be in line with that objective. That inconsistency might be warranted, though, if the other goals for the multifamily market, such as greater support for subsidized rental housing, overrode the objective of limiting taxpayers' risk.

An advantage of a broadly consistent approach is that it would allow the programs to share common functions. Although the GSEs' single-family and multifamily businesses operate largely independently of each other, they share several important functions, such as legal support, accounting, finance, and human resources. Transitioning to a structure in which the single-family and multifamily businesses of the GSEs took different forms would require coordination in allocating those shared functions. For example, if policymakers chose to pursue a largely private single-family market while creating a fully federal guarantee in the multifamily market, the two business lines at the GSEs would take different paths. The single-family business could be wound down or spun off as a purely private entity. The multifamily operation, however, would become governmental, either as a stand-alone federal entity or as part of an existing government agency (like FHA). If the multifamily operation became a stand-alone entity, it would require some of the support functions formerly provided to the larger GSE, resulting in a possible loss of economies of scale and higher administrative costs.

29. For a more detailed description of the weaknesses of that model, see Congressional Budget Office, *Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market* (December 2010), www.cbo.gov/publication/41487.

Table 3.

Criteria for Evaluating Alternative Approaches to the Multifamily Mortgage Market

	Availability of Mortgage Credit	Taxpayers' Exposure to Risk	Availability of Low-Income Multifamily Rental Housing
Fully Federal Agency	Supply of mortgages would be stable under most market conditions.	Taxpayers' exposure to risk would increase for loans currently guaranteed by the GSEs.	Subsidies could be directed to support multifamily low-income rental housing.
Hybrid Public/Private Approach	Supply of mortgages would be stable under normal market conditions but could be restricted under market stress if private capital could not fund the initial losses.	Taxpayers' exposure to risk would decrease for loans currently guaranteed by FHA and RHS.	Low-income multifamily rental housing could be subsidized by underpricing the catastrophic risk guarantee for some loans, or those guarantees could remain with FHA and RHS as fully federal programs.
Federal Guarantor of Last Resort	Supply of mortgages would be fairly stable, particularly during times of market stress.	Taxpayers' exposure to risk would decrease under normal market conditions. Their exposure would be greater in times of market stress.	In normal market conditions, government support for low-income multifamily rental housing could be a designated share of the federal guarantor of last resort's guarantees or be confined to FHA and RHS.
Largely Private Approach	Supply of mortgages would fluctuate with market conditions.	Taxpayers' exposure to risk would decrease under normal market conditions. Their exposure could be greater in times of market stress if moral hazard led banks to bear more credit risk before a crisis.	Government support for low-income multifamily rental housing would be confined to FHA and RHS.

Source: Congressional Budget Office.

Notes: The fully federal agency and guarantor of last resort could combine the multifamily operations of FHA, RHS, and the GSEs (Fannie Mae and Freddie Mac). Under the hybrid public/private approach, the federal government would guarantee against catastrophic losses only. The largely private approach would retain FHA's and RHS's multifamily programs.

FHA = Federal Housing Administration; GSE = government-sponsored enterprise; RHS = Rural Housing Service.

Fully Federal Agency

This approach would convert the GSEs into a stand-alone federal agency or consolidate their operations with the multifamily credit programs of FHA and RHS, protecting investors against the costs of default by explicitly guaranteeing all credit losses on federally backed MBSs. The cost of that guarantee could be covered in whole or in part by charging fees to the originators of the loans, the investors in the MBSs, or both. However, taxpayers would be fully exposed to the risk of losses on those guarantees should the losses exceed the value of the fees charged.

This approach might promote liquidity in the agency-backed MBSs if the combined entity offered relatively homogenous securities backed by a single guarantee. But that potential liquidity could come at a cost—combining the multifamily loan guarantees might reduce the agency's ability to specialize in certain segments of the larger market and to create tailored loan products to serve those segments. A full federal guarantee would also promote a more stable supply of multifamily credit in all market conditions, because private capital would not need to share in the credit risk of those loans. Additionally, although the risk of losses to taxpayers might be

highest in this approach, the explicit nature of the federal guarantee would increase the transparency of the costs of those guarantees because those costs would appear alongside those of other federal credit programs in the budget.

An explicitly federal entity could more readily attend to federal policy goals than a privately owned enterprise. By setting eligibility standards and prices for its guarantees, the agency could offer underwriting concessions (by providing guarantees on long-term fixed-rate loans) and subsidies (to reduce guarantee fees) that were tied directly to loans for properties meeting some measure of affordability—for example, having a certain number of units occupied by renters with income below the median for the area or charging rents deemed affordable for people with that income (criteria similar to those for determining eligibility for LIHTCs).

Hybrid Public/Private Approach

Several proposals for restructuring mortgage markets involve private and federal entities sharing in the credit losses associated with multifamily loans. In most of those proposals, private firms would reimburse investors in qualifying MBSs for a portion of credit losses associated with loan defaults. A federal government guarantor, which could be a new agency that was created from scratch or one that subsumed the operations of an existing agency, would absorb the remaining losses through an explicit guarantee, ensuring that investors were completely protected. That type of guarantee would preserve many features of the way in which Fannie Mae and Freddie Mac currently operate in the multifamily market.

At issue is the structure of the guarantee that private firms would provide to cover their portion of credit losses. One alternative would use a structure similar to that of Fannie Mae's Delegated Underwriting and Servicing program. The main advantage of such a structure, which requires lenders to retain some portion of losses, is to align interests between lenders and the government, helping to ensure that loans are underwritten to the prevailing standard. Drawbacks of that approach include the potential to concentrate lending in larger institutions, exposing the government to economic consequences if those institutions fail and putting smaller, community-based financial institutions at a competitive disadvantage. A second alternative would be to structure the program like Freddie Mac's K-deals, in which Freddie Mac shares risk through the securitization process by creating two classes of securities—a senior class, which is guaranteed by the government, and a subordinated class, which is not. That structure eliminates counterparty risk (the chance that other parties to a transaction will not be able to meet their obligations) because the nongovernmental share of the loss is borne by investors holding the unguaranteed securities. However, that structure requires a sufficient number of investors willing to take on such credit risk.

Adopting one of those structures under the hybrid public/private approach should ensure that credit is available under normal market conditions. During a crisis, though, availability might be constrained or might disappear if the private investors became less willing to hold mortgages with partial guarantees. Both structures would also reduce taxpayers' exposure to risk relative to their exposure through loans guaranteed by the GSEs, FHA, and RHS under current policy, because private capital would absorb some credit losses before the government's guarantee was invoked. The costs of the federal share of the guarantees would appear in the budget alongside that of other federal credit programs.

Support for low-income multifamily rental housing under a hybrid public/private approach could take several forms. One way to ensure a supply of low-income housing would be to give access to the government's standard guarantee only to lenders who require that a certain number of units in a property meet some level of affordability for low-income households. Another way would be to dedicate a portion of the government's guarantee fee to a fund that finances multifamily rental housing projects for low-income households; such an arrangement would be similar to the one that directs the GSEs to fund the Housing Trust Fund and the Capital Magnet Fund (both established in the Housing and Economic Recovery Act of 2008).[30]

Federal Guarantor of Last Resort

Because federal guarantees have the greatest potential impact during a crisis, a federal agency acting as a guarantor of last resort would adjust its share of the secondary mortgage market to economic circumstances. In a strong economy, when private credit for multifamily properties was widely available, the federal agency would guarantee a very small share of the market. That share could encompass a sample of all loans (allowing the government to gain experience with valuing its guarantee for a representative

30. See Federal Housing Finance Agency, *FHFA Statement on the Housing Trust Fund and Capital Magnet Fund* (December 2014).

range of mortgages) or target a segment of the broader market (such as low-income multifamily rental housing, for which credit might be tight even in a strong market). During periods of economic stress, the federal agency would increase the share of loans it guaranteed, filling in for the likely withdrawal of private capital that would be subject to multifamily mortgage credit risk and ensuring that loans were still available for viable projects. Once the economy recovered, the government's share would drop back to precrisis levels. In all cases, the government's guarantee would be explicit and the costs would be included in the budget.

Policymakers would need to carefully consider the circumstances that would trigger an increase in the dollar volume of loans guaranteed during a crisis and a subsequent return to a more typical share of the market. They would also need to establish the processes—including the required technology and personnel—that would enable the guarantor to ramp up its market share quickly once the trigger to do so was reached.

The federal agency could use a competitive process, such as an auction, to arrive at prices for its guarantees. In that case, the quantity of loans the government chose to guarantee in a given economic environment would establish the price and the federal subsidy for that guarantee.

The new federal agency's guarantee could be designed to offer full credit protection on long-term fixed-rate loans (as FHA does) or partial protection on shorter-term or variable-rate loans (as the GSEs do). Offering a full guarantee would increase taxpayers' exposure to credit losses on individual loans but would promote a more stable supply of multifamily credit in all economic markets.

To support low-income housing, the federal guarantor of last resort could designate a fixed portion of its market share to go toward loans on properties with units that are affordable for low-income households; that portion would be based on the extent to which private firms provided credit for those properties whose financing the agency did not guarantee. Otherwise, support for low-income housing would be confined to FHA and RHS (or a successor agency).

Largely Private Approach

Mortgage markets could be designed to rely almost exclusively on the private sector. In that case, FHA and RHS would provide a limited quantity of mortgage guarantees to owners and developers of multifamily properties, either by applying eligibility and underwriting criteria used in their existing programs or by further restricting eligibility to more narrowly target the development of low-income multifamily units. (The guarantees made by those agencies could be reduced through explicit dollar-volume caps or other restrictions.) All of the loans now guaranteed by Fannie Mae and Freddie Mac and the portion of FHA's and RHS's loans that could be supported by private capital would be guaranteed by private investors, reducing taxpayers' explicit exposure to credit risk.

That structure would make the market for multifamily mortgages much more consistent with the securitization markets for other commercial real estate assets. The large share of the multifamily mortgage market that would not have a federal guarantee would place the burden on private market participants to more prudently assess the risks of their lending, and they would bear the costs of any mistakes. But doing so would increase the likelihood that credit would be interrupted if those market participants incurred losses that threatened their solvency. Furthermore, during such events, the government might feel compelled to ramp up FHA's and RHS's guarantees in the same way that it would under the federal guarantor of last resort approach, but the response would be more ad hoc and, hence, might be more costly given the rapid speed at which financial crises can unfold.

Comparative Advantages and Disadvantages of the Approaches

Each approach's advantages and disadvantages depend largely on the degree to which it relies on a federal guarantee. The approach that would create a fully federal agency benefits the most from the positive aspects of a federal guarantee and suffers the most from the negative ones, whereas the opposite holds true for the largely private approach. The effect of a government guarantee on the approaches that would combine public and private entities or create a federal guarantor of last resort is more complex. The government guarantor in a hybrid public/private approach would offer guarantees on more loans than a guarantor of last resort in normal economic conditions. However, the guarantor of last resort would increase its share of guarantees in times of crisis, when that guarantee would be most valuable to the market and most costly to the government.

Government Guarantees. Under the first three approaches (fully federal agency, hybrid approach, and guarantor of

last resort), providing a guarantee for multifamily loans through a federal agency would help to ensure the availability of financing to the secondary mortgage market, particularly during a crisis. As long as that guarantee was priced at or below what a private guarantor would charge, those approaches would allow the government to direct subsidies to low-income multifamily rental housing. By decreasing costs for developers and owners of multifamily properties, those subsidies could spur production of more low-income units (for loans supporting new development) or reduce the operating costs of existing projects (for loans refinancing existing loans), thus lowering costs for renters. Control over the qualification criteria and product structure for loans eligible for a federal guarantee might also ensure that loan quality remained high in the multifamily market, reducing the likelihood that the availability of rental housing would be diminished by mortgage defaults.

Creating a federal guarantee agency for multifamily mortgages could have disadvantages, too. Such guarantees would favor multifamily mortgages over nonresidential commercial real estate loans (such as those for office buildings and hotels), which are financed mainly with private capital. Subsidizing multifamily mortgages might tilt the allocation of capital away from potentially more productive non–real estate investments and other segments in the commercial real estate sector. In addition, taxpayers, rather than private firms, would bear much of the credit risk on guaranteed mortgages, particularly if those guarantees offered full credit protection. (Even if those guarantees provided only partial protection, taxpayers would still bear the risk of losses not covered by private entities.) If lenders, in an effort to increase support for low-income multifamily rental housing, offered more favorable terms to borrowers (such as longer-term fixed-rate financing or a greater loan-to-value ratio), then the risk posed by federal guarantees would be even higher. Finally, the potential that the federal agency might assume the credit risk on existing private-sector guarantees in the midst of a crisis, particularly those guarantees in some stage of delinquency, might promote moral hazard—the tendency for people or organizations to be more willing to take risks for which the potential costs or burdens will be borne in whole or in part by others—in private guarantors before the crisis.

Maintaining or increasing the government's share of guarantees in the multifamily mortgage market would have mixed effects on other forms of rental market support. Greater access to low-cost financing might generate more demand for LIHTCs, as developers often need to combine those tax credits with other forms of government support to make a project viable. But more low-income units and lower rents might reduce the demand for other federally funded programs that directly subsidize the rent of low-income tenants.

Private Risk Bearing. By relying mainly on private-sector firms to assume the credit risk on multifamily mortgages, the largely private approach would, among the market structures that CBO analyzed, provide the greatest reduction in the exposure of the government to large losses. It would also align the market for multifamily assets most closely with other, similar markets for commercial real estate assets. Without a direct government subsidy, private markets would have less incentive to invest in multifamily loans and greater incentive to be prudent in their lending and securitization, which could result in a somewhat more productive allocation of credit away from multifamily housing and toward other investments.[31]

One drawback of privatization of the multifamily mortgage market is that credit to low-income rental housing projects and other underserved market segments probably would be more limited. The smaller dollar volume of subsidized federally backed guarantees would increase the cost of those loans to multifamily property developers, potentially resulting in higher costs for renters and possibly fewer multifamily units (if developers were unable to earn their required return on a project because of higher borrowing costs). That concern would become even more acute in an economic crisis, when, without the stabilizing force that government guarantees provide the securitization market, private firms might withdraw credit. Furthermore, if the market came to be dominated by a handful of large institutions, those institutions might be perceived as being too big to fail and, hence, implicitly guaranteed by the federal government.

Before any future crisis, the markets would need to believe that the government's pullback was credible and that it would not rescue private firms experiencing financial stress to maintain market liquidity. If that was not the case, those private firms might invest more heavily in

31. See Thomas White and Charles Wilkins, *Moving Toward a Viable Multifamily Debt Market With No Ongoing Federal Guarantee* (American Enterprise Institute, March 2013), http://tinyurl.com/mowtsw7.

multifamily loans and make riskier loans than they would otherwise, expecting that assistance would be provided if those loans generated significant losses.

Illustrative Budgetary Costs of the Approaches

The budgetary effects of changing the government's guarantees in the multifamily mortgage market would depend on the details of each approach and its implementation. One key decision is how the new guarantees would be structured and priced. The market's response to those changes, particularly the degree to which private financial institutions would decide to alter their use of federal guarantees, would also affect the budgetary costs.

The ordering of the relative budgetary costs of the different approaches would depend on the amount of federal guarantees, their structure and how they were priced. For example, a guarantor of last resort offering a partial guarantee on a relatively large portion of the market during normal market conditions could have costs to the government similar to those under the hybrid public/private approach. And a fully federal agency that was required to set the prices for its guarantee through a competitive process would probably have costs to the government similar to those of a private approach. To make the approaches distinct in spite of those possible similarities, CBO selected four illustrative implementations that have the government guarantee a larger share of the market in the fully federal agency and hybrid public/private approaches than the federal guarantor of last resort and largely private approaches.

CBO's estimates are further based on the assumption that guarantees offered under the four approaches would be priced to yield subsidies roughly equal to those offered under similar guarantees in the current system; in other words, full guarantees would yield subsidy rates similar to those in FHA's programs, and partial guarantees would result in rates similar to those of the GSEs. Because the assumed change in guarantee fees charged to lenders and the resulting change in subsidies would be small, the estimates reflect an expectation that replacing full guarantees with partial guarantees and vice versa would result in at most small increases or decreases in the number of multifamily mortgages that would receive a federal guarantee compared with the number of mortgages that CBO projects will receive a federal or GSE guarantee under current policy.

In this analysis, CBO reports the budgetary effect for a single year, 2020.[32] That year represents a feasible date by which the transition of the federal government's role in the multifamily guarantee market could be completed, in CBO's estimation.[33] The estimates of budgetary costs are complicated by CBO's differing budgetary treatments for the GSEs and for other federal credit programs, so they are presented in two ways. One set of estimates compares costs for FHA, RHS, the GSEs, and any new government agency entirely on a fair-value basis; that "apples-to-apples" comparison is a useful indicator of the economic costs or savings to the government. The other set of estimates reflects CBO's differing budgetary treatments for the different types of entities. CBO would estimate the costs of approaches that created a new federal agency or that expanded existing agencies (FHA and RHS) on a FCRA basis unless directed otherwise by lawmakers. However, CBO would estimate the costs of approaches that reduced the GSEs' guarantees on a fair-value basis (which is consistent with CBO's baseline projections for those entities). With that approach, the estimated changes reflect substantial technical differences as well as economic differences.

CBO's estimates in this analysis do not include the appropriations that would be made for administrative costs associated with preserving the value of the federal multifamily loan guarantees.[34] Although the administrative costs of FHA, RHS, and the GSEs are large in dollar terms—the GSEs alone reported administrative expenses of nearly $4.7 billion in their 2014 annual reports—they are a small percentage of their outstanding mortgage

32. The 2020 guarantee volume is based on CBO's August 2015 baseline estimates for fiscal year 2015, with a 2 percent increase in volume in each succeeding year. The subsidy estimates also are based on CBO's August 2015 baseline estimates for fiscal year 2015; CBO obtained from the Office of Management and Budget the detailed cash flows necessary for fair-value estimates.

33. A CBO cost estimate for legislation to alter the guarantee programs of FHA and RHS and the operations of the GSEs would include the 10-year effects on those programs and operations. Those effects would include CBO's assessment of the likely change in the dollar volume and risk profile of guarantees over that period. Such an estimate would include the costs associated with the transition from the current system to one proposed in the legislation, which might include several years with minimal costs during the early stages of the transition.

34. Those amounts are recorded in the budget separately—on a cash basis—and thus are not included in estimates of credit subsidies under either FCRA or fair value.

guarantees (0.1 percent of the $4.4 trillion in total MBSs). For alternatives that would simply shift loan guarantees between the GSEs and a federal agency, there would probably only be small changes in administrative costs. For the approaches that would reduce the total amount of federally backed lending, administrative costs would probably decline somewhat, which would add to the savings estimated in this report for those options.

Fully Federal Agency. Under this approach, all federal guarantees of multifamily mortgages would be provided by a new federal agency. CBO's estimate of the cost of this approach reflects that consolidation, as well as the following changes to existing programs:

- All of FHA's and RHS's guarantees would not change in structure but would be moved to the new agency.

- All of the guarantees provided by the GSEs would be offered by the new agency. The terms of those guarantees would be the same as those of FHA's two largest guarantee programs, Multifamily Development and Apartments Refinance. (The specific program chosen would depend on the purpose of the loan underlying the guarantee.) The new federal agency would offer a full guarantee of credit losses on long-term fixed-rate loans and would charge guarantee fees required to yield a subsidy rate equal to FHA's. Because CBO does not have loan-level data on the GSEs' multifamily loan guarantees to use to determine the appropriate FHA program, it assumed that 80 percent of the GSE guarantees would be replaced by guarantees under the Apartments Refinance program and 20 percent by guarantees under the Multifamily Development program, the same proportions that FHA uses.

On the basis of those changes, CBO estimates that the total dollar volume of loans guaranteed would increase by 5 percent of the dollar volume of the GSEs' guarantees under the baseline, because a full guarantee would provide a higher subsidy. With that higher subsidy, if all guarantees were accounted for on a fair-value basis, adopting the fully federal approach would *increase* the government's projected costs by $1.4 billion in 2020 (see Table 4). Most of that increase would come from providing more comprehensive coverage on loans formerly guaranteed by the GSEs without increasing fees enough to cover the cost, on a fair-value basis, of that more generous guarantee.

A cost estimate reflecting the different budgetary treatments of guarantees of federal agencies and the GSEs would show different results, which would mostly reflect those technical differences rather than the true economic change. Specifically, such a comparison would show projected budgetary *savings* of $3.3 billion in 2020. Most of those estimated savings would be generated by borrowers shifting from GSE financing (which is accounted for under fair value) to other federal guarantees (which are valued under FCRA).

Hybrid Public/Private Approach. Under this approach, CBO assumed the following changes would be made:

- A single government agency would provide partial guarantees on generally shorter-term and variable-rate loans—as the GSEs offer today.

- Guarantees that would have been provided by FHA and RHS would instead be made under that new structure; the agency would charge fees necessary to yield a subsidy rate on their mortgage guarantees equal to that on the GSEs' guarantees.

The total dollar volume of loans guaranteed would decrease by 5 percent of the dollar volume of FHA's and RHS's guarantees under the baseline, because the partial guarantee would be less subsidized than the full guarantee that was no longer available, CBO estimates. On a fair-value basis, projected costs would *decrease* by roughly $0.3 billion in 2020, mainly because the extent of the government's guarantee would be smaller for loans that would otherwise have been guaranteed by FHA and RHS.

A cost estimate reflecting the different budgetary treatments of guarantees of federal agencies and the GSEs would show different results: Projected budgetary savings under that approach would be $3.5 billion greater in 2020. Most of those estimated savings would be generated by shifting from fair-value accounting for the GSEs to FCRA accounting for the new federal agency.

Federal Guarantor of Last Resort. Under this approach, the federal government would provide an explicit guarantee that adapted to economic circumstances. The budgetary cost of the approach, relative to CBO's current baseline, would depend on how many new guarantees were offered during the 10-year budget period and how those new guarantees were structured and priced. To illustrate

Table 4.

Budgetary Costs of Multifamily Mortgage Guarantees Under Current Law and Alternative Approaches, 2020

Billions of Dollars

	Loans Guaranteed by Federal Entities	Change in Loans Guaranteed	Budgetary Cost Under the Current Procedure	Projected Change in Budgetary Cost	Fair-Value Cost	Change in Estimated Fair-Value Cost
			Current Law			
FHA and RHS[a]	11.5		-0.5		0.3	
GSEs[b]	66.2		0.1		0.1	
Total	77.7		-0.3		0.4	
			Fully Federal Agency			
FHA and RHS[a]		-11.5		0.5		-0.3
GSEs[b]		-66.2		-0.1		-0.1
New Federal Agency[a,c]		81.0		-3.6		1.8
Change From Current Law		**3.3**		**-3.3**		**1.4**
			Hybrid Public/Private Approach			
FHA and RHS[a]		-11.5		0.5		-0.3
GSEs[b]		-66.2		-0.1		-0.1
New Federal Agency[a,d]		77.1		-3.8		0.2
Change From Current Law		**-0.6**		**-3.5**		**-0.3**
			Federal Guarantor of Last Resort			
FHA and RHS[a]		-11.5		0.5		-0.3
GSEs[b]		-66.2		-0.1		-0.1
New Federal Agency[a]		7.8		-0.3		0.2
Change From Current Law		**-69.9**		*		**-0.3**
			Largely Private Approach			
FHA and RHS[a]		-8.6		0.4		-0.2
GSEs[b]		-66.2		-0.1		-0.1
Change From Current Law		**-74.8**		**0.2**		**-0.3**
			Total Under Alternative Approaches			
Fully Federal Agency	81.0		-3.6		1.8	
Hybrid Public/Private Approach	77.1		-3.8		0.2	
Federal Guarantor of Last	7.8		-0.3		0.2	
Largely Private Approach	2.9		-0.1		0.1	

Source: Congressional Budget Office.

Notes: Positive values indicate budgetary costs; negative values indicate budgetary savings. Under the approach that would create a *fully federal agency*, loans guaranteed by FHA would be full guarantees and those for RHS would remain 90 percent guarantees, either as part of an existing agency or as part of a new federal agency (as shown here). The loans guaranteed by the GSEs would move to the new federal agency and be converted to full guarantees (similar to FHA's). Under the *hybrid public/private approach*, loans guaranteed by FHA and RHS would be moved to the new federal agency and converted to partial guarantees (similar to the GSEs'). The loans guaranteed by the GSEs would move to the new federal agency and remain partial guarantees. Under the approach that would make the federal government a *guarantor of last resort*, 10 percent of the loans guaranteed by FHA and RHS would be full or 90 percent government guarantees. Ten percent of the loans guaranteed by the GSEs would move to the new federal agency and be converted to full government guarantees (similar to FHA's). Under the *largely private approach*, 25 percent of the loans guaranteed by FHA and RHS to finance the development of new multifamily units would be full or 90 percent government guarantees. This table shows the guarantees as coming from a new federal agency (not an existing one). The federal government would no longer provide FHA guarantees to refinance existing units and GSE guarantees.

FHA = Federal Housing Administration; GSE = government-sponsored enterprise; RHS = Rural Housing Service;
* = between -$50 million and zero.

a. Budgetary cost based on Fair Credit Reform Act methodology.

b. Budgetary cost based on fair-value methodology.

c. The volume of loans guaranteed by the new federal agency would increase by 5 percent of the GSEs' volume as a result of offering a full guarantee with a higher subsidy.

d. The volume of loans guaranteed by the new federal agency would decrease by 5 percent of FHA's and RHS's volume as a result of offering a partial guarantee with a lower subsidy.

the effects of this approach, CBO assumed the following changes would be made to existing guarantees:

- On average, the government's total exposure would be approximately 10 percent of the dollar volume of loan guarantees for the GSEs, FHA, and RHS projected under current law. (Guarantees issued by each agency would be reduced proportionally to retain the same share of the total.)

- The new federal agency would offer guarantees with a subsidy rate similar to those offered by FHA and RHS under current law.

- GSE guarantees would be converted to the same structure as guarantees issued by FHA's Multifamily Development or Apartments Refinance programs. (The purpose of the loan underlying the guarantee would determine which program was chosen.)

If all guarantees were estimated on a fair-value basis, adopting this approach would *reduce* projected costs by $0.3 billion. That decline in costs would come from offering fewer FHA, RHS, and GSE guarantees, each of which has a positive subsidy rate.

A cost estimate reflecting the different budgetary treatments of guarantees of federal agencies and the GSEs would show a *decrease* in projected costs of less than $50 million. That change would come largely from reducing the number of guarantees offered by FHA and RHS, because each guarantee has a negative subsidy rate.

Those dollar volume and cost estimates factor in the potential effect of an increase in the share of mortgages that might be guaranteed by the new federal agency in the event of a crisis. Specifically, in its estimates, CBO projected that the government would increase its share of guarantees significantly 1 year out of 40 and moderately 1 year out of 10. In all other years, the agency would maintain a share of 5 percent of the total market. On average, the government would maintain a 10 percent share.

Largely Private Approach. For the transition to a largely private market, CBO assumed that these changes would occur:

- Lawmakers would shrink the number of mortgages insured by FHA and RHS guarantees to 25 percent of their projected amount. The guarantees available under those programs would be limited to the development of new multifamily units. Refinancing transactions would not be eligible for a federal guarantee.

- All loans projected to be guaranteed by the GSEs under current law would instead be provided by the private sector or would not be made at all.

On a fair-value basis, projected costs for the government would *decrease* by $0.3 billion in 2020 because there would be fewer FHA, RHS, and GSE guarantees, each of which has a positive subsidy rate on a fair-value basis. The dollar volume of loans guaranteed and the costs might be higher if the government provided additional credit in times of crisis. Those potential costs are not reflected here.

A cost estimate reflecting the different budgetary treatments of guarantees of federal agencies and the GSEs would show an *increase* in projected costs of $0.2 billion in 2020, mainly because of a reduction in the number of FHA and RHS guarantees, each of which has a negative subsidy rate under FCRA.

About This Document

This report was prepared at the request of the Chairman of the House Committee on Financial Services. In keeping with the Congressional Budget Office's mandate to provide objective, impartial analysis, the report makes no recommendations.

Mitchell Remy wrote the report with guidance from Damien Moore. Leigh Angres, Douglas Elmendorf (formerly of CBO), Mark Hadley, Mark Lasky, Susanne Mehlman, Jeffrey Perry, Natalie Tawil, David Torregrosa, and Rebecca Verreau provided useful comments on various drafts of the report.

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