Research Brief

Credit Constraints for Small Multifamily Rental Properties

INTRODUCTION

Small multifamily properties are critical to the supply of affordable rental housing in Cook County and nationally, but this segment of the market faces challenges around accessing sufficient capital for acquisition, rehabilitation, and refinancing. The lending market for small multifamily properties is served largely by portfolio lenders whose ability and willingness to lend, particularly during times such as the recent financial crisis, may be limited by factors such as access to sources of lending capital, changes in the performance of their loan portfolios, and tighter regulatory safety and soundness requirements. Small loan size and the relative complexity and high cost of underwriting and servicing mortgages to small multifamily buildings has made it difficult for a secondary market to develop for loans to these types of properties. Without an active secondary market, lending to small multifamily buildings could be marginalized in favor of lending to owner-occupied single family properties or large multifamily rental projects for which robust secondary markets exist. Additional challenges around access to credit may also be tied to the geographic concentration of these properties in neighborhoods that have been disproportionately destabilized by the foreclosure and economic crisis.

A recent working paper by Jin Man Lee and James D. Shilling of the Institute for Housing Studies (2012) examined credit constraints for small multifamily rental properties in Cook County.[1] It looked at lending to multifamily buildings in Cook County between 2005 and 2010 and examined whether the estimated supply of credit available to buildings with 10 to 49 units was sufficient to meet the expected demand for credit for these types of buildings, particularly when compared to the supply of credit available for larger buildings with 100 or more units. The analysis controlled for factors likely to affect the demand for and supply of credit such as building cash flow, building age, year of mortgage origination as well as community factors such as area foreclosure rate and median income level.

KEY DEFINITIONS

Small multifamily properties: The universe of rental units is typically divided into those coming from single family properties and those from multifamily properties. Single family properties are considered buildings with four or fewer units. A large portion of the rental housing stock comes from single family buildings with two to four units. Multifamily buildings are those with five or more units. Within this universe of buildings, a small multifamily building is generally considered one with fewer than 50 units. The analysis in the working paper discussed in this research brief focuses on buildings with 10 to 49 units.

Credit Constraint: A property is considered credit constrained if the supply of credit for that property is not sufficient to meet the property's demand for credit.

[1] See Jin Man Lee and James D. Shilling, "Small Unit Rental Properties Financing Needs," Institute for Housing Studies Working Paper, March 2012. For the full working paper, see ihs.depaul.edu. The working paper focuses on credit constraints for 10 to 99 unit properties, but the authors conducted a special analysis of constraints for 10 to 49 unit properties for this research brief.

SMALL MULTIFAMILY BUILDINGS AND THE RENTAL HOUSING STOCK

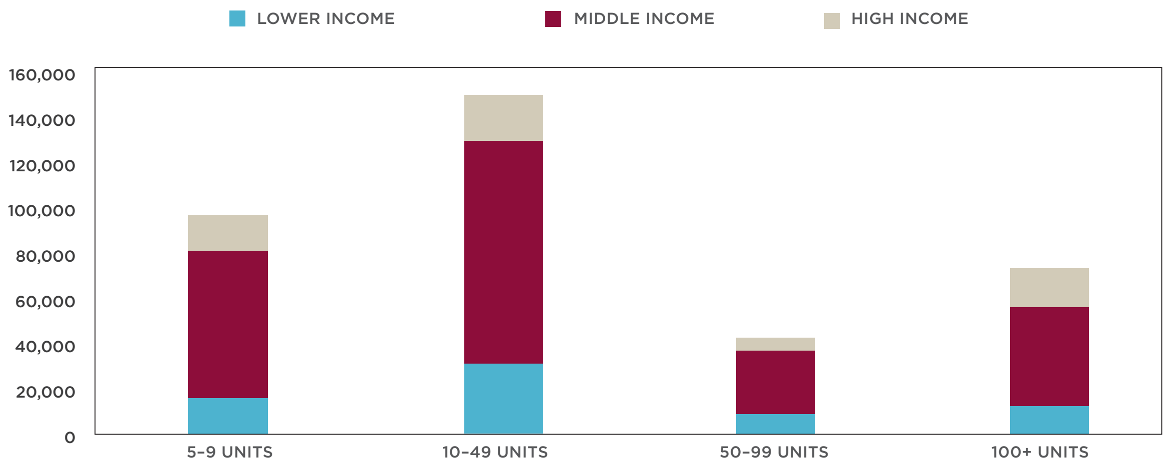
Small multifamily buildings make up a critical portion of the rental market nationally and in Cook County. When considering rental units in both single family and multifamily structures, nationally buildings with between five and 49 units accounted for over 31 percent of the rental housing stock in 2010. [2] In Cook County this share was even higher. Buildings with between five and 49 units accounted for over 35 percent of the county's rental units.[3]

When looking in more detail at the multifamily segment of the rental market (buildings with five or more units), buildings with between 10 and 49 units make up a substantial portion of the stock. Chart 1 shows that buildings with between 10 and 49 units contribute over 147,000 units to the Cook County multifamily rental housing stock compared to roughly 94,000 units for buildings with 5 to 9 units and 72,000 for buildings with 100 or more units. Additionally, buildings with 10 to 49 units make up a critical portion of the rental housing stock in lower income communities. Chart 1 also shows that these buildings contribute over 30,000 units to lower income areas which are communities often most in need of affordable rental housing.[4] This accounts for nearly half of the multifamily rental units in lower-income communities in Cook County.

LENDING TO SMALL MULTIFAMILY PROPERTIES

Access to financing for small multifamily properties is critical for the preservation of the affordable rental housing stock. This is particularly important in the current environment where there is little or no production of new affordable rental housing units. Financing allows potential building owners to acquire and rehabilitate properties. Such lending can preserve existing rental units that may have otherwise gone into foreclosure if no new buyer could be found or return units previously offline to the rental housing supply. Financing can also allow building owners to pursue rehabilitation projects such as improving energy efficiency or other types of building repair that help maintain buildings and control or reduce building operating costs. Access to financing can also allow a building owner the opportunity to refinance maturing debt and take advantage of lower interest rates.

CHART 1. COOK COUNTY RENTAL UNITS BY BUILDING SIZE AND NEIGHBORHOOD INCOME LEVEL, 2010



Source: Cook County Assessor's Data, 2010

[2] This number includes rental units in both single family and multifamily properties. Source 2010 ACS 1 year estimates, data element B25032-Tenure by Units in Structure accessed on 3/1/2012.

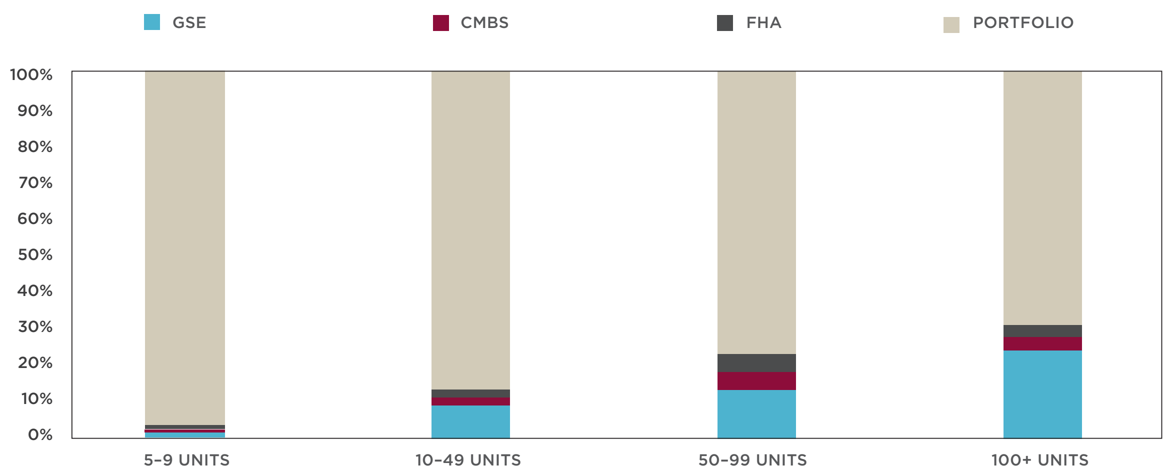
[3] See Institute for Housing Studies. November 2011. *The State of Rental Housing in Cook County*. Chicago, IL: DePaul University. This number includes rental units in both single family and multifamily properties.

[4] Lower income communities are those where the median family income is 150 percent of poverty level or less.

Loans to small multifamily properties are typically more expensive to originate and less profitable for lenders than loans to larger buildings however. Underwriting mortgages for multifamily properties is complex and costly. During the underwriting process, a lender will conduct an analysis of a property's income and expenses, evaluate vacancy rates, appraise the property's value, assess the property's condition, consider the overall financial strength of the owner, and evaluate property management capacity. In Cook County between 2005 and 2010, the median loan size for 10 to 49 unit properties was $760,000 compared to $6.7 million for buildings with more than 100 units.[5] Because larger properties tend to have larger loans, they are better able to offset higher origination costs than are transactions involving smaller loans. In addition to origination costs, lenders also have ongoing costs associated with servicing a loan. For lenders the relative cost of servicing smaller loans is also much higher than servicing large loans relative to the overall value of the loan. These high origination and servicing costs present a substantial barrier to selling loans for small multifamily buildings to the secondary market.

Because no significant secondary market has developed for the smaller loans that typically finance small multifamily properties, the lending market for small multifamily buildings is most commonly served by a wide range of depository institutions such as commercial banks and thrifts. These institutions typically have a deep knowledge of the local housing market, have a specialization in lending to certain segments of the multifamily market, and have developed strong relationships with their borrowers. These lenders do not necessarily have standardized products and typically hold loans in their portfolios after origination as opposed to selling them to the secondary market. As seen in Chart 2, between 2000 and 2010 in Cook County, portfolio lenders made up the vast majority of loans to properties with 10 to 49 units. The remaining loans in Cook County were funded by secondary market players such as the Government Sponsored Enterprises (GSE) Fannie Mae and Freddie Mac and, to a much lesser extent, the Federal Housing Administration (FHA) and commercial mortgage backed securities (CMBS).[6]

CHART 2. SOURCE OF FINANCING FOR COOK COUNTY MULTIFAMILY BUILDINGS BY BUILDING SIZE, 2000 TO 2010



Source: IHS calculations based on data from multiple sources including the Cook County Assessor's Office, the Cook County Recorder of Deeds, SNL Financial, Fannie Mae, and Freddie Mac

5 IHS calculations based on data from the Cook County Recorder of Deeds and Cook County Assessor's Office.

6 For a more detailed discussion of the small multifamily mortgage financing market see "Fannie Mae's Role in the Small Multifamily Loan Market." First Quarter 2011. Washington, DC: Fannie Mae.

POTENTIAL REASONS FOR CREDIT CONSTRAINTS FOR SMALL MULTIFAMILY BUILDINGS

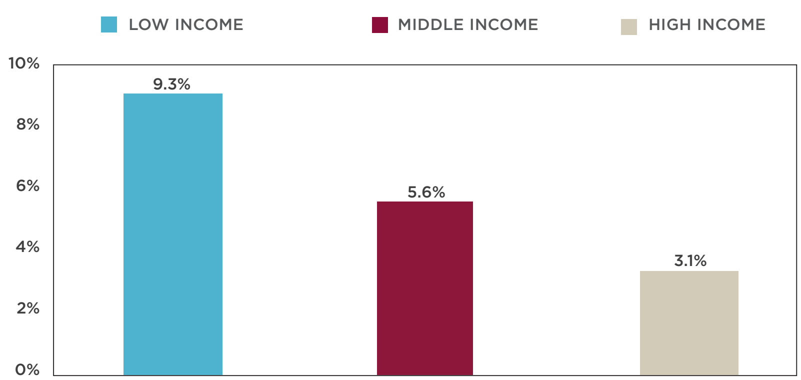
While portfolio lenders dominate the multifamily lending market in Cook County, the recent financial crisis has illustrated how this might pose a challenge to accessing sufficient capital for multifamily properties. The downturn caused substantial losses to bank loan portfolios tied to commercial real estate and single family residential mortgages, and many commercial banks and thrifts failed as a result of these losses. During this period, many banks had a more difficult time accessing lending capital and spent increased time managing troubled loans in their existing portfolios. Additionally, new regulations intended to increase bank safety and soundness required banks to raise additional capital for expanded loan loss reserves. These factors led banks to tighten underwriting criteria for most loan products and reduce overall lending volume.

Another potential challenge for small multifamily building owners seeking financing is the location of these properties in communities that have been heavily impacted by the foreclosure and economic crisis. As stated earlier, a substantial portion of the rental housing stock in low-income areas of Cook County is provided by units in 10 to 49 unit buildings. These communities often have higher unemployment and vacancy rates. Owners of buildings in lower-income communities often operate on thin margins which can make them more vulnerable to foreclosure. Chart 3 shows that, between 2007 and 2010, over nine percent of the units in multifamily buildings in low-income areas were affected by foreclosure, compared to less than six percent in middle-income areas and roughly three percent in higher income areas.[7] This higher level of community distress might cause some lenders to be more risk averse in their lending to properties in lower-income communities.

QUANTIFYING CREDIT CONSTRAINTS FOR SMALL MULTIFAMILY PROPERTIES

The working paper by Lee and Shilling examined whether small multifamily properties have more significant constraints when accessing credit compared to larger multifamily properties. In the analysis, credit was considered constrained when a property's estimated demand for credit exceeded the estimated supply of credit for that property. A loan supply and demand model was developed that estimated the cash flow a building would generate and then used that estimated cash flow to determine the expected loan demand for that property. The model also controlled for factors likely to affect the supply of credit. These factors include property cash flow, neighborhood foreclosure rate and median income level, building age, property size, and year of mortgage origination.[8]

CHART 3. PERCENT OF COOK COUNTY RENTAL UNITS IN BUILDINGS WITH MORE THAN 5 UNITS DIRECTLY AFFECTED BY A FORECLOSURE BY NEIGHBORHOOD INCOME LEVEL, 2007 TO 2010

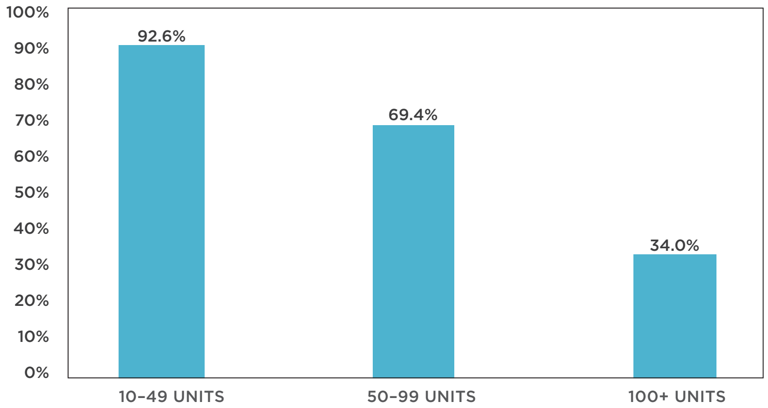


Source: Foreclosures in Cook County Records and Deeds obtained by Property Insight, Record Information Services, and Cook County Assessor's Office

[7] See Institute for Housing Studies. November 2011. *The State of Rental Housing in Cook County*. Chicago, IL: DePaul University.

[8] See the Working Paper for full explanation of the model used to estimate loan supply and demand.

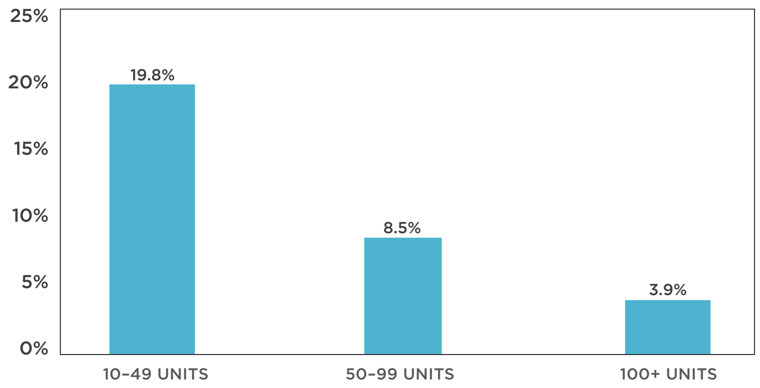
CHART 4. PERCENT OF COOK COUNTY MULTIFAMILY PROPERTIES WHERE ESTIMATED LOAN DEMAND WAS HIGHER THAN ESTIMATED LOAN SUPPLY BY BUILDING SIZE, 2005 TO 2010



Results of the model show that after controlling for the above factors, a far greater share of buildings with between 10 and 49 units experience credit constraints than did larger buildings. As illustrated in Chart 4, nearly 93 percent of properties with 10 to 49 units that received a mortgage between 2005 and 2010 were considered credit constrained and nearly 70 percent of 50 to 99 unit properties were similarly credit constrained. Conversely, only 34 percent of properties with over 100 units were considered credit constrained.

The depth of credit constraint was particularly acute for properties with 10 to 49 units. One way to illustrate this is to look at how typical buildings falling into different size categories would fare in terms of accessing enough credit to meet expected loan demand. For example, the typical 10 to 49 unit building is one whose units have monthly rents of $1,100, has a building vacancy rate of 6 percent, and is 82-years old, the average age of the housing stock in Cook County. Chart 5 illustrates that, based on these assumptions, the IHS model estimates that the credit available to the typical constrained 10 to 49 unit property investor would be 19.8 percent less than the expected demand. By comparison, the estimated credit available to the typical credit constrained 50 to 99 unit property investor be about 8.5 percent less than the expected demand. For buildings with over 100 units property, the expected available supply of credit would be 3.9 percent less than expected demand.

CHART 5. ESTIMATED UNMET CREDIT DEMAND AS A SHARE OF TOTAL ESTIMATED DEMAND FOR CREDIT CONSTRAINED COOK COUNTY MULTIFAMILY PROPERTIES BY BUILDING SIZE, 2005 TO 2010



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IMPLICATIONS

The authors see their results as having serious implications for the preservation of affordable housing. Credit constraints for small multifamily rental properties could significantly limit the ability of owners and investors to purchase, rehabilitate, and refinance these types of rental properties. Because rental units in small multifamily buildings make up a substantial portion of the rental stock in lower-income communities, constraints could also have an impact on access to affordable rental housing. It is important that federal, state, and local agencies concerned about access to affordable rental housing work with financial institutions and property owners to ensure a consistent flow of credit to small multifamily rental properties and support institutions and loan products that bridge any financing gaps that may exist.

The Institute for Housing Studies (IHS) is a multidisciplinary academic research center that provides data and analysis to inform housing-related policy and resource allocation decisions.

IHS was created in 2007 as part of Preservation Compact, a multifaceted initiative to preserve Chicago-area affordable rental housing launched by the Urban Land Institute/Chicago and a coalition of public and private partners, including DePaul, with funding from The John D. and Catherine T. MacArthur Foundation.

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DePaul University

The Preservation Compact
A Rental Housing Strategy for Cook County

MacArthur Foundation