Multifamily Mezzanine Loan Offering

Freddie Mac recently announced its Multifamily Mezzanine Loan offering, which provides incentives for multifamily owner/operators to voluntarily keep properties affordable as workforce housing. This factsheet expands on the information Freddie Mac has publicly released, further explaining how this pilot can help preserve affordable rental housing.

Summary of Mezzanine Loan Offering

Freddie Mac's Multifamily Mezzanine Loan offering incentivizes multifamily property owners to limit rent increases without any federal, state or municipal expenditures. Under the financing, the property owner receives favorable pricing on the Mezzanine Loan in exchange for voluntarily limiting rent growth on 80 percent of the units in the property and keeping a majority of the property's units affordable to working families of low and moderate incomes. This preserves both the specific units and the property overall as workforce housing for the 10-year life of the loan.

Mezzanine financing delivers additional debt capital necessary to fill in the gap between the property owner's equity and the first lien mortgage loan amount. Under the Mezzanine Loan offering, the first mortgage loan and the Mezzanine Loan are originated simultaneously in a streamlined single process.

To qualify for the Mezzanine Loan pilot, property owners voluntarily agree to several conditions and limitations:

1. Either 50 percent of units in the property must have rents affordable to households making no more than 100 percent of Area Median Income (AMI) at origination, or the property must be located in a relatively affordable census tract[1], with rents on at least 50 percent of the units less than or equal to area median rent.

2. On 80 percent of the units in the property (including the 50 percent of units with rents affordable to families earning AMI), annual rental rate increases are limited to the greater of one percentage point above the rate of inflation (as measured by the Consumer Price Index) or 2 percent of the rent for the 10-year life of the loan.

3. Both the first lien mortgage loan and the Mezzanine Loan are funded and purchased simultaneously, with a maximum combined loan-to-value ratio of 90 percent.

To ensure rental increases do not exceed those allowable under the program, servicers will check rents on an annual basis. Property owners out of compliance will incur an affordability penalty fee equal to 5 percent of the original principal balance of the Mezzanine Loan, subject to a one-time, 30-day cure period, assessed every six months until rents are returned to compliant levels.

Freddie Mac makes the Mezzanine Loan offering available through both its Conventional platform (which provides a full range of financing products) and its Targeted Affordable Housing platform (which focuses on financing rent-restricted properties in underserved areas that are affordable to families with low and very low incomes and benefit from a federal, state, or municipal program). Term sheets for the offering are available online:

- Conventional: https://mf.freddiemac.com/docs/product/workforce_housing_mezz.pdf
- Targeted Affordable Housing: https://mf.freddiemac.com/docs/product/tah_mezz.pdf

[1] "Relatively affordable census track" is defined as an area where the estimated median income of the residents of the property is less than 80 percent of the area median income for the surrounding area. Freddie Mac would determine this affordability using acceptable methods for statistical inference.

The Mezzanine Loan offering was developed in consultation with and approved by the Federal Housing Finance Agency (FHFA).

Policy Background

Freddie Mac developed the Mezzanine Loan offering as part of its ongoing efforts to find new ways to responsibly preserve affordable rental housing.

Throughout the nation, the supply of multifamily housing affordable to low- and moderate-income working families is unable to meet growing demand. This scarcity is further exacerbated by the growing trend in rehabilitation of properties in order to increase rents beyond levels affordable to these families. Overall during the 2015-2017 period, inflation for non-housing-related items was flat (0.5 percent growth) while rents rose 11.6 percent.[2] Furthermore, new supply is focused predominantly on high-rent, class A properties or subsidized, Low-Income Housing Tax Credit (LIHTC) properties. The middle of the rental housing market – workforce housing – is therefore not being adequately supported or preserved.

This in turn puts further pressure on the supply of rental housing affordable to those making lower incomes. The Joint Center for Housing Studies at Harvard University gives perspective on the loss of affordable housing units available.

> "Between 1990 and 2016, the number of rental units in the U.S. priced below $800 per month (in real terms) shrank by nearly 2.5 million. However, over the same period, the number of low-income renters … grew by more than 4.5 million households… Overall, this drop represented a net loss of 15 percent of the 16.2 million low-cost units that rented for less than $800 (in 2016 dollars) in 1990… The loss took place even as the total number of renters rose by over 10 million.[3]

In addition, the vast majority of multifamily projects without a federal, state, or municipal subsidy do not require verification of incomes, due to its arduous, costly and privacy-challenging nature. First, income verification is privacy-challenged in that many tenants are reluctant to voluntarily provide personal information to their landlords or a third party. Second, income verification would add a level of expense that could make it more difficult to meet the affordability needs of renters without additional subsidy. Third, ongoing monitoring poses even greater challenges and significantly greater costs, which would be passed down to the renter.

In recognition of this growing challenge, Congress and FHFA directed the Government-Sponsored Entities (GSEs) to seek ways to increase their support of affordable rental housing:

- The 2017 FHFA Scorecard required Freddie Mac to explore opportunities to further support liquidity in multifamily affordable housing, including workforce housing and Targeted Affordable housing.

- The 2018 FHFA Scorecard directed Freddie Mac to focus specifically on developing plans to support liquidity in the workforce housing segment of the multifamily market.

- Freddie Mac's statutory Duty to Serve (DTS) obligations include preserving affordable rental housing nationwide. DTS was created by Congress as part of the Housing and Economic Recovery Act of 2008 and implemented by FHFA regulations in 2017.

[2] Rent Growth Relative to Inflation, http://www.jchs.harvard.edu/ARH_2017_rent_growth_vs_inflation
[3] Our Shrinking Supply of Low-Cost Rental Units, http://www.jchs.harvard.edu/blog/our-shrinking-supply-of-low-cost-rental-units/

Benefits of the Mezzanine Loan Offering

While the Mezzanine Loan offering is expected to comprise a small portion of Freddie Mac's overall multifamily business volume, it is tailored specifically to help mitigate the shortage of multifamily rental housing affordable to low- and moderate-income families.

- **Favorable Mezzanine Loan pricing encourages the acquisition and improvement of affordable rental properties** by enabling property owners to better leverage their equity and lower their cost of capital. This includes refinancing or acquiring Section 8 properties and LIHTC properties following their compliance period, or repositioning any subsidized affordable property for resyndication.

- **The program targets families that are low and moderate income,** by voluntarily restricting annual rent increases on 80 percent of the units, with at least half affordable to families earning no more than AMI at origination.

- **By slowing rent growth, this program mitigates attrition/tenant turnover.** This helps low- and moderate-income renters stay in units that may otherwise go to more affluent renters as rents increase. In addition, less frequent turnover results in lower costs for borrowers and more stable lives for tenants.

- **The Mezzanine Loan offering provides positive, market-based economic incentives to property owners without an explicit affordability mandate**. It seeks to increase the amount of affordable and workforce housing available by targeting conventional owner/operators of multifamily properties that are not necessarily focused on affordable housing.

- **The program seeks to qualify properties on day one,** to identify those that are largely affordable and workforce housing and preserve them as such. This may enable current tenants to remain in these units for longer than they might if rents were able to increase faster. It may also mitigate the economic incentive for owner/operators to more significantly improve the units with resulting high rent increases that would likely price out lower-income families.

- **Properties that qualify for mezzanine financing will be geographically diverse.** The program is available nationally and designed such that its affordability will vary appropriately to account for different rent levels in different markets.

- **Favorable pricing on the Mezzanine Loan also mitigates any need for property owners to cross-subsidize.** Cheaper financing alleviates the need to charge more for market-rate units not covered by rent growth limits.

Additional Details

Mezzanine loans are originated alongside senior loans and will follow the designation of the senior loan to determine whether it counts against the FHFA's multifamily lending cap. As a second (i.e., not senior) loan, Mezzanine loans are not eligible for consideration under the FHFA's affordable housing goals criteria. The anticipated volume in Mezzanine Loans is less than 1 percent of Freddie Mac Multifamily's overall volume, thereby having a limited expected impact in overall production and thus the volume cap. The average size of a Mezzanine Loan is expected to be about $2 million, which is 10 percent of Freddie Mac's average senior loan size.

In developing this offering, Freddie Mac sought to balance its policy goals with practicality and flexibility for borrowers. The program allows for expense pass-throughs to help manage unexpected expense increases due to real estate taxes, insurance and utilities during the loan term. It also provides the borrower the flexibility to properly manage tenant unit variations, move ins/move outs and, if applicable, staggered renovation schedules by limiting rent growth on 80 percent of the units. Finally, it does not call for income verification, in order to ensure the program serves its intended purpose of incentivizing borrowers to keep costs low for tenants. Income verification would add a level of costs that could make it more difficult to meet the needs without an additional subsidy to cover those costs.

A Voluntary Offering that is Not Rent Control

This is an entirely voluntary offering that operates very differently from a typical rent-control program. It seeks to incent borrowers with an alternative investment strategy in the acquisition and operation of affordable and workforce properties. No borrower will be compelled or required to participate, and the same first-mortgage financing will be available through Freddie Mac whether or not they chose to also pursue a Mezzanine Loan.

In addition, the offering does not restrict rents, but rather it limits the rate of rent growth, which does not resemble a typical rent control regime. This more closely resembles rent stabilization in that it simply slows and smooths the rate of rent growth over the loan term, thereby reducing disruption to the lives of tenants and tenant turnover while lowering the volatility of rents in affordable housing communities.

Lastly, the program is limited to the term of the loan, and does not encumber any property through a deed restriction, as rent control would. While there are significant economic penalties for non-compliance, enforcement of the rent restrictions will not be the purview of any local or state government, but a private matter in terms of contract enforcement.

About Freddie Mac's Multifamily business

Freddie Mac Multifamily is the nation's multifamily housing finance leader and the leading funder of affordable housing in the United States[4]. Since inception, Freddie Mac Multifamily has financed millions of rental housing units throughout the nation, including approximately 820,000 units during 2017 and 343,000 units during the first half of 2018. Historically, nearly 90 percent of the units funded have been affordable to families with incomes at or below area median incomes.

We hope this information is helpful to those seeking to understand the Multifamily Mezzanine Loan offering.

[4] Freddie Mac Multifamily funded more units affordable to low-income (80 percent of median income) and very low-income (50 percent of median income) households than other lenders in each of the last two years.