Navigate the GSE Highway

Understanding the options for small-balance multifamily loans can pay dividends

By Igor Zhizhin

Since the Great Recession ended in 2009, no other market players have had a greater impact on the multifamily lending industry than Fannie Mae and Freddie Mac. As of this past May, Fannie and Freddie held or guaranteed 44 percent of all outstanding multifamily mortgages, up from 25 percent in 2006. The two government-sponsored enterprises, or GSEs, also play a vital role in the purchase or guaranteeing of small-balance multifamily commercial mortgages — loans valued between $750,000 and $7.5 million.

Although they target borrowers and property types with similar profiles, Fannie Mae's and Freddie Mac's programs are fundamentally different. It is imperative for a successful commercial mortgage broker to understand these differences, so they can provide value to their multifamily clients by offering uniquely customized solutions, particularly in the small-balance market.

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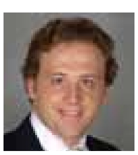

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Fannie Mae's and Freddie Mac's programs have historically been the preferred choice for commercial mortgage brokers because of their highly competitive structures, broker-driven business models and yield-premium options, compared to placing loans with commercial banks.

In the past decade, the increase in the GSEs' multifamily-loan market share was based on an aggressive government response to overall limited liquidity in the commercial mortgage sector during the recession. In particular, this was true of affordable housing in smaller, remote markets.

While the national multifamily market currently maintains healthy fundamentals and a strong appetite across all lender types, the GSEs continue to be a leading option for most small-balance borrowers. The Federal Housing Finance Agency's announcement that its lending caps for the GSEs wouldn't change in 2017 only bolsters that trend.

Pricing and structure

With pricing being one of the biggest drivers in choosing a loan type, it is important to understand the sizable differences between Fannie's and Freddie's programs. Fannie Mae has one set of pricing that is effectively uniform, regardless of whether the property is in one of the top 10 markets or a remote area. Freddie Mac, on the other hand, has four pricing tiers: top market, standard market, small market and very small market. The variations among these four tiers is substantial — including a variance in the interest rate between tiers that can be 1 percentage point or more.

The programs also have different prepayment options and maximum leverage requirements. Freddie Mac designates market-pricing tiers by county, for example, so it is important to check the pricing scheme to avoid erroneously quoting a wrong price to clients. While Freddie Mac has considerably lower rates in the top markets, Fannie Mae is generally better priced in small markets. A savvy mortgage broker should know instinctively which program's pricing is the natural fit for a property's location.

Both Fannie's and Freddie's small-balance programs offer balloon-loan structures. The differences between Fannie's and Freddie's loan structures, however, are considerable. Fannie primarily offers fixed-rate balloon loans with terms ranging from five to 30 years. The loan terms can be customized, usually at a premium, for any duration between five and 30 years.

Freddie offers a 20-year hybrid mortgage that is fixed for the first five, seven or 10 years before converting to an adjustable-rate loan for the duration of the term. Floating-period rates are based on the six-month Libor index with the initial rate as the start floor, a 1 percent annual reset and a lifetime rate cap of 5 percent above the start rate.

The structure of these loans target two different types of clients, and it is important to match a client's investment strategy to an available loan structure. Investors with a short-term ownership horizon, strong concerns about access to competitive debt at loan maturity, or those looking for flexible loan terms would be better suited to take a Freddie Mac loan. Investors who have extensive interest-rate concerns, longer investment horizons, or life-event needs that require a customized, fully amortizing loan would most benefit from a Fannie Mae loan.

Closing the loan

Timing is often the most important factor when financing an acquisition, and the two GSE small-balance multifamily loan programs have essential timing differences that can make or break a transaction.

Fannie Mae exclusively uses a handful of Delegated Underwriting and Servicing (DUS) lenders. These companies underwrite and internally approve loans without requiring Fannie Mae's involvement unless, in rare instances, there are multiple extenuating circumstances that require program waivers. Barring that, the typical Fannie loan process takes 45 to 50 days for approval and an additional seven to 10 days to close.

Freddie Mac, on the other hand, is not a delegated program. Even after a loan has received full lender approval, Freddie internally underwrites the loan before issuing a commitment. This additional layer typically adds 10 to 15 business days to the loan-approval process, depending on the complexity of the deal and the volume of transactions under review.

Freddie rarely makes material changes to a loan seller's recommendations but, unfortunately, it is even more rare for it to finalize an internal review in less than 10 business days. These are conservative estimates, and sometimes it takes longer. If Freddie is involved, a seasoned mortgage broker will always make sure an additional two weeks of contingency time is built into the loan-closing timeframe.

Prepayment penalty

One of the main reasons borrowers decline a GSE-based loan is the prepayment penalty. Like all securitized loans, the GSE small-balance platform has historically offered only yield-maintenance prepayment options. This complex and impossible-to-predict formula was not a fit for most small-balance borrowers who had come to expect a simple and straightforward prepayment schedule from commercial banks.

Understanding this was a fundamental problem and opportunity, Fannie Mae and Freddie Mac began offering step-down prepayments. Fannie offers a single step-down prepayment plan for adjustable-rate loans and three step-down options for fixed-rate loans, as long as the property has 50 or fewer units.

Freddie offers step-down options for its hybrid and fixed-rate loans. The floating-loan portion of a Freddie hybrid mortgage has a 1 percent prepayment charge regardless of loan term.

These types of customized prepayments are a real competitive advantage over commercial banks. Detailed product knowledge in this area makes a big impact for a broker when sourcing potential clients.

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Loan size

The extremely competitive loan costs for the Fannie and Freddie small-balance programs are greatly impacted by the loan-amount ceilings. One of the biggest advantages of both programs is having total third-party costs that are generally less than what is charged by most commercial banks.

A third-party deposit, ranging from $5,500 to $8,500, covers an appraisal, property-condition report, Phase I environmental report and a lender's legal costs. That expense varies by market, not by loan size. It's somewhat costly for a $1 million loan, but is substantially inexpensive for a $5 million loan.

Fannie Mae's program typically has loan amounts from $750,000 to $5 million, with Freddie Mac ranging from $1 million to $7.5 million. Both programs will consider smaller and larger transactions, typically within 10 percent of the loan floor or ceiling.

Amortization schedule

When a small-balance borrower considers a loan, the monthly payment amount is usually a leading factor in their decisionmaking process. Both Fannie's and Freddie's programs offer a standard 30-year amortization schedule, but each has a very different approach to offering interest-only payments and a customized amortization schedule.

Fannie Mae is the only option if a client is looking for a fully amortizing loan of any duration. The program offers interest-only payments but is more conservative in that area. A loan can include one year of interest-only payments, at any leverage, on a term of at least 10 years. Partial-term interest-only loans must have a loan-to-value (LTV) ratio below 65 percent, with a debt-service coverage (DSC) ratio above 1.35. Full-term, interest-only loans must have an LTV below 55 percent and a DSC above 1.55.

Freddie Mac typically will not accept an amortization schedule of less than 20 years and does not offer a fully amortizing loan. Its interest-only options are much more competitive, however, particularly in top and standard markets. In those markets, Freddie offers no interest for one year on a five-year loan; two years of no interest on a seven-year loan; and three years of no interest on a 10-year loan.

For clients looking to aggressively pay down their loan or eliminate the risk of refinancing, Fannie Mae is the best option. For clients that are looking to maximize cash flow or have a value-add opportunity requiring a smaller payment burden while they reposition the asset, Freddie Mac is a more appropriate choice.

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With the continued commitment by the GSEs to play an active role in the multifamily financing sector, mortgage brokers would be wise to develop detailed knowledge of Fannie's and Freddie's unique benefits in order to capitalize on their programs and be successful. Once they have a transparent and smooth loan process, most borrowers will maintain a strong commitment to their broker as well as to these programs that address their small-balance multifamily financing needs. ■