Multifamily Housing In the 1970's

By Peggy Brockschmidt*

The housing market is one of the most volatile parts of the U.S. economy. The level of housing starts changes rapidly over short periods of time in response to general economic conditions, shifts in the cost and availability of credit, and changes in the demand for various kinds of housing. In the past several years, this volatility has been particularly noticeable in the multifamily sector of the housing market. Construction of multifamily residences rose rapidly in the first part of the 1970's, then declined sharply during the 1973-75 recession. The sharp decline was followed by a slow recovery that is continuing in 1978. This article first describes the general structure of the construction and mortgage markets for multifamily housing. The article then describes and analyzes the fluctuations that have occurred in the level of multifamily starts over the past several years.

THE STRUCTURE OF THE MARKET

Multifamily Construction Market

Multifamily housing structures are defined here as those containing five or more separate dwelling units. In most cases, the units are rented; however, a new type of multifamily housing unit — typically referred to as a condominium — has appeared in recent years. The condominium is a type of ownership in which the owners of the individual housing. units in a building are also joint owners of the common areas of a building or community.

The multifamily sector is an important part of the nation's residential housing market. During the 1970-77 period, construction starts of multifamily units averaged about 450,000 units per year, or 30 per cent of all housing units started during the period.

Financing Multifamily Construction

The financing of multifamily residences occurs in both the construction loan market, which provides temporary funds during the building stage, and the permanent mortgage market, which provides funds over longer periods of time. In addition, the secondary market for multifamily mortgages provides a mechanism for transferring mortgages from originators to permanent holders and from one permanent holder to another.

The Construction Loan Market. Construction loans for multifamily units, which averaged $8.8 billion yearly in the 1970-77 period, are extended mainly by financial

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Table 1
CONSTRUCTION LOANS FOR MULTIFAMILY RESIDENCES
Yearly Average: 1970-77

Lender Group	Originations—1970-77 Billions of Dollars	Originations—1970-77 Per Cent	Holdings—Sept. 30, 1977 Billions of Dollars	Holdings—Sept. 30, 1977 Per Cent
Commercial Banks	2.7	30.4	3.4	35.1
Savings and Loans	2.1	24.1	2.6	27.1
Mortgage Companies	1.4	16.5	0.9	9.6
Real Estate Investment Trusts	1.6	18.6	1.0	10.4
State and Local Credit Agencies	0.4	5.0	1.3	13.7
Others*	0.5	5.4	0.3	4.2
Total	8.8	100.0	9.8	100.0

SOURCE: Department of Housing and Urban Development.
'Mutual savings banks, life insurance companies, state and local retirement funds, and Federal credit agencies. Other-groups not included here due to lack of data also make or hold small amounts of construction loans.

intermediaries. (See Table 1.) The two major groups granting construction credit in this market are commercial banks and savings and loan associations, which together made 54 per cent of all construction loans in the 1970-77 period. These two lender groups held 62 per cent of all outstanding construction loans on September 30, 1977. Mortgage companies and real estate investment trusts made 35 per cent of total construction loans, and state and local credit agencies made 5 per cent.

Permanent Financing. Originations of permanent mortgages for multifamily housing averaged $12.4 billion a year during the 1970-77 period. (See Table 2.) Of this amount, 57 per cent was used for loans for new buildings, while the remaining 43 per cent was used for loans on existing property.

Four groups—savings and loan associations, life insurance companies, mortgage companies, and Federal credit agencies--originated 78 per cent of total loans on new properties in the 1970-77 period.' In contrast to the importance of commercial banks in the construction lending market, banks are relatively inactive in the permanent financing area; the same is true for real estate investment trusts (REIT's). On the other hand, life insurance companies, mutual savings banks, and Federal credit agencies are more heavily involved in permanent financing than in construction lending.

Mortgages on existing properties generally are made when property is sold or a mortgage is refinanced. Savings and loans accounted for nearly one-half of this market in the 1970-77 period and mutual savings banks and commercial banks together contributed an additional 32 per cent. These groups, along

[1] Mortgages closed by one investor, but transferred to another within a few weeks of closing, are considered to be originations of the second investor.

Table 2
PERMANENT LOANS FOR MULTIFAMILY RESIDENCES
Yearly Average: 1970-77*

Lender Group	New Properties: Billions of Dollars	New Properties: Per Cent	Existing Properties: Billions of Dollars	Existing Properties: Per Cent	Holdings—Sept. 30, 1977: Billions of Dollars	Holdings—Sept. 30, 1977: Per Cent
Commercial Banks	0.4	5.3	0.7	13.3	4.6	5.1
Mutual Savings Banks	0.6	8.4	1.0	19.0	14.5	15.8
Savings and Loan Associations	1.6	23.1	2.5	46.8	29.0	31.6
Life Insurance Companies	1.3	18.1	0.3	6.2	18.0	19.7
Mortgage Companies	1.1	15.1	0.2	3.3	0.3	0.3
Federal Credit Agencies	1.6	21.8	0.1	1.2	13.0	14.1
State and Local Credit Agencies	0.3	4.5	0.3	6.1	6.1	6.6
Others†	0.3	3.7	0.2	3.9	6.2	6.8
Total	7.1	100.0	5.3	100.0	91.7	100.0

SOURCE: Department of Housing and Urban Development.
*Figures do not include 1977 Q4.
†Real estate investment trusts, private pension funds, and state and local retirement funds. Other groups not included here due to lack of data also make small amounts of mortgage loans.

with state and local credit agencies, are more involved in financing existing properties than lending for new properties. Mortgage companies are much less active in the existing property market than in the new property area. The same is true of Federal credit agencies and life insurance companies.

Approximately 20 per cent of the permanent multifamily mortgages originated in the 1970-77 period were insured by the Federal Housing Administration (FHA). Most FHA mortgages were on new properties rather than existing properties and nearly two-thirds of the new mortgages were made by the Federal credit agencies. Mortgage companies made an additional 21 per cent of FHA mortgages on new properties. Conventional mortgages make up the remaining 80 per cent of multifamily originations, and savings and loans made 40 per cent of these mortgages.

The Secondary Market

The secondary market for multifamily mortgages provides a mechanism for transferring mortgages from originators to permanent holders and from one permanent holder to another. Purchases of multifamily mortgages in the secondary market averaged $2.3 billion yearly in the 1970-77 period, or 18 per cent of total originations. Federal credit agencies accounted for 30 per cent of all purchases in the secondary market and pools sponsored by Federal agencies purchased an additional 20 per cent.[2]

In the private sector, the most important purchasers were savings and loan associations, which accounted for about one-fourth of total purchases. The most important sellers of mortgages were mortgage companies, which accounted for one-half of all sales in the 1970-77 period. The second largest selling group was the Federal credit agencies; savings and loan associations were also prominent sellers.

U.S. Government's Role in the Multifamily Housing Market

Federal credit agencies are very important in the construction and financing markets for multifamily housing. The Federal Government provides funds at various levels for the construction and maintenance of low-income housing. In some subsidy programs, the Government contributes funds to housing projects to reduce the cost to the developer. In other programs, the Government contributes part of the rent and thus lowers housing expenditures for qualifying households. Starts of multifamily units constructed with Department of Housing and Urban Development (HUD) subsidies totaled 900,000 units in the 1970-77 period—nearly one-fourth of all multifamily units started during the period.

Various subsidy programs have been employed by the Federal Government to support multifamily housing. Under one plan, the low-rent public housing program, housing is constructed and owned by local public housing authorities and provided at below-market rents. Another plan—which was discontinued in 1973—was the FHA's Section 236 program. This insured loan program was available to both public agencies and private investors; it lowered the effective interest rate on the mortgage to 1 per cent. A third program, the Section 8 plan, supplements rental payments made by low-income families.

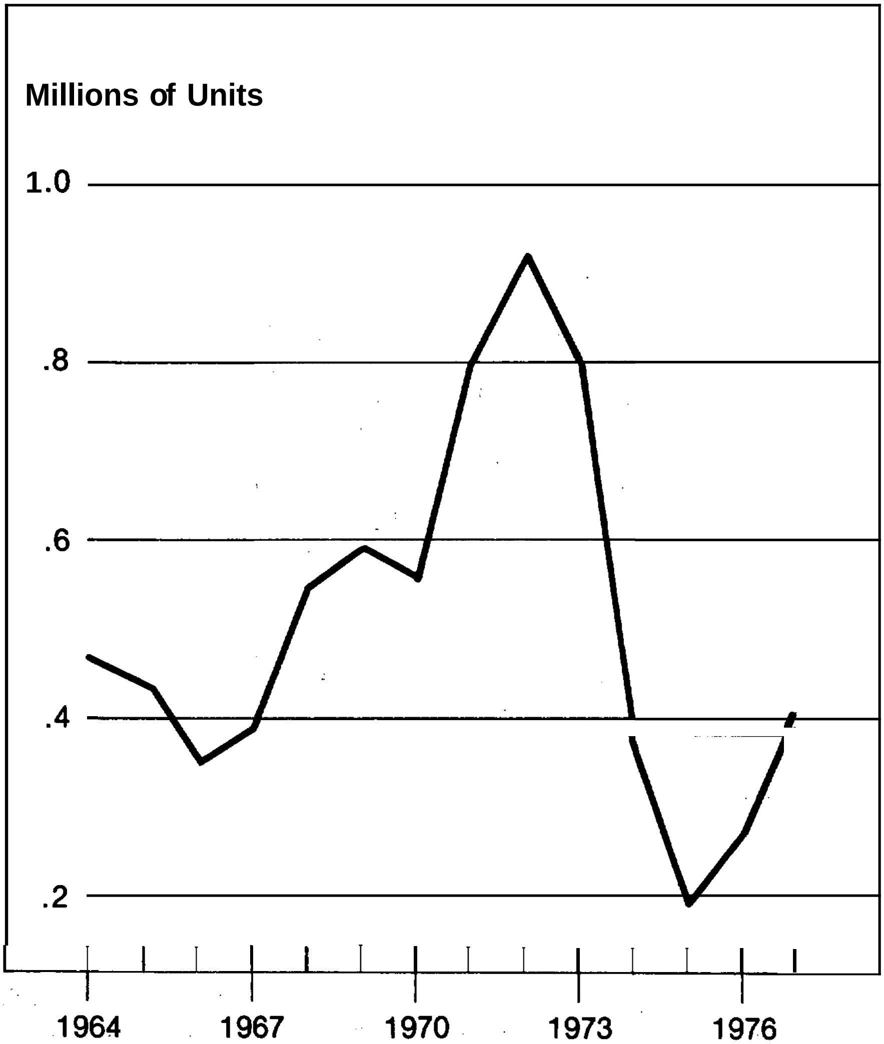
During the 1970-77 period, in addition to originating $12.8 billion in multifamily mortgages, Federal agencies purchased $5.6 billion and sold $4.5 billion in the secondary market. The Government National Mortgage Association (GNMA) purchases multifamily mortgages with below-market interest rates and sells these mortgages at prices based on market interest rates, absorbing the difference as a subsidy. The Federal National Mortgage Association (FNMA) purchases mortgages from GNMA and private mortgage lenders. The FHA holds mortgages as a result of default by mortgage borrowers. Difficulties in the rental housing market in the 1970's—particularly the market for low-income housing—pushed many federally insured multifamily mortgages into default and resulted in a rise in FHA's holdings of multifamily mortgages. In addition to holding mortgages outright, three of the Federal credit agencies—GNMA, the Federal Home Loan Mortgage Corporation, and the Farmers Home Administration—sponsor multifamily mortgage pools.

VOLATILITY IN THE 1970'S

Multifamily housing starts have fluctuated sharply in the past few years. Starts increased

2 **Mortgage pools are created by setting aside a package of mortgages and insuring securities that represent shares in the pool mortgages. Federally sponsored pools are those in which a Government agency guarantees payment of the principal and interest on the securities of the pool in case of default or delinquency by the mortgagee. Pools provide a way for groups which do not wish to directly invest in mortgages because of administrative difficulties or risk of default to supply funds to the market by purchasing a federally guaranteed security.**

Chart 1
MULTIFAMILY HOUSING STARTS



in the first part of the 1970's, reaching a level of 917,000 units in 1972. (See Chart 1.) However, multifamily starts dropped sharply in the 1973-75 period, totaling only 208,100 units in 1975. The three-year decline was followed in 1976 by a moderate increase, and starts rose further in 1977 and in the first few months of 1978. In the first four months of 1978, multifamily starts averaged 426,000 units on a seasonally adjusted annual rate basis, higher than in any year since 1973, but much lower than in 1972.

The decline in multifamily housing starts during the 1973-75 period was much more pronounced than the decline in single-family starts. Thus, multifamily starts as a per cent of total starts dropped from 39 per cent in 1973 to 18 per cent in 1975. The ratio of multifamily to total starts increased in 1976 and 1977 but remained lower than in 1974.

Factors Affecting Multifamily Starts

The economic recession of the 1973-75 period was a major factor leading to the sharp decline in multifamily housing starts during that period. The severity of the recession kept demand below builders' expectations. Also, the increase in interest rates and restrictive credit conditions in 1973 and 1974 reduced the availability of funds to the housing market and contributed to the drop in starts. Similarly, the lower level of interest rates and easier credit conditions since 1975 have contributed to the partial recovery in multifamily starts.

Conditions in the multifamily construction market were also important in setting the stage for the 1973-75 decrease in the level of multifamily construction activity. The rental vacancy rate had declined steadily from 8.3 per cent in 1%5 to 5.6 per cent in 1972. After 1972, the low vacancy rate contributed to considerable "overbuilding." Thus, the vacancy rate moved back up, reaching 6.2 per cent in 1974.

Overbuilding was especially evident in the condominium sector of the multifamily housing market. By 1973, over one-fourth of all new multifamily units were intended for condominium use, with the ratio being much higher in vacation areas such as Florida. The heavy building of new condominium units accompanied by conversion of existing units to condominium status led to an oversupply of units. This condition was reflected by the "market absorption rate," which is the 'percentage of completed units that are sold within three months. The market absorption rate was less than 50 per cent in 1975, indicating that more than one-half of all new condominium units were unsold three months after completion.

Role of Federal Subsidies

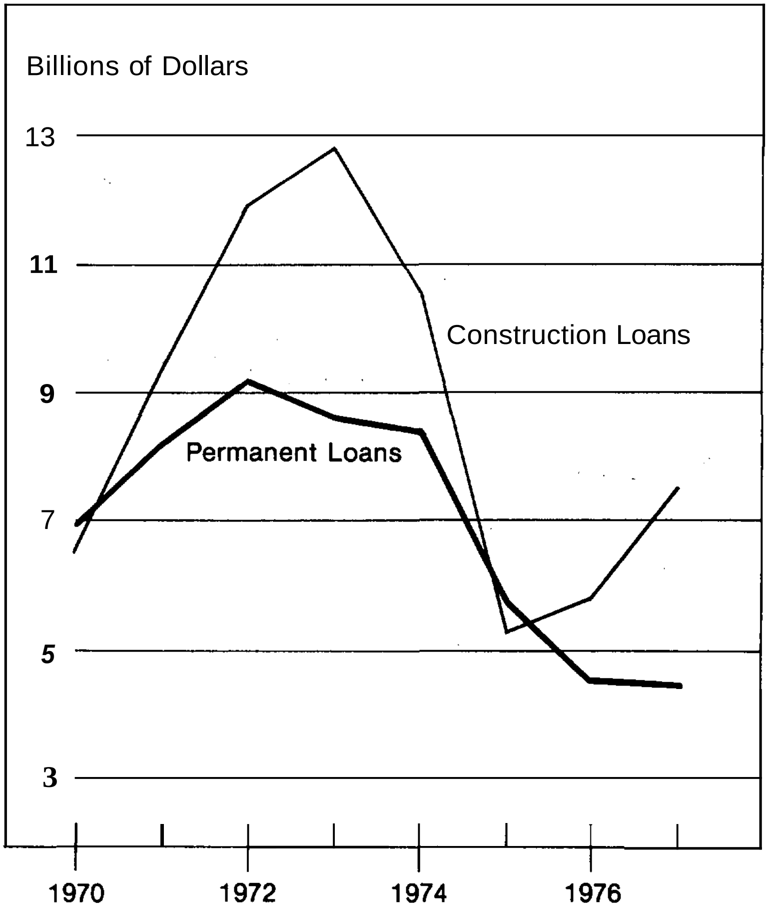
Another important factor contributing to volatility in the multifamily construction market in the 1970's was a change in the volume of starts subsidized by the Federal Government. HUD-subsidized starts declined from 155,000 units in 1972 to 37,000 units in 1975, due in part to cutbacks in the Section 236 program. Starts under the Section 236 program fell from 81,000 units in 1972 to 14,000 units in 1975. As operating costs of Section 236 projects rose rapidly in the early 1970's rents were not sufficient to cover these costs and many borrowers defaulted on the FHA-insured loans. Due to the high loan default levels and to alleged abuses in housing programs for low-income families, a moratorium on new commitments for subsidized housing was announced in January 1973. As a result, subsidized'starts fell dramatically at the same time that other multifamily starts were declining.

Lenders in the Multifamily Housing Market in the 1970's

The volume of funds made available by lenders to the multifamily mortgage market in the 1970's followed a pattern similar to the level of housing starts. Construction loans increased sharply in the first part of the 1970's, reaching $12.9 billion in 1973. Lending declined sharply in the 1974-75 period, and recovered somewhat in 1976 and 1977. (See Chart 2.)

Fluctuations in the volume of construction lending were accompanied by sharp changes in the relative importance of various types of lenders. Commercial banks steadily increased their share of the multifamily construction loan market from 26 per cent in 1970 to 43 per cent in 1977. (See Chart 3.) Savings and loan associations reduced their share of the market

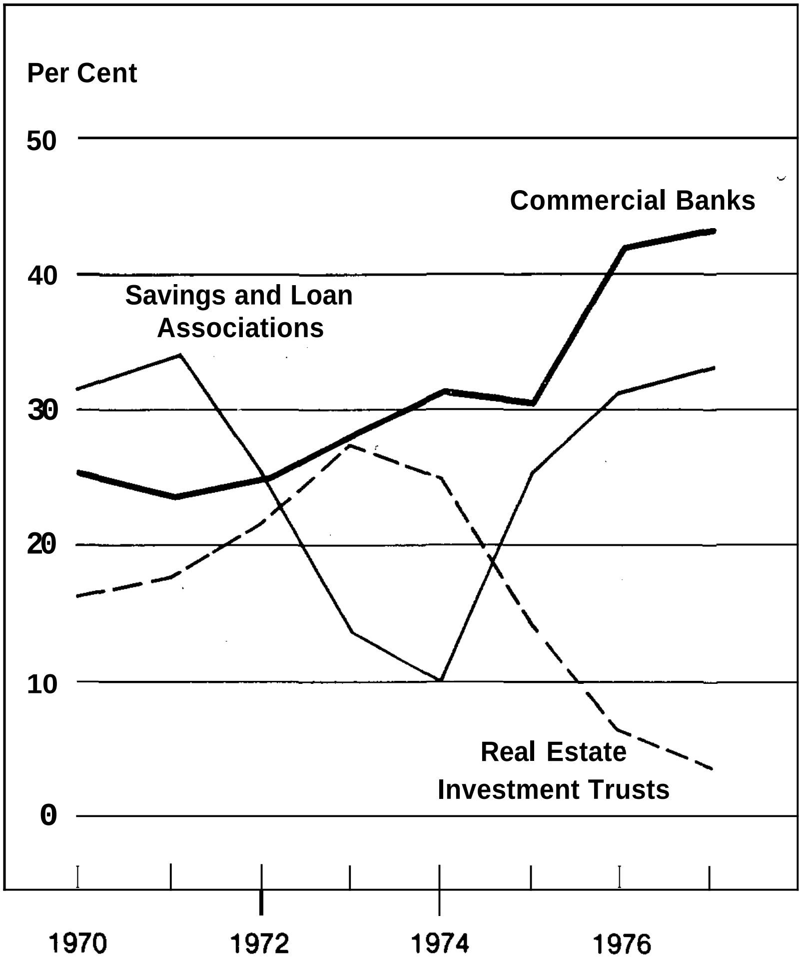
Chart 2
CONSTRUCTION AND PERMANENT LOANS
NEW MULTIFAMILY HOUSING



in the early **1970's**, but increased in the latter half of the period.

The market share of REIT's fluctuated considerably during the period, increasing from 16 per **cent** in 1970 to 28 per cent in 1973, then declining sharply to 3 per cent in 1977. Real estate investment trusts make equity investments, construction loans, and permanent mortgages for income properties such as apartments, motels, or office buildings. REIT's act as a "mutual fund" for real estate investment; they were initially seen as a way for small investors to reduce the risk of real estate investment through diversification. REIT's earn income on the spread between the interest received on **loans** and the cost of funds acquired. In the early **1970's**, building cost overruns sometimes required additional injections of funds and project delays tied up funds for longer than expected. In 1973 and

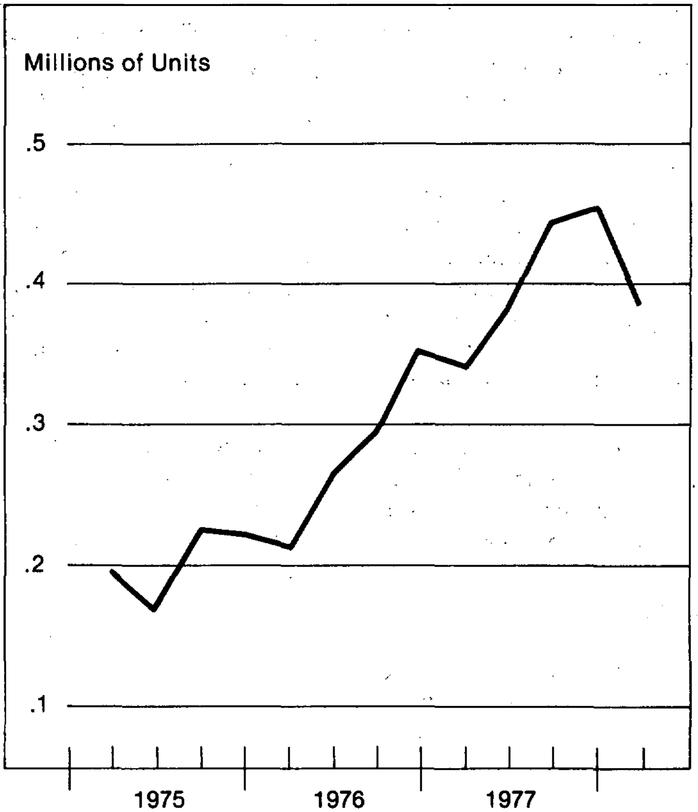
Chart 3
LENDER SHARE OF MARKET
MULTIFAMILY CONSTRUCTION LOANS



1974, loan defaults by developers, particularly those building condominiums, jeopardized the financial stability of several large **REIT's** and contributed to a sharp increase in the cost of acquiring funds. While the commercial paper market closed to them in **1974, REIT's** turned to bank loans to avoid bankruptcy, and they have yet to return to construction lending in any great amount.

Permanent financing for new properties peaked in **1972,** a year earlier than construction lending. (See Chart **2.)** Life insurance companies .were once the most important investors in . multifamily mortgages but they reduced their involvement in real estate investment in recent years as the rate on competing investments like corporate, bonds rose. Also, the market share of mutual savings

Chart 4
PRIVATE MULTIFAMILY HOUSING STARTS



banks fell during the 1970-77 period. Savings and loans' market share, on the other hand, rose steadily over the period to 50 per cent in 1977.

Prospective Developments

It is likely that future declines in multifamily construction will be less pronounced than those of the 1973-74 period. The severity of the recession was a major reason that the construction drop was so steep. If future slowdowns in economic activity are not as severe, then the decline in construction activity should not be as sharp. In the current economic recovery, multifamily housing starts have grown steadily but not as rapidly as in the early 1970's.

The development of the secondary market for mortgages for multifamily housing also may help stabilize the market. The secondary market quadrupled between 1970 and 1977, and multifamily mortgage purchases rose much faster than originations. Purchases rose from about 10 per cent of originations in 1970 to nearly 30 per cent in 1977. (By comparison, single-family purchases are now about 35 per cent of originations.)

Another factor that could influence the future volatility of multifamily housing is lender caution. After the REIT difficulties, lenders may be more conservative about rapidly expanding their volume of loan commitments for multifamily housing.

Over the next year or so, multifamily housing starts are expected to continue on a steady upward trend. From the second quarter of 1975 to the fourth quarter of 1977, private starts rose from a seasonally adjusted annual rate of 171,000 units to 458,000 units. (See Chart 4.) Extremely bad weather conditions reduced the number of units started in early 1978, but the level has risen substantially since then. Further gains are expected for the remainder of 1978, in the absence of a sharp economic slowdown or severely restrictive credit conditions.

SUMMARY

Multifamily housing construction fell sharply in the mid-1970's following a period of rapid growth, and is only now recovering some of its former strength. Overbuilding of units, particularly condominiums, contributed to the decline, as did the drop in new units subsidized by Federal programs to house lower income families. The various lender groups participating in the mortgage markets for multifamily structures reacted in different ways to the decline in construction. Difficulties in the construction sector forced real estate investment trusts to reduce their commitments to the construction loan market, and REIT's have yet to increase their lending significantly. On the other hand, commercial banks have steadily increased their construction lending in recent years. In the permanent financing area, life insurance companies partly withdrew from the market while savings and loan associations' participation increased. The Federal credit agencies and the pools sponsored by these agencies have come to be a major source of funds to the multifamily housing market in recent years through their participation in the secondary market. In the absence of a severe recession, the growth of the secondary market should help to stabilize the multifamily construction market in coming years.