Fannie Mae’s Financing of Single-Family Rentals: Good Pilot, but Plenty to Think About

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Invitation Homes (IH), the largest single-family rental (SFR) operator in the United States and a unit of the private equity giant Blackstone Group, recently disclosed that it had secured Fannie Mae’s backing for a 10-year, $1 billion loan. Under the terms of this pilot, the loan will be originated by Wells Fargo, securitized, and sold to investors with Fannie Mae’s guarantee of the timely payment of principal and interest.

This development is highly noteworthy because this marks the first time a government-sponsored enterprise (GSE) has facilitated financing for a large institutional operator of SFR properties. The GSEs’ role in the rental market previously was limited to financing mostly multifamily properties and, to a lesser extent, SFR properties owned by small investors with typically no more than 10 properties. Fannie Mae’s pilot transaction with IH, which owns over 48,000 SFR homes across the country, is an early signal that it is seriously considering entering this space.

In this note, we describe the role of SFR within the broader rental market and explain why it makes sense, policy-wise, for GSEs to enter this space. But at the same time, we believe that a framework that allows taxpayer guarantee to be used for subsidizing institutional SFR debt should also contain measures which ensure that (1) the benefits of taxpayer guarantee are used in a manner similar to that in the GSE multifamily arena to increase availability of rental housing to those earning 100 percent of the area median income (AMI) or less, and (2) noninstitutional players such as small investors, community-based organizations, and mission nonprofits with scale and capacity are able to compete effectively. Ultimately, we believe that the Federal Housing Finance Agency should articulate a clear role for the GSEs in the SFR market and work to fulfill that role in a manner that attracts new investment while meeting the demand for workforce housing.

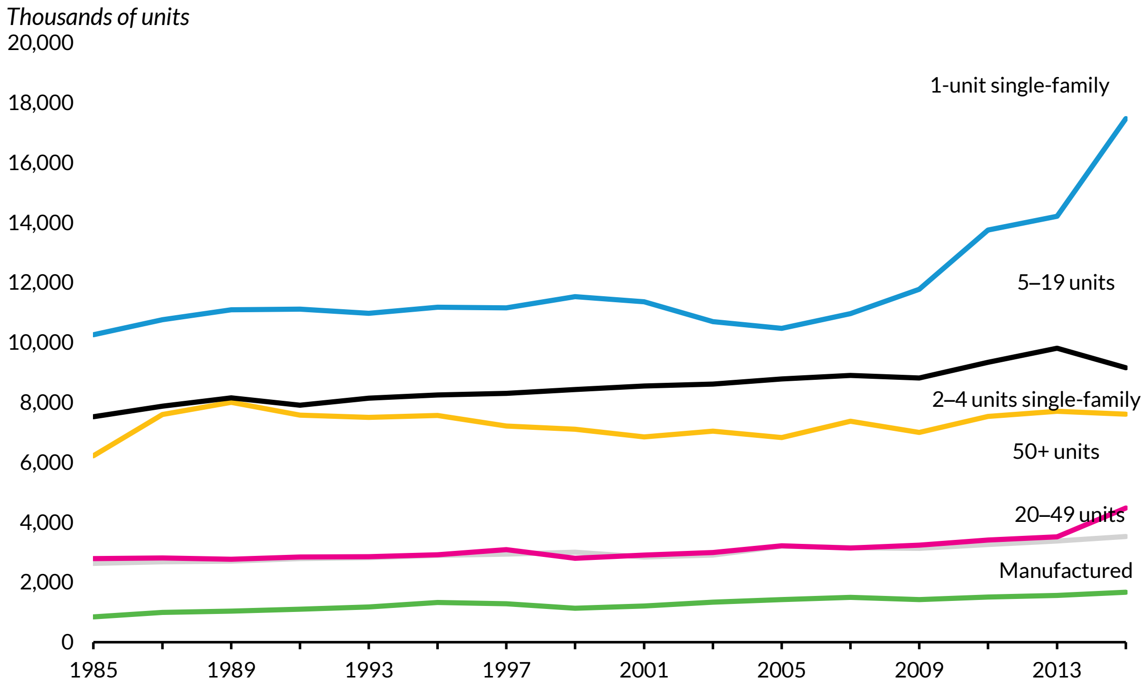
The Case for GSEs’ Presence in the SFR Market

Fannie Mae and Freddie Mac play a critical role in financing multifamily housing, which is classified as structures with more than four units. In 2015, the GSEs financed 34 percent, or over a third of all multifamily originations. The main goal of the GSEs’ multifamily businesses is to enable the financing of rental housing for families with annual incomes up to the median income in the areas where they live. While there are no explicit affordability requirements (other than housing goals), 80 to 90 percent of GSE multifamily financing has historically been affordable to those earning 100 percent of area median income.

Although multifamily properties are a critical source of US rental housing, they are, surprisingly, not the largest. According to 2015 American Housing Survey data, approximately 40 percent of the US rental housing stock is in the form of one-unit, single-family structures. An additional 17 percent is two-to-four-unit structures, which are also classified as single-family. Thus, 57 percent of the US rental housing stock is single-family, and 43 percent is multifamily. This is also not a few phenomenon: figure 1 shows that one-unit, single-family structures have always been the largest component of the total rental housing stock, with two-to-four-unit structures also quite significant.

FIGURE 1

Occupied Rental Housing Units, by Number of Units in Structure



Source: American Housing Survey.

Figure 1 also shows the substantial growth in the number of one-unit structures—from 10.5 million units in 2005 to 17.5 million in 2015, a 67 percent increase. This reflects the rapid growth in the number of renter households over this period. As the recent foreclosure crisis intensified, many households lost their homes and became renters. Others were unable to obtain a mortgage because of tight credit, competition from cash buyers, heavy student loan burdens, or simply preferred renting over ownership.

At the same time, large institutional investors, for the first time starting in 2011, purchased hundreds of thousands of foreclosed single-family properties at rock-bottom prices and rented them out to meet the growing rental demand. In doing so, these players also entered a market that was previously dominated by small investors who typically owned no more than a few properties. Despite this growth, however, institutional ownership of one-unit, single-family rental properties adds up to only 300,000 properties, or 1.7 percent of the total 17.5 million units (Magder and Goodman 2015).

Historically, Fannie Mae and Freddie Mac have financed small investor purchases of single-family rental homes. Fannie typically financed up to 10 properties in the name of a single borrower while Freddie allowed up to six properties. Clearly, this doesn't work for institutional investors like IH, who own thousands of properties. Early on, the financing for institutional buyers of SFR homes began as cash. Then came debt financing via single-family rental securitization and bank lending. Until the latest IH pilot transaction, neither GSE had financed any institutional investment in the SFR space, even though it can be argued that SFRs are simply a scattered-site version of multifamily housing.

These investments are also needed because the homeownership rate is likely to decline over the next 15 years, as the bulk of net new households will be renters. Given the acute shortage of rental homes and skyrocketing rents, it is therefore a no-brainer that we need to invest more in rental housing. And one-unit, single-family homes being the largest *and* the fastest-growing segment of the rental market, it should also be a no-brainer that this space offers the most promise if we are to begin addressing the problem of rent affordability.

The Invitation Homes Transaction

We have no doubt that it makes sense for the GSEs to finance SFR properties. Access to stable, long-term and nonfleeting financing—which allows institutional landlords (both for-profit and nonprofit) to purchase, hold, and stabilize the properties, and run the stabilized properties as a business, rather than flipping them—will be crucial in preserving their long-term commitment to this space. And Fannie Mae's pilot with IH seems to be a good first step in that direction for a few reasons.

- **It helps Fannie Mae understand the economics, opportunities, and risks of the SFR business:** This being an entirely new market for Fannie Mae, a pilot was necessary to understand the pros, cons, risks, and challenges of the SFR business. To conduct this analysis effectively, Fannie Mae needed robust property and rent data. Unlike the single-family purchase market, where the GSEs have vast experience and access to large loan performance, borrower, and property-level datasets, the SFR market is very new. Being the largest SFR operator, IH had large datasets at its fingertips, which allowed Fannie to conduct the necessary due diligence. Additionally, the fact that this was a refinance loan (i.e., the funds were not being used to purchase homes) meant that Fannie Mae was not under time pressure and could thus vet the deal carefully.

- **Taxpayer is adequately protected:** Fannie Mae has imposed rigorous credit risk retention terms that require IH to retain a 5 percent nonguaranteed first-loss position in the $1 billion loan. In addition, Fannie Mae's guarantee of the top 95 percent is reinsured under a loss-sharing arrangement with Wells Fargo, the originator of the loan. While the precise arrangement is not public, Fannie Mae's Delegated Underwriting and Servicing approved multifamily lenders (of which Wells Fargo is one) are typically required to share one-third of the loss while Fannie absorbs the remaining two-thirds on a pari passu basis.

The risk to Fannie Mae is further reduced by the low loan-to-value ratio (LTV) of this loan. IH will use proceeds from this $1 billion loan to refinance existing debt that was originally issued in 2014. One of these 2014 loans that will be refinanced had an original LTV of 75 percent. Assuming annual house price appreciation of 6 percent over last three years puts the current LTV at 63 percent, not accounting for the principal balance repaid over this period. Put together, this three-stage risk mitigation framework—IH's 5 percent first-loss piece, Wells Fargo's loss sharing, and low LTV of a seasoned loan—should offer Fannie Mae and taxpayers greater loss protection than they receive on typical multifamily loans.

That said, multiple safety valves are fully warranted because this deal is the first in this space. In addition, this transaction is the first time Fannie Mae has shared credit risk with an *owner* of rental properties. Fannie's typical practice is to share loss with approved multifamily *lenders*, who are carefully vetted and are subject to ongoing monitoring.

How Should the GSEs Support SFR Market?

Our view that the GSEs should finance the SFR market raises another fundamental question: How should they provide this support? The IH transaction, while a good first step, raises important questions that need to be addressed before the pilot can move to the next step:

1. **What affordability criteria should be imposed on this type of financing?** It is clear that Fannie Mae's financing will reduce borrowing costs and improve funding stability for SFR owners like IH. Although this should facilitate more investment in rental housing, the mission of making rental housing more broadly available, both now and in the future, to those earning less than the AMI could be furthered by making this financing available to community- and mission-based nonprofits

that have both scale and skills, but lack capital. The more nonprofits are allowed to participate in this space, the greater the number of properties that could ultimately be preserved as affordable. We should also point out that institutional buyers of single-family homes compete with first-time homebuyers and families looking to purchase homes for their own occupancy.

This suggests that taxpayer-backed financing for institutional SFR owners should be accompanied by explicit affordable housing requirements. GSEs could, for example, require institutional landlords to rent a certain percentage of units to renters earning 100 percent of the AMI or less. Although we believe that a large number of IH-owned rental homes are affordable at 100 percent of the AMI, more granular breakout by AMI buckets would allow for better assessment of SFR rent affordability. In addition, Fannie Mae could require landlords to accept Section 8 vouchers.

2. **Should the GSEs be able to finance the purchase of vacant or to-be-built single-family rental properties?** The SFR homes owned by IH are currently 95 percent occupied and have a well-established rent payment history, making the deal a relatively low risk one for Fannie Mae. But that may not always be the case. In many instances, time is required to repair and rehabilitate properties before they can be rented out. Clearly, the availability of financial and operating performance data for such properties will be limited, hence somewhat more risk to the GSEs. At the same time, making such financing available would make it easier for smaller operators and nonprofits—many of whom are mission specialists in neighborhood stabilization, but lack financing—to play a bigger role in this market. In 2015, the Urban Institute documented a situation in Baltimore where, had this program been in place and available to nonprofits, 450 units would have been preserved as affordable rentals (Magder and Goodman 2015).

3. **What sale restrictions should be imposed on SFR homes receiving taxpayer backing?** Over the normal course of business, institutional landlords may choose to sell some properties (e.g., those that are less profitable). It is also possible that landlords will come up with programs to sell properties to tenants. Should this activity be permitted? If so, what restrictions should be put in place? At the very least, it seems that the use of land contracts or similar arrangements should be strictly prohibited.

4. **How should SFRs be treated in the context of housing goals and multifamily caps?** To the extent these properties are in underserved markets, should they count toward the GSEs multifamily housing goals? Or should they be excluded from the purposes of meeting housing goals? Similarly, should SFR properties that are affordable to renters at the 60 percent AMI level be exempt from

the GSEs' multifamily caps?

5. **What eligibility and property maintenance criteria should SFR owners be held accountable to?** It would seem that if more IH-like pilots are done, owners should be subject to appropriate approval and eligibility standards that include property maintenance requirements. These should be transparent and clearly articulated.

We view this pilot transaction as an important first step and assume there will be more pilots in the future. And as single-family rentals move from pilot to program, we trust that the Federal Housing Finance Agency will work with stakeholders to evaluate the role GSEs should play in this market, how that role can increase the availability of rental housing, and ultimately construct a scalable program to do exactly that.

Reference

Magder, Dan, and Laurie Goodman. 2015. "Single-Family Rentals: A New Approach to Affordable Housing." Washington, DC: Urban Institute.