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## Small Balance Loans

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- Small multifamily properties are a significant part of the rental market. Thirty-one percent of U.S. renter households live in small properties that comprise five to 50 units.
  - The debt financing market for small properties will benefit from standardization, as the market for larger properties has.
  - Risk analysis of small properties is similar to larger properties; underwriting property income is paramount to understanding the credit risk of this segment.
  - Historical performance data show that default rates for small and large properties are similar, whereas losses in the event of a default are higher for small properties.
  - Small balance loans have fewer restrictions on loan prepayments. They typically have step-down prepayment premium structures instead of defeasance, making it important for investors to understand prepayment behavior.
  - Historically, prepayments have increased during the loan term as the cost to prepay has declined. Over the life of these loans, our research found that an annual prepayment rate of 15 percent approximates the historical prepay speed.
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## Introduction

Small multifamily properties – with five to 50 units – compose a sizable portion of the multifamily rental market and much of this housing stock is affordable to low- and very low-income households. Yet lending programs in this segment are inconsistent across lenders and regions and the secondary mortgage market has participated little compared to conventional market activities. In line with Freddie Mac Multifamily’s mission, we launched a small balance loan (SBL)<sup>1</sup> program in September 2014 focused on loan amounts ranging from \$1 million to \$5 million; targeting properties with five to 50 units. Greater government-sponsored enterprise (GSE) presence in this segment will increase liquidity and stability. By structuring these loans into securities where private parties hold the first-loss position, the vast majority of the credit risk is shifted away from Freddie Mac and U.S. taxpayers.

Our in-depth research and analysis into the SBL market’s size, underwriting, risk factors, and historical loan performance highlight ways in which the market is similar to our conventional business and how it differs. Several factors need to be taken into account to fully understand this market segment: underwriting and due diligence differences, higher percent of expected losses in the event of a credit default, and the borrower often has more flexibility to prepay at little to no cost.

## Section 1 – The Composition, Size, and Risk Profile of the Small Balance Loan Market

### *Composition and Market Size*

Small multifamily properties represent a sizable share of the rental market. According to the most recent American Community Survey (ACS) in 2013, renter households living in five- to 49-unit<sup>2</sup> properties account for 31 percent of all renter-occupied housing, compared to just 12 percent in 50-plus-unit properties. On the capital market side, about a third of the properties representing the 30,000 multifamily loans that have been securitized in the non-agency commercial mortgage-backed securities (CMBS) market had 50 units or fewer. However, the secondary market, including the GSEs, disproportionately serves larger properties. The total small loan volume purchased by the two GSEs in 2013 was \$2.6 billion of \$56 billion in total business.

Within the CMBS market, we also found that multifamily property sizes are disproportionately served based on location. In major markets – which include the

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<sup>1</sup> Small balance loans can be defined by property size or loan size. In this document, we refer to this market segment as “small loans” or “small properties”, and much of our empirical work centers on properties with five to 50 units. The program targets properties with five or more units and loan balances of \$1 million to \$5 million.

<sup>2</sup> Due to available data from the American Community Survey, which breaks out property structure as five to nine units, 10 to 19 units, and 20 to 49 units; we use five to 49 units for ACS data to represent small properties.

metropolitan statistical areas (MSAs) of Boston, New York City, Washington D.C., Chicago, Los Angeles and San Francisco – the distribution of small and large property loans is roughly equal. In non-major markets – or all other MSAs and non-MSAs – small properties make up only 16 percent of multifamily CMBS loans, whereas large properties represent 84 percent. This is starkly different compared to the composition of the renter-occupied units across property sizes. According to the ACS, renter-occupied units in small properties represent two-thirds of all multifamily units in major markets and about three-quarters of all units in non-major markets.<sup>3</sup> Therefore, small properties in non-major markets are underrepresented in the CMBS market.

*With our increased presence in the SBL market, we expect to help serve more lower-income renters because they are more heavily concentrated in small properties.*

Furthermore, our recent research, “Multifamily Affordability”<sup>4</sup>, found low- and very low-income multifamily renters are heavily concentrated in small properties. Close to 80 percent of lower-income renters live in buildings<sup>5</sup> with five to 50 units. With this country’s growing gap between affordable housing demand and supply, it is critical and beneficial to provide an effective financing vehicle to provide capital to this market.

With further GSE involvement, more efficient operations could help better serve small properties in major and non-major markets along with providing vital support to the affordable housing sector.

Due to the nature of SBLs, the number of loans and lenders involved is much larger than for larger properties. Data from Mortgage Bankers Associate (MBA) break down the number of lenders, loans, and dollar volume into four categories based on original loan volume: less than \$1 million, \$1 million to \$3 million, \$3 million to \$10 million, and greater than \$10 million. The categories do not match the industry definition of SBL, which includes loans up to \$5 million, but looking at loans of less than \$3 million can give an idea of the composition of the SBL debt market.

In 2013, loans originated of less than \$3 million made up 26 percent of the total multifamily dollar volume but composed 92 percent of all lenders and 70 percent of all loans originated, as shown in Exhibit 1. On the other hand, only 2 percent of lenders had an average loan size greater than \$10 million. The large number and variety of participants in the SBL market, compared to the conventional market, can have an effect on the SBL risk profile.

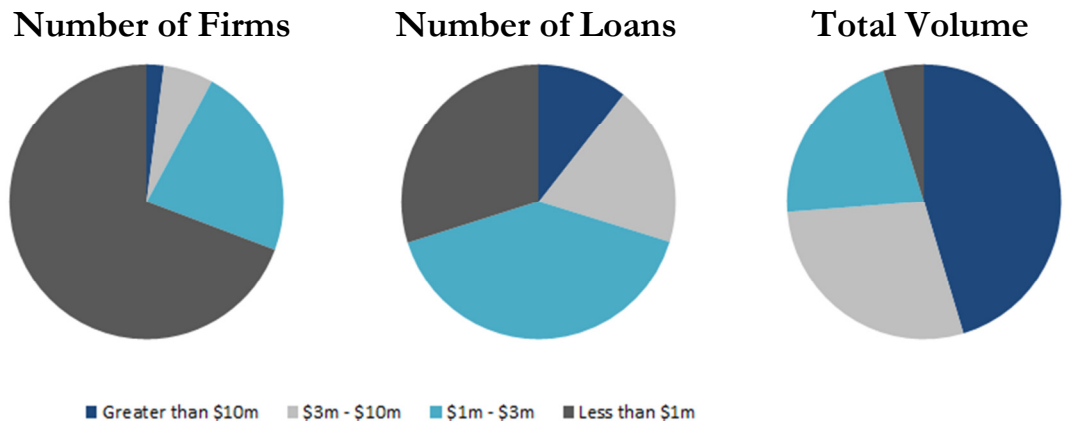
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<sup>3</sup> To keep ACS data consistent with CMBS data, we are using only five-plus, renter-occupied units to determine the distribution between small and large property types, instead of all renter-occupied unit structures.

<sup>4</sup> [http://www.freddie.mac.com/multifamily/pdf/mrp\\_affordable.pdf](http://www.freddie.mac.com/multifamily/pdf/mrp_affordable.pdf)

<sup>5</sup> The property, in our definition, can include more than one building.

Exhibit 1 – Multifamily Lending in 2013, by Lender Average Loan Size



Source: MBA

***Risk Profile***

Loan performance in the SBL market ranges from excellent to poor; the results depend largely on the underwriting of several important factors. Many of the risk drivers are similar for small and larger multifamily properties. The most important: income underwriting is critical for small properties with the primary focus on the cash flows of the property. But underwriting should carefully consider the factors that tend to differ relative to conventional multifamily loans: borrower experience level, financial information, and property condition.

*Small multifamily properties have similar risk profiles to larger properties with the primary focus on cash flows.*

Small property borrowers tend to have smaller scales of efficiency than larger property borrowers. Borrowers on smaller properties may only have a few properties that they manage either themselves, sometimes as a part-time job, or through a contracted company. More due diligence is usually necessary for smaller property borrowers due to the large number of borrowers and their diverse experience. Meanwhile, the typical borrower sponsors for larger properties are large corporations, partnerships, funds or other entities that have sizable portfolios and solely invest in and operate large commercial real estate properties. With more repeat borrowers for large properties, lenders can streamline their lending practices through repeated experience with each borrower.

Similarly, small property borrowers’ financial documentation is likely to be different and less standardized relative to large commercial real estate companies. It takes more time and due diligence for underwriters to review and analyze the variety of financial statements seen for small property borrowers.

The physical characteristics of small multifamily buildings also differ from those of larger properties. Many of the buildings are often classified as Class B or Class C properties because they tend to be older and lack high-end amenities. As a result,

*Many small properties are older buildings without high-end amenities and often attract renters who favor location but cannot afford the high cost of newer, larger buildings.*

renter profiles may differ; renters who are more cost conscious may be more likely to rent in smaller buildings even though they may lack amenities available in newer buildings. Because the effective age of many of the buildings may be older, underwriting should also take into account the amount of maintenance that the building may need.

As an example of the importance of understanding a small property's risk profile and what can happen when loans are not properly underwritten, we analyzed some of LaSalle Bank's small multifamily loan deals from the mid-2000s. Several issues were later found in the underwriting that probably contributed to higher defaults: lower credit standards for borrower, aggressive lending in small markets, inconsistent underwriting of cash flows, and uneven property conditions. Some borrowers were not seasoned investors in real estate and instead many were first-time investors, or out-of-town investors unfamiliar with both local market dynamics and property management. This issue was exacerbated by uneven property conditions, underfunded replacement reserves and insufficient funds to operate the property.

Freddie Mac Multifamily understands the importance of maintaining consistent, high standards of loan quality for all loans. Underwriting the risks associated with small properties on a loan-by-loan basis can cost proportionally more compared to our conventional business. Our SBL program addresses these concerns by leveraging the strength of our conventional multifamily loan business while working with a network of qualified, experienced lenders and underwriting each loan in-house.

## Section 2 – Historical Performance

While underwriting quality is one of the main drivers of expected loan performance, understanding historical default and delinquency rates along with loss severity in the small property segment is imperative to pricing risk appropriately in these loans. To gain this understanding, we analyzed CMBS multifamily loan performance data maintained by Trepp<sup>6</sup> as well as portfolio-level performance available to us.

*Credit performance is similar between small and large properties and both incur higher losses during recessionary years.*

### **CMBS Historical Credit Performance**

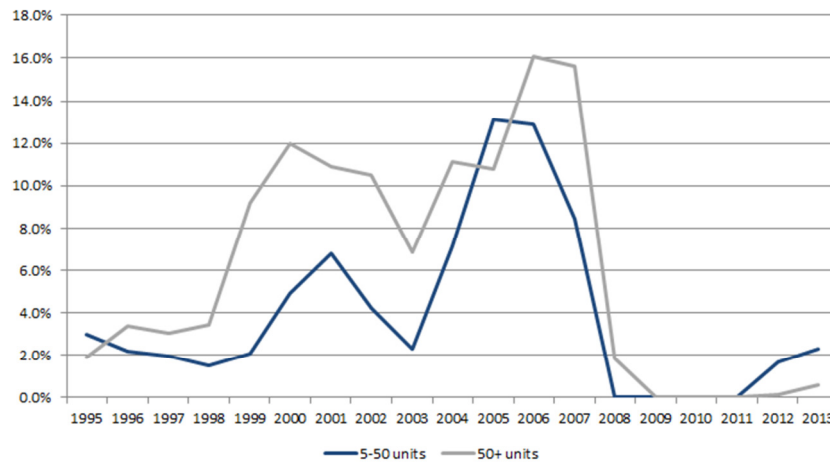
Default rates, defined as loans that are currently 60-plus days delinquent<sup>7</sup>, were similar for small and larger properties. The overall default rate for small properties is 6 percent compared to 6.2 percent for larger properties. Credit performance of these two market segments have historically moved together, as Exhibit 2 shows. Smaller

<sup>6</sup> Using unit size is consistent with industry research and captures the segment of the market that is newest in this program. A downside of using units is that the information must be included in Trepp data to be able to analyze this population.

<sup>7</sup> Default rate is defined as loans that are currently 60-plus days delinquent or worse, which does not include loans that have recovered from being 60-plus days delinquent.

properties generally perform better and have lower default rates in most years relative to larger properties. Default rates for loans originated just prior to recessions, in the early and mid-2000s, increased for both property types and then fell dramatically afterwards.

Exhibit 2 – Default Rates by Origination Year



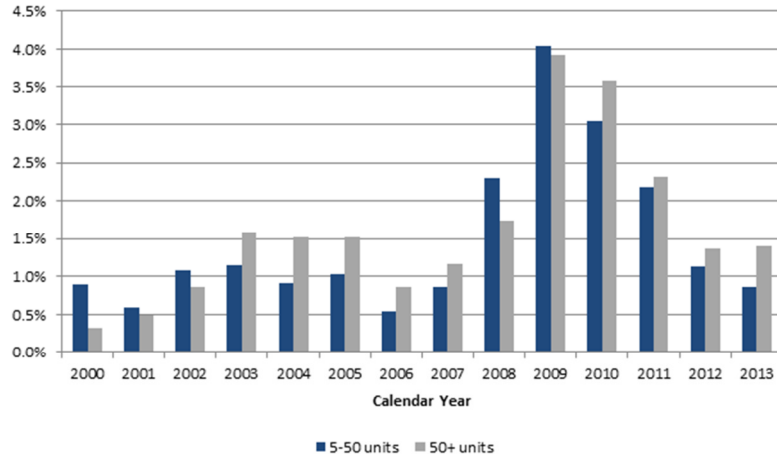
Sources: Trepp, Freddie Mac

The default rate illustrated above does not take into account loans that have recovered, or made current on their payments, after being 60-plus days delinquent. We use a broader definition to capture credit events that further test the comparability of these two market segments. The conditional delinquency rate, shown in Exhibit 3, represents all loans that have ever been 60-plus days delinquent<sup>8</sup>. Because this rate shows the likelihood of a loan ever having a credit event in a given year, not just those that are currently delinquent by origination year, it gives another comparison of how the two property types perform, given prevailing economic conditions.

As with the default rates, delinquency rates were higher during and after recessionary years but there is no clear pattern of SBLs systematically performing differently than larger property loans. Since 2000, the average conditional delinquency rate was 1.5 percent and 1.6 percent, respectively for small and large properties. The similar performance can be partially attributed to similar demand drivers for rental housing.

<sup>8</sup> Conditional delinquency rate is defined as loans that are 60-plus days delinquent or worse at any point in their lifetime.

Exhibit 3 – Conditional Delinquency Rates by Year



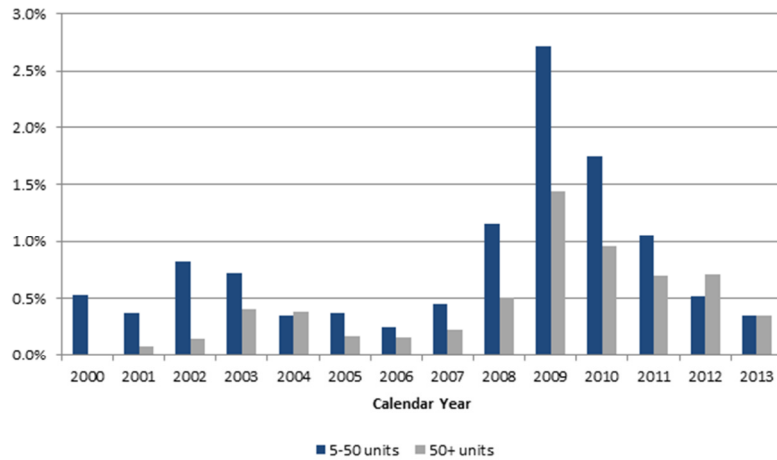
Sources: Trepp, Freddie Mac

*Small properties performed worse in the major markets during the recessionary years compared to larger properties.*

In major markets, delinquency rates of small properties were higher than for larger properties during the last two recessions, as Exhibit 4 shows. This reflects the vulnerability of small properties in major markets during a stressful period and the competitive environment which favors larger properties. More notable, delinquency rates were lower in major markets than in non-major markets for properties in both size categories, as shown in Exhibits 4 and 5, respectively.

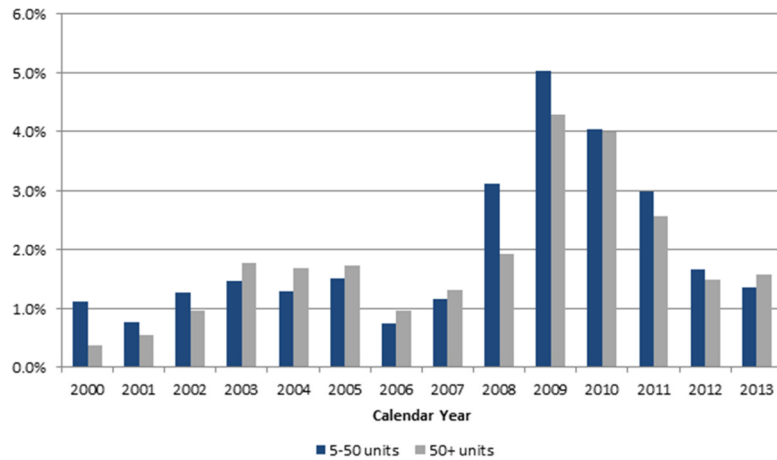
Overall, the incidence of default across property sizes is quite similar. But as shown, there are nuanced differences across characteristics like market size. Given that high-level credit drivers are so similar, it is intuitive to see similar delinquency and default performance.

Exhibit 4 – Conditional Delinquency Rates in Major Markets



Sources: Trepp, Freddie Mac

Exhibit 5 – Conditional Delinquency Rates in Non-Major Markets



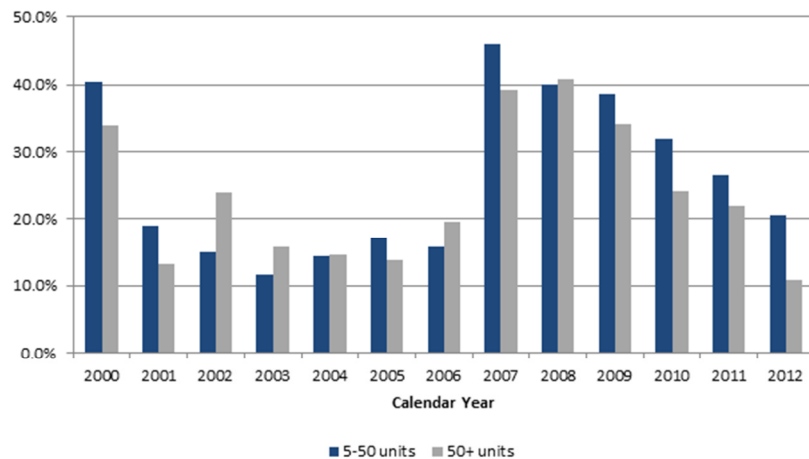
Sources: Trepp, Freddie Mac

**Loss Severity**

*In a credit event, small properties have higher expected losses partially due to proportionately higher fixed costs.*

From the data, it is evident there are some underlying differences between property sizes that can affect the expected losses in the event of default. Smaller properties experience greater losses when a credit event occurs, as seen in Exhibit 6. The total loss severity is 33 percent for smaller properties compared to 26 percent for larger properties. Particularly in the major markets, the loss-severity level for small property loans consistently exceeded that for large property loans, 20 percent compared to 7 percent, respectively. Some of the fixed expenses that are involved in managing and disposing of defaulted properties do not vary by property size, partially explaining the higher losses among smaller properties. Also, during periods of economic stress, investors seek safer, more transparent assets, favoring larger properties, which can further drive differences in loss severity.

Exhibit 6 – Historical Loss Severity by Year



Sources: Trepp, Freddie Mac

Note: Loss severity for 2013 is not included due to inconsistencies in the data.



***Loan-to-Value Impact***

Loans that are more leveraged, with higher loan-to-value (LTV) ratios, are expected to have higher incidence of default and losses in the event of default. In our analysis, small property loans had lower LTVs – 66.5 percent compared to 70.7 percent for larger property loans. Furthermore, large property loans were found to be more leveraged; about 42 percent of them had LTV higher than 75 percent at securitization, compared to only 24 percent of small property loans. This implies that investors require more equity from borrowers for small property loans in general.

*Loan-to-value ratios of small properties are on average lower than larger ones, implying investors are more cautious toward small properties.*

Consistent with expectations, the empirical data show that lower-LTV loans performed much better than higher-LTV loans for both small and large properties. The delinquency risk on loans with LTV of 75 percent or more, regardless of loan size, was about 45 percent higher than on loans with 70 to 75 percent LTV. Meanwhile, compared to delinquency rates, the loss severities increased more drastically as LTV increased, as Exhibit 7 shows, except for the highest two LTV buckets, which had similar loss severities. While the delinquency rate and loss severity increase as LTV increases for both property sizes, the pattern between small and large loans is the same; delinquency rates are similar across property types but small properties incur higher loss severity.

Exhibit 7 – Delinquency Rate and Loss Severity by LTV

LTV at Securitization	Delinquency Rate			Loss Severity		
	Total	5 – 49	50+	Total	5 – 49	50+
Less than 50%	5%	5%	5%	6%	10%	2%
50% - 60%	7%	8%	7%	13%	17%	10%
60% - 70%	10%	10%	10%	22%	25%	21%
70% - 75%	13%	15%	13%	29%	35%	26%
75% and Greater	22%	23%	22%	29%	34%	27%

Source: Trepp, Freddie Mac

***The GSEs in the Small Property Market***

While historical performance of small properties in CMBS deals is informative in setting expected losses, it does not take into account any “Agency effect” of the GSEs. Historically, GSE loans have had lower delinquency rates than non-GSE loans in the multifamily sector. Because Freddie Mac only recently entered the SBL arena, we assessed loan performance from several decades ago and looked at recent performance of Fannie Mae’s small loan program.

Freddie Mac's "old book of business"<sup>9</sup> was comprised of many loans that were either backed by smaller properties or properties with unpaid balances (UPBs) of \$5 million or less. That book of business is notable because it was largely from the early 1980s; a period characterized by tax-advantaged investment in commercial real estate that fueled investment and aggressive underwriting of cash flows and property values to keep up with inflation. At that time, Freddie Mac did not do its own underwriting and had not yet developed the approaches to underwriting that are the cornerstone of our business today. Thus, the portfolio was originated with methods now identified as weak underwriting, including relying on LTV with little to no understanding or vetting of the property cash flow. Also, borrower and property underwriting was different as loans were made to unqualified borrowers and property conditions were not used to determine loan size or borrower financial strength. More than 10,000 loans on properties with 50 or fewer units or with balances less than \$800,000 were purchased into the old book. Overall, the default rate for these small loans was 10 percent with a severity of 75 percent; reflecting the poor underwriting at the time. Even though Freddie Mac experienced high default rates, the performance of these loans was better than the larger loans that were held at the same time. As Freddie Mac began the current multifamily program in the mid-1990s, staff re-underwrote a sample of old-book collateral. Of the 51 loans in the sample, only four would have qualified to be purchased under the current program. Weighted average debt coverage ratio (DCR) and LTV were represented as 1.20 and 73 percent at the time the loans were purchased. But the re-underwriting revealed that, if prudently underwritten, the DCR and LTV would have been 1.02 and 95 percent, respectively.

The delinquency rate on our conventional loan business is 3 basis points (bps), or 0.03 percent, as of the first quarter 2015. In contrast, the multifamily CMBS delinquency rate was 125 bps at the end of 2014; down from rates above 1,000 bps seen in the aftermath of the recession. Because Freddie Mac has not had a dedicated small balance program until last year, we look at the performance of Fannie Mae, which entered the SBL market back in 2000. In the first quarter 2015, Fannie Mae's non-SBL delinquency rate is 8 bps, compared to 24 bps for their SBL program.<sup>10</sup> Although Fannie Mae had a higher delinquency rate for SBLs than for conventional loans during this period, the overall lifetime delinquency rate for both programs is relatively low and is considered similar to one another when compared to CMBS performance.

*Our small balance loan program is expected to perform in line with other agency small balance loan programs and be more like our larger loan business.*

<sup>9</sup> The volume of multifamily loans Freddie Mac purchased from 1986 to 1992.

<sup>10</sup> Fannie Mae's first quarter credit supplemental: [http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2015/q12015\\_credit\\_summary.pdf](http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2015/q12015_credit_summary.pdf)

The drastic difference in delinquency rates between the GSEs' and the CMBS market implies an Agency effect for the larger, conventional multifamily properties. Given the strong standards we now have in place, we anticipate that loan performance in our new SBL program will also have a similar Agency effect and be more like that of our current conventional loan business and Fannie Mae's small balance program than the CMBS market or small loan offerings of the past. Only qualified, experienced, small loan lenders with dedicated resources, proven infrastructures, and platforms for originating, underwriting, closing, and servicing small loans participate in our SBL program, with each loan underwritten in-house.

### Section 3 – Prepayment Speed Analysis

Historically, banks have offered short term loans with flexible prepay structures to borrowers in the SBL segment because the borrowers typically desire more flexibility than offered by conventional multifamily lenders. Normally, the prepayment structure for conventional multifamily loans is in the form of yield maintenance or defeasance. Freddie Mac Multifamily provides a yield maintenance option for SBLs, but also allows for step-down prepayment structures.

These step-down structures set the cost to prepay, referred to as the prepayment premium, to a fixed percentage based on the age of the loan. For example, for a five-year loan, a typical step-down structure is 5-4-3-2-1, where the borrower owes 5 percent of the principal balance if prepaying in the first year of the life of the loan, 4 percent if prepaying in the second year, and so on. In general, the less seasoned the loan, the higher the prepayment premium. Most loans then have an open period, normally the last few months of the balloon term, when no premium is charged.

*Prepayment options are typically step-down structures, which give the borrowers disincentive to prepay earlier in the loan term.*

The use of step-down prepayment premiums introduces another factor into modeling and pricing SBL securitization transactions. As with conventional loans, there is little prepayment risk when the loan has yield maintenance or defeasance because the prepayment restrictions make investors less concerned about prepayments. However, because investors are affected by prepayments in the step-down structure, it is necessary to determine a prepayment speed for pricing the SBL securitizations.

To understand the prepayment speeds, we analyzed Trepp CMBS data from 2004 to 2013. In it, we isolated the population of fixed-rate multifamily mortgages with step-down prepayment premiums in conduit deals.<sup>11</sup> Of the 5,206 loans we've identified

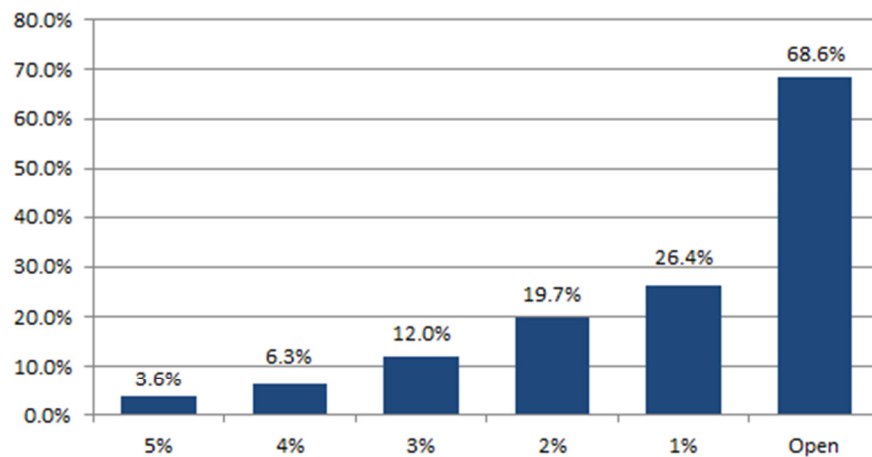
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<sup>11</sup> Because prepayment information was not well populated in the Trepp CMBS data tape until 2004, we selected the sample effectively covering loans from August 2004 to December 2013. We refined our sample to include only multifamily properties in domestic deals and fixed-rate loans. For hybrid loans, where loans have an initial fixed period and then a floating period, we only included the fixed-rate payment period in the sample. We used the reported amount of prepayment premium in each period to calculate the premium percentage for each individual loan. In order to exclude

with such structures, 2,134 loans had prepaid voluntarily during the loan term. Even though there are limitations in the scope of the sample size, it is the most informative loan-level data available to understand prepayment behavior relevant to the loan structures of the SBL program that provides some ability for borrowers to prepay. While the data is not definitive, it provides valuable insights for developing expectations.

Focusing on loans with the 5-4-3-2-1 prepayment premium structure<sup>12</sup>, the most common structure in Freddie Mac Multifamily’s SBL program, we calculated the historical conditional prepayment rate (CPR)<sup>13</sup>. Exhibit 8 shows the CPR for properties with five to 50 units for each prepayment premium period.

Exhibit 8 – Historical CPR for Loans with 5-50 Units and Step-Down Prepayment Structures (by Loan Count)



Sources: Trepp, Freddie Mac

From the historical CPR data, we established a “prepay curve”<sup>14</sup> that varies based on the prepayment premium period. It is intuitive that prepayments of loans increase as the premium declines. Because the SBL transactions will be backed by mixed collateral terms, an average prepay speed is useful to price the SBL transactions. We found that applying an average prepayment speed of 15 percent for the entire length of the loan term approximates the derived prepay curve. Exhibit 9 shows prepay curves for a 7-year loan based on the prepay curve and using a CPR of 15 percent. The two methods result in roughly the same percentage of the remaining balance at

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deals with yield maintenance or defeasance, we combined the prepay premium and prepay description to identify loans with step-down prepayment structures.

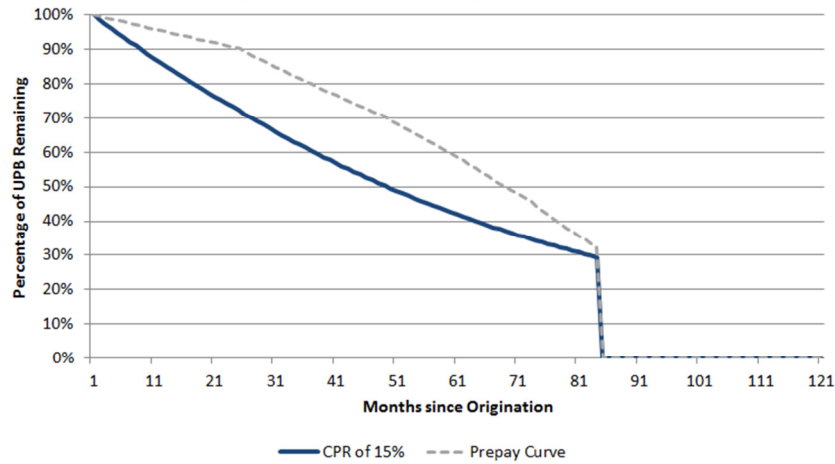
<sup>12</sup> The common prepayment structure is 5-4-3-2-1 for a 5-year term; 5-5-4-4-3-2-1 for a 7-year term; and 5-5-4-4-3-3-2-2-1-1 for a 10-year term.

<sup>13</sup> The annualized CPR is calculated using the single month mortality rate by loan count:  $CPR = 1 - (1 - SMM)^{12}$

<sup>14</sup> Historical prepayment speeds are rounded up to the closest factor of five to establish a “prepay curve”.

the balloon term, 32.4 percent using the varying prepay curve and 29.4 percent for the 15 percent CPR.

Exhibit 9 – CPR of 15% Compared to the Prepay Curve for a 7-year Term



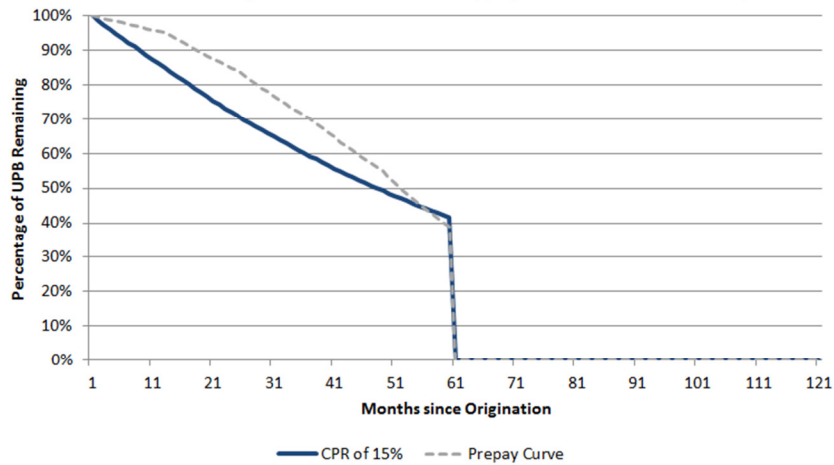
Remaining Years	7	6	5	4	3	2	1
Prepay Premium	5%	5%	4%	4%	3%	2%	1%
Prepay Curve	5%	5%	10%	10%	15%	20%	30%

Source: Trepp, Freddie Mac

*Using historical prepayment speeds, the average CPR across 5-, 7-, and 10-year terms is 15 percent.*

Likewise, Exhibits 10 and 11 show the prepayment curves for the 5- and 10-year loan comparisons. While the balloon balance for the 7-year loan is slightly understated using the 15 percent CPR, it is slightly overstated on the 5- and 10-year loans. Because the collateral backing the securitizations will be mixed terms, the 15 percent CPR is an acceptable reference prepayment speed to price our SBL program consistent with historical performance. Furthermore, if the collateral performs consistently with GSE-type multifamily collateral, the 15 percent CPR captures all loan terminations, both voluntary (prepay) and involuntary (credit).

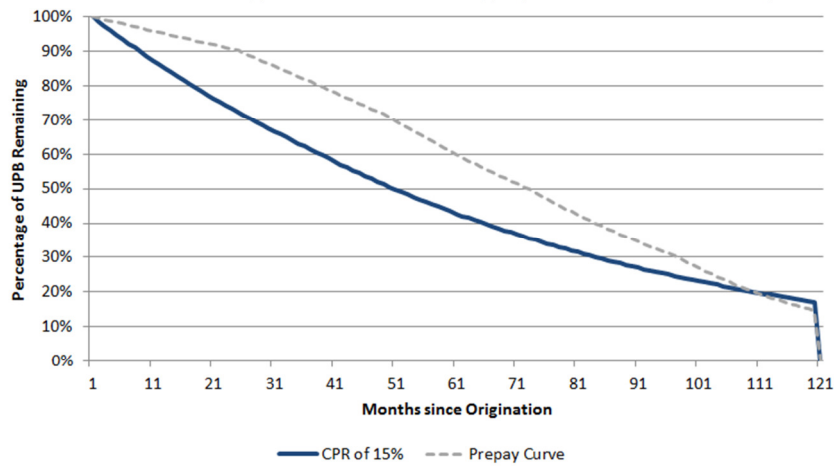
Exhibit 10 – CPR of 15% Compared to the Prepay Curve for a 5-year Term



Years Remaining	5	4	3	2	1
Prepay Premium	5%	4%	3%	2%	1%
Prepay Curve	5%	10%	15%	20%	30%

Sources: Trepp, Freddie Mac

Exhibit 11 – CPR of 15% Compared to the Prepay Curve for a 10-year Term



Years Remaining	10	9	8	7	6	5	4	3	2	1
Prepay Premium	5%	5%	4%	4%	3%	3%	2%	2%	1%	1%
Prepay Curve	5%	5%	10%	10%	15%	15%	20%	20%	30%	30%

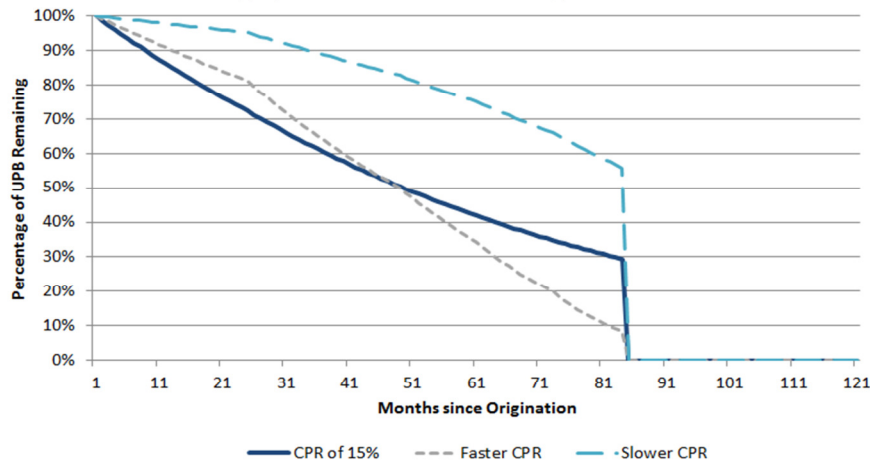
Sources: Trepp, Freddie Mac

*Several factors could slow down or speed up prepayments, including interest rate movements, economic stresses, and alternative step-down structures.*

While a 15 percent CPR is a reasonable average for modeling prepayment speeds, other factors can influence the speed of prepayments. Alternative step-down structures with lower starting prepayment premiums could result in faster prepayment speeds during the first few years. Interest rate and economic factors also will influence the borrower’s decision to prepay. A declining-interest-rate environment with increasing property values will drive many more loans to refinance into lower mortgage rates – as we’ve seen historically – where an increasing-interest-

rate environment and modest property appreciation will produce fewer refinances. To illustrate, Exhibit 12 shows comparisons of our 15 percent CPR with faster and slower prepayment scenarios for a 7-year loan. We set the faster prepayment scenario to twice as fast as the derived prepay curve while the slower prepayment scenario to half as fast as the derived prepay curve. It would be reasonable for market participants to scale the prepay curve to be faster or slower based on their views of market conditions that impact prepayments.

Exhibit 12 – Fast and Slow Prepayment Curves Compared to 15% CPR



Sources: Trepp, Freddie Mac

As stated above, our sample period covers 2004 to 2013, during which the market experienced a severe crisis. Presumably, it is very difficult for borrowers to get financing during a recession because of liquidity constraints and valuation issues. These factors would influence the prepayment behaviors, particularly for the loans originated prior to 2007. The historical data here, combined with knowledge of prevailing economic conditions and interest rate trends, can give investors insights they need to consider prepayment expectations appropriately in their investments.

**Conclusion**

Small balance loans – while different than larger loans – provide a comparable investment opportunity for market participants who understand the risks involved. Underwriting property income remains an important factor for a successful SBL investment. Overall, credit performance of our SBL program is expected to be similar to our conventional program due to our high standards of loan quality. Loss severity is generally higher for small properties given their higher liquidation costs and there are reasonable expectations that SBLs may prepay before maturity. We’ve found a flat prepay speed of 15 percent is not only a reasonable average to accurately reflect the prepayment risk during the life of the loan, but can also be used to measure the rate of all terminations because the expected credit losses are relatively

low. Alternatively, instead of a flat prepayment speed, it may be worth considering a prepayment curve that increases speeds as prepayment restrictions decline.

While SBLs are similar to larger, conventional multifamily property loans in some ways, market participants must understand the differences. Small properties will continue to represent a sizable share of the multifamily market and help provide affordable rental housing. Further involvement from the GSEs would increase the liquidity and stability of this market segment.

*For more insights from the Freddie Mac Multifamily Research team, visit the Research page on [FreddieMac.com/Multifamily](https://www.FreddieMac.com/Multifamily).*