An Untapped Source of Green Rental Homes

The federal government's stock of foreclosed houses offer better value to taxpayers and our economy as energy efficient family rental homes

Andrew Jakabovics February 2010

Introduction

The rolling home foreclosure crisis continues to haunt homeowners facing foreclosure, their neighbors due to falling home prices, and of course the broader U.S. economy. Relief programs initiated by the Obama administration and Congress are making a difference, but we at the Center for American Progress believe policymakers need one more arrow in their quiver—a targeted program to convert already foreclosed homes owned directly by the federal government into thoroughly energy efficient, affordable rental homes that can be resold as portfolios of rental properties to private investors.

Huge numbers of foreclosed homes are already falling into the hands of the Federal Housing Administration from the rising number of foreclosures from mortgage guarantees it made before the housing bubble burst. Over the next several years, many more single-family homes are likely to do so also, recognizing that even if foreclosure rates return to historical norms, FHA's increased role in supporting housing finance during the crisis will translate into additional properties in absolute terms.

Rather than quickly selling these foreclosed houses off individually at depressed prices, which drives down the value of other homes in the neighborhood and does little to minimize the ultimate losses to FHA's insurance fund, policymakers should instead maximize the value of these homes for taxpayers over the long term.

How? By pooling these houses by location, renting them out affordably, and then selling them in as a portfolio of already-occupied rental properties to institutional investors. Retrofitting and weatherizing these homes before renting them out provides even more value to taxpayers by reducing operating costs in the form of lower energy bills. Because the value of rental properties is driven by the net cash flow from the properties, demonstrable cost savings on operations increase the portfolio's value.

In 2009 alone, FHA paid insurance claims and then took title on 75,000 single-family houses.[1] As increasing numbers of foreclosed homes come into the possession of the FHA, the federal government could create long-term affordable rental housing in communities across our nation while minimizing losses to taxpayers who stand behind FHA mortgage payment guarantees. By repairing these foreclosed homes to meet the highest energy efficiency standards and then renting them out, taxpayers may well recover the most value after foreclosure.

Foreclosed homes, known as "real estate owned" or REO in real estate parlance, are most often sold off one house at a time in their current condition. The aim is to move them off the books as quickly as possible, and this has typically meant finding a new homeowner to buy the house. But with homeownership rates falling significantly as a result of the foreclosure crisis and many properties in disrepair, there aren't enough of these ideal buyers in the market, leaving too many opportunistic investors who are only interested in flipping these homes to homeowners or other investors.

When REO properties are auctioned off in bulk, the buyers are nearly always investors with a short investment horizon. To the extent these investors make repairs to the property to improve the chances of sale and increase their returns, the repairs are often largely cosmetic and can saddle unwary buyers with significant maintenance costs. Indeed, these kinds of investors have little regard for the long-term habitability of the homes they bought and sold.[2] This market reality was the impetus for the Department of Housing and Urban Development's Asset Control Area program, which offers housing-related nonprofit organizations the first right to purchase HUD properties in their communities.[3]

So instead of valuing an REO property based on the price it might fetch at auction through sale to investors looking to hold until they can resell for a quick profit, the federal government should consider the value of these properties for sale as packaged rental assets. Specifically, REO properties held by FHA should be thoroughly retrofitted, rented out, and then aggregated by location for sale to private investors as rental portfolios complete with tenants.

In many cases, the value of the cash flow from these properties as rentals will be greater than what individual homebuyers would be willing to pay for the houses in the aggregate, which means the federal government should receive more from the sale of these foreclosed properties than would otherwise be the case. What's more, investing in energy efficiency retrofits and then renting these properties would help stabilize local housing prices by keeping these properties out of the market not only while FHA prepares them for sale as bulk rental portfolios but for the foreseeable future.

This policy is designed not only to help rebalance housing policy to reflect increased demand for rental housing and to optimize the disposition of FHA properties, but also to help drive a true economic recovery that will not happen without job creation. As such, it complements the strategies laid out in Vice President's Middle Class Task Force report, "Recovery through Retrofit."[4]

In this policy memo, we will examine the details needed to inaugurate such a green rental conversion program in communities across our country. Our proposed new program on the face of it seems complex, but once the different facets of the program are considered together it becomes clear this green rental home program would help mitigate the home foreclosure crisis, improve rental opportunities for families in need of better rental homes, and boost jobs growth at a critical time in our economy's nascent recovery.

How to create green rental home investment portfolios

There are several steps that must be taken to convert some of the federal government's stock of foreclosed homes into portfolios suitable for sale to institutional and other large private investors as rental properties. First, the existing stock of REO homes needs to be catalogued by geography. Not all FHA-owned properties would necessarily make for good rental housing. Rural and exurban homes, for example, are likely to have less rental demand as potential residents choose to live closer to where jobs are and incur lower commuting costs. Suburban properties, however, particularly in good school districts, will likely have stronger rental demand.

The cost of managing a widely scattered portfolio of rental properties may deter private investors from bidding on such a portfolio. This is why the government must be strategic in identifying appropriate homes to aggregate, retrofit, and rent. But in rental housing submarkets with stronger demand, assembling green rental home portfolios can create value. The volume of properties falling into the hands of FHA control creates an opportunity to identify concentrations of properties that would make narrowly scattered rental management more realistic. As of the end of 2009, there were more than 30 metropolitan areas where FHA paid claims on 50 or more mortgages issued in the past two years alone.[5]

Second, many properties that ultimately become REO properties when mortgage holders or mortgage insurers such as FHA take title after foreclosure have significant damage, either as a result of outright vandalism or simply through neglect and abandonment. Simply selling them "as-is" almost guarantees a steep discount to market value and, by extension, results in significant losses to FHA, which already paid a claim based on the outstanding mortgage balance and not the current property value. Regardless of the reason for the damage, these properties will need rehabilitation to be suitable rental properties. So just as under the Neighborhood Stabilization Program, which provides funds to local governments and nonprofit groups to buy and rehab REO properties in an effort to put the houses back into productive use, select REO properties held by FHA should be rehabilitated according to the Department of Housing and Urban Development's Housing Quality Standards, which establish a baseline for health and safety standards.[6]

Further, these REO properties should be retrofitted consistent with green building and weatherization programs. In addition to demonstrating the feasibility of moving toward a low-carbon economy, greening and weatherizing these properties ultimately lower the cost of operating the properties in exchange for a marginal increase in the capital costs of the rehabilitation. A 20 percent improvement in efficiency directly translates into a 20 percent reduction in utility bills over the long term—and potentially even greater savings where deep, whole-home, verified retrofits are conducted.[7] Indeed, $2,500 spent on green retrofits can save, on average, $900 annually on energy costs.[8]

Once these retrofits and weatherizations are completed, a property manager should be identified who will handle leasing these properties on behalf of FHA prior to their resale in bulk as rental portfolios to private investors. Rents would be capped at HUD-determined Fair Market Rents to ensure long-term affordability for the tenants. Given that these properties are already in public hands, we should take the opportunity to ensure that when they are sold, the sales are done with public purpose in mind. Because of the energy efficient green retrofits, these properties would also be more affordable for tenants due to lower utility costs. In turn, vacancy rates would be lower than in comparable houses that have not been retrofitted. The anticipated lower long-term vacancy rate would increase the portfolio's value, again minimizing losses to FHA.

Despite pooling these properties into small geographies, these new rental homes ultimately will remain scattered throughout neighborhoods and communities, which means rental management companies with specific expertise in scattered-site rental housing must be found to manage these portfolios for private investors interested in purchasing these portfolios of rental properties. Scattered-site rental management can be difficult to do, particularly to do well at scale and at a modest cost. In some markets, contracting out to public housing agencies may be an option, as some of them have expertise in this line of business. Public housing agencies also may also be interested buyers of the portfolios, particularly those looking for a way to deconcentrate their housing stock, which is often found in only a handful of neighborhoods within their jurisdictions.

The operating costs for these single-family green rental portfolios will be somewhat higher than for an equal number of units in multifamily rental buildings. Consider a 50-unit multifamily building. It probably has one roof and one boiler. Not so for the single-family homes in this portfolio. They will have 50 roofs and 50 hot water heaters, so reserves for future capital expenditures will be somewhat higher on a per unit basis.

Despite these additional costs, bulk purchases and maintenance contracts for 50 roofs or hot water heaters make it relatively less costly than rehabilitating and maintaining 50 houses under 50 different owners. Moreover, while the per-unit labor costs for managing a handful of scattered houses are high, they decrease significantly with scale, arguing in favor of a portfolio-based approach to selling these properties.[9]

Once the properties in these new green rental portfolios are rented out to families, the portfolios can be sold off to private investors. Given the public funds that are going to go into the properties to retrofit and weatherize them, it is only reasonable to expect public purpose in return. Specifically, the properties should have long-term affordability obligations attached to the deeds.

The portfolio's value will ultimately be determined by the net cash flow from the rents. This is why reducing vacancy rates by virtue of the green rehabilitations and lowering operating and management costs by working at scale will add value to the properties and minimize losses to FHA. Possible buyers include life insurance companies and other institutional investors with long-term investment horizons.

Expanding the green rental home portfolio investment model

While the policy as proposed above specifically relies on FHA's portfolio of REO properties, the policy could potentially be expanded to include foreclosed homes held by Fannie Mae and Freddie Mac as well. In the first nine months of 2009, Fannie Mae and Freddie Mac took possession of almost 160,000 single-family homes.[10] In that instance, it may be necessary to establish a separate limited-purpose public corporation capitalized with public dollars—perhaps funds drawn from the Troubled Asset Relief Program if it is deemed an eligible vehicle for the acquisition of these troubled assets—to acquire foreclosed properties from FHA, Fannie, and Freddie so that the capacity to pool properties and identify true concentrations would be greatly enhanced. This new corporation would retrofit the properties it acquires, find tenants, and then sell them off in portfolios by location.

Additionally, this new public corporation could also acquire already rehabilitated properties from nonprofits participating in the Neighborhood Stabilization Program so nonprofits would not be left with long-term liabilities from stabilization activities—allowing them to recycle NSP funds much faster than if they retained ownership rights in rental properties. This is particularly important given the mandate of using 25 percent of the funds for low-income households, which are unlikely to be appropriate candidates for homeownership. These acquired properties would be added to the portfolio, rented out, and sold alongside the other properties in the area.

There is some historical precedent for a policy of renting foreclosed properties rather than selling them off immediately. During the Great Depression, properties acquired by the Home Owners Loan Corporation after borrowers defaulted on their HOLC loans were often rented out for a period of time through local brokers until the market value of properties improved. The policy of renting prior to resale was intended to minimize losses to HOLC that they otherwise would have realized on a postforeclosure sale in a depressed market.[11]

Similarly, over the past year, both Freddie Mac and Fannie Mae have implemented small-scale rental initiatives, [12] wherein they negotiate deed-for-lease arrangements with existing owners on the brink of foreclosure.[13] When launched, these programs only offered month-to-month leases as Fannie and Freddie expected to sell the houses to owner-occupants in the near term.[14] More recently, however, they began to offer year-long leases,[15] implicitly recognizing that renting may be more valuable than selling under current market conditions. The ultimate disposition strategies for foreclosed properties owned by Fannie and Freddie is not clear, but at this point there is no broader program for creating rental portfolios to be sold to larger investors.

In short, our proposed policy consists of aggregating, retrofitting, leasing, and selling government-owned REO properties, first those held by FHA and if successful, potentially those held by Fannie and Freddie. In addition to creating many new green-collar jobs, this program will begin to rebalance housing policy to provide additional family rental homes at a time when homeownership may not be appropriate for many households. Given the confluence of the location of many hard-hit communities and high unemployment rates, this policy can both stabilize neighborhoods as well as provide much-needed jobs.

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Endnotes

1 Author's calculation based on aggregated HUD Monthly Reports to the FHA Commissioner, available at http://www.hud.gov/offices/hsg/comp/rpts/com/commenu.cfm.

2 This was the impetus for HUD's Asset Control Area program, which offers housing nonprofits the first right to purchase HUD properties in their communities. For more information, see Ellen Seidman and Andrew Jakabovics, "Learning from the Past: The Asset Disposition Experiences of the Home Owners Loan Corporation, the Resolution Trust Corporation and the Asset Control Area Program" (Washington: Center for American Progress, 2008), available at http://www.americanprogress.org/issues/2008/09/learing_from_the_past.html.

3 Seidman and Jakabovics, "Learning from the Past."

4 Middle Class Task Force, Council on Environmental Quality, "Recovery Through Retrofit" (Executive Office of the President of the United States, October 2009), available at http://www.whitehouse.gov/assets/documents/Recovery_Through_Retrofit_Final_Report.pdf.

5 Neighborhood Watch, "All Lenders/Areas-Area Totals MSAs in the United States" (U.S. Department of Housing and Urban Development, 2010), available at https://entp.hud.gov/sfnw/public/ew-defall-out.cfm?loan_type=fha&RequestTimeout=500&TYPE=area&FA=US&FAvalue=US&FAname=United%20States&defyear=3&catkey=ALL&cutvalue=100&sortkey=TO&cutvalue2=50&sortkey2=TC&cutvalueb=9999999&cutvalue2b=9999999&target=MSA&mortype=x&lendstat=x&report=BOTH&orderkey=tot_clm&varorder=DESC&thisname=%20&comp=x&sortkey3=x&cutvalue3=x&cutvalue3b=x&arrts=x&datechoice=1&crw=x&CFID=5939067&CFTOKEN=bd6c10186175a0b9-BDB4321D-0EC0-2CCD-D357EE1D0DF4E6EE.

6 U.S. Department of Housing and Urban Development, "Housing Choice Voucher Guidebook," Chapter 10, available at http://nhl.gov/offices/adm/hudclips/guidebooks/7420.10G/7420g10GUID.pdf.

7 Bracken Hendricks, "Creating Clean Energy Jobs to Drive Economic Recovery," Testimony before the U.S. Senate, "Job Growth, Tax Incentives and Small Business," October 16, 2009, available at http://www.americanprogressaction.org/issues/2009/10/hendricks_specter_testimony.html.

8 Bracken Hendricks, Andrew Light, and Benjamin Goldstein, "Seven Questions About Green Jobs" (Washington: Center for American Progress, 2009), available at http://www.americanprogress.org/issues/2009/04/green_jobs_questions.html/#q4.

9 See Allan Mallach, "How to Spend $3.92 Billion: Stabilizing Neighborhoods by Addressing Foreclosed and Abandoned Properties," Federal Reserve Bank of Philadelphia, October 2008, available at http://www.philadelphiafed.org/community-development/publications/discussion-papers/DiscussionPapers_Mallach_10_08_final.pdf. Mallach examines vacant property management costs and the benefits of scale, but there is a significant overlap between managing vacant properties and rented ones. If anything, tenanted properties can be easier to manage since the risk of vandalism and property damage is far lower.

10 See 10-Q filings for Fannie Mae and Freddie Mac for data through September 30, 2009

11 For more on historic models of asset disposition, see "Learning From the Past: The Asset Disposition Experiences of the Home Owners' Loan Corporation, the Resolution Trust Corporation, and the Asset Control Area Program," co-authored with Ellen Seidman and published by the Federal Reserve Bank of San Francisco, available at http://www.frbsf.org/publications/community/review/vol5_issue1/seidman.pdf.

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13 Renters living in foreclosed properties are protected from eviction in foreclosure for 90 days. See National Low Income Housing Coalition, "Renters Have Immediate Protections from Foreclosure Under New Bill," Press release, May 20, 2009, available at http://www.nlihc.org/detail/article.cfm?article_id=6140&id=48)

14 Fannie Mae explicitly reserves the right to market the property unless precluded by a pre-existing lease. See Fannie Mae, "Fannie Mae's REO Tenant-in-Place Rental Policy FAQs," available at http://www.fanniemae.com/homebuyers/pdf/rental_faqs.pdf.

15 Alan Zibel, "Fannie Mae Rental Program DETAILS: Program Will Let Thousands Rent Out Homes To Avoid Foreclosure," *The Huffington Post*, November 5, 2009, available at http://www.huffingtonpost.com/2009/11/05/fannie-mae-deed-for-lease_n_346988.html.