



Rehab-to-Rent Can Help Hard-Hit Communities and Our Economy

What to Consider When Converting Vacant Foreclosed Homes into Affordable, Energy Efficient Rentals

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Introduction and summary

Half a million houses, many of them vacant and deteriorating, are languishing in a bloated U.S. real estate market, threatening to turn some cities into ghost towns, undermining the stability of working families, and proving to be an anchor on a shaky economy. Many of these vacant homes, nearly a quarter-million, are controlled by the federal government.

If the situation wasn't already bleak enough, there are also more than a million additional American homes saddled with delinquent mortgages that are in the process of foreclosure. Chances are many of these homes will also end up as the property of the federal government. The only way to lower the inventory of decaying homes is to find a use for the ones we have before new ones swell the pool. Without assistance, the current "overhang" of foreclosed homes is expected to take four years to work back into the market.

The good news is the Obama administration and independent federal regulators are formulating plans to sell government-controlled foreclosed properties to investors who would bring them onto the rental market. The aim is to reduce the number of vacant homes which depress housing prices and burden the economy while meeting an increasing demand for rental homes. If made affordable these new rentals can help meet the needs of approximately 20 million American households—about half of all renters—who are "rent impoverished" today, meaning they devote more than a third of their monthly income just to housing.¹ This is a key indicator of pent-up demand for new rental housing.

The Federal Housing Administration, or FHA, and the two mortgage giants Fannie Mae and Freddie Mac—both currently in government conservatorship—collectively own about 230,000 foreclosed homes, mostly from mortgages insured or securitized before the housing bubble burst.² Unfortunately, only a small subset of these foreclosed properties are in good enough shape and in strong enough markets to be sold directly to families looking for a place to call home. For the rest, low home prices and weak demand for owner-occupied homes mean that selling hundreds of thousands of them into that market will depress prices for a long time to come.

In this paper we lay out a set of priorities for removing a portion of these properties from the glutted for-sale market by converting them to affordable rental units, a process we call “Rehab-to-Rent” or “R2R.”

With home prices slumping and rental demand and rents rising, these government-owned properties could earn a greater return for taxpayers and do more to promote an efficient and resilient housing market if they are taken out of for-sale markets and converted into rental units. Residents of these communities and American taxpayers who are on the hook for homes now owned by Fannie, Freddie, and FHA would be best served if these homes were rehabilitated, potentially retrofitted for energy efficiency, and then rented out at affordable rates.

The Federal Housing Finance Agency, or FHFA, which is responsible for Fannie Mae and Freddie Mac as their regulator and conservator, earlier this year solicited information from companies, community groups, governments, and other stakeholders on how to do this successfully. Our response was one of over 4,000 received, demonstrating a healthy appetite for this program.³

When deciding what to do with these properties, we believe FHFA should focus on its congressional mandate to:

- Preserve and conserve the government-controlled assets and property of Fannie and Freddie.
- Ensure Fannie and Freddie support stable and liquid mortgage markets by operating in a financially safe and sound manner even though they are in conservatorship.
- Maximize assistance for homeowners, where warranted, and minimize preventable foreclosures.⁴

We acknowledge a possible tension in this mandate, namely between maximizing short-term return to Fannie Mae and Freddie Mac—likely by selling the foreclosed homes they own to the highest bidder—and stabilizing local housing markets to benefit taxpayers generally by not flooding the housing market with the mass sale of foreclosed single-family homes. But we believe these goals can actually work in tandem if FHFA focuses on maximizing the medium- and long-term returns on these assets, which will in turn stabilize housing markets and neighborhoods hit hardest by the foreclosure crisis.

This paper offers key considerations for any Rehab-to-Rent initiative Fannie, Freddie, and FHA wish to pursue. It expands on the principles laid out in the Center for American Progress’s official response to FHFA’s request for information, focusing on how R2R could best work in the real world to serve multiple goals. This paper focuses exclusively on how a Rehab-to-Rent program could deal effectively with the continuous flow of so-called “real estate-owned,” or “REO” properties—industry parlance for lender-owned foreclosed homes—that are under federal government control. But we believe that its success could pave the way for similar private-sector initiatives to deal with the quarter-million foreclosed homes held by banks and other financial institutions.⁵

This paper is the product of many hours spent with the underlying economic and housing data as well as conversations with stakeholders in both public and private spheres, including institutional investors, community-based nonprofits, rental-property managers, and representatives from federal, state, and local governments. Because many of those with whom we spoke are intimately involved in internal discussions about what to do with government-controlled foreclosed properties, those conversations took place with the understanding that we would not attribute statements to particular groups or individuals.

The results of our research are detailed in the main pages of the report, but briefly here we present a summary of our proposal.

FHA, Fannie, and Freddie: A primer

Since the Great Depression, the federal government has played a key role in maintaining a stable U.S. housing market, promoting liquidity in the mortgage-finance market and access to affordable mortgages in times of economic growth and contraction. The Federal Housing Administration is the largest purely governmental body in the housing market, providing insurance for mortgages issued by private lenders. This includes loans for single-family residential properties, apartments, hospitals, assisted-living facilities, and nursing homes. The agency has two primary missions: promote long-term stability in the American housing market and expand access to affordable housing to underserved segments of the market, such as first-time

homebuyers, low-income families, and minority communities. The Federal National Mortgage Association, commonly called Fannie Mae, was created first as part of the federal government in 1938 and later as a government-sponsored, privately owned enterprise to expand the secondary mortgage market through the securitization of mortgage loans. A second housing finance entity with the same basic mission the Federal Home Loan Mortgage Corporation, or Freddie Mac was created as a government sponsored, privately owned enterprise.

Continued on page 4

Continued from page 3

While their structures and business practices have changed drastically over the past 40 years, Fannie Mae and Freddie Mac's central goal is to provide a liquid and stable mortgage market by purchasing residential mortgages, pooling them into mortgage-backed securities, and selling them to investors. They also maintain a portfolio of mortgage-backed securities and other investments, paid for by issuing institutional debt.

After the housing crisis of 2007-08 severely weakened the value of Fannie and Freddie's portfolios and left them both on the brink of bankruptcy, the federal government stepped in to bail them out. Fannie Mae and Freddie Mac have been under government conservatorship, supervised by the Federal Housing Finance Agency, since August 2008.

How R2R would work

This paper is built on two assumptions: First, Fannie Mae, Freddie Mac, and FHA should each determine the best way to dispose of its own REO inventory because each of them brings separate business processes, corporate attitudes, and legal and financial tools to managing their portfolio of foreclosed-upon houses. Combining their inventories of foreclosed properties could have benefits to R2R, but the complexity makes it an unlikely prospect.

Second, Fannie, Freddie, and FHA should use multiple methods to dispose of their stock of foreclosed houses—determining which to sell to individual owner-occupants (referred to as the “retail market” in this paper), which to sell in bulk to investors and community groups, and which to hold as assets and possibly rent out through joint ventures for a period of time.

Regardless of the configuration, any disposition strategy should target the same goals, namely:

- Maximize the long-term return of foreclosed single family homes to taxpayers
- Stabilize local home prices by reducing the glut of foreclosed properties on the market
- Stabilize communities hit hard by the foreclosure crisis
- Expand affordable rental housing in markets with unmet need
- Expand the stock of energy-efficient homes
- Create new jobs and economic activity in depressed areas

With these goals in mind, we've set out benchmarks below by which any R2R strategy should be evaluated. Each benchmark may not apply to every government-controlled foreclosed property, but we believe that each should at least be considered for every community where substantial quantities of them exist. Let's examine these benchmarks more closely.

Benchmark #1: Tailor strategy to the specific needs and market conditions of the community

As FHFA Acting Director Edward DeMarco stated in his testimony before Congress on November 3, 2011, a “single, national program for REO disposition” will not work.⁶ FHFA is rightly interested in “proposals tailored to the needs and economic conditions of local communities,” such as employment opportunities, industry mix, income-level, and the age and quality of the housing stock.

What is required instead is a set of criteria that will help FHFA identify a few fundamental traits that make R2R possible in a community and then look to bidders to make the case for viability in that community. Considerations include having sufficient numbers of government-controlled REO properties within a specific geographic area, unmet demand for rental housing, and financial incentive to invest in rental properties.

Benchmark #2: Ensure bidders have a track record and viable plans to rehabilitate and rent the units

If R2R is to have a measurable impact on communities or the balance sheets of Fannie, Freddie, and FHA then it will have to achieve substantial scale—at the very least tens of thousands of homes within a couple of years. Based on our discussions with Fannie and Freddie representatives, these institutions have around 60,000 to 90,000 foreclosed properties available for active sale right now; larger potential investors have told us they would purchase 10,000 to 25,000 properties immediately if they could. If even a fraction of this is achieved, tens of thousands of homes across the country will be moving into the hands of new owners to be held out for rent. A failure by any one of these new owners—even a partial failure, such as a big delay in rehabilitating properties—could have a large impact on the community where those homes are located.

While we don't harbor idyllic notions of working within a perfect system, a top priority has to be to qualify buyers and property managers based on proven track records in property rehabilitation and market performance as well as demonstrated potential to provide local benefits through community engagement.⁷ Fannie, Freddie, and FHA should consider a bidder's track record in acquiring, rehabbing, and managing scattered-site, single-family homes; primary location of operation; knowledge of the local real estate market; relationships with the community; and, where appropriate, the organization's history of community and economic development.

Benchmark #3: Acquire properties for R2R in communities that will maximize long-term returns to taxpayers and stabilize housing markets

One of the most prominent issues in FHFA's request for information was how to get the properties from the hands of the federal government to those who will responsibly manage them for rent. The primary focus here should be selling to responsible buyers under terms that are most likely to maximize long-term returns. In some instances, that may be an auction to a qualified bidder in order to yield the highest immediate reward. In others, a multiyear joint venture where Fannie, Freddie, or FHA holds the title while the joint venture partner rehabilitates, retrofits, maintains, and rents the properties could yield a greater overall return under certain circumstances.

Regardless of the resulting ownership structure, the process for transferring properties from the federal government for R2R must be carefully designed to avoid cherry picking, to accommodate consortiums of bidders and property managers, and to ensure that neighborhood stabilization remains a key consideration.

Benchmark #4: Expand the affordable rental housing market

At a time of high unemployment and stagnant middle-class wages, affordable housing is critical to our economic recovery. The more low- and moderate-income families spend on housing each month, the less they spend in stores, making businesses leery of investing and hiring new employees. People coming out of their homes due to foreclosure need a place to live, as do workers who need to move to find jobs and will need access to affordable rental housing.

Indeed, the need for affordable rental housing is unprecedented in recent history, therefore any disposition plan should include mechanisms to encourage its provision. One way to do this is by encouraging the participation of local community organizations with experience rehabilitating and managing affordable rental properties. But these nonprofits often lack the capital necessary to be competitive with certain classes of investors such as private equity groups. That is why it is important to provide low-cost seller financing to ensure the participation of mission-driven community groups.

Benchmark #5: Provide incentives to property owners to properly renovate properties and undertake economically justifiable retrofits

Hundreds of thousands of steadily deteriorating foreclosed properties sit vacant today. They will need to be rehabilitated before they can be rented. In some cases, especially when the federal government maintains some financial stake in the property through a joint venture (as we discuss later), this provides an opportunity to reduce the total cost of ownership through economically justifiable, energy-efficient retrofits.

Since individual owners will be rehabilitating many properties simultaneously in a relatively short time period in any Rehab-to-Rent program, they will have an opportunity to go beyond mere rehabilitation and improve home energy-efficiency performance through a deeper retrofit at marginal additional cost. If a new owner of these properties, for example, is already replacing windows or heating systems, energy savings can be achieved for little additional cost by installing higher-quality materials and mechanical systems. There are also social benefits of energy-efficient rental housing: it helps lower our dependence on foreign oil, reduces carbon emissions to help combat climate change, and lowers utility bills for tenants, many of whom are low- and moderate-income families.

Retrofits should be encouraged in any R2R program. Through financing and other methods, the federal government can offer incentives to property owners to conduct proven and cost-effective energy and water saving retrofits that can enhance the long-term value of the property.

Benchmark #6: Ensure sufficient measures are in place to monitor compliance

It is a given that with such an ambitious undertaking involving large numbers of buyers, things will occasionally not work as planned. It is imperative that the government sets up strong monitoring and contingency plans in place not to simply mitigate the risk of failure, but also to effectively respond if investors fail to meet certain compliance requirements. FHFA must monitor those who hold formerly government-owned REO properties out for rent and lay out clear penalties for noncompliance.

Fannie, Freddie, and FHA should restrict a poor-performing investor's ability to acquire more properties, and for the most serious offenders, establish a mechanism for recapturing properties. The federal government should draw on its experience (both good and bad) in previous efforts to transfer properties from government to private entities, such as the Resolution Trust Corporation set up after the savings and loan crisis of the 1980s.

We take a more detailed examination of each benchmark later in this report, but first let's turn to a detailed assessment of today's foreclosed property market to understand more clearly how our Rehab-to-Rent approach can help resolve several festering problems resulting from the housing market crash and subsequently slow and uneven recovery.

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