



Economic Letter

Foreclosures' Silver Lining: They Could Restrain Rent Inflation

by Alex Musatov and Danielle DiMartino Booth

► Rental inflation has surpassed historic levels despite a supply of housing that partly reflects a persistent inventory of foreclosed, vacant homes.

The U.S. housing market served both as a trigger and a catalyst during the recent financial crisis. Roughly \$7 trillion in household wealth was lost as average house prices declined by nearly one-third from their peak (*Chart 1*). The resulting negative wealth effect—decreased income and deleveraging of consumer balance sheets—suppressed consumption and deepened the recession.

Recent economic indicators suggest that the worst of the housing crisis has passed, with home sales and prices reaching bottom in 2012. Construction, housing prices and homeowner's equity show early signs of resumed growth.

While these signs are encouraging, a notable disconnect has emerged. Rental inflation has surpassed historic levels despite a supply of housing that partly reflects a persistent inventory of foreclosed, vacant homes. Several impediments have hindered a market-based resolution to the crisis' lingering effects. Among them, individuals have found mortgages hard to come by due to tougher credit standards, and investors interested in bulk purchases have encountered owners unwilling to enter into these types of sales.

Foreclosures at Historic Levels

At the downturn's onset, vacant-home inventories swelled amid slumping

valuations and high unemployment.¹ The properties ended up on the balance sheets of banks and government-sponsored enterprises (GSEs), most notably Fannie Mae and Freddie Mac, which purchase mortgages and bundle them for sale as debt securities. These foreclosures are collectively known as "real estate owned," or REO. The share of loans in foreclosure exceeded 4 percent three years ago and remains near its high (*Chart 2*).

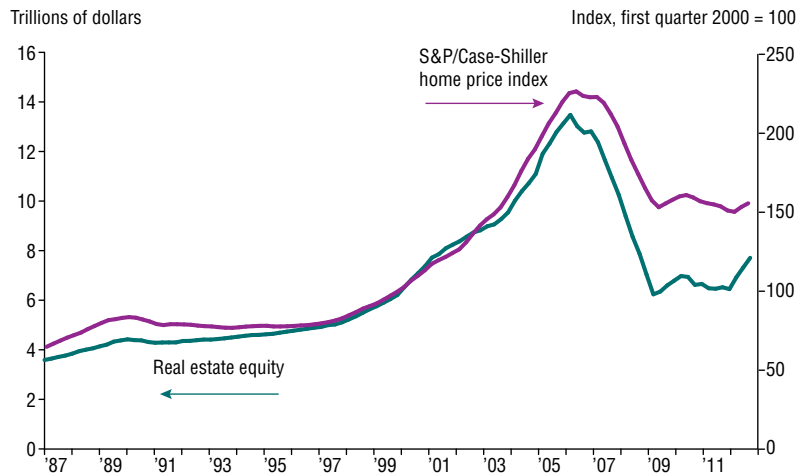
Not all foreclosed properties become vacant, but many do—3.8 million, according to the fourth quarter 2012 census.² That is 50 percent higher than in the years preceding the housing crisis. Long-empty homes tend to fall into disrepair and invite crime. A foreclosed, but not vacant, home lowers the neighboring property value by 3.9 percent, while an empty home impairs values by more than twice that amount, according to the Federal Reserve Bank of Cleveland.³

Excess Inventory Persists

A tepid economic recovery, stagnant wage growth, tight mortgage lending standards, fear of further house price declines and shifting homeownership patterns contribute to still-large distressed property inventories. Moreover, home sales remain well below peak levels even as the 30-year, fixed-rate mortgage

Chart
1

Home Prices, Equity Remain Well Below Precrisis Peaks



SOURCES: S&P/Case-Shiller; Federal Reserve Board of Governors' flow of funds accounts.

► In the six years through 2006, 16 million Americans became new homeowners, while a net 700,000 became renters. In the five years that followed, homeowner ranks contracted by 1.2 million, while 4.2 million additional renters emerged.

reached a record-low 3.5 percent. Slow personal income growth may explain some of the inactivity. Real (inflation adjusted) per capita disposable income grew at an average annual rate of 2.1 percent from 2000 to 2007, but it shrank 0.03 percent annually in the most recent five years.

Relaxed lending standards and policy initiatives that encouraged homeownership just before the crisis widened the pool of buyers to include people who couldn't previously qualify. Now, tighter credit standards hinder buyer access to financing. At the peak, first-time homebuyers accounted for 51 percent of existing-home sales, compared with 37 percent today.⁴ The average credit score of the bottom 10 percent of borrowers has risen from about 625 out of a possible 850 points in 2006 to 690 today.⁵ While tougher lending standards should strengthen the long-term mortgage market, for now they stymie the housing recovery.

Rising Rental Inflation

Even with housing affordability near historic highs, rental inflation has increased, reflecting demand outstripping supply (*Chart 3*). From year-end 2009 to September 2012, the average monthly apartment rent increased almost 10 percent, to \$1,310.

The retreat from homeownership has been remarkable. In the six years through 2006, 16 million Americans became new

homeowners, while a net 700,000 became renters. In the five years that followed, homeowner ranks contracted by 1.2 million, while 4.2 million additional renters emerged.

Apartment starts rose from a seasonally adjusted, annualized rate of 58,000 in October 2009 to 338,000 in December 2012, reflecting this burgeoning demand. Theoretically, the inventory of GSE-foreclosed homes could meet some of this need.

Obstacles to Rental Conversion

Although an estimated \$10 billion in private funds has been raised to target the distressed real estate sector, several obstacles have hindered deployment of capital.⁶

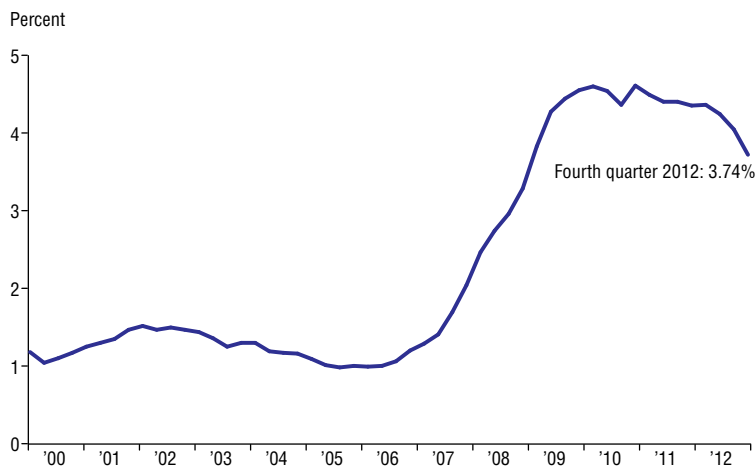
First, institutional buyers—real estate investment trusts (REITs) and private equity funds—normally seek large, dense projects such as office buildings or high-rise apartment complexes. (Blackstone Group's \$250 million purchase of foreclosed homes marks a recent strategic change.)

Second, financing for groups of single-family homes isn't readily available, a disadvantage for smaller investors.

Third, ownership of foreclosed properties is spread among banks, GSEs and investment funds, limiting bulk sales. Furthermore, such sales of REOs typically command significant price concessions relative to direct owner-occupied sales.

Chart 2

Foreclosed Home Inventory Remains Near Peak



SOURCE: Mortgage Bankers Association's National Delinquency Survey.

After sustaining significant write-offs due to the housing collapse, banks are reluctant to recognize further losses.

Finally, while most suburban REO properties are in neighborhoods where median home values mirror those of the larger metropolitan area, many others are in poorer, low-demand communities.⁷ Vacant and sometimes vandalized, these properties may appear unattractive to potential landlords.

Pilot Program

In August 2011, the Federal Housing Finance Agency (FHFA), which oversees Fannie Mae and Freddie Mac, requested proposals on how best to handle foreclosed properties. By some estimates, the GSEs hold half the nation's foreclosed homes. The agency unveiled a pilot program in February 2012, drawn from the more than 4,000 responses it received.

The initiative allowed qualified investors to purchase pools of assets—homes that are vacant or already rented—in the hardest-hit markets, with a caveat: The properties must be used as rentals for a predetermined time. To broaden the potential investor base, FHFA allowed individuals, corporations and investment trusts to participate in a sealed-bid auction. Bids were requested in two formats: an outright cash purchase and a joint-venture partnership with FHFA.

Prospective purchasers were prequalified, filing detailed applications that

focused on financial capacity, real estate investing experience and ability to manage rental assets long term. FHFA was also concerned about the impact of foreclosed properties on neighboring communities and sought investors with experience in managing groups of scattered single-family homes, which demand operational expertise that distinctly differs from what is required to oversee multifamily developments.

Fannie Mae supplied 2,490 pilot-program properties (from a 250,000-unit inventory) in a relatively few metropolitan areas—Chicago, Atlanta, Los Angeles, Las Vegas, Phoenix and two regions in Florida. Based on results of the initial effort, the next round could include homes from Freddie Mac and the Federal Housing Administration. Officials wanted to test investor appetite, assess operational strategies and, in particular, ascertain the availability of debt financing structures needed to execute the transactions.

Partial Disposal Suggested

FHFA revealed winners for all REO pools but Atlanta, which leads the nation in foreclosed properties. The agency has not disclosed why Atlanta wasn't awarded. In all, 24 firms competed—a group that ranged from sophisticated hedge funds to relative newcomers.

The bids, now public, confirm the housing market uncertainty confronting some investors. Of the two firms that

competed for all 2,490 properties, one valued them at \$65 million, while the other offered \$262 million. Bid ranges for individual pools were relatively narrower but still substantial. The package of 341 properties in Phoenix attracted offers from \$28 million to \$49 million. While some of the difference can be attributed to operational and management skill, it appears that even specialized investors still materially disagree about the intermediate-term outlook for the distressed-housing sector.

Rather than accept the outright sale offers, FHFA opted for joint-venture arrangements. For instance, the winner of 699 properties in Florida will manage the rented properties in exchange for a fee of 20 percent of gross realized rents. Pacifica LLC, a Santa Barbara, Calif.-based real estate investment company, may sell only 10 percent of the units during each of the venture's first three years. The firm will receive 10 percent of equity distributions, while Fannie Mae collects 90 percent until its receipts reach a specified threshold. The two entities will then equally split equity distributions. FHFA expects the joint ventures to last 10 years, after which it can force the sale of the remaining rentals.

Promise and Limitations

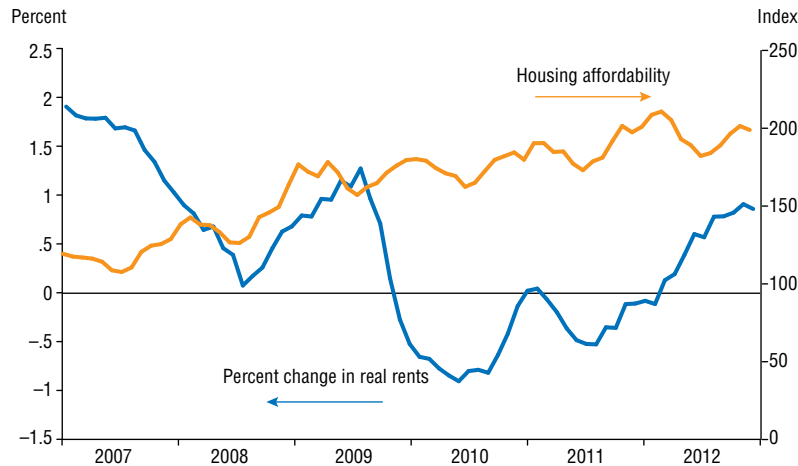
Interest in the pilot program from established, prominent firms validates the potential for this new REO asset class.

But the trial run's small size is unlikely to materially coalesce the disconnect between the ownership and rental markets. To attract investors, the pilot included mostly properties with live-in, paying tenants—Capital Economics, a global macroeconomic research firm, estimates that renters occupied up to 80 percent of the properties. This strategy guaranteed that the new owners would collect cash rent from day one. It also created a trade-off—very few new rental units were created, perhaps too few to measurably affect house values or local rents.

Moreover, FHFA's preference for a joint venture may have deterred some larger, more prominent funds that intended to aggregate the acquired properties into a REIT or to securitize the rents, packaging them into a rent-backed security. Without full ownership, that

Chart 3

Rents Outpace Inflation as Housing Affordability Nears High



NOTES: The real rent inflation series is calculated as the difference between the year-over-year change in the rent component of the Consumer Price Index (CPI) and the Trimmed Mean CPI produced by the Federal Reserve Bank of Dallas. A value of zero implies that rents increased exactly in line with the broad level of prices. A rise in the National Association of Realtors' Housing Affordability Index means that homeownership has become more affordable. The index equals 100 when a median-family-income household qualifies for an 80 percent mortgage on a median-priced existing, single-family home.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas; National Association of Realtors.

exit strategy could not be pursued. Large funds may not return if similar bulk auctions are held in the future. Och-Ziff Capital Management—a \$31 billion hedge fund and an early entrant into the rental market, with a portfolio of 300 foreclosed California homes—recently announced its exit after less than a year, citing disappointing returns. FHFA has yet to announce plans to expand the pilot into a larger-scale initiative.

While the full economic and social benefits of the REO-to-rental pilot will be difficult to gauge for some time, the program's potential to alleviate the dis-

joint between rental inflation and home affordability appears limited. At least for now, rental demand growth appears strong, fueled by economic and financial shifts. Still, combined with complementary efforts from the public and private sectors, this initiative may become a pillar for a sustained housing recovery.

Musatov is an alternative investments specialist and DiMartino Booth a senior financial industry analyst and advisor in the Financial Industry Studies Department of the Federal Reserve Bank of Dallas.

Notes

The authors would like to thank Joshua Zorsky of the Financial Industry Studies Department for analytical support.

¹ National Delinquency Survey, Mortgage Bankers Association, Second Quarter, 2012.

² Housing Vacancy Survey, Census Bureau, Fourth Quarter, 2012.

³ "The Impact of Vacant, Tax-Delinquent and Foreclosed Property on Sales Prices of Neighboring Homes," by Stephen Whitaker and Thomas James Fitzpatrick IV, Federal Reserve Bank of Cleveland Working Paper no. 11-23, December 2011.

⁴ Profile of Home Buyers and Sellers, National Association of Realtors, Nov. 10, 2012.

⁵ "Prescriptions for Housing Recovery," speech by Governor Elizabeth A. Duke, Federal Reserve Board, May 15, 2012.

⁶ "Rental Market's Big Buyers," by Craig Karmin, Robbie Whelan and Jeannette Neumann, WSJ.com, Oct. 3, 2012.

⁷ "Addressing Long-Term Vacant Properties to Support Neighborhood Stabilization," speech by Governor Elizabeth A. Duke, Federal Reserve Board, Oct. 5, 2012.

DALLAS FED



Economic Letter

is published by the Federal Reserve Bank of Dallas. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

Articles may be reprinted on the condition that the source is credited and a copy is provided to the Research Department of the Federal Reserve Bank of Dallas.

Economic Letter is available free of charge by writing the Public Affairs Department, Federal Reserve Bank of Dallas, P.O. Box 655906, Dallas, TX 75265-5906; by fax at 214-922-5268; or by telephone at 214-922-5254. This publication is available on the Dallas Fed website, www.dallasfed.org.

Richard W. Fisher, *President and Chief Executive Officer*
Helen E. Holcomb, *First Vice President and Chief Operating Officer*
Harvey Rosenblum, *Executive Vice President and Director of Research*
E. Ann Worthy, *Senior Vice President, Banking Supervision*
Mine Yücel, *Vice President and Director of Research Publications*
Anthony Murphy, *Executive Editor*
Michael Weiss, *Editor*
Kathy Thacker, *Associate Editor*
Ellah Piña, *Graphic Designer*

FEDERAL RESERVE BANK OF DALLAS
 2200 N. PEARL ST., DALLAS, TX 75201