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State of the Market 42: Reviving the foreclosure inventory by reinventing it

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Today, the more than 3,000,000 homes that are foreclosed or in advanced stages of foreclosure are acting as an enormous deadweight on our economy and our communities; the nation's health requires that we find ways to restore their occupancy and economic appeal.

An empty single-family home is an inert risk magnet; it revives only occupied by an active householder; operated and reinvested in by a motivated owner; and financed to allow optionality and upside. Efforts that focus on just the financing are not working, because it tackles only one of these (financing), and a foreclosure-recovery ecosystem that coped effectively well when defaults were a trickle has collapsed entirely when confronted with this flood.

To get the system working, therefore, we have to change simultaneously the three interdependent components that prevent or enable success – tenure options, operational management systems, and financial structures. We do it by reinventing all three forms, using principles proven around the world or in America's own past.[1]

"How do we move millions of homes like this one from Before (left) to After (right)?"

New tenure forms: workforce rental and 'future homeownership'

Though they must now be operated as rental (there being a dearth of financeable buyers), these homes were physically and architecturally designed for ownership, and ideally we would like many of them returned eventually to homeownership. We can do this by enlisting the occupants as essential partners in managing the asset via new tenure forms that combine rental's low entry cost with homeownership's responsibility and upside potential.

Homeownership is the most potent economic goal for millions of American families, and it is the yearning for homeownership, even to the point of economic desperation, that was so cruelly exploited in the subprime debacle. Even today, people want to become homeowners, but millions of American families have been knocked out of the market, their cash assets diminished, their credit histories blackened, and their psyches (and risk tolerance) battered. Though they cannot be returned to homeownership with a sudden stroke, we want to give them a hopeful path to homeownership that motivates them to be active partners in improving the value of their homes, by creating an earned equity equivalent that enables them to

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[1] The business concepts articulated in this *State of the Market* were first developed in Recap's work developing a response to the FFIs' Request For Information that we submitted on behalf of the Housing Partnership Network; for a copy of our full response (75 pages, with detailed analysis and exhibits) just email me at dsmith@recapadvisors.com.

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accumulate skin in the game essential for being a legitimate stakeholder.

The key is a hybrid tenure, via a rent-to-own model that we have dubbed a Contract for Future Homeownership. The occupant enters into a rental arrangement that gives the householder three critical attributes of homeownership (security of property, security of tenure, and controllable occupancy cost) and allows the renter/occupant the option, but not the obligation, to step up to full homeownership when the circumstances allow it, with provisions akin to these:

- ***Initial 'workforce housing' at an affordable rental***. The initial tenure will be normal rental at a manageable rent, with future increases tied to a formula (say, CPI Urban or four percent, whichever is lower) that provides ongoing economic affordability.
- ***Purchase option dates***. Provided they meet the qualifying criteria and otherwise comply with the rental requirements, occupants will generally have the option to purchase their home directly, as fee-simple homeownership at specified dates, giving a goal to strive for.
- ***Formula prices for occupant to buy earned homeownership***. The option price can also be set by formula (say initial cost plus renovation/repositioning costs, times an affordable inflation factor). This motivates the occupant to stay in the home and further invest in the home, because the affordability of its purchase will be assured.
- ***Potentially assumable financing***. Upon purchase by the occupant from the landlord-owner, the ratable portion of the landlord's acquisition loan (see Part 3 below) will convert from being the landlord's loan to a direct home mortgage to the occupant (now, the new owner), which provides reliable offtake liquidity and leaves the home buyer seeking only the down payment.
- ***Durability of workforce rental as the fallback.*** Not all those who move in aspiring to be homeowners will be able to accumulate down payment capability, so our endgame has to allow for permanent workforce housing in a secure rental tenure with a controllable occupancy cost.

By creating a different set of expectations for the occupant, this rent-to-own model also redefines the roles of tenant and landlord in ways that will facilitate the new operational model. It has been developed and proven in Britain, and tested at micro scale by non-profits in Atlanta and Cleveland.

New operational model: hub-and-spoke Web-based management

For more than forty years, professional multifamily property management has operated on two premises: site specificity and resident passivity, both of which work fantastically in large developments (i.e. 300 apartments and up) and founder completely in multiple individual locations within a neighborhood.

- ***Site specificity***. In today's modern management companies, everything from the rental office to the site team personnel ties particular management people to particular properties.
- ***Resident passivity***. Our standard lease model is little different from a hotel occupancy contract: the tenant rents the space and does nothing to maintain it, while the landlord provides every function and fixes every problem, so the solution to any surprise is "Call the management company."

Given those two operating premises, many people will tell you that scattered-site or single-family rentals are operationally unmanageable – especially in the low-income communities where most of the ARAEO stock resides. Yet units in single-family structures represent 58% of America's rental housing stock and virtually all of the REO stock. So we have to go back to first principles.

Instead of seeing landlord and tenant as two parties at odds with different incentives, they should both be seen as partners over time with shared interests in improving the property, strengthening the resident's economic situation, and increasing the prospects for a successful sale by the landlord to the tenant on a basis that will please both.

As presented in the previous section, the tenure can be presented to the public and marketed as a for-sale product ("rent today the home you want to buy tomorrow") – a multi-year lease agreement (with the resident's right to opt out given notice) where the option to buy vests if and only if the resident complies with the rental and operating provisions. Elements of our new operational model can include:

- ***Hub-and spoke management and operations***, dispatched via call center as described below, to increase responsiveness and specialization in the manager's work force while reducing the cost of site-specific rental offices, management workshops, and personnel.
- ***A call-center model of operations***. Americans are increasingly used to receiving in-home support via remote-access communication (over the Web or the telephone) and have shown willingness to accept such remote support if it is prompt, responsive, personal, and friendly. In the UK, large housing associations do everything via a call-center model, with quality and touch that can put many of our managers to shame.
- ***Help-do-it-yourself tenancy***. Residents who cut their own grass, clean up property, or undertake do minor repairs (based on remote-viewing authorization from the call center), can gain economic benefits (either reduced rent in agreed amounts or potentially the accumulation of credit toward a down payment). Property condition before-and-after can be verified by digital camera and random inspection and reported real-time.
- ***Limited privacy waiver relating to remote real estate operations***. Residents benefiting from cheaper rents and having the 'free' option to buy later will be willing to permit privacy waivers allowing for remote viewing of the property's state (e.g. utility reporting or public-space web cameras) to substitute for physical in-person inspections by landlords.

Affordable housing veterans may shudder at some of these points, but consider – occupancy in affordable housing is a privilege, not a right, the more so when there is an aspirational element (as in a path to homeownership). Experiments such as the Austin Housing Authority's Six Stars program have shown that poorer tenants will embrace a new lease form making them more active and more responsible if it comes with a tangible and valuable bargain.

New financial structure: public-private partnership modeled on the RTC

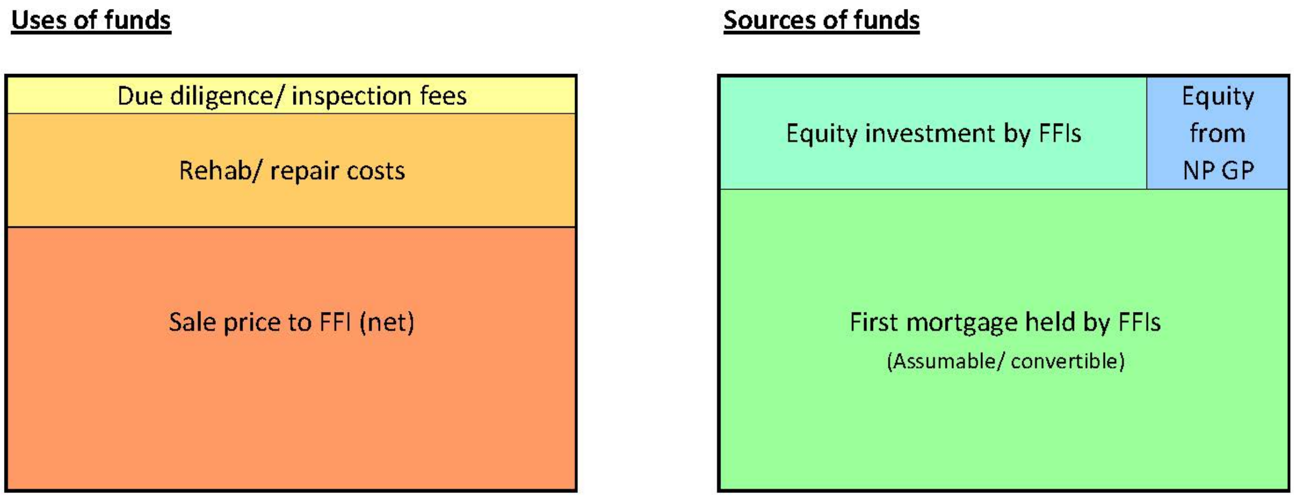
Sales using classical debt-equity structures will produce terrible results for the government – poor property management, flipping, distressed pricing, and other practices that accelerate neighborhood destabilization. The properties are unstable assets, whose valuation is hard because physical improvements for restoration may not be scoped or priced. Property management challenges limit the field to mission-oriented acquirers, who lack cash at the necessary enormous scale.

Fast execution requires sales in bulk. Customized repositioning requires individual underwriting. Federal public policy objectives include community stabilization and the revitalization of lower- and moderate-income homeownership. To reconcile these competing interests, we need to use large pools, public-private partnerships where the government provides financing and owns a significant chunk of the upside, stewarded by entities trustworthy on both economic and mission grounds.

Fortunately, we have two previous successes to use as models: HUD's mark-to-market demonstration (2000) and the RTC's bulk sales programs (1990).

As in the RTC pools and HUD mark-to-market demonstration, the Federal Financial Institutions can (1) aggregate loans and properties into consolidated portfolios (preferably by geography such as metropolitan area), (2) sell the assets into a partnership in which the government entity is the 80% (say) limited partner, and (3) finance the entity's acquisition with purchase money loans (at, say, 75% loan-to-cost), as shown in the schematic below. This financial-operational model (illustrated below) has worked well twice before.

Uses and Sources of Funds, FFI recovery pool



All figures are schematic, to show the relationships among components and the relative sizes of each.

Conclusion: rethink in three dimensions

Old-think got us into this mess and is doing nothing to get us out. To move this inventory we need new-think, broadening our tenure models, reinventing our property management delivery system, and financing the mission-oriented buyers who will in turn incubate the eventual future homeowners.

Beyond the immediate benefits to homes, cities, and homeowners, these innovations will diversify and thereby strengthen American affordable housing, and will go a long way to building out a nationwide mission-owner capacity – a desirable outcome for creating broader efficiencies in the delivery of limited public resources.

As 2012 opens, the Administration and the Federal Financial Institutions need to launch this program as a large-scale pilot. It's long overdue, it's urgently needed, and if done right it will work.