

August 8, 2011

Securitized Credit

Global

## Housing Market Insights

### REBUILD – What to Do About US Housing

**Our REBUILD proposal could help America emerge from its housing predicament.** The US housing market remains mired in crisis, while tight mortgage credit and rising rents are leading us down an unsustainable path. If nothing is done soon, we could find ourselves in a situation where owner-occupied housing becomes unobtainable due to lack of credit, and rental housing becomes unobtainable due to rising costs.

**While the housing market faces several challenges, we believe one critical issue must be resolved:** the backlog of distressed homes must be cleared – as fast as possible and without further detriment to home prices – ideally to be rehabilitated to provide affordable housing options for all Americans.

**We offer a proposal to address this critical issue by promoting investor purchases of distressed homes.** Our proposal centers on five key concepts: Redevelopment, Bulk sales, Incentive programs, Lending facilities, and Diligent oversight – for which we use the convenient acronym REBUILD.

**Our proposal would work within a set of constraints to prevent undesirable activity and protect current homeowners.** In doing so, it would promote high-quality, affordable housing for all Americans without placing the burden on taxpayers.

**Ours is a market-based proposal that builds on investor activity and expands on various pilot programs for agencies, banks and investors.** It would align existing ideas with investor activity that has already begun but remains in its infancy.

**We believe our proposal benefits all stakeholders at the expense of none, while working to stabilize the housing market.** We believe it would also have positive secondary effects by promoting job growth, rebuilding neighborhoods, increasing tax revenues, restoring housing-related payments and reducing moral hazard.

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### REBUILD – What to Do About US Housing

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Despite several programs, both public and private, the US housing market remains mired in crisis and headed down an unsustainable path. Mortgage credit remains tight, making home purchases more difficult, while rental demand is accelerating, causing rents to rise quickly. If nothing is done soon, we will find ourselves in a situation where owner-occupied housing becomes unobtainable due to lack of credit, while rental housing becomes unobtainable due to rising costs. An oversupply of homes with nobody to purchase them, and an undersupply of rentals with too many people to occupy them makes for an imbalance that would have serious negative implications. If this occurs, all Americans will suffer, as owners face continued price declines while renters face continued rent hikes. Unfortunately, we are beginning to see the outlines of this scenario unfolding, and the threat that it develops into a more substantial crisis looms large.

In this report, we present a proposal to try to avert this predicament. Our goal at this time is not to provide a detailed plan for implementation, but instead to present a framework for a solution that we believe benefits all stakeholders at the expense of none, while being fair and sensitive to the hardships faced by all Americans.

#### Where We Are Today

Let us be clear about the size and scope of the challenges we face, because they are both broad and substantial. We currently face a plethora of challenges, inseparable between the housing and mortgage markets.

1. Depressed and still-declining home prices, which reduce current owner wealth, keep future buyers on the sidelines and affect how Americans view home purchases.
2. The 2.2 MM properties vacant and available for sale, plus 7.5 MM liquidations from delinquent borrowers that we project will result in distressed sales, create an excess of housing supply – putting further pressure on prices.
3. Tight mortgage credit is restricting the pool of potential buyers, whether owner or investor, while GSE reform, bank litigation and securitization rules may further reduce overall mortgage credit availability.

4. Loan modifications have provided limited relief for delinquent borrowers who struggle to qualify for programs and re-default at high rates. Principal reduction mods have been limited in their adoption and present a moral hazard for strategic defaults (see [ABS Market Insights: Understanding Strategic Defaults](#), April 29, 2010).
5. A declining homeownership rate is causing rental vacancies to plummet and rents to rise (see [Housing Market Insights: A Rentership Society](#), July 20, 2011). This trend can only continue for a limited time before rents become unaffordable and larger problems arise.
6. Weakness in the US housing market remains a headwind to the macro economy, constraining growth as consumers struggle with mortgage payments, declining home values, and rising rents, while corporations struggle with lower home sales and construction, ultimately affecting job creation, spending and investment.

#### What Needs to Be Fixed?

While the challenges are numerous, we believe that they can be traced back to one critical issue that must be corrected:

The backlog of distressed homes (both empty and with borrowers who cannot be saved through modification) must be cleared – as fast as possible and without further detriment to home prices – ideally to be rehabilitated to provide affordable housing options for all Americans.

In addressing this issue, however, the following constraints should be met:

1. Borrowers who can be saved through modifications should be; however, moral hazard should be avoided to prevent additional strategic defaults.
2. The concept of paying for shelter should be restored.
3. High-quality and affordable housing must be available to all Americans.
4. The solution should not be dependent on taxpayer dollars.

Is there a way to do all of this? We believe there is.

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## REBUILD America

In summary, our proposal is to promote investor ownership of distressed properties for the purpose of providing high-quality yet affordable long-term rental housing. It is a market-based approach which given current economics, conveniently targets the median and lower tier of the housing market, and takes advantage of a trend that is already beginning. It builds in safeguards to control opportunistic home flipping and unscrupulous landlords, and it combines components from various pilot programs and initiatives that are already in place. Importantly, it is not intended to replace or interfere with the loan modification effort, but rather to provide better options for both borrowers who ultimately default, and owners of properties who must ultimately liquidate them. Finally, it requires no out-of-pocket taxpayer dollars. Below, we outline the framework for our proposal, built around 5 concepts: Redevelopment, Bulk Sales, Investment Incentives, Lending Facilities, and Diligent Oversight – for which we use the convenient acronym REBUILD.

### Redevelopment

1. Investors must agree to perform a minimum level of investment and rehabilitation on each purchased property based on safety and inhabitability standards. This level can be decided by an eventual program, and certified through existing home certification procedures.
2. Investors must provide flexible lease terms, such as short-term, long-term or rent-to-own. Restrictions may be required to prevent flipping, but should allow for flexibility to maximize rental housing options while maintaining portfolio management abilities.

### Bulk Sales

1. Agencies would be required to set up bulk sales programs for unoccupied properties – something they are already doing on a small scale. Banks and trusts can voluntarily do the same, not because they are forced to, but because such bulk sales could increase the value they would receive upon liquidating their collateral, thus allowing them to act in their best interests. They would all retain the option to sell through existing channels to maximize recovery values.
2. Lease-back programs can be set up alongside bulk sales programs, which would allow investors to purchase properties currently inhabited by a delinquent borrower, with a pre-negotiated agreement to exchange their deed for a lease. Versions of such programs are already in place at certain financial institutions.

3. To protect them from being priced out of the market, owner-occupied buyers would have exclusive initial access to distressed homes in this program for a limited time, similar to existing programs designed to sell distressed properties.

### Investment Incentives

1. Investors should be able to charge market rents, which today can be significantly lower than the mortgage payments on legacy mortgages for delinquent borrowers.
2. Rental income tax breaks or deferrals should be created for property investors to promote activity. Such tax incentives would not come out-of-pocket, nor affect current tax revenue projections, as they would only apply to rental income otherwise not generated.
3. Tax incentives could also be used to subsidize rents for low income renters, passing on partial rental income tax to renters and thereby increasing affordability.

### Lending Facilities

1. The government would promote access to reasonable leverage, which would be limited by a cap on loan to value (LTV). Access can be provided through various means, including making investor loans QRM-eligible (Qualified Residential Mortgage), CRA-eligible (Community Reinvestment Act), and relaxing regulations for investor loans.
2. A private-public lending program should be established to provide a controlled level of debt financing for investors. This program could jump-start investor lending before private securitization or bank lending emerges, and do so at minimal risk to taxpayers as the collateral would have strict LTV limits and include only already income-generating properties.

### Diligent Oversight

1. Diligent oversight will be necessary to ensure that any eventual program adheres to the principles of providing high quality, affordable housing. Oversight is particularly important, as an eventual program would involve investors and operations that are spread out across the country and subject to local real estate laws that can vary significantly by region.
2. Diligent oversight also applies to ensuring that an eventual program abides by all fair housing laws and other consumer protection programs, particularly for any provisions that might exist for low income households.

## Why We Believe It Would Work

Our proposal directly addresses the critical issue we identified above, while adhering to the constraints we posed as well. First, by allowing investors to purchase properties in bulk, but only if it makes economic sense, the backlog of distressed homes can be cleared faster than under current conditions. We see indications that investors are already beginning to raise institutional capital to pursue this strategy, and distressed prices appear to be stabilizing in parts of the country. This indicates that the investment is attractive, and facilitating these sales could be accomplished without further depressing prices.

Second, the proposal would allow modifications to continue for those borrowers who qualify and can continue to make payments, while providing more robust rental options for those who would ultimately default, including the potential to lease-back their current house. By removing the ownership stake of such defaulting borrowers, moral hazard would also be diminished vis-à-vis principal forgiveness, while the concept of paying for shelter would be restored. The increase in single-family rental supply would ease pressure on rising rents while providing more suitable housing for defaulting suburban families.

Finally, this proposal would further the goals of providing high quality, affordable housing to all Americans, while not being dependent on taxpayer dollars.

## Who Benefits?

We believe the most important part of this proposal is that all stakeholders benefit at the expense of none, and secondary effects can be considerably positive. Each stakeholder benefits in their own way, as we summarize below:

1. For current home owners, it would help stem the declines in home prices, thereby increasing confidence and stabilizing housing-related wealth. For future home owners, it would provide exclusive access to distressed properties, allowing them to take advantage of low pricing. And for current and future renters, it would provide high-quality, affordable, better-suited rental options, while easing pressure on rising rents.
2. For delinquent borrowers, it would allow modifications to continue, while offering lease-back options and, if ultimately needed, high-quality affordable rental housing, while at the same time minimizing moral hazard.
3. For property investors, it would provide improved access to distressed home inventory and increased borrowing

ability to promote more investment for a strategy that is increasingly being adopted already.

4. For financial investors, it would offer a private-public investment opportunity to provide debt financing to property investors on not a highly-levered distressed asset, but rather on income-producing, low-leveraged collateral.
5. For taxpayers, it would potentially improve agency collateral recovery values, limiting future losses, while not requiring out-of-pocket costs to address housing market issues.
6. For banks and non-agency bondholders, it would also potentially improve collateral recovery values, as well as reducing some transaction costs, limiting future losses. It could also potentially provide a future lending business around low-LTV loans on high income-producing properties in either the form of investor mortgages or commercial portfolio lending.

Finally, the secondary effects of an increase in investor purchases of distressed properties for long-term rentals should not be discounted. Among the most important:

1. Jobs would be created, particularly in industries most hurt by the housing collapse, including construction (for property redevelopment) and service contractors (for property leasing, management and maintenance).
2. Taxes, dues and premiums would be paid again. Property taxes that are in arrears from delinquent borrowers would be paid. Homeowners' association (HOA) dues that neighborhoods depend on for maintenance would be paid. Insurance premiums for homeowners would be paid. Finally, state and local income taxes would increase as investors pay taxes on rental income that otherwise would not exist.
3. Neighborhoods and communities would benefit by having empty, deteriorating houses redeveloped and tenant occupied.

## Implications and Hurdles

As with any proposal, ours is not exempt from hurdles to be surmounted. Clearly some will be process-based, including how to implement and effectively administer such a program with multiple stakeholders. However, there is one hurdle that will need to be overcome that is more fundamental, and that is the implication and acceptance that such a program would

lead to a lower level of homeownership and a fundamental change in the way that Americans live.

Luckily, however, it seems the time may be right for such an acceptance to occur. As we pointed out in our previous housing report (see [Housing Market Insights: A Rentership Society](#), July 20, 2011), the market is already moving us in that direction. The homeownership rate is already declining, and excluding delinquent borrowers would already be at a new low since records were initially kept in 1965. At the same time, while the majority of Americans would still like to own a home, that number is lower than it was during the housing bubble, and the view that homeownership is a safe investment has also diminished. Finally, the government seems finally to be moving away from a vision of homeownership for all, and toward an approach of providing affordable housing for all Americans. If both Americans and their leaders are ready to accept this new American Dream, then our proposal may indeed have a high probability of success.

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