Three Reasons Why Converting Vacant Homes to Rentals Will Be a Challenge in Some Places…

…and Three Ways It Can Succeed

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When a lender takes ownership of foreclosed property, it gets a new name — real estate owned — and goes back into the hands of the lender. And for scores of lenders and neighborhoods, that's a problem. More often than not, real-estate-owned properties (or REOs, for short) in weak housing markets sit empty. For the lender, that means steep carrying costs. For communities, that means increased crime and decreased values for houses nearby.

The largest holders of REOs are Fannie Mae, Freddie Mac, and the Federal Housing Administration. Last summer, the government put out a call for possible solutions to the mounting REO problem. One approach that has gathered momentum is developing incentives to help turn REOs into rentals.

In some cases, the properties would be sold to investors who intended to convert them to rentals; in others, new programs would be set up to allow lenders to rent out their stock of REO homes, at least ensuring they are occupied. Decay is less likely, and communities get a fighting chance to stabilize themselves.

Unfortunately, REO-to-rental isn't a one-size-fits-all solution. My research, along with that of my colleagues at the Cleveland Fed, underlines three big reasons why converting REOs to rentals in the industrial Midwest may prove difficult. But our research also points to three other ideas that could go a long way toward achieving the main goal of neighborhood stabilization, while lowering REO carrying costs.

Why REO-to-Rental Will Be a Challenge in Weak Markets

1. There's probably not enough demand in weak markets to effectively or profitably convert significant numbers of REO homes into rentals.

In the Fourth Federal Reserve District, which encompasses all of Ohio and parts of Pennsylvania, Kentucky, and West Virginia, population loss has been a long-term trend. Many of the region's older cities are distressed, and new residential building has outpaced household growth. This has produced a significant oversupply of housing, which depresses home values and leads to an abundance of vacant and abandoned properties.

In this kind of environment, it's hard to see sufficient demand at prices high enough to make renting profitable. Consider the severity of the vacancy problem: Five years after auction, foreclosed homes in high-poverty areas of Cuyahoga County (home to Cleveland) are about 20 percent more likely to be vacant than foreclosures in low-poverty areas of the county. If there were strong rental housing demand, we would expect people to buy these homes and make them available for rent, not let them stand vacant. And since REO portfolios consist mostly of single-to-four-family units, there are few economies of scale that might make the financial numbers work for larger-scale rental buildings.

Finally, recently foreclosed properties, including REOs, are often in poor condition. Coupled with the already weak housing demand, it would cost new owners more to bring the homes up to code than they could reasonably expect to recoup in rent.

2. Compliance is a headache.

Converting bulk REO holdings to rentals all but guarantees an operational nightmare of complying with numerous local laws, depending on where the properties are located across the United States. REO homes will have to be inspected and brought up to code, and licenses will have to be issued.

For both the lender and the buyer, this process makes bulk transfers burdensome. They each will have to comply with different local laws in different cities. They will have to wait, sometimes months, for cash-strapped and under-equipped municipalities to inspect the homes. And they may face further delays or even fines and lawsuits if the inspections reveal substantial property distress. These delays might be lengthy with bulk transfers of REOs being converted together.

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3. Some bulk buyers are slow, and historically, many are not dependable homeowners.

My Bank's research has found that bulk property purchasers tend to occupy homes — with themselves, renters, or even friends and family — more slowly than people who buy individual homes or small batches of them. The strategy bulk buyers follow is either to make only cosmetic improvements to distressed properties with the expectation they will be quickly rented or resold, or to abandon the homes when sale is impossible.

In weak markets, such homes often remain empty eyesores. They might technically be converted to rentals, but they will be no less vacant.

Three Promising Strategies for Weak Markets

1. Use a high-capacity "land bank."

A land bank is a way for governments to acquire and amass vacant and abandoned, tax-foreclosed properties. From there, the land bank managers can make strategic choices about the properties' future — be it demolition, rehabilitation, or repurposing. The main idea with a land bank is that homes are not a permanent fixture in the portfolio — they flow back into productive use in private, nonprofit, or public hands.

Some properties may be in such a sorry state of decline that the land bank needs extra funding to cover demolition costs. Granted, REO holders may be reluctant to foot the bill for demolition. But when demolition costs are fully covered, it's easier to scale demolition projects. This results in faster disposition, which can substantially lower the REO holder's carrying costs.

For reference, those carrying costs are heavy. Property maintenance alone can cost more than $1,000 per property per year, not to mention possibly thousands more for taxes and transaction costs. Rehabilitation adds on even more — potentially a lot more — for homes that need repairs before they can sell to an owner-occupier. Demolition costs can seem minor in comparison.

2. Screen potential purchasers.
Given the high stakes, an extra level of scrutiny is warranted with purchasers of REOs. Screening the potential purchaser's history of code compliance and tenant complaints is a good first step. Some states forbid anyone who has outstanding code violations from purchasing foreclosed homes. Local governments, nonprofits, and real estate brokers are good sources of information about property manager track records. One promising screening practice is placing the property deed in escrow, to be released to the purchaser once agreed-upon maintenance has been completed.

3. Categorize REO homes based on physical condition and neighborhood characteristics.
Assuming there are ready and qualified purchasers for REOs, a final useful step is dividing the homes into categories. This can help lenders and government agencies determine what should be done with the homes before they are released.

The home's condition should play a role in deciding whether to dedicate REO homes to sale or rental. A poorly maintained home is a good candidate for a land bank, as are those in need of moderate repair.

Neighborhood characteristics come into play in determining the vibrancy of the local market. The more demand in the market, of course, the better. Otherwise, bulk sales may encourage harmful speculation that merely prolongs vacancy and causes further blight.

The Bottom Line: Flexibility

The strategies outlined in this article are nothing new to community development practitioners and housing policymakers. But they do reinforce the fundamental importance of allowing for local market customization in neighborhood stabilization efforts. We know housing markets are not identical and there is no one-size-fits-all approach for any of the problems housing markets currently face. But solutions in weak markets should be focused on reducing supply rather than creating it. ■

Recommended reading

For more on the impact of foreclosures on vacancy rates, see Cleveland Fed Economist Stephan Whitaker's "Foreclosure-Related Vacancy Rates, *Economic Commentary*.
www.clevelandfed.org/research/commentary/2011/2011-12.cfm

Also see this proposal to harness the Community Reinvestment Act in the fight against speculative housing transactions: "Slowing Speculation: A Proposal to Lessen Undesirable Housing Transactions" *Forefront*, Winter 2011.
www.clevelandfed.org/forefront/2011/winter/ff_2011_winter_11.cfm