Foreclosure Recovery: The Work That Remains

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The house on 40th Street in Richmond, California, was just one of millions of homes that were lost during the foreclosure crisis. The husband got sick and the couple fell behind on their payments. He died and the bank foreclosed. Right around the same time, the Gomez family (not their real name) moved from Texas to San Francisco, where they, along with their two sons, moved into a one-room basement apartment with no kitchen and only a shared bathroom. Both husband and wife were employed as janitors and they set about shopping for a house to buy.

They looked and made offers, over and over again, but they never succeeded in getting to the contract stage. By their estimation, they made more than 40 unsuccessful offers during 2011 and 2012. Time and again they were told that they had lost to an all-cash offer from an investor. They were about to give up when their agent came across a listing for the house on 40th Street. It had been purchased and remodeled as part of the Foreclosure Recovery and Asset Building Project, an effort created and funded by the East Bay Community Foundation and managed by the Self-Help Community Development Corporation, for which I serve as Project Manager. The program provides homeownership opportunities to low- and moderate-income families by buying, fixing and re-selling foreclosed homes.[1]

Their offer was one of 25 submitted. It was not the highest, but project managers selected it because their predicament symbolized one of the great dislocations of the housing collapse and recovery: families with steady employment and good credit were continuing to live in substandard housing because of competition from well-funded investors.

Diagnosing the Bubble

The housing bubble, its collapse, and the subsequent economic decline have been diagnosed and analyzed from a variety of angles. We have also spent a great deal of time worrying about a recurrence of those events: Are we seeing another bubble in home prices? Will prices fall again when the dreaded shadow inventory hits the market? But we should also examine how the response to the foreclosure crisis has changed the residential real estate landscape and how that response has sown the seeds for the next set of housing policy challenges.

One can, to a certain extent, view the housing bubble and ensuing debacle as the result of an epidemic of misunderstanding throughout the U.S. housing market. Subprime lenders misled borrowers about the risks embedded in the mortgages they were taking on, and at the

1 Debt financing for the project is provided by One PacificCoast Bank and homebuyer education and counseling is provided by the Community Housing and Development Corporation of North Richmond and the East Bay Asian Local Development Corporation.

other end of the financial spectrum, financial analysts and investment managers seriously underestimated the risks in their investments in the securities backed by those misunderstood mortgages. An entire edifice of credit was built on this web of misunderstanding, and eventually it collapsed.

But what about now? What are we potentially not seeing properly right now as the housing market and the entire economy continue to recover? In particular, what has been the impact on low- and moderate-income communities, and what are the policy implications of that impact?

Is It Still the American Dream?

One major misunderstanding may be the belief that the foreclosure crisis will produce a lasting change in Americans' desire to own a home. I recall a conversation with a Wall Street banker whose breezy interpretation of the bubble and its aftermath was that a lot of people who shouldn't have bought homes had done so, and the ensuing deluge of foreclosures meant that two things were going to happen: the first was that a lot of those people would never be owning homes again, and the second was that their foreclosed homes would become a new asset class of detached rental housing. In this particular instance, his analysis was more than slightly self-serving since he was trying to arrange financing for one of the larger regional buy-and-hold funds that was acquiring and then renting out a substantial number of single-family homes. But he was hardly alone in seeing the market in this light.

As a matter of public policy, there has been a debate in some quarters over what constitutes the "right" level of homeownership, despite the numerous studies that have demonstrated its benefits. But while economists debate the after-tax costs of shelter, they fail to recognize the noneconomic factors that drive the urge to own one's home. Renting may make more financial sense than ownership for many households, but that does not provide very good guidance as to how those households will behave, precisely because deciding to buy a home is not an entirely financial decision.

For people for whom certain levels of educational and professional achievement are not attainable, owning a home offers a significant and tangible sense of accomplishment. For the immigrant, it signals arrival. For those who have faced discrimination, it represents release from the sometimes arbitrary authority of a landlord. Finally, in the eyes of many working-class families, owning a home offers a degree of control and safety that their rental housing choices cannot provide.

Here in California, home prices in communities with "good schools" have increased well above those with inferior school systems as public funding of education is spread thinner across the state. Housing prices in those fortunate communities capture the premium homebuyers are willing to pay in order to get an increasingly scarce commodity: good public schooling. Less well appreciated is that a similar premium exists for single-family homeownership in low- and moderate-income communities. As people feel less safe in public space—the streets where they and their children walk, their parks, and even their schoolyards—they will increasingly seek out the safety of a home where a sturdy fence protects a yard where their children can play, and a private driveway and garage provide a safe place to park their cars. In both instances—the suburban house in a good school district and the tidy bungalow in an urban neighborhood—the price of the house represents demand not just for shelter, but for other benefits as well.

As a result, if we continue to underfund the public realm, lower-income households—the people who experience a disproportionate share of the violence and crime that develop in the wake of that depletion—will strive even harder to find shelter where they will feel safe. This, in turn, will add even more demand for what passes as affordable housing in already expensive markets. This also explains the counter-intuitive outcome of rising property values in areas where other indicators of quality of life are declining.

Carpe Domus

One of the great clichés of the real estate market is the old chestnut, "Cash is king." But if so, never has royalty been so eager to insert itself into our less well-heeled neighborhoods. An equally apt description of what has happened can also be found in the adage that "nature abhors a vacuum." In late 2008 and early 2009, there were lots of homes available but not that many buyers. There was an eerie post-neutron bomb feeling to the neighborhoods where subprime lending had been most prevalent. House after house stood vacant, sometimes stripped of all appliances and plumbing. The houses were there, just barely, but the people had disappeared. There were houses, but no buyers.

Into this void stepped pools of private capital that scooped up houses at prices not seen for more than a decade. Some investors were flippers—i.e. they fixed and resold the homes—while most were building portfolios of rental properties as a longer-term investment. Viewed from one perspective, these investor groups were performing the classic function of speculative capital in a depressed market: absorbing excess supply, thereby stabilizing the market.

But over time a different dynamic began to emerge. As the economy recovered, households returned to the market, hoping to take advantage of cyclically low prices and historically low interest rates. But at the same time, the success of the initial investor groups had spawned further growth of that business. In a low interest rate environment, the prospect of 6-8 percent annual returns plus future capital gains from sales of the homes was a very attractive proposition. Furthermore, these investment groups had made major strides in creating operating platforms that could analyze, acquire, lease, and manage a large number of homes spread across a wide area.

Thus the stage was set for the story that has been repeated thousands of times in the past year. A family finds a house and tries to buy it, only to have the seller accept an all-cash offer from an investor group. The Foreclosure Recovery Project was designed to break this pattern. The Project is an all-cash buyer with a difference: after the houses are remodeled, we market them exclusively to potential owner-occupants. All offers must include a letter from the buyers explaining their situation and background. The Gomez family's situation is repeated in most letters, and it is not uncommon to hear from families who have submitted 20 or more unsuccessful offers.

Furthermore, the evidence suggests that the impact of investor acquisitions has been disproportionately greater in low- and moderate-income neighborhoods. This is not merely a result of limited financial resources and restricted access to credit. As a general rule, rental yields–net income divided by the cost of the house–are higher in lower-priced neighborhoods, making investments there potentially more profitable. The sweet spot for investors was at the lower end of the market, especially given the substantial decline in valuations in those neighborhoods in the aftermath of the collapse of the subprime lending market.

Most press accounts about investor involvement in the market have focused on either the aggregate numbers–investors are playing a large role–or this "crowding out" phenomenon. Less attention has been paid to the longer-term impacts of this significant redistribution of homeownership. The most critical is the substantial appropriation of income and potential wealth that will take place over the coming years. Ever since the bubble burst, it has cost far less per month to own than to rent a house in the working-class neighborhoods of the Bay Area. Quite simply this is what made buying and renting out those homes such an attractive investment. But this also means that there are thousands of households that could have afforded to buy a home but instead are paying more each month as rent, and that excess cost of shelter flows right out of their neighborhoods. An even more significant impact is the lost opportunity for lower-income families to realize substantial increases in household net worth as the houses they couldn't buy appreciate in value over the coming years. The scale of this transfer of wealth will ultimately be measured in the billions of dollars.

Slumlord or Merely Absentee?

Every investor-owned home represents an ownership opportunity that has been delayed indefinitely. This has implications in addition to the income and wealth effects discussed above. The first is that community stability may be compromised in these neighborhoods. This is not merely the result of the displacement of long-term residents through foreclosure. Rental properties turn over at a faster rate than owner occupied homes. Neighbors have less time to get to know one another, and in certain respects, less incentive to do so. This can erode neighborhood cohesion, particularly if mobility is high in and out of poorly maintained or otherwise inadequate rental units.

The second impact is more qualitative. Some community leaders have expressed concerns that these investor groups will become the new breed of slumlord. But there is no evidence that these new investment groups will be any worse at property management than smaller "mom and pop" operations. In fact, one could argue that these larger, better-capitalized groups have the resources and management capacity to provide a superior level of property management. But there is still an unavoidable aspect to their dominance in certain markets:

they may never be slumlords, but they will also never be occupants. As a result, neighborhoods where most houses were once occupied by owners are now communities of predominantly renters.

There is no denying that very few absentee owners will do the extra embellishment or landscaping that an owner would. Pride of ownership is evident at every address in a wealthy neighborhood, but it plays a potentially even greater role in lower-income neighborhoods. The well-maintained yards and homes of owner occupants are statements that life, even in dangerous surroundings, does not have to be ugly or degraded. Quantifying the impact of this is difficult, but sadly, the possibility exists that crime could follow in the wake of this erosion of community identification and appearance.

The third and most significant impact is simply this: a substantial portion of the single family housing stock in our low-to-moderate income neighborhoods is "off the market" for purchase by households. When these homes become available for purchase and at what price is anybody's guess. Many of these investment funds have fixed maturity dates, at which point they are obligated to sell their portfolios and return capital and accrued profits to their investors. The largest funds are exploring the possibility of becoming REITs (Real Estate Investment Trust) in which case their inventory of homes would not necessarily need to be sold. (In the REIT scenario, the funds convert their investors' ownership interests into stock; the newly formed REIT continues to own the houses, but any investors who need or wish to cash out would sell their stock in the public markets.) Regardless of which course of action these funds pursue, the facts on the ground as of fall 2013 remain the same: We have constrained supply in our lower-priced neighborhoods in the face of sustained strong demand from households who are interested in and capable of becoming owners.

Conclusion and Policy Responses

A crisis, even one as long-standing as this, is a fluid situation. Although foreclosure and delinquency rates are still high by historical standards, they are trending lower. Prices have increased dramatically from the trough. In the meantime, a new set of players, the investment funds, has a significant role in lower priced single-family markets. Now seems like the appropriate time for thinking about the next phase of this housing cycle. While the work on loan modifications and other resolutions of individual hardships must continue, the new and important challenge in this next phase will be to recapture investor-owned housing units in low- and moderate-income neighborhoods. A sample of ideas provides a starting point for developing possible programs, including:

- Down payment assistance and housing and credit counseling to help tenants rebuild their credit scores and purchase the houses they are currently renting. This would help neighborhood stability by allowing tenants to stay in place.
- Tax incentives for investors to transfer their houses to nonprofit ownership and management. Tax credits plus Community Reinvestment Act financing could provide

a low cost capital structure for these nonprofit entities, or tax incentives could be used to encourage sales by investors directly to low-income families.

- Expanded down payment assistance or shared equity programs to bridge the affordability gap for low-and-moderate income buyers. Such a program could provide an inflation hedge for socially minded capital by allowing invested dollars to earn a return based on home price appreciation.
- A nonprofit, single-family REIT that could acquire and control investor portfolios of homes. Property management for such a venture could be outsourced to one of the private platforms that have been developed in the wake of the housing collapse.

The foreclosure crisis was a devastating experience for the millions of families who lost their homes. But at the same time it offers an opportunity for other households to buy homes at cyclically low prices and historically low interest rates. Sadly, many of these potential buyers have been unable to take advantage of these circumstances. The Foreclosure Recovery Project is a modest attempt to help low- and moderate-income households become homeowners. But there is much work remaining. The nation's recovery from the foreclosure crisis will be a challenge for years to come as we work to restore homeownership in our communities.

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