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Federal Reserve Board's White Paper on the U.S. Housing Market: Private Equity Take Note

The Board of Governors of the Federal Reserve System ("FRB") on January 4, 2012 released a white paper entitled "The U.S. Housing Market: Current Conditions and Policy Considerations."[1] The white paper addresses three forces affecting the housing market: (i) the large inventory of vacant or unsold homes; (ii) the decrease in supply of mortgage credit; and (iii) current difficulties in the foreclosure process. In the white paper, the FRB suggests that lawmakers should consider policies that would help moderate the inflow of properties into the large inventory of unsold homes, make it easier for creditworthy borrowers to access mortgage credit and limit the number of homeowners pushed into an inefficient foreclosure pipeline. This *DechertOnPoint* summarizes the white paper's discussion of issues and tradeoffs that the FRB believes lawmakers should consider in addressing these forces affecting the housing market. It remains to be seen whether other policymakers or regulators will take up the FRB's approach outlined in the white paper. To the extent market forces are making single-family rentals more attractive for investors, private parties, including private equity funds, may move into this area.

Excess Supply of Vacant Homes and Decrease in Access to Mortgage Credit

According to the FRB, two of the main forces plaguing the housing market are (i) the excess supply of vacant homes on the market, many of which stem from foreclosures, and (ii) a marked (and potentially long-term) decrease in the supply of mortgage credit. According to the FRB, the large inventory of foreclosed properties is contributing to the excess supply in the for-sale market, putting downward pressure on house prices. The FRB also notes that in some areas of the country the rental markets are getting stronger. Reducing barriers to converting foreclosed properties to rental units, suggests the FRB, will help redeploy the existing stock of houses in a more efficient way. The FRB further suggests that obstacles to mortgage credit contribute to weakness in housing demand and reducing these obstacles should aid the housing recovery.

The FRB observes that foreclosures are inefficient and result in costs that benefit no one, including the deterioration of properties that sit vacant for months or years and the negative impact these properties have on the surrounding neighborhoods. Some foreclosures, according to the white paper, could be avoided if loan modifications were pursued more aggressively by lenders and if servicers were provided greater incentives to pursue loan modifications. In those cases where loan modifications are not the solution, the FRB suggests, more expedient exits from homeownership (*e.g.*, short sales or deeds-in-lieu of foreclosure) can reduce costs and mitigate the negative impact on communities.

According to the white paper, house prices remain about 33% below their early 2006 peak, a decline unprecedented since the Great Depression and in the aggregate, more than $7 trillion in home equity has been wiped out. Currently, according to the white paper, about 12 million homeowners are underwater on their

1 Board of Governors of the Federal Reserve System, "The U.S. Housing Market: Current Conditions and Policy Considerations," *available at* http://federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf.

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mortgages (more than one out of five homes with a mortgage) and negative equity limits a borrower's ability to remedy financial difficulties. The FRB states that mortgage servicers were not prepared for the surge in delinquencies and some incentives in servicing agreements encouraged foreclosures rather than loan modifications. As a result, mortgage credit has tightened dramatically even for prime borrowers. The FRB also notes that many homeowners have been unable to take advantage of historically low mortgage rates because of negative home equity, blemished credit or tighter credit standards.

Additionally, the FRB notes that the number of homes held by banks (*i.e.*, REO properties) is at historic highs at the same time that housing demand has weakened. In contrast, the rental market across the nation has strengthened a bit recently. According to the white paper, large scale conversions of REO properties to rental properties have not occurred to date for several reasons (*e.g.*, difficulties in investors achieving efficiencies of scale due to a lack of geographical proximity of properties, pricing issues, etc.). This suggests, according to the white paper, that a government-facilitated REO-to-rental program might help the housing market and reduce losses on REO portfolios. The FRB suggests that REO holders have avoided selling properties in bulk to third-party investors because of the limited return and higher expenses such sales generate relative to sales to owner occupants and an REO-to-rental program that relies on sales to third-party investors could be more viable if the cost-pricing differential issue could be remedied. Such a program, according to the FRB, could take several forms. For example, a REO holder could rent the properties directly or sell the properties to a third-party investor who rents them or forms a joint venture with a third-party investor which rents them. Alternatively, deed-for-lease programs could be created by combining a deed-in-lieu of foreclosure (whereby the borrower returns the property back to the lender) with a rent-back arrangement (whereby the borrower remains in the home and pays market rent to the lender). The FRB also suggests that providing investors debt financing could serve as an incentive to increase the prices they offer for portfolios of REO properties.

The FRB suggests that in establishing an REO-to-rental program, policymakers should consider the effects that poorly managed or maintained properties have on communities[2] and ensure that communities are not damaged by rental practices. This approach, according to the white paper, might entail requiring investors to demonstrate some experience with property management and rehabilitation.

Mortgage Servicing and Foreclosure Process Inefficiencies

The FRB also notes that another barrier to a more vigorous economic recovery is the costs that an inefficient foreclosure process imposes on homeowners, lenders and communities. The white paper discusses ways to improve mortgage servicing by improving accountability and aligning incentives of servicers. According to the FRB, experience has shown that the mortgage servicing industry was not prepared for the large number of delinquent loans. The white paper outlines four areas of possible improvement in residential mortgage servicing: (i) data are not readily available for investors, regulators and others to assess a servicer's performance; (ii) transferring loans to another servicer is difficult; (iii) the traditional servicing compensation structure can result in servicers having an incentive to favor foreclosure over loan modifications; and (iv) existing systems for registering liens are not centralized or efficient. Regarding the data issue, the FRB suggests measuring borrowers' abilities to contact representatives through call centers and investors' abilities to get data on loss-mitigation activities. The FRB notes that transferring servicing responsibilities from one servicer to another is expensive and time consuming. Furthermore, it is important, the FRB suggests, to note that an REO-to-rental program may still result in large costs for REO holders due to the staffing and property management demands associated with rental programs. The FRB proposes two possible improvements to the servicer compensation model to help address these issues: (i) aligning servicing fees more closely with expenses (*e.g.*, smaller servicing fees for performing loans but higher compensation for servicing delinquent loans); and (ii) limiting servicers' obligations to advance mortgage principal and interest to 60 days beyond the first missed payment (so servicers do not have as strong an incentive to move quickly to foreclosure).

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2 *See our DechertOnPoints* entitled "City Councils Impose Greater Liability on Mortgagees and Securitization Trustees," *available at* http://www.dechert.com/files/Publication/f3815778-60e4-4476-a7a0-070aafb5093e/Presentation/PublicationAttachment/9d484170-5c5b-4a7f-a952-120e8b750671/FRE_10-11_48_City_Councils_Impose_Greater_Liability.pdf and "Update Regarding the Chicago City Council Vacant Property Registration and Maintenance Ordinance," *available at* http://www.dechert.com/ files/Publication/0e5938b8-ed65-4654-a414-a848944835eb/Presentation/PublicationAttachment/8883df83-41c5-43cd-8893-4d7ca70aad30/FRE_12-11_50_Update_Regarding_the_Chicago_City.pdf (which discuss recent issues surrounding recent legislative actions concerning property maintenance).

The FRB concludes that the tightening in access to mortgage credit reflects a correction of underwriting practices of the past decade and a shift in the lenders' willingness to bear risk. The FRB states that policymakers need to find a way to reconcile the existing excess supply of vacant homes on the market and the current tight mortgage lending conditions. The FRB suggests that lawmakers need to devise policies that help facilitate the conversion of foreclosed properties to rental properties or support a residential mortgage finance regime that is less restrictive than today's regime. A successful REO-to-rental program could accelerate the timing of establishing a bottom for prices in the U.S. housing market.

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