5 Rental Housing

Rental markets came under increasing stress last year as the recession took hold. Inflation-adjusted rents inched lower nationally and an unprecedented wave of foreclosures of small, investor-owned properties threatened many renters current on their payments with eviction. Meanwhile, Fannie Mae and Freddie Mac stepped in after many private issuers of multifamily mortgage-backed securities exited the market. Even so, falling property valuations made it more difficult for owners to tap their equity.

Markets in Transition

Despite the fourth consecutive annual increase in renter households, the national rental vacancy rate notched up to 10.0 percent in 2008—just shy of the 10.2 percent record set in 2004. Multifamily buildings with 10 or more apartments posted the largest increase, rising almost a full percentage point to 11.1 percent **(Figure 22).** Despite turmoil in the single-family home markets, vacancy rates for single-family rentals edged up only 0.2 of a percentage point to 9.8 percent.

With rental demand on the rise, the upward drift in vacancy rates in larger buildings suggests excess supply. Given that new construction has held near 200,000 units per year since 2005, conversion of condominium units to rentals is the likely culprit. Indeed, several new developments slated for sale as condos were converted to rental properties even before completion, including more than 18,500 units in 27 metros evaluated by M|PF Yieldstar. In some locations, the additions were significant, reaching 4,000 units in Washington, DC, 1,700 units in Las Vegas, and 1,600 units in Atlanta.

While nominal rents rose 3.7 percent last year, real rents fell by 0.2 percent. As measured by M|PF Yieldstar, rents on investor-grade apartments took a bigger hit, down 2.5 percent in real terms between the fourth quarters of 2007 and 2008. Declines spread to fully 50 of the 57 metropolitan areas that M|PF Yieldstar covers, up from just 17 in 2007. Even in formerly strong markets in California, real rents were off 2–7 percent. The few metros with still-healthy rental markets were primarily in Texas and other Gulf Coast and oil patch states that had benefited from higher energy prices for most of the year.

Rent declines and higher vacancies slowed the growth in 2008 net operating incomes, which looked to turn negative in 2009. The real price of multifamily properties dropped in 2008 for the first time in years as investors demanded a higher return for taking on greater risk **(Figure 23).** Falling valuations reduced the real

volume of multifamily transactions from $103 billion in 2007 to $37 billion in 2008 with fewer buyers and sellers able to settle on prices. Lower valuations also made it more difficult for rental property owners to tap their equity or to refinance loans to make necessary repairs and improvements.

Going forward, rising unemployment will almost certainly take a further toll on demand. Rental markets are usually more sensitive to economic downturns than owner markets because most new households rent rather than buy their homes. These younger households are especially vulnerable to job losses during recessions. Indeed, the National Multi Housing Council reported that job-related vacancies were on the rise in 2008 as more renters were forced to double up or relocate in search of better opportunities.

Configuration of the Rental Stock

While the phrase "rental housing" may conjure up images of apartments in huge structures, less than 10 percent of rentals are in buildings with at least 50 units. Instead, more than a third of rental units are single-family homes, and more than half are in buildings with fewer than five apartments **(Table W-7).** Size is important because small (1–4 units), midsize (5–49 units), and large (50 or more units) rental buildings differ systematically in location, year of construction, and types of households they attract. For example, single-family rentals are much more likely to be occupied by white, middle-aged, married couples with higher incomes than are units in large multifamily structures. They are also more apt to be located in the suburbs.

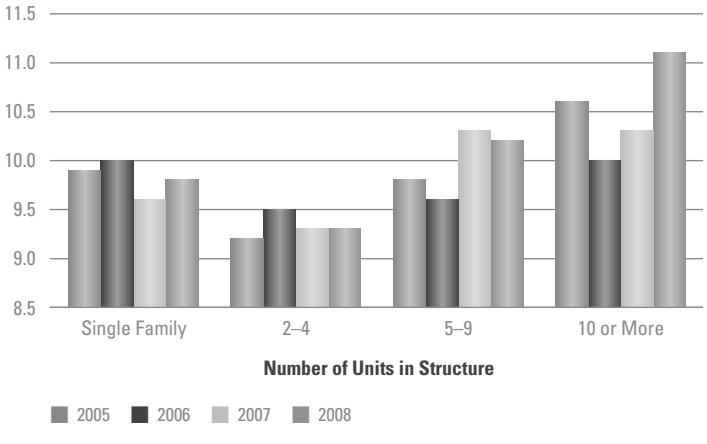
In addition to building size, property size also matters because financing options depend on the number of units in the property, not the structure. Individually owned condos even in large multifamily buildings are considered single-family properties, as are rental properties with two to four units. In contrast, properties comprising several single-family or small multifamily buildings are treated as large multifamily properties for financing purposes.

Ownership and management practices also vary for different-sized rental properties. For example, most small properties are held by families and individuals owning only one or a few properties, and are unlikely to have professional managers. Larger properties are more often owned by institutional investors and partnerships, and are usually operated by professional managers **(Table W-8).**

Figure 22

Larger Rental Buildings Have Seen the Sharpest Rise in Vacancy Rates

Rental Vacancy Rate (Percent)



Source: US Census Bureau, Housing Vacancy Survey.

Small Rental Property Problems

The stock of small rental properties is made up of single-family detached homes, townhouses, condos in multi-unit buildings, and two- to four-unit properties with or without resident landlords. In 2001, there were 13.2 million single-family rentals (including 1.6 million condos) and 6.3 million two- to four-unit rental properties (including 1.3 million with resident landlords).

Individuals and couples owned 85 percent of these small properties. Many of these owners have relatively low incomes and operate on thin margins **(Figure 24).** In 2001, about one-quarter of single-family rental owners, two-fifths of resident owners of two- to four-unit properties, and one-fifth of nonresident owners of such properties had gross incomes under $30,000. A 1995 survey revealed that more than half of all resident owners, and nearly half of nonresident owners of properties with one to nine units, reported barely breaking even or losing money. As a result, many of these owners lack the resources to maintain, let alone improve, their properties.

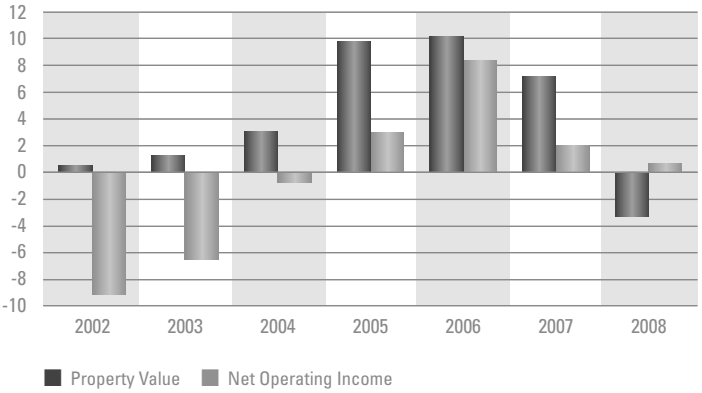
The financing of one- to four-unit rental properties is similar to that of owner-occupied single-family units, with most loans made through the same channels and on similar terms. Before the housing boom, small rental properties purchased as investments usually faced somewhat higher interest rates, higher downpayment requirements, and more stringent underwriting. Lenders also included rental income from the property when qualifying some buyers.

When the housing boom took off, however, lenders relaxed many of these standards. Downpayment requirements were sharply

Figure 23

After Growing Much Faster than Operating Income, Rental Property Values Fell in 2008

Change (Percent)

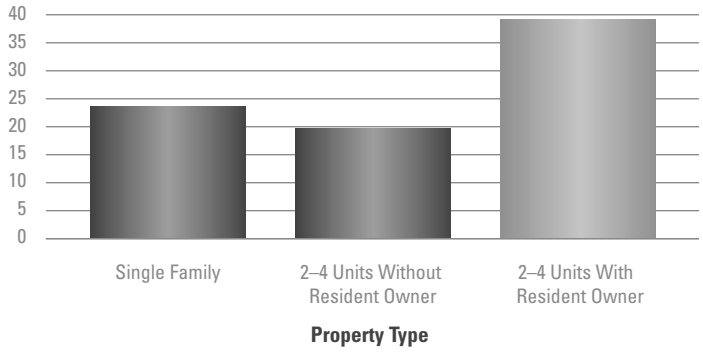


Note: Changes are based on index values adjusted for inflation by the CPI-U for All Items.
Source: National Council of Real Estate Investment Fiduciaries.

Figure 24

Resident Owners Are Nearly Twice as Likely to Have Low Incomes as Other Owners of Small Rental Properties

Share of Owners with Incomes Under $30,000 (Percent)



Notes: Includes individual and married-couple owners only. Owner incomes are pre-tax revenues from all sources.
Source: JCHS tabulations of the 2001 Residential Finance Survey.

reduced, even to zero in some cases. Lenders also offered investors many of the same types of risky loans as they did to owner-occupants, including subprime and Alt-A mortgages as well as loans with affordability features. Even with the interest-rate markup for investors, financing for these properties became relatively cheap and easy to get. LoanPerformance reports that the number of originations classified as investor loans more than doubled from 2000 to 2005, and the share of such originations rose four percentage points. Meanwhile, the Survey of Consumer Finances indicates that the number of households reporting at least some rental income from one- to four-unit properties jumped from 2.0 million in 2001 to 2.9 million in 2007.

Many inexperienced investors made bets they could not cover when declining prices put them underwater on their mortgages. Indeed, tenant evictions from small rental properties in the foreclosure process are now a major concern, and all the more so because some landlords reportedly continued to collect rent even as they fell behind on their mortgages and left tenants unaware of the pending foreclosure. According to the most recent study by the Mortgage Bankers Association, absentee owners accounted for almost one in five loans entering foreclosure in the third quarter of 2007.

While federal housing policy has largely ignored small rental properties, this may soon change as the nation grapples with record foreclosures in this key market segment. Recently passed legislation has provided some protections for tenants. But efforts to resell foreclosed small properties have so far paid scant attention to whether the new owners rent them out, live in them, or keep them vacant in the hopes of later profit. State and local governments receiving federal neighborhood stabilization funds may, however, find value in conveying some properties to mission-motivated entities that will own and operate the properties as affordable rental housing.

Midsize Multifamily Rental Challenges

Midsize multifamily properties have 5–49 units and make up about a fifth of the rental stock. This segment falls in between small and large properties on a range of indicators, including the shares that are individually owned, have mortgages, and are professionally managed. When last measured in 2001, median capital improvement costs per unit were higher for midsize properties than for large properties, although per-unit administrative, maintenance, and utility costs were lower. At the same time, rent receipts per unit were just three-quarters of those for large properties, but still higher than those for small multifamily properties. Finally, only one in four midsize properties benefited from government or nonprofit support, compared with four in ten large properties.

While mortgage finance for both small and large rental properties is closely integrated into capital markets, financing for midsize multifamily properties is less so. As a result, loans on these properties are not as standardized and lenders are less able to diversify their holdings or replenish their capital by selling off loans. Loan terms on midsize properties are therefore apt to be less favorable than those on other rental properties. For example,

owners of midsize rental properties were much less likely to have level-payment and longer-term mortgages than owners of large and small properties in 2001 **(Figure 25).**

In addition, Fannie Mae and Freddie Mac hold the mortgages on a smaller share of midsize rental properties than of larger properties with mortgages. While the two entities made inroads into this market during the boom—Fannie through direct purchases and Freddie through its support of small balance loans packaged into private commercial mortgage-backed securities (CMBS)—they pulled back when loan performance deteriorated in 2008 and their private partners slowed their activity. Without a recovery by banks (which are the primary providers of credit for these properties) or further expansion by Fannie Mae and Freddie Mac, credit for midsize properties will remain in short supply.

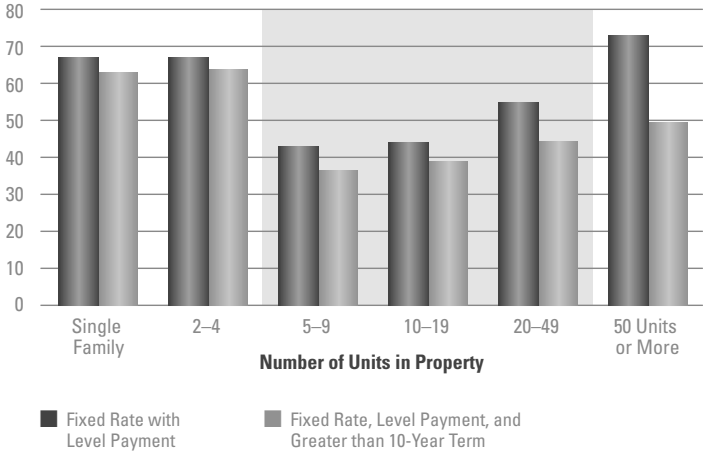
Large Multifamily Rental Fortunes

Because so many large properties are made up of several smaller buildings, fully 30 percent of all rentals are in properties with 50 or more units. Of these, roughly two-thirds are properties with at least two buildings. While mostly unsubsidized, large properties have a disproportionate share of subsidized units. In fact, the majority of all subsidized rental units were in properties with at least 50 units in 2001 **(Figure 26).**

Figure 25

Midsize Property Owners Have Less Access to Favorable Loan Terms

Share of Mortgaged Properties (Percent)



Note: Level payment mortgages require the same payment each month (or other period) for full amortization.
Source: JCHS tabulations of the 2001 Residential Finance Survey.

The corporations and private partnerships that own the vast majority of large rental properties are more likely to have the resources and economies of scale to provide professional management and to tap a broader set of financing sources. The size of the properties permits careful underwriting, making their loans more attractive to institutional investors and to the secondary mortgage market.

Multifamily Finance in Transition

After other investors reduced their purchases of multifamily debt during the downturn, Fannie Mae and Freddie Mac stepped in to play a bigger role in multifamily finance, especially of larger properties. The amount of multifamily debt owned by Fannie and Freddie jumped 23 percent in real terms from 2007 to 2008, while that owned by banks and savings institutions increased only 3 percent. Insurance companies, in contrast, pared back their holdings. Meanwhile, the share of multifamily debt backed by FHA edged down from 6.7 percent in December 2007 to 6.3 percent in December 2008.

Multifamily mortgage performance—even of loans securitized without Fannie Mae or Freddie Mac backing—has so far held up better than single-family mortgage performance. Default rates on multifamily loans in CMBS pools did, however, climb sharply in the last quarter of 2008 and the first quarter of 2009. By the end of March 2009, Deutsche Bank estimates that the share of loans in CMBS pools 90+ days delinquent or in foreclosure was about 1.8 percent. This was still well below the 3.7 percent rate that single-family (one- to four-unit) prime loans or the 23.1 percent rate that single-family subprime loans hit at the end of 2008. Meanwhile, the 60+ day delinquency rates on Fannie Mae and Freddie Mac multifamily loans stayed below 0.5 percent, suggesting that underwriting of these loans remained strict even during the housing boom **(Figure 27).**

All told, multifamily loan defaults have not approached the peaks reached in the late 1980s and early 1990s, and are about in line with the peak following the 2001 recession. But with the economy still contracting, multifamily loan performance is likely to deteriorate further. Indeed, early signs suggest a sharp uptick in defaults in the first quarter of 2009.

Attractive terms on multifamily loans have therefore become harder to get. In January 2009, 88 percent of the owners of large rental properties responding to a National Multi Housing Council survey said the market for mortgages was worse or unchanged from three months prior. In addition, respondents were unanimous in reporting that the credit environment was having some impact on current or planned business activities.

Figure 26

Larger Properties Anchor the Subsidized Housing Stock

Distribution of Units by Property Size (Percent)

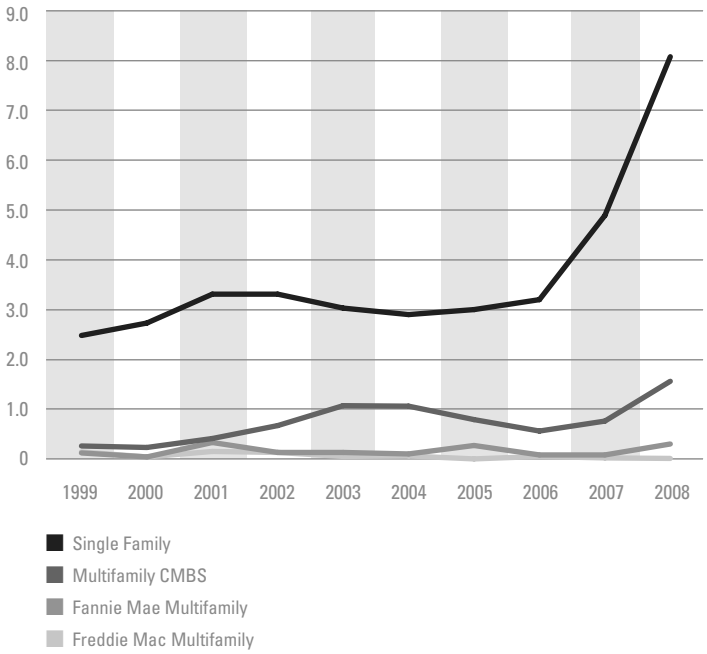
Notes: Numbers may not add to 100 because of rounding. Subsidies include all federal, state, and local government benefits—including low-income housing tax credits—as well as subsidies from nonprofit organizations as defined in the 2001 Residential Finance Survey.

Source: JCHS tabulations of the 2001 Residential Finance Survey.

Figure 27

While Still Well Below Single-Family Rates, Multifamily Delinquencies Have Turned Sharply Higher

Delinquency Rates (Percent)



Notes: Rates are for loans 60+ days delinquent or in foreclosure. Multifamily CMBS rates and single-family rates are based on numbers of loans, while Fannie Mae and Freddie Mac multifamily rates are based on values of loans. Single-family rates are for properties with 1–4 units.

Sources: Mortgage Bankers Association; Deutsche Bank.

The Outlook

With the recession taking its toll, vacancies increasing, and credit tight, the financial performance of rental properties is likely to slide further in the short term. While single-family rental vacancy rates have so far been stable, this may change as foreclosed properties come back on the market. Higher vacancy rates could in turn make it difficult for more property owners to pay their mortgages. With credit remaining scarce, owners will also find it challenging either to sell or to raise capital to make improvements.

The full impact of excess inventories, job losses, and federal interventions may not be known for another year. In the meantime, the public and private sectors have a unique opportunity not only to ease the current crisis but also to deal with some of the longer-standing issues related to rental housing. These include ongoing losses of affordable units to upgrading or removal, and the stubbornly high number of severely cost-burdened renters. This is also a good time to rethink federal affordable housing policy, which has until recently strongly favored homeownership programs. With new recognition of the risks that homeownership brings, policymakers now have a chance to develop better ways to place renters who want to buy homes on a secure path to that goal.