

## Right to Rent: Responding to the Housing Crisis

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It has been more than three years since the housing bubble began to deflate. During this time, nationwide house prices have fallen by close to 30 percent, after adjusting for inflation. This decline in house prices has pushed close to 20 million homeowners underwater, as they now owe more than the value of their homes. This loss in equity coupled with near double-digit unemployment, has pushed the foreclosure rate above 2 million units year.

Both President Bush and President Obama have sought to slow this rate of foreclosure with mortgage modifications plans that would make it easier for homeowners to make their payments. These plans have had relatively little impact thus far, with fewer than 15 percent of homeowners facing foreclosure even entering the modification process. Many of these homeowners will be unable to arrange a modification and a high percentage of those who do will still end defaulting a second time.

In addition to being slow, modifications can end up being costly to the government. The Home Affordability Modification Plan put forward by the Obama administration can lead to payments to loan servicers of several thousand dollars for each modification and tens of thousands to lenders. Since many homeowners will end re-defaulting after a modification, this program can imply a substantial commitment of taxpayer dollars for each home kept out of foreclosure.

### The Right to Rent Alternative

There is a simple alternative that could instantly provide housing security to the vast majority of families facing foreclosure. Congress could vote to temporarily change the rules on foreclosure to allow homeowners to remain in their homes as renters for a substantial period of time (e.g. 5-10 years) following a foreclosure. During this time, homeowners would pay the market rent for their house. This change would instantly provide housing security to the millions of families who now fear losing their home, without any new bureaucracy and with no taxpayer dollars.

The basic point is very straightforward. The “right to rent” rule would be a temporary change to the foreclosure procedure in recognition of extraordinary situation created by the collapse of the housing bubble and the proliferation of bad mortgages that fed the bubble. It could be limited by both the years in which mortgages were issued (e.g. 2002-2007) and the value of the house. The latter limit could be set relative to the median house price in an area. For example, it could only apply to homes that sold for less than 120 percent of the median price in a metropolitan area. This information is readily available from Census Bureau data.

Under the right to rent rule, the judge or court officer handling the foreclosure would offer the homeowner the option to stay as a tenant following the foreclosure. If the homeowner is interested, then the judge would arrange to have an appraisal done to determine the rental value of the house. The appraisal would assign a rental value to the home based on the rent of comparable units in the area,

just as an appraisal for sale assesses the sale price based on the sales price of comparable units in the area. The cost of the appraisal would be split between the homeowner and the lender.

For subsequent years, the rental price would be adjusted in step with the consumer price index for rent for the nearest metropolitan area. At any future point, if either party felt that the rent was out of line with the market, then they could request a new appraisal from judge. The party requesting the appraisal would pay the full cost of the appraisal, which should discourage frivolous requests.

After foreclosure, the rules governing the rental unit would be the same as those that apply to other rentals in the area. The one major difference would be that the former homeowner would effectively be subject to a just cause eviction rule. It would not be possible for the lender to evict the former homeowner for the duration of time provided under the right to rent law without demonstrating cause.

### Benefits to Homeowner

In many of the former bubble markets, a right to rent law would allow homeowners to remain in their home at a much lower cost than they had been paying as owners. During the housing bubble, house prices grew out of line with rents. This means that ownership costs based on bubble prices are far higher than current rents. This would be the case even if the homeowner was able to get a relatively low-cost mortgage.

For example, a recent paper by the Center for Economic and Policy Research, calculated that the monthly ownership costs would be \$3,050 for someone who had purchased a home near the peak of the bubble in San Diego, priced at 75 percent of the median for the area.<sup>1</sup> By comparison, the rent on a comparable unit would be just \$1,400 for a saving of \$1,650 a month. In Los Angeles, the ownership cost would be \$3,300 compared to a rental cost of a comparable unit of \$1,350, for a saving of \$1,950 a month. There are similarly large savings for renting compared with ownership costs in most of the former bubble markets. As a result, many current homeowners who find their mortgage unaffordable would be able to easily pay the market rent on the home they now own.

While a secure rental unit is certainly better for current homeowners than simply being foreclosed and thrown out of their home, an additional benefit of a right to rent policy is that it would make foreclosure less likely by making it a much less attractive option for lenders. With a right to rent rule, lenders would still have the option of reselling a foreclosed home to a third party, but the right to rent would remain. In other words, if a homeowner was guaranteed the right to stay in their home as a renter for 5 years following a foreclosure, the homeowner would still have this right even if the lender opted to sell the home.

Having a renter attached to a property will generally reduce its sales value. This would make foreclosing on homes less attractive to lenders. As a result, lenders will be more likely to pursue alternatives to foreclosure, such as modifications that allow homeowners to remain in their homes as owners. For this reason, the granting of right to rent not only gives homeowners facing foreclosure more security in their home, but it also almost certainly increases the probability that they will be able to stay in their house as homeowners.

<sup>1</sup> Baker, Dean and Hye Jin Rho, 2009. "The Gains from Right to Rent," Washington, DC: Center for Economic and Policy Research, available at <http://www.cepr.net/documents/publications/gains-right-to-rent-2009-07.pdf>.

## Objections to Right to Rent

There have been three main objections raised to right to rent:

- 1) banks have no experience being landlords;
- 2) this change in foreclosure rules will hurt banks and therefore lead to higher mortgage interest rates in the future; and
- 3) it interferes with the sanctity of contract.

There are ready responses to each objection.

It is true that most banks have no experience as landlords, but this problem can be easily addressed. In most cases, banks would presumably contract out to management companies to deal with former homeowners turned tenants. This is done all the time. It is not that uncommon for banks to come into possession of rental properties and this is usually how they deal the situation.

Banks also argue that changing the rules on foreclosure will lead to larger losses and therefore make future mortgage lending more risky, requiring higher mortgage interest rates. However, the whole point of this temporary change in foreclosure rules is that it is attributable to an extraordinary situation – the collapse of an \$8 trillion housing bubble. There is no reason to depart from standard foreclosure rules in normal times, but these are not normal times.

If this implies that banks may respond by being more cautious about making loans when it seems that house prices are rising out of step with the fundamentals of the housing market, then this would be another desirable side-effect of the policy. We should want banks to exercise more caution in making loans when house prices are being inflated by a bubble. This would help stem the growth of the bubble, which is exactly the outcome that we would want.

Finally, there is the more general concern that changing the rules on foreclosure interferes with the sanctity of contract, in effect denying basic rights of individuals and corporations in the market. While there are undoubtedly legal issues that can and will be raised by a right to rent law, it is worth noting that it is changing the terms of enforcement for a contract, not directly taking property. In this respect, there is the important precedent of the 2005 change in the bankruptcy law that made it far more difficult to have debt discharged in bankruptcy.

This law did not only apply to debts incurred subsequent to its passage, it was also applied retroactively. As a result, people who had incurred debt under one set of bankruptcy rules were suddenly subject to a different set of bankruptcy rules in regards to paying back their loans. At the time of the debate, this retroactive changing of the bankruptcy rules was never even raised as a serious issue. When it came to changing the rules to make them more generous to creditors, it seems that sanctity of contract was not an issue.

## Comparing Right to Rent and Bankruptcy Cram Down

Over the last year, Congress has repeatedly debated bankruptcy cram down legislation as a way to address the foreclosure crisis. This legislation would temporarily change the bankruptcy laws that apply to at least some mortgages, allowing bankruptcy judges to adjust the terms of mortgages in a bank-

ruptcy. This would be a change from current law, which uniquely prohibits home mortgage debt from being adjusted in a bankruptcy.

Cram down has many of the advantages of right to rent legislation. It can immediately benefit homeowners facing foreclosure, without requiring any administrative bureaucracy. Bankruptcy cram down also does not require any taxpayer dollars. Insofar as there is a loss from the rule change, it will be borne by the lender. However, cram down is likely to prove less helpful to homeowners for two reasons.

First, the vast majority of foreclosures are not currently associated with a bankruptcy proceeding. Bankruptcy proceedings can be expensive and complicated. They often require the involvement of lawyers. Many homeowners may also be reluctant to go into bankruptcy for both moral and economic reasons. In some cases, they may have other assets, such as a retirement fund, that they may not want to risk in a bankruptcy proceeding. They may also not want a bankruptcy on their credit record. For these reasons, it is likely that even if Congress passed cram down legislation, many homeowners facing foreclosure would still not choose to go through the bankruptcy process to keep their house.

The second reason why cram down legislation may not be very helpful to homeowners facing foreclosure is that there is no guarantee that bankruptcy judges will rewrite terms of a mortgage to allow homeowners to keep their homes. They may opt to make some reduction in mortgage payments, but many homeowners would still be unable to afford their mortgages even if the payment was substantially reduced. In such cases, a modest reduction in mortgage payments put in place by a bankruptcy judge will be of relatively little benefit.

The most important gain to homeowners from cram down legislation would likely be the increase in their bargaining power. There will be uncertainty about the outcome of a bankruptcy process, which means that the threat by a homeowner facing foreclosure to declare bankruptcy will be more of a deterrent to a lender than it is at present. As a result, lenders may be more likely to voluntarily negotiate modification terms that are acceptable to homeowners. In this sense, it is similar to the incentive created by right to rent laws to voluntarily modify mortgages.

## **Conclusion**

The country is currently on path where it is likely to see foreclosures at a pace of more than 150,000 a month for at least two years. Existing loan modification programs at best benefit a small fraction of the families facing foreclosure. By contrast, granting foreclosed homeowners the right to rent would immediately help the vast majority of families facing foreclosure while creating no new bureaucracy and without using any taxpayer dollars.