Money in the Time of Coronavirus

D. Kennedy, The Fed Should Bail Out Low-Income Tenants and Not Just Banks and Landlords

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Duncan Kennedy, Harvard Law School

In the last financial crisis millions of American home owners lost their homes while low-income renters were evicted *en masse*. This time the policy consensus is that renters thrown out of work by the crisis are already bearing the brunt of what may be an even worse disaster. For extremely low-income (ELI) households, the COVID crisis is aggravating what is already a highly distressed environment. The number of affordable units for ELI households is only 36 per 100, reflecting a shortage of 7 million units. 71% of ELI households are already spending more than half their income on housing (all figures from NLHIC 2020). There are many worthy plans on the table to avert the COVID rental crisis, pushed in editorials and op-eds in the New York Times, the Washington Post and the Boston Globe. They all have the serious drawback that they require not just legislative action but taxpayer dollars in a hopelessly polarized political environment.

An alternative plan would be for the Fed to exercise, creatively, its vast powers over the monetary system to relieve poor tenants and prevent decimation of the remaining supply of low income housing. The Fed could buy mortgage debt, secured by low-income housing. Then it could bail out low-income landlords in exchange for tenant protection. The Fed would need Treasury support in order to protect against credit risk; without that protection the Fed would not be able to lend under current law. But the Treasury has generously extended protection against credit risk from its existing Exchange Stabilization Fund for large corporations, municipalities, the fossil fuel industry, and a variety of other borrowers. Surely the Treasury would do same to stop meltdown in the market for low-income mortgages.

The Fed should offer to buy the debt for more than the value of the underlying property but for significantly less than the face value of the mortgages. Creditors choosing to sell their debt would liquidate their losing investments for the price of a “haircut.”[1] Mortgage debt in hand, the Fed’s bailout of landlords and tenants would be done through the issuing banks that now hold the servicing contracts with the investors in the mortgage-backed securities into which individual mortgages are bundled. The Fed as creditor then instructs the servicing banks to forgive or defer some or all of the mortgage carrying charges of qualifying owners of low-income rental housing.

In exchange, landlords agree to a moratorium on evictions for non-payment and to forgiveness or deferral of the rent obligations of qualifying tenants. Landlords also agree to limits on their power to take units out of low-income residential housing use, and to strict enforcement of maintenance standards.[2]

The plan is based on the prediction that crisis conditions will push (are pushing) down the market value of the low income rental stock so that buildings are worth less than the face value of their mortgages — and that those conditions will persist well beyond the present moment.[3]

A realized plan to take advantage of the moment would be full of devilish details such as: how much if any means testing for tenants; what mix of rent forgiveness and forbearance; how big a haircut for the investors in mortgage backed securities; what restrictions on landlords’ rights to alienate their now rent-restricted property; how the Fed would exercise or dispose of its new creditor rights.

A big objection is likely to be that the Fed doesn't know how to administer loans directly and certainly not low income loans containing complex tenant protections. The answer is that the servicing banks, usually originators with their own sub-servicers, will administer for the Fed just as they did for the holders of the mortgage when it was part of a mortgage-backed security. The Fed will have to supervise the servicers but not administer loans directly. This is not out of line with standard portfolio maintenance.[4]

As negotiated, the plan could be watered down so as to do practically nothing for low income tenants and a lot for landlords and holders of mortgage backed securities, or it could signal a vast gain for the working poor.[5]

The argument for a seriously pro-tenant version of the proposal goes beyond the mere assertion that if it worked it would benefit low-income tenants faced with economic wipe out and possible homelessness. Here are some of the assumptions that justify the various parts of the scheme as a response to the peculiar circumstances of the health crisis within the housing crisis that has been unfolding in metropolitan areas all over the country.

The various relief and bail out provisions of state and federal law will not come close to closing the rent gap for newly unemployed workers. The unemployment insurance system, backlogged with unprecedented claim volume, will not substantially overcome the gap for many months. Millions of workers now unemployed are not covered in the first place. The CARES Act provides certain forbearance and eviction moratorium to landlords and tenants in multifamily housing with a federally backed (=GSE or FHA) mortgage. But these provisions only cover one quarter of rental units, and even for those lucky few, protections are of limited duration. These provisions are also already running into administrative difficulties.

Owners of low income housing will see a precipitous decline in their rent rolls and in the present value of their equity in their buildings. Rent rolls will not cover mortgage covering charges, real estate taxes and current maintenance expenditures.

Among the decisions owners will have to make, a big one will be when to exercise their absolute legal power to evict tenants (except the very few represented by expert legal services lawyers) for failure to pay even part of a single payment when due, regardless of hardship. One possibility will be to empty a building and put it on the market not for low income housing but for conversion to middle or upper-income use. Another will be to forgive rent to the extent necessary to keep a building occupied while cutting back or eliminating maintenance, "milking" the building as it deteriorates.

The long-term trend in many metro areas of displacement of low income tenants in favor of middle and upper-income buyers will continue, even though middle and upper-income groups are losing wealth and income in the recession. Income inequality keeps bargaining power unequal in the housing market whether the economy is going up or down.

The recession will paralyze high cost upper-income development by new construction away from the city. Falling prices will make conversion of existing units in the remaining low income neighborhoods in and near the city much more desirable. Banks and brokers and builders will arbitrage units out of low into middle and upper income use, devastating what is left of affordable housing in the metro area.

A Fed intervention by conditional bailouts might prevent this result. (Note that passing a rent control bill with tenant eviction protection could accomplish some of the same.) That would be a major collateral benefit of preventing a chaos of eviction and displacement in the immediate future as low income people lose their ability to pay rent.

The beauty of it all: no legislative action required. No new taxes – federal, state or local. The Fed would be doing good first of all for big business, stimulating the economy through the familiar form of quantitative easing. The conditionalities for once support the survival of the poor rather than attacking them in the name of austerity.

The author is a retired Harvard Law School professor who taught low income housing law and policy for many years and still writes in that field.

1. What it is a “haircut” you ask? In ordinary times, property value (say, $10 million) is greater than mortgage face value (say, $8 million). But in crisis, property values can drop such that the relationship inverts. For example, the mortgage can become $2 million “underwater”, meaning the property’s liquidation dropped to $6m. In a stylized example, the Fed bids, say, $7m for the mortgage. The difference between the bid and the property price (=$7 million -$6 million) is the bailout to the seller; the difference between mortgage’s face value and the Fed’s offer ($8 million – $7 million) is the “haircut” or loss to the seller. ↑

2. Both my friend and a hyper critical semi-sympathetic legal economist X remind me that the structure of mortgage backed securities makes it difficult to identify creditors. X says that the trustee for the first syndicate that bought this mortgage to bundle it is the first responsible party, and could sue. But according to him the trustee could reassemble and sell the dispersed fragments by agreement of the dispersed crowd of the fragment owners, with no pre-set process to unbundle or deal collectively. It does seem that unbundling will involve substantial transaction costs, for someone. It also seems plausible that if the Fed offers hundreds of millions of bail out money to banks struggling with massive business failure all around

them, quick witted finance entrepreneurs will figure out a way to get a share by helping the creditors get theirs. ↑

3. The Fed offers to buy mortgages at prices that reflect the extent to which the loan is under water. Everyone thinks the crash in rent means possible massive landlord default and concomitant loss in market value and danger of foreclosure. The creditors will only sell to the fed if something like that is happening. The amount of the haircut negotiated by the fed with the MBS holders depends on the level of distress and could be done for example, by a single fed offer to everyone or different offers for different situations.

   The whole idea is that there might be a lot of distressed cases (listen to the moaning from the industry) but even a few would be all to the good. So the proposal is not dependent on there being some large minimum number of properties underwater by a particular amount. ↑

4. The concessions that need to be enforced cover:

   -rent, building maintenance and evictions (again, forbearance or forgiveness, eviction moratoria with or without good faith eviction protection), and

   -the agreement not to take the units out of the low-income stock (for some period of time).

   The part that needs enforcement is the landlord's promises to the tenants. The prohibition of conversion to higher-income use is easy because the landlord can't convert the building without getting the Fed's permission as mortgagee. That involves simple portfolio management.

   The enforcement of the tenant protections is more complicated. The servicing of the mortgage is in the hands probably of the initiating bank, contracted out to a servicing firm. That firm collects the landlord's payments and transfers them to the Fed*. The servicer* enforces tenant concessions by requiring the landlord to report rents charged, evictions for cause, code inspections and the like. Lying is a federal offense. The section 8 program enforces some tenant rights through this kind of mechanism.

The second enforcement mechanism is tenant self interest in the reduced rent, maintenance obligations and eviction protections. The Fed would require landlords to give a lot of information to tenants and would make it clear to the local legal services bar that it welcomes complaints *to the servicer* of landlord abuse of its agreement. Portfolio management of this kind would be new, but not *that* new, given that the Fed is already in the business of enforcing its bank operation regulations for the benefit of bank customers (analogous to renters). ↑

5. The outcome of the plan is that the losses of income suffered by renters are born as follows:

   -some portion by mortgage-backed securities owners (according to the size of the haircut);

   -some part by landlords, who get carrying charge relief to avoid foreclosure but have to make all kinds of concessions to tenants;

   -some part by tenants, in multiple ways determined by the amount of rent left to pay after forbearance and not forgetting the indirect benefit of the preservation of the stock;

   -and some part by taxpayers, who assume the risks of default on the mortgages the Fed has bought.

Readers have had a lot of trouble grasping that this scheme distributes the cost of tenant relief among all parties with no predetermined specific outcome: it all depends on negotiations. ↑