



## RENTAL MARKET CONDITIONS

The housing market crash and Great Recession took a toll on rental markets, pushing up vacancy rates and pushing down rents and property values in many areas. While many measures indicate that rental markets remain under stress, other evidence points to the beginnings of a turnaround. Vacancy rates have retreated as the troubled homeowner market has spurred strong growth in renter households. And with limited new supply in the pipeline, the ingredients may be in place for rents to rise quickly when the economic recovery strengthens.

### FALLING VACANCY RATES

Even before the Great Recession, rental housing production had been at modest levels. With renter household growth stalled in the midst of the homebuying boom, starts of single-family and multifamily rentals held below 300,000 units annually on average from 1995 through 2004. By comparison, homes built for sale exceeded 1.0 million units each year and topped out at 1.7 million in 2005. When the owner market crashed and the recession took hold, rental starts fell from their already weak levels to about 230,000 units a year in 2005–8, and then to just over 100,000 units in 2009—the lowest production in more than 50 years.

At the same time, renter household growth picked up sharply to more than 600,000 annually from 2005 to 2009. But despite rising demand and limited new construction, rental vacancy rates remained stubbornly high. After hovering near 8 percent for much of the 1990s, vacancy rates climbed to just under 10 percent by the mid-2000s and then to a new high of 10.6 percent in 2009 (**Table A-1**).

This trend reflects in part the flood of formerly owner-occupied homes into the rental market. After an increase of 720,000 units in the first half of the decade, the number of single-family rentals jumped by 2.3 million in the second half. Even so, much of the increase in the overall rental vacancy rate was concentrated in structures with 10 or more units, where rates climbed from 10.0 percent in 2006 to 12.7 percent in 2009. The vacancy rate for single-family rentals was unchanged, suggesting that many former owners relocated to these homes.

Recent trends indicate that rental markets are tightening (**Figure 6**). The annual vacancy rate fell to 10.2 percent in 2010, with a sharp drop at the end of the year to 9.4 percent. How far vacancies need to fall to restore the market to balance is difficult to determine. In the mid-2000s, vacancy rates consistently exceeded 9.5 percent; in the 1990s, they remained close to 8 percent; and in the 1980s, they held near 6 percent.

As of the fourth quarter of 2010, 4.0 million vacant housing units were available for rent. Assuming that markets are in balance with a rental vacancy rate of 8 percent (the rate prevailing in the decade before the housing boom), the excess would be about 700,000. Given that the number of renter households has been growing by more than 700,000 annually on average since 2006, working off this inventory would take about a year.

The process could, however, be much faster. The Great Recession has held down rental demand in two ways: by slowing the rate at which young adults form independent households, and by reducing the flow of immigrants into the United States. As the recovery strengthens, release of this pent-up demand could lift renter household growth quickly—long before multifamily construction could respond. In addition, the sustainable rental vacancy rate may be closer to the 10 percent averaged in 2003–7, which would trim the amount of excess inventory considerably. The accuracy of national vacancy rate estimates is also in question. Indeed, initial results from the 2010 Census indicate that the vacant share of the overall housing stock is much lower than national surveys report.

### TRENDS IN RENTS

After climbing for much of the 2000s, rent increases came to a halt during the recession as vacancy rates rose and the recession took a toll on household incomes (Table A-2). Based on

the national consumer price index, contract rents (excluding tenant-paid utilities) increased by 1 percent from 2007 to 2010.

The consumer price index, however, tends to be a conservative measure. Rent indices for professionally managed apartments, in contrast, show sharper swings since 2007. According to MPF Research, nominal rents for large investment-grade apartment properties slipped 0.3 percent in 2008 and then dropped 4.1 percent in 2009—both declines outpacing the change in overall prices. The weakness in 2009 was widespread, with rents down in 61 of 64 metropolitan areas. The largest decline was in the West (6.2 percent) and the smallest in the Northeast (1.8 percent), with the South (3.3 percent) and Midwest (3.5 percent) falling between these extremes (Figure 7).

As of the fourth quarter of 2010, though, MPF Research surveys point to a 2.3 percent annualized rise in nominal rents. While only modestly faster than overall inflation, this increase still represents a sharp turnaround that is evident in all four regions. Across the 64 metropolitan areas surveyed, 61 posted rent increases. Indeed, the only declines were in Las Vegas (down 5.0 percent), Fort Meyers (down 2.1 percent), and Tucson (down 0.8 percent).

### BOOM AND BUST IN MULTIFAMILY PRICES

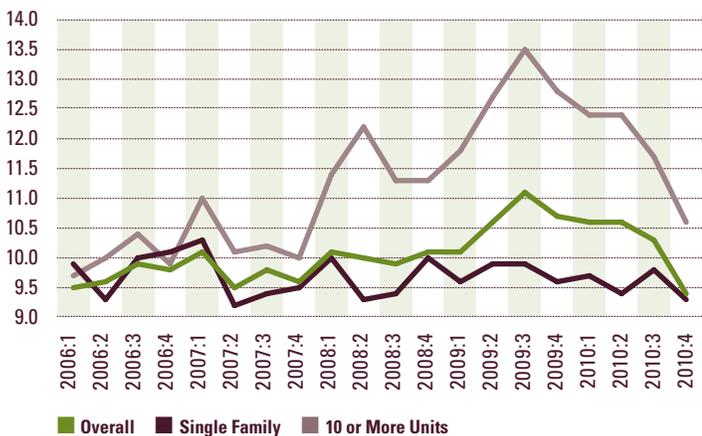
A similar mix of factors that fueled the single-family housing bubble also ignited multifamily property prices, including a flood of global capital seeking investment and falling risk premiums. The homeownership boom also helped to push up prices as property owners hoped to cash in on the homebuying frenzy by converting their rental units to condominiums. Initially affecting only high-end multifamily properties, conversion fever eventually spread to middle-market apartments as well. Properties began to change hands not on the basis of their fundamental value as rental housing, but of their speculative value when converted to homeownership. This put upward pressure on appraisals, and the potential for short-term profits attracted huge amounts of capital.

The ensuing cycle in multifamily property prices was spectacular. Moody's Commercial Property Price Index for apartment buildings surged by 95 percent from the end of 2000 to the peak in 2007 (Figure 8). While other series such as the NCREIF apartment price index do not show quite as large a rise, they still indicate a nearly 70 percent climb in apartment prices over this period. By comparison, the S&P/Case-Shiller Price index for single-family homes jumped 76 percent between the

**FIGURE 6**

### With Vacancy Rates Falling, Rental Markets May be Turning the Corner

Rental Vacancy Rate (Percent)



Source: US Census Bureau, Housing Vacancy Surveys.

end of 2000 and the peak at the beginning of 2006. From peak to trough, Moody's index registered an even greater drop in multifamily prices (40 percent) than in single-family prices (32 percent), while the NCREIF index posted a decline of similar magnitude (30 percent).

The multifamily market now shows signs of recovering. According to Moody's index, prices for properties valued above

\$2.5 million rebounded by 20 percent from the third-quarter low in 2009 to the fourth quarter of 2010. Even so, property values remain 28 percent below peak levels and it is unclear whether the recovery evident in the larger, investment-grade property market extends to other multifamily segments.

### FINANCING FOR RENTAL PROPERTIES

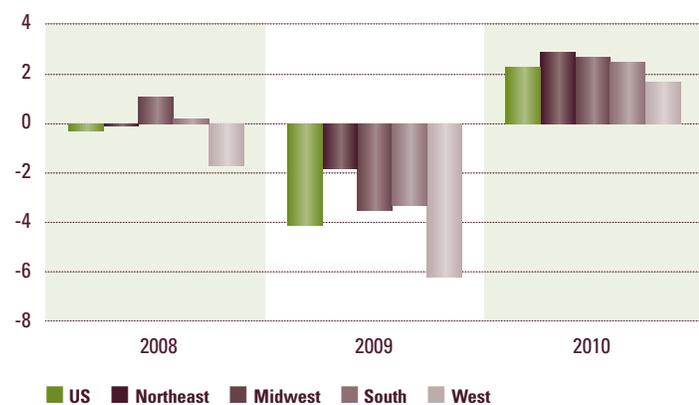
In tandem with property prices, multifamily lending volumes rose rapidly beginning in 1998. After holding near \$400 billion from 1975 until 1998 in real terms, the amount of outstanding multifamily debt doubled by 2008. Loans backed by the GSEs and FHA led growth, together driving 43 percent of the net increase in debt. Indeed, the GSE share of the market swelled from 18 percent to 31 percent. Commercial banks and commercial mortgage backed securities (CMBS) also contributed about a quarter of the increase. By 2008, the GSEs, commercial banks, and CMBS accounted for fully two-thirds of the market.

The financial market crisis then brought growth in overall multifamily debt to a halt. The CMBS market evaporated while banks wrestled with high losses on existing portfolios and had little appetite for new loans. As a result, the only net additions to multifamily debt since 2008 have come from the GSEs and FHA (Figure 9). The volume of outstanding loans held or guaranteed by the GSEs and FHA soared by \$71 billion between the first quarter of 2008 and the fourth quarter

FIGURE 7

### After a Sharp Drop in 2009, Rents in Large Apartment Properties Rebounded Across the Country in 2010

Annual Change in Rents (Percent)

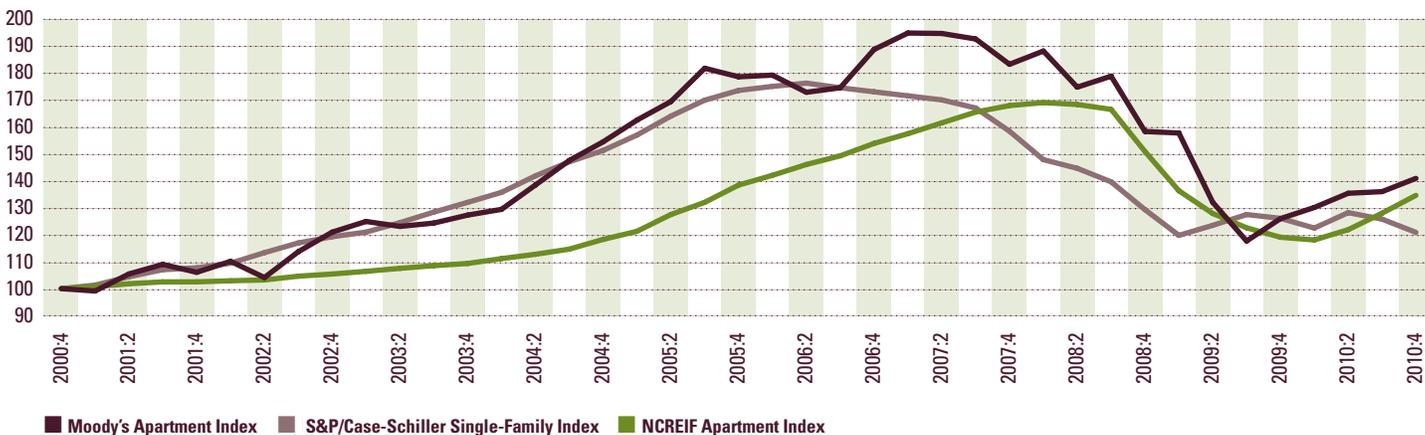


Note: Rent change is the average nominal change from fourth quarter to fourth quarter for a sample of large investment-grade apartment properties.  
Source: MPF Research.

FIGURE 8

### The Boom and Bust in Multifamily Property Prices Was as Dramatic as That in the Single-Family Market

Price Index



Notes: Data are normalized to 100 in 2000:4. Single-family index is based on sales of 1- to 4-unit properties. Moody's apartment index is based on repeat sales of apartment properties worth at least \$2.5 million, while the NCREIF index is based on appraised valuations of investment-grade apartment properties.  
Sources: Economy.com, Moody's/REAL National Commercial Property Price Index for apartments and S&P/Case-Schiller National Home Price Index; National Council of Real Estate Investment Fiduciaries, Apartment Price Index.

of 2010, while the volume for all other financing sources combined dropped by \$40 billion. Just as in the single-family market, the GSEs and FHA have thus played a critical role in keeping credit flowing in the multifamily market.

While it is difficult to discern how restricted credit is playing out in different submarkets, lenders and investors alike clearly prefer larger, higher-end properties located in major metropolitan areas. Even in the best of times, properties that are smaller, of lower quality, and outside of larger markets face greater challenges in getting access to lower-cost funding available through national lenders. A combination of factors, including high fixed underwriting costs and greater default risk, make it difficult for large lenders to serve this submarket. For policymakers, however, smaller properties (generally with 5–19 units) are of particular concern because they represent a significant source of affordable rental housing.

It is also important to note that half of all rentals are in properties with 1–4 units and are financed through the single-family mortgage market. The credit options for these small investor-owned properties are more limited than for owner-occupied units because the risk of default is thought to be higher. Between the 2005 peak and 2009, the drop in loans for purchase of properties without owner-occupants (76 percent) was therefore even sharper than that for purchases

of properties with owner-occupants (60 percent). Refinance loan volumes for absentee owners of 1- to 4-unit properties were also down 41 percent, compared with just 17 percent for owner-occupants.

With other funding sources (including FHA) out of this market, the GSEs stepped in to keep credit flowing—nearly doubling their share of absentee-owner loans for home purchase from 30 percent in 2006 to 56 percent in 2009. Their share of refinances increased even more over this period, up from 24 percent to 61 percent.

### MULTIFAMILY LOAN DELINQUENCIES

Many multifamily properties were purchased or refinanced when prices were surging in the 2000s. Debt financing was liberally available with looser underwriting based on rosy assumptions about future net operating income and property values. With the onset of the recession, however, the overly optimistic nature of these assumptions became apparent as delinquency rates began to rise in 2008 and then shot up in 2009.

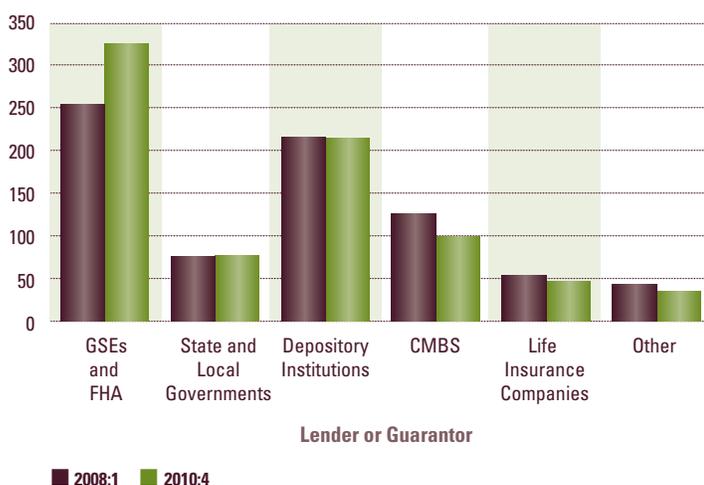
Loan performance, however, varies considerably by investor class (Figure 10). The share of multifamily loans held in CMBS that was 60 or more days delinquent or in some stage of foreclosure climbed to 7.3 percent at the end of 2009 and then hit 13.4 percent in the third quarter of 2010. Meanwhile, the 90-day delinquency rate for multifamily loans held by banks and thrifts jumped from 1.8 percent at the end of 2008 to 4.6 percent in the first quarter of 2010 before easing. In contrast, the share of troubled loans held or guaranteed by Fannie Mae rose much more modestly, up from less than 0.10 percent at the start of 2008 to a peak of 0.8 percent in the second quarter of 2010. The increase for Freddie Mac loans was even smaller, from 0.04 percent to 0.35 percent. FHA's 90-day delinquency rate held steady near 0.75 percent over this period.

The much better performance of the GSE portfolios suggests that Fannie Mae and Freddie Mac did not get caught in a “race to the bottom” with the rest of the market. Strong investor demand for multifamily loans in the early to mid-2000s generated intense competition, reflected in more generous underwriting terms and pricing. Because multifamily loans helped to boost the value of commercial loan pools, demand from CMBS issuers was particularly strong. The GSEs thus appear to have better managed the screening and underwriting of the loans they purchased or guaranteed. The GSEs did, however, purchase a significant share of the most highly rated multifamily tranches of CMBS created

FIGURE 9

### Federal Sources Account for Virtually All of the Growth in Multifamily Debt Since 2008

Outstanding Multifamily Debt (Billions of 2010 dollars)



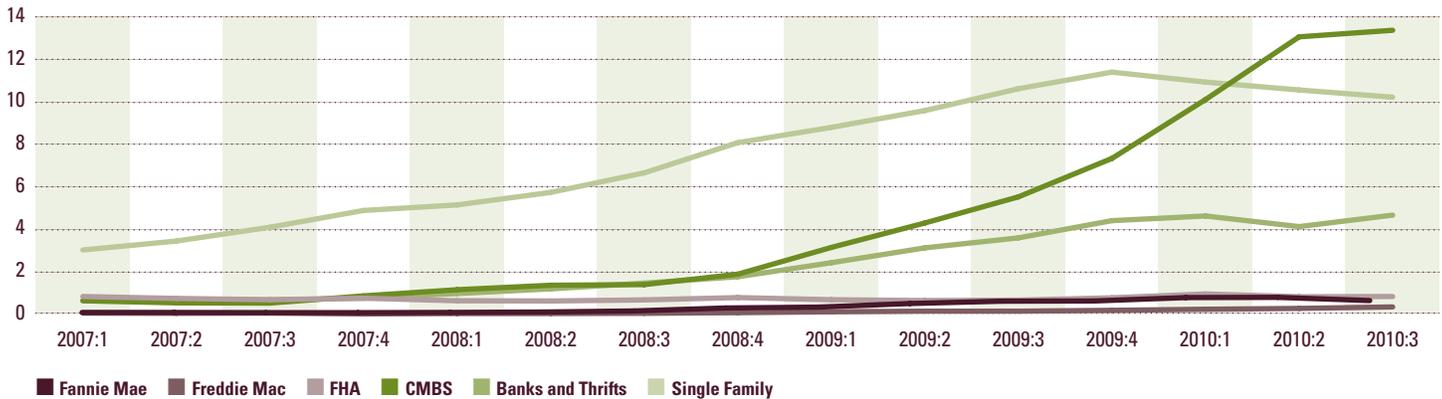
Notes: Values are adjusted for inflation by the CPI-U for All Items. GSEs (government sponsored enterprises) include Fannie Mae and Freddie Mac. FHA is the Federal Housing Administration, and CMBS are commercial mortgage backed securities. Other includes the federal government, finance companies, businesses, pension funds and REITs.

Source: Mortgage Bankers Association analysis of Federal Reserve, Flow of Funds and FDIC.

FIGURE 10

**CMBS Multifamily Delinquencies Have Soared While Federally Backed Loans Have Performed Relatively Well**

Share of Loans Delinquent or in Foreclosure (Percent)



Notes: Rates for different types of financial institutions are not directly comparable because of differences in data-gathering methods. Single family includes loans for 1- to 4-unit properties. All other categories are investors in or guarantors of multifamily loans. CMBS delinquencies include properties foreclosed but not yet sold. Delinquency rates for GSEs, CMBS and single family are the share of loans by volume or number that are 60 or more days delinquent; rates for banks and thrifts and FHA are the share 90 or more days delinquent.  
Sources: Mortgage Bankers Association, National Delinquency Surveys and Commercial/Multifamily Mortgage Delinquency Rates; Moody's Multifamily CMBS Delinquency Tracker; Federal Deposit Insurance Corporation, Quarterly Loan Portfolio Performance Indicators; Federal Housing Administration.

especially for them, and thus were a source of demand for those securities.

One potential concern about the current credit environment is that borrowers with loans maturing in the next few years may be at risk of default. At the height of the lending boom, it was common for multifamily loans to have amortization periods of 25–30 years (the period over which the loan is fully paid off) but maturities of only 7–10 years (the date at which the loan must be repaid). With such a large volume of debt issued over the last decade, many property owners will therefore have to refinance in the next 5–7 years. The decline in both net operating income and property values, along with stricter underwriting guidelines, may thus make refinancing difficult.

While the magnitude of this problem is unclear, it appears to be most concentrated among CMBS and depository loans. A 2010 survey by the Mortgage Bankers Association (MBA) indicates that 15 percent of outstanding nonbank multifamily loans would mature between 2010 and 2012, with an additional 23 percent maturing by 2015. Fortunately, this means that more than half of outstanding nonbank multifamily mortgages will not come due until 2016 or later, including more than a quarter that will mature sometime after 2020.

But among CMBS loans, 22 percent will mature by 2012 and another 26 percent by 2015. Credit companies, which the MBA report notes tend to make shorter-term loans similar to

depositories, have 40 percent of their loans maturing by 2012 and another 12 percent by 2015. Loans guaranteed or held by the GSEs or FHA face less maturity risk than other classes of loans, with only 30 percent of outstanding loans maturing by 2015. Moreover, with rents and property values now on the upswing and vacancy rates falling, market conditions may well improve enough to make refinancing easier over the next few years.

**FALLOUT FROM THE FORECLOSURE CRISIS**

Based on Mortgage Bankers Association data, the number of home loans in some stage of foreclosure appears to have stabilized at around 2.0 million, but this number is still four times the average before the crisis began. Meanwhile, the number of homes forfeited through foreclosures, short sales, or deeds-in-lieu of foreclosure continues to rise, up 46.7 percent between 2009 and 2010 (Figure 11).

While the foreclosure crisis has obviously had its greatest impact on homeowners, it has also displaced a significant number of renters. All told, about half of renters live in the types of properties that are at the center of the crisis, including single-family homes, condominiums, manufactured homes, and buildings with 2–4 units. Indeed, the National Low Income Housing Coalition estimated that, as of 2009, renters may have accounted for some 40 percent of households that faced eviction because of foreclosure.

Foreclosure rates for small multifamily properties have increased at least as sharply as those for single-family homes. According to an analysis of the Chicago market area by James Shilling of DePaul University, the share of loans in foreclosure for buildings with 2–6 units climbed to 10 percent in 2009, about twice the MBA’s estimated rate for single-family properties. Similarly, researchers at the Federal Reserve Bank of Boston found that buildings with 2–4 units make up 10 percent of the Massachusetts’ housing stock but account for almost half of foreclosures.

Renters in low-income and minority neighborhoods appear to have felt the fallout from the foreclosure crisis most acutely. Based on data from First American CoreLogic, the 2010 foreclosure rate for loans originated in 2004–7 in low-income communities (with incomes below 80 percent of the area median) was almost two-and-a-half times that in higher-income areas (with incomes above 120 percent of the area median). The disparity is even larger in predominantly minority communities, where foreclosure rates are almost three times those in predominantly white areas. Not only are properties in these types of neighborhoods more likely to go through foreclosure, but foreclosures also affect a greater number of households because of the high concentration of buildings with 2–4 units. These properties account for 17 percent of occupied units in the poorest neighborhoods—more than three times the share in the highest-income areas.

The impact of rising multifamily loan delinquencies on tenants is unclear. When the single-family foreclosure crisis erupted in 2008, lenders often evicted tenants to prepare the units for sale. The federal Protecting Tenants at Foreclosure Act was then passed in May 2009, requiring that new owners of foreclosed or sold properties honor the terms of existing leases and provide tenants at least 90-days notice to vacate.

Renters of multifamily units, however, may be in less danger of eviction because property owners and lenders alike have incentives to retain good tenants to maintain cash flow. Instead, the main risk to tenants may be from under-maintenance of their buildings. If owners are squeezed by inadequate operating income and limited access to financing, they may be unable to invest in necessary upkeep and property quality may deteriorate. For marginal buildings, the inability of owners to provide adequate maintenance may also lead to further losses from the affordable housing stock.

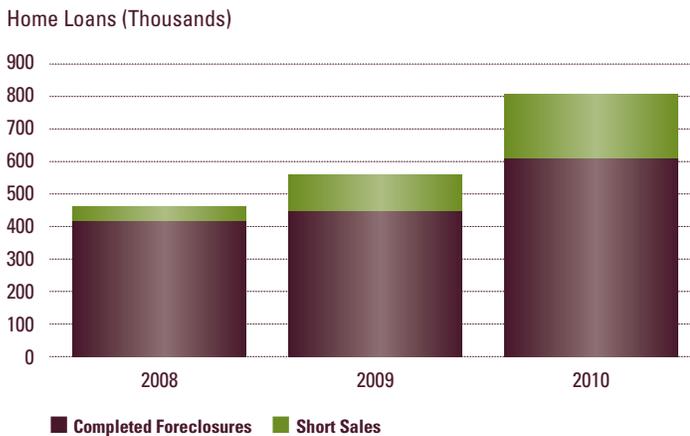
### THE OUTLOOK

A variety of rental market indicators suggest that the worst repercussions from the recession may be over. While this is good news for property owners, the recovery may increase the rent pressures on households still struggling in an environment of sluggish job growth. The ongoing foreclosure crisis should continue to spur growth in the number of renter households as former owners switch to renting. Single-family home foreclosures will also add a steady flow of units to the rental market. The ability of renter households to occupy these homes will be an important factor in maintaining the stability of distressed neighborhoods hard hit by the foreclosure crisis.

One of the most important questions going forward is whether mortgage financing will be available to fuel rental property purchases and investments. Even before the financial crisis, Fannie Mae and Freddie Mac were an important source of financing for both multifamily and investor-owned single-family properties. And during the crisis, the GSEs—along with FHA—accounted for the vast majority of new financing. As Congress takes up debate about what, if any, role the GSEs should play in the mortgage markets, policymakers must consider the vital importance they have as a source of capital for rental housing.

**FIGURE 11**

### Home Forfeitures Continue to Escalate



Notes: In short sales, the selling price of the property is lower than the total amount due on the mortgage. Home forfeitures also include deeds surrendered in lieu of foreclosure (not shown). Homes forfeited include 1- to 4-unit properties and condominiums in multifamily buildings.

Source: Office of the Comptroller of the Currency and Office of Thrift Supervision, Mortgage Metrics Reports, 2009–2010.