

## **Foreclosures and the Rental Market** **by Robert L. Cain**

Last June, Sonya lost her El Cajon, California home to foreclosure. It was a year after she and her husband separated and she “couldn’t do it anymore” she said. She had used all her savings. Recently, she moved into an apartment with a roommate. Before she could move in, she had to disclose her financial problems to the property manager who did a background check before allowing Sonya to become a tenant.

“It was embarrassing”, she said. “I had to put it in my paperwork. She said she would get back to me and she did.”

The property supervisor rented to her partly because her roommate was an established tenant. Other than the foreclosure, Sonya’s credit was pretty good.

Attorney Steven Kellman, director of the Tenants Legal Center of San Diego, observed that mortgage defaults are “creating a new population of tenants.”

And the population is growing daily. According to foreclosures.com, almost 1.1 million homes have entered the foreclosure process so far this year. That is in addition to the 559,750 homes that were foreclosed in 2006. “About 526,936, or more than six out of every 1,000 households in the United States, were repossessed by banks or lenders during the first 11 months of the year – up 41 percent from the same time last year,” reports the Orlando Business Journal. That has made the homeownership rate the lowest since 2002.

That amounts to over 1 million households back in the tenant pool or over two million people, even if we only count two people per household.

### **The Effect on Rental Owners**

So what? How does that affect us as rental property owners?

These ex-homeowners are going to become renters again – possibly forever. Mark Twain’s analogy about the cat on the hot stove is particularly apropos. He said, “We should be careful to get out of an experience only the wisdom that is in it – and stop there; lest we be like the cat that sits down on a hot stove-lid. She will never sit down on a hot stove-lid again and that is well; but also she will never sit down on a cold one either.

We are going to have a growing cadre of renters by choice for the next two or three years, until the sub-prime and adjustable-rate mortgage crisis works its way out. If Congress or HUD interferes in this issue, the crisis will last at least twice as long.

This cadre of renters will be moving into existing rental properties. Single-family, foreclosed-on homes are sitting vacant. Lenders are not equipped to become landlords. They don’t want the properties and they are having difficulty selling them, but they don’t want to rent them out, either. Since 2005, the Census Bureau reports the number of vacant, single-family homes has increased a full percentage point. That means returning tenants will not be renting those homes. In fact, CNN Money published on October 26, 2007, “The Census Bureau report puts the number of vacant homes for sale at 2.07 million in the period, up about two percent from the second quarter and seven percent above year ago levels.”

Add to that the figures on multi-family starts and completions and we will have something we have not had for a number of years – a demand that exceeds supply. That means rents will rise as they already have in many parts of the country.

The adage “raise the rent, raise the rent” needs now to be taken as directive. As more and more people became homeowners in the last few years, we had more and more difficulty finding

qualified applicants. As we reported in the June 2005 issue, "The people still in the apartment market [2005] don't necessarily possess the financial resources of the ones who left." Also in the June, 2005 issue, Dave Woodward, CEO and managing partner at The Laramar Group in Greenwood Village, Colo., says he's had to revisit credit cut-offs at selected properties. "If you need to capture the same number of residents to maintain occupancy and you haven't lowered your cut points, you won't be able to capture that traffic," Woodward explained. "We haven't done it across the board, but in certain instances we've lowered our scores.

"We're seeing that the people who used to lease at the B properties are now trying to lease A properties," Jared Miller, director of marketing for Lane Properties, said. "They're moving up one asset class."

National data in 2005 supported apartment executives' sense that the financial quality of tenants had gone down. There was "a gradual decline in overall credit scores [that had] occurred over the [previous] 24 months," said David Carner, a senior vice president for Carrollton, Texas-based RealPage, whose data says renter credit scores hit the bottom in the fall of 2004, a decline that corresponded with plummeting interest rates. "Just as you would expect, as 30-year fixed rates dropped, credit scores dropped similarly," said Carner, who speculated that the conversion to homeownership started with people who had higher credit scores and started to trickle down as the single-family market began to solicit prospective buyers "who previously were constrained from homeownership by insignificant income, poor credit and the inability to raise the appropriate down payment."

Those days are not gone, but they are slightly less perilous to our fortunes than they were. No longer will we have to give away free trips to Hawaii to attract new tenants. No longer will we be subject to rent concessions to keep tenants. Now we can get the rents to where they need to be so that we can properly maintain our properties, select more qualified applicants and make a reasonable profit.

#### Fair Housing an Issue?

But wait, there's more! Just as in the case of Sonya, prime applicants' credit scores may be worse than they were before they bought homes. Foreclosures have tarnished the credit of ex-homeowners who are coming back to us. We have to decide who will be an acceptable applicant now. Count on there to be a backlash against landlords requiring the same credit standards they did before the "sub-prime debacle."

As I wrote in a previous article, "What do good landlords do before renting to any applicant? They pull credit reports to find out how well an applicant has paid his or her bills. If an applicant has a spotty or bad credit history, the landlord properly rejects the applicant."

Since a larger percentage of low-income people are minorities, the very people the zero down payment mortgages are aimed at, they will end up with foreclosures and bad credit more often than will other, more qualified home buyers. As a result when they lose their homes, these low-income buyers will become renters and come to us to find a place to live. With a credit history such as the one we will see on their credit reports, we will reject them.

That will mean a disparate impact on minorities in the rental market.

When all else fails, the Fair Housing persecutors resort to "disparate impact." If they can't show with testers that a landlord was showing illegal bias against an applicant, they start rummaging around in his or her business policies. The first they will look at is the standards that a landlord uses to decide if an applicant is qualified. HUD will step in and claim that we – landlords- are breaking the Fair Housing Act by rejecting these applicants on the basis of bad credit because using a credit history has a disparate impact on protected classes.

Where there is no perfect answer to the perversity of the Fair Housing persecutors and their hangers-on, we still have to make business decisions based on our experience and the average credit demographics of our current and previous tenants. Showing that business pattern will be the only defense against having a Fair Housing complaint filed or adjudicated against you.

#### Conclusion

What we must do to prepare for the onslaught of returning tenants and their damaged credit is to make sure we have a clear idea of who is an acceptable applicant and create our policies and standards accordingly. We are in a position to raise our standards about who is an acceptable applicant. We owe it to ourselves to do just that.

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