Morgan Stanley

MORGAN STANLEY RESEARCH

Morgan Stanley & Co. LLC

Oliver Chang
Oliver.Chang@morganstanley.com
+1 415 576 2395

Vishwanath Tirupattur
Vishwanath.Tirupattur@morganstanley.com
+1 212 761 1043

James Egan
James.F.Egan@morganstanley.com
+1 212 761 4715

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Securitized Credit

Global

Housing Market Insights

REBUILD – Part II

We provide more details on our REBUILD proposal. For background, please see *Housing Market Insights: REBUILD – What To Do About US Housing*, August 8, 2011.

We estimate 6MM properties at a current market value of $700 billion are either currently REO, in foreclosure, or more than 90 days past due. Any program designed to address this backlog will need to attract sufficient private capital and allow for bulk sales. Our REBUILD proposal does just this.

The bulk sales component of REBUILD is critical, as it must be able to scale yet align volumes with existing operating capacity. We believe that initially, sales are best pooled at the MSA level in sizes that investors can operate efficiently, while being able to grow with market development.

Lending facilities in REBUILD are also essential to attracting private capital and boosting bid prices. Reasonable levels of leverage can improve investor demand and purchase power, resulting in higher bids and faster program effectiveness, while limiting credit risk.

We believe that any institutional investor lending facility should structure loans to better match investor needs while facilitating securitization or other exits. Pools of single family rental properties will look more like commercial rental portfolios, so loan characteristics should match, including non-amortizing bullet structures with shorter maturities than traditional residential mortgages.

We believe our REBUILD proposal balances the interests and concerns of all stakeholders, while remaining simple, feasible and implementable. Initial components of our REBUILD proposal can be implemented relatively quickly, and success can be measured fairly easily.

Housing Market Insights

REBUILD – Part II

Oliver Chang (415) 576 2395
Vishwanath Tirupattur (212) 761 1043
James Egan (212) 761 4715

On August 10th, the US Treasury, Federal Housing Finance Agency (FHFA), and US Department of Housing and Urban Development (HUD), issued a joint request for information (RFI) seeking ideas to address the disposition of real estate owned (REO) properties, specifically the potential transition of such properties to rentals. This RFI, along the lines of our own REBUILD proposal but more narrowly focused, addresses REO properties (not foreclosures or delinquencies) held by the GSEs and FHA (not banks or non-agency trusts). However, despite that more narrow focus, the RFI has created some momentum behind the idea of converting distressed properties into rental housing in an effort to clear the inventory backlog, as well provide additional rental housing. At the same time, it has also brought up some legitimate concerns about how such a program would actually work. In this report, we directly address some of these concerns and expand on our REBUILD proposal by providing details on how we believe it would be best to implement such a program.

Market Feedback

The feedback that we have received on our initial REBUILD proposal, along with the conversations that we have had regarding the RFI, have made it clear to us that the idea of turning the backlog of distressed housing inventory into rental properties is a good one, and receives considerable support from both sides of the ideological spectrum. In fact, the Neighborhood Preservation Act, a bill currently before the House of Representatives, essentially proposes that same idea: allowing FDIC-member banks and GSEs to rent out REO properties for up to five years. This bill is not only a bi-partisan sponsored bill, but it actually passed the House a year ago on a bi-partisan vote, even though it has not yet been taken up by the Senate. While it does not specify sales to private investors, it does show that at least the rental concept has broad appeal. In addition, the potential positive impact on job creation and the ability to address rising rents have also been well received.

That said, the implementation of this concept is where the main concerns now lie, which can broadly be summarized in two points:

1. There is a concern that the solution will not be market-based, and will instead see the GSEs and FHA become landlords, operating a business that they have no experience running, while growing their balance sheets and extending the period before being reformed.
2. The other concern is that the solution will be too unregulated, creating a free-for-all for investors purchasing properties at rock-bottom prices with little concern for rehabilitation, while leaving the taxpayer out in the cold when home prices recover and those properties are sold at a profit.

While we agree that both of these concerns are legitimate, we want to be clear that we are ***not*** proposing either one of them. First, we are not proposing that the GSEs, FHA, or any other government agency become the landlord in potential rental properties. We believe that the operations of rehabilitating, leasing and managing rental properties are best left to those whose profession it is to do such work – namely real estate investors. Second, we are also not proposing that the GSEs, FHA, banks or anyone else simply have a fire-sale and give up all financial upside without any restriction on what investors can do with their newly acquired properties.

We believe the best solution lies somewhere in the middle, and instead of focusing on what we don't want, we think it's better to focus on what we do want, and figure out a way to reach those goals. In this case, we believe that the goal should be effective ownership and management of rental properties, while retaining some upside for taxpayers if everything works out and home prices recover. Interestingly, most investors we talked to agree on both points – that they would make better owners and landlords, but that if everything works out, there will be enough of a return to pay part of it back to taxpayers for providing this opportunity in the first place. We offer more details on this idea in a later section.

Sizing the Problem and Solution

Before we get into the details of the proposal, we first identify just how large this potential program could be, by looking at the estimated number and value of REO, foreclosure and seriously delinquent properties out there. In Exhibit 1, we show this breakout at the national level.

Exhibit 1
The Size of the Problem Is Substantial

	Count	Value ($Billions)[2]
REO[1]	500,000	62.5
Foreclosure	3,160,000	395.0
90+ Delinquent	2,340,000	292.5
Total	**6,000,000**	**750.0**

1. REO counts are difficult to estimate as reporting is limited and inventory is fluid. We estimate 500K-750K units currently but use a conservative estimate to calculate value.
2. We estimate average market value at $125K per unit.
Source: FHFA, Morgan Stanley Research

Clearly, the sheer number of properties will require the participation of a large number of investors to be successful. But perhaps more importantly, the size of the problem in dollar value means that in no uncertain terms, the amount of capital required to move the needle is significant. We keep these factors in mind while developing the details of our proposal.

Details, Details

In proposing more specific guidelines for how to structure other aspects of our REBUILD proposal, we believe it is best to keep it simple. As with all restrictions on investor programs, the more onerous the restrictions, the less likely the participation of the investors, and therefore the lower the effectiveness of the program. Moreover, we believe that it's useful to see what the market will bear, and propose minimum requirements that are acceptable to most investors, so long as they conform to stated goals. This allows the requirements to simply prevent unscrupulous parties from taking advantage of the program, instead of providing guidelines so strict that they would impede the participation of more productive investors. Over the next few sections, we provide details on these guidelines and others using the framework we previously created.

REBUILD: Redevelopment

We propose the following guidelines for the redevelopment component of our proposal:

1. Minimum habitability standards based on a pre-determined set of requirements that could include safe and working appliances, plumbing and electrical systems, along with clean carpets, paint and no structural damage.
2. A maximum percentage limit on home re-sales within the first six months of a purchased pool to prevent excessive flipping while allowing investors the flexibility to manage portfolios. We recommend no more than 5%. Limiting flipping will ensure that properties do not simply all end up as inventory again in only a few months.
3. A tiered holding period schedule with maximum re-sale percentages per year for a purchased pool up to five years to help manage reintroduction of supply into the market, if necessary. We suggest 10% in the first year (including the 5% mentioned above), followed by an equal share each year following. These percentages would be subject to other program guidelines. Five years is roughly the amount of time we project it otherwise would take to clear distressed inventory and return to supply/demand equilibrium.

While some may perceive minimum standards for redevelopment to be a hurdle for investors to participate in such a program, we believe it won't prevent many investors from actually being involved. We say this because several of the institutional investors currently in the market are already doing all of these improvements. Nearly all say that those improvements are a minimum level of work and that often additional redevelopment is done to command better rents. If it is already in the best interest of the investor to make minimum improvements to maximize rent, then this restriction should not be much of a hurdle at all.

As for the holding periods and limits on flipping, the market is helping to take care of this one as well, since flipping has become more difficult now that home buyers are less plentiful, while rental demand is growing. Most investors pursuing the buy to rent strategy today already do not flip the great majority of their purchases, because they see greater back-end HPA once the market recovers. In fact, they usually have at least a 3-5 year target holding period, if not a perpetual rental strategy. Again, what seems like a restriction is more of a preventative measure.

Finally, to those who believe that restrictions of any kind would limit investor participation, we say that this is not a bad thing. We are trying to solve the issue of the distressed housing backlog productively, while avoiding other negative effects such as further degradation of housing quality or prices.

REBUILD: Bulk Sales

The bulk sales component represents the core of our proposal. While we provide expanded details, the majority of the work for creating an implementable program will need to be focused here. For now, we recommend the following guidelines:

1. GSEs and FHA would be required to adopt a bulk sales program to complement, but not replace, existing sales channels. This program will require that inventory be made available for purchase at a pool level, with pool sizes, locations and other characteristics to be determined by investor demand.

2. We recommend that bulk sales initially occur at the local (MSA) level to better align interests and capacity with existing investors. As investor capacity and operational abilities increase, bulk sales could expand in both size and geographical area.

3. We recommend a bidding process that allows investors to have “eyes on site” for each property in the pool. This would maximize information flow and therefore bid levels. Agencies would provide all information they already provide in the case of retail REO sales.

4. Bulk sales would result in a full transfer of ownership and operational rights to investors. We do not believe agencies should become landlords. To address upside participation for taxpayers, see the next bullet point.

5. Upside participation for taxpayers should be structured like a call option payout, not an equity-sharing arrangement. This has the benefit of limiting additional downside for taxpayers, while allowing for upside participation if properties are sold at a profit, and being simple at the same time. We recommend a payout as a percentage of net profit above a certain strike, to expire in 10 years. If the property is held longer, the option would expire as, effectively, that home would be permanently removed from the oversupply of owner-occupied housing, thereby benefiting the market as a whole. The actual percentage and strike should be determined with the input of investors, regulators and stakeholders, but not be so onerous as to dissuade investors from participating.

6. GSEs and FHA would also be required to adopt a bulk deed-for-lease program, in which pools of delinquent and foreclosed borrowers would be offered deed-for-lease opportunities as investors see fit. These respective properties could then be sold in bulk to those investors with tenants already in place. Details for this type of program could be complicated and would need to be evaluated separately from bulk REO sales.

7. Banks and non-agency trusts can set up bulk sales programs as they see fit, but will not be required to participate in any program. The hope is that increased investor demand and higher bid prices would make it in the best interest of other financial institutions to implement their own programs.

The bulk sales component of our proposal should be viewed as a natural extension of the level of investor activity that is already in the market. In fact, the agencies are already starting down this path, and initial bulk sales have already been completed, albeit still on a very small scale. One immediate benefit to bulk sales is removing the 6% broker fee from the recovery value equation. Therefore, even if bids don’t move, the taxpayer could recover a higher value.

The proposal that taxpayers retain some upside for GSE and FHA sales is in recognition of the fact that they effectively provided the original guarantees. In practice, the market seems willing to address this concern as well – viewing it as a tradeoff for the increased accessibility to distressed inventory, and the headaches avoided from purchasing properties piecemeal. Several investors that we’ve spoken to would support this payout, so long as it is not excessive.

We admit that the bulk deed-for-lease program is ambitious, and not likely to be an immediately implemented solution. However, agencies have also initiated pilot programs along these lines, so it is not inconceivable that scaling those programs up could occur as a follow-up step to the initial implementation of a bulk REO sales program.

REBUILD: Incentives

Before we go into details for the incentives part of our proposal, we note that tax-related incentives would likely require congressional approval. Given the gridlock in Washington, we would not expect these proposals to make their way quickly through the system. Also, as we are not tax experts, we will not opine in detail about tax effects or accounting treatments. Nonetheless, we believe they can be beneficial to this program, and therefore we include a couple of broad options here. Importantly, we note that any tax incentive should serve the purpose of increasing investor demand and therefore generating higher bids.

1. Rental income generated from properties purchased through the program would not be subject to income tax for five years.

2. Capital expenditures related to the redevelopment of properties would be allowed to be taken as a one-time deduction instead of being depreciated over time.

REBUILD: Lending Facilities

Lending facilities are an integral part of our proposal. They allow capital to be allocated more efficiently and investors to increase their bids but still hit target returns, thus resulting in better execution levels than would be available otherwise.

We believe that any institutional investor loan is best structured as a non-amortizing bullet loan similar to existing commercial real estate loans, which would better match investor needs and facilitate securitization or other exits.

There are four key lending facilities that could be considered. We describe each below with pros and cons before making our recommendation:

Lending Facility Options

1. To facilitate lending to individual or smaller investors, investor mortgages within certain guidelines could be made to be QRM (Qualified Residential Mortgage) eligible. Agency caps on investor properties for individuals could also be relaxed.

   Pros: Facilitates the non-agency and agency securitization of investor mortgages that conform to certain lending standards, thereby increasing the availability of those mortgages.

   Cons: If lending standards are too loose, investor mortgages may result in higher credit-related losses.

2. To facilitate lending to smaller investors as well as in economic development areas, investor loans could also be made to be CRA (Community Reinvestment Act) eligible.

   Pros: Facilitates lending in hard-hit areas that arguably require more investor capital to address distressed inventory issues.

   Cons: If lending standards are too loose, investor mortgages may result in higher credit-related losses

3. For institutional investors, one option for providing leverage is seller financing on the part of agencies who in our proposal would be required to participate in a bulk sales program. In this case, the agency would finance the senior part of the transaction at a fairly conservative LTV. We recommend 50-65 LTV. The investor would pay the equity component, then a coupon on the financed portion.

   Pros: Seller financing is the simplest structure, in our opinion, as the agencies already own these assets on balance sheet. Potential securitization of such loans could also go a long way in creating liquidity and moving assets off of agency balance sheets.

   Cons: Seller financing from agencies would act as a subsidy, making it effectively cheaper to purchase bulk agency properties over those held by banks or non-agency trusts. This could put those liquidation values at a disadvantage in the short term. While banks may be able to provide their own seller financing, non-agency trusts will not be able to do so.

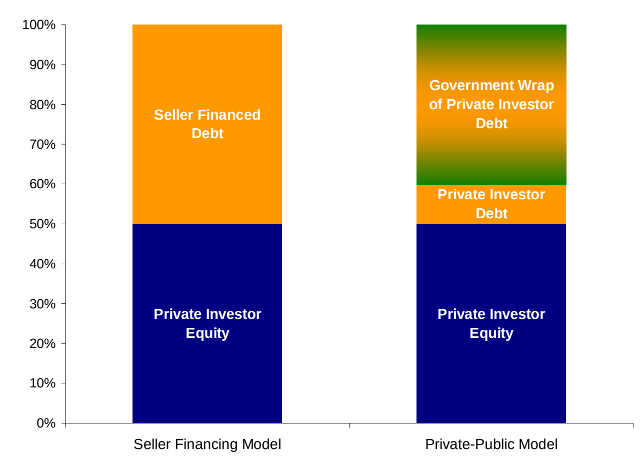
4. Another option for institutional investors would be a private-public lending facility where private investors provide the capital while a government agency provides a guarantee for the senior part of the debt. In this case, lending from the facility would be available to qualified investors who purchase any distressed properties, not just limited to those from agencies. Again, LTVs should be conservative.

   Pros: Lending would be more widely available to investors without putting distressed properties on bank and non-agency balance sheets at a disadvantage.

   Cons: Requires a government guarantee, which would put taxpayer dollars at risk, though with a significant equity cushion on income generating properties purchased at distressed prices.

Exhibit 2

Possible Capital Structures Assuming 50 LTV



Source: Morgan Stanley Research

Exhibit 2 shows potential capital structures for the facilities described in options 3 and 4, but actual attach/detach points for a government wrap would depend on market requirements.

Recommendations

For individual investors and smaller institutions, we believe investor loans can be effective even if leverage is reasonably low (<65 LTV) and limited to high credit borrowers. We see no reason why investor loans should be explicitly excluded from the QRM definition even if they are relatively safe, nor a reason why agency investor loans to individuals should be capped by quantity so long as buyers are able to put up significant equity. Similarly, conservatively underwritten investor loans in harder-hit areas that qualify geographically for CRA lending could provide a boon to the recovery in such areas without much downside. Therefore, we recommend implementing options 1 and 2.

For institutional investors, the choices are a bit more difficult. While seller financing could potentially be set up relatively quickly, it would probably have a short-term negative impact on the bids for non-agency and bank-owned distressed properties. However, in the longer term, all property values should benefit as competing inventory is removed from the market. On the other hand, private-public lending would benefit all sellers of distressed properties, but could take longer to set up and face more push-back. At the end of the day, we believe both lending programs should be pursued in parallel, with the market determining the allocation and pricing of capital.

Exhibit 3

Leverage Can Help Increase Bids

	No Leverge	50 LTV at 5%
Bid Price	100,000	132,000
Redevelopment Cost	10,000	10,000
Total Cost	110,000	142,000
Gross Rent	14.5%	11.3%
Expense Ratio	45.0%	45.0%
Net Rent	8.0%	6.2%
Cumulative HPA	40%	40%
Exit Timing	5 years	5 years
IRR	**9%**	**9%**

Source: Morgan Stanley Research

In Exhibit 3, we illustrate the possible effect of leverage on a generic investment using typical current market assumptions. It is clear that leverage can have a large impact on potential bid prices as investors aim for target returns. We understand that not all of the additional purchase power will be used to raise bids, but even if it is split between increased return and purchase power, it can have a positive impact on sale prices. We believe it is in everyone's best interest to maximize the selling prices so long as the leverage provided is safe. Other government programs that have employed this type of leverage, such as PPIF and TALF, have successfully increased the value of distressed assets.

REBUILD: Diligent Oversight

The final part of our proposal is in the hands of the government to determine which department or agency to best oversee the program. However, we do have a few suggestions on how to implement certain components:

1. Oversight of redevelopment requirements, leasing and holding periods can begin with self-reporting by investors, followed by auditing from administrators. The sheer number of properties sold will make it very difficult to inspect each individual property efficiently.

2. Oversight of fair housing laws, consumer protection programs, lending guidelines, affordable housing rules, etc., can be outsourced to the various departments responsible for oversight today. Even without bulk purchases, these departments would oversee such issues anyway, so it makes sense to utilize existing infrastructure.

Fortunately, regulators already exist to oversee various participants in the sales process, and the fact that the Treasury, FHFA and HUD have jointly sought this RFI speaks to potential cooperation on program oversight. If banks are also involved, the FDIC could potentially provide additional regulation. Assuming program requirements are reasonable and simple, oversight should not be a hurdle to success.

Measuring Success

One question that will be asked from the beginning of any program will be how success is measured. In some ways, the implementation of this program could lead to short-term changes that appear to be counterproductive. One example is that a pick-up in bulk sales would probably cause aggregate home price indices to fall sharply because the mix will shift substantially to distressed sales. We have argued that such changes have nothing to do with actual home prices, but the perception of declining prices will remain. One possible way to address this concern would be to create ex-bulk sales indices.

Another more significant example is that the increase in bulk sales could put downward pressure on non-distressed prices if they are used for comps. This issue is more subtle, since bulk sales would generally require a capital investment to make the properties inhabitable, which should factor into their use as comps. It could also be addressed by labeling bulk sales as such in the tax record, so that their effect on comps can be discounted. That said, these properties would need to be sold regardless, and if done so in an inefficient manner, they could have an even greater negative impact over a longer period of time.

Short-term fluctuations aside, we believe there are concrete measurements that can be made to determine whether the program is meeting its goals – remember that the ultimate goal is to clear the backlog of distressed inventory as quickly as possible with as little detriment to home prices as possible. The easiest way is for sellers to track their transaction prices on inventory, which they do already. Tracking these prices over time (preferably at the local level and on a price per square foot basis), would allow a measurement of the impact on prices. The sales pace is even easier to track, as monthly sales figures can be aggregated across participating sellers.

Finally, to ensure that redevelopment requirements, leasing terms and other program guidelines are being met, simple surveys of tenants who rent properties sold through this program can be administered on a periodic basis. There is no better place to get end user feedback than from end users directly, all of whom could be accessible through participating program investors.

Conclusion

While all parts of our proposal are important in our view, the components related to bulk sales and lending facilities are critical and point to the relationship between housing and housing finance, which are inextricably linked. It is crucial that any implemented solution get these two factors right.

Furthermore, given the size and scope of the issue at hand, the successful implementation of any program to address the backlog of distressed home inventory will be difficult. Taking into consideration the various concerns of stakeholders – from taxpayers to agencies to banks and investors – is no small task. The feasibility of the program will also need to be weighed against any particular interest or component. We are confident that our proposal, if implemented effectively, would benefit all at the expense of none.

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Total	**2,759**		**963**		

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Morgan Stanley

The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1)212 761 4000

Europe
20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3, Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0)3 5424 5000

Asia/Pacific
International Commerce Center
1 Austin Road West,
Kowloon, Hong Kong
Tel: +852 2848 5200