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## The Real Estate Problem is Not Foreclosures, it's Capital Utilization

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Modification proposals and programs have one goal in mind: keep the home occupied in order to reduce neighborhood spillover effects of foreclosures. The problem is – and we all know this – that many subprime borrowers cannot afford even their existing “teaser” rates. These are *subprime* mortgage teaser rates and unlike credit card teaser (zero-APR) rates or even prime mortgage rates, they can already be an unaffordable eight, ten, or even twelve percent. Furthermore, borrower types include not only speculators but also *de facto* renters, who never planned to pay down the principal balance of the mortgage and now have no market choice but a fully amortizing loan.

Policymakers know that mortgage modification plans are not a panacea, and they are very, very, afraid. Indeed, they should be, because modification is an incomplete solution to a very real economic problem: that of keeping capital – whether that be industrial machines, factories, or houses – utilized and therefore sustaining economic growth. Leasing, a common solution in many durable goods markets, can provide solutions that better maintain capital utilization without the moral hazard effects of mortgage bailouts.

### MODIFICATIONS DO NOT ADDRESS THE REAL ECONOMIC PROBLEM

The capital utilization problem is very important for economic performance. According to Kiyotaki and Moore (“Credit Cycles,” *Journal of Political Economy*, Vol. 105, No. 2, April 1997, formerly NBER Working Paper No. W5083 at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3914](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3914) ) and Anari, Kolari, and Mason (“Bank Asset Liquidation and the Propagation of the Great Depression.” *Journal of Money, Credit, and Banking*, August 2005 (37:4), pp. 753-773, formerly Wharton Financial Institutions Center Working Paper No. 02-35 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=326782](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=326782) ), a high outstanding inventory of unsold assets seized from firm or household bankruptcies can lengthen and deepen economic recessions. The effect is sensible: economic growth will falter until capital can be reallocated to its most productive use. Too many loan workouts can leave capital equipment in the hands of uneconomic producers, extending economic malaise.

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Viewed through the lens of capital utilization, therefore, the problem is not how to *avoid* foreclosures (perhaps to the chagrin of the speculators and the renters), but how to *better manage* foreclosures and sales to maintain property and neighborhood values and avoid neighborhood spillover effects by keeping homes occupied. More importantly, in that more general sense the problem takes on a much more straightforward and manageable form, and one that is commonly dealt with in the financial literature.

According to Mason (“A Real Options Approach to Bankruptcy Costs: Evidence from Failed Commercial Banks during the 1990s.” *Journal of Business*, July 2005 (79:3), pp. 1523-53, formerly Wharton Financial Institutions Center Working Paper No. 02-20 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=326783](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=326783)) the problem works as follows. Capital is underutilized while it awaits sale and reallocation. But owners of nonperforming assets have an option to sell now or to wait until they think markets might improve. The value of the option to sell those nonperforming investments is fueled by higher volatility and lower interest rates.

But higher volatility (a result of the magnitude of the market decline) and lower interest rates (a result of stimulative monetary policies) increase the value of *waiting*. Hence, deep market declines followed by low interest rates can be followed by rational waiting to sell capital and incorporate it into economic growth. Until assets are sold on secondary markets and put to productive use, economic growth suffers. Certain types of firms lease their products, rather than sell them outright, to avoid the pricing pressures that can result from those dynamics.

#### **WHY DO FIRMS CHOOSE TO LEASE INSTEAD OF SELL THEIR PRODUCTS?**

One important question in the financial literature is the leasing puzzle: why do some firms lease their products rather than sell them outright? The answer seems to be that firms that produce large-ticket durables whose resale can artificially pressure primary market prices (precisely the problem we face with real estate markets today) choose to lease in order to control the secondary market price.

The primary examples of leasing are mainframe computers and aircraft. It is widely held that IBM leased mainframe computers because the resale value of used computers could suppress the retail value of newly-introduced models. In aircraft, leasing companies would rather park older used jets in the Nevada desert than flood the relatively thin secondary market with used aircraft.

The problems of market depth and secondary market efficiency also affect real estate. Often people think that the sale of a foreclosed home is similar to the typical home sale: list the home on the market and wait for an offer. Sometimes that is true. But more often than not the home is auctioned for cash. Auctions of individual properties, one-by-one, are grossly inefficient. That inefficiency often detracts from the economics of large institutional investors, who could otherwise

purchase many homes at once and offer them for sale or lease in order to keep them occupied.<sup>1</sup>

### LAND TRUSTS, LEASING, AND REAL ESTATE

Real estate satisfies the basic criteria for a product to be leased: it is a large-ticket durable whose capacity can suppress market prices in a cyclical downturn. In fact, therefore, one does find that leasing is commonly used for commercial real estate and is growing in the residential market.

Real Estate Investment Trusts (REITs) are common in commercial real estate. A REIT aggregates investor capital to buy numerous commercial properties, which it then rents out to occupants. The REIT management looks after property maintenance and upkeep, as well as occupant billing and collections and other issues. The REIT returns earnings above financing costs to investors, providing them an attractive rate of return. All in all, a simple business enterprise.

There is no reason why, besides the aggregation problem, that residential real estate can't be handled similarly. Indeed, faced with high returns investors are already active in Florida, purchasing homes from both developers and banks despite the inefficiencies of the common auction system. The fund strategies are simple: "Buy new homes cheap, rent them for a few years and sell them at huge markups when the real estate market inevitably rebounds," (James Thorner, "Funds picking over bones after collapse," *St. Petersburg Times*, December 17, 2007). In general, the funds are offering homebuilders about 70 cents on the dollar for unsold new construction and offering banks about 40 cents on the dollar for foreclosures.

Recent investment offerings include an "'REO pool' of 30 Tampa area homes worth \$5-million. The pooler promises the fund will increase in value. In a few years, those homes could be worth a collective \$7.5-million, a gain of 50 percent. Another Tampa Bay area developer said the amount of private equity chasing cut-rate real estate is staggering. A few years ago a \$250-million fund was an impressive fund. Nowadays you hear a group's assembled \$1-billion and you say, 'That's all?'" (James Thorner, "Funds picking over bones after collapse," *St. Petersburg Times*, December 17, 2007).

In neighborhoods and cities that are not as attractive as Florida, real estate land trusts sometimes purchase vacant properties and lease them to occupants at attractive prices, sometimes through rent-to-own agreements. The land trusts are usually "...private nonprofit corporations created to acquire and hold land for the benefit of a community and provide secure affordable access to land and housing for community residents. In particular, [many of these land trusts] attempt to

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<sup>1</sup> Furthermore, small investors typically do not want to be landlords, with the accompanying legal risks and costs. But large investors can benefit from economies of scale in property management and are more willing to rent properties until they can be sold in the subsequent economic recovery (which will come).

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meet the needs of residents least served by the prevailing market,” (see NeighborWorks America at <http://www.nw.org/Network/newsRoom/pressReleases/2006/netNews072006.asp> ).

In some arrangements, such as those in the Community Land Trust network, “...improvements on community land trust property such as single-family or apartment dwellings are privately owned and can be bought and sold within certain terms, but the land remains under the ownership of the trust,” (*ibid*). In others, like the Cuyahoga Community Land Trust, the focus is on home ownership, promoting “...secure and stable homeownership for lower-income families. [Cuyahoga Community Land Trust] reduce[s] the risks associated with homeownership for both homebuyers and their neighborhoods by offering quality homes at substantially reduced prices, assisting [their] clients to qualify for healthy mortgages, and maintaining the affordability of the homes [they] sell,” (see Cuyahoga Community Land Trust at <http://www.cclandtrust.org/> ).

In a survey of community land trusts nationwide, the National CLT Network found that just two CLT mortgages had gone into foreclosure in 2007 (see the Community Land Trust website at <http://www.cltnetwork.org/> and the Cuyahoga Community Land Trust website at <http://www.cclandtrust.org/News.asp?id=57> ).

#### SUMMARY

The big question is, therefore, how capital can be directed to private funds and land trusts to address the current market need. Capital is already flowing to private arrangements, but can be helped by a regulatory recognition that such investments are both socially worthy as well as reasonably safe and sound, perhaps enough to justify bank investment. Land trust investments can be similarly encouraged and incentivized.

The mortgage crisis has numerous structural causes. Quick fixes, therefore, will leave the structural problems that caused the crisis in place, sowing the seeds of both moral hazard and future problems. *Real* structural solutions, on the other hand, can create improvements that will outlast the present need. For instance, land trust and leasing arrangements will provide market liquidity that can help avoid another mortgage crisis. Furthermore, land trust arrangements have proved particularly useful in overly-expensive areas that have outpriced middle-class workers who provide important services to the community.

Encouraging real estate leasing, therefore, whether through private sector or land trust arrangements, has the capacity to improve real estate market functionality in ways that will continue to smooth real estate market fluctuations well into the future.