

## House Committee on Oversight and Accountability

### Subcommittee on Health Care and Financial Services

#### “Health of the Commercial Real Estate Markets and Removing Regulatory Hurdles to Ensure Continued Strength”

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#### **Introduction and Topic**

Chairwoman McClain, Ranking Member Porter, and distinguished members of this subcommittee, thank you for the opportunity to address you today on an important aspect of the issue at hand. At the same time many communities have seen greater vacancies in office buildings, stores, and other commercial properties the nation is several years into a substantial housing shortage - and in particular an affordable housing shortage.

#### **America’s Housing Shortage**

The problem is not new. Housing production has not kept pace with demand. After overbuilding and the burst of the housing bubble in 2007, production fell by over a third. Estimates of the current shortage are generally between 2 and 4 million units. But that number grows as housing production continues to lag new household formation.

According to the latest American Community Survey from the U.S. Census Bureau, almost 41 million households are considered “housing cost burdened<sup>1</sup>,” meaning they pay more than 30% of their gross income for housing. That's just under one third of the country. Over half of renters and 19.1 million homeowners are housing cost burdened.

In the last 15 years, we have completed roughly 1 million new housing units per year. In the 15 years prior to that, we averaged almost 1.6 million. We actually have not fared as well in producing affordable units and starter homes. There are 43 million rental households, but fewer than 14 million pay \$1,000 per month or less.

For purposes of this discussion - the conversion of commercial space to housing units, the most relevant figure is likely in the middle income bands. Half of households making

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<sup>1</sup> U.S. Census Bureau. "Selected Housing Characteristics." American Community Survey, ACS 1-Year Estimates Data Profiles, Table DP04, 2022, <https://data.census.gov/table/ACSDP1Y2022.DP04?q=2022 DP04&moe=false>. Accessed on April 29, 2024.

between \$35,000 and \$49,999 pay more than 30% of their income for housing<sup>2</sup>. Amazingly, one-third of households making between \$50,000 and \$74,999 per year are housing cost burdened. This is no longer a problem only of those in poverty (though it hits them particularly hard) - it is a problem well into what would be considered the middle class.

### **What to say about interest rates or inflation?**

There is no question that higher mortgage interest rates are hampering the effort to reduce the housing cost burden – and uncharacteristically – to reduce the sale price of starter homes. Borrowing costs make production and purchase of housing more expensive. Over the past 50 years, the 30 year mortgage rate has averaged just over 7.7% - today's rates are about half a point lower. Usually the sale price of homes drops when mortgage rates rise. However, we are currently seeing a substantial drop in current home sales as owners are reluctant to pre-pay their pandemic-era mortgages with rates at 4% or less. The lack of supply is driving up home prices even with higher mortgage rates.

It is overly simplistic to say that adding any type of housing is helpful. To the greatest extent possible, the country needs new housing units that immediately serve lower income and middle class families. But there is value in adding housing - increasing the supply - where current units become more affordable as their occupants move. The process termed “filtering” in housing is a long-standing way that more affordable housing was created. In filtering, as a property ages and new properties are available in the market, an existing property usually lowers its prices - creating opportunities for families who could not previously afford them.

### **Conversions**

The idea of converting a different type of building to housing is not new. Former office buildings, department stores, hotels, and schools have been converted to housing. Conversions have spanned the spectrum from luxury condominiums to homeless shelters. There is an important difference, though, between most of those conversions in the past to the ones we may discuss today. Typically, the building being converted is vacant and has been for many years.

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<sup>2</sup> U.S. Census Bureau. (2022). Financial Characteristics. American Community Survey, ACS 1-Year Estimates Subject Tables, Table S2503. Retrieved April 29, 2024, from <https://data.census.gov/table/ACSST1Y2022.S2503?q=2022.S2503&moe=false>.

The conversion of current commercial properties (primarily office space) brings a new set of challenges and opportunities. There is an urgency here that is not typically a factor. As a country we have an urgency to create housing. Communities have an urgency to re-populate or preserve commercial buildings that were key to thriving downtowns or suburban economic hubs. Owners and lenders have an urgency to preserve the maximum possible value of an asset. There is an urgency to maintain some level of a tax base and to continue to fully use public assets like transportation, greenspaces, and even parking facilities.

Conversion on the scale that is needed by many stakeholders is greater than we have seen.

### ***Environmental Benefits***

Where conversion to housing is possible, the assets hold great potential. Even older office buildings are often more energy efficient and climate resilient than freestanding homes built in the last few years.

- Building standards and materials have been more resilient - while wood frame is still the dominant method of low density housing, commercial real estate relies more on concrete and wood.
- Air quality in commercial buildings has been regulated by evolving OSHA standards going back to 1970 while the latest EPA practices for single family homes are recommended practices for state and local governments.
- Almost 30% of greenhouse gas emissions in the U.S. are from buildings. By rehabilitating existing structures, rather than adding units by new construction, the this sector could produce 50 to 75 percent fewer carbon emissions<sup>3</sup>.
- Much of this, simply, can be explained by the lack of materials and construction effort in completing the exterior envelope.

### ***Feasibility***

Few days go by without at least one article in my newsfeed saying commercial to residential conversion is either the ultimate solution to problems facing both

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<sup>3</sup> White House brief, October 23,2023 Commercial-to-residential Conversion: Addressing Office Vacancies, <https://www.whitehouse.gov/cea/written-materials/2023/10/27/commercial-to-residential-conversion-addressing-office-vacancies/>

industries or a naive fantasy that doesn't account for the substantial hurdles involved.

No doubt the truth lies somewhere in between. There are asset and market specific considerations. There are constraints to residential conversion as the Panacea.

- Floorplates do not lend themselves well to traditional apartment layouts (distance from windows)
- The per-square foot charge for office space (in most markets) substantially exceeds that of for-sale or for-rent housing
- Plumbing and electrical connections are very different for offices than residential (especially bathroom configuration)
- Scale is an issue - though suburban office parks have been studied much too little as it relates to conversion
- Only a subset of potential renters / buyers would be interested in a non-traditional product
- Common area expense in CRE properties are usually substantially higher than residential

### **Efforts of the Biden Administration to Improve Housing Affordability**

The Biden administration has prioritized making housing more affordable - especially by increasing housing supply - using different methods to fit the needs of diverse communities across our country. The administration also recognized "the unprecedented level of commercial vacancies across the United States," in October publishing the first version of a guidebook to federal resources for conversion of commercial properties to residential to address an unfolding situation. It's helpful to understand those resources as a first version - a strong signal of the seriousness the administration places on current both CRE problems and a re-commitment to affordable housing.

### **Response to Conversion**

In a letter of April 15, Mr. DeBoer and the Real Estate Roundtable both thanked the White House Council of Economic Advisers for understanding the need for these

conversions and offered specific suggestions on ways to improve and expedite the process<sup>4</sup>.

Many of these suggestions are sensible. They could help direct evolving policy in the right way. The United States is attempting to produce housing from commercial real estate on a compressed timeline and at a volume unlike before. Mr. DeBoer's letter said, "candidly, the Federal Guidebook's featured programs have not lived up to their promise – yet."

To properly accomplish this, there is a real need to expand the toolbox from the federal government to local communities.

- With existing and any new incentive programs, there is a need to minimize time lags -
- As Mr. DeBoer points out, many current programs do not actually have dedicated affordability components - and those that produce affordable housing directly should be prioritized with preferential treatment in certain programs.

### **Closing**

Thank you for the opportunity to speak with you about our country's need to expand housing and ways in which part of that need can be met with the shared goals of leaders of the commercial real estate industry.

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<sup>4</sup> RER letter dated 15 April 2024 - [https://www.rer.org/wp-content/uploads/FINAL\\_041524\\_Bernstein\\_Conversions\\_Letter.pdf](https://www.rer.org/wp-content/uploads/FINAL_041524_Bernstein_Conversions_Letter.pdf)