Acquiring Privately Held REO Properties with Public Funds: The Case of the Neighborhood Stabilization Program

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The Neighborhood Stabilization Program (NSP) was authorized by the Housing and Economic Recovery Act of 2008 for the stated purpose of assisting states and local governments redevelop abandoned and foreclosed homes and residential properties. Its establishment was an acknowledgment that the negative effects of the foreclosure crisis are not limited to households that lose their homes and the banks and investors that own these mortgages, but also spill over to the jurisdictions and neighborhoods where foreclosed properties are located. The U.S. Department of Housing and Urban Development (HUD) was assigned responsibility for the program, which was initially funded at $3.9 billion.[2] HUD allocated program monies directly to states and to certain Community Development Block Grant entitlement communities,[3] based on the magnitude of the foreclosure problems faced, using a formula that incorporated several indicators of such problems.[4] States, in turn, developed systems to distribute their allocations among their jurisdictions,[5] thereby creating a group of indirect grantees.[6] Within grantee jurisdictions, funds were to be targeted to areas with the worst problems. All grantees, whether funded directly or indirectly, were required to obligate all funds within 18 months of the date that HUD released these monies.[7]

NSP funding could be used for five types of activities:

- Establishment of financing mechanisms, such as down-payment assistance, for the purchase and redevelopment of foreclosed residential properties
- Acquisition and rehabilitation of abandoned or foreclosed residential properties with the aim of restoring them to residential use
- Creation of land banks for homes that have been foreclosed on
- Demolition of blighted structures
- Redevelopment of demolished or vacant properties.

Effective implementation of several of the items on this list requires that jurisdictions, or the entities and individuals with whom they partnered,[8] have access to REO properties. Further, since REO properties have commonly changed hands through private-market transactions, it is important that jurisdictions and their partners understand and be able to carry out the steps involved in these transactions.

This article focuses on the challenges faced by NSP grantees in purchasing privately-held REO properties within program parameters that require, for example, that grantees acquire properties at a discount from market value. We use quantitative and qualitative survey data collected from program administrators of more than 90 direct and indirect NSP grantees;[9] these data were gathered as part of a project on the planning and early implementation of NSP undertaken by researchers in the Federal Reserve System's Community Affairs offices. REO acquisition is explored primarily in the context of acquisition and rehabilitation (A&R), the NSP-eligible activity most frequently included in these grantees' NSP plans.

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The Context: Grantee Acquisition and Rehabilitation Activities[10]

More than 90 percent of the surveyed program administrators indicated that their NSP program included an A&R component. Many reported this activity was the most necessary in dealing with the impact of the foreclosure crisis. More specifically, some indicated that A&R was best suited to deal with the single-family properties and blighted stock that comprised a large share of their communities' foreclosure inventory, while other respondents viewed A&R as a means to restore older housing stock or to increase the community's supply of affordable housing.

Although about three-quarters of grantees had at least some past experience with A&R activities, about half of grantees indicated that their NSP acquisition and rehabilitation activities constituted a new program. Almost a third more indicated that at least some of their A&R activities were new.[11] Yet, despite the role of A&R activities in almost all respondents' programs, along with the stringent timeframe of the Neighborhood Stabilization Program, five to seven months into their A&R activities, only 53 percent of grantees had purchased at least one property for rehabilitation. This suggests the possibility that many respondents encountered difficulties in their attempts to complete REO transactions.

Challenges to Acquiring REO Properties from the Private Sector

Success in implementing A&R activities under NSP required success in accessing REO properties. NSP grantees and their partners had to be able to identify REO properties and to negotiate purchase prices below properties' market values,[12] as required by the legislative language for NSP. Congress left it to HUD to specify the size of the price discount, which HUD initially set at 5 percent for individual purchases, with a required 15-percent aggregate discount for the entire portfolio purchase.

Competition from the private sector. The required discounts were soon dropped to 1 percent for individual purchases and no aggregate discount requirement.[13] However, the comparatively high discount in HUD's initial regulations suggests the belief at that time that acquisition of REO properties would be relatively easy: If, for example, there was little private-sector demand for these properties, then one might expect that the institutions that held them would be willing to sell the properties at a discount. This may have been the case when NSP legislation was written. What NSP grantees found as they began to implement their programs, however, was often quite different. Instead of undertaking activities that the private sector had opted out of—as often happened with publicly sponsored redevelopment and rehabilitation efforts—many grantees found themselves in competition with private-sector investors, a phenomenon that was widespread across different types of housing markets with different underlying sources of foreclosure problems. Moreover, NSP grantees often found themselves at a disadvantage in the competition.

Locating REO stock. At the most basic level, many grantees cited problems in identifying REO properties. In part, this may have reflected a lack of experience with REO acquisition, or start-up problems with new forms of acquisition programs, as statistics presented in the previous section suggest. Even grantees with considerable acquisition experience may have been inexperienced in acquiring REO properties, and lacked channels of communication with the entities that held them. Adding to the difficulty in identifying a potential pool of properties, any individual lender might have relatively few REO holdings in a particular community. However, many NSP grantees felt that their difficulties went beyond such logistical problems; rather, they sensed REO holders' reluctance to work with them. Grantees cited a need for greater transparency concerning who held the properties. They also believed that these holders should release more properties for purchase. One grantee reported that asset managers at national-level banks were often uncooperative; another cited a similar problem with local banks.

Making the deal: Hurdles posed by federal requirements. Reluctance on the part of REO holders to work with NSP grantees and their partners probably did not arise simply because private investors provided an alternative purchaser for their properties, but also because REO holders often preferred the terms on which they dealt with these private investors. Unlike NSP grantees, private investors often paid in cash. Furthermore, NSP grantees were subject to a wide range of federal requirements that made them slower than their private competitors in responding to opportunities, narrowed the range of properties that they could consider, and limited the amount that they could pay.[14] In some cases, these requirements also caused extra work for the entity holding the REO property.

Among the federal regulations, one stipulating that a property receive an environmental review before a grantee or one of its partners could purchase it was cited particularly frequently by program administrators as a deterrent to property acquisition. A number of grantees complained that, because holders of REO property would not allow for contingencies in purchase contracts, a potential purchase might be lost to an investor during the time it took to complete the review. Two other requirements—one concerning protection of tenants living in a property at the time it was foreclosed on, and another requiring that for a property to be classified as "abandoned" it must have been vacant for at least 90 days (among other conditions)—required certification and paperwork from the property holder in order to qualify for purchase with NSP funds. Property holders often did not know whether these requirements had been met and, in the case of the 90-day vacancy requirement, a number of grantees noted that the property holders were slow to return paperwork.

The requirement that properties be bought at a 1-percent discount from market value, while much less onerous than the 15-percent aggregate discount initially included in program regulations, was still problematic for a number of grantees, who noted that banks were reluctant to sell at below-market prices. One grantee noted that banks were reluctant to sell even at market value if that was less than the outstanding loan amount. Another grantee suggested that the discount itself was not the problem, since REO purchasers tend to buy at a discount; rather, the heavy-handedness with which the discount requirement was imposed in NSP was the problem. Some program administrators noted that REO holders' lack of knowledge and understanding of NSP regulations added to grantees' difficulties in acquiring such properties. The task of educating REO holders, one pointed out, might have been assigned to HUD, but instead had fallen to the grantees themselves.

Other obstacles. The competitive disadvantage caused by federal NSP requirements was exacerbated by local requirements and practices. For example, one grantee noted that a conservative approach to property acquisition by his community's legal department had slowed the implementation process. In another community, stringent local standards for publicly financed rehabilitation put the grantee at a potential disadvantage to a private investor, who did not have to incur the costs associated with those standards and might therefore be willing to pay more for the property. Indirect grantees, because they received funds from their states, might face additional requirements, developed by the state NSP program, that could further delay the property acquisition process.

In addition to the challenges facing grantees in navigating private REO channels, problems sometimes arose when grantees tried to acquire foreclosed properties held by the Federal Housing Administration (FHA). In part, this occurred at least initially because of differences in the way particular requirements—such as environmental review—were implemented. In addition, FHA regulations might affect how an NSP grantee looking to purchase FHA properties could design its program. Two NSP grantees complained that FHA field staff had not made it easy to learn about the agency's REO assets.

Responding to the Challenges

In response to the widespread difficulties NSP grantees encountered in their attempts to acquire REO property, HUD and, in some cases, other entities such as state and local governments, made changes to the framework in which NSP operated, while NSP grantees made adjustments to their programs. For example, in addition to decreasing the size of the required discount in purchase price soon after the program got underway, HUD also broadened the definitions of "foreclosed" and "abandoned" used in determining whether a property was suitable for purchase with NSP funds.[15] At the local level, certain regulations were adjusted for purposes of implementing NSP in some jurisdictions.

Grantees also identified steps that holders of REO properties might take to increase grantees' ability to purchase suitable properties, including arrangements for "first looks" at properties, multiple-lender registries, and allowing for contingencies in contracts. The National Community Stabilization Trust was established specifically to implement a number of these steps; as that organization got off the ground, some NSP administrators reported that it had become an effective channel for indentifying REO properties. (See also in this publication "Acquiring Property for Neighborhood Stabilization: Lessons Learned from the Front Lines," by Craig Nickerson.)

Meanwhile, many grantees, faced with the 18-month deadline for obligating NSP funds and uncertain about the likelihood or timing of changes to program regulations or the easing of other problems, took a number of steps they felt were critical if they were to meet their goals. They paid more—often considerably more—for properties than they had planned. They also bought properties that had greater rehab costs than anticipated, because of investors' tendency to get the REO properties in better physical condition. These higher costs obviously reduced the number of properties overall that could be restored with NSP funding. In some cases, grantees decreased (and, in at least one case, abandoned) their targeting in order to increase the size of their potential purchase pool. One community hired realtors to identify any potentially eligible property within its jurisdiction below a specific, relatively high, price. In effect, marketplace realities—particularly in the context of a short program timeline—meant that in a number of cases, NSP grantees needed to revise their goals.

Implications for Policymakers

As a number of grantees noted, start-up problems are a feature of any new program. In the case of the Neighborhood Stabilization Program, these typical start-up issues were exacerbated by the program's short timeline, by its designation by HUD's Inspector General as a high-risk program, and by frequent changes to HUD regulations. Certainly, balancing the need for quick action (as was the case in stabilizing neighborhoods affected by foreclosure) with sufficient time for communities to move along a learning curve for a new, complex, and risky undertaking is a topic that deserves consideration independent of the specifics of any particular program. However, many of the issues that have arisen in the implementation of NSP are specifically related to program substance. Two such issues arise from the role that acquisition of REO properties from the private sector played in program implementation; both have implications for policymakers.

First, we discuss the need for greater awareness of private market conditions and concerns in designing a program where the public–private interface is critical. It is important to remember that NSP is a statutorily mandated federal program and, as with many such programs, legislative language and requirements do not always reflect the practicalities of program implementation. While the agencies charged with developing regulations to make programs operational may attempt to better account for real-world considerations, as HUD did when it required that NSP funds be *obligated* rather than *spent* within an 18-month period, an agency's ability to do so is ultimately constrained by legislation. HUD was further constrained by the very short period it was allowed to get the program underway.[16] Many of the steps suggested below as means for building greater awareness of private-market conditions may not have been feasible, given the period allotted for the program.

Based on our survey of program administrators, federal policymakers and program officials might have taken some additional steps in designing and implementing the program to help overcome private REO holders' reluctance to participate. For example, background research on the REO market, including how it works and how it changes over time, would have been useful.[17] Consultation with REO holders of different types (lenders and servicers with a national market, local banks, GSEs) while developing the regulations could have eased program implementation, to the extent that such consultation is allowable.[18] A number of grantees suggested it would have been useful if HUD had provided education about the NSP program to REO holders. In addition, technical assistance to NSP jurisdictions on operating in this part of the private housing market might have lessened some of their start-up problems. Finally, while many of these suggested steps focus on ways to facilitate interactions between NSP grantees and the private sector, better coordination with other federal programs, particularly FHA, is also needed.

At a broader level, policymakers may want to consider the roles played by public and private investors in markets where both are active. In particular, one would like to know whether the role of the private investor supports or conflicts with the neighborhood stabilization process. For example, investors might buy cheap properties, make very superficial repairs, rent the properties out for a few years, and then walk away when they were no longer profitable. Such activity is clearly very different from that envisioned for NSP. On the other hand, investors might buy the "best" foreclosed properties, do limited rehabilitation as needed, and then rent them out and maintain them until the housing market rebounds and the properties can be sold for a profit. In this scenario, NSP grantees, by plan—or by necessity if private investors are more adept at getting the best properties—might purchase properties that need more rehabilitation, but where investment is justified by social, if not private, benefits. Public and private investment would complement each other in this circumstance. In a third scenario, public and private investors might purchase very similar properties. This raises the interesting question of whether similar public and private purchases can lead to different long-term outcomes for properties and neighborhoods, taking into account differences in the scale of rehabilitation; the buyer/renter status of post-rehabilitation occupants; and the conditions—such as pre-purchase counseling—that some homebuyers must meet.

The *particular* scenarios that occur are very likely to depend on the underlying nature of the housing market; one might expect the first example to occur in older communities with declining population, while the second would be more likely in communities where population growth would be expected to push up housing prices within a relatively short period of time. By better understanding when the actions of private-market investors are likely to promote neighborhood stabilization and when these actions are likely to undermine it, policymakers will be better able to target limited public funds in the future.

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Federal policymakers and program officials could take additional steps in designing and implementing the program to help overcome private REO holders' reluctance to participate.

Endnotes

[1] This article has its origins in a research project on the Neighborhood Stabilization Program jointly undertaken by researchers across the Federal Reserve System's Community Affairs departments. The author would like to acknowledge the contributions of Fed colleagues who, through their extensive fieldwork for the project and as authors of a report on the project as a whole, have supported the writing of this article. Dan Gorin and Karen Leone de Nie deserve particular recognition.

[2] A second round of funding, $2 billion, was included in the American Recovery and Reinvestment Act of 2009. The successive rounds of funding are commonly known as NSP 1 and NSP 2. Although both programs operate under the umbrella of the Community Development Block Grant Program, some program requirements, as well as the method for allocating funds, differ. In this chapter, we confine discussion to the NSP 1 program, which we refer to simply as NSP.

[3] The Community Development Block Grant Program provides annual funds for community development activities to larger cities and urban counties on an entitlement basis.

[4] In developing the formula, HUD incorporated—but did not limit itself to—criteria specified in the program's enabling legislation.

[5] Some states awarded funds to nongovernment entities as well as to local governments.

[6] A direct grantee is also allowed to receive indirect funding, depending on the way a state sets up its allocation system. As NSP was implemented by HUD, only entitlement communities whose formula allocation would be at least $2 million received direct grants; not surprisingly, states like Florida, where the crisis has been most severe, have many direct grantees; other states, including some with large numbers of entitlement communities, have very few. States received a minimum allocation of $20 million. Once designated, direct grantees (states and some Community Development Block Grant Program–entitlement communities) had to submit an application describing their NSP programs to HUD and gain approval for them before actually receiving funding, while candidates for indirect funding submitted applications to their states.

[7] Based on the release date, funds must be obligated by September 2010. Under the terms of HERA, all funds were to be *used* within 18 months, but HUD regulations softened this provision to an 18-month obligation requirement.

[8] The term "partner" is used broadly here. It includes not only nonprofit and for-profit organizations, but also homebuyers who, under the terms of a number of NSP plans developed by funded jurisdictions, identify foreclosed properties for purchase and come to the jurisdiction for purchase or rehabilitation assistance.

[9] The sample was not chosen to be statistically representative of all NSP grantees. However, the communities in the sample show considerable variation along the dimensions of region, size, and jurisdiction type.

[10] A copy of the data collection protocol is available from the author. A full report on the research project and its findings will be available in a report scheduled for completion later this year.

[11] Grantees often had more than one A&R component in their NSP programs.

[12] In this article we do not consider the process by which "market value" is set, although we note that determining this in the context of a "post-bubble" housing market may be problematic.

[13] The regulation implementing this change was published in the *Federal Register* in mid-June 2009, about three months after HUD signed agreements with direct grantees. Difficulty in acquiring property at the higher discount rate was one of several factors cited for the change; another was the potential negative impact on neighborhood house prices if NSP properties were purchased at prices below market value.

[14] Some of these requirements were associated with NSP in particular, some with federal housing and community development programs more broadly and, in at least one case, protection of tenants living in properties that were foreclosed on, the requirement applied to anyone undertaking the relevant housing market activities. In addition to requirements affecting the ease with which REO properties could be acquired, grantees identified a number of other problematic requirements associated with the program. Several grantees also noted that HUD's frequent changes to the regulations added to the difficulty of implementing NSP. Finally, because HUD's Inspector General had designated NSP as a high-risk program, and thus one that would receive particular scrutiny, a number of grantees felt particular pressure to ensure that they were in compliance with all regulations, a factor that may have affected the speed of implementation in some cases.

[15] HUD also issued frequent clarifications of regulations. For example, it clarified the situations in which grantees could enter into conditional contracts for purchase of a property prior to completion of an environmental review.

[16] HUD's frequent changes and clarifications to its initial NSP regulations likely reflect the short period given to the agency in NSP's enabling legislation to get the program underway.

[17] Of course, the REO market, and the private housing market more generally, have been changing rapidly since the legislation mandating NSP was put into place; it is unlikely that all of the changes could have been anticipated or that it would be possible to respond to all them in a manner that did not itself cause some disruption in program implementation. But a better understanding of the REO market by both HUD and its grantees, along with better tracking of market changes, might nonetheless have smoothed the implementation process.

[18] We note that such consultation would likely have been useful not only on acquisition provisions, but also on provisions related to homebuyer aids, such as down-payment assistance or assistance with rehabilitation. For example, banks that tightened lending standards in response to the crisis may be leery of providing mortgages to buyers when a large part of the down payment does not come from the buyers' own resources or when the house for which the mortgage is provided needs considerable repair work.