

REO & Vacant Properties

Strategies for Neighborhood Stabilization



Features

- REO markets and how they operate
- Keeping properties occupied despite delinquencies
- Stabilizing neighborhoods after foreclosures

Research and Commentary from

- Nonprofit and municipal practitioners
- Federal Reserve, academic, and policy researchers
- Private sector partners

REO&Vacant Properties

Strategies for Neighborhood Stabilization

A Joint Publication of the Federal Reserve Banks of
Boston and Cleveland and the Federal Reserve Board

The views expressed here are those of the editors and
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Letter from Presidents Rosengren and Pianalto and Governor Duke

Foreclosures are the hard reality of the housing crisis. In 2009 alone, roughly 2.5 million homes received a notice of foreclosure, according to the Mortgage Bankers Association. That represents a nearly 25 percent increase from already-elevated 2008 levels and is far higher than previous years. Given the magnitude of these numbers, the question then becomes how best to help communities, particularly low- and moderate-income communities, where foreclosed properties are concentrated.

The purpose of this volume is to shed light on the problem of vacant and abandoned properties in the hands of lenders who have foreclosed but continue to hold them as real-estate-owned (REO) on their books. We have asked a variety of experts to address such questions as

- What are the key challenges faced by communities as the REO inventory grows?
- What do the data tell us about REO markets?
- What incentives influence buyer and seller decision-making?
- What strategies guide community, municipal, and nonprofit responses?

This collection of work examines field-tested solutions for neighborhood stabilization, such as code enforcement, maintaining occupancy through tenants, and land banking. It reports on ongoing programs such as the federal Neighborhood Stabilization Program and a national “first look” program for community-minded buyers. The volume also examines unintended consequences and proposes new solutions.

We are pleased to present this volume as a joint effort of the Federal Reserve Banks of Boston and Cleveland and the Board of Governors that is part of a broader Federal Reserve initiative to address the impacts of foreclosures on individuals and neighborhoods. We hope you find the publication useful and pass on its lessons.

Eric Rosengren
President & CEO
Federal Reserve
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Sandra Pianalto
President & CEO
Federal Reserve
Bank of Cleveland

Elizabeth Duke
Governor
Federal Reserve
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About the MORE Initiative

Since the start of the financial crisis, the Federal Reserve System has undertaken a series of unprecedented actions to help stabilize the mortgage and financial markets and promote economic recovery. What is less well known is that the Federal Reserve has also been working to respond to the foreclosure crisis on “Main Street,” leveraging the System’s research, community affairs, and supervision and regulation functions to support innovative foreclosure prevention and neighborhood stabilization strategies at the local level. In the spring of 2009, the Federal Reserve’s Conference of Presidents embarked on a collaborative effort to bring to bear the substantial expertise and knowledge of mortgage markets across the Federal Reserve System. Under the auspices of MORE—the Mortgage Outreach and Research Efforts initiative—the 12 Federal Reserve Banks and the Board of Governors have worked together determinedly, leveraging the System’s expertise to inform and engage policymakers, community organizations, financial institutions, and the public.

This publication, *REO and Vacant Properties: Strategies for Neighborhood Stabilization*, is one of numerous MORE-sponsored projects designed to promulgate best practices and innovative programs for local communities and individuals who are working to improve the conditions of neighborhoods that have been affected by high rates of foreclosure. Information on other MORE projects, including foreclosure toolkits and other valuable information for borrowers and community organizations, can be found at www.chicagofed.org and the Web sites of each of the Federal Reserve Banks.

The MORE initiative demonstrates the Federal Reserve’s commitment to ending the foreclosure crisis and promoting neighborhood recovery. We will continue to use our resources to provide relevant data, research, and outreach in support of individuals and neighborhoods struggling to recover from the housing crisis and the resulting recession.

Charles Evans

President & CEO

Federal Reserve Bank of Chicago

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Foreword

Residents of Rust Belt cities harbor dark memories of past economic downturns. In cities like Lawrence, Massachusetts, and Cleveland, Ohio, economic shifts led to significant job losses and disinvestment, along with the related problems that frequently accompany such changes. In 1992, for example, Lawrence lost 120 buildings to arson. Crime and other illicit activity proliferated. But thanks to the hard work of community activists and successful public/private partnerships, the late 1990s and early 2000s saw redevelopment in Lawrence and dozens of cities like it. This urban renaissance also took hold in larger cities like Cleveland, which leveraged a robust community development corporation network to rehabilitate existing residences, construct new homes, and revitalize the city's commercial district.

The recent housing crisis threatens to undo the progress made in communities over the past 20 years. The viability of investments made in neighborhoods by banks, investors, non-profits, foundations, business owners, and residents is in question as the foreclosure problem persists, compounded most recently by high unemployment levels. The issue of vacant and abandoned property threatens the very sustainability of many communities. But the effects of the housing crisis are not limited to urban areas; suburban and rural areas have been hit hard as well. Communities across the country have lost revenue because of dwindling property-tax bases; they face severe cuts in critical services such as police, social services, libraries, and schools despite sharp increases in demand. As older communities face familiar fears, neighborhoods in newer or rapidly expanding communities face different challenges, such as how to fund the provision of municipal services to the remaining residents of half-empty neighborhoods.

With this publication, we aim to shed light on how community development practitioners and policymakers can help stabilize the neighborhoods most at risk, that is, those beset by concentrations of foreclosures. The animating idea here is that community development practitioners should be guided by the best available research, by anecdotal reports of what efforts are working, and by the best new ideas about what other approaches might work. We culled the country for individuals and institutions that are deeply engaged in this issue, both academically and at street level. Our authors, figuratively speaking, have rolled up their sleeves and gotten their hands dirty in the data or in the field, whatever their institution or perspective. This publication is presented in two parts; one focuses on research and analysis and another focuses on policy solutions.

Market Dynamics

Several articles look at selected cities, counties, or metropolitan areas to identify patterns and draw broader inferences about the REO market. These articles highlight the distinctions between so-called weak and strong markets, and among inner-city, inner-ring, and “exurb” communities. Claudia Coulton, Michael Schramm, and April Hirsh look at foreclosures in the Cleveland area, which experienced the rise in foreclosures earlier than other parts of the country. They find compelling evidence of disproportionate numbers of foreclosures in minority communities, changes in how REO properties are sold and to whom, and that many REO properties are being left to deteriorate. Kai-yan Lee takes us to some of the cities and towns of Massachusetts, many of them former mill towns that successfully

pursued revitalization plans, only to be at risk of having their efforts reversed. Both articles examine prices for REOs and find steep drops in value.

Foreclosures are not limited to the older, industrial areas of the country. Carolina Reid describes the outlying “boomburbs” of California’s cities, which have dense concentrations of REO property. Dan Immergluck focuses on Fulton County, Georgia, where he finds that a few sellers account for most REO sales to a wide variety of buyers. Immergluck also finds increasing volume and sales of low-value REOs (the most distressed properties), many of which were sold to investors. This suggests that neighborhood stabilization policies need to incorporate thinking about what to do with investor-owned properties after their purchase, not just thinking aimed at lender-owners. Alan Mallach illustrates some broader findings with a close look at Phoenix, Arizona. Intriguingly, he unpacks the dynamic behind the so-called “shadow inventory” by looking at how short sales, loan modification, and sales to investors at foreclosure auction are likely to affect the inventory of REO properties.

The Slow Starts and Hard Slogs of REO Redevelopment

Designers and implementers of national efforts to address barriers in the acquisition of REO properties have faced a steep learning curve. Several authors address the federal Neighborhood Stabilization Program (NSP) and the difficulty of obligating money within that program’s 18-month time limit. Drawing on case studies of more than 90 NSP sites around the country, Harriet Newburger highlights some of the program requirements that slowed NSP’s start. Others point to similar challenges in using NSP funds in a competitive environment where many properties are sold singly and in as-is condition. In some areas, NSP administrators can only watch as properties are bought in bulk by investors who can afford to do so and who are not constrained by strategic neighborhood stabilization plans. By contrast, NSP’s program stipulations (environmental and others) hinder communities’ ability to bid on properties and limit bid amounts to maintain the affordability of rehabbed properties. With rare exceptions, municipalities cannot be nimble or flexible buyers.

Craig Nickerson describes the National Community Stabilization Trust as an effort to broker REO properties for communities and nonprofits with major servicers. The Trust provides a first look at REO properties for nonprofits, and although a possible complement to the NSP, it struggled initially to secure a good number of viable properties from participating servicers. Fannie Mae has also developed its own First Look program to sell REO properties to communities at a discount.

Acquiring and redeveloping REOs is a demanding process fraught with considerable uncertainty. At the local level, some authors highlight the challenges practitioners face, including “toxic title” problems, rehabilitation needs, and difficulty in contacting property owners, all of which impede efforts to prevent blight and to acquire and redevelop properties. Determining proper exit strategies in advance is difficult under current market conditions. Several articles address questions facing communities, such as what to do with properties where values continue to decline, credit standards are tight, and potential buyers have impaired credit. Demonstrating their resolve and initiative, the New Jersey-based Community Asset Preservation Corporation successfully completed the first bulk purchase

by a nonprofit of foreclosed properties—47 in all, as described by Harold Simon—an accomplishment even more impressive considering that these were not REO sales but note sales, which are even more challenging.

The Importance of Targeting

Scarce funds make hard choices. Even a third round of NSP funding, included in the 2010 financial reform bill, cannot adequately address the REO inventory in targeted NSP areas, much less the massive number of REO properties throughout the country. Only a small fraction will be rehabbed or demolished with NSP funds. Ira Goldstein describes an analytical data tool that can be used to conduct a market analysis to target scarce funds and apply fresh strategies. Dan Fleishman details the varied development strategies that apply in different neighborhood typologies.

Innovative Approaches to Preserve Value

Despite the challenges, communities are responding in some innovative ways. Thomas Fitzpatrick describes a Cuyahoga County land bank, modeled on a similar effort in Flint, Michigan, that holds properties until they can be returned to productive use. The Cuyahoga County land bank is financed by fees and fines on property taxes. In some cases, properties are demolished and converted to green space or altered to fill another community need. In all cases, the land bank creates value from damaged goods. The Cuyahoga County Land Reutilization Corp., better known as the County Land Bank, is the lead agency for a consortium of municipal and nonprofit partners in implementing NSP2. The Land Bank has successfully negotiated REO acquisition agreements with Fannie Mae and HUD that align with the overall vision for neighborhood stabilization in the region.

Another way to stabilize neighborhoods is to keep foreclosed properties occupied. Anecdotal reports suggest that more REO servicers are realizing that keeping paying tenants in houses may be the best avenue to maintaining the property's value and the quality of the neighborhood—particularly if the only alternative is to try to sell in a market with high REO volumes. Elyse Cherry and Patricia Hanratty describe a model developed by Boston Community Capital to purchase foreclosed properties and sell them back, either to tenants or to the property's former owners, using a licensed mortgage affiliate. In a similar vein, Danilo Pelletiere describes the need to create rental housing from the inventory of foreclosed homes, not only to provide affordable housing, but also as a method to stave off blight and disinvestment.

Bringing the Government and Community to Bear

Neighborhood stabilization is about more than acquiring properties. Municipalities have tools, such as code enforcement, fines, and other legal options, to address problems. For example, in order to resolve issues of neglect, courts can appoint a receiver to take control—but not ownership—of a property. In some cases, threat of receivership or demolition is enough to spur recalcitrant actors to address blight and safety issues. Frank Ford's article highlights the phenomenon of bank “walk aways,” where financial institutions fail to pursue or claim title to vacant and abandoned properties. He shows how property-based data and community partnerships can help organizations intervene to help homeowners stay in their homes and to target resources for REO acquisition.

For many communities, neighborhood stabilization may involve rethinking housing policy and retooling plans to adapt to the reality of shrinking populations and to offer more green space and affordable rental housing to attract and retain residents. Preserving neighborhoods involves complementary interventions—such as investments in police and fire safety, lighting, and maintaining streets—that preserve the perception of the community as a good place to live. These types of investments may, in fact, be some of the most cost-effective strategies of all. Many cities, which have memories of past crises, have intervened comprehensively. The entire region of Northeast Ohio, for example, is engaged in thinking through land-use challenges, led by the Youngstown and Cleveland examples of “shrinking,” or “right-sizing.” Cleveland’s community development industry is engaged in “reimagining” the metropolitan area to find strategies for putting properties into productive reuse, including the possibility of urban agriculture.

Understanding Private-Sector Methods and Incentives

Negotiating for the disposition of REO property does not typically involve the lender, since the majority of mortgage loans have been sold into the secondary market. Rather, communities or their agents must negotiate with the loan’s servicer, who has a fiduciary duty to the mortgage holders and may be guided by other incentives as well. This does not necessarily conflict with community interests. In fact, several articles report the positive results of collaborating with servicers, although many others describe the steep learning curve involved in negotiating successful transactions. Terry Theologides outlines the servicer guidelines in the REO process, with an eye toward improving the community’s ability to understand and work within the process. He also highlights an unintended consequence of foreclosure moratoriums by pointing out that the extension of foreclosure timelines increases the chance that value is destroyed as the property deteriorates. Once a property has been abandoned, there is no economic reason to delay its return to productive use. Jay Ryan of Fannie Mae outlines the practices being developed by this holder of a huge REO inventory and highlights steps the agency has taken to avoid vacancies and convey properties to municipalities and nonprofits as efficiently as possible.

The Community Reinvestment Act (CRA) has been shown to influence private capital and activity by CRA-regulated financial institutions. Mike Griffin shows why the proposed CRA rules on neighborhood stabilization efforts in areas designated for NSP dollars may give banks sufficient incentive to make further investment in these areas.

Conclusion

Taken together, these articles provide hard-headed facts and advice for those trying to preserve the character and vitality of neighborhoods endangered by foreclosures. We also think they provide some measure of hope that committed practitioners and policymakers can address the issue of neighborhood stabilization effectively and creatively. Community groups were quick to identify the problem and articulate the fears. Several of the initiatives highlighted here are the product of many people’s determination, innovative thinking, and willingness to work together. We dedicate our publication to their efforts.

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Section I: Research and Analysis

The Scope and Nature of the REO Challenge

REO Properties, Housing Markets, and the Shadow Inventory

by Alan Mallach
Brookings Institution

As the foreclosure crisis has spread, the term “REO property” has gone from something only specialists were familiar with to nearly a household word. With foreclosures at epidemic levels and foreclosure sales daily events, the number of REO properties has skyrocketed.¹ Their increasing number has affected housing markets and neighborhood stability throughout the United States. This article will explore the effects of these lender-owned properties, and how those effects are likely to change in the future as the nature of the foreclosure trajectory changes and the potential of a looming “shadow inventory” of properties that are in default or foreclosure—but not yet REO—grows. While much of the analysis in this article is based on the author’s research into these issues in the area of Phoenix, Arizona, the article’s findings and conclusions apply nationwide.

REO Properties, Housing Markets, and Neighborhoods

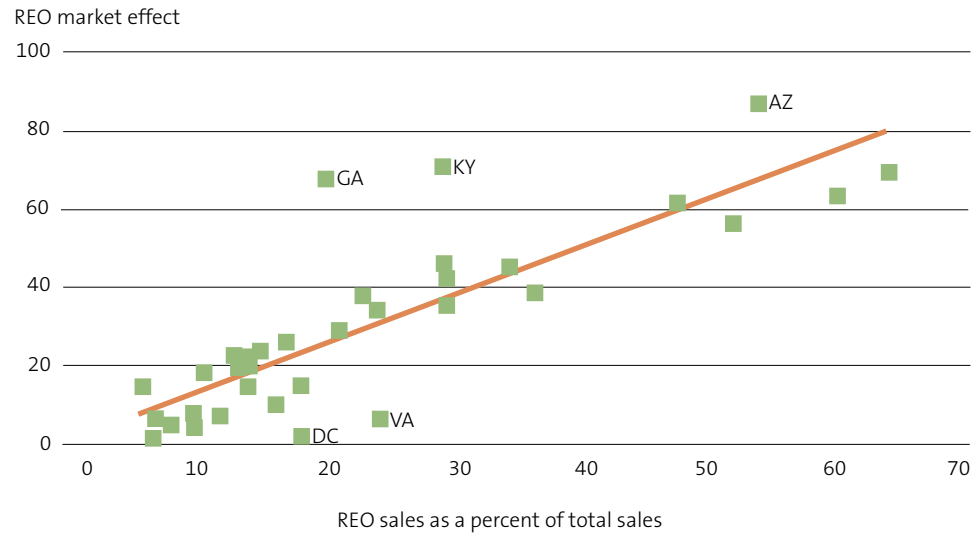
Since the onset of the foreclosure crisis in 2006, mortgage defaults and foreclosures have steadily increased, and with them the number of properties reacquired and put back on the market by lenders. Because those houses have come on the market at a time of sharply reduced overall housing demand, they have had a dramatic effect on housing markets throughout the United States.

REO sales are as much arm’s-length transactions between willing buyers and sellers as any other sales. Large numbers of them can, however, drastically distort market conditions relative to what would take place in their absence.² REO properties are often in poorer

condition than properties with similar physical or locational features in the traditional market, and—once the property finally reaches the market—REO sellers are highly motivated to sell as quickly as possible, often dumping or unloading properties in substandard or uninhabitable condition to buyers who have no intention of occupying or improving them. Evidence of such activity is most likely to be seen in weak-market areas.³ REO sellers are subject to few of the psychological or economic pressures that deter homeowners from lowering their prices to reflect market realities, or the practices that have made lenders reluctant to approve short sales by homeowners.⁴ REO sellers also engage in bulk sales of properties rather than individual transactions, where, in return for lower transaction and holding costs, they may accept a substantial discount on the price of properties sold individually.

The market effect of REO properties is almost always negative. REO property sales pulled prices down in 31 of 34 states analyzed by the author with data from LPS Applied Analytics using a repeat sales model. As figure 1 shows, the larger the share of REO properties in the market, the greater the effect on the area house price index.⁵ We also see, however, a few outliers. The price effect of REO sales in the District of Columbia and the State of Virginia is much less than would be suggested by the national picture. The reason is likely to be found in the relative market strength of these areas, rather than in any differences in the character or condition of the housing stock. Although rapid appreciation in those areas during the bubble years has led to high levels of foreclosures and REO inventory, the continued strong housing-market demand

Figure 1
Effect of REO Sales on House Prices by State*
 January – June 2009



*Each square represents a different state. In some cases, state data represent market area in major metropolitan areas only.
 Source: Analysis by author based on data from LPS Applied Analytics

in the District of Columbia and Northern Virginia appears to have mitigated the price effect of REO sales on the rest of the market. These are exceptions to an otherwise largely

consistent pattern of declines in house prices due to high numbers of REOs.

The price-depressing effect of REO sales has a second impact on the real estate market. REO sales drive out non-REO sales. If REO properties are priced lower than similar non-REO properties on the market, rational buyers are more likely to seek out these lower-priced properties. As a result, REO properties sell faster than non-REOs. These dynamics are visible in the Phoenix housing market.⁶ In May 2009, the listing success rate, defined as the percentage of listings that closed with a sale rather than expiring or being cancelled within a defined period, was 90 percent for REO sales, 41 percent for traditional sales,⁷ and 37 percent for short sales.⁸ Thus the share of REO sales will generally be greater than the share of REO properties on the market, further depressing prices. As figure 2 shows, when demand began to increase in the Phoenix market during 2008, the increase in sales was concentrated in the REO market. Most non-REO sellers, in contrast, saw no improvement in their properties' marketability from the overall increase in sales activity.

Traditional Sales

Property transactions between buyers and sellers where no distress is associated with the transfer

Foreclosure Sales

The end of the foreclosure process (also called a sheriff's sale in some states). Can lead to REOs if properties are not purchased by a third party

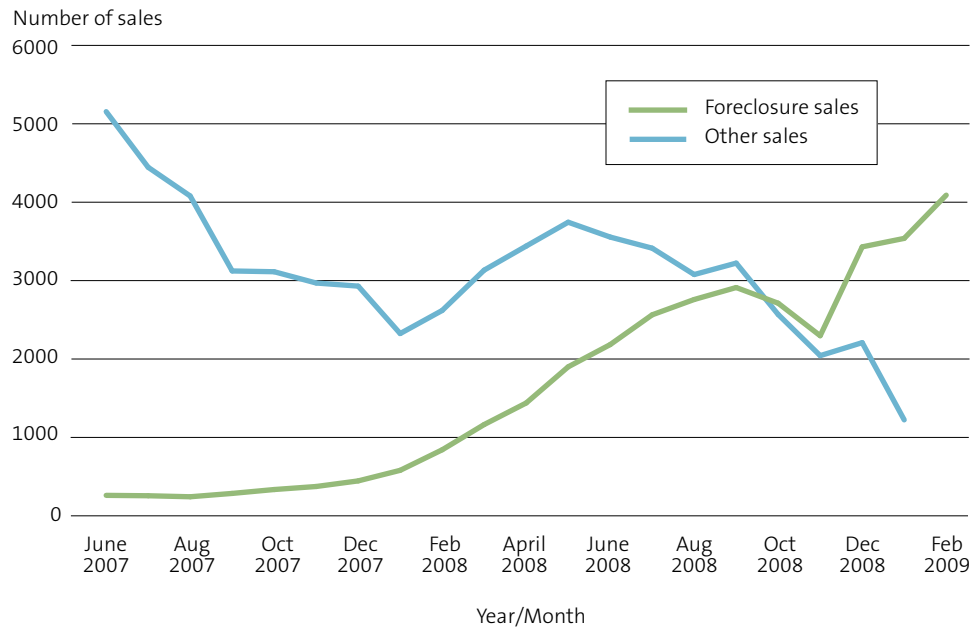
REO Sales

When REO properties are offered for sale by the lender

Short Sales

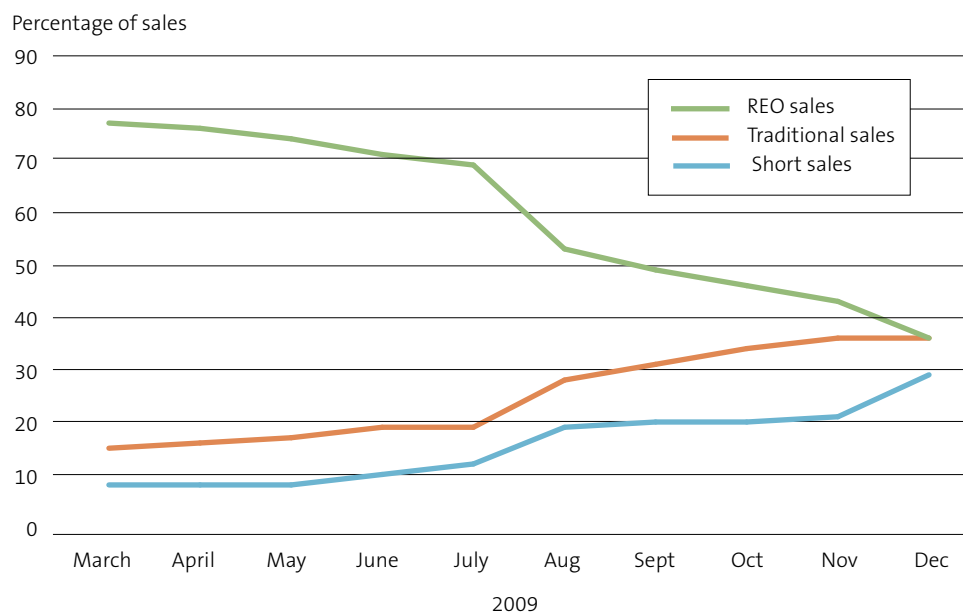
Property transactions where the selling price is less than what is owed on the mortgage; often the only way for an underwater mortgagee to avoid foreclosure. Short sales require the approval of the lender

Figure 2
House Sales, Phoenix Metropolitan Area
 June 2007 – February 2009



Source: The Cromford Report/data from Arizona Multiple Listing Service

Figure 3
Distribution of Real Estate Sales, Phoenix Metropolitan Area
 March – December 2009



Source: The Cromford Report/data from Arizona Multiple Listing Service

The neighborhood impact of an increase in REO properties stems less from the number of properties than from what happens to them once they go through foreclosure.

During 2009, however, the picture became more complicated, as the market share of short sales increased—paralleling the increase in short sales—while the REO share decreased. By the end of 2009, the number of short-sale MLS listings in Maricopa County exceeded the number of REO listings. Between March and December, as the local housing market showed tentative signs of stabilization, short sales jumped from 8 percent to 29 percent of all real estate sales in the Phoenix Metropolitan Area.⁹ During the same period, as shown in figure 3, REO sales plummeted and traditional sales rebounded, although they grew at a more modest rate than short sales. As will be discussed below, short sales increased nationwide during the same period, although at a less dramatic pace.

In sum, the wave of REO properties that hit metropolitan real estate markets with the collapse of the housing bubble and the rise of foreclosures has contributed significantly to the collapse of house prices, although many markets were so overpriced that a significant correction would arguably have been inevitable. Even in regions where the overall effects of REO properties may be less pronounced, their effects can nonetheless be far more intense in specific areas within those regions. For example, the Northside neighborhood in Minneapolis and Brooklyn Center, an inner-ring suburb of that city, have been affected far more heavily than the Twin Cities region as a whole.

Measuring the effects of REO properties on neighborhood stability is more complicated. The neighborhood impact of an increase in REO properties stems less from the number of properties than from what happens to them once they go through foreclosure. The impact of an REO property that sits vacant and boarded up for a year after a foreclosure sale is far more damaging than that of a property that is quickly fixed up and sold at an affordable price to a homebuyer. While it is hard to pin down what is happening in neighborhoods across the country, a few observations can be made.

In most parts of the United States, few REO properties, once put on the market, simply sit. During the first five months of 2009, some 20,000 properties were sold at foreclosure sales in Maricopa County, of which 1,000 to 2,000 were bought by parties other than the lender, thus escaping the REO inventory. During the same period, nearly 23,000 REO properties were purchased in the same area, leading to a significant drop in the inventory of REO properties on the market. Similar increases in purchases of REO properties have been seen in many different market areas nationwide. What happens to these properties?

Where an REO property is acquired by an individual homebuyer, it is likely that any neighborhood impact is transitory. The magnitude of that impact, as noted above, is largely a function of how long the property sat vacant prior to resale. The shorter the period from initial notice to foreclosure sale, and from then until the property is resold and reoccupied, the less the impact. In many areas, however, most REO purchases are made by investors who will not actually occupy the property themselves. In fact, the level of investor activity dwarfs public sector and CDC investment. We estimate that total absentee-buyer investment in one- to four-family houses in the Phoenix metropolitan area during the second half of 2009 alone was between \$1.5 and \$1.8 billion, vastly exceeding public-sector and CDC investment during the same period.¹⁰

In such cases, neighborhood impacts vary widely. In areas where responsible investors plan to hold and rent properties for an extended period, the impact may be modest. One might prefer to see those properties bought by owner-occupants, but that is often not a realistic alternative. The most likely alternative to an investor purchase is that the property will remain empty. This buy-and-hold strategy appears to be common in Sunbelt cities like Phoenix, where most investors appear to be planning to keep their properties for five years or more. The picture is very different in other weak-market locations, including many

parts of Detroit and Cleveland, and in very low-value neighborhoods in other cities, such as Atlanta's Pittsburgh neighborhood.¹¹ These areas are attracting short-term investors, whose speculative actions are far more destructive to neighborhood stability than those of longer-term buy-and-hold investors.

Areas that draw these longer-term buy-and-hold investors appear to have two key features. First, acquisition costs, although low enough to permit a positive rental cash flow, are still high enough to require due diligence by the buyer and to make flipping—reselling just-bought properties at higher prices with no improvements—a less attractive strategy. Second, the area has strong enough rental demand for a landlord to maintain a stable tenant base. This is true in Phoenix, where a large part of investors' tenant pool consists of former homeowners who have lost their homes to foreclosure.¹² In other areas, where the market has collapsed and houses are being unloaded to investors for nominal amounts, the instability of the market draws short-term speculative investors, who may buy houses in bulk, sight unseen, and pursue quick-return strategies that further undermine already deeply distressed communities.

Thus, the neighborhood effect of REO properties is a function of their volume, the dynamics of the market where they are present (including time left on the market), and how those dynamics affect buyer behavior. While this subject needs closer study, we can add one more observation. *Local governments affected by destructive investor behavior are not powerless to influence that behavior.* Licensing ordinances, inspections, and other regulatory tools, as well as incentives for responsible property ownership, are all opportunities for local officials and CDCs to influence investor behavior in order to minimize neighborhood destabilization.

The Future Course of REO Properties and the Looming Shadow Inventory

Few observers believe that the foreclosure crisis has run its course. Although the rate of decline has slowed and the volume of overall

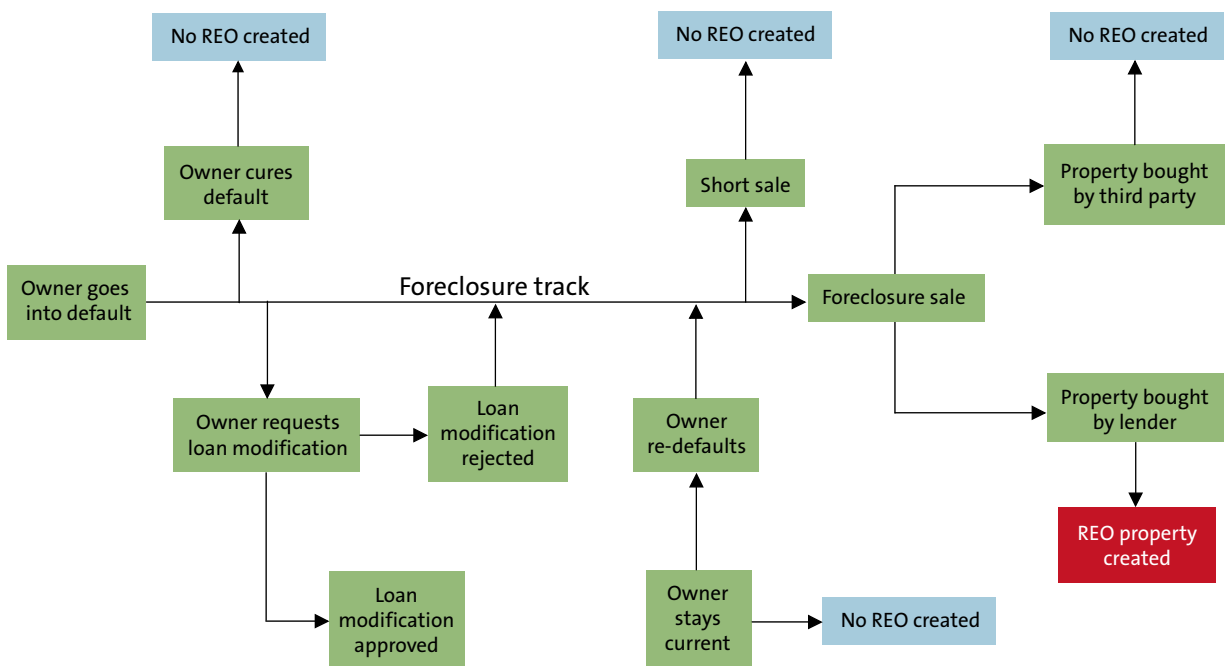
sales transactions has increased, house prices in many areas are still dropping. In addition, unemployment remains at dangerously high levels. Data from the Mortgage Bankers Association's National Delinquency Survey indicate that the numbers of delinquent mortgages and foreclosure filings have continued to grow, with no sign of leveling off. It would seem logical, therefore, that the flow of REO properties onto the market should also increase.

This does not appear to be happening. During 2009, the relationship between the number of delinquencies and foreclosure filings and the number of completed foreclosures—the best available indicator of the size of the REO inventory—shifted markedly. As the number of new REO properties entering the market stayed level or declined, speculation arose that servicers, seeking to keep house prices from falling even further, had begun to ration the flow of properties coming on the market. That, in turn, suggested—assuming those properties eventually had to make their way onto the market—a backlog was accumulating that might lead to a sudden influx of REO properties, further destabilizing markets and neighborhoods.

Although it can't be ruled out entirely, there appears to be no evidence to support an explicit rationing theory. There are, however, solid explanations for why the REO inventory has not kept pace with delinquencies and foreclosure filings. Some of these arise from the way the foreclosure process has gradually evolved, and others from changes in lender and servicer behavior, which may indeed be intended in part to reduce or slow the flow of properties into REO inventory. While some of these trends may help some properties avoid REO status entirely, others could lead to potentially destabilizing future property flows into the REO inventory.

Foreclosure is no longer a speedy and predictable process in many states. Figure 4, a generalized representation of the foreclosure process from initial filing to foreclosure sale, shows that there are many points in the process

Figure 4
The Foreclosure Process and the Diversion of Properties from the REO Inventory



at which a property can be temporarily or permanently diverted from becoming an REO property. Around these diversion points, steps have been added to the foreclosure process, including moratoria or forbearance periods enacted by many states in order to promote loan modifications, which increase the lag between initial filing and the ultimate outcome by 60 days to six months. While a successful loan modification or short sale diverts the property from REO inventory, unsuccessful attempts add to the time between the filing and the sale. In cases where a borrower has received a loan modification and subsequently redefaulted, the property returns to the foreclosure track, but only after a year or more.¹³

Short sales and third-party purchases at foreclosure sales both divert significant numbers of properties from the REO inventory. They reflect not only increased market demand for residential properties, but also servicers' greater readiness to accommodate alternatives

to foreclosure and taking properties into REO inventory. As figure 3 shows, short sales grew from 8 percent to 29 percent of all sales transactions in Phoenix during 2009. National data show a significant, though less dramatic, increase in short sales during the same period, with short sales nearly doubling from the fourth quarter of 2008 to the third quarter of 2009.¹⁴ During the same period, the number of properties that were bought by end users at foreclosure sales rose from 5 percent to 20 percent. We estimate that at the end of 2008, a foreclosure filing in Phoenix had a 60 percent probability of becoming an REO property. By the end of 2009, that probability had declined to 39 percent. Assuming a constant level of foreclosure filings, these changes alone would reduce the number of properties added to the foreclosure inventory by more than a third.¹⁵

REO flow is further reduced by the slower pace of the foreclosure process and changes—both intentional and capacity-related—in servicers'

behavior. Changes include a greater readiness to defer foreclosure in situations where mortgage holders remain in the property, and a reluctance to put tenant-occupied REO properties on the market until after the tenants have vacated them; the delay can lead to a property's not being listed until many months after the foreclosure sale.¹⁶ In extremely weak markets, servicers even forgo finalizing foreclosures and simply walk away from properties, leaving them in legal limbo.

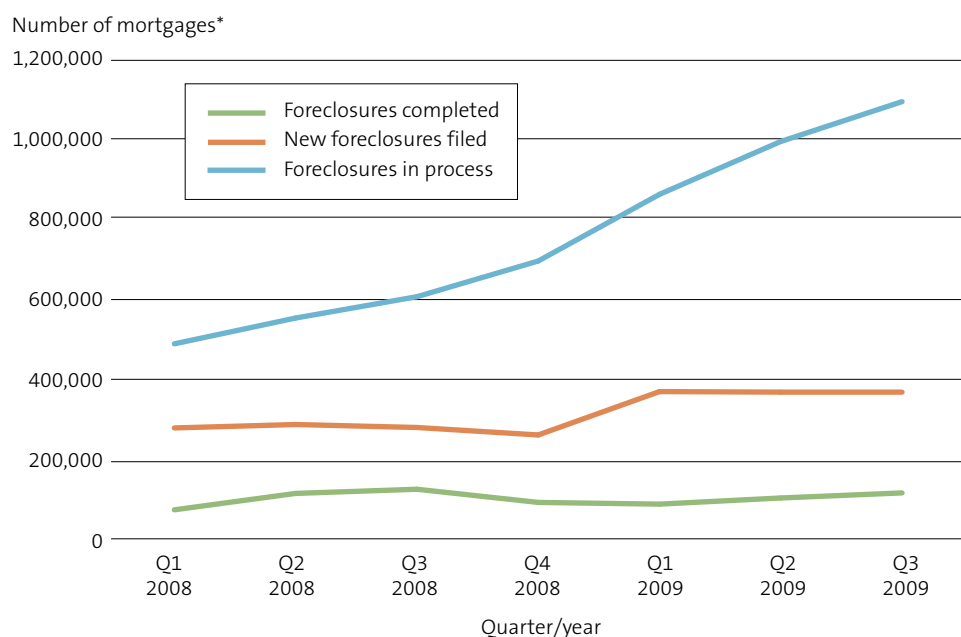
The effect of these changes can be seen in figure 5, which compares the trends in completed foreclosures, new foreclosure filings, and the number of properties in the foreclosure process since the beginning of 2008. While foreclosure completions have stayed roughly level and filings have grown moderately, the number of properties in the pipeline has skyrocketed, highlighting the greater duration of the foreclosure process. From an average of five months at the beginning of 2008, the length of time from initial filing to resolution (through

foreclosure, short sale, loan modification, or otherwise) had grown to nine months by the fall of 2009. While some of the practices leading to this trend may be constructive—and others, like walkaways, highly destructive—none reduces the ultimate REO inventory. They only constrain its *apparent* growth by putting it off to a later day.

The housing market has major problems that, coupled with continued high unemployment and uneven economic growth, could undo what little stability some markets have achieved and further exacerbate the weakness of still-unstable areas. Looking forward, three separate factors suggest a high risk of future increases in the REO inventory.

Large numbers of loans in the foreclosure process will ultimately be liquidated. Although increased use of short sales will remove many properties from the foreclosure process, ultimately the still-rising tide of defaults and foreclosure filings is likely to lead

Figure 5
U.S. Foreclosure Trends by Quarter
2008 – 2009



Source: The Cromford Report/data from Arizona Multiple Listing Service

* Sample represents roughly 60 percent of all mortgages

Lower rents and higher vacancy rates could deter investors, particularly responsible ones, from continuing to buy REO properties.

to an increase in foreclosures and in the REO inventory. This overhang of potential additions to the inventory of REO properties has been estimated at 7 million properties nationwide.¹⁷ This is particularly likely if, as was true through mid-2010, few defaults are cured, few loan modifications become permanent, and those that are modified have a high re-default rate. The movement of these foreclosures through the pipeline will be slow, but barring major public policy changes, they are unlikely to be removed from the pipeline. This could easily result in an increase in the REO inventory during 2010.

Demand may be unstable. Two factors could potentially dampen homebuyer demand: the federal homebuyer tax credit's expiration in April 2010 and the possibility that the Federal Reserve may begin to raise interest rates in 2010. While these factors have much less impact on investors, the housing market overall could be affected by rising rental vacancy rates and dropping rent levels. Average rents fell 12.5 percent in the Las Vegas area from the end of 2008 to the end of 2009, and nearly as much in the Phoenix area.¹⁸ While part of this reflects the near-collapse of the multi-family rental market in these areas as a result of single-family rentals flooding the market, it also suggests that the latter market—Phoenix's—may be approaching saturation.¹⁹ Lower rents and higher vacancy rates could deter investors, particularly responsible ones, from continuing to buy REO properties, while pushing prices downward. If demand from both homebuyers and investors declines significantly, that could undermine the nascent positive trend toward higher volumes of short sales.

The future of millions of underwater borrowers remains unresolved. The largest question mark for the housing market is the vast number of underwater borrowers. At the beginning of 2009, estimates of the total number of underwater borrowers nationwide ranged from 11 to 15 million. A Deutsche Bank study estimated that the number may reach 25 million

by 2011, by which time 80 percent or more of borrowers in 20 metropolitan areas will be underwater.²⁰ By mid-2009, there were 49 different metropolitan areas where 40 percent or more of all mortgage holders were underwater, largely in the most heavily affected Sun Belt states, like Nevada, and Rust Belt states, like Michigan and Ohio. Nearly 70 percent of all mortgages in the Las Vegas area were underwater, as were more than 50 percent of the mortgages in the Detroit area.²¹

While owing more on one's mortgage than the house is worth does not necessarily lead to foreclosure, it both increases the likelihood of default and reduces the owner's motivation to avoid foreclosure, particularly when the value of the property falls so far below the mortgage amount that the owner can see no realistic prospect of ever regaining a meaningful equity stake in the home. Forty-five percent of all mortgage holders in Nevada, and a quarter of all mortgage holders in Arizona and Florida, have more than 25 percent negative equity; from that level, it would take 10 years of modest but steady appreciation to reach a point where the owner might hope to begin building equity.

Right now, the majority of underwater mortgages are not in default. However, large numbers of strategic defaults (decisions by underwater borrowers to default on mortgages despite being economically capable of making the payments) are a real possibility. One study estimated that 588,000 such defaults took place in 2008, or 18 percent of all delinquencies of more than 60 days during the year.²² For an owner with a \$250,000 mortgage on a Phoenix- or Miami-area home that is now worth \$100,000 or less, the strategic default option can look compelling. While some argue that such behavior is morally reprehensible, others consider it a rational move, not only for the mortgage holder but also for the economy.²³ Should large numbers of underwater borrowers choose that course over the next few years, the number of foreclosures could rise sharply, further swelling the REO inventory.

Conclusion

Finally, the economy itself remains unsettled, with unemployment rates and uncertainty about the future both remaining high. In this climate, it would be foolish to attempt to predict the future; few people, after all, predicted the changes to the market that would emerge during the course of 2009. Looking forward to the next two years, however, it appears that risk factors are accumulating and that the shadow inventory is a looming reality. If, as a result, a significantly larger volume of properties start to come through the foreclosure pipeline in 2010 and 2011, there is a serious question whether a still-fragile market will be able to absorb them, or whether they will lead to renewed declines in house prices and increased destabilization of American neighborhoods.

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Endnotes

¹ The process by which a foreclosure is completed, and the property is either sold or taken back by the lender, goes by different names in different states—foreclosure sale, sheriff's sale, trustee sale, or foreclosure auction; in a few states, such as Connecticut, title is transferred by judicial decree rather than by sale. In the interest of consistency, the process will be referred to as a "foreclosure sale" throughout this article.

² Even before the accumulation of evidence from current market conditions, a body of scholarly literature had emerged in support of this point; it is summarized in Anthony Pennington-Cross, "The Value of Foreclosed Property," *Journal of Real Estate Research* 28(2): 193–214. As Pennington-Cross shows, a number of separate papers have indicated that the "foreclosure discount"—the deviation between the expected price or appreciation of typical or average property and the price or appreciation of foreclosed property—is in the range of 22–24 percent. This appears consistent with the author's findings in Phoenix, discussed below.

³ While there is little literature focused exactly on this point, see Claudia Coulton, Michael Schramm, and April Hirsh, "Beyond REO: Property Transfers at Extremely Distressed Prices in Cuyahoga County, 2005–2008," Cleveland, Oh.: Center on Urban Poverty and Community Development, Case Western Reserve University,

2008; and Alex Kotlowitz, "All Boarded Up," *New York Times Magazine*, March 4, 2009, for two strongly suggestive assessments, one statistical and the other vividly reportorial.

⁴ See endnote 8.

⁵ The baseline of the index is January 2000.

⁶ The author is currently conducting research into trends in REO sales to investors in the Phoenix and New Haven, Connecticut, housing markets and into the effect of investor purchases on neighborhood conditions, with support from the Local Initiatives Support Corporation. The Phoenix data presented in this paper were collected by the author as part of that research.

⁷ Traditional sales are those where there is no distress associated with the transaction; they typically exclude REO sales, foreclosure sales, and short sales.

⁸ The Cromford Report, based on data from the Arizona Multiple Listing Service. Short sales, in which the selling price is less than the amount owed on the mortgage, are often the only way for a homeowner who is underwater to sell her home and avoid foreclosure. Such sales require the approval of the lender. Although data on this point are lacking, it is reasonable to assume that short sales are likely to reflect greater price reductions than other non-REO transactions. In theory, the success rate should be higher for short sales than for normal transactions because the seller's motivation should make the pricing more realistic; the price effect, however, is counteracted by the obstacles to a successful transaction imposed by the need to obtain lender approval of the transaction. Widespread reports indicate that lender approval is often either denied or is delayed to such an extent that many potential transactions fall through; however, there are strong indications that lenders are becoming more supportive of short sales as they recognize that such sales are often preferable to foreclosure.

⁹ Arizona Real Estate Investors Association, based on data from the Cromford Report.

¹⁰ DataQuick provides data on the median sales price by month for the Phoenix MSA as well as an estimate of investor-buyers, using files where the address of record for tax purposes is different from the property address. The latter, however, significantly overrepresents the number of investors, since the Phoenix market includes large numbers of second-home buyers. To make this estimate, we have assumed that only 80 percent of the DataQuick files actually represent absentee investors, and that their average purchase price was 65–80 percent of the MSA median price.

¹¹ See Alyssa Katz, "There Goes the Neighborhood," *The American Prospect*, September 10, 2009, for a powerful depiction of destructive investor activity in Atlanta's Pittsburgh neighborhood.

¹² This point was made separately by a number of informants, who cited two particular reasons. First, the strong preference of former homeowners for single- rather than multi-family rentals; and second, the fact that landlords with smaller numbers of properties are less likely to be strict about a tenant's credit score and more willing to overlook the foreclosure in light of a strong job

history and other factors, compared to the more formal ownership and management structure of most apartment complexes.

¹³Of all loan modifications made during the second half of 2008, 53 percent had re-defaulted; that is, were at least 60 days delinquent, within nine months after the modification. Office of the Comptroller of the Currency, OCC and OTS Mortgage Metrics Report, Third Quarter 2009.

¹⁴Office of the Comptroller of the Currency, cited above.

¹⁵For purposes of the analysis, we made these assumptions: 1) 30 percent of defaults in which an initial foreclosure filing is made are cured; 2) the rate of loan modifications increased over the course of the year from 5 percent to 8 percent of filings; and 3) the re-default rate after loan modifications held constant at 60 percent.

¹⁶Under federal law, effective April 2009, entities taking tenant-occupied properties through foreclosure must honor the terms of outstanding leases and allow tenants without leases 90 days to vacate. Some lenders and realtors speed up the process by offering tenants “cash for keys” as an incentive to vacate early.

¹⁷Amherst Mortgage Insight/Amherst Securities Group LP. “Housing Overhang/Shadow Inventory = Enormous Problem,” September 23, 2009.

¹⁸Data from RealFacts, quoted in Hubble Smith, “If you’re looking to rent, now is the time: Prices down 8.2 percent in Las Vegas,” *Las Vegas Review-Journal*, February 3, 2010.

¹⁹One Phoenix informant estimated that the vacancy rate for garden apartments in that area was in the vicinity of 25 percent.

²⁰Karen Weaver and Ying Shen, “Drowning in Debt—A Look at ‘Underwater’ Homeowners.” Deutsche Bank Securitization Report, August 5, 2009.

²¹Data from loan performance. Weaver and Shen estimate that the percentage of underwater homeowners in the Las Vegas area was 81 percent in the first quarter of 2009.

²²The study was conducted by Experian, a credit reporting firm, and the consulting firm Oliver Wyman, and was reported by Kenneth Harney, “Homeowners who ‘strategically default’ on loans a growing problem,” *Washington Post*, September 20, 2009.

²³See, for example, a column by Dean Baker of the Center for Economic Policy Research, “Walking away from negative equity,” the *Guardian*, February 1, 2010. The comments on this column offer a microcosm of the spectrum of opinion on this subject; see <http://www.guardian.co.uk/commentisfree/cifamerica/2010/feb/01/goldman-sachs-negative-equity>.

Shuttered Subdivisions: REOs and the Challenges of Neighborhood Stabilization in Suburban Cities

by Carolina K. Reid
Federal Reserve Bank of San Francisco

Driving along California's Interstate 580, the freeway that connects San Francisco to Stockton, the landscape of newly built subdivisions is hard to miss. Neat rows of clay-colored roofs, all of which are the same size, the same shape, and extend just to the edge of the property line, flank both sides of the road. A huge sign hanging from the concrete wall that encircles one development reads, "If you lived here, you'd be home already," beckoning new buyers with the promise of a three-bedroom home with a two-car garage. At the exit ramp, there's a Target, a Home Depot, a few gas stations, and a fast food restaurant or two. And a drive-through Starbucks, providing much-needed caffeine to early morning commuters headed toward the distant labor markets of San Francisco and San Jose.

Get off the freeway, however, and the repetitive roofline of these communities disappears from view. The neighborhoods are much more vibrant and varied. Yards are decorated with personal tchotchkes, ranging from statues of the Virgin Mary to flags in support of the A's or the Giants; strollers, Big Wheels, and basketball hoops hint at the ages of the kids inside. The residents themselves represent a wide range of ages, races, family types, and nationalities, and a sunny afternoon reveals women walking around in colorful saris as well as elderly African-Americans tending their yards. Unlike the Levittown homes and exclusionary credit markets that fueled the suburban sprawl of the 1950s and 60s, these new suburban spaces have provided homeownership opportunities for a much more diverse population.

Since 1990, subdivisions such as these have sprung up all over urban America, but nowhere more rapidly than in California, Nevada, and Arizona. In *Boomburbs: The Rise of America's Accidental Cities*, authors Lang and LeFurgy point out that areas that were once small subdivisions with obscure names such as Henderson, Chandler, and Santa Ana have grown larger than many better-known cities, including Miami, Providence, St. Louis, and Pittsburgh, and house an ever-increasing share of the nation's urban population. By 2000, nearly 15 million people lived in boomburbs and "baby boomburbs."¹ That number has likely grown, as new construction fueled by the recent housing boom has led, in just a few years, to a doubling of population in communities such as Avondale, Arizona, and Elk Grove, California.

Whether or not these boomburbs continue to grow is dependent at least in part on whether these neighborhoods can stabilize their housing markets in the wake of the foreclosure crisis. Indeed, it is not only Detroit and Cleveland that have been hit by waves of foreclosures: Some of the highest rates of foreclosure and subsequent concentrations of real-estate-owned (REO) properties have been in both small and larger subdivisions near larger metropolitan areas.

The large number and concentration of REOs in suburban communities has troubling policy implications, since these areas often have less-well-established community development infrastructure.² Local governments and non-profits may therefore have limited capacity to respond to the destabilizing effects of large

numbers of vacant homes. In addition, most strategies for addressing blight and vacant buildings have been developed based on the experiences of inner-city neighborhoods with older housing stock. Lessons and best practices for how to respond to vacant and abandoned property in suburban communities are scarce.

This article seeks to fill that gap by exploring what is happening with concentrations of REOs in suburban cities, focusing on the states of California, Arizona, and Nevada. How long are REOs staying on the market in these suburban areas? What are the implications of vacancies and house price declines for the long-term viability of these subdivisions and the services that support them? Will these boomburbs become ghost towns, particularly as rising energy costs limit the attractiveness of neighborhoods that require long commutes? Or will the continued demand for homeownership translate into new buyers once house prices and the economy stabilize?

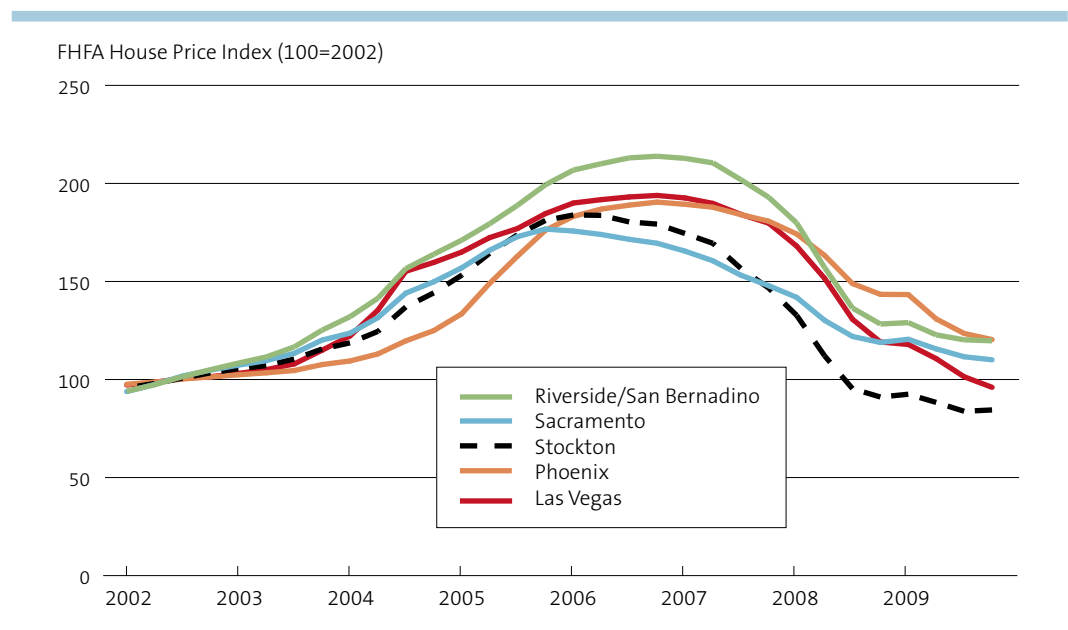
The Wild West of Mortgage Lending: Subprime Lending in the Suburbs

It's a real tragedy. So many families thought that they were moving out from [San Francisco] to Antioch to buy a home, have a real house for the kids with a yard and a neighborhood school, and now they're coming back and having to live with their parents or grandparents...it wasn't affordable after all.

—San Francisco foreclosure counselor
November 2009

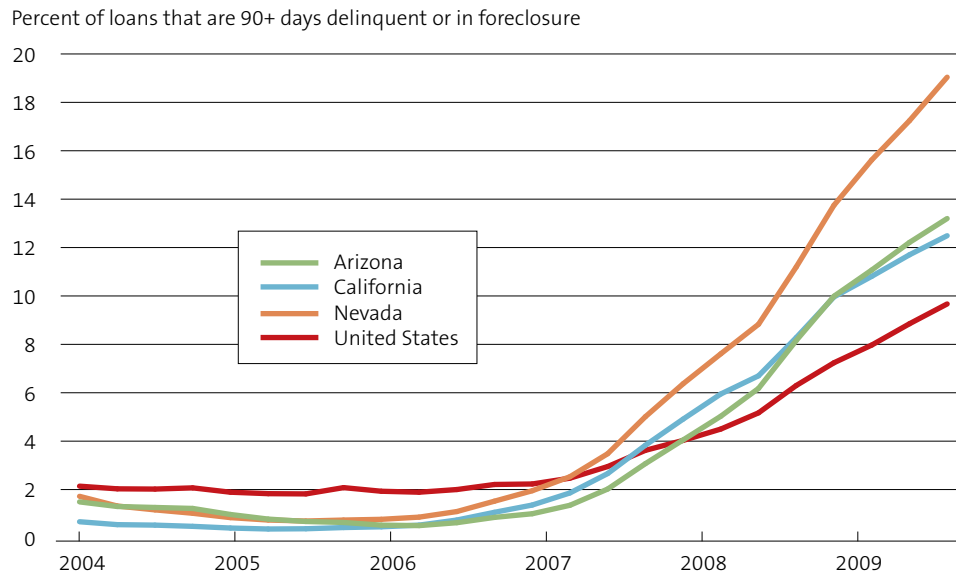
In an early paper on the subprime crisis, Karen Pence and Chris Mayer found that subprime originations were heavily concentrated in fast-growing parts of the country with considerable new construction, such as Florida, California, Nevada, and Arizona.³ Earlier research had primarily focused on neighborhood racial disparities in the geographic distribution of subprime lending, showing, for example, that subprime loans are more frequent in low-income neighborhoods than in upper-income neighborhoods, and more frequent in predominately black neighborhoods than white neighborhoods.⁴

Figure 1
Boom and Bust of West Coast Housing Prices



Source: FHFA House Price Index

Figure 2
Serious Delinquencies in Western States



Source: Mortgage Bankers Association, National Delinquency Survey

Pence and Mayer's paper also pointed to a new development in the geographic distribution of subprime lending. Although initially defined as risk-based pricing for borrowers with lower credit scores, "subprime" increasingly became an umbrella moniker for a much wider range of nontraditional and alternative mortgage products, including interest-only loans, option ARMs, and loans that coupled extended amortization with balloon-payment requirements. Driving the demand for these products in Arizona, California, and Nevada was a need for greater housing affordability; in many urban markets in these states, house values nearly doubled between 2002 and 2006 (see figure 1). The use of non-traditional mortgage products exploded in tandem. In 2005, approximately two-thirds of all subprime mortgages in Arizona, California, and Nevada included exotic features such as option payments and had limited or no documentation associated with the loan origination.⁵

In 2007, this boom came to an abrupt end. The rise in delinquencies and foreclosures in Arizona, California, and Nevada was sudden and steep (see figure 2). At the start of 2006,

these states had among the lowest serious delinquency rates in the country; by the last quarter of 2009, they far eclipsed the national serious delinquency rate, a trend that does not seem to be abating. The combination of falling house values and the origination of loans that did not consider a borrower's ability to repay over the long term have led to unprecedented levels of foreclosure, with significant repercussions not only for neighborhoods but also for city governments that are grappling with the challenges associated with concentrated vacancies and REOs. In two recent papers on the distribution of REOs, Dan Immergluck found that REOs were concentrated in metropolitan real estate markets that saw large concentrations of subprime lending and high rates of house appreciation in the first half of this decade, and that suburban communities contained a large number of ZIP codes with high and severe concentrations of REOs.⁶

Corresponding to the scale of the foreclosure crisis, these states also received a large share of funding under the first wave of the Neighborhood Stabilization Program (NSP1). Authorized in 2008 in response to growing

Table 1
Sample Means for City Clusters

	Established Core Cities	Steady-Growth Cities	Boomburb Cities
Number of loan observations in cluster	2,639,211	1,531,775	441,652
Percent change in population (2000–2008)	2.61	17.69	62.25
Percentage point change in Black share of overall population (2000–2008)	–0.54	0.19	0.70
Percentage point change in White share of overall population (2000–2008)	–3.46	–7.32	–6.16
Percentage point change in Hispanic share of overall population (2000–2008)	3.01	6.36	2.81
Percentage point change in Asian share of overall population (2000–2008)	1.86	1.15	2.73
Percent change in housing units (2000–2008)	4.24	18.18	62.71
Percent of units built after 2000	5.20	16.03	35.07
Median income 2008	\$66,542	\$58,889	\$69,789
Appraisal amount	\$572,998	\$365,394	\$358,243
Percent high-cost loans 2004	10.95	17.06	12.53
Percent high-cost loans 2005	24.93	31.89	25.13
Percent high-cost loans 2006	25.11	35.12	28.10
Median house value 2008	\$598,472	\$374,095	\$377,924

Source: Author's calculations of data from LPS, the American Community Survey, and the U.S. Census

concerns over the concentration of foreclosed homes, NSP1 allocated more than \$3.9 billion in funding for the acquisition and rehabilitation of foreclosed properties. Arizona received \$121.1 million, California received \$529.6 million, and Nevada received \$71.9 million. At the time, the largest concern was that these grant amounts were small in comparison to the need.

Yet the implementation of NSP in these states has been challenging, and many grantees have struggled with allocating the money within the 18-month timeframe. In part, difficulties arose because of the NSP1 program itself: the program was adopted, designed, and deployed

quickly and in a period of crisis, leading to inevitable implementation challenges. But city officials also found that the landscape of REO properties was very different from what they had anticipated. It was hard to find REO properties in NSP1 target areas, for one, and competition from investors with cash offers resulted in numerous lost deals for cities and nonprofits. Why, for example, did North Las Vegas, a city that had more than 4,000 recorded foreclosures by mid-2008, find it so difficult to identify and acquire foreclosed properties under NSP? Clearly, early assumptions about REOs and trends in the housing market in these Western boomburbs deserve to be revisited.

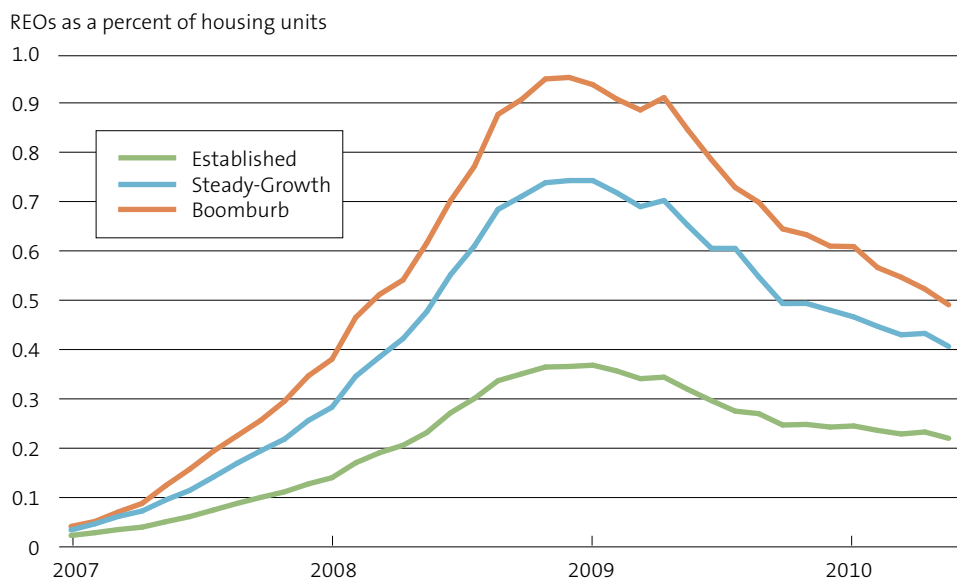
Data and Methods

This article examines vacancies and REOs in more than 275 cities with a population over 25,000 in Arizona, California, and Nevada.⁷ These places include older and larger cities, such as Los Angeles, Oakland, and Phoenix, as well as suburban cities that grew quickly in both housing and population during the subprime boom, such as Avondale City, Arizona, and Riverside, California. These cities were then classified into three clusters using Census data and labeled as follows: a) *established core cities*, with older housing stock and slower overall population growth; b) *steady-growth cities*, which saw a moderate amount of growth and investment during the subprime boom, but that have a mixture of older and newer neighborhoods and housing stock, and c) *boomburb cities*, which saw rapid growth in both population and housing stock during the subprime boom.⁸ Despite the diversity of cities within each cluster, boomburb cities saw very rapid changes between 2000 and 2008 (see table 1). More than a third of the housing stock in boomburb cities was built after 2000, compared with

just 5 percent in established core cities, and the population became increasingly diverse as new households sought the more affordable housing located in these communities.

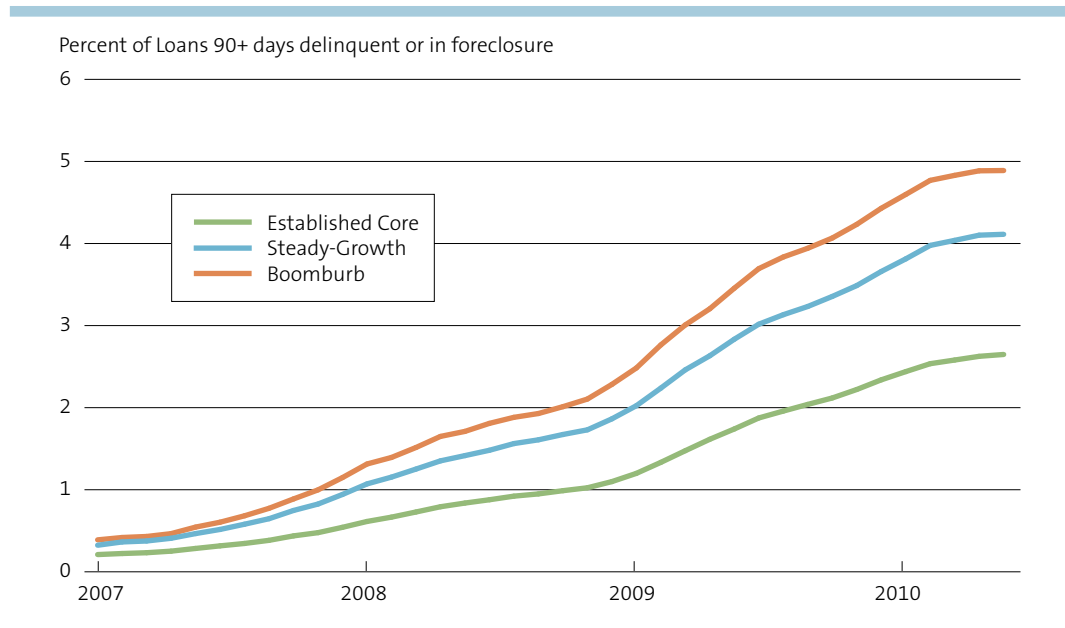
Data on REOs are derived from a proprietary loan performance database known as Lender Processing Services (LPS) Applied Analytics, Inc. As of December 2008, the LPS dataset covered nearly 60 percent of active residential mortgages in the United States, representing about 29 million loans with a total outstanding balance of nearly \$6.5 trillion. The broad coverage of LPS allows for comparison across places, yet it also has drawbacks, particularly when one wants to describe what is happening in a specific locality.⁹ As a result, the numbers presented here should be viewed as indicative of broad trends across the three clusters of cities rather than as exact percents or estimates of local REO stock. The status of the loans in the database—for example, if they are seriously delinquent, in foreclosure, or in REO—is observed monthly from January 2007 through February 2010. In addition, I draw on insights

Figure 3
Concentration of REO Properties in U.S. Cities
By Cluster Type



Source: Author's calculations of data from Lender Processing Services Applied Analytics, Inc., the American Community Survey, and the U.S. Census

Figure 4
Delinquencies and Foreclosures in U.S. Cities
 By Cluster Type



Source: Author's calculations of data from Lender Processing Services Applied Analytics, Inc., the American Community Survey, and the U.S. Census

from interviews with local leaders in many of these communities to supplement the quantitative results.

What's Happening in the Boomburbs?

We've been competing with investors on the acquisition side for months, losing out on a number of houses. Now we don't even have a chance because the houses don't even reach the REO stage.

—NSP coordinator
 Central Valley, CA

Figure 3 illustrates the concentration of REOs in each category, measured as the percent of REOs in relation to the number of housing units. The figure illustrates two clear findings: first, REO stock in boomburb cities is much greater than that in established core cities; and second, the concentration of REOs increased dramatically from early 2007 to the end of 2008. In October 2008, approximately 1 in 100 properties in boomburb cities were REOs. Yet the graph also shows that since then, the concentration of REOs has fallen more quickly

in boomburb cities than in the other clusters. Although this could be attributed to a drop in the number of foreclosures, in fact, the data show that the share of loans that are 90-plus days delinquent or in the foreclosure process continues to rise steadily, and is greatest in boomburb cities. By February 2010, nearly 5 percent of all housing units in boomburb cities were in this “shadow inventory” of homes on the cusp of foreclosure sale and transition to REO (see figure 4).

So what is driving the drop in REO concentrations in these markets? One contributing factor could be the pace of REO sales. Figure 5 presents data on the number of REOs sold each month as a share of all the REOs on the market. Although REO sales were stronger in established core cities at the start of the foreclosure crisis, REO sales rates in the three categories have converged since the start of 2009. Overall, about one in five existing REO properties is sold each month. Because the inventory of REOs in boomburb cities is significantly higher, greater overall numbers of REOs are sold each month,

thus clearing these properties more quickly from banks' books, which may have some effect on the ratio of REOs to the total number of housing units in a city.

Another contributing factor to the drop in REO concentrations is the rise in forced or distressed sales. Interviews with local leaders point to a growing percentage of sales occurring *before* the property becomes an REO, either selling at auction or through the short-sale process. Nevada Title Company, a local provider of market-level data in the Las Vegas Valley, has seen a significant rise in the number of short sales in the region, accounting for nearly a quarter of all closings in February of 2010.¹⁰ The LPS data show a similar increase, with a greater percent of distressed properties in boomburb markets selling before they enter the REO process, compared to distressed properties in established core cities (see table 2).¹¹ Within the LPS sample, 8 percent of distressed properties (90-plus days delinquent or in foreclosure) in boomburb areas sold before becoming REO, compared to 3.9 percent in established core cities. REOs also cleared through the pipeline a bit more quickly

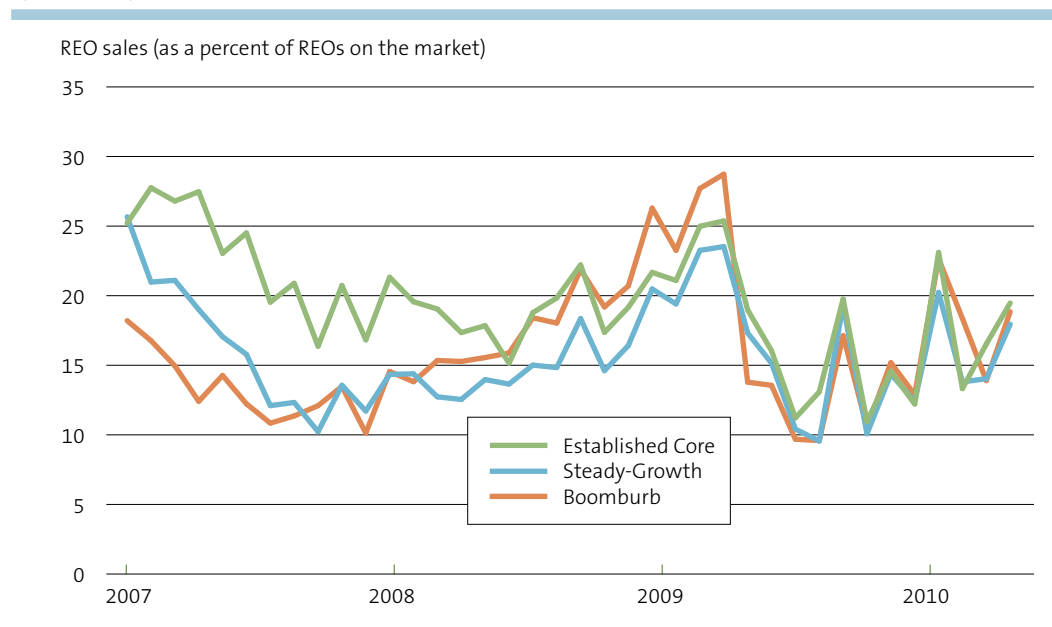
in boomburb markets, at an average pace of 231 days to REO sale compared with 254 days in established core markets.

Challenges for Neighborhood Stabilization

City officials tasked with implementing the NSP program say that the increasing number of properties selling before they become REO has made it even more difficult to acquire foreclosed properties. Until recently, the program limited acquisition to properties that had gone completely through the foreclosure process, thereby disallowing grantees from purchasing properties through a short sale. In April 2010, the U.S. Department of Housing and Urban Development issued changes to NSP requirements, broadening the definitions of "foreclosed" and "abandoned" and allowing jurisdictions to acquire properties earlier in the foreclosure process.

While the rapid turnover of REO properties may indicate the stabilization of the housing market in these suburban communities, it is hard at this point to assess whether the clearing

Figure 5
REO Sales Rates in U.S. Cities
By Cluster Type



Source: Author's calculations of data from Lender Processing Services Applied Analytics, Inc., the American Community Survey, and the U.S. Census

Table 2
Movement of Properties through Foreclosure Process

	Established Core	Steady-Growth	Boomburb
Mean Number of Days in Foreclosure	189	177	176
Mean Number of Days REO Remains on Market	254	245	231
Percent Short Sales	3.89	7.37	8.01
Percent Change in House Values Since Origination	8.63	23.43	26.48

Source: Author's calculations of data from Lender Processing Services Applied Analytics, Inc., the American Community Survey, and the U.S. Census

of the REO inventory is truly the right way to view “stabilization.” One troubling finding in this analysis is that in boomburb markets, prices have fallen much more dramatically than in established core cities. Borrowers in boomburb cities saw price declines of more than 25 percent in their ZIP code since origination, compared with price declines of around 9 percent in established core cities.¹² The increasing number of houses selling at far below their previous assessed values has many housing counselors worried, particularly as they see more and more homeowners questioning whether or not they should remain in their homes.

“The psychology does seem to be changing,” said one counselor. “We used to have homeowners coming in begging us to help them keep their homes, but now maybe one in four or one in five clients is asking us the best way of getting out.”

In addition, the predominance of investor purchases of distressed properties leads many local leaders to question what kind of communities they will be left with at the end of the crisis. While the LPS data don't allow an analysis of who is buying the REOs, local interviews corroborate the fact that houses at the lower end of the market are selling much more quickly than higher-priced homes.

“Investors—both big and small—are buying up the cheap inventory. So far we've seen no evidence that they plan to put any money into these properties,” reported a city official in Murrieta,

a suburban community located in southwestern Riverside County in Southern California. “If they're just holding these houses for land values to go back up, we're going to have a hard time rebuilding the schools, small businesses, and services that go into a healthy community.”

Others offer a less bleak assessment for the future of these communities. In Elk Grove, California, a community that typifies the “boom” and “bust” of newspaper headlines, city administrators are seeing many homes being purchased by families and other first-time homebuyers, driven at least in part by the federal homebuyer tax credit.

“Investors seem less interested in these homes,” reported one city official. “They're still selling a bit too high to buy in bulk, and instead they look attractive to new homebuyers who can now buy a three-bedroom house—which was out of reach just a few years ago—for around \$150,000.”

NSP administrators from boomburb cities report that the REOs they purchase in these markets generally need less rehab investment than those in older neighborhoods, which allows them to commit more funding to acquisition. This is different from the experience of cities such as Los Angeles, where rehabbing properties is generally significantly more costly than administrators there had anticipated.

“Buyers like the newer homes,” said a housing developer in Stockton. “The properties that are

languishing are the older homes, in the older neighborhoods. No investor wants those either, and they require a lot of investment to turn around, which makes it hard for a nonprofit. I'd be more worried about the lower-income neighborhoods than the new ones."

Conclusion

At this point, it's too early to know which neighborhoods will experience the most long-lasting negative spillover effects from concentrated foreclosures, especially given the lack of publicly available data sources that compile comparable data on housing units, their mortgage status, and information on the purchaser and seller. However, the LPS data provide a small window into this question, and so far shows that REO inventory in newer cities is selling and clearing faster than REO inventory in older cities. Concerns that these communities will become "shuttered subdivisions" seem to be largely unfounded; Postal Service data indicate that long-term vacancy rates in these cities have not dramatically increased. In addition, anecdotal evidence suggests that new households are moving in. While the length of the recession and strength of the labor market will be critical—and uncertain—factors shaping the housing market in these communities going forward, unmet housing demand in western states will likely prevent wholesale abandonment of these suburban cities.

More troubling from the community development perspective is that this positive trend in boomburb cities is being driven both by the deep discounting of house values in these areas and a high volume of investor purchases. Stabilization thus remains elusive.

Although some boomburb cities have been able to obligate a large share of their NSP1 funds, the number of REOs redeveloped to date as affordable housing (both rental and homeownership) remains small. And while house prices have fallen, median house values still remain out of reach for many low- and moderate-income households, especially in California. Other boomburb cities, especially those with limited local community-development infrastructure,

have struggled with implementing NSP1 and stand to lose their non-obligated allocations.¹³ In both cases, the promise of these cities to serve as bedroom communities with affordable homeownership opportunities for an emerging middle class is at risk.

While it may seem naïve to have thought that a small federal program like NSP could intervene in the larger world of private housing-market investment, it is worth considering the importance of public funding—local, state, and federal—in helping to build community in these places: Investing in local schools, transit, and small businesses is critical if we hope to ensure that property values stabilize and that investors view the houses as more than junk bonds. As the recent Brookings report *The State of Metropolitan America*¹⁴ points out, the growth of these boomburbs was neither economically nor environmentally sustainable. The report concludes that the long-term viability of these communities requires investing in their workforce and new industries, as well as reconfiguring their housing and transportation plans to provide options for both homeowners and renters within a carbon-constrained economy.

Carolina K. Reid, PhD, is manager of the research group in the Community Development Department at the Federal Reserve Bank of San Francisco, which she joined in 2005. Her recent research includes analyses of the impact of state anti-predatory lending laws on mortgage market outcomes, the Community Reinvestment Act and the subprime crisis, loan modification outcomes, and racial disparities in housing and mortgage markets. Dr. Reid earned her PhD in human geography from the University of Washington.

Endnotes

¹ Robert E. Lang and Jennifer B. LeFurgy, *Boomburbs: The Rise of America's Accidental Cities* (Washington, D.C.: Brookings Institution, 2007). Lang and LeFurgy define a boomburb as a municipality of more than 100,000 people that has been growing at a double-digit pace for three consecutive decades and is not the major city of any metropolitan area. A "baby boomburb" is a place with the same characteristics but with a population between 50,000 and 100,000.

² Daniel Immergluck, "The Accumulation of Foreclosed Properties: Trajectories of Metropolitan REO Inventories during the 2007–2008 Mortgage Crisis,"

REO inventory in newer cities is selling and clearing faster than REO inventory in older cities.

Community Affairs Discussion Paper No. 02-08, Federal Reserve Bank of Atlanta (2008).

³ Chris Mayer and Karen Pence, "Subprime Mortgages: What, Where, and to Whom?" Federal Reserve Board of Governors, Finance and Economics Discussion Series Working Paper No. 2008-29 (2008).

⁴ Paul S. Calem, Kevin Gillen, and Susan M. Wachter, "The Neighborhood Distribution of Subprime Mortgage Lending," *Journal of Real Estate Finance and Economics* 29(4): 393-410 (2002); Daniel Immergluck and Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development* (Chicago, Ill.: Woodstock Institute, 1999); and Jonathan Hershaff, Susan Wachter, and Karl Russo, "Subprime Lending: Neighborhood Patterns over Time," paper presented at Promises and Pitfalls, the Federal Reserve System's Fourth Community Affairs research conference, Washington, D.C., April 7-9, 2005.

⁵ Anthony Sanders, "The Subprime Crisis and Its Role in the Financial Crisis," *Journal of Housing Economics*, 17(4): 254-61(2008).

⁶ Daniel Immergluck, "The Accumulation of Foreclosed Properties: Trajectories of Metropolitan REO Inventories during the 2007-2008 Mortgage Crisis," Federal Reserve Bank of Atlanta, Community Affairs Discussion Paper No. 02-08(2008); and Daniel Immergluck, "Intrametro-politan Patterns of Foreclosed Homes: ZIP-Code-Level Distributions of Real-Estate-Owned (REO) Properties during the U.S. Mortgage Crisis," Federal Reserve Bank of Atlanta, Community Affairs Discussion Paper No. 01-09 (2009).

⁷ Population data of Census-designated places in the 2006-2008 American Community Survey.

⁸ Clusters were defined using PROC CLUSTER in SAS following Ward's minimum-variance method on the following four variables: percent of housing units built after 2000, change in population between 2000 and 2006-08, change in house values between 2000 and 2006-08, and change in the percent of minority households between 2000 and 2006-08.

⁹ The data collected by LPS do not represent a random sample of the mortgage lending industry and significantly underrepresent subprime loans. In addition, the LPS data have added new servicers over the study period, which means that an increase in REO activity might not represent an increase in the number of new REOs, but rather additional new loans entering the survey as servicer participation expands. To account for the differences in subprime-mortgage-market coverage between LPS and the overall mortgage market, I create weights using data from the Mortgage Bankers Association National Delinquency Survey. In addition, I restrict the observations to loans that entered the dataset before January 2007 or those that entered after January 2007 but had less than five months of history (which ensured that they were newly originated loans, not loans that merely transferred from one servicer to another). See Immergluck 2008, 2009 for a similar approach.

¹⁰ Hubbell Smith, "Short sales skyrocketing: Trend may prevent foreclosure wave," *Las Vegas Review-Journal*, April 25, 2010.

¹¹ LPS does not officially record whether a property is a short sale. To estimate short sales, I assume that properties that are at least 90 days delinquent or in foreclosure and are "paid off" before entering REO are short sales. A loan is paid off when it is sold or refinanced, so this method may overestimate. However, given the difficulty borrowers faced in refinancing homes during the period of this study, the error is probably small.

¹² Using ZIP code-level data on house price changes from Zillow, I attach house price data to each of the loans in the LPS sample for every month the loan is in observation. These estimates of house price declines at the ZIP code level are likely an underestimate, since Zillow's index does not include the sales prices of foreclosed homes.

¹³ In May of 2010, HUD announced plans to reallocate non-obligated funds from NSP1 through a new round of funding.

¹⁴ See brookings.edu/metro/stateofmetroamerica.aspx.

Holding or Folding?

Foreclosed Property Durations and Sales during the Mortgage Crisis

by Dan Immergluck
Georgia Institute of Technology

The problem of vacant and abandoned residential properties is not a new one. In the early 1970s, many U.S. cities were affected by surges in vacancies fueled by property-flipping schemes related to problems with the FHA 235 loan program.¹ Beginning in the latter decades of the twentieth century, industrial restructuring and the development of long-term population loss in many parts of the industrial Midwest and Northeast also created problems of vacancy and abandonment. The national foreclosure crisis beginning in 2007, however, has resulted in unprecedented surges in numbers of vacant homes across many metropolitan areas—including regions that had not experienced large-scale vacancy problems before.

By 2007–2008, the evidence that vacant, foreclosed homes—especially when geographically concentrated—had negative impacts on neighboring property values and social conditions was considerable.² In July 2008, the Housing and Economic Recovery Act (HERA) established what was to become the Neighborhood Stabilization Program (now often referred to as NSP 1). HERA allocated more than \$3.9 billion in NSP funds to be awarded on a formula basis by the U.S. Department of Housing and Urban Development. The purpose of NSP was to allow local governments and their partners to purchase vacant, foreclosed homes and either rehabilitate them for housing or, to a limited extent, redevelop the properties for other uses. HUD was given just 60 days to design and implement the allocation scheme and eligible use rules for NSP, and so NSP funds were allocated beginning in October 2008. By early 2009, most NSP 1 recipients had fully approved

plans for how they were going to deploy funds and had the legal documents in place to begin acquiring properties. NSP 1 provided localities with a window of only 18 months to obligate NSP funds.

NSP was, in the scheme of federal programming, adopted and implemented very quickly—with less than nine months from adoption (late July 2008) to money beginning to hit the streets as early as the spring of 2009. However, the tumult in the nation's financial and housing markets during this period was so great that the nature of the vacant property problem was changing quite rapidly and, by spring of 2009, was significantly different than that of 2007 or the first half of 2008, at least as suggested by the evidence below. The narrow, targeted crafting of NSP, while perhaps justified by other reasons, was not well suited to address the fast-changing nature of the vacant property problem posed by the foreclosure crisis, especially in that it focused on one tactic—the acquisition of properties held by lenders as real-estate-owned (REO) property, or homes where the lender has taken title after a foreclosure sale.

This paper examines property transaction data for Fulton County, Georgia, to identify changes in the duration of properties held in REO status by lenders as well as the nature of the REO sales, including the levels of concentration of sellers (lenders) and buyers, the nature of buyers, and the relative values of properties being sold. It builds on some of the work of Coulton, Schramm, and Hirsh (2009) and Smith and Duda (2009) in Cleveland and Chicago, respectively.³

Anecdotal reports suggest that many if not most REO properties are bought by investors, and that this share has grown during the crisis.

The findings here suggest that, during the time that the NSP 1 program was being initially implemented and rolled out in late 2008 and early 2009, the vacant property problem in Atlanta shifted from one of REO properties to one of primarily investor-owned properties. Banks began to sell off lower-value REO rapidly to a diverse set of buyers. Lenders continued to hold on to higher-value properties for similar amounts of time, however. As properties moved rapidly to nonbank ownership, NSP recipients had less ability to gain control of them.

Fulton County is the central county of the Atlanta metropolitan statistical area and the largest county in Georgia. Its population is approximately one million, and it includes the bulk of the city of Atlanta within its borders. The city of Atlanta accounts for more than 40 percent of the county's population. The county includes a number of quite affluent suburbs to the north as well as moderate-income suburbs surrounding the Atlanta Hartsfield–Jackson airport and large, low-density areas to the south.

Data and Methods

Data on all recorded residential property transfers from January 2005 through April 30, 2009, were obtained from the Fulton County Tax Assessor's Office. From these data, all transfers on one-to-four-unit residential properties, condominiums and townhouses were identified and retained. Data were cleaned for duplicate

records. The buyers and sellers of these properties were then classified as either lenders (including financial institutions, Fannie Mae, Freddie Mac, HUD, the VA, etc.) or nonlenders (individuals or corporate entities of various kinds).⁴ After identifying the buyer and seller for each transfer, sales were categorized as: 1) nonlender-to-nonlender sales transactions; 2) lender-to-nonlender transactions (which would be considered sales of REO properties, or REO sales); 3) nonlender-to-lender transfers (which are properties entering REO status, usually through foreclosure sale or through a deed in lieu of foreclosure); and 4) lender-to-lender transfers, which occur for various reasons and are usually non-cash conveyances.⁵

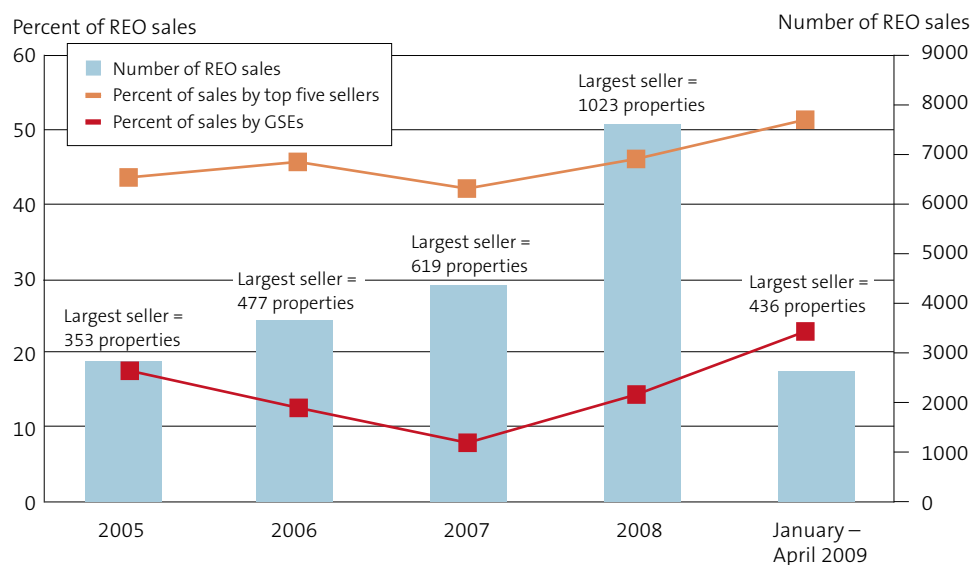
For REO sales (category 2 above), buyers were classified as “likely investors” via two approaches.⁶ First, the buyer's name was examined for various corporate identifiers (e.g., LLC, corp., etc.). Then, buyers purchasing more than two properties in the county in any one calendar year were identified. If a buyer fell into either of these two groups, it was classified as a “likely investor.” Given that some investors may not have purchased more than two properties in any one year and/or have a corporate name, this method almost certainly under-counts investor-buyers versus owner-occupiers. But it is expected that any such undercount would be relatively consistent over time and space and a good indicator of differences and changes

Table 1
Sales on Properties that Entered REO Status at Least Once from January 2005 to April 2009

	2005	2006	2007	2008	Jan–April 2009	Total
Number entering REO	3,206	4,795	7,159	7,672	1,815	24,647
Percent change from prior year		49.6%	49.3%	7.2%		
Number of REO sales	2,886	3,719	4,444	7,751	2,674	21,474
Percent change from prior year		28.9%	19.5%	74.4%		
Nonlender-to-nonlender sales	11,582	9,748	5,594	4,111	1,052	32,087
Total	17,674	18,262	17,197	19,534	5,541	78,208

Source: Fulton County Tax Assesor

Figure 1
Market Concentration and GSE Share Among REO Sellers



Source: Fulton County Tax Assessor

in investor buying. REO sellers (lenders) and buyers were also ranked by REO purchases in each year to examine the concentration of sellers and buyers.⁷

The working dataset for this paper included all transfers on properties that entered REO status at least once from January 2005 through April 2009, excluding inter-lender transfers. The date of REO entry was identified for each REO sale. Thus, the duration of the REO period was determined for each REO sale.⁸ The price of each REO sale was also identified. Table 1 shows that, of the more than 78,000 sales in the dataset, REO sales accounted for more than 21,000. These are the sales that are of interest in this study.

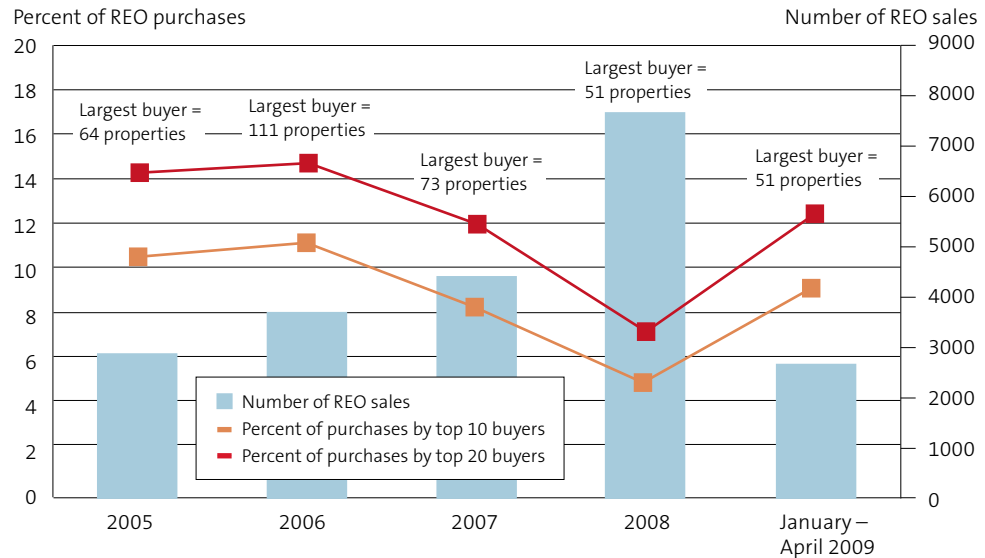
Table 1 also shows that the number of times properties entered REO increased rapidly in 2006 and 2007, but that the rate of growth dropped to only 7 percent from 2007 to 2008.⁹ The drop-off in 2008 was, most likely, partly the result of foreclosure moratoria introduced by many servicers in the fall of 2008.

The number of REO sales in Fulton County increased significantly as well over the 2005 to 2007 period, but at an appreciably slower pace than that of properties entering REO. This roughly matches national trends in which lenders' REO inventories were rising to high levels through much of 2007 and well into 2008.¹⁰ In 2008, the rate of REO sales in Fulton County picked up quite dramatically, with an increase of almost 75 percent, and lenders began selling many properties that they had been holding onto and selling even newer REO more quickly. This will be demonstrated in more detail below.

The Nature and Concentration of REO Sellers and Buyers

Figure 1 provides information on the nature of the sellers of the REO properties, that is, the lenders or mortgagees. While REO properties are often sold by loan servicers, the mortgagee is typically a trustee of a mortgage pool for which the servicer is acting as an agent. For government-sponsored enterprise (GSE) and FHA loans, following the typical foreclosure and initial transfer from the servicer to the GSE or HUD, the transferee owns the REO and is the seller. Figure 1 indicates the volume

Figure 2
Market Concentration of REO Buyers



Source: Fulton County Tax Assessor

of REO sales against two measures describing the composition of REO sellers. First, it gives a concentration ratio—the share of REO properties sold by the largest five sellers of REO properties for each calendar year. It also gives the proportion of REO properties sold by the GSEs, Fannie Mae, and Freddie Mac.

The top-five-seller concentration ratio increased somewhat, but not dramatically, over the period, ranging from just over 40 percent of sales to just over 50 percent. The increase in this share beginning in 2008 is due to the greater presence of the GSEs among the top sellers. GSE share had dropped from 2005 to 2007 as the initial subprime crisis grew, because non-GSE subprime loans dominated REOs. Most of these loans were held in securitized trusts. This meant that the GSE share of REO sales dropped to less than 10 percent in 2007. But with the foreclosure problem spreading to Alt-A and prime-market segments, the GSE share of REO sales grew in 2008 and early 2009, exceeding 20 percent by early 2009. Figure 1 also indicates the volume of REO sales in the county by the largest seller in each year. As will be shown below, the REO seller

market is much more concentrated than the REO buyer market.

Figure 2 provides information on REO buyers similar to the information on sellers provided in figure 1. However, it shows the percent of all REO properties bought by the top 10 and top 20 buyers in each year. It also indicates the number of properties purchased by the largest buyer in each year. Similar to patterns found in Cuyahoga County, Ohio,¹¹ the buyer market is highly atomistic, or disparate, with numerous small buyers and relatively few large buyers. Most properties are purchased by entities—usually individuals—purchasing one or a few properties in the county over the course of a year. The top 10 buyers comprised less than 12 percent of purchases every year, a share that fell to less than 5 percent in 2008 as REO sales surged. Even among the top 20 buyers, their share of all sales never exceeds 15 percent of purchases. Most of these larger buyers are corporate entities, usually structured as limited liability corporations (LLCs). Eighty to 95 percent of the top 20 buyers in each year were identifiable as corporate buyers.

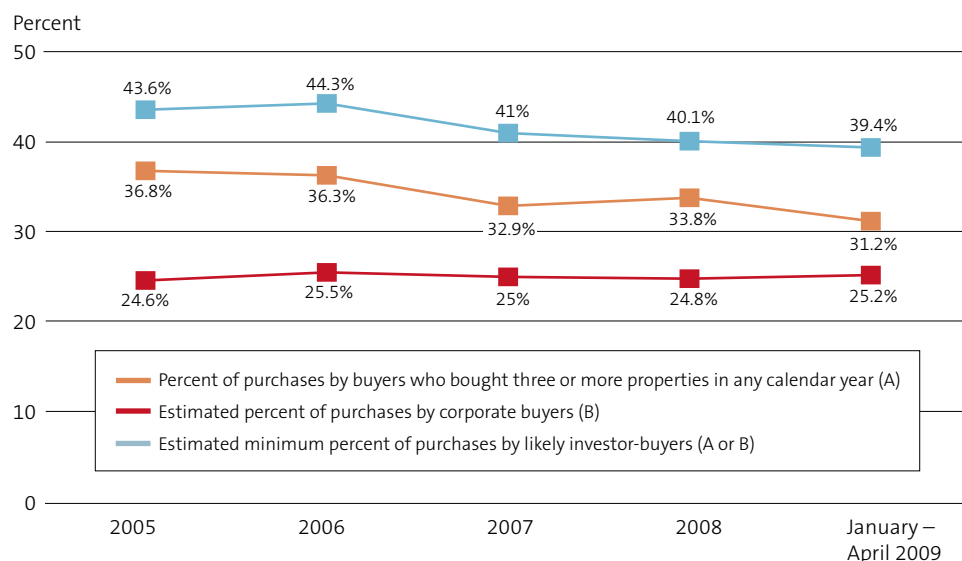
One question that arises is the extent to which REOs have been bought by owner-occupants versus investors. Anecdotal reports suggest that many, if not most, REO properties are bought by investors, and that this share has grown during the crisis.¹² In Atlanta, there has long been a very active investor market for single-family homes, and a large share of rental housing in the city occurs via detached single-family properties.

Figure 3 breaks out the REO sales between “likely investors” and other buyers. The raw data obtained from the Fulton County tax assessor do not provide a reliable indicator of owner occupancy. Therefore, investor versus owner-occupant status must be estimated. The approach used here is a conservative one and almost certainly underestimates the share of investor purchases. First, all corporate buyers are assumed to be investors. REO properties are identified as having corporate buyers if the buyers’ names include “LLC,” “corp.,” “group,” and similar terms. Figure 3 shows that the share of purchases by corporate entities held quite steady at about 25 percent each year. A second category of likely investor-buyers were those who bought three or more properties in

any calendar year. This share declined significantly, from more than 36 percent in 2005 and 2006 to 31 percent in the first four months of 2009. The top curve in figure 3 measures the share of properties that fall into either of the first two groups, which are not mutually exclusive. Many corporate buyers purchased three or more properties in a year and so fall into both of the categories.

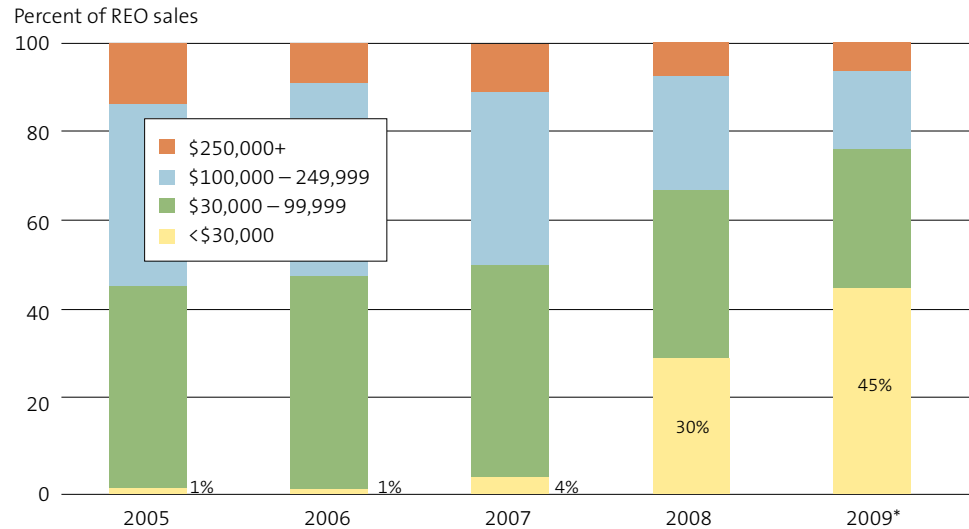
The approach used here is a conservative one. Some small investors may never purchase more than one or two properties in any year, for example, and so would not be classified here as likely investors unless they used a corporate name in their transactions. Nonetheless, the degree to which this measure underestimates investor activity is not expected to vary across time or geography, making this a useful indicator. Because the percent of purchases by buyers who bought three or more properties declined, the overall likely investor share declined, although not drastically, over time. It could be that this downward trend is, in fact, due to a rise in the number of investors purchasing one or two properties per year.

Figure 3
Percent of REOs Purchased by Likely Investors



Source: Fulton County Tax Assessor

Figure 4
Shares of REO Sales by Price Range



* January–April 2009
Source: Fulton County Tax Assessor

Figure 3 shows that, overall, the share of REO sales that went to likely investors did not change very much over the study period. However, this share varies a great deal across different housing-value ranges, and that within some ranges this share changed quite substantially over time.

REO Sale Prices and Investor Shares by Price Range

The single most dramatic change in the REO sales market during the mortgage crisis was the rapid increase in REO properties selling at very low prices. Similar to findings from the Cleveland area, figure 4 shows that the share of REO properties in Fulton County that sold for under \$30,000 shot up from negligible levels in 2005 through 2007 to more than 30 percent in 2008 and 45 percent in the first four months of 2009. This is consistent with reports of low-value properties languishing in REO for extended periods during the early part of the foreclosure crisis in Atlanta, followed by lenders beginning to dump properties—the practice of rapidly selling these mostly low-value properties—as the foreclosure crisis spread nationally and the national and global financial crises took hold in the fall of 2008.

Figure 5 provides additional data on REO sales by showing their raw magnitudes by year across various value levels, but then also breaks out those properties that were purchased by “likely investors,” as defined in the previous section. Two things are important to note here. First, as might be expected, low- and moderate-value REO properties were sold to likely investors at much higher rates than were middle- and high-value REO over the study period. For example, likely investors never accounted for more than 23 percent of high-value (more than \$250,000) REO sales, and this share declined in 2008 and 2009. Similarly, for middle-value (\$100,000–249,999) properties, the share of likely investors never accounted for more than 32 percent of sales, and declined to less than 10 percent in 2008 and 2009.

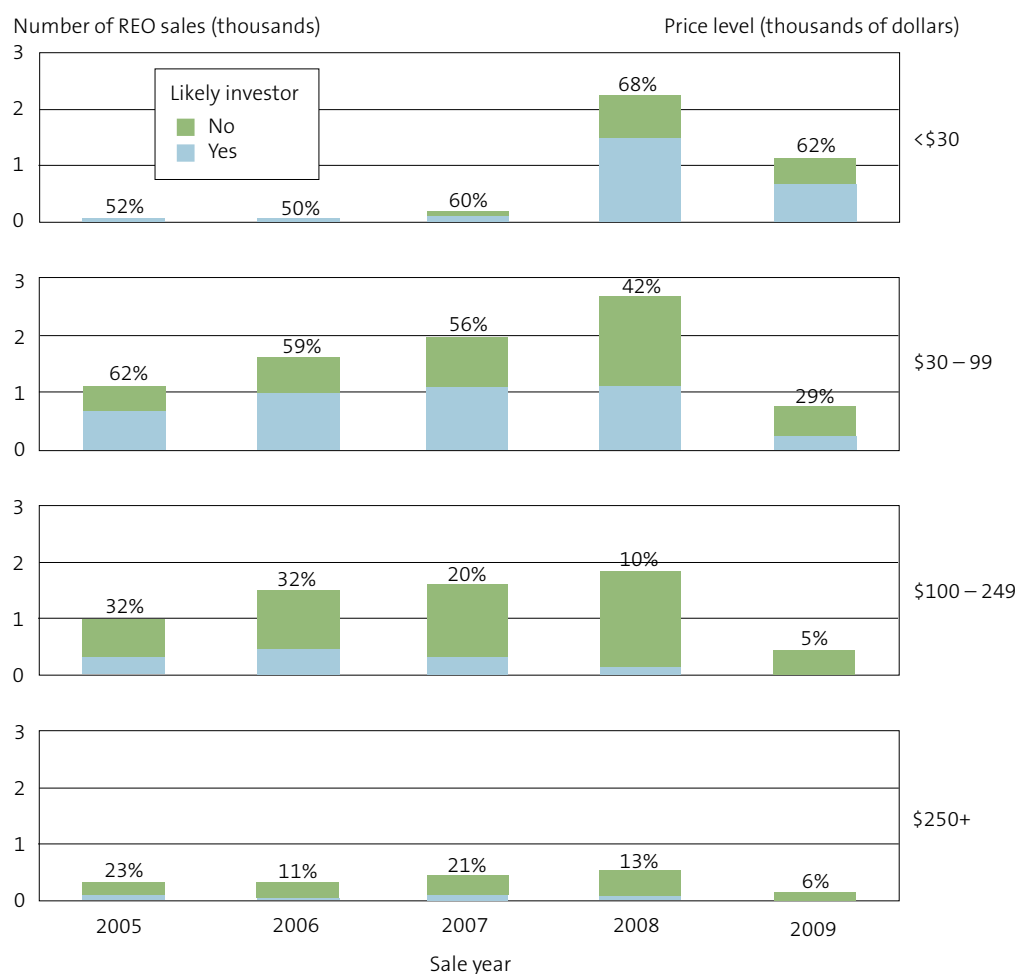
Second, the surge in low-value REO sales was driven by sales to likely investors, who accounted for 68 percent of low-value REO sales in 2008. Prior to 2008, most REO sales to likely investors were in the \$30–99,999 range, but the under-\$30,000 category grew in 2008 and 2009. Two phenomena likely underlie these shifts. First, investors moved away from

moderate- and higher-value properties and toward low-value ones. While an explanation is beyond the scope of this research, it may be that the ease of acquiring such low-value properties via cash transactions and the much tighter mortgage market for investor-owned property played a role. Moreover, property investors' relative difficulty in purchasing multiple properties at higher prices given the more restrained lending environment likely played a role in these trends.¹³ The second phenomenon underlying these shifts is the significant drop in value of many moderate-value properties, moving them into the low-value category and increasing the REO activity in that price range.

REO Duration

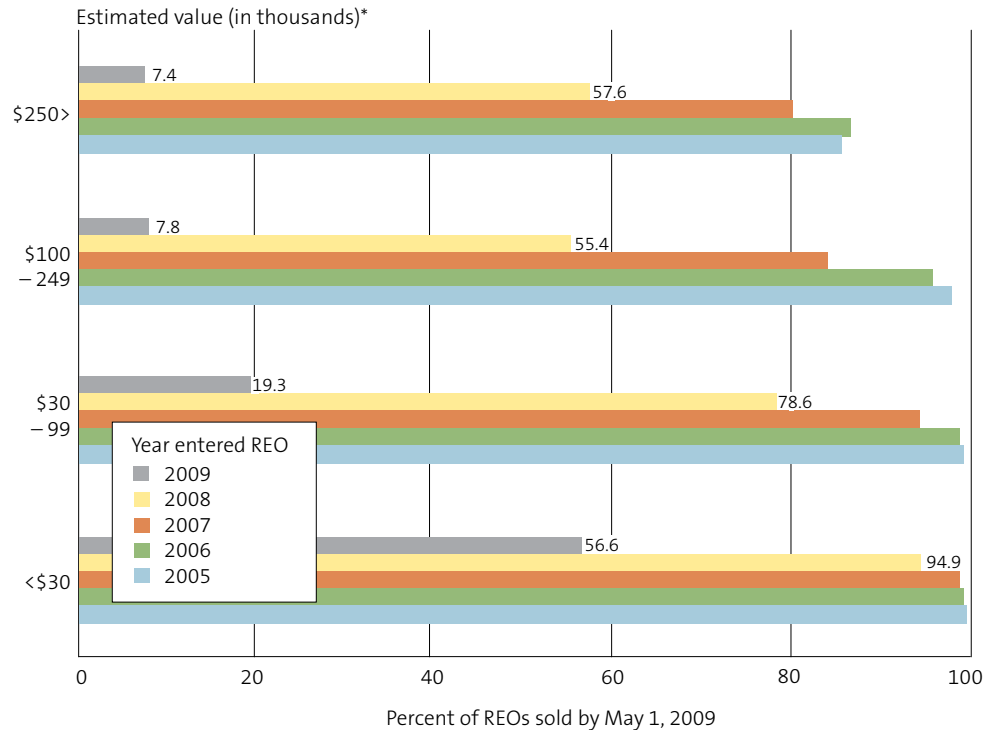
One significant feature of a local REO market that directly affects redevelopment efforts like NSP is the length of time properties remain in REO. There was some concern around the time of HERA's adoption that properties would languish in bank ownership, which some felt the private market had little interest in purchasing. Moreover, there were indications that some lenders were reluctant to sell properties at depressed prices and might hold on to many REO properties in the hope that values would recover to pre-crisis levels or somewhere close to them. On the other hand, given some

Figure 5
REO Sales by Value and by Likely Investor Status
 (Percentages are the shares of REO buyers who are likely investors)



Source: Fulton County Tax Assessor

Figure 6
Percent of All REOs Sold by May 1, 2009
 By Year of REO Entry and Value



*Price of REO sale or, if remaining in REO at May 1, 2009, foreclosure sale price.
 Source: Fulton County Tax Assessor

of the challenges and requirements involved in implementing the NSP program at the local level, longer REO times might provide more opportunities for local governments to acquire properties. If properties are sold quickly and at very low prices, competition from investors and other buyers is likely to be more intense.

Figure 6 shows the percent of REOs, by year of entry and price level, that were sold by the end of the study period. As would be expected, for properties entering in 2005 through 2007, these shares tend to be quite high, although a significant share of high-value properties entering REO during these years remained in REO at the end of the study period. For example, almost 14 percent of properties with estimated values of at least \$250,000 that entered REO in 2005 were still in REO up to four years later. On the other hand, essentially all properties entering REO in 2005 and 2006 with values under \$100,000 were sold by May 1, 2009.

Figure 6 also shows that low-value properties have sold more quickly than higher-value properties in recent years (2008, 2009). For REOs priced below \$30,000 (either the sale price or the foreclosure sale price if still in REO), almost 95 percent of the REOs entering in 2008 were sold by May 1, 2009. (Later analysis will show, however, that in the earlier years of this study, most low-value properties did languish in REO for long periods of time.)

Figure 7 examines the median REO durations for just those REO sales where the estimated value was below \$30,000. This analysis includes properties in REO at May 1, 2009 (these are called “censored observations” since we don’t know the end of the REO period), but in this price range, there are relatively few of those.¹⁴ This fact mitigates the censoring bias when looking at median durations in this low-value range of REO sales.

Also shown in figure 7 are the volumes of low-value (less than \$30,000) REO entrants. In 2005 and 2006, there were very few of these. This is both because there were fewer REO entrants at any value level and because sale prices for REOs were higher for the earlier years. Low-value REO entrants surged in 2007 with the subprime crisis and continued in 2008. However, the duration of low-value properties plummeted over time as lenders began selling low-value REO more rapidly in 2008. In fact, the median time in REO for these properties dropped by more than half from those entering in 2007 to those entering in 2008.

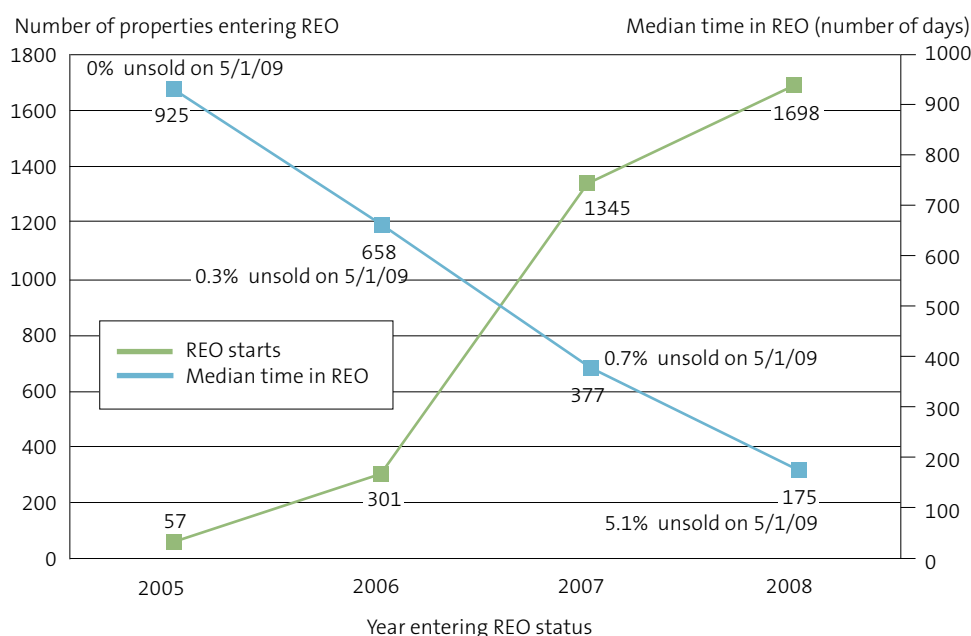
One method for examining durations until events of interest is survival analysis. Because it may be conceptually easier to view REO duration by examining the percent of REOs selling within various durations rather than examining the percent not selling (which would be equivalent to survival), “one-minus-survival” curves are plotted for REO entrance-to-sale durations across different entrance years for four value categories. These curves allow one to compare

the REO durations across different years of entry. We can also examine whether REOs at different price points behaved differently over time. Moreover, Kaplan–Meier survival analysis allows us to include censored observations (properties remaining in REO as of May 1, 2009), thus increasing the reliability of estimated durations for REOs beginning in 2008 and 2009.

Figure 8 is the set of one-minus-survival curves for REOs with values under \$30,000. It shows large differences in the speed to sale of low-value properties over the study period. The curves move clearly to the left as the year of entrance progresses. Thus, low-value properties entering REO in 2008 or 2009 took far less time to sell than those entering in 2005 or 2006.

Figures 9, 10, and 11 provide the Kaplan–Meier results for homes in other value ranges. They show far smaller differences in REO durations across the year of entry. Moreover, they suggest two other important patterns. First,

Figure 7
Median Time on Market for Low-Value Properties Entering REO
 <\$30,000

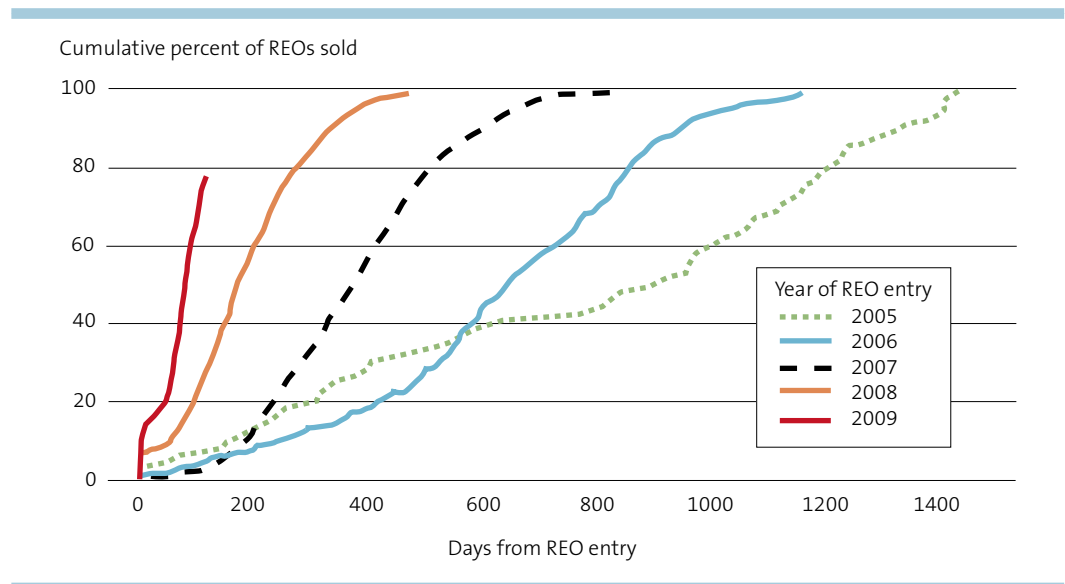


Source: Fulton County Tax Assessor

for high-value properties (\$250,000 or above; figure 11), the curves tend to reach their limits at less than 90 percent, consistent with the findings in Figure 6. Thus, some modest but nontrivial portion of high-value REO properties fails to sell for very long periods of time.

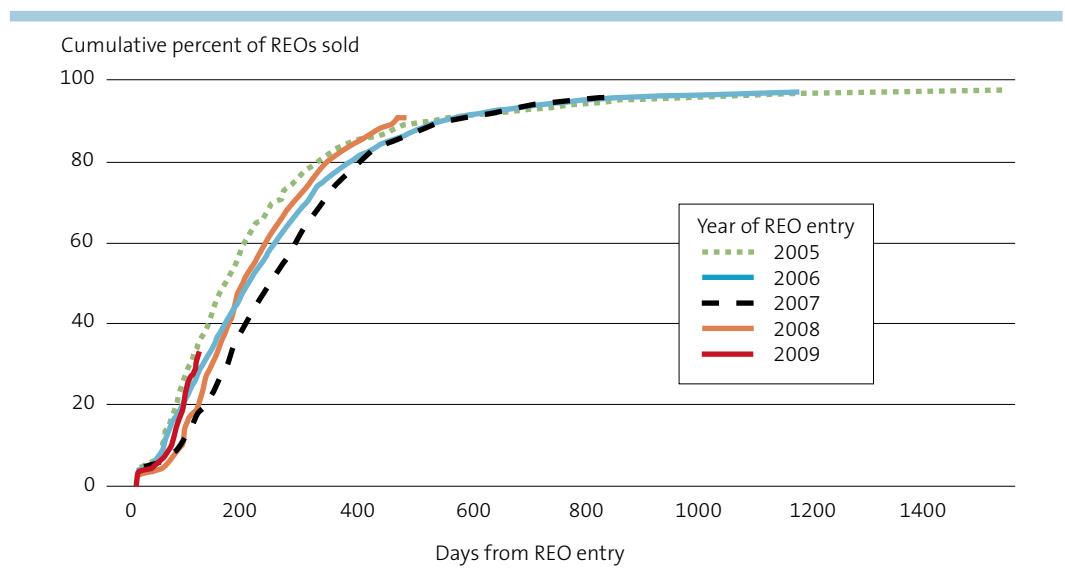
Second, this phenomenon appears to have begun affecting REOs in the moderate price range (\$100,000–249,999) in 2008 and 2009. Thus, lenders may be increasingly likely to hold onto higher-value and, more recently, even moderate-value REOs for longer periods of time.

Figure 8
Time to REO Sale by Year of REO Entry
<\$30,000



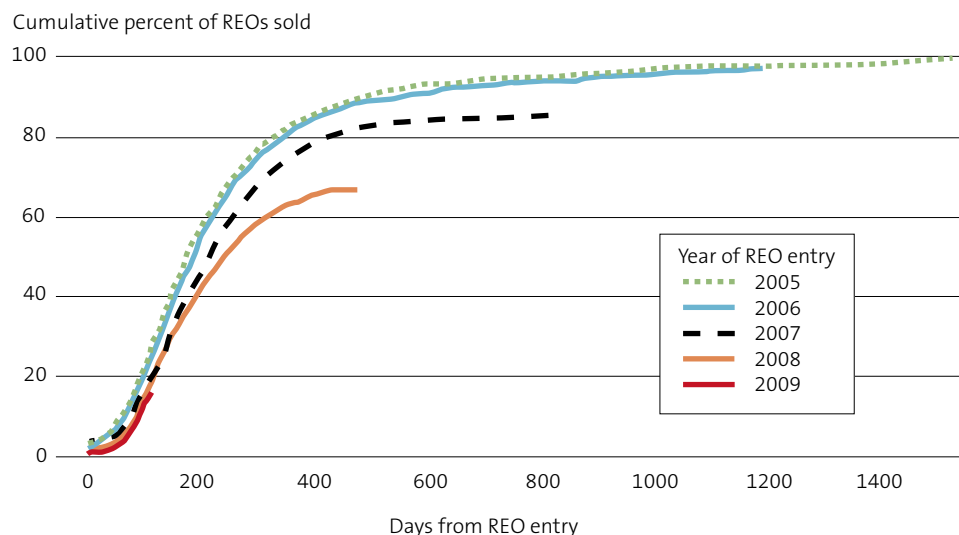
Source: Fulton County Tax Assessor

Figure 9
Time to REO Sale by Year of REO Entry
\$30,000–99,999



Source: Fulton County Tax Assessor

Figure 10
Time to REO Sale by Year of REO Entry
 \$100,000–249,999



Source: Fulton County Tax Assessor

time. This may reflect lenders' willingness to bet that the prices of higher-value homes may recover. Mortgagees may conclude that the possibility of such price recovery is worth the carrying costs entailed in holding the properties for longer periods. Carrying costs may also be higher for low-value properties that are located in places where they are more likely to be subject to vandalism and/or the stripping of fixtures, copper, or other materials. Because the NSP program prescribed most funds to be used for acquiring foreclosed properties, in places where REOs were dumped by lenders to investors, NSP recipients were left with fewer properties that they could acquire in neighborhoods heavily impacted by vacancies.

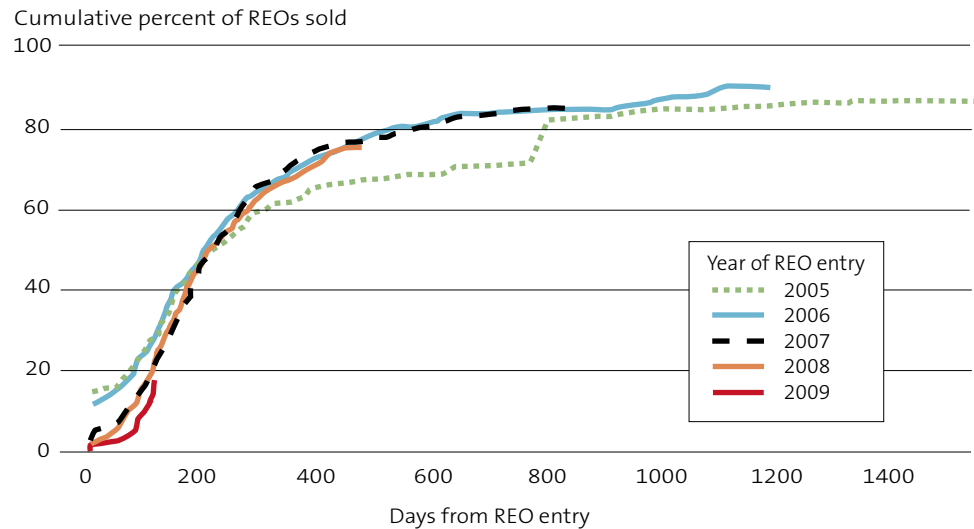
Summarizing the Key Empirical Findings

This analysis shows that some aspects of the REO market shifted quite significantly during the U.S. mortgage crisis, at least in the central county of the Atlanta metropolitan area. Some patterns were quite consistent over time, including the fact that the seller side of the market was much more heavily concentrated than the buyer side. Another consistent pattern

over time was the atomistic, or separate and highly disparate, nature of the buyers, with the largest buyers comprising only a very small portion of the market. The overall share of buyers who were likely investors also did not change very much from 2005 to 2009, although there was some decline in the share of properties bought by investors purchasing at least three properties in a calendar year. And finally, while the levels changed over time, the share of buyers who were likely investors was consistently higher at lower property-value levels.

The striking changes in the durations of low-value REOs support anecdotal reports of lenders beginning to sell such REOs rapidly and in higher quantities in the latter part of 2008 and into 2009. The volume of low-value properties entering REO in Fulton County rose drastically in 2007 and 2008; likewise, the sales of these properties rose rapidly in 2008 and early 2009. The speed at which low-value REOs increased so much that 95 percent of those entering in 2008 were sold by May 1, 2009. Similarly, more than half of REOs entering between January and May of 2009 were sold by May 1.

Figure 11
Time to REO Sale by Year of REO Entry
\$250,000+



Source: Fulton County Tax Assessor

Interestingly, lenders did not respond this way for the higher-value REOs they held. Durations for moderate-value REOs (\$30,000–99,999) were much more consistent overall, and the modest changes fluctuated back and forth during the study period. In the case of high-value properties (more than \$250,000), lenders tend to hold onto a small but nontrivial portion—more than 10 percent—of properties for a very long time. This behavior was generally consistent over the study period. For middle-value properties (\$100,000–249,999), the REO durations also changed over time, but in the opposite direction, as was the case for low-value properties. Durations increased in later years, so that only about 65 percent of REOs started in 2008 were expected to be sold within 500 days, compared to approximately 90 percent for REOs started in 2005 in this value range.

While the more rapid selling of low-value REOs may at first seem to signal a successful absorption of such properties into productive reuse, the on-the-ground impacts of such activity are less than entirely clear. For example, researchers found that many low-value properties in the Cleveland area went from REO sale to another transaction in fairly short order.¹⁵

This flipping of properties suggests speculative buyers that may have little intention of rehabilitating properties that tend to be physically distressed and in need of rehabilitation or even demolition. More work is needed to determine whether similar flipping behavior is occurring in Fulton County.

Implications for Neighborhood Stabilization Policy and Practice

The findings above have implications both for the near-term implementation of neighborhood stabilization efforts and for future policy design. First, the rapid turnover of lower-value REO properties—often to investor-owners—raises several concerns. While responsible investor activity in the market is necessary to reutilize REO properties and can provide increased supplies of affordable, decent-quality rental housing, such an outcome may not be the predominant one in all communities. Some investor properties remain unoccupied and boarded up or dilapidated, perhaps driven by investors' betting on near-term increases in values and hoping to merely resell the property in fairly short order. Other investors may seek to rent out properties without rehabilitating homes that are likely in very

poor condition; these properties may continue to have significant negative spillover impacts on neighborhoods.

Given the dominance of what appear to be “mom and pop” investors who purchase no more than a handful of properties each year, and given the very low values of many REO sales, the capacity and inclination of these investor-owners to rehabilitate and maintain properties adequately are of some concern. Many of these low-value transactions are likely to be all-cash purchases. In addition, credit availability for repairs and improvements is likely to continue to be scarce.

Such a scenario suggests the likelihood of two other problems either growing more acute or, in some places, emerging. First, housing code enforcement resources may be severely stressed by growing numbers of deteriorating properties. Second, small, cash-strapped investors may also have difficulty paying property taxes, suggesting the potential for increased tax delinquency problems. Many local governments will need stronger and more effective policy tools and programs to enforce property tax collection and to reclaim tax-delinquent properties for revitalization. State lawmakers should provide local governments with the fundamental tax foreclosure and reactivation powers to design and implement such programs.

In terms of policy and program design in the neighborhood stabilization arena, our findings here suggest that highly restricted funding schemes, such as the federal NSP programs, may be far too inflexible to provide for effective local responses to property vacancy and abandonment. By the time NSP 1 program funding was made available to localities, the vacant REO problem—at least in many low-income, impacted neighborhoods—may have become the more serious problem of many vacant, investor-owned homes and dilapidated, shoddy rental housing.

With continued waves of foreclosures and new REO properties mounting, community development groups must have flexible pools of

funds to respond opportunistically and strategically by buying properties either from banks directly or possibly from investors or homeowners (via short sales, for example). Using public funds to purchase homes from investors may be cause for some concern over whether such efforts would provide for middle-men speculators to extract subsidy from the process. This is a legitimate concern and any such buying must be done carefully. However, in practice, allowing for modest gains to investors may be the necessary cost of achieving scale in property recovery and redevelopment.

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Endnotes

¹ See Calvin Bradford, “Financing Homeownership: The Federal Role in Neighborhood Decline,” *Urban Affairs Review* 14: 313–335 (1979); and Rachel Bratt, “Homeownership Risk and Responsibility before and after the U.S. Mortgage Crisis,” in Richard Ronald and Marja Elsinga, eds., *Beyond Home Ownership* (London: Routledge, forthcoming).

² See Dan Immergluck and Geoff Smith, “The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values,” *Housing Policy Debate*, 17(1): 57–80 (2006); Dan Immergluck and Geoff Smith, “The Impact of Single-family Mortgage Foreclosures on Crime,” *Housing Studies* 21(6): 851–866 (2006); and Jenny Schuetz, Vicki Been, and Ingrid Gould Ellen, “Neighborhood Effects of Concentrated Mortgage Foreclosures,” *Journal of Housing Economics* 17(4): 306–319 (2008).

³ See Claudia Coulton, Michael Schramm, and April Hirsh, “Beyond REO: Property Transfers at Extremely Distressed Prices in Cuyahoga County, 2005–2008,” Center on Urban Poverty and Community Development (Cleveland, Oh.: Case Western University, 2008) at http://blog.case.edu/msass/2008/12/09/20081209_beyond_reo_final.pdf; and Geoff Smith and Sarah Duda, *Roadblock to Recovery: Examining the Disparate Impact of Vacant, Lender-owned Properties in Chicago* (Chicago, Ill.: Woodstock Institute, 2009), at <http://www.woodstockinst.org/publications/download/roadblock-to-recovery%3a-examining-the-disparate-impact-of-vacant-lender-owned-properties-in-chicago/>.

The single most dramatic change in the REO sales market during the mortgage crisis was the rapid increase in REO properties selling at very low prices.

- ⁴ This process involved an automated search of the seller and buyer fields for various words or abbreviations that denote a financial institution or mortgagee. The search strings were developed after careful examination of the data. After this classification, random samples of the data were checked for the accuracy of the classification and the classification was iterated to account for financial institution names not captured by the original attempt.
- ⁵ Inter-lender transfers are common in Fannie Mae and Freddie Mac foreclosures, where the servicer typically takes recorded title to properties when foreclosure is complete, then quickly conveys title to Fannie Mae or Freddie Mac. Typically, this also occurs for FHA loans, where conveyance is to HUD.
- ⁶ The term “investors” here means buyers who are likely purchasing the property for investment-income purposes—either to rent out or for expected capital gains, or both. Investors can be corporate entities (including LLCs, corporations, etc.), individuals, or couples.
- ⁷ This required identifying seller and buyer names that were probably different variations of the same entity. For example, Bank of New York, NA, was considered equivalent to Bank of New York. This was done only for seller names and corporate buyers; individual names were assumed to be unique. While this certainly was not always the case in reality, it is very difficult to identify variations in individual buyers’ names consistently. More importantly, corporate buyers dominated the ranks of the top 20 buyers in all years (accounting for 16–19 of the top 20), so this assumption should not be material in calculating concentration.
- ⁸ Sales for properties already in REO status as of January 1, 2005, are not included in any analyses here. Also, inter-lender transfers are ignored in calculating REO durations, which are measured as the number of days from the foreclosure sale (nonlender-to-lender) to the REO sale (lender-to-nonlender).
- ⁹ Properties flowed into REO status more quickly in Atlanta than in some other markets for two reasons. First, mortgage defaults and foreclosures began growing earlier in Atlanta than in Florida, California, or many other “bubble market” regions because property value growth had mitigated foreclosures in those places until late 2006. Second, the quick foreclosure process in Georgia means that properties can flow into foreclosure very rapidly once the process begins, often in less than two months. In most places, the period from foreclosure notice to sale is much longer.
- ¹⁰ Dan Immergluck, *The Accumulation of Foreclosed Properties: Trajectories of Metropolitan REO Inventories during the 2007–2008 Mortgage Crisis*. Federal Reserve Bank of Atlanta, Community Affairs Discussion Paper, No. 02-08 (2008).
- ¹¹ Coulton, Schramm, and Hirsh, cited above.
- ¹² Coulton, Schramm, and Hirsh, cited above.
- ¹³ Moreover, homebuyer tax credits and low interest rates may have helped increase the owner-occupied shares of purchases in these price ranges.
- ¹⁴ In cases where properties remained in REO at the end of the study period, the value of the property is estimated by the previous transaction value, which is the foreclosure sale price. The only alternative is to use tax-appraised values; however, given rapid depreciation, especially at the lower value ranges, tax values would be expected to be much higher than actual market values and so are not considered reliable.
- ¹⁵ Coulton, Schramm, and Hirsh, cited above.

REO and Beyond: The Aftermath of the Foreclosure Crisis in Cuyahoga County, Ohio

by Claudia Coulton, Michael Schramm, and April Hirsh
Case Western Reserve University

The foreclosure crisis was apparent earlier in the Cleveland area than in many other parts of the country. Signs began appearing in the late 1990s as foreclosure filings rose steeply, more than quadrupling between 1995 and 2007 and peaking above 14,000 in 2007, higher than any county in Ohio.¹ Since 2006 alone, one in five homes has been foreclosed on in the hardest-hit areas, including neighborhoods on the northeast and southeast sides of the City of Cleveland and in East Cleveland, a municipality bordering it. The growth of subprime lending played a major role in the crisis: Studies by local researchers show that subprime home-purchase loans *had an 816 percent higher chance of going into foreclosure* than other loans.² Subprime lending and foreclosure did not fall evenly on everyone. In fact, African-Americans held subprime loans two to four times more often than their white counterparts of similar income, leading to high rates of foreclosure and a disproportionate impact on neighborhoods with high proportions of African-American residents.³

This article focuses on properties in Cuyahoga County, Ohio, home to the City of Cleveland, and uses administrative data from county agencies to examine property transfers and property value after foreclosure. Though our focus is on Cuyahoga County municipalities and Cleveland neighborhoods, some foreclosure-related processes and phenomena are also applicable to the greater Northeast Ohio region and other weak-market cities across the United States. In addition, we provide examples of the ways that communities have partnered with local researchers, using data to strategize and focus efforts on REO property remediation.

Examining the growth and waning of REO property inventories can help communities understand the forces behind the movement of REO properties from sheriff's sale out of REO; it can also help communities strategize relationships with the most significant REO owners.

In our examination of REO properties and in partnership with community development organizations, we use data in three ways:

- **To test and create proxies where data are scarce or unavailable.** Data about the current condition of a property are unavailable and would be labor-intensive to create, but U.S. Postal Service vacancy data and tax delinquency data from the County Treasurer can serve as indicators of the level of productive ownership of a property after foreclosure.
- **To present a picture of the current landscape of foreclosure and REO properties.** This picture helps community organizations strategize rehabilitation efforts and scarce resources around existing neighborhood assets. Timely data on the status of properties help communities resolve housing issues early on.
- **To encourage data-driven decision making.** Together, these data allow us to examine the foreclosure and market processes involved with REO properties and to inform policies around foreclosures and other property issues.

The Growth of REO Properties

If a foreclosure does not get resolved by other means, most properties eventually end up at a foreclosure sale (called a "sheriff's sale" in Ohio). Prior to the current crisis, foreclosed properties in Cuyahoga County often went to private

Properties leaving REO in 2009 on Cleveland's east side were selling for a mere 13 percent of their estimated previous market value.

buyers (individual homeowners and investors) at foreclosure sales. In 2000, private buyers made up 35 percent of the market at these sales. Since 2007, almost all properties coming out of foreclosure sales enter real-estate-owned, or REO, status. REOs are thus properties owned by banks and lenders as a result of foreclosures that ended in unsuccessful attempts to sell them.

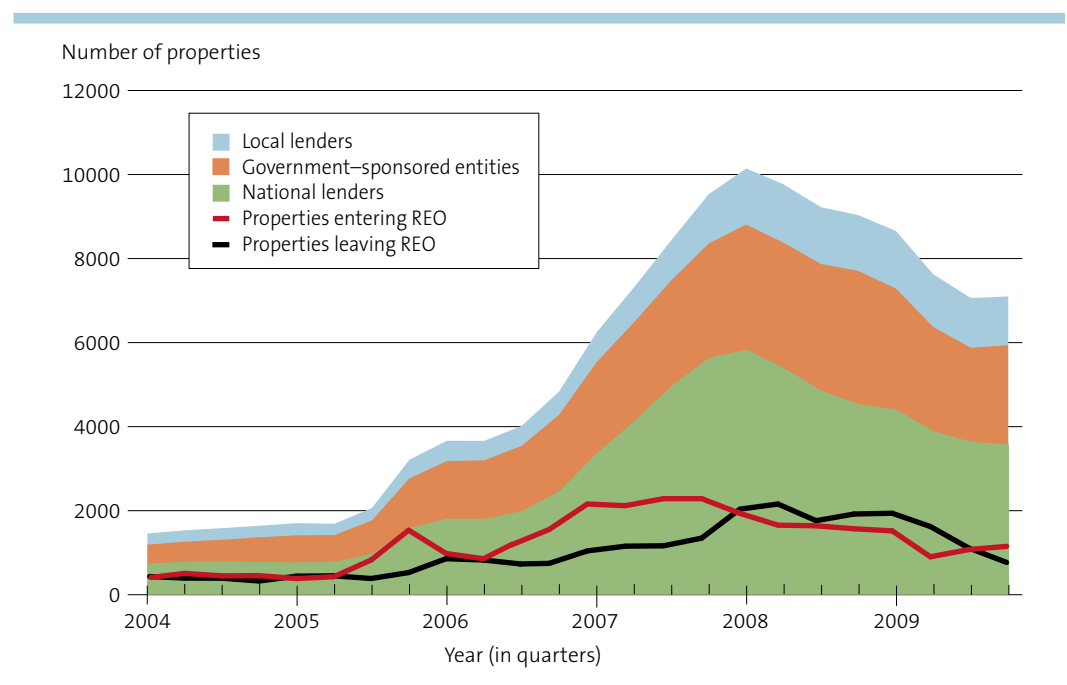
REO properties can be problematic because they are often vacant and susceptible to vandalism and devaluation. It can be difficult for neighbors and others to determine who is responsible for care and maintenance of the property, since REO owners frequently hire servicers to care for properties. Additionally, municipalities have a hard time discerning who should be held accountable when the property is in violation of housing codes.

Cuyahoga County's inventory of REO properties has grown rapidly (see figure 1). From 2004 to 2008, REOs increased from 1,449 to

10,133, a jump of nearly 600 percent. Figure 1 shows that this accumulation occurred initially because of the rapid growth in properties entering REO and the concomitant slowing of the rate at which properties were sold out of REO. In fact, the median time that foreclosed properties spent in REO doubled from 2000 to 2007.⁴ Since its peak in 2008, the county's REO inventory has declined gradually, probably because of a slowing of the number coming in from foreclosure sales and an increase in the number of properties leaving REO. Possible reasons for these changes in the flow of properties into and out of REO are discussed later in this article.

Figure 1 also shows the mix of REO inventory holders. National lenders account for the largest proportion of REO inventory throughout the study period; their inventories rose more sharply in 2006 and 2007 and dropped more quickly in 2008 and 2009 than GSEs' or local banks' inventories. National lenders, local lenders, and GSEs all experienced a sharp decline in properties entering

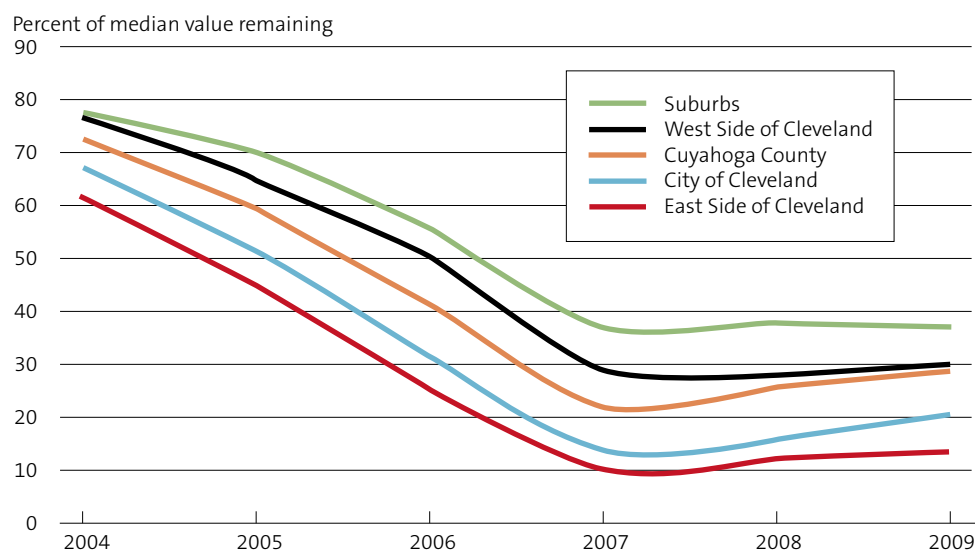
Figure 1
Properties Entering and Leaving REO
Cuyahoga County



Prepared by: Center on Urban Poverty and Community Development, Mandel School of Applied Social Sciences, Case Western Reserve University.

Source: NEO CANDO (<http://neocando.case.edu>), Tabulation of Cuyahoga County Auditor data.

Figure 2
Median Percent of Property Value Remaining after Sheriff's Sale



Prepared by: Center on Urban Poverty and Community Development, Mandel School of Applied Social Sciences, Case Western Reserve University.
Source: NEO CANDO (<http://neocando.case.edu>), Tabulation of Cuyahoga County Auditor data.

REO from the fourth quarter of 2008 until the second quarter of 2009. GSEs rebounded sharply in the third and fourth quarters of 2009, while national and local lenders' properties entering REO leveled off. All three types of lenders have seen a decrease in properties leaving REO since the fourth quarter of 2008.

Sales of Distressed REOs Dominate Some Areas

The Cleveland region has numerous areas inundated with vacant, for-sale REO properties. How is their presence affecting housing values? One measure compares the selling prices of properties coming out of REO with their estimated market value prior to foreclosure (see figure 2).

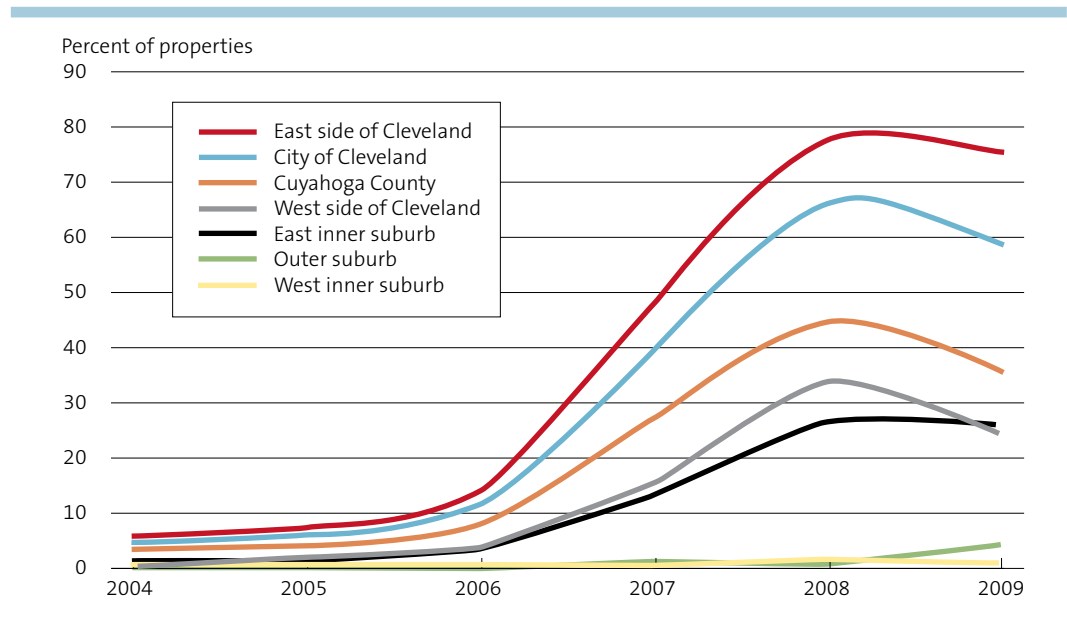
Not surprisingly, properties sold out of REO in Cuyahoga County, within the City of Cleveland, and in Cleveland's suburbs are selling for less than their previous estimated market value. What is notable now is *how much* less than their previous value these properties are selling for. In 2000, properties sold out of REO were purchased for up to 76 percent of their pre-foreclosure estimated market value.

But by 2007, post-REO sales prices hit a low point relative to their previous estimated market value. By 2009, prices had rebounded, but only slightly. Properties leaving REO in 2009 on Cleveland's east side were selling for a mere 13 percent of their estimated previous market value. In Cuyahoga County and suburban Cleveland, properties selling out of REO in 2009 fetched sales prices of 28 percent and 37 percent of their estimated market value, respectively. Though housing prices also dropped during this period, this change in itself does not account for all of the value lost after a sheriff's sale. Consider that from 2004 to 2009, housing prices in the Cleveland metropolitan region fell only 11 percent;⁵ taking into account the already-low housing prices and the sheer number of transactions, these post-REO sales price figures have disastrous effects on the values of neighboring properties not in foreclosure and on the tax bases of neighborhoods and communities.

REO properties in Cuyahoga County are also increasingly being sold at extremely distressed prices—defined as \$10,000 or less—mainly to

Figure 3

Percentage of all REO Properties Sold at Extremely Distressed Prices*
Cuyahoga County, 2004–2009



* An extremely distressed price is \$10,000 or less.

Prepared by: Center on Urban Poverty and Community Development, Mandel School of Applied Social Sciences, Case Western Reserve University.

Source: NEO CANDO (<http://neocando.case.edu>), Tabulation of Cuyahoga County Auditor data.

out-of-state corporations and individuals looking for bargains. As figure 3 shows, 2.6 percent of REO properties were sold at extremely distressed prices in 2004, a share that increased 17-fold before peaking in 2008. The proportion declined to 35 percent in 2009, still 13 times greater than in 2004. As is the case with subprime lending, this trend of houses selling at extremely low prices has affected areas within the county disproportionately. In this case, too, much of the activity is concentrated on Cleveland's east side. In 2004, 4 percent of properties on the city's east side coming out of REO were sold for less than \$10,000. Three years later, nearly 80 percent of the properties on the east side sold out of REO were purchased at extremely distressed prices. Even though the total number of properties in the county leaving REO dropped significantly by 2009, the proportion of properties leaving REO at distressed prices on the east side of Cleveland declined only slightly, from 78 percent to 75 percent.

A small number of sellers account for most of these distressed sales. An examination of the owners of record for thousands of houses that were sold for \$10,000 or less in Cuyahoga County from 2007 to 2009 reveals that, although numerous financial institutions are involved in these sales, the top five sellers of REO properties at these prices are responsible for more than 50 percent of these transactions. From 2007 to 2009, the following companies topped the list: Deutsche Bank, Fannie Mae, Wells Fargo, the U.S. Department of Housing and Urban Development, and U.S. Bank. The data also show that houses sold for \$10,000 or less make up substantial percentages of all REO properties sold. These findings, along with anecdotal information provided by buyers, suggest that some sellers are unloading large quantities of REO properties at extremely low prices. "Dumping" is what some call it.

However, public record can be deceiving in this regard. It is important to note that while public record indicates the party that holds title to

a property, often a bank or lender has hired a servicer to handle transactions related to a property. Most property sales out of REO, in fact, are handled by mortgage servicers whose identity does not appear in the public records of sales transfers; this makes communication difficult for parties interested either in purchasing a property or raising concerns about its condition.⁶

On the purchasing side, the data reveal that there are many buyers of these properties—more than 1,200 in 2008—with only a handful of buyers purchasing more than 100 properties each in the Cleveland area. Here, too, local records are not always indicative of what’s happening. Buyers may purchase properties under many different auspices, and may own many more properties than public records show. By and large, however, buyers are out-of-state corporations or investors. It is typical for sellers of REO properties and investors to have relationships; some sellers package properties regionally

and sell them to their customers in bulk. Almost all properties are sold sight unseen.⁷ These transactions, which are collectively defining and reshaping some neighborhoods, are often conducted by individuals from outside the region who have no direct knowledge of the neighborhoods or the properties.⁸

Many Former REO Properties Left to Deteriorate

After being sold out of REO, properties can go in two directions. Either they return to some productive use or they continue on a path of neglect and deterioration. The price of a property at REO sale is one indicator of the direction in which the property will go. Table 1 includes all REO sales in 2004–09, and evaluates three markers of deterioration as of February 2010: vacancy status as recorded by the U.S. Postal Service and supplemented by vacancy survey data from the City of Cleveland; tax delinquency status, which is conferred when

Table 1
Distress Signs of Properties after Leaving REO, 2004–2009
(as of February 2010)

Price on leaving REO	% vacant	% tax delinquent	% demolished*
\$1–10,000	49%	56%	9%
\$10,001–30,000	27%	27%	3%
\$30,001–50,000	19%	19%	2%
\$50,001–75,000	12%	11%	2%
\$75,001–100,000	14%	11%	4%
\$100,001–125,000	10%	10%	3%
\$125,001–150,000	8%	4%	0%
\$150,001 and above	5%	3%	0%
Total	27%	25%	5%

*Data for demolitions are available for properties located in the City of Cleveland only. Percents are out of number of REO properties in the City of Cleveland.

Sources: NEO CANDO and tabulation of Cuyahoga County Auditor data by the Center on Urban Poverty and Community Development, Case Western Reserve University.

Timely, accurate,
and accessible
data are essential
to strategically
addressing fore-
closure prevention
and property
remediation
efforts.

a property carries a balance from any previous tax year; and whether or not the property has been demolished by the City of Cleveland (private demolitions and demolitions by suburban municipalities are not included because data are not available).

Properties sold for \$10,000 or less represent some of the most at-risk for deterioration after they leave REO status. Of properties that were sold out of REO at extremely distressed prices between 2004 and 2009, 56 percent were tax delinquent as of February 2010, 49 percent were listed as vacant, and nine percent of those located in Cleveland have since been demolished. Properties sold at higher prices have lower incidences of these outcomes, although the rates for properties in the \$10,000–\$30,000 price range are still relatively high. Markers of deterioration are inversely related to the sales price, suggesting that many of the properties sold out of REO at low prices are not being occupied or maintained and thus are becoming problematic for neighborhoods and local governments.

Addressing the Challenges of Post-REO Properties

Tremendous efforts have been made in Cuyahoga County to manage the foreclosure process and assist households at risk of losing their homes. Now, additional and increased attention is being paid to the maintenance and reutilization problems of properties that have come through REO.

Critical to understanding Cleveland's capacity to handle this crisis is awareness of the long history of local investment in building community capacity. Going back several decades, local and national philanthropic organizations have invested in institution-building by providing targeted and sustained resources to the field, particularly through intermediaries that support housing and community development.⁹ Moreover, these philanthropic organizations have provided essential support for developing a robust capacity among local universities that, in part through longstanding partnerships

with local governments, can provide up-to-date data on housing and neighborhoods. Local universities partner with community organizations to provide data that help them determine which properties are priorities for acquisition and rehabilitation, to keep abreast of current property conditions, and to continue developing tools to monitor other property issues as they arise.

Providing these critical data and information to community organizations requires keeping up-to-date records of the foreclosure, sheriff's sale, and REO status of properties, as well as gathering and organizing information that can serve as a credible proxy for property delinquency status (such as vacancy and tax delinquency information). Researchers also monitor property issues that communities are experiencing through more qualitative measures; in this way, they can further support the partnership by developing tools to help organizations keep track of what is going on in communities.

On the prevention side, researchers identify mortgages that are at risk of foreclosure—high-cost mortgages whose interest rates will soon increase—and pass this information on to community organizers who encourage homeowners to seek preventative foreclosure counseling. On the remediation side, researchers provide community development organizations with up-to-date property transfer information, vacancy information, and tax delinquency information, so organizations can strategize property remediation. For example, in Cleveland, the Neighborhood Stabilization Team, comprised of local researchers and community development officials, meets monthly with neighborhood groups to exchange knowledge on changes in the status of neighborhood properties, noting, for instance, whether any properties have gone into foreclosure or been sold at foreclosure sale. The group then discusses strategies for rehabilitating problematic properties, focusing on the properties that are closest to community assets.

The property rehabilitation and acquisition side of this partnership consists, first, of strategically identifying areas in which to target resources, areas that have both great strengths and needs. Because of limited funding, community organizations must focus on rehabilitating homes in areas with existing community assets. Once areas are identified, community development organizations keep a close eye on properties in the areas, watching for foreclosure filings and property transfers.

On a national level, two organizations are working to acquire REO properties and connect them to local organizations: The nonprofit National Community Stabilization Trust was formed in 2008 by six national nonprofits with expertise in community development and housing. The REO Clearinghouse, a for-profit agency formed by Safeguard Properties, was established in early 2009. Both agencies' purpose is to help stem the decline of communities with high concentrations of vacant and abandoned property by connecting national-level servicers with local community development organizations, offering foreclosed properties to these organizations at discounted rates. Cleveland was one of the first cities to work with both the Trust and the REO Clearinghouse. Although these organizations' current efforts in northeast Ohio are small in scale and strategically focused on very specific areas, they will help inform and direct broader efforts going forward. (See also in this publication "Acquiring Property for Neighborhood Stabilization: Lessons Learned from the Front Lines," by Craig Nickerson.)

On a local level, once an organization establishes a connection with holders of REO properties—a sometimes-difficult step—it can employ any of several measures to return properties to viable use. One new approach to cycling vacant Northeast Ohio houses back into productive use is the recently established Cuyahoga County Land Reutilization Corporation (informally called the "county land bank"), whose primary function is to obtain and utilize tax-foreclosed properties, although the land bank can also accept any property donated to them. Led by

County Treasurer Jim Rokakis, a coalition of local and state agencies managed to overcome a lot of barriers in passing state legislation to create the new land bank, which is modeled after a highly successful program in Genesee County, Michigan. (See also in this publication "How Modern Land Banking Can Be Used to Solve REO Acquisition Problems," by Thomas J. Fitzpatrick IV.)

The county land bank can help further the revitalization efforts of individual communities as well as regional coalitions. By strategically amassing land, it can help communities implement plans for communal green spaces. Pooling properties in the new land bank will also mitigate the risks associated with land ownership, risks that were previously assumed by small, local CDCs. With the land bank in place, these same area CDCs can focus their efforts on getting land bank properties back on the market and into productive use in their neighborhoods.

Finally, a critical component of any effort to bring vacant properties back to productive use is financing. The federal Neighborhood Stabilization Program provides a crucial piece of this equation, allotting funds to localities to help them meet their specific needs. The program's funds in Cleveland and Cuyahoga County are helping to support the demolition and remediation of numerous vacant and abandoned properties. However, given the enormity of the need here, these funds will only go so far.

Conclusion

In summary, the data reveal that in Cleveland and Cuyahoga County, properties are leaving REO through bulk sales at extremely low prices. It is uncertain whether or not these market processes will be able to bring properties back to productive use. To date, properties sold at extremely low prices have high levels of vacancy and tax delinquency.

Though this report focuses on Cleveland and Cuyahoga County, it includes information on specific tools being employed here that other areas may be able to replicate and use to identify

and prevent potential issues. Timely, accurate, and accessible data are essential to strategically addressing foreclosure prevention and property remediation efforts, and are essential for those carrying out these programs.

Cleveland has been characterized as a “resilient” weak-market city, in part because of its ability to use data to strategically target resources within communities to help spur neighborhood recovery.¹⁰ Cleveland’s strong network of non-profit community development organizations is essential to developing and carrying out these strategies. Efforts to address the crisis—here in northeast Ohio and in every community across the nation—must be multifaceted and coordinated among various entities, must be data-driven, and must be strategic.

Claudia Coulton is co-director of the Center on Urban Poverty and Community Development at Case Western Reserve University (CWRU). In this role she engages in research, evaluation, and policy analysis and oversees NEO CANDO (Northeast Ohio Community and Neighborhood Data for Organizing), a web-based data warehouse for neighborhood indicators and property information. A founding member of the National Neighborhood Indicators Partnership, Dr. Coulton is also an advisor to community initiatives such as the Annie E. Casey Foundation’s Making Connections program. She earned a PhD in social welfare from CWRU, where she is a professor in the Mandel School of Applied Social Sciences.

Michael Schramm, formerly of the Center on Urban Poverty and Community Development at CWRU, was instrumental in developing and maintaining NEO CANDO and continues to assist community groups in the use of data and GIS mapping as tools for social change. In July 2010 he was named director of IT and research at the Cuyahoga County land bank. Mr. Schramm received an MA in geography from Syracuse University.

April Hirsh is a research assistant at the Center on Urban Poverty and Community Development at CWRU. She works with Dr. Coulton and Michael Schramm on foreclosure and property issues in Cleveland. Before joining the Center, April interned at Policy Matters Ohio, North Coast Community Homes, and Fairfax Renaissance Development Corporation. She received an MSSA from Case Western Reserve University.

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¹ Zach Schiller and April Hirsh, “Foreclosure Growth in Ohio” (Cleveland, Oh.: Policy Matters Ohio, 2008). Available at <http://policymattersohio.org/publications.htm>.

² Claudia Coulton, Tsui Chan, Michael Schramm, and Kristen Mikelbank, “Pathways to Foreclosure: A Longitudinal Study of Mortgage Loans, Cleveland and Cuyahoga County, 2005–2008” (Cleveland, Oh.: Case Western Reserve University, Mandel School of Applied Social Sciences, Center on Urban Poverty and Community Development, 2008). Available at <http://neocando.case.edu>.

³ Coulton et al., cited above.

⁴ Claudia Coulton, Kristen Mikelbank, and Michael Schramm, “Foreclosure and Beyond: A Report on Ownership and Housing Values Following Sheriff’s Sales, Cleveland and Cuyahoga County, 2005–2007” (Cleveland, Oh.: Case Western Reserve University, Mandel School of Applied Social Sciences, Center on Urban Poverty and Community Development, 2008). Available at <http://neocando.case.edu>.

⁵ Calculated using the Federal Housing Finance Agency’s housing price index for the Cleveland-Elyria-Mentor City/MSA, sale price only, seasonally adjusted using the annual average over four quarters.

⁶ Claudia Coulton, Michael Schramm, and April Hirsh, “Beyond REO: Property Transfers at Extremely Distressed Prices in Cuyahoga County, 2005–2008,” (Cleveland, Oh.: Case Western Reserve University, Mandel School of Applied Social Sciences, Center on Urban Poverty and Community Development, 2008). Available at <http://neocando.case.edu>.

⁷ As evidenced by the business models of some of the country’s largest REO buyers.

⁸ See note 7.

⁹ Some examples of these intermediaries in Cleveland are Neighborhood Progress Inc., Cleveland Housing Network, and Enterprise Community Partners.

¹⁰ Todd Swanstrom, Karen Chapple, and Dan Immergluck, “Regional Resilience in the Face of Foreclosures: Evidence from Six Metropolitan Areas” (Berkeley, Ca.: University of California at Berkeley, Institute of Urban and Regional Development, 2009).

Examining REO Sales and Price Discounts in Massachusetts¹

by Kai-yan Lee
Federal Reserve Bank of Boston

Between 2005 and 2009, home sales prices² and volume³ declined by 27 percent, new housing construction dropped by 71 percent,⁴ and the rate of foreclosure inventory⁵ quadrupled. Given these statistics of a weak housing market, it is not too surprising that close to half of the adults surveyed in the Northeast United States expect a 50 percent or more price discount for a foreclosed property.⁶ Even the federal Neighborhood Stabilization Program assumes the availability of a significant price discount for foreclosed properties.⁷ While potential buyers have high expectations of discounts, sellers may be hesitant to concede. The underlying questions for the seller are whether to discount a distressed property at all and, if so, by how much. So how much of a discount is really occurring in the current market, and is the level of any price discount associated with the type of property and factors like neighborhood and sales characteristics? This article explores these questions by examining distressed properties in Massachusetts, in particular, bank-repossessed houses, also known as real-estate-owned (REO) properties.⁸ These questions, and their answers, are important because many municipalities and nonprofits (as well as private buyers) are trying to negotiate with sellers for the appropriate price for properties.

This article begins with a brief review of the literature on distressed property sales and the limitations of traditional valuation methods. It moves on to describe the terminology and the dataset used in this study. Following a section that describes overall trends in REO sales in Massachusetts, the article then analyzes factors associated with price discounts of REO sales.

It closes by discussing policy implications and future research.

What Does Prior Research Tell Us?

The most relevant literature, of which there is rather little, discusses two issues: the sale price discounts of distressed properties and the limitations of applying the traditional residential valuation mechanism on distressed properties.

Many previous studies define the discount as the sale price difference between foreclosure sales and nonforeclosure sales; this definition is related to, but different from, the price differential used in this analysis, as explained in more details in the next section. Table 1 summarizes the key findings from these prior studies. Many of these studies find significant sale discounts in the range of 20 percent. However, recent research argues that the previous research has omitted important variables (such as property conditions), has other methodological shortcomings, and likely exaggerates the level of price discount.⁹ The more recent research generally concludes a discount in the 10–20 percent range.

Standard economic reasoning fosters skepticism about deep discounts of distressed property sales. Wouldn't speculators rush to take advantage, bidding up the price to erase the discount? Countering this line of reasoning, Harding et al. argue that economic rationale could also support significant discounts due to¹⁰

- significant repair cost on foreclosed properties
- the seller's weak bargaining position in a weak market

Table 1
Prior Research on Price Discounts of Foreclosed Properties
(in order of publication date, most recent first)

Authors	Study Market	Study Period	Estimated Price Discounts
Harding, Rosenblatt, Yao ¹¹	Atlanta, GA; Columbus, OH; Las Vegas, NV; Los Angeles, CA	1990 – 2008	–1% in Las Vegas, –11% in Los Angeles, –14% in Atlanta, and –21% in Columbus
Clauretie and Daneshvary ¹²	Las Vegas, NV	2004 – 2007	–7.8%
Campbell, Giglio, Pathak ¹³	Massachusetts	1987 – 2008	–21.6% to –47.2% depends on the length of properties' time on market ¹⁴
Chau and Ng ¹⁵	Hong Kong, China	1996 – 2000	–1% to –10% depends on whether the sale happens in an up or down market
Pennington-Cross ¹⁶	U.S.	1995 – 1999	–22% on average, but sensitive to housing condi- tions, legal constraints, and loan characteristics
Carroll, Clairetie, Neil ¹⁷	Las Vegas, NV	1990 – 1993	No statistically significant discounts
Springer ¹⁸	Arlington, TX	1989 – 1993	–4% to –6%
Hardin and Wolverton ¹⁹	Phoenix, AZ	1993 – 1994	–22%
Forgey, Rutherford, VanBuskirk ²⁰	Arlington, TX	1991 – 1993	–23%
Shilling, Benjamin, Sirmans ²¹	Baton Rouge, LA	1985	–24%

- higher risk premium on foreclosed properties
- stigma discount of foreclosure.

Second, can traditional residential valuation mechanisms even reliably appraise distressed properties? One researcher argues that the traditional valuation system is retrospective in nature, and therefore inappropriate and unreliable for valuing distressed properties in the current crisis;²² the system relies on the assumptions of stable, liquid, open, and competitive markets; complete information; no compulsion to sell or buy; customary marketing periods; and availability of recent comparable sales. But in our current circumstances, there is a large and growing inventory of unsold distressed properties coupled with thin transactions in the market, a rapid and continuing house price decline, and market comparables reflecting previous “bubble” pricing. Other studies concur, further finding that appraisers, even those with more experience and higher reputation

risk, tend to produce greater appraisal errors on foreclosed properties than on other types of properties.²³

The Massachusetts REO Dataset

This article focuses particularly on the REO sale price differential, which is the difference between an REO property's foreclosure auction price and its subsequent REO sale price.²⁴ This definition of REO sale price differential is *not* the same as the price difference between REO sales and comparable normal sales, which was the focus of some previous studies. The sale price differential is not necessarily a discount. About 10 percent of the REO sales included in this article have higher REO sale prices than their foreclosure auction prices and thus a *positive* price differential.

This article uses the Massachusetts registry of deeds property transaction data and assessor's data, which are digitized by the Warren Group,

a private real estate information company. Some deed offices and the Warren Group have manually identified REO sales in the dataset, but not very consistently. Using a mathematical and logical process, this analysis recaptures omitted REO sales in the dataset.²⁵ Of the 3,300 REO sales included in this study, only about 55 percent were originally identified as REOs in the Warren Group dataset.

For this analysis, only those properties that entered REO status between June 2007 and May 2008 are included. The 2007 start date is used to focus on the current market trend in the crisis, while the May 2008 end date allows properties sufficient time (less than five quarters) to go through the resale process.²⁶ Prior research indicates that about 85 percent of Massachusetts's REO properties were resold within five quarters of entering the REO status.²⁷

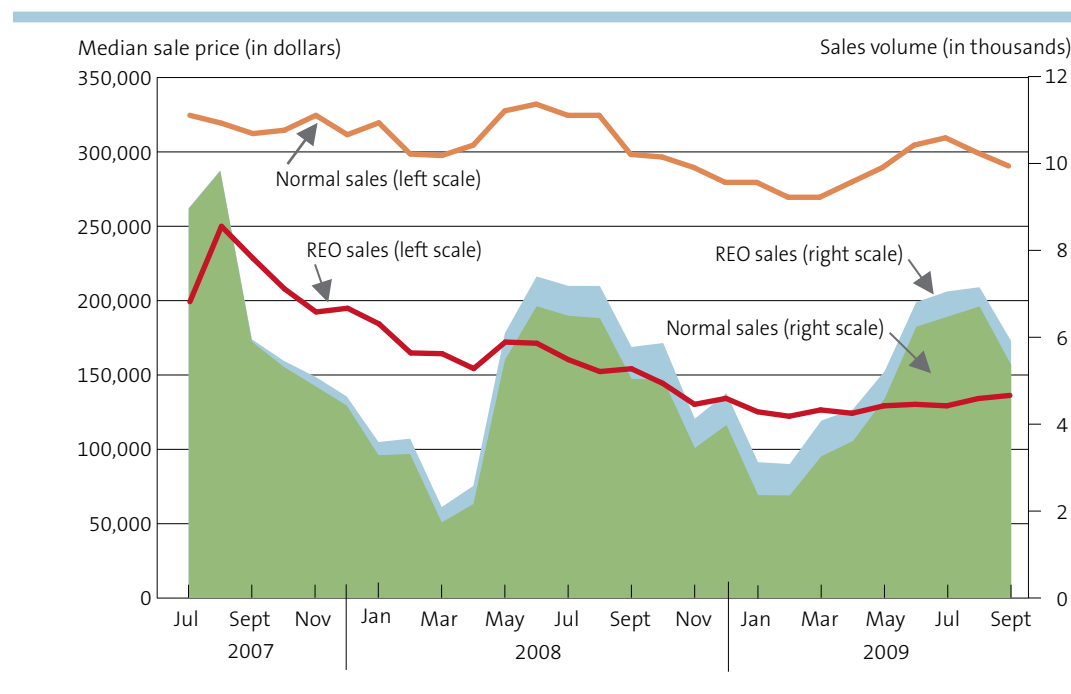
Comparing REO and Normal Sales and Prices

How do REO sales differ from normal sales? Figure 1 compares the sales volume and median

sales price of all REO and all “normal” sales between July 2007 and September 2009. Normal sales exclude foreclosure, REO, or nominal sales.²⁸ While the volume of normal sales displays typical seasonality fluctuation, REO sales volume remains relatively unchanged since mid-2008. Similarly, the median price of normal sales has declined modestly with seasonality fluctuation; but the median price of REO sales has declined more noticeably initially but with almost no obvious seasonality fluctuation later on. This suggests that the REO and the normal market may behave differently in the current housing cycle, possibly due to differences in the expectations of buyers and sellers, and/or supplies and demands in these two markets.

Table 2 further illustrates that property, neighborhood, sales, and mortgage characteristics are indeed quite different between REO sales and normal sales. In general, properties in REO sales tend to be older homes with slightly larger living areas, more bedrooms and full bathrooms, but smaller lot sizes. This apparent contradiction between larger living areas and smaller

Figure 1
Median Prices and Volumes of REO and Normal Sales



Source: Author's calculations based on the Warren Group raw data.

Table 2
Profiles of REO and Normal Home Sales

	Mean			Median	
	REO sales	Normal sales	Difference	REO sales	Normal sales
Property characteristics					
Lot size (sq ft)	15,260	33,079	−17,819	6,893	13,504
Living area size (sq ft)	1,857	1,705	153	1,597	1,490
Number of buildings on lot	1.003	1.027	−0.023	1	1
Number of bedrooms	3.845	3.215	0.630	3	3
Number of full bathrooms	2.365	2.24	0.125	2	2
Age of property at sale	75.502	58.214	17.288	83	50
Neighborhood characteristics					
% minorities in tract	31.00%	15.70%	15.3%	19.70%	8.00%
% people in urban tracts	94.54%	94.41%	0.13%	100%	100%
Median household income	\$44,138	\$59,749	−\$15,610	\$42,107	\$56,365
% home sales price change in tract (2006–2009)	−32.10%	−16.20%	−15.9%	−32.40%	−16.50%
% high-cost highly leveraged mortgages	0.15%	0.08%	0.078%	0.14%	0.06%
Sale and mortgage history					
Days since last normal sale	1,757	3,112	−1,354	1,280	2,016
Days since last mortgage/refinance	1,087	1,288	−200	1,019	1,121

All differences are statistically significant at 1%, except “% people in urban tracts”

lot sizes is mainly attributable to about 33 percent of the REO sales being small multi-family structures (two to four units) as opposed to less than 8 percent in normal sales.²⁹

How do REO sales and prices differ by property and neighborhood type? In terms of neighborhood characteristics, REO sales are more likely to be located in neighborhoods with a high percentage of minorities, a lower median household income, a significant decline

in recent median home sales prices, and a higher concentration of high-cost, highly leveraged mortgages.³⁰ This makes sense, as other research reveals that neighborhoods with such characteristics tend to have a higher concentration of foreclosures, which are often precursors to REO sales.³¹

Small multifamily structures merit special attention as they accounted for 23 percent of Massachusetts’s housing stock and 33 percent

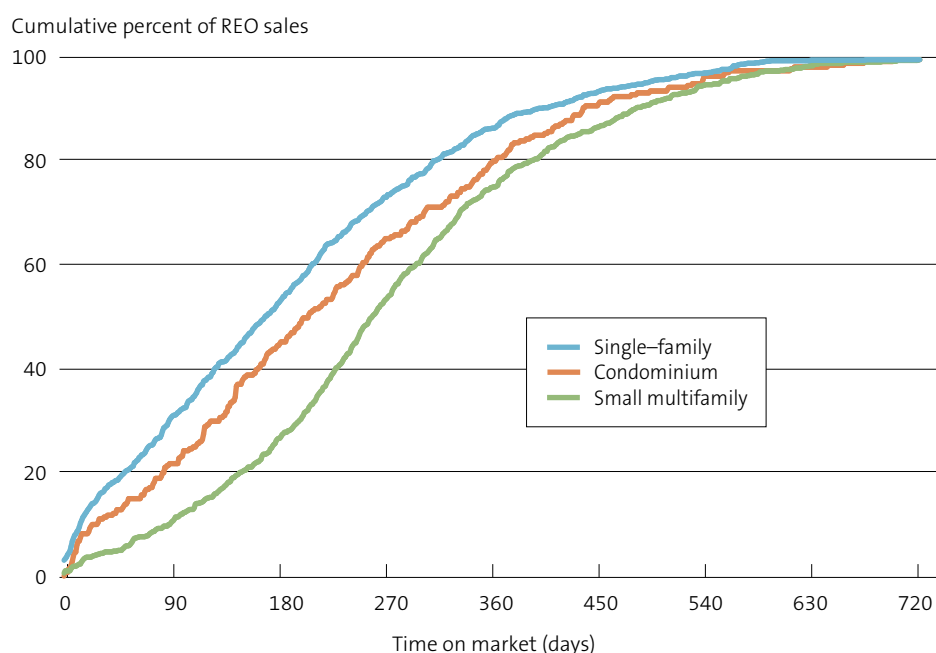
of its REO sales.³² Figure 2 reveals that their REO sales experience is also noticeably longer than that of single-family properties and condominiums in terms of time on the market.³³ The median time on the market for small multifamily (262 days) is more than 50 percent longer than that of single-family properties (171 days). This gap is more conspicuous immediately after the foreclosure sale, narrowing later, suggesting that small multifamily REO properties may have more difficulties in attracting buyers initially, possibly because of factors like higher upfront financial commitment and higher risk. From the community perspective, longer time on the market for small multifamily structures means that they exert negative effects on communities for a longer period of time, delaying the recovery in communities with a high concentration of these properties.

Figure 3 shows the REO sale price differentials by property type. As expected, most properties, regardless of their type, sell for a discount (the distribution is skewed left). This figure also

reveals that small multifamily REOs are more likely to experience greater price discounts than single-family and condominium REOs. The median sale price differentials for small multifamily, single-family, and condominium REOs are –40.6 percent, –19.9 percent, and –29.2 percent, respectively.

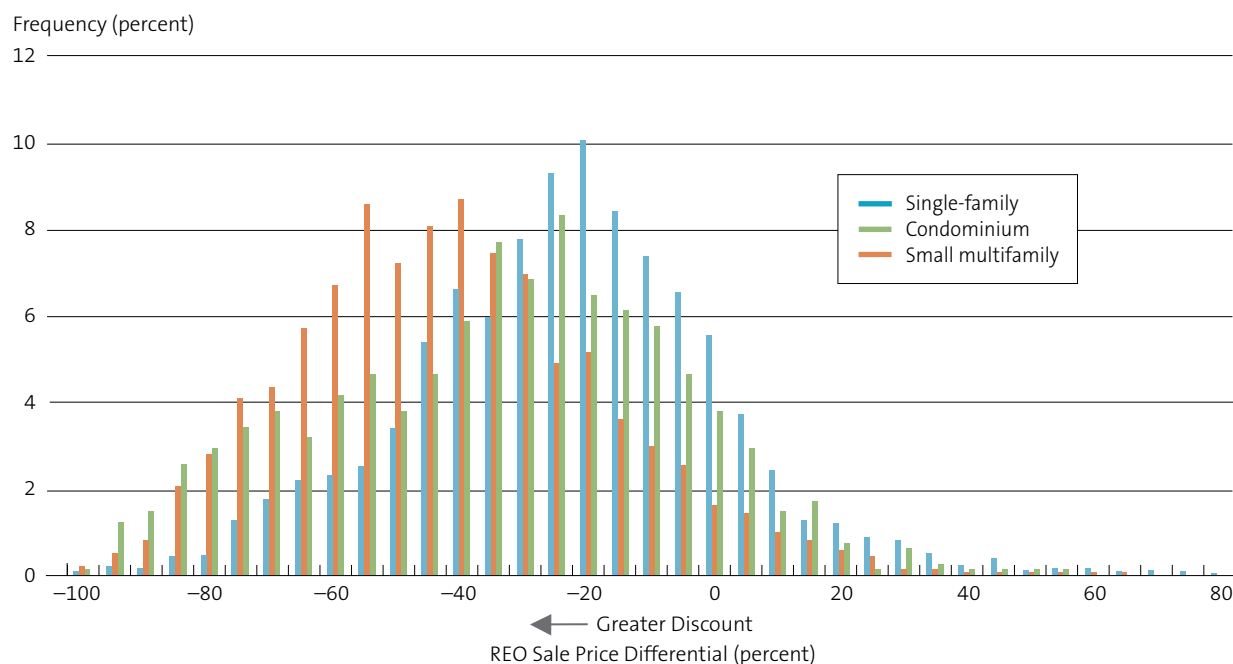
Figure 4 further illustrates that REO sale price differentials are associated with various neighborhood characteristics, including the percent of home sales that are REO sales, median household income, the percent of racial or ethnic minorities in the tract, and the percent of high-cost mortgages. Two sets of lines are used in the chart to examine the experiences of different types of neighborhoods. The solid lines represent the experience of neighborhoods with a higher likelihood of foreclosure and the dashed lines represent the experience of neighborhoods with a lower likelihood of foreclosure.³⁴ Quite clearly, REO sales in neighborhoods with high foreclosure likelihood (high share of REOs, high share of high-cost loans, high share

Figure 2
Time on Market of REO Sales
(Massachusetts properties that entered REO status in 2007)



Note: Time on market is defined as the number of days between foreclosure sale and REO sale.
Source: Author's calculations based on the Warren Group raw data.

Figure 3
Distribution of REO Sale Price Differential
 By property type



Source: Author's calculations based on the Warren Group raw data.

of minority population, and lower income) command greater discounts. It is strikingly evident that these eight distributions cluster into two shapes, one for lines representing characteristics of high foreclosure likelihood and the other for low likelihood. This is mostly because that these variables are highly correlated with each other, a phenomenon stemmed from the fact that high-cost mortgages were more common in racial minority and lower-income neighborhoods.³⁵

The Facts about REO Discounts

This section summarizes the results of applying several regression models to analyze factors related to the REO price differential.³⁶ Major findings include:

- Steeper price discounts for REO properties were associated with certain neighborhood characteristics. Specifically, lower household incomes, a higher share of minorities, and steeper overall house-price declines saw comparatively lower prices for REO sales.
- An REO property's sale price differential

is negatively associated with its time on the market. REOs show little evidence of seasonality in sales trends.

- Using a composite model that controls for property, neighborhood, and sales characteristics, it reveals that, on average, a small multifamily REO sale is associated with a 4.6 percentage discount, everything else being equal. This affirms the earlier trend analysis that small multifamily REO properties face a more challenging market and that they are more likely to experience a greater sale price discount.
- In the composite model, the negative association between REO sale price differential and the concentration of REOs has the greatest magnitude. In addition, REO sale price differential is associated, in this case upward, with stronger housing market conditions (that is, a smaller decline in median home sale price in higher-income neighborhoods). Moreover, the model also indicates that, on average, every additional day an REO property is on the market lowers its price.

Limitations and Future Research

The analysis in this article has several limitations. First, it includes only REO properties with a successful subsequent REO sale and may have left out the less-desirable REO properties, possibly introducing an upward bias in its estimated sale price differential. Second, properties that entered REO status near May 2008 may still lack sufficient time to complete the REO sale process and may not be correctly captured in this study. Third, the regression models cannot successfully control for spatial interdependence and property conditions, which are likely to have an impact on sale price. Moreover, there may be variance in the duration between foreclosure sale date and the actual date the property was listed for REO sale. As time on the market is counted from the date of foreclosure sale onward in this article, such variance could affect its accuracy. Lastly, the models cannot control for lenders' motivation in foreclosure and REO sales (for example, expedited sales of distressed properties for accounting reasons), and some may be willing to concede to greater-than-usual discounts.³⁷ Future research

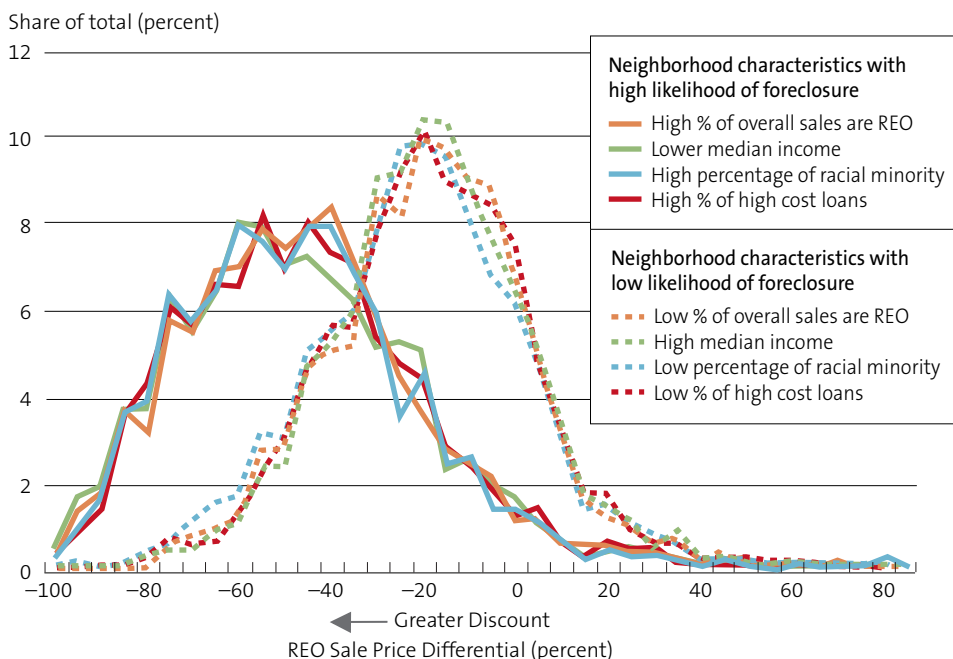
can help address these limitations, and can also ascertain another type of sale price differential between the prices of REO sales and that of comparable nondistressed sales.

Conclusion and Implications

The large amount of REO properties nationwide is a unique event of the past 50 years, and there is relatively little literature on their sales price. The analysis in this article reveals that REO properties' time on market is strongly associated with their sale price differential, so a quick sale is important. This could be achieved by making sales information more transparent, by having lenders provide direct REO contacts, by standardizing paperwork in the REO sales process, and by working proactively with nonprofits with the capability and interest in bulk purchases (a rare occurrence thus far) to minimize lengthy individual negotiation.

Second, this article demonstrates that small multifamily REO properties merit additional policy attention for their longer time on market and greater sale price discount. These small

Figure 4
REO Sale Price Differential by Neighborhood Characteristics



Source: Author's calculations based on data from the U.S. Census, HMDA, and the Warren Group.

multifamily properties are a critical component of the housing stock in Massachusetts, especially for the socially and financially vulnerable populations.³⁸ Stabilization of these properties is not only critical for the health of New England's housing market, but also for minimizing the negative impact on these most vulnerable occupants.

Last, this study reveals that racial minorities and lower-income neighborhoods have a disproportionate share of the REO sales in Massachusetts, likely due to their higher concentration of foreclosures and high-cost, highly leveraged mortgages. Stabilization in these neighborhoods requires a more comprehensive approach going beyond REO properties to the root causes. Fair access to safer mortgages and better financial education on home purchasing are some of the preventive and complementary efforts to REO rescue efforts.

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Endnotes

- ¹ This is an abridged version of the full paper, which can be accessed at www.bos.frb.org/commdev/pcadp/index.htm.
- ² S&P/Case-Shiller Home Price Index, National Association of Realtors.
- ³ National Association of Realtors.
- ⁴ U.S. Census Bureau.
- ⁵ Mortgage Bankers Association.
- ⁶ RealtyTrac and Trulia, "New Survey from Trulia and RealtyTrac Shows Investors, Trade-up Buyers and Renters Most Likely to Consider Foreclosure Purchase," (December 15, 2009).
- ⁷ Section 2301(d)(1) of the Housing and Economic Recovery Act of 2008 initially established a minimum 15 percent discount requirement for aggregate foreclosed property acquisitions in the Neighborhood Stabilization Program. This requirement was eliminated a year later.

⁸ In this article, "REO sale" refers to the sale of a property, previously foreclosed, by a lender to a private buyer. The REO sale can occur anytime after a foreclosure auction in which usually the bank has retained ownership of the property.

⁹ John P. Harding, Eric Rosenblatt, and Vincent Yao, "The Foreclosure Discount: Myth or Reality?" Working Paper. (January 11, 2010); and Terrence M. Clauretie and Nasser Daneshvary, "Estimating the House Foreclosure Discount Corrected for Spatial Price Interdependence and Endogeneity of Marketing Time," *Real Estate Economics* 37(1) (2009): 43-67.

¹⁰ Harding, Rosenblatt, and Yao (2010).

¹¹ Harding et al. (2010).

¹² Clauretie and Daneshvary (2009).

¹³ John Y. Campbell, Stefano Giglio, and Parag Pathak, "Forced Sales and Housing Prices," Discussion Paper.

¹⁴ The Campbell et al. study also includes other types of "forced sale," but the figures cited here are for foreclosed properties only.

¹⁵ Kwong Wing Chau and R. Ng, "Agency Theory and Foreclosure Sales of Properties," *International Journal of Property Sciences* 1 (1) (2008): 16-24.

¹⁶ Anthony Pennington-Cross, "The Value of Foreclosed Property," *Journal of Real Estate Research* 28 (2006): 193-214.

¹⁷ Thomas M. Carroll, Terrence M. Clauretie, and Helen R. Neil, "Effect of Foreclosure Status on Residential Selling Price: Comment," *Journal of Real Estate Research* 13 (1) (1997): 95-102.

¹⁸ Thomas Springer, "Single Family Housing Transactions: Seller Motivation, Price, and Marketing Time," *Journal of Real Estate Finance and Economics* 13 (3) (1996): 237-254.

¹⁹ William G. Hardin and Marvin L. Wolverton, "The Relationship between Foreclosure Status and Apartment Price," *Journal of Real Estate Research* 12 (1996): 101-109.

²⁰ Fred A. Forgey, Ronald C. Rutherford, Michael L. Van-Buskirk, "Effect of Foreclosure Status on Residential Selling Price," *Journal of Real Estate Research* 9 (3) (1994): 313-318.

²¹ James D. Shilling, John D. Benjamin, and C.F. Sirmans, "Estimating Net Realizable Value for Distressed Real Estate," *Journal of Real Estate Research* 5 (1990): 129-139.

²² Charles S. Laven, "Pricing and Valuation of Vacant Properties: Developing a Neighborhood Stabilization Approach," Presented at the NeighborWorks Training Institute. (December 11, 2008).

²³ Shuang Zhu and R. Kelly Pace, "Distressed Properties: Valuation Bias and Accuracy," presented at the Critical Issues in Real Estate Symposium, Florida State University, April 2010.

²⁴ "Lender" is used loosely in this article, which also includes lenders' representatives such as servicers and trustees. In some states, properties in court-imposed "strict foreclosures" often bypass the foreclosure auction step to enter REO status directly. In those cases, no foreclosure auction prices are observed. However, Massachusetts does not allow "strict foreclosures," so these exceptions are not a concern for this article.

Technical Note on Regression Models

This section presents further detail on five hedonic regression models assessing the correlation between the price differential and the property, neighborhood, and sales characteristics of these REO sales.

Hedonic regression model is a commonly accepted method to study factors correlated with property pricing, including distressed properties.³⁹ The general form of the models is:

$$PD_{ij} = \beta_0 + \beta_1 PC_i + \beta_2 NC_j + \beta_3 SC_i + \varepsilon_{ij},$$

where the dependent variable, PD_{ij} , is the sale price differential of REO property i in census tract j . Sale price differential is, as defined earlier, the percentage difference between the property's foreclosure sale price and its subsequent REO sale price. There are three bundles of independent variables: 1) PC_i is a vector of property characteristics for property i , including lot size, living area size, number of buildings on lot, number of bedrooms and full bathrooms, age of property, and dummy variables for small multifamily and condominium structures; 2) NC_j is a vector of neighborhood characteristics for tract j , including the percentage of racial and ethnic minorities in the tract, the percentage of residents who live in urban areas, median household income, the percentage of home sale price change between 2006 and 2009, and the percentage of sales in tract that are REO sales in the same period; and 3) SC_i is a vector of sales characteristics for property i , including the days on market and dummy variables for the quarter in which the property is sold.

The property and neighborhood characteristics included are typical in hedonic pricing models, with the exceptions of property type dummies and the percent of home sales that are REO sales. The property type dummies are included because of their prominence in Massachusetts' housing stock and REO sales. The percent share of REO sales in a tract's home sales controls for local spillover effects within a tract from nearby distressed sales, which recent studies have widely documented as a factor in driving down an individual property's sale price.⁴⁰

In addition to the models controlling for various bundles of these variables, the last composite model includes a set of census tract dummy variables (714 in total) to control for the time-invariant fixed effects from omitted and unobserved neighborhood factors, such as the school districts for these properties and the neighborhood's overall physical attractiveness.

This study attempted to control for, albeit unsuccessfully, REO properties' conditions at sale in two ways: the most recent assessor's record for property conditions and records of renovation. Further investigation into assessors' records revealed that their records on these two variables are not sufficiently consistent to be included.

- ²⁵The full version of the paper, which is accessible at <http://www.bos.frb.org/commdev/pcadp/index.htm>, includes a detailed description of the algorithm.
- ²⁶This time frame also minimizes the potentially distorting impacts of the Massachusetts 90-day right to cure protection for foreclosed homeowners (Chapter 206) that went into effect in May 2008.
- ²⁷Willen, Paul. "REO Retention Rates in Massachusetts." Presented at the Furman Center Roundtable, New York University (May 2008).
- ²⁸A "normal" sale is generally called an arm's-length sale, referring to a transaction in which sellers and buyers of the property act independently without undue pressure or interest from the other party. A nominal sale usually refers to a mere transfer of ownership, such as adding a spouse's name.
- ²⁹About one-third of the normal sales are condominium properties and it is likely that some of them are units of small multifamily properties.
- ³⁰Based on convention, loans are considered "high-cost" loans if their annual interest rates are 6 points or above Treasury securities. Some studies use high-cost loans as a proxy for subprime loans. Loan underwriters typically would like to see 20 percent equity when underwriting a mortgage, but this threshold for "high leverage" is more fluid, especially in tight and expensive housing markets (e.g., Manhattan) where underwriting mortgages with loan-to-value ratio greater than 0.8 are more common.
- ³¹Michael Grover, Laura Smith, and Richard Todd, "Targeting Foreclosure Interventions: An Analysis of Neighborhood Characteristics Associated with Higher Foreclosure Rates in Two Minnesota Counties," *Journal of Economics and Business* 60 (1-2) (2008): 91-109; and Kristopher Gerardi and Paul Willen, "Subprime Mortgage, Foreclosures, and Urban Neighborhoods," *The B.E. Journal of Economic Analysis and Policy* 9 (3) (2009).
- ³²Historical Census of Housing Tables. 2000 Census. U.S. Census Bureau.
- ³³Days elapsed between a property's initial foreclosure auction and its sale as an REO. Figure 2 includes only properties that entered REO status in 2007, to allow sufficient time to age and clear the REO sale process.
- ³⁴For the purpose of this figure, "high level" is defined as the top quartile and "low level" is the bottom quartile. For instance, a neighborhood with a "high percentage of home sales are REO sales" refers to the tracts with such percentage in the top 25 percentile rank among all tracts.
- ³⁵Paul S. Calem, Kevin Gillen, and Susan Wachter, "The Neighborhood Distribution of Subprime Mortgage Lending," *Journal of Real Estate Finance and Economics* 29 (4) (2004): 393-410; William Appar and Allegra Calder, "The Dural Mortgage Market: The Persistence of Discrimination in Mortgage Lending." In Xavier de Souza Briggs, ed., *The Geography of Opportunity: Race and Housing Choice in Metropolitan America* (Washington, D.C.: The Brookings Institution, 2005): 101-123; and Kristopher Gerardi and Paul Willen, "Subprime Mortgage, Foreclosures, and Urban Neighborhoods," *The B.E. Journal of Economic Analysis and Policy* 9 (3) (2009).
- ³⁶For those who wish greater detail and a discussion of caveats, a technical appendix can be found online at www.bos.frb.org/commdev/pcadp/index.htm.
- ³⁷See Michael Glower, Donald R. Haurin, and Patric H. Hendershott, "Selling Price and Selling Time: the Impact of Seller Motivation," *Real Estate Economics* 26(4) (1998): 719-740, which provides a more detailed analysis on the impact of sellers' motivation on the selling price.
- ³⁸For instance, about one in six small multifamily units in the Boston metropolitan area was occupied by seniors and more than a quarter (27 percent) of the residents of these units lived in poverty. U.S. Department of Housing and Urban Development and U.S. Census Bureau, *U.S. Census Bureau Current Housing Reports, Series H170/07-3, American Housing Survey for the Boston Metropolitan Area: 2007* (2009).
- ³⁹For instance, see Zhenguo Lin, Eric Rosenblatt, and Vincent Yao, "Spillover Effects of Foreclosures on Neighborhood Property Values," *Journal of Real Estate Finance Economics* 38 (4) (2009); and Jenny Schuetz, Vicki Been, Ingrid G. Ellen, "Neighborhood Effects of Concentrated Mortgage Foreclosure," *Journal of Housing Economics* 17 (2008): 306-319.
- ⁴⁰Kai-yan Lee, "Foreclosure's Price-Depressing Spillover Effects on Local Properties: A Literature Review." Community Affairs Discussion Paper 2008-01 (Federal Reserve Bank of Boston, 2008).

Maximizing the Impact of Federal NSP Investments through the Strategic Use of Local Market Data

by Ira Goldstein
The Reinvestment Fund

Through two federal responses to the deepest economic recession since the Great Depression—the Housing and Economic Recovery Act of 2008 (HERA) and the American Recovery and Reinvestment Act of 2009 (ARRA)—Congress directed some \$6 billion toward efforts aimed at stabilizing neighborhoods through the acquisition, rehabilitation, financing, demolition, and land banking of properties that are blighting communities around the country.¹ The Neighborhood Stabilization Program is the vehicle through which those funds were distributed; the U.S. Department of Housing and Urban Development (HUD) is the federal agency charged with distributing the funds and monitoring their use.

Under the HERA, HUD distributed \$3.92 billion formulaically, using Community Development Block Grant guidelines;² this first infusion of funds is referred to as the Neighborhood Stabilization Program 1 (NSP1). Under the ARRA, Congress allocated an additional \$1.93 billion, which was competitively awarded by HUD. This second allocation of funds through the Neighborhood Stabilization Program is known as NSP2. Communities around the country quickly realized that these allocations to neighborhood stabilization, though large in number, still could not make a significant dent in the blight that is challenging community stability.

It is our contention that, in order to maximize the impact of NSP investments, the funds needed to be invested locally with guidance from the best available market data. By

themselves, NSP funds could not redevelop an area; they could, however, support stabilization if invested strategically.

HUD's Distribution of NSP Funds

In the HERA, Congress required HUD to create a funding formula that would recognize and quantify the notion of “greatest need.” By statute, HUD’s formula for greatest need was to include the number and percentage of home foreclosures, subprime mortgages, and homes with default and delinquency status. On their face, these are entirely appropriate indicia upon which to build a funding formula. However, those familiar with the issue knew immediately that this formula was virtually impossible; no reliable or universally available data on either delinquency or foreclosure exist. Moreover, although these might have been the appropriate indicators, they likely did not represent the complete set necessary to pinpoint the problem. Lastly, Congress did not contemplate—and HUD did not incorporate—indicators of a local market’s strengths, challenges, or assets. Nevertheless, Congress’s objective was good: that HUD should make *data-based decisions* in allocating these funds.

In an almost unprecedented fashion, HUD created indices based on a variety of data that, albeit imperfect, generally pointed to the areas of greatest need. HUD’s solution fit well into Voltaire’s maxim, “The perfect is the enemy of the good.” Under NSP1, HUD created an index with scores ranging from one to 10, with higher scores representing greater need. Under NSP2, the scores were slightly more refined; they were based on better data and ranged from one

Table 1
NSP Allocations and Properties These Funds Could “Touch”

	NSP1 allocation*	NSP1 allocation less 10% admin cost	Median sale price 2008**	80% median sale price 2008	Median sale price 2009 (Q2) **	80% median sale price 2009	Number of properties touched (2008 prices)	Number of properties touched (2009 prices)	USPS vacancies 2009 (Q2) ***	Estimated percent touched by NSP1 funds (2009)
Phoenix	\$39,478,096	\$35,530,286	\$150,660	\$120,528	\$85,500	\$68,400	295	519	36,809	1.1%
Sacramento	\$18,605,460	\$16,744,914	\$190,500	\$152,400	\$164,000	\$131,200	110	128	6,214	1.9%
Miami	\$12,063,702	\$10,857,332	\$209,000	\$167,200	\$140,000	\$112,000	65	97	7,227	1.1%
Atlanta	\$12,316,082	\$11,084,474	\$119,000	\$95,200	\$87,000	\$69,600	116	159	15,263	0.9%
Chicago	\$55,238,017	\$49,714,215	\$230,000	\$184,000	\$185,000	\$148,000	270	336	43,563	0.7%
Boston	\$4,230,191	\$3,807,172	\$327,000	\$261,600	\$315,481	\$252,385	15	15	N/A	N/A
Baltimore	\$4,112,239	\$3,701,015	\$230,000	\$184,000	\$215,000	\$172,000	20	22	21,942	0.1%
Detroit	\$47,137,690	\$42,423,921	\$31,875	\$25,500	\$20,500	\$16,400	1664	2587	59,692	3.6%
Las Vegas	\$14,775,270	\$13,297,743	\$175,000	\$140,000	\$106,000	\$84,800	95	157	13,163	1.0%
Cleveland	\$16,143,120	\$14,528,808	\$26,667	\$21,334	\$25,000	\$20,000	681	726	22,084	3.2%
Philadelphia	\$16,832,873	\$15,149,585	\$120,000	\$96,000	\$105,000	\$84,000	158	180	23,745	0.7%

*Source: <http://www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg/nsp1.cfm>

**Source: Policymap.com

***Source: USPS city-level vacancy estimates from Policymap.com

to 20, with higher scores representing greater need, risk, or both. HUD’s guidance to the public was that, to comply with Congress’s mandate, NSP funds must be targeted to areas with higher scores.

Generous Allocation, Giant Shortfall

Even the generous amount of money available under NSP1 was insufficient to overcome the blighting influences across all areas within a locale with high scores. In fact, NSP1 funds were insufficient to address the blighting influences *in even a single impacted area* within some locales. Table 1 illustrates some examples of recipients of NSP1 funds from around the United States. For each, we present the recipient city’s NSP1 allocation (less an allowable 10 percent administrative cost), the median sale price of homes there, the figure that is

80 percent of that median sale price, and an estimated number of homes that could be acquired (or “touched,” in the language of the legislation) by NSP1 funds, given those median prices.³ In none of the cities in table 1 would NSP1 touch more than 3–4 percent of the vacant residential properties as identified by Postal Service data.

Additional sources corroborate this finding. Under the best-case scenario, for example, the City of Detroit could use its NSP1 allocation to touch fewer than 2,600 properties. However, the Detroit Vacant Property Campaign estimates that there are some 78,000 vacant addresses throughout the city. The City of Boston estimates it had 187 residential distressed properties as of 2008,⁴ yet its NSP1 allocation would accommodate touching fewer

than 20. In Philadelphia, approximately 22,000 residential properties have stood vacant for more than 12 months; NSP1 allocations could touch fewer than 200, and NSP2 allocations are projected to touch fewer than 1,000 more.⁵ In light of this, we contend that a community's neighborhood stabilization program can succeed *only* if it selects reasonably small areas wherein NSP funds, either alone or in tandem with other public or private funds, address a significant portion of the blighting influences in those areas. We use data descriptive of the City of Philadelphia to explore this contention.

Using Data to Pinpoint the Problem

Grantees and aspiring grantees employed HUD-supplied and other data in a variety of ways to help target their activities under NSP1 and NSP2.⁶ The Local Initiatives Support Corporation (LISC), for example, created some customized measures for identifying areas of greatest need and made those data publicly available at the ZIP code level.⁷ Several communities around the country that received NSP1 dollars used a variety of administrative and secondary data to target acquisition of properties.⁸

Figure 1
Philadelphia MVA, 2008

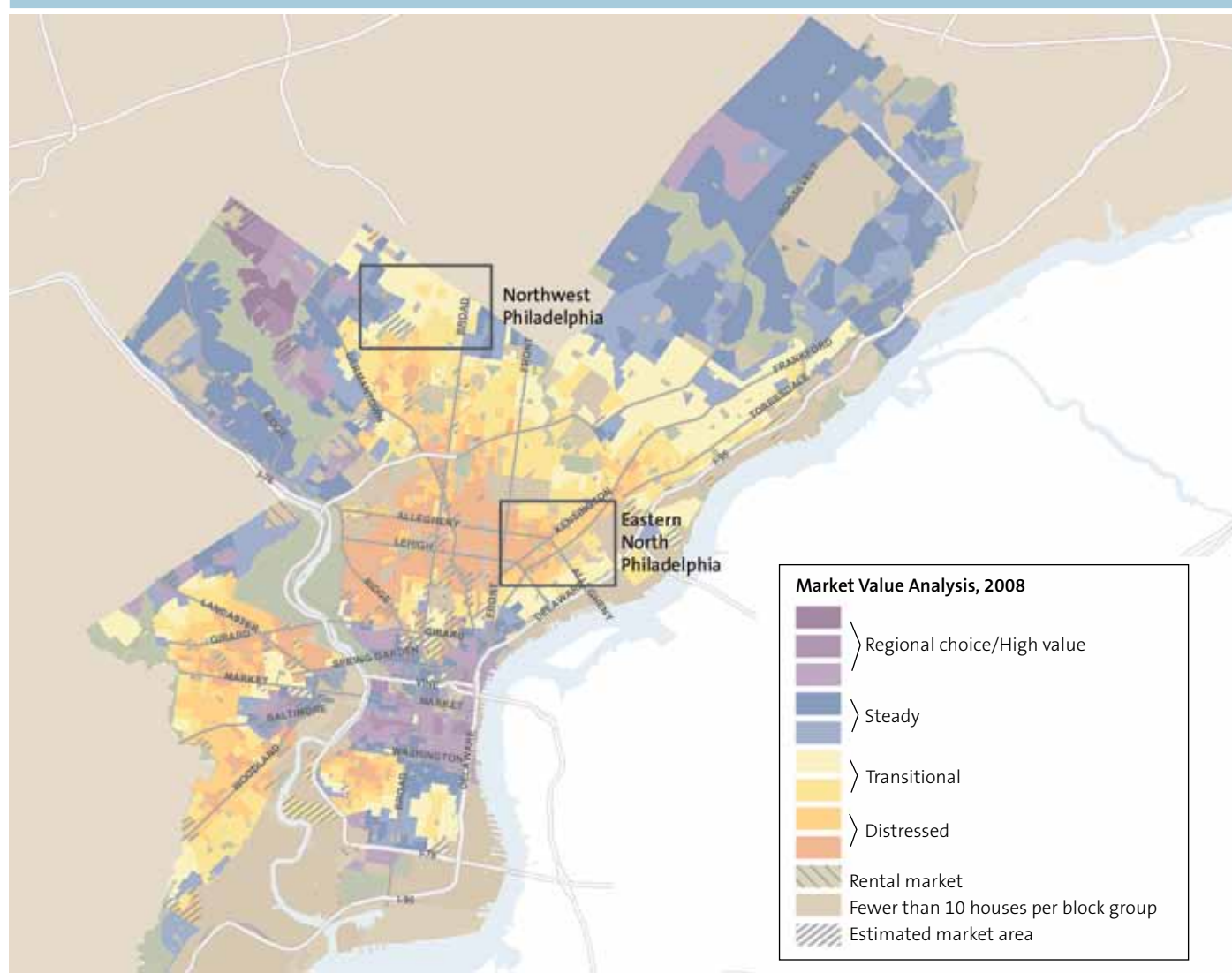


Table 2
Market Characteristics of Philadelphia MVA Categories

Market Value Analysis 2007–2008		Median sales price 2006–2007	Coefficient of variance of sales price 2006–2007	Vacancy factor	Foreclosures as a percent of sales 2006–2007	Percent owner occupied 2007	Percent commercial or stores with dwellings	Percent of residential properties tax abated or built 2000–2008	Percent of rental units that are PHA owned	Housing units per acre
Regional choice/ High value	Median	\$960,450	0.47	0.4	12.5	90.3	4.4	3.4	0.0	0.8
	Mean	\$928,670	0.45	0.5	37.5	74.4	5.4	4.0	0.0	4.3
	Median	\$550,000	0.54	0.3	4.4	29.9	6.1	4.5	0.0	18.9
	Mean	\$576,436	0.51	0.6	8.3	34.1	6.9	15.5	0.4	20.7
	Median	\$351,250	0.38	0.6	7.7	49.8	4.3	3.7	0.0	13.5
	Mean	\$360,387	0.41	1.1	17.2	48.5	7.5	11.5	0.7	17.5
Steady	Median	\$220,000	0.28	0.6	14.6	64.0	3.2	0.7	0.0	8.4
	Mean	\$224,727	0.31	1.1	18.9	61.3	6.1	3.9	0.6	10.5
	Median	\$171,000	0.28	0.6	29.1	62.5	2.9	0.0	0.0	9.5
	Mean	\$179,421	0.32	1.2	39.2	60.4	5.3	1.3	0.5	10.9
Transitional	Median	\$124,000	0.29	1.2	27.4	76.9	2.8	0.0	0.0	12.6
	Mean	\$125,974	0.32	1.9	36.0	71.0	4.4	1.0	0.8	12.6
	Median	\$80,000	0.41	4.3	39.2	68.5	3.4	0.0	0.0	12.7
	Mean	\$82,226	0.45	5.0	46.0	63.9	5.3	1.1	2.7	12.5
Distressed	Median	\$49,925	0.55	9.5	45.5	63.6	4.0	0.0	0.9	13.1
	Mean	\$50,325	0.56	9.8	52.1	61.0	5.6	0.3	3.2	12.9
	Median	\$28,875	0.75	13.8	27.1	55.6	4.0	0.0	3.8	12.1
	Mean	\$27,153	0.81	13.7	32.7	52.9	5.6	0.4	10.8	12.5
City total		Median	\$105,900	0.42	2.9	27.5	62.3	3.7	0.0	11.2
		Mean	\$137,701	0.47	5.3	35.5	58.6	6.3	3.0	12.2

Sources: The City of Philadelphia's Board of Revision of Taxes, Department of Revenue, and Prothonotary; the United States Postal Service; the Philadelphia Housing Authority; and Claritas, Inc.

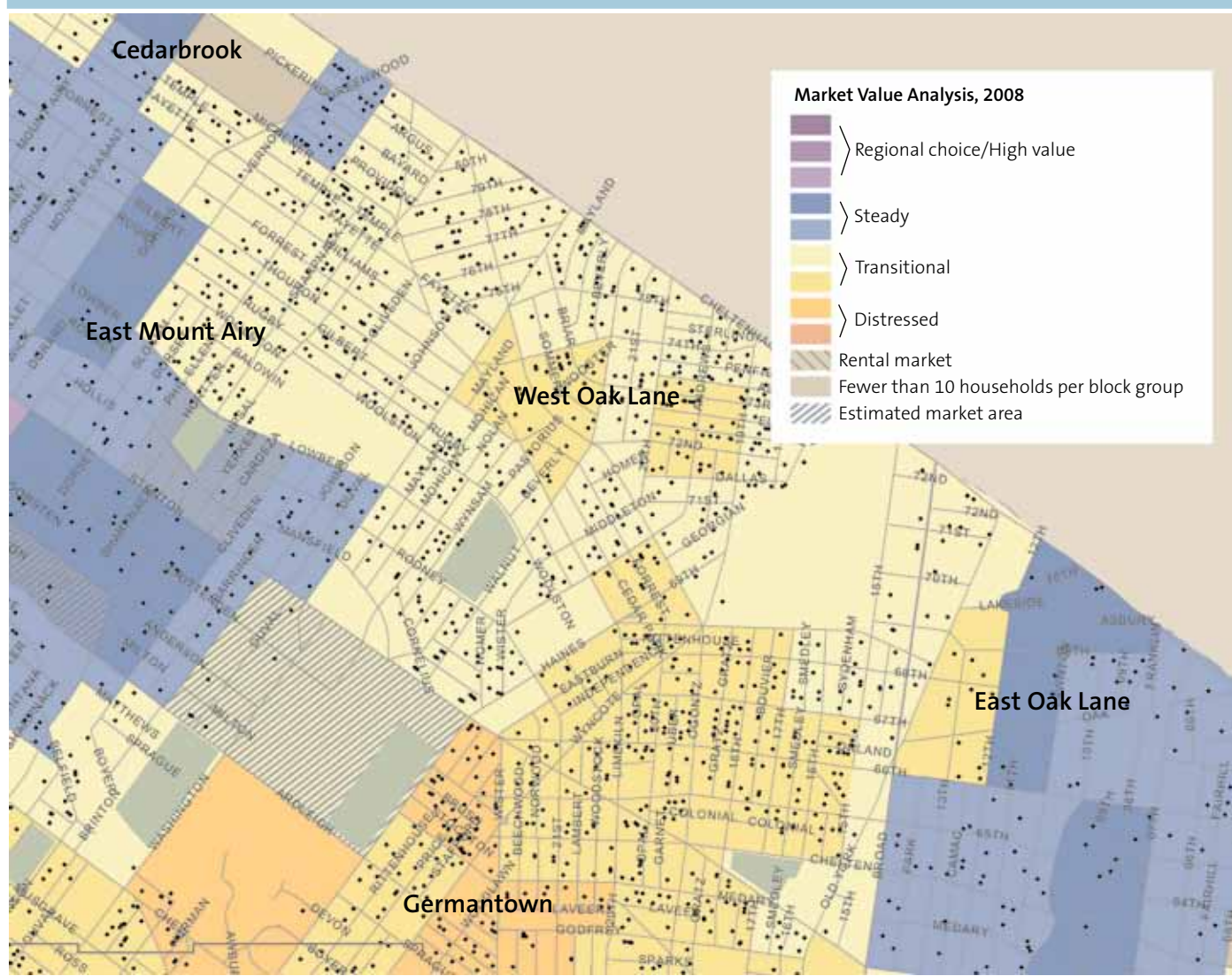
Some used our tool to help direct their NSP activities. The Reinvestment Fund has worked with a number of cities and states to prepare a Market Value Analysis (MVA),⁹ an objective, data-based tool used to characterize the underlying dynamics of a locale's real estate markets. The MVA is designed to help public officials make informed decisions about the design and nature of reinvestment activities as well as the size and type of investments necessary to influence that market positively. It is based on a set of indicators, some of which are typically found among a locale's administrative records; other

indicators may need to be purchased or licensed from third-party data providers.¹⁰

Preparation of Philadelphia's MVA involved attaching the following indicators, drawn from a variety of public and administrative sources, to each of the approximately 1,800 census-block groups in the city:¹¹

- median sale price of homes sold in Philadelphia in 2006 and 2007
- number of sales as a percent of housing units (that is, the velocity of transactions)
- housing units per acre

Figure 2
Northwest Philadelphia MVA with Foreclosure Filings



Note: Foreclosure filings 2005–07 and Q1 2008

- mortgage foreclosure filings in 2006 and 2007 as a percent of sales in 2006 and 2007
- percent of properties that are commercial
- percent of properties that are real-estate-tax abated or built after 2000 (reflective of new construction)
- percent of properties that are owner occupied
- residential vacancy factor.¹²

The census-block group is used for two reasons. First, it is sufficiently small that it captures the mosaic that exists in most communities across the country. Second, it is large enough that data

can usually be reliably aggregated for mapping and statistical analysis.

Creating a Market Value Analysis

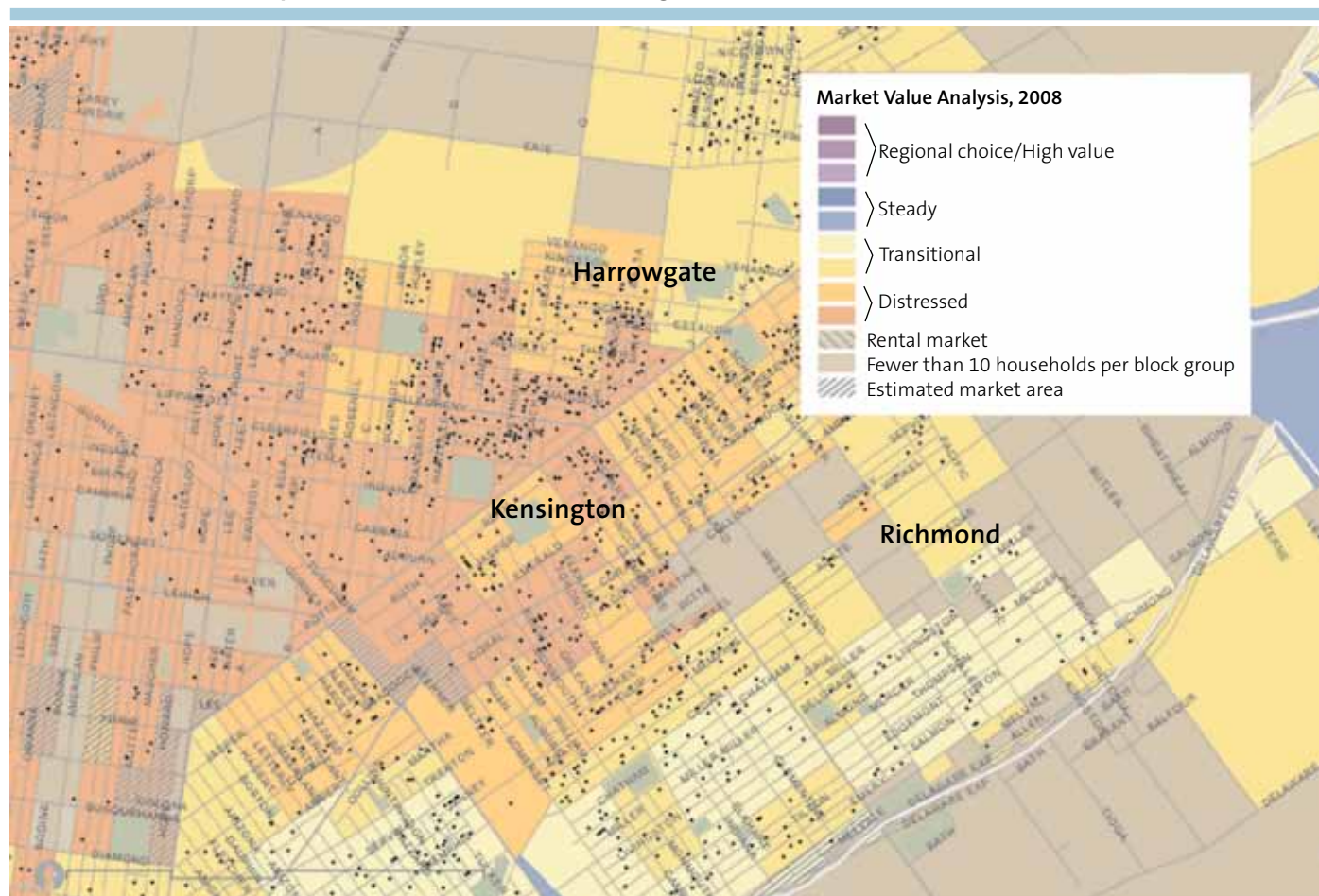
Each of these indicators is mapped and systematically examined for accuracy. Next, the data are analyzed using a statistical cluster analysis that identifies homogeneous groupings of block groups. Upon completion of the analysis, the clusters are mapped; the resulting map forms the basis of our initial visual inspection of the city. Inspections are designed to identify consistency in the statistical-cluster identification

Figure 3
Northwest Philadelphia Vacancy Estimate with Foreclosure Filings



Note: Foreclosure filings 2005–07 and Q1 2008

Figure 4
Eastern North Philadelphia MVA with Foreclosure Filings



Note: Foreclosure filings 2005–07 and Q1 2008

as well as differences across cluster types. Any required modeling adjustments are then made to the MVA, after which the clusters are re-mapped, re-examined, and reviewed by local subject matter experts to ensure that the statistical results are consistent with the observed built environment (see figure 1).

Table 2 shows the constellation of characteristics for each of the market types in Philadelphia’s MVA. The analytic power comes not only in the proper identification of what each individual block group manifests, but also in how adjacent block groups are characterized. Thus, a highly distressed block group surrounded by other highly distressed block groups represents a large expanse of market distress without adjacent stronger markets upon which to build.

Conversely, a highly distressed block group that has transitional or steady block groups near it may be able to draw on those positive local market forces to help effect change.

What Does the MVA Tell Us?

In general, the data clearly suggest that highly distressed areas—especially those that are contiguous to other highly distressed areas—are probably not places in which NSP funds will be sufficient to address the existing problem of vacant and abandoned properties. Within the City of Philadelphia, many of the highly distressed areas could, by themselves, consume the entirety of the City’s NSP1 allocation without addressing the majority of that single area’s problem. Moreover, experts report that highly distressed communities often are plagued by

Figure 5
Eastern North Philadelphia Vacancy Estimate with Foreclosure Filings



Note: Foreclosure filings 2005–07 and Q1 2008

other issues (for example, violent crime, extreme poverty, and racial turnover) in addition to having high numbers of abandoned and foreclosed properties that contribute to the area’s widespread blight.¹³

Figure 2 focuses on a community in the northwest section of Philadelphia; its neighborhoods are known locally as East and West Oak Lane, East Mount Airy, Germantown, and Cedarbrook. In MVA terms, this community is characterized by a preponderance of “transitional” markets. Table 2 displays the characteristics of these markets, including

modest home prices, relatively low levels of vacancy, modest foreclosure levels, high owner occupancy, little new construction, limited assisted-rental housing, and modest density. Economically, residents of these neighborhoods have modest incomes, commensurate with the home prices; racially, these neighborhoods are almost exclusively African-American. Figure 2 also displays foreclosure filings (each filing between 2005 and the first quarter of 2008 is represented with a black dot). A review of HUD’s NSP1 scores shows this area to be largely undifferentiated in the highest ranges of foreclosure risk. The NSP2 scores provide

a more accurate depiction, with scores in the modest range. Surrounding the “transitional” markets are some steady markets—among them East Oak Lane, Cedarbrook, and East Mount Airy—that provide local housing market strength upon which to build.

Figure 3 shows the same geographic area as figure 2, shaded according to our estimated vacancy factor. The neighborhoods, except for Germantown at the southernmost tip of the larger area, manifest low to medium levels of vacancy. This is consistent with the MVA’s categorization of these areas as typically transitional.

Figure 4 shows an area of the city known as Eastern North Philadelphia. Communities shown in figure 4 include Kensington, Harrowgate, and Richmond. Note the vast expanse of severely distressed markets, with some neighboring distressed markets. According to table 2, areas in this category reflect the lowest levels of Philadelphia’s home-price range, elevated vacancies, typical Philadelphia homeownership rates, and high levels of subsidy attached to the rental market. Economically, these are poor areas. Racially, the population in this area is largely African-American in the western portion, transitioning eastward to Hispanic and then ethnic non-Hispanic white at the far eastern sections. Note also the abundance of foreclosures. HUD’s NSP1 and NSP2 scores reveal this area to be consistently in the highest ranges of risk.

Lastly, figure 5 shows the housing vacancy factor we estimated for Eastern North Philadelphia. This section of the city manifests acutely high levels of vacancy that rival any in Philadelphia.

Where Do Data Suggest NSP Dollars Could Be Most Impactful?

The answers to this question fall along a few dimensions. First, a comparison of Northwest Philadelphia neighborhoods (figures 2 and 3) to those in Eastern North Philadelphia (figures 4 and 5) reveals similar numbers of foreclosures. However, a comparison of the vacancy levels in the two areas reveals that in Eastern North Philadelphia and the surrounding communities

(figure 5), vacancies are so high that even if NSP funds could touch the majority of the foreclosures, vacancy and abandonment would remain at high levels. Moreover, the number of vacant and foreclosed properties that would remain after depletion of NSP funds would be so great that the ultimate goal of the program—market stabilization—would be thwarted.

On the other hand, in Northwest Philadelphia (figure 3), vacancy levels are sufficiently low that if vacant and foreclosed properties were abated through strategic deployment of NSP funds, the majority of the area’s adverse market forces would be removed, allowing these communities to flourish and achieve stability. The Philadelphia MVA reveals a healthy market in the northwest section but a severely troubled market in Eastern North Philadelphia. In short, NSP funds will make the most impact when invested in areas where objective and systematic data show the housing market is functioning reasonably well. That logic suggests that deployment of NSP funds would have a greater impact in Northwest Philadelphia than in the neighborhoods of Eastern North Philadelphia.

Consideration of the target market and its surrounding area is critical to the success of NSP investment. A “deep dive” with limited NSP funds into vast areas of multi-dimensional market distress cannot be successful and will not serve the intended purpose of neighborhood stabilization. By design of HUD and Congress, NSP funds must leverage other funding sources; in actuality, NSP dollars must be invested to take advantage of other nearby market strengths. Targeting places where the problem is manageable and the surrounding markets have strength is critical to success. Therefore, although work in severely distressed markets is vitally important to the future of our cities, NSP is not the correct vehicle to address large-scale blight in a property market that is not otherwise functioning well.

As Alan Mallach, a senior fellow at the Brookings Institution, aptly put it in a presentation to a convening of the National Vacant Properties Campaign in 2008, “Neighborhood

By design, NSP funds must leverage other funding sources; in actuality, NSP dollars must be invested to take advantage of other nearby market strengths.

destabilization is a function of market deterioration or failure. Neighborhood stabilization is a function of restoring a functioning, vital market. **NSP funds should be directed toward restoring well-functioning housing markets**” [emphasis added].¹⁴

Conclusion

Many have called for the use of objective data to make decisions about where and how to deploy NSP funds. The MVA is one way of capturing a comprehensive set of market data about specific places and their surrounds. It is a tool that helps to identify where there is existing market strength upon which to build. And if replicated after a given period of time, it is a tool that is capable of showing change in relation to NSP investments.

Some say that being data-based and strategic must take a back seat to the realities of the REO market, and that NSP’s programmatic requirements favor the quickness of a community’s obligating NSP funds over the strategic investment of those funds.¹⁵ That argument is a formula for coming to the end of the NSP funding cycle only to find that, while some properties may have been addressed with these funds, communities have not been stabilized. While it is undoubtedly true that REO departments are more interested in selling properties for which they cannot otherwise find buyers to NSP recipients, municipalities—especially if they can avail themselves of the economies of scale afforded by, for example, the National Community Stabilization Trust—must use objective data and strategically deploy those funds to the places where they can make the greatest difference.

NSP is an infusion of capital to communities that may not occur again—at least at the levels in HERA and ARRA. NSP’s success is dependent upon ongoing data collection and the ability to make mid-course corrections, based on the analysis of those data, as the process unfolds. Fundamentally, its success relies on strategic investments in areas where the funds are commensurate in magnitude to the dimensions of the problem. Although an “equitable”

distribution of funds across high-NSP-score areas has some appeal of practical and political ease, there is no community-based upside to sprinkling these funds in small doses across a city.

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Endnotes

- ¹ HERA and ARRA are multifaceted acts of Congress that allocated funds and created programs and agencies designed to assist homeowners having difficulty paying their mortgages. In addition to NSP1, HERA included GSE reform and FHA modernization. ARRA was more broad-based than HERA in its attention to various components of the American economy (such as infrastructure investments, communication technology, research, education, and healthcare), in addition to the housing sector.
- ² More on CDBG guidelines can be found at <http://www.hud.gov/offices/cpd/communitydevelopment/programs/>.
- ³ This simple example assumes that acquisition is the primary activity funded with NSP1 funds. The example further assumes that no post-acquisition repairs/upgrades are required. These costs, to the extent that they exist, will further reduce the number/percent of homes NSP1 could address.
- ⁴ Statistics obtained from www.cityofboston.gov/dnd/PDFs/Distressed_Buildings_Report.pdf.
- ⁵ USPS data obtained from www.policymap.com; Philadelphia’s NSP2 application may be found at www.phila.gov/ohcd/nsp/Philadelphia%20NSP2%20application%20final.pdf.
- ⁶ See www.huduser.org/nspgis/nspdatadesc.html for a description of the HUD vacancy and foreclosure risk scores.
- ⁷ See www.foreclosure-response.org/maps_and_data/lisc_data.html for a description of the LISC risk scores.
- ⁸ See, for example, http://static.baltimorehousing.org/pdf/nsp_amendedapplication.pdf (Baltimore, Md.) or www.state.nj.us/dca/divisions/dhcr/offices/docs/nsp/nspactionplanfinal.pdf (New Jersey). Also see Amanda Sheldon, Phillip Bush, Aaron Kearsley, and Anne Gass, “The Challenge of Foreclosed Properties: An Analysis of State and Local Plans to Use the Neighborhood Stabilization Program” (Columbia, Md.: Enterprise Community Partners, Inc., 2009) at www.enterprisecommunity.org/resources/publications_catalog/pdfs/nsp_2009.pdf.

⁹ The Reinvestment Fund prepared MVAs for a variety of cities, many of which used them as the basis for targeting their NSP investments (in some cases, the cities' states used the MVAs for the same purpose). For example, Pittsburgh identified a set of target markets based on its MVA and related foreclosure-density data (see www.ura.org/pdfs/NSP-Presentation-Jan302009.pdf). San Antonio applied a similar strategy by first identifying markets that could be influenced with NSP funds and then adding the foreclosure-density dimension (see www.sanantonio.gov/gma/pdf/COSA_NSP2_Application-FINAL%2007.14.09.pdf). Lastly, New Jersey, where TRF completed a number of MVAs in different parts of the state, required applicants for the state's allocation of NSP funds to tie their strategy to the MVA. TRF supported applicants by preparing an instruction manual (see www.trfund.com/planning/NSP_NJ/njinstructionmanual.pdf) and county-by-county maps depicting market types and the density of REO within 1,000-foot squares.

¹⁰ The Reinvestment Fund prepares market value analyses for municipalities, cities, and states around the country. The process requires some statistical and GIS sophistication along with substantial on-the-ground validation of results. In every instance, TRF clients have made their MVAs publicly available.

¹¹ Each locale has different administrative data; thus, proxies for one or another of the indicia used in the Philadelphia MVA must be identified.

¹² Because the city of Philadelphia did not have a measure of vacancy that was considered sufficiently reliable, TRF created a composite factor based upon several measures,

including water shut-offs, five or more years of tax delinquency, recent demolition of properties, and vacant lots.

¹³ See, for example, Vern Baxter and Mickey Lauria, "Residential Mortgage Foreclosure and Neighborhood Change," *Housing Policy Debate* 11(3): 675–699 (2000); Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-family Mortgage Foreclosures on Property Values," *Housing Policy Debate* 17(1): 57–79 (2006); Dan Immergluck and Geoff Smith, "The Impact of Single-family Mortgage Foreclosures on Neighborhood Crime," *Housing Studies* 21(6): 851–866; G. Thomas Kingsley, Robin Smith, and David Price, "The Impacts of Foreclosures on Families and Communities" (Washington, D.C.: The Urban Institute, 2009); and Mickey Lauria and Vern Baxter, "Residential Mortgage Foreclosure and Racial Transition in New Orleans," *Urban Affairs Review* 34(6): 757–786.

¹⁴ See www.vacantproperties.org/resources/reports.html.

¹⁵ The collective wisdom of the Urban Land Institute's Shaw Forum in 2009 on the topic of neighborhood stabilization is that communities indeed feel the pressure of "use it or lose it" with respect to obligating NSP funds; participants conclude that this cannot take a back seat to a comprehensive investment strategy. (See www.uli.org/CommunityBuilding/UrbanInitiatives/~media/CommunityBuilding/Urban%20Initiatives/Shaw%20Forum/shaw%206%20tenents2010%2020pg%20FF.ashx.)

Servicing REO Properties: The Servicer's Role and Incentives

by Stergios Theologides
CoreLogic

In evaluating how best to mitigate the impact of foreclosed properties on communities, policymakers must understand the mortgage servicer's role in managing and disposing of REO properties. What are the servicer's legal and contractual obligations? What are its financial incentives? And what constraints and challenges have emerged as a result of the dramatic increase in foreclosures since 2007?

This article sheds some light on these questions, looking principally at servicers of private-label securitizations of subprime and Alt-A loans, which represent a disproportionately large percentage of foreclosures and REO inventory.¹

The Role of a Servicer in a Pooling and Servicing Agreement

The servicer's responsibilities in a private-label securitization are set forth in a pooling and servicing agreement (PSA),² in which the trustee of the securitization trust that holds the mortgage loan pool for the benefit of the certificate holders engages a loan servicer.³ The PSA stipulates that the servicer's responsibilities include collecting payments, escrowing taxes and insurance, and handling loss mitigation, foreclosure, and REO administration.⁴

Under a PSA, the servicer's main compensation is a fee representing a portion of the interest accruing on the loans serviced, typically 50 basis points per year for subprime mortgage securitizations and somewhat less for Alt-A securitizations.⁵ The servicer may also retain certain ancillary fees, such as late-payment and insufficient-funds charges, and earn interest income from holding the proceeds of borrowers'

payments for an interim period, pending the servicer's monthly remittance of collections to the trustee.

The servicer's expenses consist of operating expenses and the interest expense relating to funds the servicer is obligated to advance to the trustee. Operating expenses include office space, hardware and software systems, employee compensation, and the fees of specialized vendors and service providers, as well the cost of maintaining appropriate licensure, compliance, and related controls.

The servicer is also responsible for remitting to the trustee the scheduled principal and interest (P&I) advances and paying certain out-of-pocket costs relating to key servicing functions (servicing advances). Servicing advances can include paying a local attorney to prosecute a foreclosure; hiring an appraiser to update the valuation of a property; paying to secure and maintain a vacant property; paying delinquent property taxes; and procuring substitute insurance when a homeowner allows coverage to lapse.⁶ The servicer is entitled to recoup all outstanding P&I and servicing advances relating to a mortgage from the ultimate proceeds of the property's liquidation or the loan's prepayment.⁷

However, because the advances on a loan might remain outstanding and grow for many months, servicers may incur significant interest expenses attributable to the credit facilities or other funding sources for the advances. At any given time, servicers may have up to tens or hundreds of millions of dollars of advances outstanding.⁸

Once a loan is delinquent, there is no extraordinary reward that would justify exceptional efforts to return the loan to current status.

There is an important exception to a servicer's obligations to make P&I and servicing advances: If a servicer determines that the aggregate proceeds from pursuing foreclosure and liquidation of a particular property will not cover any additional advances—a so-called “non-recoverability determination”—the servicer is absolved of the obligation to make additional advances relating to that loan.

Servicers regularly evaluate delinquent loans in their servicing portfolio in order to determine whether or not continuing advances are required. In distressed markets with long foreclosure and REO timelines, significant deferred maintenance and code violation remediation, and very low resale prices, it is not uncommon for servicers to conclude that future P&I advances would not be recoverable from the net liquidation proceeds.

Servicer compensation, it should be noted, is not tied directly to recoveries or results from servicing specific loans. Rather, the compensation is pool-based. Accordingly, as long as the servicer is fulfilling its basic obligation to service in accordance with the PSA, there is only a weak direct financial incentive for the servicer to spend incremental, extraordinary time and expense on achieving a superior result on a loan.⁹ Since revenues are essentially fixed, the servicer's incentive is to keep costs as low as possible. To be sure, a servicer's cost is lowest and its profit margin highest on current loans that require only the processing of timely monthly payments. However, once a loan is delinquent, there is no extraordinary reward that would justify exceptional efforts to return the loan to current status or achieve a lower-than-anticipated loss.¹⁰

Likewise, because the servicer recovers certain third-party expenses as servicing advances, there is a financial incentive to outsource those functions to the extent practicable, rather than build them in-house. For example, if an in-house attorney prosecutes a foreclosure, that attorney's salary is not recoverable as a servicing advance. However, the out-of-pocket expenses a servicer incurs to engage a

local attorney to foreclose on a property are typically reimbursable.

REO Properties, Servicers, and PSAs

PSAs are generally structured to include a broad grant of authority to the servicer, governed by some overarching principles, combined with more specific delegations of authority relating to particular tasks.

The broad grant typically includes

- Delegation to the servicer of the authority to “service and administer” the loans
- A requirement that servicing be performed in a manner that is either in the best interests of the trust-certificate holders or designed to maximize the receipt of principal and interest with respect to the loans
- An additional qualification that servicing be performed in accordance with “accepted servicing practices” or consistent with prudent mortgage servicers' administration of similar mortgage loans
- A qualification that the servicing should be performed in the manner in which the servicer administers similar mortgage loans for its own portfolio and without regard to potentially conflicting interests, such as the servicer's relationship with the mortgagor or the servicer's obligation to make P&I or servicing advances.¹¹

The broad grant is qualified by more specific directions on how particular servicing-related tasks are performed and by restrictions on what the servicer may do.¹² The two most salient provisions for REO properties are the PSA sections addressing realization upon defaulted mortgage loans and those addressing the title, management, and disposition of REO properties.

The “realization upon defaulted mortgage loans” provision authorizes the servicer to foreclose when it reasonably believes that doing so would maximize the trust's proceeds; the servicer may also recoup as servicing advances certain third-party expenses incurred in connection with the foreclosure.¹³

The “title, management, and disposition of REO” section of the PSA typically

- Directs the servicer to manage, conserve, protect, and operate each REO with a view to liquidating it as soon as is practicable, but no later than the end of the third year following the year in which title is taken (a tax requirement)
- Directs the servicer in what name to take title to the REO
- Permits the servicer to dispose of the REO or rent it for a period of time, subject to preserving the trust’s tax treatment
- Allows the servicer to recoup as servicing advances certain out-of-pocket expenses of managing and disposing of the REO; this last point is important because servicers must inevitably rely on local contractors to inspect, appraise, secure, maintain, and sell REO properties.

After taking title to REO on behalf of the trust, the servicer continues to be responsible for making P&I advances, unless it has determined that such advances are non-recoverable.

Some PSAs permit as a recoverable servicing advance the costs of a professional REO management firm, thereby incenting a servicer to outsource its entire REO function to such a firm and avoid the incremental overhead expenses of an internal REO department.¹⁴ Even when an REO management firm’s fees are not a recoverable servicing advance, many servicers find it more efficient to outsource some or all of their REO function to regional or national REO management firms. Because such firms spread their overhead over a larger volume of REOs, which they manage for several different servicers, they tend to have more refined and efficient systems, processes, and technology than smaller servicers.

The REO Management Process

The servicing of REO property is governed not only by the specific contractual requirements of the PSA, but also by the broader standard of “accepted servicing practices” and the requirements of local laws and regulations. The REO management process typically falls into three

phases, each of which relies on local service providers such as local real estate agents for

- securing and assessing the property
- developing a marketing strategy for the property
- executing the strategy from sale to closing.

Immediately after completing a foreclosure, the servicer secures the property, typically by re-keying the locks if the property is vacant and making emergency repairs to avoid damage to or deterioration of the property. The servicer also completes any required registration.

For occupied properties, the servicer evaluates the occupants’ intentions and may offer a modest cash payment to induce the tenant or prior owner to vacate. If the property is occupied by a bona fide tenant, federal law requires that the servicer permit the tenant to remain in the property, at fair market rent, for the remaining term of their lease.

If the occupants are not willing to vacate the property or accept an offer for renting it, the servicer begins the eviction process. Generally, in the course of the foreclosure, the servicer will have performed at least an external inspection of the property and may have a sense of its condition prior to taking title.

After taking title and securing the property, the servicer develops a marketing strategy. On the basis of an appraisal or a broker’s price opinion, the servicer estimates the likely sales price and anticipated net proceeds of the property. The servicer also determines whether there are any title defects that could impede a sale.

A more thorough inspection of the property helps the servicer determine its value and condition as well as establish whether the property is in a condition suitable for a purchaser dependent on FHA financing. If repairs are needed, the servicer obtains bids and engages contractors.

One factor influencing the servicer’s repair decisions is whether there will be sufficient proceeds to recover the repair costs as a servicing advance. If the P&I and servicing advances that accrued during foreclosure—and those likely to

be incurred during the REO and sale process—exceed the expected liquidation proceeds so that there probably will not be any net proceeds, the servicer is likely to make more limited repairs or seek to sell the property quickly to an investor as is.¹⁵

If further advances are likely to be recoverable, the servicer then executes the marketing strategy by overseeing necessary or desired repairs; engaging a listing broker; establishing a listing price; ensuring that any delinquent taxes, HOA fees, or similar assessments have been paid; and, if some of the property damage is insured under the homeowner's policy, pursuing insurance claims. When it receives a suitable offer, the servicer will accept it and then oversee the closing, receipt of proceeds, and transfer of title.

Less commonly, the servicer elects to pursue an alternative disposition strategy, such as an auction or a bulk sale, particularly for properties in declining markets saturated with such properties, where traditional sales methods take longer to complete and would likely exacerbate the trust's loss.

While the basic elements of the REO management process tend to be consistent, servicers have varying degrees of authority. For example, in some instances, an investor or bond insurer will require approvals for decisions that fall outside narrow grants of authority.

Industry Measures of Servicer Effectiveness

Two categories of industry metrics gauge servicer effectiveness in REO administration: timeliness and net value, or proceeds.

Timeliness measures evaluate how quickly and steadily REO properties move through the process. On a portfolio level, servicers and industry participants such as ratings agencies measure the total inventory “turn” rate on a month-to-month basis—that is, the number of property closings as a percentage of the number of REOs in inventory at the beginning of the period. They also evaluate the average

duration in REO inventory and the average time in various stages of the REO process to determine trends.

The second metric is a measure of proceeds—not in absolute terms but in comparison to the expected sales price developed when title was taken. Servicers strive for accuracy and predictability. Industry participants scrutinize the degree to which the actual outcomes of REO transactions deviate significantly from the expectations that drove the initial REO strategy.

Challenges Spurred by the Housing Crisis

The dramatic rise in foreclosures since 2007 has placed additional stress on standard REO management processes, increasing the costs, complexity, and risk to servicers. Like the housing finance industry, the servicing industry has had to adjust to these challenges. This section examines some of the challenges, their effect on servicers, and how the industry has responded.

Declining home values. Broad and relatively rapid home value declines since 2007 forced servicers to scrutinize and adjust their marketing strategies more carefully. A property on the market for several months might decline in value and require successive price drops during that period.

In calculating the value of an REO property, servicers and local real estate listing agents increasingly employ more robust automated tools to assess factors that influence the REO sale strategy, such as other foreclosures, negative equity, and owner occupancy rates in the immediate neighborhood.

Over time, servicers have adjusted their models to accommodate selling properties quickly rather than holding onto potentially wasting assets. At times this may mean selling to a cash investor immediately, at a slightly lower price, instead of waiting for a prospective owner-occupant to receive financing for the purchase.

Tighter credit standards. The significant tightening of underwriting standards has limited the funding available to purchasers of REO properties, especially first-time homebuyers. Although the FHA has partly filled the gap, it is hampered by more stringent collateral requirements that may require substantial repairs to make a property eligible for such financing. In order to increase the likelihood that a property will qualify for an FHA loan, some servicers, immediately after taking title, improve properties to a level that would pass an FHA inspection. That fact is even noted in some listings in order to attract potential buyers.

On the other hand, in some situations the substantial costs and time necessary to make a property FHA-eligible drives a servicer to focus on a quick, “as is” sale to an investor as the best outcome for the trust.

Vacant property registration requirements and code enforcement. Many local governments, concerned about the increasing number of vacant homes, have passed registration ordinances that allow them to track which homes have become vacant.¹⁶ Likewise, code enforcement officials and homeowners’ associations have become more aggressive in pursuing servicers for repairs and maintenance. Even when a servicer believes that allegations of the prior owner’s infractions are without merit, it is sometimes cheaper simply to make the required repairs. Longer foreclosure timelines also increase the likelihood that REO properties will be in greater disrepair when title is taken.

Servicers have adjusted their models to reflect these higher expected costs; their adjustments influence the timing and price of the sale and whether it might be preferable to arrange a short sale or adopt a bidding strategy that would allow the property to be purchased at auction by a third party, rather than by the servicer on behalf of the trust.

Heightened tenant protections. Policymakers have become increasingly concerned about reports of tenants in foreclosed homes facing

eviction. Likewise, the proliferation of vacant properties has placed a premium on keeping distressed properties occupied to mitigate the potential negative neighborhood impact of another vacant property.

In May 2009, the Protecting Tenants at Foreclosure Act became law, obliging the successor-in-interest to a foreclosed property to permit tenants with bona fide leases to remain in REO property on market terms and requiring longer notice periods to tenants to vacate the property. Some states have also adopted longer notice requirements and additional protections for tenants in foreclosed properties.¹⁷ Accordingly, the GSEs and servicers have had to develop the capability, internally or through vendors, to manage the rental process as well as other requirements of the legal directives.

Despite these added protections, anecdotal reports from servicers indicate that most tenants elect not to pursue the lease option, preferring to accept financial inducement to relocate.

In some jurisdictions, tenant advocates have become more aggressive in pursuing strategies to permit tenants to forestall eviction or command a higher inducement price to vacate the property. Servicers in those jurisdictions find it increasingly difficult to fulfill their obligations to maximize proceeds for the trust. Until they take title, servicers have very limited authority and ability to perform a robust inspection to determine whether or not the current owner is adhering to applicable rental-housing laws. Once the servicer takes title on behalf of the trust, advocates for the tenants may pursue court action to require repairs and financial compensation for the tenants that may result in substantial additional losses for the trust.

In a troubling development, some servicers report fraud schemes in which individuals who are not bona fide tenants of a foreclosed property move in during the foreclosure process and use these laws and protections to extract monetary settlements.

Most tenants elect not to pursue the lease option, preferring to accept financial inducement to relocate.

Efforts to make properties available for nonprofits and local governments. Local governments and nonprofits have reacted to the increase in REO, foreclosed, and abandoned properties by seeking ways to offset the negative local impact. The Neighborhood Stabilization Program, created by federal legislation in 2008 and expanded in 2009,¹⁸ provides funding to stabilize communities that have suffered from foreclosures and abandonment. Organizations such as the National Community Stabilization Trust and the REO Clearinghouse also help local organizations purchase or receive contributions of REO property from servicers. Servicers participating in the Trust agree to provide a “first look” to local organizations interested in purchasing REO that meet specified criteria in certain markets.

Although these programs have experienced modest success, the volumes of properties coming to market each month that meet the designated geographic and other criteria established by participating nonprofits and community-based organizations are still quite small compared to the total number of REO transactions in a given month. Also, there are persistent operational challenges to reconcile the often-longer timelines of nonprofits that have funding, governance, and charter constraints with servicers’ strong desire to dispose of REOs quickly.

Extended foreclosure timelines. Foreclosure moratoria, loan modification programs, courts’ administrative backlogs, and legislative changes to the foreclosure process (such as additional notice periods and mandatory mediation), while well meaning, have nevertheless increased the “shadow inventory” of properties suspended in various stages of foreclosure.¹⁹ At the same time, the number of properties in REO has actually declined as capacity expansion, both internally and through the use of REO management firms, has helped servicers to complete sales more quickly than new REO properties come in.

Because of the longer foreclosure timelines, more advances have accrued that will ultimately

offset any liquidation proceeds. In order to mitigate the advances and accelerate the disposal process, servicers are becoming more aggressive about short sales and third-party sales at foreclosure auction. Funds that could be used more productively to maintain or repair a property once it reaches REO have increasingly been exhausted through the longer foreclosure timeline and P&I advancing burden.

The “toxic title” phenomenon. In some markets with high foreclosure rates, low property values, and aging housing stock, servicers have started to suspend the foreclosure process on a home rather than pursue it to REO and liquidation. This phenomenon is sometimes referred to as “toxic title”—the owner of record has abandoned the property and may believe the foreclosure has been completed, but the lien-holder has not yet taken title. In most jurisdictions, code enforcement has very limited ability to pursue a lien-holder; at the same time, the owner who has vacated the property is either unreachable or is unwilling or unable to make the repairs or pay fines.²⁰

Although this practice is uncommon in most markets, in certain of the hardest-hit markets servicers will increasingly find that their obligations to the trust to maximize proceeds (or minimize losses) might require them to abandon foreclosure and walk away from the property. Some servicers elect to release the lien in such a case.

Whether or not the lien is released, if the owner of record is unaware that the foreclosure has been abandoned, or if the owner is unwilling or unable to engage with local authorities with respect to taxes, code issues, or the potential transfer of the property, efforts to address the property will be hampered. One response to this phenomenon is to broaden vacant-property ordinances so that registration and maintenance obligations extend to lien-holders of vacant properties in default.²¹

The expansion of the lien-holder’s obligation troubles mortgage investors and their servicers. Investors understand that they bear

the risk of total loss of their investment in a particular mortgage. However, they consider it inequitable to compound their loss by also making them liable for code violations, unpaid taxes, delinquent homeowner association obligations, landlord-tenant issues, or other property-related obligations of the defaulting property owner.

Servicers face legal and practical constraints on accessing and repairing a property that the borrower still owns. On the other hand, they face reputational risks relating to being identified with a “toxic title” or abandoned property. In addition, even if legislative changes expand a servicer’s right to access and alter a vacant property during the foreclosure process, doing so would potentially breach the servicer’s obligation to the trust if the servicer reasonably believed that such repairs would constitute non-recoverable advances. As policymakers strive to reach back earlier in the process to impose on lien-holders certain obligations for code violation remediation and general repairs and upkeep, those efforts will merely force servicers to decide earlier whether or not to proceed with foreclosure. Once the servicer concludes that the expenses of upkeep and repair will not be recoverable, it may be precluded contractually from making those repairs.

Conclusion

Although there are no clear transformational policy or community approaches to addressing the challenges of REO properties, a few incremental steps are worthy of further exploration to mitigate the impact REO properties have on communities.

First, when a property is vacant or when it is clear that no foreclosure alternatives are likely to succeed with a given borrower, policy measures that can streamline the foreclosure process are more likely to leave funds available for the servicer to make code improvements, do repairs, pay taxes, and list and dispose of the property in an orderly fashion. Funds depleted through drawn-out periods of making P&I advances could be utilized more constructively in facilitating an orderly sale of a code-compliant

property to an owner-occupant or community-based organization.

Second, although there will continue to be situations where a servicer must contractually forgo foreclosure, under certain circumstances there could be requirements, for lien release and/or enhanced efforts, to notify the title holder that foreclosure is not being pursued. This would increase the likelihood that owner-occupants or tenants will stay in cases where the servicer does not intend to take title.

Third, commercially available information can give community-based organizations and local governments more insight concerning properties that are likely to be in REO within six, 12, or 18 months, or that are at risk of ending up with toxic titles. When records of tax payments, delinquency status, ownership, lien status, and similar data are combined with information on valuation, negative equity, and neighboring properties, they can provide earlier warnings to allow community-based organizations and local governments to engage with servicers and develop neighborhood- or even property-specific strategies.

Finally, in order to reduce the number of toxic titles, policymakers should explore the prospect of allowing a servicer or investor who would normally forgo pursuing foreclosure due to non-recoverability of code-violation remediation or back taxes to take title nevertheless, provided there is an instantaneous contribution of title “as is” to a local government or non-profit. If investors who have lost their entire mortgage investment (or the servicers acting on their behalf) know that they will not be further burdened by obligations for code remediation, they may be more willing to take title and transfer the property to a government or nonprofit entity that will be able to begin moving the property back into productive use.

Funds that could be used more productively to maintain or repair a property once it reaches REO have increasingly been exhausted through the longer foreclosure timeline and P&I advancing burden.

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Endnotes

¹ CoreLogic data for REO properties in January 2010 show that slightly over 50 percent of first liens in REO status came from subprime or Alt-A mortgages. Although prime or conforming loans represent a much larger proportion of mortgages outstanding, they are under-represented relative to subprime and Alt-A loans among delinquent and REO properties. Moreover, GSEs control their own REO disposition, whereas subprime and Alt-A REO are typically dispersed among and controlled by a much larger number of servicers.

² Sometimes this agreement is called a sale and servicing agreement and sometimes it takes the form of an assignment, assumption, and reconstitution agreement that reconstitutes an existing servicing agreement.

³ In a securitization transaction, the trustee holds the loans in trust for the owners of the certificates or securities that represent the ownership interests in the trust. For a basic (although slightly dated) overview of asset securitization, see *Asset Securitization*, Comptroller’s Handbook 1997 available at www.occ.treas.gov/handbook/assetsec.pdf (July 2010).

⁴ Some PSAs divide servicing responsibility among a master servicer, a servicer, and/or one or more subservicers. This division of responsibility typically reflects a desired division of economic interests or specialization that results in carving up the servicer’s role between two or more parties. In a large pool with multiple servicers, a master servicer is typically responsible for aggregating all monthly remittance reports and determining the pool’s aggregate results.

⁵ In some transactions, the initial pricing is lower, and then steps up as the pool seasons. This more closely replicates the cost to service that increases over time as a percentage of the remaining pool balance for two reasons: First, as the pool size decreases (due principally to prepayments), the fixed costs of servicing are spread over a smaller pool balance; second, the delinquency level of the remaining loans increases as the pool seasons and some current loans refinance and are paid off.

⁶ A representative 2007 subprime PSA defines servicing advances as “[a]ll customary, reasonable, and necessary ‘out of pocket’ costs and expenses (including reasonable attorneys’ fees and expenses) incurred by the Servicer in the performance of its servicing obligations, including... (i) the preservation, restoration, inspection and protection of the Mortgaged Property, (ii) any enforcement or judicial proceedings, including foreclosures, (iii) the management and liquidation of the REO Property, and (iv) compliance with the obligations under [sections relating to taxes, insurance, recording of releases and other out-of-pocket expenses]” (Option One 2007-6 PSA).

⁷ If the proceeds of liquidating the loan cannot completely reimburse the servicer for accumulated advances on that loan, the servicer may reimburse itself from collections and prepayments on other loans in the pool.

⁸ For smaller, independent servicers, this advancing obligation is more than a significant interest expense; it can strain a servicer’s liquidity. In fact, ratings agencies consider a servicer’s ability to fulfill advancing obligations as an important factor in rating it.

⁹ Ratings agencies, issuers, and investors track the overall effectiveness of servicers. Typically, they compare a servicer’s performance to the results of servicers of loans of similar characteristics and vintages. Achieving better-than-average results increases a servicer’s chances of being selected for future pools.

¹⁰ PSAs’ compensation structure is very different from that used by investors in pools of distressed mortgages to incent special servicers to maximize recovery. Special servicing agreements are customized to induce a performance consistent with the investor’s objectives. For example, servicers may get extra payment for successful short sales, deeds in lieu, or other loss-mitigation measures. They may also receive bonuses for keeping aggregate losses below projected levels.

¹¹ For a representative formulation of the broad delegation of authority, see www.sec.gov/Archives/edgar/data/1365364/000119312506141969/dex101.htm. See also Option One, cited above.

¹² Some restrictions exist to give certificate holders the desired tax treatment of the trust. Others empower certain stakeholders to approve specific measures. For example, in securitizations where certificates are credit-enhanced by a bond insurer, modifications or short sales commonly require the insurer’s prior approval.

¹³ See, for example, www.sec.gov/Archives/edgar/data/1372671/000114420406043873/v055673_ex4-1.htm.

¹⁴ In some more recent transactions, REO management firms’ fees are not recoverable as servicing advances. Some industry participants perceive the REO management function (management and oversight of local vendors who handle REO preservation and disposition functions) as an internal expense that a servicer should bear as a general operating expense. See Option One, cited above.

¹⁵ In fact, if the proceeds are unlikely to cover accrued P&L and servicing advances, the servicer might not even take title to the REO, preferring to pursue an alternative strategy such as a short sale or a lower bid at auction that might allow a third-party bidder to prevail. This is an

important area in which the interests of local governments and nonprofits diverge from the contractual obligations of servicers. If a servicer reasonably believes future repairs, maintenance, and improvements would be “non-recoverable” advances, it would arguably be breaching its PSA obligations if it were to incur those expenses rather than execute a rapid “as is” sale or even avoid taking title.

¹⁶For a list of vacant property ordinances, see <http://www.safeguardproperties.com/vpr/city.php>.

¹⁷For example, Illinois HB 3863, which became effective in November 2009, amends certain foreclosure-notice language to give tenants more information about their rights.

¹⁸See the Housing and Economic Recovery Act of 2008 and the American Recovery and Reinvestment Act of 2009.

¹⁹CoreLogic estimated that there was a pending supply of 1.7 million residential properties as of September 2009, up from 1.1 million a year earlier. This includes REO properties, pending foreclosures, and properties with

mortgages more than 90 days past due. Normally, this “shadow inventory” would not be included in official measures of unsold housing inventory.

²⁰Professor Kermit Lind describes this phenomenon in “The Perfect Storm: An Eyewitness Report from Ground Zero in Cleveland’s Neighborhoods,” *Journal of Affordable Housing* 17(3): 237–258 (2008). For local governments’ code-enforcement challenges with respect to properties abandoned during the foreclosure process, see Joseph Schilling’s “Code Enforcement and Community Stabilization: The Forgotten First Responders to Vacant and Foreclosed Properties,” *Albany Government Law Review* 2: 101–162 (2009).

²¹For example, see Miami-Dade County, Florida, Ordinance No. 08-134, adopted December 2, 2008; and New Haven, Connecticut, Ordinance No. 1583, adopted January 22, 2009.

Section II: Solutions

Strategies for Dealing with REO and Vacant Properties

Acquiring Property for Neighborhood Stabilization: Lessons Learned from the Front Lines

by Craig Nickerson
National Community Stabilization Trust

Motivated by a growing sense of urgency and aided by billions of dollars in federal aid, hundreds of communities across the nation have been working for more than a year to reclaim neighborhoods hard hit by foreclosures and abandonment. To date, almost \$6 billion in federal Neighborhood Stabilization Program (NSP)¹ funding has been made available to select communities to stem the steady deterioration of property values and community confidence.

One key to the success of local stabilization efforts is acquiring foreclosed and abandoned real-estate-owned (REO) properties in a predictable, timely, and concentrated basis. To date, acquisition of such property has been the primary use of NSP funding. Founded in 2008, the National Community Stabilization Trust (NCST) was established specifically to help facilitate the transfer of foreclosed and abandoned properties from financial institutions nationwide to local housing organizations, to promote the productive reuse of these properties as well as neighborhood stability.

The Trust, sponsored by six national nonprofit organizations known for their innovation, was created to build local capacity to effectively acquire, manage, rehabilitate, and sell foreclosed property, to ensure that homeownership and rental housing are available to low- and moderate-income families.² Through the promotion and facilitation of public-private collaborations, the Trust seeks specifically to leverage federal NSP funding to ensure that these dollars have maximum impact.

Despite the efforts of the Trust and scores of state and local community development practitioners, however, progress in revitalizing neighborhoods remains slow and fragmented. What happened? Why has progress toward neighborhood stability been so slow? And what can policymakers and housing providers do to accelerate local stabilization efforts?

This article

- assesses primary reasons for NSP's slow start,
- discusses some of the lessons learned by NCST and its partners during the first year of the Trust's operation, and
- offers ideas for more efficient and scalable property acquisition to help communities gain a better foothold against the rising tide of property foreclosures and abandonment.

A Slow Start to Stabilizing Neighborhoods

New national housing initiatives typically start slowly. In fact, slow starts have blemished the first years of single-family and multifamily programs alike, including the HOME Program, Low Income Housing Tax Credits, and Hope VI. And yet, NSP was particularly sloth-like in its first year, while foreclosures in hard hit markets continued to grow. By March 2010, a full year after NSP funding was provided to more than 300 state and local grantees, less than half of all funds were obligated, and only 25 percent of funding was actually expended.

These slow starts can nevertheless prove instructive. Lessons learned in the first year of a high-profile housing initiative can pay dividends in ensuring that future efforts are

The National Community Stabilization Trust will remain committed to ensuring that a predictable, transparent, high volume of property traffic flows to local buyers.

more productive. With that in mind, we offer the following four primary causes of the NSP's slow start:

Lack of buyer and seller capacity and skills.

Acquiring, renovating, and subsequently disposing of large numbers of abandoned and deteriorated properties in a highly targeted geographic setting requires a level of planning, collaboration, and choreography that in many instances was not in place when NSP funds initially became available in 2009. Many NSP grantees and their participating housing providers lacked the REO transactional expertise, development infrastructure, asset-management and land-banking skills, and comprehensive planning necessary for success. Financial institutions found themselves in a similarly challenging situation. Institutions holding large inventories of REO properties were faced with a multitude of operational and leadership challenges as they managed unprecedented caseloads, built new technologies, and overhauled servicing and REO-processing systems. They sought to be responsive to socially motivated buyers who insisted on revised purchase agreements, foreign purchase conditions such as environmental requirements, and federally mandated property-purchase discounts. Moreover, financial institutions had to balance their interest in selling to motivated NSP buyers with their obligation to gain adequate financial returns for investors.

Changing NSP requirements. The United States Department of Housing and Urban Development (HUD), which administers NSP, has responsibility for issuing requirements related to the purchase of foreclosed and abandoned property with NSP funds. These requirements underwent a steady stream of revisions from October 2008 through March 2010, causing hesitancy on the part of some state and local grantees to start using funds. While many of these changes—to provisions regarding discount levels, tenant protections,³ environmental reviews, purchase agreements, the Uniform Relocation Act,⁴ proper selection of sub-recipients and developers, and

definitions of key terms—were warranted, they have also prompted considerable grantee caution and delays.

Competition from investors. Traditional mom-and-pop buyers and local property investors can be contributors to community solutions, even encouraged as partners in public efforts to supplement NSP investments by buying and renovating properties in the target markets of a community's NSP plans. More troubling to local housing providers has been the growing number of well-capitalized, out-of-state, and newly formed investor pools scooping up low-value REO properties, particularly in NSP target markets. Many of these investors are motivated by the prospect of a fast “flip” of the properties, undertaking only minimal interim renovations so the properties can be rented to generate cash flow until sale. Investors' ready access to cash for closing and their close relationships with some financial institutions' REO brokers exacerbates the challenge of aggregating the right property assets for market rejuvenation.

Lack of REO inventory. In June 2010, the inventories of large financial institutions such as Bank of America, Chase, and Wells Fargo had dropped to 35–40 percent of their inventories from June 2009. This significant decline caught many in the industry by surprise, even as mortgage default and foreclosure filing levels in the same time period increased month over month.

Where did the REO inventory go? There are many reasons for the reduction in inventory, most notably:

- **The “anything but REO” mindset.** Increasingly over the past year, distressed servicers have adopted the mantra “anything but REO”; virtually any alternative is preferable to the cost and uncertainty of generating additional REOs, including short sales and deeds in lieu of foreclosure. The foreclosure process is expensive for servicers and investors: The typical price tag is \$50,000 per foreclosed home, or as much as 30–60 percent of the outstanding loan balance.⁵ REO means higher disposition costs, local taxes and

insurance obligations, a more deteriorated property, and the risk of flooding an already-saturated, weak real estate market.

- **HAMP purgatory.** Implementing the U.S. Department of the Treasury's Home Affordable Modification Program (HAMP) has been a capacity challenge for many financial institutions. Until recently, loss-mitigation efforts were not resulting in either streamlined approval or definitive denials of HAMP borrower requests. Because of the mandatory trial period within the program, it can take a borrower six to seven months to find out whether he or she qualifies for a permanent loan modification. Based on the May 2010 update from the federal government, only 31 percent of trial-period HAMP modifications had been converted into permanent status, for a total of approximately 340,000 modifications among the 7 million seriously delinquent homeowners facing foreclosure. All signs point to more post-HAMP foreclosure filings in 2010.
- **Short sales.** Short sales involve a property being sold by a defaulted borrower with the approval of the servicer for less than the outstanding loan amount, in satisfaction of the mortgage. Major servicers have stepped up their efforts to significantly increase the number of short sales as a cost-saving alternative to foreclosure. Many are making improvements to technology and devoting more staff to increase these volumes. The Treasury Department's new Home Affordable Foreclosure Alternatives Program (HAFA), an aggressive incentive program for short sales, should further reduce REO levels.
- **Keeping occupied properties in default status.** Increasingly, financial institutions find it fiscally preferable to keep a nonperforming asset in their servicing pipeline, rather than move it to REO. This is particularly true when the defaulted borrowers remain in the property. Keeping the property occupied avoids vandalism and buys time for market demand to increase.

- **Charge-offs.** Charge-offs, or "walk-aways," are a growing problem, especially in weak markets. Some financial institutions are simply walking away from low-value property, rather than take title to the property at the sheriff's sale. This action leaves the property, which is almost always abandoned, in legal limbo; it is not an REO and thus is not counted among financial institutions' REO inventory.

Lessons Learned during the First Year of NCST

When creating the National Community Stabilization Trust, its founders aimed for an organization that would connect two disparate worlds—the financial institutions holding unprecedented levels of foreclosed and abandoned property and local housing providers seeking to purchase and reuse these properties to foster neighborhood stabilization. The Trust would both create a highway between these two worlds and serve as "traffic cop" to ensure that sellers and buyers were adhering to the rules of the road.

While the Trust's role as property-acquisition intermediary is now well established, the first year of NCST's operations felt more like a roller coaster than a highway, with many unanticipated dips and turns. In an ever-changing housing market, predictability was difficult to find. Yet, despite the detours, by June 2010 financial institutions had shown more than 45,000 properties through the Trust to more than 130 NSP grantees. Some communities—such as Minneapolis; Clark County, Nevada; and Los Angeles—each purchased more than 80 properties in the first half of 2010. Property transactions facilitated by the Trust gained NSP grantees an average property discount of more than 15 percent from fair market value—a savings of more than \$16,000 per property.⁶

Perhaps most important, the Trust has learned some valuable lessons over the first 12 months of operations that can serve the housing industry well going forward.

1. **Quick and certain sales save all parties money.** By arranging for quick sale of REOs to publicly supported buyers, financial institutions are saving money and avoiding property disposition uncertainty. A quick sale means lower carrying and marketing costs, less property deterioration and vandalism, and other savings. This “net realizable value” has resulted in the 15 percent average discount to date for buyers of REOs through the Trust, and has helped the sellers defend their sale prices to the investors who own these properties.

2. **NSP buyers need preferential access through programs like First Look.** Although initially developed to ensure a discount consistent with early NSP requirements, the Trust’s “first look” program has become the most popular way to ensure that NSP buyers can see and selectively buy the REO property best suited for their neighborhood stabilization plans. Through the program, NSP and other socially motivated buyers are provided an exclusive window to see and determine interest in new REOs before these properties are marketed to the public. First Look saves NSP buyers the challenges of searching for property holders of record and competing with cash-ready investors.

3. **Less-focused showings of REOs are hugely inefficient.** In 2009, the Trust pushed thousands of available REO property notifications out to NSP grantees or sub-grantee buyers (typically one or more entities designated by the NSP grantee to purchase REO property), principally through the First Look program. Many of these properties were subsequently purchased at an attractive discount. This process, however, was staff-intensive and did not help NSP buyers discern which REO properties were most strategically important to acquire. For example, REO departments within financial institutions typically categorize properties by ZIP code only, even though most NSP buyers’ target markets are much smaller, often smaller than a census tract. In

effect, the Trust had been providing a whole basket of apples for sale, knowing that only a few ripe ones would ultimately be purchased. This supply-side solution was helpful but inefficient. A more targeted approach will allow the Trust, financial institutions, and buyers to identify, search for, and secure the most strategically important properties.

4. **More sophisticated tools are critical to promoting and transacting REO properties.** Getting to scale with REO acquisition and disposition efforts will necessitate more streamlined operations and better technology for sellers, buyers, and intermediaries alike. Making the process workflow more efficient will require adopting technology that can quickly identify foreclosed and abandoned properties, track down the owner or manager of the right ones, determine property values, and generate purchase agreements quickly and consistently. Also critical is the ability to map, track, and report on progress.

More Strategic Property Acquisitions

Clearly, there must be a more robust and comprehensive process in place to acquire sufficient concentrations of new and existing REO property in order to revitalize distressed neighborhoods. At the same time, new strategies must be developed to secure property *before* it becomes REO. Some key tactics will include:

New technology solutions. New technology resources can help NSP providers more accurately assess their local real estate landscape, pinpoint the most important property assets for purchase, and track and report on their progress. One such tool is the Trust’s REO Match, a new, web-based mapping and property-transaction tool that will allow property buyers to view all current REO inventory in their target markets. New REO properties identified by financial institutions populate the maps daily. Work flows can be managed electronically, and Trust staff can provide customer support rather than focus on administrative property-transfer processing. REO Match will also permit

buyers to identify other vacant property in the target markets, including properties in default (pre-REO status), and to track progress in accessing them. Policy Map, created and maintained by The Reinvestment Fund, is another indispensable tool. A geographic information system, it aggregates neighborhood-level demographic and economic information and allows users to create custom maps, tables, and charts using more than 10,000 indicators of neighborhood economic health. (Also see in this publication, “Maximizing the Impact of Federal NSP Investments through the Strategic Use of Local Market Data” by Ira Goldstein.)

For coordinating complex projects, Mercy Housing developed a tool called Community Central for local NSP programs. This web-based platform offers asset and project management capacity for NSP evaluation, acquisition, rehabilitation, and disposition processes. The tool can automatically generate compliance and oversight reports that accurately document risk management, obligation levels, and performance efficiency.

Demand-side “reverse inquiries.” To date, most NSP grantees have relied on a supply-side approach to REO property purchases—they buy properties as they become available as new REO by the larger financial institutions. With the advent of new technologies, NSP grantees and other housing providers can now shop more strategically, pinpointing specific properties rather than relying on the “right” REO properties to serendipitously become available for purchase. Once the grantees identify strategically important vacant properties in a neighborhood, the Trust can track down the servicers or REO holders using resources such as trustee data, MERS, First American Core Logic, and RealtyTrac. The Trust sees this demand-side approach as the new frontier of property purchases. With REO Match, it will now be possible to conduct a “reverse inquiry” for NSP and other socially motivated buyers.

Short sales and other pre-REO executions. With HUD’s recent expansion of the definitions of foreclosed and abandoned properties,⁷ NSP grantees can now use federal funds against a significantly expanded pool of distressed properties. The broadened definitions mitigate some of the challenges localities have in accessing sufficient volumes of property. With these broader definitions, more thoughtful planning, and new technology tools, NSP buyers will soon be able to engage as preferred short-sale and low-value property buyers. REO sellers will benefit by knowing earlier in the foreclosure process of interested public buyers with cash to close. In low-value markets, this new capability may discourage bank walk-aways. In other instances, it will facilitate more efficient short-sale transactions. While the short sale will inevitably be more time-consuming than REO purchases, the opportunity to identify and then control key property assets through a short sale should prove appealing to some local housing planners.

Conclusion

With serious defaults and foreclosures likely to remain a significant challenge for the next 18–24 months, communities will need new collaborations, new technology applications, and new comprehensive approaches to keep up. Technical assistance from HUD and on-the-ground experience are helping. Moreover, as the focus moves from obligating NSP funding quickly to using limited public funding in more creative ways, building property acquisition and disposition infrastructure for the long run will be essential. Evidence to date indicates that the accelerated learning curve of the past 18 months will place more property sellers and NSP buyers in a stronger, more productive position going forward. For its part, the National Community Stabilization Trust will remain committed to ensuring that a predictable, transparent, high volume of property traffic flows to local buyers. For localities with the discipline to maintain highly focused geographic target markets and to undertake a thoughtful property acquisition and disposition strategy, the prospect of tangible and sustainable neighborhood stabilization looks promising.

In an ever-changing housing market, predictability was difficult to find.

Craig Nickerson is president of the National Community Stabilization Trust. From 1997 to 2008, Mr. Nickerson was vice president of expanding markets for Freddie Mac. Prior to that, he worked for HUD in multiple capacities, including coordinating the National Partners in Homeownership program and directing the agency's housing rehabilitation efforts. He has also held positions with municipal, mortgage financing, and consulting organizations. Mr. Nickerson has authored numerous publications on neighborhood revitalization and affordable lending; he was a co-author of the National Homeownership Strategy for the Clinton Administration; and he developed the *Catch the Dream and Don't Borrow Trouble* campaigns for Freddie Mac.

Endnotes

¹ The Neighborhood Stabilization Program, authorized under Title III of the Housing and Economic Recovery Act of 2008, is administered by the U.S. Department of Housing and Urban Development. NSP provides emergency assistance to state and local governments to acquire and redevelop foreclosed properties that might otherwise become sources of abandonment and blight within their communities. The first \$3.92 billion in NSP funding was allocated by HUD to more than 300 state and local governments in the spring of 2009; in January 2010, HUD announced a new second round of almost \$2 billion in additional funding.

² The National Community Stabilization Trust was created in 2008 by Enterprise Community Partners, the Housing Partnership Network, Local Initiatives Support Corporation, NeighborWorks America, the National Council of la Raza, and the Urban League.

³ The Protecting Tenants at Foreclosure Act, passed in May 2009 under Title VII of the Helping Families Save Their Homes Act of 2009, creates a right for certain bona fide tenants of foreclosed properties to remain in possession of their rented property after the foreclosing lender

becomes its owner. The tenant is allowed an extra period of time to remain in the property, equal to 90 days after a notice to vacate is given or the remaining term of that tenant's lease, whichever is longer.

⁴ The Uniform Act, passed by Congress in 1970, establishes minimum standards for federally funded programs and projects that require the acquisition of real property (real estate) that could cause the displacement of persons from their homes, businesses, or farms. The Uniform Act's protections and assistance apply to the acquisition, rehabilitation, or demolition of real property for federal or federally funded projects.

⁵ Mortgage Bankers Association, "Lender's Cost of Foreclosure" Policy Paper, May 28, 2008 (<http://www.nga.org/Files/pdf/0805FORECLOSUREMORTGAGE.PDF>).

⁶ Financial institutions calculate the price at which they are willing to sell the properties to National Community Stabilization Trust local buyers using a net-realizable value process. The price offered to local buyers reflects cost savings realized from expedited REO sales, including savings from the projected time on the market for properties in that target market and the various carrying and marketing costs.

⁷ On April 2, 2010, HUD announced significant revisions to the definitions of "foreclosed" and "abandoned" properties under NSP. Properties are eligible for NSP assistance if any of the following conditions apply: The property is at least 60 days delinquent on its mortgage and the owner has been notified; or the property owner is 90 days or more delinquent on tax payments; or under state or local law, foreclosure proceedings have been initiated or completed; or foreclosure proceedings have been completed and title has been transferred to an intermediary aggregator. The definition of an abandoned property was expanded to include homes where no mortgage or tax payments have been made by the owner for at least 90 days or a code enforcement inspection has determined that the property is not habitable and the owner has taken no corrective actions within 90 days of notification of the deficiencies (http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2010/HUDNo.10-066).

REO Disposition and Neighborhood Stabilization: A Servicer's View

by Jay N. Ryan Jr.
Fannie Mae

As one of the key players in nationwide efforts to stabilize the housing market, Fannie Mae wants to keep people in their homes whenever possible. It is our organization's first priority. One of Fannie's highest-profile efforts is the Obama Administration's Making Home Affordable program, which includes opportunities to modify or refinance mortgages. In addition, Fannie Mae has developed an online tool called "Know Your Options" to help borrowers learn about options for avoiding foreclosure and how to have more informed discussions with their mortgage companies.

Despite these and other federal, state, and local efforts to help homeowners avoid foreclosure, the unfortunate reality is that a growing number of borrowers face economic and other hardships that make them unable or unwilling to stay in their homes. The result is more foreclosures and increasing numbers of real-estate-owned (REO) properties. In two years, Fannie Mae's REO dispositions almost doubled—from 64,843 in 2008 to 123,000 in 2009.

Because empty homes depress neighboring homes' values, which deepens the loss that Fannie Mae incurs on each of our properties, we continue to manage our REO pipeline as efficiently as possible, both to minimize our losses and to stabilize neighborhoods. Managed correctly, our REO dispositions can help the housing market recover and protect the interests of taxpayers.

With neighborhood stabilization at the core of our REO management efforts, we have

developed a number of creative initiatives that support our overall strategy. Our REO disposition efforts focus on:

- Selling as many REO homes as possible to owner-occupants. The best tool we have to promote neighborhood stabilization is that of selling to homeowners who are invested in the long-term sustainability of their communities.
- Continuing to develop and implement viable REO rental options for former borrowers, tenants in foreclosed properties, and potential new tenants as a way to return vacant and abandoned homes to productive use in communities.

One of the most important of these efforts is our First Look initiative, which began as a pilot in summer 2009 and was rolled out nationally that November.

First Look

First Look is a way to promote home purchases by owner-occupants and buyers who qualify for publicly funded housing programs.¹ With First Look, Fannie Mae will only consider offers from owner-occupants or buyers using public funds during the initial listing and marketing period of a foreclosed property. For most areas, this is typically the first 15 days a property is marketed. While investors play a role in the REO market, homebuyers who intend to occupy the property make an immediate and lasting commitment to the community, and therefore merit extra consideration in the REO

While Fannie's efforts are centered on owner-occupants and renters who will live in the communities, investor sales—which provide a much-needed infusion of private capital—also play a role in our REO disposition efforts.

sales process. First Look provides this extra consideration and is designed for owner-occupants seeking to acquire individual properties as well as public entities seeking to acquire more than one property. As our property inventory increases, we will continue to explore steps that give owner-occupants the best possible chance of a successful offer.

Feedback from national and local community partners tells us that not only has First Look balanced a scale that has traditionally tilted towards investors, but it's also a simple, easy-to-use program. And if imitation is the sincerest form of flattery, others apparently think the First Look approach is a good one: The Federal Housing Administration, for example, recently rolled out a similar program. First Look has been well received by homebuyers and public partners, too, and has become an effective tool for directing property disposition with neighborhood stabilization in mind. Of our 123,000 dispositions in 2009, roughly 70 percent were to owner-occupants or buyers using public funds. Because First Look was implemented in the summer of 2009, historical data are still too limited to allow us to draw conclusions. However, we continue to track the data and plan to provide metrics in 2011.

Deed-for-Lease and Other Options for Renters

While options for owner-occupants and public entities remain our focus, we recognize that renters also act as a stabilizing force in neighborhoods. Fannie Mae has several different programs for renters, all intended to deter the displacement of families, the deterioration caused by vandalism and theft from vacant homes, and their effects on families, communities, and home-price stabilization. Renters already occupying foreclosed properties have several basic protections under the Protecting Tenants at Foreclosure Act of 2009, which provides that tenants may stay at least until the end of their existing lease, and that month-to-month tenants are entitled to 90 days' notice before having to move out. Fannie Mae has extended opportunities for renters in Fannie Mae-owned properties, providing new

12-month leases as well as possible extensions for those who meet some basic qualifications.

Fannie Mae also offers a rental option for owners who would otherwise lose their homes to foreclosure, but would like to remain in their homes as renters. Through the Deed-for-Lease program, qualified borrowers of properties transferred through deed-in-lieu of foreclosure can remain in their homes by executing a lease of up to 12 months in conjunction with the deed-in-lieu.

Finally, through a pilot program in Chicago, Fannie is making its REO properties available to renters. Through this program, vacant for-sale properties are removed from the market and assigned to property managers, who rent them to individuals with certain qualifications. This contributes to stable and diverse communities and enables Fannie Mae to hold the properties in a long-term rent portfolio and dispose of them when the market has stabilized.

Cities, Counties, and States

A dedicated team of Fannie Mae employees within the agency's REO sales group supports government entities, public agencies, and non-profit organizations seeking to acquire REO. A key constituency of this "public entities" channel is the group of 365 grant recipients of the U.S. Department of Housing and Urban Development's Neighborhood Stabilization Program (NSP), which Fannie is reaching out to in order to explain First Look and help grantees understand how the program can help them make the best use of their NSP allocations.

Sales through the public-entities channel are handled like traditional REO sales: Public entities contact the listing broker, arrange to see an REO property, and submit an offer. Brokers, however, are required to tell us when an offer involves public funds. These offers are assigned to the appropriate representative in our public-entity sales channel, and that individual negotiates the transaction.

Throughout the entire process, Fannie's REO sales and community development teams make

direct contact and partner with all 365 NSP recipients to build relationships and ensure that brokers are acting in good faith to bring all offers forward.

Under First Look, public-entity buyers—including those using NSP funds, Community Development Block Grant funds, HOME Investment Partnerships Program funds from HUD, local housing trust funds, or charitable foundation funds—may qualify for additional benefits, including

- **Deposit waivers.** Fannie Mae will waive the deposit requirement for public entities that use public funds to purchase a Fannie Mae-owned property. For individual homebuyers who qualify for public funds and want to purchase a Fannie Mae-owned property, the deposit requirement can be as low as \$500.
- **Reserved contract period.** Upon receipt of an acceptable offer, buyers may be able to renegotiate their offer after obtaining an NSP-required appraisal.
- **Extra time for closing.** Buyers receive up to 45 days to close—15 days more than is usually permitted for purchases of Fannie Mae-owned properties. Generally, however, we find that the average number of days to close on a publicly funded REO transaction is no higher than on a traditionally financed REO transaction.

Between January 2009 and March 2010, Fannie Mae sold nearly 3,000 properties to buyers using public funds. We continue to seek nontraditional ways to sell properties, including selling homes to cities, counties, states, and other public entities and selling multiple properties in pool transactions or through public auctions. At the heart of many federally and locally funded initiatives are public and philanthropic funds, which have community stabilization as a common goal.

Targeting Municipalities and Communities for Scaled Acquisitions

As our public-entities sales channel conducted its outreach efforts, we found partners that were interested not only in retail REO sales, but also in transactions including low-value properties for demolition and rehabilitation programs (such as NSP), deals that targeted specific neighborhoods, and other customized acquisitions. We identified several cities and markets where local capacity and a high concentration of Fannie Mae inventory made it possible to complete strategic transactions that had the potential for near-term, transformative results in stabilizing specific neighborhoods.

Low-value pools. Structured low-value transactions appeal to potential buyers in markets with large numbers of low-value properties and where public entities, such as NSP grantees, may be pursuing strategies that include the demolition or acquisition and rehabilitation of such properties. Entities must commit to purchasing a pool of at least 25 properties, either in a single transaction or over a specified period. We identify appropriate properties based on buyers' criteria. These transactions carry specific benefits for public entities:

- Buyers negotiate with one representative of our public-entity sales channel, rather than with multiple brokers and listing agents in the traditional retail method.
- Because buyers' criteria specify only low-value properties, which are difficult to price with a great deal of precision, purchase prices are much more flexible.
- Buyers tend to realize substantial cost savings.

Traditional pools. Traditional-pool deals are available for entities that want to purchase 25 or more properties and are not necessarily limited to low-value ones. Buyers can engage in direct negotiations with Fannie Mae, in most cases submitting an offer for entire pools. Benefits of this method to buyers include

- Negotiations with a single party
- No limits in property-value categories
- Traditional closing, with escrow and prorating.

Sales of occupied properties. In these transactions, public-entity buyers may purchase properties from Fannie Mae's inventory before the properties are placed on the market; this gives public-entity buyers an advantage over other potential bidders. Execution is limited to properties that fit the entity's strategy and can accommodate complications, including redemption periods (the time in which the original property owner can reclaim a foreclosed property by making full payment on the mortgage debt) and evictions.

In a traditional retail REO transaction, public entities can purchase properties occupied by tenants who have entered into rental agreements with Fannie Mae. The Occupied Properties program extends to properties with tenants who have *not* entered into rental agreements with Fannie Mae. These occupants are frequently the tenants of former homeowners, or the former homeowners themselves who have yet to vacate the property, perhaps because of redemption periods. Public entities may wish to purchase these properties to keep tenants and former homeowners in the homes.

Investor Sales

While Fannie's efforts are centered on owner-occupants and renters who will live in the communities, investor sales—which provide a much-needed infusion of private capital—also play a role in our REO disposition efforts. As the number of our REO properties has increased, we have responded by significantly increasing the amount of investor screening we do before we approve pool sales to investors. For instance, we conduct site visits to other projects the investor has purchased as well as follow-up visits to our properties after they're sold, and conduct title searches to ensure that our investors are performing as they said they would.

We also introduce the investor to representatives of the local community, whom we encourage to do their own research on the investors. In short, we care about what investors do with the properties we sell to them. In our

experience, we have found that some investors are mission-driven, like housing-focused nonprofits, and often are better capitalized.

Strategic Partnerships for Neighborhood Stabilization: Examples of Results

As we enhance our programs, Fannie Mae continues to seek partnerships that can focus our REO sales on neighborhood stabilization. Here are some examples of Fannie Mae's work and the partnerships we create:

Minneapolis/St. Paul. Fannie Mae has been supporting communities in the Twin Cities metropolitan area on several fronts. We are a member of the Minnesota Foreclosure Partners Council, a collaborative effort established by the Family Housing Fund that focuses on foreclosure prevention, acquisition and rehabilitation of REO properties, new product development, and legislative action to help stabilize neighborhoods in the Twin Cities. We work with more than 25 partners in the area to provide property lists and information on mortgage products and services that may be useful in accomplishing their goals. In 2009 alone, the council used NSP and other funds to buy and rehabilitate 68 Fannie Mae homes for resale to homeowners.

City leaders in Minneapolis are acquiring properties for demolition and also working with nine nonprofit and for-profit partners to acquire, rehab, and sell REO properties to owner-occupants. City leaders support this effort with down-payment and closing-cost assistance programs. Minneapolis and St. Paul also recently closed on first-time-buyer mortgage bonds, purchased in part by Fannie Mae.

St. Paul, which has purchased 45 properties to date from Fannie Mae through our retail channel, is interested in a much more aggressive approach. To that end, we have finalized an innovative agreement in which St. Paul reviews Fannie Mae's available REO properties and submits an offer for a pool of properties that will be either demolished or renovated in support of St. Paul's ongoing stabilization efforts.

Another joint effort involves the Twin Cities Community Land Bank, which was established in the fall of 2009 and is interested in a coordinated pool purchase from Fannie that encompasses 18 cities and multiple counties in the metro area.

The Greater Minnesota Housing Fund is also working with us to purchase REO properties for its extended partner network throughout the rest of the state, primarily to acquire and rehabilitate properties it can sell or rent. We are working closely with the Fund's staff to make sure it has up-to-date property information for distribution to its network.

Phoenix. Phoenix and Maricopa County are stabilizing communities through programs that support owner-occupancy of foreclosed properties and through direct acquisition and rehabilitation of foreclosed properties. These programs have received more than \$121 million in NSP funding since March 2009. In 2009, they supported the purchase of 162 Fannie Mae properties through down-payment assistance for owner-occupants and acquisition and rehabilitation programs.

Fannie Mae engaged with Phoenix and Maricopa County, as well as with their non-profit partners, to help complete these transactions. Our staff provided on-the-ground assistance to local partners to explain the First Look program and our procedures for REO purchases. We provided intellectual and economic capital to support these transactions from offer to closing.

We are working with the Arizona Department of Housing, Housing Our Communities, the Local Initiatives Support Corporation, and other partners in Phoenix and Arizona as these organizations seek to expand their programs. We have discussed alternative strategies for the sale of REO properties and piloted a community auction for these properties in April of 2009. The auction was successful in linking buyers with NSP-eligible properties. These community auctions are only open to

NSP-qualified buyers to ensure that the properties are ultimately delivered to buyers who are committed to living in their communities.

Cleveland. Fannie Mae has been working with municipal leaders in Cleveland and the surrounding suburbs to assist their efforts to purchase Fannie Mae REO through our retail channel. Cleveland has aggressively attacked the problem of vacant properties through a city-wide demolition strategy and, with guidance from its land-assembly team, formed the Cuyahoga County Land Reutilization Corporation (CCLRC) to implement its plans. Fannie Mae has agreed to an ongoing monthly sale of low-value properties to the CCLRC. We typically sell these properties for one dollar, plus a contribution towards the cost of demolition.

Our agreement with the CCLRC is our first month-to-month flow transaction for low-value properties in the nation. We completed our first sale under the agreement in December of 2009, and we continue to assemble pools of low-value properties for transfer. The demolition accomplishes the goals of reducing excess housing stock and eliminating blighted and nuisance properties. CCLRC also acts as an aggregator to ease the transfer of salvageable property to local nonprofits and other community-approved redevelopment efforts.

At the outset, the local plan called for the redevelopment of 50 vacant properties each year for homeownership, rental, or lease/purchase, each targeting buyers with incomes between 60 percent and 120 percent of the community's median income. The CCLRC plan augments city-run efforts to demolish thousands of non-salvageable properties over the next few years.

Looking Forward

At Fannie Mae, our challenge is to manage the disposition of our REO properties in a manner consistent with our public mission to support liquidity and stability in the secondary mortgage market and increase the supply of affordable housing. We are mindful that we must minimize losses as we do so. Our neighborhood

For individual homebuyers who qualify for public funds and want to purchase a Fannie Mae-owned property, the deposit requirement can be as low as \$500.

stabilization efforts are a key strategy in fulfilling these mandates.

Placing REO properties in the hands of owners who will live in them—owners who are making an emotional as well as a financial commitment to the communities the properties are in—is perhaps the most fundamental means of stabilizing neighborhoods. That is no small task, given the rising tide of foreclosures and the commensurate demands on our property-disposition team.

Old methods alone won't get the job done; in this case, innovation is not a luxury, but a requirement. We are planning new initiatives and enhancements of existing programs in the weeks and months ahead as we continue to work with partners in cities and communities across the country in achieving our shared goal of stabilizing and revitalizing neighborhoods.

Jay N. Ryan Jr. is Fannie Mae's vice president for REO Alternative Disposition. He manages the disposal of Fannie's REO through non-traditional methods, including auctions, pool sales, rental programs, and working with public entities and Neighborhood Stabilization Program fund recipients. In addition, he is directly responsible for managing the company's equity investments in tax-advantaged properties, primarily those that qualify for federal low-income housing tax credits. Before joining Fannie Mae in May 1998, Ryan was with Freddie Mac's Multifamily Community Development Investment Group. He has an MBA in finance from the University of Maryland's Smith School of Business and a BS in accounting from the University of Maryland.

Endnote

¹ All Fannie Mae-owned properties (which are listed on www.homepath.com) are part of First Look.

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

by Harriet Newburger¹
Federal Reserve Bank of Philadelphia

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:

- 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.
- Establishment of financing mechanisms, such as down-payment assistance, for the purchase and redevelopment of foreclosed residential properties

Success in implementing A&R activities under NSP required success in accessing REO properties.

The Context: Grantee Acquisition and Rehabilitation Activities¹⁰

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.

Nonprofit Strategies for Returning REO Properties to Effective Use¹

by Daniel Fleischman

Real-estate-owned (REO) and vacant homes resulting from the economic crisis continue to destabilize low- and moderate-income neighborhoods across the country. Nonprofit organizations that seek to redevelop these properties face myriad challenges. The lenders and servicers responsible for REO disposition are difficult to access, for example, and may be unwilling to negotiate lower sales prices. Furthermore, many REOs require substantial rehabilitation, and the overwhelming volume of foreclosures affects the resale value of redeveloped housing.

This paper presents a range of strategies that nonprofit organizations can utilize to address REO and vacant properties.² The paper emphasizes the conditions necessary for REO redevelopment and discusses how several factors—including local market conditions; REOs' geographic distribution, physical characteristics, ownership, and legal status; organizational capacity; and public policies—affect the efforts of nonprofits to acquire, rehabilitate, sell, and rent REO properties. Finally, given the unique circumstances of the current housing crisis, the paper outlines several alternative, non-redevelopment strategies that many nonprofits may choose to pursue.

Nonprofit approaches to REO or vacant homes can be divided into two broad categories: *redevelopment strategies* and *non-redevelopment strategies*. Organizations engaged in the former acquire, rehabilitate, and repurpose vacant properties into affordable for-sale, for-rent, or rent-to-own housing. Those taking the latter approach either facilitate the redevelopment of vacant housing by responsible buyers or

attempt to stabilize and maintain vacant properties. Each strategy entails different financial resources, internal capacity, and exposure to risk.

All successful nonprofit strategies for REOs, whether redevelopment or non-redevelopment in nature, begin with an understanding of neighborhood housing demand and the market for redeveloped housing. Redevelopment strategies are often most appropriate in intermediate, warm-market neighborhoods, defined for the purpose of this paper as areas in which housing demand has declined but is expected to rebound. In hotter neighborhoods—areas with high home prices and strong demand—nonprofits may not be able to compete for properties; moreover, nonprofit redevelopment may be unnecessary in these neighborhoods due to the presence of private homebuyers. Colder neighborhoods, too, may be unsuitable for redevelopment strategies. In these areas, characterized by high levels of vacancies, heavily deteriorated buildings, and low demand for rental and for-sale housing, redevelopment may be risky because resale values are low. Instead of taking approaches that involve redevelopment, nonprofits that operate in hot- and cold-market neighborhoods may choose to pursue one or several of the non-redevelopment strategies described in this report.³

In addition to market conditions, nonprofits should also account for complications related to acquisition, as well as the existence of any policies or funding that support specific REO strategies. Nonprofits must also consider internal capacity as it relates to REO redevelopment. Although the U.S. Department of Housing and Urban Development's Neighborhood

Acquiring properties through short sales also poses substantial challenges to a CDC.

Stabilization Program (NSP) and other governmental and private efforts provide financial support for REO redevelopment activities, nonprofits should be wary of expanding their redevelopment efforts during the current period of market volatility.

Redevelopment Strategies

For-sale housing.⁴ For both practical and ideological reasons, many community development corporations (CDCs) prioritize the development of for-sale housing over rental and rent-to-own properties.⁵ According to a recent survey, for-sale housing was the preferred strategy of 69 percent of nonprofits engaged in property redevelopment.⁶ The federal first-time homebuyer tax credit and historically low mortgage rates provide further impetus to nonprofits' efforts to develop housing for sale to responsible homeowners.

In neighborhoods with concentrated foreclosures, however, the development of for-sale housing is risky. Capacity constraints prevent most CDCs from redeveloping enough vacant homes to reverse the decline of neighborhood home values, which jeopardize the resale value of each individual property. To ensure that resale value will exceed acquisition and rehab costs, nonprofit organizations should target property acquisition geographically within the context of larger public and private community stabilization efforts.

Rental housing.⁷ A CDC may wish to redevelop one- to four-unit REOs into rental housing for several reasons. First, the neighborhood may exhibit weak demand for for-sale housing, making rental housing the only viable redevelopment strategy. Second, a CDC may determine that the addition of well-maintained rental properties will address a neighborhood housing need. Finally, a CDC may choose to develop rental housing according to the building typology of the REO. Two- to four-unit rental properties, for example, are particularly susceptible to speculative and absentee ownership. By developing and managing these

properties, a CDC can help keep them out of the wrong hands and mitigate neighborhood instability.

Nonprofits that redevelop REOs into rental housing face substantial property management challenges. Results from a 1995 survey of property owners indicate that less than 40 percent of one- to four-unit property owners turned a profit in the previous year.⁸ One approach to helping ensure profitability is to concentrate properties geographically and standardize building specifications. In this way, nonprofits can reduce the management costs associated with this type of housing.⁹

Lease-purchase housing. In a third strategy, lease-purchase, the nonprofit agrees to rent a home to a tenant for a period of time, after which the tenant purchases the home from the nonprofit. A successful example of this approach is that of the Cleveland Housing Network, which has employed the Low Income Housing Tax Credit (LIHTC) to develop lease-purchase homes and stabilize low-income neighborhoods in Cleveland. As potential homeowners experience difficulty obtaining financing, and more homes continue to sit vacant for longer periods of time, nonprofits may increasingly turn to lease-purchase as a means of redeveloping REOs or selling properties for which they cannot find conventional buyers.

Barriers to implementing a successful lease-purchase program include the challenge of shepherding long-time renters toward homeownership, a process that, if unsuccessful, can leave the nonprofit with vacancies and turnover expenses while it finds new program participants. Furthermore, development financing for lease-purchase is complex. For instance, nonprofits that wish to utilize the LIHTC for development financing must comply with the 15-year rental period required before they sell the property to the tenant.¹⁰ Furthermore, conventional financing may not be available for this complex disposition strategy. For these reasons, many CDCs avoid lease-purchase and develop only for-sale or for-rent housing.

Overcoming Acquisition Challenges

The disposition strategies described above assume a property's potential for redevelopment and an organization's ability to undertake such redevelopment. Complications related to REO acquisition, however, can derail the best-intentioned efforts to redevelop otherwise suitable properties. Despite increased pressure and financial incentives for lenders to sell properties to mission-driven organizations, acquisition remains one of the greatest challenges for nonprofits seeking to redevelop REOs into affordable housing.

Nonprofits that wish to acquire REOs face several barriers. First, lenders and servicers that hold REOs can be difficult to access and may not have the authority to lower sale prices due to fiduciary obligations to investors in mortgage-backed securities. In addition, while some lenders list their inventory of REO properties on the Internet, the sales themselves are typically facilitated by local brokers who may not be interested in negotiating discounted prices for nonprofit buyers. Complex legal issues compound these difficulties. If the mortgage has been securitized, the lenders and servicers themselves may not be certain which party is responsible for disposition. If liens on the property have been sold to a third-party investor, or if the cost of liens exceeds the resale value of the property, municipal intervention may be necessary to clear the title prior to acquisition.¹¹

Many of the challenges nonprofits face in acquiring REOs can be addressed only with governmental or large-scale, institutional assistance. The National Community Stabilization Trust, a national nonprofit, is one such organization that helps facilitate the transfer of properties from servicers to nonprofits. Through its "First Look" program, the Trust negotiates with servicers to offer cities and nonprofits an opportunity to purchase REOs before the properties are listed on the open market.¹² Local nonprofits may also wish to explore the following strategies to expedite their acquisition of REO properties.

Bulk-Purchase Strategies

Strategies that involve bulk purchases of REO properties enable both lenders and purchasers to avoid the inefficiencies and higher costs associated with piecemeal, retail-level REO sales. Through a bulk purchase, the nonprofit may get a discounted sale price on a portfolio of properties while acquiring a critical mass for redevelopment. This strategy may also enable the purchaser to subsidize the rehabilitation of deteriorated homes with profits generated from sales of more intact homes.

In March of 2009, the nonprofit Housing and Neighborhood Development Services, Inc. (HANDS), based in Orange, New Jersey, pioneered an innovative strategy to address the problems of neighborhoods affected by foreclosures. It purchased a bundle of 47 mortgages that comprised a single portfolio of fraudulent mortgages, then conducted or oversaw a thorough physical inspection, title search, and market appraisal for each home, assigning one of five exit strategies to each according to the property's location, resale value, and physical condition. HANDS also enlisted six CDCs to assist with redevelopment, worked with local municipalities to ensure that the redeveloped properties are affordable, and negotiated flexible financing from both local and national mission-driven lenders to fund this effort. (In this publication, see also "The Community Asset Preservation Corporation: A New Approach to Community Revitalization," by Harold Simon.)

More often, unfortunately, the properties held by a lender or servicer do not lend themselves to bulk packaging in this manner. The fact that the 47 mortgages acquired by HANDS were tied to a single lending scam became a key point of leverage that enabled the organization to acquire the entire portfolio at a discounted price from the servicer which, by then, had been taken over by the FDIC. Moreover, the mortgages had not been securitized, which enabled HANDS to acquire the properties with relative legal ease, unaffected by the barriers typically confronted when purchasing securitized mortgages.

For these reasons, HANDS' bulk acquisition is the product of unique conditions and is not easily replicable.

Furthermore, capacity is likely to be a constraint for most CDCs that wish to execute bulk purchases. Few CDCs have the resources to acquire and redevelop a portfolio of properties large enough to warrant a meaningful price reduction from lenders. For this reason, bulk purchase strategies are more frequently initiated by local governments and special-purpose entities. In 2008, HANDS helped establish the Community Asset Preservation Corporation, a special-purpose nonprofit, to help purchase REO properties in bulk, then to triage and systematically dispose of them to responsible developers.¹³ In a similar manner, local governments may be able to purchase bulk properties for disposition to nonprofit developers by using NSP or other funding.¹⁴

Short Sales

Short sales involve what the name implies—selling short, or at a price lower than the seller desires. The difficulty lies in finding sellers with something to gain through a short sale. If a nonprofit is able to identify a mortgagor at risk of default, it can attempt to execute a short sale to acquire the property prior to foreclosure. In such an arrangement, the mortgagor sells the home to the nonprofit for less than the value of the mortgage, and the mortgage holder agrees to forgive all or some of the remaining balance of the loan. The mortgage holder's loss is typically less than what a foreclosure would cost, hence its incentive to engage in such a transaction. For its part, a CDC achieves the twin objectives of helping a distressed borrower avoid foreclosure while acquiring a property for redevelopment.

Acquiring properties through short sales also poses substantial challenges to a CDC. First, short sale opportunities are not typically advertised and may be difficult to identify. Furthermore, investor-owners in some hot and warm markets are likely to outbid CDCs for short sale properties, and mortgage servicers may not be willing to offer discounted properties to nonprofits. One source of assistance is

a mission-driven mortgage brokerage, which can help a nonprofit identify and purchase properties at risk of foreclosure. NHS Realty, for example, a mission-driven brokerage established by Neighborhood Housing Services of New York City, helps facilitate the sale of distressed properties to responsible buyers.¹⁵

Non-redevelopment Strategies

Nonprofits that pursue a non-redevelopment strategy for REO properties typically do so for a couple of reasons. First, redevelopment may be infeasible because of weak market conditions, the legal status of the property, or the capacity of the nonprofit. Second, redevelopment may simply be unnecessary, due to the presence of responsible purchasers of REO properties. When redevelopment is infeasible, the CDC may attempt to mitigate the negative neighborhood impact of REO properties by promoting code enforcement, land banking, and/or demolition. When redevelopment is unnecessary, the CDC may serve to facilitate the sale of REO properties to a responsible third party. Mitigation and facilitation strategies can each be used as a primary approach to REOs or as a complement to redevelopment activity.

Code enforcement. Code enforcement strategies respond to the failure of some lenders to adequately maintain vacant REO properties. Many cities have enacted vacant property ordinances to encourage lenders to maintain their properties. While local government provides the muscle behind code enforcement, nonprofit community organizations can participate by documenting instances of property neglect and advocating for increased governmental action.

Receivership laws provide municipalities with a more aggressive means of confronting negligent property owners. Through receivership, the city places a lien on a deteriorated property and appoints a receiver to execute the necessary rehabilitation work. A receivership lien, like a tax lien, supersedes all other claims to the property, including the mortgage. In this way, receivership forces the lender to either pay the lien or sell the home to a party willing to carry out the terms of the lien. CDCs with strong

community standing have utilized threat of receivership to acquire properties from delinquent servicers and other absentee owners.

Land banking. Land banks are chartered by state governments to acquire, triage, and dispose of vacant properties. While most land banks focus on tax-delinquent or nuisance properties, they may also be permitted to acquire REOs for demolition or disposition to qualified developers. Additionally, some land banks have responded to the growing number of vacant homes by providing management services for properties acquired by nonprofit developers. In 2008, the Fulton County/City of Atlanta Land Bank introduced a program wherein a nonprofit can transfer a property to the land bank for up to three years if the nonprofit cannot redevelop the property immediately. In addition to clearing existing liens on the property, the land bank provides low-cost property management and enables CDCs to purchase available properties quickly and without need for immediate redevelopment. Furthermore, CDCs are not required to pay property taxes for homes held by the land bank.¹⁶ While land banks require state-level enabling legislation and have not typically focused on bank-foreclosed properties in the past, they are an increasingly important resource in cities with large numbers of foreclosures.¹⁷ (In this publication, see also “How Modern Land Banking Can Be Used to Solve REO Acquisition Problems,” by Thomas J. Fitzpatrick IV.)

Demolition. Demolition may be the only feasible strategy for REO properties that have little or no reuse potential.¹⁸ Some CDCs and community organizations have worked to maintain or transform vacant lots following the demolition of buildings. Since the mid-1990s, the New Kensington CDC in Philadelphia, in collaboration with the Pennsylvania Horticultural Society, has conducted a “greening” program to address vacant neighborhood lots. The CDC either stabilizes lots by cleaning and planting trees on them, or develops them as community gardens. Side lots are offered for sale to abutting property owners.¹⁹ Where redevelopment is infeasible, this type of strategy can be a low-cost and

relatively quick means of transforming pockets of neighborhood blight into community assets.

Mitigation and Facilitation Strategies

Homebuyer financing. Providing financing or subsidies to homebuyers is an effective REO strategy if the lack of mortgage credit, rather than poor neighborhood or property conditions, is the primary impediment to redevelopment. Under such conditions, a nonprofit may establish a mortgage brokerage to provide financing to qualified potential homebuyers. Nonprofit mortgage brokerages work with lending institutions to assemble a pool of subsidized financing for approved low-income buyers. The brokerage typically charges fees to cover its overhead costs.

Dayton’s Bluff Neighborhood Housing Services in St. Paul, Minnesota, utilizes a nonprofit mortgage brokerage as part of a comprehensive effort to address neighborhood REO properties. The brokerage provides second mortgage financing of up to 20 percent of the appraised value of homes in qualified neighborhoods. Participating borrowers obtain low-cost financing and avoid the need for private second mortgages or mortgage insurance, either of which might otherwise be necessary due to tight credit standards and declining home values in the Twin Cities. This lending program complements its traditional acquisition and rehabilitation efforts for more deteriorated neighborhood vacant properties. While homebuyer financing programs require specialized capacity and are not appropriate for every nonprofit, this alternative to REO acquisition provides a useful tool for organizations operating in warm-market neighborhoods.

Neighborhood marketing campaigns. Like homebuyer financing strategies, neighborhood marketing campaigns are most effective in relatively stable, warm-market neighborhoods. In some cities, nonprofits and local government have enhanced marketing efforts to address increased levels of foreclosures and vacancies. The City of Rochester, New York, for example, co-sponsors Home Rochester, a nonprofit initiative that engages local CDCs and contractors to redevelop vacant properties. Rochester City

Many of the challenges nonprofits face in acquiring REOs can only be addressed with governmental or large-scale, institutional assistance.

Table 1
REO Strategy Matrix

Market conditions*	Building typology	Physical condition**	Initial CDC action	Exit strategy
Hot market	Single family	Good	X***	X
		Fair	Homebuyer financing/Acquisition	Sell to homebuyer
		Poor	Acquisition	Sell to homebuyer
	2–4 units	Good	X	X
		Fair	Homebuyer financing/Acquisition	Sell to homebuyer
		Poor	Acquisition	Sell to homebuyer
Warm market	Single family	Good	Homebuyer financing/Acquisition	Sell to homebuyer
		Fair	Consider acquisition	Sell to homebuyer/ Hold as rental/ Lease-purchase
		Poor	Acquisition for strategic properties/Demolition for non-strategic properties	Sell to homebuyer/ Hold as rental/ Lease-purchase
	2–4 units	Good	Consider acquisition	Hold as rental
		Fair	Consider acquisition	Hold as rental
		Poor	Acquisition for strategic properties/Demolition for non-strategic properties	Hold as rental
Cold market	Single family	Good	Acquisition	Hold as rental/Lease-purchase
		Fair	Code enforcement	Advocate for land banking/ Greening strategy
		Poor	Advocate for demolition	
	2–4 units	Good	Consider acquisition	Hold as rental
		Fair	Code enforcement	Advocate for land banking/ Greening strategy
		Poor	Advocate for demolition	

***Market Condition Definitions:**

Hot market: Housing demand outpaces supply, and prices are high; vacant properties are quickly purchased

Warm market: Housing demand has slowed temporarily but is expected to return; vacant properties are eventually purchased

Cold market: Housing demand is weak and is not expected to increase significantly; vacant properties sit for prolonged periods

****Physical Condition Definitions:**

Good: Minimal rehab needed

Fair: Significant rehab needed, but structure is salvageable

Poor: Structure is not salvageable

*****X** indicates that nonprofit intervention may not be necessary

Living Center, another initiative undertaken by the City, markets neighborhoods and specific home-buying opportunities. Rochester also underwrites the Home Store, a one-stop center administered by the Urban League of Rochester that matches potential buyers with subsidies and provides credit and homebuyer counseling.²⁰ Together, the three programs help CDCs redevelop, market, and sell properties in target neighborhoods. CDCs operating in neighborhoods with scattered REOs may consider these strategies to increase market activity for vacant properties.

The REO strategies described above, and the conditions under which each may be optimal, are arranged in table 1 in a matrix.²¹ The table illustrates the decision-making process and the range of nonprofit interventions for REO properties. For each scenario, an alternative strategy may be possible or preferable.

Conclusion

Several characteristics of the current crisis—including declining home values, the legal status of REOs, and the volume of vacant homes—pose challenges to nonprofit organizations. CDCs accustomed to acquiring tax-delinquent properties or homes at or near the bottom of the market must take into account the unique risks and uncertainties associated with REO properties. Many nonprofits will determine that non-redevelopment strategies, rather than redevelopment strategies, are the more appropriate course of action for most REOs in their communities.

Opportunities for successful redevelopment strategies do exist for nonprofits in relatively stable neighborhoods with sufficient capacity and resources. As states and cities continue to deploy NSP dollars and funding from other sources, nonprofit organizations can exercise their knowledge of local conditions to help identify redevelopment opportunities and partners. While nonprofits can address only a fraction of foreclosures nationwide, they play a critical role at the neighborhood level in low-income communities. By accounting for the risks and opportunities of various redevelopment and

non-redevelopment strategies, nonprofits can continue to help move these neighborhoods toward recovery.

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Endnotes

¹ An expanded version of this paper, “CDC Strategies for REO Properties: An Analytical Framework,” was published in 2009 by the Joint Center for Housing Studies of Harvard University.

² The REO strategies discussed in this paper are distinct from pre-foreclosure efforts to keep borrowers in their homes.

³ Several cities and consulting groups have developed sophisticated typologies of neighborhood housing demand. See the Reinvestment Fund’s typology of Philadelphia neighborhoods and the City of Baltimore’s neighborhood typologies described in Alan Mallach, *Bringing Buildings Back: From Abandoned Properties to Community Assets* (New Brunswick, N.J.: Rutgers University Press, 2006), pp. 233–39.

⁴ For a complete guide to acquisition, rehab, and resale, see “Successful Single-Family Acquisition and Rehabilitation: A Complete Overview of the Skills and Operations Needed to Run a Successful Program” (Columbia, Md.: Enterprise Foundation, 1999).

⁵ The term “community development corporation” refers to a community-based, nonprofit developer of affordable housing.

⁶ Daniel Fleischman, “CDC Strategies for REO Properties: An Analytical Framework” (Cambridge, Mass.: Joint Center for Housing Studies of Harvard University, 2009).

⁷ For a complete guide to scattered-site rental development, see “Developing and Managing Scattered-site Rental Housing: A Complete Overview of the Skills and Finances Needed to Run a Successful Program” (Columbia, Md.: Enterprise Foundation, 2009).

⁸ Alan Mallach, “Landlords at the Margins: Exploring the Dynamics of the One- to Four-Unit Rental Housing Industry.” Prepared for Revisiting Rental Housing: A National Policy Summit, Harvard University, Joint Center for Housing Studies, 2007.

⁹ For an assessment of scattered-site rental development as a response to the foreclosure crisis, see Ivan Levi,

“Stabilizing Neighborhoods Impacted by Concentrated Foreclosures: Scattered-Site Rental Housing Challenges and Opportunities” (Cambridge, Mass.: NeighborWorks America and the Joint Center for Housing Studies of Harvard University, 2009).

¹⁰Practically speaking, the use of the Low Income Housing Tax Credit to develop lease-purchase and scattered-site rental housing presents the additional challenges of assembling multiple parcels simultaneously to bundle into a financing package, paying for fixed legal and syndication costs that may be disproportionate to the number of units in the package, and attracting tax-credit buyers willing to invest in these notoriously difficult development models. For these reasons, the use of the tax credit to develop lease-purchase and scatter-site rental housing has been limited. See the publication referenced in note 7 above.

¹¹Kermit J. Lind, “The Perfect Storm: An Eyewitness Report from Ground Zero in Cleveland’s Neighborhoods,” *Journal of Affordable Housing* 17 (3) (Spring 2008): 237–58.

¹²“Purchasing Properties at Scale: Lessons on Acquiring REOs During the Foreclosure Crisis from Pioneering Projects in New Jersey, Phoenix and the Twin Cities,” Living Cities case study available at <http://www.livingcities.org/innovation/rapid/property-acquisition/>.

¹³Morrissey, Patrick, Executive Director, HANDS, Inc., interview by Daniel Fleischman, July 2, 2008.

¹⁴See Living Cities, cited above.

¹⁵Kevin McQueen, “Using Mission-Driven Real Estate Brokerage to Mitigate the Impact of Foreclosures” Living Cities case study (2009), available at <http://www.livingcities.org/innovation/rapid/brokerage/>.

¹⁶Kevin Duffy, “Property Sits Like Money in the Bank: Affordable Housing Gets Boost from Agency that Holds Foreclosed Buildings Until they can be Developed by Nonprofits,” the *Atlanta Journal-Constitution*, August 23, 2008.

¹⁷For more information on land banks, see Frank S. Alexander, “Land Bank Authorities: A Guide for the Creation and Operation of Local Land Banks” (New York, N.Y.: Local Initiatives Support Coalition, 2005).

¹⁸Alan Mallach, *Bringing Buildings Back: From Abandoned Buildings to Community Assets* (Montclair, N.J.: National Housing Institute, 2006), includes a decision tree for properties in poor physical condition. Mallach’s book is an excellent resource on this issue and on small property rehabilitation in general.

¹⁹Susan Wachter, “The Determinants of Neighborhood Transformation in Philadelphia: Identification and Analysis: The New Kensington Pilot Study.” University of Pennsylvania, Wharton School, 2004.

²⁰Mallach, cited above.

²¹Certain factors, such as the legal status of the property, are not represented.

Purchasing Properties from REO and Reselling to Existing Occupants: Lessons from the Field on Keeping People in Place

by Elyse D. Cherry, Boston Community Capital, and
Patricia Hanratty, Aura Mortgage Advisors

Low-income communities have been disproportionately affected by foreclosures and the preceding subprime mortgage frenzy. Falling property values have somewhat restored the equilibrium between neighborhood incomes and real estate values and provide an opportunity to repurchase foreclosed properties at current market values at significant discounts off prior mortgages. With appropriate underwriting and tailored mortgage products, many foreclosed homeowners and tenants facing eviction can remain in their homes, preventing displacement, vacancy, and further neighborhood destabilization.

In the fall of 2009, Boston Community Capital (BCC), a Community Development Financial Institution¹ with a 25-year track record of working to stabilize low-income neighborhoods, developed a pilot program it called Stabilizing Urban Neighborhoods (the “SUN initiative”) to stabilize local families and neighborhoods hardest hit by foreclosure. Through two affiliate subsidiaries—NSP Residential LLC, a real estate acquisition company, and Aura Mortgage Advisors, a licensed mortgage lender—BCC acquires foreclosed properties at discounted prices and reconveys them to existing owners and tenants, providing financing through 30-year fixed-rate mortgages. BCC aims to stop the displacement of families before evictions occur and to prevent further neighborhood destabilization caused by vacant and abandoned properties.

Boston Community Capital launched the SUN initiative with \$3.7 million. These funds

were used to support property purchases, mortgages, and program administration. Through April 2010, BCC had closed on, or scheduled for closing, more than 60 units of foreclosed housing totaling \$6.7 million and resold these properties to their existing occupants. The organization has secured \$3.5 million in additional equity from a private investor to serve as first loss reserves, and is currently raising \$50 million in loans from private investors to support property purchases and mortgage loans in Boston and the adjacent city of Revere. BCC estimates these funds will finance up to 2,000 units of housing in Boston and Revere over the next five years.

SUN focuses on foreclosed units from which occupants have not yet been evicted. It complements other neighborhood stabilization programs in Massachusetts, most of which focus on housing stock that is already vacant. The program is scalable, too, given continuing high levels of foreclosures in the target neighborhoods and property values remaining at the lower levels that accompany foreclosures. In addition, banks and servicers will have a growing need to reduce REO inventory, while foreclosed homeowners and tenants will continue to require affordable, market-rate homes.

The premise of SUN is pretty straightforward: Buy foreclosed homes out of REO at discounted present-market values, and resell them to existing occupants. The main steps involved—buying, reselling, financing—are handled by two of BCC’s affiliates. NSP Residential purchases occupied foreclosed homes at a price

Factors that Make the SUN Initiative Possible

Conducive market conditions. The program operates in neighborhoods where property values increased rapidly during the housing boom and have since fallen an average of almost 60 percent, allowing BCC's affiliate to acquire properties at discounts.

Strong community partnerships. During its 25 years working in the Boston area, BCC has developed strong partnerships with community organizations. These existing relationships helped BCC affiliate NSP Residential reach out to tenant organizing groups and legal advocates for help identifying and screening potential clients.

Purchase offers based on market research. NSP Residential does its homework. Along with each purchase offer, it provides REO departments of banks and loan servicers with ZIP code-level detail on the number of foreclosed properties in the neighborhood, recent nearby distressed property sales, and property-level detail on additional issues or conditions that may affect the servicers' ability to sell the property.

Innovative mortgage products. Aura Mortgage provides previously foreclosed borrowers with mortgage products and services developed to meet their needs.

at or below present value, free and clear, from first and second mortgage lenders at a steep discount from the amount of the foreclosed mortgage. Between October 2008 and April 2010, for example, its acquisition discount averaged 53 percent. NSP Residential resells those homes to their existing occupants—owners and tenants—at a price they can afford. If the buyer has the ability to finance the purchase independently, the affiliate sells the property for cost plus expenses and a 1 percent fee. If the buyer needs financing, NSP Residential will sell the property back to them at a markup of 25 percent from its discounted purchase price, using the markup to fund loan loss reserves that help secure the investments of BCC's funders.

Aura Mortgage Advisors, its mortgage lending subsidiary, received its Massachusetts license in June 2009. Aura underwrites the new purchase mortgages with strict underwriting criteria, including a maximum housing expense of

38 percent of household income and/or a maximum debt-to-income ratio of 48 percent. Aura loans the funds on a 30-year basis at fixed rates only.

Target Market Conditions

The SUN initiative has focused its efforts on six low-income neighborhoods in Boston hit with the highest concentrations of foreclosure: Dorchester, Mattapan, Roxbury, Hyde Park, East Boston, and Roslindale. These communities represent less than a third of all housing units in Boston, but more than 83 percent of the city's foreclosure activity.² They share similar characteristics: housing prices that surged from 2003 to 2006 and then rapidly declined; sagging local employment and credit; stable population levels with, at best, modest rates of growth; incomes that have not kept pace with inflation; and high concentrations of aggressive and often predatory lending. According to Home Mortgage Disclosure Act (HMDA) data, more than a third of all purchase and refinance mortgages made in these six communities from 2003 to 2006 were high-cost loans, twice the rate of high-cost lending in the rest of the state. Together, these characteristics have contributed to high rates of foreclosures and steep property value declines, spurring further defaults, delinquencies, and neighborhood destabilization.

A key factor in the current foreclosure crisis is the disparity between resident incomes in these neighborhoods and property purchase prices. From 2003 to 2006, while rents and incomes remained relatively stable, sale prices for condo units, single-family, and two- to four-family homes more than doubled, from an average of \$159,000 to an average of \$359,000.³ These increases coincided with the expansion of subprime mortgages, a nationwide interest in investing in housing, and a local expansion of ownership housing stock owing to the conversion of triple-decker homes into multiple condominium units. In fact, the six neighborhoods targeted by BCC have high concentrations of two- and three-family homes that have been converted into condominiums and have seen a high incidence of foreclosure.⁴

Unfortunately, this multiplying of housing units has exacerbated the effects of foreclosures, in that multifamily buildings can suffer from multiple foreclosures by multiple lenders.

These factors have contributed to the return of housing values in these neighborhoods to levels more in line with rental rates. In BCC's dealings with lenders and mortgage servicers, we have seen greater receptivity to selling at discounts off current market values⁵ and anecdotal evidence that they are placing a premium on cash purchases from buyers willing to close quickly. Not surprisingly, in light of the freeze-up in the credit markets, lenders and servicers have also become more willing to work with nonprofit intermediaries.

Partnerships Matter

BCC works with a group of community organizations—including tenant organizing groups City Life/Vida Urbana and the Boston Tenants Organization, as well as legal advocates such as Harvard Legal Aid Bureau and Greater Boston Legal Services—to identify foreclosed homeowners and tenants who might be eligible for SUN. We provide these organizations with income tables and charts showing property-value declines by neighborhood; they can then discern whether candidates have income sufficient to support a traditional mortgage for a property in their community. Using BCC intake forms, these community partners also screen candidates for personal hardship—for example, predatory loans, loss of employment, major illness, etc.—and provide BCC with a referral package that allows us to begin to underwrite the candidate for a mortgage loan. BCC will accept applications from anywhere within our six target neighborhoods, provided the occupant meets the criteria for personal hardship and has an income sufficient to support a mortgage at current fair-market values for the neighborhood. According to our partnering organizations, some 60 percent of the clients they screen can be pre-qualified for the SUN program.

Next, a pre-qualified client applies to NSP Residential, for foreclosure assistance. Staff

Red Light, Green Light: Answers Come Quickly from SUN

A typical potential client comes to SUN after contact with and screening by a referral source. The referral source, one of our partnering community organizations, asks the client about the household's current income and work situation, where they are in the foreclosure process, how much they have in mortgages on the home, who services the mortgages, and what caused the delinquencies and default. If the client appears to meet SUN's requirements, the referral source helps the client complete the application and tells them to send it with all attachments to SUN.

Once the application reaches SUN, an intake specialist works with the client to make sure all the required information and supporting materials are submitted and complete; this can take anywhere from two days to two weeks, depending on the responsiveness of the client. Completed applications are then "triaged" using a green-, yellow-, and red-light system to indicate the applicant's likelihood of meeting the program's guidelines. Those that appear to be strong applications, or "green lights," are scheduled for site evaluation and inspection, while more questionable ones, the "yellow lights," are sent to a foreclosure counselor for detail review, evaluation, and client interviews. Applications that appear to be beyond our guidelines, "red lights," are reviewed one more time at weekly management meetings before the referral sources and clients are notified.

Client turnaround time differs by the category of the application. For green lights, we can submit an offer to purchase the property in as little as three weeks. Red lights are usually notified within two weeks. The yellow-light applications take the most time, since they usually require more analysis and several client meetings; decisions on them can take between four and six weeks.

The most difficult turnaround to predict is the response from the bank or servicer. This timeframe can be as short as one week or as long as three months, depending on the servicer's sale process and requirements. Once an offer has been accepted, however, SUN typically closes on both the property purchase and the resale and mortgage to the client within 30 days.

members begin foreclosure and credit counseling, which includes all aspects of the client's financial situation, evaluating client tax returns, bank statements, pay stubs, and a credit report. Based on all of this information, BCC determines what housing cost a client is able to

The premise of
SUN is pretty
straightforward:
Buy foreclosed
homes out of
REO at discounted
present-market
values, and resell
them to existing
occupants.

support, and then analyzes the current market value of the distressed property, based on current Multiple Listing Service data. An NSP Residential property specialist conducts a thorough review of the home for which the client is requesting assistance, including a title search, site inspection, and discussion with the client regarding any maintenance that needs to be done. BCC seeks to determine whether the property can be acquired at a discount large enough to allow building in a 25 percent loss reserve and still provide the client with an affordable mortgage.

Purchasing Properties from REO: Using Market Research

Once BCC ensures the client's income is sufficient to stay in and maintain the property, it approaches the loan servicer or REO department with an offer to purchase the property at fair market value. But the offer contains more than a purchase price. When making an offer, BCC provides significant additional information, including recent Multiple Listing Service sales data for nearby distressed properties of similar size and condition, together with any additional information that may influence the mortgagee's ability to sell said property (e.g., tax liens, needed repairs, etc.). BCC has developed an extensive database of property values and trends over the past six years—including foreclosure levels and trends by neighborhood and recent residential real estate sales—which allows staff to estimate current values per square foot for distressed properties. A BCC offer letter includes the addresses of comparable properties that have recently sold and the average price per square foot for these properties.

This level of detail is critical—especially when working with the REO department of a national versus a local bank—to helping asset managers and servicers make the case that they are getting a fair price for these properties. For example, a servicer looking at Boston-level data in the fourth quarter of 2009 would see that city-wide property values have declined 2 percent from the peak; however, neighborhood-level data show that property values in these six target areas have fallen 59 percent.⁶ Distressed properties warrant

an additional discount, typically 20–30 percent. Along with this detailed supporting evidence for the purchase price offered, BCC's offers are contingent on the current occupants remaining in the property. We also provide proof of funds. If the offer is accepted, BCC agrees to pay cash and to close in 30 days.

From October 2009 through April 2010, BCC successfully negotiated the purchase of more than 60 units of housing, at an average discount of 53 percent off the original mortgage amount (discounts vary significantly by property type and neighborhood).

Once a purchase offer has been accepted, BCC staff members meet with clients to discuss their purchase and mortgage options. A client able to obtain financing from another, non-BCC source (e.g., friends, family members, or another mortgage lender) may purchase the property from NSP Residential for the amount paid plus expenses and a modest (1–2 percent) transaction fee. Clients who need financing for the purchase and are unable to secure it on their own are directed to Aura Mortgage Advisors, which has developed a series of mortgage products and services designed to meet low-income borrowers' needs.

Experience-Informed Mortgage Products for Low-Income Borrowers

In order to create mortgage products that would meet the needs of low-income borrowers who had been through foreclosure, BCC sought to understand the root causes of the foreclosure crisis from the perspective of foreclosed homeowners. In the summer of 2008, we examined more than 700 title histories of residential properties undergoing foreclosure in our target geography. We engaged in many individual conversations and conducted three formal focus group meetings of foreclosed homeowners from Boston, Fall River, and New Bedford. These various investigations allowed us to create a detailed and coherent picture of borrowers' circumstances.

The majority of the randomly selected participants in our focus groups and the majority of

homeowners in the cases we reviewed involved first mortgages. More than 70 percent of focus group participants were first-time homebuyers who purchased their homes between 2003 and 2006. In some cases, homeowners had difficulty paying as early as the first month after mortgage finance. Still others lost their homes because a relatively short-term personal or family crisis (e.g., a car accident or spouse's illness) compromised their ability to keep mortgage payments current.

A small percentage of homeowners refinanced their homes on multiple occasions and in quick succession, trading substantial additional costs and fees for a new "teaser" rate that, for a short while, reduced the monthly mortgage payment. Eventually, however, these additional costs and fees encumbered all available equity and eliminated the possibility of another refinance; at that point, the true cost of the mortgage debt skyrocketed, the homeowner became unable to pay, and the mortgage went into default. For both purchase mortgages and refinances, teaser rates led to defaults in the initial mortgage for first-time homebuyers who had no ability to pay the true, ongoing cost of their mortgage debt.

What we discovered was that, although homeowners reached foreclosure through a variety of routes, low-income borrowers face a common set of challenges that must be resolved if they are to succeed at homeownership and mortgage repayment. Low-income borrowers are far more likely to succeed in paying a mortgage on time and over time if they have the following:

- a fixed-rate, properly underwritten mortgage that ensures a manageable, predictable monthly payment
- automatic deposit of paychecks and automatic withdrawal of mortgage payments, timed to ensure that the mortgage is the first bill paid each month
- assistance with budgeting
- up-front reserves to help manage the lack of a financial cushion and to cover unexpected emergencies such as illness, the loss of a job, or emergency household repairs

- education on the real costs of mortgage finance and of owning and maintaining a home.

Based on data analysis and these discoveries from our focus groups, Aura Mortgage Advisors developed a set of mortgage products designed to meet the needs of low-income borrowers. All Aura products, for example, are 30-year fixed mortgages with no prepayment penalties. Payment plans require automatic deposit of the borrower's paychecks, automatic deduction of payments from the borrower's bank account, and payments coincident with paydays, generally bi-weekly. Closing escrows require three to six months of real estate taxes, insurance, and condominium fees, so that financial reserves are available right away in case a personal crisis jeopardizes the borrower's ability to stay current. Biweekly payment plans provide one additional payment each year that can be used for shortfalls, or for home repairs with loan officer approval. (If not tapped, biweekly payments will reduce the term of the mortgage from 30 years to 24 years.)

Underwriting Standards Specific to Borrowers and Properties

Aura also tailors its underwriting to the specific conditions of the property and the homeowner's household. For example, if the property includes occupied rental units, BCC will include a portion of the rental income in its underwriting, depending on current occupancy and the rental history of the units. SUN attempts to ensure that borrower income covers the majority of the mortgage payment, rather than relying heavily on rental income. If units become vacant, emergency reserve funds can be used to cover gaps until a new tenant is found. SUN also provides ongoing support to homeowners through access to financial education resources. Benefits include quarterly follow-ups by loan officers, semi-annual peer group meetings, and seminars on home maintenance, budgeting, and filing for tax abatements.

Aura clients must demonstrate that they have a stable income and can afford a home in their neighborhood, given current real estate values.

Table 1
Two Clients Helped by the SUN Initiative

	Client 1: Hyde Park		Client 2: Dorchester	
	Pre-SUN	Post-SUN	Pre-SUN	Post-SUN
Mortgage amount	\$350,000	\$161,930	\$326,000	\$121,500
Loan-to-value ratio		94%		72%
Mortgage rate	11.25%	6.50%	11.50%	6.50%
Monthly payment	\$2,522	\$1,545	\$3,561	\$1,063
NSP purchase price		\$123,559		\$94,000
Resale price		\$153,750		\$117,500
Cash from borrower		\$3,679		\$5,540
Capital reserves*		\$3,130		\$3,000

* Reserve amounts vary according to loan size, property taxes, homeowners association fees, etc.

All mortgages provide permanent financing for owner occupants, and are underwritten as full documentation loans using historically standard debt-to-income ratios, albeit with a non-traditional approach to credit scores damaged by foreclosure. Mortgages are issued only to households in which the fixed monthly mortgage payment—including principal, taxes, and insurance—equals no more than 38 percent of their gross income. In addition, housing and debt payments combined must consume no more than 48 percent of total gross income. Mortgages are not issued with teaser rates, adjustable rates, negative amortization, or similar features. Aura's products also fully conform to the FDIC's Statement on Subprime Mortgage Lending.

Avoiding Moral Hazard

Reducing borrowers' mortgage debt can cause anger among neighbors who are continuing to pay the full cost of their mortgages. It can also encourage owners not in foreclosure to default on their mortgages in order to achieve a

“windfall”—a potential scenario often cited by the financial industry as a reason not to restructure mortgage loans. In order to avoid this moral hazard, BCC includes a zero-percent, zero-amortizing, shared-appreciation second mortgage, which limits return to the borrower to a fraction of eventual appreciation equal to the principal balance of the new mortgage, divided by the outstanding principal balance of the foreclosed mortgage.

For example, if the homeowner's prior mortgage was \$300,000 and BCC is able to purchase the property and resell it to the occupant for a purchase price of \$150,000, BCC will place a shared-appreciation second mortgage on the remaining \$150,000, or 50 percent of the prior mortgage balance. In the event of resale, the homeowner will be entitled to 50 percent of the appreciation over his or her BCC first mortgage. If the property sells for \$250,000, the homeowner will repay BCC its \$150,000 first mortgage, and will split the remaining \$100,000 evenly with BCC. In the case of tenants

who had no prior mortgage or foreclosure, BCC does not include a shared-appreciation second mortgage.

Sample Loans

Table 1 shows data on two homeowners assisted by the SUN initiative. In each case, BCC was able to negotiate purchase prices of the homeowners' foreclosed homes at discounts of more than 50 percent off the clients' original mortgage amounts. The clients' new mortgage amounts are less than half their prior mortgages, and their monthly payments have been cut by 40–70 percent.

Table 2 shows how the average SUN client compares to the average City of Boston homeowner. Median family income is \$57,387, compared to \$86,827. Median property value is \$199,531, compared to \$419,500. The median monthly housing expense for SUN clients before participating in the SUN initiative was \$2,728, or

\$376 higher than the average monthly payment for City of Boston homeowners. Post-SUN, clients' average monthly housing payment had been reduced by \$1,165 to \$1,563, or \$789 lower than the average City of Boston homeowner's.

Conclusion

Falling property values in low-income neighborhoods have helped restore the equilibrium between neighborhood incomes and real estate values. These now-lower property values provide an opportunity to repurchase foreclosed properties at current market values at significant discounts from previous mortgage amounts. Boston Community Capital's pilot program in Boston and Revere, aimed at preventing vacancies and helping restore neighborhood stability, has resulted in the purchase, reconveying, and financing of 60 foreclosed properties. Most important, the SUN initiative helped occupants facing eviction from foreclosure to remain in their homes. By bringing the program to scale in

Table 2
SUN Clients Compared to City of Boston Homeowners

	SUN clients	Homeowners City of Boston*
Owner-occupied properties **		
Median family income	\$57,387	\$86,827
Median property value	\$199,531	\$419,500
Pre-SUN median monthly housing expenses, including mortgages	\$2,728	\$2,352
Post-SUN median monthly housing expenses, including mortgages	\$1,563	\$2,352
Average family size	4.29	3.42
Foreign born	47.1%	27.5%
Speak a language other than English at home	47.1%	35.5%
Non-white	82%	43.7%

* 2006–2008 American Community Survey, three-year estimates. See <http://factfinder.census.gov>.

** These numbers represent 23 units in SUN's portfolio as of February 2, 2010, including homes of rent-to-own clients who have not yet closed on their SUN mortgages.

Boston and across the State of Massachusetts, BCC hopes to demonstrate that a similar program could be replicated in low-income communities across the country.

Elyse D. Cherry is a co-founder and current chief executive officer of Boston Community Capital (BCC). She also serves as president of Boston Community Venture Fund, a BCC affiliate. Under Cherry's leadership, BCC has grown from a start-up organization in 1984 to a national model for community investment. To date, BCC has invested more than \$450 million in low-income communities, financing more than 9,700 affordable homes and 750,000 square feet of inner-city commercial real estate, and creating or preserving more than 1,400 jobs. Cherry is a graduate of Wellesley College and the Northeastern University School of Law.

Patricia Hanratty is president of Aura Mortgage Advisors and NSP Residential, LLC, both affiliates of Boston Community Capital. Dr. Hanratty served as assistant secretary of economic affairs for the Commonwealth of Massachusetts and has been a professor of political science at the College of the Holy Cross. Dr. Hanratty has a PhD in political science and public policy from the Massachusetts Institute of Technology and a bachelor's degree from the University of Massachusetts at Boston.

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Endnotes

- ¹ Community Development Financial Institutions provide credit, financial services, and other services to underserved markets or populations. They include loan funds, development banks, development credit unions, and development venture capital funds. According to the CDFI Data Project, in FY 2006, CDFIs closed \$4.75 billion in loans and investments, which financed 69,893 housing units, 8,185 businesses, 35,609 jobs, and 750 community service organizations. See <http://www.opportunityfinance.net/industry/industrymain.aspx?id=234> for details.
- ² Warren Group CHAPA Town Foreclosure Statistics, January 1, 2007–November 30, 2009.
- ³ Boston Community Capital “NSP2 Application Narrative,” p. 5.
- ⁴ See the *New York Times*, June 19, 2009, “Hard Times for New England’s 3-Deckers”; and Kristopher S. Gerardi and Paul S. Willen, “Subprime Mortgages, Foreclosures, and Urban Neighborhoods.”
- ⁵ Available at http://campbellsurveys.com/housingreport/press_032210.htm.
- ⁶ NSP Residential, LLC, “Real Estate Value Declines in Target Neighborhoods in Boston,” fourth quarter 2009.

The Community Asset Preservation Corporation: A New Approach to Community Revitalization

by Harold Simon
National Housing Institute

The onslaught of the mortgage crisis is far from over; the damage to neighborhoods worsens daily. Millions have lost their homes, and properties lie vacant and abandoned in communities around the nation. As these properties pile up, especially in low- and moderate-income communities like those in Newark, New Jersey, and its surrounding cities, the need for new approaches to community development is ever more apparent. One such approach is that of the Community Asset Preservation Corporation (CAPC) of New Jersey.

The organization was conceived and designed in 2007 and 2008 as a public-purpose, non-profit organization whose mission is to stabilize fragile neighborhoods and protect homeowners and tenants from the toxic effects of the foreclosure crisis.

To fulfill its mission CAPC

- Buys property in the foreclosure track quickly and at meaningful scale
- Preserves the assets and financial integrity of at-risk resident homeowners
- Maintains properties to preserve their value and minimize neighborhood harm
- Returns properties to productive use in an equitable manner
- Builds collaborations with for-profit, non-profit, and municipal partners.

The initial goal of the organization was to recover up to 1,500 living units in the first five to seven years. CAPC acquires pools of nonperforming residential mortgages (notes) or foreclosed, real-estate-owned (REO) residential property

in low- to moderate-income communities, primarily in urban Essex County, New Jersey. The properties are then returned to productive use through a variety of exit strategies, including:

- Sale to nonprofit or for-profit affordable housing developers
- Sale directly into the market
- Demolition
- Land banking
- Rental conversion
- Shared-equity homeownership.

The elements of CAPC are all replicable and scalable. They include bulk purchases, a value-assessment model based on the costs and likely sales of each property, a proactive asset-management program, a non-traditional financing strategy, and a mixed-market disposition strategy built on the various exit options noted above.

The Need for CAPC

Nationally, the number of foreclosed homes is staggering—and growing. In 2008, Credit Suisse projected that, by the end of 2012, more than 8 million mortgages will be foreclosed on.¹ The number of U.S. residential properties receiving at least one foreclosure filing jumped 21 percent in 2009 to a record 2.82 million.²

Although foreclosures affect every corner of the country, they are especially devastating to low-income and minority communities.³ As of December 2009, in the Essex County municipality of Newark and its bordering cities of Orange, East Orange, and Irvington, there were 3,465 properties in foreclosure.⁴ Preliminary

HANDS reduced Orange's vacant and abandoned homes from 400 in 1996 to fewer than 40. But in 2007, the subprime crisis began to undo that success.

analysis indicates that at the current pace of filings, more than 6,500 properties will have been at some point in the foreclosure cycle in Essex County in 2009, making the Newark area New Jersey's foreclosure hot spot.⁵ The ripple effect of these foreclosures, in terms of loss of market value, abandonment, and neighborhood destabilization, is devastating, undoing decades of revitalization efforts and stripping the hard-won assets of thousands of low-income families.

In response, considerable research and program activities that focus on foreclosure prevention have been undertaken. But despite these efforts, millions will lose their homes. The national State Foreclosure Prevention Working Group, which tracks loan-mitigation efforts by 13 of the 20 largest subprime mortgage servicers, found in 2009 that six out of 10 loans were not involved in any work-out process.⁶ More disturbing is an evaluation of loan-mitigation efforts that showed 56 percent of modified loans falling back into foreclosure within six months.⁷ With the downturn of the real-estate market continuing, many of these foreclosed properties will become vacant and abandoned.

While an isolated foreclosure may not have a significant impact, the foreclosure risk from subprime loans is far from isolated. In November 2009, 52 percent of owner-occupied homes with subprime loans and 32 percent of owner-occupied homes with Alt-A loans in New Jersey were delinquent, in foreclosure, or REO.⁸

As the number of completed foreclosures grows in already-weak markets, these bank-owned properties are frequently abandoned, leading to increases in criminal activity, health hazards, and fires, while destabilizing and diminishing the value of an entire neighborhood.⁹

Abandonment and blight continue to pose huge challenges for both community development corporations and local government agencies. Dealing with the diffuse ownership of these abandoned properties, coupled with the legal difficulties of acquiring title, requires a specific skill set that is costly and time-consuming to

develop. The acquisition and productive and equitable reuse of these properties are proving to be very difficult tasks for many.

At the national level, the federal government has made large sums available through programs to prevent the loss of homes to foreclosure and to recover properties lost to foreclosure that have become abandoned.¹⁰ These programs, which have not yet reached the scale necessary to make a significant impact, are still being refined and expanded.¹¹

Even with sufficient resources to manage this problem, without adequate planning and capacity at the local level, much of this funding will not accomplish the intended goals. To meet these new challenges, organizations with deep knowledge of local real estate markets, experience in housing development and finance, and strong public/private partnership agendas are needed to change the course of the foreclosure tsunami.

A Tragic Opportunity in Orange, New Jersey

The city of Orange is typical of many older, urbanized inner-ring suburbs. It was once a community of single-family homes, stately apartment buildings, and thriving commercial, manufacturing, and retail districts.

For three decades following the 1967 Newark riots, the city of Orange saw its economic base decline, homeownership plummet, and poverty rise dramatically, and suffered the ills of high crime, poor schools, and the increasing abandonment and vacancy common in such environments. By 1996, the city's population had fallen to nearly 33,000 from 39,000 in 1950, the poverty rate was 20 percent, and approximately 400 homes were abandoned.¹²

At that point, one of the leading community development corporations in the state, Housing and Neighborhood Development Services (HANDS) Inc. of Orange, committed itself to reducing the number of abandoned homes in Orange through a process they call high-impact

development for long-term sustainable change. This process begins with an annual inspection of each abandoned residential property in the city, after which HANDS identifies pivotal properties with the greatest potential to catalyze neighborhood change. Properties are assessed for their impact on surrounding homes and the level of existing community response.¹³ Often, these properties have been abandoned for many years, partly because of a morass of title problems, including unresolved mortgage and tax liens. To accomplish their goals, HANDS developed in-house expertise in curing even the most complex title problems.¹⁴

Over the following decade, HANDS reduced Orange's vacant and abandoned homes from 400 in 1996 to fewer than 40. But in 2007, the subprime crisis began to undo that success.

Searching for the source of these new foreclosures, HANDS identified a pool of 47 nonperforming mortgages on properties scattered around the state, but primarily located in fragile neighborhoods in Newark and bordering cities. The mortgages were held in portfolio by a single lender.

At the same time, the author and a small group of experienced real estate, affordable housing, and community development professionals (including the executive director of HANDS) began to identify ways to deal with the coming flood of REO properties. We developed the outlines of a new organization, the Community Asset Preservation Corporation.¹⁵ CAPC's approach would be a significant departure from the way nonprofits usually approached abandoned property remediation, and so, to secure funding, we would need to prove that our concept was sound.¹⁶ Together, HANDS and CAPC recognized that the acquisition of these mortgages presented an opportunity for such proof. We developed a project, dubbed Operation Neighborhood Recovery, and in the spring of 2008 HANDS and the nascent CAPC joined efforts to pursue the purchase of these mortgage notes.

A Blueprint for Neighborhood Recovery

The 47 mortgage loans were part of a larger real estate fraud and subsequent bankruptcy case. All of them were in serious default, but the lender had not yet initiated foreclosure proceedings. At the time, foreclosures in New Jersey, a judicial foreclosure state, took up to 18 months to complete.

Many of the properties were vacant and deteriorated, creating significant safety risks and financial loss to their communities and neighbors. None were owner-occupied. HANDS-CAPC approached the lender to find a way to minimize harm to the neighborhoods during the anticipated long duration of the foreclosure process and returning the properties to productive use.

Following initial negotiations, HANDS-CAPC offered to purchase all 47 loans, after which, through foreclosure and other legal means, it would expeditiously clear title to all of them, maintain the properties, and pay all maintenance and carrying costs during the title-clearance period. We anticipated that the process, from purchase to title clearance, could take up to two years. Once HANDS-CAPC had clear title to the properties, we would move quickly to implement an exit strategy for each property.

Exit Strategy Drives All Decisions

To establish a realistic valuation of these properties, HANDS-CAPC and the lender agreed in 2008 to enter into a 45-day exclusive due diligence period. During this time, HANDS-CAPC conducted title searches and performed comprehensive physical inspections to determine rehabilitation costs; worked closely with a local real estate firm to develop market assessments and analyses to determine current "as-is" values and resale values after rehabilitation; and evaluated the costs of carrying and managing the properties through foreclosure as well as all costs related to executing the foreclosures.¹⁷

How Did Operation Recovery Get Funded?

The potential funders of this project had great confidence in HANDS, a 25-year-old CDC with an impressive track record of accomplishments, an expert development and real estate staff, a healthy balance sheet, and significant assets under management.¹⁸ However, the \$3.6 million funding HANDS–CAPC sought for Operation Neighborhood Recovery was not entity-level funding but narrowly defined project funding, which would make underwriting a challenge. Beyond the unknowns typically associated with housing development in distressed communities, we were contending with plummeting housing values and properties that were abandoned, deteriorated, and scattered across the state. Perhaps most challenging to investors accustomed to having their loans secured by property was the fact that HANDS–CAPC would be purchasing notes, not REO.

Although the prospective funders of Operation Neighborhood Recovery understood the importance of this pioneering work, they required more assurance. One of them, New Jersey Community Capital, suggested an 80/20 debt-to-equity facility, offering 52 percent of the equity if HANDS contributed the remainder. The high first-loss ratio, along with priced-to-risk debt, provided enough assurance to the other funders—Prudential Social Investments, LISC, Enterprise Community Partners, and NeighborWorks America—to bring the deal to conclusion.

Debt is usually senior to equity. As money was earned by selling properties after title was secured, investors would be paid back. Debt investors (senior) would receive their money before (subordinate) equity investors. The payments were based on a formula. If there was loss, equity investors would take the first loss.

The interest rate on loans, comprising the debt portion of a funding arrangement, can range anywhere from zero percent (for example, with forgivable loans from a foundation) to the current market rate for high-risk commercial loans. HANDS did not receive a special interest rate on the debt; the rate was based on the level of risk determined by the underwriting, or assessment of the project's likelihood of being completed successfully; in other words, debt was priced to risk.

A limited liability corporation, of which HANDS was the managing partner and an equity investor, was also created. The investment capital facility was designed to provide funds to the corporation for loan purchases, title clearance, property maintenance and management, and carrying costs. Forward subsidy commitments from local municipalities and Essex County were secured.

The due diligence revealed:

- Of the 47 properties, 38 were located in Newark and its bordering cities. The remaining nine were scattered around the state. The 47 properties represent a total of 93 living units.
- Eight properties required demolition because of substantial fire damage or because their condition made rehabilitation prohibitively expensive.
- Sixteen needed major or gut rehabilitation.
- Twenty-three properties were located in neighborhoods that were in distress.
- Six were occupied by tenants who were not paying rent.
- The average cost of rehabilitation/renovation for each property not demolished was \$76,000.
- The initial estimated cost of clean-out and security was \$105,000.

The potential sale price of each property was assessed under a variety of scenarios, and a likely exit strategy was determined for each. According to the plan developed by HANDS–CAPC,

- Fourteen properties would be sold to homebuyers or responsible private investors at market rate.
- Eight properties would be demolished and the sites would be land-banked or redeveloped as new housing.
- Twenty-five properties would be conveyed to CDCs or other affordable housing developers at a rational sale price to allow for affordability with minimal public subsidy.

The local real estate market at the time was in flux. Home values were dropping and foreclosures were on the rise. While transactions were still occurring in New Jersey, the absorption rate of for-sale homes was weak and varied widely throughout the region. Many potential homebuyers were having difficulty qualifying for mortgages, further reducing sales. We had to consider a rental option, with ongoing management costs built into the calculations.

Based on this demand-side model, HANDS–CAPC made an offer to the lender and, after some negotiation, a price was agreed upon. The purchase closed in March 2009. HANDS–CAPC immediately secured each property,

provided emergency repairs for current tenants, and began the process of gaining title.

Building a CDC Collaborative

Integral to the CAPC concept is the purchase of pools of property or notes. Such purchases are efficient and can reduce transaction costs significantly. The seller can include properties unlikely to sell (in some cases, with negative value) and the buyer can receive some properties that may sell at a higher price, perhaps at market rate, which effectively creates an internal subsidy for our organization's affordable housing component. This also provides cash to allow debt to be drawn down early, which helps ensure the organization's financial sustainability.

But targeted neighborhood stabilization is not easily achieved with this model unless there are also strategic collaborations among nonprofit, for-profit, and government partners. It was clear at the onset that such partnerships would be vital to the project's success. During the due diligence period, the location of each property slated for redevelopment as affordable housing was matched to the footprint of a nonprofit organization. Six community development corporations (CDCs) were invited to form a collaborative with HANDS-CAPC.¹⁹ During the title-clearance period, the CDCs helped monitor, maintain, and protect the value of the properties.

Once clear title was secured, each CDC would purchase the units within their footprint and rehabilitate them for affordable housing.²⁰ And each would be responsible for arranging subsidy, acquisition, and construction financing in advance of the purchase. Early discussions included representatives from the City of Newark and surrounding municipalities as well as Essex County government, all of whom agreed to provide support as the transaction progressed.

Asset Management

The CAPC model stresses early, ongoing, and consistent asset management at a level sufficient to counteract the neighborhood destruction caused by empty, deteriorating properties. As

soon as legally possible, CAPC cleans and secures each property, makes emergency repairs, and works with tenants to create safe homes. When necessary, it provides relocation assistance and additional appropriate services.²¹

Outcomes of Operation Neighborhood Recovery to Date

One year after the purchase closed, the disposition of these 47 properties is well ahead of schedule. Foreclosure proceeding have been initiated on two of the properties, four have title complications that are being resolved, and clear title was acquired for the remaining 41, primarily through deed in lieu. Of these 41, 24 have been sold to CDCs or mission-based for-profits, eight are under contract, and nine are being rehabbed by HANDS-CAPC. In total, about 70 percent of the properties will ultimately be developed as affordable rentals and homes.

To date only about \$2.6 million of the \$3.6 million of available funding has been used. The rapid acquisition of title to the majority of the properties and the sale of many of them resulted in a significant amount of cost savings and allowed HANDS-CAPC to pay down early almost \$1 million of the debt used.

Moving Forward

In late 2009, as the work with HANDS on Operation Neighborhood Recovery progressed, CAPC began merger discussions with New Jersey Community Capital, the lead funder of Operation Neighborhood Recovery and New Jersey's largest community development financial institution, or CDFI. Aligning with NJCC would give CAPC statewide reach, a robust balance sheet, and existing relationships with many public, private, and nonprofit organizations. A merger of the two organizations was recently completed, with CAPC becoming a subsidiary of New Jersey Community Capital.

As a statewide organization, CAPC today continues to pursue a mixed-market approach that relies less on public subsidy than on internal subsidies and efficiencies of scale to create affordable housing. Pivotal to this approach is

Targeted neighborhood stabilization is not easily achieved with this model unless there are also strategic collaborations among nonprofit, for-profit, and government partners.

CAPC's demand-side valuation model, which is driven by exit strategy, deep understanding of local markets, and close working relationships with other mission-based organizations.

CAPC is pursuing its bulk-acquisition strategy in two ways:

- In March 2010, CAPC completed a purchase of 10 REO properties from JP Morgan Chase. As of July 2010, the organization was negotiating with lenders and GSEs for additional pools, both REO and mortgages, ranging from 10 units to more than 75.
- CAPC is a New Jersey state coordinator for the National Community Stabilization Trust's First Look program to acquire REO properties.²² In mid-October 2009, CAPC launched the program in the Newark area and later throughout the state. As of March 2010, CAPC had worked with 28 groups in 137 ZIP codes and facilitated access to 360 REO properties, including 130 in Essex County. CAPC is also negotiating a possible purchase of 25 to 30 REO properties directly through NCST over the next six months.

While northern New Jersey has been the proving ground for CAPC and the organization continues to focus much of its attention there, it is also working closely with municipalities across the state and with New Jersey's Department of Community Affairs.

CAPC is also engaged in other collaborations aimed at neighborhood revitalization. CAPC and the Housing and Community Development Network of New Jersey, for example, established a collaborative of neighborhood organizations to work on NSP1 and NSP2 projects. New Jersey Community Capital/CAPC is providing financing and technical assistance to member groups and is helping to coordinate their use of NSP funds.²³

To facilitate efficient purchase and construction efforts, CAPC and its parent, New Jersey Community Capital, are developing financing strategies, including a state-supported revolving acquisition fund, a New Market Tax Credit program, and, in collaboration with the

nonprofit grantees of the Newark area NSP2 program, a \$15 million revolving loan pool. The grantees have committed up to 10 percent of their allocations as a first-loss reserve to the facility.²⁴ In June 2010, CAPC secured a \$3 million financing commitment from the National Community Stabilization Trust's REO Capital Fund and a \$1 million financing commitment from Community Housing Capital, a NeighborWorks America CDFI, to create a revolving property-acquisition fund.

Lessons Learned

Money talks. Over the past year, an increasing number of investors have entered the market for bulk purchase of notes and REO properties. Many are operating at a scale far larger than CAPC and over a much wider geography. Needless to say, they are better financed and able to deploy funds faster than most nonprofits doing this work. To compete, even on a smaller scale, CAPC and other organizations need ready, flexible, entity-level financing.²⁵ Such financing can come from judicious use of government subsidy dollars aimed at guaranty debt, mission-related or impact investments, and access to equity markets. As long as organizations like CAPC are constrained by project-based funding, overly stringent and costly underwriting, and heavy reliance on unleveraged subsidy, their reach will never match the scope of the problem.

Exits drive all decisions. Many of the elements of the CAPC valuation model resemble the net-present-value model established by the National Community Stabilization Trust and others. CAPC's approach differs in that it is driven by the demand side of the equation. No matter what the modeled price would be, the maximum price CAPC could pay for the properties from purchase to disposition would be the amount that allows the deal to be done with the smallest subsidy possible. This valuation model requires starting at the end: What is the likely disposition, or exit strategy, for each property? It also demands clear-eyed assessment of all costs associated with the project and accurate appraisal of current market conditions.

An open-minded approach helps. There may never be enough affordable housing in states like New Jersey. There certainly isn't enough now. Deciding to develop both market-rate and affordable homes is not easy for many organizations committed to maximizing the number of affordable units created. But by selling some units at market rate, the organization will realize returns that can support the creation of more units than would otherwise be possible.

A little goes a long way. States should deploy their housing assets to maximize productivity. As noted earlier, one important way is to redirect funds as first-loss guaranties to attract private equity and support homebuyer mortgages. States should also create funding streams for the bulk acquisition of properties. The \$2.6 million acquisition facility used for CAPC's Operation Neighborhood Recovery pilot project had no public funds and leveraged approximately \$15 million in development; it produced 93 living units.

Public policy should boost development efforts. States and municipalities can use subsidies to encourage collaboration among public and private organizations. Cities especially should carefully assess their varied development projects and concentrate their priorities to leverage each project's funding stream. Partnerships are vital. Pooled capacity and resources should thus be encouraged and rewarded.

The community development field has produced remarkable changes over the past three decades, under circumstances whose difficulty easily rival today's. But the scope and speed of destruction brought on by the foreclosure and economic crises challenge us to develop new ways of responding that incorporate newer market tools and disciplines but are driven by—and stay true to—mission. The Community Asset Preservation Corporation is one such way.

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journal on affordable housing and community building. In 2007 and 2008, he helped conceive and launch the Community Asset Preservation Corporation of New Jersey. Simon is a graduate of the City University of New York's Hunter College.

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- ¹⁰ The programs include the Home Affordable Refinance Program, the Home Affordable Modification Program (funded through the Troubled Asset Relief Program), the Housing Finance Agency's Hardest-Hit Fund, and the Home Affordable Foreclosure Program. See also H.R. 3221, *The Housing and Economic Recovery Act of 2008*, section 2301, "Emergency Assistance to the Redevelopment of Abandoned and Foreclosed Homes," and H.R. 1, "The American Recovery and Reinvestment Act of 2009," Title XII, pp. 100–12.
- ¹¹ "October Oversight Report: October 9, 2009, "An Assessment of Foreclosure Mitigation Efforts after Six Months," submitted under Section 125(b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343.
- ¹² U.S. Census and the Housing and Neighborhood Development Services, Inc.

- ¹³The role of HANDS is to leverage communities' investment decisions, bolster public-sector action, and generate more private-sector investment. For HANDS, the level of community attention to a problem property—for example, calls to police or complaints to town council members—is an indication of the potential for catalytic change revitalizing the property would have.
- ¹⁴In transitional neighborhoods, for-profit developers shun properties with difficult title problems because they are costly to resolve. These properties remain abandoned for years, even decades, as tax and other liens pile up and the poison that results from abandonment affects surrounding homes.
- ¹⁵Alan Mallach, Harold Simon, and Patrick Morrissy, "Creating an Entity to Preserve Individual and Community Assets from Subprime Foreclosures," unpublished concept paper, January 2008.
- ¹⁶These efforts were led by Diane Sterner, Harold Simon, Patrick Morrissy, Wayne Meyer, Alan Mallach, and Bridget MacLean-Lai. Early support was provided by the Ford, F.B. Heron, JP Morgan Chase, Victoria, and Citibank foundations.
- ¹⁷HANDS-CAPC engaged an attorney expert in real estate transactions, including foreclosures, and also received significant pro bono support from Gary Wingens, Allen Levithan, Kenneth Zimmerman, John Wishnia, and others from the firm of Lowenstein Sandler.
- ¹⁸At the time, Wayne Meyer was the housing director for HANDS.
- ¹⁹The CDC collaborative eventually included Brand New Day, Episcopal Community Development, La Casa De Don Pedro, Newark Housing Partnership, Unified Vailsburg Service Organization, and HomeCorp.
- ²⁰An important element of the valuation model was to determine a reasonable sale price of the properties to participating CDCs. That price needed to be high enough to cover HANDS-CAPC expenses but low enough to ensure a fair return to the CDCs, while requiring the smallest public subsidy possible to make the homes affordable to low- and moderate-income families.
- ²¹In several cases, HANDS-CAPC helped secure social services and emergency housing assistance, not only to legal tenants but also to squatter families who would otherwise become homeless.
- ²²CAPC serves as the point of contact for program participants in the state and facilitates the flow of information between the participants and NCST. The program provides nonprofit organizations and mission-based for-profit developers the opportunity to acquire recently foreclosed bank-owned properties at a discount and through an expedited purchase process before those properties go on the market. CAPC also participates in NCST's recently launched capital grant program.
- ²³An important venue supporting collaboration in the greater Newark area is the Essex/Newark Foreclosure Taskforce. Early on, the CAPC concept and Operation Neighborhood Recovery were presented to the Property Recovery Working Group of the task force. All of the ONR collaborators participated in the working group.
- ²⁴The Newark Collaborative received a \$22 million NSP2 award.
- ²⁵In Jersey City and many other U.S. cities, private investors are now purchasing REO properties within hours of listing. They come with cash in hand, ready to close.

Embracing Renting to Accelerate Neighborhood Recovery

by Danilo Pelletiere

National Low Income Housing Coalition

When it comes to neighborhood stabilization, the primary problem policymakers face today is not falling homeownership rates or house prices, though attention often focuses on these. The more fundamental problem is the growing numbers of vacant homes. Today, nearly 19 million homes nationwide are vacant, and both the for-sale and for-rent vacancy rates are at or near record highs.¹ Prices and neighborhoods cannot stabilize unless households are able to remain in their homes and the vacancy rate is reduced.

It is tempting to perceive the vacancy problem as an “oversupply” of housing, whether in specific areas or nationwide. Yet millions of Americans are unable to afford their homes and are being evicted. If we have too much housing, why should these families have to move in with others or become homeless, and why are hundreds of thousands more already homeless? Unlike agricultural commodities, which can be easily removed from the market to help stabilize prices, removing vacant homes—either proactively or through neglect—from residential use in all but the worst-hit neighborhoods not only destroys the housing but also can detract from the value of neighboring properties, leading to further instability.

For policymaking, it is better to view the vacancy problem as a deficit of households willing and able to buy or rent and sustain homes on their own, rather than as an oversupply issue. From this deficit-of-households perspective, the overarching questions for policymakers become more positive. How do we keep current households independently housed? At the same time, how can we add to their numbers? To address the current overhang of vacant homes

and stabilize the housing market as broadly as possible, we need to not only keep existing households in their homes but also to increase the number of households in the U.S. so that it approaches 115 million as quickly as possible.²

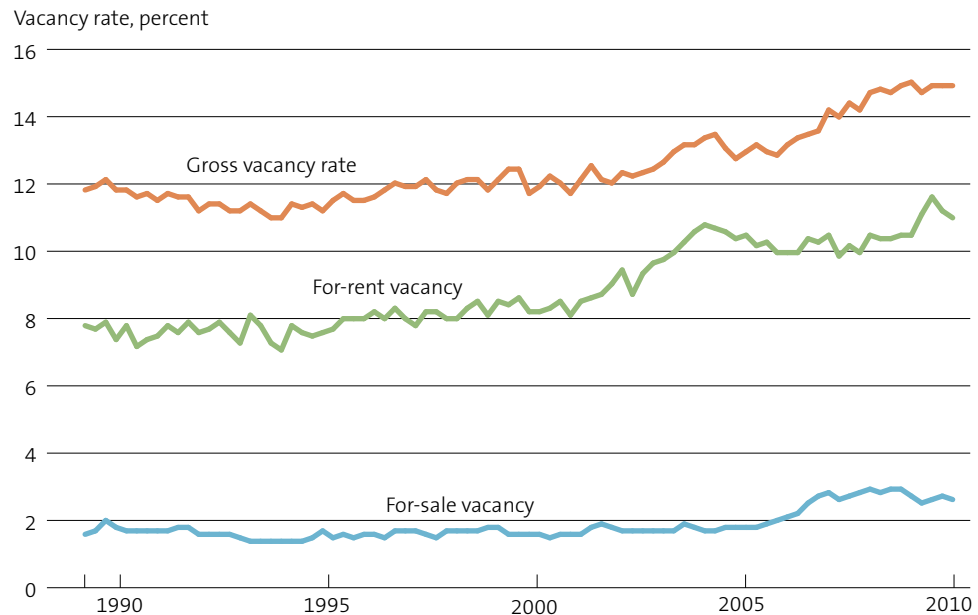
This article argues that, in order to achieve these outcomes, policymakers at all levels of government must put a greater emphasis on renters and rental housing than they have in the past. The major barrier to this approach is that after years of focusing on raising homeownership rates, policymakers at all levels are unaccustomed to seeing rental housing as a solution to any community problem. Fortunately, a number of local and federal policies have begun to show the way.

Vacancy and the Lagging Demand for Housing

During the growth of the housing bubble in the first half of this decade, the nation’s housing supply increased ahead of demand. According to the Housing Vacancy Survey, in the first quarter of 2010, the for-rent vacancy rate was 10.7 percent and the for-sale rate stood at 2.6 percent, near-record highs for both indexes.

After remaining just below 8 percent for more than a decade, the for-rent vacancy rate began to increase dramatically in 2001, reaching 10.4 percent in the first quarter of 2004, the highest rate since the series began in 1956 (see figure 1). Renters were moving into ownership and taking advantage of low interest rates and looser credit. As they left the rental sector, however, they were not replaced by new renters at the same rate. Though at first there was a corresponding decrease in the for-sale vacancy rate, as new construction and conversion of

Figure 1
National Vacancy Rates By Quarter
 Q1 1989 – Q1 2010



Source: NLIHC calculations U.S. Census Bureau Housing Vacancy Survey Data

existing buildings to for-sale housing picked up, the rental vacancy rate subsided, and the for-sale vacancy rate grew from 1.8 percent to 2.9 percent between 2004 and 2008. This was a historical high for that series as well, representing an increase of nearly 1 million homes for sale.

After the housing bubble burst in 2007, building continued for a time and vacant units were increasingly offered for rent. At the same time, the unemployment rate grew to more than 10 percent, limiting the demand for housing in general.³ In this environment, the rental vacancy rate once again shot upward, to more than 11 percent.

From the perspective of the entire housing industry, the problem of vacancy continues to worsen. Census Bureau estimates from the first quarter of 2010 showed 131 million units of housing and only 112 million households (that is, occupied homes) in the country, resulting in a gross housing vacancy rate of 14.5 percent.⁴ Almost a decade earlier, in the first quarter of

2001, the gross vacancy rate was 11.9 percent and the average for all quarters from 1990 through 2000 was 11.4 percent. More important, the gross vacancy rate has continued its upward trend even in recent quarters, when both the for-rent and for-sale vacancy rates dipped. The total number of distressed and vacant homes has continued to grow as more homes are being delayed in the foreclosure process, adding to the swelling inventory.⁵

The country's vacancy problem can certainly be attributed in part to overbuilding in areas where housing demand never fully materialized as expected and to population loss from local economic shocks. But nationwide, the population continues to grow. What's happening to explain this? The demand for housing has been tempered by a decline in the "headship rate," the rate at which the number of households increases with population.⁶ A number of recent reports have highlighted the growing numbers of households moving in together and the increased household sizes and rates of crowding in the past few years.⁷ In the past decade alone,

the incidence of multigenerational households within the population has climbed to levels not seen since World War II.⁸ First in response to higher housing costs and foreclosure and then to the current recession, families and individuals who previously lived alone—including the growing ranks of the elderly—have increasingly “doubled up.” Perhaps more important, the number of new households—defined as newly established households of individuals or families⁹ who previously lived with others, were homeless, or are new immigrants—entering the housing market has declined dramatically. This drop is a reflection of fewer children leaving their parents’ homes and the recent slowing of immigration.¹⁰

The most important factors in boosting the nation’s headship rate are economic recovery and policies that increase employment and minimize loss of income, such as extending unemployment insurance. Income and job security help current households maintain their homes; similarly, families and individuals within larger households are more likely to move out on their own when they, and the households they are leaving, are economically secure.¹¹ Policymakers can speed up household formation with housing policies that reduce the costs associated with establishing and moving into one’s own household. This is where shifting attitudes in favor of rental housing will be decisive.

A Focus on Renting Can Boost Housing Demand

The first step to stabilize housing markets reeling from the foreclosure crisis is to keep as many current residents in their neighborhoods as possible, preferably in their own homes. Such actions will minimize the disruption to communities, schools, and of course the households themselves. This has certainly been a focus of policy in reacting to the crisis. However, at all levels of government, policy aimed at stabilizing existing households during this crisis has focused largely on helping owners maintain ownership through mortgage counseling and loan modification programs. Renters have not been a primary focus of such

policies. And while many households have been helped by these programs, success nationwide has been limited.¹²

One concern with this homeowner-focused approach is that owner-occupiers are not the only ones in distress or facing eviction due to foreclosure and turmoil in housing markets. Nationally, as many as 20 percent of properties in foreclosure and 40 percent of households facing eviction due to foreclosure may be renters.¹³ Many of the properties in distress and foreclosure or vacant are single-family (defined as one- to four-unit) buildings that were purchased or refinanced during the bubble and rented out. More recently, larger commercial multifamily properties have also begun showing signs of distress.¹⁴ Another concern with a homeowner-focused policy approach is that many distressed homeowners never had the resources or financial prospects necessary to sustain homeownership without assistance, such as from politically unpalatable write-downs of mortgage principal balances.¹⁵ The recession has only increased the number of households unable to sustain homeownership in the foreseeable future.

However, while many of these households cannot afford the payments and maintenance costs for their current homes, they can afford rents in nearby markets.¹⁶ Households that can make an ownership-to rental transition that involves renting the house they currently live in or moving to a rental property elsewhere in the community can keep their children in the same schools, shop in many of the same stores, and access the same institutions they did as owners, minimizing community as well as household upheaval.

With existing households shored up by the addition of an owner-to-renter conversion strategy to existing stabilization tools, the second step in stabilizing a community involves encouraging new households to move into vacant homes. To date, the major focus of most local and federal programs has been on attracting new, first-time homebuyers to the community through down payment incentives

In periods of uncertainty, renting provides tenants with greater flexibility to scale their housing consumption up or down as their circumstances change.

Renters are an integral part of most communities, and keeping rental properties occupied is as much a concern to the recovery of these places as maintaining homeowner occupancy.

and subsidized purchase–renovate–resell programs. At the federal level, there has also been a series of first-time homebuyer tax credits.

A challenge facing any program aimed at boosting the number of new homeowners is the lagging economy. The success of these programs is predicated on achieving a level of homeownership that was difficult to achieve before the recession, when credit was easy and labor markets were stronger. Moreover, households that choose and qualify to be new homeowners today are not likely to be new households at all, but rather existing households that are currently occupying rental housing. As discussed above, some rental demand may be coming from existing households moving from ownership into rental; these are likely households that recently suffered a foreclosure or job loss, for example, as well as others making lifestyle choices, such as seniors moving out of the homes where they raised their children. But these households' moves, either from rental to homeownership or vice versa, are not part of increased demand for housing overall. In fact, without a new household to take its place, the community (or, more broadly, the national housing market) is simply swapping one vacancy for another.

Where can new households come from? The most likely prospects are young people who are doubled up or living at home, and recent immigrants. These two groups are also more likely to rent than to own. In general, the growing age groups in the population are those under 35 and those 65 and over, both traditionally considered age groups that are more likely to rent or end up living with others when they move.¹⁷ Providing—and making these groups aware of—affordable renting options may increase the likelihood that they will choose this option. As recent experience has shown, extremely lenient terms and down payment requirements encouraged some new and re-emerging households to move directly from shared or rental housing into owner-occupancy. However, even without questioning the wisdom of such a move, after the pushing of credit and ownership during the boom and the subsequent increase in credit-damaged households, it must be recognized

that there is no longer a large pool of potential new households with access to the financing necessary to make the jump directly into homeownership.

In addition to young people and immigrants, the other pool of potential new households consists of those returning to the housing market after a period of living with others or being homeless, perhaps following an eviction or divorce. As economically recovering households, often with damaged credit and limited income, these households appear likely to rent when they return to the housing market. Those who recently endured a foreclosure may also be reluctant or unable to pursue homeownership in the near future.

A final reason why new households appear more likely to turn to renting versus homeownership in the early stages of the economic recovery is that homeownership is inherently more difficult to enter and exit than renting. In the current market, with nearly a quarter of American single-family homes with mortgages in negative equity,¹⁸ it seems likely that many households, even those who are eligible to own, will choose to rent for the foreseeable future.¹⁹ In periods of uncertainty, renting provides tenants with greater flexibility to scale their housing consumption up or down as their circumstances change. Renters can move to take advantage of employment and other opportunities at a lower up-front cost than homeowners. Such benefits can limit households' preference for ownership. In addition, some economists have argued that a high rate of homeownership in general limits labor mobility, increases joblessness during an economic transition, and slows growth more generally.²⁰

The upward trend in renter household growth, in the face of growing vacancies and declining household headship nationwide, reflects the fact that renters are growing as both a number and as a proportion of all households. Renters were responsible for the net increase in households from the fourth quarter of 2006 to the first quarter of 2010, adding 2.6 million households against a decline of 698,000 owner households

in the same period. In the first quarter of 2010, renters comprised 33 percent of all households nationally, up from an historic low of 31 percent in the fourth quarter of 2004.²¹

Addressing Policy Challenges

The biggest challenge to housing policies placing greater emphasis on renting is that for decades a growing homeownership rate was a top-line indicator of success for a neighborhood or community. This simple metric never really accounted either for the numerous vital and stable mixed-tenure and majority-renter neighborhoods across the country or for the significant failure rate among low-income owners at sustainable homeownership, even prior to the current crisis.²² This crisis has begun to undermine the belief that homeownership is a sufficient contributor to neighborhood stability. Many of the neighborhoods hardest hit by foreclosures, in fact, were those with the highest rates of ownership.²³

Today, the choice faced by an increasing number of communities is no longer between a rental and an owner-occupied property; it is between an occupied rental home and a vacant property. Communities are seeing previously owner-occupied homes convert to rentals, formally and informally, contributing to a conundrum for many: While rental homes are far more desirable than vacant homes, these communities often lack the staff and the institutions to regulate rental housing without discouraging it.²⁴

Another barrier to a greater policy emphasis on rental housing stems from the fact that banks own a significant proportion of vacant homes.²⁵ Historically, banks have not been in the business of managing rental properties. In an age of national and international banking and securitized loans, banks must overcome significant inertia to develop this capacity, often without local market knowledge. Policies to address these challenges should include stepped-up enforcement of bank-owned homes and technical assistance that focuses on being good local landlords.

Challenges are not exclusive to reluctant policymakers, local officials, and lending institutions. Local nonprofit organizations often are motivated to pursue rental strategies but have difficulty acquiring rental properties using existing resources. Even where funding is available, they often lack experience managing rental housing, particularly scattered single-family homes and properties traditionally owned and managed by small “mom and pop” landlords.²⁶

Indeed, there is an overall dearth of well-financed, capable, responsible, long-term landlords. Few communities recognize or support these landlords where they exist, and many actively discourage them with stepped-up inspections and higher tax rates (costs that are often passed on to tenants). Any policy to encourage renting should include a requirement that landlords be accountable,²⁷ but should also include incentives that reward good landlord behavior and support struggling rental owners with training and, where possible, low-cost financing and reduced taxes.

Policies and Proposals

Recent policies that seek to encourage renting in vacant and distressed housing fall into a few distinct categories. In the first category are policies designed to provide short-term assistance to renters affected by the foreclosure crisis. The Protecting Tenants at Foreclosure Act, for example, which was passed on May 20, 2009, allows bona fide tenants to occupy the property until the end of the lease term except if the unit is sold to a purchaser who will occupy the property, and provides all such tenants with 90 days notice prior to eviction. Similar state provisions exist in New Jersey, Ohio, and the District of Columbia.

Another federal program, the Homelessness Prevention and Rapid Rehousing Program, passed as part of the American Recovery and Reinvestment Act of 2009, directed \$1.5 billion in funds to renter households in need of short-term assistance to remain in their current homes and to displaced owners and renters in need of help to move quickly into a new home in their community and avoid being doubled up

or in the shelter system.²⁸ Similar short-term emergency assistance exists with state and local funding nationwide, though these funds are often threatened by the tight fiscal conditions at the state and local level.²⁹

In the second category are policies aimed at providing longer-term assistance to renters. These policies, many in the proposal stages now, employ renting as a strategy for keeping distressed homeowners within their communities. For example, an own-to-rent policy proposal from the Center for Economic and Policy Research would simply provide all underwater owners the option of giving up title and becoming market-rate renters with a long-term lease, perhaps as long as five years.³⁰ A bill along these lines—the Right to Rent Act of 2010—was introduced on April 15 by Representative Raul M. Grijalva of Arizona. Similar legislation has been introduced at the state level, with recent bills in the Arizona³¹ and New Jersey legislatures.³²

There has been related activity at Fannie Mae and Freddie Mac, the government-sponsored entities currently under government conservatorship. Formally, both agencies now offer households the option to rent at the end of the foreclosure process. While the Freddie Mac program offers a lease after foreclosure, the current Fannie Mae policy has the homeowner sign a lease and voluntarily transfer the property deed back to Fannie Mae through a deed in lieu of foreclosure. Avoiding foreclosure reduces costs for Fannie Mae and should limit the damage to the homeowner's credit and future financial opportunities. The house is leased back at a market-rate rent to the homeowner, who must live in the home as his primary residence. To be eligible, a household must show proof that, while it cannot afford its current mortgage, it can afford the rent, which Fannie limits to no more than 31 percent of the household's gross income.³³

Another approach involves a third party purchasing a home at some point in the foreclosure process in order to rent it back to the owner. This kind of “rescue” transaction has

been associated with mortgage fraud; nevertheless, a number of communities have begun to experiment with programs that provide funding and support to nonprofit groups to undertake such transactions. In New Jersey, the Mortgage Stabilization and Relief Act, passed in December 2008, established a \$15 million housing recovery program that will help nonprofits buy dwellings from homeowners who cannot afford their mortgages, then lease the homes back to homeowners for up to seven years while they recover financially.

A third category of neighborhood stabilization policies seeks to provide rental housing that results from the foreclosure crisis. One approach involves purchasing multifamily buildings that are foreclosed and vacant, mostly vacant, or soon to be vacated, for the specific purpose of providing low-income rentals. Some communities have undertaken such projects with dollars from the federal Neighborhood Stabilization Program, which requires that some funds be spent on lower-income households and rentals.

Programs to turn scattered-site housing into rentals are more complicated. Much of this activity is purely private and conducted by speculative investors; it has led to community concerns and the need for new local policies.³⁴ But local community development organizations from Chelsea, Massachusetts, to Cleveland, Ohio, to Chula Vista, California, have undertaken such projects, and NeighborWorks America has begun offering a class in scattered-site rental management to increase the capacity of local groups to succeed in this realm.³⁵ Some programs explicitly seek to house formerly homeless families,³⁶ for instance, while some seek to provide a planned transition to ownership.³⁷

At the federal level, the Center for American Progress recently proposed a program based on the Home Ownership Loan Corporation rental program set up in the Great Depression.³⁸ The 1930s program was meant to establish a market for houses that could not be easily sold. Not only did renting the homes generate income for the corporation, but a verifiable cash flow

and rent-paying tenants also provided a clear indication to homebuyers and investors that the housing had market value—an added benefit of renting vacant homes versus allowing them to sit vacant. In this vein, the Center for American Progress program proposes to “convert already foreclosed homes owned directly by the federal government into thoroughly energy efficient, affordable rental homes that can be resold as portfolios of rental properties to private investors.”³⁹ The proposal’s authors reason that homes that have been repaired, weatherized, and rented should sell more quickly as a portfolio and command a higher price than if speculators purchased the properties singly. In addition, they argue that the program would boost employment (and perhaps housing demand) by creating jobs in repairing, retrofitting, and managing foreclosed homes.

Finally, a policy that should also be under consideration is one that involves federal housing vouchers and local rent supplements that enable and encourage households, particularly those doubled up and homeless, to live on their own in rental properties. This could be one of the most important policies to help families as neighborhoods and the housing market recover. Additional vouchers could significantly boost demand for housing while also stabilizing households. While general vouchers would likely serve this purpose well, programs targeted specifically at doubled-up and homeless up populations, similar to the Veterans Affairs Supportive Housing voucher program, would most directly increase housing demand.

Conclusion

Recognizing current renters and stabilizing current rental properties should be a necessary part of any neighborhood stabilization plan. Renters are an integral part of most communities, and keeping rental properties occupied is as much a concern to the recovery of these places as maintaining homeowner occupancy. Moreover, the new and returning households that are needed to reduce vacancy and stabilize neighborhoods are most likely to be renters, whether by choice or from necessity, a trend that is already observable. Plans and policies that accommodate just

owners, whether directed at the recovery or instituted previously and for other purposes, will not help all the households that need assistance and will only delay a return to higher occupancy levels and housing market vitality.

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Endnotes

¹ National vacancy statistics cited throughout this report come from the Census Bureau’s Housing Vacancy Survey. Recent and historical data are available at <http://www.census.gov/hhes/www/housing/hvs/hvs.html>.

² This three-million increase in households should be considered a rough order of magnitude, based on applying the average gross vacancy rate of 11.4 percent for the 1989–2000 period to the current housing supply.

³ Gary Painter, “What Happens to Household Formation in a Recession?” (Washington, D.C.: Research Institute for Housing America, 2010).

⁴ The Census Bureau defines the gross vacancy rate as the percentage of total housing inventory that is vacant. The rate is computed with the formula (All vacant units/All housing units [occupied + vacant]) * (100). This measure includes seasonal properties. It is possible to calculate a gross year-round vacancy rate that excludes these units, but this distinction does not affect the trend and conclusions discussed here. Further, it is likely that many second and vacation homes were originally purchased as first homes or investment properties, supporting the use of the Census-defined gross vacancy rate. See also <http://www.census.gov/hhes/www/housing/hvs/annual09/ann09def.html>.

⁵ According to the Census Bureau’s Housing Vacancy Survey, the number of units held off the market increased by 211,000 between the first quarter of 2009 and the first quarter of 2010. The number of vacant for-rent units increased by 297,000 and the number of for-sale vacancies fell by 107,000. More recently, it seems, for-sale inventories have increased as well. See James R. Hagerty, “Housing Inventories Rise in Many Cities,” *Wall Street Journal* Development Blog, May 10, 2010. Available at <http://blogs.wsj.com/developments/2010/05/06/housing-inventory-rises-in-many-cities/>.

⁶ More formally, the headship rate is the inverse of the average household size.

⁷ Rob Collinson and Ben Winter, “U.S. Rental Housing Characteristics: Supply Vacancy and Affordability.” Working Paper 10-01 (U.S. Department of Housing

Today, the choice faced by an increasing number of communities is no longer between a rental and an owner-occupied property; it is between an occupied rental home and a vacant property.

Policies that accommodate just owners will not help all the households that need assistance and will only delay a return to higher occupancy levels and housing market vitality.

and Urban Development, Office of Policy Development and Research, 2010); and Gary Painter, cited above.

⁸ Paul Taylor and others, "The Return of the Multi-Generational Family Household" (Washington, D.C.: Pew Research Center, 2010).

⁹ A family is formally defined as two or more people, related by blood, marriage, or adoption, living in one housing unit. A household, defined as any group of people living in one housing unit, may be made up of a single family; singles or groups of unrelated individuals; multiple families; or a mix of individuals and families.

¹⁰ *The State of the Nation's Housing 2010* (Cambridge Mass.: Joint Center for Housing Studies, Harvard Kennedy School, 2010).

¹¹ Gary Painter, cited above.

¹² See, for example, United States Department of the Treasury, "Making Home Affordable Program: Servicer Performance Report through January 2010," available at <http://www.financialstability.gov/docs/press/January%20Report%20FINAL%2002%2016%2010.pdf>; James R. Hagerty, "An Odd Way to Measure the Success of Mortgage Mods," *Wall Street Journal* Development Blog, at <http://blogs.wsj.com/developments/2010/03/16/an-odd-way-to-measure-the-success-of-mortgage-mods/>; and Neil Mayer, Peter A. Tatian, Kenneth Temkin, and Charles A. Calhoun, "National Foreclosure Mitigation Counseling Program Evaluation: Preliminary Analysis of Program Effects November 2009" (Washington, D.C.: Urban Institute, 2009).

¹³ Danilo Pelletiere, *Renters in Foreclosure: Defining the Problem, Identifying Solutions* (Washington, D.C.: National Low Income Housing Coalition, 2009).

¹⁴ Congressional Oversight Panel report, "Commercial Real Estate Losses and the Risk to Financial Stability" (Washington, D.C., 2010).

¹⁵ Loan modifications, including principal write-downs, may be preferable for some distressed owners. This paper does not argue that renting is a one-size-fits-all solution, but the success rate of loan modification programs has not been high, and there remain concerns about subsidizing homeownership to this degree, not least for what a principal write-down based on the buyers' circumstances without relation to market values may do to surrounding property values, along with the potential for some of these assisted owners to reap significant profits as a result when they sell their homes. Households that cannot maintain homeownership without such a subsidy should be assisted in making the transition to rental housing.

¹⁶ A number of recent media stories have chronicled households that left their owned home and moved into the same neighborhood as renters, for example, Mark Whitehouse, "American Dream 2: Default, Then Rent," the *Wall Street Journal*, December 16, 2009. Recent publications also look at typical current rental and homeownership costs. See, for example, Danilo Pelletiere, Hye Jin Rho, and Dean Baker, "Hitting Bottom? An Updated Analysis of Rents and the Price of Housing in 100 Metropolitan Areas" (Washington, D.C.: Center for Economic and Policy Research and the National Low Income Housing Coalition, 2010) or Trulia.com, Rent vs. Buy Index, at <http://info.trulia.com/index.php?s=43&item=91>.

¹⁷ Jack Goodman, "The Changing Demographics of Multifamily Rental Housing," *Housing Policy Debate*

10(9): 31–58 (1999); Joint Center for Housing Studies, *America's Rental Housing: The Key to a Balanced National Policy* (Cambridge, Mass., 2008), and *The State of the Nation's Housing 2010* (Cambridge, Mass., 2010).

¹⁸ "Underwater" refers to a situation in which a household owes more on its home than it is worth. Julie Haviv, "RPT-Trend of U.S. mortgages 'underwater' grows—Zillow" (London: Reuters, May 10, 2010).

¹⁹ Andrew Haughwout, Richard Peach, and Joseph Tracy, "The Homeownership Gap," Federal Reserve Bank of New York, *Current Issues in Economics and Finance* 16(5) (May 2010).

²⁰ Andrew J. Oswald, "The Housing Market and Europe's Unemployment: A Non-Technical Paper," Department of Economics, University of Warwick, U.K. (May 1999), available at www2.warwick.ac.uk/fac/soc/economics/staff/academic/oswald/homesnt.pdf.

²¹ U.S. Bureau of the Census, Housing Vacancy Survey.

²² Donald R. Haurin and Stuart S. Rosenthal, "The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells" (Washington, D.C.: U.S. Department of Housing and Urban Development, 2004).

²³ Danilo Pelletiere, "Recognizing Renters in the Foreclosure Crisis: Challenges and Opportunities" (presented at the Ralph and Goldy Lewis Center for Regional Policy Studies, University of California-Los Angeles, 2009); and Keith E. Wardrip and Danilo Pelletiere, "Neighborhood Poverty and Tenure Characteristics and the Incidence of Foreclosure in New England," Research Note #08-02, National Low Income Housing Coalition, June 2008.

²⁴ Sarah Treuhaft, Kalima Rose, and Karen Black, "When Investors Buy Up the Neighborhood: Preventing Investor Ownership from Causing Neighborhood Decline" (Oakland, Calif.: Policy Link, 2010).

²⁵ Estimates of the housing stock currently owned by banks as of late April 2010 range from around 500,000 to over 750,000. See James Hagerty, "Debate Rages over Supply of Foreclosed Homes," *Wall Street Journal* Development Blog, available at <http://blogs.wsj.com/developments/2010/04/28/debate-rages-over-supply-of-foreclosed-homes/>.

²⁶ Ivan Levi, "Stabilizing Neighborhoods Impacted by Concentrated Foreclosures: Scattered-Site Rental Housing Challenges and Opportunities" (Washington, D.C.: NeighborWorks America, 2009).

²⁷ Treuhaft, Rose, and Black, cited above.

²⁸ Information and data on the implementation of this program are available at <http://www.hudhre.info/hprp/> (May 10, 2010).

²⁹ Danilo Pelletiere, Michelle Canizio, Morgan Hargrave, and Sheila Crowley, "Housing Assistance for Low Income Households: States Do Not Fill the Gap" (Washington, D.C.: National Low Income Housing Coalition, 2009).

³⁰ Dean Baker, "The Right to Rent Plan" (Washington, D.C.: Center for Economic and Policy Research, 2009).

³¹ Dean Baker, "Arizona Leads the Way in Combating Foreclosure" (Washington, D.C.: Center for Economic and Policy Research, 2010) and HB 2765 Arizona House

of Representatives, 49th Leg. 2 sess., available at <http://www.azleg.gov/legtext/49leg/2r/bills/hb2765p.pdf>.

³² The “right-to-rent” provisions were not in the Mortgage Stabilization and Relief Act (S1599/A3506) that eventually passed.

³³ Under a Citibank pilot program in New Jersey, Texas, Florida, Illinois, Michigan, and Ohio, borrowers agree to turn over their deeds after a period of up to six months. In return, CitiMortgage allows them to live in the property rent free during this period and provides a minimum of \$1,000 in relocation assistance, relocation counseling by trained professionals, and coverage of certain monthly expenses that Citi determines the homeowner can no longer afford, such as homeowners’ association and escrow fees. Bob Tedeschi, “Another Foreclosure Alternative,” *New York Times*, February 24, 2010, available at www.nytimes.com/2010/02/28/realestate/28mort.html.

³⁴ Treuhaft, Rose, and Black, cited above.

³⁵ Levi, cited above.

³⁶ For example, the Veteran’s Administration’s “Acquired Property Sales for Homeless Providers” program obtains properties as the result of foreclosures on VA-insured mortgages; it makes them available for sale to homeless provider organizations at a discount of 20–50 percent, depending on length of time on the market.

³⁷ The Self-Help Federal Credit Union is attempting to be a non-predatory rent-to-own model to scale to absorb excess inventory. Self-Help Federal Credit Union, “Self-Help Lease Purchase Program,” available at www.self-help.org/neighborhood-stabilization-program/Self-Help%20Lease%20Purchase%20Programforwebsite.pdf.

³⁸ Ellen Seidman and Andrew Jakobovics, “Learning from the Past: The Asset Disposition Experiences of the Home Owners Loan Corporation, the Resolution Trust Corporation, and the Asset Control Area Program” (Washington, D.C.: Center for American Progress, 2008).

³⁹ Andrew Jakobovics, “An Untapped Source of Green Rental Homes” (Washington, D.C.: Center for American Progress, 2010, p. 1).

Cleaning up after the Foreclosure Tsunami: Practices to Address REOs in Northeast Ohio¹

by Frank Ford
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Like a tsunami, each tidal wave of foreclosures has left in its wake hundreds of thousands of vacant, blighted, and vandalized properties. The immediate damage—the disrupted lives, the emptying of homes—has been followed by collateral damage to neighboring homeowners and their communities at large.

The full measure of post-foreclosure damage is understood only when one considers that every blighted house can negatively impact five or six other houses near it. In Cleveland today there are an estimated 11,500 vacant houses, which could easily lower the market value of 60,000 occupied homes. Speaking to scale, if each occupied home lost \$10,000 in value, the loss of homeowner equity would come to \$600,000,000. Further, that loss in value inevitably results in a loss of property tax assessment and lost tax revenue for publicly supported schools, police, fire, and social services. The saga is doubly tragic because it is undermining Cleveland's highly regarded community-development system, which made steady progress through the 1990s and the early part of the 2000s.

In the case of the financial institutions that bought the mortgages—specifically, the servicers and trustees who manage the loan pools—it appears that some of the same questionable decision-making that brought us the foreclosures in the first place is now compounding the problem by the manner of handling post-foreclosure vacant homes, which banks refer to as real-estate-owned, or REO, property.

In this regard, Cleveland may again serve as a useful illustration and, to some extent, a warning to other cities that have yet to experience a severe post-foreclosure problem. Any city, regardless of how strong its real estate market appears, could suffer a market failure if its foreclosures reach a critical mass. For hundreds of years, foreclosures have worked as a successful debt-recovery mechanism when an isolated foreclosure is surrounded by otherwise stable, occupied homes. The foreclosed home can be quickly re-marketed and re-sold, and the lender's loss minimized. Numbers of foreclosures in some areas of Cleveland, however, doubled and even tripled in a single year during the subprime crisis. When neighborhood markets have high levels of subprime lending and foreclosures, the system breaks down completely. Streets in Cleveland that had no foreclosures five years ago now have four or five. Streets that had a few foreclosures now have 10 to 20.

So who's buying these properties, and what are they doing with them? The buyers range from inexperienced individuals who watch late-night infomercials and are captivated by the promise of making millions in real estate, to a new niche industry that seems to have sprung up in the past decade: companies, most of which are located outside the state, that specialize in making bulk purchases of vacant foreclosed homes. Their business models vary. Some merely act as wholesalers and flip a package of 10 to 20 homes to another investor for a small markup;

some post them on eBay without making any repairs; and some make a bulk purchase to acquire just one decent prospect, assuming they may abandon the other properties.

In Cleveland, urban and suburban civic leaders from the public and community development sectors are fighting back in two ways. First, they're changing the economics of foreclosure and vacant property ownership. Second, they're creating tools and programs for responsible management and redevelopment of abandoned foreclosed property. This article discusses aspects of both.

Changing the Economics of Foreclosure and Vacant-Property Ownership

Following the age-old axiom that behavior doesn't change without a financial incentive to do so, civic leaders have taken a number of steps to shift greater financial responsibility for REO properties to the banks and investors that own them. The following tools have been employed to date, to varying effect.

Threat of demolition. The City of Cleveland has substantially ramped up its demolition effort. In the years leading up to 2006, it inspected, condemned, and demolished roughly 200 homes per year. In 2007, the numbers began a steep ascent: In 2007 and again in 2008, the City demolished 1,000 homes; in 2009, the number was 1,700. The City is imposing demolition liens and aiming to collect an average of \$10,000 per house to cover the costs of demolition. The prospect of having a vacant lot with a \$10,000 demolition lien on it can be a powerful motivator.

Prosecuting code violations. The City of Cleveland and its inner-ring suburbs are also prosecuting banks and REO investors for criminal violations of housing codes. In addition, the Cleveland Municipal Housing Court has issued arrest warrants for bank presidents and has levied stiff penalties against irresponsible investing in abandoned property. In 2008, the Court issued a \$140,000 fine against an investor from Oklahoma. In late 2009, an

\$850,000 fine was imposed on an investor from California. And in June 2010, Housing Court Judge Raymond Pianka levied a total of \$13 million in fines against two out-of-state real estate companies that have neglected properties they own in Cleveland.²

Private code enforcement. In addition to government-led code enforcement, private code enforcement has been spearheaded by the Cleveland-based nonprofit group Neighborhood Progress, Inc., which has brought public-nuisance lawsuits against two of Cleveland's largest REO owners, Wells Fargo and Deutsche Bank. The lawsuits allege that owning and dumping vacant REO property is a public nuisance that threatens the health and safety of neighbors and damages property values. As a direct result of these suits, the two banks have collectively demolished 40 blighted homes, saving the City approximately \$400,000 in demolition costs.

Combating bank walk-aways. Some lenders have begun dodging accountability for foreclosed properties by litigating a foreclosure case to judgment but not taking title at sheriff's sale. This tactic, commonly referred to as a "bank walk-away," allows lenders to obtain whatever insurance or accounting benefit is available by documenting the loss, but leaves them immune from responsibility for the damage caused by a vacated property. To counter this latest tactic, Rep. Dennis Murray in October 2009 introduced a bill in the Ohio House of Representatives (HB 323)—based on an innovative New Jersey statute enacted in May 2009—that would make foreclosing lenders accountable for nuisance conditions in properties they are foreclosing on *prior to* taking title. The bill was passed by the Ohio House of Representatives and as of July 2010 was being reviewed by the Ohio Senate.

Making Responsible Use of Vacant Abandoned Property

In its 40-year history of community development, Cleveland has consistently exhibited two major strengths. First, it's a city steeped in community organizing tradition, and civic and community leaders have not been shy

about holding banks and investors accountable, as noted in the examples above. But it is also a city of innovation, as witnessed by the Cleveland Housing Court, the Cleveland Housing Network (which introduced one of the first scattered-site lease-purchase programs in the country), and the publicly accessible NEO CANDO property data system at Case Western Reserve University.³ Civic leaders have been no less creative in addressing the current crisis of post-foreclosure vacant property.

Integrating rehabilitation with neighborhood stabilization. More than a year before the federal government announced Neighborhood Stabilization Programs 1 and 2, Neighborhood Progress, Inc. (NPI) partnered with the Cleveland Housing Network to develop Opportunity Homes, a program that rehabilitates vacant foreclosed property in strategically targeted areas to leverage existing assets and investments. Rehabbed homes are then supported by other neighborhood stabilization activities on the same streets—blight remediation, demolition (for homes beyond rehab), home repair, and landscaping. In what may be the most innovative aspect of this program, data from the NEO CANDO system is used to help identify occupied homes, in the vicinity of rehabbed homes, that are at risk of foreclosure. Using both public and proprietary data sources, NPI then targets every occupied home with a subprime or adjustable-rate mortgage for door-to-door outreach and loan modification assistance.

Reimagining Cleveland. The City of Cleveland, in planning ahead for the productive, sustainable, and responsible re-use of the thousands of vacant lots accumulating throughout the City and its suburbs, has partnered with NPI on a project called “Reimagining Cleveland.” The project, funded by the Surdna Foundation, involves engaging block clubs, civic organizations, and local institutions in planning for short-term utilization and long-term redevelopment of vacant property.

Land banking. Faced with a growing flood of post-foreclosure vacant property, the City

of Cleveland first needed to get control of those properties in order to keep them out of the hands of irresponsible investors and prevent further damage to neighborhoods. But it also needed a place to “park” these properties while it triaged them for immediate demolition, eventual rehabilitation, or “mothballing” until market conditions are more conducive to redevelopment. None of the local nonprofits have the capacity to acquire and hold a large inventory of vacant property. And while the City of Cleveland’s land bank owns thousands of vacant lots, it lacks the financial resources to manage and maintain vacant structures. Enter Cuyahoga County Treasurer Jim Rokakis, who led a collaborative effort that resulted in the creation of the Cuyahoga County Land Reutilization Corporation—referred to as the “county land bank”—in April 2009. Modeled after the Genesee County Land Bank, based in Flint, Michigan, the new land bank’s anticipated success, and what differentiates it from the City Land Bank or local nonprofits, is that it will have an expected annual budget of \$6 million to \$8 million from fees and penalties collected on late property-tax payments. The county land bank has already negotiated significant deals to acquire REO properties from Fannie Mae and the U.S. Department of Housing and Urban Development. (See also in this publication “How Modern Land Banking Can Be Used to Solve REO Acquisition Problems,” by Thomas J. Fitzpatrick IV.)

Lessons Learned

The foreclosure crisis hit Cleveland hard and earlier than it hit many other cities. Because of this, Cleveland has had time to develop a variety of innovative approaches that other cities can learn from. The Cleveland experience can be distilled down to several major lessons learned. First, ramp up code enforcement to control the ownership and irresponsible transfer of post-foreclosure vacant property. In other words, change the economics of owning vacant property. Second, while fighting the immediate battle, be forward-thinking and start planning ahead for the sustainable reuse of accumulating vacant property. Third—and critically important—establish an entity, such as a land bank,

Civic leaders have taken a number of steps to shift greater financial responsibility for REO properties to the banks and investors that own them.

Every blighted house can negatively impact five or six other houses near it.

that can receive and responsibly hold vacant property. It should be noted that a land bank can only be useful if it has the proper financial resources to undertake this task. Linking land banks to excess spin-off property tax revenue, as first developed by the Genesee County Land Bank, may be the single most important innovation in urban redevelopment in recent years.

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Endnotes

¹ Adapted from an article published in *Shelterforce* 159/160 (Fall–Winter 2009).

² Sandra Livingston, “Cleveland housing court judge fines two real estate firms about \$13 million for neglect,” the *Plain Dealer*, June 22, 2010. Available at http://blog.cleveland.com/metro/2010/06/cleveland_housing_court_judge_1.html.

³ NEO CANDO (Northeast Ohio Community and Neighborhood Data for Organizing) is a free, publicly accessible social and economic data system. It can be accessed at <http://neocando.case.edu/cando/index.jsp>.

How Modern Land Banking Can Be Used to Solve REO Acquisition Problems

by Thomas J. Fitzpatrick IV
Federal Reserve Bank of Cleveland

The foreclosure crisis has become a national issue over the past few years, affecting virtually every region of the country. Problems of widespread vacancy and abandonment, however, have persisted primarily in older, shrinking cities, many of which can be found in the Rust Belt, where once-strong industries like manufacturing and raw materials production have moved overseas or otherwise reduced employment. As these industries moved and evolved, the populations of their host cities and their inner-ring suburbs have fallen, while outer-ring suburbs grew.¹ Without steady or increasing population to occupy housing stock, vacancy and abandonment occur organically. The recent foreclosure crisis has aggravated this existing problem for shrinking cities. One of the natural results of foreclosures in such hard-hit areas is an increase in real-estate-owned (REO) properties.

In shrinking cities, as home loans become delinquent and properties go into foreclosure and are auctioned off, it is unsurprising that ownership often reverts to the loan owner; there is simply too little demand to fill the housing stock. Logic dictates a rather predictable cycle: the highest-quality properties will be filtered out of the pool of properties before or after foreclosure through short sales or at foreclosure auctions. This leaves lower-quality houses among those that end up as REOs. Anecdotal reports and empirical research suggest that REO properties in shrinking cities are more frequently distressed than they were even a few years ago.² Private markets often find the REO properties in shrinking cities undesirable, as evidenced by the lack of interest in acquiring them.

Problematic, for sure. But these distressed REO properties can also represent opportunities for local governments to help stabilize, or even revitalize, areas struggling with population loss and an overhang of housing stock. To capitalize on these opportunities, local governments must first overcome the challenges of acquiring REO properties. Two commonly reported challenges that local governments in and around shrinking cities face when trying to acquire REO property are bringing the owners to the table to negotiate for the purchase of REO properties and obtaining the financing necessary to acquire and remediate such properties. This article will explore how modern land banking differs from traditional land banking, and how the newer land banks can be a useful tool to solve these two challenges.

Land Banking: Then and Now

Land banking in one form or another has been around, in Ohio and other states, for more than 40 years. For most of this time, only minor changes occurred in what land banks were thought to be, how they were funded, and the type of properties they acquired. Recent Ohio legislation dramatically overhauled land banking in the state, reshaping the way land banks can be funded and organized and augmenting the powers they have to acquire, address, and dispose of distressed properties.

Land banking was originally used as a municipal tool to acquire and hold large amounts of property for redevelopment as a way to encourage development consistent with municipalities' long-term plans.³ As land banking evolved, some have advocated its use as a tool to further

Distressed REO properties represent opportunities for local governments to help stabilize or revitalize areas struggling with population loss and excess housing stock.

specific goals, such as affordable housing or acquiring and redeveloping tax-delinquent properties.⁴ Traditional land banks shared many limiting features; the most important to this discussion is that they were local government programs that passively received properties either not sold at tax-foreclosure sales or acquired through donation.

Structuring land banks as municipal government programs is limiting in two important ways. First, it means that land banks depend on local governments for funding and staff support, which forces land banks to coordinate the efforts of the multiple agencies that support it without the ability to incentivize those agencies' efforts. It can also cause land banks' funding and operations to be politicized, making it difficult to engage in long-term, optimum strategic planning. Second, the limited geographic scope of municipal land banks' operations prevents them from taking advantage of economies of scale that would be available if they were operating in a wider geography, and from better addressing problems along municipal borders.

Modern land banking has departed from these traditional land banking forms in several key ways. For one, the purpose of land banks has broadened considerably. While the seeds of modern land banking were planted in the Genesee County (Michigan) land bank model, it is in Ohio that modern land banking has further developed.⁵ The Ohio legislation illustrates that modern land banks are no longer simple tools to control future development patterns. Rather, modern land banks assist public and private redevelopment by actively identifying and strategically acquiring parcels otherwise unattractive or unobtainable by public or private markets, clearing their titles, and, where necessary, deciding how to remediate the property to make it attractive for future investment. Another key difference between traditional and modern land banks is that the modern ones are not organized around narrow goals such as furthering fair housing. Instead, they are given a broad public mission and the flexibility to operate as an independent private entity within the

scope of that mission. In Ohio, such land banks are organized as nonprofit corporations with a statutorily defined public mission.⁶

Equally important to modern land banks' flexibility is having dedicated staff and a statutorily defined revenue stream, both of which allow for long-term planning. In addition, modern land banks are organized and funded on a broader geographic scale, allowing them to take advantage of economies of scale when acquiring, rehabilitating, or demolishing properties and when funding their operations. These benefits allow modern land banks to make bulk purchases of REO properties directly from lenders in situations where municipalities, acting on their own, would be unable to do so.

Some Roadblocks on the Path to Acquiring REO Properties

Modern land banks can be powerful tools to acquire REO properties as a way to stabilize, and in some cases revitalize, at-risk neighborhoods. These newer land banks are designed to deal with the distressed property that is more frequently becoming REO in shrinking cities. Additionally, their structure allows them to overcome the challenges municipalities face when attempting to acquire REO properties. In practice, these points are driven home by the success of Ohio's modern land bank in overcoming these challenges.

The ownership of REO properties within a municipality is frequently extremely fragmented. This may be a natural by-product of securitization, which encouraged the aggregation of a geographically diverse pool of loans into a trust that sold securities to a diverse set of investors.⁷ Because geographic diversity was an important factor to many investors during the securitization boom, only the largest REO sellers will own more than a relatively small number of properties in the largest jurisdictions. Even the largest mortgage owners—such as Fannie Mae and Freddie Mac—who may own a significant number of REO properties in a region will generally only own a small number of properties in any one municipality.

The fragmentation of ownership can be a large problem for municipalities. Municipalities tend to only be interested in acquiring properties within their borders, and fragmented ownership makes it very difficult for them to negotiate with any one REO seller for a large number of properties. Because modern land banks typically cover a much broader geography than traditional land banks or any single municipality, fragmentation does not interfere with bulk purchasing to the same extent. The more the geographic scope of the land bank's jurisdiction expands, the more likely it is that the land bank will be able to engage in bulk purchases of properties from REO sellers.

There is usually no shortage of REO properties in shrinking cities or their surrounding suburbs. And it is not uncommon that the acquisition of such property fits into a local government or nonprofit plan to revitalize a neighborhood, suburb, or the central city itself. And yet, once interested prospective buyers find the right people to talk to, they often report having a hard time getting to the negotiating table. Anecdotal reports suggest that this phenomenon is likely aggravated by a few factors. First, as discussed, the securitization of home mortgage loans has fragmented the ownership and servicing of REO property. Second, a municipality or nonprofit will only be interested in properties that are parts of a preexisting development plan covering a narrow geography: municipalities and most nonprofits are not designed to inventory property. These two factors suggest municipalities or nonprofits will likely only be interested in a very small number of properties from any one REO seller at any given time.

These two factors do not fully explain why municipalities would be unable to bring REO sellers to the negotiating table. A third factor, however, might help. Private market participants have shown an interest in buying and holding large quantities of REO properties, ostensibly in the hope or expectation that property values will rise and allow them to sell at a higher price than they paid. Municipalities may have a hard time competing for the attention of

REO sellers against private market participants, in part because private markets are not bound by municipal borders.⁸ Thus, it is more likely that private market purchasers will be more interested in making bulk REO purchases than municipalities will. If acting rationally, REO sellers—who want to be short-term property owners—should prefer to deal with private-market bulk buyers over municipal buyers interested in fewer properties, as it could help reduce REO sellers' transaction costs and time of REO ownership.

Another challenge facing municipalities is obtaining funding. Assuming municipalities can get REO sellers to the table, they often have a hard time obtaining funding to acquire the properties in which they are interested. One reason is that shrinking cities have correspondingly smaller tax bases to fund operations. Additionally, traditional land banks, and often the municipalities themselves, do not have a revenue stream earmarked for acquisition of REO property, and creating new earmarks may be politically challenging. This limits the source of funding for municipal REO acquisition to discretionary funds, which are scarce. This scarcity of discretionary funds is also a natural consequence of shrinking municipalities losing tax base while retaining much of the overhead required when providing government services within their jurisdiction.

How Modern Land Banks Solve these Challenges

Modern land banks are much better suited to bringing REO sellers to the table and funding bulk REO purchases than traditional municipal land banks are. This is due to three features of modern land bank design: their broad geographic coverage, their broad powers to acquire, deconstruct, demolish, lease, mortgage, and rehabilitate inventory, and their dedicated revenue stream. Because they are not limited to a small geography or narrow purpose, modern land banks are better positioned to compete for the attention of REO sellers and can achieve economies of scale and scope not easily obtained by municipalities. In Ohio, for example, modern

Through the deal, the land bank can acquire all of Fannie Mae's foreclosed properties within Cuyahoga County valued at less than \$25,000 for \$1 each.

land banks can negotiate for all of the properties a servicer owns within an entire county. They do not need an immediate use for each property, but instead can inventory those properties that cannot be immediately transferred to developers, municipalities, or nonprofits operating within the land bank's jurisdiction. Inventoried properties can be mothballed, sold, leased, demolished, or deconstructed. Modern land banks can also offer advantages to sellers of REO properties, such as the ability to negotiate for the regular disposal of all of a seller's REO properties within a county. In this way, modern land banks solve the problems caused by lack of municipal collaboration.

Modern land banks have dedicated revenue streams that can be used to fund bulk REO purchases. Such revenue sources are dictated by the land bank's enabling legislation. To date, one of the most innovative funding mechanisms incorporated into modern land banking legislation is Ohio's use of penalties and interest of unpaid real property taxes and assessments to provide a stable, predictable revenue stream for the land bank.⁹ Because this revenue can be used for any purpose within the land bank's public mission, it is not necessary to earmark any portion specifically for REO acquisition. This provides the flexibility necessary to make ad hoc bulk purchases of REO property. In addition, Ohio implements the system county-wide, which frees the revenue stream from fluctuations in any one municipality's real property tax base.

There are many ways a land bank's revenue stream may be structured. For example, modern land banks in Michigan automatically receive property not sold at sheriff's sales and are funded primarily by retaining proceeds from all properties sold out of inventory, either by recapturing a portion of the real property taxes on every property it puts back into productive use for the first five years, or by renting properties that are held in inventory. Ohio, on the other hand, grants similar powers to land banks: They may retain proceeds of properties sold out of inventory and rent a specified amount of their inventory to tenants. Additionally, Ohio increases penalties and fees on delinquent

property taxes and redirects those penalties and fees to land banks. The advantage of the Ohio method is that historically a portion of the population consistently pays property taxes after they are due. This allows land banks to mathematically model their expected revenue streams on a forward-looking basis to support issuing bonds or borrowing from a financial institution to fund operations.

So far this essay is a mostly conceptual discussion of how modern land banks can be a powerful tool for REO property acquisition. It would be incomplete without at least one example of the successful implementation of these concepts. Ohio's modern land banking system, established in 2009, provides just such an example.

Fannie Mae is one of the country's largest purchasers of home mortgage loans. Because of its extensive loan ownership and the current economic conditions, Fannie Mae has found itself with a large REO inventory. In Cuyahoga County, Ohio, numerous municipalities anxious to stabilize their neighborhoods were interested in acquiring some of Fannie Mae's REO properties. However, they had a hard time getting Fannie Mae to the negotiating table. In late 2008, the City of Cleveland opened negotiations with Fannie Mae—a process that took more than a year—but the parties were unable to finalize an agreement.

During this time, Ohio passed what is arguably the country's most innovative land bank-enabling legislation. Six months after it began operating, the Cuyahoga County Reutilization Corporation, or land bank, finalized a landmark deal with Fannie Mae. Through it, the land bank can acquire—without competition from private investors—every one of Fannie Mae's foreclosed properties within Cuyahoga County that are valued at less than \$25,000 for \$1 each. Further, Fannie Mae contributes \$3,500 toward the demolition of each property deemed unsalvageable.¹⁰ Many of the properties acquired in the deal are located in different municipalities within Cuyahoga County, and not all of the properties fit into current development plans—factors that may

have prevented their acquisition in the past. A representative from Fannie Mae explained that the company preferred to work with the land bank because it allowed for ongoing high volume sales to a single purchaser.¹¹ In addition, the deal laid the groundwork for the acquisition of higher-value REO properties by the land bank, when appropriate.

A similar deal was struck with the U.S. Department of Housing and Urban Development (HUD), in which HUD agreed to give the Cuyahoga County land bank a right of first refusal on the lowest-value properties it disposes of. Through the deal, the land bank can purchase any property worth less than \$20,000 for just \$100, while properties worth more than \$20,000 can be purchased at discounts that vary based on the amount of time they have been on the market.¹²

Conclusion

Modern land banks hold great promise as a dynamic community development tool that can help shrinking cities and local parties overcome the two biggest challenges they face when trying to acquire REO property. Practice provides us with a powerful example of their successes. As regions struggle to control their inventories of vacant, abandoned, or REO properties, they would be remiss not to consider the innovative modern land banking approach that is currently being employed in states like Ohio.

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Endnotes

¹ For a more detailed discussion of the building trends and their effects on cities and inner-ring suburbs, see Thomas Bier and Charlie Post, "Vacating the City: An Analysis of New Homes vs. Household Growth" (Washington, D.C.: Brookings Institution, 2003).

² Claudia Coulton and others, "Pathways to Foreclosure: A Longitudinal Study of Mortgage Loans, Cleveland, and Cuyahoga County 2005–2008" (Cleveland, Oh.: Center on Urban Poverty and Community Development, Case Western Reserve University, 2008).

³ See, e.g., Sylvan Kamm, "Land Banking: Public Policy Alternatives and Dilemmas" (Washington, D.C.: Urban Institute, 1970); Model Land Dev. Code (American Law Institute, Tentative Draft No. 6, 1974); and Frank S. Alexander, "Land Bank Authorities: A Guide for the Creation and Operation of Local Land Banks" (New York and Washington, D.C.: Fannie Mae Foundation and LIISC, 2005), on the history of land banking.

⁴ See, e.g., Cassandra N. Jones, "Public Land Banking and Mount Laurel II—Can There Be a Symbiotic Relationship?," *Rutgers Law Journal* 15 (1984): 641–665; and Frank S. Alexander, "Land Bank Strategies for Renewing Urban Land," *Journal of Affordable Housing* 14(2) (2005): 140–169 (discussing more recent land banking efforts).

⁵ The state law required for the Genesee County land bank to operate at its current scale did not pass until 2004—two years after the land bank began operation. See Mich. Const. Art. III, § 5 and Art. VII §§ 27, 28 and 34; 1951 Mich. Pub. Act 35; Mich. Comp. Laws §§ 124.1 and 124.2; 1967 Mich. Pub. Act 7; Mich. Comp. Laws §§ 124.501 et seq. For a discussion of Ohio's recent land bank legislation, see Thomas J. Fitzpatrick IV, "Understanding Ohio's Land Bank Legislation" (Cleveland, Oh.: Federal Reserve Bank of Cleveland, Policy Discussion Paper, 2009).

⁶ This mission is statutorily defined in Ohio Rev. Code § 1724.01(B)(2) (2009).

⁷ Securitization is not a primary topic of this piece, so it will be discussed only briefly. Securitization is accomplished by selling pools of loans into a legal vehicle—a trust—that owns those loans. The loans in any one pool are from broad geographical areas by design; thus, no single trust will have many loans from any particular location. Relative to the number of trusts, there are fewer institutions that serve as servicers of the trusts and have responsibility for inventorying and selling REO properties. Still, there are hundreds of servicers, and even the largest may control only a relatively small number of REO properties in any one municipality.

⁸ In theory, this could be solved through municipal collaboration when acquiring REO properties. If enough municipalities collaborated to make bulk REO purchases, they should be able to compete effectively with private bulk buyers for REO sellers' attention. And yet, a significant collective action problem exists. Major collaborative efforts such as the REO Clearinghouse have had limited

success in coordinating numerous municipalities and other small REO purchasers. This could be due to the difficulties of navigating numerous government bureaucracies and legal restrictions on municipal action, or other political difficulties associated with collaborative government action.

⁹ In essence, Ohio's modern land banks are funded by advancing taxing districts the principal value of real property taxes when they are due, based on historic collection rates. There are multiple ways to fund this advance, for instance: borrowing from the county under Ohio Rev. Code § 307.781 (2009) or issuing unpaid and delinquent tax anticipation securities under Ohio Rev. Code § 133.082 (2009). When taxes are collected, their principal value, plus some interest, goes to pay down the line of credit or security holders. The penalties on delinquent real property taxes, which are increased in counties with land banks under Ohio Rev. Code § 323.121(B)(2) (2009), remain

in the land bank to fund operations. This provides for a stable revenue stream for land bank operations, albeit a moderate one. In Cuyahoga County, Ohio, of which Cleveland is the central city, it is estimated that this will create a revenue stream of \$7 million to \$9 million each year. See Thomas J. Fitzpatrick IV, cited above.

¹⁰ See Sandra Livingston, "Fannie Mae and the new Cuyahoga County land bank forge unique agreement," the *Plain Dealer*, December 16, 2009. Available at http://blog.cleveland.com/metro/2009/12/fannie_mae_and_the_new_cuyahog.html (accessed May 3, 2010).

¹¹ See Sandra Livingston, cited above.

¹² See Sandra Livingston, "HUD agrees to sell foreclosed houses to Cuyahoga County land bank," the *Plain Dealer*, July 2, 2010. Available at http://www.cleveland.com/open/index.ssf/2010/07/hud_agrees_to_sell_foreclosed.html.

The Community Reinvestment Act and NSP: A Banker's Perspective

by Mike Griffin
KeyBank

"Mind the gap! Please mind the gap! Mind the gap between the train and the platform!"

On a recent trip to London, my children were entertained by every variation of this continually repeated warning on the Underground. From the recorded soundtrack at the airport to the conductor at the Notting Hill Gate Tube stop, we heard reminders of just how dangerous the space between the train and the platform can be. These warnings become little more than background noise to those who take the Underground on a regular basis.

In similar fashion, the Community Reinvestment Act (CRA) bank regulators are continually cautioned to "mind the gap" between the written regulations and the reality of what is going on in the world of banking and community development. Interest groups abound. Bankers implore regulators to give them credit for this or that innovation in lending, investment, or service. Banks, for example, believe direct credit as Community Development Loans should be given for letters of credit supporting affordable housing. Community groups, on the other hand, say that there has been "grade inflation" in CRA exams and that every bank is graded as an A or B student. These groups point out the areas where they feel regulators have missed the mark, as well as the banking practices regulators should pay more attention to. Large cities would like more focus on important urban cores, while rural communities say that their needs are ignored in much of the discussion. With all of these apparently competing interests, it is sometimes difficult

for regulators to discern the true nature of communities' needs and banks' CRA efforts as the advocacy voices become background noise from frequent repetition.

In the case of the proposed expansion of the CRA regulation to encourage banks' support of National Stabilization Program (NSP)-eligible activities, the regulatory agencies are "minding the gap" between the regulation and the real world with a positive move to address the issue of vacant and abandoned properties in some of the country's hardest-hit communities. As we move beyond the subprime crisis, through the foreclosure crisis, and on to the growing crisis in vacant and abandoned properties, communities are increasingly saddled with empty, deteriorating houses that devalue neighboring properties, attract crime, and demoralize neighborhoods.

The four bank regulators—the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision—have proposed some changes in the CRA to address the growing problem of vacant and abandoned houses. How banks manage, dispose of, and support the rehabilitation of their real-estate-owned (REO) property¹ can have a significant impact on the survival of a street, a block, a neighborhood, and a city. This new CRA proposal gives banks an added incentive to work with community partners to address this serious issue.

The four regulatory agencies announced the proposal on June 17, 2010, and accepted written comments through August 31. They also

The proposed change to the CRA articulates how banks can partner with community organizations.

held public hearings in three U.S. cities in July and August. A final announcement on the proposal is pending at the time of this publication.

As someone who has worked in the community development field for nearly 20 years, I find it painful to see the hard work of committed community development corporations and other community development professionals being undone by the abandonment of homes, quickly stripped of everything of value, to become a blight on our neighborhoods. While a great deal of this damage is concentrated in low- and moderate-income neighborhoods, a significant number of middle-income areas are also being negatively affected by this issue either directly or through contagion.

The proposed change to the CRA articulates how banks can partner with community organizations to address swelling inventories of REO properties and help stabilize neighborhoods. For example, as written, the CRA applies only to low- and moderate-income borrowers and census tracts, defined as those whose residents, on average, have less than 80 percent of the area median income; however, the NSP allows funds to be used “with respect to families *whose income does not exceed 120 percent of the area median income.*” This discrepancy has made it difficult for banks to determine whether their support of NSP projects would qualify for CRA consideration. The proposal addresses this discrepancy; specifically, it would

revise the interagency CRA regulations by adding to the definition of ‘community development’ loans, investments, and services that support, enable, or facilitate NSP-eligible activities in designated areas identified in plans approved by HUD under the NSP ... A financial institution would receive favorable CRA consideration for a donation of Other Real Estate Owned (OREO) properties to non-profit housing organizations in eligible middle-income, as well as low- and moderate-income, geographies.

In their request for comments, the regulatory agencies asked several questions about this specific proposed change. One asks whether regulators should restrict CRA consideration for NSP activities to only those that are specifically part of a HUD-approved NSP plan. From a banker’s perspective, such a narrow rule would be short-sighted. Given the severity of the vacancy and abandonment issue, particularly in those communities hit hardest by the foreclosure crisis, it is important not to restrict credit for these activities simply because they are not specifically spelled out in an NSP plan.

It is difficult to foresee everything that should be included in a plan in advance of beginning the work. As NSP recipients work through their plans, changes, such as the involvement of a new community partner or a change of physical location because of an inability to gain control of an important structure, are often needed to meet a community’s shifting reality. Regardless of whether it is directly tied to an NSP project, if that activity is consistent with the goals of NSP it should be included for CRA credit. To artificially exclude consideration of all activities consistent with NSP’s intentions, and include only those activities that are part of a plan, would be overly restrictive and would stifle the intended commitment to addressing the current housing quagmire.

Another aspect of the proposal is also welcome—that which would allow banks to take CRA credit for NSP-eligible activities outside of their assessment areas. This part of the proposal recognizes that many institutions have done mortgage lending—and therefore have REO properties—outside of their assessment areas. This provision, of course, comes with the usual caveat that an institution must have “adequately addressed the community development needs of its assessment area(s).” Allowing banks the flexibility to receive credit for NSP-related activities outside of their assessment areas provides banks the opportunity to take a global look at their real estate portfolios instead of segregating the properties inside from those outside their assessment areas. This expansion allows institutions to move forward with

engagement in NSP activities *regardless of the location* of the properties involved, assured that some CRA benefit will accrue to them.

Overall, the proposal will probably have a limited effect on banks' CRA activities. Banks that are engaged with their communities and are in discussions concerning NSP-eligible projects have already assumed that these activities, by their very nature, would qualify for CRA consideration. Because most NSP activity takes place in low- and moderate-income areas, the activity is presumed to qualify, and any issues would be worked through with banks' examiners at their next CRA exam.

While the proposal provides greater certainty about banks' receiving CRA credit and will simplify recordkeeping, it will not be the driving force behind their engagement with communities. The proposal should make institutions with large REO portfolios take a second look at—and perhaps a fresh approach to—how they manage their portfolios outside their assessment areas and evaluate what they can do to work with community groups in middle-income neighborhoods as well as low- and moderate-income areas to facilitate the transfer of properties.

The proposal will, however, increase the banking industry's consciousness of the importance of NSP initiatives and responses to the vacant and abandoned property issue without significantly increasing banks' compliance burden. It may prompt bankers to think and work creatively on ways to address this serious issue. This proposal is a positive sign that the regulators are finding ways to react more nimbly and sort through the cacophony of voices coming at them from different directions. Regulators have heard where financial institutions' and communities' interests have aligned to "mind the gap" between regulation and the very real problem of foreclosed and abandoned properties besieging our communities.

It is the collective responsibility of bankers, along with community groups, to advocate for the needs of our communities and to speak up when we think an important issue is being overlooked by the regulation that has had such a positive impact on the redevelopment of our neighborhoods over the past 30 years. This proposed change to the CRA may be a precursor of more agile regulatory responses in the future. As we have seen over the past few years, circumstances can change rapidly; interagency regulatory change, with its complicated procedures, can be slow and cumbersome. The ability to adapt quickly, with sufficient prudence, will determine the success of the Community Reinvestment Act in helping to address as-yet-unforeseen issues through the remainder of this crisis.

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Endnote

¹ The proposal refers to this as "other real-estate-owned property," or OREO.

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