

Community Development INVESTMENT REVIEW

www.frbsf.org/cdinvestments

FEDERAL RESERVE BANK OF SAN FRANCISCO

Confronting the "Second Wave of the Tsunami":
Stabilizing Communities in the Wake of Foreclosures
Carolina Reid, Federal Reserve Bank of San Francisco

The Accumulation of Foreclosed Properties: Trajectories of Metropolitan
REO Inventories during the 2007–2008 Mortgage Crisis
Dan Immergluck, Federal Reserve Bank of Atlanta

Learning From the Past: The Asset Disposition Experiences of the Home Owners'
Loan Corporation, the Resolution Trust Corporation, and the Asset Control Area Program
*Ellen Seidman, New America Foundation and ShoreBank Corporation
and Andrew Jakobovics, Center for American Progress*

Community Development Financial Expertise Put in
Service of Neighborhood Stabilization
Mary Tingerthal, Housing Partnership Network

Massachusetts' Efforts to Address Foreclosed Properties
Prabal Chakrabarti, Federal Reserve Bank of Boston

Community Land Trusts Work In the Best and Worst of Times
Tina Brooks, State of Massachusetts

Using New Markets Tax Credits to Mitigate the Impact
of Foreclosures on Communities
Anna Steiger, Federal Reserve Bank of Boston



Community Development INVESTMENT REVIEW

The Community Affairs Department of the Federal Reserve Bank of San Francisco created the Center for Community Development Investments to research and disseminate best practices in providing capital to low- and moderate-income communities. Part of this mission is accomplished by publishing the *Community Development Investment Review*. The *Review* brings together experts to write about various community development investment topics including:

Finance—new tools, techniques, or approaches that increase the volume, lower the cost, lower the risk, or in any way make investments in low-income communities more attractive;

Collaborations—ways in which different groups can pool resources and expertise to address the capital needs of low-income communities;

Public Policy—analysis of how government and public policy influence community development finance options;

Best Practices—showcase innovative projects, people, or institutions that are improving the investment opportunities in low-income areas.

The goal of the *Review* is to bridge the gap between theory and practice and to enlist as many viewpoints as possible—government, nonprofits, financial institutions, and beneficiaries. As a leading economist in the community development field describes it, the *Review* provides “ideas for people who get things done.” For submission guidelines and themes of upcoming issues, visit our website: www.frbsf.org/cdinvestments. You may also contact David Erickson, Federal Reserve Bank of San Francisco, 101 Market Street, Mailstop 215, San Francisco, California, 94105-1530. (415) 974-3467, David.Erickson@sf.frb.org.

Center for Community Development Investments
Federal Reserve Bank of San Francisco
www.frbsf.org/cdinvestments

Center Staff

Joy Hoffmann, FRBSF Group Vice President

Scott Turner, Vice President

John Olson, Senior Advisor

David Erickson, Center Manager

Ian Galloway, Investment Associate

Advisory Committee

Frank Altman, Community Reinvestment Fund

Jim Carr, National Community Reinvestment Coalition

Prabal Chakrabarti, Federal Reserve Bank of Boston

Catherine Dolan, Wachovia Community Development Finance

Andrew Kelman, Bank of America Securities

Judd Levy, New York State Housing Finance Agency

John Moon, Federal Reserve Board of Governors

Kirsten Moy, Aspen Institute

Mark Pinsky, Opportunity Finance Network

John Quigley, University of California, Berkeley

Benson Roberts, LISC

Ruth Salzman, Ruth Salzman Consulting

Ellen Seidman, ShoreBank Corporation and
New America Foundation

Bob Taylor, Wells Fargo CDC

Kerwin Tesdell, Community Development Venture
Capital Alliance



Table of Contents

Confronting the “Second Wave of the Tsunami”: Stabilizing Communities in the Wake of Foreclosures	1
<i>Carolina Reid, Federal Reserve Bank of San Francisco</i>	
The Accumulation of Foreclosed Properties: Trajectories of Metropolitan REO Inventories during the 2007–2008 Mortgage Crisis.....	7
<i>Dan Immergluck, Federal Reserve Bank of Atlanta</i>	
Learning From the Past: The Asset Disposition Experiences of the Home Owners’ Loan Corporation, the Resolution Trust Corporation, and the Asset Control Area Program	43
<i>Ellen Seidman, New America Foundation and ShoreBank Corporation and Andrew Jakobovics, Center for American Progress</i>	
Community Development Financial Expertise Put in Service of Neighborhood Stabilization	53
<i>Mary Tingerthal, Housing Partnership Network</i>	
Massachusetts’ Efforts to Address Foreclosed Properties	65
<i>Prabal Chakrabarti, Federal Reserve Bank of Boston</i>	
Community Land Trusts Work In the Best and Worst of Times.....	73
<i>Tina Brooks, State of Massachusetts</i>	
Using New Markets Tax Credits to Mitigate the Impact of Foreclosures on Communities	76
<i>Anna Steiger, Federal Reserve Bank of Boston</i>	

Foreword

Real Estate Owned

Ian Galloway
Federal Reserve Bank of San Francisco

April 2009

The collapse of the housing market has devastated neighborhoods and balance sheets alike. Millions of homeowners have defaulted on their mortgages and holders of mortgage-backed securities (MBS) have suffered massive write-downs. Banks and servicers have been increasingly called upon to renegotiate payment terms and reduce mortgage principle to slow the tide of foreclosures and stabilize the housing market. Despite such attempts to “work out” troubled mortgages, however, the foreclosure rate continues to rise at a steady pace.¹

Lost in the current economic turmoil is a discussion of what happens to properties when they have completed the foreclosure process and revert back to the primary mortgage lender.² In some cases, foreclosed properties are auctioned off or converted to rental housing. In others, they are razed or put into public use. In many cases, however, foreclosed properties remain unoccupied and become a financial drain on their owners. Such properties are known as real estate owned (REO).

Barclays Capital estimates that as of November 1, 2008, mortgage lenders and investors held 871,000 REO properties—up from 414,000 a year earlier. That inventory is expected to peak around 1.4 million in mid-2010.³ For communities that experienced rapid housing appreciation, the REO fallout has been particularly acute. In this issue of the *Community Development Investment Review*, Dan Immergluck provides city-level data that raises alarming questions about the stability of communities overwhelmed by abandoned properties. Yet from a community development standpoint, this large inventory of REOs offers an unprecedented opportunity to increase the nation’s stock of affordable housing. Community organizations and housing authorities across the country have been exploring ways to acquire REO properties and make them available to low-income homeowners and renters.

Holding REO properties can be a significant ongoing expense. Taxes, insurance, and repairs slowly erode owners’ equity in a down housing market.⁴ Concern over these costs has led many lenders to sell their REO properties at significant discount; recouping, on average,

-
- 1 Les Christie, “11% of Mortgages are Troubled.” CNNMoney, March, 5, 2009, available at http://money.cnn.com/2009/03/05/real_estate/record_delinquency_rates/?postversion=2009030512.
 - 2 Foreclosed properties do not always become the possession of the primary mortgage lender. When the foreclosed mortgage has been securitized, trusts (typically servicers) operate on behalf of the investors that own the security. For the purposes of this article, “mortgage lender” will serve as shorthand for the entity that controls the property upon foreclosure.
 - 3 James Hagerty, “Real-Estate Finance: Lenders Tiptoe Into Bulk Sales—Glut of Foreclosed Homes Spurs Some Trial Runs,” Wall Street Journal, December 2, 2008, C12.
 - 4 Kate Berry, “REO Strategy: From Daily Task to Damage Control,” American Banker, October 12, 2007, available at <http://www.americanbanker.com/article.html?id=200710105JC7NWG9&queryid=1246839635&hitnum=13&pagenum=1&numpages=3>.

only 70 percent of the attached mortgage principal balance.⁵

These discounted prices have allowed some community organizations and housing authorities to purchase REO properties and put them back into effective use for low-income homeowners and renters. To date, these purchases have been sporadic and uncoordinated, mostly because of capacity and funding constraints.

Locating REO properties for potential purchase and rehabilitation can be a time-consuming and costly process. Few community organizations are equipped to identify, bid on, and acquire properties efficiently and cost-effectively. To assist these organizations many advocates have proposed online platforms to catalogue REO properties in an easily searchable format. Prabal Chakrabarti notes in this journal that such a database will soon be available in New England, and others are expected to follow. These online tools will lower REO acquisition costs and give smaller community organizations better access to REO properties. Large nonprofits have also emerged to provide capacity-building support. In her article, Mary Tingerthal discusses how the National Community Stabilization Trust (Stabilization Trust) has supported community organizations operating in neighborhoods experiencing a high incidence of foreclosure.

The Stabilization Trust has also advocated for increased neighborhood redevelopment funding. According to Tingerthal, the Stabilization Trust successfully lobbied Congress to set aside \$3.92 billion of the \$300 billion appropriated for the Housing and Economic Recovery Act of 2008 to fund the Neighborhood Stabilization Program (NSP). The NSP will directly support REO disposition through the Community Development Block Grant (CDBG) program. Other sources of federal funding are available as well. For example, Anna Steiger explores the use of the New Markets Tax Credit program as a vehicle to acquire REOs. As the foreclosure crisis worsens, more federal and state programs will undoubtedly be tapped to mitigate its effect on community stability.

In general, housing authorities and community organizations can reduce the national inventory of REOs in three key ways:

Scattered Site Acquisition and Rehabilitation

REO properties are disproportionately concentrated in inner-city communities.⁶ Housing authorities and community organizations can acquire and rehabilitate these properties to help address the national urban affordable housing shortage. In their article profiling three federal asset-disposition programs, Ellen Seidman and Andrew Jakobovics point out that this approach has been successful in the past. They maintain that targeted REO acquisition and rehabilitation, if sufficiently informed by previous attempts, could achieve two community development goals simultaneously: returning abandoned homes to occupancy, and increasing the stock of affordable housing in low-income communities.

Land Banking and Deed-Restricted Affordability

While an acquisition and rehabilitation strategy would result in a one-time increase in

5 Brian Collins, "Fannie Having Debt Woes," National Mortgage News, November 21, 2008, available at <http://www.americanbanker.com/article.html?id=20081121KTHBM848&queryid=838962708&hitnum=4>.

6 Teresa Lynch, "Foreclosures and the Inner City: The Current Mortgage Crisis and its Inner City Implications," ICIC Policy Briefing, March, 2008, available at http://www.icic.org/atf/cf/%7BC81898B2-76E9-4A18-B838-A3F65C9F06B9%7D/ICICReport_ForeclosuresInnerCityFINAL%20080421.pdf.

available affordable housing units, those units will become unaffordable as housing market appreciation resumes. One solution to this problem is “land banking”—limiting a property’s resale value through deed restriction. Tina Brooks discusses this strategy in this issue as she explores the possibility of making land banking a sanctioned municipal activity in Massachusetts. As Brooks notes in her article, capping appreciation allows land-banked properties to remain affordable for an extended period. Housing authorities and nonprofits can adopt this approach with REOs and price discounts can be passed directly to the homeowner. The flip side of this tactic is that homeowners will be unable to capitalize on significant gains in the housing market.

Blight Remediation and Housing Stock Contraction

A foreclosed home can significantly affect the value of the properties surrounding it. Some researchers have estimated that a foreclosed property can depress adjacent home values by as much as 8.7 percent.⁷ Although this effect decreases over time and distance, most homeowners would agree that living next to an unoccupied home is undesirable for a number of reasons, not the least of which being crime and fire risk. In cities that have suffered significant population decline, housing-stock contraction may be the best long-term strategy for rehabilitating neighborhoods racked by foreclosures and abandoned properties. This contraction might involve combining property parcels or razing buildings and auctioning off the underlying land to prospective mixed-use developers. In either case, blight is eliminated and local housing supply is reduced (potentially increasing the value of the homes that remain).

These approaches, and others explored in this journal, are just a few of the ways that REO properties can be used for public benefit. As foreclosures continue to mount and house prices continue to decline, more homeowners will find themselves in a negative equity position or unable to make their mortgage payments, or both. Already, one in five American homeowners is underwater—owing more on their homes than they are worth—and that number is expected to increase.⁸ This presents a community development challenge on two fronts. First, there is an immediate need to put millions of recently foreclosed-upon families into homes with affordable mortgage or rental terms. Second, the inventory of REO properties must be reduced before it threatens to destabilize neighborhoods across the country. For either of these goals to be met, Carolina Reid offers three lessons to the community development field: more data are needed for targeted intervention, cross-sector collaboration is critical, and complex sources of funding must be managed and leveraged to achieve maximum impact. With billions of newly disbursed federal funds, the community development industry should heed these lessons and develop a coherent national strategy to put REO properties back into effective use.



Ian Galloway

7 Z. Lin, E. Rosenblatt, and V. Yao, “Spillover Effects of Foreclosures on Neighborhood Property Values,” *Journal of Real Estate Finance Economics* 38 (4) (2009).

8 Jonathan Stempel, “One in Five U.S. Homeowners Are Underwater,” Reuters, March 4, 2009, available at <http://www.reuters.com/article/domesticNews/idUSN0349273420090304>.

Confronting the “Second Wave of the Tsunami”: Stabilizing Communities in the Wake of Foreclosures

Carolina Reid

Federal Reserve Bank of San Francisco

In July 2008, the Federal Reserve Bank of San Francisco convened a symposium in Los Angeles on the topic of stabilizing communities in the wake of foreclosures. The goal of the conference was to identify strategies that could help to mitigate the negative spillover effects of foreclosures on families and neighborhoods.¹ Frank Ford, a veteran community developer from Cleveland, caught everyone’s attention when he referred to the rise in real estate owned properties (REOs) as the “second wave of the tsunami.” With maps of Cleveland literally covered with dots of REOs, Ford graphically showed that communities no longer have to contend solely with the loss of assets and home ownership associated with foreclosure, but that they must now also confront the crime, neighborhood disinvestment, and loss of revenue associated with concentrations of vacant and abandoned properties. There was a collective recognition in the room that the current foreclosure crisis threatens to undo years, if not decades, of community investment.

Confronting this challenge will be far from easy. The current scale of the foreclosure crisis, coupled with an economic recession and the freezing up of credit markets, dwarfs previous efforts at property disposition (See article by Seidman and Jakabovics in this issue). There isn’t much of a road map for how to successfully redevelop the current wave of REOs, and the symposium highlighted that in the area of neighborhood stabilization there are still more questions than there are answers, and more innovative ideas than best practices. Most of the programs were still “in development” or a “small-scale pilot,” while others were “waiting to see what kinds of federal funds may be directed toward property acquisition.” Servicers at the symposium were still struggling with understanding their legal obligations under loan pooling and servicing agreements, and were resistant to talk about bulk sales or significant discounts on REO properties. Would federal funding for property acquisition come through? How do you value REO properties in a declining housing market? At the end of the symposium, participants were energized about the possibility of figuring out solutions to these challenges, but there was also a real sense that the community development field was being tasked to stop a tsunami with a sandbag.

Emerging Lessons

The field has come a long way in nine months. Importantly, Congress authorized \$3.92 billion in neighborhood stabilization grants as part of the 2008 Housing and Economic

¹ The Symposium was part of a Federal Reserve System initiative, *Recovery, Renewal, Rebuilding*, a series of forums held across the country in 2008 to share information about how communities are responding to the challenges associated with concentrated foreclosures. For more information, visit <http://www.stlouisfed.org/rrseries/>.

Recovery Act. Administered through the Community Development Block Grant (CDBG) program, the Neighborhood Stabilization Program (NSP) grants can be used to acquire land and property; to demolish or rehabilitate abandoned properties; and/or to offer down-payment and closing-cost assistance to low- to moderate-income home buyers. The American Recovery and Reinvestment Act of 2009 has further boosted funds for community development, including an additional \$2 billion for NSP, \$100 million in capital for qualified community development financial institutions, as well as new allocations for HOME, CDBG, and public housing. Hopes are high that these programs can be leveraged to help bolster community reinvestment, and that the administration's newly announced housing plan—which emphasizes homeownership affordability and encourages streamlined loan modifications—will work to prevent additional foreclosures.

In addition to federal funding to support neighborhood stabilization, since July 2008 the community development field has also increased its capacity to respond to concentrated foreclosures. Key among these developments has been the creation of the Neighborhood Stabilization Trust, a collaborative effort between NeighborWorks, Enterprise, LISC, and the Housing Partnership Network. (See article by Mary Tingerthal in this issue.) And in the field, as local governments and nonprofits develop and implement their NSP plans, some of the “innovative ideas” raised in panels last July are being tested on the ground.

While it is still too early to put a definitive stamp on what works and what doesn't, the experiences of municipalities across the country are starting to pave the way for a better understanding of how to approach neighborhood stabilization.² In reviewing these strategies, there appear to be three key lessons emerging across sites.

Using Data to Target Interventions

The first lesson is to use data to help identify where investments should be targeted. Granted, the challenge of accessing accurate and timely data on foreclosures is a formidable one. Data on foreclosures are notoriously difficult to work with: most of the data sources are proprietary, do not include important information about the borrower, loan terms, or servicer, and have imperfect coverage, particularly at the local level.

A few cities—most notably Cleveland and Minneapolis—have developed robust data management systems that collect detailed information on neighborhood-level foreclosures. These systems have been incredibly helpful in guiding foreclosure prevention efforts, and now form the foundation for understanding which areas to target for REO acquisition. In Cleveland, for example, the NEO CANDO system has allowed nonprofits to identify which properties are at risk for foreclosure and abandonment so that they can target that home for foreclosure prevention activities, including visits from nonprofit staff and the dissemination of financial literacy information. The data have also guided the development of Neighbor-

2 For an excellent review of the issues associated with foreclosed properties and neighborhood stabilization, see Josiah Madar, Vicki Been, and Amy Armstrong. “Transforming Foreclosed Properties into Community Assets,” NYU Furman Center for Real Estate and Urban Policy White Paper, December 2008.

hood Progress Inc.'s Strategic Investment Initiative, which focuses on the comprehensive redevelopment of six "model" neighborhood blocks, and targets those blocks with a wide range of interventions including foreclosure prevention, land assembly, demolition, acquisition and rehab, and home and landscaping improvements.³

For the rest of us who do not have access to these Cadillac data systems, however, there is still a lot that can be learned from existing information, even if it isn't perfect. For example, neighborhoods with a high proportion of higher priced loans in 2004 and 2005 are almost certainly neighborhoods that are now dealing with concentrated foreclosures; these HMDA data are publicly available and easily accessed through dataplace.org. Aligning these data with Census data on race and/or income can help to define priorities associated with racial or socioeconomic equity. In addition, there are also many local sources of information that can help to identify neighborhoods at risk of the negative effects of foreclosure. Local real estate agents can provide important insights about which neighborhoods are still attracting new buyers, utility companies can provide information on the number of properties shutting off their water or electricity, or a local nonprofit may help to shed light on which immigrant communities have been affected based on who is seeking out foreclosure prevention counseling. In addition, some of the best NSP plans integrate these new federal funds with existing priorities or investments, such as aligning NSP target neighborhoods with city redevelopment areas.

The City of Los Angeles provides a compelling example of how the strategic use of data can help to guide a comprehensive strategy for neighborhood stabilization as well as build political support for the strategic use of resources. Mercedes Márquez, the general manager of the Los Angeles Housing Department, recognized early on that the strategic use of data was critical to developing targeted interventions in Los Angeles, a city larger in size than Boston, Cleveland, St. Louis, Pittsburgh, Minneapolis, Milwaukee, San Francisco, and Manhattan combined. Using data obtained relatively inexpensively from DataQuick, they learned that foreclosures in Los Angeles were a two-pronged problem: the city had to grapple with significant concentrations of multifamily foreclosures in South Los Angeles, a predominantly low-income, minority part of the city, as well as concentrations of foreclosed single-family homes in the San Fernando Valley. The city then aligned these data with existing priorities, such as the preservation of affordable rental housing and transit-oriented development. The result: a strategy that targets NSP investments in a way that supports these other goals.⁴ Márquez notes that the guiding principle for developing their NSP plan was, "How many of our values can we hit with the same dollars?" The data were also important in helping to build political support among city council members about the need for targeting interventions and avoided the problem of local infighting over who and where would get the most NSP dollars.

In all of this, the foreclosure data were only a small part of L.A.'s analysis. Perhaps more

3 For more information, see <http://www.stablecommunities.org/node/1489>.

4 Mercedes Márquez, "Models of Vacant Property Disposition: Los Angeles Housing Department," presented at *Confronting the Neighborhood Impacts of Foreclosure Conference*, Federal Reserve Board, Washington, D.C., October 20, 2008. Available at http://www.stlouisfed.org/rrseries/event_5.html.

important were the answers to questions like “Where do we want to preserve affordable multi-family rentals? Does the existing single-family-housing stock (small, two-bedroom/one-bath homes) meet the needs of current families, or should we use this as an opportunity to “resize” foreclosed homes? Where can we complement our existing investments in transit-oriented development? Where will prospective home buyers be able to “cherry pick” high quality foreclosed properties, so all we need to do is provide some down-payment assistance?” It was the answers to these questions that allowed the city of Los Angeles to develop a strategy for foreclosed properties that was responsive to the market forces affecting its neighborhoods.

Cross-Sectoral Collaboration

If data are critical to developing effective interventions, so is the establishment of a local collaborative or task force that brings together a wide range of stakeholders, from nonprofits, researchers, and state and local governments, to real estate agents, servicers, and lending institutions. The scale of the foreclosure problem, coupled with the complexity of acquiring, rehabbing, and selling REO properties, means that it is impossible for any one entity to take on the task alone.

Take, for example, the role of the servicer in REO disposition strategies: lenders and servicers control the information about the REO inventory, are responsible for REO property maintenance and upkeep, and determine the REO sales price on behalf of the properties’ investors. Many of the large servicers are participating in the National Stabilization Trust’s “First Look” and “Bulk Purchase” programs, yet there is still a need to engage local servicers and CRA officers in the development of neighborhood stabilization strategies. Heidi Coppola, formerly of Citibank, notes that local servicers and bankers are often more knowledgeable about local market conditions than national REO units, and as a result can be an important ally to nonprofits in negotiating discounted sales that make sense for both the community and the investors. CRA officers in particular can also be important partners in providing end-loan financing once the acquired REOs are ready for resale to newly qualified home owners.

In Massachusetts, a statewide task force initiated by the Urban Land Institute and the Massachusetts Association of CDCs was critical in helping to develop a multipronged approach to foreclosures in the state.⁵ By building on the strengths of multiple partners, the task force was able to develop local models for neighborhood stabilization and helped to build political support for a \$20 million revolving loan fund for property acquisition. (See article by Prabal Chakrabarti in this issue.) At the symposium, Rebecca Regan, COO of Boston Community Capital, said that the Massachusetts Task Force has been effective because it has tackled the problem from all directions, including foreclosure prevention,

5 Prabal Chakrabarti, “Foreclosed Properties in Massachusetts: Early Responses,” presented at *Confronting the Neighborhood Impacts of Foreclosure Conference*, Federal Reserve Board, Washington, DC, October 20, 2008. Available online at http://www.stlouisfed.org/rrrseries/event_5.html.

code enforcement and vacant-property ordinances (the “stick” that can help bring servicers to the table), data collection and dissemination to community groups, and models for property acquisition and disposition.

While nonprofits and servicers/lenders are clearly key partners in neighborhood stabilization efforts, other groups can also play an important role in delivering services and helping to fill in gaps in capacity. For example, in Colorado, Funding Partners for Housing Solutions has been working with the housing authority on its strategy to stabilize communities. The housing authority has the experience of managing scattered-site rental housing and also has connections to the social services residents will need to get back on a path to financial stability. Mission-oriented real estate brokers can help to connect prequalified home buyers with foreclosed and REO properties with minimal public investment. In other cities, NSP plans rely on engaging private developers for acquisition and redevelopment, paying a developer incentive fee once the home is sold to a qualified home buyer.

Leverage Multiple Sources of Funding

The third lesson is to leverage public funding and to use it effectively. After all, let’s be honest; while the NSP funds are a welcome addition to local neighborhood stabilization efforts, even now with \$5.92 billion allocated to NSP, this level of funding is a drop in the bucket. Mercedes Márquez puts Los Angeles’ NSP allocation in perspective: the \$33 million that L.A. received is probably just about enough to turn around 150 properties, yet in September 2008 the city had more than 18,000 units in foreclosure.

Several neighborhood stabilization strategies, therefore, are drawing in other sources of funding to make acquisition and redevelopment possible, including HOME funding, Lead Abatement Grants, FHA’s 203(k) program, and local private investment or revolving loan funds. Washington, DC, and Columbus, Ohio, are both making use of New Markets Tax Credits to redevelop areas affected by foreclosures. (See article by Anna Steiger in this issue.) In New York, the city is supplementing its NSP grant with \$6 million from the Battery Park City Authority Housing Trust Fund.⁶

Floyd Gardner of NHS Chicago also provided an important word of caution: nonprofits should not underestimate the carrying costs of holding properties either, particularly in the current climate of declining property values and tightened credit availability. Under these conditions, it may be difficult to find willing and able buyers, and nonprofits may face the need to find additional subsidies or offer deeper discounts to sell the rehabbed homes. In light of this, many groups are exploring other disposition strategies, such as Self Help’s lease-to-purchase model, that do not rely on quickly finding new home-owners.⁷

⁶ See <http://www.innovations.harvard.edu/news/144041.html>.

⁷ See *Self-Help: National Initiative to Bring Lease Purchase to Scale, Secondary Market Initiative to Help Absorb Excess Inventory*, available at <http://www.stablecommunities.org/node/450>.

Effectively Valuing REO Properties

Ultimately, one of the most important factors that will influence the success of NSP and other community stabilization efforts is the ability to negotiate sufficiently discounted house prices to make the acquisition and redevelopment of REOs into affordable housing feasible. At the San Francisco Fed conference in July 2008, many participants noted that a key challenge was negotiating house values: declining property values and servicers' obligation to sell the property at the highest value to meet investor contracts constrained the ability to determine a fair price for REOs. Since the symposium, one of the key innovations has been the development of a model that helps to determine the "net realizable value" of REO properties, which attempts to capture the "current" market value minus the costs of disposition (including the holding costs of insurance, real estate taxes, maintenance, transaction costs, rehab costs required for code compliance, and marketing).⁸ While posing its own challenges, this approach may bring seller prices closer to what nonprofits may be able to pay based on program feasibility (e.g., rental income, affordability for low- and moderate-income home buyers).

Conclusions

While these emerging lessons provide a framework for neighborhood stabilization, many questions remain unanswered. For example, what are the right policy responses in the "boomburbs" of cities like Atlanta, Stockton, Phoenix, and Las Vegas? (See article by Dan Immergluck in this issue.) What are the best ways to leverage NSP funds in communities that have less infrastructure or experience related to housing or community development strategies? What will be the impact on communities if the bulk of REOs are swept up by investors rather than home owners? And can the community development field—which even in the best scenarios may be able to redevelop only a fraction of the growing REO inventory—really have much of an impact? Ultimately, the answer to that question may depend on whether or not the NSP program is a one-time federal investment that may make a difference on the margins, or whether it represents the first step in a much more concerted and longer-term effort to bring reinvestment and responsible lending back into low- and moderate-income communities.

Carolina Reid manages the community development research group at the Federal Reserve Bank of San Francisco. She conducts community development research and policy analysis, with a special focus on asset building and housing issues. Carolina earned her PhD in 2004 from the University of Washington, Seattle.

8 Charles Laven, "Pricing and Valuation of Vacant Properties: Developing a Neighborhood Stabilization Approach," presented at *Confronting the Neighborhood Impacts of Foreclosure Conference*, Federal Reserve Board, Washington, DC, October 20, 2008. Available online at http://www.stlouisfed.org/rrrseries/event_5.html.

The Accumulation of Foreclosed Properties: Trajectories of Metropolitan REO Inventories During the 2007–2008 Mortgage Crisis¹

Dan Immergluck

*Federal Reserve Bank of Atlanta*²

In addition to causing financial and social hardship to families and individuals, high foreclosure rates can have negative effects on neighborhoods, cities, and metropolitan regions. One key concern among policymakers and community developers is the extent to which lender-owned homes, often called real estate owned or REO properties, accumulate in different local housing markets. The neighborhood and community impacts of foreclosure are expected to be worse if foreclosed properties sit vacant for significant periods of time and are not absorbed back into the market in some productive way. The inventory of REO properties in a local housing market or submarket may become not just a symptom of housing market decline but an impediment to recovery. An increasing amount of REO inventory in a local or regional housing market may discourage price stabilization and the return of even moderate levels of home purchase activity and financing.

A related reason for concern over the accumulation and aging of REO in a local market involves the negative effects of spatially concentrated vacant homes, especially if their physical condition deteriorates.³ If REOs are disproportionately concentrated in some neighborhoods, and if some of these properties fall into disrepair or become blighted or vandalized, they may have particularly strong negative impacts on these neighborhoods.⁴ One particular sign of potential problem REO properties are those properties that have been held by banks for more than a few months. Thus it is important to examine the aging of REO inventory—the length of time that properties have been owned by the lender.

1 This paper first appeared at a Federal Reserve Bank of Atlanta, Community Affairs Discussion Paper 02-08.

2 The author thanks Kris Gerardi, Todd Greene, Karen Leone de Nie, Brian Mikelbank, Roberto Quercia, and Geoff Smith for comments on an earlier version of this paper. All errors, omissions, and opinions remain solely the author's responsibility. The views expressed here are the author's and not necessarily those of the Federal Reserve Bank of Atlanta or the Federal Reserve System. Comments to the author are welcome at daniel.immergluck@atl.frb.org.

3 Not all REO properties are vacant, or vacant during the entire REO period. Non-owner-occupied rental properties that go into foreclosure, particularly in states with tenant protection laws, may be particularly likely to be occupied during some or all of the REO period. On the other hand, in most states, lenders are able to evict tenants fairly quickly after taking possession of a foreclosed property.

4 It is important to point out that just because a property “exits” from REO inventory does not necessarily mean that the property has been returned to some productive use that is beneficial to a community. Properties may continue to sit vacant or may be purchased by “bottom feeders” who may not rehabilitate dilapidated properties, etc. In the longer term, properties may even become tax-delinquent and abandoned. The analysis in this paper does not address the nature or disposition of the property after it exits REO status. See Coulton, Schramm and Hirsh (2008) for an excellent analysis of post-REO properties in the Cleveland area.

Although they pose many challenges, REO properties can also present opportunities for community developers and policymakers to turn the homes into a source of long-term affordable housing or provide opportunities for other forms of redevelopment by providing relatively low-cost land and building stock. The growth and concentration of REO properties in various neighborhoods and cities has prompted a variety of policy and programmatic responses, first by many local governments and nonprofits and more recently at the federal level with the advent of the Neighborhood Stabilization Program (NSP). The NSP, which was authorized in the 2008 Housing and Economic Recovery Act, provides \$3.92 billion in funding over 18 months to state and local governments for neighborhood recovery from foreclosures.⁵ NSP funds can be used for a variety of purposes related to neighborhood stabilization, including the purchase and redevelopment of foreclosed properties by governmental or quasi-governmental entities such as land banks, the demolition of such properties, or the financing of home-purchase activity.

Despite the attention and policy response aimed at the problems of vacant, foreclosed homes, data on REO properties in the United States are generally quite scarce, especially in a form that is highly comparable across different localities or regions. In this article I seek to describe the spatial distribution of REO properties across U.S. metropolitan areas. I examine the growth of REO inventory, with particular attention to REO trajectories, in a set of thirteen large metro areas with relatively high levels of REO activity. I also look at the aging of recent REO inventory. That is, I examine the extent to which REO properties have been in REO for more than a few months, as well as those held for over one year. The purpose of this aging analysis is to determine whether some metro areas with large numbers of REO may be experiencing only high levels of “frictional” or short-term REO, in which properties are sold within a few months, but not numerous properties that stay in REO for longer periods. Conceivably, some metro areas experiencing very high foreclosure rates may also see properties go into and out of REO very quickly. Such properties might be expected to have less deleterious impacts on neighborhoods than those remaining in REO—and likely vacant—for longer periods of time. Finally, I use cluster analysis to identify similar groups of MSAs using initial levels of REO inventory and changes in house-price appreciation.

This article is intended to be a first look at REO inventory trajectories during the most recent mortgage crisis cycle of 2007 and 2008. To do this, I examine data from August 2006 to August 2008. The analysis is not exhaustive. Given the fast-moving nature of foreclosure problems in recent years, following up this work with additional research will be important.

One limitation of this article is that its analysis is at the level of metropolitan statistical areas (MSAs). The MSA is a common, but quite large, geographical level of housing market hierarchy. Some smaller MSAs may approach a notion of a fairly unified, unsegmented housing market. In most large MSAs, however, there can be many geographic submarkets that are somewhat distinct from one another. In such metro areas, there may be both areas

5 For more detail on the Neighborhood Stabilization Program see Mallach (2008).

with little REO activity and other areas with substantial REO activity. Notwithstanding these submarket variations, MSAs represent a common notion of regional housing markets, and their use captures the very substantial regional differences in REO trajectories and composition. My intent in the future is to scope down in several high-REO metropolitan areas to examine submetropolitan patterns of REO to understand which parts of these metro areas have experienced the greatest buildup of REO and to explore the aging of REO in such places. But that will need to wait for a subsequent article.

Data on REO Properties—from Local to National

Although researchers have increasingly focused their attention on foreclosure-related issues in recent years, the paucity of comprehensive, cross-market data on REO properties has made it difficult to gain a strong understanding of the REO problem since the advent of the 2007–2008 mortgage crisis. Data on foreclosures and post-foreclosure properties, such as REO, are not compiled on a regular, uniform basis by any public agency at a multistate level. Public real estate records can be used in many places to identify lender-owned properties, although the process can be quite labor intensive, and the quality and accessibility of such data vary across local jurisdictions (often counties). Some firms purchase or assemble local property records data and/or foreclosure notices or filings and compile them for resale. Again, however, due to variation in state law, state data systems, and local property records, the uniformity of these data can be quite limited.

In any one locality or region, the best data on REO properties may well be local or state property records or private real estate listing data. Assuming these data are accessible, they can provide valuable information on REO properties. However, they may also be limited in that they may provide relatively little information concerning the nature of the financing related to the property before it was foreclosed upon (or assumed in some alternative to foreclosure).

My objective is to compare trends in REO activity across metropolitan housing markets. Therefore, using local property records data is not practical. Instead, I use a private, large national database of mortgages, the Lender Processing Services Inc. (LPS) Applied Analytics data set (formerly referred to as the “McDash Analytics” data set), to describe REO buildup and aging across most metropolitan areas in the United States, with some special emphasis on a set of large metropolitan areas with relatively high levels of REO.

The LPS data are compiled from mortgage servicing firms that collect mortgage payments for investors and lenders and handle the associated REO for these loans. By August 2008, nine of the top ten servicers and a total of sixteen firms provided data to LPS. The data set includes monthly information, including REO status, on more than 100 million loans, including more than 30 million loans that are currently active. Loans stay in the LPS data set through the REO process, making it useful for the purposes here. However, the data set does

not capture all mortgages, and it significantly underrepresents the subprime market.⁶ Therefore, I have prepared a number of measures using weights based on comparing the LPS data to other information on the size and composition of the mortgage market. This approach and more information on the LPS data are described in more detail in the appendix.

A Cross-Sectional Look at REO Density across Metropolitan Areas, August 2008

I begin by calculating the number of prime/near-prime and subprime REO properties in the LPS database in August 2008 across 358 MSAs in the United States.⁷ This is done by identifying loans in REO status in the LPS database in that month. Subprime loans are identified in the data, allowing one to distinguish between prime/near-prime and subprime REO. These raw REO counts are then divided by the estimated number of “mortgageable properties” in the MSA in 2006. This denominator is estimated using the Census Bureau’s 2006 American Community Survey. I will refer to the ratio of REO properties per 10,000 mortgageable properties as “REO density.” The REO density measure has the advantage over a measure of REO as a share of outstanding loans because it indicates the prevalence of REO properties relative to single-family and condominium housing stock in the region. From a community development and neighborhood stabilization perspective, this is generally a preferred measure of REO inventory.

I present some analysis using the prime/near-prime and subprime REO densities calculated from the LPS data and American Community Survey data only. However, in order to obtain an estimate of total REO density for each MSA, and especially because the LPS data is estimated to cover a smaller portion of the subprime (versus prime/near-prime) market, I also provide and use estimates of “total REO.” I do this by adjusting the subprime and prime/near-prime REO densities upward to reflect the estimated total markets (using industry estimates of outstanding prime/near-prime and subprime loans) for each loan type and then summing these adjusted figures. The subprime and prime/near-prime REO densities calculated directly from LPS, which I call “unadjusted” densities, are adjusted upward by national scaling factors for prime/near-prime and subprime loans separately. (See the appendix for more details.) Because the estimates of total density depend on the adjustment factors used, an alternative set of adjustments was calculated using a different estimate of the total prime/near-prime and subprime markets to test the sensitivity of my findings to adjustment factors. The results using the alternative adjustments (not shown here) do not differ substantially from the results provided below.

6 The LPS data also do not include REO properties owned by the Federal Housing Administration or other federal agencies.

7 The LPS data do not break out what are often called “Alt-A” loans from prime loans. These are sometimes termed “near-prime” loans. Alt-A loans include many loans made to borrowers who have relatively high credit scores but that have other features (e.g., limited or no documentation) that increase default risk. They are included here with prime loans. Although they represent a relatively small share of all prime/near-prime loans, they account for a disproportionate share of foreclosures and REO in this category.

Table 1 lists the 50 MSAs with the largest estimated total REO density as of August 2008 among 358 MSAs. It indicates the unadjusted prime/near-prime and subprime REO densities as well as the estimated total REO density. The table also indicates in bold the relatively large MSAs (those with more than 400,000 mortgageable properties) among these 50 high-REO MSAs. The estimated REO densities in these 50 MSAs generally range from just under 100 to more than 500 REO properties per 10,000 mortgageable properties. It is important to keep in mind that the estimated total REO density is merely an estimate and may overestimate or underestimate the true level of REO properties. The key aim here is not to develop a highly accurate, definitive measure of REO activity but rather to develop strong relative measures of REO density across MSAs. The “estimated total REO” is used primarily to provide some general sense of the volume of total REO compared to mortgageable housing stock and to control roughly for the underrepresentation of subprime loans in the LPS data.

When examining measures of metropolitan REO density, it is important to keep in mind variations in MSA size. Smaller MSAs are often less heterogeneous in terms of housing stock and neighborhood types and so will tend to vary more in REO density. As a result, many of the MSAs with the highest REO densities are relatively modest in size, including the top three MSAs in Table 1—Merced, Stockton, and Modesto. Notwithstanding this limitation, it is apparent that some states and regions are disproportionately represented at the top of this list. Eight of the top ten MSAs are in California, and another is in Nevada. The remaining MSA in the top ten is the Detroit area.

Table 1. 50 MSAs with Highest Estimated REO Density, August 2008
(MSAs with >400,000 mortgageable properties are highlighted in bold)

Metropolitan Area	Unadjusted Prime/ Near-Prime REO per 10,000 Mortgageable Properties	Unadjusted Subprime REO per 10,000 Mortgageable Properties	Total Estimated REO per 10,000 Mortgageable Properties
Merced, CA	175.4	71.1	524.8
Stockton, CA	158.7	60.6	463.0
Modesto, CA	132.9	64.3	430.0
Riverside-San Bernardino-Ontario, CA	125.3	45.0	356.7
Las Vegas-Paradise, NV	141.8	33.8	349.9
Vallejo-Fairfield, CA	95.6	41.1	293.3
Detroit-Warren-Livonia, MI	93.6	38.9	283.1
Madera, CA	84.7	42.5	278.6
Bakersfield, CA	86.4	39.5	272.5
Yuba City, CA	90.0	33.3	259.2
Salinas, CA	100.1	26.1	254.2
Sacramento-Arden-Arcade-Roseville, CA	79.2	31.9	236.3

Flint, MI	91.6	244	2341
El Centro, CA	77.5	31.4	231.7
Jackson, MI	79.3	23.3	209.5
Phoenix-Mesa-Scottsdale, AZ	72.2	26.8	208.1
Minneapolis-St. Paul-Bloomington, MN-WI	63.8	23.5	183.6
Cape Coral-Fort Myers, FL	57.1	25.1	177.1
Lansing-East Lansing, MI	58.9	24.0	176.7
Fresno, CA	52.3	26.9	174.3
Grand Rapids-Wyoming, MI	60.5	21.3	170.9
Greeley, CO	62.1	19.6	168.2
Battle Creek, MI	54.9	21.8	162.7
Muskegon-Norton Shores, MI	53.0	22.6	162.1
San Diego-Carlsbad-San Marcos, CA	63.4	14.7	155.3
Atlanta-Sandy Springs-Marietta, GA	53.9	18.7	151.5
Reno-Sparks, NV	55.9	15.0	143.2
San Francisco-Oakland-Fremont, CA	46.5	19.6	141.5
Visalia-Porterville, CA	40.7	22.6	140.7
Naples-Marco Island, FL	46.6	19.1	139.8
Washington-Arlington-Alexandria, DC-VA-WV	50.6	16.7	139.4
Denver-Aurora, CO	51.9	14.6	135.0
Miami-Fort Lauderdale-Pompano Beach, FL	39.0	20.3	130.8
Ann Arbor, MI	50.3	13.7	129.6
Oxnard-Thousand Oaks-Ventura, CA	50.7	13.1	128.5
Santa Rosa-Petaluma, CA	40.7	16.8	122.6
Los Angeles-Long Beach-Santa Ana, CA	44.7	14.4	122.0
Saginaw-Saginaw Township North, MI	47.8	12.5	121.5
Monroe, MI	44.3	14.3	121.2
Elkhart-Goshen, IN	40.5	15.2	117.2
Memphis, TN-AR-MS	36.4	16.6	114.8
Niles-Benton Harbor, MI	30.5	19.6	113.8
Santa Barbara-Santa Maria-Goleta, CA	43.4	12.2	113.2
Kalamazoo-Portage, MI	39.2	13.5	109.7
Winchester, VA-WV	38.1	13.6	108.4
Port St. Lucie-Fort Pierce, FL	34.3	14.2	103.4
Pueblo, CO	31.8	15.3	102.4
San Jose-Sunnyvale-Santa Clara, CA	36.1	12.2	100.3
Bay City, MI	36.4	11.1	97.5

Data Source: Lender Processing Services Inc. (LPS) Applied Analytics

* “Mortgageable properties” is the estimated number of 1–4 unit-residential properties plus condominiums in 2006, based on American Community Survey data on housing units by structure. Total estimated REO based on adjustments by national scale factors derived from estimates of the coverage of the LPS data of the total market. See appendix for more information.

Besides the many smaller metro areas in California in Table 1, smaller MSAs in Michigan are well represented among the highest-REO metro areas, accounting for 12 of the top 50 MSAs. At the same time, many large metropolitan areas rank high among all metro areas in REO density. Among the large MSAs in Table 1 are Riverside, Las Vegas, Detroit, Sacramento, Phoenix, Minneapolis, San Diego, Washington, DC, Atlanta, Denver, Miami, Los Angeles, Memphis, San Francisco, and San Jose.

Changes in Metropolitan REO Density, August 2006 to August 2008

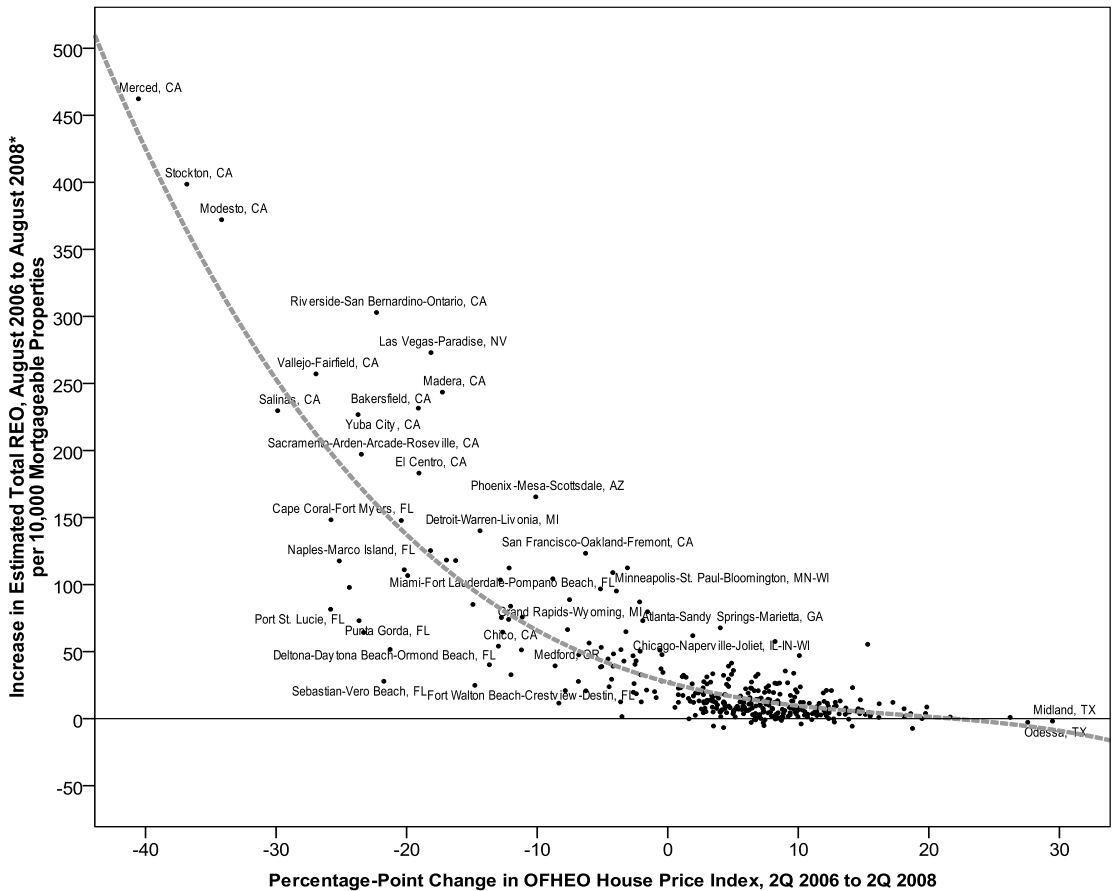
A good deal of attention has been paid to the large increases in foreclosures since late 2006 in many parts of the country. However, there have been fewer systematic examinations of changes in REO inventory—or the accumulation of REO properties—in different parts of the country. I now turn to examining the trajectories of REO accumulation (or, in a few cases, inventory decline) at the MSA level. I begin by looking at trends across all 358 MSAs and then scope down to a set of large MSAs with high REO densities.

In order to examine changes in REO density over time using the LPS data, it was necessary to take into account the dynamic nature of the data set, which grew as more servicers entered the data set over time. To address the expanding sample, all analyses of changes over time in REO activity were conducted after excluding “well-seasoned” loans that entered the data set after August 2006. (“Well-seasoned” is defined here as seasoned for more than four months.) The appendix describes this process in more detail and examines the extent and the size of the excluded activity compared to overall activity in the data set.

While many factors might affect REO density in an MSA, one variable that is expected to be closely related to REO, most likely as both cause and effect, is home price appreciation in the region. First, property values can be tightly linked to foreclosure activity. A variety of research has pointed to the negative impact of foreclosures on nearby home values (Immergluck and Smith 2006; Mikelbank 2008; Schuetz, Been, and Ellen 2008). Other research suggests that foreclosed properties will appreciate more slowly than other comparable properties (Pennington-Cross 2006). At the same time, declining home values, especially in the cases of highly leveraged borrowers, make it difficult for borrowers to refinance or sell their home to avoid foreclosure. Moreover, at least in the case of investor properties, declining values can make it more likely that a borrower will willingly default even if he or she can afford to continue making payments. Therefore, declining values are likely to spur increased foreclosures. A variety of research has found positive effects of declining home values on loan default and foreclosure (Danis and Pennington-Cross 2005; Gerardi, Shapiro, and Willen 2008).

In addition to the positive relationship between property values and foreclosures, declining values may also be linked to the accumulation and duration of REO properties by affecting the “exit” of properties from REO status. In declining-value markets, REO may not be easily absorbed into the broader market as buyers retreat. Moreover, accumulating REO can put downward pressure on price. Until prices are thought to have stabilized, buyers may remain scarce. Hence, increasing REO and declining values can reinforce each other in a vicious cycle.

Figure 1. Increase in Estimated Total REO Density* vs. Change in Housing Price Index, August 2006 to August 2008, by Metropolitan Statistical Area



Data sources: Federal Housing Finance Agency; Lender Processing Services Inc. (LPS) Applied Analytics

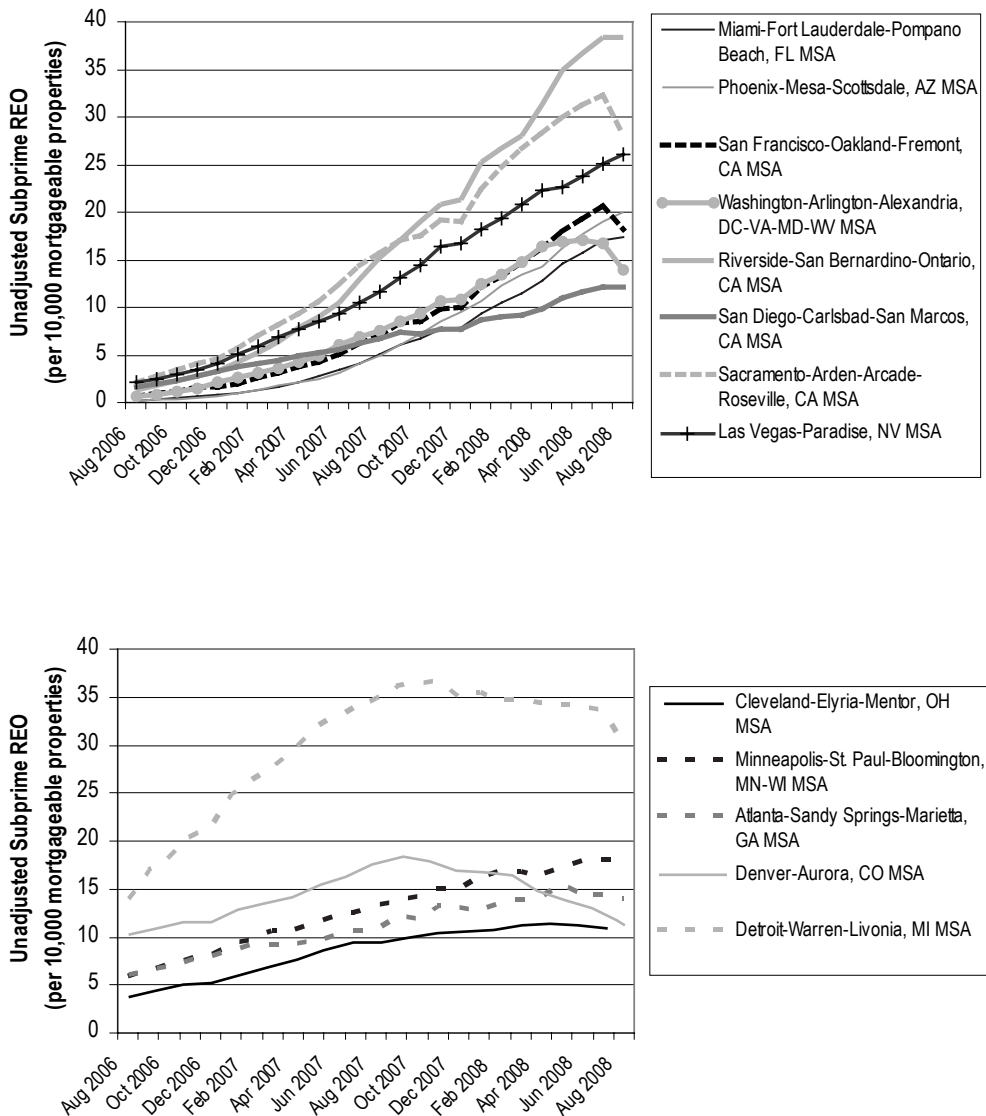
* Estimated total REO based on adjusting prime/near-prime and subprime REO upward based on differences in prime/near-prime and subprime volumes in LPS data set vs. Mortgage Bankers Association National Delinquency Survey. Excludes loans entering LPS after August 2006 *and* more than 4 months after origination (aged loans entering after August 2006). See appendix for more information on methods.

Figure 1 plots the percentage-point change in the Office of Federal Housing Enterprise Oversight (OFHEO) house price index from the second quarter of 2006 to the second quarter of 2008 versus the increase in estimated total REO density from August 2006 to August 2008. A cubic bivariate regression line is also shown to illustrate the nonlinear relationship between the two variables. For most MSAs where house price appreciation (HPA) was positive, there was some increase in REO density over the two-year period, and any relationship between HPA and increase in REO density was slight. As HPA approaches zero and goes slightly negative, increases in REO density tend to grow. As HPA approaches a drop of 10 percent or

more over the two-year period, REO density grows more quickly. However, the dispersion of changes in REO density grows as HPA grows more negative. That is, among metro areas with similarly high rates of price decline, large differences often exist in how much REO density increased over the two-year period.

Figures 2 through 5 more closely examine the trajectories of REO accumulation in thirteen large MSAs with high levels of REO. These include eight MSAs that could be described as “formerly hot” housing markets, including Miami, Phoenix, San Francisco, Washington, DC, Riverside, San Diego, Sacramento, and Las Vegas. The remaining five metro area could be considered weak (Cleveland, Detroit) or relatively stable (Atlanta, Denver, and Minneapolis) markets. As expected during hot housing market conditions, the initial unadjusted subprime REO densities in the formerly hot MSAs in August 2006 were generally very low, well under five per 10,000 mortgageable properties. The weak or stable market MSAs generally began the study period at substantially higher subprime REO densities, on the order of five to fifteen per 10,000 mortgageable properties.

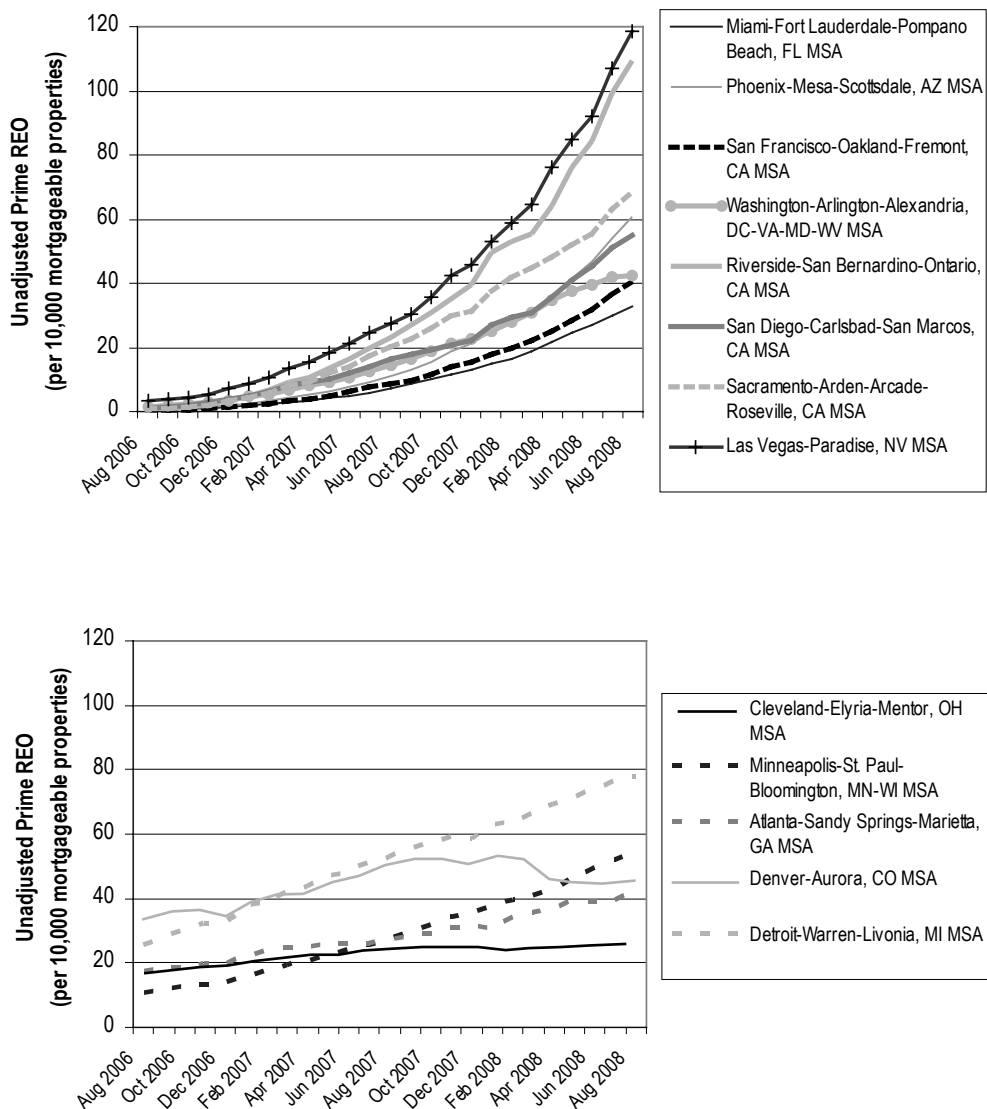
**Figure 2. Increase in Unadjusted Subprime REO* Density,
13 Large, High-REO MSAs, August 2006 to August 2008**



Data source: Lender Processing Services Inc. (LPS) Applied Analytics, American Community Survey 2006

* Excludes loans entering LPS after August 2006 *and* more than 4 months after origination (aged loans entering after August 2006). See appendix for more information on method.

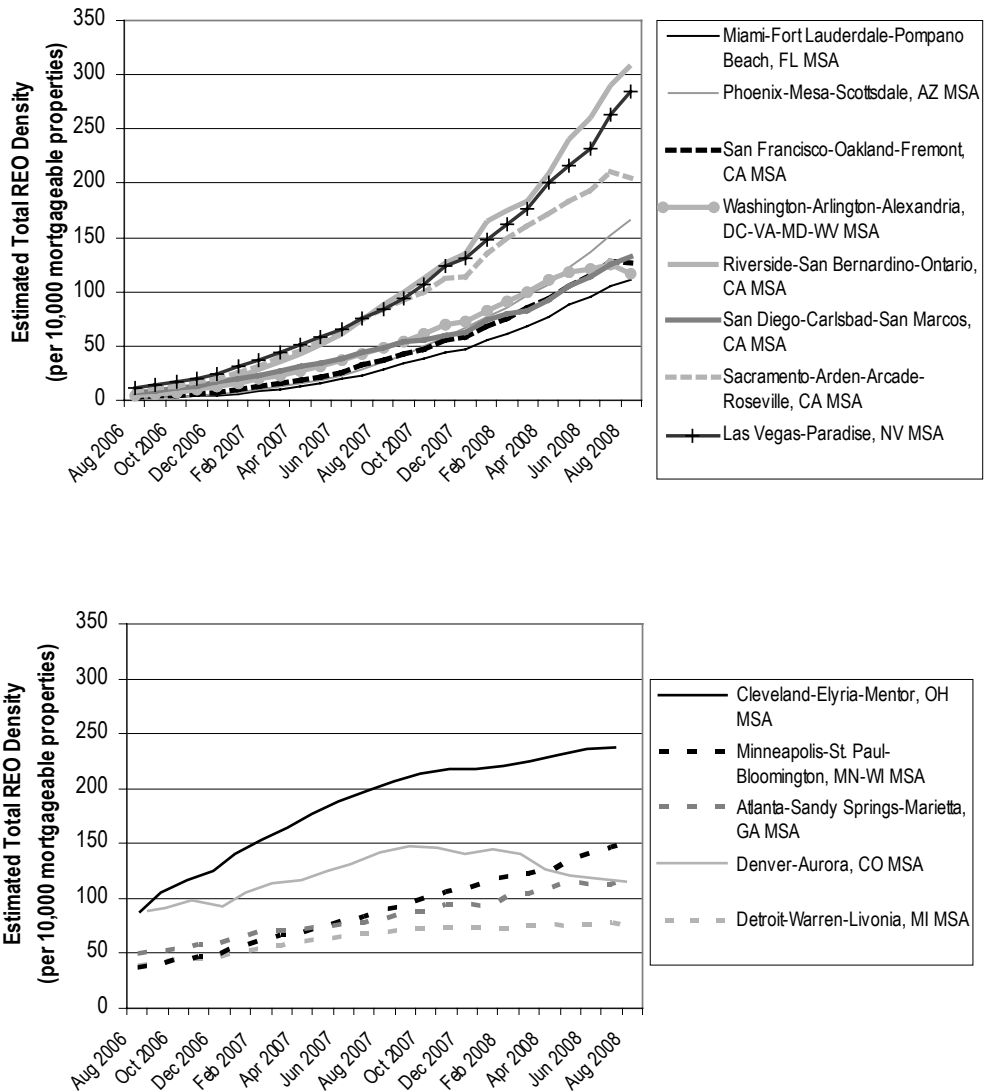
Figure 3. Increase in Unadjusted Prime/Near-Prime REO* Density, 13 Large, High-REO MSAs, August 2006 to August 2008



Data source: Lender Processing Services Inc. (LPS) Applied Analytics, American Community Survey 2006

* Excludes loans entering LPS after August 2006 *and* more than 4 months after origination (aged loans entering after August 2006). See appendix for more information on method.

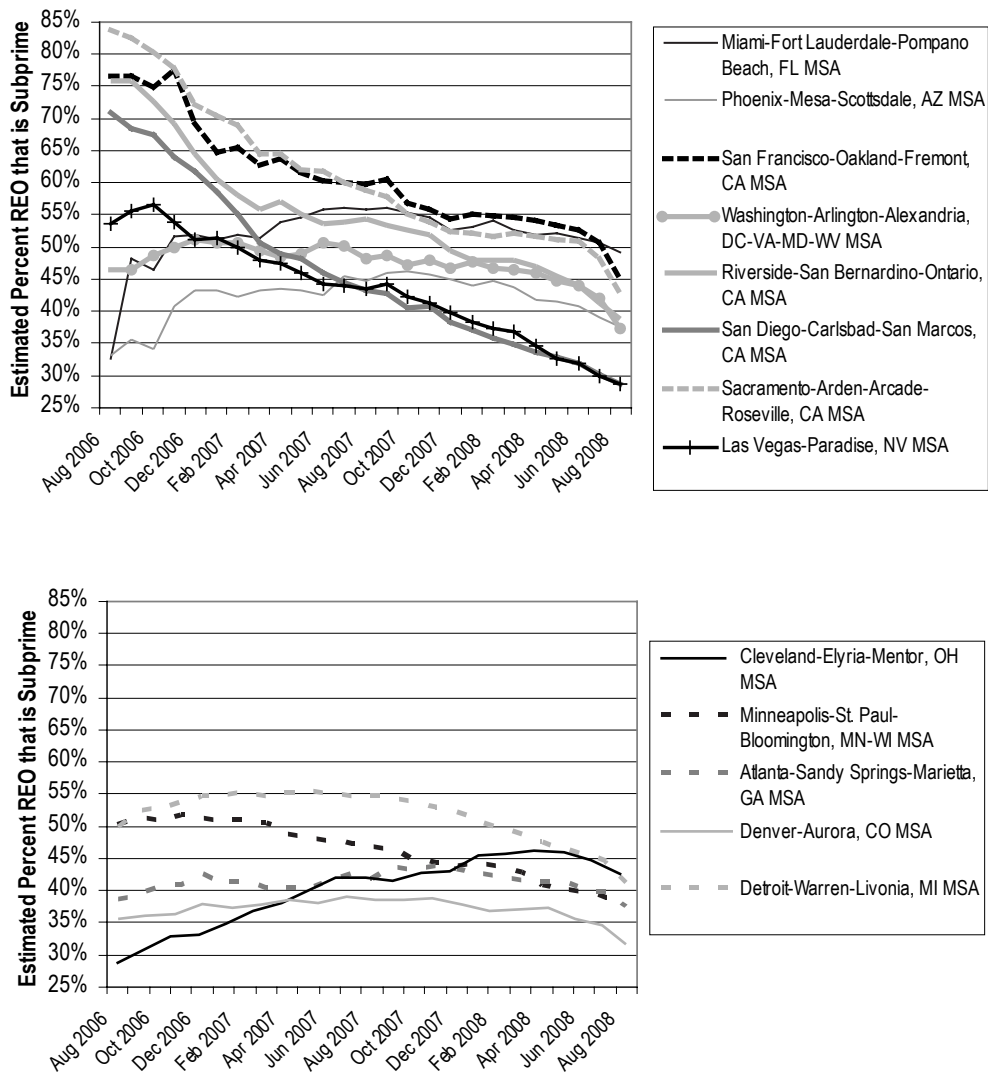
Figure 4. Increase in Estimated Total REO* Density, Based on Adjusted Prime/Near-Prime and Subprime Densities, 13 Large, High-REO MSAs, August 2006 to August 2008



Data source: Lender Processing Services Inc. (LPS) Applied Analytics, American Community Survey 2006

* Estimated total REO based on adjusting prime/near-prime and subprime REO upward based on differences in prime/near-prime and subprime volumes in LPS data set vs. Mortgage Bankers Association National Delinquency Survey. Excludes loans entering LPS after August 2006 *and* more than 4 months after origination (aged loans entering after August 2006). See appendix for more information on methods.

**Figure 5. Change in Share of Estimated REO that is Subprime,
13 Large, High REO MSAs, August 2006 to August 2008**



Data source: Lender Processing Services Inc. (LPS) Applied Analytics, American Community Survey 2006

Figure 2 illustrates the change in unadjusted subprime REO density for the thirteen MSAs. The top chart shows that San Francisco, Miami, Phoenix, Washington, DC, and San Diego have had similar subprime REO density trajectories, with strong increases over the two-year period. Meanwhile, REO density in Riverside, Sacramento, and Las Vegas MSAs grew even faster.

The bottom chart in Figure 2 shows that the Detroit MSA experienced a very large increase in subprime REO until the end of 2007, but then subprime inventory slowed and declined somewhat. The Denver area saw a steady increase in subprime REO until October 2007, but since then it has seen a substantial decline. Although they did not experience the very steep increases in REO as the metro areas in the formerly hot markets in the top chart, the Minneapolis, Atlanta, and Cleveland MSAs also saw large increases in subprime REO over the study period. In some metro areas, the subprime REO density either slowed or even dipped slightly in August 2008, the last month of the analysis.

Figure 3 repeats the analysis in Figure 2, but for prime/near-prime loan REO density. Similar to the subprime findings, prime/near-prime REO density increased more in some metropolitan areas than others, with the greatest increases in the Las Vegas and Riverside MSAs, with somewhat smaller—but still very fast—growth in the other formerly hot-market MSAs in the top chart. Comparing the top chart in Figure 2 to the top chart in Figure 3 shows that prime/near-prime REO growth has generally lagged behind that of subprime REO, but by early 2008 prime/near-prime REO was, in some MSAs at least, accelerating and growing more quickly than subprime REO. Comparing the bottom chart in Figure 3 to the bottom chart in Figure 2 shows that prime/near-prime REO grew more steadily in the Detroit area.

Figure 4 plots the change in estimated total REO density from August 2006 to August 2008. Again, due to the somewhat similar trajectories of prime/near-prime and subprime REO in formerly hot-market MSAs, the top chart of Figure 4 resembles those in Figures 2 and 3. Riverside, Las Vegas, and Sacramento MSAs experienced the sharpest increases in estimated total REO, but increases were also quite large and steep in the other formerly hot-market MSAs. The bottom chart in Figure 4 shows that, in the stable-weak-market MSAs, the estimated total REO generally grew quite steadily, with the Denver MSA experiencing a significant decline since late 2007. However, the increase in REO density in these metropolitan areas was generally much less than in the formerly hot-market MSAs, so that by the end of the period the formerly hot-market MSAs tended to have similar or higher total REO densities than the stable-weak-market metro areas. The Detroit MSA remained among the large metropolitan areas with the highest estimated total REO density, but by the spring of 2008 Riverside and Las Vegas had surpassed it in terms of estimated REO density. Moreover, by August 2008, Sacramento and Phoenix exceeded the REO densities of the Denver, Minneapolis, Atlanta, and Cleveland MSAs.

Figure 5 shows that the source of REO, in terms of prime/near-prime versus subprime loans, shifted significantly across most MSAs toward prime/near-prime and away from subprime loans, especially after late 2007. Whether an REO property is associated with a

prime/near-prime or subprime loan may be important for various reasons. In particular, most subprime loans are held in complex securitized trusts, which can complicate the disposition and purchase of the properties. Prime/near-prime REO, compared to subprime REO, will more often be held by Fannie Mae or Freddie Mac (either in their portfolios or as backing for GSE securities) or on the balance sheet of a lender. Therefore, one might expect that the disposition of many prime/near-prime REO properties might involve less complicated negotiations and acquisitions. However, the Alt-A portion of the prime/near-prime REO is more likely to be held in a wide variety of disparate private-label securities, and so, like subprime REO, their disposition may be relatively more complex.

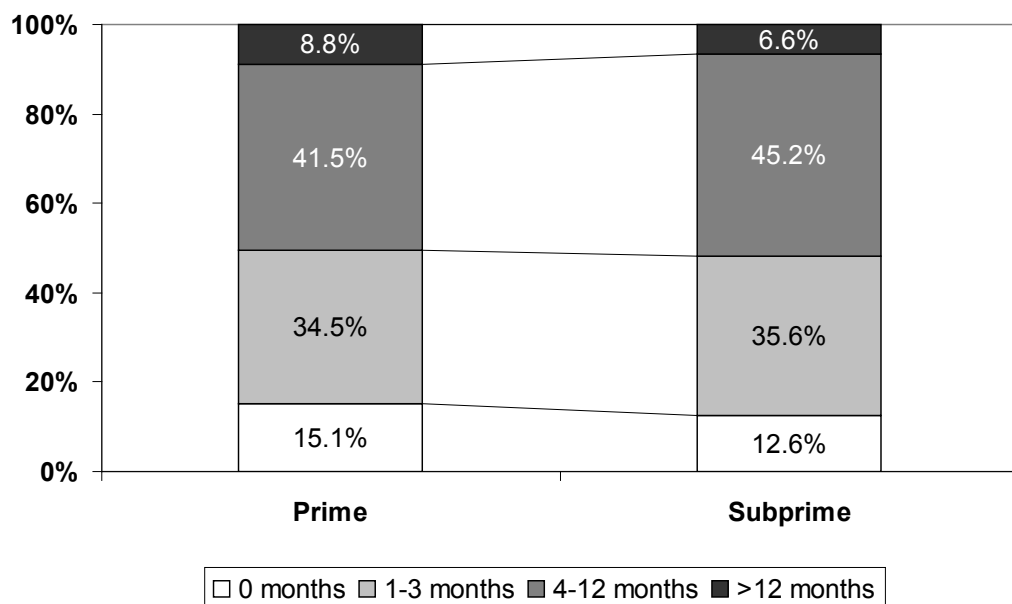
In some MSAs (Riverside, Sacramento, San Francisco, and Washington, DC), this shift began as early as August 2006, but in other MSAs, including most of the stable-weak-market metro areas, the decline in the subprime share of REO did not begin until late 2007. By August 2008, the share of REO that was associated with subprime loans had dropped below 50 percent for all 13 of the MSAs, with the share dipping below 40 percent in 7 of the 13 MSAs. Of course, within these and other MSAs, the distribution of prime/near-prime and subprime REO is likely to vary considerably. In particular, subprime REO are expected to be located more in lower-income and minority neighborhoods relative to prime/near-prime REO. Subprime REO might also be more clustered in various other types of locations within metropolitan regions. Further research is needed to examine these patterns.

REO Aging Across MSAs

The simple volume of REO inventory is not all that is of concern. We might be particularly concerned with the volume of “old” REO, that is, the properties that entered REO status longer than a few months ago. In some markets, a high degree of “frictional” REO may be possible, that is, many properties entering and exiting REO status at any one time with relatively few properties staying in REO for more than a few months. Conversely, in some places many REO properties could be “stale,” that is, have been in REO status for more than a few months, or in more extreme cases for a year or more.

Figure 6 shows that, in metropolitan areas overall, approximately 50 percent of the REO in August 2008 was more than three months old. The distribution of prime/near-prime REO aging is a bit broader than for subprime REO, with a higher percentage of prime/near-prime REO being over twelve months old and a slightly higher percentage being sold in less than a month (zero months).

Measuring the frictional aspect of REO stock across different metropolitan markets is made a bit complicated by the fact that in some areas the portion of REO stock that entered REO fairly recently is quite large due to the more recent surge in foreclosure activity. Therefore, rather than measuring the proportion of REO that is older (e.g., more than x months old), which will be heavily affected by the amount of recent REO flowing into the market, a better estimate is to measure the density of older REO in the region.

Figure 6. Aging of REO Inventory, U.S. Total, August 2008

Data source: Lender Processing Services Inc. (LPS) Applied Analytics

Figure 7 plots the combined density of “old” and “very old” REO, combined, by MSA. Old REO are defined here as those properties that have been in REO for four to twelve months. Very old REO are those that have been in REO for more than twelve months. Figure 8 plots the density of very old REO alone. The two maps are quite similar, suggesting that the MSA-level distributions of old and very old REO are at least roughly similar.

Figure 7. REO Aging: Old and Very Old REO per 10,000 Mortgageable Properties 358 MSAs, August 2008

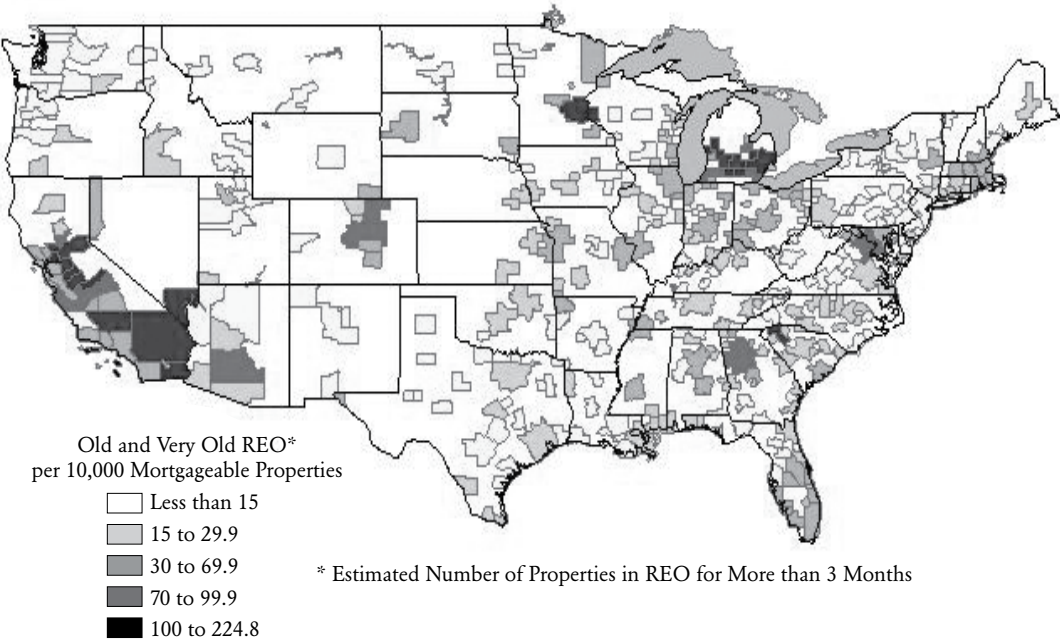


Figure 8. REO Aging: Very Old REO per 10,000 Mortgageable Properties

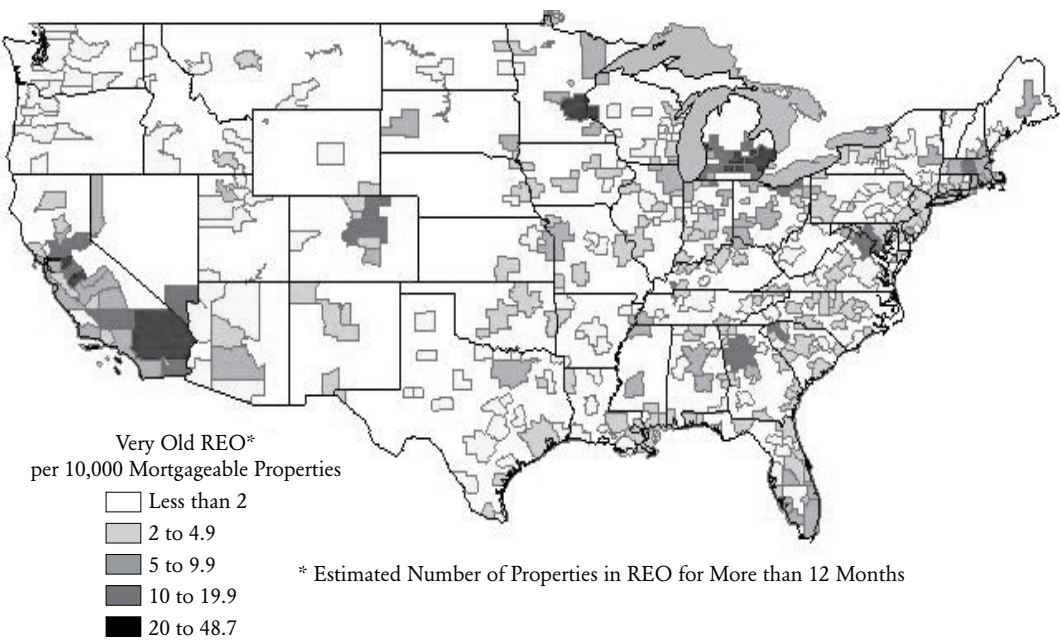
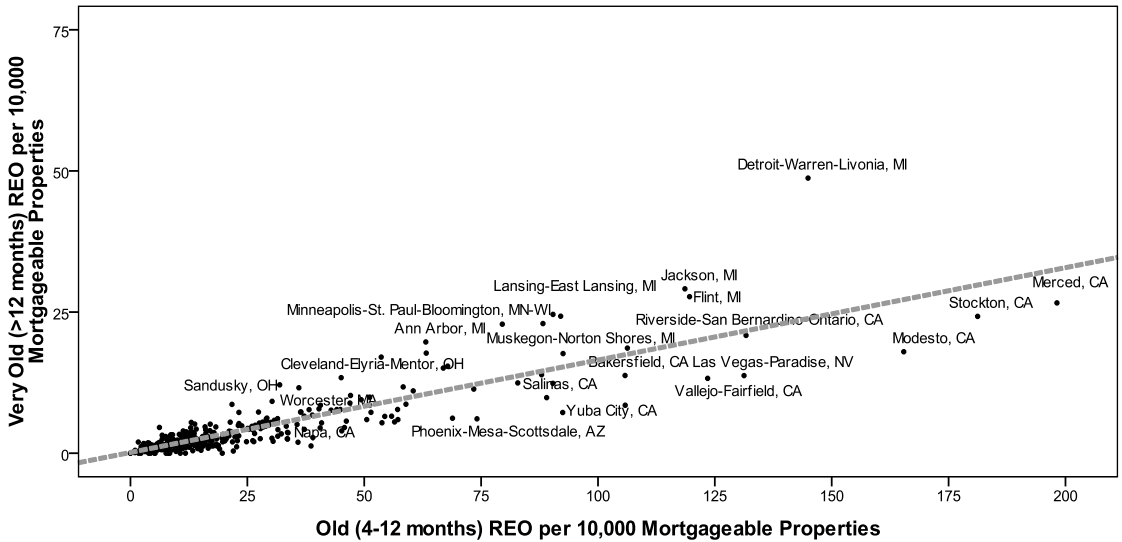


Figure 9. Very Old versus Old REO Densities by Metropolitan Area, August 2008

Data sources: Lender Processing Services Inc. (LPS) Applied Analytics, American Community Survey 2006

Figure 9 extends a comparison of Figures 8 and 9 by plotting the density of very old REO against the density of old REO. In general, the plot shows a strong correlation between the two aging categories. Metropolitan areas with a high density of old REO also tend to have a high density of very old REO. However, many of the MSAs that have experienced very fast increases in REO since August 2006, including many in California, tend to lie on the lower/right of the dashed line. Although many of these MSAs have high rates of very old REO, their rates of old REO are particularly high. Conversely, in many of the MSAs where foreclosures and REO have been high for a longer period of time, the rate of very old REO is particularly large.

However, it should be noted that even in some metro areas where the density of REO was small in late 2006, the density of very old REO has become quite large. In fact, of the ten MSAs with very old REO densities of more than 20 per 10,000 properties, three were housing markets in California (Merced, Stockton, and Riverside). Of the remaining seven, six are MSAs in Michigan, and the last is the Minneapolis–St. Paul–Bloomington MSA. Therefore, although the stable-to-weak markets that have experienced high levels of foreclosure and REO for a longer period of time—well before 2007—tend to have the highest rates of very old REO, many formerly hot housing markets appear to be “catching up,” amassing a large amount of both old REO and very old REO.

Cluster Analysis: A Typology of Metropolitan REO Markets

Given the relationship between home price appreciation and increases in REO density, I use cluster analysis to identify a typology of MSAs using the initial (August 2006) subprime REO density, the initial prime/near-prime REO density, and the change in the OFHEO home price index from the second quarter of 2006 to the second quarter of 2008. The cluster analysis results in three clusters described in Table 2 and illustrated in Figure 10. Metropolitan areas in the largest cluster, Cluster 1, are characterized by initial REO densities that are close to the median of all 358 MSAs. This cluster is also characterized as having a modest initial share of subprime REO (26.1 percent median) over the two-year period and a moderate level of home price appreciation (7.7 percent median versus the 358 MSA median of 5.8 percent).

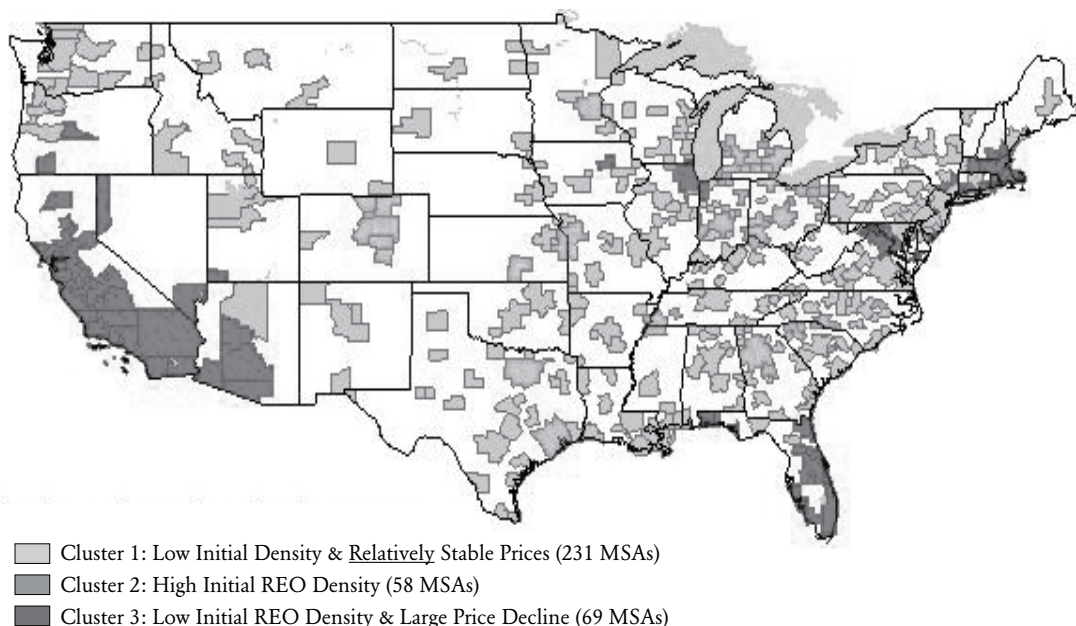
Cluster 1 MSAs tend to be mostly modest in size (median number of mortgageable properties was 61,079). Finally, the median increase in estimated total REO density was relatively low at 8.31. This cluster, which I label “Low Initial REO Density and Stable Prices,” accounts for almost 65 percent of MSAs but less than 47 percent of the mortgageable properties in all of the MSAs.

The second cluster includes metropolitan areas with relatively high initial estimated REO densities. This includes many metropolitan areas in Michigan and other weak-market cities as well as some stable-market cities with relatively high foreclosure and REO levels in 2006. Besides the Detroit MSA, this cluster includes the Minneapolis, Atlanta, Indianapolis, Memphis, and Denver MSAs. The MSAs in Cluster 2 are characterized by above-average initial subprime REO shares and modest home price appreciation or moderate declines in value. This cluster is labeled “High Initial REO Density.” It accounts for 16 percent of the MSAs but 22 percent of total MSA mortgageable properties.

Table 2. Cluster Analysis: MSAs Clustered by REO Prime/Near-Prime and Subprime Density in August 2006 and Change in OFHEO Housing Price Index

	<i>Cluster 1: Low Initial REO Density & Stable Prices, 8/06 – 8/08</i>	<i>Cluster 2: High Initial REO Density 8/06</i>	<i>Cluster 3: Low Initial REO Density & Large Price Decline 8/06 – 8/08</i>	<i>All 358 MSAs</i>
Number of MSAs in Cluster	231	58	69	358
Number of MSAs in California in Cluster	0	0	26	26
Median Level of REO per 10,000 Mortgageable Properties, 8/2006	11.08	36.76	2.78	10.81
Median Level of Subprime REO per 10,000 Mortgageable Properties, 8/2006	2.92	11.98	144	3.21
Median Estimated Share of REO that is Subprime, 8/06	26.1%	35.0%	53.7%	29.8%
Median Increase in REO per 10,000 Mortgageable Properties, 8/06 – 8/08	8.31	23.01	64.83	12.70
Median Percentage Point Increase in OFHEO Housing Price Index, 2Q 2006 – 2Q 2008	7.7%	2.0%	-12.2%	5.8%
Median Number of Mortgageable Properties, 2006	61,079	88,691	137,758	75,319
Total Number of Mortgageable Properties in Cluster MSAs, 2006	32,401,199	15,802,851	22,250,703	70,454,754

Note: Clustering process used Ward's Method with squared Euclidean distance measure

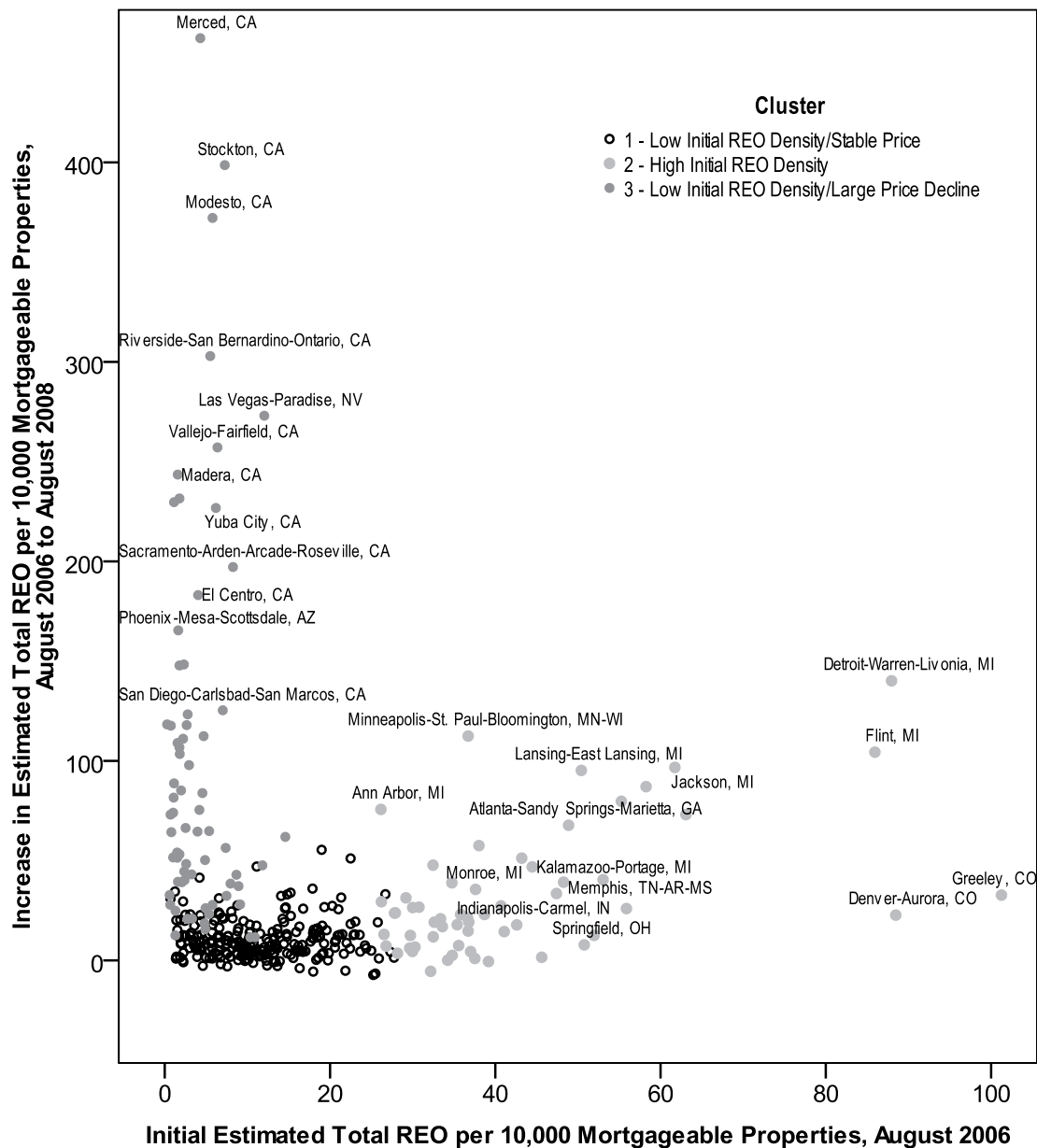
Figure 10. Locations of MSAs by Cluster

Data sources: Lender Processing Services Inc. (LPS) Applied Analytics, American Community Survey 2006; Federal Housing Finance Agency

The third cluster includes mostly metropolitan areas that had very low REO densities initially (August 2006) and experienced significant loss in property values over the two-year period. It includes all of the California MSAs in the data set as well as most of the other formerly hot-market metropolitan areas, many of which have seen large increases in REO density. These metro areas began the period with very low REO densities (median 1.44 per 10,000 properties) and high subprime REO shares (median of 53.7 percent). They were relatively large with a median number of mortgageable properties of more than 130,000. This cluster accounted for 19 percent of MSAs but 31 percent of mortgageable properties in all 358 MSAs. This cluster is labeled “Low Initial REO Density and Large Price Decline.”

Figure 11 plots the increase in estimated total REO density (August 2006–August 2008) against the initial estimated total REO density (August 2006), indicating cluster membership for each MSA. It shows that most of the MSAs in Cluster 2 (light solid) experienced sizeable increases in REO density and that, within this cluster, generally MSAs with higher initial REO densities tended to see larger increases in REO density. The outliers in this cluster are the Denver and Greeley MSAs, which had very high initial REO densities but saw relatively moderate increases in REO density over the two-year period.

Figure 11. Initial Estimated REO Density and Increase in REO Density among MSAs Clustered by Change in Value and Initial REO Density

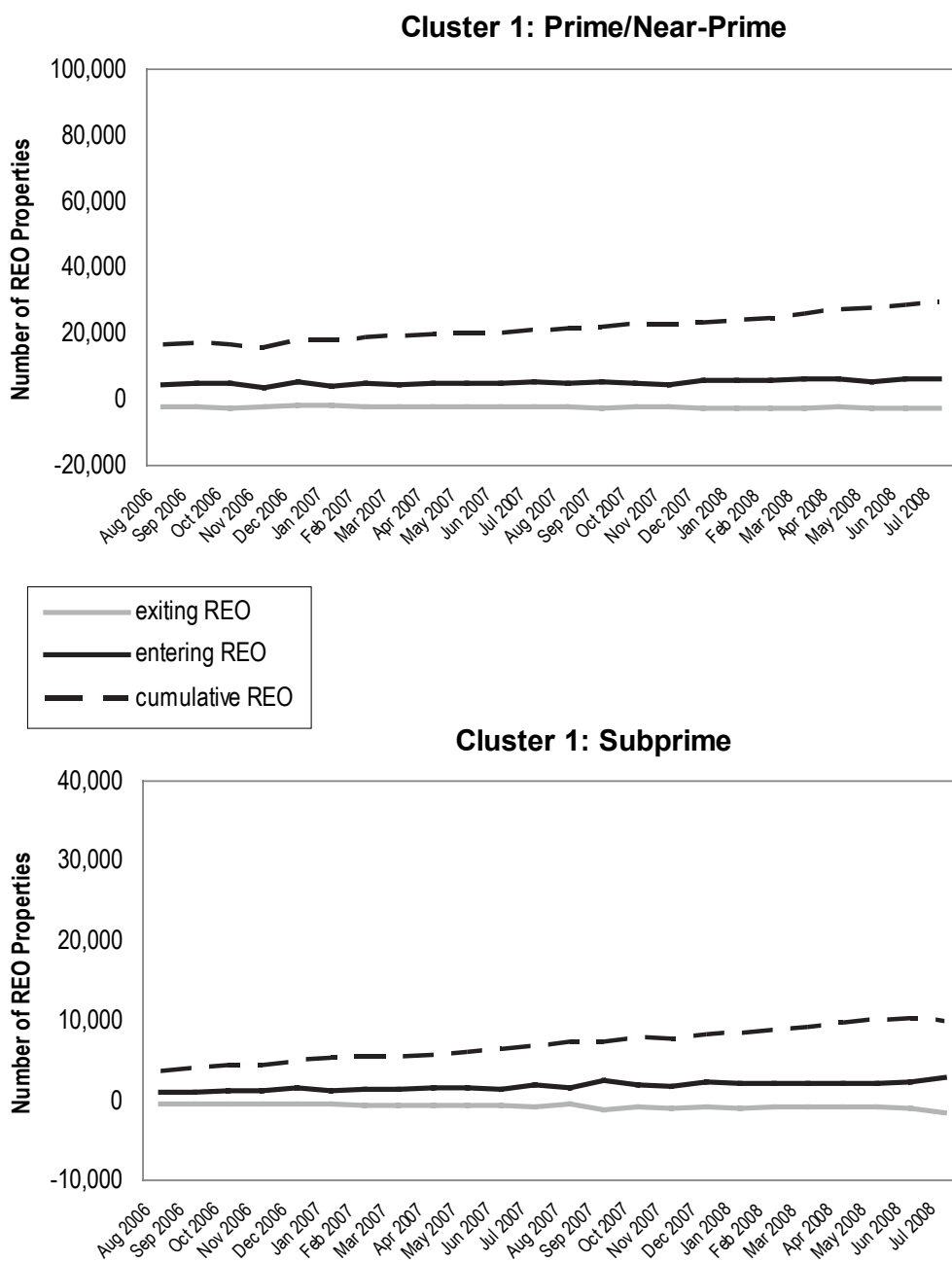


Many MSAs in Cluster 3 (dark solid) experienced extremely large increases in REO density. However, the variance in increased REO density within the cluster is quite large. That is, a good number of MSAs in this cluster show more moderate (but still substantial) increases in estimated total REO density despite large declines in their house price indices. This finding is consistent with Figure 1, which shows a large dispersion of REO increases among MSAs experiencing large property-value declines.

REO Exit by Cluster

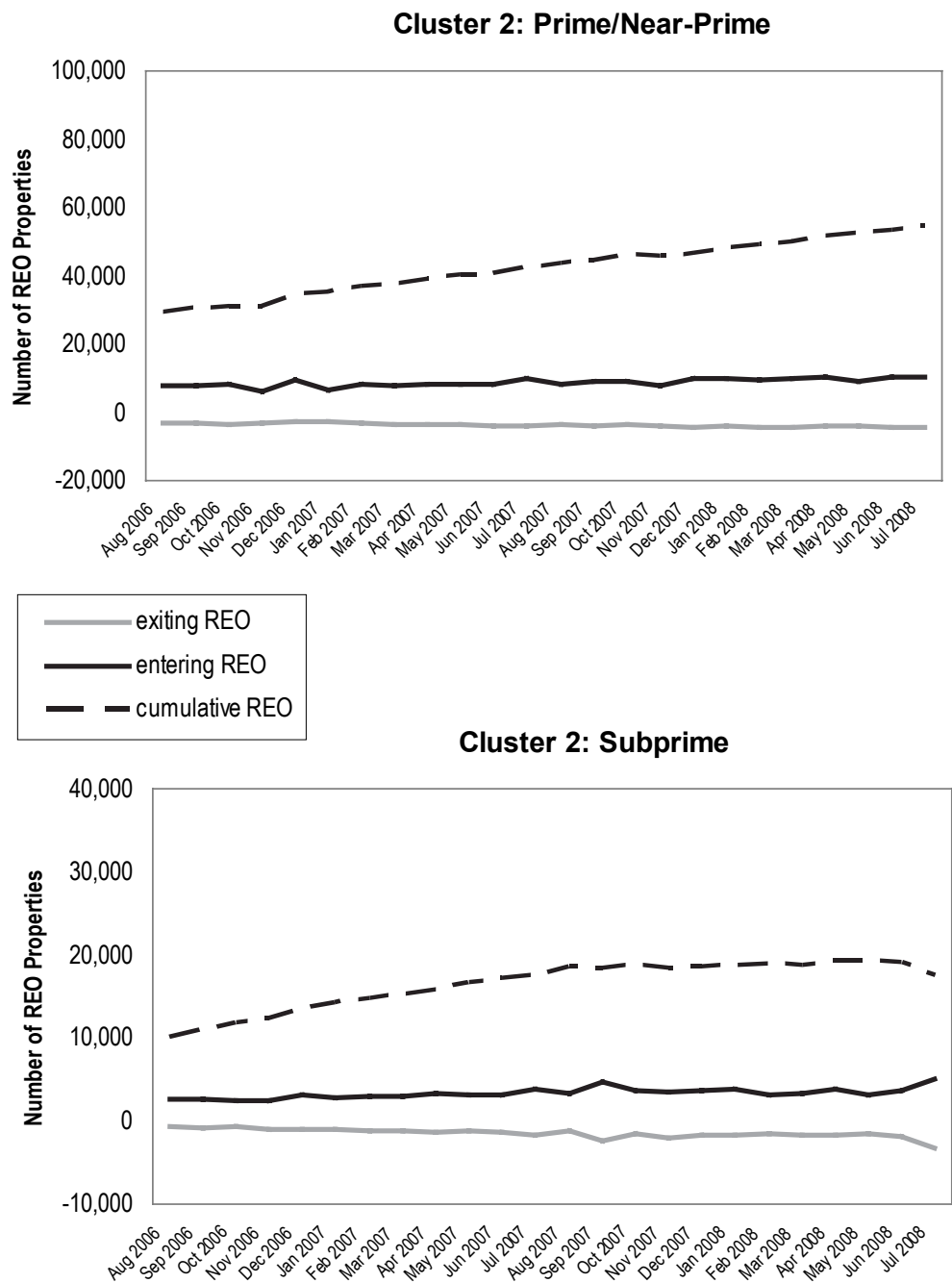
The analysis of REO inventories thus far suggests that REO accumulation varies greatly across metropolitan areas. This is consistent with the fact that foreclosure rates (and therefore REO entrance) vary greatly across metros. However, what has been less clear is whether REO exit rates (primarily sales by servicers of REO properties) vary substantially across MSAs, and how these exit patterns may be contributing to differential rates of REO accumulation. In order to address this question, I examined REO exit and entrance data across the three clusters of MSAs described above. This was done separately for prime/near-prime vs. subprime mortgages. (Because there was no attempt to estimate total REO densities in this section, there was no need to adjust raw LPS REO numbers to arrive at estimated total REO figures.)

Figures 12 through 14 illustrate the prime/near-prime (top chart) and subprime (bottom chart) aggregate patterns of REO entrance and exit, together with the resulting REO accumulation, for each cluster of MSAs. Again, REOs have grown appreciably in all three types of MSAs.

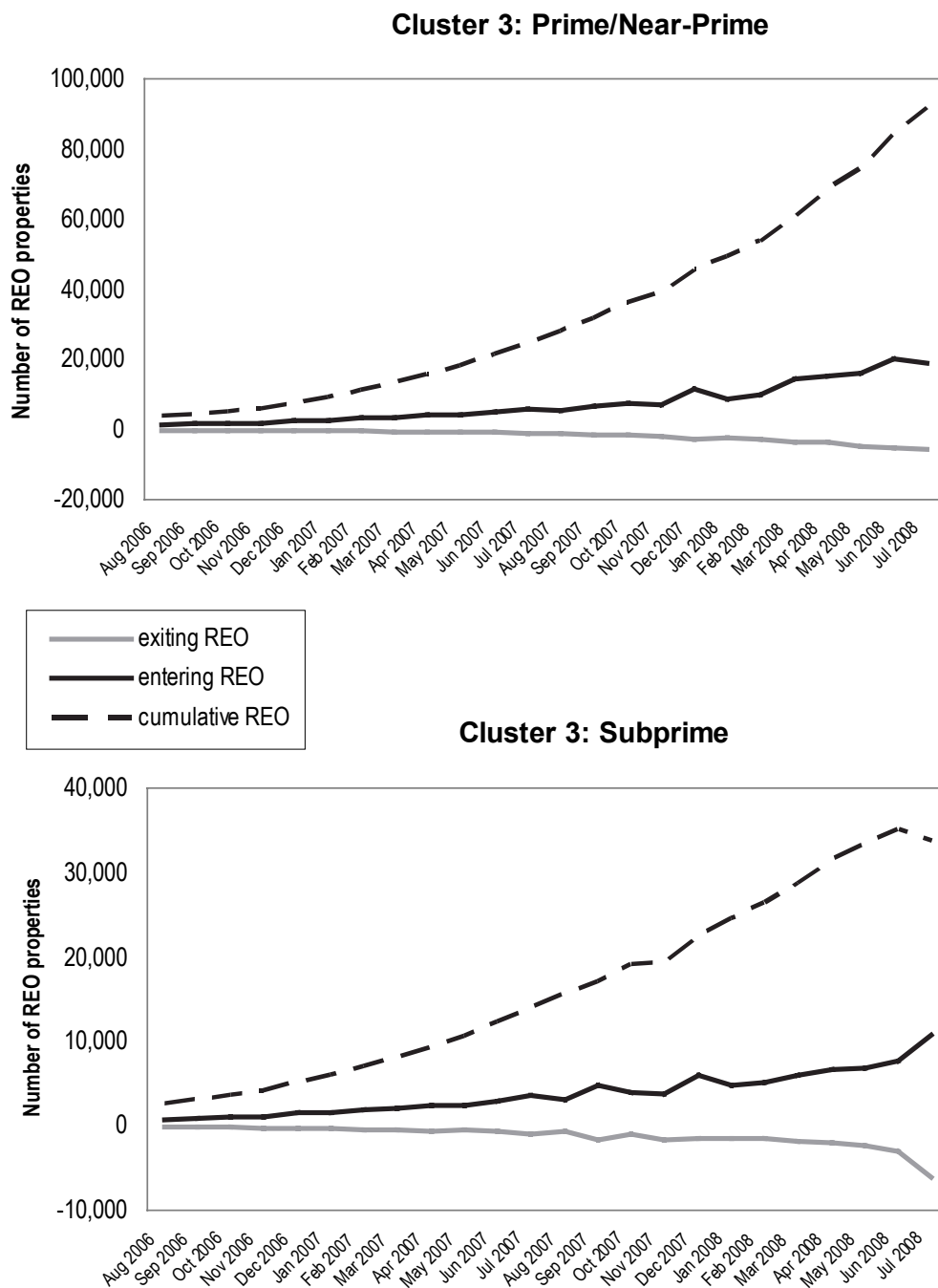
Figure 12. Cluster 1 REO Entrance and Exit, by Prime and Subprime Mortgage Type

Data sources: Lender Processing Services Inc. (LPS) Applied Analytics; Federal Housing Finance Agency

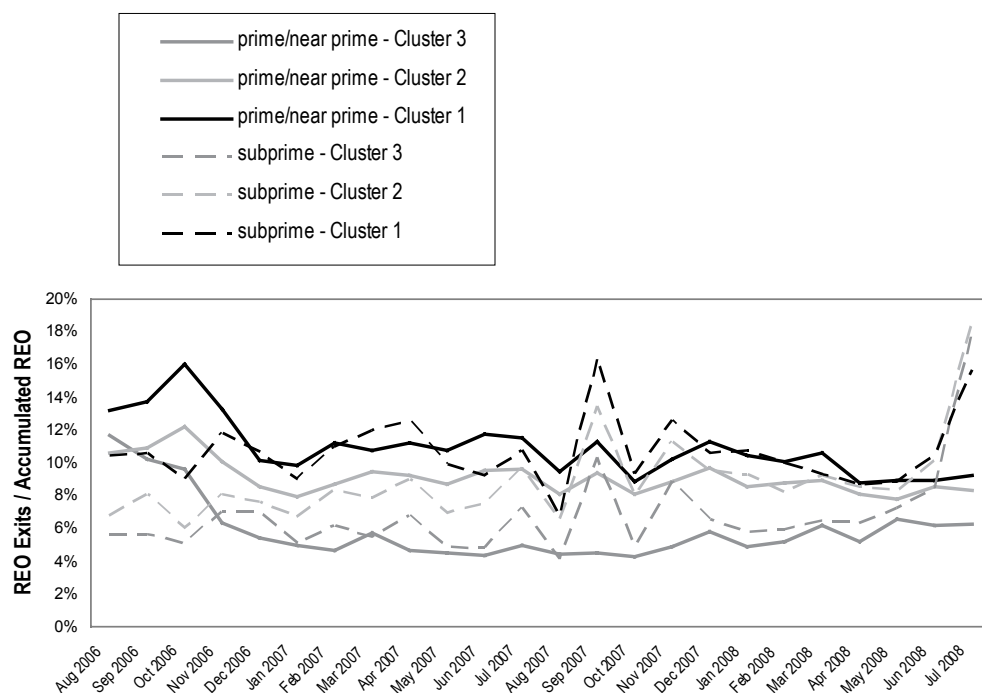
Figure 13. Cluster 2 REO Entrance and Exit, by Prime and Subprime Mortgage Type



Data sources: Lender Processing Services Inc. (LPS) Applied Analytics; Federal Housing Finance Agency

Figure 14. Cluster 3 REO Entrance and Exit, by Prime and Subprime Mortgage Type

Data sources: Lender Processing Services Inc. (LPS) Applied Analytics; Federal Housing Finance Agency

Figure 15. REO Exit Rates for Prime/Near-Prime and Subprime, by Cluster

Data sources: Lender Processing Services Inc. (LPS) Applied Analytics; Federal Housing Finance Agency

The rate of increase is much faster in Cluster 3 MSAs generally, and the raw magnitude of the increase in Cluster 2 MSAs is generally greater than in Cluster 1 MSAs, which started at lower levels of REO density. These charts also show that the primary contributor to REO accumulation is REO entrance, that is, newly foreclosed properties reverting to bank ownership. In general, REO exit rates have not increased appreciably, especially in Cluster 1 and Cluster 2 MSAs. While REO exit rates grew slowly in Cluster 1 MSAs, these rates began from very low levels and have not at all kept pace with the increases in REO entrance.

REO entrance in Cluster 1 and 2 MSAs generally did not increase dramatically since late 2006. Cluster 2 MSAs generally saw large increases in foreclosure levels well before late 2006 and were typically at high foreclosure levels already. However, the net surplus of REO entrants over exits has remained consistently substantial in both Cluster 1 and Cluster 2 MSAs, at least in the aggregate, so that even while foreclosures did not increase dramatically over this period, REO accumulation continued to mount. In Cluster 3 MSAs, REO exits did increase some since late 2007, but this increase was slower than the increase in new REO.

The bottom charts in Figures 12 through 14 show that in the summer of 2008 there was a significant increase in subprime REO entrance and exit activity. The reason for this is unclear,

as is whether this trend continued into late 2008. The increase in exit rates was enough to cause a slight drop in subprime REO inventory in Cluster 2 and Cluster 3 MSAs overall.

Figure 15 illustrates the REO exit rates for prime and subprime REO, broken out by MSA cluster. The exit rate is the number of REO exits in a month divided by the total inventory of REO in that month. There are a few patterns worth noting here. First, the subprime exit rates are generally more volatile from month to month than the prime/near-prime exit rates. This may be due in part to a greater level of tumult in the subprime market relative to the prime market over this period.

Second, consistent with the patterns shown in Figures 12 through 14, the subprime exit rates across all three clusters showed a particular spike upward at the end of the period studied here. The explanation for this is unclear, but it is something worth paying close attention to going forward. Exit rates for prime/near-prime REO showed no such spike upward. Other than this late spike, subprime REO exit rates were not consistently higher or lower than corresponding prime/near-prime exit rates in Clusters 1 and 2, but subprime rates tended to be slightly higher in Cluster 3.

Third, the exit rates of Cluster 1 REO are generally substantially higher than those for Cluster 2 and, especially, Cluster 3 properties. The one exception is the spiking convergence of exit rates late in the period. Cluster 3 REO exit rates are generally substantially slower than is the case for the other two clusters. This may not be surprising given the very high levels of REO inventory that must be absorbed in many of these markets. However, it is worth noting that, at the beginning of the period, the prime/near-prime REO exit rate for Cluster 3 was higher than that for Cluster 2 and almost as high as that of Cluster 1. Cluster 3's prime/near-prime exit rate dropped from just under 12 percent to just over six percent over the study period.

Finally, in the aggregate, the prime/near-prime REO exit rate for each of the three clusters declined significantly over the study period. At the beginning of the period, these rates were in the ten percent to 14 percent range, but by the end of the period they had declined to a range of between six percent and 9.5 percent. This is consistent with a general pattern of REO entrance consistently outweighing REO exit over time.

Conclusion

This article provides a first look at REO accumulation across metropolitan areas since the advent of the 2007–2008 mortgage crisis. Overall, the buildup of REO properties has been quite steep, with the steepest REO accumulations in the formerly hot housing markets where foreclosures have increased most dramatically. Many of these are in the West, including metro areas in California, as well as Las Vegas and Phoenix. Some metro areas in Florida and the Washington, DC area have also seen very sharp increases in REO inventory. Metro areas that had relatively high levels of REO in late 2006 (at least compared to other metro areas at that time) have also generally seen quite substantial increases in REO densities, although these recent increases, while large, have not been as steep or generally as large as in the formerly hot-market metro areas. Moreover, four out of the five large metro areas with the

highest estimated REO densities as of August 2008 were formerly hot-market metro areas (Riverside, Las Vegas, Sacramento, and Phoenix). (The Detroit metropolitan area ranked third among large metro areas.)

The findings above also suggest that, although the growth of subprime REO began earlier during the crisis period, the estimated share of REO that is associated with subprime loans has generally declined in most MSAs, especially since late 2007 or early 2008. This finding is consistent with recent increases in prime/near-prime foreclosure rates, including among Alt-A and adjustable-rate loans. In many metro areas, these estimates suggest that the majority of REO are now associated with prime/near-prime loans. However, in particular parts of metropolitan areas, subprime REO densities likely still dominate prime/near-prime REO densities. More research is needed to understand small-area patterns of REO accumulation, including differences in the share of REO that is associated with subprime loans. Given the existing evidence on the spatial concentration of subprime lending within metropolitan areas, there is reason to expect significant variations across neighborhoods or other submarket geographies.

The analysis of REO aging suggests that, although the metro areas that had initially higher REO densities in August 2006 were likely to have the highest densities of very old (more than twelve months) REO, some of the formerly hot markets have substantial levels of old (four to twelve months) REO and some even have high levels of very old REO, despite having only had a major foreclosure problem for just a couple of years.

Metropolitan areas appear to cluster fairly well into three groups. First is a fairly large set of metro areas that had modest initial REO densities and have had relatively stable price trends over the two-year period. This largest group of metro areas—which includes many small MSAs—tended to see fairly moderate increases in REO density over the two-year period. A second cluster of metro areas includes those that had relatively high initial REO densities. In general within this group, a positive relationship exists between the initial level of REO density and the size of the increase in REO density over the two-year period. Denver and Greeley, Colorado, were clear exceptions here. They both began with very high REO densities but experienced relatively moderate increases over the study period. The third cluster includes those metro areas that began the period with very low REO densities but saw large declines in property values. Many—but by no means all—of these metro areas experienced very large increases in REO density. Some metro areas in this group saw more moderate increases in REO density.

Finally, the analysis of REO exit and entrance across the different MSA clusters shows that, overall, REO accumulation has been driven primarily by entering REO. In Cluster 1 and Cluster 2 metro areas, there has been a fairly consistent and substantial surplus of entrants over exits, resulting in a steady rise in REO inventory. In Cluster 3 metros, foreclosures have increased more, so that REO entrants have grown at higher rates over time. Although REO exits have grown some, the surplus of entrants over exits has increased, resulting in rapid accumulation of REO inventory. Generally, REO exit rates do not appear to differ substantially between prime/near-prime versus subprime REO. However, there was a

spike in subprime REO exits at the end of the study period, but it was too brief to enable any strong conclusions. Overall, exit rates have been considerably lower in Cluster 3 (primarily the formerly hot-market metros) than in Cluster 2 and, especially, Cluster 1.

Understanding the accumulation, aging, and nature of REO inventories across metropolitan areas is important to formulating policies and informing practice regarding how to help communities and neighborhoods recover from surging foreclosures. More research is needed to understand the corresponding intrametropolitan patterns of REO accumulation and aging to respond more effectively to the aftermath of the foreclosure crisis.

The findings in this article have several implications for community development policy and urban and regional planning. In considering such implications, it is important to keep in mind the fast-paced dynamics of changes in foreclosure and real estate markets in recent years. Cross-metro REO accumulation should be continuously monitored to inform policy and practice going forward.

First, at this stage of the mortgage crisis at least, it appears clear that REO accumulation has been quite severe not only in what had been considered weaker market metro areas but also in many formerly hot markets, some of which have experienced the heaviest and fastest increases in foreclosures over the last several years. Although this finding is most likely not surprising to many—especially those with local knowledge of these markets—there is little evidence at this point that the broader real estate market is readily absorbing REO properties in these formerly hot housing markets at sufficient speed to slow REO accumulation appreciably. Even in places where serious increases in foreclosures began fairly recently (late 2006 and early 2007), there are serious buildups in REO properties and, in most of these markets, substantial accumulations of old and very old REO. Given the earlier trends of population and economic growth in many of these regions, some may expect that these accumulations will be worn down rapidly via “regular” market forces and the settling out of credit market problems. This question remains unsettled. The evidence thus far suggests that many formerly hot-market metro areas have accumulated very severe REO inventories. Given that some of the factors that contributed to escalating valuations and rapid development in these markets—including easy access to construction and mortgage financing and low commuting costs (due in part to low gasoline prices)—are unlikely to return on a long-term basis, some may have reason to doubt that a quick clearing of the REO supply is likely, at least in some of these metro areas. The scale of the foreclosure and REO problem in many of these metro areas may herald a longer-term spatial restructuring of some regional housing markets. This has implications for policymakers and planners who may be considering longer-term development proposals, infrastructure planning, and neighborhood or local recovery efforts.

Second, because the growth in REO accumulation is driven primarily by growth in new, entering REO, it remains important to consider mixed strategies of slowing the inflow of new REO as well as encouraging the responsible and sustainable absorption of REO into productive use. As long as REO entrance rates remain very high, efforts aimed solely at REO recovery are likely to have limited impacts. In markets where the inventories have

reached very high levels, it is also important to consider possible land reuse, especially where population and economic forecasts do not suggest substantial increases in aggregate housing demand.

Third, notwithstanding the need to do more work at the submetropolitan level, the shift in REO accumulation from subprime to prime/near-prime mortgages suggests a likely spatial shift in REO accumulation over time. Thus, some suburban communities that had not previously experienced major REO problems may begin to see their REO inventories increase. While the problems in such places are unlikely to reach the levels in many central cities or smaller, formerly hot-market MSAs (Modesto, Merced, Stockton), they may become serious. Moreover, many suburban communities have little infrastructure or experience related to housing or community development and may be ill equipped to deal with such problems. Some older-, weaker-, or stable-market cities have faced episodic challenges of vacant property over several decades. Although these communities face serious problems with foreclosed properties as well, they often have somewhat of a head start in terms of an established community development infrastructure.

The spatial impacts of the shift toward prime/near-prime REO is not entirely clear. Subprime loans tend to be more spatially concentrated within metropolitan areas. The shift toward prime/near-prime loans suggests a potential spatial dispersion of REO, which may reduce the negative impacts associated with heavily concentrated foreclosed properties. Moreover, the neighborhoods in which the REO properties are located may be more economically resilient. At the same time, many of the Alt-A and prime loans that are going into foreclosure are likely to be adjustable-rate loans with teaser rates and, especially in the case of Alt-A loans, involve significant instances of fraud or inflated incomes and investor properties. Some of the properties associated with such loans are likely to be heavily underwater (where the loan balance far exceeds the property's value), making recovery of the property more challenging.

A fourth implication of this study concerns the desirability and utility of having broader access to reliable measures of foreclosure and REO activity that are comparable across neighborhoods, cities, counties, and states. The data used in this study are not generally available at reasonable costs for most researchers and policy analysts. Moreover, they are not entirely comprehensive and depend on the voluntary participation of loan servicers. Comprehensive, consistent, and accessible data on foreclosures and REO properties are critical to furthering solutions to problems of excessive foreclosures and to improving the prospects for returning REO to productive use. Data on loans entering foreclosure and through the REO process could be required from all mortgagees via federal regulations, similar to the way loan origination data are reported and disclosed via the Home Mortgage Disclosure Act. Moreover, linking of mortgage data from HMDA through to the foreclosure and REO process would be particularly helpful. This would allow researchers, policy analysts, and others to more clearly identify the characteristics of mortgages, lenders, and borrowers associated with foreclosures and REO properties.

Notwithstanding the desirability of having foreclosure and REO data on residential properties available at the federal level, many states could do more to ensure better and more accessible data at the state and federal level. Real estate recording is generally governed by state law, and more transparent and accessible data could be collected and disseminated by states through state-level property record keeping. Currently, lower-level jurisdictions—typically counties—collect and manage property records data, which leads to a great deal of variability in the quality and accessibility of the data, often making tracking REO in a large metropolitan area difficult.

Good data on real estate transactions can be an important tool in identifying problems related to foreclosures and vacant properties and in developing better policies to promote neighborhood and market recovery. For example, recent work by Coulton, Schramm, and Hirsh (2008) using an extensive data set on property transactions in Cuyahoga County, Ohio, show that the proportion of REO sales for under \$10,000 (what they term “extremely distressed sales”) increased from less than 10 percent in 2006 to more than 40 percent by the first half of 2008. The extremely distressed sales share in the City of Cleveland increased to 63 percent citywide, and to over 75 percent on the city’s Eastside. Such analysis is impossible without good, robust, local data.

The findings of this study demonstrate the magnitude of the challenge that many communities face in dealing with the distress caused by the ongoing foreclosure crisis. While many metro areas have not experienced large inventories of REO properties at this point, a sizable portion of them, representing a majority of mortgageable properties in metropolitan America, have seen large increases in the density of REO properties over a relatively brief period of time. Moreover, many markets, including most formerly hot housing markets, show little sign that the growth of REO has slowed. The shift from subprime to prime/near-prime foreclosures may bring with it a different spatial distribution of REO. More research is needed to understand the neighborhood or submarket nature of REO accumulation within different types of metropolitan housing markets.

Dan Immergluck is a visiting scholar in Community Affairs at the Federal Reserve Bank of Atlanta and an associate professor of City and Regional Planning at the Georgia Institute of Technology. Beyond his work on foreclosures and mortgage markets, Immergluck conducts research on housing markets, fair lending, community development finance, neighborhood change and segregation, and related public policies. At Georgia Tech, he teaches courses in housing policy, real estate finance, and research methods. Immergluck publishes regularly in scholarly journals, as well as in more applied venues, and has testified before Congress, the Federal Reserve Board, and state and local legislatures. His work has been widely cited in research around the foreclosure and mortgage crisis, and he has been quoted or cited in the a wide variety of media, including the New York Times, the Wall Street Journal, TIME Magazine, USA Today, the Boston Globe, the Chicago Tribune, the Associated Press, and many others.

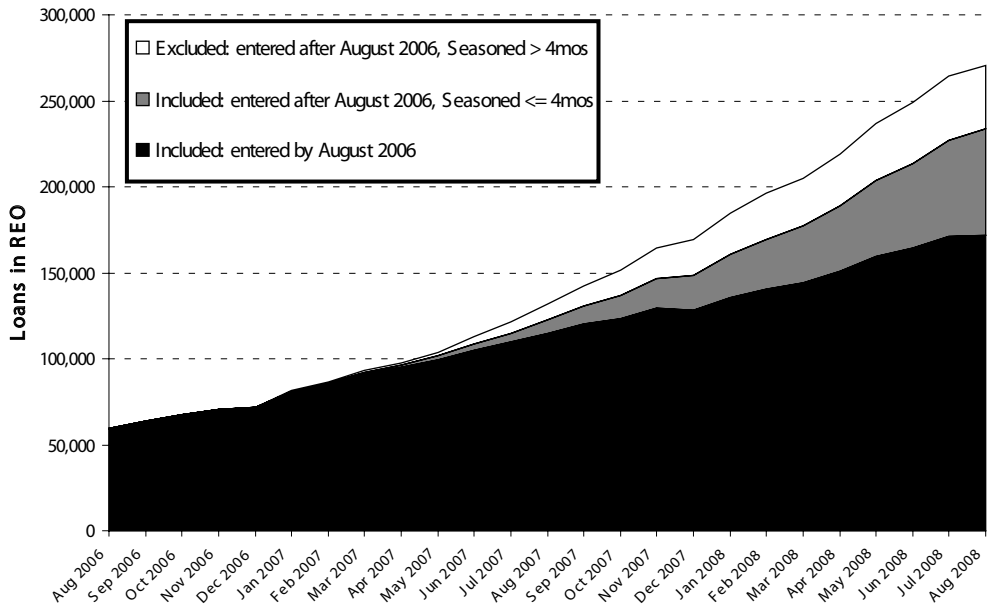
Appendix

The primary data used in this article, the LPS data, are collected from loan servicers. The LPS data do not include all REOs. Therefore, in places where estimates of total REO properties are desired, I have derived them by multiplying the LPS unadjusted totals of prime/near-prime and subprime REOs by factors used to scale up the LPS figures. The figures used for this purpose are national-level estimates of outstanding prime/near-prime and subprime loans from the publication National Mortgage News (NMN). Alternative estimates from the Mortgage Bankers Association National Delinquency Survey (NDS) were also used to judge the sensitivity of the findings to the use of alternative adjustment factors. The sensitivity analysis results (not shown here) indicate that the findings in this article are not substantially affected when switching to the NDS adjustments. The NMN estimates of the total market were somewhat larger than the NDS numbers, so those figures were chosen as the best available estimates.

By comparing LPS data to the NMN estimates, the relative extent of the LPS coverage of the mortgage market is estimated and adjusted for. Using these figures, the LPS figures are estimated to cover 58 percent of the total prime/near-prime market and 32 percent of the subprime market. Therefore, unadjusted LPS prime/near-prime figures are adjusted by a factor of 1.72 ($1/0.58$), and subprime figures are adjusted by a factor of 3.13 ($1/0.32$).

The LPS data set grew significantly in recent years. While the expansion of the data set was the greatest in years before 2006, the sample size continued to expand during the study period. Therefore, the growth in the number of loans in the data set represents not only growth in mortgage loan activity (or REO activity) but also the additional new loans entering the survey due to expanded servicer participation. Over time, many well-seasoned loans (loans that were not recently originated) have entered the data set in “lumpy” spurts. If the entrance of large numbers of well-seasoned loans is not controlled for, increased REO activity may merely reflect the expansion of the sample over time. At the same time, many newly originated loans would normally enter the data set after August 2006 even if the aggregate sample (as a share of all loans) did not change. Therefore, merely restricting the REOs to those for loans originated by August 2006 would provide an overly conservative measure of REO activity and growth, especially given the poor loan performance of many loans originated after August 2006.

Figure A-1 shows the growth in REO in the LPS data set over time broken out into three categories: (1) those associated with loans that entered the data by August 2006; (2) those briefly seasoned (four months or less) loans that entered after August 2006; and (3) well-seasoned (more than four months) loans entering after August 2006. In all analyses involving tracking or measuring changes over time, only REO properties in groups (1) or (2) are included. In the cross-sectional analysis of REO as of August 2008, all three groups are included.

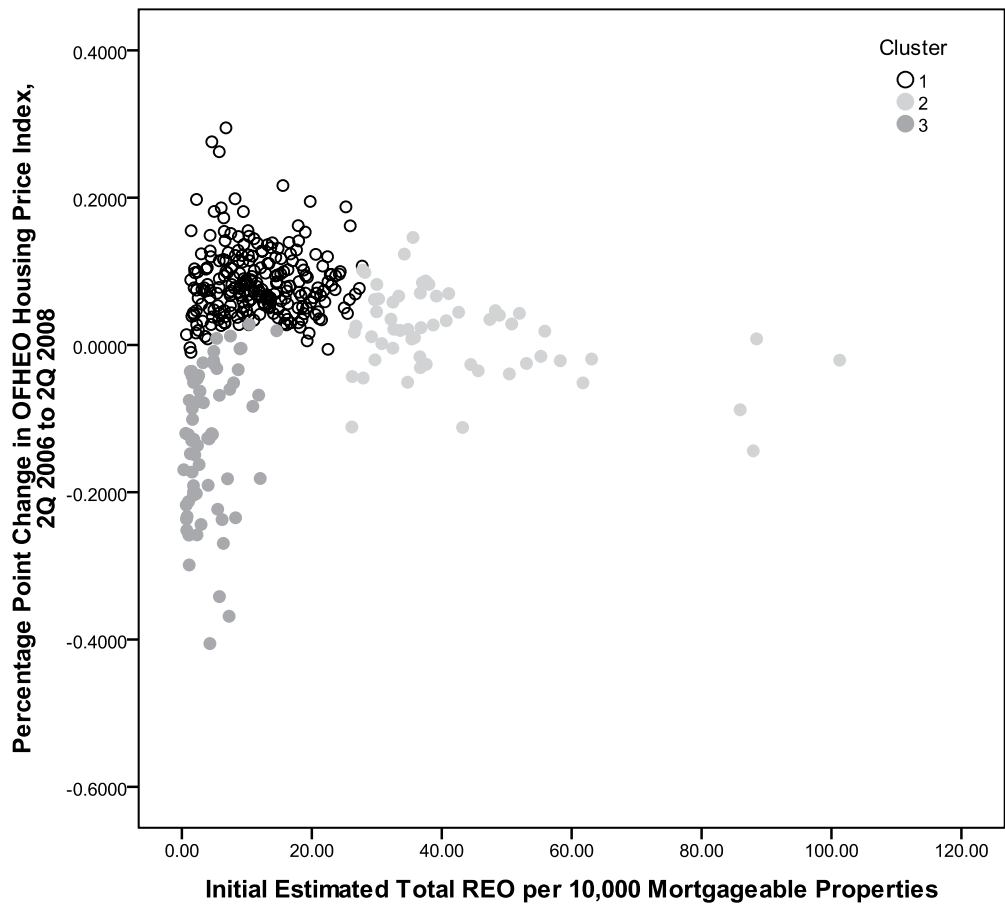
Figure A-1. REO Loans by Entrance Date and Seasoning, August 2006 to August 2008*

* Unadjusted counts, all loan types; all loans in MSAs

Data source: Lender Processing Services Inc. (LPS) Applied Analytics

The cluster analysis in this article uses three variables: (1) the initial (August 2006) prime/near-prime REO density; (2) the initial (August 2006) subprime REO density; and (3) the percent change in OFHEO Home Price Index from the second quarter of 2006 to the second quarter of 2008. Squared Euclidean distance was used as the measure of proximity and Ward's method, which is aimed at minimizing variance within clusters of cases. Figure A-2 illustrates the cluster analysis result by simplifying the initial prime/subprime REO density dimensions by the estimated initial total REO density variable.

Figure A-2. Cluster Analysis Result



References

- Coulton, C., M. Schramm, and A. Hirsh, 2008. "Beyond REO: Property Transfers at Extremely Distressed Prices in Cuyahoga County, 2005–2008." Center on Urban Poverty and Community Development, Case Western Reserve University. December.
- Danis, M., and A. Pennington-Cross, 2005. "A Dynamic Look at Subprime Loan Performance." Federal Reserve Bank of St. Louis Working Paper 2005-029A. May.
- Gerardi, K., A. H. Shapiro, and P. Willen, 2008. "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures" Federal Reserve Bank of Boston Working Paper 07-15. Accessed on November 15, 2008 at <http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf>.
- Immergluck, D., and G. Smith, 2006. "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values." *Housing Policy Debate* 17 (1): 57–79.
- Mallach, A. 2008. "How to Spend \$3.92 Billion: Stabilizing Neighborhoods by Addressing Foreclosed and Abandoned Properties." Federal Reserve Bank of Philadelphia Discussion Paper. October. Accessed on November 15, 2008 at http://www.philadelphiafed.org/community-development/publications/discussion-papers/DiscussionPapers_Mallach_10_08_final.pdf
- Mikelbank, B. 2008. "Spatial Analysis of the Impact of Vacant, Abandoned and Foreclosed Properties." Unpublished manuscript, Cleveland State University. June.
- Pennington-Cross, A. 2006. "The Value of Foreclosed Property." *Journal of Real Estate Research* 28: 193–214.
- Schuetz, J., V. Been, and I. G. Ellen. 2008. "Neighboring Effects of Concentrated Mortgage Foreclosures." Working Paper 08-03. Furman Center for Real Estate and Urban Policy, New York. October 1.

Learning From the Past:

The Asset Disposition Experiences of the Home Owners' Loan Corporation,
The Resolution Trust Corporation, and the Asset Control Area Program

Ellen Seidman

New America Foundation and ShoreBank

Andrew Jakabovics

Center for American Progress

While there is little to celebrate in the current foreclosure disaster, one potential silver lining in the large number of bank-owned properties is the opportunity to turn those properties into community assets. A May 2008 conference hosted by the Furman Center for Real Estate and Urban Policy at New York University and sponsored by the Ford Foundation brought together policy experts and practitioners to share best practices for “Transforming Foreclosed Properties into Community Assets.” Most of the discussion focused on what can be done by partners working together at the local level. The current situation is not, however, the first time that the federal government has faced the challenge of turning foreclosed residential property into affordable housing. In this essay, prepared for the NYU conference, we consider three earlier experiences with asset disposition by the federal government—the New Deal-era Home Owners’ Loan Corporation (HOLC), the Resolution Trust Corporation (RTC), and HUD’s Asset Control Area (ACA) program. In each case, the federal government was forced to deal with large-scale disposition of private-sector assets that passed into public hands as a function of federal funds put into an earlier, related transaction.

In the case of the HOLC and ACA, default on federally guaranteed home loans triggered foreclosure and transfer of the property to the respective entities. Both programs were entirely focused on residential properties. In the case of the RTC, the properties in question were already owned by failed banks insured by the FSLIC or the FDIC or were collateral on RTC-owned loans that proceeded to foreclosure. The vast bulk of the RTC’s loans and properties were commercial, although there was enough residential property to make the case worth studying. All three programs were challenged to maximize revenues from the disposition of the assets acquired while also not overburdening local markets already in a weakened state. In the case of the RTC and ACA, the mandate included a third element: preservation and expansion of affordable housing. Here we provide an overview of the three programs with a focus on their residential property disposition experiences. We conclude with some lessons we think we can take from these experiences and pose a series of questions we believe they raise for our current situation.

The Home Owners' Loan Corporation

The Home Owners' Loan Corporation was established in 1933 and issued new loans through 1936. Homeowners would apply to the HOLC to refinance their existing loans through one of 458 local offices around the country. At its peak in 1934, the HOLC employed approximately 20,000 people, in addition to contractors paid on a fee basis.¹

When a borrower applied to the HOLC, the corporation would appraise the property and offer the borrower a new loan based on the property's current value. In exchange for the lien on the property, the HOLC would offer the mortgagee a corporate bond backed by an explicit government guarantee.² The homeowner was given a 15-year fully amortizing loan.³ To put the scale of the program in perspective, one out of every five qualifying owner-occupied properties on which a mortgage was outstanding in 1934 was refinanced through the HOLC. Approximately one million loans were issued, with a total principal balance of \$3.1 billion, or an average of slightly more than \$3,000 per property.⁴

As critics of the HOLC have always been quick to point out, roughly 20 percent of the borrowers re-defaulted to the point of losing their homes to foreclosure. The HOLC disposed of 198,000 foreclosed properties, although the process was spread throughout the corporation's existence. The maximum number of properties managed was roughly 103,000, from early 1938 through early 1939, after which numbers declined steadily, with only 6,000 properties owned by 1944.⁵

Many of the properties acquired by the HOLC through foreclosure required significant investment to make them salable, above and beyond any tax liens that needed to be paid. This was due to a combination of aged stock and neglect by the homeowners foreclosed upon. Properties were often rehabilitated to bring them in line with comparable local property quality. Nationally, expenditures on rehabilitation averaged 11 percent of the original loan amount or about 12 percent of the net sales proceeds. All together, for the 198,000 properties acquired by the HOLC, rehabilitation costs came to \$89 million, or \$451 per property. HOLC's property management division relied on a combination of its own employees and contractors to fulfill a range of tasks.⁶

HOLC engaged in a surprising amount of due diligence in advance of acquiring properties. When the various loss-mitigation strategies employed by the corporation seemed to fail, setting a property on the path to foreclosure, HOLC would reappraise the property using

1 Home Owners Loan Act of 1933; see also *The FHA Story in Summary*, Federal Housing Administration, 1960, 140, 145.

2 Originally the government only guaranteed interest on HOLC bonds, but in 1934 legislation to guarantee both principal and interest was enacted. See C. Lowell Harriss, *History and Policies of the Home Owner's Loan Corporation* (New York: National Bureau of Economic Research, 1951), 28–29.

3 "Roosevelt Signs Home Loan Bill," *New York Times*, June 13, 1933, 8.

4 Harriss, *History and Policies*, 1.

5 *Ibid.*, 101, 107–8.

6 Harriss, *History and Policies*, 140–51.

the three appraisal methods it used before originating the HOLC loan. The three methods were market comparables, replacement cost less depreciation, and capitalized rent stream.⁷ For the purposes of determining what to do with property acquired in foreclosure, emphasis was placed on the rental valuation—a critically important concept when, like today, accurate sale comparables are hard to come by. In many cases, HOLC worked with the borrower to try to sell the property before foreclosing. The fact that the property ultimately proceeded to foreclosure was an indication of continued weakness in the for-sale market, suggesting that renting the property would maximize value to the corporation.

HOLC properties were rented out on a month-to-month basis (which may have lowered the rents asked) by contract brokers, who were also responsible for property management. The brokers were allowed to make necessary repairs up to \$25 without approval and spend up to \$100 on an emergency basis, such as for a stove or heating. HOLC representatives would check properties annually to assess conditions. Maintenance costs on rented units totaled \$26.8 million over the life of the corporation and equaled 19.3 percent of the gross rental income. As markets improved, rental properties were offered for sale. When a determination was made to sell a HOLC-owned property, either directly after acquisition or after a period of renting, local brokers (often the same ones who managed properties), under commission-based contracts, listed and sold the properties. Advertising costs were paid by the brokers.⁸

Prices were set based on appraisals that indicated estimated sales prices based on varying levels of rehabilitation. The decision to rehabilitate for-sale properties was based on the anticipated return on that investment. The minimum value HOLC would accept for a property was kept secret when the property was put up for sale. There was also HOLC oversight in setting the floor: any property offered for less than \$1,000 but that was profitable to the HOLC or properties over \$1,000 where the price reflected less than a 35 percent loss were approved by HOLC's regional property committee; losses greater than 35 percent needed to be approved by a Home Office Property Committee.⁹ The actual offering price was often far higher than the reserve, but it rarely exceeded HOLC's costs.

HOLC was often forced to finance its own sales, both because as a government entity it could obtain better rates and because other lenders were unwilling to take on the risk. HOLC required a down payment that averaged 12.2 percent nationally (New York and New Jersey down payments were higher) and a year's taxes and insurance in escrow, but the down payment would vary with creditworthiness and local standards. The down payment was designed to cover, at a minimum, HOLC's anticipated costs should the new owner default on the loan.¹⁰

7 Ibid., 41, 110.

8 Ibid., 114.

9 Ibid.

10 Harriss, 116–18.

From this summary, we think four HOLC innovations and practices stand out, as well as a few important lessons. First, the 15-year fully amortizing loan was a major breakthrough in mortgage finance. Second, the corporation was rigorous in its appraisal practices, both when initially making a loan and when putting a foreclosed property up for sale. In part this was a matter of risk management, but it was also an attempt not to add to a downward market spiral. Third, the agency had a clear understanding both that it was a temporary entity and that real estate markets are highly localized. This led to the heavy reliance on a network of contract brokers and others. Fourth, when faced with the choice of continuing to hold onto a property for which it had a credit-worthy buyer or financing the buyer itself, it chose to self-finance.

As to lessons, we think a clear one is that when a government agency is tasked with the job of cleaning up after a major financial disaster, success is mitigating and spreading out over time the effects of the problem. The HOLC's 20 percent default rate in a rising market may look troubling today, but the question is "compared to what?" It almost certainly reduced the suffering of both homeowners and markets at a very troubled time. Moreover, best estimates are that profits from the HOLC's lending operations were slightly larger than losses on foreclosures.

The Resolution Trust Corporation

The Resolution Trust Corporation came into existence with the passage of FIRREA in August 1989, which transferred conservatorship of just over 250 failed thrifts from the FSLIC to the RTC. By the end of 1990, the RTC had taken over 531 thrifts with \$278 billion in assets. This represented slightly more than two-thirds of the assets ultimately under the RTC's responsibility. The volume of new assets dropped to \$79 billion in 1991 and dropped again to \$44 billion in 1992, the last year with any significant inflows to the RTC. Nearly half (48 percent) of the RTC's assets were commercial and residential mortgages, with the other half a combination of REO (properties foreclosed upon by failed banks as well as bank real estate such as branch locations), other loans, securities, and other assets, including subsidiary corporations.¹¹

In contrast to HOLC, whose primary task was to refinance mortgages, with asset disposition a consequence of the inevitable failure of some of that financing, the RTC was about asset disposition from the start. Moreover, only about \$3 billion of the \$402 billion of assets that passed through the RTC consisted of residential real estate.¹² The RTC's enabling legislation emphasized maximizing returns and minimizing losses, minimizing the impact on local real estate, and maximizing affordable housing preservation. As should be obvious, at least two of these goals are inherently in conflict. While the RTC was initially expected

11 Authors' calculation based on FDIC data available at <http://www.fdic.gov/bank/historical/managing/Chron>.
See also *Managing the Crisis: The FDIC and RTC Experience* (Washington, DC: FDIC, August 1998), 298.

12 *Managing the Crisis*, 390.

to take many years to dispose of all its assets, the organization, staffed heavily with recruits from the bank regulatory agencies and under constant funding pressures, determined that maximizing returns meant moving quickly to reduce the properties' drag on the market, especially in Texas. The RTC received its final funding from Congress in 1993 and closed up shop in 1995.

The RTC disposed of assets through a variety of channels—direct sales, auctions, securitization, and a small number of joint ventures with private firms. The corporation relied heavily on private firms to evaluate, package, and sell assets, which was both a matter of direction from Congress and a matter of necessity. Servicing performing loans was contracted out to conventional mortgage servicers until disposition, while nonperforming loans, REO, and other assets were offered to contractors to process for disposition.

From 1991 to 1993, 91 contractors won 199 contracts for the RTC's Standard Asset Management and Disposition Agreements (SAMDA) to handle assets of \$48.5 billion, a small fraction of which was residential real estate.¹³ The contracts were for three years, with two optional one-year extensions, depending on the number of outstanding assets. The SAMDAs set up management, disposition, and incentive fees but did not cover overhead costs. Firms bidding for SAMDA contracts would offer bids on their management and disposition fees; the incentive fee structure was fixed by the RTC for all contracts and paid a 20 percent bonus on the disposition fee for assets sold in the first year of the contract and ten percent in the second year. The SAMDAs further required engaging other private-sector firms and employees by mandating subcontracts for appraisals, REO brokerage, property management, and the like. In total, 12 services required subcontractors under SAMDA. A change to the program in January 1992 dropped disposition from contracts as the RTC moved toward a national, multi-asset disposition model that improved net recovery and shortened holding times over individual asset sales.¹⁴

The SAMDA program's record was somewhat mixed relative to similar contract programs run through the FDIC. Real estate expense ratios were higher under the SAMDA program, but the asset quality in the SAMDA program was worse, which accounts for some of the discrepancy. All together, the \$48 billion in book value of assets disposed of through SAMDAs returned net collections of \$19 billion, for a recovery rate of 41 percent. The overall expense-to-collection ratio was 19 percent. Real estate sales accounted for 40 percent of the book-value reductions but 70 percent of the disposition fees.¹⁵

In addition to disposing of real estate through SAMDA, the RTC used a direct sale approach, and later shifted to auctions as the volume of properties became too great to handle directly. To address concerns about flooding local markets with large numbers of distressed properties for sale, the RTC was under a mandate not to sell properties for less

¹³ Ibid., 333–34.

¹⁴ For a full description of the SAMDA program, see *Managing the Crisis*, 354–69.

¹⁵ *Managing the Crisis*, 361, 368.

than 95 percent of value in direct sales or under the SAMDA contracts. Under the auction program rules established in March 1991, an absolute floor of 70 percent of value was set. In practice, the actual floor varied with each auction.¹⁶

Residential real estate, a combination of single-family homes and multifamily buildings, was funneled through the RTC's Affordable Housing Disposition Program (AHDP). Over all, the RTC sold 91,000 units of multifamily housing and another 28,000 single-family homes through the AHDP. Another 25,000 multifamily and 14,000 single family units were sold outside the AHDP. As noted, residential real estate represented about one half of one percent of the \$402 billion in book value of assets that passed through the RTC. Seventy percent of the multifamily properties were in the South and West, and nearly 30 percent of the single-family properties were in Texas.¹⁷

Multifamily properties were initially sold through a clearinghouse process with sale to the highest bidder. Multifamily property sold through the AHDP had use restrictions for 40 years, during which 35 percent of the units needed to be rented to households below 80 percent of area median income. In addition, 20 percent of the units were to be rented to households below 50 percent of area median income (AMI). Single-family houses were also deed restricted, but eligibility extended up to 115 percent of AMI. At closing, buyers were obligated to sign certificates of intent to occupy the property and to certify income eligibility. There was also a one-year recapture provision that allowed the RTC to take 75 percent of the profits of a sale that took place within a year of closing. Single-family properties could be sold directly to income-qualified households or to local housing nonprofits, who were obligated to rehabilitate the properties and rent them or sell them to households meeting the eligibility requirements.¹⁸

The RTC engaged in several activities to speed the disposition of its assets under the AHDP and improve the outcomes for buyers. First, the RTC engaged local nonprofits to provide pre-purchase counseling to prospective buyers as well as post-purchase seminars on owner responsibilities like maintenance, mortgage payments, and insurance. Nonprofits also provided technical assistance to public housing authorities seeking to purchase the RTC's multifamily buildings. Second, the RTC established a seller financing program for both single- and multifamily properties, in recognition of the difficulty many potential purchasers had in finding suitable financing, including through the FHA. RTC loans were offered for up to 97 percent of the value of single-family homes, with the RTC also covering closing costs. Approximately 20 percent of single-family sales involved RTC financing. In addition, the RTC would provide up to \$5,000 to repair single-family homes in inventory, in recognition of the fact that low- and moderate-income buyers would likely be unable to afford repairs.¹⁹

¹⁶ Ibid., 328–29.

¹⁷ Ibid., 376–77.

¹⁸ Ibid., 375.

¹⁹ Ibid., 377–80.

In May 1992, the RTC changed how it sold multifamily properties, from sale to the highest bidder with use restrictions to direct sales through a series of sales windows. Public agencies were given the first 30-day opportunity to buy a property. If the property was unsold after 30 days, nonprofits would be given a chance, and if it remained unsold after that time, the property would go into a clearinghouse for anyone to purchase within 90 days. Buyers would have to commit to the affordable unit set-asides described previously. Only after a property failed to sell through the clearinghouse would the RTC place it for sale outside the AHDP. Under FIRREA, Congress established a similar 90-day marketing period for single-family houses for public agencies, nonprofits, and qualified buyers.²⁰

The innovation for which the RTC is best remembered is the commercial mortgage-backed security. But while residential real estate was a relatively minor part of the RTC's activities, the RTC was responsible for several important innovations in that area, especially with respect to protecting housing affordability. These include working through nonprofits and local housing authorities, use restrictions, the tiered sale process, and systems to provide counseling to new homeowners. Like HOLC, the RTC provided some seller financing and assisted in upgrading many of its properties before or as part of their disposition.

HUD's Asset Control Area Program

The final asset disposition program we discuss is HUD's Asset Control Area program, the only one of these programs still in existence. The ACA program was initially authorized in 1998 as a pilot program to dispose of 40,000 FHA-foreclosed properties while stabilizing communities and reducing opportunities for speculative buying, superficially fixing and flipping properties.²¹ It has since become a permanent program.

Within each asset control area, housing intermediaries, originally acting on behalf of local governments but now directly contracting with HUD for preferred bulk purchasing rights, agree to purchase FHA-owned properties, rehabilitate them, and resell them as affordable housing. The FHA sales price is determined by appraisal and discounted to account for necessary rehabilitation. Early ACA programs were in Chicago,²² Cleveland, and Los Angeles, among other places.²³

One of the central components of the ACA program is its narrow geographic focus. ACA program participants submit a plan to HUD that identifies specific census tracts for targeted investment, affordability requirements, counseling programs, marketing plans, sales projections, and quality-control measures. Once a contract is reached with HUD, ACA participants

²⁰ Ibid., 380, 381.

²¹ Jennifer Blake, "Innovations in Community Development: Rebuilding Neglected Los Angeles Communities," Enterprise Community Partners, 2004, available at <http://www.practitionerresources.org/showdoc.html?id=19723>.

²² See http://www.chicagoareahousing.org/AssistPgm_Detail.asp?pgmid=338&newlayout=.

²³ "Industry News," *Shelterforce*, January–February 2001.

are obligated to purchase all HUD-owned single-family homes within the designated area, up to an annual cap. For example, Enterprise's Dallas ACA program committed to buying 100 homes per year during its two-year contract.²⁴

After receiving notice of HUD-owned properties in the area, the nonprofit has a short period of time in which to inspect the properties and itemize needed repairs. HUD then sells the properties to the nonprofit at a discount of at least 50 percent of as-is appraised value. Purchases are funded through credit facilities provided by local lenders, often with interest reserves funded by the city.²⁵

Once the nonprofit acquires the properties, it begins rehabilitation. Rehabilitation includes lead and asbestos abatement, improving energy efficiency, and repairing major building systems to provide a minimum 10-year service period. Substantial rehabilitation can cost as much as \$150,000 per property, but it varies significantly by market. Enterprise reports that in Los Angeles, the average cost of acquisition and rehabilitation was \$235,000 per property.²⁶ The cost in Rochester was approximately one-third of that.²⁷ In Dallas, rehabilitation alone costs an average of \$25–30,000, but there is a significant range, with new properties needing as little as \$11,000 and older, wood frame properties with deteriorated foundations costing as much as \$70,000.²⁸

Once a property has been rehabilitated, it is offered for sale to low- and moderate-income buyers. Pricing is set based on a strict formula: acquisition costs, plus rehabilitation costs, plus a 15 percent markup. At the time of sale, the property is appraised, and the difference between the appraised value and sales price is captured by a soft second note held by HUD for three years. If the owner stays in the property for three years after purchase, the soft second is extinguished and the equity is transferred to the owner.²⁹

Eligibility is determined by the terms of the ACA agreement with HUD. Unlike HOLC or the RTC, which offered seller financing, ACA program participants are unable to finance prospective buyers. In many cases, the nonprofits or local government will offer down-payment assistance or other subsidies, but the bulk of the purchase price must be met with other financing. For example, the city of Dallas offers buyers below 80 percent of AMI up to \$10,000 in down-payment assistance.³⁰ To protect buyers from predatory lending practices, all financing arrangements must be approved by the nonprofit. Two-thirds of buyers in the

24 Author interview with Richard Pine, EHOP-Dallas, April 29, 2008.

25 Jennifer Blake, "Innovations in Community Development: Rochester Housing Development Fund Corporation: Renovating Houses and Rebuilding Lives," Enterprise Community Partners, 2006.

26 Blake, 2004.

27 Blake, 2006.

28 Richard Pine, April 29, 2008.

29 Ibid.

30 See http://www.dallascityhall.com/html/home_buyer_assistance_programs.html.

Dallas ACA program rely on FHA financing.³¹ Buyers must complete pre-purchase counseling to be eligible to buy a home through the program.

Anecdotally, the ACA program has been effective in stabilizing communities that previously had high rates of foreclosures. The program's success is now being challenged, however, by the fact that lenders are tightening credit standards, which makes it difficult for prospective buyers to purchase rehabilitated properties. This increases the risk to nonprofits of participating in the program. The program is difficult to make work in highly distressed communities because of HUD's rigid pricing structure, as well as program rules that determine profit and loss on a per-property basis rather than at the portfolio level, which would allow a small measure of cross-subsidization. ACA programs rarely include the most distressed neighborhoods because there is no way for participants to cover their costs.³²

While the ACA's rigid rules make it a less than perfect model for dealing with today's foreclosure crisis, the program has provided those who have used it with valuable experience. ACA participants are starting to apply the knowledge and experience they gained under the ACA program to make bulk purchases of properties from private servicers.

Conclusion

What can we learn from these three experiences? We think there are three big lessons. First, achieving the balance among maximizing returns, stabilizing markets, maintaining or enhancing affordability, minimizing government outlays, and getting the job done quickly is hard—and pressures are constant to accomplish all five goals simultaneously. Second, the entity that undertakes the task must have multiple skills—asset manager, property manager, contract manager, financier, and coalition builder among them. Third, the job will require flexibility and innovation. Both the HOLC and the RTC, maligned as “cowboys” in their day, are in retrospect remembered as flexible and innovative entities. In contrast, the rigidity of the ACA program has limited its utility.

Any new disposition program will face not only the old questions, but new ones that reflect changes in both sensibility and law since even the early 1990s. For example, what will be the impact of modern landlord-tenant law on strategies that envision use of single-family properties temporarily for rental housing? Are income-based eligibility requirements appropriate in all cases, and if not, how should they be used? What is the effect of such criteria on the communities in which the homes are located? To what extent have these been mixed-income communities, and is the maintenance or expansion of mixed-income neighborhoods a goal? How do we best harness the capacity and discipline of the for-profit sector alongside the nonprofit and governmental sectors? And finally, can we abide the “cowboy” flexibility and innovation that a temporary entity might be able to exercise—and can we find anyone in this day of “gotcha” politics and journalism who would take the job of leading such an entity?

31 EHOP-Dallas, Enterprise Profile Report, March 27, 2008.

32 Richard Pine interview, April 29, 2008.

To state the obvious, none of this will take place in a political vacuum. We began by acknowledging that the properties being disposed of came into public hands as a result of taxpayer funds used in an earlier transaction. With public funding comes not only public purpose but politics. Congressional pressure to liquidate the HOLC as its outstanding loan balances declined meant selling off mortgages to local banks sooner than a profit-maximizing strategy would have dictated.³³ The RTC was under constant political pressure to get the job done quickly with no money, which definitely influenced the corporation's strategy and operations. And of course the RTC was subject to three arguably inconsistent mandates: maximizing profit, minimizing local market distortion, and enhancing affordable housing.³⁴ It is probably too much to ask, but there is something to be said for setting priorities in law rather than leaving it to the bureaucracy to figure out.

In the end, the question is, What are our overall goals? What types of communities do we envision ten years from now in the places with large numbers of foreclosed properties? Can we fundamentally change the boom-and-bust cycles in these communities that seem to recur in 20-year intervals? How can we use this crisis to improve our stock of quality, affordable rental housing? And—maybe biggest of all—what is the role of homeownership in America?

Ellen Seidman is a senior fellow at the New America Foundation and executive vice president, National Program and Partnership Development, at ShoreBank Corporation. From 1997 to 2001 she was Director of the Office of Thrift Supervision.

Andrew Jakobovics is the associate director for Housing and Economics at the Center for American Progress. He works on housing, household debt, and higher education, as well as other issues related to sustaining and growing the middle class. Andrew holds a BA in Urban Studies from Columbia University and an MCP from the Massachusetts Institute of Technology, where he is currently pursuing his doctorate.

33 Harriss, *Histories and Policies*, 6.

34 *Managing the Crisis*, 8.

Community Development Financial Expertise Put in Service of Neighborhood Stabilization

Mary Tingertbal

Housing Partnership Network

As we began 2009, communities across the United States faced an unprecedented crisis brought about by millions of mortgage foreclosures and chaos in the capital markets. More than one million homes stand vacant and home values have fallen in every major metropolitan area over the past year. Several icons of the capital markets – Lehman Brothers, Merrill Lynch, and Wachovia Bank – no longer exist, and others, including Fannie Mae and Freddie Mac, are deeply wounded.

Yet as communities ponder these massive problems and work to save their neighborhoods in the midst of frozen credit markets, lessons learned over the last 30 years by community development organizations are fostering new tools and solutions. Because there is a rich network of mission-based organizations that are committed to building strong communities across the country and because these organizations have developed savvy and skills in using capital markets tools, community development leaders were able to quickly partner with major financial institutions to set a course for saving neighborhoods ravaged by home mortgage foreclosures.

This article will: (1) briefly explore the history of community development organizations and how they multiplied their impact through the use of sophisticated capital markets tools; (2) describe how community development organizations worked together with major financial institutions to identify key tools that would be needed to dispose of hundreds of thousands of vacant foreclosed properties; (3) describe the National Community Stabilization Trust – a partnership that helps communities effectively bring vacant properties back into productive reuse; and (4) discuss the future of community development organizations working in partnership with financial institutions.

Community Development and Capital Markets – A Rich History

When the term and practice of “community development” came into use in the 1970s, it really marked a change in the way we think about how change happens in communities. The implementation of the federal Community Development Block Grant (CDBG) program in 1975 played a role in cementing a place for the term in our vocabularies as it provided one of the first federal programs that required that cities solicit input from communities in developing plans for how the dollars would be spent. It replaced the Urban Renewal programs of the late 1960s and early 1970s, which were seen by many communities as being “top-down” in their decision making and were seen as emphasizing wholesale demolition and clearance of

blighted neighborhoods as primary tactics. CDBG was part of the Housing and Community Development Act of 1974, which also brought significant dollars to the table for the development of low- and moderate-income housing through the Section 8 housing program.

The Woodstock Institute, an organization committed to the issues of racial justice, economic development, and low- and moderate-income housing, preceded CDBG by two years. Within the next seven years, the Community Reinvestment Act was passed (1977), NeighborWorks was founded (1978), the Local Initiatives Support Corporation (LISC) was formed (1979), and the Enterprise Foundation (Enterprise) was established (1982). In this period, the work of thousands of small community-based organizations began to gain credibility as a powerful “bottoms-up” way for communities to change horrendous local conditions caused by economic disinvestment and racial and economic segregation.

As community development gained credibility, there was a growing realization that community development organizations needed tools to access economic capital directly if they were going to bring about large-scale change in communities. The introduction of the Low Income Housing Tax Credit (LIHTC) program in 1987 provided one of the first tools that enabled community organizations to directly attract private investors to invest in affordable housing. While the Section 8 program had been a powerful tool in developing thousands of affordable housing units, most of the housing was developed by for-profit developers and often was located without much regard to the priorities important to communities. Furthermore, properties developed using the Section 8 program were dependent on continuing federal subsidies in order to keep rents affordable to low-income households. By contrast, the LIHTC builds the federal subsidy into the equity structure of the property rather than using ongoing rent subsidies to generate enough cash flow to pay debt service on large mortgages. In addition, the LIHTC is allocated from the federal level to states and a few cities on a simple per capita basis. The actual direction of LIHTC to projects is managed by state agencies, which must adopt allocation plans that are subject to public review on an annual basis.

Both LISC and Enterprise developed investment entities that used the LIHTC to attract billions of dollars in private capital to develop affordable housing projects. Because they worked directly with investors, they were able to attract this capital to projects located and built with a significant amount of community involvement. This allowed LISC and Enterprise to direct investment to projects developed by nonprofit development organizations whose missions are focused on community development. In addition, community development organizations all over the country were able to influence directly the allocation plans adopted by state agencies.

The 1990s saw a continued flowering of community development organizations that were directly accessing the capital markets to support the redevelopment of communities and the development of affordable housing. The Housing Partnership Network was formed in 1990 by nonprofit affordable housing and community development organizations from across the country that wanted to learn from one another. In 1994, the Community Develop-

ment Financial Institutions (CDFI) Fund was established to provide equity capital directly to banks and loan funds that focused their lending on community development projects. In 1995, the Community Reinvestment Act was significantly modified to require that financial institutions not only lend and maintain branches in low- and moderate-income communities where they collect deposits, but that they also invest in these communities. The decade ended with the creation of the New Markets Tax Credit (NMTC), which allows community development organizations to attract private capital to low-income communities for economic development.

This long history is recounted to underscore the point that community development organizations have produced positive changes in communities across the country because they are mission-based organizations that take their direction from the low- and moderate-income communities they serve and because they have developed successful tools for attracting private investment capital to these communities. They have been able to make the case for investments in projects and in communities that the conventional capital markets often overlooked or shunned. Such projects have often been the vanguard for the subsequent investment of purely private capital in enough volume to turn around whole neighborhoods. The Harlem community in New York City is just one of the best-known of such reinvestment stories. The story has been repeated in hundreds of low-income communities across the country.

A Community Development Response to the Mortgage Foreclosure Crisis

In the past year, community development organizations across the country were quick to realize that the mortgage foreclosure crisis was threatening the health of low-income communities as the number and concentration of vacant and foreclosed properties mushroomed. Communities that they had worked to rebuild for 30 years were being devastated as families lost their homes and their economic situations became perilous. As families left, vacant properties triggered further disinvestment and a sense of hopelessness among the families that remained in the communities. The strong communities that they had worked so hard to build were slipping away.

It should be noted that prominent community development organizations including Self-Help and its Center for Responsible Lending had sounded the alarm in the early 2000s about the dangers of predatory lending and the irresponsible lending products that have now been discredited. The calls of the community development industry for regulation of mortgage lenders went largely unheeded.

In 2007, as foreclosures began to mount in cities like Cleveland and Minneapolis, community development organizations began to convene key players in their communities to figure out how to address the crisis. They looked first to improve and increase foreclosure-prevention strategies.

While there have been and continue to be many successes in the foreclosure-prevention arena, by the end of 2007 it became apparent that bad lending practices and widespread

fraud had resulted in many families having mortgages that they could not afford even with substantial modifications to their terms. Moreover, it became apparent that many single-family homes had been acquired by absentee owners who had purchased properties with the hope of reselling them in rapidly appreciating markets for quick profits. When the credit crisis hit all markets in 2007 and residential property values began to fall, these owners were caught with investments they could not sell and mortgage payments they could not afford. These properties served to quickly balloon the number of vacant and foreclosed properties, which, in turn, added to the downward spiral of property values in communities with high concentrations of these properties.

As the story of foreclosures and vacant properties continued to unfold, community development organizations realized that they had to become engaged in stemming the tide of growing neighborhood devastation. The “we live here” underpinnings of community development stimulated a push for action.

In early 2008, local community development organizations, in addition to their local organizing efforts, began talking to the national community development organizations with which they worked. They realized that some large-scale solutions at a national level would be needed to help them tackle the problems they were seeing at a local level. Two problems emerged as issues that could not be addressed effectively purely at a local level.

- First, the widespread use of securitization for single-family mortgages had resulted in the ownership and decision making about the disposition of vacant and foreclosed properties being spread across the globe.
- Second, the scale of economic losses throughout the financial markets often left local communities holding the bag when it came to dealing with the very real problems of maintaining vacant properties, addressing the neighborhood issues created by vacant properties, and planning for their productive reuse. Local communities needed additional financial resources to deal with these problems.

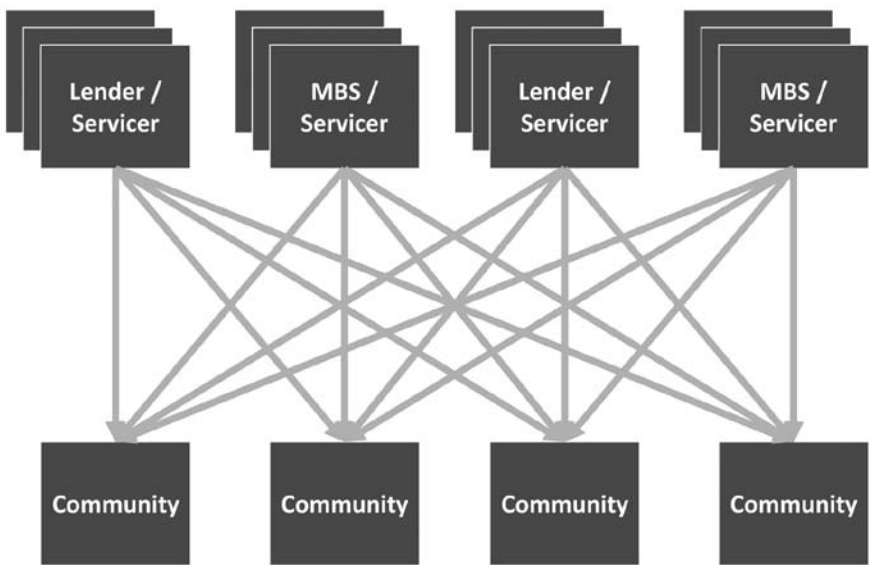
In February 2008, four national community development organizations – Enterprise, the Housing Partnership Network, LISC, and NeighborWorks – came together to explore whether they could help the local and regional community development organizations with which they are affiliated to address these large-scale problems. These four sponsors formed a working collaborative effort called the National Community Stabilization Trust (the Stabilization Trust) to formally frame some solutions.

First, they tackled the issue of financial resources. Working with a broad coalition of community development organizations, they helped form the Save America’s Neighborhoods campaign to advocate for federal resources to help communities acquire and redevelop vacant residential properties. They also began a dialogue with the philanthropic community about directing resources to this issue. They simultaneously engaged in a campaign to heighten awareness of the problems of neighborhood destabilization that were a result of the foreclosure crisis among state, local, and federal government decision makers. As one

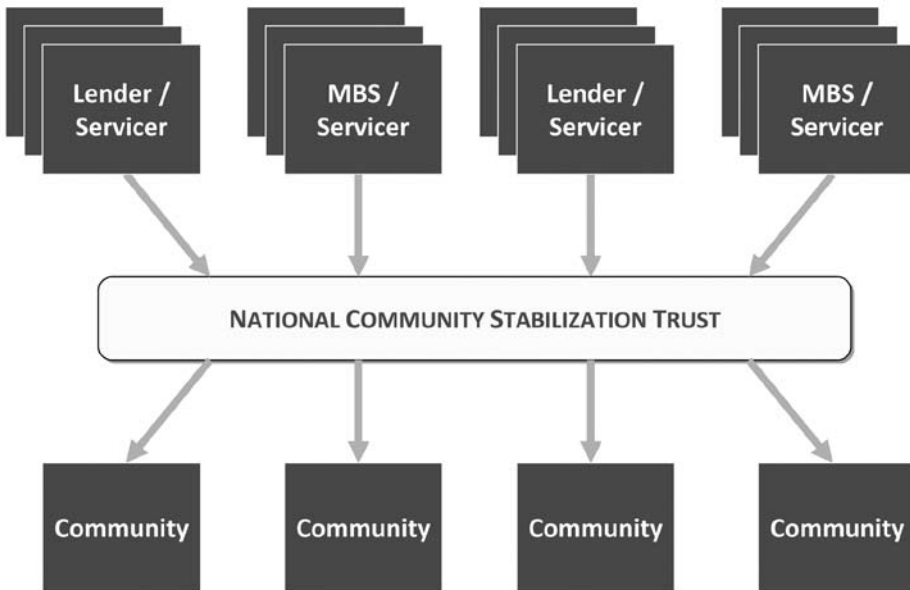
tangible result of these efforts, the Neighborhood Stabilization Program (NSP) was included in the Housing and Economic Recovery Act of 2008, which was enacted in July 2008. The NSP program directs \$3.92 billion through more than 300 state and local government agencies for stabilizing communities by acquiring and redeveloping vacant properties. The NSP program is currently being implemented through the Department of Housing and Urban Development (HUD) and funds will be available for use in communities early in 2009.

Second, they tackled the issue of developing a method by which state and local governments and community development organizations could efficiently and cost-effectively acquire vacant properties from the myriad mortgage loan servicers and investors that make the decisions about the sale and disposition of vacant foreclosed properties. In previous times when neighborhoods faced large numbers of vacant properties, most of these properties were controlled by HUD because the foreclosures occurred under the FHA insurance program. This time, communities would need to make multiple contacts to acquire all the properties even in a small target area. Multiply this by hundreds of communities nationwide and it became clear that an intermediary could potentially serve a useful purpose.

Transfer Foreclosed Properties



Transfer Foreclosed Properties



Using research dollars from the Ford and MacArthur foundations, the Stabilization Trust engaged consultants knowledgeable about both the mortgage banking industry and the community development industry to develop a set of solutions. The four sponsors of the Stabilization Trust quickly realized that this research would best be conducted by working with actual examples of foreclosed properties in communities that were already organizing to tackle the issues of neighborhood stabilization. They also realized that it would be critical to begin working with the major financial institutions that provide mortgage loan servicing for more than half of the country's residential mortgages.

The research had several major components:

- About 20 communities that are affiliated with the four sponsor organizations of the Stabilization Trust were asked to:
 - provide specific information about the neighborhood stabilization efforts that were already under way;
 - identify the zip codes for the areas of their communities that they were targeting for stabilization efforts; and
 - identify the financing gaps that they anticipated as they redevelop vacant properties for effective reuse.

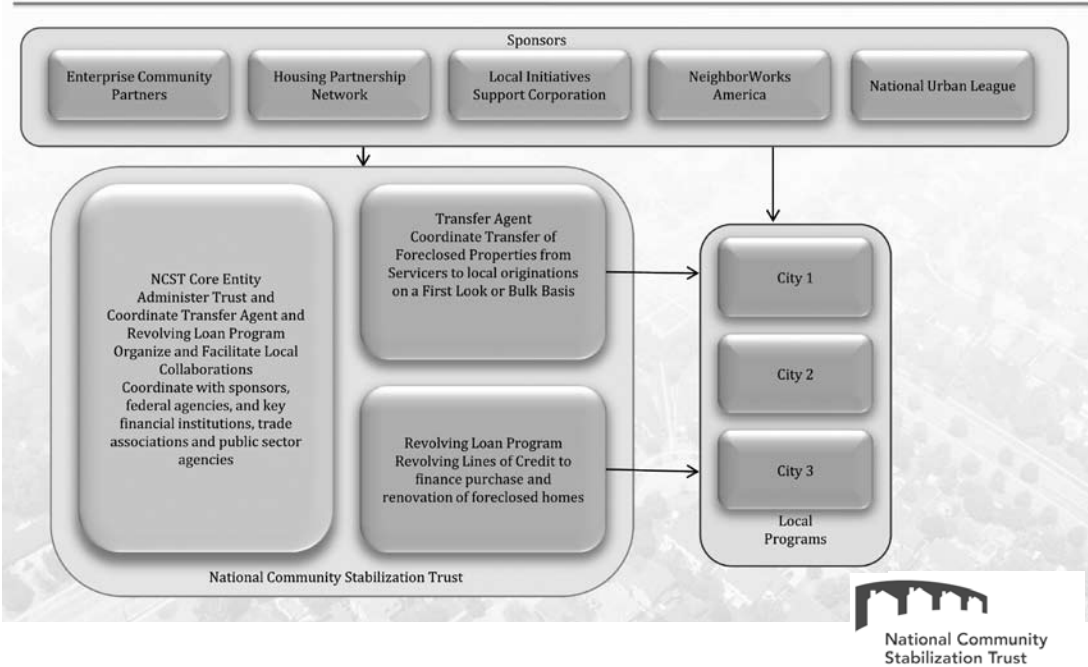
- The Office of the Controller of the Currency (OCC), working with the Stabilization Trust, convened a working group comprised of representatives from the largest mortgage loan servicing operations in the country. Through this working group, the Stabilization Trust gained the commitment of several financial institutions to:
 - provide information to the Stabilization Trust about vacant properties for which they were the loan servicer and which were located in the zip code areas identified by the communities; and
 - arrange for their loan servicing managers to participate in detailed interviews about the processes they use in working with foreclosed properties, particularly when those properties complete the foreclosure process and become “real estate owned” or REO properties.
- The Stabilization Trust developed a methodology for calculating the Net Realizable Value of an REO property that would both:
 - fulfill the fiduciary obligations of the loan servicers to the investor owners of the REO; and
 - take into account the market risks that communities would take on when they acquired REO properties.

This initial research was completed in late July 2008 and a plan was presented to the four sponsoring organizations for implementing an organization that would have two major functions:

- a Transfer Agent entity that would provide an exchange platform for local communities to efficiently and effectively acquire vacant properties from financial institutions; and
- a Capital Corporation that would aggregate capital from philanthropic and capital markets investors to supplement the financial resources available through the NSP program.

The initial four sponsors of the Stabilization Trust, and a fifth sponsor, the National Urban League, subsequently agreed to take the steps necessary to form and capitalize a limited liability company that would implement this plan. They also agreed to engage an executive leader that would direct the work of the Stabilization Trust. The diagram below shows the general business model for the Stabilization Trust.

Functional Structure of NCST



The National Community Stabilization Trust – The Leading Voice for Neighborhood Stabilization

By early October 2008, the National Community Stabilization Trust LLC had been formed and Craig Nickerson, a seasoned executive with extensive experience in both community development and mortgage banking, had been engaged as its executive. When HUD announced the commencement of the new Neighborhood Stabilization Program at a national summit meeting in early October, the Stabilization Trust was featured on the program as an important tool for states and localities to use in implementing the NSP program in their communities. At this same meeting, several major financial institutions announced that they intended to work through the Stabilization Trust to offer REO properties for acquisition by states and localities.

While these activities were unfolding nationally, the Stabilization Trust was beginning to engage specific financial institutions to offer properties to local communities under the terms of a Memorandum of Understanding (MOU). The MOU contains the Net Realizable Value procedure for determining the prices at which properties will be offered to local communities acquiring properties through the Stabilization Trust. The formula for calculating the Net Realizable Value for a property is shown in the diagram below. The Stabilization Trust confirmed with HUD that this Net Realizable Value approach fulfills the requirements for calculating the discount required by the NSP guidelines.

Transfer Agent

Applying the Net Realizable Value Approach to Vacant Property

Net Realizable Value model balances needs of buyers and sellers.

	Estimated market value assuming normal market conditions and procedures through a Broker's Price Opinion, an Automated Valuation Model or a full appraisal
Less	Saved holding costs of insurance, real estate taxes and maintenance
Less	Avoided transaction costs of brokerage and sellers internal supervision and administration
Less	Savings in capital costs due to early receipt of proceeds
Less	Possible decline in value over the holding period
Less	Rehabilitation required for code compliance and marketing
Equals	Net Realizable Value



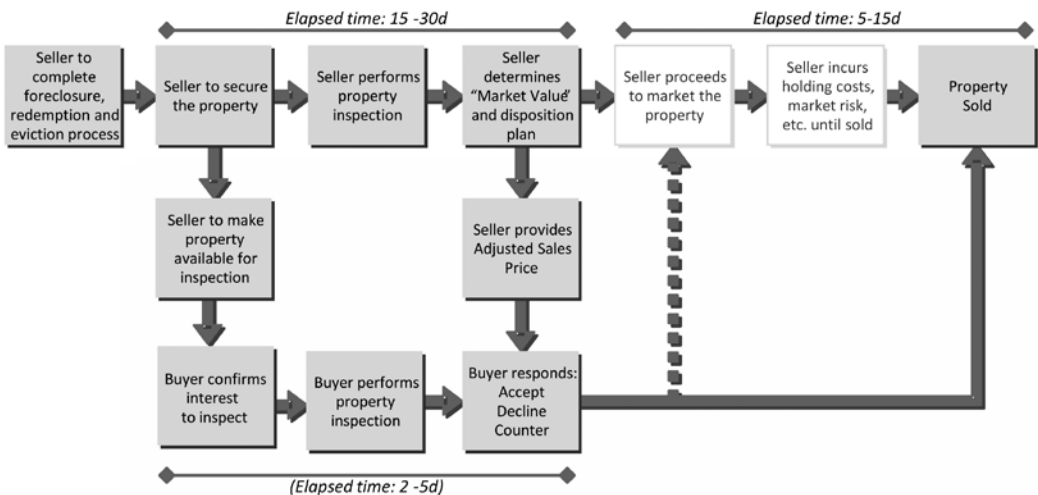
The MOU also outlines two processes for offering properties – a “First Look” process through which financial institutions offer properties in specified target areas as soon as the properties become REO and before they are listed for sale; and a targeted bulk-purchase process through which financial institutions offer properties that have been on the market in designated target areas for an extended period of time.

The responsibilities of the Stabilization Trust under the MOU are to engage local and state organizations to purchase properties through the Stabilization Trust and to ensure that these organizations have addressed a set of five criteria:

- Concentration – The local community stabilization effort should focus on one or more defined geographic areas to increase the likelihood that a significant, visible impact can be achieved.
- Capacity – The local community stabilization effort should include organizations with the ability to assess, acquire, manage, rehabilitate, and convey properties quickly and at scale.
- Capital – The program should have sufficient resources from the HUD NSP fund and other public and private resources to conduct a successful stabilization program.

- Collaboration – The local community stabilization effort involves an established partnership with government agencies, nonprofit organizations, and other local stakeholders that defines the roles and accountabilities of each participant.
- Comprehensive – Bricks-and-mortar activities such as the acquisition and rehabilitation of properties purchased through the Stabilization Trust should be complemented by a broader strategy that leverages related social investments and improvements to infrastructure, incorporates a marketing campaign, and otherwise integrates tangible and intangible community efforts.

Also in early October 2008, the Stabilization Trust Transfer Agent began to test its operations by engaging in a small number of actual transactions, with properties being offered by two loan servicers under the terms of the MOU and properties being reviewed and acquired by two local communities. The initial transactions have yielded offers in the price ranges anticipated by the Net Realizable Value methodology. The first purchases closed in mid-November. The following is a diagram of how the First Look process for acquiring properties works.



The Transfer Agent continued its test implementation with the result that, at year-end 2008, six financial institutions – Wells Fargo, Bank of America/Countrywide, JPMorgan Chase, Citibank, Fannie Mae, and GMAC/RESCAP – were offering properties in five local communities. These communities – Minneapolis, St. Paul, New York City, Memphis, and Rochester, NY – were in a position to acquire properties through the Stabilization Trust. The Transfer Agent became fully operational April, 1, 2009, and funds are available through the NSP program to acquire properties. The Transfer Agent forecasts that it will complete the transfer of more than 4,000 properties during 2009 and that it will engage at least 100 communities and 20 major financial institutions. The Transfer Agent is intended to have a short life span as financial institutions work through the glut of REO properties that are currently flooding the markets, but it is expected to operate at least through 2011.

The Capital Corporation of the Stabilization Trust anticipates receiving a large commitment of philanthropic support early in 2009 and has a goal of having an operating loan fund by July 2009.

The Stabilization Trust is widely seen as a component critical to the success of the Neighborhood Stabilization Program and efforts to turn around neighborhoods ravaged by foreclosures and vacant properties across the country. Congress included an additional \$2 billion for the Neighborhood Stabilization Program in the American Recovery and Reinvestment Act of 2009.

Conclusion

The National Community Stabilization Trust is a clear demonstration of the power of strong relationships between major financial institutions and community development organizations. Years of proven performance by the community development organizations have made it possible to reach agreement with major financial institutions in a very short time-frame that will allow many communities to implement neighborhood stabilization strategies before deterioration becomes severe.

Using these relationships, their detailed knowledge of the capital markets and how they operate, and their deep knowledge about the needs of communities, community development organizations have crafted in the National Community Stabilization Trust a critical capacity to assist those communities in stabilizing neighborhoods that have been ravaged by home mortgage foreclosures. The National Community Stabilization Trust and the Neighborhood Stabilization Program will truly help communities implement strong neighborhood stabilization programs.

As citizens and the new administration wrestle with the severe economic challenges facing the country, this lesson of the National Community Stabilization Trust should not be lost on the country's policy and financial leaders. Healthy communities stand at the heart of the country's economic health. Communities that offer good jobs, safe and affordable places to live, good educational choices for children, and affordable health care are communities that will contribute in a positive way to a bright economic future. Community development organizations now have a 30-year track record of providing support for the jobs, housing, primary health care, and good schools, often in communities that were ignored by conventional capital markets.

At a time when many long-standing institutions have faltered, it is critical that financial institutions and government alike turn to these community development organizations to help keep communities strong. Because community development organizations are grounded in the communities they serve, they are often the first to recognize when things are going wrong. Witness the voice of Self-Help and other community development organizations that early on spoke out against subprime mortgage lending and demonstrated that it was possible to lend to low-income families with loans that those families could afford over the long term. Witness the community development financial institutions that have been in

the vanguard of providing financing for charter schools and primary health-care facilities in communities where traditional schools and clinics were failing. Witness the hundreds of thousands of affordable housing units managed by community development organizations with low vacancy, excellent physical conditions, and social services offered on site.

Community development organizations have clearly earned a place at the table as the country moves forward toward a new era of economic recovery and growth.

Mary Tingerthal joined the Housing Partnership Network as president of the Capital Markets Companies in September of 2007. She coordinates the work of the Housing Partnership Fund, which provides acquisition and predevelopment financing; Housing Partnership Ventures, which serves as the Network's investment vehicle; and the Charter School Financing Partnership, a new conduit for charter school loans. In 2008 she was instrumental in establishing the National Community Stabilization Trust – a new national company dedicated to helping local organizations get vacant and foreclosed properties back into productive reuse.

Massachusetts' Efforts to Address Foreclosed Properties

Prabal Chakrabarti

Federal Reserve Bank of Boston¹

The growing number of troubled mortgages in New England poses challenges for local communities. As foreclosures mount, so do the number of vacant homes, given that most properties that do not sell at auction remain in the hands of the foreclosing lender. These foreclosed properties, known as lender-owned or real estate owned (REO) properties, present an obstacle to preserving healthy neighborhoods.

The negative spillover effects of lender-owned properties on housing values in the surrounding neighborhood have been well documented, notably by Dan Immergluck and Geoff Smith.² Other problems connected to rising foreclosures include municipal tax revenue losses, higher crime rates, and general social disruption.

There are clear public benefits to preventing foreclosures, but efforts to do so have been slow and complicated. Some borrowers would be able to remain in their homes with a moderate change in the terms of their loan, but the steep fall in house prices and the rising delinquency rates mean some foreclosures are inevitable. As of late 2008, there was no government or private-sector program mitigating foreclosures in any substantial way.

For borrowers who are unable to afford their property even with a reasonable loan modification, the best solution may be to help them transition to rental housing. Then, to preserve the neighborhood, the best solution would be to find a new buyer for the property. However, the weak housing market has resulted in light demand for foreclosed properties at a price that is acceptable to the selling party, the lender. Federal Reserve Bank of Boston economist Paul Willen looked at nearly 20 years of property data from the Massachusetts Registry of Deeds and found that lenders find it much more difficult to sell foreclosed property when the market is down, especially in low- to moderate-income areas. Another recent study on foreclosure sales by Campbell, Giglio, and Pathak found that these properties eventually sell at a substantial price discount, about 32 percent less than the prevailing market value. The longer a property takes to sell, the bigger the discount.

Foreclosed properties sell at a discount for a number of reasons. They tend to be in greater need of rehabilitation; they are at greater risk of having a title problem or an unpaid lien; and in general there is more uncertainty about their condition. The sellers (often absentee sellers) also tend to be anxious to be rid of the property and its holding costs. Because of this,

1 A version of this article appears in *New England Community Developments*, Issue 3 (2008), Federal Reserve Bank of Boston. <http://www.bos.frb.org/commdev/necd/index.htm>.

2 For a literature review of the price-depressing spillover effects of foreclosures, see Kai-yan Lee (2008).

foreclosed properties may be more attractive to speculators looking to turn a quick profit without undertaking necessary repairs.

States and municipalities know they must respond quickly. But the question is how best to do so. This article aims to help answer this question by highlighting the response in Massachusetts—including the creation of a foreclosed-property task force, a revolving loan fund, and an online database of foreclosed properties open to nonprofits and municipalities working to stabilize neighborhoods—as a potential model for other states. I describe these efforts and discuss some of the obstacles and recent trends facing the state.

The Massachusetts Response

Massachusetts had three advantages that allowed it to recognize the magnitude of the foreclosure problem early on and address it quickly. The first is the recent history of a housing market downturn. Affordable-housing developers, municipal leaders, and others remember the sharp housing downturn in New England during the economic recession and rash of banking failures in the early 1990s. The rise in foreclosures and the associated blight and even arson caused community advocates to remark at the time that the situation threatened to undo the progress the community development field had made over the previous two decades.

Second, to date, the fall in housing prices in Massachusetts has not been as steep as in the most hard-hit states like Florida, California, and Nevada. Nor has the economic situation been as dire as that of the auto-manufacturing regions now facing large-scale unemployment—Ohio and Michigan, for example.

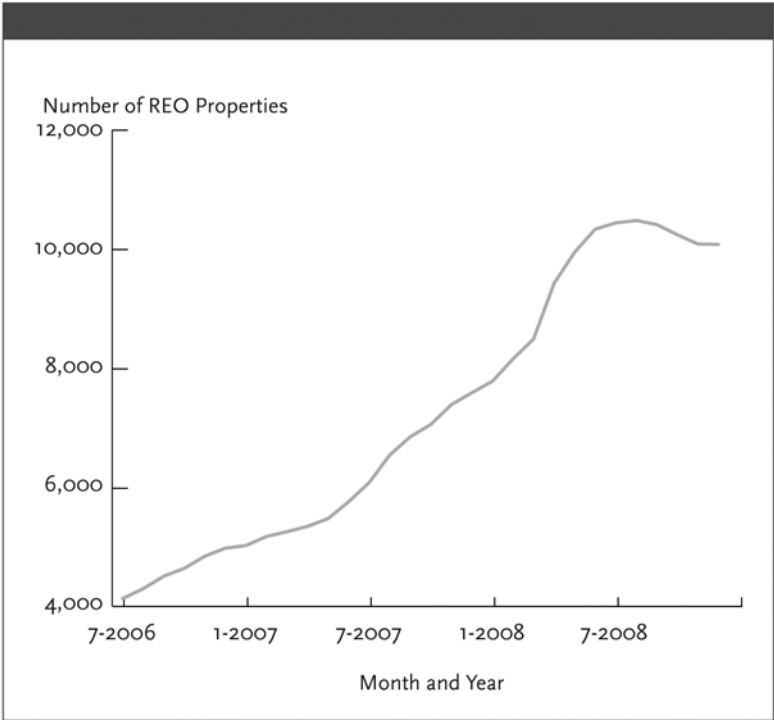
The Commonwealth's other advantage has been the collaborative nature of its nonprofits and public agencies. As groups began to understand the scale of the problem, many looked for opportunities to share knowledge and resources. One result of these efforts was the Mortgage Summit task force convened in November 2006 by the Massachusetts Division of Banks.

The group was set up to inform a larger state process involving other state agencies, the attorney general, the mayor of Boston, and state legislators. The collaboration eventually resulted in the 2007 Act Protecting and Preserving Homeownership, which strengthened consumer protections in the mortgage market. The act included measures aimed at providing relief to borrowers, such as a 90-day Right to Cure provision. In effect since May 1, 2008, this provision provides a statutory right to cure for holders of a residential mortgage, beginning from the time they receive a notice of default and right to cure from their lender. The measure also protects the borrower from being required to pay charges or fees related to the exercise of this right, including any attorney fees charged by the lender. Its main purpose is to allow the borrower time to pursue a loan modification or short sale, or find another method to prevent foreclosure. Other measures, such as restrictions on the use of subprime adjustable-rate mortgages and a requirement that brokers be licensed, were aimed at preventing future abuses.

Foreclosed Property Task Force

Though the implementation of the Right to Cure provision in May 2008 slowed the inflow of foreclosed properties into REO stock, foreclosures continue to occur at elevated levels. Chart 1 shows the sharp increase in REO properties since 2006.

Chart 1. Massachusetts Real-Estate-Owned Property Count



Source: Paul Willen and Tonja Bowen Bishop, Federal Reserve Bank of Boston

Wanting to get ahead of the problem, representatives from affordable-housing developers, community groups, municipal and state officials, public and quasi-public agencies, and other parties met at a forum convened by the Massachusetts Association of Community Development Corporations (MACDC), the Urban Land Institute, and the Citizens’ Housing and Planning Authority (CHAPA). At the meeting, a foreclosed property task force was initiated, with funding provided by the Massachusetts Housing Partnership and the Boston Foundation. The task force sought participation from a variety of stakeholders.

The task force split into five subcommittees, each of which was charged with addressing different aspects of foreclosed properties. The first subcommittee sought to identify sources of financing for acquiring properties, including public and private subsidies. The second explored techniques and mechanisms for acquiring properties from lenders. The third examined the

holding costs incurred in the period between the time a property is acquired and the time it is sold or otherwise transferred. The fourth looked at exit strategies, including converting housing into rental units, land banking, sales to new homebuyers, and even demolition; the final, related subcommittee sought ways to match homebuyers to foreclosed properties.

Throughout, the task force prioritized certain test communities like Chelsea and Lawrence, which were already in the process of acquiring or seeking to acquire properties. These cities and towns served as test cases for implementation, providing information that was fed back into the design process. The work of the task force gave participants a deeper understanding of the acquisition process and resulted in specific work products. These findings and outcomes were contained in a final report by CHAPA.³ I present some of the key points here.

The report shared emerging practices, provided estimations of holding costs and property taxes, and outlined models of exit strategies, including a receivership model used in Worcester. It also highlighted a major accomplishment for the task force, which was the establishment of a \$20 million revolving loan fund designed to facilitate the purchase of foreclosed properties by municipalities, nonprofits, or even for-profit developers. As much as \$17 million of the funding was pledged by the Massachusetts Housing Investment Corporation (MHIC), a public agency, and the Massachusetts Housing Partnership (MHP), a quasi-public organization. Two private foundations—The Boston Foundation and the Hyams Foundation, along with the nonprofit Living Cities—pledged funds to cover some of the “soft” costs of the effort, such as predevelopment costs. The Massachusetts Department of Housing and Community Development pledged an additional \$1 million.

One often-cited problem in trying to purchase a foreclosed property was dealing with the new owner of the property, typically the servicer of the foreclosed borrower. Finding out that a property had been foreclosed upon, determining the new holder of the title, and then finding good contact information for the owner was difficult. Many nonprofits reported difficulty finding someone within a firm that had knowledge of the organization’s REO portfolio. Often servicers had outsourced REO sales to another company but kept some control over the decision-making process.

Finally, task force participants initially found that an underlying difference in judgment about the value of foreclosed properties in these neighborhoods slowed the process. Sellers had yet to come down sufficiently in price to match buyer expectations, given the severity of the market decline and the likely rehab costs.⁴ Appraisals were also difficult because they depend on the eventual use of the property. More recently, nonprofits have begun to report successful purchases of foreclosed properties, albeit with considerable staff effort.

3 *Massachusetts Foreclosed Properties Task Force: A Report on Its Accomplishments, Recommendations for Next Steps and Lessons for Addressing Future Crises*. Citizens’ Housing and Planning Association, September 2008.

4 It is too early to tell whether this difference in valuation is temporary, or whether they represent fundamental differences. One possible explanation is that nonprofits have a different set of considerations than other for-profit buyers, such as renovating to a higher standard of rehabilitation (for example, in including energy-efficient appliances or higher-quality renovations, or meeting Section 8 tenant requirements) or desiring to fill the property more quickly, and so need to leave more room in the purchase price to allow for these preferences.

Some task force members—nonprofits and certain cities—wished to purchase a pool of properties held by a single servicer in their community. This would allow for economies of scale and ideally a lower price per property resulting from a bulk sale. But as of this writing, there were no such successful bulk sales in Massachusetts.

Creation of an Online Database of Foreclosed Properties

Several task force members reported that they subscribed to data from the Warren Group, a real estate information provider, which provides weekly updates of data for foreclosed properties based on records filed with the state Registry of Deeds. CHAPA and several members of the task force began working with a consultant to create an online database with enhanced tracking tools that many nonprofits and municipalities could use, with monthly subscriptions starting at \$40 per month. CHAPA entered into a licensing agreement with the Warren Group to purchase statewide foreclosure data. The database includes the following information:

- Property address
- Current state in the foreclosure process (REO status and whether initial notice has been given, auction conducted, and deed issued)
- Information about the property, including square footage, number of units, number of rooms
- Tax lien status and other data

Users of the database are able to target specific neighborhoods within municipalities and map properties, download and save property information, and enter in additional fields and notes unique to each user. Overall, the effort allows for both a unified subscription to the data and for data updates and mapping tools that many nonprofits do not have the capacity to compile in-house. The site was unveiled by CHAPA in October 2008 on the CHAPA Web site at www.chapa.org.

Since the initial release, the tool has already undergone a number of improvements. In addition to searching by street name, there are now more ways to target geographic areas—for example, by zip code or census tract. Some limited information can be exported to spreadsheet software.

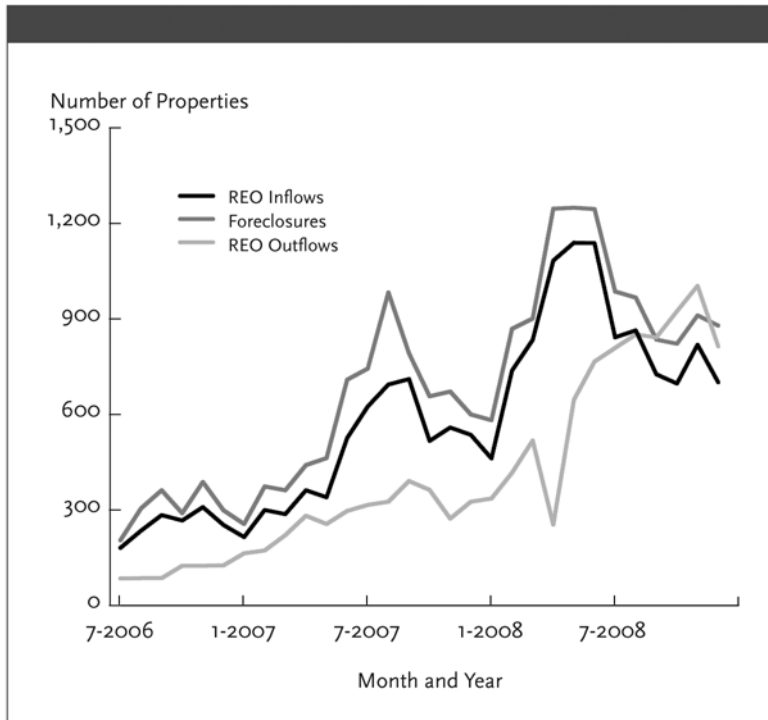
The CHAPA website subscription is open to all organizations that have at least one employee who is a CHAPA member. As of January 2009, there were roughly 30 subscribers, including nonprofits, municipal offices, state agencies, and a handful of private developers. Recent improvements should mean that more cities and towns find the online tool useful.

The CHAPA website has the potential to support purchases of foreclosures by local entities, but it also could give municipal services like fire departments, police, and code enforcers a way to keep tabs on foreclosed properties in their neighborhoods. For keeping neighborhoods stable, aggressive code enforcement in some places may be more effective than purchasing foreclosed properties. It is also likely to be cost-effective.

Recent Trends

There are preliminary signs that REO sales are now occurring. Chart 2 shows the buildup of the REO stock in Massachusetts, breaking out the data into two categories—inflows and outflows.

Chart 2. Inventory of REO Properties (inflows and outflows, 2006 – 2007)



Source: Paul Willen and Tonja Bowen Bishop, Federal Reserve Bank of Boston

Inflows occur when a foreclosed property does not sell at auction. Outflows occur when a lender-owned property is sold to an outside party. As shown, the number of REOs flowing into the stock is unabated as more troubled borrowers lose their homes. But the rise in outflows shows that although lenders typically buy the property back at auction, some sales out of REO are occurring.

This is also borne out anecdotally by activity among applications to the revolving loan fund, which has grown to \$23 million with additional contributions. As of January 2009, the fund had been nearly fully committed, with approved applications for roughly 250 units by nonprofit community development corporations (CDCs), and in some cases private

developers who pledge to work within an overall strategic plan.⁵ While most of the approvals had not yet been purchased by nonprofits, in some cases CDCs have successfully purchased REO properties.

With the allocation of \$4 billion in federal funds through the 2008 Housing and Economic Recovery Act, additional money should begin to flow in early 2009 from the U.S. Department of Housing and Urban Development through states to organizations for the purpose of redeveloping foreclosed properties. Massachusetts has been allocated roughly \$53 million. Some of this funding will go directly to municipalities; most will go to the state to be administered by the Department of Housing and Community Development.

Conclusion

Both the task force recommendations and the online database should facilitate the decision making of nonprofits, towns, and cities as they grapple with foreclosure. In a paper recently released by the Federal Reserve Bank of Philadelphia, visiting scholar Allan Mallach laid out a set of principles to guide the use of the Housing and Economic Recovery Act money. The federal funds can be used for purchases, down-payment assistance, and counseling for buyers of foreclosed properties, land banking, and other uses. Mallach counsels groups to plan strategically so as to avoid inefficiencies, which would harm the chances of receiving future monies for neighborhood stabilization. This argument, combined with groups' knowledge of the neighborhood distress that occurred during previous downturns, should be incentive enough to get them to use the funds wisely. The practice of sharing information and resources, along with the availability of the online database, will help in Massachusetts.

*Prabal Chakrabarti is assistant vice president of Community Affairs at the Federal Reserve Bank of Boston. He focuses on access to credit and capital and co-authored *Venture Capital in Secondary Cities and Understanding Foreclosures in Massachusetts*. Previously, he held analytical and research positions at the Initiative for a Competitive Inner City, the U.S. Treasury during the Clinton administration, and Cap Gemini Ernst & Young. He holds degrees from the University of Illinois, MIT, and Oxford, where he was a Marshall Scholar.*

5 According to Nancy Blueweiss at the Massachusetts Housing Partnership, citing data from Bruce Ehrlich at the Massachusetts Housing Investment Corporation.

References

- Campbell, John Y., Stefano Giglio, and Parag Pathak. Forced Sales and House Prices. Revised December 2008.
- Citizens Housing and Planning Association (CHAPA), <http://www.chapa.org>.
- Gerardi, Kristopher, and Paul Willen. "Subprime Mortgages, Foreclosures, and Urban Neighborhoods." Federal Reserve Bank of Boston Public Policy Discussion Paper No. 08-6. Federal Reserve Bank of Boston, December 2008.
- Immergluck, Dan. "The Accumulation of Foreclosed Properties: Trajectories of Metropolitan REO Inventories during the 2007–2008 Mortgage Crisis." Community Affairs Discussion Paper. Federal Reserve Bank of Atlanta. No. 02-08, December 2008.
- . "Community Response to the Foreclosure Crisis: Thoughts on Local Interventions." Community Affairs Discussion Paper. Federal Reserve Bank of Atlanta. No. 01-08, October 2008.
- Immergluck, Dan, and Geoffrey Smith. "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values." *Housing Policy Debate* 17 (1) (2006): 57–79.
- Implementing an Act to Protect and Preserve Home Ownership. Massachusetts Division of Banks, available at <http://www.mass.gov>.
- Lee, Kai-yan. "Foreclosure's Price-Depressing Spillover Effects on Local Properties: A Literature Review." Public and Community Affairs Discussion Paper No. 2008-1. Federal Reserve Bank of Boston, September 2008.
- Mallach, Allan. "How to Spend \$3.92 Billion: Stabilizing Neighborhoods by Addressing Foreclosed and Abandoned Properties." Community Affairs Department Discussion Paper. Federal Reserve Bank of Philadelphia, October 2008.
- Reade, Julia. "Massachusetts Mortgage Summit Issues Recommendations," New England Community Developments. Issue 3. Federal Reserve Bank of Boston, 2007.
- Willen, Paul. REO Retention Rates in Massachusetts. Presentation to the New England Consumer Advisory Group, Federal Reserve Bank of Boston, June 17, 2008.

Community Land Trusts Work In the Best and Worst of Times

Tina Brooks

Executive Office of Housing and Economic Development, State of Massachusetts

Recently I gave a speech at the National Community Land Trust Network's annual meeting in Boston to talk about the important role that community land trusts have in our neighborhoods by promoting stability through affordable housing and economic development opportunities. Those efforts are always welcomed and needed under normal conditions, and they are appreciated and needed even more so as we cope with unprecedented economic challenges not seen since the Great Depression.

Well before the reality of the nation's economic woes became daily front-page news, the administration of Massachusetts governor Deval Patrick had already been hard at work implementing new initiatives and enacting policies to get ahead of the looming crisis to stem the tide of foreclosures and build more housing that is truly affordable to those across a broad range of incomes.

Obviously the complexity of nationwide and worldwide issues still reverberates today, but with the help of the economic stimulus package recently passed by Congress and signed by President Obama, we are continuing to move forward and invest in our communities by working hard to improve our overall quality of life and attract new jobs and businesses to Massachusetts.

To chart our future, we have taken a number of multipronged, comprehensive actions. We recently completed a housing marketing assessment of the Commonwealth to determine what our policies and actions should be to meet our housing needs through 2012. This is the first assessment we have done in Massachusetts in more than 20 years. That, along with a regional economic development strategy already rolled out by the Patrick administration, will help us target growth in ways that will make Massachusetts economically strong and competitive for many years to come.

Because housing is a critical part of our infrastructure for economic growth, we have partnered with employers in Massachusetts to set up pilot programs to obtain more affordable housing for our workforce so that businesses can expand and thrive.

We have tackled the issue of homelessness head on and are now working to overhaul our emergency shelter system into one that emphasizes a housing-first strategy, rather than one of shelter first.

To help those who need a boost toward self-sufficiency, we have convened an asset development commission to find the best ways to lead folks out of poverty into solid working-class status.

We have enacted our own neighborhood stabilization fund program to make sure that foreclosed properties in hard-hit neighborhoods get sold and reoccupied as quickly as possible. That program, along with the \$54.4 million that Massachusetts received from the federal government under the Housing and Economic Recovery Act, will strengthen our mission to make sure foreclosed properties are fixed up and reoccupied.

With the number of foreclosures and the rate of unemployment increasing and with the stock market so volatile, it is impossible to predict what the economy will look like in a year, so it is more important than ever to continue investing in our neighborhoods to make them vibrant and economically diverse and offer opportunities for all residents.

Organizations like the NCLT Network help us in our overall mission by providing training and educating the folks who run community land trusts to make sure that the idea and practice of “community” is always embedded in an affordable housing development.

There are 15 community land trusts in Massachusetts serving cities as large as Boston and as small and rural as Great Barrington in western Berkshire County. Clearly there is room in every community for a land trust.

How do community land trusts fit into our actions in Massachusetts? When the housing market is heated, they offer affordability. In troubled times, they offer stability as well. Through their investments and supportive actions, land trusts are models of civic engagement. In these difficult economic times, they offer an extra buffer for homeowners who in other situations might face foreclosure. Land trusts let people know that they are buying more than just a house—they are buying into a community.

Community land trusts help buyers with their home purchases and supply support services that will step in before a homeowner gets into financial difficulty. And because a land trust has the right of first refusal, the home and its affordability can be preserved. Statistics show that of 3,100 community land trust homeowners completed in 2007, only two had been foreclosed upon—that’s an annual rate of 0.06 percent. The overall rate of foreclosure is 33 times higher.

State and community land trusts can work together by identifying opportunities to secure land; for example, land held by a corporation, institution, or local housing authority that can be turned over to a land trust for development or rehabilitation. This spirit of cooperation will help to enhance the success of our employer-assisted housing program.

We are exploring the possibility of establishing a land trust within municipal government. By funding the acquisition of foreclosed or vacant property by a land bank, which would also be within a city’s purview, the state could ensure that the property could be held for up to ten years and transferred to a land trust for final development when the trust had the capacity to develop it. The land trust could then build affordable housing and ensure its long-term affordability.

The word “partnership,” often overused, is particularly relevant in this case. It will take many partners and various resources within the public and private sectors for us to ensure the economic vitality of our cities and towns.

We are proud of our association with community land trusts, especially in times like these, and we look forward to expanding that relationship to make our communities as vibrant and healthy as they can be.

Tina Brooks serves as the Commonwealth's housing policy chief within the Patrick administration's Executive Office of Housing and Economic Development. With more than 18 years of experience in affordable housing finance and development, Brooks is a key architect in expanding affordable housing opportunities in Massachusetts. A Jamaica Plain resident, Brooks most recently served as the director of the Boston office of the Local Initiatives Support Corporation (LISC), a program that provides loans, grants and technical assistance to spur the development of affordable housing, new businesses, recreational facilities, schools, safety programs and other neighborhood institutions.

Using New Markets Tax Credits to Mitigate the Impact of Foreclosures on Communities

Anna Steiger

Federal Reserve Bank of Boston¹

Across the country, committees have been established to come up with ways to mitigate the impact of foreclosures on lower-income communities. A few are exploring the feasibility of having community-based organizations use the New Markets Tax Credit (NMTC) Program to facilitate the purchase of foreclosed residential properties for rehabilitation and resale to low- and moderate-income families.² In theory, these organizations could use the tax credits to help recover their costs for purchasing, fixing up, and selling homes at a price that is affordable to lower-income buyers. Moreover, the tax credits could help community-based organizations attract appropriate amounts of capital to conduct transactions at a scale that would stem disinvestment in troubled neighborhoods.³

We interviewed numerous community development finance practitioners and asked them to identify: (1) organizations across the country using or considering using the NMTC Program to mitigate the community impact of foreclosures, and (2) the potential barriers that organizations need to overcome when seeking to use NMTCs for these purposes. Below we have incorporated their responses into a brief discussion of the potential for using the NMTC Program to promote neighborhood stability in communities with concentrated foreclosures.

-
- 1 A version of this article appears in *New England Community Developments*, Issue 3 (2008), Federal Reserve Bank of Boston, available at <http://www.bos.frb.org/commdev/necd/index.htm>.
 - 2 The NMTC Program, established by Congress in December 2000 and administered by the CDFI Fund at the U.S. Department of Treasury, gives individuals and corporations the opportunity to receive a credit against income taxes by investing in businesses located in or serving low-income communities. The CDFI Fund (<http://www.cdfifund.gov>) and Coastal Enterprises Inc., available at <http://www.ceimaine.org>.
 - 3 In an NMTC deal, the capital flows to a business through a special-purpose financing LLC, known as a Certified Development Entity (CDE). A bank, private equity investor, or other capital source can invest directly in the CDE or through an upper-tier conduit LLC as a means of leveraging the equity capital and bifurcating the tax credits. In the leveraged transaction, investors can provide the debt, equity, or both. Community partners often provide debt capital alongside other investors in a leveraged transaction. The equity provider would most likely receive its return using the available tax credits calculated on the basis of the combined total investment amount (debt and equity), thereby assuming nominal project risk. The 39 percent tax credit on the amount invested is realized over seven years. The business gets the capital on favorable terms and the investor gets the tax credits. Any debt financing in such a leveraged NMTC model could be at market rates if the available tax credits are mostly allocated to the equity investors. Alternatively, some tax credits could be allocated to the debt provider as incentive to make the capital available at more attractive financing rates and terms.

Four Models

Enterprise Community Investment Inc. and Columbus Housing Partnership's NMTC Transaction

We identified four examples of organizations planning to make use of NMTCs to promote neighborhood stabilization in areas with high foreclosures. Only one of these models has been implemented so far: A NMTC transaction by Enterprise Community Investment Inc. and the Columbus Housing Partnership (CHP) to build and rehabilitate single-family homes.

The transaction involved capitalizing a \$9.5 million investment fund leveraging \$3 million in NMTC equity. The proceeds from the fund were used to make low-cost loans totaling \$9.5 million to CHP for the purpose of financing the construction and rehabilitation of up to 700 homes targeted to households earning less than 80 percent area median income (AMI) in the Columbus, Ohio, area. Using this model, the \$9.5 million helped to fund and create capacity for a project that could reach \$80 million in total development costs. To date, CHP has purchased and rehabilitated 29 foreclosed properties under the program, of which ten have been sold.

The strength of the model lies in the support of key partners. CHP will offer home-buyer education and counseling services and buyer financing incentives made possible with funding from City of Columbus sponsored programs. The public funding is provided as part of the city's Home Again program, which was established in 2006 to stimulate home development in areas close to employment, to encourage homeownership, and to stop neighborhood deterioration. CHP has also partnered with local financial institutions, including Huntington Bank, to offer mortgage financing to targeted homebuyers. Many homes are also located in Columbus Neighborhood Investment Districts (NIDs), which enjoy 15-year property-tax abatements.

City First Homes Housing Trust Model

The community housing trust City First Homes (CFHomes) Inc., part of the City First Enterprises family, will manage a \$75 million fund to create 1,000 units of permanently affordable workforce housing in Washington, DC. CFHomes will leverage both a \$10 million grant from the District and NMTCs to raise an additional \$65 million in capital to create the pool of second mortgages for use by low- and moderate-income buyers. In addition, the program leverages operational grant funds from a variety of supporters, including DC United Way, HSBC, F. B. Heron Foundation, Ford Foundation, Fannie Mae, NeighborWorks America, and Living Cities.

Foreclosure response has emerged as a key component in the larger effort and will account for at least ten percent of homes placed in the trust over the next 24 months. CFHomes will purchase real estate owned (REO) properties, complete necessary renovations, and place the properties back in service, selling them to eligible buyers, who will agree to the accompanying deed restrictions.

Partnering with qualified developers and trusted realtors, CFHomes will offer newly built as well as rehabbed homes for sale. Homes will be located in mixed-income neighborhoods throughout all eight wards of the city. CFHomes will assume stewardship responsibilities for the portfolio of homes, provide ongoing support to homeowners, manage resales, and maintain the permanent affordability of the homes.

As a housing trust, CFHomes provides low-interest second mortgages to qualifying purchasers in exchange for agreeing to share any future appreciation. Sellers retain 25 percent of any increase in value accruing to the property, as measured appraisal to appraisal, thus maintaining affordability over the long-term life of the property without the need for future subsidy. The second mortgages will consist of 40-year subordinate mortgages averaging \$75,000 with a fixed 3.99 percent mortgage that is interest-only for seven years and then amortizes for years eight to 40. The deal includes mandatory homeownership counseling incorporating best practices of the NeighborWorks America full-cycle lending model, with a focus on shared equity and post-purchase support.

Clearinghouse CDFI's NMTC Single-Family Model

The model proposed by Clearinghouse CDFI in Lake Forest, California, is different from the others in that it aims to help homeowners avoid foreclosure in the first place. The program would use NMTCs to help finance a rescue loan product for low-income homeowners who are unable to repay their subprime mortgage and/or to finance first-time homebuyers of single-family homes.⁴

Clearinghouse would finance a home aggregator, an entity engaged in the purchase and resale of single-family homes. In the case of occupied properties, the home aggregator would purchase the home from the owner, retire the existing mortgage on the property, and then sell it back to the family while providing a new fixed-rate, 80/20, regularly amortizing mortgage. The aggregator would provide favorable financing to the family by using NMTCs to finance the 20 percent second loan. For low-income families seeking a loan on their first home, the home aggregator would purchase the home and then immediately sell it to the family, also providing favorable financing made possible by leveraging NMTCs for the second mortgage.

Clearinghouse estimates that when factoring in a conservative loss rate, NMTC investors would receive an acceptable market-rate after-tax IRR. The returns become more attractive when even a small amount of foundation or government resources are factored in and as the performance of the second loans increases. Currently, the CDFI sees an opportunity in using Neighborhood Stabilization Program (NSP) resources as leverage under an NMTC structure.

⁴ Clearinghouse CDFI received feedback from the IRS indicating that a rescue-loan product may constitute a "refinance" and therefore may not be allowable under the current NMTC program. The CDFI will seek additional clarification on this point while continuing to pursue both the rescue-loan product and financing for first-time homebuyers.

The organization was successful in obtaining a \$90 million NMTC allocation in 2008, which it plans to apply toward such a program. In spite of the obstacles that would need to be overcome in order to develop a feasible program, the Clearinghouse CDFI is optimistic that it will be able to develop an application for NMTCs that can help troubled borrowers and first-time purchasers of single-family homes.

The Rhode Island Statewide Community Land Trust's "Rebuilding Equity and Ownership Fund of Rhode Island"

The Housing Network of Rhode Island has proposed offering NMTCs to investors who own REO properties. These tax credits would allow the investors to sell the properties to the Network's nonprofit affiliate, the Statewide Community Land Trust (SCLT), at a reduced sales price. The SCLT has undertaken a demonstration fund that would purchase up to ten vacant properties and rehabilitate and sell them to low- or moderate-income homeowners. The demonstration fund does not make use of the NMTCs; rather, it is intended to illustrate the strengths of the various partners for bringing the program to scale.

As originally envisioned, the SCLT would leverage the success of the demonstration fund to implement a larger program using the tax credits. The SCLT would create a for-profit Community Development Entity (CDE)—Rhode Island Rebuilding Equity and Ownership Fund (RIREO)—that would raise \$20 million in debt and \$10 million in equity from up to five banks under the NMTC Program. Because of the revolving nature of the CDE portfolios, the REO Fund should be able to purchase, rehabilitate, and sell more than 1,000 units in the state over the seven-year period of NMTC eligibility. Participating community development corporations would be able to purchase vacant properties from the investors in the RIREO and borrow acquisition funds and rehabilitation funds from the RIREO at low rates.

The effort was initiated and funded by NeighborWorks America and developed by them and several private-sector experts in discussion with staff of the CDFI Fund.

However, the Housing Network has tabled the proposal for the time being because of the challenge of getting all the parties together for a statewide effort, the fluctuating economic position of the target banks, and the difficulty in securing properties that need to be aligned with the target banks. The group is instead going with a program involving three CDCs and one lender that holds a large amount of REOs in the state, Fannie Mae. But since Fannie Mae is not in a position to find the NMTC attractive, this option is not being pursued.

Key Issues

Our interviews identified several potential barriers to using the NMTC Program to promote neighborhood stabilization. Below we highlight the most frequently cited issues. The first three pertain to the requirements and/or limitations of the NMTC Program. The others pertain to current conditions in the housing and financial markets.

1. **The difficulty obtaining an NMTC allocation.** Some organizations are reluctant to invest the up-front time and effort needed to develop a viable model for using the program to address neighborhood stabilization because they may not be able to obtain an allocation from the CDFI Fund or be able find current allocatees willing to use their allocations for nontraditional uses.
2. **The need to secure a strong pipeline of deals and a solid exit strategy for those deals.** Under the NMTC Program, any return of capital needs to be redeployed within 12 months. Therefore, partnerships must include organizations with a strong capacity for identifying properties for purchase and rehabilitation, as well as organizations with a strong capacity to identify and educate potential homeowners and connect them with affordable financing.
3. **The need to combine the NMTCs with other subsidies in the cases where groups intend to purchase foreclosed properties.** While the NMTC Program can help offset the costs organizations would incur for purchasing and reselling foreclosed properties, in many scenarios the tax credits may not be sufficient and would need to be supplemented with other subsidies.
4. **The current appetite for tax credits, given bank losses. Banks are large users of NMTCs, and many NMTC transactions are dependent on these institutions' demand for tax credits.** At present, there is a lot of uncertainty over banks' appetite for these tax credits in the near to medium term, in light of recent financial losses at these institutions. The consolidation in this sector may be an even bigger issue because some of the formerly large players in the NMTC market will not continue to exist in 2009.
5. **The impact of housing market trends on project goals.** A further downslide in housing prices or a prolonged slump in housing prices could hamper the ability of projects to meet production and sales goals and/or adversely affect organizations' ability to redeploy funds.
6. **The impact of housing market trends and tightened credit on the ability to refinance distressed borrowers.** Many mortgage refinancing programs rely on the willingness of lenders to undertake principal write-downs or modify existing loans in other ways. As of the end of 2008, the Hope for Homeowners program (part of the Housing and Economic Recovery Act of 2008 passed by Congress)—designed to help homeowners by encouraging lenders to voluntarily write down loan principal—has had lighter volume than anticipated. Lenders largely view write-downs as harming the net present value to end investors and so assert that the contracts that govern mortgage-backed securities do not allow for such write-downs. Moreover, many homeowners have taken out a second lien on their property; second-lien holders have to consent to principal write-downs and so far have been slow to do so. In addition, tighter credit standards are affecting the ability of potential new homeowners to acquire mortgages.

7. **The holding costs of rehabilitating foreclosed properties.** These costs, including property taxes and utility bills, increase the longer properties stay vacant. Any financing vehicle needs to account for these holding costs and have a clear exit strategy to minimize its holding time.

Conclusion

In our interviews, community development practitioners suggested several areas for policy action that could facilitate the use of NMTCs for promoting neighborhood stabilization. Some groups are advocating for changes to the NMTC Program itself. A number of groups have suggested legislation that would create a separate, additional allocation of tax credits that would be used for the purchase, rehabilitation, and resale of foreclosed properties in low-income areas. Clearinghouse CDFI believes there is an opportunity for clarification about whether the tax credits can be used to refinance mortgages when the credits are intended to help families who might otherwise face foreclosure. Many groups have also lamented the complexity of navigating the NMTC Program requirements. Some of the organizations interviewed for this article suggested bringing together stakeholders from various sectors, including the public sector, investors, and community development groups, for targeted conversations on how to use the NMTC Program to help neighborhoods that are facing high levels of foreclosure.

Anna Steiger is a policy analyst in Community Affairs at the Federal Reserve Bank of Boston with a research focus on investment flows into low- and moderate-income and underserved areas. She is also editor of New England Community Developments, a publication that explores emerging issues in community development and consumer affairs. Previously she worked in international business and microfinance. She holds a master's of public policy from Harvard's Kennedy School of Government and a B.A. in economics from Barnard College.

References

Interviews

Colin Bloch, Consultant, BlochWorks

Douglas J. Bystry, President & CEO, Clearinghouse CDFI

Linda Davenport, formerly the Deputy Director of Policy and Programs, the CDFI Fund

Carla Dickstein, Vice President for Research and Policy Development, Coastal Enterprises Inc.

Ray Neirinckx, Coordinator, State of Rhode Island Housing Resources Commission

Alazne Solis, Vice President, Public Policy, Enterprise Community Partners Inc.

Charlie Spies, Managing Director, CEI Capital Management LLC

Charles D. Tansey, Senior Adviser, Office of the Chief Executive Officer, NeighborWorks America

Joseph A. Wesolowski, Senior Vice President, Structured Finance, Enterprise Community Investment Inc.

Sources

City First Enterprises.

Columbus Housing Partnership. Enterprise Community Investment Inc. February 2008.

"Enterprise Makes New Markets Tax Credits Investment to Create up to 700 Affordable Homes in Columbus, Ohio." News Release. Enterprise Community Investment Inc. January 2008.

NMTC Transaction Overview: Columbus Housing Partnership. Enterprise Community Investment Inc.

New Markets Tax Credits and Single Family Foreclosure Crisis Prevention. Clearinghouse CDFI.

The Rebuilding Equity and Ownership Demonstration Fund of Rhode Island. NeighborWorks America.

The Rebuilding Equity and Ownership Fund of Rhode Island. NeighborWorks America.

Community Development INVESTMENT REVIEW

Free subscriptions and additional copies are available upon request from the Community Development Department, Federal Reserve Bank of San Francisco, 101 Market Street, San Francisco, California 94105, or call (415) 974-3467.

Change-of-address and subscription cancellations should be sent directly to the Community Development Department. Please include the current mailing label as well as any new information.

The views expressed are not necessarily those of the Federal Reserve Bank of San Francisco or the Federal Reserve System. Material herein may be reprinted or abstracted as long as the *Community Development Investment Review* is credited.

