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Addressing Foreclosures

A Great American Dream Neighborhood Stabilization Plan

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Introduction

For the first time in 40 years, Americans across the country are finding their homes on average are worth less today than they were just the year before.[1] Foreclosures are rampant, up 75 percent nationally last year over 2006, and the number of lender-owned homes nearly doubled in the fourth quarter of 2007 over the same period in 2006.[2] Among the scores of communities with a growing glut of vacant, lender-owned homes are Stockton, California; Fort Lauderdale, Florida; and Las Vegas, Nevada, all of which had more than one in every 50 homes foreclosed on in late 2007.[3]

As the dramatic effects of rapid housing deflation become more and more apparent, debating whether subprime borrowers were more at fault than unregulated mortgage companies is no more productive than arguing about whether the negligent camper or the neglected forest clearance practices contributed more to the rapid spread of a wildfire—the first order of business is putting out the fire before it consumes more homes.

On the ground in hundreds of communities, it is apparent that any delay in acting could lead to far greater costs and devastation later. "We don't have the luxury of picking and choosing what issues we focus on when people lose their homes, when the grass isn't cut, when property taxes aren't collected and when property values drop,"[4] said Douglas Palmer, mayor of Trenton, N.J., and president of the U.S. Conference of Mayors, whose winter meeting ended on January 25. "Mayors are on the front line."

Indeed, sudden drops in home prices have community-wide ramifications and widespread human costs that boast large and lasting ripple effects—unlike a purely financial market correction where some sophisticated investors make educated bets and lose while others have an offsetting gains. These properties attract vandalism, arson, and crime as they sit vacant, and they drag down local property values, making it very difficult for local real estate markets to operate normally.

That's why the Center for American Progress and Enterprise Community Partners present an effective strategy in this paper to address the glut of foreclosed properties in communities across the United States. We propose to establish a Great American Dream Neighborhood Stabilization, or GARDNS Fund to provide money quickly and efficiently to local non-profit organizations or municipalities to purchase foreclosed properties and offer them for sale to qualified low- and moderate-income families on affordable terms. Proceeds from the sale would be used to purchase additional properties, thus multiplying the purchasing power provided by this new fund.

Before detailing the policy guidelines that would govern our proposed GARDNS Fund, however, a closer look at the increasing devastation wrought by the foreclosure crisis is in order. The cascading foreclosure crisis threatens to engulf more and more American communities in the coming months unless Congress and the Bush administration act swiftly and surely with targeted federal funds.

The Foreclosure Crisis: Larger than the Subprime Mortgage Crisis

Today the U. S. economy is afflicted with a widespread housing deflation epidemic, but perceptions about the scope of what is actually happening have evolved more slowly than the pace of foreclosures. This is not surprising since early press reports focused heavily on the subprime mortgage crisis facing those types of borrowers, who for some reason seemed outside the norm of homeowners. Then the costs of the subprime crisis on financial players started to dominate the headlines, and attention shifted to the major writedowns faced by our largest financial institutions.

But as the economy has more broadly slowed—sparking recession fears amid recent economic data that shows U.S. Gross Domestic Product growth slowed sharply in the last quarter of 2007—attention is now broadening yet again, this time toward the effect of the housing crisis on the economy at large and consumer spending. By year end, economic observers such as investment advisor Jeremy Grantham were noting the ominous scale of the implications facing us:

> *This crisis is likely to make the S&L crisis look 'contained.' In the end, total financial writedowns this time are likely to be two to three times the S&L crisis, as a share of GDP. .It seems likely to be the defining market event for many years (unless we're incredibly unlucky and something else truly horrible and unexpected occurs). Be particularly alert to potential problems beyond subprime mortgages. If U.S. house prices decline by over 20 percent, which we believe is likely, and if there is a recession, which we believe is very possible, then there will be painful defaults in regular mortgages. Commercial real estate debt is likely to have some writedowns as office estate prices decline and borrowing terms become more onerous. Writedowns and defaults in other debt will also be plentiful. Private equity deals in particular will probably turn out very badly indeed. In my opinion it is the most underappreciated risk of all and is likely to be the center of another phase of the crisis. The longer-term problem is that all debt standards fell so that losses will accumulate right across the entire credit system. In the end perhaps only government intervention and public funds will stabilize the system.*[5]

While such fears are prompting broad agreement in Washington that federal economic stimulus is essential, most of the proposals to date are only tangentially related to the core problem. What's needed is strong action aimed at facilitating a recovery in the area of perhaps greatest need—the breakdown of a well-ordered housing market.

One of the most pervasive and potentially most devastating aspects of this cycle over the long-term that needs greater attention are the hundreds of communities facing rapid deterioration of their economic fabric almost overnight due to something close to

a home pricing panic. This can lead to a fast downward spiral for previously strong moderate income communities, as a report by the U.S. Conference of Mayors (prepared by Global Insight) in late 2007 succinctly captures:

> *The continued downturn in the residential real estate market will further limit the resale opportunities of homeowners facing payment difficulties. Sales will continue to be negatively affected by the lack of credit available to prospective buyers. Home price declines will mean that the price they could get for the home is less than their outstanding mortgage balance. Homes already foreclosed on adversely affect sellers as well, adding to the inventory of homes competing for buyers, and their presence in neighborhoods negatively affects the perceived value of other homes nearby. Lastly, the credit markets have become less hospitable to re-financing. Adding to this stress will be reduced job opportunities as economic growth slows in late 2007 and into 2008. Such a lack of jobs and income historically leads directly to greater mortgage payment delinquency and subsequent foreclosure.*[6]

As foreclosures grow more frequent, real estate appraisers may have to include as "comparables" any bids by foreclosing lenders at the sale, which are often a fraction of the loan amount. This creates the feedback information loop where values slide quickly downward, well below replacement costs in most areas. Homeowners across an area then are told that they have "negative equity," in their homes, which blocks the ability of all homeowners in a neighborhood to sell and move, or to use home equity responsibly for education, home improvement, or a sudden medical emergency.

Moreover, lenders that take possession at the foreclosure sale have no incentive to put the property to productive use; they seek to get it off their books as quickly as possible. These properties usually sit vacant, waiting for a new buyer to come along and make an offer. While these properties sit on the market, neighboring homeowners have little chance to sell their homes if need be, or access equity for normal expenses.

Even a small number of foreclosures in a community can drag down house prices and clog local housing markets. According to a 2006 study entitled "The External Costs of Foreclosure," by Dan Immergluck of the Georgia Institute of Technology and Geoff Smith of the Woodstock Institute, each conventional foreclosure within an eighth of a mile of a single-family home results in a decline of 0.9 percent in value, and perhaps as high as a 1.44 percent loss in value for the nearby home.

Applying this analysis to the City of Chicago, the authors calculated: "This less conservative finding corresponds to a citywide loss in property values (again, not considering multifamily or commercial values) of just over $1.39 billion—or an average of more than $371,000 per foreclosure."[7]

This neighborhood-wide free fall in home values, apparently affecting hundreds of communities across the country, exacerbates other quality of life-eroding problems. As already foreclosed homes stand vacant, they invite crime and arson. We are also beginning to see the impact that the decline in values is having on municipal budgets, with school funding being threatened as a function of reduced property tax revenues.[8] Where the impacts have grown widespread and systemic, there is great danger that low- and moderate-income communities with concentrations of foreclosures will be hit

harder, and recover more slowly. Some of these communities already went through prior cycles of blight and were finally on the rebound, jeopardizing years of gains.

This is why targeted economic intervention alongside sensible housing policies offers a path to halt the downward slide, giving these communities some control over the situation and accelerating a recovery. In fact, out of this economic disaster there could arise an approach to affordable homeownership that could actually expand opportunity in both the short-term and long-term. This approach aims for broader access to local, affordable housing for nurses, police, fire, maintenance workers, and many other workforce families—not just in the current down market but also in the future when some of these communities once again become overheated markets.

Basic Principles for Tackling the Foreclosure Crisis

The current wave of foreclosures implicates many parts of our financial system, making remedies on any one level unlikely to bring a positive correction on their own. In other papers and analyses, the Center for American Progress has proposed policies aimed at preventing properties from falling into foreclosure, and for breaking the logjam in the servicer market through a SAFE plan, which Center for American Progress Senior Fellow Michael Barr will present in congressional testimony on January 31, 2008.

But also necessary is a plan to address the local market glut of foreclosed homes and financially trapped non-defaulting homeowners, in order to help where the pain is now greatest. Direct action at the local market level, easily overlooked by purely financial market approaches to foreclosures, can have powerful stabilizing effects by moving housing markets back to normal. To be effective, policies directed at benefiting local markets should be guided by the following basic concepts:

- Efforts to aid homeowners facing foreclosure and to help neighborhoods already flooded with foreclosures require different specific sets of actions, but those solutions must be designed to work in tandem as much as possible
- Action is needed to quickly break the downward price spiral that threatens many communities that were on their way to building a working family homeownership culture before the foreclosure crisis brought with it abandoned buildings, disinvestment, and economic blight
- Local action by many cities and towns can be utilized to counter the widespread consequences of foreclosure on neighborhoods
- Extraordinary circumstances justify extraordinary intervention

The approach that best serves these goals is in concept fairly direct and simple: Move relatively flexible funds quickly to the hardest hit localities and states. Such funds in the hands of responsible community-based non-profit groups, community land trusts, and where necessary local governments, in addition to regional or national non-profit intermediaries and housing authorities, would be used to acquire foreclosed homes—in housing market parlance, real estate-owned or REO homes—in communities with ever multiplying foreclosure signs. Also needed are a limited number of ancillary activities such as necessary house rehabilitation and extraordinary police and fire protection.

Jumpstarting the buying process in this way injects economic stimulus into local markets where housing activity is grinding to a halt. Each transaction in particular establishes a reasonable floor value for homes and clears inventory. This is analogous to many other instances of government stepping forward to get capital into other "frozen" markets, where economists can agree it is essential to get prices stabilized in a short-term crisis. As a recent study from Cleveland stated succinctly:

> *It is unlikely that there will be sufficient buyers in the immediate future, either homeowners or investors in rental properties, to assure that these homes are reoccupied by families. Given the sharp decrease in values, there is the threat that the supply of affordable housing will be lost unless the market is supplemented by activities of nonprofit or government organizations who can acquire and maintain some of this housing stock that is stuck in transition.*[9]

Beyond the present benefits of economic stimulus, the current sharp home-price plunge is also a unique, once-in-a-generation window to establish a stable stock of long-term, affordable, shared equity housing. Allowing good affordable housing stewards to buy homes in these neighborhoods is responsible policy. The public gets a return on its investment now, and also long beyond the first homeowner is helped.

How to Do It: A GARDNS Fund

To work quickly and effectively, funds need to move that are the most flexible, with the least barriers and complications. Longer-term, more complex structured financing, such as debt or existing and even new tax credits, might be useful in bringing in capital or refinancing a portfolio. A general rule of thumb, however, is that most credit-based transactions are complicated, require multiple parties and intermediaries, have significant transaction costs, and are not designed too well with individualized small-scale transactions such as buying homes from a number of different owners.

Therefore, to accomplish the overriding goal of swiftly stemming the foreclosure crisis, we propose a $10 billion Great American Dream Neighborhood Stabilization Fund, or GARDNS Fund. This Fund builds on insights gained from the Department of Housing and Urban Development's so-called Asset Control Area program that already deals with government insured foreclosed homes. Input also comes from the work of intermediaries such as Enterprise Community Partners, and a range of effective local efforts around the country. The basic program attributes of the GARDNS Funds would include the following:

Block Grants

Funding would come through a special appropriation of block grant money under HUD's HOME or Community Development Block Grants programs, with some relaxation of otherwise applicable restrictions such as the local match requirements. The hardest hit cities are losing tax revenues while facing increased police and fire costs, so they will have a hard time with matching dollars. Other programmatic waivers, such as were granted at the time of a special post-Katrina appropriation process, would be granted as necessary to carry out the goals of the Fund.

To address local implementation needs and the desirability of keeping the targeted neighborhoods secure, a portion of the funds equal to perhaps four percent of the local share should also be available to local governments for police, fire, and code enforcement efforts in the same neighborhoods where the GARDNS Fund purchase effort focuses.

Local Community Involvement

Use of these funds would be primarily for acquisition of foreclosed homes by a local community land trust, community development corporations, other non-profit groups, or a governmental agency. These types of local organizations would become so-called local stabilization buyers. They would purchase foreclosed or vacant absentee-owned homes in low- and moderate-income neighborhoods with high concentrations of foreclosures or high rates of loan defaults.

For instance, foreclosure rates for 2007 in excess of one per 100 homes puts a community above the national average.[10] The amount per purchase would not exceed the 2007 median price for homes in a particular standard metropolitan statistical area, or SMSA, a measure used by government housing authorities.

Once purchased, these homes would be promptly resold to a low- or moderate-income homeowner who would receive appropriate home buying counseling. This new buyer would purchase the property with a fixed-rate mortgage product that is affordable to the family's particular situation, based on standard guidelines established by the state or local participating jurisdiction. If the house is then resold, then the homeowner and the local stabilization buyer would enter into some form of shared equity affordability arrangement. The arrangement would be monitored by a local organization with some expertise in affordability arrangements such as a community land trust.

In a shared equity affordability arrangement, any increase in home value above what the homeowner pays initially is viewed as shared jointly by both the homeowner and the public. The homeowner can increase family wealth if the home goes up in value, but cannot walk away with all the price appreciation at the public's expense. This type of arrangement ensures that the home will later be resold to another low- or moderate-income household, without the first buyer reaping a windfall profit. The public investment stays with the home for the long term.

Where no appropriate homebuyer is promptly available—within 3 months of acquisition, for example—then the local stabilization buyer may rent out the home to a low- or moderate-income household at affordable rents, with preference given for rent-to-own arrangements. As the local stabilization buyer receives funds back from the initial resale, those funds can be reused for the same purpose and to recover associated costs of the effort.

Appropriate Safeguards, and Long-Term Affordability

Some fiscal controls on the use of GARDNS Funds are necessary to avoid waste and overspending, but overregulation should be minimized as much as possible. For example, it is questionable whether there is much value to requiring appraisals of a recently foreclosed home in advance of acquisition. Appraisals are inherently uncertain in a local submarket when foreclosures may be the primary comparable sales. Using a somewhat broader area median house price figure as a cap—given that each local stabilization buyer has only a limited pool of resources to work with—the local parties have every incentive to pay only what is necessary to purchase the home in question.

A hypothetical case in point: Using Massachusetts-area prices, a house carry-

ing a $265,000 mortgage loan sells at a foreclosure auction back to the lender as a real estate-owned property. The local stabilization buyer negotiates to buy the home from the lender holding it for, say, $200,000, using cash from the GARDNS Funds. This price is below both replacement cost for creating a new similar home in the area, and substantially below the market value of the home in 2006 when the mortgage loan originated. The local stabilization buyer then resells the home to a qualified low/moderate income buyer who can afford a $150,000 fixed rate mortgage. By generally used calculations of affordability, a family making roughly $50,000 could afford this size mortgage.

That $150,000 paid at sale to the local stabilization buyer would then be recycled back into the program, but the $50,000 subsidy stays locked in the land and the house. When the home is resold to the next buyer, the homeowner gets a share of the appreciation above the price paid. The local stabilization buyer typically would state the sales price as $200,000, and hold a "soft" $50,000 second mortgage. This soft second mortgage often will be rolled forward if the next sale complies with the affordability requirements—in order to continue as much affordability as possible.

Alternatively, if the home is sold under the community land trust model, then the home is sold for, say, $175,000, with $25,000 attributed to land value that stays with the community land trust. The local stabilization buyer, acting as a seller, takes back a $25,000 soft second mortgage. A nominal ground lease payment to the community land trust is built in to the affordability calculations. The community land trust monitors long-term affordability, and also plays a role aiding the homeowner in the event of financial difficulties with the lender in the future.

Under either approach, the home is sold subject to a shared appreciation arrangement, either a deed rider with covenants that run with the land, or pursuant to a community-land-trust model. These affordable homeownership arrangements have long been used and recognized, including at the federal level under provisions of the Housing and Community Development Act of 1992. Such long-term affordable homeownership arrangements are now used in all parts of the country, with a growing base of knowledge and a good track record.

A number of municipalities and local groups have sponsored community land trusts in recent years, including many in Florida (such as Delray Beach and West Palm Beach), cities from Irvine, California to Chicago, and suburban communities such as Evanston, Illinois.[11] A recent sampling by the National Association of Community Land Trusts of 2,500 homeownership transactions going back a decade showed that only 17 out of the 2,500 homes went to foreclosure in the past decade, and only two during 2007, despite serving an entirely low- and moderate-income homeowner population.

The Dudley Street Neighborhood Initiative in Boston's Roxbury neighborhood is an excellent example of these types of programs at work This initiative reports that none of the 250 homes on its land went into foreclosure over the past 12 years because the land trust required long-term, fixed-rate mortgages and aided homeowners who got into financial trouble, according to a *Boston Globe* report.[12]

Conclusion

The virtually unprecedented reversal in home ownership values challenges our national capacity to find an effective response. Some will argue that the market will sort it all out in the end—a housing bubble needs to burst just as much as the earlier technology stock bubble needed to burst to correct unrealistic investment assumptions.

But when tech stocks burst, generally some people of means lose, others win, and the economy in relatively short time adjusts. When home prices drop with amazing speed and severity, millions are displaced, and tens of millions suddenly feel poorer and in reality have fewer economic options. While the market may eventually find a new price equilibrium, the human costs and collateral economic consequences are devastating and very possibly intolerable.

But we are not without reasonable options. Our GARDNS Fund provides one targeted way of accomplishing multiple important goals: Housing price stability, community preservation, and an increase in the stock of housing within reach of average American working families. The costs of inaction are far too high to await the outcome of a slow-moving market correction. Sensible action now can restore confidence to markets and stability to neighborhoods, and merits swift action.

Endnotes

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