Financial Innovations Lab™ Report

THE NEED FOR AFFORDABLE HOUSING
Finding Solutions in the REO Crisis

May 2009
ACKNOWLEDGMENTS

We would like to thank the participants in this Financial Innovations Lab and in the follow-up roundtable discussion at the 2009 Milken Institute Global Conference. We are especially grateful to George McCarthy and Ellen Seidman for their leadership in planning and executing the Lab. We wish to express our appreciation to our Milken Institute colleague Patricia Reiter, who prepared this report, as well as Caitlin MacLean and Jill Scherer. Finally, we thank the Ford Foundation for its support of this work.

ABOUT FINANCIAL INNOVATIONS LABS™

Financial Innovations Labs bring together researchers, policymakers, and business, financial, and professional practitioners to create market-based solutions to business and public policy challenges. Using real and simulated case studies, participants consider and design alternative capital structures and then apply appropriate financial technologies to them.

ABOUT THE MILKEN INSTITUTE

The Milken Institute is an independent economic think tank whose mission is to improve the lives and economic conditions of diverse populations in the United States and around the world by helping business and public policy leaders identify and implement innovative ideas for creating broad-based prosperity. We put research to work with the goal of revitalizing regions and finding new ways to generate capital for people with original ideas.

We focus on:

- **human capital**: the talent, knowledge, and experience of people, and their value to organizations, economies, and society;
- **financial capital**: innovations that allocate financial resources efficiently, especially to those who ordinarily would not have access to them, but who can best use them to build companies, create jobs, accelerate life-saving medical research, and solve long-standing social and economic problems; and
- **social capital**: the bonds of society that underlie economic advancement, including schools, health care, cultural institutions, and government services.

By creating ways to spread the benefits of human, financial, and social capital to as many people as possible—by *democratizing* capital—we hope to contribute to prosperity and freedom in all corners of the globe.

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Vacant and neglected houses surrounded by overgrown weeds. Stagnant swimming pools drawing swarms of mosquitoes. Graffiti left scrawled across facades.

These signs of blight are the most visible manifestations of America’s foreclosure crisis. In the most highly distressed neighborhoods, an epidemic of foreclosures has led not only to a sense of despair but to increased crime and vagrancy that can drag down surrounding property values, setting off a vicious cycle of economic distress. Some communities have been so hollowed out that the remaining residents feel they’re left living in virtual ghost towns.

Some of these abandoned properties tell a story of homeowners who overstretched during the heady days of the housing boom, when subprime lenders took a free and easy approach to extending credit. Others were never family homes to begin with: They belonged to speculators or investors looking for rental income. And still other foreclosed properties bear testament to those unlucky souls whose jobs simply evaporated as a deep recession descended. However these homes entered the enormous pool of REO (real-estate-owned) properties, they’ve left local officials from coast to coast wondering how to save communities from sliding further into decline.

But could there be a silver lining?

During the housing boom, while much of the media was captivated by the seemingly endless run-up in housing prices, another story was unfolding under the radar. For years, the poor and middle class have been hamstrung by a shortage of decent affordable housing options—and their dilemma grew much more pronounced as prices skyrocketed. Especially in locations where the cost of living was already high, these individuals and families found themselves priced right out of the market.

But today lenders are overwhelmed with a glut of foreclosed properties; in fact, the U.S. averaged more than 70,000 home repossessions per month during the first quarter of 2009. Amid this devastation lies opportunity: to buy and rehabilitate REO properties, subsequently turning them into long-term affordable housing or rental units, ensuring stable and healthy communities well into the future.

Making this supply of properties available to those with modest incomes is easier said than done. Across the country, local governments are experimenting with old and new strategies to acquire and refurbish foreclosed and abandoned properties, rehabilitate them, and turn them into affordable housing. Despite some success, many communities could still benefit from more experience and institutional knowledge.

In early 2009, the Milken Institute, with the support of the Ford Foundation, convened a Financial Innovations Lab to address this challenge. This workshop brought together experts from federal, state and local governments; banks; foundations; community development organizations; and research institutes. They explored ways to simultaneously reduce neighborhood blight and add affordable housing, and continued this important discussion at a roundtable at the Milken Institute’s Global Conference. This report summarizes their ideas, findings, and recommendations.
The Scope of the Problem

By 2004, homeownership rates reached an all-time high of 69.2 percent, as low interest rates and new mortgage products placed the American dream within reach for many who previously did not qualify. The demand for homes pushed prices up dramatically, with prices in many coastal states rising more than 90 percent from their low points earlier in the decade (see figure 1). In some booming markets, these increases were even greater: 134 percent in California, 140 percent in Florida, and 141 percent in Nevada.²

Initially, these trends appeared to be beneficial in terms of wealth creation for new homeowners. Eventually, however, the bubble burst, resulting in a dramatic loss of value. Home prices plummeted across the country: by 41 percent in Florida, 46 percent in Arizona, 47 percent in California, and 50 percent in Nevada (see figure 2 on the following page).³ Some cities have been particularly hard-hit, with markets such as Las Vegas and Phoenix still more than 50 percent below their 2006 peaks (see figure 3 on the following page).⁴
FIGURE 2

Decrease in state home prices through Q1 2009

Note: Percentages reflect 1999-2001 low point in median existing single-family home price versus cycle peak in 2005-2007. HI=128 percent, AK=49 percent

Sources: National Association of Realtors, Moody’s Analytics Estimates, Milken Institute.

FIGURE 3

Home prices in major cities are far below 2005-2007 peaks


Source: S&P Case-Shiller/Fiserv (data through March 2009).
The decline in home prices wiped out many owners who had invested little to no down payment and now found themselves with negative equity (that is, their outstanding mortgages exceed the value of the homes). In fact, 32.5 percent of all residential properties with mortgages were underwater at the end of the first quarter of 2009.\(^5\)

When combined with widespread layoffs, the result was a tidal wave of foreclosures, resulting in a dramatic increase in the number of real-estate-owned properties (REOs)—homes that entered foreclosure, failed to sell at auction, and are now owned by mortgage lenders (see figure 4). Subsequently, there has been a sharp rise in REO inventory at government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac (see figure 5 on the following page). Moreover, REO inventory at FDIC-insured institutions now exceeds $11.4 billion, a more than 460 percent increase from the fourth quarter of 2005 (see figure 6 on the following page).

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**FIGURE 4** U.S. monthly foreclosure filings

![Graph showing U.S. monthly foreclosure filings](image)

Sources: RealtyTrac, Bloomberg (March 2009).
Foreclosures and REO properties have exacerbated the resale inventory glut, as 13.9 million U.S. homes (roughly 11 percent of all housing units) were year-round vacant through 2008 (see figure 7 on the following page). This level is markedly higher than in previous recessions (vacancies stood at 9 percent in 2001, 8.5 percent in 1991, and 6.8 percent in 1981).
Deserted neighborhoods are of utmost concern, as the presence of vacant properties can lead to significant neighborhood blight and decline, reducing the value of nearby homes as much as 8.7 percent. Moreover, crime and vandalism are common around these properties.

Ideally, vacancy would be short-lived. In a healthy real estate market, in which credit is available and housing supply and demand are close to equilibrium, foreclosed homes would find buyers and be absorbed into the market. However, in the turmoil of today’s housing market, credit is tight and supply vastly outstrips demand. Many properties are sitting vacant for far too long.

Recognizing the negative impact of foreclosed properties, Congress created the Neighborhood Stabilization Program (NSP) in July 2008 as part of its Housing and Economic Recovery Act. The program aims to stabilize the communities hardest hit by foreclosures by supporting the acquisition, rehabilitation, demolition and disposal of foreclosed and vacant residential properties. In addition, NSP funds down-payment assistance to support purchases in neighborhoods affected by foreclosures and provides credit enhancement to leverage private capital. In 2008, NSP received $3.92 billion to be allocated to grantees, including state and local governments and nonprofit organizations.

While NSP has been instrumental in stemming some neighborhood degradation, there remains a need to develop sustainable programs and methods to address the massive inventory of REO properties. Vacant and abandoned houses can be reborn as long-term affordable housing.
Findings from the Financial Innovations Lab

The February 2009 Financial Innovations Lab and the subsequent roundtable at the Milken Institute Global Conference took up the challenge of identifying scalable strategies for converting the existing inventory of REO properties. Lab participants considered how to finance the acquisition of distressed assets and dispose of the properties in a way that preserves neighborhoods and supports affordable housing.

Several key factors will have to be overcome:

- **Inability to price properties.** In a functioning real estate market, pricing evolves from appraisals, largely based on recent sales of comparable properties. In the post-crisis climate, homes simply haven't been selling, especially in areas with a glut of REOs. The usual standards of comparison have been erased. Establishing a price acceptable to buyers and sellers has grown difficult, creating tension between mortgage servicers, who want their pre-crisis loans repaid, and investors, who seek the best financial returns.

- **Excess of REO properties on the market.** After the mortgage meltdown, servicers were handling a record number of properties. Although local housing providers may have been willing to step in and convert some of these properties, they lacked a way to intervene on a large scale.

- **Need for layered, complex financing at different stages.** Neighborhood stabilization requires a complex set of financing solutions. Different types of capital are needed at different stages. Debra Schwartz from the MacArthur Foundation characterized capital needs as short-term (to acquire the property), mid-term (to rehab or demolish homes), and exit or permanent (to transfer the property to a buyer). Tight credit and cautious investors limit availability at every stage.

- **Difficulty in preserving affordability.** Affordable housing is vital to keeping neighborhoods stable. Speculators often buy distressed properties, but they have no vested interest in preserving homeownership, renovating the houses, or selling them at reasonable prices. Low- and moderate-income individuals need access to affordable, responsible mortgage options.

- **Inadequate capacity to manage affordable housing stock.** Local governments and community groups have a strong interest in preserving home affordability, but few localities have a community development infrastructure that is robust enough to match the scale of the ambition. They lack both the financial and human resources to absorb the flood of REO properties and reposition them in the market.
FINDING SOLUTIONS IN THE REO CRISIS

An underlying theme of the proposed solutions was opportunity—taking advantage of this moment to not only expand the nation’s affordable housing stock, but to update it to meet new energy efficiency and green building standards.

Bill Goldsmith of Mercy Housing said, “This is the first opportunity I think we have to control all the assets and funding at the same time. We can’t pass up that opportunity, so we have to build the right delivery system to make this work.” Jim Gray of NCB Capital Impact agreed. “We need to make the most of this crisis and find a way to create some permanent affordability and also to build wealth for people over the long term,” he said.

Solution 1: Use Innovative Pricing Models

In markets where values are fluctuating, it is important to find ways to arrive at a fair, affordable price. During the Lab, two models were presented:

- **Top-down approach.** The National Community Stabilization Trust (NCST; see sidebar on page 9) starts with a market price under normal conditions and then derives a current value. It calculates a “net realizable value” by taking the estimated market value and subtracting holding, insurance, and other market-specific costs. Key to this approach is that the final sale price reflects local market conditions and predictions about future home prices.

- **Bottom-up approach.** The Community Asset Preservation Corporation (CAPC) of New Jersey buys pools of non-performing mortgages and REO properties in low- and moderate-income communities, and employs a variety of strategies to return these properties to productive use. Its pricing model starts with an estimate of current value and adds the costs necessary to bring the property to market. In March 2009, CAPC was the first nonprofit to complete a bulk purchase of foreclosed properties.

George McCarthy of the Ford Foundation urged a move to make mortgages affordable to homeowners. “In an environment in which you actually don’t know what the price of anything is, then you don’t bother to try to underwrite the property—it just doesn’t make any sense. …The most efficient kind of mechanism that we could find to modify loans was just to underwrite the borrower, and basically get them to a point where they could get into an affordable mortgage and ignore whatever the value of the debt was or the value of the property was, provided that the mortgage you ended up with was more than whatever you would consider to be the fair value for the property,” he said. Thus, in an effort to prevent additional REOs from hitting the market, loan modifications are initiated for borrowers to ensure affordable payments, subsequently incentivizing continued residency within the property despite the overhang of negative equity.
Solution 2: Clear the Property Logjam

Wherever there is a large inventory of REO properties, it’s difficult to quickly get them back to stable owner-occupied status. One solution is to set up an intermediary between REO servicers and local housing organizations. NCST has pioneered this role.

Solution 3: Aggregate Capital from Various Sources

Lab participants agreed that the federal Neighborhood Stabilization Program, although tremendously helpful, can only address a small portion of REO properties. Until housing markets recover, public subsidy and philanthropic capital must leverage private capital in order to have a widespread impact. Creative financing is necessary at each stage, from the acquisition of the properties to disposition.

Some strategies for aggregating capital might include:

- **Use program-related investments (PRIs).** PRIs, below-market investments, could be used more widely to subsidize returns for private capital. With public subsidies and dollars from socially motivated investors, PRIs could take the form of subordinated debt.

- **Credit-enhance housing funds.** NSP dollars can be used for credit enhancement. Protecting private-sector investments from the downside would encourage investors.

- **Create a publicly traded vehicle.** Thomas Humphreys, a partner at Morrison & Foerster LLP, suggested that Congress create a publicly traded vehicle that has tax advantages. Such a vehicle would be able to raise large amounts of private capital to stabilize communities.
■ Make communities more attractive to developers. Bill Goldsmith of Mercy Housing stressed the pivotal role of developers. “Our theory is that the fundamental link in the ground is not buyers, it is not renters, it is developers. …We are going to build a system around what it’s going to take for developers to come to the table,” he said.

■ Allow specialized asset managers. “The housing market not only needs a new mortgage paradigm; it also needs a new securitization paradigm with more responsibility,” Shekar Narasimhan from Beekman Advisors said. This shift would require safe harbors for specialized asset managers, who would be allowed to make decisions on loan modification without fearing litigation from investors, and have a greater authority in administrating the pool of loans. In return, they would have to meet regulatory standards.

■ Increase access to takeout financing. Access to responsible takeout financing is essential to put individuals in homes they can afford. The model used by the Neighborhood Assistance Corporation of America has been successfully implemented in low- and moderate-income communities. NACA developed and uses online software that features a user-friendly application process and stores a borrower's documents. This greatly facilitates the underwriting of mortgages and enables NACA to offer a 30-year fixed-rate product at a slightly below-market rate with no down payment and no closing costs. At the time of the Lab, only 0.0023 percent of homeowners who bought this product defaulted on their mortgages. In addition, NACA holds free events around the country to restructure unaffordable mortgages.

In addition, public capital must be streamlined and targeted to local uses. Referring to the number of federal responses to the housing crisis, George McCarthy of the Ford Foundation stressed the need to respond responsibly and effectively. “One of the issues that we have right now is a fire hose of resources and ideas coming out of Washington without a lot of attention being paid to what's actually going to happen at the local level,” he said.

Solution 4: Preserve Affordability

Innovative financial products can help low- to moderate-income households achieve the dream of homeownership more safely than the mortgage products that failed in recent years. Options such as lease-purchase mortgages and shared-equity mortgages provide a middle ground between rental and ownership. They are especially attractive for households that cannot initially qualify for standard 30-year mortgages, but will be candidates for homeownership several years down the road.

■ Shared-equity ownership. Models of shared equity, such as deed-restricted housing, community land trusts, and limited-equity cooperatives, are time-tested in the U.S. and Europe. A government or nonprofit invests in a property alongside the homebuyer. Shared equity enables borrowers to trade some potential upside of a purchase for financing. Hundreds of these programs now operate in the U.S.
Lease-to-purchase mortgages. Self-Help is piloting this more experimental solution. The nonprofit buys and rehabilitates properties in Charlotte, North Carolina, then leases the homes to “tenant purchasers”—renters likely to be able to assume Self-Help’s lease-purchase mortgages in one to five years. During the rental period, Self-Help provides credit and homeownership counseling, as well as property management services, to the tenant purchasers. When the tenant purchaser qualifies, he or she assumes the lease-purchase mortgage from Self-Help.

Additionally, Elyse Cherry, CEO of Boston Community Capital, spoke at the Lab about testing new mortgage products that could include features such as periodic payments to see what works best for lower-income populations.

It is also important to provide counseling to homeowners. The Ford Foundation’s George McCarthy characterized counseling as a form of credit enhancement, which enables homeowners to be better borrowers and increases the likelihood of their making the required payments.

Solution 5: Expand Local Capacity to Manage REO Properties

It is critical to develop the capacity at the local level to manage foreclosed properties. Lab participants noted that some cities, such as Chicago, New York, and Minneapolis, have strong community development sectors to handle housing issues. Other communities, however, come up short in financing, infrastructure, human resources, and policy—and many of these are among those hardest hit by the housing crisis.

Mary Tingerthal, president of Capital Markets Companies at the Housing Partnership Network, spoke about the challenges of deploying NSP dollars in newer communities, where much of the subprime lending occurred. These areas have grown dramatically over the past decade but lack community development infrastructure. They should be targeted and equipped with necessary resources to deal with the fallout.
## Financial Innovations Lab Participants

*(Affiliations at time of Lab)*

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1. RealtyTrac, Bloomberg (March 2009).


3. Ibid.


