

**STABILIZING COMMUNITIES:
A FEDERAL RESPONSE TO THE SECONDARY IMPACTS OF THE
FORECLOSURE CRISIS**

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Executive summary

The wave of home mortgage foreclosures that began in 2006 continues to surge, greatly destabilizing neighborhoods, towns and cities across the United States. Without robust, carefully-targeted federal policies to mitigate the community-level impacts of foreclosure, local and state efforts will invariably fall far short of what is needed. For that reason, the federal government should adopt a four-part strategy that provides state and local leaders with the tools to stabilize affected neighborhoods and promote market recovery in the wake of the mortgage crisis.

America’s Challenge

Over 1.2 million residential properties went into foreclosure in 2008, and analysts project that perhaps 8 million more will be in foreclosure over the 2009 to 2012 period. Problems began among subprime mortgages but are rapidly spreading into broader segments of the market. Homes in foreclosure or REO (real-estate owned) status concentrate in major metropolitan areas; those in over-built markets like the interior West and South Florida, and in economically distressed regions like Ohio and Michigan, exhibit the most severe challenges. Rising foreclosures in all types of markets threaten to create or exacerbate underlying problems of vacancy and abandonment, thereby diminishing area property values, destabilizing neighborhood economic and social conditions, and eroding state and local fiscal capacity to address these problems.

Limitations of Existing Federal Policy

Since the mortgage crisis erupted in 2006, the federal government has played only a limited role in attempting to mitigate its effects on families and communities. The 2008 Neighborhood Stabilization Program (NSP) provided \$3.92 billion to state and local governments to acquire and rehabilitate foreclosed or vacant properties, but is too small

to have systemic impact. Only the federal government can deliver resources commensurate with the scale of the problem, while helping to address state and local variations in planning and stabilization capacity, market conditions, and legal conditions establishing the ground rules for foreclosures and the means to address them.

A New Federal Approach

The federal government should provide essential leadership to facilitate neighborhood stabilization and recovery in the face of the mortgage foreclosure crisis. Four actions deserve particular consideration:

Creating a **redesigned and multi-year neighborhood stabilization program** that includes competitive grant awards to support strategic, high-leverage, collaborative projects, while fixing the Neighborhood Stabilization Program enacted in 2008.

Financing the acquisition of distressed properties via a new federal **Land Banking Entity**, and using it to encourage state reforms that mitigate the impact of foreclosures on families and communities

Enacting a **targeted tax credit** that assists individual home buying for occupancy in areas destabilized by foreclosures to speed neighborhood housing market recovery

Developing a **national mortgage and foreclosure database** to aid neighborhood stabilization efforts

I. INTRODUCTION

The wave of home mortgage foreclosures that began in 2006, and continues to grow, has destabilized neighborhoods, towns and cities across the United States.¹ While the burden of addressing this crisis has fallen primarily on state and local entities, that burden threatens to overwhelm them by virtue of their limited resources and capacity, their inability to assemble properties in a timely and cost-efficient manner, and their failure to undertake strategic efforts to stabilize distressed neighborhoods.

Without strong and carefully targeted federal involvement, local efforts will invariably fall far short of what is needed, with devastating effects on millions of families and their communities. While the Neighborhood Stabilization Program (NSP) enacted in the summer of 2008 is a valuable first step, it is at best a modest beginning for a meaningful federal role. If this crisis is to be addressed, such a federal role is not only desirable, but necessary.

This paper outlines the principal elements that would constitute a federal role in mitigating the secondary, community-level impacts of the foreclosure crisis. After an initial section that summarizes the scope of the crisis as of the end of 2008, the paper briefly reviews the extent of the federal response to date. A third section summarizes what is known about the secondary effects of foreclosures: how they affect properties, neighborhoods and communities across the nation. After a short discussion which lays out a framework for federal intervention in this area, the final part of the paper describes four initiatives that the federal government should pursue to fully address the crisis.

II. THE FORECLOSURE CRISIS IS GROWING AND AFFECTING METROPOLITAN AREAS IN DIFFERENT WAYS

1. *Nationally, housing distress is increasing and spreading*

Delinquencies and foreclosures have increased dramatically across all mortgage types in the two years since U.S. housing prices reached their peak. The number of 90-day delinquencies, for instance, jumped by 192 percent between October of 2006 and October of 2008 (see Box 1 for definitions). Likewise, mortgages in the foreclosure process and those that are real estate owned—or in “REO”—increased 204 and 275 percent, respectively.² In total, over 1.2 million properties went into foreclosure in 2008.³

Box 1. Definitions

Analysis for this section of the study is based on mortgage banking industry data from McDash Analytics, whose repository includes loan-level information from nine of the industry’s top 10 residential mortgage servicers. This study considers loans that fall into several different categories and are experiencing varying degrees of distress. These categories include:

- *Prime loans:* Mortgage loans that qualify for “prime” interest rates, indicating that the borrower has good credit. This category is subdivided into two subcategories. Agency-prime loans are defined as loans that are first lien (loans taken for credit, rather than second-lien loans taken against a borrower’s asset, such as a second mortgage), grade A, and where the investor is Fannie Mae or Freddie Mac. Non-agency prime loans are defined as those first lien, grade-A loans where the investor is portfolio or private. These loans must have a FICO score greater than or equal to 720, or a FICO score between 680 and 719 with full documentation
- *Subprime loans:* Mortgage loans generally issued at a higher interest rate than prime loans to borrowers with inferior credit ratings. These loans are often marked by characteristics like prepayment penalties, artificially low “teaser” rates, and steep, one-time “balloon payments.” For the purposes of the McDash data set, subprime loans are defined as first-lien loans that are grade B or C, or are grade A with FICO scores less than 620 and non-Ginnie Mae investors

- *Alt-A*: Non-traditional mortgage loans issued to borrowers with good credit. McDash defines Alt-A loans as first lien, grade A loans where the investor is portfolio or private, the FICO score is between 680 and 719, and full documentation is not required
- *Government*: McDash defines government loans as first lien, grade A loans where the investor is Ginnie Mae
- *Other*: Those mortgage loans not included in the categories above

Degrees of mortgage distress include:

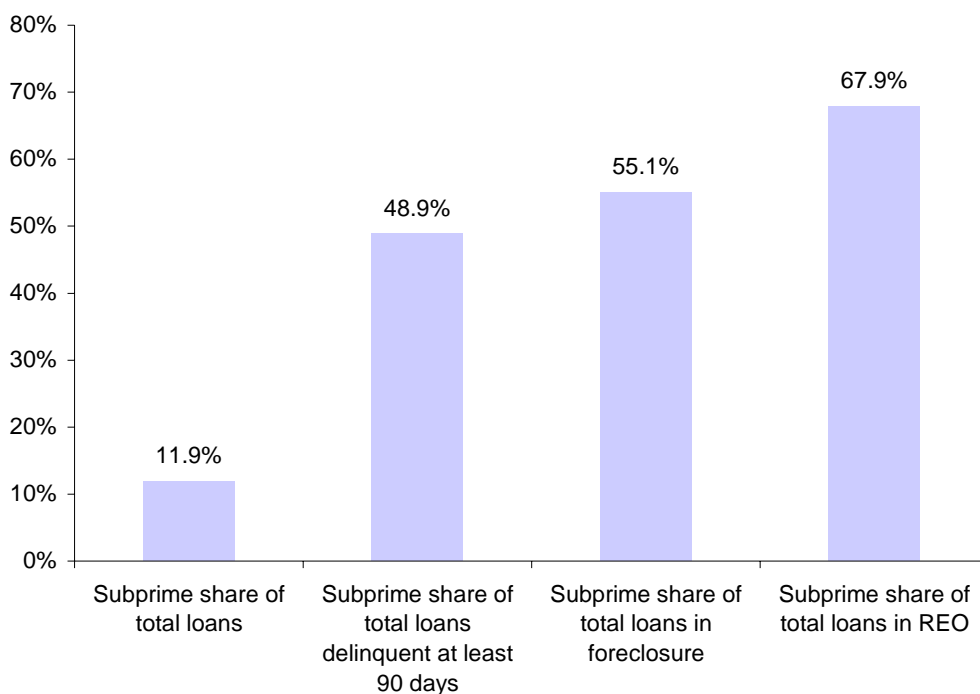
- *Delinquency*: Mortgage loans in which the borrower's payment is late. McDash data tracks 30-, 60-, and 90-day delinquency. Unless otherwise stated, this analysis examines only 90-day delinquencies
- *Foreclosure*: Mortgage loans from the date at which the first notice of foreclosure is issued until the date of the foreclosure sale
- *REO*: The inventory of "real estate owned" properties (or "REOs") includes mortgages that are "post sale," meaning that the foreclosure sale has already taken place such that the properties are owned by the bank

Source: McDash Analytics

The foreclosure crisis originated largely in the subprime mortgage sector. Among all three categories of distress—delinquency, foreclosure, and REO—subprime loans account for the lion's share of the problem. Not only are rates of distress several times higher for subprime loans than other mortgages, but the total number of subprime delinquencies, mortgages in foreclosure, and REOs make up 50 percent or more of all distressed loans despite subprime mortgages accounting for just 12 percent of all loans (Figure 1).

FIGURE 1

While representing just 12 percent of all mortgages, subprime loans accounted for the bulk of delinquencies, mortgages in foreclosure, and REOs in October 2008



Source: Brookings analysis of McDash Analytics data

But the problem is broadening beyond the subprime market. Indeed, the subprime share of delinquencies, mortgages in foreclosure, and REOs actually fell between October of 2006 and October of 2008. Over the same period of time, the contribution of Alt-A and non-agency prime loans to total delinquencies, in-foreclosure mortgages, and REOs increased significantly, despite virtually no change in the composition of all mortgages by loan type (Figure 2).

FIGURE 2.
The subprime market’s contribution to the foreclosure crisis appears to have peaked

Loan type	Share of all mortgages delinquent 90 days or more			Share of all mortgages in foreclosure			Share of all mortgages in REO		
	October, 2006	October, 2008	Percentage point change	October, 2006	October, 2008	Percentage point change	October, 2006	October, 2008	Percentage point change
Subprime	52.7%	48.9%	-3.9%	59.8%	55.1%	-4.8%	69.0%	67.9%	-1.1%
Alt-A	5.1%	7.5%	2.4%	6.4%	12.0%	5.7%	4.1%	8.6%	4.5%
Agency prime	16.9%	17.6%	0.6%	18.7%	19.1%	0.3%	16.5%	12.0%	-4.5%
Non-agency prime	1.2%	3.5%	2.3%	1.9%	5.4%	3.5%	2.7%	4.6%	2.0%
Government	9.7%	6.6%	-3.0%	5.0%	3.7%	-1.2%	1.2%	1.3%	0.1%
Other	14.3%	16.0%	1.6%	8.2%	4.7%	-3.5%	6.5%	5.6%	-0.9%

Brookings analysis of McDash Analytics data

More troubling is the fact that even prime mortgages—which account for the majority of all loans—are also recording large increases in their rates of

distress. The 90-day delinquency rate for agency prime mortgages, for instance, increased from just 0.37 percent to 0.92 percent over the last two years. The recession and the potential for large increases in unemployment only compound the problem.

Figure 2 shows that delinquency and foreclosure rates are rising rapidly among Alt-A mortgages, too. These loans, which often feature a “teaser” rate that resets after a few years, account for \$1 trillion of the mortgage market—over \$100 billion more than the total amount of subprime loans outstanding. Of the 3 million people who took out an Alt-A mortgage, as many as 70 percent may have exaggerated their income.⁴ Most of these borrowers never expected to undergo a rate reset, but declining home prices effectively prevent them from refinancing into a better loan. After the resets, many will be left with monthly payments they cannot afford, and will fall into delinquency and foreclosure.

Forward-looking analysis projects continued housing market turmoil related to Alt-A and “Option ARM” mortgages. Hundreds of billions of dollars in interest rate resets are due to occur on these loans in 2010 and 2011, particularly in states suffering the greatest home price declines, such as California, Nevada, Florida, and Arizona.⁵ Absent dramatic government intervention to refinance these mortgages, the foreclosure crisis could broaden and deepen significantly over the next two to three years.

2. The foreclosure problem concentrates in large metro areas, but varies in its intensity and character

While national numbers illustrate the overwhelming scale of the problem, the foreclosure problem overwhelmingly concentrates within major metropolitan areas. In 2006, the 100 largest metro areas accounted for 73 percent of the nation’s 90-day delinquencies, 72 percent of mortgages in foreclosures, and 70 percent of REOs, despite containing just 65 percent of the nation’s population. Fast-forward to 2008 and these numbers have significantly worsened. Now, these same metros account for 75 percent of delinquencies, 77 percent of mortgages in foreclosure, and a startling 78 percent of REOs.

The extent of the problem, though, varies considerably across metro areas, with distinct regional trends evident in an analysis of the share of all mortgageable properties experiencing mortgage-related distress.⁶ Foreclosure problems are acute in several metro areas that were, until recently, regarded as relatively healthy economically. For instance, of the 10 metro areas recording the largest shares of mortgages in foreclosure, seven are located in Florida. Cape Coral, Miami, Orlando, Tampa, and Sarasota represent the nation’s five most troubled markets (with Palm Bay and Jacksonville ranked 7th and 10th, respectively), with foreclosure rates between 3.8 and 10.0 percent. These Florida metro areas experienced some of the fastest rates of new home construction in the early 2000s, speculative and second home buying, and rapid

price declines in the wake of the subprime mortgage fallout. Las Vegas, Phoenix, and several California markets followed a similar trajectory (Figure 3).

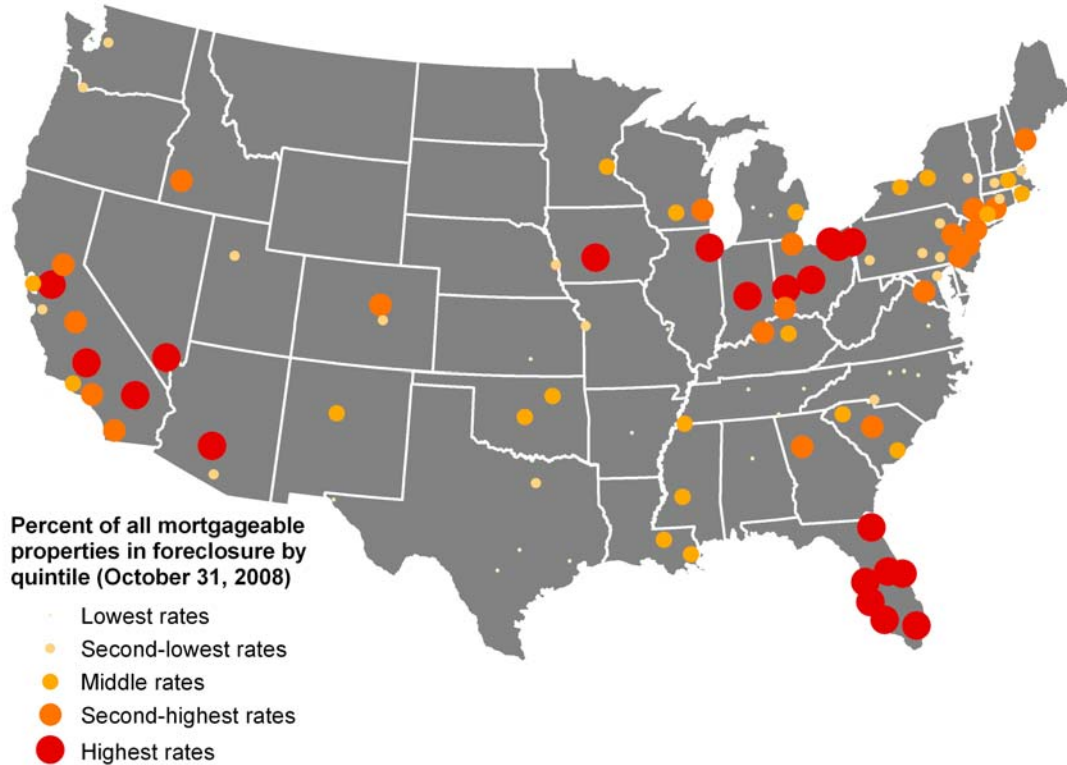
FIGURE 3
Seven large Florida metro areas and five large Ohio metro areas are among those reporting the highest shares of properties in foreclosure

Rank Metro	In-foreclosure rate (mortgages in foreclosure divided by mortgageable properties), October, 2008
1 Cape Coral-Fort Myers, FL	10.00%
2 Miami-Fort Lauderdale-Miami Beach, FL	6.35%
3 Orlando, FL	5.13%
4 Tampa-St. Petersburg-Clearwater, FL	4.04%
5 Sarasota-Bradenton-Venice, FL	3.77%
6 Las Vegas-Paradise, NV	3.38%
7 Palm Bay-Melbourne-Titusville, FL	3.34%
8 Stockton, CA	2.78%
9 Riverside-San Bernardino-Ontario, CA	2.76%
10 Jacksonville, FL	2.66%
11 Phoenix-Mesa-Scottsdale, AZ	2.31%
12 Cleveland-Elyria-Mentor, OH	2.23%
13 Chicago-Naperville-Joliet, IL-IN-WI	2.14%
14 Akron, OH	2.08%
15 Indianapolis, IN	2.01%
16 Des Moines, IA	1.98%
17 Bakersfield, CA	1.97%
18 Columbus, OH	1.95%
19 Youngstown-Warren-Boardman, OH-PA	1.92%
20 Dayton, OH	1.91%
100 metro average	1.53%
U.S. average	1.22%

Source: Brookings analysis of loan performance data from McDash Analytics and Census data

Of course, metro areas that experienced a recent growth-fueled housing boom are not the only places now suffering from high rates of distress. Weak markets are also feeling the pain. Cleveland, Akron, and Youngstown, for instance, are among five Ohio metro areas that record high percentages of properties in foreclosure. Chicago, Indianapolis, and Des Moines add to the list of hot-spots in the Midwest (Figure 4).

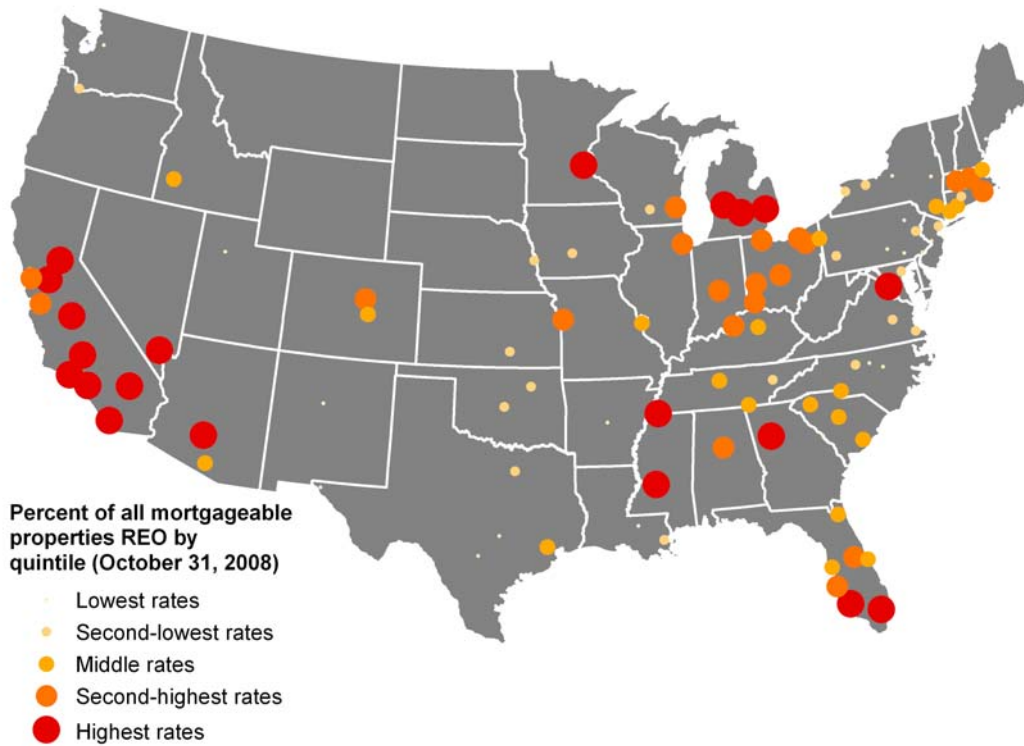
FIGURE 4
Metro areas with high foreclosure rates concentrate in Florida, the interior West, and the industrial Midwest



Source: Brookings analysis of McDash Analytics data

The geography of REOs—properties that have gone through the foreclosure process and are now bank-owned—is similar. However, California’s problem is particularly acute, with seven metros in the most-distressed quintile (Figure 5). Michigan also faces a severe problem, with all three of its large metros falling in the worst quintile. Minneapolis-St. Paul, Jackson (MS), and Memphis contend with high shares of REO properties despite average shares of properties in foreclosure. Variation in foreclosure laws from state to state (see below) may account for the differences in metropolitan foreclosure and REO rankings, with the number of REOs likely to be higher in states with faster non-judicial foreclosure systems.

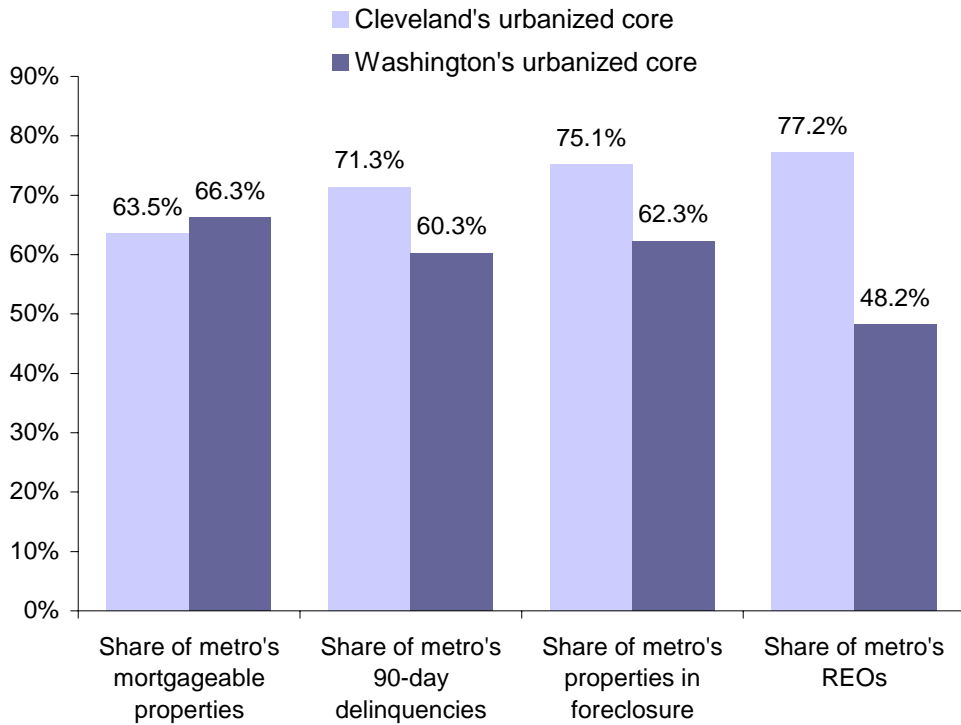
FIGURE 5
REO rates are especially high in California, Michigan, and the Southeast



Source: Brookings analysis of McDash Analytics data

Significant *intra*-metro variation also exists across the country on measures of distress. In places like Cleveland, the core urban area accounts for a disproportionately high share of delinquencies, properties in foreclosure, and REOs. The Washington metro area epitomizes the opposite trend, with the core generating a disproportionately lower amount of distressed properties (Figure 6).⁷

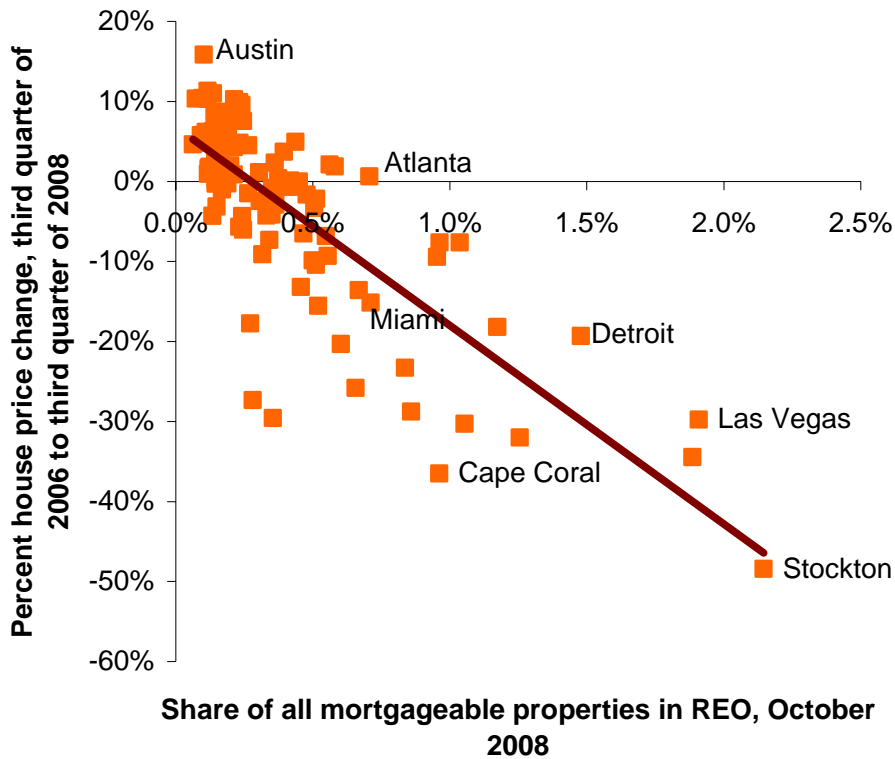
FIGURE 6
Distressed properties in metropolitan Cleveland's lie disproportionately in the urbanized core, while problems in metropolitan Washington concentrate outside the core of the region



Source: Brookings analysis of McDash Analytics data

While foreclosures are occurring throughout the country—in strong markets and weak ones—the severity of the problem appears to be related to the change in housing prices over the last two years.⁸ On average, metro areas experiencing the worst price declines between the third quarter of 2006 and the third quarter of 2008 also record the highest shares of mortgageable properties in REO (Figure 7).

FIGURE 7
Metro areas that have experienced large housing price declines over the last two years tend to have a higher percentage of properties in REO



Source: Brookings analysis of McDash Analytics and FHFA data

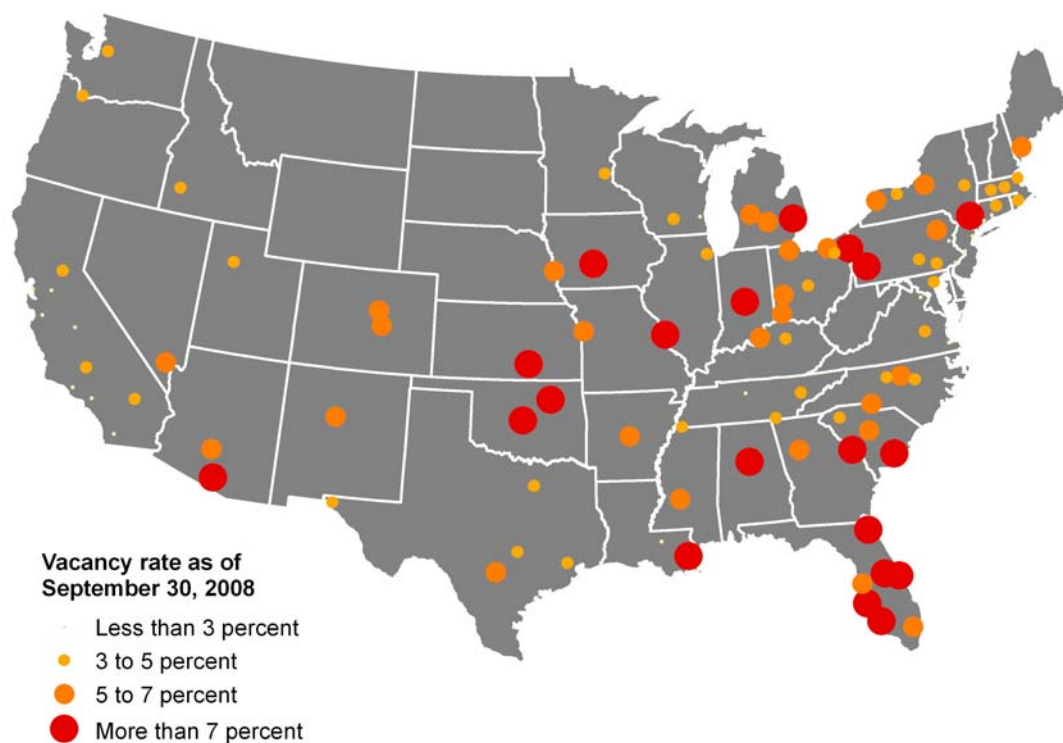
3. The mortgage crisis has created or exacerbated problems associated with vacancy and abandonment

These problems contribute to and compound existing vacancy challenges, leaving many metro areas struggling with the deleterious effects of abandonment. Here again, the problem varies in its impact across markets.

In some places—such as Las Vegas, Phoenix, and metro areas in Florida and South Carolina—high foreclosure rates have created new vacancy problems. In other areas—particularly places like Cleveland, Detroit, and Indianapolis—increasing foreclosure rates and a growing stock of bank-owned properties are exacerbating pre-existing vacancy problems. Still other metros face persistent vacancy challenges despite relatively low incidence of foreclosures and REOs, as in Syracuse, Pittsburgh, or Scranton.

Vacancy problems burden metro areas of every size across every region of the country, in both strong and weak markets (Figure 8). For instance, Palm Bay, FL has seen house prices plummet 27.3 percent since 2006, while prices in Poughkeepsie, NY have declined just 6.0 percent. But the two metro areas have nearly identical vacancy rates, both around 9.2 percent.⁹

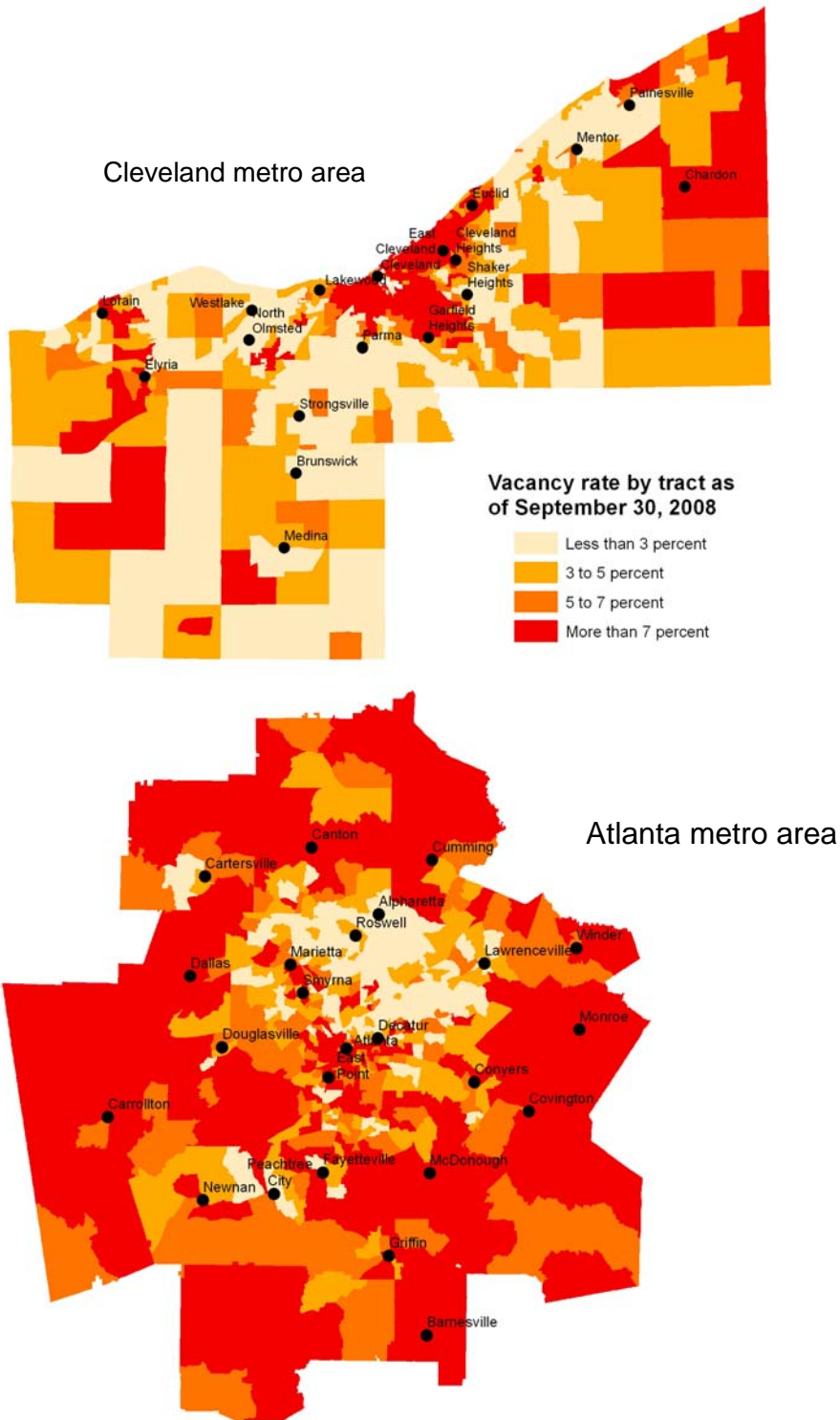
FIGURE 8
A diverse group of metro areas confronts high vacancy rates



Source: Brookings analysis of USPS data

Even a metro-level examination, however, hides the intensely local nature of the vacancy problem (Figure 9). Cleveland's highest vacancy rates, for instance, are predominantly found in the urban core of the metro area, encompassing Euclid and Cleveland Heights to the northeast, Lakewood to the west, and Parma and Garfield Heights to the south. Metropolitan Atlanta faces a different challenge. There, vacancy rates are high in large parts of the urban core, particularly the southern sections of Fulton and DeKalb counties. But vacancy rates are also high in the outer suburbs, home to a substantial amount of the metro area's recent growth. The wide-reaching nature of the vacancy problem in metropolitan Atlanta—as in other places—implies that policies addressing the issue must also be sensitive to the large variation in local capacity across and within metros. The newer suburbs of Atlanta, for instance, bring to bear very different levels of financial resources and technical expertise than the city and its older suburbs.

FIGURE 9
Like other measures of housing market distress, the geography of vacancies varies considerably by metro area



Source: Brookings analysis of USPS data

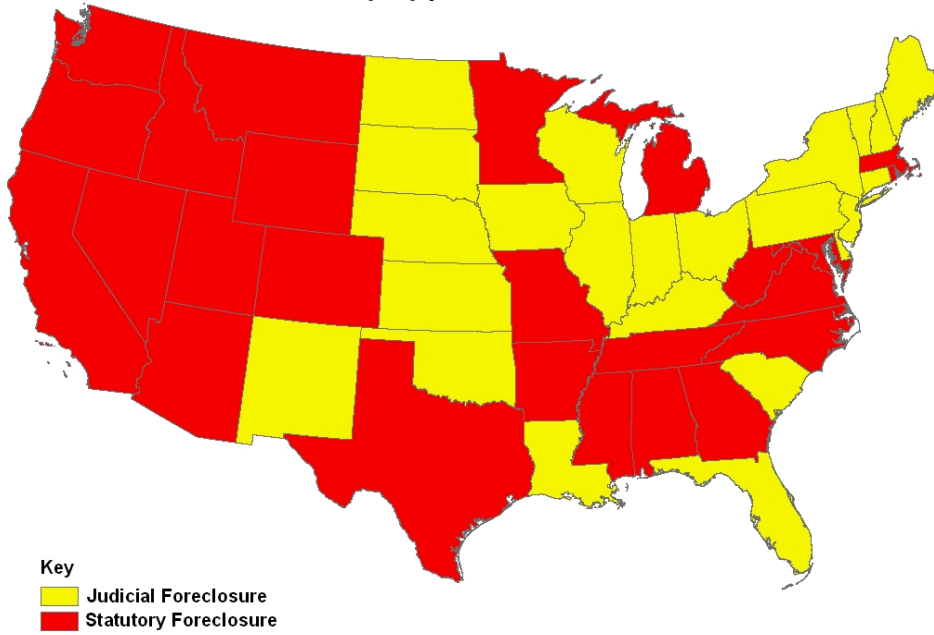
Meanwhile, the federal government's initial response to the foreclosure crisis—represented primarily by the Neighborhood Stabilization Program—does not match the scope of the problem. While NSP funds are in no way intended to help states and municipalities buy up entire REO inventories, it is worth noting that the total national funding amount equates to little more than \$2,500 for every mortgage that is either bank owned or currently in the foreclosure process as of the end of 2008. In the Miami metro area, where there are an estimated 90,000 properties in foreclosure and another 10,000 in REO, federally-mandated NSP allocations per property amount to about \$1,900. In the Los Angeles metro area, where there are 35,000 properties in foreclosure and 4,000 in REO, the per-property allocation is less than \$1,400.¹⁰ These figures, of course, do not include other vacant and abandoned properties which exert similar downward pressures on neighborhood stability (see Section III).¹¹

Adding to the complexity of the mortgage crisis is the variation in foreclosure processes from state to state. Differences exist both in legal structure and in the length of time that typically elapses between foreclosure referral and the actual foreclosure sale. Some states require a court action (“judicial foreclosure”) whereas other states have “statutory” foreclosure laws, which do not require a court appearance. As seen in the accompanying maps, statutory foreclosure is typically accompanied by a shorter timeline. While states with judicial foreclosure tend to concentrate in the northeast, most western states have statutory foreclosure laws.¹²

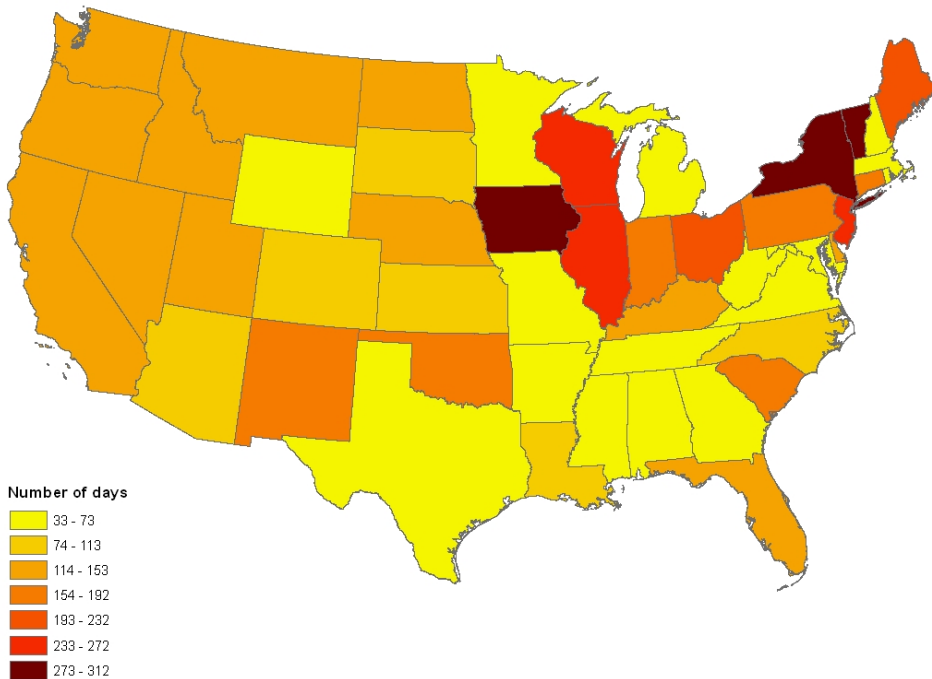
In summary, the mortgage crisis continues to grow and spread, with deleterious consequences for local communities buffeted by foreclosures and resulting vacancy and abandonment. The magnitude and character of the problem vary greatly across markets, however, as do the market circumstances and state and local policy environments that frame the efforts to respond. As described further in Section IV, initial federal efforts to help communities cope with the secondary effects of the crisis have fallen far short of the mark.

FIGURE 10
States vary in their legal structure around foreclosures and average time to complete foreclosure

States by type of foreclosure law



States by number of days from foreclosure referral to sale



Source: Analysis by Amy Crews Cutts and William A. Merrill, "Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs." In *Borrowing to Live* (Brookings/JCHS, 2008). Based on Freddie Mac data

III. THE FORECLOSURE CRISIS EXERTS NEGATIVE SECONDARY IMPACTS ON PROPERTIES, NEIGHBORHOODS, AND COMMUNITIES

The secondary effects of the mortgage crisis—the economic and social impacts on properties, neighborhoods and communities—may turn out to be greater than its primary effects on homeowners and tenants directly affected by foreclosure. Although the research that would enable us to measure these effects is just beginning to emerge, it is clear that the crisis is triggering a series of powerful negative impacts, which will only grow more severe as the number of foreclosures continues to rise.

The secondary effects are not so much the outcome of foreclosure, in the sense of a legal procedure, as they arise from the close relationship between foreclosure, disinvestment, and vacancy, often leading to abandonment of the properties. While these outcomes are not inevitable, as the previous section suggests, they are widespread. Moreover, they are most likely to occur precisely in the most vulnerable communities, such as struggling lower-income and minority communities in cities and older suburbs. Market-wide economic conditions, as well as the legal ground rules each state has adopted to govern foreclosure and its aftermath, each contribute to the context for these secondary effects.

The relationship between foreclosure and abandonment reflects in turn the relationship between lender or servicer behavior and property value. The greater the value perceived in the property, the greater care the servicer will take to maintain both the quality and the value of the property being foreclosed. A foreclosure in an upscale community such as Palo Alto, CA or Princeton, NJ will likely be pursued aggressively; the property will be assiduously maintained (at the servicer's expense, if necessary) during the process; and will be sold quickly after the foreclosure sale. In an area with lower market values, the servicer will devote less effort to either maintaining the property or ensuring its speedy conveyance to a new owner. Moreover, the weaker the market, the longer it may take to find a new owner while the property sits vacant, during which time the property is at risk of vandalism and fire. In many weak market areas, servicers do not even bother to complete foreclosure actions or to record the outcome of foreclosure sales, believing that the cost of foreclosure outweighs the value of the property. The outcome is often an abandoned property with a title in legal limbo.

Where properties in foreclosure are not maintained, deteriorate and fall vacant, their effects on the neighborhood and the community can be powerful:

- Foreclosures lead to deterioration and loss of value of the property being foreclosed¹³
- Foreclosures diminish the value of surrounding properties; the more foreclosures in the immediate vicinity, the greater the loss of value¹⁴

- Foreclosures destabilize economic and social conditions in the neighborhood¹⁵
- Foreclosures impose additional cost burdens on state and local governments, while reducing the revenues available to those entities¹⁶

The evidence of these effects is easily visible. In the most extreme cases, in cities like Cleveland or Detroit, widespread market collapse has resulted in parts of each city turning into virtual wastelands. Between 2006 and 2008, the median sales price of single family houses in Detroit plunged from \$75,000 to \$18,000 (representing a loss of \$16 billion in property value), while in the inner-ring Cleveland suburb of East Cleveland, prices fell from \$100,000 to \$13,000 between 2005 and 2007. By mid-2007, one out of every eight properties in East Cleveland was an REO property. In other cities, such as Boston, Newark, Baltimore or Memphis, once-viable neighborhoods are now destabilized or at risk of future destabilization.

The impacts of foreclosure on these cities and their neighborhoods, however, goes beyond property values. With declining property values and increasing vacancy and abandonment, the entire social and economic fabric of these neighborhoods deteriorates.¹⁷ Rebuilding that fabric will be a complex task, and will require far broader steps than simply removing blighted and abandoned properties from the neighborhood.

To aggregate the cumulative costs to the society and the economy of these effects with any accuracy is extremely difficult. Using an analysis by Immergluck and Smith, the Center for Responsible Lending (CRL) concluded--looking only at the effect of 2005 and 2006 foreclosures on subprime home loans--that 40.6 million neighboring homes will be devalued, and the total resulting decline in house values and tax base will be \$202 billion.¹⁸ This analysis reflected their assessment of the impact of slightly more than 1 million foreclosures. Before the crisis runs its course, the total number of foreclosures is likely to significantly exceed that figure. Simply extrapolating the CRL impact figure to the most recent Credit Suisse projection of 8.1 million foreclosures through 2012, we would arrive at a figure for the total impact on house values in excess of \$1.5 *trillion*.¹⁹ This is, of course, highly speculative. The wide variation in the geographic distribution of foreclosures and the market values of surrounding properties makes more accurate estimation impossible.

It is also difficult to disentangle the effects of foreclosures from the effects of the collapse of the housing price bubble since 2006. It seems clear, however, that the two reinforce one another. While the collapse in house prices has increased the number of foreclosures, particularly on the part of the millions of homeowners who owe more than the value of their home and find themselves "underwater", the increase in foreclosures has further exacerbated the decline in house prices. A vicious cycle has been established, which by the second half of

2008 was further reinforced by the onset of a severe economic recession, accompanied by widespread job losses.

The duration and severity of the recession will certainly increase the number of foreclosures and their secondary effects, and may well lead to some areas seeing far more severe secondary effects than would otherwise have been the case, particularly in the Sunbelt. While until recently many observers expected that the foreclosure crisis in those areas was likely to be resolved through a manageable but far from painless process of market correction, that outcome looks increasingly unlikely as the recession deepens and house prices plummet. While the year-over-year trend between the fall of 2006 (at or near the peak for most Sunbelt areas) to the fall of 2007 typically showed a loss of value around 10 percent, from the fall of 2007 to the fall of 2008 the loss of value was between 25 percent and 35 percent, unprecedented losses for a single year (Figure 11).

FIGURE 11
House prices have plummeted in many Sunbelt metro areas

Metro area	October 2006	October 2007	October 2008	Change, 2006-2007	Change, 2007-2008
Phoenix, AZ	224.50	200.72	135.18	- 10.6%	- 32.7%
Los Angeles, CA	273.66	249.50	179.82	- 9.2	- 27.9
San Diego, CA	244.03	217.02	159.12	- 10.7	- 26.7
Miami, FL	278.91	244.35	173.42	- 12.4	- 29.0
Las Vegas, NV	233.80	208.68	142.57	- 10.7	- 31.7

Source: S&P/Case-Schiller Home Price Indices (January 2000 = 100)

The research findings bear out intuitive assessments and anecdotal evidence on the spillover effects of foreclosures:

- Property values are most greatly diminished among properties in closest proximity to foreclosed properties
- An increase in the number of foreclosures within a relatively small area dramatically increases the magnitude of the spillover effects, and the loss in neighboring property values, compared to a single foreclosure
- As the foreclosure process continues, the negative effect on neighboring property values gradually increases, and continues well beyond the resale of the REO property after the foreclosure has taken place

As the number of foreclosures increases in a given area, and as the properties remain longer in foreclosure and REO inventory, the neighborhood housing market can disintegrate. When foreclosed and vacant properties exceed a critical mass, as yet undefined, the market collapses; as one Detroit real estate agent commented about a once-stable middle class neighborhood in that city, “nobody’s going to want to buy into a neighborhood with 20 percent foreclosures.

You end up with no neighborhood.”²⁰ While such extreme conditions are far from the norm nationally, they are widespread. Without effective intervention, their number is likely to increase and spread significantly in the next few years.

IV. EXISTING FEDERAL EFFORTS TO STEM THE FORECLOSURE CRISIS AND ITS IMPACT ON COMMUNITIES ARE NOT EQUAL TO THE TASK

Since the mortgage crisis erupted in 2006, the federal government has played only a limited role in attempting to mitigate its effects, both with respect to the homeowners and tenants of properties at risk, as well as their neighbors and the towns and cities in which they live.

Federal actions to date have been largely limited to attempts to create opportunities for voluntary modification of troubled mortgages that would enable more home owners to avoid foreclosure and remain in their homes. The federal government played a supportive role in creating the Hope Now Alliance, a consortium of banks and other entities led by NeighborWorks America (NWA), designed to facilitate loan modifications by increasing homeowners’ access to counseling and information. Congress appropriated \$180 million to NWA, which it distributed in turn to state agencies to expand the availability of foreclosure prevention counseling services in their areas.²¹ Although many families have benefited from the Hope Now Alliance, the consensus is that its overall impact on reducing foreclosures has been modest. It has become apparent that, under current circumstances, many lenders and servicers have neither the capacity nor the will to provide the sorts of modifications that will actually provide stressed homeowners with long-term stability of tenure.

A more ambitious effort was included in H.R.3221, the Housing and Economic Recovery Act (HERA), which became law on July 30, 2008. The HOPE for Homeowners Program created a new mortgage program in the Federal Housing Administration to refinance loans for at-risk homeowners. Sensitive to potential criticism that the program would constitute a “bail-out” for holders of subprime mortgages, the program required that mortgagees discount their mortgages and allow the FHA to refinance the loan at a substantially lower principal value than the current mortgage. Although some lenders have expressed interest in the program, as of late 2008 it had had little visible effect on a rapidly deteriorating situation, and was being restructured by HUD to reduce lenders’ “haircut.”²²

In a similar vein, the recently enacted Troubled Assets Relief Program (TARP) has to date provided little substantive benefit to homeowners facing foreclosure. Up to the end of the Bush administration, the Treasury Department did not use any of the funds made available under the program to acquire either whole mortgages or shares in securitized mortgage pools.²³ That may change, of course, with the arrival of the Obama administration and new Congressional efforts in this direction.

While the Bush administration recognized and made some symbolic efforts to address the effect of the mortgage crisis on homeowners, it made no comparable efforts to address the other dimension of the crisis: the impact on properties, neighborhoods and communities. To be fair, the administration was not alone in failing at first to recognize the severity of this problem. The first substantial effort to address this issue at the federal level was in the Neighborhood Stabilization Act, introduced as H.R.5818 in April 2008. Although this and similar initiatives had the support of House and Senate leadership, the administration strongly opposed them until the political compromise that made it possible to include such a program as part of the HERA omnibus legislation.

Sections 2301 through 2304 of HERA created a program, subsequently dubbed the Neighborhood Stabilization Program (NSP), under which states and selected local governments would receive federal funds to address the property and neighborhood impacts of the foreclosure crisis. These jurisdictions would be allowed to use NSP funds for a variety of purposes:

- Acquisition of foreclosed or vacant residential properties
- Rehabilitation of foreclosed or vacant residential properties
- Demolition of blighted properties
- Redevelopment of sites created through demolition of blighted properties

Congress appropriated \$3.92 billion for the NSP, instructing the Department of Housing and Urban Development (HUD) to adopt program regulations and a formula under which the funds would be allocated to states and local governments, taking into account the number and rate of foreclosures, delinquencies, and subprime loans by jurisdiction. Given 60 days to do so, HUD promulgated the formula and regulations on September 27.²⁴ Jurisdictions slated to receive funds under the HUD allocation formula were given until December 1 to submit action plans, and will receive funds early in 2009. The statutory provisions governing the program require that all funds be used within 18 months.²⁵

Although both the act and the regulations betray the haste with which they were drafted, they are a serious first step in helping states and localities grapple with a mounting problem which they clearly lack the resources to address without federal assistance. At the same time, both the program itself and the way states and local governments are likely to use the funds are severely flawed. As a result, many of these funds may not be effectively targeted or used strategically, and in the end, may yield little sustainable long-term impact. Both how the current program can be improved, and how these issues should be addressed if the program is to continue beyond this initial one-shot effort, are discussed further in the recommendations section of this paper.

The size of the appropriation also raises questions. Roughly equivalent to annual CDBG appropriations in recent years, \$3.92 billion is a modest amount relative to the magnitude of the need (although arguably enough to have a significant impact in at least a few areas if carefully targeted and used strategically). At the same time, many of the jurisdictions that will receive NSP funds may lack the capacity to plan and execute effective, strategic use of even the modest funds they will receive. This is particularly true of many Sunbelt jurisdictions, which received large allocations of NSP funds because of their high levels of foreclosure, but which have little or no organizational infrastructure or track record with respect to community development and neighborhood revitalization activities.

In short, at the end of 2008, over two years since informed observers clearly saw that the nation was entering into a mortgage and foreclosure crisis unprecedented since the Great Depression, the federal response has been halting, uncertain and inadequate. The NSP, the only federal step that has been taken to address the property and neighborhood impacts of the crisis is not only far too small to have a systemic impact, but reflects not a systemic strategy but a one-shot, palliative approach to a complex problem.

V. THE FEDERAL GOVERNMENT HAS A CLEAR ROLE AND RESPONSIBILITY TO MITIGATE THE NEGATIVE COMMUNITY IMPACTS OF THE FORECLOSURE CRISIS

The magnitude of the problem described in the preceding section makes a compelling case that the federal government should assume a strong role in addressing the secondary impacts of foreclosures, and assisting state and local governments along with key private and non-profit sector players to do to as well.

One could argue that, from a laissez-faire standpoint, the market should be allowed to take its course and ultimately to find its equilibrium. Yet the costs of failing to act, in terms of lost property values, asset destruction, neighborhood social and economic deterioration, and the destabilization of local government finances, are far greater than the cost of action. Moreover, as was the case with the Home Owners' Loan Corporation in the 1930's and the Resolution Trust Corporation in the 1980's, if the federal intervention is carefully planned and responsibly executed, much of the potential initial federal outlay can be seen as an investment that will bring a return over time to the Treasury.

The challenge can be summarized briefly. Large numbers of foreclosures destabilize neighborhoods. The greater their number, and the longer they remain vacant, the greater the destabilization. Once destabilized, neighborhoods are not easy to bring back to health. While eliminating vacant properties and putting them back to use is an important part of any revitalization strategy, in most cases far more than that will be needed. A central element of any strategy, however, must be that of rekindling housing market activity. Without a functioning housing market, neighborhood vitality is unlikely to be regained.²⁶

The federal role in addressing the secondary impacts of foreclosure must be *in addition to*, and not in place of, a far stronger federal role in addressing the primary impacts of the crisis – its impact on millions of struggling homeowners. Far more action is urgently needed in that arena, including a strategy to modify or refinance the millions of mortgages that are held in investor-held mortgage-backed securities and have to date been untouched by public sector intervention. Although millions of homeowners have already lost their homes, the homes of millions more might still be saved by timely action.

Even with the best efforts and most aggressive policies, however, intervention will not always succeed. In addition to the hundreds of thousands of lender-owned or REO properties already taken through foreclosure, and the millions of properties already on the foreclosure track, further millions are likely to enter foreclosure before the epidemic runs its course.

This suggests that federal action should concentrate on addressing three fundamental issues:

- Providing financial and technical resources to further neighborhood stabilization
- Financing the acquisition of distressed properties
- Fostering housing market recovery in destabilized neighborhoods

This paper also proposes a fourth area of federal responsibility, to create a national mortgage and foreclosure data base.

While state and local governments, as well as many private entities, are attempting to address these issues, only the federal government can potentially bring resources to bear that are even remotely commensurate with the scale of the problem.

Gaining control of problem properties is the most difficult part of addressing this problem, but it is hard to imagine any successful strategy that does not include such a feature. As states and cities gear up to use their allocations of Neighborhood Stabilization Program funds, it has become clear that only limited, piecemeal, acquisition efforts, falling far short of the need, will be possible under the program. This is a product both of the limited funds available and the difficulties local entities face in dealing with national servicers holding national property portfolios.

In framing specific recommendations for federal action, it is critical to recognize the significant variation in circumstances among states, metro areas, cities and neighborhoods that must frame those policies. Among the many variations, three are of particular significance:

- **Variations in market conditions**, including the extent to which active public intervention will be needed to acquire and rehabilitate properties, and to restore market stability to destabilized neighborhoods

The strategies that will work in a suburb of Las Vegas will not work in the inner-city neighborhoods of Detroit or Cincinnati. Federal programs should not only permit local jurisdictions to tailor their efforts to their distinct market conditions, but should ensure that their strategies are grounded in a solid, realistic assessment of those conditions.

- **Variations in legal conditions**, including the ground rules for foreclosure and the tools available to local governments to address property issues

State laws and practices, which dictate the length of time the foreclosures process takes, the manner in which properties are maintained (or not) during the process, and the likelihood that they will become or remain vacant after foreclosure sale, all affect the magnitude of the secondary effects of foreclosure on a state's towns and cities. As we discuss further below, the federal government should not passively accept dysfunctional state legal systems, but should actively work to encourage those states to change their systems to better deal with foreclosure issues.

- **Variations in capacity**, including the organizational and technical capacity available to local governments and the presence of capable community development corporations (CDCs) and other entities engaged in neighborhood revitalization

As will be discussed further below, states and localities vary greatly in their capacity to address these issues. The federal government needs to address these disparities in capacity, and frame programs to build greater capacity in areas where the need is great but the ability to address it is lacking.

The federal government can and should play some roles directly. Other roles are more appropriate for state and local government, or for private non-profit entities such as CDCs, but cannot be carried out effectively unless federal resources are available to augment local resources. As the federal government enters this arena, it must be mindful that in the past two decades, public and non-profit entities at the state and local level have addressed neighborhood issues with creativity and intelligence in the absence of a strong federal partner. Federal programs that attempt to force these entities back into a narrow federally-dictated mold can do as much harm as good.

At the same time, the federal government cannot solve the problem in the absence of constructive action and leadership at the state and local levels. The federal government should hesitate to throw money at states and localities that lack capacity to use those funds, or that have failed to take legislative or

administrative actions that lie within their powers that will best enable them to address these problems. Not only must the federal government take steps to build state and local capacity, but—while careful to avoid imposing federal mandates on states and localities—it should nonetheless set clear standards for the steps that lower-level actors should take in order to be eligible for additional federal funds.

VI. THE FEDERAL GOVERNMENT SHOULD PURSUE A MULTI-FACETED STRATEGY TO PROMOTE NEIGHBORHOOD STABILIZATION AND RECOVERY

The federal government should play many different roles to facilitate neighborhood stabilization and recovery in the face of the mortgage foreclosure crisis. These include: providing financial and technical support for neighborhood stabilization activities; purchasing properties and financing property acquisition by local government; creating tax incentives to build market demand by home buyers in neighborhoods destabilized by foreclosures and vacant properties; and providing a vehicle through which a national mortgage and foreclosure data base can be created. In all of these areas, federal investments must be carefully targeted to ensure that they will have the greatest possible impact for the dollars expended. Public funds should not be used either where the private market will achieve similar results, or where conditions are such that they will end up having little or no effect.

1. A redesigned and multi-year neighborhood stabilization program is needed to facilitate market recovery

The Neighborhood Stabilization Program (NSP) enacted by Congress as part of the Housing and Economic Recovery Act (HERA) in the summer of 2008 has already been briefly described. While no funds have yet been disbursed, and while as of this writing HUD is reviewing the action plans submitted by states and localities for use of their allocations, many potential issues with the NSP have already become apparent. It is not too late for the incoming administration and Congress to make the regulatory and legislative changes that can make it a more effective, productive program. At the same time, if neighborhood stabilization is to become a long-term strategy and more than a one-shot infusion of funds, it is critical that many of the provisions of the program be fundamentally reconsidered, and other elements added to it.

That raises a threshold question. Should the NSP should become an ongoing multi-year program?

There are two compelling reasons for making a long-term, sustained federal commitment in this area. First, stabilizing and restoring health to America's distressed neighborhoods, whether located in cities, inner-ring suburbs or elsewhere, is vital to the health of the nation's cities and regions in which they are located. Second, the problem of neighborhood stabilization is a long-term

problem. Even if foreclosures were to diminish significantly over the next year or two, and return by the end of 2010 to historically modest levels (a highly optimistic scenario), the devastation that years of rampant defaults, foreclosures and abandonment will have wreaked in America's struggling neighborhoods will take far longer to reverse. Many of these neighborhoods, particularly in older cities and inner-ring suburbs, showed great vitality only a few years ago thanks to market improvement and decades of determined efforts by neighborhood organizations and community development corporations (CDCs). Recapturing that vitality in the wake of the mortgage crisis may take many years, and will require resources far beyond the means of state and local government, or local philanthropic institutions.

First, it is important to discuss at least briefly what is meant by the term "neighborhood stabilization," and how that can translate into a coherent funding program and into effective on-the-ground strategies.

What is neighborhood stabilization?

The purpose of neighborhood stabilization is to render neighborhoods more stable. A stable neighborhood is one in which residents and potential buyers feel confident that their investment—psychological as well as financial—is secure. It is an area in which prospective homeowners feel comfortable buying a home, while existing homeowners want to stay—even if their incomes rise—rather than move elsewhere.²⁷

A stable neighborhood also has a healthy and well-functioning housing market, in which houses that come on the market sell in timely fashion for a reasonable price, and where they tend to retain their value over time. It is, as many authors have noted, a neighborhood where people *choose* to stay or buy homes, rather than one in which people only live because they cannot afford to live anywhere else. The existence of such a market is in many respects a precondition for a cluster of different factors that drive social and economic vitality, including the extent to which people living in the area invest their time, money and energy in the neighborhood.²⁸

Many different forces can undermine the neighborhood's attractiveness to its present residents as well as potential buyers, including, among others:

- Vacancy and abandonment levels in the neighborhood
- Residents' investment in and maintenance of their properties
- Homeownership rate
- Crime levels

Foreclosures trigger all of these destabilizing forces, particularly where markets are declining, or are weak to begin with. As foreclosures take place,

properties are vacated, often leading to longer-term abandonment. As some owners go into default, and other owners see the value of their properties decline, they are less likely to invest in and maintain their properties. Homeownership declines, as defaulting owners are forced out, to be replaced by renters, or by no one. As more properties become vacant, crime increases.²⁹

While foreclosures can trigger destabilization, addressing distressed properties does not necessarily stabilize a neighborhood. If defaults and foreclosures persist—as is likely—one may devote massive amounts of time and effort to restoring one group of properties, while other properties around them are being abandoned. More fundamentally, while vacant and abandoned properties may have triggered destabilization, they are a *symptom*, not the *cause*, of that destabilization. The cause is the loss of resident and homebuyer confidence in the neighborhood.

The solution is market recovery. This entails restoring the confidence of homeowners in the neighborhood, and the readiness of new buyers to invest in that same neighborhood. In some areas, fixing up and finding buyers for a manageable number of vacant properties may restore resident and homebuyer confidence. Many more, however, will need a much more robust, multifaceted approach. As CDCs that have worked to revitalize distressed urban neighborhoods over the past decades have learned, there is no one “magic bullet” to revitalize a neighborhood or bring about market recovery in an area that has lost resident and homebuyer confidence. Strategies may have to include, code enforcement; neighborhood marketing campaigns; open space improvements; streetscape enhancements; building stronger community pride and cohesion; and crime prevention. The relevant mixture of activities and initiatives will vary depending on the strengths and weaknesses, assets and challenges of each neighborhood.

This perspective forms an essential context for the design of any federal neighborhood stabilization program, and for the use of federal neighborhood stabilization funds by local entities. Without such a perspective, the activities for which NSP funds are used, however desirable in themselves, are unlikely to lead to sustainable, long-term neighborhood stabilization.

Fixing the 2008 Neighborhood Stabilization Program

The NSP does represent a serious effort on the part of the federal government to address a complex problem. At the same time, the program was the product of both haste and compromise, a dangerous combination. As a result, there are problems both in the way the funds have been allocated, and the constraints on how they can be used. While HUD made a honorable and conscientious effort to frame an allocation formula and prepare guidelines consistent with the statute, in some cases the agency’s efforts further compounded the problem.

The most serious problems with the program are statutory, and not the product of regulations which can be reversed by the new HUD secretary. Some statutory problems can and should be fixed immediately, in order to make possible more effective use of already allocated program dollars. Other problems, such as the nature of the allocation formula for the 2008 funds, are academic: allocations have been made, and cannot be unmade. Changes to the allocation formula should be made in the context of either a second round or a long-term commitment of NSP funds, and are discussed later part in this section.

The comments below follow in the order that the issue appears in the HUD guidelines. Figure 12 indicates whether the recommended fix is likely to be regulatory or statutory in nature:

1. The statute is ambiguous about whether funds may be used for properties that are *either* abandoned *or* foreclosed, or abandoned *and* foreclosed. The HUD guidelines attempt to provide some flexibility, but statutory clarification is needed.³⁰
2. The provisions that mandate continued affordability for all housing acquired or rehabilitated with NSP funds (Sec. 2301(f)(3)(B)) frustrate efforts to stabilize neighborhoods through market recovery.³¹ If the goal is to encourage middle-income families—who presumably have housing choices elsewhere in the city or metro area—to buy homes to help restore destabilized neighborhoods, affordability controls work against the goal of market recovery.³²
3. The requirement that all homebuyers receive counseling may further complicate efforts to attract middle-income families. The guidelines should be revised to provide for a waiver of this requirement for households meeting reasonable criteria.
4. The requirement that land banks must obligate properties for specific, eligible redevelopment activities within 10 years, although not burdensome in the short term, is gratuitous and unnecessary. The history of land banks has amply demonstrated that this issue is a red herring; few, if any, have ever shown any tendency to hold onto land for its own sake. Indeed, the opposite is usually the case: land banks often dispose of property prematurely.
5. The 10 percent of funds which HUD guidelines permit grantees to spend on administration is modest (particularly by contrast with the 20 percent allowed by the Community Development Block Grant program, or CDBG) but not unreasonable. More egregious, however, is that some states retain a disproportionate share of these funds rather than share them equitably with their sub-grantees, even though they bear a much smaller administrative load than local entities charged with actually using these funds.³³ HUD should establish rules to ensure that the majority of the

administrative funds are passed through by the state to sub-grantees, where they are most needed.

6. As noted earlier, the rehabilitation or demolition of foreclosed properties is unlikely to foster neighborhood stabilization if other nearby properties are simultaneously vacated as a result of foreclosure. Some percentage of these funds, perhaps with a specific matching requirement, should be eligible to be used for foreclosure prevention.
7. Sec. 2301(d)(3) provides that the sale of any property for which NSP funds are used must be “in an amount equal to or less than the cost to acquire or redevelop or rehabilitate such home or property....” This provision is counter-productive in two ways. First, it makes it impossible for local entities to cross-subsidize their activities, and thereby limits their ability to leverage the scarce NSP resources. Second, it hinders market recovery by, under some circumstances, forcing the local entity to sell the property for less than market value, even where the buyer can afford and is willing to pay full market value.³⁴
8. HUD guidelines do not allow grantees to use NSP funds to cover the costs of maintaining a property “in a static condition,” or costs of sale, except where those funds have been used for rehabilitation or redevelopment. Holding costs between acquisition and rehabilitation are a necessary cost of doing business, and it seems irrational not to allow costs of sale for properties acquired with NSP funds, whether or not NSP funds are used for rehabilitation or redevelopment.
9. Sec. 2303 restricts the use of eminent domain, but in a highly ambiguous fashion, which is understandably not clarified by the HUD guidelines. As a matter of common sense, if a local government seeks to use eminent domain against a vacant, blighting property, it should not be a matter of concern for the federal government.³⁵
10. Sec. 2301(d)(4)(A)(ii) provides that all “profits”—that is, program income that is generated as a result of use of NSP funds—beginning five years from the date of enactment of HERA, must be returned to the Treasury. This is not only inconsistent with federal practice in similar programs (e.g., CDBG, Urban Development Action Grants), under which program income can be reinvested in eligible activities by the recipient, but acts as a disincentive to use the funds in ways that will permit them to revolve and leverage other resources. Since HERA gives HUD discretion to approve continued use of NSP funds, HUD should adopt guidelines indicating under what circumstances such continued uses will be approved.
11. Sec. 2301(d)(1) provides that any acquisition of property must be “at a discount from the current market appraised value of the home or property.” Congress understandably intended to prevent lenders and

servicers from unduly profiting from sales under the program, but the provision is nonetheless problematic, particularly in terms of its potential effect on market recovery. While the HUD guidelines provide adequate operational guidance for local entities, by creating a safe harbor for the amount of the discount, they also have the effect of limiting the ability of NSP entities to negotiate more substantial discounts than the modest standards set by HUD.³⁶

FIGURE 12
The current Neighborhood Stabilization Program needs several fixes to work more effectively for state and local governments

PROVISION	STATUTORY	REGULATORY	COMMENTS
(1) abandoned and/or foreclosed	X	X	Statutory ambiguity could be better clarified in guidelines
(2) continued affordability	X		
(3) counseling		X	Waiver language should be provided
(4) 10-year limit on land banks		X	Provision should be deleted
(5) misuse of 10% administrative funds		X	Specific standard for state/local split should be established
(6) permit use for foreclosure prevention	X		
(7) "equal or less" sales price cap	X		
(8) definition of allowable costs		X	Definition should be revised
(9) ambiguous language regarding eminent domain	X	X	Guidelines should provide greater clarification
(10) Return of program income to Treasury	X	X	Language should be provided indicating what continued uses are permitted
(11) Discount from market value	X	X	

Source: Author's analysis of HERA and HUD regulations

Principles for a long-term neighborhood stabilization program

While the current NSP should be improved, it remains a single, one-shot program. As discussed earlier, neighborhood stabilization is a complex process of strategic change, not simply a matter of buying buildings, fixing them up, and trying to find someone to live in them. The federal government should make a long-term commitment to support neighborhood stabilization efforts at the state and local levels. To that end, the following six principles should inform a redesigned federal neighborhood stabilization program.

- *Neighborhood stabilization should be a long-term effort.* The federal government should commit to annual appropriations for the program over an extended period.
- *Neighborhood stabilization should be strategic.* Funds should be targeted to areas where they can have a significant impact, and spent in ways that are grounded in a coherent theory of change.
- *Neighborhood stabilization should focus on market recovery.* Each local strategy must be grounded in an assessment of market conditions and opportunities, and explicitly address the need to move the housing market to achieve neighborhood recovery.³⁷ From a policy perspective, as discussed further below, there are significant trade-offs between a strategy driven by market recovery, and one driven by affordable housing goals.
- *Neighborhood stabilization is a multifaceted process.* It is not enough to pursue a property acquisition, rehabilitation and demolition strategy. Even if property issues have triggered destabilization, solving those issues is likely to be only one of many facets of a meaningful stabilization strategy. Preventing future foreclosures, carrying out targeted code enforcement, and many other activities may be equally or even more important to achieving sustainable neighborhood stabilization, and should be incorporated into local programs.
- *Neighborhood stabilization demands building greater state and local capacity.* In parallel with funding state and local efforts, the federal government should mount a systematic and simultaneous effort to build state and local capacity to plan and execute effective, targeted and multifaceted neighborhood stabilization programs.
- *Neighborhood stabilization is a reciprocal responsibility.* A federal role in neighborhood stabilization is dictated by the need for resources that only the federal government can provide. Yet that does not absolve state and local government, as well as private and non-profit stakeholders, from taking whatever actions lie within their power to address the same issues, and ensuring that federal funds will have the most beneficial impact.

The proposed program directions below flow directly from these principles.

Directions for a new Neighborhood Stabilization Program

A modified Neighborhood Stabilization Program should be enacted, designed to be an ongoing program based on an annual appropriation, structured along the following lines:

1. *A significant share of any future neighborhood stabilization funds should be provided on a competitive, rather than a formula-driven, basis.*

While there is an argument that some future funds should be allocated by formula (discussed further below), the greater part of future NSP funding should be awarded through a competitive process that rewards states, cities and multi-jurisdictional entities that demonstrate that they have framed strong neighborhood stabilization strategies, and that they can carry them out effectively.

A competitive process would allow HUD to identify the criteria that will result in successful neighborhood stabilization programs and see that federal resources are used on projects that fit those criteria.³⁸ Some of those criteria could be:

- Strategic targeting of resources
- Clear connections between program strategies and market conditions
- Leveraging of other funds
- Formation of public-private partnerships
- Creation of multi-jurisdictional programs³⁹

The capacity of local jurisdictions to carry out effective neighborhood stabilization efforts varies widely. A competitive program can reward communities that have built the capacity to plan and manage effective programs, while HUD launches a capacity-building effort described further below.

It is appropriate to divide the funds into two separate pools, and to create a minimum formula “floor” to ensure that some help—perhaps up to one-third of the appropriation—flows to all communities in need. Even with respect to formula funds, perhaps half of those amounts could be allocated subject to substantive criteria that have a significant bearing on the likelihood of effective neighborhood stabilization.

2. *The eligibility of states to receive all or part of their formula-based allocation should be conditioned on appropriate state action to create favorable conditions for effective neighborhood stabilization.*

States should be required or encouraged to enact appropriate legislation and regulations as a condition of eligibility to receive federal funds or to compete for funds above a minimum floor allocation. The actions should be those that have been found to reduce the destabilizing effect of foreclosures (such as non-eviction statutes), or to increase the effectiveness of the tools available to state and local governments to pursue stabilization strategies, such as land banks or expedited tax foreclosure of vacant properties.⁴⁰ The nature of potential state actions is discussed further below.

3. *Funds should be targeted to areas that have been destabilized through foreclosures and vacancy/abandonment, but which also have clear market assets making stabilization and market recovery realistically feasible.*

Requiring that funds be targeted to areas with the most adverse conditions regardless of their prospects for market recovery (as under the current NSP) may lead to large amounts of federal money achieving little or no neighborhood stabilization. There is some evidence that risk-averse local jurisdictions, following the letter of the statute and the HUD guidelines, will end up using a substantial part of the NSP money in that fashion. Future versions of the program must address this shortcoming.

4. *Program rules should mandate that grantees use funds to pursue an explicit stabilization or revitalization strategy within designated target areas.*

Stabilization strategies should include clear and credible steps to foster market recovery. Plans should integrate complementary activities, such as foreclosure prevention or targeted code enforcement. Scattered activities to acquire, rehabilitate, or demolish properties absent a larger strategy to stabilize the surrounding area should be discouraged, if not barred.

5. *Eligible uses for federal neighborhood stabilization funds should be defined more broadly and flexibly.*

Foreclosure prevention, targeted code enforcement and nuisance abatement, as well as other activities including neighborhood marketing, are likely to be integral elements in many, if not most, neighborhood strategies. In that light, jurisdictions should be permitted to use some percentage of their NSP funds for these or similar purposes. Where funds are to be used to supplement existing local government or private functions, they should be provided subject to matching or maintenance of effort requirements.

6. *Program rules should maximize the ability of states and localities to leverage neighborhood stabilization program funds.*

The NSP provides no incentives, and some disincentives, for states and localities to maximize leverage and efficiency in their use of federal funds. As noted earlier, the requirement in HERA that program income be returned to the Treasury, for example, acts as a perverse incentive to use the funds *inefficiently*, in order to retain them locally. Similarly, the requirement that any sales be at a price “equal to or less” than the cost of acquisition and rehabilitation is inconsistent with both efficiency standards and market recovery considerations. Both of these provisions should be removed in future iterations of the program.

Two further issues central to a neighborhood stabilization program must also be addressed: building local capacity, and navigating the relationship between facilitating market recovery and providing affordable housing.

Building local capacity

As noted earlier, while the initial federal NSP appropriation of \$3.92 billion is modest in light of the scope of the problem, it arguably exceeds the amount that many jurisdictions currently receiving funds are capable of spending in an efficient, strategic fashion. States and localities vary widely with respect to the critical organizational and human capital resources needed to both plan and execute complex activities involving property acquisition and rehabilitation, as well as to integrate these activities into multifaceted neighborhood stabilization strategies.

Some cities have strong planning capabilities, while others have little or none. Few city governments have staff with the skills to analyze market conditions and use that analysis to frame targeted neighborhood-scale market recovery strategies. Some cities have extensive networks of capable CDCs in their neighborhoods, while others have few viable CDCs. Even where CDCs exist, many of them have directed their energies in recent years to building new affordable housing projects on land provided by city government, and may have little or no expertise in either property acquisition or scattered-site rehabilitation. Local government and CDC capacity is most often greatest in the nation's large cities, such as Chicago or Boston. Capacity is more limited in smaller cities, and often severely limited in central cities under 100,000 population and smaller suburban jurisdictions. The capacity of other key non-governmental players—developers, lenders, realtors, and local philanthropy—also tends to fall along the same size gradient as local government and CDC capacity.

Many skill areas may be relevant to carrying out neighborhood stabilization strategies:

- Improving state and local policies, statutes, ordinances and regulations to address foreclosure and abandonment issues
- Analyzing neighborhood market conditions and developing strategies on the basis of those conditions
- Designing, establishing, and operating land banks
- Conducting targeted, systematic code enforcement and nuisance abatement
- Understanding and utilizing complex legal tools for property acquisition and related activities
- Creating and maintaining property information systems
- Assembling and utilizing data for strategic planning
- Developing neighborhood stabilization plans

- Carrying out effective asset management and property maintenance
- Conducting scattered site housing rehabilitation
- Developing effective marketing strategies for rehabilitated properties
- Designing and implementing greening programs as interim or permanent uses for cleared land.

To address this problem, a new neighborhood stabilization program should include sustained capacity-building, using training, technical assistance and grants to local governments and CDCs.⁴¹ Training and technical assistance could be provided through highly qualified contractors, and small grants could be provided to address specific capacity needs. These might include multi-year grants to provide a CDC with operating support or to enable a city to add critically needed personnel; or one-time grants to assist a city to set up a property information system or upgrade the technology used by its code enforcement agency. A small percentage of each year's federal appropriation should be earmarked for this purpose.

Market recovery and affordable housing

While market recovery and provision of affordable housing are not incompatible with one another, when it comes to neighborhood stabilization programs, one must distinguish between the two. Affordable housing—however important for many different reasons—is often not an effective vehicle to foster market recovery. The NSP, as enacted in HERA, suffers from a severe lack of clarity and consistency on this point, conflating the provision of affordable housing with market recovery in a way that is potentially counter-productive. In many neighborhoods, it is more urgent in the short run today to prioritize market recovery, while establishing a reasonable floor for affordable housing provision.

The NSP contains two affordable housing provisions: (1) a requirement that all housing created through the program benefit households earning 120 percent or less of Area Median Income (AMI) on an ongoing basis; and (2) a requirement that 25 percent of NSP funds benefit low-income households (earning 50 percent of AMI or less). The low-income benefit requirement is sound, and should be retained. These households are disproportionately likely to suffer from housing cost burdens or other housing problems, even in weak market communities, while their presence in reasonable numbers should be no impediment to market recovery. Indeed, if a neighborhood begins to see significant appreciation, this requirement may provide the valuable service of ensuring that at least some percentage of the units in the area will still remain affordable to low income households.

The former requirement, however, accomplishes nothing of value. The income ceiling it establishes is not low enough to ensure that program

beneficiaries are truly in need, while it *is* low enough to potentially impede successful market recovery efforts. While in practice there may be many neighborhoods in which few households with incomes higher than 120 percent of AMI might choose to live, to exclude them from the benefits of the program serves no useful purpose. Similarly, as noted earlier, the requirement that units targeting middle-income households be subject to long-term affordability controls is particularly questionable, and likely to serve in itself as a drag on market recovery.

If similarly priced housing is available to a typical middle-income buyer elsewhere in the city or region, there is no good reason why she would buy a house that limited her potential appreciation through long-term affordability controls over equally good houses that did not impose that restriction. It is unlikely that target areas will have such unique features that will motivate buyers to buy there despite that constraint. Moreover, if a city or CDC lowers the price substantially below the market price in order to induce the buyer to accept the restriction, they may solve the immediate problem of unloading the property, but by lowering the price, they work against the goal of restoring the market.

A local government or CDC may have good reasons, based on local housing needs, to target more of its NSP funds to low- or moderate-income (under 80 percent of AMI) households. Under many circumstances, however, a decision to do so will reduce the extent to which those funds will advance market recovery in their target areas. Local governments or CDCs should not be barred from imposing income limits in excess of those required by statute; however, where such limits are proposed, the entity proposing them should bear the burden of demonstrating that they will not impede the goal of fostering neighborhood stabilization and market recovery.

2. The federal government should establish a Land Banking Entity to finance the acquisition of distressed properties

Despite many different efforts over the past two years, hundreds of thousands (if not millions) of properties are locked into problematic and dysfunctional situations. They range from occupied properties where owners cannot secure the modification or refinancing that will enable them to retain their homes, to properties that are sitting vacant and abandoned, undermining their surroundings. Some may be in lenders' REO inventories; others may be in the foreclosure process; and still others may be in limbo, where the owner has vanished but the lender is taking little or no action to foreclose.

Local and state entities have neither the financial resources nor the potential leverage to carry out large-scale purchases of mortgages or REO properties.⁴² A federal undertaking to acquire, or to provide resources to others to acquire, distressed properties has the potential to both preserve the homes of thousands of homeowners and tenants, and to restore additional thousands of properties to productive use.

An entity should be established within the federal system to acquire properties and provide resources to others to acquire properties. This paper refers to such an entity as a Land Bank Entity or LBE. Legally and organizationally, it is likely that the best place for the LBE would be within a GSE, either Fannie Mae or Freddie Mac. The principal role of the LBE would be to serve as the central entity for the acquisition of foreclosed REO properties and mortgages, by dealing directly with mortgage holders and facilitating efforts by local entities to gain control of those properties. It could either purchase properties directly or finance bulk purchases by other entities that meet the LBE's criteria.

This role entails serious risks. Federal funds could end up being used wastefully to acquire properties that, given time, are likely to be absorbed by the private market. Conversely, lenders and servicers might attempt to use any federal initiative as a way of dumping worthless properties in their inventory, and thus make money that they would never make from the marketplace. Without the presence of willing and capable state and local government and non-profit entities to take properties that might be acquired through federal intervention, the federal government or its agents could find themselves holding a substantial inventory of properties for an extended period.

These are serious concerns, and should not be underestimated. However, they can be largely—although not entirely—addressed through certain policies and regulatory guidelines, including:

- Effective oversight with respect to the nature of properties purchased and the pricing of those properties
- Federal statutory and regulatory changes designed to motivate entities holding mortgages to sell them at reasonable prices or donate them to the LBE
- Clear ground rules to guide when the LBE will control properties, and carefully-framed procedures for how it will manage and dispose of properties it controls
- Federal conditions imposed on states to be eligible (or have priority) to obtain financing or properties

To the extent possible, rather than hold properties, the LBE would pass properties through to state and local entities willing to accept them. As discussed below, priority for access to LBE resources and properties would go to states and localities with such entities in place, while the LBE would not operate in areas where state or local governments objected to its activities. In addition to acquiring property interests directly and financing bulk purchases by others, the LBE would also act as a special-purpose neighborhood stabilization bank under certain circumstances to finance the acquisition of individual properties by local

government. Finally, the LBE would be the vehicle through which mortgages acquired by the Treasury or the Federal Reserve System as a result of the various financial relief efforts underway are restructured, refinanced, foreclosed and recycled.⁴³

This last point merits special attention. The number of REO properties already in the control of federally-related entities, and the number of mortgages held by those entities—or likely to come into their hands over the coming two years—is already considerable.⁴⁴ While Fannie Mae has recently shown some flexibility in designing foreclosure and REO policies that are supportive of community interests, as the Federal Reserve and Treasury have acquired mortgage portfolios, they have allowed servicers to continue to manage these portfolios as they do for their private clients.⁴⁵ This is bad public policy. Even worse, HUD is coming to be known as a particularly irresponsible holder of foreclosed properties, neglecting them and allowing them to fall into the hands of speculators. *Federal entities have an obligation to manage their portfolios in ways that better balance public interest and asset preservation considerations.* This would include more aggressive strategies to provide modifications and refinancing to borrowers, as well as efforts to screen out problem properties—particularly vacant properties—and work with local governments to dispose of them responsibly.

Selecting and pricing properties

Selecting and pricing properties for acquisition is straightforward in concept, although admittedly difficult in execution. There are inherent difficulties in bulk purchasing of portfolios, where time constraints make it difficult if not impossible to thoroughly evaluate each of the properties in a portfolio individually. The LBE's pricing policies would be based on the *realistic* net value of the properties to be acquired.⁴⁶ The LBE would also adopt market-based standards to govern which properties it would be willing to acquire.⁴⁷ It would not, as a rule, acquire properties in areas where market recovery appears likely to mitigate any secondary impacts of foreclosures without severe destabilization.⁴⁸

Motivating mortgage holders

The experience to date has demonstrated that the entities that control troubled property assets have been less than fully responsive to efforts to acquire these assets, particularly where current market conditions and public policies dictate that they should be sold for substantially less than the amount owed the mortgagee. This is particularly the case with respect to assets that are buried within mortgage-backed securities and similar non-transparent obligations, and controlled by largely anonymous investors scattered around the world. While there is no doubt that the LBE will be able to buy many assets simply by making an adequate amount of capital available, regulatory actions taken in parallel would dramatically enhance the LBE's effectiveness. Such actions would increase its access to properties by “unlocking” mortgages held in pooled

securities, and increasing the readiness of servicers and lenders to negotiate terms of sale that realistically reflect the current value of their portfolios and the externalities resulting from the condition of the properties under their control.

Legal experts differ sharply regarding the flexibility that servicers currently have to negotiate the sale of mortgages held in pools, and the extent to which federal law can provide servicers with a “safe harbor” to cover transactions that might fall outside standard practice.⁴⁹ This deserves further investigation, as does the extent to which federal law can be used to modify the structure governing these investment pools. Notwithstanding constitutional protections for contract rights, there is abundant legal precedent for modifying those rights when action is dictated on compelling public policy grounds.⁵⁰

The federal government should explore both incentives for constructive behavior, as well as disincentives for failure to engage in such behavior. One disincentive might be a stiff “exit tax” that investors would pay at the time any mortgage in a pool is liquidated for any reason. The tax would be waived if the mortgage were liquidated in a “public benefit liquidation,” that is, sold at a discount through certain designated public programs or under other statutorily-defined conditions. Conversely, it may be appropriate to offer tax incentives to cover some part of the investor’s “haircut” for assets sold at a significant discount. Moreover, although it may seem redundant to mention it here in light of the attention it has already received, amending the bankruptcy laws to permit a “cram-down” of the amount of the mortgage with respect to a petitioner’s principal residence remains arguably the single most powerful step that could be taken to motivate greater lender and servicer flexibility for loan modification.

A complementary approach would be to impose conditions requiring servicers or lenders to bear the cost of the externalities created by their foreclosure actions. Some cities and states have acted to make servicers responsible for maintaining properties from the point at which the foreclosure proceedings are initiated. As a related effort, municipalities could impose fees on lenders to cover the costs imposed by the property having become vacant, including both municipal service costs and loss of property values. Given the research evidence that the impact increases steadily over time, the fee could be a graduated one, increasing each month the property remained in foreclosure or in the REO inventory.⁵¹ The fee could then become a priority lien on the property and/or a judgment against the servicer or lender. The existence of legislation or regulations at the state level imposing such fees (or permitting municipalities to impose them) could become one of the conditions for a state gaining access to LBE resources.⁵²

Property holding and disposition

No land bank wants to hold properties where it has a viable alternative, and the proposed LBE would be no exception. The LBE would be designed to move properties to capable public and qualified non-profit entities at the state

and local levels, either by providing those entities with the financial resources they need to acquire properties, or by taking title to properties for immediate transfer to third parties.

At the same time, it would be counter-productive to prohibit the LBE from undertaking transactions that did not fit either of those two models. Leaving aside the mortgages and properties already being held by—or likely to come into the hands of—federally-related entities, situations will arise where it is clearly appropriate, even necessary, for the LBE to take control of properties even knowing that it may not be able to dispose of them immediately.

Distressed property management is a difficult task, and can only be carried out effectively if those responsible develop a solid, well-grounded plan of action well in advance, including:

- Decentralized management, so that responsible parties are close to the scene and can take expeditious action
- Working relationships with capable property management firms and non-profit entities to manage the inventory
- Clear protocols to address management situations, such as when properties should be demolished, when tenants should be evicted, etc.
- Allocation of adequate resources to provide responsible property management
- A clear focus on the end game—conveyance of properties to suitable local entities

Public land banks, including the Genesee County Land Bank in Michigan, have shown that public entities can effectively manage their inventories. So can the LBE, if the groundwork is properly laid in advance and adequate resources made available for the task.

State and local action

The federal government has a long history of using the power of the purse to encourage state governments to act in desired ways, where the particular action falls within the purview of the states. The use of federal highway funds to prompt state action with respect to speed limits and DWI standards is particularly well known.

There are compelling reasons to adopt similar practices to guide federal investment for property acquisition and neighborhood stabilization. Responsible state laws governing foreclosures, evictions and other property-related matters will enhance both the impact and cost-effectiveness of federal investments in

stabilizing neighborhoods and increase the likely ultimate return on those investments to the federal government. Conditioning access to LBE resources in this way would certainly raise questions of politics and fairness.⁵³ In response, state actions of the sort described here might qualify applicants for additional resources as part of a competitive process.

A list of possible state statutory actions that should be considered in this light appears in Figure 13. These provisions could be treated either as conditions for eligibility for federal resources, priority criteria for those resources, or criteria to be used in a competitive process. The rationale for most of the possible actions is straightforward. States should have policies in place that both ensure that foreclosure of today's mortgages takes place in a way that best protects both borrowers and the community as a whole, while also ensuring that the practices governing mortgage-making in the state are not such that the problems are likely to recur in the future. The state should also have policies in place that minimize the extent of time that properties remain vacant, such as expedited foreclosure for vacant properties and non-eviction rules, as well as those that maximize their ability to maintain and dispose of vacant properties.

It is worth highlighting three state actions, because they offer the potential of having a dramatic effect on the severity of the secondary effects of foreclosure – as well as the primary effects – without costing state governments a penny, a compelling criterion in this time of fiscal stringency:

- *Eliminate foreclosure as grounds for eviction of tenants*

Responsible tenants who pay their rent should not be made to suffer for their landlord's failure to make mortgage payments. Moreover, by keeping a property occupied during foreclosure proceedings and after the sale, the impact on neighbors is minimized, the risk of damage is reduced and the value of the property is preserved.⁵⁴

- *Allow responsible ex-owners to remain in their home as tenants after foreclosure sale*

If an owner is still on the premises at the time of foreclosure sale, and has properly maintained the property, she should be allowed to remain as a tenant and pay a fair market rent until such time as the property is purchased by a new owner-occupier. This will give homeowners losing their homes more time to find alternative accommodation and minimize the impact of the foreclosure on neighboring properties. It will also motivate the owner to maintain the property, and preserve its value for the lender, particularly in areas where vacancy often leads to stripping and property damage.

- *Establish lenders' responsibility to abate code violations and nuisance conditions on vacant properties from the point at which they initiate foreclosure proceedings⁵⁵*

Owners often vacate properties after they receive the notice of foreclosure, even though the actual foreclosure sale may be a year or more away. During this time, the property falls into limbo, with the owner unavailable and the lender often unwilling to maintain the property. While lenders maintain some properties, this is often not the case, particularly in low value areas. By requiring the lender initiating the foreclosure to take responsibility in the event the property becomes vacant, a city or county can ensure that a responsible party is always present, the value of the property is maintained, and the harm to the neighbors from a vacant property is minimized.

The inclusion of spot blight taking in Table 3 may be controversial, but is potentially important. Spot blight taking is a compelling tool of last resort where properties are being neglected by their owners, where no one is exerting control over the property, or where the owner is either unavailable or being unreasonable in its demands. It involves taking the property and conveying it to a third party for reuse.⁵⁶ However toxic the subject of eminent domain has become in the past few years, its use in cases where the individual property is both vacant and demonstrably doing harm to its neighbors, should be far less problematic (to all but the most extreme property rights advocates) than the highly publicized cases that pit economic development interests against homeowners. This distinction should be stressed in discussing this issue.

Spot blight can be used for properties where the owner has vacated the property, but the creditor has refused to take responsibility. Moreover, by defining fair market value in the statute in a way that reflects the realistic market conditions of the area, and the cost of restoring the property to use, spot blight taking provides an effective means by which municipalities can effectively control the cost of assembling vacant properties. New Jersey, for example, has taken an important step forward in that respect.⁵⁷ The use of spot blight is critical where the LBE might partner with local governments in its role, described below, as a neighborhood stabilization bank. The availability of this particular remedy might be required of any municipality seeking to partner with the LBE in that role, but would not be required as a general condition of eligibility to receive funds or properties from the LBE otherwise.

Finally, as an alternative to using federal funds to motivate state action, it may be worth considering whether to set a federal floor under state-level regulation. A modest step toward establishing minimum federal regulation for mortgage brokers was taken in the Housing and Economic Recovery Act enacted in 2008 (Division A, Title V). Such action may be appropriate in two areas:

- A fair foreclosure standards law, which would establish minimum procedural standards for the conduct of residential foreclosures
- A 'just cause' eviction law, that would protect tenants in rental foreclosures, conditioned on lease compliance

FIGURE 13
Several categories of state action could be required to trigger eligibility or priority for federal land banking entity investments

Statutory provision	Description
Fair foreclosure practice standards	State foreclosure law should embody standards designed to ensure that foreclosure process is fair to both creditor and borrower, clear notices are provided, adequate time is provided to enable borrower to seek counseling, and filings are screened for evidence of fraud in initial mortgage ⁵⁸
Expedited foreclosure case management for vacant properties	State law should provide that if the property is vacated before or during the foreclosure process, the remainder of the process through sheriff's sale is expedited, in order to reduce the length of time the property remains vacant ⁵⁹
Non-eviction	State law should remove foreclosure as grounds for eviction of sitting tenant in good standing, and permit owners to remain on premises as tenants until property is bought by individual seeking to occupy premises ⁶⁰
Creditor responsibility	State law should provide that first priority creditor becomes responsible for maintenance of property if owner vacates at any point after foreclosure proceedings have been initiated, or gives local government authority to impose such responsibility
Creditor secondary cost obligation	State law should authorize municipalities to levy charges against creditors reflecting the cost burden of vacant/problem properties and the secondary impacts of those properties
Minimum licensure standards for mortgage brokers	State law should set minimum licensure standards to ensure that all mortgage brokers have both financial stability and technical fitness to carry out responsibilities ⁶¹
Minimum underwriting and loan product standards	State law should impose minimum standards, such as an "ability to pay" standard, prohibit certain practices such as "no-doc" loans, or limit others such as pre-payment penalties
Land Banking	State law should permit municipalities and counties to create land bank entities with adequate powers and resources to assemble, hold and maintain, and dispose of properties in ways consistent with sound neighborhood stabilization practices
Tax foreclosure to land bank	State law should provide for expedited tax foreclosure of vacant properties directly into land bank rather than through auction or public sale
Spot blight taking	State law should permit municipalities to use eminent domain to take individual properties that are vacant and have a blighting influence on their surroundings

The Neighborhood Stabilization Bank

The principal role of the LBE would be to finance bulk property acquisition or acquire assets in bulk and subsequently convey them in smaller packages to state and local public or private entities.

In addition, it could perform a second valuable function by providing a means for financially-strapped cities and counties to acquire troubled properties with limited current value without imposing a financial burden on those cities and

counties. Even though these distressed properties have little market value, most of the municipalities and counties in which they are located lack even the modest financial resources to acquire and clear title to them without assistance. As discussed above, local governments will need the ability to acquire these properties at realistic net market value, using the power of spot blight taking where necessary as a last resort.

Under this scenario, local governments would acquire vacant or occupied/blighted properties.⁶² The properties could include both those where the owner had defaulted on the mortgage but the mortgagee had not completed a foreclosure, or REO properties.⁶³ The net fair market value of the property would be established through an appropriate appraisal procedure reflecting realistic market conditions, the costs imposed on the municipality and the neighbors by the property, and the cost to put the property back into productive use. In lieu of a payment from the municipality, the owner would receive a voucher for the net fair market value, which the owner could cash at the neighborhood stabilization bank. Title to the property would vest in the municipality, while the LBE would take back an equity share or other silent interest in the property.

3. A targeted federal tax credit would further stimulate market recovery in areas affected by foreclosures

Neighborhood stabilization and market recovery are inextricably linked. While the NSP is directed solely to dealing with specific problem properties, and future iterations are likely to maintain that focus while providing some greater flexibility, a true market recovery strategy requires a broader approach that will build demand for housing throughout target areas. Tools designed to motivate prospective homebuyers to purchase homes in target areas therefore complement effective neighborhood stabilization efforts.

Any area in need of stabilization is likely to be one in which market demand has declined along with consumer confidence in the future of the area. In such areas, prospective buyers have little expectation of future appreciation, and fear of continued depreciation. Since house prices have often fallen below replacement cost levels, the cost to acquire a property in need of significant work and restore it for owner-occupancy is likely to exceed the resulting market value of the property. In other words, a prospective buyer's economic calculus works against buying a house in the area, and doubly against buying a house in need of rehabilitation.

Others have suggested a number of different approaches to address this problem, including direct cash subsidies, tax credits, and home equity insurance programs.⁶⁴ While the subject of home equity insurance deserves further consideration, a targeted federal income tax credit may represent the most effective approach to aid market recovery. The credit would assist individuals buying homes for owner-occupancy in areas that have been destabilized by

foreclosures and vacant properties, and which are targeted for a neighborhood stabilization effort.⁶⁵

A tax credit is preferable to direct capital subsidy. It is far easier and less expensive to administer, it leverages buyers' own cash and credit resources rather than requiring commitment of public funds in advance, and it can be spread over time to reward continued owner-occupancy.⁶⁶ Experience with a variety of state-level historic rehabilitation tax credits in recent years strongly suggests that they are effective ways of motivating buyer investment in areas where current market reality falls short of the future market potential.

The following are suggested parameters for such a tax credit:

1. *The tax credit would be available only in neighborhoods meeting specific criteria in terms of both destabilization and market potential; it may or may not be appropriate to further limit it to areas that have been designated as target areas for the neighborhood stabilization program or similar state/local efforts*

How broadly or narrowly to target the tax credit is a major issue, reflecting the likelihood that there may be many more neighborhoods (particularly in regions with weaker market conditions) which might be eligible on the basis of both need and market potential, than are explicit targets of neighborhood stabilization efforts. If access to the tax credit is limited to those areas that have been formally designated under NSP or similar programs, it will exclude many areas where it could prove effective. Conversely, if the criteria were too broad, the cost of the program might be excessive and its impact limited.

2. *The tax credit would be a two-tier credit, offering both an acquisition credit (perhaps at 10 percent of acquisition cost net of any subsidies such as soft second mortgages) and a more substantial rehabilitation tax credit (perhaps at 25 percent)*

The purpose of the tax credit is two-fold. It would aim to stimulate market demand generally in the area, and encourage homebuyers to purchase and upgrade properties in need of extensive rehabilitation, in order to complement ongoing efforts to restore vacant and problem properties. A two-tiered credit design would reflect this dual purpose. It could also be designed to incentivize green standards in rehabilitation, including use of recycled materials and high energy-efficiency standards.

3. *The tax credit would be available only to individuals acquiring properties for owner-occupancy*
4. *The tax credit would be taken over 3 to 5 years, beginning with the tax year in which the household occupies the house, as long as the household continues to occupy the house as its principal residence*

A multiyear credit offers a number of advantages. First, for households with modest tax liabilities, it would allow them to gain the full benefit of the credit. Second, and perhaps more importantly, it would motivate households to remain owner-occupants of the property over time, in order to secure the full benefits of the credit.

5. *A neighborhood would no longer be eligible for the tax credit at such time as it was determined that market values had reached self-sustaining levels*

The tax credit should not be seen as a neighborhood entitlement, but as a means of stimulating market demand to the point where the neighborhood housing market was self-sustaining. Indicators of that status would include steady demand for houses in good condition, and house values exceeding replacement cost, which would stimulate ample private investment in rehabilitating remaining vacant properties.⁶⁷ Ideally, the Internal Revenue Service or other federal entity administering the program could use publicly available data to determine on an annual basis which areas would qualify for the credit.

The tax credit could be administered locally at minimal cost, using simple forms attesting to the net acquisition cost and the rehabilitation cost, the latter certified by the municipal building inspector, attached to the homeowner's income tax return.

4. A national mortgage and foreclosure database would greatly aid neighborhood stabilization planning and execution

A lack of even marginally accurate and complete data on the characteristics of mortgages, or the level and nature of foreclosure activity, poses a recurring challenge for federal, state and local policymakers in their efforts to develop rational strategies to deal with the foreclosure crisis.

The closest thing to a national mortgage inventory, other than the limited amount of data provided through the Home Mortgage Disclosure Act, is found in a small number of proprietary data bases. None of these are complete, and all are difficult for state and local policymakers to use because of cost and use restrictions.

Foreclosure data are even more severely limited. Few states provide detailed data on foreclosure filings and foreclosure sales, and such data as are provided to the public tend to be limited and uneven. In neither case are comprehensive data available at the small area (census tract) level necessary for addressing neighborhood stabilization. Many of the small-area data used in developing NSP action plans and other local strategies have been assembled, often with considerable cost and difficulty, by organizations such as The Reinvestment Fund in Philadelphia or NEO-CANDO in Cleveland.

Much as it has done in areas such as health care and construction, the federal government should establish a national mortgage and foreclosure data

base, which can provide data disaggregated to the census tract level, to make possible more effective, targeted planning and execution of neighborhood stabilization strategies.⁶⁸ The system could be based on a simple reporting form that would be required at the closing or recording of each mortgage, and a second set of forms that would be filed by the entity in each state responsible for managing the foreclosure process.⁶⁹ Ultimately, all of these data would be integrated into a web-based system that would make detailed, user-friendly small-area data widely available.

5. A serious federal financial commitment will be needed to achieve sustainable neighborhood stabilization

An accurate assessment of costs for the initiatives outlined above awaits further work on program details. It is important, however, to suggest the general cost parameters that would be associated with a federal initiative to tackle the secondary effects of the foreclosure crisis.

From the standpoint of historic United States community development expenditures, these costs are likely to be seen as expensive. Seen, however, in the light of current federal investment in stabilizing the financial sector, and in light of the devastating financial impacts of foreclosures on neighborhoods, states, cities, property owners and investors, these initiatives are not unduly expensive. Moreover, they would likely produce savings—in terms of preserved property values and state and municipal revenues—substantially greater than the expenditures involved.

The most expensive initiative, although one whose costs are difficult to project, relates to the acquisition activities of the land banking entity (LBE). While these activities may “piggy-back” on other federal investments, such as TARP, it is clear that they will have to be capitalized at a significant level to be effective. It is likely that the initial capitalization would need to be between \$50 and \$100 billion, which could take the form of Congressional authority to issue bonds backed by a federal repayment guarantee. In that fashion, the payments would be spaced over time, and could be offset in part by the likely downstream revenues that would be realized by the LBE. Alternatively, they could be financed in part through a “foreclosure assessment” levied at the filing of every foreclosure deed (or deed in lieu of foreclosure).⁷⁰

A reasonable scale for a restructured neighborhood stabilization program might be \$10 to \$15 billion per year. The cost of creating the national mortgage and foreclosure data base, although also difficult to project, would be in the millions, not billions of dollars.

The cost of the tax credit program depends on the number of homebuyers taking advantage of the program, which is likely to be driven largely by the extent to which the tax credit is narrowly targeted or broadly available, the cost of the

properties, and the split between acquisition and rehab costs. Figure 14 projects the potential cost of the tax credit based on a series of simplified assumptions:

- The tax credit is enacted in 2009, and the first credits are taken in 2010
- The number of homebuyers taking the credit will be 50,000 per year, a number that will be reached in 2013⁷¹
- The average tax credit per homebuyer will be \$40,000
- The tax credit is taken in equal installments over four years

Based on these assumptions, the estimated cost to the Treasury would increase gradually until it levels off around \$2 billion per year by 2015 or 2016.⁷²

VII. CONCLUSION

As the Obama administration assumes office, the foreclosure crisis presents a bleak picture. With the recession deepening, the number of families in trouble and homes at risk grow steadily. Public and private interventions have barely slowed down the pace of foreclosures and abandonment, if at all, and the only federal action that has been taken to address the secondary impact of foreclosures, the Neighborhood Stabilization Program, is acknowledged to be little more than a token response.

In concluding this paper, it is worthwhile to consider the potential implications of this crisis via a simple thought experiment. Begin with the Credit Suisse projection of 8.1 million foreclosures, or roughly 1 out of every 9 homeowners in the United States, over the next four years, and try to imagine how that will affect American neighborhoods in the context of today's recession and credit crisis. The picture is a frightening one:

- Few parts of the country would be left untouched; cities, suburbs and small towns from Massachusetts to California would be devastated
- House prices would continue to plummet as REOs and distress sales crowd other houses out of the market, and new construction, already at its lowest level in decades, would drop further
- While not all the foreclosed houses would be abandoned—people have to live *somewhere*—many will, particularly if properties enter REO inventories damaged and in need of major repair (as they often do today)
- Urban neighborhoods in cities like Detroit and Cleveland are already turning into ghost towns as foreclosures compound long-standing economic decline in those cities. It is not hard to imagine the same thing happening on a far

larger scale, from neighborhoods in New York or Philadelphia and subdivisions in Phoenix or San Diego, far beyond what is happening today

- While ultimately, no doubt, the market will stabilize, in the process an entire generation of Americans will have lost all or most of their most significant financial asset

This is a worst-case scenario. If we see a strong, sustained economic revival within the next two years, the worst may not take place. Even moderately optimistic forecasters consider this highly unlikely, suggesting the most the United States can expect is a slow, difficult recovery spread over many years. The question is, then, is this a scenario which we as a nation are willing to risk coming to pass? If not, there appears to be no alternative to a strong, sustained, federal commitment to address the foreclosure crisis, first by keeping as many people as possible in their homes, and second, by tackling the secondary impacts of foreclosure head-on. The new administration and Congress will hopefully make such a commitment, guided by the analysis and ideas set out in this paper.

FIGURE 14

A targeted Neighborhood Stabilization Homebuyer Tax Credit could eventually cost \$2 billion annually

(all amounts in \$M)

		Total tax credit for 2010 year class	Total tax credit for 2011 year class	Total tax credit for 2012 year class	Total tax credit for 2013 year class	Total tax credit for 2014 year class	Total tax credit for 2015 year class	Total tax credit for 2016 year class	Total Treasury outlay (\$M)
		2010	2011	2012	2013	2014	2015	2016	
Homebuyers taking tax credit in year		10,000	20,000	35,000	50,000	50,000	50,000	50,000	
Treasury outlay in 2010	2010	\$100							\$100
Treasury outlay in 2011	2011	\$100	\$200						\$300
Treasury outlay in 2012	2012	\$100	\$200	\$350					\$650
Treasury outlay in 2013	2013	\$100	\$200	\$350	\$500				\$1,150
Treasury outlay in 2014	2014		\$200	\$350	\$500	\$500			\$1,550
Treasury outlay in 2015	2015			\$350	\$500	\$500	\$500		\$1,850
Treasury outlay in 2016	2016				\$500	\$500	\$500	\$500	\$2,000

Source: Author's calculations

NOTES

¹ While the scale of foreclosures nationally reached crisis proportions in 2006, it is worth noting that in many of the nation's older industrial cities, a significant increase in foreclosures began to appear many years earlier.

² County-level mortgage data from McDash analytics were utilized in this analysis. Because the McDash dataset undercounts total mortgages, numbers were adjusted upward based on state-level data from the Mortgage Bankers Association (MBA). The MBA state totals were divided by the McDash state totals to calculate state adjustment factors that were applied to each state's counties. For more information, see Dan Immergluck, "The Accumulation of Foreclosed Properties: Trajectories of Metropolitan REO Inventories during the 2007–2008 Mortgage Crisis" (Atlanta: Federal Reserve Bank of Atlanta, 2008). Thanks to Dan Immergluck for advice on using these data.

³ Cumulative number provided by McDash Analytics.

⁴ See the September 12, 2008 Bloomberg article, "Alt-A Mortgages Next Risk for Housing Market as Defaults Surge," by Dan Levy and Bob Ivry. Also see the January 17, 2009 Washington Post article "The Growing Foreclosure Crisis," by Dina ElBoghdady and Sarah Cohen for more background on growing Alt-A problems.

⁵ T2 Partners LLC, "An Overview of the Housing/Credit Crisis and Why There is More Pain to Come." Online at www.eri.com/PDF/T2_Housing_Analysis.pdf [accessed January 2009].

⁶ The term "mortgageable properties" refers to all residential properties of one to four units, including condos. Metro-level estimates of mortgageable properties were obtained from the U.S. Census Bureau's American Community Survey.

⁷ Here, the core of the Cleveland metro area is defined as Cuyahoga County. The core of the Washington metro area is defined as the District of Columbia, Montgomery County and Prince George's County in Maryland, and Alexandria city, Arlington County, Fairfax city, Fairfax County, and Falls Church city in Virginia.

⁸ Percent changes in housing prices by metro area were calculated using metro-level Federal Housing Finance Agency House Price Index data from the third quarter of 2006 to the third quarter of 2008.

⁹ Vacancy calculations utilize the Department of Housing and Urban Development's Aggregated United States Postal Service Administrative Data for the quarter ending September 30, 2008. Vacancies are defined here as residential properties that have been denoted as vacant for at least 90 days plus properties that have been coded "no-stat" for at least two years. The HUD USPS dataset is available at www.huduser.org/DATASETS/usps.html [accessed January 2009].

¹⁰ Note that calculations of NSP funding at the metropolitan level only include the sum of federal allocations to local jurisdictions within metropolitan levels. Additional NSP funding will trickle down to metropolitan regions as states enact formulas to distribute NSP funding that was allocated at the state level.

¹¹ A conservative national vacancy estimate of 3.14 million properties implies that total NSP dollars amount to just over \$1,200 per vacant property. An upper-bound estimate of 7.6 million vacant properties yields only \$500 per vacancy. The "conservative" lower-bound estimate of vacancies includes only addresses considered vacant for at least 90 days, according to the HUD-

USPS data set. The upper-bound estimate adds “no-stat” properties that have been denoted as such for at least two years.

¹² Data analysis by Amy Crews Cutts and William A. Merrill, “Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs.” In *Borrowing to Live* (Brookings/JCHS, 2008). Analysis based on data from Freddie Mac.

¹³ The literature has documented a variety of direct costs associated with foreclosures. Some examples include: (a) legal, sales and maintenance costs equivalent to 10 percent of principal amount, and total losses to creditors exceeding 50 percent of principal amount; cited in speech by Ben Bernanke, Chair, Federal Reserve System Board of Governors, to Independent Community Bankers of America, March 4, 2008; (b) 5 percent of unpaid balance in transaction costs, 10 percent to dispose of property and 22 percent in resale discount; Ellen Schloemer et al., “Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners” (Center for Responsible Lending, 2006); and (c) estimated costs to creditors of approximately \$59,000 per foreclosure; Amy Crews Cutts and Richard K. Green, “Innovative Servicing Technology: Smart Enough to Keep People in Their Houses?” (Freddie Mac, 2004). Although some of these costs represent out-of-pocket costs to servicers, which may not be seen as having any neighborhood impacts, the greater part of the costs reflect a diminution of property value associated with foreclosure.

¹⁴ The most compelling research study to date documenting the effect of foreclosures on neighboring property values is John P. Harding, Eric Rosenblatt, and Vincent W. Yao, “The Contagion Effect of Foreclosed Properties.” Online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1160354 [accessed January 2009] and Zhenguo Lin, Eric Rosenblatt and Vincent W. Yao, “Spillover Effects of Foreclosures on Neighborhood Property Values.” *Journal of Real Estate Finance & Economics* 38(4)(2007). Also worth noting is Dan Immergluck and Geoff Smith, “The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values.” *Housing Policy Debate* 17(1)(2006): 57–79.

¹⁵ Dan Immergluck and Geoff Smith, “The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime.” *Housing Studies* 21(6)(2006): 851–66. Again, it is likely that the impacts measured by Immergluck and Smith are not so much the product of foreclosure as such, but the product of the disinvestment and vacancy associated with foreclosure.

¹⁶ The effect of foreclosures on municipal services is analyzed in William C. Apgar and Mark Duda, “Collateral Damage: The Municipal Impact of Today’s Mortgage Foreclosure Boom” (Minneapolis: Homeownership Preservation Foundation, 2006). The most recent survey of municipal finance officers by the National League of Cities found that cities expect a net loss of 3.6 percent in property tax revenues in constant dollars in 2008. Michael Pagano and Christopher Hoene, “City Fiscal Conditions in 2008” (Washington: National League of Cities, 2008).

¹⁷ For a discussion of the research on the effects of vacant properties on factors other than property value, see “Vacant Properties: The True Cost to Communities” (Washington: National Vacant Properties Campaign, 2006).

¹⁸ Center for Responsible Lending, “Subprime Spillover: Foreclosures Cost Neighbors \$202 Billion; 40.6 million Homes Lose \$5,000 on Average” (Washington: Center for Responsible Lending, 2008).

¹⁹ Credit Suisse Fixed Income Research, “Foreclosure Update: Over 8 million Foreclosures Expected,” issued December 4, 2008. This report was an update of an April 2008 report that projected 6.5 million foreclosures.

²⁰ Quoted in Mark Whitehouse, “Subprime Aftermath: Losing the Family Home.” *Wall Street Journal*, May 30, 2007, p. A1.

²¹ Congress appropriated a second \$180 million for this purpose in 2008 in the Housing and Economic Recovery Act.

²² On November 18, 2008, HUD announced substantial modifications to the New Hope for Homeowners program, designed specifically to make participation in the program more attractive to lenders. For a discussion of the issues associated with the program, see William Streeter, “Bankers’ view of the new HOPE for Homeowners Program.” *ABA Banking Journal*, October 2008. A recent initiative, announced in November 2008, provides for modifications to loans held by Fannie Mae and Freddie Mac. As with the other initiatives, commentators do not expect it to have a significant effect.

²³ H.R.1424, which enacted TARP on October 3, 2008, clearly contemplated that the funds were to be used for this purpose. In anticipation that the federal government would thereby gain control of a substantial part of the pool of outstanding troubled mortgages, Congress mandated that the Treasury create an office of homeownership preservation, and take unspecified steps to protect the interests of the borrowers. While the office has been established, it is unclear at this point what its mission is to be.

²⁴ The regulations were published in the Federal Register as Vol.73, no.194 on October 6, 2008.

²⁵ The HUD regulations define “used” as obligated; that is, contractually committed to a specific activity that will require payment.

²⁶ For a more extensive discussion of this issue, see Alan Mallach, “Managing Neighborhood Change: A Framework for Sustainable and Equitable Revitalization” (Montclair, NJ: National Housing Institute, 2008).

²⁷ Homebuyers, rather than renters, are emphasized because in the great majority of American housing markets, it is the homebuyers, not renters, that drive neighborhood housing markets. Renters are, for the most part, seeking short-term tenure options (the average urban renter stays in his or her unit less than 3 years), and often seek economy over other considerations.

²⁸ For a discussion of the relationship between market factors and neighborhood vitality, see Mallach, “Managing Neighborhood Change.”

²⁹ See William Spelman, “Abandoned Buildings: Magnets for Crime?” *Journal of Criminal Justice* 21(5)(1993): 481–495.

³⁰ The usage “abandoned and foreclosed” appears in Sec. 2301(c)(1), while “abandoned or foreclosed” appears in Sec. 2301(d)(3). Moreover, Sections 2301(d)(1) and (2) refer exclusively to “foreclosed” properties.

³¹ All statutory citations are to H.R. 3221, the Housing and Economic Recovery Act (HERA) as enacted by Congress.

³² The statute provides that families with incomes up to 120 percent of area median income are eligible to benefit from the NSP funds—this includes roughly 60 percent of all the households in each metro area, and typically 75 percent or more of all of the households in most central cities.

³³ This is particularly serious in those states, such as New Jersey or Connecticut, where the state government received all or nearly all of the funds coming into that jurisdiction. One can

sympathize with the state agencies involved, many of which are facing budget cuts or even layoffs as a result of their state's fiscal problems, but dedicated federal funds should not be re-directed to fill state budget holes.

³⁴ This is hardly far-fetched. In most major metropolitan areas, the income ceiling for a family at 120 percent of AMI is between \$75,000 and \$90,000 (e.g., \$71,880 in Cape-Coral/Ft. Myers FL; \$83,040 in Atlanta; \$85,920 in Chicago; and \$93,960 in New Haven, CT). Assuming a family can afford a house costing 3 times its income, that means that houses selling for \$225,000 to \$270,000 are likely to be affordable to NSP-eligible households.

³⁵ As HUD recognizes, there is in any event an inherent inconsistency between acquisition through eminent domain—which by law must be at fair market value—and the HERA requirement that any acquisition with NSP funds be at a discount from fair market value. The ambiguity of the statute carries over to create uncertainty whether NSP funds could be used to rehabilitate or redevelop an abandoned or foreclosed property acquired through use of eminent domain, even if other funds were used to acquire it.

³⁶ The effect of this has already become apparent in the recent policy adopted by Fannie Mae of setting a non-negotiable 15 percent discount, corresponding to the HUD safe harbor, for bulk sales of their properties under the NSP.

³⁷ One may want to look somewhat differently at those communities experiencing widespread market collapse, where a rational strategy might be to assemble properties for long-term land banking. While such strategies have merit, particularly in communities such as Detroit or Youngstown, it is debatable whether they should be considered neighborhood stabilization strategies, and whether they should be supported through a neighborhood stabilization program. Even there, while some resources may appropriately be used for land banking, the city's strategy must include efforts to stabilize those neighborhoods—which exist in even the weakest market communities—that maintain potential market vitality.

³⁸ A formula-based allocation, however much those criteria are embedded in program guidelines, cannot achieve this; all it can do is disallow those projects or activities that are clearly in violation of the guidelines. Given HUD's limited capacity to conduct detailed project monitoring, even that is likely to be uneven.

³⁹ The HUD NSP guidelines contain an extended section encouraging multi-jurisdictional efforts, but nothing in the program provides any incentive for a city or county to counteract its natural tendency to avoid collaboration and hold onto every dollar it receives.

⁴⁰ Given the time needed to make state statutory or regulatory changes, states would have to be given some window (at least one year, but no longer than two years) in which to comply with these requirements.

⁴¹ Current economic conditions, and their effect on CDC funding streams, have placed the viability of many CDCs at risk. Since the presence of capable CDCs is arguably essential to the successful implementation of neighborhood stabilization activities, particularly in older urban areas, the provision of support to these CDCs to help them implement stabilization programs should be given serious consideration within the NSP program.

⁴² This is, in the author's judgment, the greatest weakness in the otherwise well-conceived National Community Stabilization Trust created by NeighborWorks America, LISC, Enterprise Community Partners and the Housing Partnership Network. It appears highly unlikely that the amount of capital these entities will be able to raise will permit the NCST to carry out more than a modest number of pilot projects. Should the NCST, however, become a solid, capable, entity; and

should the policy recommendation made in this section be adopted, it might well be a candidate for federal funds with which to pursue its activities.

⁴³ These could include mortgages that the federal government might at some point acquire through TARP, as had been initially planned. The Federal Reserve System has already acquired billions in mortgage interests as a result of its financial interventions, such as the Bear Stearns bail-out; it announced at the end of December that it would buy up to \$500 million in mortgage-backed securities, starting early in 2009.

⁴⁴ A needed first step is for the federal government simply to conduct an inventory of what it currently holds, including holdings by Fannie and Freddie.

⁴⁵ The recent announcement by Fannie that it would offer leases to tenants in properties taken through foreclosure, rather than evicting them as had been prior practice, is a significant step to both minimize the harm to families affected directly by foreclosure, and—by reducing the likelihood that the property will sit vacant—minimizing the secondary effects of the foreclosure, a path that other lenders will hopefully follow.

⁴⁶ The pricing model should address a number of different features that would discount the price from the current market value, including: (1) the holding costs of the property over time; (2) the diminution of market value over time based on both the continuing decline in the housing market as well as the risk of property damage and stripping; and (3) in many markets, the extent to which the cost of rehabilitation may exceed the market value of the property after rehabilitation. Where such a “market gap” is present, common sense dictates that the resulting value of the property is actually negative, or at best zero. Charles Laven of Forsyth Street Advisors, LLC has developed a pricing model for the NCST that embodies some of these features. That model, however, does not incorporate the opportunities for more aggressive discounting strategies that could be achieved if combined with regulatory changes.

⁴⁷ In practice, there may be cases in which the Trust purchases an entire portfolio that includes properties that it would not choose to acquire via stand-alone acquisitions.

⁴⁸ The effects of the deepening recession, of course, have made it increasingly difficult to distinguish those areas with reasonable certainty. Such areas should, however, remain eligible for Neighborhood Stabilization Program funding, in order to address the short-term effects of foreclosures and create the climate for market revival.

⁴⁹ The Housing and Economic Recovery Act amended the Truth in Lending Law (15 USC 1601 et seq.) to create such a safe harbor; providing that, “*except as may be established in any investment contract between a servicer of pooled residential mortgages and an investor* (emphasis added) a servicer of pooled residential mortgages shall be deemed to act in the best interests of all such investors and parties when participating in the HOPE for Homeowners Act of 2008, for a residential mortgage or a class of residential mortgages that constitute a part or all of the pooled mortgages in such investment, provided that any mortgage so modified meets the following criteria: (a) default on the payment of such mortgage has occurred or is reasonably believes foreseeable; (b) the property securing such mortgage is occupied by the mortgagor of such mortgage; and (c) the anticipated recovery on the principal outstanding obligation of the mortgage under the modification or workout plan or other mitigation actions will maximize the exceeds, on a net present value to be realized on the loan over that which would be realized basis, the anticipated recovery on the principal outstanding obligation of the mortgage through foreclosure.” A further option would be for the Treasury to revise its ruling on REMIC pass-through status, although such changes are unlikely to eliminate the threat of litigation against servicers.

⁵⁰ The case law governing the circumstances under which contracts can be impaired without violating the Contract Clause of the U.S. Constitution is extensive. In *Home Building & Loan Association v. Blaisdell* 290 U.S. 398 (1934), the Supreme Court upheld a Minnesota law that temporarily restricted the ability of mortgage holders to foreclose, reflecting the problem, not dissimilar from today, of mass foreclosures triggered by Depression conditions. The Supreme Court held that this law was a valid exercise of the state's police power, in light of both the temporary nature of the contract impairment, and the compelling public policy justification. A three-part test for whether a law violates the Contract Clause was set forth by the Supreme Court in *Energy Reserves Group v. Kansas Power & Light* 459 U.S. 400 (1983).

⁵¹ Such a fee could distinguish between properties that are vacant and those that continue to be occupied by the homeowner or legal tenants. Indeed, by doing so, one could provide a strong incentive for a servicer to allow the tenants to remain in the property, or allow the former homeowner to change her status to that of a tenant, rather than being forced to vacate the property.

⁵² A counter-argument to some of these conditions is that it would further deter creditors from pursuing foreclosures in weak-market communities, thus putting properties into the limbo described earlier. While this is arguably the case, it argues that states and municipalities need stronger tools to end such limbo situations, either through expedited tax foreclosure or through "use it or lose it" statutes, under which if a mortgagee failed to exercise its right to foreclose on a property that had been vacated by its owner, the local government could seek and obtain a court order transferring either the security interest or title to it.

⁵³ Aside from the larger issue of the heavy hand of federal pressure trampling on state prerogatives, many actions might spur considerable opposition in state legislatures, particularly in states where financial interests exert considerable influence over the activities of the state legislature. Since those interests might not see themselves as benefiting from the federal funds being offered, they might have no qualms in blocking state action designed to lead to those funds becoming available. Even where the political will was present, legislative processes are uncertain and often time-consuming; in some small states, the legislature may only meet for a few months a year, or even a few months every other year. Thus, a question of fairness arises. Whether dealing with access to funds for property acquisition or NSP funds, should residents be penalized for their state government's inaction, particularly where there are capable local entities willing to act responsibly within their state's legal constraints?

⁵⁴ This provision already exists as settled state law in New Jersey. It is also embodied in many rent control ordinances in California cities, including Los Angeles.

⁵⁵ N.J. Senate Bill 1599, signed into law by Governor Corzine in January 2009, establishes clear liability on the part of entities initiating foreclosure proceedings to maintain the property in the event that the owner abandons the premises at any point subsequent to their having initiated proceedings. The creditor must serve notice to the municipal code officer. Subsequently, "if a residential property becomes vacant at any point subsequent to the creditor's filing the notice of intention to foreclose, but prior to vesting of title in the creditor or any other third party, and the property is found to be a nuisance or in violation of any applicable State or local code, the local public officer or municipal clerk shall notify the creditor, which shall have the responsibility to abate the nuisance or correct the violation in the same manner and to the same extent as the title owner of the property, to such standard or specification as may be required by the [code enforcement officer]." If the municipality expends public funds in order to abate a nuisance or correct a violation on a residential property in such cases, it has the same recourse against the creditor as it would have against the owner of the property. Ordinance No. 3080 enacted by the city of Chula Vista, California in August 2007, requires lenders to exercise the abandonment

clause in the mortgage, register the property with the city and immediately begin to secure and maintain the property to the neighborhood standard. It must also hire a local company to inspect the property on a weekly basis and handle maintenance and security of the property. The company must have a 24-hour contact number, which must be posted on the property. See www.chulavistaca.gov/City_Services/Development_Services/Planning_Building/Default.asp [accessed January 2009]. Similar ordinances have been adopted by many other California cities, as well as a handful in other states.

⁵⁶ Many states have spot blight statutes, including Iowa, Maryland (for the city of Baltimore), Michigan, New Jersey, Ohio, Pennsylvania, Tennessee, Virginia, Wisconsin, and the District of Columbia.

⁵⁷ The New Jersey spot blight statute, enacted in 2004, provides that, “the fair market value of the property shall be established on the basis of an analysis which determines independently: (a) the cost to rehabilitate and reuse the property for such purpose as is appropriate under existing planning and zoning regulations governing its reuse or to demolish the existing property and construct a new building on the site, including all costs ancillary to rehabilitation such as, but not limited to, marketing and legal costs; (b) the realistic market value of the reused property after rehabilitation or new construction, taking into account the market conditions particular to the neighborhood or subarea of the municipality in which the property is located; and (c) the extent to which the cost exceeds or does not exceed the market value after rehabilitation, or demolition and new construction, and the extent to which any “as is” value of the property prior to rehabilitation can be added to the cost of rehabilitation or demolition and new construction without the resulting combined cost exceeding the market value as separately determined. *If the appraisal finds that the cost of rehabilitation or demolition and new construction, as appropriate, exceeds the realistic market value after rehabilitation or demolition and new construction, there shall be a rebuttable presumption in all proceedings under this subsection that the fair market value of the abandoned property is zero, and that no compensation is due the owner* (emphasis added)” (New Jersey Statutes Annotated, 55:19-102).

⁵⁸ See Mallach, “Tackling the Mortgage Crisis,” for a more detailed discussion.

⁵⁹ This is a much more significant issue in states with judicial foreclosure procedures, where the delay between initial filing and foreclosure sale can be substantial, with drastic implications for properties and neighborhoods.

⁶⁰ Lenders claim that they are harmed by allowing either the tenant or former owner to remain in the property, arguing that they can get more for the property if vacant. This harm is illusory, particularly in areas where the risk of vandalism or destruction to a property left vacant is substantial. The econometric literature, moreover, strongly suggests that under most normal conditions a vacant property will be worth less than an occupied one. See John P. Harding, John R. Knight and C.F. Sirmans, “Estimating Bargaining Effects in Hedonic Models: Evidence from the Housing Market.” *Real Estate Economics* (31)(4)(2003): 601–22; and John R. Knight, “Listing Price, Time on Market, and Ultimate Selling Price: Causes and Effects of Listing Price Changes.” *Real Estate Economics* (30)(2)(2002): 213–37.

⁶¹ See Mallach, “Tackling the Mortgage Crisis,” pp. 18-19, for a more detailed discussion. While all 50 states regulate mortgage brokers (although Alaska has only done so since 2007), the standards of regulation vary widely, and most fall well below the minimum standard needed to establish either fitness or financial stability.

⁶² In some jurisdictions spot blight taking can be used against occupied but blighted properties as well as vacant properties.

⁶³ Where the lender/servicer has not yet taken title to the property, the option would exist for a “friendly” eminent domain taking, done with the co-operation of the property owner.

⁶⁴ Home equity insurance programs are programs in which homebuyers can purchase insurance against a decline in the nominal value of their homes as a result of declining property values at the neighborhood level. The most extensive experience with such programs has been in Chicago, where a 1988 state law authorized creation of neighborhood-level programs. Under the programs, which are funded by a small surcharge on residential property tax bills in the designated area, if an owner (after a minimum holding period of five years) cannot sell her home for the value at which it was appraised when she bought it, the program must reimburse her for the difference. Three home equity assurance programs have been established under the law, two in the city’s southwest and one in the city’s northwest. The programs do not insure homeowners against declines in the national, state or citywide housing market, and benefits are suspended if there is a 5 percent decline in any of those markets. One study has suggested that, “Given the limitations on use and the restrictions in the right of sale, it is no wonder that take up rates have remained small. In fact the complexity of the claims process may in part explain the apparent success of the program, at least as measured by the miniscule claims against the insurance funds.” Andrew Caplin et al., “Home Equity Insurance: A Pilot Project” (New Haven, CT: Yale ICF Working Paper No. 03-12, 2003). Just the same, the availability of the product—even if most people chose not to use it—may have had a stabilizing effect, and thus a community benefit. Another program, with somewhat different parameters, was initiated in Syracuse, New York in 2002. There is no question that home equity insurance has the potential to contribute to a market recovery strategy, although further analysis and investigation are needed to determine how best to pursue such an approach at a larger scale than has hitherto been attempted.

⁶⁵ The idea of a homebuyer tax credit as a spur for housing demand is not new. Congress enacted a \$7,500 tax credit for home purchases between April 8, 2008 and July 1, 2009 in HERA. The credit must be repaid in the future, however, and has spurred little or no homebuyer interest, with Lawrence Yun, chief economist of the National Association of Realtors recently quoted as saying, “to economists....it was a clear benefit, but nonetheless the average Joe Homebuyer does not see it that way.” Amy Hoak, “First Time Homebuyers Snub Tax Credit,” Marketwatch, Nov. 10, 2008. The National Association of Home Builders is currently lobbying for a \$22,000 tax credit. An across-the-board tax credit for homebuyers, however, is likely to be less effective at stimulating demand than at propping up prices (as is the case with the mortgage interest tax deduction), since most of the transactions that will utilize the tax credit will be in areas where the issue is less demand than price stabilization and market correction. This should be distinguished from a targeted tax credit designed to work in areas where there is a need to stimulate demand, as well as create a price floor.

⁶⁶ In addition, it is often politically difficult to offer direct capital subsidies except on a means-tested basis, which in this context would clearly be counter-productive.

⁶⁷ It may be appropriate, however, that rather than have such neighborhoods go “cold turkey,” the tax credit could be phased out over some period, such as three years.

⁶⁸ Collecting data at the census tract level is not burdensome, as web sites are available that allow a user to obtain an instant identification of the census tract for any property by its street address.

⁶⁹ If there is any difficulty mandating this level of reporting, the reporting could be required as a condition of eligibility for federal property acquisition and/or neighborhood stabilization funds, rather than imposed as a legal requirement. The outcome is likely to be the same.

⁷⁰ The author is indebted to Frank Alexander for this suggestion. Prof. Alexander also suggests that local governments should be permitted to retain these funds if they create a land bank or

other effective property assembly strategy, and dedicate the proceeds to that strategy as well as activities in support of their neighborhood stabilization efforts.

⁷¹ This figure assumes that the program will be relatively narrowly targeted, since this represents roughly 1 percent of all homebuyers in a typical year.

⁷² The actual cost will inevitably be somewhat less, because some homeowners' tax liabilities will not allow them to take the full value of the credits for which they are eligible.

For More Information

The shorter brief summarizing this paper is available at
www.blueprintprosperity.org

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