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*Insights*

Community Affairs  
Department

## Property Disposition

### Exploring Different Approaches for Preserving Affordable Housing Opportunities

#### Abstract

This *Insights* report highlights partnerships between banks<sup>1</sup> and other entities that are working with foreclosed or real estate owned (REO) properties<sup>2</sup> in creative ways to preserve affordable housing opportunities and stabilize communities. This report reviews initiatives and strategies for building partnerships among banks or mortgage servicers and nonprofit organizations, for-profit affordable housing developers, government entities, and others that are implementing plans to create affordable rental or homeownership opportunities and revitalize areas hard hit by foreclosures. The information presented in this report was obtained from a variety of sources including financial institutions, nonprofit entities, and government agencies.

#### I. What Are the Strategies Presented in This Report?

Banks and mortgage servicers are holding growing inventories of foreclosed properties<sup>3</sup> and are searching for suitable and innovative solutions to move these properties as quickly as possible out of their REO backlogs. Some banks have developed an affordable housing or homeownership component as a piece of their broader REO disposition strategy. This *Insights* report describes different disposition approaches, the regulatory and legal considerations, and the relative cost and the potential barriers to implementing these initiatives.

All of the approaches we reviewed tap into the existing strength of a community development or community relations department within the bank to help build an effective connection with community entities interested in acquiring REO properties for their rental and homeownership initiatives. Ideally, many banks develop these strategies along with their asset disposition units. Banks see that nonprofit entities, housing finance agencies, and local governments can leverage

<sup>1</sup> A bank that is servicing a loan on behalf of an investor will, in some cases, be referred to in this report as a mortgage servicer or servicer. A bank may also own and service foreclosed properties that were originated for its own portfolio. Investors rely upon a mortgage servicer to collect payments and perform other duties, including foreclosure processing and property disposition.

<sup>2</sup> Foreclosed properties are generally referred to in this report as REO. If the property is owned by a national bank, then it is referred to as Other Real Estate Owned (OREO). This paper uses the term REO, except where the discussion specifically involves regulatory treatment of OREO.

<sup>3</sup> A *Wall Street Journal* article on August 14, 2008, "Banks Incur Housing Pain—Foreclosures in U.S. Are Sold at Big Losses," cited a recent Barclays Capital estimate of 721,000 bank-owned properties in the United States, up from 112,000 two years ago and noted that Barclays expects the total to rise 60 percent more before peaking in late 2009. A Credit Suisse report forecasted that 8.1 million mortgages will be in foreclosure through 2012, representing 16 percent of all mortgages. See Foreclosure Update: Over 8 Million Foreclosures Expected, Fixed Income Research, Credit Suisse, December 4, 2008, at <http://www.credit-suisse.com/researchandanalytics>.

their resources and provide access to grants, subsidies, below-market financing, or loan programs.<sup>4</sup> Because nonprofit partners are familiar with key community leaders and programs, they may have access to public agency financial resources to obtain rent subsidies for acquired properties as well as down payment and closing cost assistance, rehabilitation financing, or affordable loan products for potential purchasers in their home-buyer counseling programs.<sup>5</sup>

Banks are using or testing a range of REO disposition strategies. The most straightforward partnership approach involves the transfer of REO properties at reduced prices or as outright donations to a nonprofit or local government entity. Some banks are using sophisticated financing structures to fund acquisition and rehabilitation activities employing the federal Low Income Housing Tax Credit (LIHTC) and the New Markets Tax Credit (NMTC) programs. Some banks have provided equity equivalent investments (EQ2) or equity capital to partner with nonprofits and public agency-financed entities to acquire and rehabilitate properties. In some instances, the OCC has granted prior approval for national banks to transfer OREO to a subsidiary community development corporation (CDC) for redevelopment, relying on the public welfare investment authority provided under 12 U.S.C. 24(Eleventh).<sup>6</sup> Several bank REO initiatives have tested different lease/purchase approaches to help renters strengthen their credit before taking the step to homeownership.

## II. Why Are These Disposition Strategies of Interest to Banks?

An affordable rental housing or homeownership strategy can be one aspect of a bank's broader REO disposition strategy. Reaching out to nonprofit partners can expand the pool of potential REO buyers. Nonprofits that provide homeownership education typically have a pipeline of qualified potential borrowers who are interested in becoming homeowners but may have been previously priced out of the market. Nonprofits also manage affordable rental properties, and some even offer lease-to-own programs as an alternative.

Public agency and nonprofit housing providers often have access to subsidy monies through the U.S. Department of Housing and Urban Development's (HUD) Section 8 rental assistance program and the LIHTC program and may see the current market environment as an opportunity to add units to their rental housing inventory at less than the cost of building new units. These entities often manage scattered site units and may be interested in purchasing foreclosed single family homes in a variety of locations to add to their rental housing inventory.<sup>7</sup> REO properties may offer local housing authorities or nonprofits a source of units to accommodate large family households who often have difficulty securing assisted housing.

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<sup>4</sup> Some state and local governmental entities are funding initiatives or using federal grant funds to purchase and rehabilitate foreclosed properties (e.g., New York, Boston, Minneapolis, San Diego, and Fairfax County, Virginia). State housing finance agencies are also implementing flexible financing programs for potential REO purchasers (e.g., California Housing Finance Agency). Purchase incentives or local real estate tax abatement can also encourage potential buyers to consider REO properties. See "Communities Become Home Buyers to Fight Decay," *The New York Times*, August 26, 2008.

<sup>5</sup> A variety of federal, state, and local initiatives provide financing, grants, funding, subsidies, and loan programs that support acquisition and rehabilitation activities. Both Community Development Block Grant (CDBG) (see 42 USC 5305 and 24 CFR §570.201 for eligible CDBG activities) and the HOME program (see 42 USC §12742 and 24 CFR §92.205 for eligible activities under the HOME program) allow funds to be used to acquire and rehabilitate properties. The Federal Home Loan Bank (FHLB) Affordable Housing Program (AHP) is another potential source of funding for disposition initiatives. The Neighborhood Stabilization Program (NSP), which was authorized in 2008 by Public Law 110-289, is providing \$3.92 billion in CDBG funds for state and local efforts to acquire and redevelop foreclosed properties. Banks that sell properties to NSP grant recipients must reduce the price to at least 5 percent below current market value. In February 2009, \$2 billion in additional NSP funding was authorized by Public Law 111-5. For more details, see the NSP Web page at <http://www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg/>.

<sup>6</sup> 12 CFR§24.5(a)(6)(i) requires prior approval if the investment involves properties carried on a bank's books as "other real estate owned."

<sup>7</sup> Some public housing authorities have been required to disperse their concentrations of public and assisted housing. See, e.g., *Gautreaux v. Chicago Hous. Auth.*, 265 F. Supp. 582 (N.D. Ill. 1967), *subsequent opinion*, 296 F. Supp. 907 (N.D. Ill. 1969), *subsequent order*, 304 F. Supp. 736 (1969); *Gautreaux v. Romney*, 448 F.2d 731 (7th Cir. 1971), *subsequent opinion*, *Gautreaux v. Landrieu*, 523 F. Supp. 665 (N.D. Ill. 1981), *aff'd*, 690 F.2d 617 (7th Cir. 1982).

Proactively marketing foreclosed properties to nonprofit and public agency community stakeholders that can renovate homes for affordable rental or homeownership also may have a positive spin-off effect by shoring up neighboring property values and limiting current and future losses.<sup>8</sup>

Affirmative steps to manage REO disposition effectively and limit the destabilizing impact of foreclosures also help banks to manage their reputation risk. Bankers should be aware of local government requirements for managing vacant properties; these include boarding and providing such ongoing services as mowing or trash collection. Some localities require registration of vacant or foreclosed properties. A bank's name can become associated with the foreclosure in the public eye, even if the bank is not the originator and simply is servicing the loan.

### ***Community Reinvestment Act***

Some activities related to REO disposition may be eligible for positive consideration under the Community Reinvestment Act (CRA). CRA-eligible activities must meet the geographic requirements of the regulation by benefiting the bank's assessment area or a broader statewide or regional area that includes the bank's assessment area.

### ***Investments***

Bank donations made to organizations whose primary purpose is consistent with the definition of community development in the CRA regulations may be considered qualified investments. Such donations can be in the form of cash or as an in-kind donation, including OREO. CRA consideration for OREO dispositions would apply to the portion of the in-kind donation that represents the difference between fair market value (FMV) and the discounted disposition price of the property. If the property is donated outright, then the property's FMV would be the amount of the in-kind donation. FMV should be established based on a recent appraisal.

Examples also include investments in qualified funds, as well as EQ2 investments. Direct investments and loans made to LIHTC projects or investments in funds (if the primary purpose is community development) meet the definition of qualified investments under CRA.<sup>9</sup> Banks will receive positive CRA consideration for such investments when they (1) benefit the bank's assessment area or (2) provide benefits to a broader statewide or regional area that includes the bank's assessment area(s).<sup>10</sup>

A bank's investment in or loan to a community development entity (CDE) in connection with the NMTC program may receive consideration as a qualified investment or community development loan for CRA evaluation purposes.<sup>11</sup> A bank also could fund its subsidiary CDC that has received a NMTC allocation and will devote those funds to eligible activities to stabilize LMI communities hit by foreclosures.

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<sup>8</sup> See "The Contagion Effect of Foreclosed Properties," John Harding, Professor of Finance, University of Connecticut, July 15, 2008. A recent study examined the "contagion effect" on nondistressed properties located near distressed or foreclosed property. The study found that values of nondistressed properties diminished by approximately one percent for each nearby distressed or foreclosed property, with more significant price declines for homes near multiple foreclosed properties. The contagion effect increases in magnitude from the onset of distress through foreclosure sale but stabilizes once the property is sold. However, the impact diminishes rapidly as distance from the foreclosed property increases, even for relatively short distances. The report concludes that "when foreclosure is inevitable, efforts to speed the foreclosure process would be effective at reducing the contagion effect."

<sup>9</sup> See 2009 Interagency CRA Questions and Answers, 74 Fed. Reg. 498, January 6, 2009, Examples of qualified investments, one of which describes projects eligible for low-income housing tax credits, can be found at \_\_.12(t)—4. Additional information about qualified direct and indirect (fund) investments is provided in \_\_.23(a)—1, \_\_.23(a)—2, and \_\_.23(e)—2.

<sup>10</sup> *Ibid.*, \_\_.12(h)—6, \_\_.23(a)—1, and .23(a)—2.

<sup>11</sup> Loans of less than \$1 million would be small business loans, not community development loans. However, Intermediate Small Banks may opt for the OCC to consider such loans as community development loans, even if the amount of the loan is less than \$1 million. See the CRA Interpretive Letter dated December 17, 2003, at <http://ffiec.gov/cra/pdf/newmarket-staxcredit.pdf>.

Generally, activities that revitalize or stabilize low- or moderate-income geographies, designated disaster areas, and designated distressed or underserved nonmetropolitan middle-income geographies would be eligible for CRA consideration.<sup>12</sup> Activities that revitalize or stabilize a low- or moderate-income geography must attract new—or retain existing—businesses or residents. An activity is presumed to revitalize or stabilize a low- or moderate-income geography if it has been approved by the governing board of an Enterprise Community or Empowerment Zone or received a similar official designation as consistent with a government plan for the revitalization or stabilization of the low- or moderate-income geography.<sup>13</sup> For example, the provision of affordable housing through OREO donations that are part of a formal revitalization and stabilization plan can help stabilize a low- or moderate-income neighborhood by helping to attract and retain residents.<sup>14</sup> Community development activities outside of these specially designated areas that provide affordable housing to low- and moderate-income individuals also may be considered positively under CRA.<sup>15</sup>

An activity that provides housing for middle- or upper-income individuals may qualify as an activity that revitalizes or stabilizes a distressed nonmetropolitan middle-income geography if the housing directly helps to revitalize or stabilize the community by attracting new, or retaining existing businesses or residents. Although all activities will be considered, greater weight will be given to those activities that respond most to community needs, including needs of LMI individuals or neighborhoods.<sup>16</sup> Also, activities that provide housing for middle- and upper-income individuals that will revitalize or stabilize underserved nonmetropolitan middle-income geographies may qualify if the activities also provide housing for low- or moderate-income individuals.<sup>17</sup> An activity revitalizes or stabilizes a nonmetropolitan middle-income geography if it helps to attract new, or retain existing, businesses or residents.<sup>18</sup> The agencies will periodically update the list of designated distressed and underserved nonmetropolitan middle-income geographies.<sup>19</sup>

#### *Community Development Services*

Nonprofit partners in some areas may lack experience with acquiring and managing REO properties. Banks can provide technical assistance to nonprofits by lending employees<sup>20</sup> or helping nonprofits develop guidelines and standards for an REO acquisition and rehabilitation program to be used for a qualified CRA purpose. In addition, banks that provide technical assistance to organizations whose primary purpose is consistent with the definition of community development in the CRA regulations may receive favorable CRA consideration.

Technical assistance provided to qualified community development organizations includes management training or financial consulting to help these partners develop or manage an effective community development program. Another form of technical assistance is help with marketing financial services, including development of advertising or promotions, publications, or workshops. Other qualifying activities include financial services training for staff, contributing

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<sup>12</sup> See 2009 Interagency Questions and Answers, 74 Fed. Reg. 498, January 6, 2009, \_\_.12(g)–2.

<sup>13</sup> *Ibid.*, \_\_.12(g)(4)(i)–1.

<sup>14</sup> *Ibid.*, \_\_.12(g)(4)(i)–1, \_\_.12(g)(h)–5.

<sup>15</sup> *Ibid.*, at \_\_.12(g)–1.

<sup>16</sup> *Ibid.*, at \_\_.12(g)(4)–2.

<sup>17</sup> *Ibid.*, at \_\_.12(h)(5) and \_\_.12(g)(4)(iii)–4.

<sup>18</sup> *Ibid.*, at \_\_.12(g)(4)(iii)–3.

<sup>19</sup> *Ibid.*, at \_\_.12(g)(4)(iii)–2.

<sup>20</sup> The amount of the salary for an employee on loan is not considered a grant. *Ibid.*, at \_\_.12(i)–3.

accounting or bookkeeping services; and assisting in fundraising, including soliciting or arranging investments.<sup>21</sup>

### *Lending*

Banks may make community development loans to organizations engaged in affordable housing, rehabilitation, and construction, as well as community development loans to not-for-profit organizations serving primarily low- or moderate-income housing or other community development needs.<sup>22</sup>

Community development loans to financial intermediaries including community development financial institutions (CDFIs) recognized by the U.S. Department of Treasury, community development corporations (CDCs), and community loan funds or pools that primarily lend or facilitate lending to promote community development also may be treated as community development loans and qualify for CRA consideration.<sup>23</sup>

A key challenge is finding permanent financing with flexible underwriting for the end-purchaser. CRA consideration would be available under the lending test for loans made to low-or moderate-income borrowers, whether they are purchasing properties directly or under initiatives sponsored by nonprofits or government entities.

## **III. How Do These Strategies Work?**

This section includes examples of ongoing initiatives that a national bank could consider and highlights best practices and lessons learned from the success of proven disposition strategies.

### *Property Donations*

Several financial institutions we interviewed for this report have formal property donation or discount programs. If values have declined precipitously or heavy property damage impacts market value, this approach may be a viable alternative. Properties can be transferred to cities or nonprofits to rehabilitate and sell as affordable housing or to demolish and place in a land bank to be repurposed as open space or held for future community development.<sup>24</sup> Bank officials we spoke to performed due diligence to evaluate the recipient's capacity to manage the property in order to avoid reputation and legal risk if the recipient does not rehabilitate and sell the property promptly.<sup>25</sup>

One bank we interviewed for this report has a small scale pilot in several cities for donating OREO to qualified nonprofit, affordable housing developers. The bank identified community partners with a track record of performing substantial rehabilitation and marketing properties to mortgage-ready potential buyers. In selecting its partners, the bank looked for nonprofits that could provide financial education and home-buyer counseling. Another consideration was whether the nonprofit could provide grant or subsidy funding to make the property and/or financing affordable to home buyers.

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<sup>21</sup> *Ibid.*, \_\_.12(i)—3.

<sup>22</sup> *Ibid.*, \_\_.12(h)—1.

<sup>23</sup> *Ibid.*, \_\_.12(h)—1.

<sup>24</sup> "Land Bank Authorities: A Guide for the Creation and Operation of Local Land Banks," Frank S. Alexander, Professor of Law, Emory University, April 2005.

<sup>25</sup> The Wells Fargo Nonprofit Resource Center has detailed instructions for nonprofits seeking donated or discounted REO properties, which includes due diligence requirements, at <https://www.wellsfargo.com/about/wfhf/realestateowned>. Citi, which posts some of its REO at, <http://www.citimortgage.com/Mortgage/Oreo/SearchListing.do>, also has a donation program. Citi participates in a special pricing initiative with the California Housing Finance Agency; REO property eligible for special pricing is listed at <http://www.calhfa.ca.gov/homeownership/programs/cshlp.htm>. Details on an HSBC property donation program are provided in a conference presentation that can be found at [http://stlouisfed.org/rrrseries/event2/Event2\\_Dallis.pdf](http://stlouisfed.org/rrrseries/event2/Event2_Dallis.pdf).

Typically, the bank initiates a memorandum of understanding with the nonprofit that outlines the terms and conditions of the donation of the property, including an agreement to complete rehabilitation in a timely manner. The bank works with the developer to identify eligible properties, but the developer is responsible for inspecting the property and developing repair cost estimates. The bank may provide services to the nonprofit, including financial education materials, credit facilities to cover rehabilitation cost, and loan products for buyers. The developer is required to provide homeownership counseling and market properties to low- or moderate-income home buyers.

Banks undertaking a donation or discounted sale strategy should consider the potential tax benefit or CRA consideration (as detailed in the previous section of this report). If the property is sold at a reduced price or donated to a 501(c)(3) nonprofit, the beneficial owner may be able to take a charitable tax deduction for the amount of the in-kind donation, which would be the difference between FMV and the property disposition price.

### ***Discounted Note Sales***

Some lenders indicate a willingness to donate or deeply discount the sale of a nonperforming loan to a qualified nonprofit or public agency that is committed to creating affordable housing. This approach involves the sale of discounted, nonperforming mortgage notes prior to foreclosure in which the borrower has abandoned the property and the property is at risk of significant deterioration during the foreclosure process. The entity acquiring the note must be prepared to incur legal costs and to secure and manage the vacant property during the foreclosure process. Donation to an entity that is prepared to shoulder exposure to legal liability (*e.g.*, environmental cleanup or accumulated maintenance fees or fines) may be the best resolution where a lender chooses not to pursue foreclosure in order to avoid this liability.

Many state laws provide for an “equity of redemption” or “right of redemption” period, which is intended to give the borrower a longer period to reinstate the loan.<sup>26</sup> Some states waive or shorten the right of redemption period if the property is abandoned or vacant. Generally, the servicer does not move to sell a foreclosed property until this time has elapsed. If a nonprofit purchases a nonperforming note in a “redemption state,” the nonprofit would assume the potential risk of losing the property at any point up to the last day of the redemption period if the borrower reinstates. Even in that case, the nonprofit could potentially recoup a gain on the property if the total amount of its holding costs over that period, plus the amount it paid for the discounted note, are less than the amount the borrower must pay to redeem the property.

A variation on this approach entailed the combination of a “short sale” agreement with a deed in lieu of foreclosure. This example involved a low-value property on which the lender did not want to foreclose. A nonprofit approached the lender and asked the lender to agree to allow the borrower to assign the property directly to the nonprofit, and the lender then agreed to accept a payoff less than the outstanding principal balance.

### ***Sponsoring or Facilitating Federally Assisted Tax Credit Transactions***

Banks and their subsidiary CDCs can play a pivotal role as long-term investors and technical experts in putting together more complex financing to fund REO acquisition and rehabilitation activities.

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<sup>26</sup> See Realty Trac for information on state foreclosure laws and procedures at <http://www.realtytrac.com/foreclosure-laws/foreclosure-laws-comparison.asp>.

### *New Markets Tax Credits*

One bank we interviewed for this report established an affiliate CDE and is planning to use new markets tax credits (NMTC)<sup>27</sup> to subsidize the rehabilitation and resale of vacant single family properties to low- or moderate-income homeowners. The bank will combine the NMTC allocation with grants to create a fund to provide up to \$75,000 in low-cost, second mortgage financing for individual home purchases.

The initiative is designed to create permanently affordable workforce housing through a shared equity housing trust feature that is enforced as a deed restriction. In this model, the buyer will agree to share a portion of future appreciation when the home is sold. At sale, the borrower will retain all of any down payment made, any equity buildup from principal payments, and the value of any home improvements, as well as 25 percent of the market appreciation. The next purchaser will get the benefit of a below-market price home but would be subject to the same shared appreciation formula. In addition to mandatory homeownership counseling by a nonprofit organization, the bank provides two hours of counseling to explain the shared equity feature.

In another instance, a bank invested in a NMTC vehicle that provides debt financing for acquisition and rehabilitation activities. In this initiative, a nonprofit partner manages acquisition, rehabilitation, and sales activities. The bank's CDC provides technical services by helping the nonprofit organization develop credit risk and operational controls. The nonprofit partner also agrees to manage its pipeline of acquisitions and sales effectively to "recycle" the NMTC capital as required.<sup>28</sup>

### *Low-Income Housing Tax Credits*

Another bank initiative involves the use of low-income housing tax credits (LIHTC)<sup>29</sup> in a "lease purchase arrangement." In this transaction, the bank partners as a limited partner investor with a nonprofit organization to form an entity that manages the property acquisition, rehabilitation, and rental of housing units. The bank provides construction financing to the nonprofit organization that handles the property renovation. Once the property is available for leasing, the LIHTC proceeds are used to provide the long-term funding for the properties.

Generally, the LIHTC program requires a portion of the units in a project to be occupied by low- or moderate-income households for at least 30 years. After the initial 15 years, the LIHTC program requires an extended 15-year binding commitment to maintain property as affordable housing.<sup>30</sup> However, this initiative takes advantage of an exception to the LIHTC rules, which allows a tenant to exercise a right of first refusal to purchase the property in year 16.<sup>31</sup> The nonprofit entity manages the property over the initial 15-year tenancy period, renting it to eligible,

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<sup>27</sup> For more information, see "New Markets Tax Credits: Unlocking Investment Potential," OCC, Community Affairs Department, February 2007.

<sup>28</sup> NMTCs are subject to recapture during the seven-year compliance period if: (1) the CDE ceases to be a CDFI fund-certified CDE; (2) "substantially all" of the qualified equity investments proceeds are no longer continuously invested in qualified low-income community investments (QLICs), which is defined as having at least 85 percent of the investment deployed in qualifying low-income investments; or (3) the CDE redeems the investment. For more information, see "New Markets Tax Credits: Unlocking Investment Potential," OCC, Community Affairs Department, February 2007.

<sup>29</sup> For more information, see "Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks," OCC, Community Affairs Department, February 2008.

<sup>30</sup> Developers seeking LIHTCs must follow Internal Revenue Code Section 42(h)(6), which states that a building is eligible for tax credits if there is a long-term commitment to low-income housing. Section 42(h)(6)(D) describes the end of the extended use period as being the later of the date specified by the housing credit agency or the date that is 15 years after the close of the compliance period. Typically, a developer's commitment to low-income housing is at least 30 years.

<sup>31</sup> IRS Revenue Ruling 95-49, 1995-2 CB 7, IRC Section. Note that the right of first refusal must be specifically referenced in the agreement between the owner and the housing agency either initially or by later amendment.

low-income tenants and applying rent payments to service the LIHTC debt. Upon exercising the purchase option, a tenant/home buyer secures a mortgage for the balance of the LIHTC debt attributable to that property—payments remain affordable and are generally less than or equal to the former rent amount.

#### *Public Welfare Investment Authority*

Banks may want to consider using the public welfare authority provided in 12 U.S.C. §24(Eleventh) to invest in funds or entities whose purpose is to acquire and/or rehabilitate REO properties. This authority generally allows national banks to make community development investments that otherwise would not be expressly permitted under the National Banking Act. Positive CRA consideration may be available for eligible public welfare investments that meet CRA requirements.

Under the implementing regulation, 12 CFR Part 24, a national bank or national bank subsidiary may make a public welfare investment directly or indirectly if the investment primarily benefits:

- Low- and moderate-income individuals;
- Low- and moderate-income areas;
- Other areas targeted by a governmental entity for redevelopment; or
- The investment would receive consideration under the CRA authority under 12 CFR 25.23, as a “qualified investment.”<sup>32</sup>

The aggregate outstanding amount of a bank’s Part 24 investments cannot exceed 5 percent of its capital and surplus, unless a bank is at least adequately capitalized and receives the OCC’s prior approval to increase the aggregate amount of its public welfare investments up to 15 percent. For each Part 24 investment, a bank must submit either an after-the-fact notice or a prior approval request to the OCC’s Community Affairs Department, using the CD-1 form, which describes the investment and how it complies with the public welfare and limited liability requirements.<sup>33</sup>

One way a bank may dispose of OREO is by transferring it to a community and economic development entity (CEDE), including a bank-owned CDC. In such a case, under the Part 24 authority, a bank must seek prior approval from the OCC if the transfer involves the bank’s own OREO.<sup>34</sup> In such a transaction, OCC could authorize the CDC to either lease or sell the properties.

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<sup>32</sup> The OCC adopted an interim final rule implementing an amendment to the public welfare investment authority, which was enacted as part of Pub.L. 110-289. One effect of this change was to allow public welfare investments in CRA-eligible investments, which “may include those benefiting rural underserved or distressed middle income areas as well as investments in government targeted areas for economic revitalization that may include a mix of moderate- and middle-income residents.” 12 CFR §24.2(c), 73 Fed.Reg. 46532 (Aug. 11, 2008).

<sup>33</sup> More information on Part 24 and how to file a CD-1 can be found at <http://www.occ.treas.gov/cdd/pt24toppage.htm>.

<sup>34</sup> The OCC has approved requests from national banks to transfer OREO properties to a bank’s subsidiary CDC. Before approving the transfer of OREO to a bank-owned subsidiary CDC, the OCC will review the bank’s condition, the nature of the investment, and whether a bank has established appropriate procedures, consistent with safety and soundness, for managing the risk associated with the property. A current appraisal must be used to establish market value at the time of transfer. OCC will also require the bank or CDC to maintain appropriate controls and recordkeeping and to provide reports upon request. OCC will review whether the CDC has experience or can build property management capacity to lease or sell properties successfully. OCC may establish requirements to ensure that the CDC has experienced personnel to manage the properties (e.g. management requirements, size of initiative, scope of leasing authority, etc.), and may impose time limits on an initiative or establish a maximum number of properties to be sold or transferred. OCC will also evaluate the investment to ensure that it does not expose the bank to unlimited liability.



### *National Community Stabilization Trust*

Five leading nonprofit organizations have formed the National Community Stabilization Trust (NCST).<sup>35</sup> A major objective of this effort is to standardize processes to make it easier for servicers to work with a single entity, which in turn has strong relationships with many local organizations and government entities that will be involved in community stabilization efforts. The NCST has established partnerships with grant recipients and facilitates the transfer of REO properties between servicers and local nonprofit and government entities. NCST will also work to secure other sources of acquisition and rehabilitation funding and financing.

Some banks already are working with NCST to provide their OREO inventory lists in targeted areas. NCST has developed a memorandum of understanding (MOU) that provides a “first look” to bid before the OREO property is publicly listed. The MOU outlines the approach for adjusting the price to reflect current local market conditions, including declining home values, long holding periods, and increased vacancies, as well as property condition, cost of capital, and other holding costs, such as taxes and insurance, and maintenance.

## **IV. What are the Key Risks and Regulatory Considerations Presented by REO Disposition?**

Certain regulatory requirements as well as contractual provisions govern how banks manage OREO property.

### ***Holding Period and Disposition: General Rule***

National banks must comply with statutory limitations on a bank’s ability to hold real estate, including properties acquired “in satisfaction of a debt previously contracted.” OREO property may be held for up to five years and that holding period starts when ownership transfers to the bank.<sup>36</sup> Within the five-year holding period, a national bank must dispose of a parcel of OREO “at the earliest time that prudent judgment dictates.”<sup>37</sup> Upon a showing by the bank that it has made a good faith effort to dispose of the property or that disposal within the holding period would be detrimental, the OCC may approve an additional five-year period. A bank is also permitted to lease OREO properties, subject to the five-year holding period and disposal requirement.

### ***Fiduciary Responsibilities to Investors***

When disposing of REO assets on behalf of an investor, banks generally must achieve the best possible net present value return. In our discussions with servicers, they indicated that disposition pricing decisions weigh such factors as projected holding costs and local market conditions (for example, whether inventories of for-sale homes are projected to rise or forecasts predict depreciating values).<sup>38</sup> Typical holding costs include taxes, insurance, maintenance, marketing costs, overhead, and interest. The servicer may conclude that adjusting the sales price to reflect

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<sup>35</sup> Enterprise Community Partners Inc., the Housing Partnership Network, Local Initiatives Support Corporation, NeighborWorks® America, and the National Urban League are the sponsoring organizations that have formed the National Community Stabilization Trust. See <http://www.stabilizationtrust.com> for a more complete description of the NCST and its objectives.

<sup>36</sup> See 12 U.S.C. 29 and 12 CFR Part 34, Subpart E—Other Real Estate Owned. It should be noted that the transfer of OREO to a subsidiary CDC constitutes the disposal required by Section 29. With prior approval, a bank may transfer OREO to a bank subsidiary CDC, which would not be subject to the five-year holding period. This type of transaction is described in detail in a prior section.

<sup>37</sup> 12 CFR §34.82(a).

<sup>38</sup> See National Association of Realtors, Existing Home Sales, which provides information by region on inventory levels of existing home sales. See also, “Economic and Real Estate Trends,” fall 2008, PMI Mortgage Insurance Co., at [http://www.pmi-us.com/media/pdf/products\\_services/eret/pmi\\_eret08v4s.pdf](http://www.pmi-us.com/media/pdf/products_services/eret/pmi_eret08v4s.pdf).

lower holding costs from a more rapid disposition will result in a net present value return equivalent to a higher price resulting from a lengthier exposure to the market. The servicer should either be able to document its decision for the investor or follow a specific methodology.<sup>39</sup>

## **V. Who Is Using Community Partnerships To Preserve Single-Family REO Properties?**

Currently, there is a wide variety of initiatives between banks and community partners, although most of these are being undertaken by larger financial institutions with relatively sophisticated community development staff. However, some community banks that currently have active community development corporations or have CDFI Fund certifications and have expertise in the economic development arena are beginning to engage in these types of initiatives. Several Web sites have been created to highlight successful models or provide links to conference presentations.<sup>40</sup>

As to nonprofit and public agency partners, these initiatives are taking place with entities that have strong single-family property preservation strategies already in place. It is anticipated that the federal Neighborhood Stabilization Program (NSP) funding for acquisition/rehabilitation will act as a catalyst to spur more activity in impacted areas. Leading nonprofit organizations have developed training for local affiliates to help prepare them to develop viable REO acquisition initiatives.

## **VI. How Does the Cost Structure Work?**

A number of factors go into determining the cost effectiveness of a proactive strategy by a financial institution to undertake property disposition initiatives and draw on the capacity of community partners. Banks that are successful in this arena have a dedicated CRA or community development staff. Developing partnerships may require specialized expertise and potentially redeployment of existing staff resources. This could be worthwhile if the end result is a more robust pipeline of motivated and qualified buyers that moves properties more quickly or if the partnership brings funding or assistance to make difficult deals work.

Partners can bring both tangible and intangible benefits to counterbalance the banks' commitment of extra resources. Some nonprofit organizations or government entities may be less price-sensitive because they are eager to purchase REO properties today to lock in a source of long-term affordable housing at less than the replacement cost of these properties. Also, entities that have secured state or federal subsidies or grants may be eager to purchase REO properties.

A proactive "first look" marketing strategy in which the partner has an opportunity to evaluate properties and make a purchase offer before a property is put on the market can reduce or avoid certain costs, such as a real estate commission or other marketing expenses. A partnership with a nonprofit that provides counseling can be a source of mortgage-ready borrowers. If that connection is made before the property is listed, pricing could reflect savings from reduced holding costs and fees.

The relative cost-effectiveness of a discount or donation program is largely dependent on whether it provides the servicer with the opportunity to reduce potential holding costs. Servicers we spoke to expressed willingness to discount sales prices through their "early look" or "first look" programs, which facilitate an expeditious disposition of the property that allows the servicer to avoid certain holding costs (*e.g.*, avoidance of real estate sales commission, property management expenses, taxes, insurance, property deterioration due to vandalism.) Appendix I of this report

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<sup>39</sup> See Appendix I for an example of an approach that evaluates the impact of holding costs across a holding period in a declining or increasing home price environment. See "Pricing and Valuation of Vacant Properties: Developing a Neighborhood Stabilization Approach," which can be found at [http://stlouisfed.org/rrrseries/event5/Event5\\_laven.pdf](http://stlouisfed.org/rrrseries/event5/Event5_laven.pdf). This presentation was made during a Federal Reserve Board conference, "Confronting the Neighborhood Impacts of Foreclosure," October 20, 2008.

<sup>40</sup> NeighborWorks America hosts a Web site at <http://www.stablecommunities.org>. See presentations from Federal Reserve Board conference series at <http://stlouisfed.org/rrrseries/default.html>.

provides a worksheet that illustrates how to analyze the cost effectiveness of various alternatives and how under certain assumptions an expedited disposition may reduce future costs.

## **VII. What Barriers Constrain the Growth of these Disposition Strategies?**

### ***Bank Resource Constraints***

Many mortgage servicing units are stretched thin as they negotiate loan modifications, short sales, and property disposition. Internal resources in the community development or CRA compliance divisions of a bank may be able to assist in identifying potential partners or disposition strategies. To help banks scale up for bulk transactions and streamline sales to a manageable group of buyers, organizations (such as the NCST) may operate as aggregators and work with affiliated nonprofits at the local level.

### ***Public Resource Constraints***

Although affordable housing advocates recognize the opportunity to acquire REO at reasonable prices, they are realistic about the challenges. Most REO properties require at least some rehabilitation because of deferred maintenance or vandalism. Acquisition cost plus renovation expenses—the “development gap”—can quickly surpass a property’s market value.

There is fierce competition for financing, grants, and subsidies. The recently approved NSP funding is limited, and it will be targeted to the areas with the highest need. As mentioned previously, NMTC or LIHTC funding structures could be a source of acquisition/rehabilitation funding.

Widespread foreclosures are a new phenomenon in many affected areas—training, staffing, and funding at many public agencies will be needed to build capacity.

### ***Market Risks***

Nonprofits may be unwilling to shoulder the market risk, especially in markets with rapidly falling prices, in less desirable neighborhoods, or in areas with large for-sale inventories. Also, they may not want to encourage their clients to purchase before prices stabilize. An interesting use of funding may be development of an insurance product to protect buyers against price declines<sup>41</sup> or offering no- or low-interest second mortgages as a buffer of protection (repayable upon sale out of proceeds, if the market value has recovered) to encourage buyers to purchase before prices have bottomed

## **VIII. Conclusion**

This *Insights* report highlights the efforts of banks and their community partners as they work together in innovative ways to preserve affordable housing opportunities and stabilize communities. With rising inventories of REO properties, banks are placing more emphasis on reaching all types of purchasers (including what might be viewed as nontraditional purchasers, such as nonprofit organizations, for-profit affordable housing developers, and government entities). A broader view of the market for REO buyers can merge the goal of minimizing losses with that of meeting CRA and community development goals. Careful analysis of the economics of deals that involve potential tax write-offs or CRA consideration may help to maximize proceeds.

Banks can evaluate the lessons learned and adopt best practices from a range of REO initiatives with a successful track record. This *Insights* report discusses a number of these successful approaches, but other efforts are under way and will continue to develop. The OCC has developed a Neighborhood Stabilization Web site, which can be found at <http://www.occ.treas.gov/cdd/neighborstabilization.htm>, with additional information and materials to help banks as they develop their initiatives.

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<sup>41</sup> See “Home Equity Insurance: A Pilot Project,” Yale ICF Working Paper, No. 03-12, May 2003, at [http://snde.rutgers.edu/Rutgers/Econ394/Unit3/yale\\_home\\_equity.pdf](http://snde.rutgers.edu/Rutgers/Econ394/Unit3/yale_home_equity.pdf).

## Appendix I

### Valuation Worksheet Example and Sensitivity Analysis Example<sup>42</sup>

Valuation Worksheet Example			
Market Assumptions		Nominal Basis	
Total Extended Time on Market		120 days	Extended Time on Market in Excess of Seller/Servicer 30-Day Hold
Estimated House Price Appreciation/Depreciation		-1% per month	
Discount Rate/Interest Rate		10.00%	For the Purposes of the NPV Calculations
Current Market Value		\$100,000	Either Seller/Servicer or Buyer Commissioned Appraisal
Holding Cost Assumptions			
Interest	10.00%	(\$3,333)	Carrying Costs in Excess of Seller/ Servicer 30-Day Hold
House Price Appreciation/Depreciation (per month)		(\$4,000)	Market Fluctuations per Local Conditions
Real Estate Taxes	3.00%	(\$1,000)	Payments Necessary to Keep Property Current
Insurance		(\$1,000)	Payments Necessary for Appropriate Insurance Coverage
Maintenance		(\$3,000)	Payments Necessary to Keep Property Sales Ready
Interim Repairs		(\$3,000)	Payments Necessary for Repairs Prior to Sale
Total Holding Costs Assumptions		(\$15,333)	
Seller/Servicer Savings			
Third Party Costs		(\$1,000)	Miscellaneous Additional Third Party Costs
Administrative Costs		(\$1,000)	Miscellaneous Additional Administrative Seller/Servicer Costs
Brokerage Fees/Cost of Sale	6.00%	(\$6,000)	
Seller/Servicer Savings of Interest on Protective Advances	0.00%		
Total Seller/Servicer Savings		(\$8,000)	
Total Adjustments		23.00% (\$23,333)	
<b>Net Realizable Value</b>		<b>\$76,667</b>	

<sup>42</sup> Different assumptions may apply in different housing markets. This worksheet and the price sensitivity analysis in the next chart are both from a presentation by Charles Laven, Forsyth Street Advisors, prepared for the National Community Stabilization Trust, entitled "Pricing and Valuation of Vacant Properties: Developing a Neighborhood Stabilization Approach." This presentation was made at a Federal Reserve Board conference and the information highlighted above can be found on pages 12-13 of the presentation at <http://stlouisfed.org/rrrseries/default.html>.

The 23 percent decline **bold-faced** in the chart below is based on the assumptions of a market decline of 1 percent per month and an estimate of 120 days on the market. If the other estimated holding costs and expenses detailed on the worksheet above are held constant, but the estimates of time on the market and estimates of house price depreciation change, the sensitivity grid solves for the new price adjustment.

**Sensitivity Analysis of Time on Market and Housing Price  
Appreciation/Depreciation on a Nominal Basis**

		<b>Estimated House Price Appreciation/Depreciation</b>				
		-2.50%	-1.50%	-1.00%	0.00%	1.00%
<b>Estimated Time on Market to Closing</b>	60 Days	22%	20%	19%	17%	15%
	90 Days	26%	23%	21%	18%	15%
	120 Days	29%	25%	<b>23%</b>	19%	15%
	150 Days	33%	28%	25%	20%	15%
	180 Days	37%	31%	28%	22%	16%

## Resource Guide

### **The OCC: Community Affairs' Neighborhood Stabilization**

This Web site offers information about strategies which can help mitigate the negative effects of rising foreclosures on communities across the country.

<http://www.occ.treas.gov/cdd/neighborstabilization.htm>

### **Department of Housing and Urban Development (HUD): Neighborhood Stabilization Program (NSP)**

This Web site provides detailed information about HUD's NSP grant program, which provides grants to states and certain local communities to purchase foreclosed or vacant homes and to rehabilitate, resell, or redevelop these properties. Guidelines about the program as well as specific information about the grantee plans are available here.

<http://www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg/>

### **Federal Reserve Board: Homeownership and Mortgage Initiative**

The Federal Reserve Board has sponsored a series of conferences to discuss neighborhood stabilization issues. Presentations from these conferences are included on this Web site.

<http://stlouisfed.org/rrrseries/default.html>

### **NeighborWorks America: Stablecommunities.org**

This Web site offers information about strategies which can help mitigate the negative effects of rising foreclosures on communities across the country. It also includes information about the National Community Stabilization Trust.

<http://www.stablecommunities.org/>

<http://www.stablecommunities.org/topics/NCST>

### **National Vacant Properties Campaign: Reclaiming Vacant Properties**

The National Vacant Properties Campaign provides information resources, tools, and assistance to support vacant property revitalization efforts.

<http://www.vacantproperties.org/>

### **Living Cities: Mitigating Impact of Concentrated Foreclosures on Neighborhoods**

Living Cities has provided grants to help foster specific initiatives to acquire and redevelop foreclosed properties.

[http://livingcities.org/2008\\_files/Living\\_Cities\\_Mitigating\\_Impact.pdf](http://livingcities.org/2008_files/Living_Cities_Mitigating_Impact.pdf)

### **National Housing Conference Foreclosure Prevention and Neighborhood Stabilization Resource Guide**

The National Housing Conference Web site provides information about current and critical issues facing the housing and affordable housing issues as well as information about foreclosure prevention efforts and neighborhood stabilization initiatives.

<http://www.nhcopenhouse.org/2008/08/foreclosure-prevention-and-neighborhood.html>

### **National Community Stabilization Trust**

The National Community Stabilization Trust provides Web site provides information about how this organization can help facilitate the transfer of foreclosed and abandoned properties from financial institutions to local housing organizations.

<http://www.stabilizationtrust.com/>

Sharon Canavan is the primary author of this report. Other contributors include Julie L. Williams, Barry Wides, and Karen Bellesi. *Community Development Insights* reports differ from OCC advisory letters, bulletins, and regulations. *Insights* reports do not reflect agency policy nor should they be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the OCC.