Banker's Primer to Managing Vacant Residential Property for Stable Neighborhoods

Published by the Community Development Department
of the Federal Reserve Bank of Cleveland | 2012

Challenges in the housing market continue to impede economic recovery. Financial institutions face unprecedented levels of delinquent and foreclosed residential property loans. Meanwhile, housing prices remain weak and REO levels remain high. In October 2011, the Federal Reserve presented a webinar on REO risks and opportunities. Panelists included Brian Hurley, President and COO of New Vista Asset Management; P.J. McCarthy, director of Public Entity REO Sales at Fannie Mae; Yves Mombeleur, Director of Seller Relations, the National Community Stabilization Trust; Jim Park, Founder and Co-CEO, New Vista Asset Management; and Tyler Smith, Vice President of REO Community Development, Premier Asset Services, Wells Fargo Home Mortgage. The Federal Reserve Bank of Cleveland developed this guide based on the webinar and on conversations with other industry experts and community leaders to highlight the risks financial institutions may incur by holding and managing REO and vacant residential property. The guide addresses banks' practices both before and after foreclosure. Although not comprehensive, this primer presents information, suggests approaches, and identifies resources for responsibly managing REO and vacant property. Its goal is two-fold: to help banks promote community stabilization through their management of vacant and abandoned residential property, and to inform banks of legal, reputational, and regulatory risks that come from holding REO property.

– Mary Helen Petrus, Federal Reserve Bank of Cleveland, Department of Community Development, and Matt Lambert, Federal Reserve Board of Governors, Division of Consumer and Community Affairs

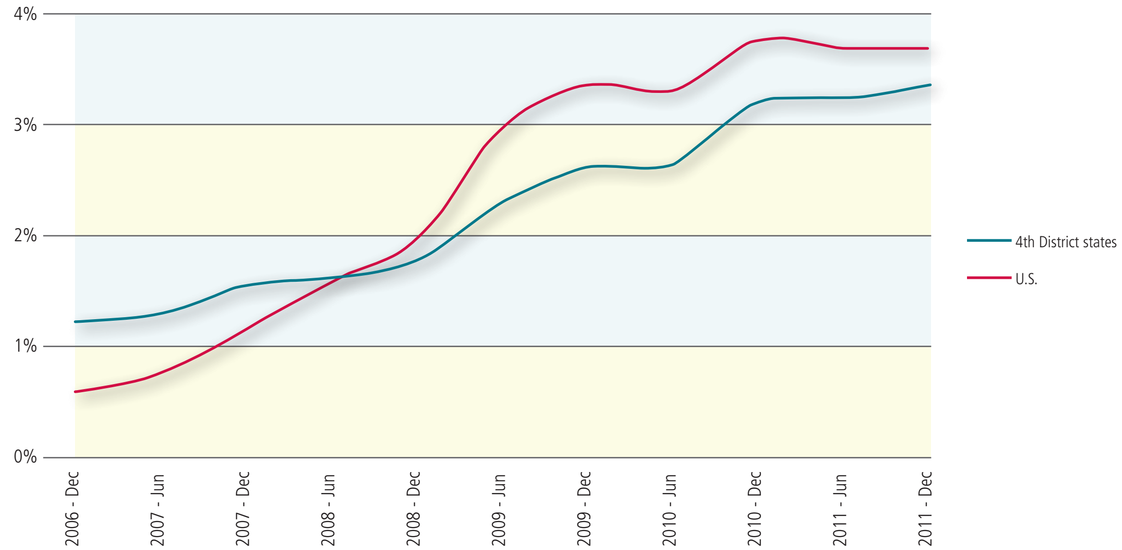
"REPAIRS INCREASE THE MARKETABILITY OF PROPERTIES AND ENHANCE HOME OWNERS' ABILITY TO GET FINANCING." – P.J. McCarthy

MANAGEMENT BEFORE FORECLOSURE

Maintenance after serving notice of foreclosure

The foreclosure process is slow; it lasts more than two years in many jurisdictions. Residential properties are often vacated long before the foreclosure is complete, which puts them at significant risk of deterioration and loss of value. Therefore, *it is in banks' best interests to secure properties and start maintaining them after serving notice of foreclosure but before the process is complete.* During this transition in ownership, banks may take steps to protect the value of a property that might otherwise deteriorate.

Percent of All Loans in Foreclosure and REO: U.S. and 4th District States
December 2006 – December 2011



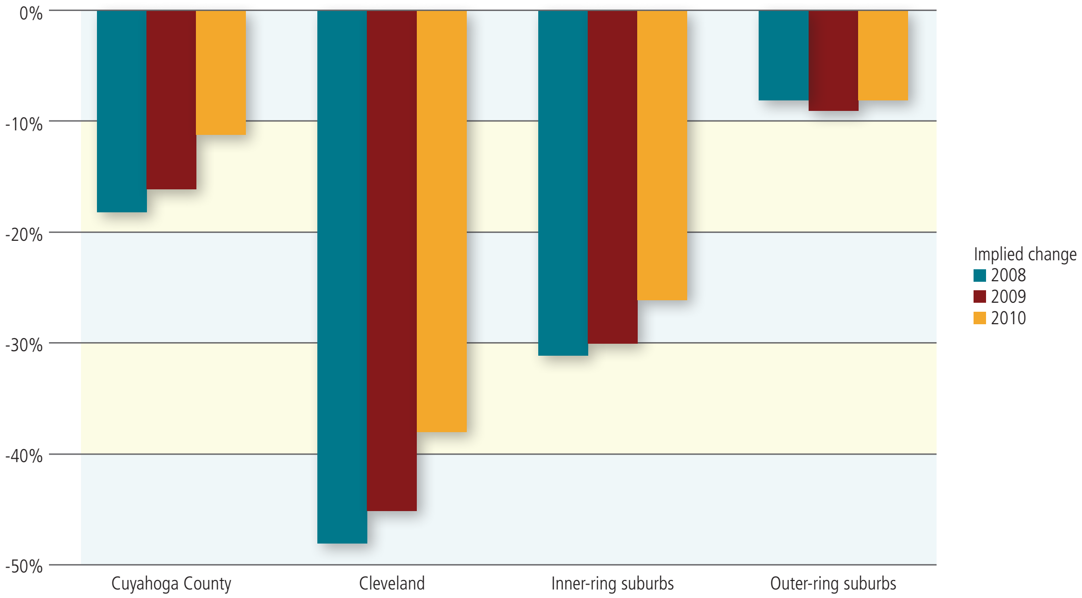
SOURCE: Lender Processing Services (LPS) Applied Analytics

"Ongoing property preservation is critical," says Yves Mombeleur of the National Community Stabilization Trust. "Neglected properties are advertisements for trouble. In effect, they may as well say, 'Come and squat in me because my owner doesn't care.'"

Before, during, and after the foreclosure process, a consistent maintenance and repair strategy can preserve a vacant home's value and help stabilize prices in the surrounding neighborhood. Brian Hurley of New Vista Asset Management points out the marketing advantages of maintaining properties. "Repaired properties present better to the marketplace overall and elevate or sustain property values in an area, which benefits surrounding neighbors. When lenders finance repairs, purchase becomes realistic for owner-occupants, and this is a good thing." According to Hurley, owner-occupant purchase prices are 41 percent higher than investor purchase prices, and the gap is at least partially attributable to repairs.

Government-sponsored entities also use a repair intervention strategy to protect properties from deterioration. "Fannie Mae gets multiple returns on repair investments," says P.J. McCarthy of Fannie Mae. "Repairs increase the marketability of properties and enhance home owners' ability to get financing."

Estimated Declines in Property Values, Cuyahoga County



SOURCE: Cuyahoga County Auditor

Failure to pursue foreclosure action

Banks may place their reputations at great risk if they are even *perceived* to be "walking away" from mortgages and properties. At the very least, if banks decide not to pursue foreclosure after serving notice, they should notify borrowers that they have the right to occupy the property until a sale or other title-transfer action occurs; that they must fulfill financial obligations, such as keeping current on property taxes; and that they must maintain the property. Some borrowers leave their homes during the foreclosure process. Many communities have centralized registries of abandoned properties. If banks know that properties are vacant, they should register them with the relevant authority or agency in a timely manner.

GAO Report: "Vacant Properties: Growing Number Increases Communities' Costs and Challenges," November 2011 http://www.gao.gov/new.items/d1234.pdf

Foreclosures with tenants

Many properties in foreclosure are occupied by tenants, who have certain rights. To comply with various related laws (Protecting Tenants at Foreclosure Act of 2009, Service Members Civil Relief Act, the Fair Housing Act, the Americans with Disabilities Act, and state and local ordinances), financial institutions should have controls to protect the rights of tenants living in foreclosed properties. In particular, tenants should receive proper, timely notice that the institution owns the foreclosed property and that the tenants must conform to timeframes, specified by law, for remaining in the foreclosed property before eviction proceedings commence.

Federal Reserve Board of Governors CA Letter: On July 30, 2009, the Board of Governors released CA Letter 09-5; it provides background information on the Protecting Tenants at Foreclosure Act along with requirements for complying with the act. http://www.federalreserve.gov/boarddocs/caletters/2009/0905/caltr0905.htm

MANAGEMENT AFTER FORECLOSURE: BANKS AS REO OWNERS

Third-party and outsourcing arrangements for REO

Many financial institutions use third-party vendors to preserve and manage their portfolios of vacant residential properties. Responsible oversight of this process is critical for ensuring that property is adequately maintained. Although most bankers are well aware of the fundamentals of vendor oversight and of managing the risks associated with outsourcing, the value of diligent oversight cannot be overstated. According to Yves Mombeleur of the National Community Stabilization Trust, property preservation and maintenance of REO are critical for stabilizing neighborhoods. "Failure to preserve and maintain properties has a perilous effect on communities," he notes.

Yves Mombeleur, National Community Stabilization Trust

The risks banks face through outsourcing include

- fines, penalties, and sanctions imposed when vendors violate local ordinances
- liability costs and damage to reputation when criminal activity or arson occurs in vacant REOs
- reputational and liability costs when vendors violate property preservation guidelines
- litigation exposure resulting from inadequate vendor and/or broker oversight.

P.J. McCarthy, Fannie Mae

To manage these risks, banks should have *sound practices for risk assessment, selection and monitoring of service providers, and the contract review.* According to P.J. McCarthy of Fannie Mae, vendor audits can minimize reputational and financial risks. In response to the growth of REOs in its portfolio, Fannie Mae has increased its internal capacity to manage third-party vendors. Wells Fargo keeps agent score cards, holds its vendors to a code of conduct, and makes unannounced inspections to check vendors' compliance. For more on vendor oversight, see the discussion below on federal, state, and local property laws.

Following federal, state, and local property laws

Financial institutions are expected to maintain vacant properties in accordance with federal, state, and local laws. These laws often concern safety, property preservation, and property registration. Failure to comply subjects institutions to fines and legal and reputational risk. Therefore, they should enforce policies and procedures that ensure compliance with

Freddie Mac website, with government-sponsored entities' joint servicing standards: http://www.freddiemac.com/singlefamily/service/servicing_alignment.html

"REPAIRED PROPERTIES PRESENT BETTER TO THE MARKETPLACE AND ELEVATE OR SUSTAIN PROPERTY VALUES... WHICH BENEFITS SURROUNDING NEIGHBORS." – Brian Hurley

these requirements. Many institutions have developed *systems to monitor and respond to varying requirements*. Tyler Smith, of Wells Fargo's Premier Asset Management, says the company's own property preservation department keeps on top of local ordinances that govern property preservation. "The number and changes in ordinances can be confusing and fluid," he says, noting that some ordinances seem to contradict each other, prompting consultation with the bank's legal department. Ultimately, Smith says, Wells Fargo tells their asset managers to do the right thing. "They don't want to incur reputational risks. It will never come back to them if a property is too secured."

Smaller regional banks should also protect themselves against problems arising from noncompliance with local property laws and ordinances. Institutions that engage third-party vendors to carry out functions related to these requirements should ensure that vendors maintain appropriate compliance controls.

Tyler Smith,
Wells Fargo

Reliance on third-party vendors does not relieve an institution of its compliance responsibilities or liabilities. Brian Hurley of New Vista Management suggests that institutions choose vendors and providers "who are familiar with local rules and have demonstrated their competency and familiarity with local ordinances. Institutions should screen brokers to be sure they are representative of the market and are well trained."

One promising strategy is to *engage directly with local municipalities* to ensure proper maintenance of REOs, as well as code compliance and enforcement. Says Tyler Smith, "It's best to be tuned in to areas where you are located, for example getting involved in various REO working groups and subscribing to different listservs. There are a number of property preservation vendors that do this work and will take some of the risks out as well."

Local Vacant Property Registration Ordinances:
http://www.safeguardproperties.com/Resources/Vacant_Property_Registration.aspx

Local Code Enforcement Contacts:
http://www.safeguardproperties.com/Resources/Code_Enforcement_Contacts.aspx

SALES AND OTHER DISPOSITION CONSIDERATIONS

CRA credit for neighborhood stabilization efforts

Selling vacant properties to owner-occupants or donating them to groups involved in neighborhood stabilization efforts can help financial institutions *receive credit under the Community Reinvestment Act*. In December 2009, federal regulatory agencies announced changes to the Community Reinvestment Act to help stabilize communities where foreclosure levels are high. Institutions can receive investment credit for

- making REO donations in Neighborhood Stabilization Areas designated by the U.S. Department of Housing and Urban Development for purposes of the Neighborhood Stabilization Program
- establishing mechanisms for buying and redeveloping foreclosed homes and other residential properties, including loan loss reserves and shared-equity loans for low- and moderate-income homebuyers
- buying and rehabilitating abandoned and/or foreclosed homes to sell, rent, or redevelop
- founding and operating land banks for foreclosed residential properties
- demolishing blighted structures
- redeveloping demolished or vacant properties
- donating other REO properties to nonprofit housing organizations in eligible *middle-income* (up to 120 percent of median family income) or low- and moderate-income areas. Activities of institutions operating outside their assessment area will be favorably considered if community development needs have been addressed within their assessment areas.

Federal Reserve Board of Governors Press Release: "Agencies Expand Scope of Community Reinvestment Act Regulations to Encourage Support for HUD Neighborhood Stabilization Program Activities," December 15, 2010, http://www.federalreserve.gov/newsevents/press/bcreg/20100617c.htm

FAILURE TO PRESERVE AND MAINTAIN PROPERTIES HAS A PERILOUS EFFECT ON COMMUNITIES." – Yves Mombeleur

Promising practices for positive community impact

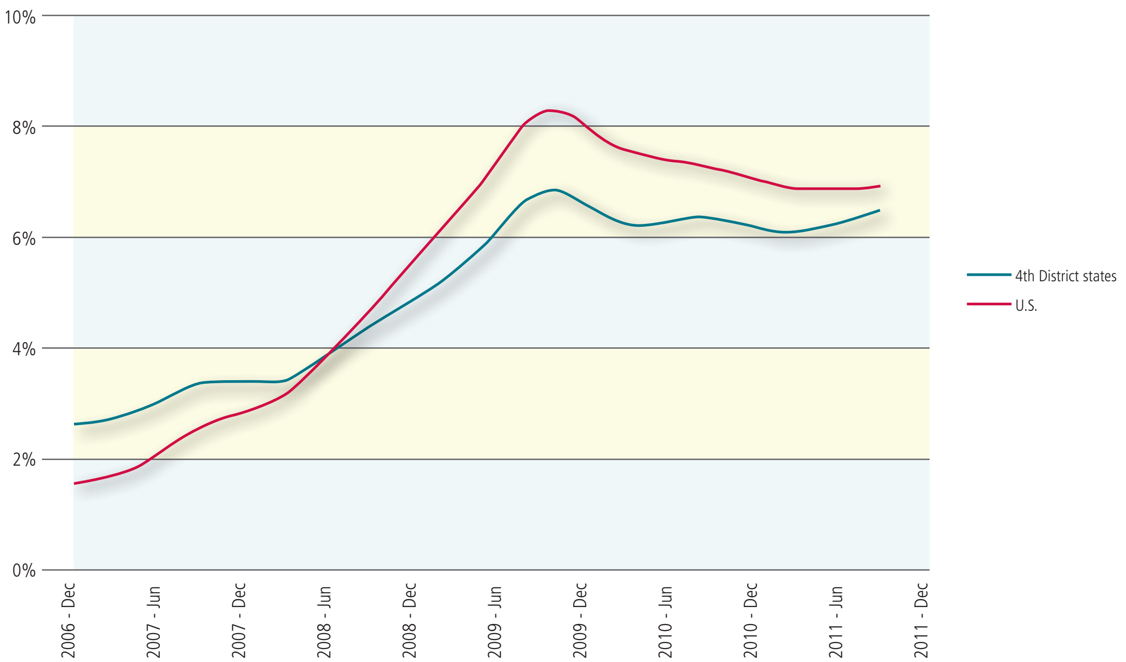
Successful REO sellers use several promising practices, including the ones detailed below.

Alternative disposition channels. Institutions may consider donating low-value properties to nonprofit partners or land banks. Low-value properties are those that are distressed and blighted, and are more suitable for demolition or condemnation than for repair and sale to owner-occupants or through rental strategies. In some cases, financial institutions make contributions to help cover demolition and nuisance abatement costs.

Tyler Smith of Wells Fargo notes that "demolition is a viable disposition strategy after you consider the market. In places where you can't give properties for free to nonprofits, you know the market conditions are not good. This justifies the contribution for demolition." In transferring REO property, institutions should ensure that local property tax liens are satisfied before demolition and sale.

Shadow Inventory: Percent Rate of All Loans at Least 90 Days Delinquent

December 2006 – December 2011



SOURCE: Lender Processing Services (LPS) Applied Analytics

"First look" programs. Many institutions have "first look" programs that give prospective homeowner and community participants a brief, exclusive opportunity to buy bank-owned homes in certain neighborhoods; these homes can be rehabilitated, rented, resold, or demolished. Giving prospective homeowners and communities a "first look" can help limit neighborhood blight, stabilize property values, and mitigate banks' reputational risk.

Fannie Mae has been operating a first look program since late 2009. According to P.J. McCarthy, "Fannie has a clearly stated preference for owner occupants, nonprofits, or publically funded buyers. These entities pay more, do quality rehabilitation, and are more likely to have a positive impact on neighborhood outcomes. In addition, Fannie has a focus on sales to public entities, initially through HUD's Neighborhood Stabilization Program, and we've made efforts to incorporate those groups as buyers in first look programs. Fannie has had great results—over 60 percent of its REO buyers are owner occupants."

Press release: "HUD Secretary Announces National First Look Program to Help Communities Stabilize Neighborhoods Hard Hit by Foreclosure," June 7, 2012
http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2010/HUDNo.10-187

Screening and monitoring bulk-sale investors. Institutions sometimes find that bulk or pool sales make the most economic sense. With bulk sales, however, banks need to exercise diligent oversight of investors and their REO purchases in order to address potential financial, legal, and reputational issues. Banks may seek to accomplish this initially by ensuring that the policies and procedures governing the sale and disposition of REO properties comply with applicable laws, such as the Fair Housing Act and the Equal Credit Opportunity Act (if the institution makes or facilitates credit). "From a community standpoint, the biggest distinction in terms of impact in one sales channel or another comes down to owner occupancy," says Brian Hurley. "New Vista has been tracking owner occupancy rates on REO, and these rates are falling. Communities have justifiable concerns about that. There is a clear institutionalized preference for investor transactions—they are easier to do and easier to leverage to dispose of REO."

A bank can also reduce its reputational risk by conducting thorough due diligence on investors to ensure they have no criminal history and do not engage in practices that could have an adverse impact on property values. Institutions may consider implementing controls to evaluate purchaser actions after the REO property is sold to an investor. Some institutions now evaluate bulk purchasers to determine whether they resell properties to responsible buyers or to those who are worsening neighborhood blight through negligence.

According to P.J. McCarthy, Fannie Mae wants to understand the entity that takes title to its properties and their operating principles, so the organization requires submission of experience and business model and performs a background check. "Fannie Mae has contractual restrictions on pool sales," he explains, "including resale restrictions. We have a certain holding period to deter flippers and a required amount of sales to owner-occupants. We require investors to report quarterly on what they've done with properties. We audit what's been self-reported. We realize that many investors can become code issues, so we've been open with community organizations about who we are dealing with. We have removed investors who don't pay taxes and let their properties go into tax foreclosures."

Brian Hurley,
New Vista Asset Management

Jim Park,
New Vista Asset Management

From REO to Rental

Recently, proposals to convert REO into rental property have gained traction, particularly in stronger housing markets. Federal Reserve regulations and policies permit the rental of REO residential (one- to-four family) properties to third-party tenants as part of an orderly disposition strategy within statutory and regulatory limits. The Federal Reserve's general policy is that banking organizations should make good-faith efforts to dispose of REO properties at the earliest practicable date. Sale of the property is the preferred means of disposition. However, under the current, extraordinary market conditions, banking organizations may rent residential REO properties (within statutory and regulatory holding-period limits) without having to demonstrate continuous active marketing of the property, provided that suitable policies and procedures are followed. Under these circumstances, banking organizations that dispose of REO property by renting it would not be contravening supervisory expectations of "good-faith efforts" to dispose of it. Moreover, to the extent that REO rental properties meet the definition of community development under CRA regulations, they receive favorable CRA consideration.

Federal and state laws typically allow banks to hold REO properties for a time, and often include a possibility of extending the permissible holding period. Short-term leasing of REO property may make sense in certain cases if a revenue stream would defray maintenance costs. During the holding period, banks are permitted to rent the REO properties on their balance sheets, as well as manage the properties directly or through a third-party vendor. Regulators generally expect that the goal of such rentals is to support the banking organization's ultimate recovery. In the prevailing economic environment, the reality is that banks are holding REO portfolios that are larger than the norm.

Banks have opportunities to contribute to neighborhood stabilization efforts through their practices of holding and renting REO property. According to New Vista's Brian Hurley, "the worst thing for a community with respect to REO is vacancy. If the alternative to rental is a vacant house, then institutions should have a rental strategy to address this." Poorly managed or maintained rental properties, however, have an adverse impact on communities. A bank's rental program should ensure that communities are not damaged by rental practices. For example, investors might be allowed to bid on properties only after demonstrating some experience with property management and their commitment to rehabbing properties. Experienced nonprofit organizations with established community ties could also play a role as rental managers. Rent-to-own provisions, which give existing tenants the option to purchase homes during their tenancies, might facilitate some renters' return to the owner-occupied market. Such provisions may also reduce costs by encouraging renters to maintain their properties.

"THE WORST THING FOR A COMMUNITY WITH RESPECT TO REO IS VACANCY. IF THE ALTERNATIVE TO RENTAL IS A VACANT HOUSE, THEN INSTITUTIONS SHOULD HAVE A RENTAL STRATEGY TO ADDRESS THIS." – Brian Hurley

A Final Word and Available Resources

Stable neighborhood housing markets are key to the recovery of communities hard hit by foreclosures. The ways financial institutions manage vacant and abandoned property make a difference. Responsible management helps financial institutions avoid and mitigate a myriad of reputational, legal and regulatory risks. Below are supplemental resources for financial institutions with REO to aid in their efforts to make positive impacts in their communities.

- Federal Reserve Policy Statement on Rental of Residential Other Real Estate Owned Properties, April 5, 2012 http://www.federalreserve.gov/newsevents/press/bcreg/20120405a.htm
- Federal Reserve Bank of Cleveland http://www.clevelandfed.org/community_development/index.cfm?DCS.nav=Main
- Federal Reserve Board of Governors http://www.federalreserve.gov/communitydev/default.htm
- National Community Stabilization Trust http://www.stabilizationtrust.com/
- NeighborWorks America http://www.stablecommunities.org/
- Federal Reserve Bank of Cleveland Drawing Board: The Foreclosure Crisis and Neighborhood Stabilization http://www.clevelandfed.org/forefront/2010/09/debt_overhang_landing.cfm
- Federal Reserve Webinar: REO Disposition Risks and CRA Opportunities, October 2011 http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2011/reo-disposition-risks.cfm
- Federal Reserve Housing White Paper: "The U.S. Housing Market: Current Conditions and Policy Considerations," January 4, 2012 http://federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf
- Publication of the Cleveland and Boston Federal Reserve Banks, along with the Board of Governors: "REO and Vacant Properties: Strategies for Neighborhood Stabilization," September 2010 http://www.clevelandfed.org/Community_Development/publications/REO/index.cfm
- Federal Reserve Bank of Cleveland working paper: "The Impact of Vacant, Tax Delinquent, and Foreclosed Property on Sales Prices of Neighboring Homes," September 2011 http://www.clevelandfed.org/research/workpaper/2011/wp1123r.pdf

Authors: Mary Helen Petrus, Federal Reserve Bank of Cleveland
Matt Lambert, Federal Reserve Board of Governors

Editor: Michele Lachman, Federal Reserve Bank of Cleveland
Designer: Mary Jane Parente-Smith, Parente-Smith Design

Published by the Federal Reserve Bank of Cleveland's Community Development department.

Members of the Cleveland Fed Community Development team include:

CLEVELAND
Paul Kaboth
Vice President &
Community Affairs Officer
216.579.2951
Paul.kaboth@clev.frb.org

Donna Nolen Brooks, CMP
Project Administrator
216.579.2309
Donna.n.brooks@clev.frb.org

Thomas J. Fitzpatrick
Economist
216.579.3087
Thomas.j.fitzpatrick@clev.frb.org

Matthew Klesta
Research Analyst
216.579.3166
Matthew.klesta@clev.frb.org

Lisa Nelson
Senior Policy Analyst
216.579.2903
Lisa.a.nelson@clev.frb.org

Anne O'Shaughnessy
Project Manager
216.579.2233
Anne.o'shaughnessy@clev.frb.org

Mary Helen Petrus
Outreach Manager
216.579.2443
Mary.h.petrus@clev.frb.org

Francisca G.-C. Richter
Research Economist
216.579.2474
Francisca.g.richter@clev.frb.org

PITTSBURGH
Joseph Ott
Senior Policy Analyst
412.261.7947
Joseph.c.ott@clev.frb.org

CINCINNATI
Bonnie Blankenship
Senior Policy Analyst
513.455.4281
Bonnie.blankenship@clev.frb.org