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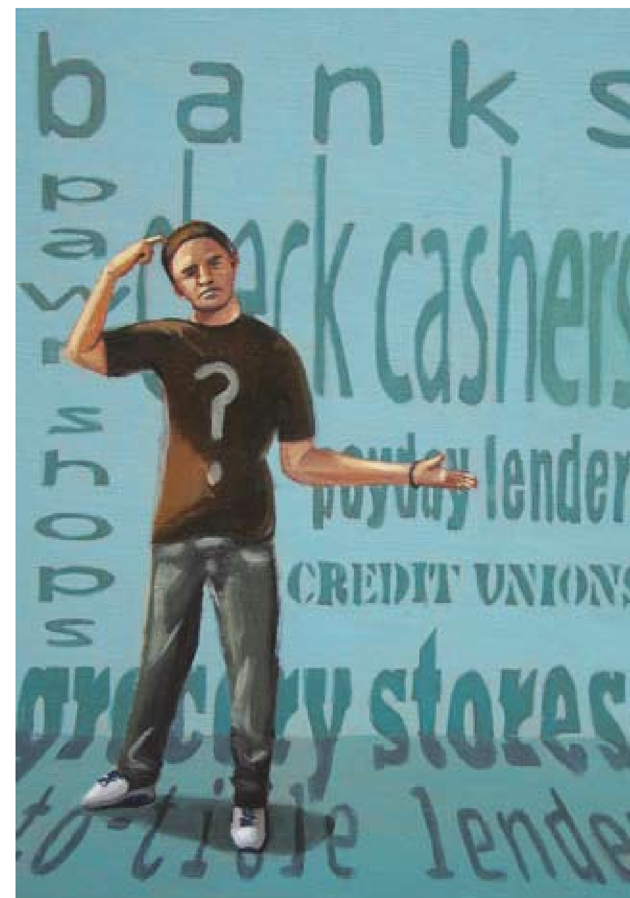
Promoting Banking Services among Low-Income Customers

by Rebecca M. Blank

A considerable number of low-income individuals make use of nonbank financial services conducted at check-cashing outlets, payday lenders, pawn shops, auto-title lenders, and grocery, convenience, department, and other stores. Although the number of unbanked households has fallen during the past 20 years, currently about 10 million households do not have a checking account or savings account and rely on alternative financial service (AFS) providers to conduct their financial transactions. Many more are considered underbanked: they make use of banks and credit unions as well as AFS providers. Indeed, the use of such services as payday loans and refund anticipation loans (RALs) has grown over the last two decades.

A 2008 report by the Brookings Institution showed that low- and moderate-income households paid $8.5 billion in fees to nonbank check-cashing providers and short-term loan providers in a recent year. The Center for Financial Services Innovation (CFSI) estimates that unbanked and underbanked households spend at least $13 billion each year on nonbank financial transactions. Most check cashers charge between 2 percent and 4 percent of each check's value. And the interest rate on a two-week or four-week payday loan is about 30 times the annualized interest rate of typical credit card.[1] The Brookings study suggested that a full-time worker could potentially save



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as much as $40,000 over his lifetime by making use of a lower-cost checking account instead of check-cashing services.

In light of the high cost charged by many AFS providers, consumer advocates continue to explore alternative avenues for promoting financial inclusion and wealth creation among low-income households. New research on consumer behavior, financial education, and the use of financial services by low-income families is bolstering these efforts. This article provides an update on current thinking around how

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to strengthen the welfare of low-income families by promoting the use of banking services by these families.[2] I begin with an overview of why low-income households utilize AFS institutions and then focus on policy options that might move more people into traditional banking services. Where possible, I emphasize new research and new thinking about these issues.

Why Do Customers Use Alternative Financial Services?

Research conducted in recent years has provided insight into why low-income households choose informal financial services over banks. Below I group these findings into five primary reasons.

1. Bank services may be ill-fitted to the needs of low-income households. A study of the demand for payday loans showed that about half of payday loan recipients claim to have considered a bank loan, but many of these borrowers indicated that it was easier to obtain a payday loan.[3] Many local banks do not make short-term loans available to low-income customers. High minimum balance checking accounts with multiple fees may be too expensive for low-income customers, who are more likely to incur penalties for lower balances and for overdrafts. And these customers appear to conduct financial transactions where they transact other business. For example, check-cashing outlets are often one-stop shops for customers, providing more comprehensive products and services than banks, such as bus passes, mobile-phone minutes, and prepaid debit cards. One study showed that 77 percent of individuals using check-cashing services reported that these services are more convenient than using banks.[4]

New research suggests that a significant number of low-income households use both banks and informal financial providers for their transactions.[5] The fact that many people choose among banks and nonbanks for different financial services supports the conclusion that low-income families often turn to informal providers to meet needs that banks ignore.

2. Low-income households may mistrust banks or have difficulty comparing costs across financial institutions. A subset of low-income persons actively mistrusts banks or perceives using them as an unpleasant experience. These customers may feel intimidated by bank employees or feel that they have been treated rudely by bank staff in the past. Some customers worry about incurring penalties or limitations on bank accounts that they do not understand. Some may not understand the true costs of using payday loans, such as the compounded costs of rolling over loans multiple times. The previously mentioned survey of payday loan users found that almost all of them were aware of the dollar charges on their most recent payday loan, but few knew how these translated into an annual percentage rate that would let them compare rates across providers.

3. Past credit problems can hinder low-income persons from qualifying for bank accounts or for bank loans. In one study, 18 percent of low-income respondents indicated that their poor credit histories prevent them from qualifying for an account.[6] Others have not yet built up their credit histories, hindering their ability to qualify for a loan. Immigrants, documented and undocumented, may not be able to provide the financial documentation required by banks for a loan. In all these cases, the simpler requirements of payday lenders make them the only viable source of credit.

4. Low-income consumers are more likely to discount future costs at high rates, making them more willing to pay high up-front costs for short-term loans or check-cashing services. Low-income consumers may have a high immediate need for funds or may place a high value on immediate gratification. This will lead them to discount future costs at a high rate and make high-cost alternative financial services look more attractive, A growing body of work in behavioral economics indicates that many people (both low- and high-income) demon-

strate time inconsistencies when making decisions. When asked, people will say that they want to save, but then will proceed to spend their money as they receive it. Unfortunately, these behavioral tendencies are more costly for low-income individuals, who have less margin for error in their financial decision-making (i.e. any "mistakes" may have much greater consequences).[7]

5. Greater income volatility for low-income households increases their need for short-term credit. Lower-income or less-educated households experience greater fluctuation in their incomes. Work hours on low-wage jobs often vary substantially from week to week, especially in the service sector. Employment is more cyclical among less educated workers. Household composition is also more unstable in lower-income families: marriage is less common and cohabitants come and go with greater frequency. Residential instability is higher and is often linked with job changes. Thus household instability feeds into earnings and income volatility.

Families can deal with short-term income instability in three ways. First, they can reduce expenditures as income falls. However, this can be difficult for low-income families as a higher share of expenditures goes toward necessities such as food or rent. Second, households can utilize savings to help smooth expenditures. For many reasons, low-income households are far less likely to have savings than higher-income households (e.g., because their incomes are low relative to needs), so this mechanism may be unavailable to them. This leaves a third option, borrowing to smooth spending in the face of income fluctuations. Although expensive, taking out a short-term, high-interest payday loan may be a better choice than having one's phone or electricity turned off.

A growing body of work in behavioral economics indicates that many people demonstrate time inconsistencies when making decisions.

Interest in the question of how to increase the welfare of low-income families through financial services has increased in recent years, leading to some interesting new research and policy proposals. In the following sections, I discuss different policy approaches that address the issues raised above.

Encouraging Greater Use of Banks

The most direct way to encourage the utilization of banks and credit unions is for these institutions to expand and market competitive products and services

that meet the unique needs of low-income households. These products and services could include no-minimum-balance debit accounts that exclude the fees associated with overdraft protection; short-term loans that provide liquidity much like payday loans but cost less; or low-cost check-cashing facilities inside banks for noncustomers. A key question is whether these activities will be profitable enough to encourage banks to engage in them, or whether the public sector will need to provide incentives or partner with these institutions to help recruit low-income customers.

A number of financial institutions have taken leadership in providing banking services to low-income households. ShoreBank in Chicago is perhaps the best-known example, but other institutions around the country are experimenting with ways to serve these customers profitably. Some banks offer "starter" accounts aimed at serving customers' needs. The Massachusetts Community and Banking Council provides guidelines to banks on what constitutes "basic banking" checking and savings accounts. Some banks and credit unions offer short-term loans explicitly designed to compete with payday lenders for much lower fees.

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There are a variety of public sector initiatives aimed at encouraging the utilization of banking services by low-income customers. In San Francisco, the mayor's office initiated the Bank on San Francisco program. The city persuaded banks and credit unions to relax standards or waive fees for new account holders in exchange for a free marketing push from the government. The program recently expanded to the rest of California. A number of other cities, including Seattle and Savannah, are drawing up their own versions of the program. An earlier proposal by former treasury official Michael Barr includes the creation of tax credits that would be made available to banks based on the number of accounts they open up for low-income persons.[8] This concept, dubbed First Accounts, was tested in a small demonstration program.

Other public sector proposals include increasing the number of public assistance benefits that are distributed through bank debit accounts. This policy would give families a relationship with a local bank, and families would be allowed to retain the accounts when they move away from public assistance into work. In a similar way, the IRS could expand the ability of unbanked taxpayers to receive tax refunds in electronic debit accounts. A demonstration project sponsored by ShoreBank indicated that over half of the unbanked participants whose refunds were placed in accounts went on to use the accounts for other purposes.[9]

A growing body of evidence suggests that low-income families can save despite their small earnings. Policies aimed at increasing their savings rates could help smooth expenditures without the need for short-term credit and could create connections with formal financial institutions. There are a number of bills before Congress and at the state level that would provide incentives to help low-income households save more. Proposals include employer-based savings plans, government matched-savings plans, and national development or savings accounts.[10] President-elect Barack Obama has proposed a matched savings plan.

Finally, there are a variety of ways in which city and state governments have sought to regulate and limit AFS providers. Some states have made it impossible for payday lenders to operate or have limited the size of payday loans or the number of times a loan can be rolled over. Evidence on results is mixed. Some studies show that payday lenders provide helpful liquidity to certain households that do not have access to other borrowing sources. One study found that households in states with higher payday loan limits do not have higher delinquency rates, although they do have marginally higher debt levels.[11] After North Carolina and Georgia eliminated payday lending, households bounced more checks and filed for bankruptcy at a higher rate.[12] Another study found that areas

Insufficient Funds: Savings, Assets, Credit and Banking Among Low-Income Households

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with payday lenders recover more quickly following a natural disaster, with fewer foreclosures.[13] Other research indicates that average payday loan recipients use multiple loans and run up quite large debt, which suggests these individuals are not using payday loans merely for occasional unexpected expenditures.[14]

One important way of reducing families' use of high-cost credit is to reduce demand for this credit.

Greater competition appears to bring down the cost of AFS services.[15] So strict regulations on AFS providers may not reduce the demand for short-term credit and may even raise the costs unless such a policy is closely linked with efforts to provide affordable credit and banking services through banks and credit unions.

Reducing Demand for High-Cost Credit

One important way of reducing families' use of high-cost credit is to reduce demand for this credit. Many researchers and practitioners believe in the need for financial education to promote wise use of credit and effective money management and financial planning. Unfortunately, there is at best limited information showing that financial literacy courses help increase savings or improve credit records.[16] There is therefore a need for well-evaluated demonstration programs that would advance our knowledge of best practices. Currently, a number of researchers have embarked on longitudinal studies of financial education programs and several organizations have produced materials to help practitioners evaluate their financial education programs, including the National Endowment for Financial Education (NEFE) and *The Journal of Extension*.

In addition, families with inadequate or no health insurance are at a greater risk of incurring medical debt and being forced to resort to high-cost credit to make ends meet. Low-income families often have low levels of private health insurance and limited Medicaid eligibility (Medicaid typically covers children but not parents in low-income working families). As a result, these families often pay cash for dental visits, eye care, or care that requires multiple doctor visits. In a 2007 report by Demos and the Access Project, 29 percent of indebted low- and moderate-income households reported that medical expenses

contributed to their current level of credit card debt. Better health insurance coverage for low-wage families would help.

Stabilizing Incomes

One cannot consider how to strengthen the financial standing of low-income families without considering policies to stabilize their incomes. Stable incomes help reduce low-income families' need for short-term credit and help make them more attractive customers to financial institutions.

Stable incomes require a macroeconomic policy of maintaining low unemployment. Maintaining a high-employment economy is more important for this group because of the greater cyclicality in employment and jobs among lower-wage workers. Elsewhere I have noted that a strong macroeconomy is probably the most effective long-term antipoverty strategy.[17] As welfare reform has moved more single-mother families off public assistance and into low-wage employment, even more families rely on low-wage jobs for their primary income support.

In addition, it is important to maintain access to coverage within the Unemployment Insurance (UI) system for low-income families. The UI system is designed to smooth income following job loss, but only a little more than one-third of unemployed workers receive UI; lower-wage workers have higher unemployment rates but are less likely to receive UI than higher-income workers. In part, this is because lower-wage workers are less likely to be eligible for UI benefits when a job ends. UI eligibility requires working at least two of the last four quarters in one job; in many states, part-time work, quitting, and being fired "for cause" are not covered. The UI system could be reformed to cover a higher share of low-wage workers and to encourage use among those eligible, making it a more effective income-smoothing mechanism for lower-wage workers.

Maintaining eligibility for and take-up in safety-net programs can also help stabilize income. While relatively few working low-income persons are eligible for cash assistance, various in-kind programs help supplement earnings and smooth incomes, including food stamps (now called SNAP, the Supplemental Nutrition Assistance Program), housing assistance, and Medicaid. While take-up in food stamps and Medicaid has risen as a result of efforts following welfare reform to increase program use among working low-income families, large numbers of eligible persons do not receive benefits. The low-take-up appears to be caused by a combination of misinformation, distaste for the difficulties and indignities of participating in the programs, and efforts to discourage participation by program employees.

Finally, expanding the Earned Income Tax Credit (EITC) program for low-wage workers without children would greatly increase its power as an income supplement. The EITC provides substantial income support to low-income families with children, but low-wage workers without dependents receive only small EITC supplements. A variety of proposals to expand EITC to this group would particularly help low-wage male workers, many of whom help support their nonresident children.[18]

Conclusion

There are many ways to encourage low-income households to increase their use of formal financial institutions. On the one hand, banks and credit unions can expand the services they provide; there may also be policies that would make informal financial services less attractive. On the other hand, focusing solely on banking services ignores some of the primary reasons why families seek short-term credit in the first place. Helping families save and smooth their expenditure and income streams is also important. This requires policies that address a range of goals, from promoting economic stability to incentivizing savings and strengthening the impact of EITC and proven financial education programs.

Policies aimed at promoting banking among low-income households need to address the multiple reasons why families utilize AFS providers. At present, we have only limited evidence on the comparative costs and benefits of the policies discussed above. Given the number of experiments with providing financial services to low-income customers that are under way, this is a particularly fruitful time to evaluate these efforts, their outcomes, and the challenges to implementation. It would be highly useful to define additional best practices to help guide federal, state, city, and institutional efforts aimed at improving the financial well-being of lower-income households by encouraging their greater use of banks and credit unions.

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Using New Markets Tax Credits to Mitigate the Impact of Foreclosures on Communities

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Across the country, committees have been established to come up with ways to mitigate the impact of foreclosures on lower-income communities. A few are exploring the feasibility of having community-based organizations use the New Markets Tax Credit (NMTC) Program to facilitate the purchase of foreclosed residential properties for rehabilitation and resale to low- and moderate-income families. In theory, these organizations could use the tax credits to help recover their costs for purchasing, fixing up, and selling homes at a price that is affordable to lower-income buyers. Moreover, the tax credits could help community-based organizations attract appropriate amounts of capital to conduct transactions at a scale that would stem disinvestment in troubled neighborhoods.

We interviewed numerous community development finance practitioners and asked them to identify: 1) organizations across the country using or considering using the NMTC Program to mitigate the community impact of foreclosures and 2) the potential barriers that organizations need to overcome when seeking to use NMTCs for these purposes. Below we have incorporated their responses into a brief discussion of the potential for using the NMTC Program to promote neighborhood stability in communities with concentrated foreclosures.

The NMTC Program, established by Congress in December 2000 and administered by the CDFI Fund at the U.S. Department of Treasury, gives individual and corporate taxpayers the opportunity to receive a credit against income taxes by investing in businesses located in or serving low-income communities.[1]

In a NMTC deal, the capital flows to a business through a special-purpose financing LLC, known as a Certified Development Entity (CDE). A bank, private equity investor, or other capital source can invest directly in the CDE or through an upper-tier conduit LLC as a means of leveraging the equity capital and bifurcating the tax credits. In the leveraged transaction, investors can provide the debt, equity, or both. Community partners often provide debt capital alongside other investors in a leveraged transaction. The equity provider would most likely receive its return using the available tax credits calculated on the basis of the combined total investment amount (debt and equity), thereby assuming nominal project risk. The 39 percent tax credit on the amount invested is realized over seven years. The business gets the capital on favorable terms and the investor gets the tax credits. Any debt financing in such a leveraged NMTC model could be at market rates if the available tax credits are mostly allocated to the equity investors. Alternatively, some tax credits could be allocated to the debt provider as incentive to make the capital available at more attractive financing rates and terms.

Four Models

Enterprise Community Investment Inc. and Columbus Housing Partnership's NMTC Transaction

We identified four examples of organizations planning to make use of NMTCs to promote neighborhood stabilization in areas with high foreclosures. Only one of these models has thus far been implemented: A NMTC transaction by Enterprise Community Investment Inc. and the Columbus Housing Partnership (CHP) to build and rehabilitate single-family homes.

The transaction involved capitalizing a $9.5 million investment fund leveraging $3 million in NMTC equity. The proceeds from the fund were used to make low-cost loans totaling $9.5 to CHP for the purpose of financing the construction and rehabilitation of up to 700 homes targeted to households earning less than 80 percent area median income (AMI) in the Columbus, Ohio, area. Using this model, the $9.5 million helped to fund and create capacity for a project that could reach $80 million in total development costs. To date, CHP has purchased and rehabilitated 29 foreclosed properties under the program, of which 10 have been sold.

The strength of the model lies in the support of key partners. CHP will offer homebuyer education and counseling services and buyer financing incentives made possible with City of Columbus sponsored programs. The public funding is provided as part of the city's Home Again program established in 2006 to stimulate home development in areas close to employment, to encourage homeownership, and to stop neighborhood deterioration. CHP has also partnered with local financial institutions, including Huntington Bank, to offer mortgage financing to targeted homebuyers. Many homes are also located in Columbus Neighborhood Investment Districts (NIDs), which enjoy 15-year property tax abatements.

City First Homes Housing Trust Model

The community housing trust City First Homes (CFHomes) Inc., part of the City First Enterprises family, will manage a $75 million fund to create 1,000 units of permanently affordable workforce housing in Washington, DC. CFH will leverage both a $10 million grant from the District and NMTCs to raise an additional $65 million in capital which will create the pool of second mortgages for use by low- and moderate-income buyers. In addition, the program leverages operational grant funds from a variety of supporters, including DC United Way, HSBC, F.B. Heron Foundation, Ford Foundation, Fannie Mae, NeighborWorks America, and Living Cities.

Foreclosure response has emerged as a key component in the larger effort, and will account for at least 10 percent of homes placed in the trust over the next 24 months. CFHomes will purchase real estate owned (REO) properties, complete necessary renovations, and place the properties back in service, selling them to eligible buyers, who will agree to the accompanying deed restrictions.

Partnering with qualified developers and trusted realtors, CFHomes will offer newly built as well as rehabbed homes for sale. Homes will be located in mixed-income neighborhoods throughout all eight wards of the city. CFHomes will assume stewardship responsibilities for the portfolio of homes, provide ongoing support to homeowners, manage resales, and maintain the permanent affordability of the homes.

As a housing trust, CFHomes provides low-interest second mortgages to qualifying purchasers in exchange for agreeing to share any future appreciation. Sellers retain 25 percent of any increase in value accruing to the property, as measured appraisal to appraisal, thus maintaining affordability over the long-term life of the property without the need for future subsidy. The seconds will consist of 40-year subordinate mortgages averaging $75,000 with a fixed 3.99 percent mortgage that is interest-only for seven years then amortizes for years eight to 40. The deal includes mandatory homeownership counseling incorporating best practices of the NeighborWorks America full-cycle lending model, with a focus on shared equity and post-purchase support.

Clearinghouse CDFI's NMTC Single-Family Model

The model proposed by Clearinghouse CDFI in Lake Forest, California, is different from the others in that it aims to help homeowners avoid foreclosure in the first place. The program would use NMTCs to help finance a rescue loan product for low-income homeowners who are unable to repay their subprime mortgage and/or to finance first-time homebuyers of single-family homes.[2]

Clearinghouse would finance a home aggregator, an entity engaged in the purchase and resale of single-family homes. In the case of occupied properties, the home aggregator would purchase the home from the owner, retire the existing mortgage on the property, and then sell it back to the family while providing a new fixed-rate, 80/20, regularly amortizing mortgage. The aggregator would provide favorable financing to the family by using NMTCs to finance the 20 percent second loan. For low-income families seeking a loan on their first home, the home aggregator would purchase the home and then immediately sell it to the family, also providing favorable financing made possible by leveraging NMTCs for the second mortgage.

Clearinghouse estimates that when factoring in a conservative loss rate, NMTC investors would receive an acceptable market-rate after-tax IRR. The returns become more attractive when even a small amount of foundation or government resources are factored in, and as performance of the second loans increase. Currently, the CDFI sees an opportunity in using Neighborhood Stabilization Program (NSP) resources as leverage under a NMTC structure. The organization was successful in obtaining a $90 million NMTC allocation in 2008, which they plan to apply toward such a program. In spite of the obstacles that would need to be overcome in order to develop a feasible program, the Clearinghouse CDFI is optimistic that they will be able to develop an application for NMTCs that can help troubled borrowers and first-time purchasers of single-family homes.

The Rhode Island Statewide Community Land Trust's "Rebuilding Equity and Ownership Fund of Rhode Island"

The Housing Network of Rhode Island has proposed offering NMTCs to investors who own REO properties. These tax credits would allow the investors to sell the properties to the Network's nonprofit affiliate, the Statewide Community Land Trust (SCLT), at a reduced sales price. The SCLT has undertaken a demonstration fund that would purchase up to 10 vacant properties and rehabilitate and sell them to low- or moderate-income homeowners. The demonstration fund does not make use of the NMTCs but is intended to illustrate the strengths of the various partners for bringing the program to scale.

As originally envisioned, the SCLT would leverage the success of the demonstration fund to implement a larger program using the tax credits. The SCLT would create a for-profit Community Development Entity (CDE)—Rhode Island Rebuilding Equity and Ownership Fund (RIREO)—that would raise $20 million in debt and $10 million in equity from up to five banks under the NMTC Program. Because of the revolving nature of the CDE portfolios, the REO Fund should be able to purchase, rehabilitate, and sell more than 1,000 units in the state over the seven-year period of NMTC eligibility. Participating community development corporations would be able to purchase vacant properties from the investors in the RIREO and borrow acquisition funds and rehabilitation funds from the RIREO at low rates.

The effort was initiated and funded by NeighborWorks America and developed by them and several private-sector experts in discussion with staff of the CDFI Fund.

However, the Housing Network has tabled the proposal for the time being because of the challenges getting all the parties together for a statewide effort, the fluctuating economic position of the target banks, and the difficulty in securing properties that needed to be aligned with the target banks. The group is instead going with a program involving three CDCs and one lender that holds a large amount of REOs in the state, Fannie Mae. But as Fannie Mae is not in a position to find NMTC attractive, this option is not being pursued right now.

Key Issues

Our interviews identified several potential barriers to using the NMTC Program to promote neighborhood stabilization. Below we highlight the most frequently cited issues. The first three pertain to the requirements and/or limitations of the NMTC Program. The others pertain to current conditions in the housing and financial markets.

1. The difficulty obtaining a NMTC allocation. Some organizations are reluctant to invest the time and effort needed up front to develop a viable model for using the NMTC Program to address neighborhood stabilization in light of concerns that they may not be able to obtain an allocation from the CDFI Fund or be able find current allocatees willing to use their allocations for nontraditional uses.

2. The need to secure a strong pipeline of deals and a solid exit strategy for those deals. Under the NMTC Program, any return of capital needs to be redeployed within 12 months. Therefore, partnerships must include organizations with strong capacity for identifying properties for purchase and rehabilitation, as well organizations with a strong capacity to identify and educate potential homeowners and connect them with affordable financing.

3. The need to combine the NMTCs with other subsidies in the cases where groups intend to purchase foreclosed properties. While the NMTC Program can help offset the costs organizations would incur for purchasing and reselling foreclosed properties, in many scenarios the tax credits may not be sufficient and would need to be supplemented with other subsidies.

4. Current appetite for tax credits, given bank losses. Banks are large users of NMTCs, and many NMTC transactions are dependent upon these institutions' demand for tax credits. At present, there is a lot of uncertainty over banks' appetite for these tax credits in the near to medium term, in light of recent financial losses at these institutions. The consolidation in this sector may be an even a bigger issue, as some of the formerly large players in the NMTC market will not exist in 2009.

5. The impact of housing market trends on project goals. A further downslide in housing prices or a prolonged slump in housing prices could hamper the ability of projects to meet production and sales goals and/or adversely impact organizations' ability to redeploy funds.

6. The impact of housing market trends and tightened credit on the ability to refinance distressed borrowers. Many mortgage refinancing programs rely on lenders' willingness to undertake principal write-downs and/or modify existing loans in other ways. As of November 2008, the Hope for Homeowners program (part of the Housing and Economic Recovery Act of 2008 passed by Congress)—designed to help homeowners by encouraging lenders to voluntarily write down loan principal—has had lighter volume than anticipated. Lenders largely view write-downs as harming the net present value to end investors and so assert that the contracts that govern mortgage-backed securities do not allow for such write-downs. Moreover, many homeowners have taken out a second lien on their property; second lien holders have to consent to principal write-downs and so far have been slow to do so. In addition, tighter credit standards are impacting the ability of potential new homeowners to acquire mortgages.

7. The holding costs of rehabilitating foreclosed properties. These costs, including property taxes and utility bills, go up the longer properties stay vacant. Any financing vehicle needs to account for these holding costs and have a clear exit strategy to minimize its holding time.

Conclusion

In our interviews, community development practitioners suggested several areas for policy action that could facilitate the use of NMTCs for promoting neighborhood stabilization. Some groups are advocating for changes to the NMTC Program itself. A number have suggested legislation that would create

a separate, additional allocation of tax credits that would be used for the purchase, rehabilitation, and resale of foreclosed properties in low-income areas. Clearinghouse CDFI believes there is an opportunity for clarification about whether the tax credits can be used to refinance mortgages, where this is intended to help families who might otherwise face foreclosure. Many groups have also lamented the complexity of navigating the NMTC Program requirements. Some of the organizations interviewed for this article suggested that there would be value in bringing together stakeholders from various sectors including the public sector, investors, and community development groups, for targeted conversations on how to use the NMTC Program to help neighborhoods that are facing high levels of foreclosure.

Interviews

Colin Bloch, Consultant, BlochWorks
Douglas J. Bystry, President & CEO, Clearinghouse CDFI
Linda Davenport, formerly the Deputy Director of Policy and Programs, the CDFI Fund
Carla Dickstein, Vice President for Research and Policy Development, Coastal Enterprises Inc.
Ray Neirinckx, Coordinator, State of Rhode Island Housing Resources Commission
Alazne Solis, Vice President, Public Policy, Enterprise Community Partners Inc.
Charlie Spies, Managing Director, CEI Capital Management LLC
Charles D. Tansey, Senior Advisor, Office of the Chief Executive Officer, NeighborWorks America
Joseph A. Wesolowski, Senior Vice President, Structured Finance, Enterprise Community Investment Inc.

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New Markets Tax Credits and Single Family Foreclosure Crisis Prevention. Clearinghouse CDFI.
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The Rebuilding Equity and Ownership Fund of Rhode Island. NeighborWorks America.

Endnotes

[1] Source: The CDFI Fund (http://www.cdfifund.gov) and Coastal Enterprises Inc. (http://www.ceimaine.org).

[2] Clearinghouse CDFI received feedback from the IRS indicating that a rescue loan product may constitute a "refinance" and therefore may not be allowable under the current NMTC Program. The CDFI will seek additional clarification on this point while continuing to pursue both the rescue loan product and financing for first-time homebuyers.

Massachusetts' Efforts to Address Foreclosed Properties

Prabal Chakrabarti, Federal Reserve Bank of Boston

The growing number of troubled mortgages in New England poses challenges for local communities. As foreclosures mount, so do the number of vacant homes, given that most properties that do not sell at auction remain in the hands of the foreclosing lender. These foreclosed properties, known as lender-owned or real-estate-owned (REO) properties, present an obstacle to preserving healthy neighborhoods.

The negative spillover effects of lender-owned properties on housing values in the surrounding neighborhood have been well documented, notably by Dan Immergluck and Geoff Smith.[1] Other problems connected to rising foreclosures include municipal tax revenue losses, higher crime rates, and general social disruption.

There are clear public benefits to preventing foreclosures, but efforts to do so have been slow and complicated. Some borrowers would be able to remain in their homes with a moderate change to the terms of their loan, but the steep fall in house prices and the rising delinquency rates mean some foreclosures are inevitable. As of late 2008, there was no government or private sector program mitigating foreclosures in any substantial way.

For borrowers who are unable to afford their property even with a reasonable loan modification, the best solution may be to help them transition to rental housing. Then, to preserve the neighborhood, the best solution would be to find a new buyer for the property. However, the weak housing market has resulted in light demand for foreclosed properties at a price that is acceptable to the selling party, the lender. Federal Reserve Bank of Boston economist Paul Willen looked at nearly 20 years of property data from the Massachusetts Registry of Deeds and found that lenders find it much more difficult to sell foreclosed property when the market is down, especially in low-to-moderate income areas. Another recent study on foreclosure sales by Campbell, Giglio, and Pathak found that these properties eventually sell at a substantial price discount, about 32 percent less than the prevailing market value. The longer they take to sell, the bigger the discount.

Foreclosed properties sell at a discount for a number of reasons. They tend to be in greater need of rehabilitation; they are at greater risk of having a title problem or an unpaid lien; and in general there is more uncertainty about their condition. The sellers (often absentee sellers) also tend to be anxious to be rid of the property and its holding costs. Because of this, foreclosed properties may be more attractive to speculators looking to turn a quick profit without undertaking necessary repairs.

States and municipalities know they must respond quickly. But the question is how best to do so. This article aims to help answer this question by highlighting the response in Massachusetts—including the creation of a foreclosed property task force, a revolving loan fund, and an online database of foreclosed properties open to nonprofits and municipalities working to stabilize neighborhoods—as a potential model for other states. I describe these efforts and discuss some of the obstacles and recent trends facing the state.

The Massachusetts Response

Massachusetts had three advantages that allowed it to recognize the magnitude of the foreclosure problem early on and address it quickly. The first is the recent history of a housing market downturn.

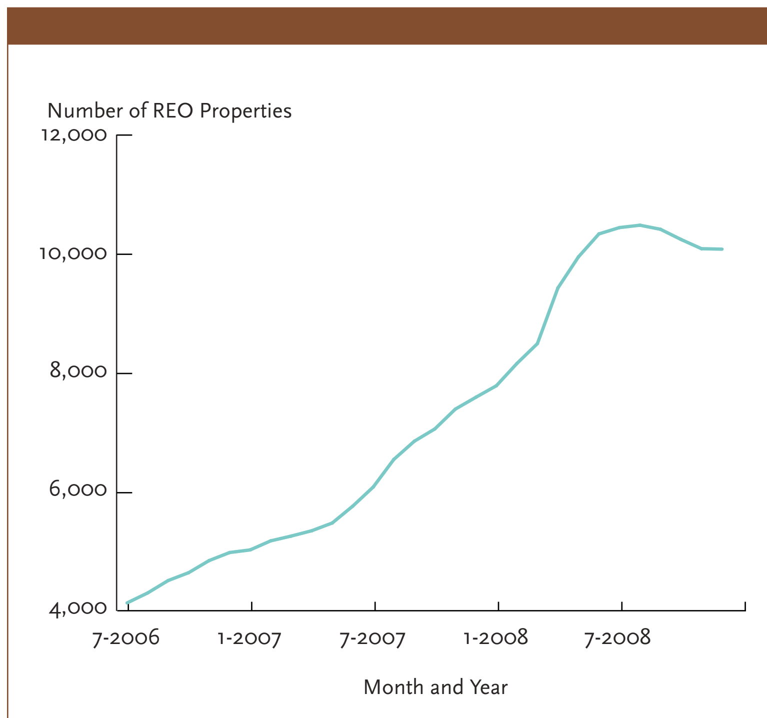
Affordable housing developers, municipal leaders, and others remember the sharp housing downturn in New England during the economic recession and rash of banking failures in the early 1990s. The rise in foreclosures and the associated blight and even arson caused community advocates to remark at the time that the situation threatened to undo the progress the community development field had made over the previous two decades.

Second, to date the fall in housing prices in Massachusetts has not been as steep as in the most hard-hit areas like Florida, California, and Nevada. Nor has the economic situation been as dire as that of the auto-manufacturing regions now facing large-scale unemployment—Ohio and Michigan, for example.

The Commonwealth's other advantage has been the collaborative nature of its nonprofits and public agencies. As groups began to understand the scale of the problem, many looked for opportunities to share knowledge and resources. One result of these efforts was the Mortgage Summit task force convened in November 2006 by the Massachusetts Division of Banks.

The group was set up to inform a larger state process involving other state agencies, the attorney general, the mayor of Boston, and state legislators. The collaboration eventually resulted in the 2007 Act Protecting and Preserving Homeownership, which strengthened consumer protections in the mortgage market. The act included measures aimed at providing relief to borrowers, such as a 90-day Right to Cure provision. This provision provides a statutory right to cure for holders of a residential mortgage and protects the borrower from being required to pay charges or fees related to the exercise of this right, including any attorney fees charged by the lender. The main purpose of the provision is to allow the borrower time to pursue a loan modification, short sale, or other means of preventing foreclosure. Other measures of the act—such as restrictions on the use of subprime adjustable rate mortgages and a requirement that brokers be licensed—were aimed at preventing future abuses.

Figure 1: Massachusetts Real-Estate-Owned Property Count



Source: Paul Willen and Tonja Bowen Bishop, Federal Reserve Bank of Boston

Foreclosed Property Task Force

Though the implementation of the Right to Cure provision in May 2008 slowed the inflow of foreclosed properties into REO stock, foreclosures continue to occur at elevated levels. Figure 1 shows the sharp increase in REO properties since 2006.

Wanting to get ahead of the problem, representatives from affordable housing developers, community groups, municipal and state officials, public and quasi-public agencies, and other parties met at a forum convened by the Massachusetts Association of Community Development Corporations (MACDC), the Urban Land Institute, and the Citizens' Housing and Planning Authority (CHAPA). At the meeting, a Foreclosed Property task force was initiated, with funding provided by the Massachusetts Housing Partnership and the Boston Foundation. The task force sought participation from a variety of stakeholders.

The task force split into five subcommittees, each of which was tasked with addressing different aspects of foreclosed properties. The first subcommittee sought to identify sources of financing for acquiring properties, including public and private subsidies. The second explored techniques and mechanisms for acquiring properties from lenders. The third examined the holding costs incurred in the period between

the time a property is acquired and the time it is sold or otherwise transferred. The fourth looked at exit strategies, including converting housing into rental units, land banking, sales to new homebuyers, and even demolition; the final, related subcommittee sought ways to match homebuyers to foreclosed properties.

Throughout, the task force prioritized certain test communities like Chelsea and Lawrence, which were already in the process of acquiring or seeking to acquire properties. These cities and towns served as test cases for implementation, providing information that was fed back into the design process. The work of the task force gave participants a deeper understanding of the acquisition process and resulted in specific work products. These findings and outcomes were laid out in a final report by CHAPA.[2] I present some of the key points here.

The report shared emerging practices, provided estimations of holding costs and property taxes, and outlined models of exit strategies, including a receivership model used in Worcester. It also highlighted a major accomplishment for the task force, which was the establishment of a $20 million revolving loan fund designed to facilitate the purchase of foreclosed properties by municipalities, nonprofits, or even for-profit developers. As much as $17 million of the funding was pledged by the Massachusetts Housing Investment Corporation (MHIC), a public agency, and the Massachusetts Housing Partnership (MHP), a quasi-public organization. The Boston Foundation, the Hyams Foundation, and Living Cities pledged funds to cover some of the "soft" costs of the effort, such as predevelopment costs.

One oft-cited problem in trying to purchase a foreclosed property was dealing with the new owner of the property, typically the servicer of the foreclosed borrower. Finding out that a property had been foreclosed upon, determining the new holder of the title, and then finding good contact information for the owner was difficult. Many nonprofits reported difficulty finding someone within a firm that had knowledge of the organization's REO portfolio. Often, servicers had outsourced REO sales to another company yet kept some control over the decision-making process.

Finally, task force participants initially found that an underlying difference in judgment about the value of foreclosed properties in these neighborhoods slowed the process. Sellers had yet to come down sufficiently in price to match buyer expectations, given the severity of the market decline and the likely rehab costs.[3] Appraisals were also difficult as they depend on the eventual use of the property. More recently, nonprofits have now begun to report successful purchases of foreclosed properties.

Some task force members—nonprofits and certain cities—wished to purchase a pool of properties held by a single servicer in their community. This would allow for economies of scale and ideally a lower price per property resulting from a bulk sale. But as of this writing, there were no such successful bulk sales in Massachusetts.

Creation of Online Database of Foreclosed Properties

Several task force members reported that they subscribed to data from the Warren Group, a real estate information provider, which provides weekly updates of data for foreclosed properties based on records filed with the state Registry of Deeds. CHAPA and several members of the task force began working with a consultant to create an online database with enhanced tracking tools that many nonprofits and municipalities could use, with monthly subscriptions starting at $40 per month. CHAPA entered into a licensing agreement with the Warren Group to purchase statewide foreclosure data. The database includes the following information:

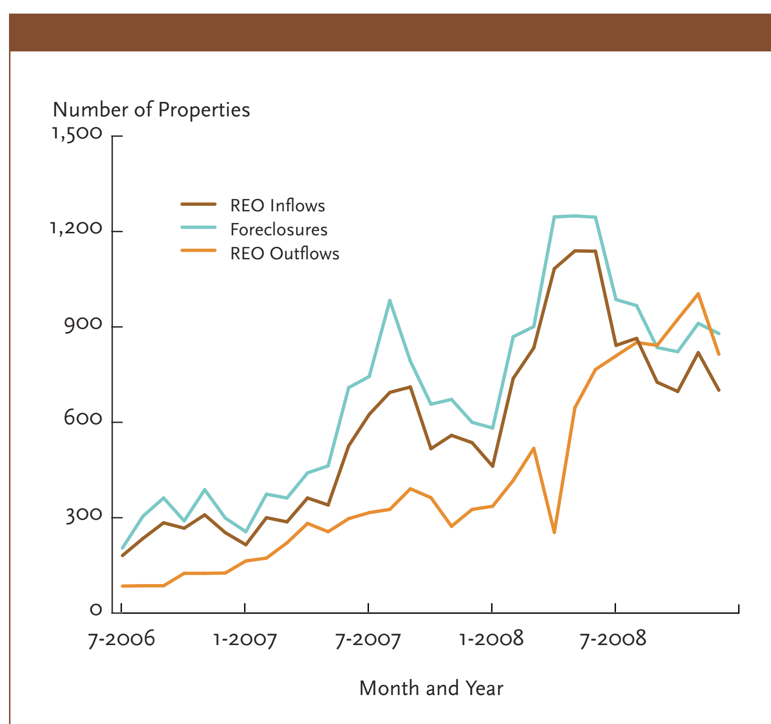
- Property address
- Current state in the foreclosure process (REO status and whether initial notice has been given, auction conducted, and deed issued)
- Information about the property including square footage, number of units, number of rooms
- Tax lien status and other data

Users of the database are able to target specific neighborhoods within municipalities and map properties, download and save property information, and enter in additional fields and notes unique to each user. Overall, the effort allows for both a unified subscription to the data and for data updates and mapping tools that many nonprofits do not have capacity to compile in-house. The site was unveiled by CHAPA in October 2008 on the CHAPA web site at www.chapa.org.

Since the initial release, the tool has already undergone a number of improvements. Besides searching by street name, there are now more ways to target geographic areas—for example, by ZIP code or census tract. Some limited information can be exported to spreadsheet software.

The web site subscription is open to all organizations that have at least one employee who is a CHAPA member. As of January 2009, there were roughly 30 subscribers, including nonprofits, municipal offices, state agencies, and a handful of private developers. Recent improvements should mean that more cities and towns find the online tool useful.

Figure 2: Massachusetts Foreclosure Property Flows



Source: Paul Willen and Tonja Bowen Bishop, Federal Reserve Bank of Boston

The web site has the potential to support purchases of foreclosures by local entities, but also could give municipal services like fire departments, police, and code enforcers a way to keep tabs on foreclosed properties in their neighborhoods. For keeping neighborhoods stable, aggressive code enforcement in some places may be more effective than purchasing foreclosed properties. It is also likely to be cost-effective.

Recent trends

There are preliminary signs that REO sales are now occurring. Figure 2 shows the build-up of the REO stock in Massachusetts, breaking out the data into two categories—inflows and outflows.

Inflows occur when a foreclosed property does not sell at auction. Outflows occur when a lender-owned property is sold to an outside party. As shown, the number of REOs flowing into the stock is unabated as more troubled borrowers lose their homes. But the rise in outflows shows that although lenders typically buy the property back at auction, some sales out of REO are occurring.

This is also borne out anecdotally by activity among applications to the revolving loan fund, which has grown to $23 million with additional contributions. As of November 2008, the fund had approved applications for roughly 100 units by nonprofit community development corporations (CDCs).[4] While most of the units had not yet been purchased by nonprofits, in some cases CDCs have successfully purchased REO properties.

With the allocation of $4 billion in federal funds through the Housing and Economic Recovery Act, additional money should begin to flow as early as February 2009 from the U.S. Department of Housing and Urban Development through states to organizations for the purpose of redeveloping foreclosed properties. Massachusetts has been allocated roughly $53 million. Some of this funding will go directly to municipalities; most will go to the state to be administered by the Department of Housing and Community Development.

Conclusion

Both the task force recommendations and the online database should aid the decision making of nonprofits, towns, and cities as they grapple with foreclosure. In a paper recently released by the Federal Reserve Bank of Philadelphia, visiting scholar Allan Mallach laid out a set of principles to guide the use of the Housing and Economic Recovery Act money. The federal funds can be used for purchases, down-payment assistance, and counseling for buyers of foreclosed properties, land banking, and other uses. Mallach counsels groups to plan strategically so as to avoid inefficiencies, which would harm the chances of receiving future monies for neighborhood stabilization. This argument, combined with groups' knowledge of the neighborhood distress that occurred during previous downturns, should be incentive enough to get them to use the funds wisely. The practice of sharing information and resources, along with the availability of the online database, will help in Massachusetts.

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[1]For a literature review of the price-depressing spillover effects of foreclosures, see Kai-yan Lee (2008).

[2]Massachusetts *Foreclosed Properties Task Force: A Report on Its Accomplishments, Recommendations for Next Steps and Lessons for Addressing Future Crises*. Citizens' Housing and Planning Association, September 2008.

[3]It is too early to tell whether this difference in valuation represents fundamental differences in opinion between buyers and sellers and will persist over time. One possible explanation is that nonprofits have a different set of considerations than for-profit buyers—they may expect to renovate to a higher standard of rehabilitation or want to fill the property faster—and so need to leave more room in the purchase price to allow for these preferences.

[4]According to Nancy Blueweiss at the Massachusetts Housing Partnership, citing data from Bruce Ehrlich at the Massachusetts Housing Investment Corporation.

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