Nonprofit Strategies for Returning REO Properties to Effective Use[1]

by Daniel Fleischman

Real-estate-owned (REO) and vacant homes resulting from the economic crisis continue to destabilize low- and moderate-income neighborhoods across the country. Nonprofit organizations that seek to redevelop these properties face myriad challenges. The lenders and servicers responsible for REO disposition are difficult to access, for example, and may be unwilling to negotiate lower sales prices. Furthermore, many REOs require substantial rehabilitation, and the overwhelming volume of foreclosures affects the resale value of redeveloped housing.

This paper presents a range of strategies that nonprofit organizations can utilize to address REO and vacant properties.[2] The paper emphasizes the conditions necessary for REO redevelopment and discusses how several factors—including local market conditions; REOs' geographic distribution, physical characteristics, ownership, and legal status; organizational capacity; and public policies—affect the efforts of nonprofits to acquire, rehabilitate, sell, and rent REO properties. Finally, given the unique circumstances of the current housing crisis, the paper outlines several alternative, non-redevelopment strategies that many nonprofits may choose to pursue.

Nonprofit approaches to REO or vacant homes can be divided into two broad categories: *redevelopment strategies* and *non-redevelopment strategies.* Organizations engaged in the former acquire, rehabilitate, and repurpose vacant properties into affordable for-sale, for-rent, or rent-to-own housing. Those taking the latter approach either facilitate the redevelopment of vacant housing by responsible buyers or attempt to stabilize and maintain vacant properties. Each strategy entails different financial resources, internal capacity, and exposure to risk.

All successful nonprofit strategies for REOs, whether redevelopment or non-redevelopment in nature, begin with an understanding of neighborhood housing demand and the market for redeveloped housing. Redevelopment strategies are often most appropriate in intermediate, warm-market neighborhoods, defined for the purpose of this paper as areas in which housing demand has declined but is expected to rebound. In hotter neighborhoods—areas with high home prices and strong demand—nonprofits may not be able compete for properties; moreover, nonprofit redevelopment may be unnecessary in these neighborhoods due to the presence of private homebuyers. Colder neighborhoods, too, may be unsuitable for redevelopment strategies. In these areas, characterized by high levels of vacancies, heavily deteriorated buildings, and low demand for rental and for-sale housing, redevelopment may be risky because resale values are low. Instead of taking approaches that involve redevelopment, nonprofits that operate in hot- and cold-market neighborhoods may choose to pursue one or several of the non-redevelopment strategies described in this report.[3]

In addition to market conditions, nonprofits should also account for complications related to acquisition, as well as the existence of any policies or funding that support specific REO strategies. Nonprofits must also consider internal capacity as it relates to REO redevelopment. Although the U.S. Department of Housing and Urban Development's Neighborhood

Acquiring properties through short sales also poses substantial challenges to a CDC.

Stabilization Program (NSP) and other governmental and private efforts provide financial support for REO redevelopment activities, nonprofits should be wary of expanding their redevelopment efforts during the current period of market volatility.

Redevelopment Strategies

For-sale housing.[4] For both practical and ideological reasons, many community development corporations (CDCs) prioritize the development of for-sale housing over rental and rent-to-own properties.[5] According to a recent survey, for-sale housing was the preferred strategy of 69 percent of nonprofits engaged in property redevelopment.[6] The federal first-time homebuyer tax credit and historically low mortgage rates provide further impetus to nonprofits' efforts to develop housing for sale to responsible homeowners.

In neighborhoods with concentrated foreclosures, however, the development of for-sale housing is risky. Capacity constraints prevent most CDCs from redeveloping enough vacant homes to reverse the decline of neighborhood home values, which jeopardize the resale value of each individual property. To ensure that resale value will exceed acquisition and rehab costs, nonprofit organizations should target property acquisition geographically within the context of larger public and private community stabilization efforts.

Rental housing.[7] A CDC may wish to redevelop one- to four-unit REOs into rental housing for several reasons. First, the neighborhood may exhibit weak demand for for-sale housing, making rental housing the only viable redevelopment strategy. Second, a CDC may determine that the addition of well-maintained rental properties will address a neighborhood housing need. Finally, a CDC may choose to develop rental housing according to the building typology of the REO. Two- to four-unit rental properties, for example, are particularly susceptible to speculative and absentee ownership. By developing and managing these properties, a CDC can help keep them out of the wrong hands and mitigate neighborhood instability.

Nonprofits that redevelop REOs into rental housing face substantial property management challenges. Results from a 1995 survey of property owners indicate that less than 40 percent of one- to four-unit property owners turned a profit in the previous year.[8] One approach to helping ensure profitability is to concentrate properties geographically and standardize building specifications. In this way, nonprofits can reduce the management costs associated with this type of housing.[9]

Lease–purchase housing. In a third strategy, lease–purchase, the nonprofit agrees to rent a home to a tenant for a period of time, after which the tenant purchases the home from the nonprofit. A successful example of this approach is that of the Cleveland Housing Network, which has employed the Low Income Housing Tax Credit (LIHTC) to develop lease–purchase homes and stabilize low-income neighborhoods in Cleveland. As potential homeowners experience difficulty obtaining financing, and more homes continue to sit vacant for longer periods of time, nonprofits may increasingly turn to lease–purchase as a means of redeveloping REOs or selling properties for which they cannot find conventional buyers.

Barriers to implementing a successful lease–purchase program include the challenge of shepherding long-time renters toward homeownership, a process that, if unsuccessful, can leave the nonprofit with vacancies and turnover expenses while it finds new program participants. Furthermore, development financing for lease–purchase is complex. For instance, nonprofits that wish to utilize the LIHTC for development financing must comply with the 15-year rental period required before they sell the property to the tenant.[10] Furthermore, conventional financing may not be available for this complex disposition strategy. For these reasons, many CDCs avoid lease–purchase and develop only for-sale or for-rent housing.

Overcoming Acquisition Challenges

The disposition strategies described above assume a property's potential for redevelopment and an organization's ability to undertake such redevelopment. Complications related to REO acquisition, however, can derail the best-intentioned efforts to redevelop otherwise suitable properties. Despite increased pressure and financial incentives for lenders to sell properties to mission-driven organizations, acquisition remains one of the greatest challenges for nonprofits seeking to redevelop REOs into affordable housing.

Nonprofits that wish to acquire REOs face several barriers. First, lenders and servicers that hold REOs can be difficult to access and may not have the authority to lower sale prices due to fiduciary obligations to investors in mortgage-backed securities. In addition, while some lenders list their inventory of REO properties on the Internet, the sales themselves are typically facilitated by local brokers who may not be interested in negotiating discounted prices for nonprofit buyers. Complex legal issues compound these difficulties. If the mortgage has been securitized, the lenders and servicers themselves may not be certain which party is responsible for disposition. If liens on the property have been sold to a third-party investor, or if the cost of liens exceeds the resale value of the property, municipal intervention may be necessary to clear the title prior to acquisition.[11]

Many of the challenges nonprofits face in acquiring REOs can be addressed only with governmental or large-scale, institutional assistance. The National Community Stabilization Trust, a national nonprofit, is one such organization that helps facilitate the transfer of properties from servicers to nonprofits. Through its "First Look" program, the Trust negotiates with servicers to offer cities and nonprofits an opportunity to purchase REOs before the properties are listed on the open market.[12] Local nonprofits may also wish to explore the following strategies to expedite their acquisition of REO properties.

Bulk-Purchase Strategies

Strategies that involve bulk purchases of REO properties enable both lenders and purchasers to avoid the inefficiencies and higher costs associated with piecemeal, retail-level REO sales. Through a bulk purchase, the nonprofit may get a discounted sale price on a portfolio of properties while acquiring a critical mass for redevelopment. This strategy may also enable the purchaser to subsidize the rehabilitation of deteriorated homes with profits generated from sales of more intact homes.

In March of 2009, the nonprofit Housing and Neighborhood Development Services, Inc. (HANDS), based in Orange, New Jersey, pioneered an innovative strategy to address the problems of neighborhoods affected by foreclosures. It purchased a bundle of 47 mortgages that comprised a single portfolio of fraudulent mortgages, then conducted or oversaw a thorough physical inspection, title search, and market appraisal for each home, assigning one of five exit strategies to each according to the property's location, resale value, and physical condition. HANDS also enlisted six CDCs to assist with redevelopment, worked with local municipalities to ensure that the redeveloped properties are affordable, and negotiated flexible financing from both local and national mission-driven lenders to fund this effort. (In this publication, see also "The Community Asset Preservation Corporation: A New Approach to Community Revitalization," by Harold Simon.)

More often, unfortunately, the properties held by a lender or servicer do not lend themselves to bulk packaging in this manner. The fact that the 47 mortgages acquired by HANDS were tied to a single lending scam became a key point of leverage that enabled the organization to acquire the entire portfolio at a discounted price from the servicer which, by then, had been taken over by the FDIC. Moreover, the mortgages had not been securitized, which enabled HANDS to acquire the properties with relative legal ease, unaffected by the barriers typically confronted when purchasing securitized mortgages.

For these reasons, HANDS' bulk acquisition is the product of unique conditions and is not easily replicable.

Furthermore, capacity is likely to be a constraint for most CDCs that wish to execute bulk purchases. Few CDCs have the resources to acquire and redevelop a portfolio of properties large enough to warrant a meaningful price reduction from lenders. For this reason, bulk purchase strategies are more frequently initiated by local governments and special-purpose entities. In 2008, HANDS helped establish the Community Asset Preservation Corporation, a special-purpose nonprofit, to help purchase REO properties in bulk, then to triage and systematically dispose of them to responsible developers.[13] In a similar manner, local governments may be able to purchase bulk properties for disposition to nonprofit developers by using NSP or other funding.[14]

Short Sales

Short sales involve what the name implies—selling short, or at a price lower than the seller desires. The difficulty lies in finding sellers with something to gain through a short sale. If a nonprofit is able to identify a mortgagor at risk of default, it can attempt to execute a short sale to acquire the property prior to foreclosure. In such an arrangement, the mortgagor sells the home to the nonprofit for less than the value of the mortgage, and the mortgage holder agrees to forgive all or some of the remaining balance of the loan. The mortgage holder's loss is typically less than what a foreclosure would cost, hence its incentive to engage in such a transaction. For its part, a CDC achieves the twin objectives of helping a distressed borrower avoid foreclosure while acquiring a property for redevelopment.

Acquiring properties through short sales also poses substantial challenges to a CDC. First, short sale opportunities are not typically advertised and may be difficult to identify. Furthermore, investor–owners in some hot and warm markets are likely to outbid CDCs for short sale properties, and mortgage servicers may not be willing to offer discounted properties to nonprofits. One source of assistance is a mission-driven mortgage brokerage, which can help a nonprofit identify and purchase properties at risk of foreclosure. NHS Realty, for example, a mission-driven brokerage established by Neighborhood Housing Services of New York City, helps facilitate the sale of distressed properties to responsible buyers.[15]

Non-redevelopment Strategies

Nonprofits that pursue a non-redevelopment strategy for REO properties typically do so for a couple of reasons. First, redevelopment may be infeasible because of weak market conditions, the legal status of the property, or the capacity of the nonprofit. Second, redevelopment may simply be unnecessary, due to the presence of responsible purchasers of REO properties. When redevelopment is infeasible, the CDC may attempt to mitigate the negative neighborhood impact of REO properties by promoting code enforcement, land banking, and/or demolition. When redevelopment is unnecessary, the CDC may serve to facilitate the sale of REO properties to a responsible third party. Mitigation and facilitation strategies can each be used as a primary approach to REOs or as a complement to redevelopment activity.

Code enforcement. Code enforcement strategies respond to the failure of some lenders to adequately maintain vacant REO properties. Many cities have enacted vacant property ordinances to encourage lenders to maintain their properties. While local government provides the muscle behind code enforcement, nonprofit community organizations can participate by documenting instances of property neglect and advocating for increased governmental action.

Receivership laws provide municipalities with a more aggressive means of confronting negligent property owners. Through receivership, the city places a lien on a deteriorated property and appoints a receiver to execute the necessary rehabilitation work. A receivership lien, like a tax lien, supersedes all other claims to the property, including the mortgage. In this way, receivership forces the lender to either pay the lien or sell the home to a party willing to carry out the terms of the lien. CDCs with strong community standing have utilized threat of receivership to acquire properties from delinquent servicers and other absentee owners.

Land banking. Land banks are chartered by state governments to acquire, triage, and dispose of vacant properties. While most land banks focus on tax-delinquent or nuisance properties, they may also be permitted to acquire REOs for demolition or disposition to qualified developers. Additionally, some land banks have responded to the growing number of vacant homes by providing management services for properties acquired by nonprofit developers. In 2008, the Fulton County/City of Atlanta Land Bank introduced a program wherein a nonprofit can transfer a property to the land bank for up to three years if the nonprofit cannot redevelop the property immediately. In addition to clearing existing liens on the property, the land bank provides low-cost property management and enables CDCs to purchase available properties quickly and without need for immediate redevelopment. Furthermore, CDCs are not required to pay property taxes for homes held by the land bank.[16] While land banks require state-level enabling legislation and have not typically focused on bank-foreclosed properties in the past, they are an increasingly important resource in cities with large numbers of foreclosures.[17] (In this publication, see also "How Modern Land Banking Can Be Used to Solve REO Acquisition Problems," by Thomas J. Fitzpatrick IV.)

Demolition. Demolition may be the only feasible strategy for REO properties that have little or no reuse potential.[18] Some CDCs and community organizations have worked to maintain or transform vacant lots following the demolition of buildings. Since the mid-1990s, the New Kensington CDC in Philadelphia, in collaboration with the Pennsylvania Horticultural Society, has conducted a "greening" program to address vacant neighborhood lots. The CDC either stabilizes lots by cleaning and planting trees on them, or develops them as community gardens. Side lots are offered for sale to abutting property owners.[19] Where redevelopment is infeasible, this type of strategy can be a low-cost and relatively quick means of transforming pockets of neighborhood blight into community assets.

Mitigation and Facilitation Strategies

Homebuyer financing. Providing financing or subsidies to homebuyers is an effective REO strategy if the lack of mortgage credit, rather than poor neighborhood or property conditions, is the primary impediment to redevelopment. Under such conditions, a nonprofit may establish a mortgage brokerage to provide financing to qualified potential homebuyers. Nonprofit mortgage brokerages work with lending institutions to assemble a pool of subsidized financing for approved low-income buyers. The brokerage typically charges fees to cover its overhead costs.

Dayton's Bluff Neighborhood Housing Services in St. Paul, Minnesota, utilizes a nonprofit mortgage brokerage as part of a comprehensive effort to address neighborhood REO properties. The brokerage provides second mortgage financing of up to 20 percent of the appraised value of homes in qualified neighborhoods. Participating borrowers obtain low-cost financing and avoid the need for private second mortgages or mortgage insurance, either of which might otherwise be necessary due to tight credit standards and declining home values in the Twin Cities. This lending program complements its traditional acquisition and rehabilitation efforts for more deteriorated neighborhood vacant properties. While homebuyer financing programs require specialized capacity and are not appropriate for every nonprofit, this alternative to REO acquisition provides a useful tool for organizations operating in warm-market neighborhoods.

Neighborhood marketing campaigns. Like homebuyer financing strategies, neighborhood marketing campaigns are most effective in relatively stable, warm-market neighborhoods. In some cities, nonprofits and local government have enhanced marketing efforts to address increased levels of foreclosures and vacancies. The City of Rochester, New York, for example, co-sponsors Home Rochester, a nonprofit initiative that engages local CDCs and contractors to redevelop vacant properties. Rochester City

Many of the challenges nonprofits face in acquiring REOs can only be addressed with governmental or large-scale, institutional assistance.

Table 1
REO Strategy Matrix

Market conditions*	Building typology	Physical condition**	Initial CDC action	Exit strategy
Hot market	Single family	Good	X***	X
		Fair	Homebuyer financing/Acquisition	Sell to homebuyer
		Poor	Acquisition	Sell to homebuyer
	2–4 units	Good	X	X
		Fair	Homebuyer financing/Acquisition	Sell to homebuyer
		Poor	Acquisition	Sell to homebuyer
Warm market	Single family	Good	Homebuyer financing/Acquisition	Sell to homebuyer
		Fair	Consider acquisition	Sell to homebuyer/ Hold as rental/ Lease-purchase
		Poor	Acquisition for strategic properties/Demolition for non-strategic properties	Sell to homebuyer/ Hold as rental/ Lease-purchase
	2–4 units	Good	Consider acquisition	Hold as rental
		Fair	Consider acquisition	Hold as rental
		Poor	Acquisition for strategic properties/Demolition for non-strategic properties	Hold as rental
Cold market	Single family	Good	Acquisition	Hold as rental/Lease-purchase
		Fair	Code enforcement	Advocate for land banking/ Greening strategy
		Poor	Advocate for demolition	
	2–4 units	Good	Consider acquisition	Hold as rental
		Fair	Code enforcement	Advocate for land banking/ Greening strategy
		Poor	Advocate for demolition	

***Market Condition Definitions:**
Hot market: Housing demand outpaces supply, and prices are high; vacant properties are quickly purchased
Warm market: Housing demand has slowed temporarily but is expected to return; vacant properties are eventually purchased
Cold market: Housing demand is weak and is not expected to increase significantly; vacant properties sit for prolonged periods
****Physical Condition Definitions:**
Good: Minimal rehab needed
Fair: Significant rehab needed, but structure is salvageable
Poor: Structure is not salvageable
***X indicates that nonprofit intervention may not be necessary

Living Center, another initiative undertaken by the City, markets neighborhoods and specific home-buying opportunities. Rochester also underwrites the Home Store, a one-stop center administered by the Urban League of Rochester that matches potential buyers with subsidies and provides credit and homebuyer counseling.[20] Together, the three programs help CDCs redevelop, market, and sell properties in target neighborhoods. CDCs operating in neighborhoods with scattered REOs may consider these strategies to increase market activity for vacant properties.

The REO strategies described above, and the conditions under which each may be optimal, are arranged in table 1 in a matrix.[21] The table illustrates the decision-making process and the range of nonprofit interventions for REO properties. For each scenario, an alternative strategy may be possible or preferable.

Conclusion

Several characteristics of the current crisis—including declining home values, the legal status of REOs, and the volume of vacant homes—pose challenges to nonprofit organizations. CDCs accustomed to acquiring tax-delinquent properties or homes at or near the bottom of the market must take into account the unique risks and uncertainties associated with REO properties. Many nonprofits will determine that non-redevelopment strategies, rather than redevelopment strategies, are the more appropriate course of action for most REOs in their communities.

Opportunities for successful redevelopment strategies do exist for nonprofits in relatively stable neighborhoods with sufficient capacity and resources. As states and cities continue to deploy NSP dollars and funding from other sources, nonprofit organizations can exercise their knowledge of local conditions to help identify redevelopment opportunities and partners. While nonprofits can address only a fraction of foreclosures nationwide, they play a critical role at the neighborhood level in low-income communities. By accounting for the risks and opportunities of various redevelopment and non-redevelopment strategies, nonprofits can continue to help move these neighborhoods toward recovery.

Daniel Fleischman *is an affordable housing consultant in New York City. His research on foreclosures and nonprofit organizations has been published by the Joint Center for Housing Studies at Harvard University and by NeighborWorks America. He has been a research fellow at the Joint Center for Housing Studies, and has held positions with an affordable housing developer, an architectural firm, and a nonprofit economic development corporation. Daniel holds a master of urban planning degree from Harvard University and a BA degree in English and American literature summa cum laude from Brandeis University.*

Endnotes

1 An expanded version of this paper, "CDC Strategies for REO Properties: An Analytical Framework," was published in 2009 by the Joint Center for Housing Studies of Harvard University.

2 The REO strategies discussed in this paper are distinct from pre-foreclosure efforts to keep borrowers in their homes.

3 Several cities and consulting groups have developed sophisticated typologies of neighborhood housing demand. See the Reinvestment Fund's typology of Philadelphia neighborhoods and the City of Baltimore's neighborhood typologies described in Alan Mallach, *Bringing Buildings Back: From Abandoned Properties to Community Assets* (New Brunswick, N.J.: Rutgers University Press, 2006), pp. 233–39.

4 For a complete guide to acquisition, rehab, and resale, see "Successful Single-Family Acquisition and Rehabilitation: A Complete Overview of the Skills and Operations Needed to Run a Successful Program" (Columbia, Md.: Enterprise Foundation, 1999).

5 The term "community development corporation" refers to a community-based, nonprofit developer of affordable housing.

6 Daniel Fleischman, "CDC Strategies for REO Properties: An Analytical Framework" (Cambridge, Mass.: Joint Center for Housing Studies of Harvard University, 2009).

7 For a complete guide to scattered-site rental development, see "Developing and Managing Scattered-site Rental Housing: A Complete Overview of the Skills and Finances Needed to Run a Successful Program" (Columbia, Md.: Enterprise Foundation, 2009).

8 Alan Mallach, "Landlords at the Margins: Exploring the Dynamics of the One- to Four-Unit Rental Housing Industry." Prepared for Revisiting Rental Housing: A National Policy Summit, Harvard University, Joint Center for Housing Studies, 2007.

9 For an assessment of scattered-site rental development as a response to the foreclosure crisis, see Ivan Levi,

"Stabilizing Neighborhoods Impacted by Concentrated Foreclosures: Scattered-Site Rental Housing Challenges and Opportunities" (Cambridge, Mass.: NeighborWorks America and the Joint Center for Housing Studies of Harvard University, 2009).

[10]Practically speaking, the use of the Low Income Housing Tax Credit to develop lease-purchase and scattered-site rental housing presents the additional challenges of assembling multiple parcels simultaneously to bundle into a financing package, paying for fixed legal and syndication costs that may be disproportionate to the number of units in the package, and attracting tax-credit buyers willing to invest in these notoriously difficult development models. For these reasons, the use of the tax credit to develop lease-purchase and scatter-site rental housing has been limited. See the publication referenced in note 7 above.

[11]Kermit J. Lind, "The Perfect Storm: An Eyewitness Report from Ground Zero in Cleveland's Neighborhoods," *Journal of Affordable Housing* 17 (3) (Spring 2008): 237–58.

[12]"Purchasing Properties at Scale: Lessons on Acquiring REOs During the Foreclosure Crisis from Pioneering Projects in New Jersey, Phoenix and the Twin Cities," Living Cities case study available at http://www.livingcities.org/innovation/rapid/property-acquisition/.

[13]Morrissy, Patrick, Executive Director, HANDS, Inc., interview by Daniel Fleischman, July 2, 2008.

[14]See Living Cities, cited above.

[15]Kevin McQueen, "Using Mission-Driven Real Estate Brokerage to Mitigate the Impact of Foreclosures" Living Cities case study (2009), available at http://www.livingcities.org/innovation/rapid/brokerage/.

[16]Kevin Duffy, "Property Sits Like Money in the Bank: Affordable Housing Gets Boost from Agency that Holds Foreclosed Buildings Until they can be Developed by Nonprofits," the *Atlanta Journal-Constitution,* August 23, 2008.

[17]For more information on land banks, see Frank S. Alexander, "Land Bank Authorities: A Guide for the Creation and Operation of Local Land Banks" (New York, N.Y.: Local Initiatives Support Coalition, 2005).

[18]Alan Mallach, *Bringing Buildings Back: From Abandoned Buildings to Community Assets* (Montclair, N.J.: National Housing Institute, 2006), includes a decision tree for properties in poor physical condition. Mallach's book is an excellent resource on this issue and on small property rehabilitation in general.

[19]Susan Wachter, "The Determinants of Neighborhood Transformation in Philadelphia: Identification and Analysis: The New Kensington Pilot Study." University of Pennsylvania, Wharton School, 2004.

[20]Mallach, cited above.

[21]Certain factors, such as the legal status of the property, are not represented.