Blueprint for American Prosperity
Unleashing the Potential of a Metropolitan Nation

Stabilizing Communities: A Federal Response to the Secondary Impacts of the Foreclosure Crisis

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

America's Challenge

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

Limitations of Existing Federal Policy

Since the mortgage crisis erupted in 2006, the federal government has played only a limited role in attempting to mitigate its effects on families and communities. The 2008 Neighborhood Stabilization Program (NSP) provided $3.92 billion to state and local governments to acquire and rehabilitate foreclosed or vacant properties, but is too small to have systemic impact. Only the federal government can deliver resources commensurate with the scale of the problem, while helping to address state and local variations in planning and stabilization capacity, market conditions, and legal conditions establishing the ground rules for foreclosures and the means to address them.

A New Federal Approach

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

- Creating a **redesigned and multi-year neighborhood stabilization program** that includes competitive grant awards to support strategic, high-leverage, collaborative projects, while fixing the Neighborhood Stabilization Program enacted in 2008.
- Financing the acquisition of distressed properties via a new federal **Land Banking Entity**, and using it to encourage state reforms that mitigate the impact of foreclosures on families and communities
- Enacting a **targeted tax credit** that assists individual home buying for occupancy in areas destabilized by foreclosures to speed neighborhood housing market recovery
- Developing a **national mortgage and foreclosure database** to aid neighborhood stabilization efforts

America's Challenge

A wave of home mortgage foreclosures that began in 2006 continues to surge, with some analysts projecting that 8 million mortgages will have been lost through foreclosure by the end of 2012. The impacts, while broadly felt across the country, vary in their intensity and character across and within metropolitan markets. In some areas, they compound pre-existing problems of low housing demand and high vacancy rates. The crisis affects not only individual families, but also destabilizes the surrounding communities in which foreclosures occur.

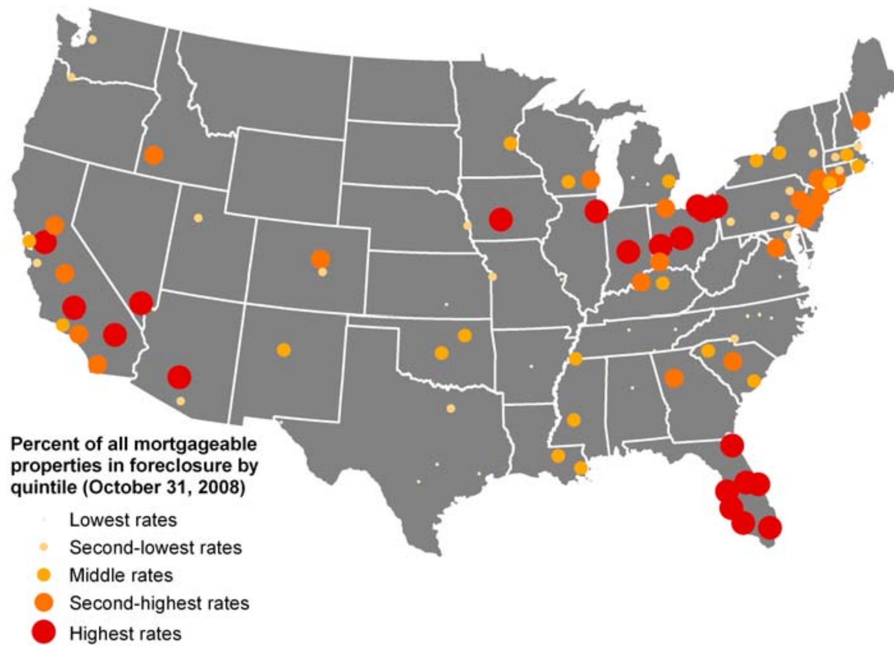
Nationally, housing distress is growing and spreading. Indicators of mortgage distress such as rates of delinquency, foreclosure, and real-estate owned (REO) properties have risen by 200 percent or more in the past two years, according to analysis of McDash Analytics data. While problems originated in the subprime sector, where rates of distress remain much higher, they are rapidly spreading to the prime and "Alt-A" market segments, exacerbated by the continued decline in house prices. Hundreds of billions of dollars in interest rate resets are due to occur on Alt-A and "Option ARM" mortgages in the next few years, and the possibility of a deep recession featuring high unemployment threatens to compound the crisis further.

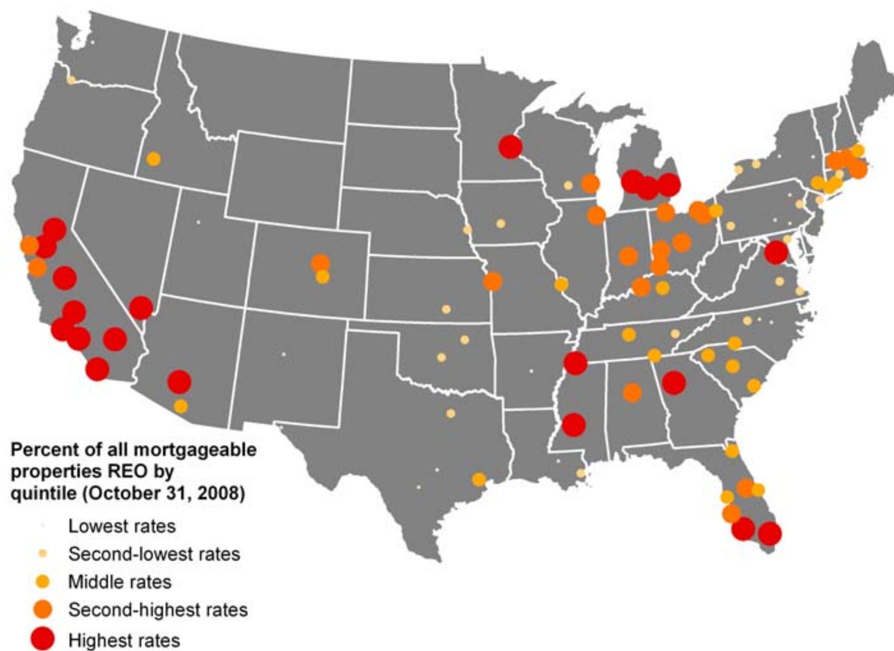
The foreclosure crisis concentrates in metropolitan areas, but varies in intensity and character. Containing 65 percent of the U.S. population, the 100 largest metropolitan areas account for 75 percent of mortgage delinquencies, 77 percent of mortgages in foreclosure, and 78 percent of REO properties. Among metro areas with the highest rates of foreclosure and REO are high-growth markets in Florida, inland California, and the Intermountain West, as well as economically struggling regions in the Midwest (especially Ohio and Michigan). Metro areas also vary in the relative location of the foreclosure crisis, with the problem confined largely to the urban core in places like Cleveland, but highly suburbanized in regions like Washington, D.C.

The crisis has created or exacerbated problems with vacancy and abandonment. In formerly hot markets, high foreclosure rates have created new vacancy problems, while in lower-demand markets, foreclosures and a growing stock of bank-owned properties are exacerbating pre-existing vacancy problems. Here, too, the location of problems varies within metropolitan areas, and creates challenges not just for inner cities like Detroit, but also for smaller suburban communities in metro areas like Atlanta. Efforts to combat vacancy and abandonment are further complicated by variations in state law, with mortgages in "statutory" states typically proceeding to foreclosure sale more quickly than in states that require a judicial foreclosure process.

The crisis exerts negative secondary impacts on properties, neighborhoods, and communities. The secondary effects of the mortgage crisis—its negative economic and social impacts on surrounding areas—arise from the close relationship between foreclosure, disinvestment, vacancy, and abandonment. These impacts include deterioration and loss of value of the foreclosed property; diminished value of nearby properties; elevated crime and destabilized neighborhood conditions; and reduced fiscal capacity of local governments to combat these problems. Estimates of future foreclosures suggest that aggregate secondary costs could eventually be measured in the hundreds of billions, if not trillions, of dollars. The market alone is unlikely to correct the problem in even formerly high-demand Sun Belt markets, suggesting that serious public intervention will be needed to avert potentially devastating losses.

Metro areas with the highest shares of properties in foreclosure and REO can be found throughout the Midwest, Southeast, and the interior West





Source: Brookings analysis of loan performance data from McDash Analytics and housing unit data from the U.S. Census Bureau American Community Survey

Limitations of Existing Federal Policy

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

The impact of federal programs on reducing foreclosures has been modest at best. Although many families have benefited from the federally initiated Hope Now Alliance, it has had little impact on reducing foreclosures because many lenders and servicers lack the capacity to modify loans to provide stressed homeowners with long-term stability of tenure. Growing percentages of modified loans are back in default only months later. Similarly, the HOPE for Homeowners program, under which the Federal Housing Administration (FHA) refinances mortgages for at-risk borrowers, has had no visible effect on a rapidly deteriorating situation. And the Bush Treasury Department failed to use authorities under the Troubled Assets Relief Program (TARP) to provide substantive benefit to homeowners facing foreclosure.

HUD's existing Neighborhood Stabilization Program is not designed nor funded to fully address the secondary impacts of the mortgage crisis. The Housing and Economic Recovery Act of 2008 (HERA) created a program, subsequently dubbed the Neighborhood Stabilization Program (NSP), under which states and selected local governments would receive federal funds to acquire and rehabilitate abandoned or foreclosed properties, and carry out demolition and redevelopment of blighted properties. Flaws in the program's design mean that a significant share of NSP funds may do little to further community stability and market recovery. Moreover, the $3.92 billion appropriated for the program is modest relative to on-the-ground needs, though many jurisdictions may lack the capacity to use even these limited funds strategically.

The federal government has a clear role and responsibility to mitigate the negative community impacts of the foreclosure crisis. The costs of failing to act, in terms of lost property values, asset destruction, neighborhood social and economic deterioration, and the destabilization of local government finances, are far greater than the costs of action. Carefully planned and responsibly executed federal intervention can over time bring a return to the Treasury. Coordinated federal action can help to address significant variation among states, metro areas, cities, and neighborhoods in:

- *Market conditions*, by permitting local jurisdictions to tailor their efforts to their distinct realities, and ensuring that their strategies are grounded in a solid assessment of those conditions

- *Legal conditions*, by using financial resources and regulatory authority to encourage reform of state laws and practices that mediate the impact of foreclosures on cities, towns, and neighborhoods

- *Capacity*, by providing resources and sharing technical expertise to help affected areas where the need is great but the ability to address it is lacking

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A greatly enhanced federal role in addressing the secondary impacts of the mortgage crisis is essential, and must add to, rather than substitute for, significantly stepped-up federal efforts to help families avert foreclosure.

A New Federal Approach

The federal government should play multiple roles to facilitate neighborhood stabilization and recovery in the face of the mortgage foreclosure crisis. These include: providing financial and technical support for neighborhood stabilization activities; purchasing properties and financing property acquisition by local government; creating tax incentives to build market demand by home buyers in neighborhoods destabilized by foreclosures and vacant properties; and providing a vehicle through which a national mortgage and foreclosure data base can be created.

First, a redesigned and multi-year neighborhood stabilization program is needed to facilitate market recovery. Stabilizing and restoring health to communities wracked by the foreclosure crisis is vital to the health of cities and suburbs, and will require a long-term vision to reverse years of rampant defaults, foreclosures, and abandonment. More than simply addressing distressed properties, stabilization strategies will require restoring the confidence of homeowners, through a mix of activities and initiatives that follow from the unique characteristics of each neighborhood. To that end, the federal government should adopt a two-stage approach:

Fix the 2008 Neighborhood Stabilization Program. Both statutory and regulatory problems exist in the way funds have been allocated, and in the constraints placed on their use. While changes to the allocation formula should be made in the context of future commitments, the new administration and Congress should consider making several changes to current program rules, including (among others): (a) reviewing requirements for continued affordability of NSP-funded housing and homebuyer counseling, which may frustrate efforts to achieve market recovery; (b) providing grantees with greater flexibility to use NSP funds for foreclosure prevention and property maintenance; (c) revising restrictions around the sales price of NSP-funded properties and profits derived from the program to provide grantees with greater leverage from the NSP funds.

Enact a modified, ongoing Neighborhood Stabilization Program. A longer-term federal commitment to support neighborhood stabilization efforts at the state and local levels should embrace a more strategic design that focuses on market recovery, facilitates a multifaceted approach, builds capacity, and holds partners accountable for taking complementary actions. In addition to the fixes to the current program described above, critical design elements for a future NSP include:

- **Substantial funds awarded via a competitive process**. Criteria against which applications should be evaluated would include strategic targeting of resources, leveraging of other funds, and formation of partnerships with the private sector or other local jurisdictions

- **Targeting of funds to areas of market potential**. Large amounts of NSP funding may achieve little or no neighborhood stabilization if areas with the most adverse conditions receive funds regardless of their prospects for market recovery (as under the current NSP). To ensure wise expenditure of public dollars, future iterations of the program must address this shortcoming

- **Capacity building through training, technical assistance, and grants**. Many cities, and even more suburban governments or non-profit entities, lack staff with the skills to analyze market conditions and frame targeted neighborhood-scale market recovery strategies. A small percentage of each year's

program appropriation should be dedicated to providing training and technical assistance through qualified contractors, and small grants to cities or non-profit organizations to bolster specific capacity

- **Revised income targeting for NSP-funded housing**. The current NSP requires that all housing created through the program benefit households earning 120 percent or less of area median income (AMI). This ceiling is not low enough to ensure that program beneficiaries are truly in need, but *is* low enough to potentially impede market recovery efforts. Future iterations of the NSP should exclude this requirement, but allow grantees to target rehabilitated units based on income provided such a strategy is consistent with local market recovery plans

Second, the federal government should establish a Land Banking Entity to finance the acquisition of distressed properties. Local and state entities have neither the financial resources nor the potential leverage to carry out large-scale purchases of the hundreds of thousands (if not millions) of mortgages and REO properties locked into problematic situations. A new federal Land Banking Entity (LBE) would serve as the central entity for the acquisition of foreclosed REO properties and mortgages. The LBE would deal directly with mortgage holders and facilitate efforts by local entities to gain control of problem properties. To the extent possible, rather than hold properties, the LBE would pass them through to state and local entities willing to accept them. In addition, the LBE would be the vehicle through which mortgages acquired by the Treasury or the Federal Reserve System are restructured, refinanced, foreclosed, and recycled. Several design considerations for the LBE merit attention:

- *Selecting and pricing properties*. The LBE's pricing policies would be based on the *realistic* net value of the properties to be acquired, and would adopt market-based standards to govern acquisition decisions. It would not, as a rule, acquire properties in areas where market recovery is imminent

- *Motivating mortgage holders*. Regulatory actions to "unlock" problem mortgages held in pooled securities, taken in concert with the establishment of the LBE, would greatly enhance its effectiveness. Options include: an "exit tax" that investors would pay any time a mortgage in a pool is liquidated, waived in the case of transfer to a public program; tax incentives to cover a portion of an investors' "haircut" when assets are sold at a significant discount; amending bankruptcy laws to permit "cram-down" of mortgage principal; and state or local laws that levy fees on lenders to cover the costs imposed by property vacancy

- *Property holding and disposition*. Situations will inevitably arise where it is clearly appropriate, even necessary, for the LBE to take control of properties knowing that it may not be able to dispose of them immediately. The LBE should have a clear plan of action that includes: decentralized management to facilitate on-the-ground decision making; working relationships with capable for-profit and non-profit property managers to maintain the inventory; clear protocols to address management situations; and a focus on the eventual conveyance of properties to suitable local entities

- *State and local action*. Responsible state laws governing foreclosures, evictions and other property-related matters would enhance the impact, cost-effectiveness, and ultimate return of federal investments in stabilizing neighborhoods. A number of provisions in state law (shown below) could be treated as conditions for eligibility for both federal LBE and neighborhood stabilization resources, priority criteria for those resources, or criteria to be used in a competitive process

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

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

Third, a targeted federal tax credit would further stimulate market recovery in areas affected by foreclosures. Because true market recovery requires a broader approach to build demand for housing throughout target areas, tools designed specifically to stimulate homebuyer demand in these areas complement effective neighborhood stabilization efforts. A targeted federal tax credit would assist individuals buying homes for owner-occupancy in areas that have been destabilized by foreclosures and vacant properties, and which are targeted for a neighborhood stabilization effort.

The credit should be available for owner-occupiers only in neighborhoods meeting specific criteria regarding market destabilization and potential. It should offer two tiers of subsidy: one for acquisition (perhaps 10 percent, net of other subsidies), and another for rehabilitation (perhaps 25 percent). The subsidy would be delivered over three to five years, so as to encourage stable ownership. Eligibility for the credit would expire at such time a neighborhood housing market became self-sustaining, as indicated by publicly available data.

Fourth, a national mortgage and foreclosure database would greatly aid neighborhood stabilization planning and execution. A lack of even marginally accurate and complete data on the characteristics of mortgages, or the level and nature of foreclosure activity, poses a recurring challenge for federal, state and local policymakers in their efforts to develop rational strategies to deal with the foreclosure crisis. Much as it has done in areas such as health care and construction, the federal government should establish a national mortgage and foreclosure data base that can provide data disaggregated to the census tract level. Simple reporting at the closing or recording of each mortgage, and by the entity in each state responsible for managing the foreclosure process, would enable such a system. Ultimately, all of these data would be integrated into a web-based system to make detailed, user-friendly small-area data widely available.

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A serious federal financial commitment will be needed to achieve sustainable neighborhood stabilization. A Land Banking Entity would need to be capitalized in the $50 billion to $100 billion range to be effective, but would be offset in part by likely downstream revenues realized by the LBE. A reasonable scale for a restructured, ongoing Neighborhood Stabilization Program might be $10 billion to $15 billion per year. Reasonable assumptions regarding the proposed tax credit program yield an eventual annual cost of $2 billion. And the cost of a national mortgage and foreclosure database would be measured in millions, rather than billions.

Yet given the likelihood of a fairly deep recession, millions more mortgages headed for foreclosure before the crisis passes, and state and local governments severely strapped for cash, the federal government cannot afford *not* to intervene in a strong and sustained way to stabilize neighborhoods, protect assets, and preserve quality of life in our communities. The new administration and Congress will hopefully make the needed investment in this agenda.

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For More Information

The full-length paper from which this brief is drawn is available at
www.blueprintprosperity.org

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