> POLICY BRIEF

Principal Reduction: A Solution to the Housing Crisis in Seattle and Beyond

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Principal Reduction: A Solution to the Housing Crisis in Seattle and Beyond

While the housing crisis may be over for some, residents in many neighborhoods of Seattle continue to feel its effects as they struggle with mortgages that are underwater — that is, worth more than the current value of their homes. When combined with the economic reality that many families now have to make due on less than before the recession, paying more than something is worth is not only dissatisfying, but is often no longer possible. In communities of color that still have high numbers of underwater mortgages, the effects on individuals overflow into the community, keeping entire areas from fully recovering from the recession.

Over 16,500 Seattle families have lost their homes to foreclosure since 2008.[1] More than a third of these foreclosures are in Southeast Seattle, where underwater mortgages disproportionately affect communities of color. Sixteen percent of homes in Delridge, 12 percent of homes in Rainier Valley, and 25 percent of homes in the Pioneer Square/International District are underwater, compared with the predominately white neighborhood of Ravenna where only 6 percent of homes are underwater.[2] Nationally, African American families are 76 percent more likely to be foreclosed upon than white families and among recent borrowers, nearly 8 percent of African Americans and Latinos have been foreclosed upon compared to 4.5 percent of white borrowers,[3] making it likely that the foreclosure crisis that continues in Seattle's communities of color will continue without intervention by the City.

As the City of Seattle seeks ways to help homeowners with underwater mortgages, they should consider who they want to bear the burden of work for such help — homeowners, or the banks requiring them to pay on mortgages that don't reflect the true value of their homes.

OVERVIEW OF OPTIONS

While assisting homeowners directly through housing counseling and community outreach can be an important component of helping families stay in their homes,[4] it continues to put the onus on homeowners to connect with counselors or make sure their bank is giving them accurate information. Rather than putting at least some of the responsibility on banks to proactively work with homeowners to renegotiate underwater mortgages, too often solutions like this leave the banks with little incentive to be good actors.

Other cities around the country are experimenting with the use of eminent domain to seize underwater mortgages from banks; unfortunately, Washington state law makes such a proposal fraught with the potential for serious legal challenges. However, learning from other cities and states across the country, there are other tools that the City of Seattle can use to help homeowners struggling with underwater mortgages without putting additional stress on those homeowners.

Throughout the foreclosure process, there are opportunities for the City to intervene to give banks the incentive to sell underwater mortgages to pre-approved Community Development Financial Institutions (CDFIs), to approve a short sale, or to pursue principal reduction to keep the homeowner in their homes with a mortgage that reflects the current value of the home.

Many other cities are already taking action to give banks the incentive to renegotiate mortgages and work with homeowners to avoid foreclosure, from instituting fees to encourage mediation to issuing fines for blight on foreclosed homes, to releasing reports on banks' actions in the community. Such actions put

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responsibility on banks to act without putting additional pressures on homeowners. Seattle should learn from other cities and lead the way in helping homeowners, without requiring those same stretched homeowners to be the ones who must make change happen. If banks are to truly take some of the responsibility, outreach to homeowners won't be enough.

PROPOSED PROCESS

The City of Seattle should encourage banks to agree to either pursue principal reduction for underwater homeowners, sell underwater mortgages to pre-approved CDFIs that have agreed to reset such mortgages, or approve short sales that could result in homeowners staying in their homes with new mortgages based on the current value of their homes. As most financial institutions are not voluntarily pursuing principal reduction, the City should push for one of the other two options.

CDFIs in other cities have already successfully purchased pools of underwater mortgages from banks and have been able to refinance hundreds of homes with principal reduction. New Jersey Community Capital (NJCC) purchased 399 troubled underwater mortgages in 2012 to refinance the mortgages with principal reduction, and estimates that they could keep up to 600 families in their homes through principal reduction. Additionally, Boston Community Capital (BCC) kept 425 families in Massachusetts through purchasing mortgages at fair market value and selling the homes back to the original homeowner. BCC's program was so successful that it is now expanding to other states. Additionally, National Community Capital, an outgrowth of NJCC, has expanded to other areas and could be an experienced resource for the City.

Another option that has already been used in Oregon is to use short sales to help homeowners obtain a new mortgage. Typically, short sales allow a homeowner to sell a distressed property for less than the principal value on the mortgage, with the agreed upon price going back to the bank rather than to the homeowner. Homeowners typically must find other housing, but do not have a foreclosure impact their credit.

In Oregon, though, the state is using the short sale process to actually help homeowners receive new mortgages on their property. The state purchases the mortgage at short sale from the bank and reissues the mortgage to the same homeowner with a lower principal balance and a fixed interest rate of six percent. Oregon then sells the mortgage to approved financial institutions to service throughout the life of the mortgage. For the homeowner, this means a more affordable monthly mortgage payment, the forgiveness of late fees, a stable interest rate, and the ability to begin building equity in the home again.

Using the following process, the City of Seattle can provide the necessary leverage to encourage major banks to work with CDFIs like National Community Capital to modify mortgages with principal reduction, or to approve short sales that can result in new mortgages for homeowners.

By using a combination of tools, the City can give banks a financial incentive to prevent foreclosure — either through a short sale, voluntary principal reduction, or sale of the mortgage to another financial institution that agrees to pursue principal reduction — and, if foreclosure must occur, to be a responsible lender and a good actor in the community. Additionally, by instituting fees throughout the foreclosure process, the City can regain some of the costs lost to foreclosure to go toward foreclosure prevention efforts as well as help homeowners who have lost their homes.

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THE PROPOSAL IN ACTION

City works with housing counselors to identify homeowners with underwater homes who would benefit from principal reduction.

City and pre-identified Community Development Financial Institution (CDFI) bring approved mortgages to banks holding those mortgages. Give banks offer to voluntarily pursue principal reduction, sell mortgages to CDFI for current market value, or approve short sale. If not, banks will be subject to a tool kit of incentives to prevent foreclosure.

If bank agrees to sell to CDFI or approves short sale ...

CDFI purchases mortgage or home.

CDFI works with homeowner to write new mortgage based on current market value.

HOMEOWNER STAYS IN HOME WITH NEW MORTGAGE

If bank refuses to sell or to allow short sale . . .

City encourages bank to prevent foreclosures through city-approved mediation.

If the bank does not comply, the City implements an accountability toolkit, including fees, fines, and publically available ratings throughout the foreclosure process.

Proceeds from fines and fees will go to foreclosed homeowners and to foreclosure prevention efforts.

ACCOUNTABILITY TOOLKIT

Inclusion of the following tools in a principal reduction program will help the City hold banks accountable by providing leverage that encourages banks to be good actors and prevent foreclosure through principal reduction, and provides a mechanism to ensure such leverage provides relief for underwater homeowners. Each tool includes a specific proposed process and a mechanism for banks that are good actors to see a direct benefit from their actions.

MEDIATION WITH THE EXPLICIT GOAL OF PRINCIPAL REDUCTION

Require banks to meet with pre-approved homeowners, with an approved representative from a CDFI or housing counseling agency present to pursue principal reduction. In this mediation, banks should work with homeowners in good faith to renegotiate mortgages based on current market value and borrower's ability to pay. If financial institutions do not comply — either by not holding the meeting with an approved third party present, or by not negotiating in good faith toward principal reduction or other forms of renegotiation — the City can levy a fine of $5,000 or $300 per day for noncompliance, whichever is greater.

The City is encouraged to model the framework of this separate mediation on an ordinance in Springfield, Mass., which "mandates mediation prior to the lender being able to proceed with a foreclosure. The parties must mediate in good faith and try to come to a "commercially reasonable" foreclosure alternative. If the mediation is conducted this way, the mediator will issue a certificate allowing the foreclosure to proceed."[5] The Springfield ordinance requires that banks be fined $300 per day for noncompliance.

While the state of Washington has a mediation program in place, this requirement could provide for mediation without the $200 fee to the homeowner that is currently part of state law, and would focus on ensuring that financial institutions provide accurate information to borrowers and pursue principal reduction for underwater homeowners, as well as provide the option of renegotiating the mortgage for other borrowers who could reasonably make payments on a renegotiated mortgage.

Note: In legal challenges to the Springfield ordinance, a U.S. District Judge ruled in favor of Springfield's ordinance, ruling that "the purpose for state laws about foreclosure would not be frustrated by the existence of a city-specific program."[6] In Washington, there is already precedent for cities to enact more stringent standards than required by state law. As an example, RCW 70.93 regulates pollution control and littering but does not include any specific regulation of plastic bags, but the City of Seattle passed its own ordinance banning plastic bags in the City. Also, as the Foreclosure Fairness Act mediation is optional rather than a requirement that must be completed before foreclosure can occur, this would not duplicate an existing requirement.

FORECLOSURE IMPACT FEE

Institute a fee of on all foreclosures to address the negative impact of foreclosures on communities. The fee for the first 10 foreclosures in the city by a given financial institution should be $5,000 per foreclosed home, increasing by $5,000 per home for each additional 10 foreclosures in the city annually, up to a maximum fee of $40,000 per foreclosed home. For banks that participate in city-approved mediation, waive the fee for that specific foreclosure, but still include the home in the count of foreclosed homes for that bank to calculate future foreclosure fees.

Foreclosed homes do not only affect homeowners, but affect the cities in which they live. In 2005, it was estimated that each foreclosed home cost a city between $5,000 and $34,000 in inspections, increased public safety calls, and other code enforcement costs.[7] As the Center for Responsible Lending notes, "communities with high concentrations of foreclosures lose tax revenue and incur blight, while homeowners living in close proximity to foreclosures suffer loss of wealth through depreciated home values.[8]"

While no other city has enacted an ordinance to set a specific fee on foreclosures, legislators in California continue to work on passage of a statewide ordinance[9] and the recommendation for local municipalities to find ways to address the cost of foreclosure has been advocated for by a number of policy experts.[10] [11] [12] The City is encouraged to model legislation after the proposed California ordinance, but scaled to a local level.

FIRST-LOOK AFTER AUCTION

For homes that are not sold at auction, encourage financial institutions to allow city-approved CDFI or nonprofit organizations to have a "first look" during the first 14 days after auction, during which only approved organizations can put an offer on the home, and the bank would approve or deny those offers before considering other offers. When banks comply with this, waive the foreclosure fee for that property, but still include the home in the count of foreclosed homes to calculate future foreclosure fees.

The federal department of Housing and Urban Development has a similar program under the Neighborhood Stabilization Program (NSP) that allows NSP grantees to have a first look at properties in areas identified as particularly hard-hit by foreclosures.[13] The goal of the HUD first look program is to "help rebuild neighborhoods that have been struggling with blight and declining home values due to foreclosures" and to help "level the playing field to give communities a better chance to stabilize these neighborhoods.[14]"

A similar city program could allow local nonprofits to purchase property at a slightly discounted value with the explicit purpose of using the home for long-term affordable housing without requiring that the home be part of a block identified by HUD for the NSP. The City of Oakland has set up standards for a similar program building off of the NSP program, which may be useful for implementation in Seattle.[15]

FEE ON SALE TO INVESTMENT FIRMS

Institute fee of $10,000 on foreclosed homes sold to investors or anyone other than an individual homeowner purchasing their primary home, to discourage sale to investors and encourage local homeownership, as sales to investors are more likely to lead to vacancy and blight. If the home is sold to a city-approved CDFI or nonprofit organization through "first look," waive this fee.

While a number of community groups in California are exploring the idea of such a fee, Seattle would be the first city to actually implement one. The fee would help promote local homeownership, contributing to the goals of the City's comprehensive plan. Additionally, it would keep owners local and invested in the community and help address the increased number of homes bought by investment firms from outside of Seattle.[16]

Investors tend to purchase homes to rent, reducing the supply of available homes for potential homeowners to purchase.[17] Firms also often do not hold onto properties for a substantial length of time, creating a potential future housing bubble. Additionally, whereas in the past rental properties were often owned by local investors, the increase in purchases by large investment firms may lead to increased blight and lack of close oversight by firms with few ties to the property or to the community.[18] Investment rental homes often have "substandard remodeling, shoddy maintenance," and lack of good communication.[19]

Homes purchased by investment firms already have a vacancy rate much higher than the national average,[20] which can lead to blight and can lead to low performance for rental-backed securities. Because investment firms are putting thousands of rental properties into rental-backed securities, "if performance falls below a certain level, the *entire portfolio* goes into default, which may also lead to evictions for thousands of renters."[21]

BLIGHT PREVENTION SYSTEM

Set up a foreclosure blight prevention system, requiring financial institutions to register unoccupied foreclosed or REO homes. Financial institutions would pay a fee of $6,000 to register the foreclosed property, after which the city would provide approved inspectors to inspect the property for signs of blight. Financial institutions with foreclosed properties with signs of blight would be fined $1,000 daily after the inspection until the blighted property was brought up to code. For each 10 homes foreclosed by the bank, the daily fine could increase, up to $5,000 per day. When the home is sold to a subsequent purchaser, the $6,000 fee is returned to the financial institution, minus the costs incurred by the city in inspecting and maintaining the property.

Foreclosures often lead to blight, simply as a result of the necessary period of vacancy. As the Tennessee Advisory Commission on Intergovernmental Relations notes, "A vacant home is less likely to be maintained regardless of ownership. … Besides being neglected, some vacant homes are further damaged by vandalism, theft of metal wiring and copper pipes, and arson.[22]"

A number of cities in California have already implemented systems to combat blight, including Los Angeles, Chula Vista, and Oakland, as well as Minneapolis, Minn. The Cities of Oakland and Minneapolis have instituted ordinances that the City of Seattle should use as a guide.[23][24] The Oakland ordinance requires banks to register foreclosed properties when a notice of default is issued, after which banks must inspect monthly whether the property is still occupied. Once the property is vacant, the bank would pay the registration fee and be liable for daily fines for blight. The ordinance has brought in over $1.6 million in fees and penalties to the City of Oakland.[25] The ordinance in Minneapolis has similar requirements, including setting a plan and timetable for returning the building to occupancy or for demolition.[26]

STRENGTHENED RESPONSIBLE BANKING ORDINANCE

Strengthen the City's Responsible Banking Ordinance by explicitly including the number of foreclosures, the number of homeowners who receive principal reduction, and the amount of fees paid on homes through other recommendations in the toolkit within the city as criteria for city contracts, and produce publically available ratings of financial institutions that own mortgages or otherwise operate within the City of Seattle.

While some cities, such as Cleveland, have had Responsible Banking Ordinances for many years, there was a growing surge of interest in ordinances in the wake of the recent recession, with many cities enacting ordinances in 2012.[27] Such ordinances "empower local governments to hold banks accountable and help to ensure that they are investing in our communities in a responsible way."[28] The specific requirements included in these ordinances vary greatly, with some cities including very strict requirements, publicly available reports, and broad consequences, and other cities including vague language with little real impact.

Though the City of Seattle passed a Responsible Banking Ordinance in 2013, it is somewhat weak when compared with ordinances in other cities. Seattle's ordinance requires that banks receive an "Outstanding" Community Reinvestment Act rating, but foreclosure-prevention is only a very small part of the CRA rating process.[29] While the City does require that banks report on loan modifications including principal reduction and on short sales and delinquencies and that banks "participate in outreach and educational opportunities aimed at salvaging distressed mortgages,[30]" there is little information on how this data is actually used. Additionally, the scope of the bill is limited to determining the bank that the City uses as a depository, and reporting only includes "periodic reports to the City Council," with no clear description of those reports or any additional impact they may have.

Strengthening the ordinance to include stronger language on how foreclosure-related records will be used in determining the depository will help the City bring the ordinance in line with ordinances in other cities and put pressure on banks to be good actors. Additionally, by publicly and regularly rating banks by these criteria (and others already included in the ordinance), residents and other businesses in the city will be better able to make smart decisions on which banks to do business with. Expanding the consequences to include any other banking matters in which the City engages would also strengthen the ordinance and put pressure on banks to be good actors in the City of Seattle.

FUND TO HELP UNDERWATER HOMEOWNERS

Create a fund to help underwater homeowners who lose their homes to foreclosure from a portion of the foreclosure fees. For pre-approved homeowners whose homes are sold in foreclosure, 50 percent of the fees paid by the bank for that foreclosure would go to the homeowner. Remaining fees should be dedicated to foreclosure prevention efforts.

Fees to discourage foreclosure can have a twofold purpose: to give banks incentive to help homeowners avoid foreclosure, as well as to provide funds to cities. However, such funds should be directed to efforts to either prevent foreclosure or directly help homeowners, rather than going to the general fund, so that even the fees themselves go toward addressing the foreclosure crisis. In Oakland, funds set aside from those received through its blight prevention program go toward foreclosure prevention activities.[31]

By additionally using some of the funds raised from foreclosure-related fees to help out homeowners, the City can ensure that even if banks do go through with foreclosure, homeowners who would have been helped by principal reduction will see some relief. This would allow the City to still regain some of the cost of foreclosure to use toward foreclosure prevention programs (and all of that cost for foreclosures on homes that are not pre-approved as candidates for principal reduction), but would also help relieve at least some of the financial toll to the former homeowner.

CONCLUSION

While some neighborhoods in Seattle have largely recovered from the foreclosure crisis, the crisis is still very real in neighborhoods like Rainier Valley. The City has the opportunity to help homeowners with underwater mortgages in a way that puts some of the responsibility on the banks, rather than only adding more pressure on homeowners.

Most banks will not willingly pursue principal reduction; if they would, there would not still be so many homeowners in Seattle with underwater mortgages. The City of Seattle should encourage banks to pursue principal reduction, but use financial incentives to put pressure on them to be good actors in our community.

Homeowners in Seattle are still struggling, and it is encouraging that the City of Seattle wants to help; however, more is needed than just outreach and counseling efforts. The City needs to put pressure on banks to take responsibility, not on homeowners who are already stretched to their limit.

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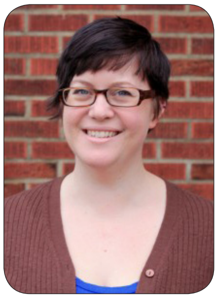

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