Community Perspectives: *Designing Responsive Community Development Investments*

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Since its inception in the late 1990s, the Equity Equivalent (EQ2) financial instrument has provided low-cost, flexible capital to non-profits serving low-income communities across the country. The EQ2 product is a long-term, low-cost unsecured loan that functions like equity. Similar to permanent capital, it enhances a non-profit's financing flexibility, although the investment must eventually be repaid and requires interest payments during its term. Historically, Wells Fargo's two main EQ2 products included a predevelopment EQ2 used by multi-family housing developers and a lending capital EQ2 for CDFIs. However, the recent foreclosure crisis provided an opportunity for Wells Fargo to use the unique, flexible nature of EQ2 capital in a new way, turning the unfortunate situation of a foreclosure into a new homeownership opportunity for a low- to moderate-income (LMI) household. In 2008, Wells Fargo launched the "REO EQ2". This article describes the development process, challenges, and early outcomes of the product, along with lessons learned.

As any lender knows, designing and piloting a new credit product during these tough economic times is not easy, especially if it involves lending in the hardest hit single-family markets in our nation. Despite the challenges, it all came down to the basics: relationships and understanding core credit risks.

First and foremost, we started with relationships. We reached out to non-profit community partners that we had long-standing relationships with and asked what their needs were. Consistently, the loudest message we heard from our partners was that the recently approved federal National Stabilization Program (NSP) had great potential but also had a critical missing link. Through NSP, the federal government provides funding to local non-profits who purchase and rehab foreclosed homes in hard-hit neighborhoods, and then sell them to low-income families. The challenge however, is that most federal NSP funds are disbursed on a "fee for service" or reimbursement basis. As a result, our non-profit partners were faced with the often daunting task of finding upfront cash for the acquisition and rehab work, as they wouldn't be reimbursed by federal NSP dollars until after the project was completed.

From these conversations, we learned that our EQ2 dollars could potentially be that missing link. The REO EQ2 could provide the long-term, low-cost capital to our non-profits who had received NSP contracts to leverage their REO rehab work. The flow of capital would be quite simple. The non-profit would use the flexible, low-cost funds for its upfront cash to buy foreclosed properties. Once it completed the rehab, the non-profit would receive its NSP reimbursement, replenish its REO EQ2 funds, and then redeploy the funds into the next set of homes.

Once we identified the need for the REO EQ2 product, the next step was to demonstrate to our Loan Supervision team that we understood the fundamental credit risks associated with this new product. We started with a close examination of the NSP regulations to understand the compliance risk associated with the program. We then carefully studied the various business models our non-profits used to execute their REO programs. We asked about the entire real estate process: who would find the homes, hammer the nails, and list the homes on MLS. We gathered information on inventory carrying costs and contingency plans for extended sales periods. We also asked the non-profits for current market data that demonstrated they would still have a cushion between their home prices and competing market rate homes even if the market kept dropping. Last but not least, we became fully versed in their customer profiles and pipelines. Ultimately, we needed to know if they could find interested, qualified borrowers in the tight credit markets.

By asking these questions and making sure we understood the inner workings of the REO business model and the NSP landscape, our bank became more comfortable with the idea of a REO EQ2. And in late 2008, we started underwriting our first REO EQ2 borrowers.

One of our first EQ2 borrowers was Tarrant County Housing Partnership (TCHP). Founded in 1991, TCHP is a non-profit located in Fort Worth, TX dedicated to increasing the supply of quality affordable housing for LMI families. Since 1998, TCHP had acquired and rehabbed foreclosed homes in order to sell them to qualified low-income borrowers throughout Tarrant County. When the foreclosure crisis hit, the demand for TCHP's program increased dramatically. Before the crisis, TCHP had developed about five to ten homes a year; after the crisis, there was opportunity to acquire and rehab at least 30 homes a year. And while TCHP had received a $7 million NSP contract, it did not have the upfront cash to buy/rehab homes before it could be reimbursed.

From both a relationship and credit perspective, we felt that TCHP was a great match for the new Wells Fargo REO EQ2. For over ten years, Wells Fargo had worked closely with TCHP on its affordable housing efforts. From operating grants and a working capital line of credit, to Board service and countless volunteer hours rehabbing homes, Wells Fargo fundamentally knew this customer, its financials and its business model. We were comfortable with TCHP's NSP compliance risk given its long track record of complying with other government programs and felt its conservative REO business model was prepared to handle the ups and downs of this recession. TCHP received a $500,000 REO EQ2 from Wells Fargo in 2009 and the results have been impressive:

- TCHP has converted 50 abandoned, vacant houses into new homeownership opportunities for working families.
- All of its families make 85 percent or less of the Area Median Income in Tarrant County, which was $68,250 for a family of four in 2011.
- With new energy star appliances, efficient HVAC systems, and drought tolerant landscaping, these homes are long-term assets in the community.
- While the process has not always been easy (unexpected costs, long sales processes), TCHP has regularly made a small profit of six to ten percent on each property, which it has reinvested into the next home.

To date, Wells Fargo has provided REO EQ2s to non-profits across the country, working in some of the hardest hit neighborhoods, in areas like Phoenix, Arizona, California's Central Valley, rural Colorado, and Charlotte, North Carolina. When we originally launched the product in 2008, we anticipated that it would only be needed for a few years until the foreclosure crisis had passed. However, we recently completed a customer survey of our REO EQ2 borrowers and confirmed that the product is still critically needed to bridge government REO funding sources. In fact, we learned that the product may need to adapt to new developments in the REO financing landscape. For example, in some states, NSP dollars have run out and local government is stepping in with different types of funds. As expected, when we consider redesigning the REO EQ2 to incorporate the new local government money, we will be going back to the basics of relationships and understanding core credit issues. The process of designing successful and responsive community development investments is never static; it regularly challenges us to balance our appetite for credit risk and the changing credit needs of our communities. CI

Endnotes

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Community Perspectives: Designing Responsive Community Development Investments

1. This article reflects the opinions of the author, and not necessarily those of Wells Fargo.

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