FEDERAL RESERVE BANK OF MINNEAPOLIS

Earning income, serving the community: Guidance for building a social enterprise

A description of the important steps nonprofit organizations should follow when creating enterprises to boost their earned income.

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Nonprofit charitable organizations receive contributed and earned income from a complex array of sources. [1/] ***Contributed income*** *comes from individual donors, foundation grants, United Way, and others. Contributors often place restrictions on how the money is used.* ***Earned income****, which allows nonprofits more flexibility and autonomy, is generated from government contracts, third-party payments, and direct fees and charges paid by clients or patrons. Because many types of contributed income come with strings attached, nonprofits are eager to increase the percentage of their total income from earned income.*

Some nonprofits receive earned income through their ongoing, core activities. A nonprofit theater, for example, is expected to generate income from ticket sales. In the past decade or so, more nonprofits have been seeking opportunities to generate earned income from some less expected activities. For example, a theater could increase its earned income by offering acting classes to the public.

When nonprofit organizations adopt entrepreneurial, market-based strategies in order to earn income in support of their missions, the ventures are generally referred to as ***social enterprises****. The creation of social enterprises is a longstanding tradition. For example, in the early 1800s, Sister Elizabeth Seton sold clothing in order to fund her school for impoverished children in Emmitsburg, Md.*[2/] *From its earliest beginnings, the Girl Scouts of the United States of America has sold cookies in order to fund its programs. And then there is the interesting case of the Mueller Macaroni Company, a social enterprise owned by New York University in the 1950s.*

On the surface, social enterprises appear to be purely beneficial. However, there is concern in some circles that promoting social enterprises could undermine the integrity of nonprofit organizations. In the following article, Kate Barr, executive director of Nonprofits Assistance Fund, offers guidance to nonprofit organizations that are considering the idea of social enterprises. Barr describes important steps in building a social enterprise and cautions that without a clear focus on mission and a well-thought-out plan, nonprofits embarking on commercial ventures may fail to maintain their organizational values. Community Dividend

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Nonprofit organizations earn income from a range of activities, including providing health care and educational programs, operating retail stores, performing plays and concerts, and offering training workshops and consulting services. The percentage of total income that a nonprofit generates from these activities is closely tied to the field of service in which the organization operates. According to data from tax returns filed by nonprofit organizations, health care nonprofits may receive 85 percent of their income from fees for services, while environmental, animal, and international service organizations are likely to receive less than 25 percent from earned income.

For nonprofits that want to boost their earned income, establishing a social enterprise may be an appealing option. However, before and after nonprofits dive into new business ventures, there are some important matters they should consider. The following guidelines are intended to encourage thoughtful planning as nonprofits examine the possibilities of social enterprises.

Assess the organization's readiness. Before a nonprofit organization jumps into planning a social enterprise, it's helpful to assess the organization's readiness for the task. Understanding and building market-based activities may require different leadership attributes, management skills, and capacity than the organization's core programs require. To assess its readiness, a nonprofit should conduct an honest evaluation of current board and management skills and capacity, staff composition, external relationships, and financial

condition. Also, the nonprofit should assess whether or not it has a supportive organizational culture. If there is discord among board members, staff members, or key stakeholders, it may be an obstacle to creating a successful social enterprise. The first step in building a successful enterprise is to confirm buy-in before making a commitment.

Choose an enterprise that fits the mission. Over the years, those working in this field have learned that a social enterprise is most likely to succeed if it has a strong connection to the nonprofit's mission. A business activity that advances the mission is likely to attract and maintain commitment from the board, staff, and community and become an important part of the nonprofit's strategic plans. Business activities with a weak connection to the mission can quickly drop from the priority list or become a distraction from the organization's primary purpose.

Identify the opportunity. When starting a social enterprise, a nonprofit should place high priority on finding a bona fide market opportunity. Identifying market opportunities may be difficult for nonprofits, since they operate in an environment that is focused on community need rather than marketplace demand. The distinction is crucial, but it often takes several discussions to sort out. Take one of the examples mentioned in our introduction: A nonprofit theater decides to offer acting classes. Perhaps the students at a local school have limited options for afterschool activities. By offering acting classes, the theater could help meet a community need for quality youth programs. However, the market demand for acting classes is a different question. To determine the market demand, the theater would need to research competing providers of performing arts education, demographics of the prospective students, possible pricing for classes, and costs of delivering the classes.

Nonprofit organizations that are looking for a social enterprise opportunity can start the brainstorming from one of two directions: the demand of the market, or the assets and capability of the organization. Suppose the theater in our example decides to offer lighting- and set-design consultations. The theater may have been asked for technical help for years before recognizing that these requests added up to a market demand. Using the other approach, our theater could conduct an inventory of its assets and capacity and identify that its technical capabilities are assets that can be marketed in a unique way for consulting and training. For both the demand-driven and organizational-asset approaches, a full inventory is a helpful step, followed by market research to identify the most viable and fruitful market-based enterprises.

Address the essential questions. The operational requirements of starting and growing a social enterprise are familiar to anyone who has started a small business or written a business plan. The plan for a social enterprise must address all the questions that are addressed in a typical business plan, in addition to questions of mission fit, organizational structure, and governance. Essential questions for a social enterprise include:

- What is the service or product?
- How well does it align with the mission?
- How much demand is there for it?
- Who is the (paying) customer?
- What is the competition?
- How will the service or product be delivered?
- Who will run the venture?
- How much time, start-up investment, management attention, and other resources will be required?
- What are the full costs of the venture?
- What are the financial prospects?
- What are the risks?

Find sources of capital. All businesses need capital to fund their start-up phase and continuing growth. Owners and shareholders of businesses provide capital through equity investments, personal assets, and loan guarantees. However, since nonprofit enterprises cannot sell equity shares or offer a financial return to investors, they face challenges in attracting capital. Where can nonprofits turn for funding? The most common source of start-up capital for nonprofit enterprises is internal funding from reserves or other activities. Less common sources include one-time start-up grants or long-term, flexible loans from philanthropic sources. Nonprofits may also turn to business loan sources, such as commercial banks or community development financial institutions.

Achieve a "double bottom line." At the outset of building a social enterprise, nonprofits must understand both the financial- and mission-based goals of the venture. This "double bottom line" can be a complex thing to measure and balance. Financially, some social enterprises can grow to become self-sufficient or profitable, with surplus funds generated to support other programs of the organization. Many other enterprises, however, never break even. That doesn't mean the enterprise is a failure, though. From a mission-based perspective, the enterprise may be considered a success if its products or services help strengthen, support, or extend the organization's core activities. The key to measuring the success of a social enterprise lies in how closely the enterprise ties to the mission and how realistic the nonprofit's financial expectations are.

For further guidance on building a social enterprise, contact Kate Barr at kbarr@nonprofitsassistancefund.org or 612-278-7182, or visit www.nonprofitsassistancefund.org.

In November 2008, Nonprofits Assistance Fund and MAP for Nonprofits announced that they will form a Minnesota Social Enterprise Network in 2009. To learn more about this venture, visit http://www.nonprofitsassistancefund.org/news/106/Announcing_the_Social_Enterprise_Network.

A social enterprise sampler

To help generate revenue in support of their core activities, nonprofit organizations have created social enterprises of every category and description. Due to the fragmented nature of the nonprofit sector, determining the total number of social enterprises is a challenge. According to the Directory of Social Enterprises, an online database sponsored by Community Wealth Ventures, Inc., and the Social Enterprise Alliance, there are 28 social enterprises in the Ninth Federal Reserve District. The actual total may be much higher.

The directory's listings include construction companies, retail shops, manufacturers, restaurants, and wholesalers. See below for a sampling of Ninth District enterprises that appear on the list.

Parent Organization	Social Enterprise
Child Care Resources Missoula, Mont. www.childcareresources.org Focus: Provides advocacy and support for child and youth development programs.	**Child Care Training** A provider of certification training for child care professionals.
The Green Institute Minneapolis www.greeninstitute.org Focus: Promotes eco-friendly policies and technologies to improve communities and the environment.	**ReUse Center & Deconstruction Services** A retail business that sells salvaged building materials, including hardwood flooring, lumber, siding, and fixtures.
Project for Pride in Living Minneapolis www.ppl-inc.org Focus: Promotes community and economic development by providing employment training, affordable housing, and human services.	**PPL Shop** A thrift store that sells home and office furniture, building materials, and catalog surplus items.
Ventures Unlimited, Inc. Hayward, Wis. www.justforthebirds.org Focus: Provides job-placement services and life-skills training for developmentally disabled adults.	**Just for the Birds, Inc.** A manufacturer of bird feeders and supplies, including suet balls, birdhouses, and hummingbird and oriole feeders.

1/ As used here, the term *nonprofit charitable organizations* refers to organizations described in Internal Revenue Code section 501(c)(3).

2/ Kathleen D. McCarthy, *American Creed*, University of Chicago Press, 2003.

NeighborWorks America releases report on foreclosure counseling

January 1, 2009

NeighborWorks® America (NWA) has released its first report to Congress about foreclosure activities funded through the National Foreclosure Mitigation Counseling (NFMC) Program. The NFMC Program was among the first federal responses to the nationwide foreclosure crisis. It was created in December 2007 with the passage of the FY 2008 Consolidated Appropriations Bill, which authorized $180 million for foreclosure counseling efforts and named NWA as program administrator.

The report, titled *National Foreclosure Mitigation Counseling Program Congressional Update: Activity through September 15, 2008*, is based on data gathered from 130 foreclosure-mitigation and housing organizations that had received a total of $55 million in NFMC Program grants as of September 15, 2008. In addition to listing statistics about the NFMC Program's activities and funding, the report includes demographic information about the clients who have received foreclosure counseling through the program, descriptions of the challenges foreclosure counselors face in their work with clients and mortgage servicers, and a discussion of successful strategies that counselors employ.

According to the report, as of September 15, 2008, the NFMC Program had provided foreclosure-related counseling to 105,071 homeowners in all 50 states. Of the clients served, 55 percent are female and 30 percent are married with dependents. Nearly two-thirds are ages 35 to 54, while one-fifth of clients are age 55 or older. A majority of the clients—52 percent—are African American, Hispanic, or Asian or Pacific Islander, although these groups make up just 18 percent of all homeowners in the U.S. More than 40 percent of foreclosure counseling clients defaulted on their mortgages because of a loss of income. Only 9 percent defaulted because their loan payment increased. Forty-four percent of clients had adjustable-rate mortgages, or ARMs, and 45 percent had fixed-rate mortgages. In comparison, 22 percent of all mortgages in the U.S. are ARMs and 72 percent are fixed-rate. About 52 percent of clients reported spending more than 40 percent of their household income on housing, while 20 percent reported that their housing payments are more than 75 percent of their household income.

In addition to the $55 million that has been awarded directly to organizations that provide foreclosure-related counseling, the NFMC Program allocated $5 million to NWA to build the skills and capacity of the grant recipients. As of September 15, 2008, the capacity-building funds channeled through NWA had provided scholarships that enabled 2,555 staff members of the 130 grantee organizations to attend foreclosure counseling training. The funds also enabled grantees to hire 1,035 new foreclosure counselors.

To download the report, visit www.nw.org.

Weathering the storm: Community developers in Minnesota face the foreclosure crisis

A close look at foreclosures in Minnesota and the ways communities are addressing the problem, individually and collectively.

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Foreclosure Photo Gallery

A notice of foreclosure doesn't just affect the homeowner who receives it. It erodes the foundation of the entire community. It depletes property values and institutional trust, weakens self-confidence, and leaves a deep mark on personal finances, industry balance sheets, and community stability.

Homeowners in Minnesota have been the recipients of most of the foreclosure notices in the Ninth Federal Reserve District. In 2007, Minnesota experienced more than 20,000 foreclosures—an increase of more than 200 percent over 2005.[1/] Most have been concentrated in the cities of Minneapolis and St. Paul, which have been dramatically affected by the wave of foreclosures and resulting vacancies.

In the hardest-hit parts of the two cities—North Minneapolis and St. Paul's East Side neighborhoods—foreclosures are dismantling neighborhood revitalization efforts by reversing gains in homeownership rates and market values. It's projected that Minnesota will experience an additional 28,000 foreclosures in 2008,[2/] likely resulting in further neighborhood deterioration and destabilization across the state.

During the latter part of 2008, much of the focus of the recovery from foreclosures and the credit crisis was on large-scale, national solutions. Nonetheless, at the neighborhood level, recovery will come house by house and block by block. This article takes a close look at foreclosures in Minnesota, with a focus on North Minneapolis and the East Side of St. Paul, and identifies ways communities are addressing the problem, individually and collectively.

A troubling trend

Historically, most foreclosures have been caused by unexpected events that create economic hardships for homeowners, such as job loss, divorce, or catastrophic illness. Many foreclosures in the current market have been triggered by broader factors, such as mortgage rate resets, low or falling home equity values, real estate flipping, and aggressive marketing of high-cost loans. Neighborhood organizations such as Dayton's Bluff Neighborhood Housing Services (DBNHS) in St. Paul noticed the last trend a number of years ago and thought the future looked grim.

"When we looked at Home Mortgage Disclosure Act data, we could see that there was a lot of subprime lending going on [in the neighborhood] and we could tell this was not going to be a good thing. We first noticed this in 2002 and saw it peak in 2005," recalls Jim Erchul, executive director of DBNHS. According to Erchul, the surge in subprime loans is partly due to the fact that brokers encouraged some people with prime loans to switch to subprime as a means of gaining equity to pay for other bills.

"Some people have done this two or three times," says Erchul. In one instance, brokers convinced a family that had no health insurance to switch to a subprime loan in order to gain equity to pay for their son's medical bills. "They were told closing costs would be $5,000 and they turned out to be $20,000," says Erchul. "They would have been better off just not paying the bill."

The return of blight

Driving through North Minneapolis and St. Paul's East Side, the sight of vacant, foreclosed homes is hard to miss. In some of the hardest-hit areas, no block is untouched. The situation affects not only the families who lose their homes, but also those who remain in the neighborhood. Foreclosures and the large number of real estate owned, or REO, properties they create have contributed to declines in home values. (REO refers to properties that have been taken back through foreclosure and are owned by the lender.) For example, staff at DBNHS estimate that values on the East Side of St. Paul have dropped almost 40 percent from 2007 to 2008. As a result, more homeowners in the neighborhood, regardless of whether their loans are prime or subprime, may now owe more on their mortgages than their homes are worth. As more and more homes are left vacant due to foreclosure, the return of housing blight[3/] may overwhelm some neighborhoods, leading to increased criminal activity and further declines in property values.

However, homeowners are not the only victims in the foreclosure crisis. Renters have also been affected. When a landlord faces foreclosure, tenants often face eviction. According to estimates from staff members of city agencies, approximately 50–60 percent of foreclosures in North Minneapolis and the East Side of St. Paul have been on investor-owned properties. As displaced renters seek out vacancies in the remaining supply of rental housing, they face competition from foreclosed homeowners who have entered the rental market. As a result, many families have found themselves homeless or without quality housing alternatives. According to a national survey conducted by the National Coalition for the Homeless, nearly 61 percent of local and state coalitions for the homeless have seen an increase in homelessness since the foreclosure crisis began.[4/]

A threefold strategy

As the incidence of vacant properties has increased, nonprofit neighborhood organizations and community development corporations (CDCs) have become key players in addressing the negative effects of neighborhood blight. To date, their strategy has been threefold. First, community organizations have identified the owners of individual properties that are in close proximity to current or proposed developments of housing, commercial, or community facilities in the neighborhood, usually in areas where CDCs and others have made considerable investments already. Second, CDCs and other neighborhood-based organizations have stepped up communication and coordination with city code-enforcement agencies to try to make sure that the owners keep their properties properly secured and maintained. Third, these same groups have increased marketing efforts to attract prospective buyers. They promote neighborhood amenities and the fact that housing is now more affordable than in recent years.

In addition, several CDCs, local lenders, and public institutions have begun to develop financing products to help prospective homebuyers purchase properties in certain neighborhoods. For example, the Minneapolis Advantage program is one early effort on the part of the City of Minneapolis to address the concentration of foreclosures and vacant properties. The program provides down payment and closing cost assistance to first-time homebuyers who purchase a home in the McKinley, Folwell, or Webber-Camden neighborhoods in North Minneapolis. The homebuyer receives a $10,000, zero percent interest loan that is forgivable if he or she lives in the house for five years or longer. The city has also used other creative tools to address the problem of foreclosed, vacant properties, including aggressive acquisition; enhanced regulatory tools, such as aggressive inspections enforcement and increased vacant-property fees; legal strategies, including lawsuits that force lenders and servicers to the table to negotiate workouts with borrowers; and campaigns that market neighborhoods to specific groups of potential homebuyers.

"When the housing crisis started, the first thing we did was access data that could give us an accurate assessment of where the foreclosures were and how widespread the problem was," says Tom Streitz, director of housing and policy development for the City of Minneapolis Community Planning and Economic Development Department. "Once we realized the scope, we went to work with a variety of outreach programs." Examples include continuing the Don't Borrow Trouble ad campaign, which spreads the message that help is available to people in foreclosure; using the city's 311 information line to direct people to assistance and counseling; putting informational inserts in utility bills mailed to strategically important areas; and sponsoring housing fairs at which homeowners can talk directly to lenders.

"Counseling and prevention were key in those early days," Streitz continues. "From there, we moved toward intervention by targeting six cluster areas [on the north side], working with the neighbors and select nonprofit and for-profit developers to purchase properties for demolition or for rehabilitation and resale. Working in these clusters enables us to have a strong, visible impact on a community and to hold back blight. Adding incentives for buyers, such as the Minneapolis Advantage—which has been wildly popular—has also had a positive impact in these distressed communities."

Collaborative efforts are under way

As the examples from the City of Minneapolis demonstrate, work is being done to combat foreclosures in some neighborhoods. However, the scope of the foreclosure crisis in Minnesota demands a widespread response from all sectors, including banks, mortgage lenders and servicers, real estate agents, government agencies, nonprofits and CDCs, elected officials, private developers, and community leaders and residents. Recognizing the need for this collaborative, comprehensive approach, key institutions came together in late 2006 and formed the Minnesota Foreclosure Partners Council (MFPC). The goal of the MFPC is to identify, fund, and implement coordinated policies and programs that effectively address the impact that the recent surge in mortgage foreclosures has had on families, neighborhoods, and communities in the Twin Cities region and throughout Minnesota (For more on the MFPC, visit www.ci.minneapolis.mn.us/foreclosure.)

The council's early efforts included ramping up foreclosure prevention counseling and making investments in pilot programs. Interventions and pilot programs already under way include the following.

- The Greater Minnesota Housing Fund, Minnesota Home Ownership Center, Family Housing Fund, and Minnesota Housing have developed a collaborative statewide funding plan to increase foreclosure prevention counseling services, outreach, and tenant assistance. According to its developers, the plan will prevent nearly 5,700 foreclosures by the end of 2008 at a counseling cost of $425 per household. The intervention will save over $2.4 million based on average foreclosure costs to the homeowner and lender (estimated at roughly $57,000 per household).
- With help from the Family Housing Fund, DBNHS in St. Paul and the Greater Metropolitan Housing Corporation in Minneapolis have developed a contract for deed program that is designed to enable renters to become homeowners in three to five years. The contract for deed is designed to assist individuals who want to be homeowners but are not yet ready for a conventional loan product.
- Through its Building Sustainable Communities initiative, Local Initiatives Support Corporation (LISC) has been working in Duluth and the Twin Cities to engage communities affected by foreclosures and vacant properties. The goal is to ensure that the work being done to address the issue is connected to and not isolated from other community development issues. (For more on the Building Sustainable Communities initiative, see the sidebar below.)

A framework for recovery

In recent months, the MFPC has turned its attention toward neighborhood recovery. Council members have designed a recovery framework that identifies neighborhood-focused strategies and pilot efforts for combating the rising number of vacant and boarded homes. The framework—which is an evolving, collaborative document—also identifies ways to meet homeowners' needs for capital and credit to stave off foreclosures. The framework's developers recognized that prevention and workouts are critical strategies for stemming the flow of foreclosures and promoting community recovery.

The recovery framework has five key principles:

- Strategies must be oriented toward providing incentives that reactivate and redirect the marketplace. *Reactivating* refers to getting conventional lenders to lend to creditworthy borrowers in areas affected by foreclosures, while *redirecting* refers to getting private investors to act with the community's well-being in mind.
- Government and nonprofit institutions have instrumental roles: providing clear and consistent signals to the marketplace regarding what public resources are available to developers and what the expectations are, in terms of community standards for property management and maintenance; taking the lead on "research and development" of new credit products; and filling gaps in markets that are not profitable for, or of interest to, the private sector.
- Unique community circumstances will require a commonly available set of tools and resources, which can be applied locally.
- Strategies must look to the future and build on likely future economic and demographic trends.
- Urgent, yet sustained, effort is needed.

Drawing from these principles, the framework has three main recovery goals:

- Prevent 10,000 foreclosures. The MFPC has identified two main tools for reaching this goal. The first is to provide foreclosure counseling and the second is to develop refinancing loan products and/or provide incentives for private market refinancing.
- Assist 2,850 homebuyers with acquiring mortgages and homeownership counseling. There remains a need for loan products for prospective homebuyers, particularly in neighborhoods where there are concentrations of foreclosures and vacant properties. Pre- and post-purchase counseling and rehab guidance should also be made available to the homebuyers.
- Acquire 4,500 homes, make appropriate improvements to them, and place them back onto the private market. To support distressed neighborhoods, the MFPC has set a goal of acquiring and rehabilitating the homes through a partnership among public agencies and nonprofit and for-profit developers. Disposition may take a variety of forms—including selling homes to owner-

occupants or converting them to quality, scattered-site rental—allowing for a controlled release of properties back onto the marketplace as localized neighborhood housing markets begin to improve.

Perhaps most important, the neighborhood recovery framework has helped prepare Minnesota to take full advantage of federal assistance from the $3.9 billion Housing and Economic Recovery Act. The framework has also positioned Minnesota to pursue creative property-disposition strategies, such as the National Community Stabilization Trust, or NCST. The purpose of the trust is to help local organizations attain properties from lenders and servicers in order to enable their rehabilitation and reuse. In mid-2008, the NCST's sponsors selected Minneapolis-St. Paul as the national pilot site for refining the negotiation and transfer process. (For more on the NCST, see the sidebar below.)

From crisis to opportunity

The correlation between the economic downturn and the housing market is clear. In the words of private developer Chuck Leer of Minneapolis, "The key to economic recovery is the housing market. And housing will not recover until we stem the foreclosure crisis. The dark cloud of foreclosures has fractured neighborhoods, sent prices into a tailspin, and left us all feeling vulnerable. The silver lining for all is an abundant supply of more affordable housing and unprecedented opportunities to revitalize our community. The foundation for recovery will be built on civic ingenuity, hard work, and market solutions. Our task is to turn this crisis of fear into the promise of hope."

There are no easy solutions to the foreclosure crisis and the upheaval it has brought to our communities. The crisis has hit hard, and there is plenty of bad news to go around. But we can also take heart. New ideas, partnerships, and solutions are emerging. The community development industry has over 30 years of experience and ingenuity. This time of unprecedented challenge has created an opportunity for the industry to reexamine its approaches to neighborhood-based revitalization and community development. It has also created an opportunity to collaborate, think holistically, and reposition efforts to develop strong, stable neighborhoods that can weather any future storm.

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Housing partners create national intermediary to address property vacancies

On October 4, 2008, four of America's leading housing and development organizations established a national, nonprofit intermediary that will coordinate the acquisition and transfer of ownership of foreclosed, vacant properties. The new entity, known as the National Community Stabilization Trust (NCST), will connect the holders of foreclosed, vacant, REO* properties with community-based organizations that are working to halt the spread of foreclosures. The ultimate goal of the trust is to promote the revitalization of affected neighborhoods by facilitating the rehabilitation and reuse of vacant homes.

The NCST and its sponsors will focus on four activities:

- Providing an efficient, cost-effective mechanism for transferring foreclosed properties from servicers and investors to local groups;
- Aggregating capital from private and philanthropic sources and providing financing to support community-stabilization efforts;
- Coordinating efforts to develop effective neighborhood-stabilization programs; and
- Serving as a focal point and voice for the housing industry in the arena of foreclosed-property reuse and community stabilization.

Discussions about forming the NCST began in early 2008, when Enterprise Partners, Inc., Housing Partnership Network, Local Initiatives Support Corporation (LISC), and NeighborWorks® America formed a partnership to develop solutions to the problem of home vacancies. The NCST took shape over the summer as the four partners convened a task force of loan servicers, performed data collection to inform the development of business and financial models, and completed a pilot project to confirm the viability of the models. The Office of the Comptroller of the Currency and the Ford and MacArthur Foundations provided support for various stages of the planning and development process. Locally, the NCST has been conducting pilot efforts with the Cities of Minneapolis and St. Paul, Dayton's Bluff Neighborhood Housing Services, the Greater Metropolitan Housing Corporation, and Twin Cities LISC.

To learn more, visit www.stablecommunities.org/taxonomy/term/339/all.

* REO refers to properties that have been taken back through foreclosure and are owned by the lender

LISC initiative takes holistic approach to community development

For more than 20 years, Local Initiatives Support Corporation (LISC) has provided resources to strengthen and sustain neighborhoods across the country. Historically, LISC has concentrated on providing capital investment for real estate development in low-income communities. Recently, in light of the devastation wrought by foreclosures, LISC has identified a need to connect neighborhood recovery to broader efforts.

In LISC's view, community developers and neighborhood organizations are uniquely positioned to broker relationships across sectors such as housing, education, safety, health, jobs, the arts, and more, to help advance a holistic approach to healthier communities. To encourage community development corporations (CDCs) to embrace a broader agenda, LISC has launched an initiative called Building Sustainable Communities.

The initiative weaves together five basic goals:

- Investing in the physical environment;
- Increasing family income and wealth;
- Stimulating economic activity locally and regionally;
- Improving access to quality education; and
- Fostering livable, safe, and healthy environments.

Building Sustainable Communities will form the basis of much of LISC's work over the next three years. The approach involves integrating the work being done on the issues community residents have identified as being important to improving their quality of life. It also elevates the importance of engaging with the community throughout the development process—from issue identification to planning to implementation. Finally, it involves a sense of mutual accountability among residents and community organizations. CDCs remain absolutely central to this approach but, in order for more comprehensive strategies to be employed, other implementation partners need to be engaged as well.

Duluth, Minn., offers an example of LISC's Building Sustainable Communities initiative in action. In Duluth's Hillside neighborhood, a new mixed-income development is emerging on the site of what was once a troubled, 200-unit, barracks-style public housing project. The development, known as Harbor View Hillside Revitalization, is a partnership between the City of Duluth Housing and Redevelopment Authority and The Communities Group, working in cooperation with Duluth LISC. The revitalization will include new housing, a village center, and a mixed-use commercial and residential complex featuring a grocery store. The neighborhood's existing Copeland Community Center will expand to include child care, early learning, after school programs, and a technology training center. There will be new parks, an outdoor softball field and skating rink, and an indoor sports facility.

Building Sustainable Communities is under way in the Twin Cities as well. Twin Cities LISC is playing an important role in a multimillion-dollar neighborhood investment project called Invest Saint Paul. The collaborative project, which is led by the City of St. Paul, will coordinate and focus private and public resources on four St. Paul neighborhoods suffering from disinvestment and foreclosures: Dayton's Bluff, East Side, Frogtown, and North End. Twin Cities LISC is helping coordinate funding efforts, community input, and outreach in two Invest Saint Paul target areas and two additional target areas in Minneapolis. A suburban target area is also emerging.

For more information on LISC, visit www.lisc.org. To learn more about efforts in Duluth and the Twin Cities, click on the Local Offices tab.

Foreclosure Photo Gallery

1/ *Foreclosures in Minnesota: A Report Based on County Sheriff's Sale Data*, HousingLink, April 2008.

2/ Ibid.

3/ Housing blight, broadly defined, refers to housing structures and properties whose physical conditions have deteriorated.

4/ *Foreclosure to Homelessness: The Forgotten Victims of the Subprime Crisis—A National Call to Action*, National Coalition for the Homeless, April 15, 2008.

Fed releases report on concentrated poverty

January 1, 2009

The Community Affairs offices of the Federal Reserve System have released a report that explores how pockets of concentrated poverty develop and why they persist. *The Enduring Challenge of Concentrated Poverty: Case Studies from Communities Across the U.S.* is based on research conducted in 16 high-poverty communities located in various regions of the country. Working in collaboration with the Board of Governors of the Federal Reserve System and the Brookings Institution's Metropolitan Policy Program, Community Affairs staff members from the 12 Federal Reserve Banks conducted on-site interviews and data gathering in the 16 study communities throughout 2006. One of the profiled communities, the Blackfeet Reservation, Montana, is located in the Ninth Federal Reserve District.

For each of the 16 communities, the report contains a detailed case study describing the history, causes, and effects of persistent, concentrated poverty. The report also includes a discussion of the factors that the selected high-poverty communities have in common, such as physical or geographic isolation and profound demographic changes.

To download the report or view an interactive map of the U.S. featuring the 16 study communities, visit www.frbsf.org/cpreport.

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Risks and realities of the contract for deed

While contracts for deed offer some advantages over a traditional mortgage, such as speed and simplicity, they can entail distinct risks for buyers and sellers. This article presents basic facts and features of the contract for deed and offers suggestions for minimizing those risks.

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Article Highlights

- Advantages of contracts for deed: speed, simplicity
- Risks for buyer and seller, particularly buyer
- People of color enter into contracts for deed more often

Because of recent credit tightening, some homebuyers may be less likely to qualify for mortgages than they were just a few years ago. Some financial counselors predict that borrowers with limited options may turn to alternative means of purchasing a home. One such alternative is the *contract for deed*.

In a contract for deed, the purchase of property is financed by the seller rather than a third-party lender such as a commercial bank or credit union. The arrangement can benefit buyers and sellers by extending credit to homebuyers who would not otherwise qualify for a loan. Indeed, public and nonprofit housing advocacy organizations have used the contract for deed as a tool to help low- and moderate-income households attain homeownership.

Nonetheless, this alternative financing mechanism lacks many of the protections afforded borrowers who have traditional mortgages. In addition, these contracts may contain provisions that leave room for abuse and can pose risks and uncertainties for both the buyer and seller. The following article presents basic facts and features of the contract for deed and offers suggestions for minimizing the risks associated with this mortgage substitute.

Facts and features

A contract for deed, also known as a "bond for deed," "land contract," or "installment land contract," is a transaction in which the seller finances the sale of his or her own property. In a contract for deed sale, the buyer agrees to pay the purchase price of the property in monthly installments. The buyer immediately takes possession of the property, often paying little or nothing down, while the seller retains the legal title to the property until the contract is fulfilled. The buyer has the right of occupancy and, in states like Minnesota, the right to claim a homestead property tax exemption. The buyer finances the purchase with assistance from the seller, who retains a security in the property.

The contract for deed is a much faster and less costly transaction to execute than a traditional, purchase-money mortgage. In a typical contract for deed, there are no origination fees, formal applications, or high closing and settlement costs. Another important feature of a contract for deed is that seizure of the property in the event of a default is generally faster and less expensive than seizure in the case of a traditional mortgage. If the buyer defaults on payments in a typical contract for deed, the seller may cancel the contract, resume possession of the property, and keep previous installments paid by the buyer as liquidated damages. Under these

circumstances, the seller can reclaim the property without a foreclosure sale or judicial action. However, laws governing the contract-cancellation process differ from jurisdiction to jurisdiction and the outcome may vary within any one state, depending on the contract terms and the facts of the specific case.

Because the buyer in a contract for deed does not have the same safeguards as those afforded a mortgagor in a purchase-money mortgage, the contract for deed may appear to be essentially a rent-to-own arrangement. However, in a typical contract for deed, the buyer becomes responsible for the obligations of a mortgagor in possession, such as maintaining the property and paying property taxes and casualty insurance. In addition, unless prohibited by the contract, either party may sell his or her interest in the contract.

Speed, simplicity appeal to buyers

Homebuyers may be attracted to a contract for deed purchase for several reasons. This method may be especially appealing to homebuyers who do not qualify for a mortgage, such as people who work cash jobs and are therefore unable to prove their ability to make payments. Since the contract for deed process is significantly shorter than the mortgage-approval process, it may attract buyers who face time constraints or have limited options, such as people who are losing their homes to foreclosure. First-time homebuyers who lack experience in the market or individuals who are wary of traditional financial organizations may also choose a contract for deed because of the relative simplicity of the buying process.

Contracts for deed are a more popular financing alternative among minority homebuyers, most notably Hispanics. According to figures from recent American Housing Surveys, while only 5 percent of all owner-occupied households in the U.S. had contracts for deed in 2005, 9.5 percent of Hispanic owner-occupied households and 7.1 percent of black owner-occupied households across the country used them.[1/] (For more figures on the use of contracts for deed, see the table below.) Though contracts for deed are sometimes referred to as the "poor man's mortgage,"[2/] American Housing Survey results indicate that only 3.9 percent of U.S. households below the poverty line used them in 2005.

However, it is difficult to know exactly how prevalent contracts for deed are, because the nature of these arrangements allows the buyer and seller a degree of anonymity. Despite laws in some states that require the buyers or sellers in all contracts for deed to record the sale in the office of the county recorder or registrar of titles within a specified time period, the sales often go unrecorded due to a lack of financial and legal sophistication on the part of both parties involved in the agreement.

Percentage of Owner-Occupied Households with Contracts for Deed in the U.S.

Household Type	Percentage with Contracts for Deed, by Year		
	2001	2003	2005
All owner-occupied	5.7	5.5	5.0
Non-black, non-Hispanic	5.3	5	4.4
Black	7.7	7.7	7.1
Hispanic	8.3	8.9	9.5
Below poverty line	3.8	3.0	3.9
Elderly (65 years or older)	1.9	2	2.1
Manufactured/mobile home	5.2	7.9	5

Source: American Housing Surveys 2001, 2003, 2005, U.S. Census Bureau.

Historical objections

Before the rise of subprime lending in the 1990s, many buyers who were unable to qualify for traditional financing resorted to contracts for deed. Indeed, for most of the last century, the contract for deed was frequently used as an alternative to a mortgage or deed trust. Today, routine use of contracts for deed persists in some parts of the country. For example, in west central Minnesota, anecdotal information suggests that contracts for deed are a commonly used alternative to mortgages.

Still, some financial counselors and property law scholars regard the contract for deed as a "legal dinosaur"[3/] or an "anomaly,"[4/] and even call for its demise. They assert that the contract for deed has no place in modern property financing, offers no real benefits over the mortgage, and leaves both parties vulnerable to risk and uncertainty.

One major objection to the contract for deed is that it is closely associated with a form of predatory lending that was prevalent from the late 1980s through the 1990s. During this period, some neighborhoods—including those in North Minneapolis—experienced a predatory lending scheme known as *equity stripping*. In an equity-stripping scheme, an investor finds a homeowner facing foreclosure and approaches him or her with an offer to buy the home. After purchasing the home, the investor pays off the debt, sells the home back to the original owner on a contract for deed, and gains the equity from the transaction. Fortunately, these equity-stripping scams have faded from the scene in recent years—largely because homeowners facing foreclosure today have little to no equity for unscrupulous investors to strip.

Another objection to contracts for deed, apart from their association with nefarious equity-stripping scams, is that they have a reputation for offering little legal protection to buyers. Despite gaining home repair and maintenance responsibilities, buyers have limited ownership rights and control over their properties while they make payments to sellers. Buyers gain no rights of redemption through the transaction.

Until several decades ago, U.S. courts routinely enforced the forfeiture clauses of contracts for deed in the event of the buyer's default. For example, if a homebuyer missed a single payment 15 years into a 20-year contract for deed, the seller could cancel the contract and retain the title and all the previous payments, while the buyer would suffer a substantial loss. However, such extreme cases are less common today. While a few courts enforce forfeiture provisions as written, most have become more sympathetic to complaints brought by the defaulting buyer, especially in circumstances where the buyer has already paid a significant portion of the purchase price. Courts today often view the contract for deed as analogous to the mortgage and, consequently, extend mortgagor's protections to the buyer in cases of default.

The risks for buyers

Despite favorable changes in the legal enforcement of forfeitures, contracts for deed pose distinct risks for buyers. One major risk stems from the short time period required to cancel the contract in the event of default. For example, in Minnesota, when a buyer falls behind on payments, the seller can file a Notice of Cancellation of Contract for Deed with the county and serve the buyer with the notice. The buyer has only 60 days from the date of the filing to address the items of default and pay the allowable attorney fees to "reinstate" the contract. This is a short time span in comparison to the six months or more afforded mortgagors who face foreclosure. As a result, a defaulting contract for deed buyer has a much narrower window of time to find a new home and is likely to have limited housing options.

Another major risk for the buyer is the balloon payment. Unlike most traditional mortgages, the majority of contracts for deed are not fully amortized. Instead, the contract is most frequently structured to require monthly payments for a few years, followed by a "balloon payment" that completes payment on the house. To make this balloon payment, the buyer will almost inevitably need to obtain a traditional mortgage. If a buyer is unable to qualify for a mortgage at the time the balloon payment is due, he or she is likely to face cancellation of the contract.

Some buyers enter into contracts for deed with the hope of repairing their credit. They expect to improve their credit profile during the first part of the contract period and then qualify for a loan at the time the balloon payment is due. However, according to Dan Williams of Lutheran Social Services in Duluth, Minn., a contract for deed often does not improve the credit of the buyer because individual sellers typically do not report to credit agencies. The buyer may attempt to use a letter from the seller stating that he or she makes the contract payments on time, but unfortunately, most lenders do not honor such a letter.

Williams warns that unexpected home repair costs may also pose a risk to buyers in a contract for deed. While this risk also applies to buyers who purchase homes through conventional mortgages, it may be greater in the case of homes purchased through contracts for deed, because a seller can execute a contract for deed with limited disclosure about the condition of the property. Minneapolis-based attorney Larry Wertheim explains that in a third-party financed sale, the lender's stringent requirements for title examination, title insurance, and appraisal provide the collateral advantage of disclosure for the buyer. Unless the buyer in a contract for deed has legal assistance or is aware of the need for appraisal and title examination, the transaction may not include these safeguards. In addition, since many homebuyers choose a contract for deed because their weak credit precludes them from obtaining a conventional mortgage, they are unlikely to qualify for loans to finance repairs. Ultimately, defects in the property could increase the chances of the buyer defaulting on payments and losing the home.

Another risk for contract for deed buyers stems from the fact that the seller retains the title to the property during the life of the contract. Since the seller retains the title, he or she may continue to encumber the property with mortgages and liens. The seller is only obligated to convey good title when the purchase price is fully paid and it is time to deliver the title. He or she does not need to have good title at the time the contract is executed nor during the life of the contract. Depending on state law and whether the contract is recorded in a timely manner, the buyer's interest may be junior in priority to these pre- and post-contract encumbrances placed on the property by the seller.

In addition to the problems described above, no two contracts for deed are alike and, according to Cheryl Peterson of Twin Cities Habitat for Humanity, the terms of the agreement are often unclear. The contract for deed is typically a one- to five-page document that includes the amount of the purchase, the interest rate, the monthly payment, and some verbiage regarding cancellation. The documents often do not include a standard arrangement for beginning the cancellation process. This lack of clarity in contracts for deed creates difficulties for financial counselors who give advice to buyers facing forfeiture. According to Peterson, "You can't say, 'If you've seen ten contracts for deed, you've seen them all.' It doesn't make you an expert, because the next ten will all be different."

A tool for promoting homeownership

While the contract for deed may entail a litany of problems in the private market, this alternative financing device has proven to be a promising tool for the public and nonprofit sectors. Some housing funders and developers are using contracts for deed as a means of promoting homeownership for low- to moderate-income households. In particular, Minnesota Housing's **Minnesota Urban and Rural Homesteading Program** (MURL) has utilized contracts for deed as an effective tool to assist hundreds of Minnesotans in achieving sustainable homeownership while stabilizing declining neighborhoods.[5/]

MURL allocates funds to local administrators to rehabilitate deteriorating single-family housing. The rehabilitated homes are then sold to at-risk homebuyers on an interest-free contract for deed. The program defines at-risk homebuyers as those who are "homeless, receiving public assistance or otherwise lacking the ability to meet mortgage underwriting standards for traditional financing."[6/]

The MURL contract for deed requires homebuyers to make a monthly payment equivalent to 25 percent or more of their gross monthly income. (This is generally a good deal, considering that recipients of Section 8 federal housing assistance pay 30 percent of gross monthly income.) The goal of MURL is to allow homebuyers to eventually refinance or pay off the contract for deed and acquire fee simple title. The affordable monthly payments under the contract for deed allow the homebuyer to repair any outstanding credit issues while reducing the principal balance. Once the balance is reduced to a reasonable level, the homebuyer can refinance into a traditional mortgage.

According to a 2008 *Annual Report Summary* from Minnesota Housing, the MURL portfolio includes 350 homes. Over the past year, the default rate was 7.7 percent and the refinance/contract payoff rate was 2.6 percent. In contrast to the 60-day cancellation period in the private market, MURL includes a generous forbearance policy, designed to help the at-risk homebuyer be successful over the long term. It allows flexibility in cases of unforeseen circumstances that limit the homebuyer's short-term ability to pay (e.g., unexpected health issue, short-term loss of employment).

The Family Housing Fund—a nonprofit Twin Cities-based organization—is launching a new program that will also utilize the contract for deed as a tool to create affordable housing opportunities. The new initiative, titled **The Bridge to Success Contract for Deed Program**, launched in fall 2008.

Through this program, the Family Housing Fund made a $500,000 loan to Dayton's Bluff Neighborhood Housing Services (DBNHS) and Greater Metropolitan Housing Corporation (GMHC). These two organizations have a lender commitment—similar to a line of credit—of up to $1 million from a private lender. DBNHS and GMHC will use the funding pools to sell properties on a contract for deed to homebuyers who may not be ready to qualify for a traditional mortgage. The funds from the Family Housing Fund will make up 20 percent of the purchase price, with a balance of 80 percent funded by lenders. This arrangement eliminates the need for private mortgage insurance. Key components of The Bridge to Success Contract for Deed Program are homeownership education and financial counseling to ensure that the buyer is mortgage-ready in three years.[7/]

Advice from the experts

While a contract for deed may have its appeal as an alternative financing device, given the risks involved, buyers and sellers should proceed with caution when entering such an arrangement in the private market. The following advice from the Minnesota Legal Services Coalition stresses that both parties should make an effort to be fully informed.

- First and foremost, the seller must set forth the terms of the contract in a purchase agreement. It is important that both parties fully understand the provisions of the contract, because once the purchase agreement has been signed, the options available to both the seller and buyer are limited.
- The buyer should know whether he or she is responsible for property tax payments and insurance and whether the contract for deed includes a balloon payment. If it does include one, the buyer should be certain that he or she would be eligible for a mortgage to cover the payment when it comes due.
- The buyer should also make sure that the seller is the true owner of the house by checking with the county recorder's office to see who is listed as the registered owner. If the seller still has a mortgage encumbering the property or is responsible for paying the taxes or insurance, the buyer should contact the seller's mortgage company prior to signing the contract to determine whether the seller is current on his or her payments. Some "scam" sellers will retain a buyer's payments and not apply them to the mortgage. If

the seller defaults on the mortgage in this scenario and the home is foreclosed, the buyer will lose the house and all the paid installments.
- The buyer should ask the seller for a Truth in Sale of Housing report to determine the condition of the house. This report is required in Minneapolis and St. Paul and some other cities. In cities where it is not required, the seller should find his or her own inspector to assess the condition of the home.

Finally, according to Wertheim, once the contract for deed is executed, the buyer should record the contract immediately with the county recorder's office or the registrar of titles. While statutes requiring this registration are rarely enforced, recording the contract will help prove the buyer's possession of the property and protect him or her from post-contract encumbrances placed on the property by the seller.

Ensuring a positive outcome

It is important to note that despite their risks and sometimes negative associations, contracts for deed are not intrinsically bad. When used wisely, they can be a good fit for some consumers. Contracts for deed offer a swift, streamlined option for people who do not qualify for traditional mortgages or would prefer not to deal with mortgage lenders. When administered by public agencies or nonprofit housing organizations, contracts for deed can be a tool for building credit, promoting homeownership, and stabilizing neighborhoods.

To protect their interests in contracts for deed, sellers and buyers must do their homework, so to speak, by making sure they learn and understand what specific provisions and risks the contracts entail. Buyers in private contracts for deed should take additional steps. These include assessing the condition of the property, confirming that the seller has clear title, and recording the signed contract at the appropriate government office. By being informed and prepared, the buyer and seller in a contract for deed can help ensure a positive outcome for both parties.

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1/ U.S. Census Bureau.

2/ A. Roy, "Urban Informality," *Journal of the American Planning Association*, 71(2), 2005, pp. 147–158.

3/ J.G. Sprankling, *Understanding Property Law (Second Edition)*, Matthew Bender & Company, Inc., 2007.

4/ Cheryl Peterson, Twin Cities Habitat for Humanity Mortgage Foreclosure Prevention Program. Personal communication, July 2008.

5/ *MURL Program Concept*, Minnesota Housing.

6/ Ibid.

7/ Lowell Yost, Program Director, The Family Housing Fund. E-mail, July 31, 2008.