



September 15, 2011

Mr. Edward J. DeMarco, Acting Director
Federal Housing Finance Agency
1700 G Street, NW
4th Floor
Washington, DC 20552

Re: Federal Housing Finance Agency's Request for Information:
Enterprise/FHA REO Asset Disposition

Dear Mr. DeMarco:

We are pleased to respond to the Federal Housing Finance Agency's Request for Information. The Collingwood Group, LLC is a Washington, DC-based business advisory firm serving companies active in the financial services industry. The firm was founded in 2009 by a number of financial services industry veterans with government and private sector experience through a merger with Capital Financial Solutions, LLC, which was founded in 2007. Today, the firm employs 10-20 professionals and has annual revenues of less than \$10 million dollars. Questions concerning this response should be directed to me at the firm's headquarters at 1700 Pennsylvania Avenue, N.W. Suite 200, Washington, D.C. 20006

Thank you for the opportunity to offer our recommendations to you in connection with this important issue, and we look forward to providing FHFA with whatever insights and assistance it believes would be helpful.

Respectfully,

Brian D. Montgomery
Vice Chairman

1700 Pennsylvania Ave., NW, Suite 200
Washington, DC 20006



The Collingwood Group’s Response to the Federal Housing Finance Agency’s Request for Information: Enterprise/FHA REO Asset Disposition

Type of strategy (check as many as appropriate)	
	Outright purchase
X	Joint-venture
	Rent-and-hold
	Lease-to-own
	Other (specify)

Type of Respondent (check as many as appropriate)	
	Private capital
	Real estate company
	Rental property management
	Asset management
	Nonprofit
X	Other (specify): Business advisory firm

A large number of foreclosures and a protracted foreclosure process have clogged the housing finance system with an unprecedented amount of bank-owned homes, a level that is likely to persist for some time. Despite near-record-low interest rates, credit conditions remain tight for many consumers and investors, particularly individual investors interested in buying residential real estate in their neighborhood(s). This has led to a negative feedback loop where price discovery is limited (bid wanted) and investor uncertainty is persistently intensified.

In response to this dilemma, the Federal Housing Finance Agency (FHFA), in consultation with the U.S. Department of the Treasury and the U.S. Department of Housing and Urban Development (the “Agencies”), have requested input on alternatives that will facilitate the current and future disposition of REO. Specifically, the Agencies seek guidance on how to structure requests for proposals to obtain third-party market participants that have the technical and financial capability to engage in large-scale transactions with Fannie Mae and Freddie Mac (the “Enterprises”) and/or FHA involving the disposition of REO.

In structuring a strategy, the Agencies have put forth the following objectives:

- Improve loss recoveries compared to individual retail REO sales to reduce taxpayer cost;
- Help stabilize neighborhoods and local home values



- Where feasible and appropriate, improve the supply of rental housing.

Given varying levels of illiquidity among individual housing markets, we contend that the Enterprises/FHA can best accomplish their stated objectives by structuring a large-scale asset sale program that aims to attract bulk bids from a diverse group of private investors capable of meeting the localized demands of regional housing markets in a manner that allows the Enterprises/FHA to retain an interest in the assets through a risk-sharing agreement. At the same time, day-to-day management responsibilities must be transferred to expert private-sector professionals who also have a financial interest in, and share in the costs and risks associated with, ownership of the assets.

For example, in the hardest hit localities, where buyer uncertainty is most intense, it would be more appropriate to incentivize long-term ownership through “Rent to Hold” and “Lease to Own” structures. However, in areas where sales comparables are not greatly distorted by an oversupply of distressed assets, the Enterprises/FHA would better meet the stated objective of improving loss recoveries (improve overall execution as the program evolves) by incentivizing bulk investors who intend to “Rehab and Sell” real-estate assets to first-time home buyers and baby-boomers looking to downsize their housing needs.

RECOMMENDATION FOR REO SALES

FDIC/RTC experience demonstrates that structured public/private partnerships can be successfully used as a vehicle to convey a large volume of assets of varying types and quality to private-sector ownership and management in a relatively short period of time by appealing to a diverse group of investors who intend to employ geographically targeted asset disposition approaches.

Applying FDIC/RTC experience to Enterprise/FHA REO

As the strategy applies to the Enterprises/FHA, structured transactions would require *joint ventures or partnerships* between the Enterprises/FHA and private sector entities which are designed to facilitate the disposition and management of distressed real-estate assets.



The Enterprises/FHA make available for bulk sale all one-to-four unit single family homes and condominium REO inventory (properties may be tenant-occupied or vacant at the time of disposition). Program stipulates minimum investment value of \$50 million and caps at \$1 billion.

Relying on well-established Enterprise/FHA pooling mechanisms and newly-established data transparency initiatives, bulk buyers are asked to construct custom REO pools (“*Pick and Choose*”) based on their specific investment objectives.

Once the investor completes the “*Pick and Choose*” process, the Enterprises/FHA forms entity (to date, all LLCs) to which custom REO pool is conveyed. Under the structured transaction partnership program, the Enterprises/FHA act essentially as a passive participant or limited partner (LP), with a private-sector investor who is responsible for managing the assets and acting as the general partner (GP).

In exchange for contributing REO assets, the GP conveys a shared percentage of cash-equity (50/50 split as an example) ownership back to the Enterprise/FHA. The remainder of the purchase price is then financed through issuance of tax-free *Housing Recovery Bonds*. These notes would be issued by the LLC as payment to the Enterprise/FHA for the assets conveyed to the LLC by the Enterprise/FHA.

PRICING METHODOLOGY FOR PURCHASED PROPERTIES

Owner/Seller of Distressed Assets

In attempting to manage the value of a distressed asset, the Enterprises/FHA generally face two options: sell the distressed asset at a deep discount in an illiquid market or expend the energy and resources required to stabilize the asset’s value over the long-term, which may entail several years of effort. Thus, as evidenced by Benveniste, Capozza, Kormendi and Wilhelm in the paper [Contract Design for Problem Asset Disposition](#), the Enterprise/FHA pricing methodology dilemma is then



reduced to determining the net present value of the long-term effort (cost) required to stabilize the prices of its still growing REO inventory. In choosing to sell REO assets today, the Enterprises/FHA must compare the net present value of current market liquidation versus the long-term effort (cost) required to stabilize asset values. Included in this value function is the cost of property maintenance and the assumption that price discovery will continue to deteriorate as new REO inventory is added to Enterprise/FHA portfolios.

Buyer/Asset Manager of Distressed Assets

Price discovery from the buyer's perspective is a function of each buyer's management or disposition strategy. For example, in a "Rent to Hold" strategy, a buyer is likely to base value on the present value of future cash-flows generated from rental income (income approach). In the "Lease to Own" and "Rehab to Sell" strategy, the value function is dependent on a sales comparables approach. Lastly, from a State and Local Government point of view, value could be determined based on the "Cost to Replace" approach. In any scenario, from the buyer's point of view, the pricing function begins with an appraised value and ends with an opportunity cost analysis.

To incentivize and attract greater numbers of private investors, the Enterprises/FHA should be prepared to extend larger price discounts earlier in the asset disposal program. These discounts will be in exchange for commitments from the investors to engage in community reinvestment and neighborhood revitalization initiatives. This represents a short-term Enterprise/FHA (taxpayer) concession but is the most effective method of creating liquidity and putting an end to the negative feedback loop, which in and of itself will progressively improve Enterprise/FHA execution as the program matures.

FINANCING REQUIREMENTS AND STRUCTURES

Amount/level of financing (using Enterprise multi-family guidelines as the benchmark) will be determined based on internal Agency assessment, such that the total amount of the equity-sharing



contract between the Enterprises/FHA and the bulk investor is large enough to cover potential default scenarios.

Equity-Sharing

The Enterprises/FHA would extend equity-sharing arrangements to bulk investors to retain the potential for upside gains. The equity-sharing agreement between the investor and the Enterprises/FHA is based on internal Agency cost/benefit analysis and will evolve as supply/demand conditions improve in the housing market. Initially the Enterprises/FHA should be prepared to extend bulk investors more generous equity-sharing splits (50/50). As time passes and price discovery improves along with the success of the structured transaction program, the Enterprises/FHA will find it easier to increase equity-share requirements on private industry and move towards an auction-style bulk sales model.

Depending on the bulk investor's management/disposal strategy, transactions may also include a provision that provides for a shift in ownership interests once a stated dollar amount of distributions to the Enterprises/FHA, including the sales price received in a sale "Threshold", is reached. The Threshold and the amount by which the percentage interests change is specific to each transaction type and disclosed to bidders prior to the *Housing Recovery Bond* bid date.

Debt Structure

Through a Dutch-auction bidding process, the Enterprise/FHA sells *Housing Recovery Bonds* to the private market. Term structure of *Housing Recovery Bond* is dependent upon the bulk buyer's ultimate management or disposal strategy. The terms of the notes are established and disclosed to bidders prior to the time bids are accepted for the transaction. Some of the notes may amortize over time or require periodic interest payments. For example, for a bulk investor whose asset management strategy is "Rent to Own," cash flows are backed by rental income, after deducting advances for such items as taxes, insurance and property expenses. Other notes might be "zero coupon" or "bullet"



notes because they do not pay periodic interest or require periodic principal payments until the ultimate maturity date. As with U.S. Savings bonds, the balance of these "zero coupon" or "bullet"

notes due at maturity includes interest. These notes must be paid off before the equity owners receive any distributions.

In certain cases, the Agency may make funding facilities and pre-funded accounts available to the LLC to fund construction draws with respect to the assets and working capital needs of the LLC. All advances must be repaid from the cash flow prior to the equity owners receiving any distributions.

REQUIRED ENTERPRISE AND/OR FHA INFRASTRUCTURE AND CAPITAL

The Agencies will rely upon well-established Enterprise pooling mechanisms as a means to construct “Pick and Choose” asset pools. Paramount in this process is the need to evaluate risk at the property-level. Thus, to enhance data quality and promote consistency, the Agencies must put into practice technology that standardizes key appraisal data elements. The Enterprises/FHA will leverage the already implemented [Uniform Mortgage Data Program](#) to meet this requirement.

Enterprise/FHA infrastructure also will be required to facilitate the issuance of the proposed *Housing Recovery Bond*. The Agencies will rely upon well-established Enterprise debt-auction and servicing technology to conduct debt issuance and servicing programs. The Enterprises/FHA will utilize the Uniform Mortgage Data Program to enhance transparency around the terms of the *Housing Recovery Bond* prior to the bid date.

COUNTERPARTY, CREDIT AND OTHER RISKS TO AN ENTERPRISE AND/OR FHA, AND APPROACHES TO MINIMIZE SUCH RISKS AND CONTROL THE RESIDUAL RISKS



In our view, the greatest risk faced by the Enterprises/FHA is an under-subscribed bulk sale program. This would exacerbate the negative feedback loop and further reduce the perceived value of Enterprise/FHA REO assets.

If a “Pick and Choose” bulk sale program were to gain traction, it likely would be the result of aggressive financing options and upfront price discounts. Beyond the political risks embedded in agreeing to short-term price concessions, the Enterprises/FHA face long-term credit and political risk in offering attractive financing terms to bulk investors. Without some form of credit guarantee, investor demand for *Housing Recovery Bonds* is likely to be weak. While a significant equity position ahead of these bonds helps offset this possibility, the FHFA has clearly stated that it has no intention of allowing the Enterprises to increase their exposure to credit risk. However, by removing distressed assets from Enterprise/FHA balance sheets and adding equity through leverage, the Agencies are actually reducing overall Enterprise/FHA retained risk. As price discovery improves along with the success of the structured transaction program, the Enterprises/FHA will find it easier to reduce their equity-sharing requirements and eventually move toward an auction-style bulk sales model.

CONDITIONS AND USAGE RESTRICTIONS THAT CAN BEST ACHIEVE THE STATED OBJECTIVE

To limit the political risk of a few private investors owning a majority of REO properties, the Enterprises/FHA should cap the amount, as a percentage of total assets, that one investor is able to purchase.

SCALE OF PROPOSED TRANSACTIONS AND THE ABILITY TO SCALE UP OVER TIME



As price discovery improves along with the success of the structured transaction program, the Enterprises/FHA will find it easier to increase equity-share requirements on private industry and move towards an auction-style bulk sales model.

TRADEOFFS BETWEEN VARIOUS STRUCTURES AND APPROACHES

The main tradeoff that must be addressed by the Enterprises/FHA is the decision of making short-term concessions to lure in private capital versus doing nothing and “seeing what happens.” What we propose is a leveraged equity-sharing arrangement. The trade-off embedded in our model is the size of the price discount and the percentage of equity sharing offered initially to bulk investors by the Enterprises/FHA. Once assets are purchased by private investors, the use or disposition of those assets will be at the discretion of the buyer’s investment objectives (within the constraints of Agency objectives). However, the Enterprises/FHA can incent investors to support the competing goal of neighborhood stabilization by encouraging management of assets to realize value through utilization of a leveraged equity-sharing structure.

USE OF PROCEEDS FROM CASH FLOWS, OPERATING PROFITS AND LOSSES, GAIN OR LOSS ON PROPERTY DISPOSITION

Once financed debt is paid in full, the Enterprises/FHA will split with GP the remaining proceeds *pro rata*. Enterprise/FHA proceeds should be used to offset any outstanding losses.

Depending on the bulk investor’s management/disposal strategy, equity-sharing arrangements may also include a provision that provides for a shift in ownership interests once a stated dollar amount of distributions to the Enterprises/FHA is reached. The Enterprises/FHA also may make funding facilities and pre-funded accounts available to the LLC to fund construction draws with respect to the assets and working capital needs. All advances must be repaid from the cash flow prior to the equity owners receiving any distributions.



TO THE EXTENT ANY JOINT VENTURE PARTNERSHIPS ARE PROPOSED, HOW FINANCIAL INTERESTS ARE STRUCTURED BETWEEN THE ENTERPRISES/FHA AND THE PRIVATE PARTNERS.

The Enterprises/FHA should extend leveraged equity-sharing arrangements to bulk investors to allow the Enterprises/FHA to retain the potential for upside gains. The equity-sharing agreement between the investor and the Enterprises/FHA is based on internal Agency cost/benefit analysis and will evolve as supply/demand conditions improve in the housing market. Initially, the Enterprises/FHA should be prepared to extend bulk investors more generous equity sharing splits (50/50). As price discovery improves along with the success of the structured transaction program, the Enterprises/FHA will find it easier to increase equity-share requirements on private industry and move towards an auction-style bulk sales model.

PLANNED USE OF PROPERTIES, WITH A FOCUS ON MAXIMIZING RETURNS UNDER STRATEGIES TAILORED TO LOCAL ECONOMIC AND REAL ESTATE CONDITIONS

Once assets are purchased by private investors, the use or disposition of those assets will be at the discretion of the buyer's investment objectives within the constraints of Agency objectives. For example, in the hardest hit localities, where buyer uncertainty is most intense, it would be more appropriate to incentivize long-term ownership through "Rent to Hold" and "Lease to Own" structures. However, in areas where sales comparables are not greatly distorted by an oversupply of distressed assets, the Enterprises/FHA would better meet the stated objective of improving loss recoveries (ultimately improving overall execution as the program evolves) by incentivizing bulk investors who intend to "Rehab and Sell" real-estate assets to first-time home buyers and baby-boomers looking to downsize their housing needs.



STEPS TAKEN TO ENSURE THAT THE PROPERTIES ARE WELL MAINTAINED AND MANAGED DURING THE PERIOD THEY ARE RENTED OR OTHERWISE HELD OFF THE MARKET.

One potential option is for the Enterprises/FHA to partner with municipalities who designate dedicated coordinators or teams to inspect properties. In that scenario, states/municipalities would

focus on aggressive code enforcement and nuisance abatement, as well as making it easier to reclaim properties by amending receivership and eminent domain laws to make them more effective for the current crisis.

Given the large number of REO properties, many of which have been on the market for extended periods, prompt rehabilitation is critical to maintaining a marketable property. HUD and FHA should consider allowing investors to utilize the FHA 203(k) program for the rehabilitation of single family homes. In so doing, FHA can help mitigate any possible risk to the FHA Mutual Mortgage Insurance Fund.

Historically, the FHA 203(k) program has offered a practical solution for those homebuyers looking to purchase a home in need of repair. Despite the program's stated goal of achieving homeownership and rehabilitating the property (within its guidelines) its volume relative to FHA's overall endorsements has been *de minimus*. Proposed guidelines:

- Require a 15% cash investment (down payment);
- Investors would be encouraged to rent the properties to families at or below 80% of AMFI;
- Properties could not be sold for a period of at least two years from the date of purchase;
- Investors could not own any more than 5 properties at any time;
- Owner-occupied buyers would have a minimum first look period of at least 60 days.

This modification would also provide a basis for job creation among the various building trades.