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"Exploiting the American Dream: How Abusive Land Contracts Prey on Vulnerable Homebuyers"

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Good afternoon, Honorable Chairwoman Smith, Ranking Member Lummis, and esteemed members of the Committee, and thank you for the opportunity to testify before you at this important hearing. My name is John Green, and I serve as Managing Principal of Blackstar Stability ("Blackstar"). Blackstar is a real estate investment management company that helps stabilize communities by expanding equitable ownership of affordable single-family homes. We are a private equity fund that changes the lives of working-class families by turning predatory land contracts into real mortgages. We focus on unsubsidized, affordable properties that are less than $100k and often sold through unregulated, predatory instruments. In today's testimony I will share with you two important findings of our work. First, that there is an immense unaddressed problem and second that there are readily available answers.

Blackstar is an investor that purchases pools of homes encumbered by predatory forms of seller financing, converts the financing to traditional mortgages at fair market terms, eventually sells these mortgages and then recycles the capital. In that process, ownership is transferred to families in a transaction that is often life changing. Any equity associated with the property is also transferred at that point, which has increased the average family's net assets by over 20x to date. Any negative equity is absorbed by Blackstar. Monthly principal and interest payments have come down roughly 30% on average, and any lingering penalties and arrearages from previous sellers are extinguished.

Nature of the Problem

Most of Blackstar's acquisition focus is on Contracts for Deed ("CFDs", also known as land contracts) and similar sorts of instruments that confer the obligations of home ownership to buyers without the benefits and take typical landlord obligations and foist them on buyers / tenants. The prevalence of CFDs and similar products reflect a larger problem that nationally, the availability of small-balance mortgages does not meet the demand from qualified buyers. The primary group of families Blackstar serves are seeking to buy small-balance properties (i.e. less than $100k) and tend to have much less access to traditional mortgages than borrowers buying larger properties. Nationally, fewer than 30% of all properties sold for less than $70k are financed with a traditional mortgage.[i]

Notably, the supply deficit of small-balance mortgages is driven much more by the high fixed costs and unfavorable economics of originating these loans than any deficiencies of financial wherewithal or creditworthiness amongst qualified borrowers. The issue disproportionately affects low-income and minority communities that comprise most of the demand for these loans. This problem is exacerbated by the fact that more than 20% of Black and 16% of Hispanic adults are considered "credit-invisible," with either non-existent or unscorable credit profiles[ii] – even when they have been strong, consistent payers of predatory loan products.

Unequal access to traditional mortgages has been a reality throughout US history. The absence of available mortgages gives rise to predatory alternatives like CFDs. This gap has made working class housing markets far less liquid, depressed homeownership, robbed communities of hard-earned equity, and diminished both the capital and incentive to reinvest in those communities. Blackstar believes there are more than $200 billion or 4 million total CFDs in place today, mostly with borrowers who would prefer a traditional mortgage.

Homeownership is a keystone for middle-class families to build generational wealth. Nearly two-thirds of household wealth for middle-income families is comprised by their principal residence. Health outcomes improve for children of homeowners, students who move less often are more successful in school, and the ability to shelter in place became an unexpected necessity in recent years. Black and brown families understand and crave these benefits, but over time have only consistently managed to exchange one set of predations and discriminatory practices for another. Unfortunately, homeownership is the largest driver of the racial wealth gap in the United States[iii], yet few policies advance equitable and inclusive strategies that would result in meaningful progress. While approximately two-thirds of all Americans own their homes, that proportion camouflages a troubling gap where only 45 percent of Black families are homeowners, compared to 74 percent of white families.[iv] Moreover, as owners and buyers, Black and brown families are significantly more likely to have a subprime loan (even if they qualify for a prime mortgage) or another, more predatory form of home financing.

It's not as-if Black and brown families have not sought homeownership despite redlining and other practices. CFDs, which fill the gap left by missing lending products, have existed in a largely unregulated manner in the US for more than one hundred years and dwarf the scale of industries like payday loans and car title loans which are often scrutinized as similarly predatory. These land contracts gained prominence due to the redlining of black communities by programs begun under the New Deal. Passage of some key legislation in the 1960-70s expanded access to mortgages somewhat, though still not equitably. However, a resurgence of CFDs resulted from the Global Financial Crisis. Black families lost their homes to foreclosure at nearly twice the rate of other groups.[v] When a glut of devalued, vacant homes in low- and moderate-income communities needed to be resold, the market reinvigorated an old tactic - CFDs. Fannie Mae and Freddie Mac, freshly bailed out by taxpayers, sold homes in bulk to corporate and individual buyers who tripled or quadrupled the price and quickly resold them to unsophisticated or desperate families, often using CFDs.

Predatory lending products wreak havoc on a family's financial and psychological well-being. What often begins as a hopeful chance to own one's own home almost always ends in unpayable debt on a home that continues to deteriorate around them. By the time Blackstar purchases these CFDs, one of two scenarios has inevitably taken place. Either the family has fallen significantly behind on their payments or despite having diligently paid on time has made almost no progress on their debt. In both cases, the family is often disgruntled and disheartened.

Overview of the Blackstar Solution

Blackstar's focus is to preserve affordable single-family housing, lower the cost of ownership, and keep families in their homes by restructuring distressed debt products and attacking predatory seller-financed, mortgage alternative practices that both undermine value and promote disinvestment in these communities.

Upon acquiring properties encumbered by these types of contracts, the first step is direct conversation to establish rapport and build trust with the family. One critical reason that Blackstar does not charge fees, ask for money up front or impose conversion deadlines is to prove that this opportunity to achieve true homeownership is different. After Blackstar has earned the trust of the borrower many families still need help to adjust to a more normalized relationship with their lender. Some families need budgeting help, some need assistance with repairs and occasionally some need to sell the home that is no longer a good fit for the needs of the family. Blackstar has found that when offered a fair opportunity, a fresh start and ongoing guidance and support, most families are eager and successful in converting to a traditional and equitable lending arrangement.

Blackstar's approach uses scalable, market-driven, common-sense tactics to confront credit invisibility and refinance homes at a lower cost for families who have been solid payers for higher-cost mortgage alternatives. We believe these improved ownership outcomes strike at the core of the racial wealth gap by extension. Blackstar's business model creates a marketplace which brings together:

- **Families** seeking to purchase affordable single-family homes at fair terms (who have often been unable to tap traditional mortgage markets),
- **Financial institutions** seeking CRA-eligible, performing mortgages,
- **Investors** seeking compelling, risk-adjusted returns that drive significant social benefits for low- and moderate-income families through a scalable, market-driven strategy; and
- **Bulk sellers** of existing CFD and substantially similar Lease-to-Own ("LTO") products, who often have limited secondary market disposition opportunities.

Inherent in this support of preserving affordable housing is a strong sustainability thesis. Unlike affordable housing solutions that are generally multifamily rental properties and require significant subsidy, our program helps organically spur reinvestment from families through a financing solution that empowers them. Our approach avoids the functional obsolescence of the homes and helps meet a dramatic supply deficit of affordable housing nationwide.

As a proof of concept, Blackstar acquired a seed portfolio of 181 homes across 18 states, encumbered by CFDs and LTO agreements that reflects the broader opportunity in a 4Q20 transaction and a follow-on acquisition in 3Q21. Blackstar has worked with the existing residents to extinguish the CFDs and LTOs by originating mortgages in a manner that provides residents with outright affordable home ownership. As of June 30, 2023, Blackstar has converted 86 CFDs and LTOs to mortgages, sold 27 vacated properties, and received full payoffs for 10 CFDs. Beyond the strong expected financial returns for this investment, its impacts include:

- **Wealth Creation:** $3.6 million in equity has been transferred to 84 families, or $43,000 per family (a more than 20x increase in their net assets on average)

- **Principal Reduction**: $131,000 in total principal balance reductions has been realized by 12 families, which is a 24% reduction in their outstanding principal balances

- **Payment Reduction**: With respect to the 84 mortgages originated with Blackstar, monthly principal and interest payments have been reduced by 27%, or approximately $122 per month on average

- **Term Reduction:** 26 families reduced the remaining term on their loans by more than 5 years

- **Interest Savings:** Approximately $1 million of projected lifetime interest savings will be realized across 60 families that were previously subjected to predatory CFDs

- **Penalties & Arrearages Forgiven**: Approximately $130,000 of penalty fees, charges, and interest forgiven across 40 families, or approximately $3,250 per family (roughly 3x the average net assets for the families)

Notably, the median household income for the families served was approximately $45,000 per year, which is slightly less than 60% of the Area Median Income in their respective markets.

The need is vast and not well understood. There were more than $300 billion of distressed loans and $200 billion of CFDs and similar predatory instruments before COVID-19 devastated the economy. This represented more than 4 million families with CFDs and over 2 million with negative equity. Disproportionately, these issues affect low-income and minority communities. The problems were particularly acute in areas with high concentrations of lower-cost properties and where state consumer protection laws are weaker. The many varied circumstances that lead families to finance a home purchase using a CFD, and the ensuing challenges often require thoughtful consideration to counteract. Below are a few examples of situations that Blackstar has worked through with borrowers:

Promises Kept – *Canton, Illinois* – Borrowers are a disabled veteran and his daughter, who is also disabled. They share a small, multigenerational house that includes young children. When Blackstar purchased the house it had no central heating, no hot water and the roof leaked. The borrowers had stopped making payments due to the condition of the home and broken promises of the seller. The veteran borrower is also an amputee and was unable to accept help from a local veterans' group to adapt the home due to not having title to the house. Blackstar provided a new roof, furnace, and hot water heater. The borrowers' disability income qualified them for a new 30-year mortgage with a 30 percent reduction in principal and interest and the opportunity to complete necessary accommodations to the home.

New School Clothes and an Affordable Payment - *Muncie, Indiana* – Borrower is a single mother of two teenagers who works in food service at a local university. She struggles to make ends meet with a gross income of $2,600 a month but always makes the house payment. In addition to lowering her principal substantially, Blackstar was able to lower her monthly payment from $530 to $375. She believes the savings will change their quality of life. When Blackstar told her that there would be no payment due in September as the new mortgage would not yet have accrued interest, she gasped and said it would be the first time in her children's life that they would have new school clothes.

Basic Necessities – *Muncie, Indiana* – Borrower is an elderly man who was buying the house using a land contract despite a leaky roof and parts of the house having inoperable plumbing. He had been bathing at his son's home across the street. He had equity in the house and could afford the payment but did not have access to the capital needed for necessary repairs. Blackstar financed a new roof and plumbing and then converted his debt to a lower interest rate mortgage. He opted for a 15-year mortgage, choosing to minimize interest costs on his now functional home.

An Affordable Home – *Dayton, Ohio* – Borrower is a disabled woman who entered an inflated lease option in hopes of securing a long-term home that she could afford on a fixed income. Despite high housing costs, she never missed a lease payment, but as her option to purchase expired, she had no realistic path to ownership. Blackstar lowered the principal balance to match the market value of the home and qualified her for a 30-year mortgage that reduced monthly housing costs by over 30 percent, thereby providing stability on a fixed income.

Blackstar's innovation counters the lack of access to financing and the related issues that disproportionately affect working class families, and minority communities. By purchasing the targeted assets at substantial discounts from market-driven sellers, Blackstar can rethink the service delivery model for originating and servicing small-balance mortgages. However, the intensity of the company's focus on borrower success and foreclosure avoidance is distinct from most investors. It employs a scalable, hybrid model for enhanced borrower interaction that provides many insights to reaching solutions that are mutually beneficial for families and investors.

Blackstar's Conversion Process

The process of "converting" a CFD or LTO is a dynamic partnership between Blackstar, the borrower and a mortgage lender. The first step, shortly after purchasing the CFD/LTO, is for Blackstar to communicate with the borrower and begin the process of building trust. Often the borrower is unaware of the CFD/LTO limitations, or alternatively is painfully aware of those limitations and is angry, cynical or disillusioned with their situation. Blackstar approaches each borrower and initiates a conversation regarding their individual circumstances and presents the option of converting the CFD or LTO to a traditional mortgage. If the borrower is not interested or ready to convert, Blackstar works with them to settle any predatory fees and arrearages to make the current situation as fair as possible while the borrower considers the new opportunity and their options. Often, these predatory arrangements have been in place for many years, and it takes time to build both trust and a shared commitment. Blackstar is careful not to impose ultimatums or false deadlines and works to create a harmonious relationship between lender and borrower.

Once the borrower is ready to convert the predatory instrument into a conventional mortgage, Blackstar refers them to a third party, licensed mortgage originator to take a traditional mortgage application. Blackstar-financed mortgages are fully documented and underwritten to Qualifying Mortgage standards for low balance loans. Approved underwriting ratios are similar to FHA and other refinance products for moderate- and low-income homeowners. Blackstar does not require a minimum credit score nor any closing costs or downpayment, as most CFD borrowers have little net worth and challenged credit. The new mortgage is offered at the lower of the current principal balance or the value of the home. Often CFDs and LTOs are written at values substantially higher than the house is worth, so it is important to reset the loan to no more than the actual value of the home. If the home needs substantial repairs, Blackstar finances the repairs prior to initiating the new mortgage with the cost added to the principal balance and then adjusted if above the home's repaired value. The new mortgage is generally a 15- or 30-year term at an interest rate substantially below the current rate of the predatory CFD/LTO.

Once the borrower is documented and approved, the new mortgage is closed and recorded at a title company and boarded with a licensed servicer. Blackstar funds the escrow reserve and pays closing costs and the lender's origination fee, so the new mortgage is achieved without additional cash out of pocket for borrowers. To date, Blackstar has closed 86 conversions with no foreclosures. All borrowers have achieved either reduced payments, shortened amortizations or repairs made possible by corresponding reductions in interest rates and in some cases principal forgiveness. Past-due fees and arrearages are forgiven, and in many states, property taxes are lowered as borrowers now have title to the home and thereby qualify for homestead exemptions.

Key challenges

Perhaps the largest challenge Blackstar faces is finding the CFDs and LTOs. While we know there are millions of these instruments existing throughout the country, very few are recorded. Even in states that require the recordation of CFDs, compliance is minimal, and enforcement of those laws is virtually non-existent. While many of the most predatory LTOs are structured and presented tantamount to CFDs, transferring the landlord's responsibilities to the tenant, there are virtually no laws that require the option arrangement to be made public. Given the extreme profitability and questionable legality in certain of these arrangements, the owners selling properties via CFDs and LTOs overwhelmingly stay in the shadows and rarely sell through transparent mechanisms.

A second consistent challenge, once CFDs and LTOs have been identified, is agreeing on a fair price. As exorbitant interest rates and inflated property values create a cash flow far beyond what could be reasonably derived from these often-sub-standard assets, owners without external motivations are often reluctant to sell. Moreover, rising interest rates and market volatility have made the acquisition landscape much less active, as sellers have been slow and often unwilling to accept the lower prices implied by higher risk-free rates and risk premiums. Blackstar routinely encounters owners unwilling to sell because the cash flow achieved by their portfolios cannot be replicated.

Once acquired, there are many challenges to converting CFDs/LTOs to mortgages. To begin with, because compensation structures favor higher balance loans, very few mortgage originators offer and none focus on loans below $100,000, let alone the even lower balance, more challenging properties that Blackstar targets. Once Blackstar is able to contract with a lender to originate these loans at QM standards it must pay the cost of the mortgage in order to not exceed statuary limits on fees. The condition of the home and appraisal gaps can also be challenging, as many of these homes have substantial deferred maintenance that limit value.

Headline, legal and regulatory risks are effective deterrents that have led many large investors to avoid CFDs altogether. Recent litigation penalties and settlements underscore the perils of not acting in good faith as with some previous investors. The unit economics of CFD investments are often favorable; however, their small balances imply a need to manage a high volume to achieve efficiency and significant scale.

Recommendations

There is a clear and better path than the limited pool of options and minimal protections afforded to small-balance home buyers today.

- Small-balance mortgage lending that reaches underserved consumers and communities should be meaningfully incentivized.
- The GSEs must not only prohibit the use of CFDs or comparable instruments by resellers of foreclosed property, but aggressively enforce these policies. They should also make better efforts to prevent foreclosure, and when it is unavoidable, to more vigorously incorporate community-minded buyers in sales processes.
- Consumer protections must be enhanced and enforced.
- Recordation of CFDs and LTOs must be required.

Conclusion

The current state of affairs is not inevitable. Blackstar has established a fund which purchases CFDs and converts them into traditional mortgages at reasonable interest rates. Our model works. It is a simple, effective approach that earns an attractive risk-adjusted return for investors while providing life-changing stability and lower payments to families. Current market conditions afford a unique opportunity to effectuate this change. Consumer advocates, state Attorneys General and regulators have begun putting pressure on some particularly egregious issuers of CFDs, but more attention is needed. Many issuers are simply looking to realize gains by liquidating their holdings in a buyer's market. Blackstar Stability is creating the sort of viable, life changing home mortgage alternative for working class families that is available to mainstream America.

Fair and equitable access to the housing finance system is both good policy and good business. More stable, economically strong homeowners will benefit everyone while tangibly lowering the wealth gap.

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[i] McCargo, Alanna; Bai, Bing; George, Taz; Strochak, Sarah. "Small-Dollar Mortgages for Single-Family Residential Properties." Urban Institute (April 2018). https://www.urban.org/sites/default/files/publication/98261/small_dollar_mortgages_for_single_family_residential_properties.pdf

[ii] Perry, Vanessa; Shnare, Ann. "Tipping the SCALE: Will Alternative Data Promote or Impede Fair Lending Goals?" National Association of Realtors (April 2021). https://narfocus.com/billdatabase/clientfiles/172/26/3624.pdf

[iii] Shapiro, Thomas; Mschede, Tatjana; Osoro, Sam. "The Roots of the Widening Racial Wealth Gap: Explaining the Black-Whate Economic Divide." Institute on Assets and Social Policy (February 2013) https://heller.brandeis.edu/iasp/pdfs/racial-wealth-equity/racial-wealth-gap/roots-widening-racial-wealth-gap.pdf

[iv] Source: The U.S. Census Bureau, Housing Vacancies and Homeownership Survey, May 2023

[v] https://www.washingtonpost.com/news/business/wp/2019/02/28/feature/the-heartbreaking-decrease-in-black-homeownership/