

Cleaning up after the Foreclosure Tsunami: Practices to Address REOs in Northeast Ohio¹

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Like a tsunami, each tidal wave of foreclosures has left in its wake hundreds of thousands of vacant, blighted, and vandalized properties. The immediate damage—the disrupted lives, the emptying of homes—has been followed by collateral damage to neighboring homeowners and their communities at large.

The full measure of post-foreclosure damage is understood only when one considers that every blighted house can negatively impact five or six other houses near it. In Cleveland today there are an estimated 11,500 vacant houses, which could easily lower the market value of 60,000 occupied homes. Speaking to scale, if each occupied home lost \$10,000 in value, the loss of homeowner equity would come to \$600,000,000. Further, that loss in value inevitably results in a loss of property tax assessment and lost tax revenue for publicly supported schools, police, fire, and social services. The saga is doubly tragic because it is undermining Cleveland's highly regarded community-development system, which made steady progress through the 1990s and the early part of the 2000s.

In the case of the financial institutions that bought the mortgages—specifically, the servicers and trustees who manage the loan pools—it appears that some of the same questionable decision-making that brought us the foreclosures in the first place is now compounding the problem by the manner of handling post-foreclosure vacant homes, which banks refer to as real-estate-owned, or REO, property.

In this regard, Cleveland may again serve as a useful illustration and, to some extent, a warning to other cities that have yet to experience a severe post-foreclosure problem. Any city, regardless of how strong its real estate market appears, could suffer a market failure if its foreclosures reach a critical mass. For hundreds of years, foreclosures have worked as a successful debt-recovery mechanism when an isolated foreclosure is surrounded by otherwise stable, occupied homes. The foreclosed home can be quickly re-marketed and re-sold, and the lender's loss minimized. Numbers of foreclosures in some areas of Cleveland, however, doubled and even tripled in a single year during the subprime crisis. When neighborhood markets have high levels of subprime lending and foreclosures, the system breaks down completely. Streets in Cleveland that had no foreclosures five years ago now have four or five. Streets that had a few foreclosures now have 10 to 20.

So who's buying these properties, and what are they doing with them? The buyers range from inexperienced individuals who watch late-night infomercials and are captivated by the promise of making millions in real estate, to a new niche industry that seems to have sprung up in the past decade: companies, most of which are located outside the state, that specialize in making bulk purchases of vacant foreclosed homes. Their business models vary. Some merely act as wholesalers and flip a package of 10 to 20 homes to another investor for a small markup;

some post them on eBay without making any repairs; and some make a bulk purchase to acquire just one decent prospect, assuming they may abandon the other properties.

In Cleveland, urban and suburban civic leaders from the public and community development sectors are fighting back in two ways. First, they're changing the economics of foreclosure and vacant property ownership. Second, they're creating tools and programs for responsible management and redevelopment of abandoned foreclosed property. This article discusses aspects of both.

Changing the Economics of Foreclosure and Vacant-Property Ownership

Following the age-old axiom that behavior doesn't change without a financial incentive to do so, civic leaders have taken a number of steps to shift greater financial responsibility for REO properties to the banks and investors that own them. The following tools have been employed to date, to varying effect.

Threat of demolition. The City of Cleveland has substantially ramped up its demolition effort. In the years leading up to 2006, it inspected, condemned, and demolished roughly 200 homes per year. In 2007, the numbers began a steep ascent: In 2007 and again in 2008, the City demolished 1,000 homes; in 2009, the number was 1,700. The City is imposing demolition liens and aiming to collect an average of \$10,000 per house to cover the costs of demolition. The prospect of having a vacant lot with a \$10,000 demolition lien on it can be a powerful motivator.

Prosecuting code violations. The City of Cleveland and its inner-ring suburbs are also prosecuting banks and REO investors for criminal violations of housing codes. In addition, the Cleveland Municipal Housing Court has issued arrest warrants for bank presidents and has levied stiff penalties against irresponsible investing in abandoned property. In 2008, the Court issued a \$140,000 fine against an investor from Oklahoma. In late 2009, an

\$850,000 fine was imposed on an investor from California. And in June 2010, Housing Court Judge Raymond Pianka levied a total of \$13 million in fines against two out-of-state real estate companies that have neglected properties they own in Cleveland.²

Private code enforcement. In addition to government-led code enforcement, private code enforcement has been spearheaded by the Cleveland-based nonprofit group Neighborhood Progress, Inc., which has brought public-nuisance lawsuits against two of Cleveland's largest REO owners, Wells Fargo and Deutsche Bank. The lawsuits allege that owning and dumping vacant REO property is a public nuisance that threatens the health and safety of neighbors and damages property values. As a direct result of these suits, the two banks have collectively demolished 40 blighted homes, saving the City approximately \$400,000 in demolition costs.

Combating bank walk-aways. Some lenders have begun dodging accountability for foreclosed properties by litigating a foreclosure case to judgment but not taking title at sheriff's sale. This tactic, commonly referred to as a "bank walk-away," allows lenders to obtain whatever insurance or accounting benefit is available by documenting the loss, but leaves them immune from responsibility for the damage caused by a vacated property. To counter this latest tactic, Rep. Dennis Murray in October 2009 introduced a bill in the Ohio House of Representatives (HB 323)—based on an innovative New Jersey statute enacted in May 2009—that would make foreclosing lenders accountable for nuisance conditions in properties they are foreclosing on *prior to* taking title. The bill was passed by the Ohio House of Representatives and as of July 2010 was being reviewed by the Ohio Senate.

Making Responsible Use of Vacant Abandoned Property

In its 40-year history of community development, Cleveland has consistently exhibited two major strengths. First, it's a city steeped in community organizing tradition, and civic and community leaders have not been shy

about holding banks and investors accountable, as noted in the examples above. But it is also a city of innovation, as witnessed by the Cleveland Housing Court, the Cleveland Housing Network (which introduced one of the first scattered-site lease-purchase programs in the country), and the publicly accessible NEO CANDO property data system at Case Western Reserve University.³ Civic leaders have been no less creative in addressing the current crisis of post-foreclosure vacant property.

Integrating rehabilitation with neighborhood stabilization. More than a year before the federal government announced Neighborhood Stabilization Programs 1 and 2, Neighborhood Progress, Inc. (NPI) partnered with the Cleveland Housing Network to develop Opportunity Homes, a program that rehabilitates vacant foreclosed property in strategically targeted areas to leverage existing assets and investments. Rehabbed homes are then supported by other neighborhood stabilization activities on the same streets—blight remediation, demolition (for homes beyond rehab), home repair, and landscaping. In what may be the most innovative aspect of this program, data from the NEO CANDO system is used to help identify occupied homes, in the vicinity of rehabbed homes, that are at risk of foreclosure. Using both public and proprietary data sources, NPI then targets every occupied home with a subprime or adjustable-rate mortgage for door-to-door outreach and loan modification assistance.

Reimagining Cleveland. The City of Cleveland, in planning ahead for the productive, sustainable, and responsible re-use of the thousands of vacant lots accumulating throughout the City and its suburbs, has partnered with NPI on a project called “Reimagining Cleveland.” The project, funded by the Surdna Foundation, involves engaging block clubs, civic organizations, and local institutions in planning for short-term utilization and long-term redevelopment of vacant property.

Land banking. Faced with a growing flood of post-foreclosure vacant property, the City

of Cleveland first needed to get control of those properties in order to keep them out of the hands of irresponsible investors and prevent further damage to neighborhoods. But it also needed a place to “park” these properties while it triaged them for immediate demolition, eventual rehabilitation, or “mothballing” until market conditions are more conducive to redevelopment. None of the local nonprofits have the capacity to acquire and hold a large inventory of vacant property. And while the City of Cleveland’s land bank owns thousands of vacant lots, it lacks the financial resources to manage and maintain vacant structures. Enter Cuyahoga County Treasurer Jim Rokakis, who led a collaborative effort that resulted in the creation of the Cuyahoga County Land Reutilization Corporation—referred to as the “county land bank”—in April 2009. Modeled after the Genesee County Land Bank, based in Flint, Michigan, the new land bank’s anticipated success, and what differentiates it from the City Land Bank or local nonprofits, is that it will have an expected annual budget of \$6 million to \$8 million from fees and penalties collected on late property-tax payments. The county land bank has already negotiated significant deals to acquire REO properties from Fannie Mae and the U.S. Department of Housing and Urban Development. (See also in this publication “How Modern Land Banking Can Be Used to Solve REO Acquisition Problems,” by Thomas J. Fitzpatrick IV.)

Lessons Learned

The foreclosure crisis hit Cleveland hard and earlier than it hit many other cities. Because of this, Cleveland has had time to develop a variety of innovative approaches that other cities can learn from. The Cleveland experience can be distilled down to several major lessons learned. First, ramp up code enforcement to control the ownership and irresponsible transfer of post-foreclosure vacant property. In other words, change the economics of owning vacant property. Second, while fighting the immediate battle, be forward-thinking and start planning ahead for the sustainable reuse of accumulating vacant property. Third—and critically important—establish an entity, such as a land bank,

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that can receive and responsibly hold vacant property. It should be noted that a land bank can only be useful if it has the proper financial resources to undertake this task. Linking land banks to excess spin-off property tax revenue, as first developed by the Genesee County Land Bank, may be the single most important innovation in urban redevelopment in recent years.

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disparities in lending to small businesses, and in 1986 litigated the first case under Ohio's nuisance-abatement property receivership law. Mr. Ford received a BA degree in English from Kenyon College and a Juris Doctor degree from the Case Western Reserve University School of Law.

Endnotes

- ¹ Adapted from an article published in *Shelterforce* 159/160 (Fall–Winter 2009).
- ² Sandra Livingston, “Cleveland housing court judge fines two real estate firms about \$13 million for neglect,” the *Plain Dealer*, June 22, 2010. Available at http://blog.cleveland.com/metro/2010/06/cleveland_housing_court_judge_1.html.
- ³ NEO CANDO (Northeast Ohio Community and Neighborhood Data for Organizing) is a free, publicly accessible social and economic data system. It can be accessed at <http://neocando.case.edu/cando/index.jsp>.