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In the City of Cleveland, 8.2 percent of the housing stock sits vacant or abandoned, according to the U.S. Postal Service. In this environment, private investment in foreclosed properties may sound like welcome news. Indeed, some speculative purchases can add liquidity to a distressed market and help heal distressed neighborhoods when properties are purchased for rehabilitation.

But if speculators fail to keep up with maintenance and taxes, allowing properties to sit empty and in disrepair, the opposite happens. In weak-market cities like Cleveland, some speculative investments extend the time that properties sit vacant, lower the value of nearby homes, and make the vacancy problem much more challenging to fix.

But are such speculative investments a large enough problem to demand a policy response? We believe they are. Evidence shows that some investors may be transacting irresponsibly, potentially hurting neighboring homeowners in the process. We outline one of many policy options states might consider if they are looking for solutions to this problem.

Financing Holds the Key

The key to understanding—and addressing—these harmful transactions is to look at how most speculative transactions are financed. When a homebuyer applies for a mortgage, the bank requires that all claims on the property, including tax and code enforcement liens, be paid off by the closing. Banks also require that past-due taxes that have not yet become liens be paid prior to closing, so they do not supersede the bank’s claim on the property.

But speculative home purchase transactions are not always funded through the banking system. If investors pay cash or secure nonbank seller financing, they can postpone paying off liens, past due taxes, and housing code assessments against the property, often for many years.

To address this problem, policymakers would need a rule that discourages investors from trying to quickly flip low-value properties without maintaining or improving them. One potential solution would require that all past-due taxes and code enforcement penalties be cleared before county recorders declare a property transfer official. This change would target the speculative activity that destabilizes weak housing markets.

This rule would apply to all residential property transfers but, in practice, would affect only the cash or seller-financed transfers of property with outstanding taxes or housing code assessments. To see how widespread cash and seller-financed transactions are, we analyzed the property transfers in Cuyahoga County, Ohio (home to Cleveland),
in 2009. Transfers totaled 16,828 excluding foreclosures; about half of them did not have any associated mortgage as reported under the Home Mortgage Disclosure Act. That is, they were most likely all-cash or seller-financed transactions. All transactions with conveyance amounts less than $10,000 (almost 3,000 of them) were in this category. Of those small-dollar transactions, almost one in three had a tax delinquency at the time of transfer.

We do not suggest that all of these transactions involved harmful speculation, as many delinquencies clear around the time of the transfer. For a significant number of properties, however, tax delinquency is persistent or grows after the transfer. These are the properties that will likely be affected by this proposal. (Note: While we include housing code assessments in our proposal, we are unable to report the data on this component of the problem because of lack of uniform record-keeping across municipalities.)

Undesirable Housing Transactions in Cuyahoga County, Ohio

We consider speculation harmful when the buyer has no intention of improving or maintaining the property or paying its taxes—but expects to resell as much of its stock as possible quickly, “as is,” and at a small markup. Speculators tend to factor in the probability that some of their purchased properties will languish or be lost to tax foreclosure. But they buy them anyway because the markup on properties sold is high enough to pay for the lost properties.

Keep in mind that a markup as low as a few hundred dollars can still provide a significant return in places such as Cuyahoga County, Ohio, where more than 40 percent of properties sold by financial institutions after a foreclosure are priced at less than $10,000, according to a 2008 Case Western Reserve University study (see “Resources” at the end of this article). This speculative activity seems to be most common among bulk buyers who purchase low-value properties in large numbers.

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How is this strategy profitable? When buying foreclosed or lender or real estate-owned (REO) properties, irresponsible buyers have a built-in advantage over rehabbers. While rehabbers must take into account the costs of improvements and delinquent tax payments, speculators who plan to flip the property at a quick profit don’t, so they can bid higher. Typically, after taking over the property, the speculator sells it as soon as possible to an unsuspecting out-of-state (or even out-of-country) buyer who believes the property is a great investment.

This belief could be rooted in the promise of future appreciation or a predictable rental income stream after minor rehabilitation. Only after the transaction closes does the new buyer find out that the property has more in delinquent taxes than the price paid to acquire it, or that the property is in need of substantially more rehabilitation than was originally thought. More often than not in these situations, the new buyer abandons the property, which may go into tax foreclosure and be sold at auction, where it may once again be acquired by a bulk buyer. As this cycle continues, the property remains vacant, falls into further disrepair, and becomes a nuisance to the entire neighborhood.

Consider what would happen if these speculators didn’t exist. First, distressed property values would fall, freeing up resources for rehabbing or demolition. Second, a large amount of distressed property would go on the market, which would allow for large-scale rehabilitation, redevelopment, or demolition and the associated economies of scale.
For example, the Cuyahoga County Land Bank (which acquires distressed properties to demolish, rehabilitate, or repurpose for long-term neighborhood stability) has been able to regularly solicit bids in small and bulk packages for demolition as its inventory has grown. As a result, the land bank reports that it has seen its average demolition cost fall by nearly 35 percent.

Substantiating Anecdotes: Data on Housing Transactions and Tax Delinquency
Some transactions illustrate the bulk-buyer business model. For example, Cuyahoga County records show that one tax-delinquent property was acquired by a bulk buyer from a securitization pool for $1 and resold four days later for $10,000. The new owner (a low-volume investor) resold the property six months later for $72,000.

A fascinating transaction, but how frequently are properties sold in bulk transactions? And what is the evidence for harmful activity? We looked at the period from 2007 to 2009 and divided investors into groups: high-volume (large) investors, who purchased or sold 11 or more properties, and low-volume (small) investors, who purchased or sold four to 10 properties. The great majority of transactions occur among people who buy or sell three or less properties over four years; we classify those as “individuals” buying or selling for consumption purposes.

Cuyahoga County Auditor’s records show that of 18,692 residential properties sold out of foreclosure by financial institutions and government agencies in the 2007–09 period, about one-quarter were bought by large investors, another one-quarter by small investors, and most of the rest by individuals. As figure 1 shows, 31 percent of the properties bought by large investors were still vacant as of June 2010. The vacancy rate was 22 percent for small investors and 15 percent for individuals (and these differences persist after controlling for property characteristics). Clearly, outcomes for homes bought by some investors are worse than for those bought by others.

Furthermore, large investors seem to have a preference for tax-delinquent properties. In 2009, 21 percent of the properties sold with a tax delinquency from the previous year were purchased by large investors. Yet, they purchased only 9 percent of properties sold without a delinquency.

This preference for tax-delinquent properties wouldn’t matter if the buyers paid those taxes, but that isn’t the case. The weighted average of the green bars in figure 2 shows that 44 percent of the properties purchased by large investors in 2009 were later tax-delinquent, despite being current the previous year. Comparable figures are 39 percent for small investors and 21 percent for individuals. In transactions where large investors sell to small and other large investors (red and green bars farthest to the right in figure 2), this pattern is particularly pronounced. In almost 60 percent of such transactions, the purchaser does not pay property taxes.

Meanwhile, the data show that when individuals and financial institutions (yellow and blue bars in figure 3) purchase a tax-delinquent property from any group, delinquencies consistently get paid more than half of the time. Large investors, however, consistently avoid paying back taxes. The most glaring result is when large investors sell tax-delinquent property to other large investors; delinquent taxes are paid in only 13 percent of those cases (green bar farthest to the right in figure 3). When large investors sell to small investors, back taxes are paid in 23 percent of the transactions (red bar farthest to the right in figure 3). Added up, the data show that most of the time, individuals transact more responsibly than small and large investors.

A final situation worth paying attention to is when a property’s tax balance actually grows after a purchase (figure 4). In these transactions, not only are back taxes not being paid, but purchasers are not paying current taxes as they come due. Again, the culprits are mostly large investors who sell to other large investors (green bar farthest to the right in figure 4)—who allow the delinquent tax balance to grow nearly 76 percent of the time. In almost all types of property transfers, investors are the worst tax avoiders.
Status Changes of Tax-Delinquent Properties in Cuyahoga County, Ohio, by Seller and Buyer Type, 2009

Note: Low-value transactions have conveyance amounts of less than $10,000.
Source: Cuyahoga County Auditor.
Taken together, these findings support the anecdotal reports that large and small investors pay the taxes on properties they purchase less frequently than financial institutions, governments, or individuals. The problems are more acute in the low-value cash or seller-financed transaction category with conveyance amounts of less than $10,000 (figures 2a, 3a, and 4a).

A more promising policy solution would require a change in state law: preventing county recorders, who are charged with tracking owners of real estate, from recording any new ownership of property that has outstanding delinquent taxes or code violation penalties.

While we have no direct evidence of harmful activity, owners of tax-delinquent properties are not likely to have the incentive to maintain them because they can be taken away in a tax foreclosure. The result can be devastating to neighborhoods.

Potential Remedies

Some have suggested that one way to address the harmful-transaction problem would be to create a list of known repeat offenders and prevent them from acquiring property. A law of this type exists in Pennsylvania, where municipalities may petition to prevent a foreclosure auction purchaser from acquiring a property if that purchaser has been convicted of a housing code violation and has not corrected it. But using blacklists to prevent property acquisition may not be effective in a world where anyone placed on such a list could incorporate a new entity to continue acquiring property, which can be done quickly and inexpensively. In that sense, blacklists may be under-inclusive.

A more promising policy solution would require a change in state law: preventing county recorders, who are charged with tracking owners of real estate, from recording any new ownership of property that has outstanding delinquent taxes or code violation penalties. Currently, the Ohio Revised Code requires recorders to record authentic instruments properly presented. Changing the law to prevent tax avoiders from closing on a transaction would directly address the problem by undermining the business model undergirding undesirable transactions. Unless purchasers paid taxes, improved the property, or kept up to code, they would be unable to legally transfer ownership.

This solution would give every purchaser an incentive to maintain properties and keep them on the active tax rolls, or they would be unable to turn over inventory. Such a transfer restriction would discourage buyers from purchasing property for which they could not provide upkeep. It might also prevent corporate shell games, where a corporate entity sells a property to another corporate entity controlled by the same owner or owners in order to delay delinquent tax or housing code enforcement actions.

A few words of caution: Because well-meaning purchasers can fall behind on taxes, broad transfer restrictions may be overly inclusive. Policymakers should carefully craft such restrictions to minimize unintended consequences. In the presence of such a restriction, for example, depository institutions may be reluctant to foreclose on a property if the property owner failed to pay taxes and they were not paid by the lender. Transfer restrictions may also chill the acquisition of properties with large amounts of outstanding taxes or code violations, even when potential purchasers would seek to rehabilitate the property or otherwise ensure its productive use.

These unintended consequences can be mitigated to some extent. For example, policymakers may want to allow properties to be transferred to public entities or land banks, to facilitate voluntary surrender of property despite back taxes and code violations. This type of exception may involve a county’s forgiving some or all back taxes when responsible buyers purchase property or allowing ownership transfers if the new owner agrees to pay taxes or code violations over time. Additionally, it may make sense to allow involuntary property transfers related to a death, bankruptcy, foreclosure, or divorce, despite back taxes or code violations. These exceptions to transfer restrictions

1. See 53 Pennsylvania Statutes § 7328(b.2) & 72 Pennsylvania Statutes § 5860.659(c) (2010), enacted in 1998. Missouri attempted to create a similar provision that prohibits persons from bidding on property at sheriff’s sales, VAMS § 141.550.2(2) (1998), but the entire bill containing the law was struck down because the title of the bill was vague, violating Missouri’s constitutional requirement that bills have clear titles. See Home Builder Association v. State, 75 S.W.3d 287 (Sup. Ct. Mo., 2002).

should be carefully crafted. Broad exceptions may allow undesirable transactions to continue, while narrow exceptions may inhibit healthy transactions.

Even with these exceptions, there could be a short-run slowdown in transfer activity as the market adjusts to the new rules. While some homeowners in the affected areas may see this as a negative outcome, we believe there are positive long-run consequences for all weak markets. Properties will be channeled to the land bank or to private rehabbers at lower cost in the absence of irresponsible buyers. This frees up resources for rehabilitation or demolition. A smaller and more pristine housing inventory should stabilize home prices and strengthen the market in the long run.

Another possible unintended consequence of this proposal is that in the short run, the restriction would slow the transfer of all property because of the time it takes to check for back taxes and assessments. This delay could be significant if records on real property taxes and other public assessments are not kept in an easily accessible electronic format.

According to an informal survey we conducted with county recorders, at least four of Ohio’s 88 counties do not yet keep electronic tax records. Code violation records are kept at the municipal level, and it is unclear how many are kept electronically. To avoid slowing the transfer of real property, the state legislature may choose to allow counties to opt in or out of restrictions on transfer. In any case, lawmakers would need to work closely with lenders, real estate buyers and sellers, community development practitioners, and county governments to create exceptions and minimize unintended consequences while limiting harmful transfers.

Final Thoughts
Stories about irresponsible property speculators abound. Their very business model allows them to pay more than bidders who are interested in rehabilitation. Our analysis shows that large investors focus on tax-delinquent properties and often fail to pay property taxes. As a result, entire communities sometimes are unable to break the cycle of disinvestment and decline of their housing stock.

What do you think?
We’re interested in hearing your comments as we refine this proposal. Send comments to foremost@clev.frb.org

Recommended reading

Resources
For suggested reading and information about states that restrict transfers of tax-delinquent properties, go to www.clevelandfed.org/forefront