How Modern Land Banking Can Be Used to Solve REO Acquisition Problems

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The foreclosure crisis has become a national issue over the past few years, affecting virtually every region of the country. Problems of widespread vacancy and abandonment, however, have persisted primarily in older, shrinking cities, many of which can be found in the Rust Belt, where once-strong industries like manufacturing and raw materials production have moved overseas or otherwise reduced employment. As these industries moved and evolved, the populations of their host cities and their inner-ring suburbs have fallen, while outer-ring suburbs grew.[1] Without steady or increasing population to occupy housing stock, vacancy and abandonment occur organically. The recent foreclosure crisis has aggravated this existing problem for shrinking cities. One of the natural results of foreclosures in such hard-hit areas is an increase in real-estate-owned (REO) properties.

In shrinking cities, as home loans become delinquent and properties go into foreclosure and are auctioned off, it is unsurprising that ownership often reverts to the loan owner; there is simply too little demand to fill the housing stock. Logic dictates a rather predictable cycle: the highest-quality properties will be filtered out of the pool of properties before or after foreclosure through short sales or at foreclosure auctions. This leaves lower-quality houses among those that end up as REOs. Anecdotal reports and empirical research suggest that REO properties in shrinking cities are more frequently distressed than they were even a few years ago.[2] Private markets often find the REO properties in shrinking cities undesirable, as evidenced by the lack of interest in acquiring them.

Problematic, for sure. But these distressed REO properties can also represent opportunities for local governments to help stabilize, or even revitalize, areas struggling with population loss and an overhang of housing stock. To capitalize on these opportunities, local governments must first overcome the challenges of acquiring REO properties. Two commonly reported challenges that local governments in and around shrinking cities face when trying to acquire REO property are bringing the owners to the table to negotiate for the purchase of REO properties and obtaining the financing necessary to acquire and remediate such properties. This article will explore how modern land banking differs from traditional land banking, and how the newer land banks can be a useful tool to solve these two challenges.

Land Banking: Then and Now

Land banking in one form or another has been around, in Ohio and other states, for more than 40 years. For most of this time, only minor changes occurred in what land banks were thought to be, how they were funded, and the type of properties they acquired. Recent Ohio legislation dramatically overhauled land banking in the state, reshaping the way land banks can be funded and organized and augmenting the powers they have to acquire, address, and dispose of distressed properties.

Land banking was originally used as a municipal tool to acquire and hold large amounts of property for redevelopment as a way to encourage development consistent with municipalities' long-term plans.[3] As land banking evolved, some have advocated its use as a tool to further

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specific goals, such as affordable housing or acquiring and redeveloping tax-delinquent properties.[4] Traditional land banks shared many limiting features; the most important to this discussion is that they were local government programs that passively received properties either not sold at tax-foreclosure sales or acquired through donation.

Structuring land banks as municipal government programs is limiting in two important ways. First, it means that land banks depend on local governments for funding and staff support, which forces land banks to coordinate the efforts of the multiple agencies that support it without the ability to incentivize those agencies' efforts. It can also cause land banks' funding and operations to be politicized, making it difficult to engage in long-term, optimum strategic planning. Second, the limited geographic scope of municipal land banks' operations prevents them from taking advantage of economies of scale that would be available if they were operating in a wider geography, and from better addressing problems along municipal borders.

Modern land banking has departed from these traditional land banking forms in several key ways. For one, the purpose of land banks has broadened considerably. While the seeds of modern land banking were planted in the Genesee County (Michigan) land bank model, it is in Ohio that modern land banking has further developed.[5] The Ohio legislation illustrates that modern land banks are no longer simple tools to control future development patterns. Rather, modern land banks assist public and private redevelopment by actively identifying and strategically acquiring parcels otherwise unattractive or unobtainable by public or private markets, clearing their titles, and, where necessary, deciding how to remediate the property to make it attractive for future investment. Another key difference between traditional and modern land banks is that the modern ones are not organized around narrow goals such as furthering fair housing. Instead, they are given a broad public mission and the flexibility to operate as an independent private entity within the scope of that mission. In Ohio, such land banks are organized as nonprofit corporations with a statutorily defined public mission.[6]

Equally important to modern land banks' flexibility is having dedicated staff and a statutorily defined revenue stream, both of which allow for long-term planning. In addition, modern land banks are organized and funded on a broader geographic scale, allowing them to take advantage of economies of scale when acquiring, rehabilitating, or demolishing properties and when funding their operations. These benefits allow modern land banks to make bulk purchases of REO properties directly from lenders in situations where municipalities, acting on their own, would be unable to do so.

Some Roadblocks on the Path to Acquiring REO Properties

Modern land banks can be powerful tools to acquire REO properties as a way to stabilize, and in some cases revitalize, at-risk neighborhoods. These newer land banks are designed to deal with the distressed property that is more frequently becoming REO in shrinking cities. Additionally, their structure allows them to overcome the challenges municipalities face when attempting to acquire REO properties. In practice, these points are driven home by the success of Ohio's modern land bank in overcoming these challenges.

The ownership of REO properties within a municipality is frequently extremely fragmented. This may be a natural by-product of securitization, which encouraged the aggregation of a geographically diverse pool of loans into a trust that sold securities to a diverse set of investors.[7] Because geographic diversity was an important factor to many investors during the securitization boom, only the largest REO sellers will own more than a relatively small number of properties in the largest jurisdictions. Even the largest mortgage owners—such as Fannie Mae and Freddie Mac—who may own a significant number of REO properties in a region will generally only own a small number of properties in any one municipality.

The fragmentation of ownership can be a large problem for municipalities. Municipalities tend to only be interested in acquiring properties within their borders, and fragmented ownership makes it very difficult for them to negotiate with any one REO seller for a large number of properties. Because modern land banks typically cover a much broader geography than traditional land banks or any single municipality, fragmentation does not interfere with bulk purchasing to the same extent. The more the geographic scope of the land bank's jurisdiction expands, the more likely it is that the land bank will be able to engage in bulk purchases of properties from REO sellers.

There is usually no shortage of REO properties in shrinking cities or their surrounding suburbs. And it is not uncommon that the acquisition of such property fits into a local government or nonprofit plan to revitalize a neighborhood, suburb, or the central city itself. And yet, once interested prospective buyers find the right people to talk to, they often report having a hard time getting to the negotiating table. Anecdotal reports suggest that this phenomenon is likely aggravated by a few factors. First, as discussed, the securitization of home mortgage loans has fragmented the ownership and servicing of REO property. Second, a municipality or nonprofit will only be interested in properties that are parts of a preexisting development plan covering a narrow geography: municipalities and most nonprofits are not designed to inventory property. These two factors suggest municipalities or nonprofits will likely only be interested in a very small number of properties from any one REO seller at any given time.

These two factors do not fully explain why municipalities would be unable to bring REO sellers to the negotiating table. A third factor, however, might help. Private market participants have shown an interest in buying and holding large quantities of REO properties, ostensibly in the hope or expectation that property values will rise and allow them to sell at a higher price than they paid. Municipalities may have a hard time competing for the attention of REO sellers against private market participants, in part because private markets are not bound by municipal borders.[8] Thus, it is more likely that private market purchasers will be more interested in making bulk REO purchases than municipalities will. If acting rationally, REO sellers—who want to be short-term property owners—should prefer to deal with private-market bulk buyers over municipal buyers interested in fewer properties, as it could help reduce REO sellers' transaction costs and time of REO ownership.

Another challenge facing municipalities is obtaining funding. Assuming municipalities can get REO sellers to the table, they often have a hard time obtaining funding to acquire the properties in which they are interested. One reason is that shrinking cities have correspondingly smaller tax bases to fund operations. Additionally, traditional land banks, and often the municipalities themselves, do not have a revenue stream earmarked for acquisition of REO property, and creating new earmarks may be politically challenging. This limits the source of funding for municipal REO acquisition to discretionary funds, which are scarce. This scarcity of discretionary funds is also a natural consequence of shrinking municipalities losing tax base while retaining much of the overhead required when providing government services within their jurisdiction.

How Modern Land Banks Solve these Challenges

Modern land banks are much better suited to bringing REO sellers to the table and funding bulk REO purchases than traditional municipal land banks are. This is due to three features of modern land bank design: their broad geographic coverage, their broad powers to acquire, deconstruct, demolish, lease, mortgage, and rehabilitate inventory, and their dedicated revenue stream. Because they are not limited to a small geography or narrow purpose, modern land banks are better positioned to compete for the attention of REO sellers and can achieve economies of scale and scope not easily obtained by municipalities. In Ohio, for example, modern

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land banks can negotiate for all of the properties a servicer owns within an entire county. They do not need an immediate use for each property, but instead can inventory those properties that cannot be immediately transferred to developers, municipalities, or nonprofits operating within the land bank's jurisdiction. Inventoried properties can be mothballed, sold, leased, demolished, or deconstructed. Modern land banks can also offer advantages to sellers of REO properties, such as the ability to negotiate for the regular disposal of all of a seller's REO properties within a county. In this way, modern land banks solve the problems caused by lack of municipal collaboration.

Modern land banks have dedicated revenue streams that can be used to fund bulk REO purchases. Such revenue sources are dictated by the land bank's enabling legislation. To date, one of the most innovative funding mechanisms incorporated into modern land banking legislation is Ohio's use of penalties and interest of unpaid real property taxes and assessments to provide a stable, predictable revenue stream for the land bank.[9] Because this revenue can be used for any purpose within the land bank's public mission, it is not necessary to earmark any portion specifically for REO acquisition. This provides the flexibility necessary to make ad hoc bulk purchases of REO property. In addition, Ohio implements the system county-wide, which frees the revenue stream from fluctuations in any one municipality's real property tax base.

There are many ways a land bank's revenue stream may be structured. For example, modern land banks in Michigan automatically receive property not sold at sheriff's sales and are funded primarily by retaining proceeds from all properties sold out of inventory, either by recapturing a portion of the real property taxes on every property it puts back into productive use for the first five years, or by renting properties that are held in inventory. Ohio, on the other hand, grants similar powers to land banks: They may retain proceeds of properties sold out of inventory and rent a specified amount of their inventory to tenants. Additionally, Ohio increases penalties and fees on delinquent property taxes and redirects those penalties and fees to land banks. The advantage of the Ohio method is that historically a portion of the population consistently pays property taxes after they are due. This allows land banks to mathematically model their expected revenue streams on a forward-looking basis to support issuing bonds or borrowing from a financial institution to fund operations.

So far this essay is a mostly conceptual discussion of how modern land banks can be a powerful tool for REO property acquisition. It would be incomplete without at least one example of the successful implementation of these concepts. Ohio's modern land banking system, established in 2009, provides just such an example.

Fannie Mae is one of the country's largest purchasers of home mortgage loans. Because of its extensive loan ownership and the current economic conditions, Fannie Mae has found itself with a large REO inventory. In Cuyahoga County, Ohio, numerous municipalities anxious to stabilize their neighborhoods were interested in acquiring some of Fannie Mae's REO properties. However, they had a hard time getting Fannie Mae to the negotiating table. In late 2008, the City of Cleveland opened negotiations with Fannie Mae—a process that took more than a year—but the parties were unable to finalize an agreement.

During this time, Ohio passed what is arguably the country's most innovative land bank-enabling legislation. Six months after it began operating, the Cuyahoga County Reutilization Corporation, or land bank, finalized a landmark deal with Fannie Mae. Through it, the land bank can acquire—without competition from private investors—every one of Fannie Mae's foreclosed properties within Cuyahoga County that are valued at less than $25,000 for $1 each. Further, Fannie Mae contributes $3,500 toward the demolition of each property deemed unsalvageable.[10] Many of the properties acquired in the deal are located in different municipalities within Cuyahoga County, and not all of the properties fit into current development plans—factors that may have prevented their acquisition in the past. A representative from Fannie Mae explained that the company preferred to work with the land bank because it allowed for ongoing high volume sales to a single purchaser.[11] In addition, the deal laid the groundwork for the acquisition of higher-value REO properties by the land bank, when appropriate.

A similar deal was struck with the U.S. Department of Housing and Urban Development (HUD), in which HUD agreed to give the Cuyahoga County land bank a right of first refusal on the lowest-value properties it disposes of. Through the deal, the land bank can purchase any property worth less than $20,000 for just $100, while properties worth more than $20,000 can be purchased at discounts that vary based on the amount of time they have been on the market.[12]

Conclusion

Modern land banks hold great promise as a dynamic community development tool that can help shrinking cities and local parties overcome the two biggest challenges they face when trying to acquire REO property. Practice provides us with a powerful example of their successes. As regions struggle to control their inventories of vacant, abandoned, or REO properties, they would be remiss not to consider the innovative modern land banking approach that is currently being employed in states like Ohio.

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Endnotes

1 For a more detailed discussion of the building trends and their effects on cities and inner-ring suburbs, see Thomas Bier and Charlie Post, "Vacating the City: An Analysis of New Homes vs. Household Growth" (Washington, D.C.: Brookings Institution, 2003).

2 Claudia Coulton and others, "Pathways to Foreclosure: A Longitudinal Study of Mortgage Loans, Cleveland, and Cuyahoga County 2005–2008" (Cleveland, Oh.: Center on Urban Poverty and Community Development, Case Western Reserve University, 2008).

3 See, e.g., Sylvan Kamm, "Land Banking: Public Policy Alternatives and Dilemmas" (Washington, D.C.: Urban Institute, 1970); Model Land Dev. Code (American Law Institute, Tentative Draft No. 6, 1974); and Frank S. Alexander, "Land Bank Authorities: A Guide for the Creation and Operation of Local Land Banks" (New York and Washington, D.C.: Fannie Mae Foundation and LISC, 2005), on the history of land banking.

4 See, e.g., Cassandra N. Jones, "Public Land Banking and Mount Laurel II—Can There Be a Symbiotic Relationship?," *Rutgers Law Journal* 15 (1984): 641–665; and Frank S. Alexander, "Land Bank Strategies for Renewing Urban Land," *Journal of Affordable Housing* 14(2) (2005): 140-169 (discussing more recent land banking efforts).

5 The state law required for the Genesee County land bank to operate at its current scale did not pass until 2004—two years after the land bank began operation. See Mich. Const. Art. III, § 5 and Art. VII §§ 27, 28 and 34; 1951 Mich. Pub. Act 35; Mich. Comp. Laws §§ 124.1 and 124.2; 1967 Mich. Pub. Act 7; Mich. Comp. Laws §§ 124.501 et seq. For a discussion of Ohio's recent land bank legislation, see Thomas J. Fitzpatrick IV, "Understanding Ohio's Land Bank Legislation" (Cleveland, Oh.: Federal Reserve Bank of Cleveland, Policy Discussion Paper, 2009).

6 This mission is statutorily defined in Ohio Rev. Code § 1724.01(B)(2) (2009).

7 Securitization is not a primary topic of this piece, so it will be discussed only briefly. Securitization is accomplished by selling pools of loans into a legal vehicle—a trust—that owns those loans. The loans in any one pool are from broad geographical areas by design; thus, no single trust will have many loans from any particular location. Relative to the number of trusts, there are fewer institutions that serve as servicers of the trusts and have responsibility for inventorying and selling REO properties. Still, there are hundreds of servicers, and even the largest may control only a relatively small number of REO properties in any one municipality.

8 In theory, this could be solved through municipal collaboration when acquiring REO properties. If enough municipalities collaborated to make bulk REO purchases, they should be able to compete effectively with private bulk buyers for REO sellers' attention. And yet, a significant collective action problem exists. Major collaborative efforts such as the REO Clearinghouse have had limited

success in coordinating numerous municipalities and other small REO purchasers. This could be due to the difficulties of navigating numerous government bureaucracies and legal restrictions on municipal action, or other political difficulties associated with collaborative government action.

[9] In essence, Ohio's modern land banks are funded by advancing taxing districts the principal value of real property taxes when they are due, based on historic collection rates. There are multiple ways to fund this advance, for instance: borrowing from the county under Ohio Rev. Code § 307.781 (2009) or issuing unpaid and delinquent tax anticipation securities under Ohio Rev. Code § 133.082 (2009). When taxes are collected, their principal value, plus some interest, goes to pay down the line of credit or security holders. The penalties on delinquent real property taxes, which are increased in counties with land banks under Ohio Rev. Code § 323.121(B)(2) (2009), remain in the land bank to fund operations. This provides for a stable revenue stream for land bank operations, albeit a moderate one. In Cuyahoga County, Ohio, of which Cleveland is the central city, it is estimated that this will create a revenue stream of $7 million to $9 million each year. See Thomas J. Fitzpatrick IV, cited above.

[10] See Sandra Livingston, "Fannie Mae and the new Cuyahoga County land bank forge unique agreement," the *Plain Dealer*, December 16, 2009. Available at http://blog.cleveland.com/metro/2009/12/fannie_mae_and_the_new_cuyahog.html (accessed May 3, 2010).

[11] See Sandra Livingston, cited above.

[12] See Sandra Livingston, "HUD agrees to sell foreclosed houses to Cuyahoga County land bank," the *Plain Dealer,* July 2, 2010. Available at http://www.cleveland.com/open/index.ssf/2010/07/hud_agrees_to_sell_foreclosed.html.