Discussion Draft – 2-22-17
Help for Older Industrial Cities

Summary

From the abandoned factories of Cleveland, Ohio, to the shuttered breweries in Milwaukee, Wisconsin, to the closed auto plants in Flint, Michigan, many places across our country suffer from population loss and other disinvestment that leads to depressed home values and blighted neighborhoods. While the Great Recession exacerbated the distress and blight in these areas, their underlying economic weakness far predated the financial crisis, and the policies that have revitalized housing markets in economically stronger geographies are not sufficient to bring these neighborhoods back.

For decades, local and state governments have trying to address this complex and intertwined set of problems. After a first wave of economic development projects failed to replace jobs lost to deindustrialization in these cities, local leaders began thinking about creative ways to adapt to more permanent population loss. What these promising local initiatives do is adapt the city for a smaller population and revitalize what remains.

For a brief period of time after the financial crisis of 2008, the federal government pitched in to help distressed communities through the Neighborhood Stabilization Program (NSP), which provided subsidies for reclaiming blighted properties. However, now that most housing markets have recovered, this program has ended, and policymakers have largely turned their focus to the important but very different problem of coastal cities struggling with soaring rents and widespread gentrification.

We recommend that the federal government recommit to partnering with state and local governments that are trying to address population loss, blight and abandonment to create neighborhoods that work for their residents. Local leaders are experimenting and learning what works, but the federal government can help support and accelerate these efforts.

Our recommendations include the following:

1. Enable demolition of blighted structures.
2. Increase access to capital in weak markets.
3. Ensure that distressed asset and REO sales support neighborhood stabilization.
4. Support the entry of high-capacity social enterprises into the single-family rental market.

Of course, many issues beyond housing, such as jobs, schools and crime, have an equally large impact on the future of these neighborhoods and cities. Fixing the housing market alone will not stabilize or revitalize a community, but improving housing is a good place to begin. While these broader issues are beyond the scope of this paper, the multidimensional needs of distressed neighborhoods underscore why it's critical for policymakers to work across issue silos when addressing community needs.

Recommendations

Our specific proposals flow from several core principles. First, there are people who wish to stay in their neighborhoods and help improve it rather than move to a less distressed community. Second, investments in housing are most effective when made before a block or neighborhood has suffered too much disinvestment to recover. Third, policies that keep wealth in a community -- through homeownership or responsible local landlords owning rental properties -- can do double-duty in supporting those communities.

Enable demolition of blighted structures.

The need for demolition is often grounded in population loss. Some cities now house many fewer people than they were originally built to accommodate. A few examples illustrate the need for a more robust response:

- Detroit had 1.8 million people in 1950, while the 2010 Census calculated the population of Detroit as just above 700,000.
- Cleveland's population peaked in 1950 at 915,000 and has less than 400,000 residents today.
- St. Louis had more than 856,000 people in 1950 yet in 2010, the population was only 319,000.

These population shifts have hit smaller cities even harder. For example, Youngstown, Ohio, has shrunk from 170,000 at its peak population to 66,000 residents today.

The scale of population loss in many legacy cities is so large that a certain amount of demolition of vacant, obsolete properties is a critical first step to restoring these cities.[1] For example, as of 2012, there were 220,931 vacant units in the Detroit Metropolitan Statistical Area, 108,558 vacant units in the Cleveland MSA, and 118, 525 vacant units in the St. Louis MSA. [2]

With such large numbers of vacant buildings concentrated in cities that have struggled with population loss for decades, local governments cannot solve this problem entirely on their own. Federal assistance for demolition should be available for localities that have developed plans to "right-size" their city and that have taken steps – such as creating land banks – to create an orderly property disposition process.

The federal government should help support depopulated localities with significant long-term vacancy problems who want to demolish vacant and obsolete structures to make their cities work with fewer residents. In developing a program to help these localities, any federal government assistance should consider the following questions:

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[1] Office of Policy Development and Research, Department of Housing and Urban Development, *Vacant and Abandoned Properties: Turning Liabilities into Assets*, Evidence Matters, Winter 2014, page 2.
[2] Ibid, page 2.

- ➢ Does the city have an overall plan to concentrate resources in viable neighborhoods and align its infrastructure with current population?
- ➢ Has there been significant community engagement and community support for the strategy?
- ➢ Is the demolition plan supported by local foreclosure and tax lien strategies designed to get properties back into productive use?
- ➢ Is there a land bank or other municipal structure that can hold properties for reuse?
- ➢ Is there a local plan with community support for the reuse of the land?, such as being used for economic development or as green space, parks, urban gardens, or part of a storm water mitigation strategy?

Currently, the only federal funding available for demolition is from the Hardest Hit Fund, a state block grant program created by the Treasury Department using TARP money that aims to help impacted states cope with the foreclosure crisis. However, this program is limited to 18 states and the District of Columbia, and it is time-limited by Congress.

Additional assistance could come in the form of direct or indirect subsidies, tax credits, forgivable loans, or block grants, and it should include allowable uses for the funds such establishing and operating land banks to dispose of vacant and abandoned properties and rehabilitating and returning properties to productive use. Most important, any significant legislation to address U.S. infrastructure needs should include assistance for cities that need to demolish obsolete buildings.

Increase access to capital in weak markets.

Ironically, while weaker markets often have large stocks of single-family homes that are affordable to aspiring homeowners or landlords, accessing credit to acquire these homes can be difficult. One key problem is that in neighborhoods with vacancy and blight, it costs more to build or rehabilitate a home or commercial property than the building can be sold for. For example, in distressed neighborhoods, the amount that it costs to purchase and rehabilitate a home is more than the home can ultimately sell for due to the depressed market conditions. This so-called “valuation gap” is a big barrier to the return to a functioning real estate market in these places.

There are different ways to use financial incentives to address the valuation gap. A coalition of nonprofits has recently proposed creating a Neighborhood Homes Tax Credit (NHTC) to address this problem.[3] Tax incentives can be very effective inducements for directing private sector capital to support public needs, as demonstrated by the success of the Low Income Housing Tax Credit (LIHTC) and New Markets Tax Credit (NMTC). These incentives, however, are oversubscribed and

[3] https://www.neighborhoodhomestaxcredit.org/

difficult to use to solve the problems of the single-family market in distressed communities.

The NHTC would attract private capital to help revitalize poor and blighted neighborhoods by filling the valuation gap associated with building and rehabilitating owner-occupied homes in neighborhoods where the cost of construction or renovation exceeds the market value of the homes. It would support the construction and rehabilitation of homes sold to eligible buyers, as well as the substantial rehabilitation of homes by existing homeowners.

Much like the LIHTC, states would receive a formula allocation of NHTC authority and would monitor the use of funding to ensure that the subsidy provided is carefully tailored to bring the projects to fruition. The private market would bear construction and marketing risks, and the tax credits could not be claimed until the construction work is satisfactorily completed and homes are owner-occupied. The NHTC's flexible design would accommodate a variety of approaches and participants, including developers, homebuilders looking to invest in multiple properties in eligible communities, and financial institutions (including CDFIs) interested in creating a loan fund to support owner-occupied homes that are in need of substantial repairs.

Only those neighborhoods characterized by some combination of high poverty, low median family income, and low home values would be eligible for investments. In addition, states would be required to further define neighborhood eligibility requirements to ensure that the program is not targeting neighborhoods where there has been a recent influx of investment (marked by improving property values, higher rents or a displacement of lower-income families)

There are also issues with accessing debt financing for real estate transactions in weak markets. Currently, Fannie Mae, Freddie Mac, and the Federal Housing Administration all offer financing products that allow individual homebuyers to borrow more than the value of their home for the purpose of rehabilitation. However, while it is critical for homebuyers to have access to renovation/rehab financing, individual homeowners cannot shoulder the entire burden of rehabbing distressed properties. Especially in more distressed neighborhoods where there are many first-time homebuyers and hard-working families with little extra time or resources for managing contractors and where the rehab needs are often considerable, the more efficient and effective path is for an intermediary to renovate the home prior to sale to an owner occupant.

Therefore, Fannie Mae, Freddie Mac and FHA should create a similar financing product aimed at high capacity nonprofits that acquire and rehab homes as part of a coordinated community development plan. It is useful that Fannie Mae and Freddie Mac will both now be able to obtain credit under their statutory Duty to Serve requirements for creating a product of this nature. At FHA, such a product could be particularly valuable if it could offer assumable mortgages, which could enable a less costly and simpler mortgage process for a low-to-moderate-income and/or first-time-homebuyer.

Ensure that distressed asset and REO sales support neighborhood stabilization.

In many weak market cities, there are concentrations of nonperforming loans and homes that have been foreclosed on held by financial institutions, mortgage servicers, Fannie Mae and Freddie Mac, and the Federal Housing Administration (FHA). In neighborhoods with rising home values, demand remains strong and foreclosures and nonperforming loans (NPLs) are less of a problem for the broader community. In neighborhoods with falling real estate prices, however, the economic incentives can be very different and more attention needs to be paid to how lenders and owners of foreclosed properties dispose of these assets.

Currently, Fannie Mae, Freddie Mac and FHA are all auctioning off NPLs, bundling them into pools and selling them in a sealed-bid auction to the highest bidder, a process that significantly benefits well-capitalized, private financial entities and is particularly attractive to private equity funds. These buyers prefer the NPLs that produce significant income, either because they are able to help the homeowner to resume mortgage payments or because they can sell either the note or the post-foreclosure property for a profit in the private marketplace. However, private buyers have no economic incentives to invest in low-value and vacant homes, and often those notes end up contributing to neighborhood blight.

FHA and GSE sales of non-performing assets should be designed to provide the maximum benefit to the public and taxpayer. To achieve this goal, the agencies should require that any note buyer -- private or nonprofit -- achieve outcomes that support homeowners and neighborhoods. No buyer or sub-buyer of these notes should be allowed to dispose of these assets in ways inconsistent with the agency's own policies for how it or its servicers would treat these assets when taking them through foreclosure and REO sales. Most important, buyers should not be permitted to release liens and walk away from the properties.

FHA, Fannie Mae and Freddie Mac also sell post-foreclosure, real-estate-owned properties (REO) as well. Both the Enterprises and FHA should create an outcome-oriented strategy for disposing of REO. To the extent possible, all REO properties should first be offered neighborhood stabilization buyers.

Support the entry of regional scaled social enterprises into the single family rental market.

Another solution to the surplus of distressed homes in weak markets is to convert them – at least until the homeownership market strengthens – into scattered-site rental opportunities. One-to-four family homes comprise the majority of rental housing in America. Yet we have no scaled models for mission-focused developers to acquire, rehabilitate and manage these properties in a responsible manner that revitalizes neighborhoods and gives residents stable housing opportunities. Too often, the homes are being acquired by speculative investors (often from outside the U.S.) seeking to flip

them for short-term profit or rent them without bringing the properties up to code. This type of investor behavior can lead to a further cycle of decline and disinvestment.

Most high-capacity, nonprofit developers in the United States shy away from this stock because of the lack of capital, subsidies and economies of scale, but this is changing. HPN's experience working with sophisticated nonprofits in Canada and the United Kingdom through the International Housing Partnership demonstrates that this model can be effective using the right tools and business practices. The U.S. does have regional nonprofits with the capacity to engage in single family rental programs, and several of the more experienced programs have an interest in obtaining capital that would enable them collectively to scale this work to something in the range of 5,000 to 10,000 properties per year.

To pursue this strategy, reasonably priced capital is needed for acquisition and renovation. The federal government should encourage Fannie Mae, Freddie Mac, and their financial partners to develop capital products to be deployed by mission focused, scaled developers interested in pursuing and managing this asset class.

We recommend that a single-family rental product be offered through their multifamily channel, because we believe the business of scattered-site single-family rental is more comparable to traditional multifamily lending. On the multifamily side, the Enterprises have enormous experience in underwriting products aimed at creating affordable rental housing, as well as a long-standing system for sharing risk with private sector partners. Additionally, many of the nonprofits that would potentially be able to create and scale a single-family rental operation have existing relationships with Fannie or Freddie through traditional multifamily projects.

The structures being used to securitize single-family rental homes in the private sector could provide some ideas for a product of this nature. For example, while any individual property would have its own mortgage, a finance agreement could allow for cross-collateralization of the homes and creates a combined financial statement for all properties in which revenue is pooled.

Conclusion

It's time for a thoughtful federal policy response to help cities and neighborhoods that face declining populations and growing neighborhood blight, but still have significant numbers of residents committed to staying in place and building a better future. With the right mix of demolition, access to capital for ownership and rental, and strategic asset disposition, these cities can become viable communities and engines of economic growth into the future. Many local governments have done the hard work to rethink their plans and make their cities work and be more sustainable with a smaller population, but they need the federal government to support them in this difficult and expensive work.