



Housing Market Overhang—Double-Shadow

Last month's Full Disclosure column focused on the growing accumulation of loans in the severe stages of delinquency, and the impact that loan inventory will have on future foreclosure and real estate-owned (REO) activity. This month, we expand our perspective by adding home-sale activity data and a bifurcated view of an aggregate shadow market of pending housing inventory.

While market discussions have been circulating for some time about the impact of the shadow market on real estate values, the typical definition of this market represents homes that should be for sale on the market but for some reason aren't right now. We tend to view two unique shadow markets: one "clean" and one "dirty."

The clean shadow market is made up of properties held by homeowners who would like to sell but choose not to due to their perception (and reality, in most cases) that values are too depressed right now. They may have even listed a home within the past few years but pulled the listing off the multiple listing service (MLS) as activity and pricing in their market disappointed, or an actual negative-equity position came to light.

The bottom line is that these homeowners may want to sell opportunistically but just don't need to sell right now. As soon as prices recover, the theory goes, pent-up activity will accelerate quickly and listings will come in droves from these patient sellers. Market prices will dictate volume and timing here.

The dirty shadow market refers to the homes owned by borrowers experiencing payment distress as well as homes owned by banks that have taken title due to default. This market is represented by REO not yet listed, the 95 percent or so of homes that are currently in foreclosure that will eventually become REO (tomorrow's problems) and the 70 percent or so of homes owned by borrowers who are in the 90-plus-day delinquency bucket that will end up as REO or short-sale activity (next year's problem). The dirty market is what banks control or will control very soon. It's a portfolio of assets that is growing in size and must be managed in the future.

Whether you agree or have your own definitions, the bottom line is that these shadow markets will impact tomorrow's supply of available housing, home prices and elapsed time until a recovery is realized.

Today's resolutions versus tomorrow's brewing problems

Everyone agrees that REO activity in a housing market has the potential to negatively impact home prices. If REO activity is low (say, less than 10 percent of all sale activity), that impact

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might be negligible. As the percentage of REO sales relative to non-distressed sales increases, prices for the clean market may be impacted.

When we look at real estate activity across the country, it's striking that the concentrations of REO sales activity is very different in prevalence and severity across home-price ranges. The only real consistency is that the inventory of the dirty shadow market is concentrated in different segments than the REO being resolved today.

Let's focus on Los Angeles County as a good example of the contrast between dirty shadow-market inventory and REO liquidations (see Figure 1). Our analysis buckets home sales into three segments of property value. During the month of August 2009, this county was dominated by distressed transactions (58 percent of all transactions), and most activity occurred in

Figure 1 Inventory and Sales by Property Value: Los Angeles County

Los Angeles County								
Sold Price Range	Extrapolated LPS Data as of 8/31/09			LPS Residential Property Sale Data as of 7/31/09				
	90-Plus-Day Delinquencies	Foreclosure Inventory	REO Inventory	Regular Sales	Short Sales	REO Sales	Total Short Sales + REO	Total Residential Sales
<\$250,000	7,206	6,140	4,129	388	562	1,296	1,858	2,246
\$250,000-\$499,999	47,444	29,404	12,973	1,394	703	1,118	1,821	3,215
≥\$500,000	45,571	28,783	8,818	1,322	303	259	562	1,884
Total	100,221	64,327	25,920	3,104	1,568	2,673	4,241	7,345

SOURCE: LPS APPLIED ANALYTICS

our middle property-value bucket, which for this geography is a range of homes priced between \$250,000 and \$500,000.

However, the majority of REO/short-sale liquidity occurred in our lowest price segment of the market: the under-\$250,000 sales-price category—82 percent of all sales in this price segment were either REO or short sales, and 44 percent of all REO and short sales occurred here. Conversely, the higher property-value segment of greater than \$500,000 saw a 30 percent concentration of REO/short-sale activity.

The dirty shadow market can be broken into three components, all showing different trends. The existing-REO segment will feed REO sales over the next couple of quarters, and there are twice as many higher-dollar homes than low-dollar homes, and three times the inventory in the mid-range bucket as compared with the lowest price bucket (see Figure 1).

Foreclosure inventories are significantly higher in the upper two price segments, and these properties will most likely be resolved over the course of 2010.

As shown in Figure 1, the number of seriously delinquent borrowers (those 90-plus-days delinquent) who have not yet entered foreclosure is approximately 60 percent larger than the number of foreclosure inventories. Recent delinquency roll-rate trends suggest that at least 70 percent of these borrowers will ultimately lose their homes to foreclosure, thereby eventually feeding REO sales into 2011.

Los Angeles County is an extreme (but not unique) example in which severely delinquent loans represent more than four years of REO inventory at the August 2009 pace of liquidation.

The bottom line is that the higher price range of homes has a nascent inventory of problems that dwarf the current pace of bank balance-sheet resolution.

Bracing for the future

Today's problems look a bit different than those on the horizon, and each major market across the country is positioned slightly differently. The only consistency is that in almost every market, what is being flushed today looks quite different than what is coming.

While banks are facing enormous pressures to step up their loss-mitigation and loan-modification efforts, we can't fixate on stemming the foreclosure tide. Foreclosure moratoria in various markets across the country clearly indicate that many people view "tapping the brakes" on foreclosures as a good thing, although the recent information from the Treasury Department regarding servicer incentives to negotiate short sales for severely troubled borrowers indicates some level of appreciation for the issue at hand.

One thing is certain: Recovery will vary greatly in different home-price ranges and geographies, and a healthy appreciation for problem-loan inventories, the pace of change in this inventory and distressed home-sale volumes will be critical in tomorrow's strategic decision making.

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