California Research Bureau

Briefly Stated

When will the pain end?

California Foreclosure Watch (Q4 2008 data)

By Rani Isaac, March 15, 2009, for the Assembly Banking & Finance Committee

Please note: Previous CRB reports and PowerPoint presentations may provide useful background information. Using a search engine, enter the author's first and last name with the word Foreclosures. CRB has been providing updates in various forms to assist committee members and their staff in ongoing deliberations.

The pain will not end until 2010. In a February briefing in San Francisco, Moody's Economy.com Chief Economist Mark Zandi presented a timeline for the recovery of the economy. The following dates are milestones to gauge whether his forecast is accurate. He discussed details of the American Recovery and Reinvestment Act of 2009 (ARRA 2009), signed into law by President Barack Obama, and factored them into his forecast.

- Stock Market Bottom: between Q4 08 and Q1 2009
- Home sales bottom: end of Q1 09
- Housing starts bottom: end of Q2 09
- House prices bottom: end of Q3 09
- Foreclosures peak: end of Q4 09
- Employment losses bottom out: Q1 2010
- Jobless rate peaks: Q2 2010
- Extraordinary writedowns end: start of Q3 2010
- Housing prices resume rising: second half of 2010

The stock market indicator is already looking unlikely, so the forecast timeline may be lengthened. Nonetheless, Zandi's timeline is a useful guide for the state and nation on a long road to recovery. Until job losses abate and home prices stabilize, it will be hard to find the bottom of the cycle. Declines in income that come with job loss and loss of wealth, particularly in stock and other assets, contribute to defaults.[1] The federal stimulus package will create or save an estimated 3.5 million jobs nationwide, including 396,000 in California over several years. [2] Yet the state and nation will still lose jobs at a 2.2 percent pace in 2009, according to Zandi. The adverse effects of the attempts by California to balance the state budget might mean that the state spending cuts and tax increases will eliminate approximately half of the effect of the federal stimulus on employment, says Dr. David Gallo, Staff Economist, Time Structures, Inc., Sacramento.

Zandi assumes mortgage defaults will be increasing at a decreasing rate through much of 2009 and that moratoriums will just delay the inevitable adjustment. Nationally, while defaults rose throughout the final months of 2008, foreclosures may have dropped in the final quarter or in the early months of 2009. Frederick Furlong of the San Francisco Federal Reserve Bank says, that for the nation, it is possible new foreclosures in 2009 could be somewhat below the 2.25 million in 2008, but still remain quite high.[3] However, for the state in 2009, Furlong expects foreclosures to remain quite elevated. He expects further deterioration in the performance of mortgage loans and further softening of housing markets since prime loans and jumbo loans have had rising delinquencies.

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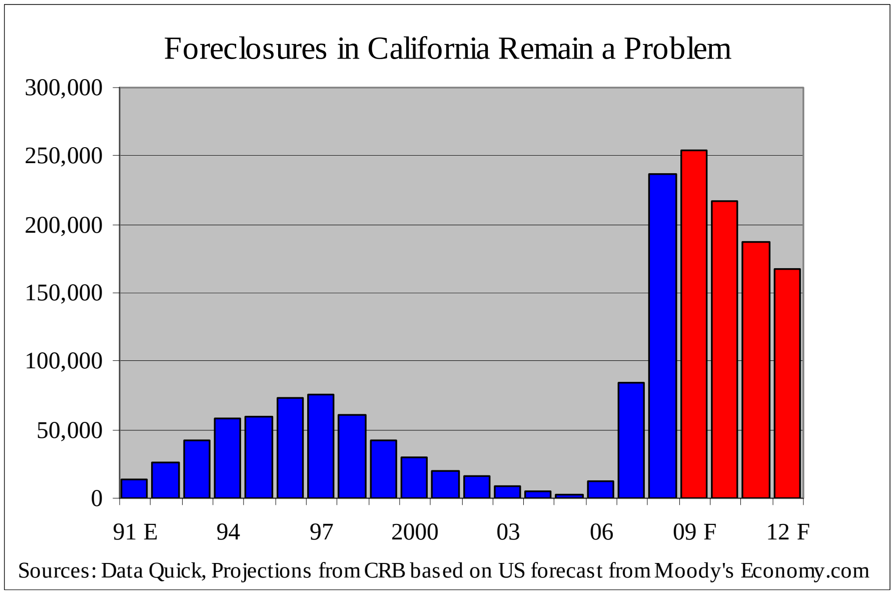
[1] Job losses include forced furloughs, underemployment (when highly educated workers accept low paying jobs), or when workers must accept part-time rather than full-time work.

[2] Population Estimates: U.S. Department of Commerce. Population Division: U.S. Census Bureau. 2007 American Community Survey 1-Year Estimates. Employment Data: U.S. Department of Labor. Bureau of Labor Statistics. Current Employment Statistics. 2007 Annual - Employment, Hours, and Earnings - State and Metro Area. 2008. Stimulus Employment Projections: Christina Romer and Jared Bernstein, "The Job Impact of the American Recovery and Reinvestment Plan," January 9, 2009.

[3] Moody's Economy.com Feb. 2009 report – *Housing in Crisis* lists foreclosure sales at 1.4 million in 2008. Projections from Economy.com are based on proprietary analysis of data from Equifax (a credit and data collection bureau) and the Federal Deposit Insurance Corp. (FDIC). They differ from sources used by Furlong (Group Vice President, Financial & Regional, SF Federal Reserve).

Nationally, around four percent of all borrowers have loans that exceed conforming limits, according to an estimate by First American CoreLogic, but in California, that share is 17 percent. [4]

Foreclosures and "lost" homes will peak and begin to level off late in 2009 as new programs by lenders and government agencies begin to mitigate foreclosures, according to Zandi. The latest data from DataQuick suggests that foreclosures dropped in the fourth quarter of 2008. [5] However, this may only be temporary. Data Quick reports that in 2007, there were 84,600 foreclosures; in 2008, there were 237,200; and in 2009, CRB's new projection is for 253,600 foreclosures (see chart). The latest CRB estimate of California foreclosures is 1.1 million for the "cycle" or period 2007-2012.[6] As lenders give cash bonuses of up to $1500 for those who are in default to mail back the keys and as lenders extend more principal forbearance in the form of short sales, some 300,000 additional units will be lost or surrendered. Total "lost" homes will therefore reach 1.4 million. In either Q3 or Q4 of 2009, foreclosures will peak and the cycle will begin to wind down in response to the measures the President, Federal Reserve Board, various federal agencies, and Congress are taking to address the crisis.[7] California is expected to follow the timeline for the nation. After a few more bad quarters, the loan modification process will be working more smoothly, forbearance by lenders will become more common, and more families facing default may have a chance of holding on to their homes.



The harmful trends are numerous. Because distressed inventory continues to build, the new projections are gloomier than previous projections. CRB's initial estimate of California "lost" homes was 1,085,000, in the 2007-2010 period, about 8.0% of all housing units in 2010 (based on Economy.com, July 08). Foreclosures were expected to reach 450,000 through 2010, but current estimates are for nearly 895,000 in 2008-2011. Conditions deteriorated: federal money has been slow in coming; unemployment surged; and more homeowners are under water as prices continue to decline. Unfortunately, it may take years for housing markets to regain balance. The

[4] A jumbo loan exceeds the maximum borrowing (conforming) limit for loans guaranteed or secured by a government agency. Jumbo mortgages are taken out in high-cost areas of the country such as Washington D.C., New York, Hawaii, and coastal California when Fannie Mae (FNMA) and Freddie Mac (FHLMC) limits do not cover the full loan amount. Fannie Mae and Freddie Mac purchase the bulk of residential mortgages in the U.S., but set conforming limits ($417,000 as of 2006) on the maximum dollar value of any mortgage, which they will purchase from an individual lender. Other large investors, such as insurance companies and banks offer jumbo loans. In February 2008, President Bush signed an economic stimulus package that temporarily increased the limit to $729,750, allowing Fannie and Freddie to buy existing jumbo loans from lenders and help to unlock the capital markets.

[5] The foreclosure data does not include short sales or deeds in lieu of foreclosure. Many more homes may be "lost" by these other two routes. Data may also not capture bulk sales by lenders.

[6] These estimates are based on Moody's Economy.com Feb. 2009 report –*Housing in Crisis*. Nationwide, 5.4 million homes will be lost in 2008-2011 to foreclosure and total losses reach 6.7 million. Short sales and deeds surrendered in lieu of foreclosure (mailing back the keys), will amount to about 1.3 million. California had 21.7 percent of all the riskiest loans (Alt-A and Subprime), as of December 2007. The previous estimates were based on Moody's Economy.com July 2008 report.

[7] Federal agencies such as the Federal Deposit Insurance Corp. (FDIC) and the Federal Housing Administration (FHA) of the U.S. Dept. of Housing and Urban Development (HUD) continue to ease the crisis and promote forbearance by setting standards as lenders or administrators of foreclosure workouts. Fannie Mae and Freddie Mac are also undergoing transformation as the Federal Reserve takes a more active role in their operations.

pain will last longer than initially estimated - to 2012. The current year is now forecast to be the peak year for foreclosures in California, higher than 2008 by 16,000.

California had 21.7 percent of all the riskiest loans, as of December 2007.[8] Subprime loan losses and resets have peaked and the number of those types of foreclosures is expected to fade, but a second wave of "toxic" mortgages is about to arrive. With the upcoming barrage of resets due in 2009 and 2010 in Alt-A and Option ARMs (stated income and low- or no-documentation adjustable rate mortgages), these risky mortgages will create new challenges for homeowners and lenders. Delinquencies in Alt-A loans may be particularly harmful to small business owners who may have used home equity to finance their company operations.[9] Foreclosures are likely to remain high as more people lose their jobs throughout 2009.

Job losses must end and home prices must stabilize for the cycle to bottom out. Homeowners who owe more on their mortgages than their homes are worth are at higher risk of default and foreclosure. [10] If homeowners who owe more on their homes than the value of their mortgages lose jobs, or have other economic shocks such as medical problems or the loss of a spouse, they may be forced to arrange short sales or mail the bank the keys to avoid a sheriff's eviction. In addition, further declines in house prices will weigh heavily on the ability of homeowners to refinance, especially those who bought in the peak price years 2005-2007, or pulled out equity based on inflated values. Unfortunately, they may not qualify for new loans.

Median existing home prices are expected to decline further in 2009, and begin to recover slowly, beginning in 2010, according to Moody's Economy.com. The median existing home price for the state in 2008 was $342,000, 30% off the 2006 peak. The projected median price in 2012 is $291,000. The data probably exaggerate the decline, since the proportions of the different types of sales during the two periods probably differ significantly. The houses sold during a given quarter may not be representative of the overall housing stock. Furthermore, homes sold during two different time periods may not be comparable. So comparing median prices in a healthy or peak period to prices in a distressed period may overstate the problem.

The prices reported by Data Quick also reflect median sales prices (recorded transfer tax sales price). In some metropolitan areas, prices are sliding faster than expected (see Excel Table 3).[11] Distressed sales are weighing heavily on prices statewide and in places such as Los Angeles and San Joaquin counties. In 08 Q4, the median price was $263,000 versus the peak in 07 Q2 of $485,000, a 46% drop. The Office of Federal Housing Enterprise Oversight (OFHEO) Conventional and Conforming Home Price Index (1980Q1 = 100) is often used as a more reliable measure of price movement, although it may under-represent low-priced homes.[12] The repeat sales OFHEO price index peaked at 636.2 in 2006, will bottom out in 2010, with a 44% decline, then recover slowly (to 410.2 in 2012).

Some rays of hope. On the other hand, foreclosures will be held in check for several reasons:

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[8] Loan performance data from First American Core Logic and the Federal Reserve Bank of New York show that California had 1,233,953 Alt-A and Subprime Loans out of 5,688,583 for the nation or 21.7 percent.

[9] Samuel D. Bornstein (Professor of Accounting & Taxation, Kean University, School of Business, Union, NJ, Bornstein & Song, CPAs & Consultants) says President Obama's foreclosure relief plan probably won't offer much help to California homeowners. "It will not save 90+ percent of Alt-A and Option (ARM) homeowners in California. These homeowners will not qualify under the LTV (Loan-to-Value) test and the Debt-to-Income Ratio test." He notes that the self-employed and other small business owners were targeted by lenders for these mortgages.

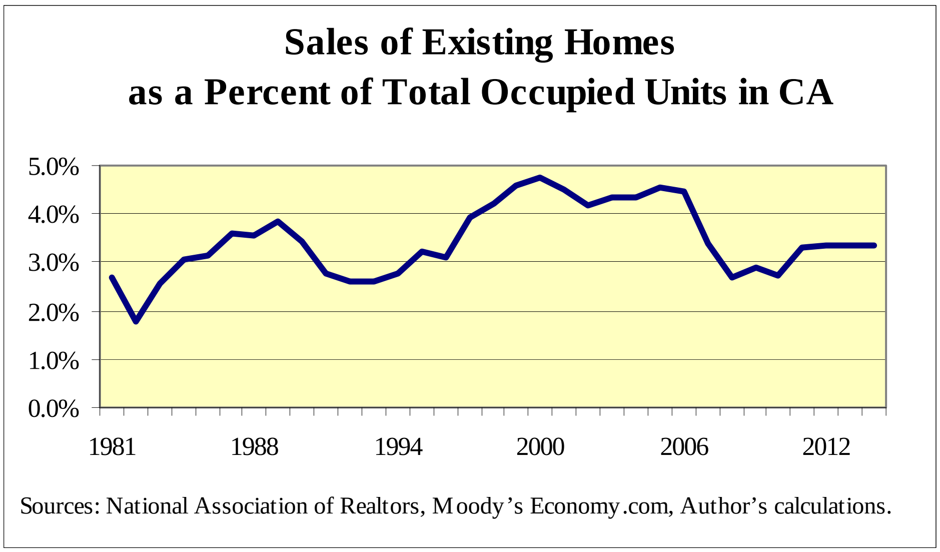
[10] In *The Economist* article, Feb 21st 2009, *Can't Pay or Won't Pay*, (p. 32), underwater loans (those with negative equity) were estimated to be $500 billion, nationally. President Obama's federal remedies only amount to $75 billion.

[11] The spreadsheets accompanying this report (available for download at http://www.library.ca.gov/crb/09/foreclosures09Q1.xls) include data for 57 counties. Tables 1-3 therein provide a summary of state and county data.

[12] *Comparing Aggregate Housing Price Measures*, by Jordan Rappaport, Federal Reserve Bank of Kansas City, *Business Economics*, "Focus on Statistics", October 2007, discusses the advantages of numerous types of home price data.

- Freddie Mac and Fannie Mae have moratoriums in place, and several major banks such as JPMorgan and Citibank announced temporary moratoriums. Both banks extended their moratoriums to incorporate details of the federal plan announced by the Obama administration, March 4.[13]
- In February 2009, California enacted ABX2 7 and SBX2 7 in the second special session to tighten foreclosure protection by imposing a 90-day delay, forcing certain notices prior to foreclosure, and requiring lenders prove they have a loan modification plan in place. The new measures will augment SB 1137, passed in July 2008.
- Federal programs administered through the Treasury Department have been set up with $75 billion to bring monthly mortgage payments back in line with household income and give other aid.[14]
- Notices of Default (NOD), one of the four indicators covered in CRB's subscription to Data Quick (DQ), are beginning to fall. For 2008, NOD totaled 384,800, but peaked in the second quarter. Q4 2008 defaults were six percent lower than the same period of 2007. The ratio of foreclosures to defaults was 89% in the two years 07-08 (559,179 foreclosures / 626,778 defaults = 89%).
- Finally, new and more aggressive loan modifications are in the works as homeowners default on already modified loans that have not forgiven principal.

What to watch. In addition to following employment and prices, disposition of the distressed properties is critical. Total DQ sales in 2008 were nearly 400,000, including properties that had been in foreclosure during the past year. REO sales (Real Estate Owned or banked-owned sales) are included if there was a foreclosure (Trustee's Deed) recorded on the property within the previous 12 months. The sales data do not include quitclaims or assignments (bulk loan transfers). The ratio of foreclosures to sales was 59%. Higher ratios suggest higher weight from distressed properties on prices. In eleven counties, the ratio was over 70%. A subset of those sales, existing single family (SF) home sales, were about 364,000, according to the National and California Associations of Realtors (NAR and CAR).



Moody's Economy.com forecasts existing SF home sales will fall 4.3% in 2009, before recovering 21.8% in 2010. The chart shows the current forecast and cycle compared to previous recessions. The 1981 correction had a V-shaped cycle, and in the 1990s, the cycle was U-shaped.

This cycle looks protracted like the 1990s cycle, but may be more of an L-shaped cycle, if the recovery does not come in 2010. Sales are expected to remain sluggish for some time to come. Many marginal buyers (including foreign and domestic migrants) bought homes earlier than they would have, borrowing from future demand. New households formed in the five years to 2010 are projected to number about 645,000. Lost homes in those five years are forecast to total 1,058,000. Homeownership has experienced a major setback – perhaps even a lost decade.

CRB will continue to post quarterly updates, forecasts and data if the new state budget permits renewal of key subscriptions. The author invites input and collaboration. She can be reached at risaac@library.ca.gov or by calling (916) 653-7522.

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[13] Kirk M. Lesh, Real Estate Economist, University of California, Santa Barbara, Economic Forecast Project has been assisting CRB with research intelligence and his colleague, Dan Hamilton, has assisted CRB with modeling expertise. The Fannie Mae and Freddie Mac moratoriums have been extended until April 1, 2009.

[14] The first time homebuyer credit is now $8,000 and available to those who have not owned a home in three years and wish to use the credit for a primary residence. Attractive interest rates for refinancing are offered through Freddie Mac, Fannie Mae, and FHA, especially for those with some equity remaining in their homes.