REO & Vacant Properties: Strategies for Neighborhood Stabilization, September 1, 2010
National Overview of the REO Crisis: Mark Zandi

Mark Zandi:
Okay. Great. Well, thank you for the kind introduction and the opportunity to be here today. Thank you, Preval, for the invitation. I understand I have two hours to speak.

[Laughter]

Nothing worse than an economist for more than 20, 25 minutes sound okay? And if there's any questions, we can do that for five, ten minutes. Okay. Good.

I'm going to make three broad points in my remarks. The first is the foreclosure crisis continues on. The pipeline of foreclosed properties is full. You can see that here. This shows the number of first mortgage loans that are in foreclosure or clearly headed in that direction, 90 days over delinquent. If they're loans that are that far along, the probability that they go into foreclosure is very high.

This is based on credit file data, data that we collect from credit bureau Equifax at the end of each month. I think the last data point in the chart is for the last week of July, so 4.1 million first mortgage loans are in this predicament.

Just to give you context, in our data, there are approximately 49 million first mortgage loans outstanding, so that gives you a clear sense of the magnitude of the problem.

There's been four waves of foreclosure. Wave number one was 2006. Those were the flippers. When the market began to turn and it became clear they couldn't make a quick buck, they turned their keys back to their lenders, went from being current on their loan straight into a default.

Wave number two was 2007. That was the subprime reset problem. This was when interest rates were still high before the Federal Reserve began lowering interest rates. These were -- most of the subprime loans were two-year ARMs, most that originated in '05, had their first payment reset in '07. The increase in monthly payments was unaffordable, and many of these borrowers defaulted.

Wave number three began in -- really in late '07, early '08, and it continues on through the current period. This is the combination of negative equity with unemployment and underemployment. By my calculation, based on the credit file data, there are just over 14 million homeowners that are in negative equity positions, so that the value of their home is less than the mortgage debt that they owe on the home. And just another statistic, 9 million of those are under water by more than 20 percent. So very deeply under water.

Of course, you mix 14 million underwater homeowners with 15 million unemployed and another 10 million underemployed, that's a pretty lethal mix, and obviously, the fodder for significant foreclosure problems.

We're now entering into wave number four, and that's what's being called strategic default, the idea being that homeowners can, under reasonable assumptions, make their mortgage payments but find it financially unpalatable to do so. Those are the folks that are deeply underwater by more than 20 percent. It's hard to get a grip on the magnitude of that problem, but it is -- it is now meaningful and increasing. The best estimates I've seen put it at about 20 percent of defaults now are strategic, and it is rising.

So the foreclosure problem is still in full swing. And it is translating and will continue to translate into more REO. This is my estimate of the number of loans that are in REO from the first quarter of 2008 through the second quarter of 2010. You can see that the peak was back in late '08, '08 Q3, '08 Q4. It did come down through late last year, but it is now picking up again. Last couple of quarters, the number of REO properties is beginning to rise.

One interesting development is that the number of REO on loans that are in securitized pools, subprime, jumbo pools, is declining; right? So if you go back to late '08, you can see that almost -- a little over 400,000 of REO property were in those securitized pools -- and now down to 200,000. And I get to see this data on a monthly basis because of Moody's. They collect the data for obvious reasons, and it is now falling relatively rapidly.

But unfortunately, the REO from Fannie, Freddie, FHA and what's sitting on bank balance sheets is now rising, and rising more than the decline in REO and securitized pools, so the total is now beginning to increase, and I suspect, given that previous chart of the number of loans that are in the foreclosure process, we will see REO begin to -- REO inventory continue to rise as we make our way through the remainder of this year into 2011. So the crisis continues on. No sign that it has peaked yet at this point.

So point number two. Unfortunately all this implies that house prices continue to decline. The key statistic is homes that are in distress, homes that are in foreclosure or short sales. You can see that here -- I think this is a chart only an economist could love -- This is the quarter to quarter change where the prices were and where price declines from Q1 2010 at the bottom are going to be greater than 5% are in red. And these are the same areas of the country that have been hardest hit, Florida, California, Arizona, Nevada, indeed, much of the west, parts of New Jersey, around New York, and of course, in distressed parts of Michigan.

And this goes back to the point that the key statistic for housing prices are the share that are distressed. The red areas are the areas where that share is going to rise most significantly in the coming months. At least, that's our expectation.

One other point about house prices. This is a very fragile forecast. You know, it can devolve pretty quickly. If house prices fall a bit more than I'm anticipating and more homeowners end up in negative equity positions than expected, then that could result in more defaults, more house price declines, and we will get right back into that vicious self-reinforcing cycle down that we were in a couple, three years ago. So it's what I would consider to be a forecast that's right on a razor's edge. If anything slightly goes wrong in the script, we'll be right back into the soup.

Now, that's point number two, and you should be thoroughly depressed.

[Laughter]

Right? Okay. So point number three is an effort to cheer you up a little bit. There are some good things happening. And I'm going to go through them. I am going to mention three very positive things that should give us some sense of hope that while we've got more work to do, it's not over. The coast is not clear. We're getting closer to the end of this process than the beginning. And let me go through them for you.

First, I think housing inventory has peaked. The number of vacant homes that are for sale, rent, or held off the market is extraordinarily high. You can see that in the chart. The green line is the actual number of vacant homes. The last data point from census is Q1 2010, just about 10 million homes were vacant.

The orange line represents an estimate of trend, so that would be a good approximation of what kind of vacant inventory we should have in a reasonably well-functioning housing market. So the difference between the two, the actual and the trend, is a pretty good guesstimate of the excess housing inventory in the economy. And you know, take 10 million actual, trend 8.5 million, that suggests what? About 1.5 million vacant properties that are in excess.

The back of the envelope calculation in the chart, in the northwest quadrant of the chart, shows you how we might work off that inventory. Housing supply is incredibly depressed. Single-family construction, multifamily construction, manufactured housing currently is running at about a 600,000-unit annualized pace. You can see how that's broken out in the chart. That's about as low as it's been since World War II. Incredibly depressed levels of construction supply.

Housing demand, that is also very depressed, given the tough economy, but it is, by my estimate, running measurably above supply, 1.35 million units annualized. You can see how that breaks out, household, about a million K. Obsolescence, the number you need to replace or get wiped out by tornadoes or hurricanes. The difference between demand and supply is about 750,000 units; right? So if demand and supply do not change going forward, how long will it take to work off 1.5 million vacant units? Two years. Two years. So you have to wait until mid-2012 before you can conclude that things are reasonably back to normal.

Now, my sense is that we'll get there sooner than that. I don't -- I think it's very likely that demand will pick up more quickly than supply. The builders are under significant financial pressure, can't get credit, and there's no appetite to increase supply quickly. But demand, I think, will improve. As the JAR market begins to engage, we get more job growth, we'll see housing markets improve more quickly. One could argue there's pent-up housing -- people are doubling up, tripling up. As soon as there's an opportunity for households to break up, they do. It's pretty difficult for those people to live in those households together for an extended period of time.

[Laughter]

In fact, you can see that in the recent data. The recent improvement in the job market since the beginning of the year, there was a very nice seeming pickup in household formations. A lot of

that went into rental property, and actually, the apartment market has improved quite noticeably since the beginning of the year. So there could be a point in time when the job market is really kicking into gear, say 2012, when we can get a lot more housing formations than we anticipated.

One other quick reason for some optimism here on the inventory front is the inventory problem is very regionally concentrated. Florida is just rife with a surfeit of inventory, around Atlanta, coastal South Carolina, Vegas, Arizona, Central Valley of California. But if you go into other parts of the country, the inventory is measurable less significant, so we are going to work through that excess inventory much more quickly, and that will lay the foundation for a much healthier market with job growth.

Reason number one for optimism is the inventory problem is at peak.

Reason number two, housing, in my view, is now fairly valued, at least if you look at house prices relative to household incomes or effective apartment rents. And just to give you a sense of that is this graphic. This shows the percent over or under valuation of single-family housing nationwide, based on those two metrics. So I've created a measure evaluation that's a weighted average of price to income and price to rent, again, using the Case-Shiller national index.

You can see by my calculation that housing -- house prices are roughly where they should be relative to household income and rent. That doesn't mean that we can't see more house price declines and we overshoot and see property markets go into a position of under valuation, as they were back in the late 1990s, when the California housing market was particularly depressed. But it is a reason for some optimism.

One other quick point. Take a look at the degree of over valuation at the height of the housing bubble in the mid part of the last decade, about 50 percent. That's nationwide. That's nationwide. So that means some markets were measurably more overvalued.

Just a quick tangent. You know, I was doing the same kind of thing, same kind of analysis, back in the middle of the housing bubble, and I was looking at these charts and saying the implications here are that house prices are going to fall, you know, 60 percent, 70 percent in Miami. And unfortunately, I didn't stick to the models, and I said we can't say house prices are going to fall 60 percent, 70 percent because if I say that, no one's going to believe me and I'm going to lose all credibility. So I said 30 percent, 40 percent. I wish I had stuck to my guns and said 60 percent, 70 percent. But it is a lesson, and now going forward, I'm sticking to my models. And that's a reason for some optimism.

Finally, the third reason for a bit of optimism is policy. I think policy is now engaging. You know, I think it's been frustrating, difficult to get the policy machinery working. This is an incredibly complex problem. You know this better than I do. Just getting our minds around the problem and then measuring the magnitude of the problem and then designing effective policies and then implementing those policies is incredibly difficult. Incredibly difficult. But you know what? I think we're there. I think we're right on the cusp of making a meaningful difference. And I think the HAMP effort has been reasonably successful. It's not been as successful as the President had hoped when he introduced the plan back in early 2009. We've only gotten

430,000, 440,000 in permanent modifications. But that is meaningful and will make a difference.

And more -- and also important -- as important, the HAMP plan is going through its own modification in the next couple, three months, we will see expanded incentives for modifications that will include incentives for principle write-down, going back to the negative equity I talked about earlier. You can see my outlook for foreclosure, short sale, deeds in lieu going forward in the context of HAMP 1.0, the original, and now HAMP 2.0, the HAMP with the added incentives and the principle write-down component to it.

So just because this is a very disconcerting topic and I know must be very disconcerting for you being in the trenches watching this on a day-to-day basis, it is going to be difficult. The coast isn't clear. The next six to 12 months are going to be very tricky, and we are going to need some good policy making from the Federal Reserve and administration. I think we've made a lot of progress, and I am sticking to my forecast.

That's the end of my remarks. I went through three points. I think we've now got five or so minutes, if anyone would like to make a comment or pose a question. Yes, ma'am.

Audience:
(Off microphone) -- In several slides previous to this one, you were comparing -- there -- the housing supply. And so my question is, it appears that in the housing supply numbers, you're not considering foreclosure inventory. And my question is why not? And if you did include foreclosure inventory, what kind of impact would that have on the supply-demand ratio.

Mark Zandi:
Good question. With respect to the foreclosure inventory, if someone gets foreclosed on and they lose their home, they have to live somewhere. It doesn't add to the vacant stock. You know, they'll go rent. They can rent another single-family home or they can rent an apartment or they can move to manufactured housing. So it's not like that household disappears. It's there. So it doesn't add to the vacant stock.

So this is just another measure of the -- of the amount of excess that exists in the housing market that's independent of the foreclosure problem. From my perspective, the foreclosure issue is very important with respect to house prices. And going back to my point about the share of sales that are distressed. This is another aspect of the vacancy problem, the overbuilding that occurred during the bubble and the boom, that does have influence on house prices but measurably less so.

Audience: (Off microphone)

Mark Zandi:
It would. You didn't hear the question. If a fair number -- she was asking will the Phillies win the World Series.

[Laughter]

The answer is yes.

[Laughter]

I am a Philadelphia native, yes.

She's asking -- she asked if a fair number of those people who lose their homes go back and double up and triple up, would that affect the results? The answer is yes, that would. My household formation number would be lower, but it is already depressed, and it is reflective of that occurring already. So I am accounting for that in that 100,000 estimate or guesstimate. It could be worse. You know, we could see more doubling or tripling up than we've had to date, and then this estimate would be too high. But you know, this does account for that already.

Audience:
Understanding that multifamily is a subset of these data, are you seeing anything significant in the multifamily sector that might not jump out in what you've just said?

Mark Zandi:
Well, yeah. I mentioned earlier to my surprise that the multifamily sector has seen -- has been strong, relatively strong, certainly relative to single-family market, over, really, since the beginning of the year. Since we saw the job market go from losses to gains, we've seen some pickup in formation and some breaking apart of those doubled, tripled-up homes. And a lot of those folks have gone into rental property.

So absorption of rental space has picked up, and vacancy rates have fallen in most markets. And in fact, effective rents are rising. They've risen quite considerably since the beginning of the year. So the rental market is in pretty good shape, surprisingly good shape compared to my expectation and most people in the industry's expectation at this point.

Now, a lot does depend on the job market. If the job market goes from positives back into negative territory, then we've got a problem. The household formations are going to slow again, and that's going to be reflected in weaker absorption in the apartment market, but the apartment market is measurably healthier.

Now, effective rents, you know, that accounts for concessions, so most of the improvement in effective rents has been just winding down the concessions that landlords were provided to get people into rental property. And of course, the level of rent is measurably lower than it was prior to the recession. So you know, the net income that's being generated on these properties is measurably lower than it was, but nonetheless, it's moving in the right direction. So that's a very positive development, I think.

I think we have time for one more comment/question if there is one. Bothering you? No? Thank you very much. It was a pleasure.

[Applause]