

Housing Supply Steps Gradually Into The Light

Servicers must balance the desire to reduce their REO inventory quickly - which leads to underpricing and oversupply - with the desire to minimize losses.

by Mark Fleming

Although house prices stabilized to some degree in 2009, there is a fair amount of trepidation in the marketplace over the growing supply of unseen inventory of homes for sale - often referred to as "shadow" inventory. Unlike the visible inventory of homes for sale - those listed for sale on Multiple Listing Services (MLS) or directly by homeowners - the shadow inventory is the stock of homes that are likely to be for sale in the future but are not yet listed or "visible."

The shadow inventory was estimated at 1.8 million single-family residential units in November 2009, as compared to 1.1 million a year earlier, and 361,000 in January 2006 at the height of the housing bubble. What's worrying the market is that the shadow inventory could cause renewed house-price declines, increase the share of homeowners underwater and lead to more foreclosures.

But will it? This article will examine whether shadow inventory will create a catastrophe in the housing market or whether government programs and the rational behavior of real estate owned (REO) property managers and homeowners will mitigate the risk of millions of homes being "dumped" into the market over the next year.

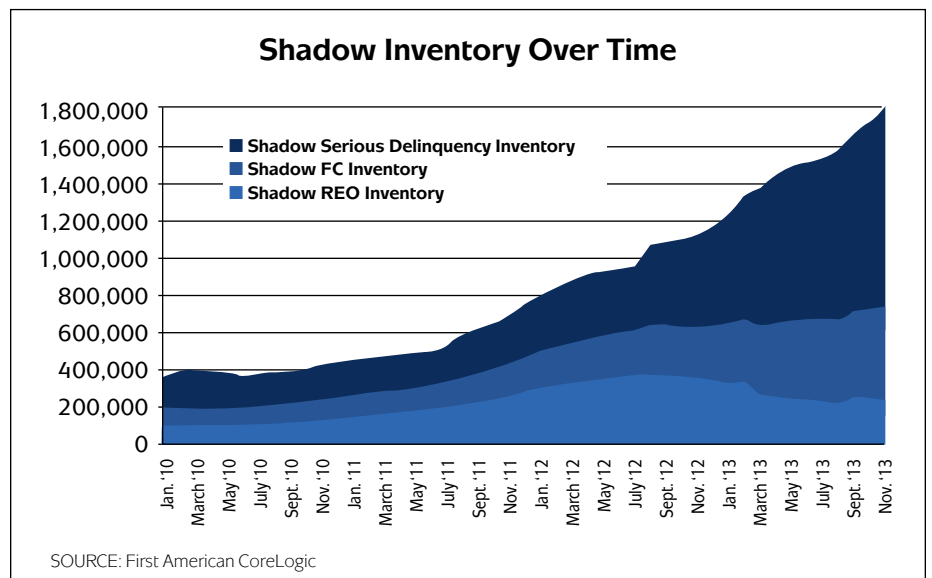
First, some definitions: Shadow inventory, as we define it, is bank-owned unlisted REO, the stock of properties that are 90 days or more delinquent and the

foreclosed properties most likely to become REOs within the next year but that are not yet actively listed. Other definitions of shadow inventory include those homes being held off the market by their owners, who are choosing not to sell because of market conditions or because they are in a negative-equity position.

Household mobility is typically pro-cyclical with unemployment, because individuals tend to move in search of new jobs and careers, leaving the geographic areas affected most by the recession for areas and industries that are less impacted or even growing. Homeowners seeking new jobs have to sell their home in one location and usually buy at their destination. Therefore, mobility contributes both to the supply and demand for housing.

The situation is different today, because non-distressed homeowners with negative equity are being prevented from moving. The New York Times recently called this phenomenon "house arrest." Census Bureau statistics indicate that 4.7 million households moved to another state between 2007 and 2008 (the latest available statistics). Mobility is down 48% relative to the average of 7.6 million households annually in the first half of the decade, when negative equity would not have been a constraint on mobility. Reduced mobility creates pent-up housing inventory and exacerbates unemployment by preventing moving for employment. Although reduced mobility is not specifically included in our shadow-inventory estimate, an argument could be made that the shadow inventory could be significantly higher if the house-arrest effect is considered.

Our company uses the following information to estimate shadow inventory: public records data indicating properties in pre-foreclosure, foreclosure and



REO; LoanPerformance (LP) loan servicing data identifying properties in serious delinquency, foreclosure or REO; and MLS listings data indicating the visible stock of REO properties for sale. The LP servicing data are used to understand transition rates of loans over time from serious delinquency to foreclosure and foreclosure to REO, as well as to provide the stock of properties that are in distress. The MLS data are used in combination with public records to estimate the share of listed properties versus unlisted REO properties.

The stock of seriously delinquent mortgages is multiplied by the "roll rate" - an estimate based on empirical measurement of the actual observed rate in the data at which seriously delinquent loans transition through foreclosure to become REO properties within the following year. Additionally, the stock of mortgages at a point in time that are in foreclosure is multiplied by the roll rate for those that are in foreclosure and will become REO properties within the following year.

Not all of the loans held in REO are part of the shadow inventory; listed REOs are "visible." To estimate the share of loans that are unlisted and, therefore, part of the shadow inventory, we match public records data for all foreclosed properties with the property-level MLS data sources. Once matched, the share of foreclosed but not listed properties is calculated. This "listing share" is multiplied by the REO stock at a point in time to reflect that not all REO stock is invisible. The roll-rate-adjusted seriously delinquent and foreclosed loans not observed as listed are added to the listing-share-adjusted total of all REO properties reported in our database to estimate the shadow inventory.

In the chart on the previous page, the shadow inventory is shown from January 2006 through November 2009, which is the most recent data available at the time of writing this article. As we've seen, the supply has grown from fewer than 400,000 housing units three years ago to just over 1.8 million units in November 2009. Interestingly, foreclosure and REO levels have stabilized at just fewer than 500,000 since mid-2008. So, the vast majority of additional shadow inventory is due to the seriously delinquent segment. Furthermore, the share of REO shadow inventory has ac-

tually receded from a peak of 381,000 in August 2008 to a current level of 243,000 housing units.

A plausible explanation for the reduced REO shadow inventory and stabilizing foreclosure shadow inventory over the latter half of 2008 and throughout 2009 is that in the last quarter of 2008, mortgage servicers were delaying foreclosures in anticipation of new government programs. Servicer expectations were that government policy was being formed to discourage the impact of foreclosure and subsequent REO sales on consumers and their local markets. Alternatives to traditional foreclosure, such as the Home Affordable Modification Program and the Home Affordable Refinance Program, were expected and, ultimately, enacted last year.

The existence of these programs throughout 2009 moderated the transition of seriously delinquent loans into the foreclosure process and, eventually, REO sale. What remains to be seen is whether the success of government programs in turning trial modifications into permanent and non-recidivistic modifications will reduce the shadow inventory or whether it has only changed the composition of the shadow inventory temporarily.

The chart also suggests that most of the shadow inventory will not be brought to market as visible REO inventory in the short term because of lengthening foreclosure processes. The differences in the length of time it takes to foreclose in different states, as well as the backlogs facing overwhelmed servicers, mitigate the risk that the shadow inventory will have a calamitous impact on the housing market in 2010. A share of the shadow inventory may not even be available for sale until 2011.

Competing risks: price, volume

Consider the "game" of selling a home. The participants in the game are the seller and the pool of potential buyers. In the case of shadow inventory, the home cannot yet be offered for sale, but the seller will eventually be the bank once it is taken into REO inventory, if it is not part of the REO stock already. In this game, the seller makes the first move by offering the property for sale at a list price. From there, a potential buyer offers a "bid," and the seller may offer a

counter bid, and so back and forth the game goes until a price is settled.

What would happen if the seller were to offer a ridiculously high first move price? Either the buyers would counter bid a more realistic price or no bids would be received, and the seller would potentially reduce the price until it attracted bids.

Alternatively, what if the seller in the first move offers a very low initial price - are the bidders going to immediately bid the much higher but realistic market price or bid (and potentially compete with other bidders) to win with the lowest bid possible relative to the initial list price? This is the same "game" that is played on eBay every day.

The importance of the first move by the seller can clearly be seen in this example. By setting a low initial-list price, one stimulates demand (multiple bids), which we can assume promotes the quick sale of the property, but also is more likely to receive a lower sale price. There are competing risks that are faced by the seller of shadow inventory once it becomes part of the REO stock.

On one hand, the seller can sell properties quickly and reduce the stock by underpricing. On the other hand, the seller can set a higher initial price, but this reduces demand and lengthens the time to sale. It seems that if we only play the game "once," the incentive would be to underprice the property so that the net-present-value savings of the reduced holding cost for the property offsets the loss from the sale.

But this game is not played only once in a neighborhood. Servicers often own many properties in the same market or neighborhood. If they were to place them all for sale at once in the neighborhood, they would increase the supply and suppress the demand. In this scenario, the buyers would have many properties to choose from, and the seller would have to significantly underprice the property in order to attract bids. In essence, sellers are competing with themselves and with servicers selling REO properties in the neighborhood.

In neighborhoods with significant REO stock, oversupplying the inventory will force prices down. Therefore, those responsible for the disposition of REO assets have to balance the amount of supply with the minimization of losses. The faster they turn the shadow inven-

tory into visible inventory, the more they risk increasing losses. For these reasons, it is implausible that high volumes of the shadow inventory will become visible inventory all at once but much more likely over the course of time, as the market can reasonably absorb the supply of REO properties relative to demand.

Although shadow-inventory levels are currently five times higher than they were at the peak of the housing boom, the impact of the shadow inventory on the housing market may not be as calamitous as some have suggested. Government intervention has the potential to

“cure” a portion of the delinquent loans that are the biggest portion of the shadow inventory, assuming, of course, that trial modifications turn into permanent ones.

Not all of today’s shadow inventory is ready to become visible inventory in the near term. Foreclosure time frames vary by state, and servicers are showing significant restraint in foreclosing. Finally, servicers understand that they must balance the desire to reduce their REO inventory quickly, which leads to underpricing and oversupply, with the desire to minimize losses - all of which suggest that the threat of shadow inventory may be

overblown and that, in all likelihood, REO stock will not be “dumped” in bulk on the market. For these reasons, the shadow inventory is expected to remain elevated throughout the year, but it is unlikely to cause dramatic price declines. **SM**



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