Point of Contention: Shadow Inventory

With this issue, we introduce a new section of Cityscape, *"Point of Contention," in which we present viewpoints on narrow issues on which expert opinions nonetheless may be remarkably different. The first point of contention is the shadow inventory. For our purposes, we define the shadow inventory as housing units being held off the market by lenders, either in the form of Real Estate Owned (REO) properties not offered for sale or in the form of mortgages delinquent for more than X months on which the lenders have not foreclosed. The unknown X is at least 3, but lenders seem to differ on how many months of delinquency they allow and what other conditions must be met before foreclosure occurs. Some commentators argue that home prices cannot stabilize as long as a large potential supply of inventory overhangs the market and that falling home prices are a major drag on the economy. For this issue, we asked three experts to explain why the shadow inventory exists, why it has increased, how large they think it is, how large it would be in a normal market, and whether the shadow inventory requires government action to accomplish economic recovery.*

Chasing Shadow Inventory: Sloppy Foreclosures and Unintended Consequences

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The specter of shadow inventory continues to loom over the housing market, despite an undeniable decrease in the actual shadow inventory numbers.

The inventory of properties in some stage of foreclosure or Real Estate Owned (REO) shrank from a record high of more than 2.2 million properties in December 2010 to slightly fewer than 1.5 million properties in September 2011—a 32-percent drop in just 9 months—according to RealtyTrac® Inc. proprietary data.

During a similar time period, the unsold REO inventory fell 30 percent, from more than 1 million properties in January 2011 to about 710,000 properties in September 2011. The inventory of properties in the foreclosure process fell 37 percent during the same period.

The decreases in foreclosure inventory in 2011 should not be too surprising given the decreases in delinquency rates in 2010. After peaking at 10.06 percent of mortgage loans in the first quarter of 2010, delinquency rates fell for three straight quarters through the end of 2010, according to the

Mortgage Bankers Association National Delinquency Survey. The national delinquency rate then increased in the first and second quarters of 2011 before decreasing again in the third quarter to the lowest level since the fourth quarter of 2008.

Nonetheless, shadow inventory continues to strike fear and uncertainty into many hearts, because no one quite trusts all of the numbers floating around. This dark corner of the housing market might be hiding the true enormity of the problem. Or, perhaps a cleverly concealed lighting effect is causing a relatively small inventory to cast a disproportionately long shadow that is simply feeding irrational fear.

The fear and uncertainty saturating the market, whether rational or not, is prolonging the shadow inventory problem, making it a sort of self-fulfilling prophecy. This fear and uncertainty about the actual magnitude of the shadow inventory problem is helping to drive down consumer confidence and demand from most real estate buyers. The lower confidence and demand mean that the market takes longer to absorb the distressed properties that make up the bulk of the shadow inventory.

RealtyTrac® proprietary data show that REO properties sold in the third quarter of 2011 sold an average of 193 days after they were foreclosed upon—the highest average since the first quarter of 2007, when RealtyTrac began tracking this metric. Properties in the foreclosure process that sold during the third quarter of 2011 sold an average of 318 days after they entered the foreclosure process, also the highest average since the first quarter of 2007.

Weak consumer demand is not entirely responsible for those record-long times to sell foreclosures, however. In fact, in-foreclosure and REO property sales increased in the first two quarters of 2011 after decreasing in the two quarters immediately after the first-time homebuyer tax credit expired in the second quarter of 2010.

In select markets hard hit by the foreclosure crisis, we have even been hearing for several months now about an inventory shortage and bidding wars on foreclosure properties. This shortage is happening in places like Stockton, California, and Detroit, Michigan, where a member of the RealtyTrac® Agent Network recently said he thinks that a “backlog of buyers” in his market is just waiting for more properties to become available (Whitelaw, 2011).

What else could be holding up the efficient sale of distressed inventory in today’s market? The two answers are sloppy foreclosure practices on the part of lenders and the unintended consequences of government intervention.

Government intervention began in earnest at the federal level with the introduction of the Home Affordable Modification Program (HAMP) in March 2009. HAMP’s beginning coincided with a key turning point in the distressed property sales trends tracked by RealtyTrac®.

Starting in the first quarter of 2006, sales of REOs and properties in the foreclosure process had steadily increased for 12 straight quarters, or 3 years. Those sales peaked at 348,629 in the first quarter of 2009 and began trending downward for the next four quarters, a trend interrupted by a sizable jump in the second quarter of 2010, most likely the result of the expiring first-time homebuyer tax credit. Although distressed sales have taken a recent uptick, the second quarter 2011 total of 265,087 distressed sales was still much less than the first quarter 2009 peak.

Although the intended purpose of HAMP and the other foreclosure intervention programs that followed was to help homeowners avoid foreclosure, the programs also had the unintended consequence of slowing the absorption rate of distressed properties, which in turn allowed for a shadow inventory of in-foreclosure and REO properties to begin building to a peak of more than 2.2 million early this year.

Whereas foreclosure sales slowed with the introduction of HAMP, actual foreclosure activity picked up. March 2009 began 20 consecutive months in which more than 300,000 U.S. properties had a foreclosure notice of some kind, according to RealtyTrac® data. That dubious trend came to an abrupt halt in November 2010, after the "robo-signing" controversy brought to light the questionable foreclosure processing and paperwork that many lenders used to push foreclosures through quickly.

The fallout from the robo-signing controversy continues to slow the pace at which lenders foreclose. Properties foreclosed in the third quarter of 2011 spent an average of 336 days in the foreclosure process, from start to completion, a record high in RealtyTrac® data and up from the 140-day average to foreclose recorded in the third quarter of 2007.

These extended timelines clearly demonstrate that lenders are not able to process foreclosures as quickly as they did in the past. This fact has reduced the shadow inventory of REOs and properties in the foreclosure process, but it may be pushing the shadow inventory of delinquencies higher—hence the uptick in delinquency rates in the first half of 2011, after three straight quarters of declines.

Although the so-called shadow inventory certainly exists, attempts to somehow contain it are a bit like trying to catch one's shadow—mostly ending in frustration and exhaustion with nothing to show for it. Instead, we should continue trying to shed light on the true nature of the shadow inventory in an attempt to remove the paralyzing fear and uncertainty it has brought to this market.

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References

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