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Variations In U.S. Shadow Inventories Could Spell Home Price Declines In Some Areas, Stabilization In Others

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RESEARCH

Variations In U.S. Shadow Inventories Could Spell Home Price Declines In Some Areas, Stabilization In Others

The volume of troubled residential properties has been growing in nearly every U.S. state since 2005, and borrowers nationwide are now defaulting on their mortgages faster than existing defaults are being resolved through liquidation, according to Standard & Poor's Ratings Services. These trends have given rise to a large "shadow inventory" of distressed properties—which we define as outstanding properties that are (or were recently) 90 days or more delinquent on mortgage payments, in foreclosure, or real estate owned (REO)—that haven't yet hit the market.

We estimate that the entire shadow inventory of distressed properties currently outstanding that back nonagency residential mortgage-backed securities (RMBS) would take nearly three years to clear at the current average national resolution rate (see the appendix for more information on our study sample and methodology). The original principal balance of the overhang amounts to roughly $480 billion, or 30% of the entire nonagency market. Given this backlog, we believe that average home prices could fall again if demand doesn't rise in step with the potential influx of supply.

Although shadow inventories remain well above historical averages in most regions of the U.S., inventory levels and trends among U.S. cities vary significantly. Our review of the 20 major metropolitan statistical areas (MSAs) included in the S&P/Case-Shiller Home Price Indices revealed that inventories appear to be falling from recent peaks in some areas while plateauing at historical highs or continuing to rise in others. In our view, these variations could indicate where home prices may pick up or continue to stabilize and where additional declines may still be in store.

Inventory Levels Varied Significantly Among The MSAs

Our review revealed striking differences in the current levels of inventory among the major MSAs (as of February 2010; see tables 1 and 2). We estimate that the shadow inventory in the New York City metro area will take the longest to clear—at 103 months—assuming the current liquidation rates. This is almost 3.5 times our estimate for the national average, at 34 months, and far exceeds the level for the Phoenix metro area, which has a projected 16 months of inventory to clear, the lowest of the 20 MSAs.

Each MSA generally has some relatively constant minimum supply of distressed properties, and the level has typically reflected—at least before 2006—individual state laws governing foreclosure timelines. To determine whether the mortgage crisis has affected timelines for resolving troubled assets, we compared recent data with historical average inventories.

Table 1

Current Shadow Inventory Statistics By MSA: Months Of Inventory

MSA	Orig. bal. outstanding (bil. $)	Mos. of inventory	Mos. of inventory: 6-mo. % change	Mos. of inventory: YOY % change
New York-Northern New Jersey-Long Island, NY-NJ-PA*	127.0	103.1	(1.8)	3.3
Miami-Fort Lauderdale-Pompano Beach, FL	62.8	61.8	10.5	(8.1)
Boston-Cambridge-Quincy, MA-NH	23.6	58.0	33.8	70.8

Table 1

Current Shadow Inventory Statistics By MSA: Months Of Inventory (cont.)				
Tampa-St. Petersburg-Clearwater, FL	17.0	52.9	15.6	1.2
Chicago-Naperville-Joliet, IL-IN-WI*	42.5	44.3	10.0	(12.4)
Charlotte-Gastonia-Concord, NC-SC	5.3	44.0	12.2	19.4
Seattle-Tacoma-Bellevue, WA	27.2	43.8	1.6	(5.2)
Dallas-Fort Worth-Arlington, TX	18.1	43.0	49.5	74.3
Los Angeles-Long Beach-Santa Ana, CA	194.0	38.6	18.8	28.7
Cleveland-Elyria-Mentor, OH	4.5	38.1	38.1	63.7
Atlanta-Sandy Springs-Marietta, GA	27.3	37.1	37.8	38.4
Washington-Arlington-Alexandria, DC-VA-MD-WV	67.4	34.2	22.1	36.3
All remaining MSAs	645.4	34.0	20.9	18.9
Portland-Vancouver-Beaverton, OR-WA	11.6	32.5	0.9	(9.1)
Denver-Aurora-Broomfield, CO	16.2	29.7	42.9	89.8
San Francisco-Oakland-Fremont, CA	88.1	29.2	27.0	33.8
San Diego-Carlsbad-San Marcos, CA	51.5	28.8	23.8	34.5
Minneapolis-St. Paul-Bloomington, MN-WI	15.0	23.5	26.7	6.5
Detroit-Warren-Livonia, MI	13.9	23.3	36.2	28.0
Las Vegas-Paradise, NV	25.7	21.4	5.8	(4.0)
Phoenix-Mesa-Scottsdale, AZ	33.7	18.5	26.0	(14.9)

*The New York and Chicago metro areas we used for this study differ from those in the S&P Case-Shiller indices.

Table 2

Current Shadow Inventory Statistics By MSA: Breakdown Of Delinquency Status

MSA	Orig. bal. outstanding (bil. $)	Closed loans: avg. mos. delinquent*	Outstanding loans: avg. mos. delinquent	Overhang (% of original bal.)	Recently cured, expected to redefault (% of orig. bal.)	90+ days delinquent (% of orig. bal.)	Foreclosures (% of orig. bal.)	REO (% of orig. bal.)	Unemployment (%)
New York-Northern New Jersey-Long Island, NY-NJ-PA¶	127.0	27.2	18.2	33.1	3.6	11.8	16.2	1.5	9.6
Miami-Fort Lauderdale-Pompano Beach, FL	62.8	22.6	19.2	54.4	3.1	12.6	35.1	3.6	11.4
Boston-Cambridge-Quincy, MA-NH	23.6	21.9	15.9	29.0	5.3	13.8	7.7	2.2	8.9
Tampa-St. Petersburg-Clearwater, FL	17.0	21.7	18.6	45.9	3.5	11.4	28.5	2.4	13.2
Chicago-Naperville-Joliet, IL-IN-WI¶	42.5	23.3	15.4	37.1	5.7	12.9	14.0	4.5	11.4
Charlotte-Gastonia-Concord, NC-SC	5.3	16.3	12.1	24.4	4.8	11.2	6.1	2.4	12.8
Seattle-Tacoma-Bellevue, WA	27.2	16.8	12.7	23.9	2.6	12.8	6.8	1.7	9.5
Dallas-Fort Worth-Arlington, TX	18.1	15.4	12.3	19.6	3.7	9.4	4.7	1.8	8.4
Los Angeles-Long Beach-Santa Ana, CA	194.0	17.7	13.9	30.1	4.2	14.8	8.7	2.3	11.6
Cleveland-Elyria-Mentor, OH	4.5	21.7	16.7	33.6	5.7	13.3	11.5	3.1	10.6

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Table 2

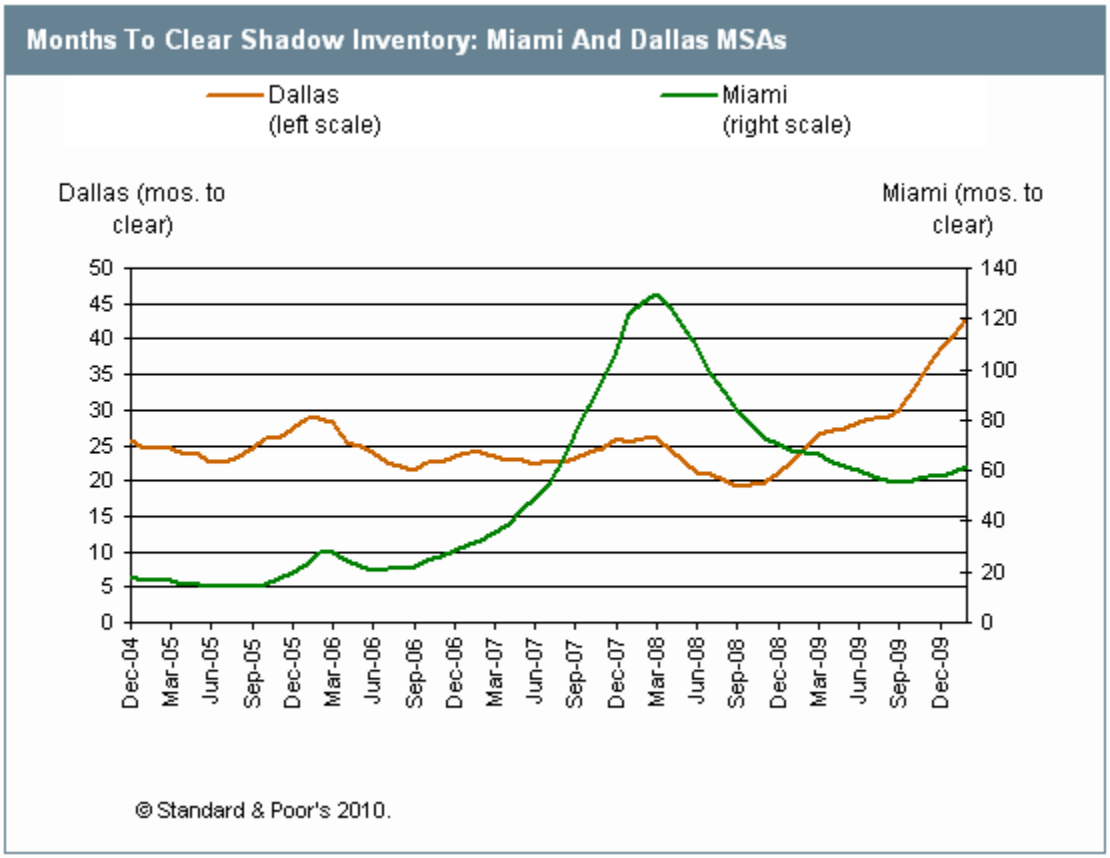
Current Shadow Inventory Statistics By MSA: Breakdown Of Delinquency Status (cont.)									
Atlanta-Sandy Springs-Marietta, GA	27.3	16.4	12.9	27.8	4.5	13.5	6.5	3.2	10.7
Washington-Arlington-Alexandria, DC-VA-MD-WV	67.4	19.1	14.3	25.4	4.3	11.8	6.6	2.7	6.9
All Remaining MSAs	645.4	18.5	14.4	31.5	4.9	13.0	10.5	3.1	11.2
Portland-Vancouver-Beaverton, OR-WA	11.6	16.2	12.4	25.0	3.5	11.1	8.4	2.1	11.0
Denver-Aurora-Broomfield, CO	16.2	16.1	11.9	20.5	3.7	8.7	6.1	2.1	8.4
San Francisco-Oakland-Fremont, CA	88.1	17.0	13.4	21.1	2.5	10.3	6.1	2.1	10.7
San Diego-Carlsbad-San Marcos, CA	51.5	16.2	13.3	27.0	3.5	13.5	7.9	2.1	10.7
Minneapolis-St. Paul-Bloomington, MN-WI	15.0	19.2	13.8	27.2	4.2	9.9	7.7	5.4	7.6
Detroit-Warren-Livonia, MI	13.9	16.2	13.3	33.8	6.0	14.2	7.3	6.4	15.3
Las Vegas-Paradise, NV	25.7	16.4	13.5	46.8	3.9	19.5	19.0	4.3	13.9
Phoenix-Mesa-Scottsdale, AZ	33.7	14.5	12.4	36.0	4.9	15.5	11.3	4.3	9.2

*Includes loans that closed in fiscal 2010. ¶The New York and Chicago metro areas we used for this study differ from those in the S&P Case-Shiller indices.

Inventory Patterns Revealed Regional Trends

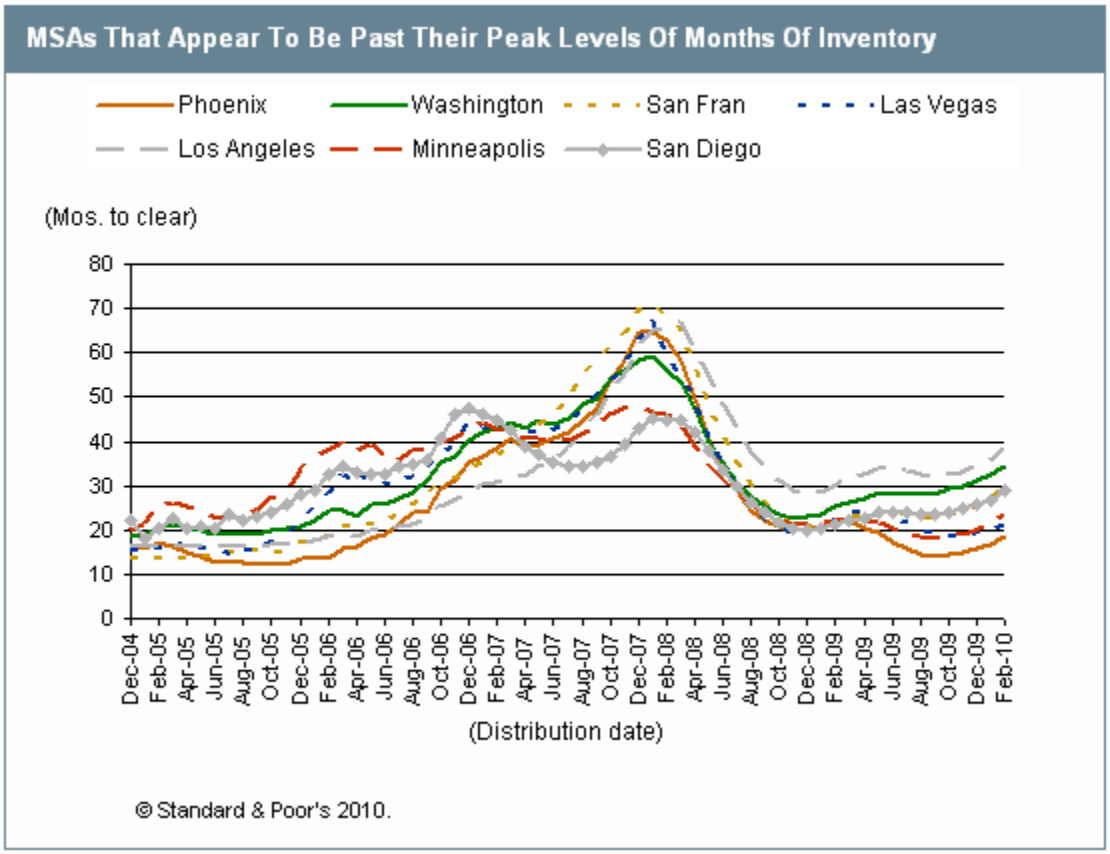
Although the variations in inventory levels among the MSAs were striking in themselves, we found the differences in inventory trends to be far more telling of the relative levels of inventory buildup and potential future price movements. Our current estimate of the months to clear the distressed properties in the Miami metro area, for instance, is over 40% higher than our estimate for the Dallas metro area. However, our estimate for Miami, at 62 months, is less than half its March 2008 peak of 129, which suggests that Miami may be past the worst of the buildup. Our estimate for Dallas, on the other hand, is at its highest point yet, at 43 months, up from about 19 months in September 2008 (see chart 1).

Chart 1



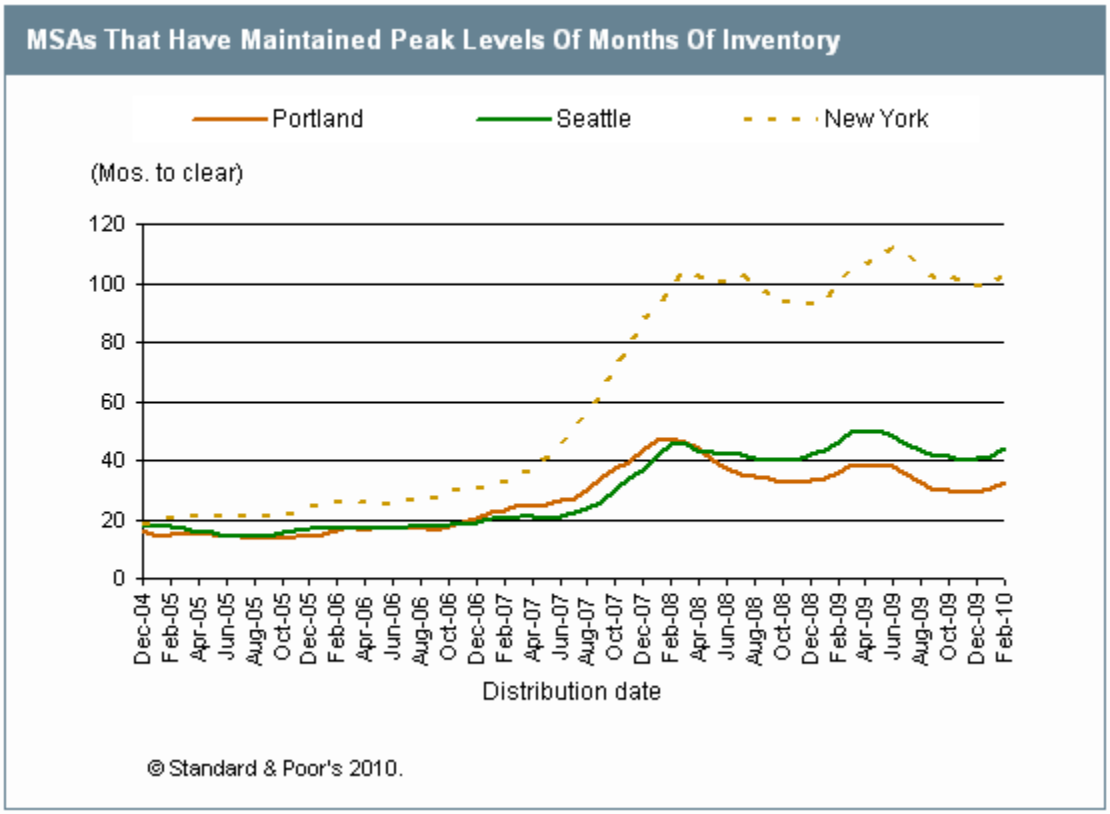
As in Miami, inventories in several other MSAs—including Las Vegas, Los Angeles, Minneapolis, Phoenix, San Francisco, and Washington, D.C.—also seem to be past their highs. In each of these MSAs, inventories began to significantly increase around the end of 2005, peaked in early 2008, and have subsequently fallen to levels close to those in the beginning of 2005, although the exact timing and magnitude of the changes varied from region to region (see chart 2). While these MSAs appear to have reached and recovered from their peaks, their inventories seem to be rising once again, particularly in Los Angeles and Washington, D.C.

Chart 2



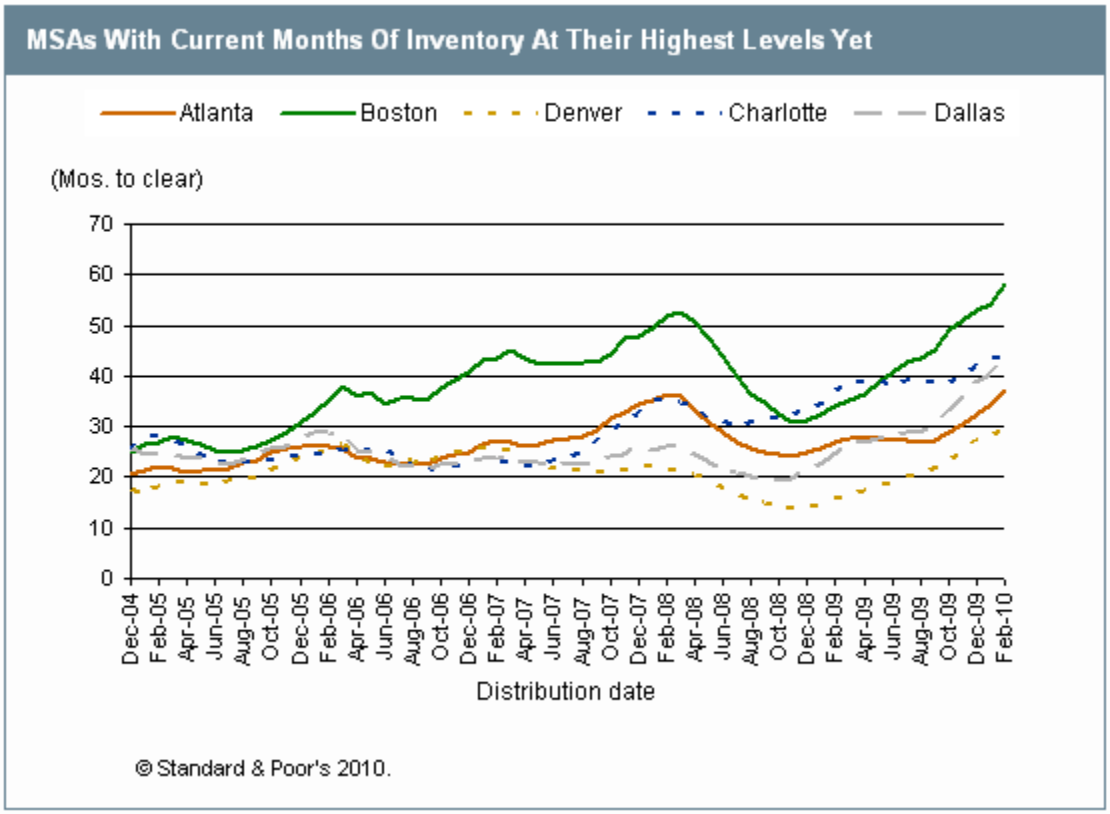
In several other MSAs, including New York, Portland, and Seattle, we observed a run-up in inventories similar to that in Miami. However, although inventories for these MSAs also reached new highs in early 2008, with another slight rise in early 2009, they appear to be maintaining these peak levels overall (see chart 3).

Chart 3



In some other MSAs, including Atlanta, Boston, and Denver, the months of inventory are currently at their highest levels yet and appear to be trending up (see chart 4).

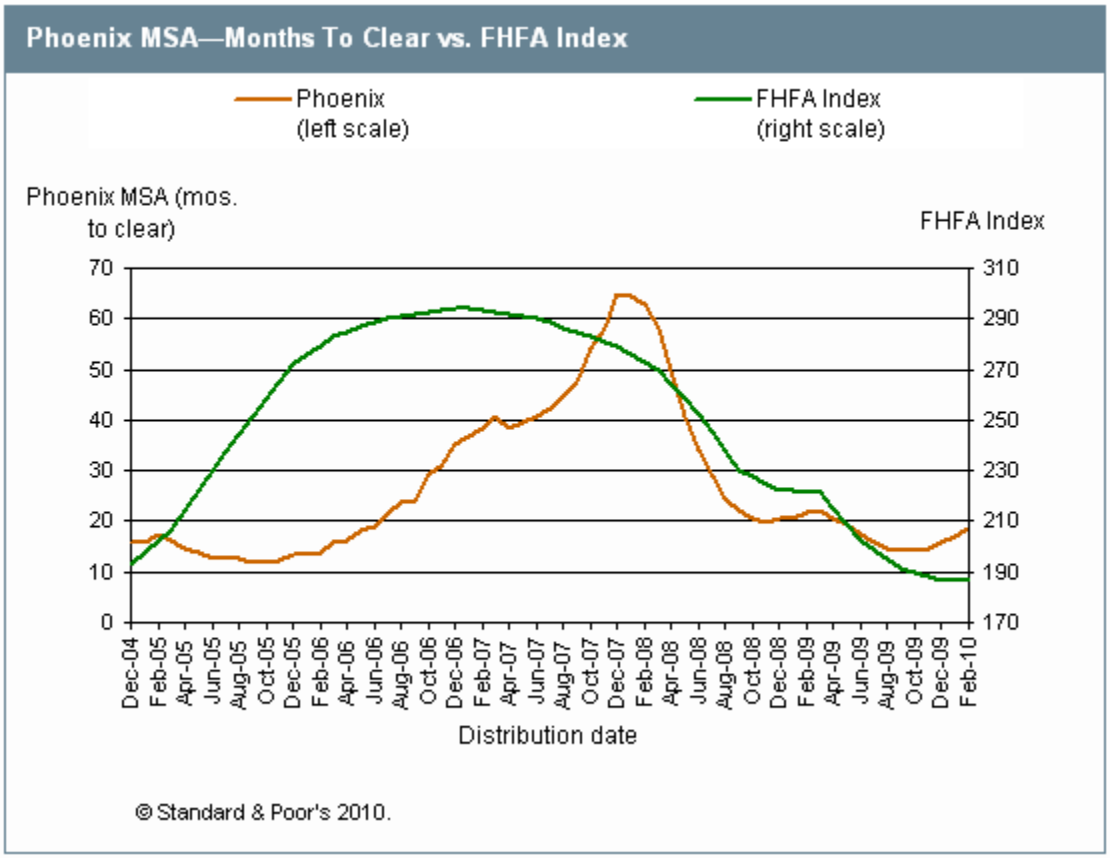
Chart 4



The Relationship Between Shadow Inventories And Property Values

In nearly every region we studied, we observed a correlation between home prices and the number of months of distressed property inventory. Generally, the months of inventory and the Federal Housing Finance Agency (FHFA) house price index trended in similar directions: significant increases in the months of inventory tended to follow substantial rises in the property value index, and decreases in both measures occurred in tandem. We found that constant peak levels of inventory, however, seemed to correspond with a slight decrease in home prices. The inventory and pricing trends in the Phoenix and Seattle metro areas are prime examples of this relationship (see charts 5 and 6).

Chart 5


Phoenix MSA—Months To Clear vs. FHFA Index
Phoenix (left scale)
FHFA Index (right scale)
Phoenix MSA (mos. to clear)
FHFA Index
70
60
50
40
30
20
10
0
310
290
270
250
230
210
190
170
Dec-04
Feb-05
Apr-05
Jun-05
Aug-05
Oct-05
Dec-05
Feb-06
Apr-06
Jun-06
Aug-06
Oct-06
Dec-06
Feb-07
Apr-07
Jun-07
Aug-07
Oct-07
Dec-07
Feb-08
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Aug-08
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Feb-09
Apr-09
Jun-09
Aug-09
Oct-09
Dec-09
Feb-10
Distribution date
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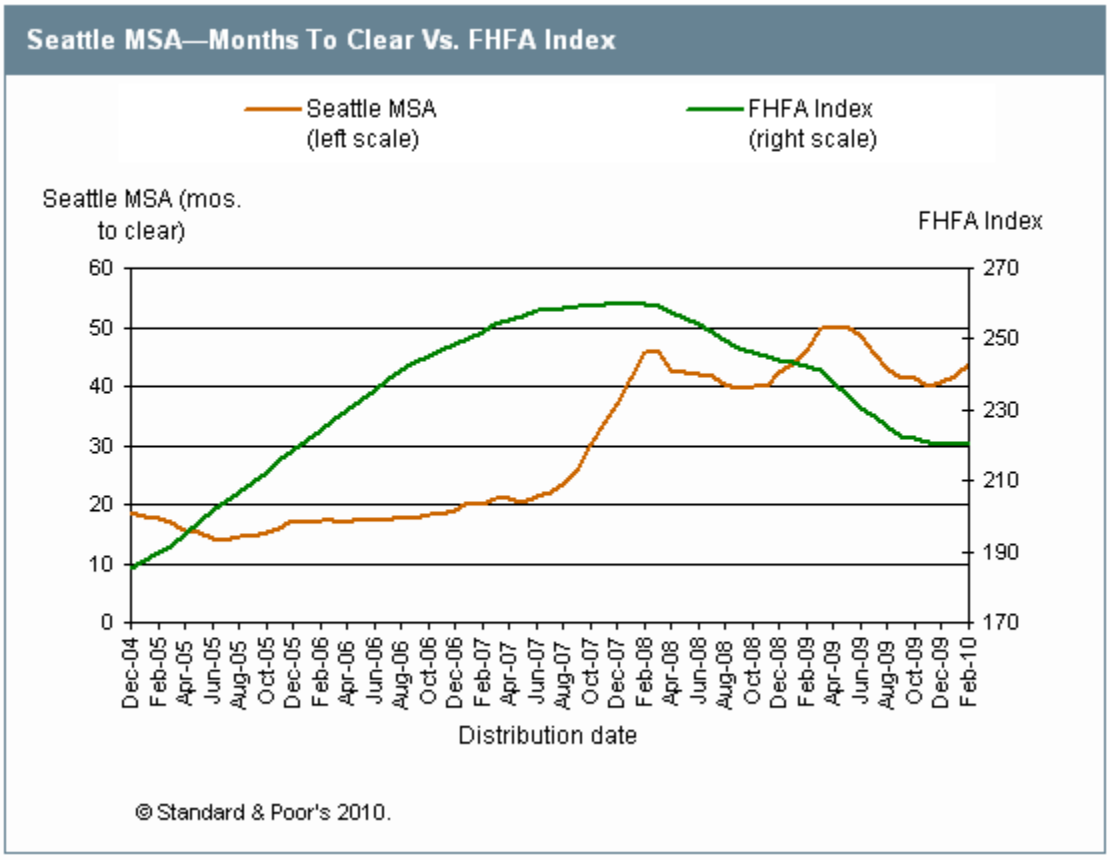
Chart 6



Not surprisingly, in most of the MSAs we studied, rising loan defaults, combined with limited sales of defaulted properties, have led to significant increases in distressed property inventories. In some MSAs, in response to these increased recovery timelines and generally high levels of inventory, servicers have accelerated liquidations sufficiently to bring the overhang of outstanding distressed properties down to more typical levels. However, as in Phoenix, these reductions were accompanied by comparable declines in property values in nearly every case.

The overall shadow inventory in Phoenix has returned to pre-crisis levels—and although housing prices are down, purchases have increased and are approaching earlier levels, perhaps only limited by the current constraints on mortgage lending (see charts 5 and 8). In Seattle, the shadow inventory is elevated and potentially increasing, housing prices have retreated from their high and seem to be stagnating (but may fall further), and sales volumes remain low (see charts 6 and 9).

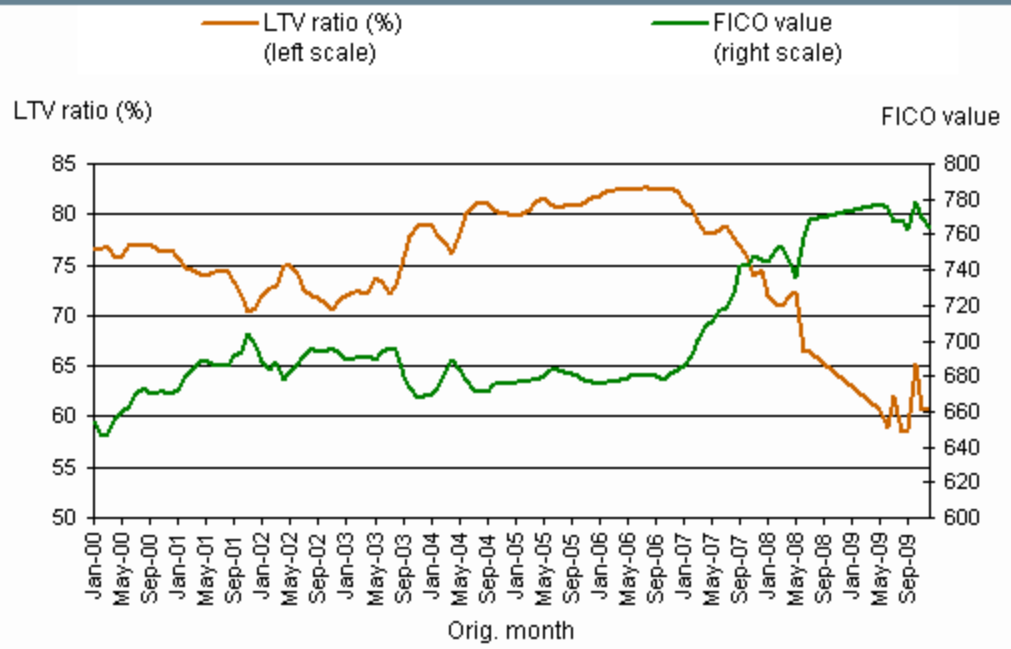
Will Home Prices Take Another Hit?

The fallout from the recent mortgage crisis has reduced financing for borrowers as lenders began to enforce stricter underwriting standards (see chart 7). Lenders have generally become more selective about their borrowers, providing fewer would-be homebuyers with loans. Furthermore, when lenders do grant loans, they generally offer fewer and less-flexible loan options, and they typically require borrowers to provide larger down payments. The stricter

underwriting and higher down payment requirements are limiting the number of would-be homebuyers who are able to purchase properties and putting downward pressure on prices.

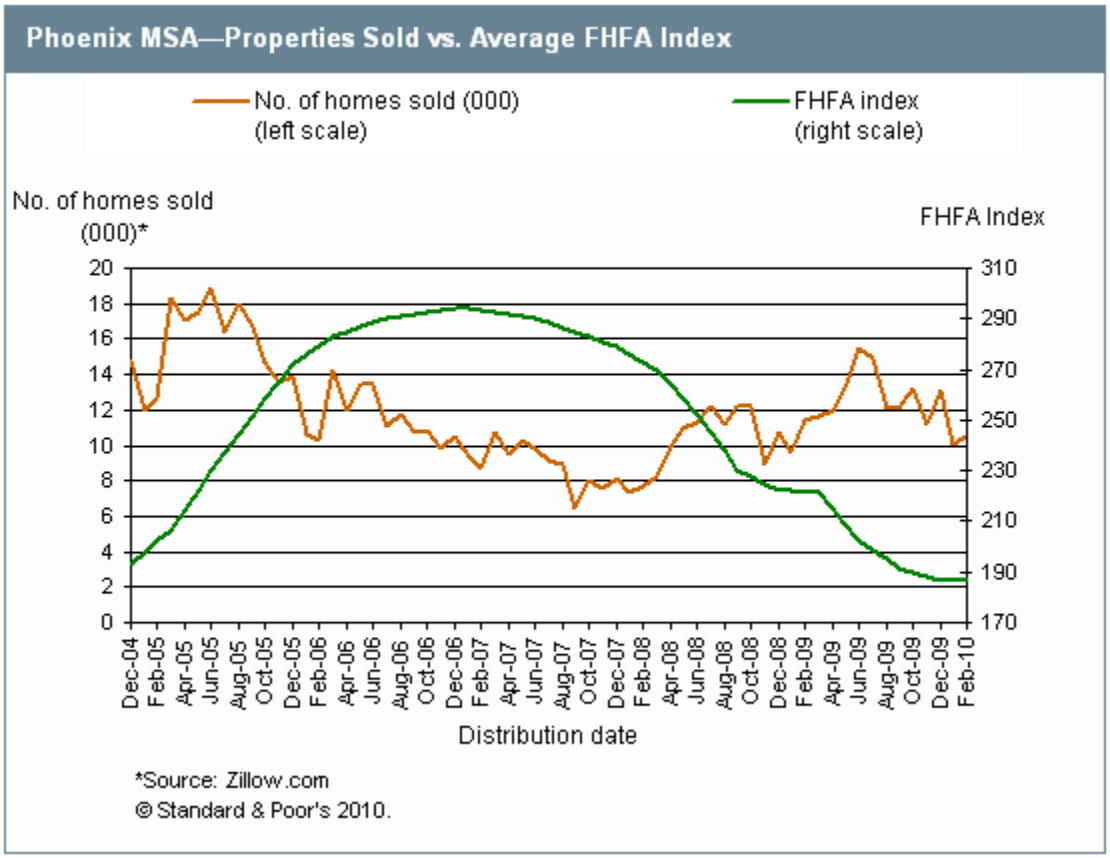
Moreover, many mortgage servicers are currently facing a surge in inventories of distressed properties, which they must offload onto a market that's lacking demand due to funding constraints. To liquidate these properties successfully, we believe servicers may be forced to reduce their prices. And as these reduced-price homes hit the market, the supply will keep keep rising—which could drive prices further down.

Indicators Of Underwriting Guidelines—Average LTV Ratios And FICO Values



Note: Loan-to-value ratios and FICOs are, respectively, positively and negatively correlated with the probability of default. Increases in LTV ratios and decreases in FICO values reflect looser lending standards and indicate an increased propensity for lenders to finance properties with relatively high levels of risk.

Chart 8


Phoenix MSA—Properties Sold vs. Average FHFA Index
No. of homes sold (000) (left scale)
FHFA index (right scale)
No. of homes sold (000)*
FHFA Index
20
18
16
14
12
10
8
6
4
2
0
310
290
270
250
230
210
190
170
Dec-04
Feb-05
Apr-05
Jun-05
Aug-05
Oct-05
Dec-05
Feb-06
Apr-06
Jun-06
Aug-06
Oct-06
Dec-06
Feb-07
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Oct-09
Dec-09
Feb-10
Distribution date
*Source: Zillow.com
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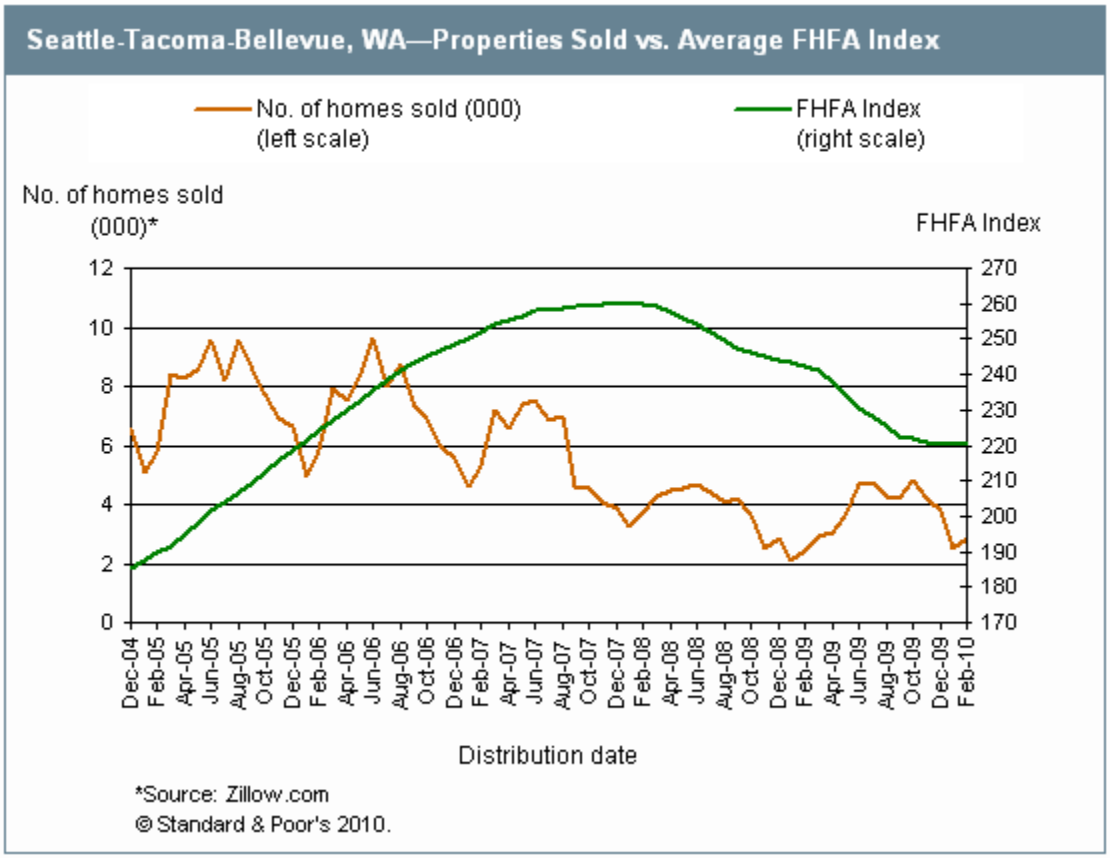
Chart 9



Appendix: Study Methodology

Our analysis included all first-lien, prime, Alternative-A, and subprime mortgages that appear in nonagency RMBS transactions. We used loan-level data available through LoanPerformance, a unit of First American CoreLogic, which provides RMBS data. We aggregated the data according to the related metropolitan statistical areas (MSAs) to observe differences in trends and assess the relative impact of the shadow inventory across the U.S.

We calculated our estimates for months of inventory by dividing the sum of outstanding distressed loans in a given month by the average liquidation rate for the previous six months. The distressed loans in our estimates included loans 90-plus days delinquent, in foreclosure, or real estate owned (REO). We also included 70% of the balance of recently "cured" loans because we assume that this percentage will ultimately redefault based on historical recidivism rates.