Shadow Inventory: Influence of Mortgage Modifications and State Laws

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As the housing market seeks stabilization and eventual recovery, one of the most significant deterrents is the magnitude of the shadow inventory. Unlike the visible inventory of homes for sale—those listed for sale on multiple listing services (MLSs) 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." CoreLogic® (2011a) estimated the shadow inventory to be 1.6 million single-family residential homes in October 2011, compared with 1.9 million a year ago. The shadow inventory is smaller than its peak of slightly more than 2 million housing units in January 2010, but it remains significantly elevated relative to the level that would occur under healthy market conditions. The elevated shadow inventory level is a significant drag on the health of the housing market, because it represents the future stock of distressed-asset sales that, when sold at a discount to market value, place downward pressure on price levels. The shadow inventory and its effect on housing markets will vary dramatically based on foreclosure laws and disposition timelines.

Shadow inventory, as we define it, is the current stock of distressed properties not currently listed on MLSs that are seriously delinquent (90 or more days), in foreclosure, or Real Estate Owned (REO). We use transition rates of delinquency to foreclosure and of foreclosure to REO to identify the currently distressed, unlisted properties most likely to become REO properties. Properties that are not yet delinquent but may become delinquent in the future are not included in current shadow inventory estimates. The cumulative estimates that measure the shadow inventory over a window of future years are significantly larger than the existing shadow inventory because they include estimates of the current shadow inventory, of future serious delinquencies, and of future redefaulting loan modifications. Shadow inventory is typically not included in the official metrics of unsold inventory.

A typically unmeasured component of shadow inventory is the incidence of owners holding their homes off the market because of market conditions or because they are in a negative equity position. CoreLogic® (2011b) estimates that more than 10 million borrowers are under water on their homes, their outstanding mortgage debt being more than the value of their home. Of course, not all underwater borrowers want to sell, but being under water makes it more difficult to move for a new or better job, or respond to changed circumstances, such as increased household size. Reduced mobility creates pent-up housing inventory and can exacerbate unemployment by keeping

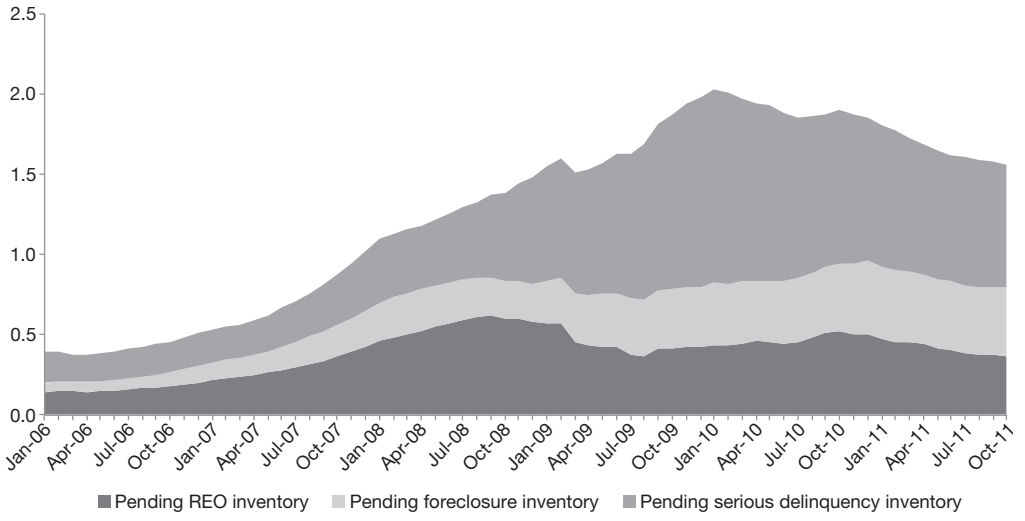
households from moving for employment. We recognize that this reduced mobility increases the size of the shadow inventory but, because estimating inaction on the part of households is challenging, we do not attempt to estimate this component of shadow inventory.

Exhibit 1 shows the shadow inventory over time from January 2006 through October 2011, the most recent data available at the time of this writing. The inventory grew from less than 400,000 housing units 3 years ago to slightly more than 1.6 million in October 2011. Foreclosure and REO levels stabilized at below 500,000 each in 2011. The most recent trend shows REO shadow inventory declining faster than foreclosed shadow inventory. We estimate that fewer than 400,000 REO properties are unlisted at this time, but that 430,000 foreclosed properties are likely to become visibly listed REO properties over the next year (CoreLogic®, 2011a). The unlisted REO count in the shadow inventory peaked in late 2010 but, because of the "robo-signing" debate and consent orders to review foreclosure practices, the transition of properties from foreclosure to REO slowed in 2011.

The declining number of seriously delinquent loans in the shadow inventory accounts for most of the 2011 decline in shadow inventory levels. The current inventory of seriously delinquent shadow properties is 770,000, down 36 percent from the peak of 1.2 million in January 2010. A reduction in the flow of new seriously delinquent loans has accounted most for the decrease of the seriously delinquent shadow inventory (CoreLogic®, 2011a). Throughout 2010 and 2011, the overall delinquency level slowly improved, along with a slow improvement in economic conditions. Alternatives to foreclosure, such as the Home Affordable Modification Program (HAMP), Home Affordable Refinance Program (HARP), short sales, and so on, have become more operationally successful. To date, HAMP and HARP have combined to prevent more than 1.7 million likely foreclosures (Treasury Department, 2011). Short sales are also an increasingly popular alternative

Exhibit 1

Shadow Inventory Detail



REO = Real Estate Owned.
Note: Count in millions.
Source: CoreLogic® (2011a)

to foreclosure. As of August 2011, short sales represented 8 percent of all home sales transactions and 30 percent of all distressed home sales (CoreLogic®, 2011c).

The effect of the shadow inventory on the housing market itself is largely dependent on the time it takes for a loan to go through the foreclosure process, enter REO, and go through the REO disposition process. The differences in the time it takes to foreclose in different states—which depends on whether they are judicial or nonjudicial foreclosure states and on the strength of demand in the different markets—can make a big difference in the effect of the shadow inventory on home sales prices. For example, California, a nonjudicial foreclosure state, and Florida, a judicial foreclosure state, have had very similar home price paths over the past 10 years. California's foreclosure inventory is currently 2.5 percent of all active loans, down 18 percent from the August 2010 inventory. This number represents a 12-month supply of foreclosures, given the prevailing pace of REO sales in California. By contrast, Florida's foreclosure inventory is currently 12 percent of all active loans, unchanged from the August 2010 rate. Given the prevailing pace of REO sales in Florida, this supply will last 61 months. California's faster disposition of distressed assets is evident in the states' respective shares of all sales that are distressed: 48 percent in California and 34 percent in Florida. The effect on price levels is also directly apparent. In California, home prices were down 6.2 percent in August 2011, whereas in Florida, prices were down moderately less: 4.7 percent. California is resolving its shadow inventory more quickly, taking the pain in the short term, but it is likely to reap the benefits of a faster resolution in the long run, whereas in Florida, the length of the process will drag out the deleterious effects of shadow inventory on the housing market and price levels.

Shadow inventory sellers face competing risks after a property becomes part of the REO stock. On one hand, they can sell properties quickly and reduce the stock by significantly underpricing the distressed properties; on the other hand, they can set a higher initial price, but doing so reduces demand and lengthens the time to sale. One incentive to underprice distressed properties is offsetting the additional loss from the sale with the net present value savings of reducing the holding cost for the property. Unfortunately, distressed property sales have spillover effects. As properties sell, they become value benchmarks for properties yet to be sold. Underpricing a distressed asset makes any other distressed assets in the local market less valuable. Servicers often manage many properties in the same market or neighborhood, so the risk of reducing the values of other distressed assets, which those servicers must subsequently sell in the same neighborhood, offsets the incentive to underprice a distressed property to facilitate a quick sale.

In addition, if a servicer were to bring too many distressed assets to market too quickly, those assets would increase the supply relative to demand. Buyers would have many properties from which to choose, and sellers would have to further underprice properties to attract contract bids. Servicers would effectively compete against themselves, and potentially against other servicers attempting to sell distressed properties in the same neighborhood. Therefore, those responsible for the disposition of REO assets have to balance the number of assets they supply and how they price those assets to facilitate timely sales without creating unnecessary downward price pressure. The faster the shadow inventory converts into visible inventory, the greater the risk of increasing losses if the market cannot support the distressed asset supply. Even if geographically diverse legal requirements did not impede the flow of the shadow inventory into the visible spectrum, servicers' attempts to mitigate losses on behalf of the investors would prevent them from "dumping" distressed assets on the market and causing large home price declines.

Conclusions

Although the shadow inventory level is currently below its early 2010 peak, it is well above the precrisis levels of only a few hundred thousand properties. It is clear that disposition of the shadow inventory impedes future home price growth and can also increase the magnitude of home price declines. But the effect may not be as calamitous as some have suggested. A slowly improving economy and a collection of government programs have intervened to provide alternatives to foreclosure, slow the pace of new delinquencies, and reduce the shadow inventory. Geographically differentiated legal requirements for the foreclosure process and disincentives for servicers to dump distressed assets indicate that the shadow inventory will not enter the visible inventory all at once, but instead will enter more slowly, as the courts and housing markets can reasonably absorb it. Even so, reducing the shadow inventory more quickly has benefits. Reducing the shadow inventory to precrisis levels will further accelerate the stabilization and growth of home prices going forward, as will longer term positive trends in economic growth and household formation.

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