Foreclosure Pipeline: Niagara Falls or Garden Hose?
By Mark Alexander, CCIM

It seemed like a good idea at the time. With so many Americans facing home foreclosures, our government tried to help people stay in their homes even if they could not afford to pay their mortgages. But as English journalist Samuel Johnson put it in 1775, “Hell is paved with good intentions”. The results of our government’s good intentions to help people stay in their foreclosed homes are just now being revealed. On the positive side, it has given a nice reprieve to defaulting homeowners by helping them stay in their homes while not making their mortgage payments for an average of 12 to 18 months. But on the negative side, Uncle Sam’s benevolent respite for defaulting mortgagees has caused a backlog of foreclosed homes or shadow inventory that must eventually hit the market. We are just not sure how many from this pent up supply of foreclosed homes will hit the market and when. Will this pipeline of foreclosed homes come at us fast and furiously now like Niagara Falls over the next few months? Or will it come at us evenly and steady like an open garden hose over the next year? Or will it come at us slowly like a drip from the kitchen faucet over the next two years? Why is this important? Because it helps us determine how quickly or slowly our residential home market will recover. This in turn will help us determine how fast or slow our overall economy will recover and get business and spending levels back to a more normal pace.

Confused Sea
Since I am a former sailor, I can’t help but use a nautical term to describe our existing state of the real estate market. I would call it a “Confused Sea”. Confused sea conditions occur as a result of major shifts in wind direction, similar to the government stepping in to change the natural course of free market enterprise. This shift in wind direction causes waves coming from different directions resulting in waves that are irregular and unpredictable. The bigger the body of water (like our US real estate market), the longer the confused seas can last. Like throwing a rock in a pond, a storm or front can send out waves in different directions from the winds that caused them. The waves come together and make the surface very bumpy. You can have the natural tide going in one direction , the gulf stream is going in another direction and the storm winds forcing

waves in yet a third direction. That leads us to rouge waves. Rouge waves are caused by two waves coming together at oblique (very wide) angles. Like two boat wakes coming together, the net effect is to create a yet higher wave, up to two or more times the size of the original wave. Rouge waves have been known to capsize a ship in an instant. There is no government intervention that can delay this ship from capsizing at sea. It is the natural order of the seas when they reach such an agitated state.

Shadow Inventory of Foreclosed Homes

Cleveland based research firm Zelman & Associates believes three to four million foreclosed homes will hit our shores sometime over the next few years. In July 2009, 1.2 million US home loans were 90+ days delinquent and the lenders had not even started foreclosure proceedings yet. At that same time, an additional 1.5 million US home loans were seriously delinquent and are somewhere in the foreclosure process. These figures do not include home equity loans and second mortgage defaults. There were 217,000 home loans in July 2009 where the owners had not made a mortgage payment in over a year and the foreclosure process had not even begun yet. In 2008, of the home mortgages in default where no payments had been made in over a year, only 8% of those mortgages had no foreclosure process started yet. In 2009, this figure has increased to 17%. Why are more and more banks waiting so long to start the foreclosure process? Two reasons: First, government programs have forced Banks to slow down and try to keep homeowners in their homes by restructuring their loans…which often does not work so it mostly just causes a delay. Secondly, banks can’t afford to create a rogue tidal wave of foreclosed homes to hit the market all at once because values will crash and they will lose much more equity than they already have on these troubled loans. Banks prefer to see a steady stream of foreclosed homes come to market through a controlled nozzle garden hose to keep values stabilized and from falling further. Here’s an example of a local bank helping to stabilize property values by not taking what the market will pay today and holding on to the asset to sell at a future date when the market is better. Bank of Naples President & CEO Robert Guididas spoke at a CCIM marketing meeting recently at the Naples Board of Realtors office. He told of a client who bought a Marco Island lot facing the Gulf of Mexico for $800,000 a few years ago. Bob’s bank had to foreclose on their $600,000 loan and they are now asking $400,000 for the lot and it is not selling. They have turned down fire sale offers of $200,000 and prefer to wait until the market comes back for Gulf front lots…which it will eventually.

Supply in Choppy Waters

In normal economic times across America, it is typical for us to carry a six month inventory supply of homes for sale. In July 2009, the US had a backlog supply of 9.4 months worth of homes for sale. With all the homes due to hit our market eventually from this pipeline of backlogged foreclosed homes, we expect to eventually add an additional 1.35 years worth of supply. So even though our federal government and the banks are doing their best to choke off this supply so we don't flood the floor with homes for sale and depress the market further, we still have a growing supply of homes for sale that must eventually come to market.

Demand During Changing Conditions

Demand has recently picked up considerably for home sales attributed mostly to first time home buyers enjoying low market interest rates and the one-time federal tax credit of $8,000. This is the main source for the positive news coming out of the home sales market these last few months leading us to be a little more confident about the future. But the wind is starting to change direction again. This $8,000 tax credit for first time buyers is due to expire in November 2009. It would help if the government extended this benefit another 6 to 12 months. Otherwise the pace of home sales could start to slow. The Federal Reserve has been buying most of these new home loans to help keep interest rates low. Seeing the good pace of home sales recently, the Fed announced in late September that it planned to slow its' pace of buying these home loans. This should eventually lead to interest rates creeping higher over time which may further slow the current pace of home buying.

Unless the Fed keeps buying these home loans to keep interest rates low and they extend the $8,000 tax credit for first time home buyers for another six to twelve months, we could see a further slowdown of home sales. Lower demand for home sales coupled with a rising supply of homes due to this growing shadow inventory will most likely lead to further lowering of home prices.

We continue our quest to find any port for shelter in this economic storm while we monitor the weather conditions and just ride it out. It will eventually pass.

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