DISTRESSED RESIDENTIAL REAL ESTATE: DIMENSIONS, IMPACTS, AND REMEDIES
COMPENDIUM OF FINDINGS

FEDERAL RESERVE BANK *of* NEW YORK

This conference was a collaboration between the staff of the Federal Reserve Bank of New York—Joseph Tracy, Dick Peach, Rae Rosen and Diego Aragon and the staff of the Nelson A. Rockefeller Institute of Government—Thomas Gais and James Follain.

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Distressed Residential Real Estate: Dimensions, Impacts, and Remedies

A conference co-sponsored by:

The Federal Reserve Bank of New York and the Nelson A. Rockefeller Institute of Government

Friday, October 5, 2012 | Federal Reserve Bank of New York | 12th Floor Conference Center

10:00 a.m. **Welcome**
William Dudley, *President, Federal Reserve Bank of New York,* and
Thomas Gais, *Director, Rockefeller Institute*

10:15 a.m. **Session I: Estimating the Volume in the Foreclosure/REO Pipeline**
MODERATOR
Richard Peach, *Senior Vice President, Federal Reserve Bank of New York*

TOPICS + PRESENTERS
National-Major Regions
Richard Peach, *Senior Vice President, Federal Reserve Bank of New York*

New York, New Jersey & Connecticut
James Follain, *Senior Fellow, Rockefeller Institute*

11:15 a.m. **Session II: Impacts of Foreclosures/Distressed Sales**
MODERATOR
Frank Nothaft, *Chief Economist, Freddie Mac*

TOPICS + PRESENTERS
Impacts on Home Prices
Mark Zandi, *Chief Economist, Moody's Analytics*
Paul Willen, *Senior Economist and Policy Advisor, Federal Reserve Bank of Boston*

Impacts on Homeownership Rate
Hui Shan, *Mortgage Strategist, Goldman, Sachs & Co.*

Impacts on Neighborhood/Families
Ingrid Gould, *Ellen Professor, New York University, Furman Center for Real Estate and Urban Policy*

12:15 p.m. **Break**
15 minutes

12:30 p.m. **Lunch**
SPEAKER
Governor Elizabeth A. Duke, *Board of Governors of the Federal Reserve System*

2:00 p.m. **Session III: Impacts on State and Local Government Finances**
MODERATOR
Andy Haughwout, *Vice President, Federal Reserve Bank of New York*

PRESENTERS
Byron Lutz, *Senior Economist, Board of Governors of the Federal Reserve System*
Kim Rueben, *Senior Fellow, The Urban Institute*

3:00 p.m. **Session IV: Remedies**
MODERATOR
Professor Kathleen Engel, *Associate Dean, Suffolk University Law School*

TOPICS + PRESENTERS
Effectiveness of Mortgage Counseling
Peter Tatian, *Senior Research Associate, The Urban Institute*

Effectiveness of Settlement Conferences
Kirsten Keefe, *Senior Staff Attorney, Empire Justice Center*

Economics of Principal Reduction
Joseph Tracy, *Executive Vice President, Federal Reserve Bank of New York*

Homeowners, Emergency Mortgage Assistance
Jim Orr, *Assistant Vice President, Federal Reserve Bank of New York*

REO Disposition
Prasant Sar, *Senior Policy Analyst, Federal Housing Finance Agency*

4:30 p.m. **Conclude**

Introduction

While the housing market shows early signs of recovery—with some progress even in the hard-hit states of California, Nevada, Arizona, and Florida—the backlog of homes in foreclosure and homes held in REO by banks is large and growing. This is particularly true on the east coast, where the duration of the foreclosure process is high due to judicial procedure for foreclosure. This accumulating volume of homes continues to weigh on the housing recovery and general economic improvement. The need for good public policy at the state and local as well as national level to minimize deadweight losses and externalities around foreclosure and the REO inventory remains compelling. This conference was designed to first examine the impact of foreclosures in its many dimensions and then review the effectiveness of a range of proposed policy initiatives. The focus in particular was on state and local level initiatives, and participants shared a diverse set of experiences with different projects.

The conference pulled together professionals with different areas of expertise. The expert panelists first attempted to quantify the pipeline of homes sliding into foreclosure, homes in foreclosure and homes in REO. Other experts presented key findings on the impact of foreclosures on home prices, neighborhoods and families, and state and local finances. Elizabeth Duke, one of the governors of the Federal Reserve Board, gave a keynote lunch speech discussing the impact of long-term vacancies on neighborhood stabilization. The last session of the conference addressed foreclosures and REOs with a set of multi-faceted solutions. Expert panelists presented research that suggests mortgage counseling, certain forms of principal reduction, emergency mortgage assistance, and settlement conferences can be effective measures. We hope you find this set of papers informative and useful.

Krishna Guha
Executive Vice President, Communications Group

Joseph Tracy
Executive Vice President, Research and Statistics

Richard Peach
Senior Vice President, Research and Statistics

William C. Dudley, *President and Chief Executive Officer*
October 5, 2012

Opening Remarks at the Distressed Residential Real Estate: Dimensions, Impacts, and Remedies Conference, New York City

As prepared for delivery

Good morning. I am Bill Dudley, president and CEO of the Federal Reserve Bank of New York. I would like to welcome you to today's conference titled "Distressed Residential Real Estate: Dimensions, Impacts, and Remedies," which we are co-sponsoring with the Rockefeller Institute of Government.

In addition to my role at this institution, I serve as vice chair of the Federal Open Market Committee (FOMC), which is charged with conducting the monetary policy for the United States. As I am sure you are aware, the FOMC has taken some extraordinary measures over the past few years to ease financial conditions and thereby improve the pace of economic recovery. While those measures have certainly helped to make the economy stronger than it otherwise would have been, nonetheless, the pace of the recovery to date has been disappointing. Over the three-year period from mid-2009 to mid-2012, the real output of the U.S. economy has grown at a compound annual rate of just over 2 percent. As a result, employment gains have been modest, only matching the growth in the population, and the unemployment rate remains unacceptably high.

While there are several headwinds that have been restraining economic growth, a key impediment is that the housing market has failed to respond fully to the significant easing of monetary policy. Now it is true that various housing market indicators have looked somewhat better of late. Housing starts and sales of new and existing single-family homes are trending up gradually. Nationally, home prices have stabilized and begun to rise modestly after falling roughly 30 percent from their 2006 peak. However, the absolute level of starts and sales remain quite low, particularly when viewed on a per capita basis. Moreover, housing market conditions still vary significantly across the country, with the worst performing counties still experiencing high volumes of distressed sales and annual house price declines of around 5 percent. The net result is that while housing's contribution to growth has finally turned positive, its magnitude is far below that experienced in previous recoveries.

There are several factors behind the relative sluggishness of housing market activity. Although mortgage credit availability is slowly improving, it remains impaired, especially for households with less-than-sterling credit histories. Moreover, we are still dealing with the legacy of the housing boom and bust. According to CoreLogic, more than one out of four homeowners with a mortgage are "underwater," making it difficult for the borrowers to either refinance or sell.

In addition, as the conference speakers who follow me will make clear, there continue to be large volumes of properties for which the homeowner is either seriously delinquent or already in the foreclosure process. It is quite likely that most of these properties will eventually end up on lenders' balance sheets and then be offered for sale.

As I discussed in a speech given earlier this year in New Jersey, the New York Fed is deeply committed to contributing to efforts to resolve the housing crisis that continues to impede our economic performance. Our economists monitor the housing market and analyze its impact on the national economy. My outreach staff works with community groups and housing practitioners to support local programs that aid distressed homeowners. Our lawyers perform pro bono work for homeowners facing foreclosure and advise on legal reforms, while our researchers and market analysts have developed proposals to mitigate current problems and improve the future structure of housing finance. Indeed, today's conference is an outgrowth of these efforts, and many of these ideas will be presented in today's various panels.

Thank you for your attention. I hope today's conference proves both stimulating and useful for you. I'll now turn the mic over to Thomas Gais, director of the Nelson A. Rockefeller Institute of Government and our co-sponsor of this conference.

Thomas Gais, Director, *Nelson A. Rockefeller Institute of Government, State University of New York*
October 5, 2012

Opening Remarks (summarized) at the Distressed Residential Real Estate: Dimensions, Impacts, and Remedies Conference, New York City

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Thank you, President Dudley. We have a great set of panels and presentations today, which the Rockefeller Institute has been delighted to help organize. We are very thankful for the opportunity to work with the Federal Reserve Bank of New York and its fine staff on this important forum.

Without giving too many hints about what you will hear today, I think that the forum's presentations will offer good evidence in favor of four propositions:

1) The severity and status of distressed residential real estate markets vary greatly by region, state, locality, and community. Jim Follain will soon show you striking evidence of enormous differences even within a single New York State county.

2) Market conditions change quickly. As Dick Peach will soon point out, the most recent national data reveal rapid shifts in the number and locations of delinquencies, foreclosures, and REO properties in inventory.

3) The varied and changing characteristics of residential real estate markets are important considerations in selecting measures to remedy distressed markets. Interventions that work well for homeowners long in foreclosure may not be effective for homeowners who are "underwater," seriously delinquent, or recently entering a foreclosure process. Also, as Follain wrote in a recent Rockefeller Institute commentary, a principal reduction program in one community may not have the same effects in another.

4) Targeting interventions is also important because some of them are costly, such as services to assist homeowners in delinquency from entering foreclosure.

5) Timely, wide-ranging, and granular data are increasingly available to track these conditions. As many of the researchers will show today, there is a wealth of data available for monitoring transitions in housing markets and distinguishing trajectories in specific communities.

These points suggest that it is both important and feasible to use rich, detailed, and timely data to identify communities most likely to respond to particular interventions; apply the appropriate interventions; and then monitor how the communities fare during and after efforts at remediation.

But that's hardly easy to do. Analytical staff in many state and local government agencies have been slashed in recent years. The relevant data are often scattered across multiple housing, banking, and other public agencies. The magnitude and complexity of the datasets are often barriers in themselves to using them for monitoring and analysis. And it's a political challenge to target particular interventions to particular communities; elected officials, especially legislatures, usually prefer to make programs widely available.

Yet there are also opportunities here. My hope is that we work on ways of building the capacities of state and local governments—which administer the great bulk of programs aimed at relieving distressed real estate markets—to target programs to the specific circumstances where and when they will do the most good, and to track those changing and varied circumstances carefully. Perhaps one way of building such capacities would be to partner with universities as well as other public agencies with great analytical skills (such as the NYFRB). Universities not only have the expertise and facilities to manage and use such large datasets; they can also play a role, if they work hard and are given the chance, in pulling together diverse data from multiple government offices. Their researchers and doctoral students would benefit greatly from access to the data. And universities, especially public institutions, usually view themselves as having a large stake in local outcomes, in building and sustaining their regions and communities.

But universities are just one option. The most important point is that today's sessions will demonstrate that there's an unprecedented amount of useful data available to inform decisions about appropriate actions to remedy distressed housing markets. It's unfortunate that these data are available precisely when state and local governments are least able to afford the analytical staff to use and apply them. Yet that should not be the end of the story. We should find some institutional means of taking advantage of our fast-growing knowledge and analytical capabilities.

Governor Elizabeth A. Duke, *Board of Governors of the Federal Reserve System*
October 5, 2012

Addressing Long-Term Vacant Properties to Support Neighborhood Stabilization
As prepared for delivery

Good afternoon. I want to thank the Federal Reserve Bank of New York and the Rockefeller Institute for inviting me to participate in this important discussion of distressed residential real estate.

The boom and bust in housing that is a hallmark of the recent economic cycle has resulted in an unprecedented volume of foreclosures that has, in turn, left us with an extraordinary level of vacant and distressed properties. Even after the official end of the recession, home sales and house prices continued to decline for several years, and residential investment languished.[1] All of this has resulted in a slow recovery in housing, which is one of the primary reasons why our overall economic recovery has been so sluggish. In order to see the robust economic recovery we all want, we need to deal effectively with the large volume of vacant and distressed properties throughout the country.

Our housing crisis has many dimensions and will require a full spectrum of policy actions to restore health to the housing market, our economy, and most importantly, to neighborhoods and communities across the country. The Federal Reserve System has been active in studying various aspects of the crisis, bringing together community leaders and market participants to share experiences in forums such as this, and using data to identify areas of particular need. I have spoken in the past about credit availability, preventing foreclosures, converting foreclosed properties to rental properties, and strategies for neighborhood stabilization. Today, I would like to focus on the problems posed by an elevated level of vacant properties. I plan to draw on research conducted by Federal Reserve Board staff and would especially like to thank Raven Molloy, an economist in our macroeconomic analysis group, for her work in this area.

As I will discuss later in my remarks, the effective use of data is a common theme among success stories in neighborhood stabilization. In the hope that the census tract data referenced in this speech might be helpful to others working to address vacancy problems, I plan to post our data on the Federal Reserve website along with this speech.[2]

Level and Distribution of Vacant Housing

Since the beginning of this year, there have been signs of improvement in aggregate housing market conditions nationally. Sales of new and existing homes have risen and home prices have turned upward. So far this year, house prices have risen sufficiently to move a noticeable number of underwater households—that is, those who owe more on their mortgages than the market value of their homes—from negative equity to positive equity. However, housing markets differ greatly both across regions and within metropolitan areas, and the positive signs in the aggregate data do not apply to all neighborhoods equally. For example, even within those metropolitan areas that have experienced rising average prices over the past year, one-fourth of ZIP codes saw a decrease in prices over the same period.[3] Moreover, those ZIP codes with falling prices have also experienced rising vacancy rates more often than in other ZIP codes.[4]

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[1] In the two years after the end of the most recent recession (Q2:2009), existing home sales rose only 4 percent, house prices fell by 4 percent, according to the CoreLogic price index, and residential investment averaged only 2-1/2 percent of gross domestic product (GDP)—half of the average GDP between 1949 and 2006.
[2] A Summary of Long-Term Vacant Typologies, Background on Analysis, and Data by Metropolitan Statistical Area (MSA) is available on the Federal Reserve Board website.
[3] Staff calculations based on house price indexes from CoreLogic.
[4] Staff calculations based on house price indexes from CoreLogic and vacancy rates from the U.S. Postal Service (USPS).

These struggling high-vacancy areas provide evidence of the hard work that remains even as housing markets show signs of improvement. Although many of these areas share a high level of vacancy, they differ significantly in other characteristics: the concentration of vacancies, age of the housing stock, cause of the problem, and even the demographics of the residents. By looking more closely at the differences, we will gain a better understanding of these markets and of the policies or program solutions that will address their vacancy issues most effectively.

One measure that is frequently cited when describing recent improvements in the national housing market is the inventory of vacant homes for sale. This measure had fallen to 1.6 million units in the second quarter of 2012, substantially below its peak of about 2 million units in 2010 and the first half of 2011.[5] However, many vacant homes are not on the market at all. These vacant units include properties that are in the foreclosure process, bank-owned properties that are not yet for sale, as well as properties for which the cause of vacancy has no connection to the foreclosure process. Indeed, the stock of non-seasonal homes held off market is nearly two and a half times as large as the for-sale vacant stock.[6] But unlike the inventory of vacant homes for sale, this stock remains stubbornly elevated relative to pre-crisis numbers, and has not gone down at all over the past year.

Moreover, vacant units are not evenly distributed throughout the United States. Some neighborhoods suffer disproportionate numbers of them. Specifically, one-tenth of all census tracts account for nearly 40 percent of the entire vacant housing stock. By comparison, the overall housing market is only half as concentrated with only 20 percent of the aggregate housing stock found in the 10 percent of census tracts with the largest total number of housing units.[7]

Problems Posed by Vacant Properties

Why focus on vacant homes? Vacant homes can be more than just an eyesore; they can have substantial negative impacts on the surrounding community, impacts that are felt most acutely by the neighbors and communities that must cope with the dangers and costs of vacant buildings. Since vacant properties tend to be concentrated in a relatively few number of neighborhoods, some communities are adversely affected much more than others.

Homes that have been vacant for a long time tend to fall into severe disrepair. Such physical blight can invite more property crime, as vacant houses are an appealing hide out and target for criminals, and the absence of residents can mean fewer eyes in the neighborhood to look out for suspicious activity. In fact, counties that experience a large increase in the number of long-term vacant homes tend to see an increase in burglary in the following year. This correlation holds even after controlling for other county characteristics, such as changes in unemployment, changes in population, and changes in violent crime.[8]

In turn, blight and crime make these neighborhoods less attractive to potential buyers, renters, and businesses. Calculations by Board staff indicate that ZIP codes with a larger increase in long-term vacancy experience smaller increases—or larger decreases—in house prices in the next year.[9] Falling home prices can harm both neighboring homeowners as well as local municipalities that are dependent on property tax revenue.

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5. Data from the Census Bureau's Housing Vacancy Survey.
6. Data from the Census Bureau's Housing Vacancy Survey. This measure of vacant homes held off market excludes properties that are held for occasional use or temporarily occupied by individuals with a usual residence elsewhere.
7. Staff calculations based on USPS vacancy data.
8. Staff calculations based on crime data from the Federal Bureau of Investigation's Uniform Crime Reports.
9. Staff calculations using USPS vacancy data and house values by ZIP code from Zillow.

Research conducted by the Federal Reserve Bank of Cleveland has shown that a home that is simply foreclosed, but not vacant, lowers neighboring property values by up to 3.9 percent. However, if a home is foreclosed, tax delinquent, and vacant, it can lower neighboring property values by nearly two and a half times that amount.[10] Moreover, properties that have been vacant for a substantial period of time can impose even larger costs on the community, and all too often, the private market is not likely to solve the problem on its own. In such cases, government authorities and public resources may be required.

Of course, not all vacant properties pose a problem for the local community, as some homes become briefly vacant during the usual process of changes in ownership. But the longer a home stands vacant, the greater likelihood that poor maintenance and the associated problems that result can become serious issues for the surrounding community. Statistics from the American Housing Survey show that properties that have been vacant for longer than two years are much more likely to have severe problems, such as cracked floors or walls, broken or boarded up windows, and a roof or foundation in disrepair, that make these properties harder to rehabilitate and less appealing to prospective buyers.

Segmenting the Inventory of Long-Term Vacancies

Analysis by Federal Reserve Board staff has calculated the fraction of housing units in each census tract that has been vacant for at least two years—which I will refer to as "long-term" vacancy—and categorized tracts that appear in the top 10 percent of this distribution into three types.[11]

The first category of high long-term vacancy census tract is an area where a large percentage of housing units were built post-2000, and that therefore can be thought of as "housing boom" tracts. These locations also have a higher median income, higher median house value, and a larger fraction of residents with at least a college degree than other high long-term vacancy census tracts. Examples of metropolitan areas with a large number of tracts in this category are Denver, Colorado; Orlando, Florida; Las Vegas, Nevada; and Phoenix, Arizona.

The second category of high long-term vacancy census tract has a large share of older housing stock built before 1960, low median income, a high poverty rate, a high unemployment rate, and a large share of residents with less than a high school degree. These tracts can be called "low demand" locations because these characteristics are frequently associated with areas suffering from persistent job loss and a decline in housing demand. Metropolitan areas with a large number of tracts in this category include Detroit, Michigan; Cleveland, Ohio; St. Louis, Missouri; and Baltimore, Maryland.

The third and final category of high long-term vacancy census tract has a low density of housing units per square mile, high shares of owner-occupied and single-family housing units, and a high fraction of white non-Hispanic residents. We can think of these neighborhoods as "traditional suburban" areas. Examples of metropolitan areas with a large number of tracts in this category are Charleston, West Virginia; Des Moines, Iowa; Peoria, Illinois; and Oklahoma City, Oklahoma—locations not often mentioned in national media coverage about the housing crisis.

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[10] Stephen Whitaker and Thomas J. Fitzpatrick IV (2011), "The Impact of Vacant, Tax-Delinquent and Foreclosed Property on Sales Prices of Neighboring Homes, (PDF)" Working Paper 11-23 (Cleveland: Federal Reserve Bank of Cleveland, October).

[11] The vacancy data are from the USPS and the tract characteristics are from the five-year sample of the 2010 American Community Survey.

Matching Solutions to Neighborhood Characteristics

As I mentioned earlier, we should endeavor to achieve full recovery in all of the many diverse housing markets around the country. The private market will likely drive recovery in many locations and, in those locations, the appropriate role of government may be to monitor local activity and ensure that the actions of the private markets improve neighborhoods and provide opportunity for all families, regardless of income, race, ethnicity, or housing tenure.

However, some neighborhoods likely will not recover without the assistance of government, and in this time of scarce resources, it is critical that the public sector has the information and tools necessary to ensure that any assistance that is provided is effective and efficient. Doubtless there will be costs associated with solving these problems, but it is important to also consider the costs of doing nothing. For example, it costs local taxpayers to let vacant buildings decline, it costs money to tear them down, and it costs money to convert them to a better use. Ultimately, a policy of neglect will be just as—or even more—costly than finding and implementing constructive solutions to the vacancy issue. We must ask ourselves, can we create policies that fairly distribute those costs? What are the limitations? What innovations can create more effective, scalable solutions? With funding scarce, how can we identify solutions that will ultimately be most cost effective?

To begin to answer some of these questions, I return to the typology of vacant properties introduced earlier.

"Housing Boom" Locations

The first type, "housing boom" areas, has relatively high median incomes and new housing stock. These characteristics are attractive to investors, and many investors are reportedly purchasing vacant homes and converting them to rental. Given the recent tightening of the rental market, such a strategy could be a win-win scenario for communities that need more affordable rental homes and suffer from an excess of single-family vacant units. In fact, in January, the Federal Reserve released a staff paper on housing issues[12] that went into some detail about the potential benefits of converting foreclosed properties to rental, and in April, the Board released a policy statement that outlines supervisory expectations for residential rental activities for certain banking organizations.[13]

Phoenix, Arizona, is a good example of an area with many census tracts that fit into the "housing boom" typology. Phoenix was one of the areas hit hard during the housing bust, with a peak-to-trough decline in prices of more than 50 percent.[14] More recently, however, prices in Phoenix have rebounded with a double-digit increase over the 12 months ending in July.[15] Reportedly, much of this demand is driven by investors who are converting vacant homes into rental properties. Direct statistical evidence on investor activity at the local level is not available. However, since investors tend to finance their purchases with cash or other non-mortgage financing, the level of cash purchases can provide an indicator of investor activity. In the past two years, the fraction of home purchases financed with cash in the Phoenix area was much higher than the national average.[16] This is an example of the private market stepping in to purchase vacant units and in turn increasing housing values.

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12. "The U.S. Housing Market: Current Conditions and Policy Considerations, (PDF)" white paper (Washington: Board of Governors of the Federal Reserve System, January 2012).
13. Federal Reserve Board Policy Statement on Rental of Residential Other Real Estate Owned Properties (PDF), April 5, 2012.
14. Data from CoreLogic.
15. Data from CoreLogic.
16. The number of transactions financed with cash are calculated by subtracting the number of mortgage originations by ZIP code (based on data gathered under the Home Mortgage Disclosure Act) from the number of home sales by ZIP code reported by CoreLogic.

As encouraging as this trend may be, it is not a panacea. For example, it is possible that aggressive investor activity could crowd out potential homeowners, especially low- to moderate-income households. In addition, investors are not interested in all markets; therefore, there will still be some areas where private investment will not step in to curb the problems associated with vacant properties.

The problem of investors crowding out local homebuyers could be addressed through "first look" programs that provide a window, usually 15 days, during which time only prospective homebuyers and non-profits may bid on a property. In Phoenix, non-profit organizations and local government officials used Neighborhood Stabilization Program (NSP) funding and enlisted local real estate professionals to match vacant homes with eligible homebuyers. These are important programs. Community leaders, banks, and real estate professionals should continue to collaborate to ensure that prospective homeowners are given a fair chance to bid on available properties.

However, most prospective homebuyers and local non-profits cannot bid on a property if they cannot access mortgage credit. Results from the Federal Reserve's Senior Loan Officer Opinion Survey suggest that banks are less willing to provide mortgage credit now than in 2006 to borrowers with lower credit scores or smaller down payments.[17] We hear much the same story from community groups and housing counselors who report that low- and moderate-income and first-time homebuyers, especially, are finding it increasingly difficult to meet the requirements for a home purchase loan due to limited funds for a down payment or weaker credit scores. While prudent lending may warrant tighter underwriting standards relative to pre-crisis levels, it is also important to ensure that tight credit does not unnecessarily dampen the housing recovery and disproportionately affect creditworthy low-income and minority homebuyers. And without the participation of owner-occupants, it will be difficult for many housing markets to recover.

Like Phoenix, Oakland, California, is also reportedly experiencing a significant amount of investor activity that may be crowding out purchases by prospective homebuyers and non-profits. We hear complaints that many of these investors are not based in Oakland, causing residents to express concern about external ownership of their neighborhoods and the long-term implications of absentee landlords. In an attempt to address these concerns and provide more homeownership opportunities to low- and moderate-income Oakland residents, a national non-profit, Enterprise Community Partners, is working with a private real estate fund to direct some of the private dollars seeking investment properties in Oakland. The non-profit partnership is using a complex data-driven platform to identify targeted low- and moderate-income neighborhoods in the city, purchasing vacant properties, rehabilitating them through a local workforce development program, and converting them to rental. The ultimate goal is to ensure that the properties remain local neighborhood assets. To achieve this, the partnership is prioritizing rentals and sales to qualified local residents or non-profits. Such an innovative strategy seeks to complement local government and investor activity so that residents can share in the benefits of a housing recovery.

"Low Demand" Locations

Not all markets are equally attractive to private investors, so some governments are developing programs to attract private capital to "low demand," high-vacancy neighborhoods. The city of Baltimore, Maryland, provides a good example of such a program. Baltimore is burdened with approximately 16,000 vacant

[17] Federal Reserve Board. April 2012, Senior Loan Officer Opinion Survey on Bank Lending Practices (PDF). In response to a special set of questions on residential real estate lending practices, banks reported that they were less likely than in 2006, to varying degrees, to originate mortgages to any borrowers apart from those with the strongest credit profiles.

and abandoned buildings, about a quarter of which are owned by the city. Much of this vacancy has been caused by population loss and suburban flight—Baltimore City has lost nearly one-third of its population over the last 50 years.[18] However, not all parts of Baltimore have a significant number of vacant properties. In fact, only 5 percent of census tracts in the Baltimore metropolitan area have a long-term vacancy rate in the top decile of the national distribution.[19] The city of Baltimore has recognized these micro-market distinctions and initiated an innovative data-driven program to identify areas with a high concentration of vacant properties and turn these properties into valuable assets.

This initiative, called "Vacants to Value," uses data and targeted housing code enforcement to foster re-development in areas where there is modest private investment interest. Using a variety of real-time data sources, this program has developed market typologies down to the census block-group level so that it can accurately determine the needs of specific neighborhoods and apply targeted programs to best meet those needs. For example, the city is targeting approximately 700 vacant properties in weak market areas where large-scale investment—encompassing at least a city block—is necessary to catalyze private investment. In healthier neighborhoods, the city believes that increased code enforcement and homebuyer or developer incentives should be enough to reduce vacancy and stabilize neighborhoods. Lastly, in Baltimore's hardest hit neighborhoods, the city is demolishing, holding, or maintaining properties that are unlikely to attract any private investment in the near future.[20]

Unfortunately, in some cases, vacant homes are beyond repair and will never be habitable again. In these instances, demolition is often the best solution, and land banks can be a good way to hold the property until it can be converted to a better use. A land bank is a governmental or non-governmental non-profit entity established, at least in part, to assemble, temporarily manage, and dispose of vacant land for the purpose of stabilizing neighborhoods and encouraging re-use or redevelopment of urban property. Land banks have been around since the early 1970s, but the recent foreclosure crisis has stimulated the creation of several new land banking programs, including in New York State and Kansas City, Missouri. A key characteristic of the new generation of land banks is that they often include mechanisms to self-finance over time, including the ability to recapture a portion of the property taxes for a fixed period of time after the property is put back to productive use.

As encouraging as these new self-financing features are, land banks and municipalities are still struggling with the high costs of demolition. For example, in Cuyahoga County, home to Cleveland, Ohio, about 80 percent of the approximately 100 properties per month that the land bank acquires need demolition, but at $10,000 in average costs per demolition, the Cuyahoga Land Bank is struggling to find the resources to fund this activity.[21] The state of Ohio recently dedicated $75 million of its direct payments from the Attorneys' General (AG) National Mortgage Settlement to fund a new grant program for demolition of abandoned and vacant properties statewide.[22] This $75 million still will not solve all of Ohio's demolition needs, but leveraging public and private funds like the AG settlement or developing new national sources of bond financing could help address this local problem.[23]

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18. Ellen Janes and Sandra Davis (2011), "Vacants to Value: Baltimore's Market-Based Approach to Vacant Property Redevelopment," Putting Data to Work: Data-Driven Approaches to Strengthening Neighborhoods (Washington: Board of Governors of the Federal Reserve System, December).
19. Staff calculations based on USPS vacancy data.
20. Ibid 18.
21. Tom Fitzpatrick. (2012). Connecting Communities [Webinar].
22. Ohio Attorney General (2012). "Attorney General Launches Moving Ohio Forward Demolition Grant Program To Remove Blighted Residential Structures," press release, April 13.
23. For example, the "Restore Our Neighborhoods Act" (H.R. 4210), sponsored in 2012 by Representative Steven LaTourette (R-OH) would authorize creation of "Qualified Urban Demolition Bonds" to support demolition costs.

"Traditional Suburban" Locations

The last category of high-vacancy areas in the typology that I discussed earlier is "traditional suburban" neighborhoods. In contrast to the other two types of high-vacancy census tracts, these neighborhoods are more evenly spread across many metropolitan areas, illustrating that vacancy can be a problem in any community. Furthermore, ZIP codes in the "traditional suburban" tracts do not tend to have a higher share of property vacancies resulting from foreclosure than other ZIP codes, which demonstrates that some neighborhoods are struggling with long-term vacancy issues even though they did not experience large numbers of foreclosures. While the vacancies faced by these suburban areas might not have been caused by foreclosure problems, the costs to neighborhoods are every bit as real. Such areas represent additional opportunities to use the lessons of the recent crisis as local leaders strive to better understand the root cause of high vacancy levels and to target limited resources. Consider the situation faced by Oklahoma City.

Oklahoma City estimates that 8,000 urban properties have been vacant for more than three years, and that the number of vacancies is increasing.[24] The city's historically high housing vacancies mostly stem from cultural and demographic changes that have occurred over decades, as well as inadequate building code laws and enforcement. Interestingly, the area did not experience the housing boom and bust that occurred in much of the nation. Whereas national house prices rose by 89 percent between 2000 and 2006, prices in Oklahoma City rose by only 35 percent. In addition, house prices in Oklahoma City have been flat since 2006, a sharp contrast to the large drop in national home prices.

But even though the vacancy rates in Oklahoma City are not a direct result of the housing boom and bust, it may be that newer solutions developed for "housing boom" and "low demand" areas can be combined with traditional community development policy tools to help solve a problem that developed over decades. Indeed, city planners recently concluded that the city could not tackle neighborhood revitalization without addressing vacancies. Increasing costs for needed city services, reduced revenues, and barriers to growth resulting from deteriorating infrastructure all combined to lend urgency to these efforts. As has been the case in other cities, officials in Oklahoma City realized that gathering data was a necessary first step. Starting earlier this year, they embarked on an ambitious study to determine the total cost resulting from vacancies. The city will then use the findings from the study to support enactment of tougher code enforcement to recover lost revenue, including assessment of fines against owners who fail to maintain their properties. This combination of new measurements and old tools to develop solutions should serve as an example to many "traditional suburban" areas around the country that have experienced, and will continue to experience, vacancy issues.

[24] Russell Claus, Director, Planning Department, City of Oklahoma City. Interview by Paul Wenske, Senior Community Development Advisor, Federal Reserve Bank of Kansas City, August 2012.

Conclusion

The potential fallout of high rates of vacancy—blight, crime, lowered home values, and decreased property tax revenue—is the same for every neighborhood and community. But there is no one-size-fits-all solution to the vacancy problem. I've used some examples of communities around the country that are facing high vacancy rates in order to illustrate their different characteristics and the different origins of their vacancy problems. Taking account of such differences will be important in crafting solutions to the problems caused by those vacancies. Hopefully, these examples and other ideas that have been shared throughout this conference will inspire new and creative solutions to the difficult issues faced by communities. Certainly, different housing markets will recover in different ways and at different paces. In some areas, the private market will lead the way, while in others, government will have to use precious resources wisely to catalyze recovery.

The examples I've discussed also illustrate the value of using data to understand vacancy issues, to determine which neighborhoods are experiencing which challenges, and to design appropriate policy solutions. Solving the problems of long-term vacancies will require the best efforts of public, private, and non-profit leaders locally and across the country. I can assure you the Federal Reserve System will continue to support recovery through the use of all its policy tools and research capacity.

Thank you.

Session I:
Estimating the Volume in the Foreclosure/REO Pipeline

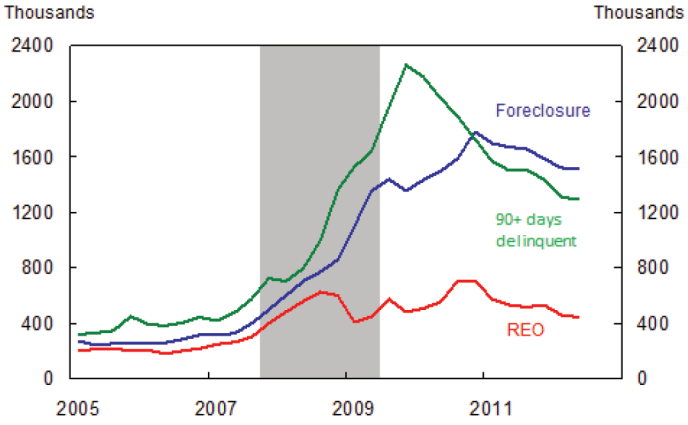
Assessing the Volume in the Distressed Residential Real Estate Pipeline[i]

Dick Peach, *Senior Vice President, Federal Reserve Bank of New York*

- Recent indicators suggest that, at the national level, the housing market may finally be on the mend. Housing starts and sales of new and existing single-family homes are trending up gradually. Home prices have stabilized and begun to rise modestly after falling roughly 30 percent from their 2006 peak. Serious (90+ day) first mortgage delinquencies have declined to a little under 3 percent as of 2012Q3 from a peak of 5 percent in 2010Q1.

- While these are certainly positive developments, the nation is confronted with a very large "pipeline" of loans which are 90+ days delinquent and in foreclosure. As shown in Chart 1, as of 2012Q2 there were about 1.3 million loans 90+ days delinquent, about 1.5 million properties in the foreclosure process, and about 450,000 properties on lenders' balance sheets as real estate owned (REO).

Chart 1. Stock of Properties in Foreclosure and REO: National



Source: CoreLogic

Note: Shaded areas denote NBER recessions.[1]

- Table 1 presents a ranking of states by two criteria—the state's share of the total number of properties held as REO and the number of properties held as REO as a percent of the total number of first mortgage loans in the state. Large states at the center of the housing boom and bust such as California and Florida account for a large share of the total REO inventory. However, in other states, such as Michigan and Illinois which are not typically associated with the boom and bust, properties in REO represent a large share of the stock of outstanding mortgages.

[i] The views expressed in this article are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

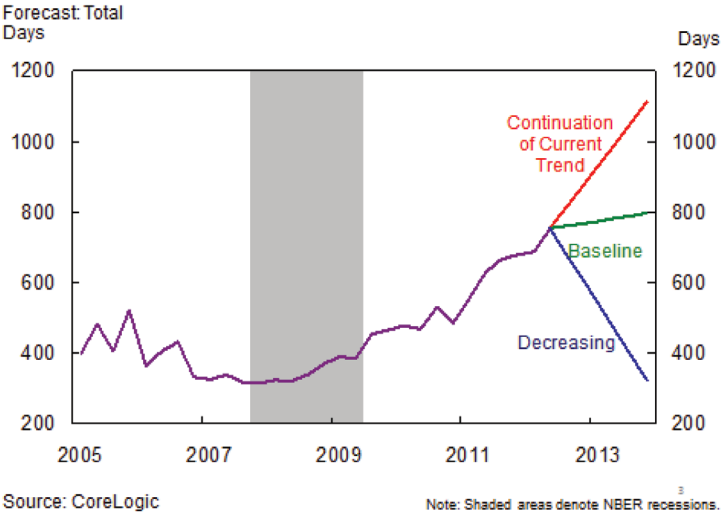
- Nationally, the average number of days a mortgage loan is seriously delinquent and in foreclosure before becoming REO (days delinquent at foreclosure start) has increased dramatically as the housing crisis has unfolded. As shown in Chart 2, that average increased from around 300 days in 2007 to nearly 800 days by mid-2012. The increase has been most pronounced in "judicial foreclosure" states.

Table 1. State Rankings

Rank	State	% in REO	Rank	State	% of National REO
1	MI	2.33%	1	CA	11.12%
2	GA	1.87%	2	FL*	10.08%
3	MN	1.61%	3	MI	8.63%
4	IL*	1.51%	4	IL*	7.57%
5	NV	1.41%	5	GA	7.56%
6	RI	1.35%	6	TX	5.08%
7	NH	1.25%	7	OH*	4.18%
8	FL*	1.20%	8	MN	3.78%
9	WV	1.18%	9	AZ	2.81%
10	AL	1.15%	10	NC*	2.71%
11	TN	1.15%	11	MO	2.44%
12	MO	1.13%	12	TN	2.38%

Note: Data for June 2012. * indicates a Judicial Foreclosure state.

Chart 2. Average Days Delinquent at Time of REO Start



Source: CoreLogic

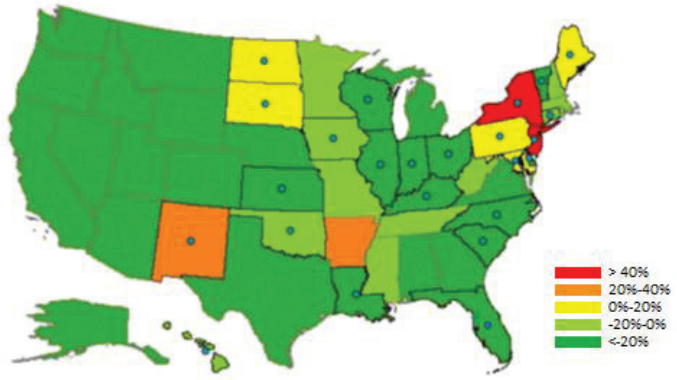
Note: Shaded areas denote NBER recessions.

- Going forward, a key determinate of the number of properties flowing into REO will be what happens to the average number of days seriously delinquent prior to REO. Shown here are maps of the United States depicting three possible scenarios for what could happen: First, if the recent trend for the length of time in serious delinquency continues through the end of 2013; second, if the trend stabilizes near mid-2012 levels; and third, if the overall trend is a decline toward pre-crisis levels. For each scenario, we project the change in the number of properties in REO from mid-2012 through the end of 2013.

- Under the first scenario, shown in Chart 3, most of the country would experience declines in the number of properties in REO through the end of 2013. However, New York and New Jersey would experience increases of 40 percent or more.

Chart 3. Projected percent change in REO inventory: Jun '12 to Dec '13

Current Trend



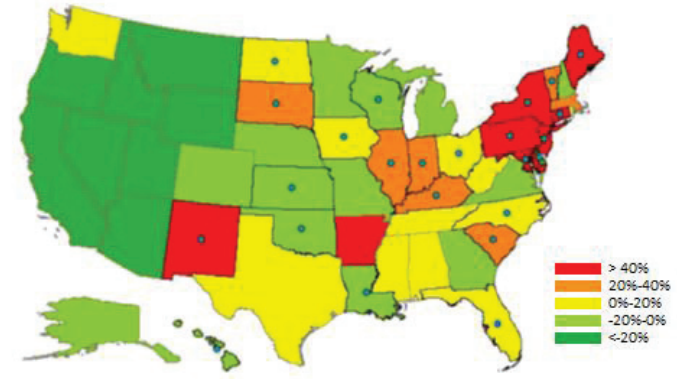
Source: CoreLogic

Note: Blue dot indicates judicial foreclosure state.

- Under the second scenario, shown in Chart 4, an increasing number of states would see sizeable increase in REO inventories, particularly the states of the Northeast and Midwest.

Chart 4. Projected percent change in REO inventory: Jun '12 to Dec '13

Flat Trend



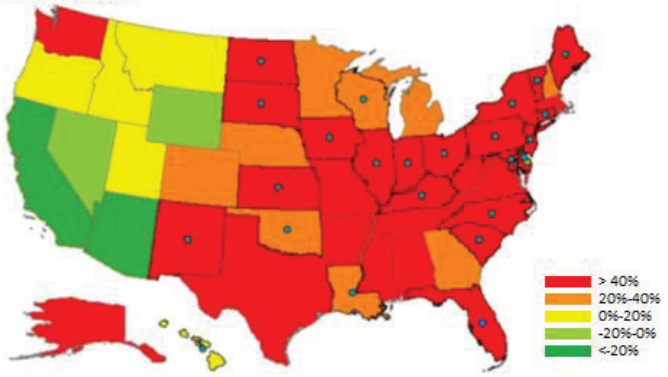
Source: CoreLogic

Note: Blue dot indicates judicial foreclosure state.

- Under the third scenario, shown in Chart 5, most of the eastern two thirds of the country would see increases of 40 percent or more.

Chart 5. Projected percent change in REO inventory: Jun '12 to Dec '13

Decreasing Trend



Source: CoreLogic

Note: Blue dot indicates judicial foreclosure state.

- Table 2 presents the top 12 states ranked by the percentage change in REO inventory under the three scenarios. Again, the largest increases under all three scenarios would be in the states of the Northeast and Midwest. What is interesting is that the states typically associated with the housing boom and bust—California, Florida, Arizona, and Nevada—do not appear on this list.

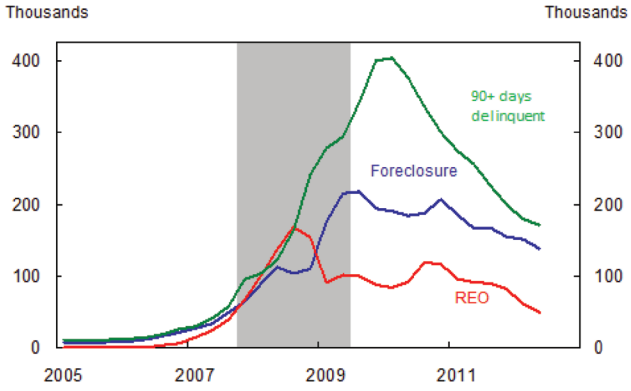
Table 2. State Rankings: Percent change in REO stock, June-12 to Dec-13

Continuing Trend			Flat Trend			Decreasing Trend		
Rank	State	%change	Rank	State	% change	Rank	State	% change
1	NY*	117.6%	1	NY*	167.6%	1	NY*	212.2%
2	NJ*	48.9%	2	MD*	99.3%	2	AR	186.6%
3	NM*	39.4%	3	NJ*	94.9%	3	MD*	180.7%
4	AR	30.6%	4	CT*	86.6%	4	NM*	172.4%
5	ME*	18.9%	5	NM*	84.1%	5	CT*	163.2%
6	MD*	17.7%	6	AR	73.9%	6	NJ*	139.9%
7	ND*	9.2%	7	ME*	62.0%	7	ME*	115.9%
8	PA*	2.5%	8	PA*	44.8%	8	PA*	109.7%
9	SD*	0.3%	9	KY*	39.6%	9	IN*	105.9%
10	CT*	-1.4%	10	IL*	34.8%	10	KY*	103.8%
11	IA*	-4.5%	11	SC*	32.8%	11	SC*	96.7%
12	WV	-5.8%	12	IN*	32.4%	12	SD*	92.2%

Note: * indicates a Judicial Foreclosure state.

- To get some insight into why California is not on the list of the top 12 states while New Jersey is, Charts 6 and 7 look at the situations in those respective states. While California saw a surge in serious delinquencies and foreclosures in 2008 and 2009, since then the numbers of loans in each category have been declining. While average number of days in serious delinquency and in foreclosure did increase in California—to 683 days as of 2012Q2—the increase was considerably less than in New Jersey—to 932 days. Thus, while the current volume of REO in New Jersey is quite low, the number of loans in serious delinquency and foreclosure remain relatively high. Thus, under all three scenarios discussed above, New Jersey experiences large percentage increases in REO.

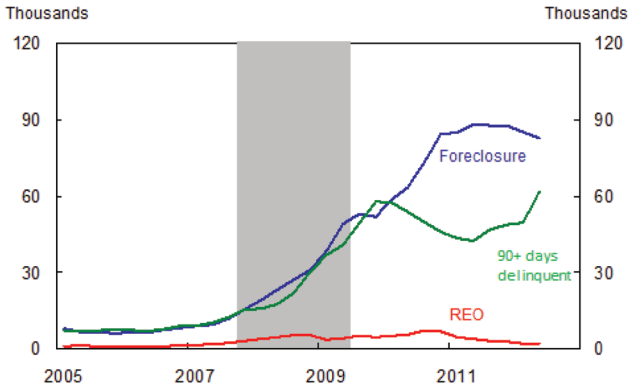
Chart 6. Stock of Properties in Foreclosure and REO: California



Source: CoreLogic

Note: Shaded areas denote NBER recessions.[8]

Chart 7. Stock of Properties in Foreclosure and REO: New Jersey



Source: CoreLogic

Note: Shaded areas denote NBER recessions.[9]

- About the data: The national and state level data on number of properties in 90+ days delinquency, in the foreclosure process, and in REO were provided by CoreLogic under contract with the Federal Reserve Bank of New York. The projections of future REO inventories were conducted by CoreLogic under a range of alternative assumptions about average days in 90+ days delinquency and average days in foreclosure. Aside from changes in those two variables, all other state and loan category roll rates were held constant at their second quarter 2012 averages. These roll rates were also based on the existing CoreLogic state level home price projections through the end of 2013.

Measuring the Size and Distribution of the Distressed Residential Real Estate Inventory in CT, NJ, and NY

James R. Follain, *Senior Fellow, Rockefeller Institute*[i]

The purpose of the presentation at the Federal Reserve Bank of New York Conference is to offer estimates of the size of the distressed residential real estate inventory. The estimates pertain to Single Family Residential (SFR) properties among the largest counties in the three states within the Federal Reserve Bank of New York District: CT; NJ; and NY. This brief summary references many of the exhibits contained in the presentation, which can be viewed at the Rockefeller Institute website.[ii]

The terminology and analysis underlying this presentation builds upon a widely accepted framework used to discuss and measure distressed real estate. This framework discusses three stages of distress. The first stage (Stage 1), as defined in this presentation, identifies those properties in which borrower equity is negative.[iii] The second stage (Stage 2) includes those properties in which the foreclosure process has begun but not yet been completed. The third stage (Stage 3) measures the foreclosure or REO (real estate owned) inventory, which consists of SFR properties that have been foreclosed upon by the lender or its representative and await sale back to the regular market via REO sales.

This presentation focuses on estimates of Stage 1 and Stage 3. The analysis also offers insights about the speed at which these inventories dissipate and the wide variation in the sizes of these inventories among local housing markets within the three-state area. The analysis uses public records-based data provided by Collateral Analytics and builds upon previous work by Norman Miller and Michael Sklarz in their monthly articles entitled Lessons from the Data.[iv]

The literature on the distressed real estate inventory is relatively recent and growing. In a recent paper for the Lincoln Institute of Land Policy, Follain (2012) demonstrates a strong empirical connection between the Stage 3 inventory and growth rates in house prices at the county level for 2005-2010.[v] The larger the REO inventory, the slower the growth in house prices holding constant a variety of other traditional drivers of house prices. As such, learning about this inventory and ways to reduce the size of this inventory is important to promoting a complete recovery of the housing market.

[i] Follain is also the principal of James R. Follain LLC, a consultant to Collateral Analytics https://collateralanalytics.com/about/), and an advisor to FI Consulting (www.ficonsulting.com).
[ii] http://www.rockinst.org/pdf/public_policy_forums/NYFRB%20Forum_10022012_follain_final.pdf.
[iii] An alternative definition of Stage 1 distress is the number of borrowers who are delinquent in their mortgage payments. This is the definition discussed in the presentation by Richard Peach.
[iv] See Lessons from the Data at: http://www.protecksservices.com/homevalueforecast/hvf-lessons/.
[v] See "A Search for the Underlying Structure Driving House Prices in a Distressed Environment": http://www.lincolninst.edu/pubs/2158_A-Search-for-the-Underlying-Structure-Driving-House-Prices-in-a-Distressed-Environment.

The estimates of the Stage 1 inventory indicate that over 800,000 SFR properties in the counties examined have negative equity; specifically, the values of the properties are no more than 95 percent of the outstanding debt on the properties. About 485,000 of these properties are in New Jersey. Three counties in New Jersey—Ocean, Camden, and Essex—each have over 40,000 properties with negative equity (See Table 1). The size of this stage of the inventory is, on average, six times larger than the inventory in 2005.

One goal of the analysis is to depict the wide variation in the sizes of this inventory among submarkets within the three states. One exhibit does so by presenting a map of the percent of the SFR stock that has negative equity at the county level (See Figure 1) in 2012. An even more geographically focused exhibit examines the variations at the ZIP code level within Nassau County, NY (See Figure 2). Note that the "hot spot" for properties with negative equity are in or near Hempstead, NY, where over 38 percent of the SFR inventory has negative equity.

Table 1: Number of SFR Stock with Negative Equity*

State and County Name	2005	2012	Change (%)
CT	29,232	144,285	394%
HARTFORD	8,651	37,169	330%
NEW HAVEN	6,007	36,535	508%
FAIRFIELD	7,621	28,129	269%
NEW LONDON	2,822	13,734	387%
LITCHFIELD	1,077	8,902	727%
NJ	87,872	484,064	451%
OCEAN	6,938	47,401	583%
CAMDEN	6,817	46,993	589%
ESSEX	15,237	43,851	188%
UNION	9,813	35,027	257%
BERGEN	3,800	34,062	796%
NY	22,129	205,048	827%
NASSAU	2,234	38,842	1639%
SUFFOLK	4,074	32,394	695%
QUEENS	1,373	18,805	1269%
ERIE	3,750	18,577	395%
WESTCHESTER	1,874	17,926	857%

* These are the five counties with the largest number of SF properties with negative equity in 2012 and with data for both 2005 and 2012. Negative equity implies that the value of the property is less than 95 percent of the outstanding mortgages on the property.
Data source: Collateral Analytics

Figure 1: Negative Equity by County

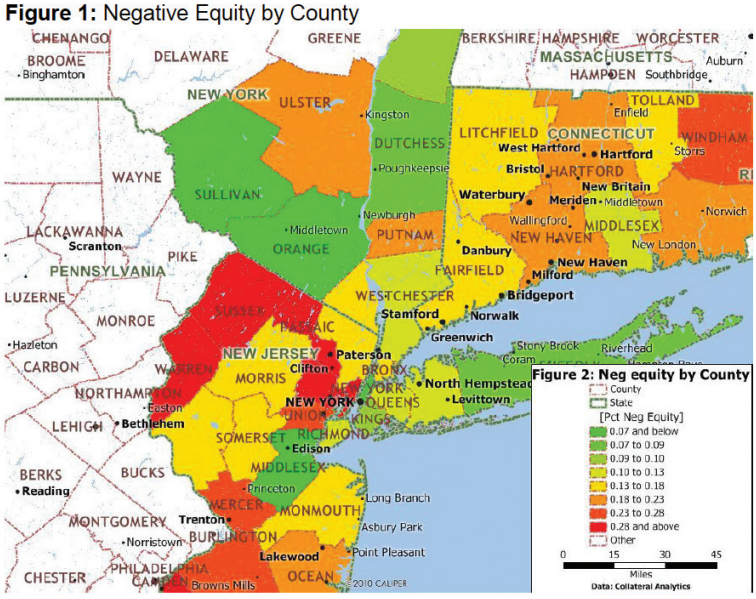
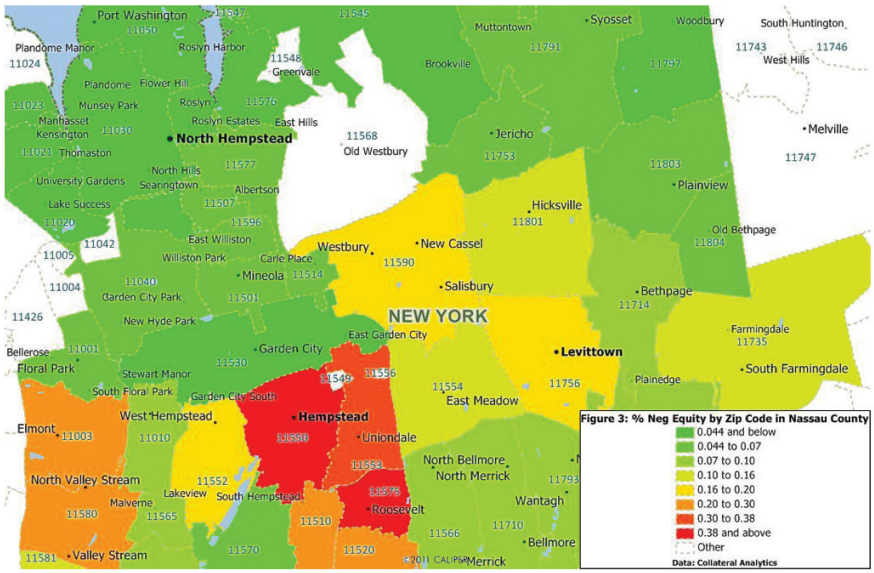


Figure 2: SFR Properties with Negative Equity (%)



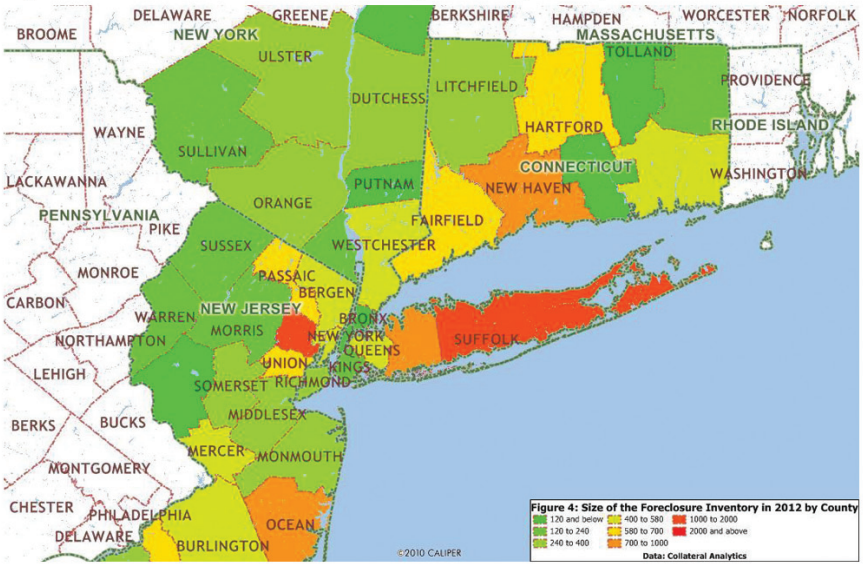
Measures of the size of the Stage 3 inventory are presented in Table 2 and Figure 3. A key point is that this inventory is much smaller in absolute size than the Stage 1 inventory. About 20,000 properties are in the REO inventory among the three states. These constitute about 0.4 percent of the SFR properties in the counties examined. Erie County in the Rochester area has both the highest percent at 0.9 percent and the highest absolute number at 2,065 in 2012. The inventories in NJ and NY are about the same size in absolute terms, about 8,300 each (See Table 2). Again, maps highlight the wide variation in this stage of distress among the counties in and around the New York Metropolitan area (Figure 3). Suffolk County, NY, and Essex, NJ, have inventories of 1,360 and 1,143, respectively, in 2012.

Table 2: Size of the Foreclosure Inventory by State and County*

State and County Name	Foreclosure Inventory	Percent of SF Stock in Foreclosure Inventory	Foreclosure Inventory	Percent of SF Stock in Foreclosure Inventory
	2005		2012	
CT	**803**	**0.11%**	**3281**	**0.4%**
NEW HAVEN	275	0.15%	877	0.5%
HARTFORD	172	0.09%	666	0.3%
FAIRFIELD	72	0.04%	584	0.3%
NEW LONDON	79	0.11%	497	0.4%
LITCHFIELD	84	0.15%	242	0.7%
WINDHAM	32	0.11%	186	0.6%
MIDDLESEX	57	0.12%	115	0.2%
TOLLAND	33	0.09%	114	0.3%
NJ	**3240**	**0.19%**	**8204**	**0.4%**
ESSEX	426	0.29%	1143	0.8%
OCEAN	344	0.15%	778	0.3%
UNION	483	0.37%	696	0.5%
CAMDEN	171	0.11%	636	0.4%
PASSAIC	240	0.23%	613	0.6%
BURLINGTON	157	0.12%	505	0.4%
MERCER	106	0.10%	443	0.4%
HUDSON	256	0.35%	428	0.6%
NY	**2621**	**0.18%**	**8395**	**0.4%**
ERIE	736	0.32%	2065	0.9%
SUFFOLK	475	0.11%	1360	0.3%
NASSAU	175	0.05%	909	0.3%
WESTCHESTER	114	0.07%	428	0.3%
QUEENS	90	0.06%	421	0.3%
ORANGE	197	0.22%	356	0.4%
NIAGARA	190	0.32%	297	0.5%
ULSTER	127	0.26%	297	0.6%

* These are the eight counties with the largest number of properties in the foreclosure inventory in 2012 and with data for both 2005 and 2012.
Data source: Collateral Analytics

Figure 3: Size of the Foreclosure Inventory in 2012 by County



Another issue focused upon in this presentation pertains to the transition of the Stage 3 inventory via REO sales. This transition offers insights about the time it will take to eliminate the inventory. One such measure offered is the number of months it will take to eliminate the REO inventory via REO sales at the recent pace of REO sales (Table 3). These tabulations suggest the inventories would be eliminated in about one year in CT, two to three years in NJ, and five years or so among many counties within NY. A limitation of this measure is that it does not take account of new entries into the Stage 3 REO inventory generated by new foreclosures. Indeed, a very different and more somber picture emerges when this is done. These measures indicate that the entry rates are about the same size or slightly smaller than the exit rates (See Table 4). Hence, taking account of both entry and exit suggests that it will take a very long time for these inventories to dissipate absent new policies or the return of a strong housing market.

Table 3: Months remaining in Foreclosure Inventory*

	Foreclosure Inventory/REO Sales	
State and County Name	2005	2012
CT	11	10
NEW LONDON	15	16
MIDDLESEX	8	12
FAIRFIELD	10	9
LITCHFIELD	10	9
WINDHAM	15	9
HARTFORD	5	8
NEW HAVEN	6	8
TOLLAND	18	7
NJ	9	15
WARREN	8	29
UNION	8	22
SALEM	7	22
ATLANTIC	10	19
SOMERSET	7	19
CAMDEN	14	19
GLOUCESTER	6	16
SUSSEX	7	16
NY	15	39
NIAGARA	3	111
SCHENECTADY	Missing Data	81
ROCKLAND	30	70
SULLIVAN	20	63
ERIE	4	62
KINGS	14	55
WESTCHESTER	17	48
RICHMOND	9	41

* Top eight counties in 2012 by state
Data source: Collateral Analytics

Table 4: REO exit and entry rates*

State Name	Average of Exit Rate	Average of Entry Rate
CT	13%	13%
NJ	7%	10%
NY	4%	5%
Grand Total	7%	8%

Data source: Collateral Analytics

Several conclusions from the analysis and possible next steps are highlighted on the final two slides. First, distinguishing among the various stages of the distressed inventory is important. In the case of these three states (CT, NJ, and NY), the Stage 1 inventory is huge compared to the Stage 3 inventory and they have grown considerably since 2005. Second, there are wide variations in the sizes of these inventories among local housing markets. This suggests that a "one size fits all" policy to deal with these inventories is not optimal. This conclusion is also highlighted in the speech made at the conference by Governor Elizabeth Duke. Third, we have much to learn about the transitions that affect both the growth and the dissipation of the various inventories because the research documents wide variations in these transition rates within the counties in the three states.

The presentation concludes with some upbeat observations about the great potential of data sets with which to study the distressed inventory and its evolution. The geographical granularity of these data are extremely valuable and will allow policy makers to drill down to those areas in which the problems associated with the distressed inventory are most pronounced. Also, these new data sets provide an opportunity to study the problem at the property level. An example of what economists call "duration analysis" is presented for three ZIP codes in the three states. This work tracks properties from the time they enter into the Stage 1 inventory until the end of the data period or until they exit via foreclosure, short sale, regular sale or other relatively minor and miscellaneous reasons. More work of this type is possible and strongly recommended.

Session II:
Impacts of Foreclosures/Distressed Sales

The Impact of Distress Sales on House Prices

Mark Zandi, *Chief Economist, Moody's Analytics*

Since World War II, house prices have tended to significantly affect foreclosures, but not the reverse; foreclosures have historically made little difference for house prices. This changed in the recent downturn because of the sheer volume of foreclosures. Indeed, foreclosures and short sales are among the most important near-term influences on the direction of house prices. The combination of rising distress sales, falling house prices and weak job growth has severely hampered the economic recovery. The large overhang of distressed properties thus clouds the outlook for housing and the broader economy.

Several factors govern the relationship between house prices and distress sales. A distressed home, particularly a foreclosure, is discounted when sold because it is often in poor condition and thus less valuable than a comparable non-distressed home (see Chart 1). Empty, foreclosed homes are subject to vandalism or may have been damaged or poorly maintained by the former homeowner. The average discount on foreclosure sales peaked in mid-2008 at more than 25 percent (see Chart 2). Typically, discounts on short sales are smaller than discounts on REO sales. There is usually a buyer ready to purchase the home in a short sale. Additionally, the seller often still lives in the home and thus the home is better maintained than an REO.

Chart 1: Home Price Index, Single-Family Homes, January 2008 = 100

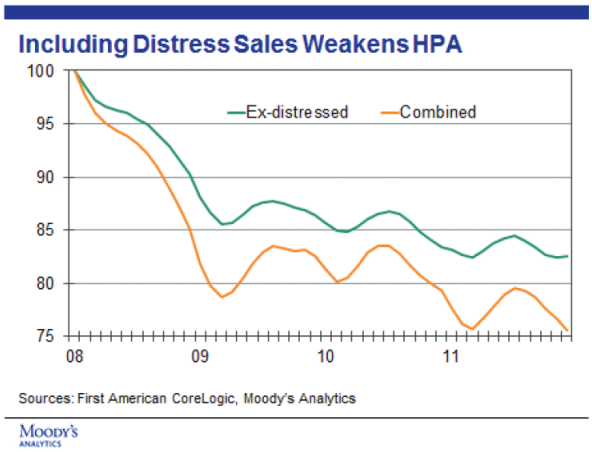
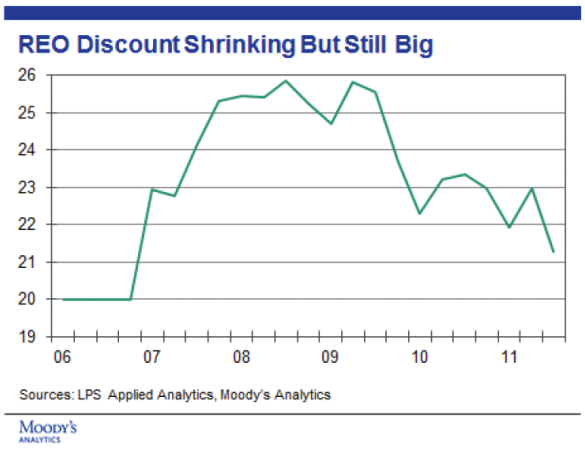


Chart 2: Discount for a REO Sale, %



When distress sales dominate the market, non-distressed house prices are also depressed. Buyers are wary of purchasing in areas with a large number of foreclosures. The blighted neighborhood thus becomes a characteristic of a non-distressed house that reduces its value. A large number of foreclosures also mean there is a large stock of vacant homes which weighs on prices of all types of houses.

Historically, distress sales have had little impact on measured house prices. Sale prices on individual distressed properties are discounted and might even have weighed on sale prices of a few nearby non-distressed homes, but aggregate measures of home prices were unaffected. The volume of distress sales was simply too small relative to normal home sales to have much impact on prices.

However, this changed dramatically in the past few years as the share of foreclosures and short sales surged to more than one-third of total home sales. As the share of distress sales increased, they came to dominate changes in house prices. A rising share of distress sales now results in a decline in house prices and a falling share results in price appreciation (see Chart 3).[i] This relationship is also evident when examining house price changes across metropolitan areas (see Chart 4).

Chart 3: Change in Foreclosure Share of Sales and House Price Growth

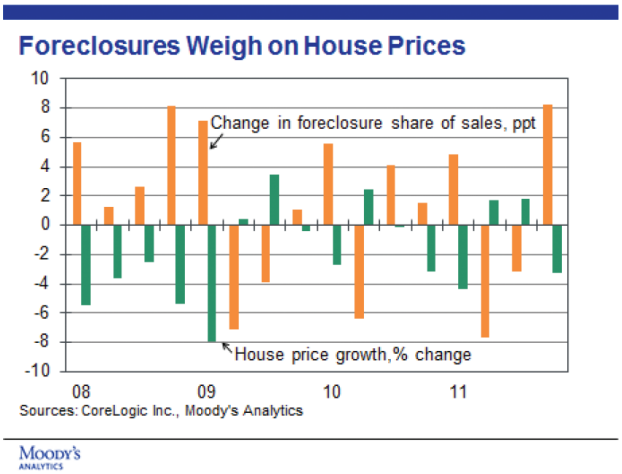
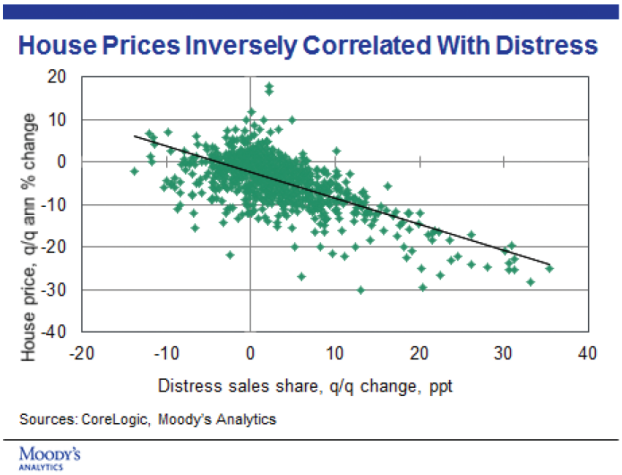


Chart 4: Quarterly Changes, 2007Q1 to 2012Q2, NSA



The importance of the distressed share of home sales is captured in Moody's Analytics model of house prices.[ii] Metropolitan area house prices are determined in two stages. In the first stage, the so-called equilibrium house price is estimated. The equilibrium price is closely tied to household incomes and effective rents, and abstracted from the business and credit cycles. The second stage determines the adjustment process by which actual house prices return to their long-run equilibrium given changing business and credit conditions.

[i] The strength of this relationship varies depending on the house price measure. It is particularly strong in repeat-purchase house price indexes such as those reported by Case-Shiller, LPS Analytics, and CoreLogic that include distress sales in their calculations.

[ii] Moody's Analytics has modeled and provides forecasts for metro area and national house prices based on the Fiserv Case-Shiller, FHFA and Realtors' gauges of median house prices. Of the three, the Fiserv Case-Shiller is the most accurate and comprehensive measure.

In the long term, house prices are most closely tied to household incomes and effective rents. Other factors that affect this relationship include non-housing household wealth, population growth, the age and ethnic composition of the population, regulatory conditions and permitting requirements, structural changes in lenders' underwriting standards, consumer preferences and the long-run, risk-adjusted return to housing and other household assets (see Table 1).

The most important explanatory variable in the equilibrium house price equation is real per capita income. On average, a 100-basis point increase in real (after-inflation) per capita income leads to an equivalent increase in real house prices. Income changes have a slightly larger impact on house prices in coastal markets than in non-coastal markets. Due to geographical constraints in the coastal markets, stronger income growth may drive up demand more quickly than supply, hence driving up house prices more rapidly.

Equilibrium house prices are also affected by shifting mortgage lending standards. The housing bubble saw rapid growth in subprime and alternative-A mortgages, interest-only and option ARMs, along with second liens and home-equity lines of credit. This lending significantly expanded the availability of mortgage credit to households that did not previously have access to any type of credit. As the bubble burst, the lending landscape shifted abruptly and a credit crunch took hold, undermining demand for housing. Lending standards are proxied in the equilibrium equation by an average of the loan-to-value ratio of mortgage originations and the adjustable mortgage share. The higher the share, the looser the lending standards. On average, a 100-basis point increase in this measure generates a 60-basis point increase in equilibrium house prices.

The collapse in stock prices and the plunge in short-term interest rates in the early 2000s made housing an attractive alternative investment. Households were rationally attracted by higher risk-adjusted returns to housing compared with the risk-adjusted returns on stocks and cash. Since the bust, falling house prices have created the reverse effect. The returns to housing are measured in the equilibrium house price equation by the difference between the risk-adjusted returns on stocks and cash, weighted according to their share of assets in the average household portfolio and the risk-adjusted return on housing. The risk-adjusted return is measured by a Sharpe ratio, proxied by the ratio of a five-year moving average of returns to the standard deviation of those returns.[iii] On average a 100-basis point increase in the risk-adjusted return to stocks and cash results in a 75-basis point decline in equilibrium house prices.

[iii] Alternative moving averages were tested. A five-year moving average provides the best statistical results.

Table 1: Equilibrium House Price Equation

Dependent variable: Log of real house price (Case-Shiller index) †				
Sample (adjusted): 1985Q4 to 2011Q4				
Included observations: 105 after adjustments				
Cross-sections included: 20				
Total pool (balanced) observations: 2,100				
R-squared	0.908			
Adjusted R-squared	0.906			
S.E. of regression	0.138			
F-statistic	701.7			
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
Constant	0.4105	0.1108	3.7	0.0002
Log real per capita income, Coastal	1.3796	0.0357	38.7	0.0000
Log real per capita income, Noncoastal	1.2093	0.0412	29.3	0.0000
Market portfolio versus housing returns, Coastal	-0.0089	0.0006	-15.2	0.0000
Market portfolio versus housing returns, Noncoastal	-0.0061	0.0006	-10.4	0.0000
Vacation home share of stock interacted with pop. share 50-64, Coastal	0.0028	0.0012	2.4	0.0145
Vacation home share of stock interacted with pop. share 50-64, Noncoastal	0.0092	0.0026	3.5	0.0005
Log 5-yr population growth, Coastal	0.4150	0.1448	2.9	0.0042
Log 5-yr population growth, Noncoastal	1.5309	0.1397	11.0	0.0000
Weighted average of ARM share and LTV of new loans, 4 qtr MA	0.0068	0.0004	19.4	0.0000
User cost of housing	-0.3787	0.5324	-0.7	0.4770
Metro Area Fixed Effects				
Atlanta, GA	-0.0399			
Boston, MA	0.0906			
Chicago, IL	-0.1323			
Dallas, TX	-0.0225			
Denver, CO	0.1442			
Detroit, MI	-0.3873			
Houston, TX	-0.4780			
Las Vegas, NV	-0.0481			
Los Angeles, CA	0.3665			
Miami, FL	-0.3111			
Minneapolis, MN	0.0492			
New York, NY	0.0796			
Philadelphia, PA	0.1654			
Phoenix, AZ	-0.2633			
Riverside, CA	0.1458			
San Diego, CA	0.4177			
San Francisco, CA	0.3539			
Seattle, WA	-0.0662			
Tampa, FL	-0.3794			
Washington, DC	0.3150			

† Case-Shiller index is benchmarked to the 2000Q1 median home price and then deflated by core PCE deflator.

The age composition of the population also affects equilibrium house prices, as people age 50 to 64 tend to have stronger demand for second and vacation homes. As the large baby-boom generation has moved into this age bracket, demand for second and vacation homes has risen significantly, lifting prices. This effect is captured in the equilibrium house price equation by the share of housing stock in second and vacation homes interacted with the share of the population age 50 to 64. A 100-basis point increase in the share of the population 50 to 64 lifts equilibrium house prices by an average of 60 basis points.

A population-growth variable is included in the equilibrium equation to capture the strength of migration flows, both domestic and international, into the various regions. Migration and population are likely to increase in coming years, with continued foreign immigration and more importantly, increased retiree migration among aging baby boomers.

Finally, the user cost of housing is included in the equilibrium equation. The user cost measures the after-tax cost of homeownership and is computed using the mortgage interest rate, the marginal income tax rate, property tax rate and house price expectations. The higher the user cost, the lower house price growth. House price expectations are proxied by consumer price inflation. The coefficient on this term has the correct sign, although its statistical significance is low. This weakness likely results from the fact that in recent years exceptionally low mortgage rates have driven down the user cost, yet house prices have fallen. Additionally, using consumer price inflation as the measure of house price expectation overstates expectations since the housing correction began.

The equilibrium equation is estimated using pooled cross-sectional estimation with metro-specific fixed effects in order to capture any systematic differences in the average quality of housing across areas. The fixed effects also capture the impact of those land supply constraints that do not vary over time.[iv] In order to capture broad regional differences in the response of house prices to the explanatory variables, the metro areas included in the estimation were grouped into metro areas situated along the coast and Great Lakes and non-coastal areas.[v] The coastal and non-coastal dummy variables were interacted with each of the explanatory variables to pull out the different responses of areas that face tighter building constraints as a result of geographical location, and are thus more susceptible to housing cycles.

The residuals from the equilibrium equation provide an estimate of the overvaluation or undervaluation of metro area house prices relative to their long-run equilibrium. Overvaluation and undervaluation can be due to temporary business cycle forces, speculation or both.

The house-price model also accounts for short-term business cycle dynamics that explain departures from the estimated long-run equilibrium house price. Business cycle drivers of housing demand include the unemployment rate and the distressed share of home sales.

[iv] F-tests of the metro area effects reject that these effects are zero at the 0.001 confidence level. Similar tests for time effects were not found to be significant.
[v] Glaeser, Edward L., Gyourko, Joseph, and Saiz, Albert, 2008 "Housing Supply and Housing Bubbles," NBER Working Papers 14193, National Bureau of Economic Research, show that metro areas in the U.S. located within 80 kilometers of the coast or the Great Lakes tend to feature supply-side constraints that produce larger and more frequent housing bubbles. The coastal dummy is an attempt to capture the inherent similarities of coastal and Great Lakes housing markets.

The adjustment process from the short to the long run is captured by time series terms that capture the tendency for house prices that have been rising or falling to continue rising or falling, as well as the tendency for prices to revert to their long-run equilibrium if they have departed from this trend for long. The larger the difference between the equilibrium house price and the actual price, the greater the reversion back to equilibrium.

The adjustment house price equation determines how house prices that deviate from their long-run equilibrium ultimately return to that equilibrium. The fitted values from the long-run equilibrium house price equation are thus an important explanatory variable in the adjustment house price equation (see Table 2). A 100-basis point increase in the contemporaneous change of the long-run equilibrium price will result in an 8-basis point increase in house prices. This response is measurably smaller than that found in other studies and may reflect the unique housing market conditions of recent years, when factors other than long-term drivers, such as mortgage foreclosures and government housing policy, have been at play.

House prices lagged one quarter are also included in the adjustment equation, reflecting the persistence of house price changes. House price persistence is marginally stronger in the coastal areas, reflecting the greater potential for speculative pressures to develop in these markets. A 100-basis point increase in the house price one quarter ago will result in a 40-basis point increase in the current house price.

The mean reversion term captures the tendency of house prices to revert to their long-run fundamental values and is calculated as the difference between the equilibrium house price and the actual house price. Thus, for example, if this term is positive—that is, actual house prices are below equilibrium—then price growth will be faster.

The principal business cycle variable included in the adjustment equation is the unemployment rate. The higher the unemployment rate, the slower real price growth. The direct impact of the joblessness rate on the adjustment to equilibrium, however, is small relative to that of serial correlation and mean reversion.

The inclusion of a measure of distress sales in the house price model also helps to explain and predict prices. An increase in the distress share will lead to a more pronounced decline in house prices, and the impact will persist for nearly one year. Over this period, a 100-basis point increase in the percent of distress sales will result in a 32-basis point decline in house prices, with the coastal metro areas feeling the impact slightly more. Thus, nearly 10 percentage points of the 34 percent decline in the Case-Shiller house price index from its peak in early 2006 can be attributed to the 30-percentage point increase in the distress share of home sales.

Table 2: Adjustment House Price Equation

Dependent variable: Change in the log of real house price, Case-Shiller index †
Method: Pooled EGLS (Cross-section weights)
Sample: 2007Q1 2011Q4
Included observations: 20
Cross-sections included: 20
Total pool (balanced) observations: 400
The mean reversion variable represents the difference between equilibrium and actual house prices.

R-squared	0.736
Adjusted R-squared	0.714
S.E. of regression	0.018
F-statistic	33.15
Durbin-Watson stat	1.95

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
Constant	-0.0089	0.0012	-7.548	0.0000
DLOG equilibrium house price	0.0782	0.0515	1.519	0.1295
DLOG house price lagged 1 qtr, Coastal	0.3632	0.0598	6.077	0.0000
DLOG house price lagged 1 qtr, Noncoastal	0.3267	0.0772	4.230	0.0000
Mean reversion, Coastal	0.0337	0.0102	3.288	0.0011
Mean reversion, Noncoastal	0.0521	0.0160	3.255	0.0012
2-qtr change in jobless rate	-0.0111	0.0022	-5.016	0.0000
1-qtr change in distress sales share, Coastal	-0.0025	0.0004	-6.830	0.0000
1-qtr change in distress sales share, Noncoastal	-0.0019	0.0005	-4.207	0.0000
1-qtr change in distress sales share, lagged 1 qtr, Coastal	-0.0002	0.0004	-0.554	0.5803
1-qtr change in distress sales share, lagged 1 qtr, Noncoastal	-0.0004	0.0005	-0.717	0.4738
1-qtr change in distress sales share, lagged 2 qtrs, Coastal	-0.0007	0.0004	-1.640	0.1019
1-qtr change in distress sales share, lagged 2 qtrs, Noncoastal	-0.0007	0.0005	-1.285	0.1994
Metro Area Fixed Effects				
Atlanta, GA	0.0042			
Boston, MA	-0.0006			
Chicago, IL	0.0031			
Dallas, TX	0.0069			
Denver, CO	-0.0095			
Detroit, MI	0.0054			
Houston, TX	-0.0064			
Las Vegas, NV	-0.0062			
Los Angeles, CA	0.0051			
Miami, FL	-0.0052			
Minneapolis, MN	-0.0042			
New York, NY	0.0037			
Philadelphia, PA	0.0046			
Phoenix, AZ	-0.0068			
Riverside, CA	-0.0036			
San Diego, CA	0.0033			
San Francisco, CA	0.0007			
Seattle, WA	0.0029			
Tampa, FL	-0.0053			
Washington, DC	0.0077			

† Case-Shiller index is benchmarked to the 2000Q1 median home price and then deflated by core PCE deflator.

It is notable that house prices are currently about 10 percent undervalued relative to equilibrium. Thus, the surge in distressed-home sales has been instrumental in causing prices to overshoot their long-run equilibrium. Even this calculation likely understates the case, as it does not account for the feedback mechanism between falling house prices, the job market, underwriting standards, and distress sales.

The economic recovery is still struggling to take root. The U.S. economy is growing, but at a disappointing pace, particularly with the unemployment rate near 8 percent. A significant impediment to stronger growth is persistent weakness in the housing market. Home sales and construction are off bottom but still extraordinarily low, and house prices continue to founder. With millions of foreclosures and short sales about to hit the market over the next several years, prices could remain weak.

The economy will not be in full swing until house prices are rising consistently. For most Americans, the home is still the most important asset, and consumers will be reluctant to spend while their wealth erodes. Many small-business owners use their homes as collateral to grow, and local governments rely on property taxes.

There are some reasons to be optimistic that the housing slump is ending. Prices have fallen enough to make single-family housing affordable and attractive compared with renting. Investors are putting up cash to purchase distressed properties. Overbuilding remains a problem, but a decreasing one given a record low pace of construction and increased household formation.

But this optimism will be easily overwhelmed if house prices fall further, risking a vicious cycle that puts more homeowners underwater, accelerating foreclosures and distress sales and driving prices lower still. During the recession, only an unprecedented monetary and fiscal policy response short-circuited that cycle.

In light of the risks, policy makers should thus consider additional temporary help for housing. Reinvigorating mortgage refinancing would provide a substantial boost with no meaningful cost to taxpayers. More refinancing will mean fewer borrower defaults and more money in the pockets of homeowners, supporting the recovery through a quick and sizable cash infusion.

Facilitating well-targeted loan modifications, including those involving principal reduction, would be a much larger and costlier step but would bring the housing downturn to a quicker and more definite end. The number of modifications and the amount of principal reduction necessary to stabilize house prices can be reasonably financed with funds from the recent settlement between state attorneys general and mortgage servicers, and the president's proposals to expand Home Affordable Modification Program (HAMP).

Moving more properties out of the foreclosure pipeline before they go to distress sales would also be a big plus, lowering the negative pressure on home values. Given the sharp decline in prices and the recent increase in effective rents, the returns to private investors participating in such efforts are increasingly attractive.

Each of these policy steps has its problems, but they are each worth careful consideration, because the weak housing market remains a significant threat to the still fragile economic recovery.

Impact of Foreclosures on Children and Families

Ingrid Gould Ellen, *Professor, New York University, Furman Center for Real Estate and Urban Policy*

Collateral Costs of Foreclosures

- The Furman Center has studied the collateral costs of foreclosures on:
  - neighboring communities
  - renters living in foreclosed properties, and
  - children living in foreclosed properties.
- All potential victims of foreclosures who clearly cannot be blamed for having taken on more debt than they could handle—but they are still adversely affected by foreclosures

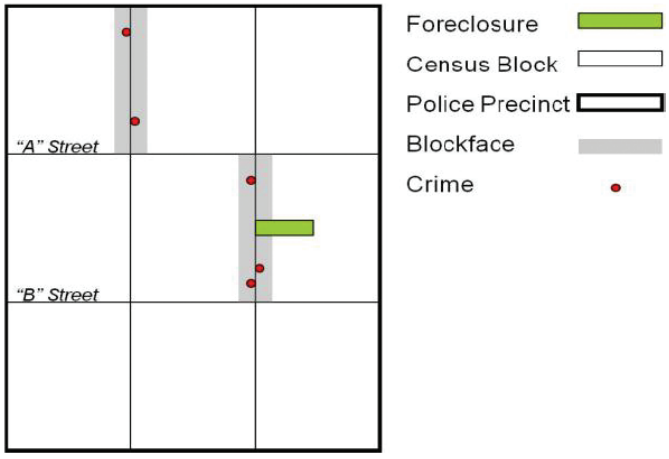
Impact on Communities

- We found that properties in foreclosure in New York reduce the value of surrounding properties (Schuetz, Been, and Ellen, 2008)
  - Consistent with other research (e.g., Harding, Rosenblatt, and Yao, 2009; Haughwout, Mayer, and Tracy, 2009; Lin, Rosenblatt, and Yao, 2009; Campbell, Giglio and Pathak; 2011; Gerardi, Rosenblatt, Willen, and Yao, 2012)
- Far less work exploring impacts on local crime (Ellen, Lacoe and Sharygin, 2012).

Does Foreclosure Cause Crime? Empirical Challenge: Identifying Causality

- Neighborhoods where foreclosures tend to occur are likely to be systematically different from other neighborhoods—and are likely to have more crime
- We need to "weed out" these baseline differences to test if additional foreclosures actually lead to additional crime using longitudinal and spatially disaggregated data

Geographic Unit of Analysis: Blockface



Impacts on Community Crime: Results

- An additional foreclosure leads to around a 1 percent increase in crime on average
- Strongest impacts on violent and public order crime
- Properties that are on their way to a foreclosure auction or in REO have largest effect on crime
  - Impacts start before auction
- The effects extend to crime on neighboring blockfaces, but these effects are attenuated

Impacts on Communities: Future Work

- So far, we have done work on crime in New York City
- We are now extending analysis to four additional cities: Atlanta, Chicago, Miami, and Philadelphia
  - These cities have seen different market conditions and are located in four different states with different laws governing their foreclosure process
  - Do differences in intensity of crisis or in requirements of foreclosure process shape effects on crime?
- Do more to explore mechanisms/timing of impacts

Impacts on Renters

- Many renters live in properties going through foreclosure
- Most of the properties that have received foreclosure notices in NYC are multifamily properties (mostly 2-4 family properties)
- This is not unique to NYC, though shares may be larger in New York

Estimated Share of Households in Foreclosed Buildings Who Are Renters

	2008	2009	2010	2011
Bronx	62.9%	69.3%	66.7%	65.1%
Brooklyn	57.4%	59.3%	61.0%	56.7%
Manhattan	87.4%	77.7%	96.0%	88.9%
Queens	40.0%	39.6%	41.6%	38.6%
Staten Island	27.1%	26.3%	25.9%	26.5%
NYC	52.6%	54.4%	66.5%	56.8%

Impacts on Renters

- While there are now protections in place for renters, we don't know how well these laws are understood or enforced, and renters may still be forced to move sooner than they would like
- Moreover, renters may experience deteriorating building conditions as owners disappear, so it is still possible that they are adversely affected

Impacts on Children

- The disruption and stress of a foreclosure may affect children profoundly
- Our focus has been on educational outcomes, as foreclosures and housing-related distress may force children to move schools and make it difficult for them to focus on school work

How Foreclosures Affect School Moves

- Owners pay back arrearages/receive modification
  - Homeowners may opt for public rather than private schools
  - Tenants may leave as owners reduce maintenance/utilities
- Owners sell property to pay off mortgage debt
  - Residents will move to new homes and perhaps schools
- Bank completes foreclosure/takes ownership
  - Residents will move to new homes and perhaps schools

Impacts on Children's School Mobility: Results

- Controlling for differences in schools and individual demographic, children living in foreclosed homes in New York City are more likely to change schools
- Students who moved to new schools after a foreclosure tended to move to lower-performing schools. (Been, Ellen, Schwartz, Stiefel, and Weinstein, 2011)

Impacts on Children: Future work

- Analysis of how negative equity has affected children's academic performance (NYC, FL, CA)
- Analysis of how foreclosures have affected children's academic performance (NYC, FL, CA)
- Study of how housing crash has affected household savings, bequests, retirement, and home maintenance

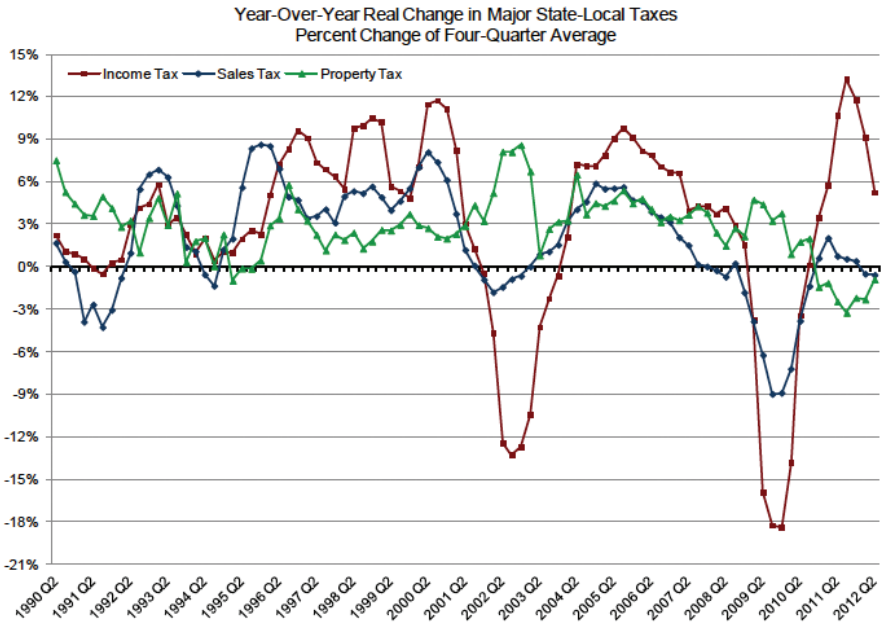
Session III:
Impacts on State and Local Government Finances

Opening remarks (summarized) for panel III, "Impacts on State and Local Governments Finances."
Thomas Gais, *Director, Nelson A. Rockefeller Institute of Government, State University of New York*

The 2007-08 recession has not only been extraordinarily harsh on homeowners; it has been unusually challenging for local governments. Recent data have shown that the ARRA's substantial increase in intergovernmental assistance went largely to states and did not trickle down to local governments. In fact, states cut their aid to localities in 2010, according to a report by the Pew Center on the States.

At the same time, property taxes—which account for about three-fourths of total local tax collections—have stagnated or declined to a degree not seen since the early 1980s (see figure; from a report by the Rockefeller Institute). Perhaps as a consequence, local government employment has declined by about 3 percent since the end of 2007, a much larger drop than the 2 percent decline in state government jobs over the same period. Local employment in education has been hit especially hard.

How do these changes relate to the housing crisis? And how do they affect different local governments, including cities, and their budgets and services? And what can we expect in the future?



Sources: U.S. Census Bureau, Quarterly Summary of State & Local Government Tax Revenue and Bureau of Economic Analysis (GDP).
Notes: (1) 4-quarter average of percent change in real tax revenue; (2) No adjustments for legislative changes.

To help answer these questions, we have two superb researchers. Kim Rueben is a Senior Fellow at the Tax Policy Center of the Urban Institute and an expert on state and local public finance and the economics of education. Her current projects include work on state budget shortfalls, financing options for California, the fiscal health of cities, and higher education tax credits and grants. Kim will focus on the economic conditions of cities, drawing on (among other data sources) a recent survey of cities conducted by the National League of Cities.

Byron Lutz is a Senior Economist at the Board of Governors of the Federal Reserve System. Like Kim, Byron is a MIT-trained economist. Byron's research has also been wide-ranging, including work on school desegregation, intergovernmental grants, state and local finances and the macroeconomy, and the effects of taxes on wage inequality. His presentation today draws on his research in housing prices and housing markets and their effects on state and local government revenues.

Summary of "The Housing Crisis and State and Local Government Tax Revenue: Five Channels"
Talk given by Byron Lutz at the Distressed Residential Real Estate Conference, Oct. 5, 2012

- The talk reflects updated results based on Lutz, Byron, Raven Molloy and Hui Shan, "The Housing Crisis and State and Local Government Tax Revenue: Five Channels," Regional Science and UrbanEconomics, vol. 41, 2011
- The housing market recently experienced the sharpest contraction since the Great Depression.
  - House prices plunged by 30 percent from 2006 to 2011
  - New single family housing starts dropped by 70 percent
- Over the same period, state and local government tax revenues have been hit hard.
  - These revenues fell 4 percent in 2009, the first nominal decline since the Great Depression.
- We ask: How important is the impact of the housing market downturn on state and local tax revenues relative to the broader, more global, impact of the recession and sluggish recovery?
  - To answer this question we identify five channels through which the housing market may impact state and local government tax revenues:
    - Property taxes at the local government level (the primary channel)
    - Four channels at the state government level
- Analysis using historical data informs two aspects of the relationship between home values and property tax revenues
  - **Timing:** It takes three years for a change in house prices to be reflected in property tax collections The lengthy lag appears to reflect three factors:
    - The property tax is backward looking in that taxes paid today are based on assessments in the prior fiscal year.
    - In many states assessments lag market values at the time they are taken.
    - Property tax caps and limits prevent house price appreciation from moving into the tax base during periods of rapid house price appreciation. When house price growth falls below the caps/limits, the past house price appreciation begins to move into the tax base. This dynamic can create significant lags between house prices and property taxes.
  - **Magnitude:** The elasticity of property tax revenue with respect to home prices equals 0.4 (i.e. a 10 percent increase in house prices produces only a 4 percent increase in property tax collections).
    - The implication is that policy makers offset house price changes by adjusting rates.
- The above analysis uses historical data in which most of the house price changes were increases. Additional analysis focuses on historic episodes of house price decreases.
  - Historically, policy makers more than offset house price declines with increases in the effective tax rate. As a result, in states where house prices declined, property tax collections continued to increase.

- House price declines during the recent downturn in the housing market were significantly greater than those in the historical data. Thus, the historical data may not provide an accurate guide to the current situation. We therefore turn to case studies using data collected from individual state governments.
  - These case studies reveal that in many states:
    - Assessed values lag market values by several years and that, as a result, there was little downward pressure on property taxes in the initial years following the fall in house prices.
    - When assessed values eventually declined, policy makers made significant increases in the effective tax rate and property tax revenues fell only modestly.
- The four non-property tax channels through which the housing market may influence state tax revenues are
  - Real estate transfer tax
    - The tax is assessed at the time real estate changes hands and is based on the dollar value of the transaction. The sharp decline in real estate sales volumes decreased the collection of the tax.
  - Direct sales tax
    - Most builders pay sales or use tax on materials. The decline in construction activity therefore decreased sales tax receipts.
  - Indirect sales tax
    - The decline in housing equity likely caused many households to reduce their consumption expenditures. In turn, sales tax receipts likely fell.
  - Personal income tax
    - Aggregate payrolls in the construction and real estate sectors declined which caused a fall in income tax collections.
- From 2005-2009, these four channels collectively reduced total state tax revenues by around 3 percent
  - However, there is significant heterogeneity across states, e.g.:
    - Florida saw a 10 percent decline in revenues due to these channels
    - New York experienced only a 1 percent decline

Economic Condition of States and Cities

Kim Rueben Tax Policy Center – Based in part on the NLC "City Fiscal Conditions in 2012"

- Economic activity drives state and local governments' fiscal health and revenue levels, with some areas doing better than others. State and local government actions can also help or hinder economic recovery. Government finances are largely pro-cyclical, so revenues fall and spending needs increase during recessions, typically lagged from when the economy falters.
- This recession far worse than past recessions.
  - Variables that drive revenue hit harder than broader economy
  - Real estate and construction sectors still weak
  - Consumer spending still low
  - Also highlights longer term pressures governments will face
- Governments mostly spend money on employees and people
- Understanding what long and short-term obligations are will be critical.
- Demographic changes (aging of the population) will also put pressure on budgets.
- State and local government actions also directly affect economic activity
  - State and local employment numbers are 600,000 lower than peak levels, and local employment is still falling. Thus current gains in employment are limited due to a lackluster public sector.

What does the outlook look like for states?

- For states, while revenue crisis is easing, fiscal crisis continues
  - State revenues are growing but so are spending pressures
  - Revenues still weaker (in real terms) than before recession
- According to the NASBO Fiscal Survey of the States Spring 2012, FY 2013 general fund revenues finally larger that pre-recession levels in nominal terms (690B in 2013 vs 680B in 2012)
- While most states passed balance budgets, some states will face shortfalls (CA budget uncertainty most stark)
  - Facing short term challenges ahead
- Medicaid growth – most of additional general fund spending going to Medicaid, in part making up for end of federal ARRA funds
- Many programs that were cut over the last four years, provided important services – Will some of these services be restored?
  - Most states, began rebuilding balances this year after facing shortfalls for the last few years
- However, states often balance budgets by cutting aid to local governments
- Many not back to pre-recession spending/revenue levels
  - Rules can make budgeting harder
- 30 states have state tax or expenditure limits
- 17 states require voter approval or supermajority of legislatures for tax increases
- Only 4 states don't limit local property taxes
- State limits on property taxes vary and make harder for some local governments.

What does the outlook look like for cities? (City Fiscal Conditions in 2012)

- Nation's city finance officers report that the fiscal conditions of cities in 2012 continue to reflect the prolonged effects of the economic downturn.
- Declines in city revenues largely driven by local and regional economies that are still experiencing struggling housing markets, slow consumer spending and high levels of unemployment.
- Cities facing sixth year in a row of year- over-year declining revenues.

- Continued decline in property tax revenues (which started falling in 2010), reflects the lagged impact of real estate market declines and is likely to continue going forward
- Yet in 2012 higher percentage of city finance officers (57%) felt better able to meet financial needs than in prior years. The percentage up starkly from 2009 and 2010 when only 12% and 13% of officers felt that they were better able to meet needs than prior year.
  – Cities that have a sales tax seem more optimistic, in part have less revenue decline
- Fiscal pressures on cities include declining local tax bases, cuts in state and federal aid, but increased employee-related costs for health care pensions and wages and growing infrastructure needs
- Cities are responding by raising fees, and cutting personnel, delaying infrastructure projects and cutting local services.

Beyond 2012

- Real estate markets slow recovery;
- Prolonged effects of unemployment and wage reductions will weigh heavily on income tax revenues and sales tax receipts;
- Underfunded pension and health care liabilities will persist as a challenge;
- State and Local governments likely to continue to operate with reduced workforces, cut services and infrastructure investment

However some opportunities in a crisis…

- Most governments realize need to change business as usual. Decisions hard, as most state and local spending is on workers and providing important services and moving to:
  – Shared service agreements, inter-local agreements and regionalization and cost-sharing;
  – Participatory budgeting and citizen engagement to reset/reevaluate priorities;
  – Redefinition of "core services;"
  – Outsourcing, privatization and "managed competition;" and,
  – New partnerships and volunteerism.
- Local bankruptcy very rare
  – Since 2010 (and as of early August 2012), only 27 municipalities have filed for Chapter 9 bankruptcy
  – Only 7 were general governments (Central Falls, RI; Jefferson County, Alabama; Stockton, CA; Mammoth Lakes, CA; and San Bernardino, CA. It also includes two filings (Harrisburg, PA and Boise County, ID) that were ultimately rejected.
  – Municipal bankruptcy as much about dysfunctional politics as finances:
- Bad earlier deals and on the hook for bonds for faulty investment (Scranton, Jefferson County)
- Inability to reach agreement
- Changes in economic conditions
- (Stockton felt would be experiencing extraordinary growth and built for it.)
- Changing demographics and difficulty meeting existing commitments (MI cities – Detroit, Flint) faced with local existing public sector pension obligations yet shrinking population and tax base
- But bankruptcy or restructuring can be an opportunity to try and help with large existing obligations (employee costs, existing debt), and can lead to adoption of rules to help going into the future.
  – Vallejo recovering and fiscal house in order
  – New York and Washington are still following rules set out under state and federal takeover

Session IV: Remedies

Reflections on Remedies

Kathleen Engel, *Associate Dean, Suffolk University Law School*

Research Needed

Throughout the country, cities, states, and the federal government are implementing programs designed to stimulate the housing market, convert distressed properties to productive use, and help borrowers who are in default or on the verge of defaulting on their home mortgage loans. How well these programs work is, at best, difficult to measure, which renders informed policy making a challenge. Specific issues:

- For several years, loan cramdowns have been on the table. Those in favor contend that they will make loans more affordable and stabilize the market. Opponents argue that people will default to be able to take advantage of opportunities for cramdowns. How do we know the extent to which moral hazard is a real, and not just a theoretical, problem? This is a tough nut to crack using actual data, but we may get closer to understanding the extent of moral hazard through experiments where people are given different scenarios and advised of the consequences of cramdowns, e.g., possible damage to their credit scores and increased tax liability based on debt forgiveness, and see what choices they make.

- Controlled, field experiments are difficult for several reasons. The first is that people who run programs designed to help homeowners may be unwilling to have a control group. Second, differences in people's financial situations would make it almost impossible to determine which factors best predict whether a particular individual would succeed under a particular program. With that said, it is possible to use treatment and control groups to determine whether, on average, a program is beneficial.

- Given that many programs are regional or statewide, it might be possible to compare states with similar demographics where only one has the program that is being studied. An alternative would be to look at border counties of abutting states where the economic conditions would likely be similar to see what effect a program might have.

- Given the complexity of housing markets and the many actors involved in housing finance, loan modifications, and REO, it behooves researchers to avoid simplifying their analyses in ways that could lead to mistakes in their conclusions about causal relationships. Although model building and empirical studies can help uncover phenomena, the complexity of housing markets demands qualitative study as well. For example, there could be empirical evidence that mediation programs are correlated with delays in foreclosures and corresponding declines in property values. From this evidence, one could conclude that mediation programs are the culprit when the real culprit could be servicers who delay mediation because they don't have the resources, are opposed to modifications because they make more money with foreclosures, or have conflicts of interest because affiliated entities own second mortgages that could be wiped out in a modification. Only through observation of the actual transactions coupled with empirical analysis can we fully understand what is taking place in programs.

- There is anecdotal evidence that some borrowers are suffering from "modification fatigue" because they have been stymied by lost documents, phone loops at call centers, and the like. It would be valuable to study what the experiences of borrowers have been. This might be possible by examining loan files to calculate the nature and frequency of borrowers' communications with lenders and servicers.

Policy

- In thinking about distressed properties and borrowers in default, what is the potential role of the Community Reinvestment Act (CRA)? One problem with CRA is that it is most valuable to depository institutions at the peak of the business cycle when there are a lot of mergers and acquisitions and when banks want to expand their services. At the bottom of the cycle, the converse is true. As a result, the CRA is least valuable when it is most needed to infuse creative financing to ameliorate the problems of distressed properties, neighborhood decline, and underwater borrowers. One option would be to give greater weight to banks' CRA-eligible activities in bad times and allow them to bank their credits for the future. Of course, for banks that are suffering themselves, no amount of CRA credit will be an incentive to invest in communities.

- Ideally, at mediation borrowers and servicers/lenders bring all the information needed to determine borrowers' eligibility for a loan modification. That doesn't always happen and the mediation either fails or is delayed. For borrowers, they may not fully understand what they are supposed to bring or how to obtain the required documentation, especially if they are not represented by counsel. Services and lender do know exactly what to bring, yet there is evidence that they do not always have accurate figures and, at times, lack the authority to renegotiate a loan. Given the differences in sophistication, one policy question is whether unprepared and unrepresented borrowers should be treated with greater leniency than lenders or servicers who are ill-prepared.

Lingering Questions

- **To the extent that we are confident that some programs are successful, are the programs scalable?**

- **Given that almost everyone agrees that delays in foreclosure are bad for neighborhoods, is it possible to preserve homeownership through modifications and protect communities at the same time?**

- **How can we gather information on effective programs to help aGs decide how to deploy their funds from the robo-signing settlement?**

- **Has it been a mistake to predicate eligibility for a modification on default? Would a better policy be to allow modifications if borrowers are underwater to avoid the problem of moral hazard?**

- **Historically, one of Fannies and Freddie's missions has been affordable housing. Are the current policies of the FHFA consistent with these goals?**

Does Foreclosure Counseling Help Troubled Homeowners? Summary of Key Findings from the Evaluation of the National Foreclosure Mitigation Counseling Program

Peter A. Tatian, *Neil S. Mayer, Kenneth Temkin, and Charles Calhoun*

Housing counseling is making a difference in helping many homeowners avoid foreclosure and stay in their homes. A large share of this counseling is being funded through the National Foreclosure Mitigation Counseling (NFMC) program, which is a special federal appropriation, administered by NeighborWorks® America (NeighborWorks), designed to support a rapid expansion of foreclosure intervention counseling in response to the nationwide foreclosure crisis. NeighborWorks distributes funds to competitively selected organizations across the country, which in turn provide much needed foreclosure prevention and loss mitigation counseling services at no cost to homeowners. Over 1.35 million struggling homeowners have received counseling through the NFMC program.

As this is a federal appropriation, NeighborWorks must inform Congress and other entities of the NFMC program's progress. The Urban Institute was selected by NeighborWorks to undertake an evaluation of the first two rounds of the NFMC program, which included persons counseled in 2008 and 2009. Our research answered the following questions.

- Did the NFMC program help homeowners stop an existing foreclosure?
- Did the NFMC program help homeowners receive loan modifications that resulted in lower monthly payments than they would have otherwise received without counseling?
- For homeowners who cured a serious delinquency or foreclosure through a loan modification or some other means, did NFMC counseling help them to remain current on their loans longer and more frequently than they would have without counseling?
- For borrowers with seriously troubled loans, did NFMC counseling increase their chances of first obtaining a cure and then sustaining that cure and avoiding redefault?
- Did the NFMC program help reduce the number of overall foreclosure completions?

The final results of this evaluation were released in December 2011. The research demonstrated that the NFMC program was having its intended effect of helping homeowners by improving the quality of mortgage modifications, increasing the frequency and sustainability of cures of delinquencies and foreclosures, and reducing the number of foreclosure completions. In addition, the program helped build the nation's foreclosure counseling capacity. As detailed in a final report and research brief, the evaluation documented the positive impacts of the program, which are summarized below.[i]

Improving outcomes for troubled homeowners. Counseling provided through the NFMC program yielded measurable and substantial improvements in client outcomes. One of the most commonly sought solutions for a homeowner who cannot afford his or her monthly mortgage payments is a loan modification, which involves changing the terms of the current mortgage, such as by lowering the interest rate. Ideally, these changes would reduce the monthly payment to make the loan affordable to the homeowner. Obtaining a modification typically involves frequent interaction and negotiation with the mortgage servicer and counselors can provide a crucial level of support to clients during this process. The evaluation found that NFMC clients who had their loans modified paid $176 a month less, on average, than homeowners who received loan modifications without the benefit of counseling assistance.

[i] The summary research brief and final report are available on the Urban Institute website at http://www.urban.org/publications/412492.html.

Counseling also increased the frequency and sustainability of cures of delinquencies and foreclosures. The data showed that homeowners in serious delinquency (three or more months of missed payments) or foreclosure had 89 to 97 percent higher relative odds of bringing their loans current through a modification if they got counseling help, as compared to troubled borrowers who did not use counseling. Furthermore, NFMC clients who got a delinquency-curing loan modification were 67 to 70 percent less likely to redefault on their mortgage payments nine months later. When these results are synthesized, they demonstrate that NFMC counseling nearly doubled the rate of curing and sustaining troubled loans.

One of the most significant impacts of the NFMC program on the national foreclosure crisis was in increasing the number of foreclosures ultimately avoided. Between January 2008 and December 2010, the program reduced the number of foreclosure completions for counseled homeowners by 13,000. Put another way, the NFMC program prevented nearly one in seven foreclosure sales that would have been completed without counseling.

Since foreclosure sales create social costs, avoiding foreclosures generates savings. Each foreclosure sale prevented by the NFMC program was estimated to have saved an average of $70,600 in avoided costs. These savings included $10,000 in moving costs, legal fees, and administrative charges for homeowners; $40,500 in deadweight lender losses; $6,500 in local government administrative and legal costs; and $13,900 in reduced neighboring property values. Assuming the 13,000 loans that avoided foreclosure because of counseling do not complete foreclosure at some point in the future, the NFMC program has helped save local governments, lenders, and homeowners $920 million, which is about $1,200 per client served by the program.

When the full costs of providing counseling services to these clients is accounted for, the savings represented a total counseling benefit-to-cost ratio of 2.4 to 1.

Building national capacity for foreclosure mitigation counseling. The NFMC program increased the funding available to counseling organizations, allowing them to hire more counselors and serve more clients. Before the national housing crisis, foreclosure counseling was a small share of the services provided by housing counseling organizations. The rapid rise in mortgage delinquencies meant that counseling organizations had to shift priorities and rapidly ramp up their capacity to provide foreclosure counseling. With NFMC funding, organizations increased the number of foreclosure clients served and expanded their service areas to respond to the increasing demand for help.

To be effective, counseling organizations also had to improve their responsiveness to the challenges faced by their clients. The NFMC program evaluation gathered extensive information from counseling agencies on specific challenges, as well as on the strategies and best practices used to address them. Counseling organizations identified lack of servicer responsiveness and client financial difficulties (such as loss of income) as their two biggest challenges. Effective counseling organizations have developed several best practices to address these and other obstacles, including building contacts and relationships with servicers, assessing a client's situation in terms of proposals that a servicer will be willing to consider, working through a "crisis budget" with the client to prioritize expenses, and empowering clients to be informed advocates on their own behalf.

The evaluation of the NFMC program has shown that counseling has been an important and successful tool in addressing the record number of troubled homeowners who have faced, and continue to face, loss of their homes because of foreclosure. While counseling cannot solve the foreclosure crisis by itself, it nonetheless has helped homeowners achieve better outcomes, which in turn has benefited the country by reducing the numbers of non-performing and failed mortgages, avoiding social costs associated with foreclosures, and allowing more people to retain their homes.

Remedies: The Effectiveness of Settlement Conferences as a Means to Prevent Properties from Ending Up in REO Inventory

Kirsten Keefe, *Senior Staff Attorney, Empire Justice Center*

The failure of national mortgage servicers and federal regulators to adequately address the foreclosure crisis has prompted a number of states to pass consumer protections in an attempt to salvage the crisis within their borders. The most popular has been the advent of mediation programs, intended to bring the servicer and borrower together through a formal process to see if a loan modification or other workout can be achieved.

New York State, a judicial foreclosure state, was the first, in February 2010, to institute mandatory settlement conferences in every mortgage foreclosure of a primary residence.[i] The statute requires a conference to be scheduled within 60 days of the filing of the affidavit of service and Request for Judicial Intervention (RJI), a document that triggers the case to be assigned to a judge.[ii] Plaintiffs are required by law to appear in person or by phone, and by a representative who is fully authorized to settle the case. There is a duty to negotiate in good faith and parties are prohibited from imposing fees on the other for participation in the settlement conference process.[iii]

The most resounding success of New York's settlement conferences has been bringing homeowners to the defense table. According to the 2011 Report of the Chief Administrator of the Courts for NYS, "only 10 percent of homeowner-defendants did not appear for any of their scheduled conferences, down from an estimated 90 percent prior to the legislation."[iv] This is simply incredible, and extremely meaningful when one thinks about a legal action to repossess a home as being one of the most serious and detrimental lawsuits that an average citizen could be party to.

New York's Foreclosure Process and Shadow Docket: Delays Caused by Mortgage Servicers

In NY, a foreclosure is initiated with the filing of a summons and complaint with the court which is then served on the homeowner. The plaintiff next is to file a Request for Judicial Intervention (RJI), triggering assignment of the case to a judge, along with the filing of the affidavit of service. Defendants have 20 or 30 days to file an answer, depending on how they were served. Under court rule, simultaneously with the RJI, plaintiff's attorney must file an Affirmation confirming they have communicated with the servicer and attesting to the veracity of the complaint. Within 60 days of the filing of the RJI, the court must schedule a mandatory settlement conference—theoretically extending the foreclosure timeline by only 30 or 40 days.

But servicers are failing to file RJI's in thousands of cases across the state, causing these cases to sit in limbo in what has become known as a "shadow docket." Why plaintiffs are choosing not to prosecute these cases is unknown though it may have to do with the inability of the servicers to provide adequate documentation to their lawyers to enable them to file the Affirmation.

Delays are further caused by servicers through the settlement conference process, failing to send a representative with authority to settle, or the usual dilatory tactics invoked by services in the loss mitigation process.

Courts are also reporting a significant docket of cases which have moved out of the settlement conference process unresolved, but yet plaintiffs are not prosecuting to judgment and sale. Homeowners are also having their cases dismissed by the plaintiff, only to have it re-filed at a later date.

[i] N.Y. C.P.L.R. 3408 (McKinney 2009). See also Uniform Civil Rules of the Supreme and County Courts Sec. 202.12-a (effective Feb. 13, 2010), available at http://www.courts.state.ny.us/courts/2jd/kings/civil/202.12-a_rev_Residential-Mortgage-Foreclosure-Action-Settlement-Conference.pdf.

[ii] C.P.L.R. 3408(a); Sec. 202.12-a(b). At the time of filing the RJI, plaintiff's attorney also must file an Affirmation pursuant to Administrative Order No.548-10, modified March 2011 Admin Order No. 431-11, available at http://www.nycourts.gov/attorneys/pdfs/AdminOrder_2010_10_20.pdf.

[iii] Id. at 3408(c), (f), (h); See also Sec. 202-12-a(c)(4).

[iv] New York State Unified Court System, 2011 Report of the Chief Administrator of the Courts Pursuant to Chapter 507 of the Laws of 2009, at 4, available at http://www.courts.state.ny.us/publications/pdfs/ForeclosuresReportNov2011.pdf.

In the very least, the settlement conferences have increased participation of homeowners in their own defenses and have made the court process friendlier and more accessible.

The report further notes that the settlement rate in foreclosure cases increased 29 percent over the 11-month period studied (November 2010 through September 2011).[v] This is evidence that servicers are capable of working with homeowners and resolving foreclosures when compelled to do so. The advantages of mediation programs are many. In addition to bringing the parties together, these programs can oversee the exchange of documents, impose deadlines, and enforce timelines so typically violated by the large servicers under the Home Affordable Modification Program (HAMP). In many ways, the settlement conferences in NY have become a means to babysit the HAMP process and ensure servicers are properly reviewing applications and not improperly denying relief to homeowners.

There has been misplaced blame recently on state consumer protections for elongating the foreclosure process. In fact, it is not these laws that create the long timelines adding costs to the process, but rather the failure of the servicers to comply with these programs, as well as with HAMP directives, that is causing the great delays in states. A report issued by the National Consumer Law Center (NCLC) in February 2012, found that "Foreclosure conference and mediation programs had little, if anything, to do with these delays."[vi] Citing a study conducted by The Reinvestment Fund of the Philadelphia foreclosure diversion program, the mediation process took on average 53 days, a process that could easily be held within the typical 10-month time period it takes for a default foreclosure to be completed.[vii]

In NY, the state attributed with having the longest foreclosure timeline, the settlement conference process is in fact being invoked to compel servicers to move foreclosure cases forward. (See insert for an explanation of NY's foreclosure process.) Delays are the fault of plaintiffs and their mortgage servicers and can be lumped into four categories: (1) lenders are not filing required paperwork to trigger settlement conference scheduling, creating a "shadow docket" of cases filed with no action; (2) servicers are engaging in dilatory practices causing conferences to be adjourned multiple times; (3) once removed from the settlement conference part, lenders are not moving cases to judgment and sale; and (4) lenders are voluntarily seeking dismissal of actions, only to re-file at a later date.[viii] In June 2012, New York's Office of Court Administration (OCA) amended its settlement conference rules to prompt courts to schedule status conferences to address the shadow docket and force servicers to prosecute foreclosure cases.[ix]

Delays disadvantage homeowners. Interest and fees continue to accrue in these cases that will eventually be capitalized onto the principal balance through a loss mitigation evaluation, rendering an eventual loan modification for the homeowner less probable. Ultimately, delays will mean fewer homeowners remaining in their homes and more properties ending up in REO inventory. The delays also cause harm to communities, and hamper national prospects to emerge from the foreclosure crisis. No doubt, some proportion of the cases sitting in limbo with no prosecution in New York's courts, involve properties that are abandoned, or which the homeowner can no longer afford. These properties are not being moved through the court system and returned to the market for sale or other disposition—they are just sitting in limbo and especially if abandoned, deteriorating in their condition and value.

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[v] Id. at 6.

[vi] Geoff Walsh, Rebuilding America: How States Can Save Millions of Homes Through Foreclosure Mediation, National Consumer Law Center, 38, (Feb. 2012), available at http://www.nclc.org/foreclosures-and-mortgages/rebuilding-america.html.

[vii] Id.

[viii] See MFY Legal Services, Inc., Justice Unsettled: How the Foreclosure Shadow Docket & Discontinuances Prevent New Yorkers from Saving Their Homes, (May 2012), (finding in Brooklyn and Queens courts, as of April 2012 almost 75 percent of foreclosures filed in October 2011 sat in the shadow docket, and as of March 2012, 43 percent of November 2010 and March 2011 filings remained in the shadow docket), available at http://www.mfy.org/wp-content/uploads/Justice-Unsettled-plus-APP.pdf. A review of cases filed November 2011 through May 2012 in the Capital Region of NY showed that as of August 2011, 67 percent of cases in Albany and Rensselaer counties, and 59 percent in Schenectady county had not had RJI's filed and sat in the shadow docket.

[ix] Amending Uniform Civil Rules of the Supreme and County Courts adding section 202.12(a)(b)(3) (June 18, 2012), available at http://www.nylj.com/nylawyer/adgifs/decisions/070212order.pdf.

The settlement conferences also play a vital role in linking distressed homeowners with reputable direct assistance provided by non-profit housing counseling and legal services programs. In a survey of New York's 62 county courts, conducted by Empire Justice Center in the summer of 2012, nearly 90 percent of clerks who responded from areas where these services are available reported that they regularly refer homeowners to local non-profits. Some courts have directly involved advocates, having them assist in an initial informational conference for homeowners. Other courts provide space in the courthouse for advocates to meet with homeowners who appear at the conferences without counsel. Involving advocate representatives for homeowners makes the process more efficient for the court, and it is well recognized that homeowners are more likely to get an affordable loan modification with the assistance of a counselor.

A number of states, and some counties, have instituted mediation programs including: Connecticut, Delaware, District of Columbia, Hawaii, Illinois (Cook Co.), Indiana, Maine, Maryland, Nevada, New York, Ohio (Cayuga Co.), Pennsylvania (Philadelphia Co.), Rhode Island, Vermont, and Washington.[x] Mediation programs have been developed in states with both judicial and non-judicial foreclosure processes. The programs have a unifying goal—to bring the parties together in a supervised forum to ensure that options for a loan modification or other workout have been explored and exhausted before a home is lost to foreclosure.[xi] States and localities recognize that it is far preferable to keep homeowners in their homes if they can afford them.

NY's Settlement Conferences

From November 2010 to September 2011:
- 4,253 initial settlements were scheduled
- Homeowners appeared in 90 percent of cases
- 80,450 conferences were held, including 55,043 adjournments
- It took four to eight appearances to settle
- Settlement rate rose 29 percent from previous year

Source: NYS Unified Court System, 2011 Report of the Chief Administrator of the Courts Pursuant to Chapter 507 of the Laws of 2009.

[x] See Walsh supra (identifying mediation programs across the country).
[xi] See e.g., C.P.L.R. 3408(a) stating settlement conference shall be held "for the purpose of holding settlement discussions pertaining to the relative rights and obligations of the parties under the mortgage loan documents, including, but not limited to determining whether the parties can reach a mutually agreeable resolution to help the defendant avoid losing his or her home, and evaluating the potential for a resolution in which payment schedules or amounts may be modified or other workout options may be agreed to, and for whatever other purposes the court deems appropriate."

The structure of mediation programs differs and states have been learning from one another to enhance effectiveness and efficiency within their processes. Some are overseen by judges while others involve independent mediators. Requirements also vary in terms of whether the conferences are mandatory, or an opt-in, requiring the defendant homeowner to schedule the conference. Rules vary as well regarding the production of documentation by the parties (including proof of ownership by the foreclosing party), requirements to negotiate in good faith and payment for the conferences. The ability of the party overseeing the negotiations to sanction a non-complying servicer seems to be a key element to the success of mediation programs.[xii]

An important aspect that has not been factored by those criticizing state programs for holding up the foreclosure crisis is the increased number of homeowners in states with mediation who will remain in their homes with once-again performing loans, preventing more properties from being dumped into REO inventory or otherwise glutting housing markets. The current reality of New York's shadow docket, coupled with the fact that once a case reaches the settlement conference process it takes on average four to eight distinct appearances before the court for a resolution to be reached with the servicer,[xiii] means that it is probably still too soon to fully calculate the long-term benefits settlement conferences will have for the state and its communities. We are able to predict, however, based on the increased rate of homeowners getting modifications as a result of the conferences that they are definitely working to prevent more homes from ending up in REO. And prevention is always the best remedy.

[xii] See Walsh supra (providing an in-depth study of mediation programs and their differences).
[xiii] New York State Unified Court System, supra at 2.

Earned Principal Reduction[i]

Adam Ashcraft and Joseph Tracy, *Federal Reserve Bank of New York*

The significant decline in house prices and increase in unemployment rates across many local housing markets as a result of the financial crisis and Great Recession created considerable stress for homeowners with mortgages. Many of these homeowners found themselves in situations where the current value of the house was less than the outstanding balance on their mortgage(s)—what we will call being underwater or in negative equity. In addition, many homeowners faced significant cutbacks in their income due to unemployment or underemployment. This situation makes it difficult for the household to continue to make their monthly mortgage payment(s) in a timely manner. The combination of these two situations often leads to a default and eventual foreclosure.

As foreclosure rates increased over time and across local housing markets, efforts were undertaken to try to minimize the risk that borrowers would default on their mortgages. A common strategy for dealing with borrower stress was to lower the monthly mortgage payments. This was done either through a modification of the existing mortgage to reset the interest rate lower and to extend the term of the mortgage or through special refinance programs. Two notable examples are the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP).

For underwater borrowers, a key aspect of these programs is that they do not attempt to deal directly with the fact that the borrower has no equity in the house. An important question is whether negative equity is an important risk factor for future defaults even if the borrower can currently afford to make the required monthly payment. Economists are known to disagree with each other and this question is no exception. However, empirical studies of mortgage default consistently find that borrowers in negative equity are more likely to default holding constant a wide range of other risk factors.

Over time the practice of treating negative equity through principal reduction—that is, writing down the balance of the mortgage to the borrower—has become more prevalent. For example, the 2012 Q1 OCC Mortgage Metrics Report indicates that 10.2 percent of all modifications over the period covered by the report involved a principal write-down. Looking across categories of mortgages the frequency of this intervention varied widely: 28.9 percent for mortgages in bank portfolios; 18.9 percent for mortgages, in private securities; and 0 percent for agency mortgages guaranteed by the GSEs (Freddie Mac and Fannie Mae). This indicates that the GSEs are clear outliers with regard to using principal write-down as a tool for mitigating default risk.

The purpose of this note is to summarize our analysis of the economic case for a principal reduction program for agency mortgages. Since the GSEs are in conservatorship, the economic case should be based on the mandate to the Federal Housing Finance Authority (FHFA) as the regulator of the GSEs to minimize the risk to taxpayers. That is, could a principal reduction program reduce the expected losses to the GSEs? If so, what would be the structure of the program that creates the best return for taxpayers?

[i] The views expressed in this article are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

We evaluated a program that we call "earned principal reduction." This program is designed to dovetail with the existing HARP. That is, the first step for an underwater borrower with an agency mortgage is to refinance using HARP in order to reduce the required monthly payment. The next step would be to enroll in the earned principal reduction program. The basic idea of the program is that the borrower earns over time the right to pay off the mortgage at a discount. The borrower earns this discount by staying current on the monthly payments. The earned discount grows over the first three years of the program. The discount is designed to allow the borrower after three years to be able to sell the house and pay off the mortgage even if house prices do not increase. In return, the borrower agrees to give up a pre-specified percentage of any house price appreciation that may occur until the house is sold. As such, our earned principal reduction program has the feature of a streamlined short-sale agreement where the borrower earns the right to do a short-sale by making three years of timely payments. Importantly, the earned discount does not change the monthly payment amount. This is why it is useful for the borrower to lower the monthly payment by first refinancing under HARP.

An important point to note is that the balance of the mortgage is not written down at the time that the borrower enrolls in the program. Rather, any loss that may be incurred by the GSEs from the discounted payoff option is realized only when the house is sold. This acts to spread out the realization of the losses into the future. However, from the borrower's viewpoint the option to pay off the mortgage at a discount in three years should reduce the default risk from the outset since the borrower now has a clear path to be able to sell the house.

A key concern of any mortgage intervention program is moral hazard. That is, does the program create incentives for borrowers to engage in undesired behavior in order to qualify for or benefit more from the program? Opponents to principal write-down programs argue that these programs create incentives for borrowers who would otherwise keep paying their mortgage to go delinquent in order to qualify for the write-down. This assumes, however, that delinquency is a requirement to qualify. To avoid moral hazard, we must design the program so that eligibility and treatment depends on the borrower's degree of negative equity and not on the borrower's payment history. Furthermore, as described above, once enrolled in the program the borrower must remain current in order to earn the discounted payoff. Insulating the program from moral hazard concerns turns out to be an important constraint on the program design.

To evaluate the economics of an earned principal reduction program, we need to project cash flows for different types of situations regarding the borrower and the mortgage assuming first that the program is not available and then assuming that they participate in the program. These projected cash flows capture both payments by the borrower, any earned discounted payoffs that are exercised at a sale of the house, and any costs incurred if the borrower defaults and the mortgage goes into foreclosure. These cash flows are weighted by their associated estimated probabilities given a specified forecast scenario and then discounted back to current dollars. The end result is what is called the net present value (NPV) for the mortgage.

To implement this analysis we use a large sample of agency mortgages from the LPS Applied Analytics database. We use this data to estimate payment transition matrices for different situations facing the borrower and the mortgage. These transition matrices indicate for each possible current payment situation for a borrower (for example, current, 30-days delinquent, 60-days delinquent, etc.) the probability associated with the borrower moving to each payment situation in the following month. Different transition matrices are estimated for borrowers with different ranges of negative equity.

The first question to address is why should we consider any intervention for a borrower who has not missed a payment to date simply because the borrower has negative equity? We can use our cash flow analysis to evaluate the impact of borrower equity on the likely losses on a mortgage conditional on the borrower having made all payments in a timely manner up to the present. Start with a borrower who has positive equity in the house. Our estimated NPV for this borrower is 99.1 percent of the full value of the mortgage. In contrast, if we assume that the borrower is underwater by 25 percent or more, then the estimated NPV falls to 82.3 percent. This drop in the economic value of the mortgage reflects both that this borrower is more likely to default in the future and conditional on a default the expected losses are higher. The key point is that the fact that a borrower has made all payments to date does not guarantee that they will make all future payments.

For a given degree of negative equity, the estimated NPV on a mortgage decline sharply as we move from a borrower who is current to one who is already delinquent. If moral hazard were not a concern, then we would want to design mortgage interventions to be more aggressive for delinquent borrowers. However, this is where the moral hazard constraint becomes binding. If we designed the earned principal reduction program to be more aggressive in its treatment as borrowers exhibit more stress as reflected in their payment status, then we risk borrowers intentionally going delinquent in order to qualify for this more aggressive treatment. This limits us to varying the treatment intensity to the borrower's degree of negative equity which is not subject to moral hazard.

Can our earned principal reduction program increase the expected NPVs on underwater agency mortgages? Our initial analysis indicates that with even modest upside sharing of any house price appreciation, small reductions in the borrower's negative equity raise the expected NPV. However, to justify a discounted payoff option that allows the borrower to be able to sell the house after three years without putting up any additional funds of their own requires that the borrower with significant negative equity be willing to give up more than half of any upside in house prices. Less upside house price sharing would be required in this case for borrowers who are already delinquent, but as discussed earlier, we must set the same program parameters for delinquent borrowers as for current borrowers.

The analysis indicates that a broad-based earned principal reduction program can be justified for all negative equity borrowers with agency mortgages. The program would save taxpayers money relative to not offering the program. In addition, since mortgage servicers are not involved, the program does not require any subsidies to induce servicers to participate. The ultimate degree to which the program reduces the losses to the GSEs depends on the borrower take-up rate. An important issue is the degree to which underwater borrowers are willing to give up potential house price appreciation in return for a definite path to being able to sell their house. The take-up rate will also depend on how effectively the GSEs market the program and its benefits. The simplicity of the program should make it easy for borrowers to evaluate and there is no complicated process involved in signing up. The benefits to the program, however, will also depend on how quickly the program is implemented.

Homeowners' Emergency Mortgage Assistance Program – Discussion Notes[i]

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Program Objectives

The Homeowners' Emergency Mortgage Assistance Program (HEMAP) is a Pennsylvania initiative that provides temporary financial assistance to borrowers who become delinquent on their mortgages because of unemployment or other financial hardship beyond their control. The program was established in 1983 with the goal of helping homeowners stay in their homes and thus preventing distressed home sales, which were believed to be very damaging to many communities in the state. The assistance is in the form of a loan to homeowners to make their mortgage current and then to help them continue to make their regular mortgage payments until their income is restored. Underlying the program was the idea that a temporary loss of income—rather than the terms of the mortgage—had caused the mortgage delinquency. The program is thus a potential alternative to a loan modification, such as might occur for delinquent borrowers under the Home Affordable Modification Program (HAMP).[ii]

Key Program Features

The administration of HEMAP has several key features. One is that borrowers must be suffering financial hardship owing to circumstances beyond their control. This financial hardship is not limited to unemployment but extends to other situations such as illness or divorce. A second is that borrowers become eligible only after their mortgage is 60 days delinquent. At that time, the lender/servicer is required to notify borrowers of their eligibility to apply for a HEMAP loan. After receiving notification, a borrower has about one month to meet with a credit counseling agency, and the agency then has a month to forward an application to the Pennsylvania Housing Finance Agency (PHFA). The PHFA then makes a determination of the borrower's eligibility based largely on job history, mortgage payment history, and a judgment about the borrower's prospects for re-employment in the area. It is expected that a successful applicant has a reasonable prospect of resuming full mortgage payments within 24 months, or 36 months in periods of high unemployment. If approved, the loan proceeds go directly to the lender/servicer.

The screening process is challenging, particularly the task of determining the re-employment prospects of laid-off workers. But the program statistics indicate that the experience with HEMAP has been very positive. Since the program began operation, roughly 75 percent of applicants were determined to be ineligible; however, of the eligible applicants, about 80 percent have paid off their loans in full and remained in their homes. These loan repayments, in turn, have been an important source of the program's continued funding.

[i] The views expressed in this article are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

[ii] For a fuller description of the HEMAP program and a comparison of the costs of HEMAP and a HAMP modification for a hypothetical unemployed borrower, see the article "Help for Unemployed Borrowers: Lessons from the Pennsylvania Homeowners' Emergency Mortgage Assistance Program," by James Orr, John Sporn, Joseph Tracy, and Junfeng Huang, in the Federal Reserve Bank of New York's Current Issues in Economics and Finance, available at http://www.newyorkfed.org/research/current_issues/ci17-2.html.

Lessons for Future Mortgage Assistance Programs

The HEMAP offers several lessons for policy makers considering similar efforts to provide loans to borrowers suffering temporary financial hardship. With regard to the target population, loan programs might be more efficient if focused strictly on unemployed borrowers. Program data show that more than half of the loan recipients who failed to repay their loans cited factors other than unemployment as the reason for their financial hardship. Different types of assistance may be warranted for borrowers whose loss of income was not due to unemployment. With regard to the timing of the assistance, the unemployment insurance application could simultaneously trigger an application for mortgage assistance. The information on an applicant's residence and earnings and employment history would be readily available, thus streamlining the screening process. If the application for mortgage assistance was processed quickly, the lender/servicer might not need to be involved at all and might well see fewer borrowers becoming delinquent. Without arrears to consider, loan amounts would likely be lower.

One factor that was not present to any great extent in Pennsylvania since HEMAP began was negative equity. Loans in these cases are riskier because they are effectively unsecured. "Underwater" borrowers who experience a loss of income have a higher likelihood of defaulting. In these circumstances, there may have to be a write-down of the principal. The lenders/servicers would appear to have an incentive to do so as the HEMAP loan would help to ensure that the borrower would continue to make mortgage payments for up to two years. Some form of shared appreciation might give an added incentive to the lender/servicer to write down the principal in the presence of a HEMAP loan.

Pennsylvania's experience with HEMAP led the New York City Bar Association to propose that New York State adopt a similar program that would provide bridge loans to homeowners experiencing temporary financial hardship to help them meet their mortgage payments.[iii] That proposal initially limits the target population to workers who are experiencing a loss of income due to unemployment. Using unemployment insurance figures for New York State for 2009, we estimate that roughly 5,000 homeowners would have qualified for a HEMAP-like bridge loan. While this number represents a small fraction of the roughly 1.5 million applications for unemployment insurance in the state that year, the loan program is not being proposed as a comprehensive solution to the problem of mortgage delinquency and foreclosure. Rather, the loan program should be considered as a potential alternative to a loan modification, and one that is tailored to homeowners who are suffering a temporary loss of income.

[iii] The proposal is available at http://www2.nycbar.org/pdf/report/uploads/9_20072233-BridgeLoanAssistanceProgram.pdf.

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