

Shadow Inventory and Foreclosure Law in the Fifth District

BY SONYA RAVINDRANATH WADDELL

In 2008, the state of Maryland passed a series of measures expanding the role of the judicial system in the foreclosure process. This, some have argued, changed the course of the housing recovery for Maryland: Requiring lenders to go through the courts to foreclose takes longer, so the law enables delinquent homeowners to stay in their homes longer after defaulting, which, in turn, slows the correction in the housing market. Others have argued that allowing homeowners to stay in their homes longer gives them time to recover financially and find a way to emerge from default, perhaps through a loan modification. Does requiring a judicial process to foreclose increase the time that a borrower spends in foreclosure? If so, does it increase the likelihood that a homeowner will be able to stay in their home, and what are the effects on the broader economy?

In the Fifth Federal Reserve District — an area comprising the District of Columbia (D.C.), Maryland, North Carolina, South Carolina, Virginia, and most of West Virginia — large, mainly suburban, parts of the Washington, D.C., metropolitan statistical area (MSA) were hit particularly hard. Because the counties in this MSA faced similar housing conditions in the early part of the downturn and because this MSA includes counties in Maryland and Virginia — two states with remarkably different approaches to foreclosure regulation — it is possible to use the region to better understand the dynamics of the housing recovery. We can analyze the extent to which the regulatory system surrounding foreclosure correlates to longer foreclosure timelines and affects the inventory of homes in delinquency or foreclosure in this region and throughout the Fifth District. Consistent with the existing literature, an analysis of Fifth District data indicates that certain regulatory regimes are correlated with longer foreclosure timelines and higher inventories. The consequences for the borrower and the implications for the housing recovery, however, are not yet well understood.

Shadow Inventory in the D.C. Area

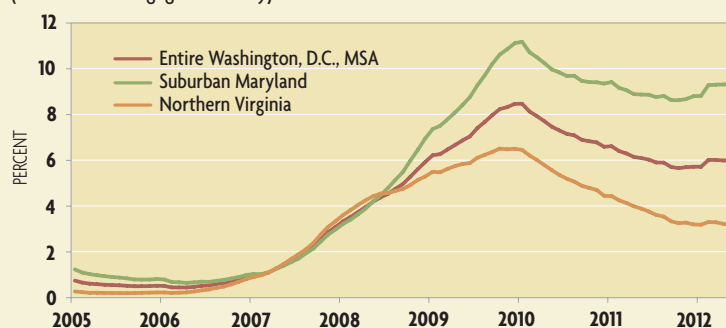
Much of the discussion of the housing recovery has centered on the idea of a “shadow inventory of homes,” those that are in serious delinquency or foreclosure and therefore are likely soon to be bank-owned. The shadow inventory is important because it is part of the excess inventory of homes that the market must work through before a strong housing recovery that includes new construction is likely. Analysis using data from Lender Processing Services Applied Analytics (LPS) indicates that the shadow inventory, which is defined as the share

of homes that are in foreclosure, owned by the lender (real estate owned, or REO), or with mortgage payments 90 days or more past due, is higher in the Maryland suburbs of Washington, D.C., (often referred to as “suburban Maryland”) than in the Virginia suburbs (“Northern Virginia”). Until around the middle of 2008, shadow inventories were similar in Northern Virginia and suburban Maryland, but from 2008 to 2010, the shadow inventory grew much more rapidly in suburban Maryland — and then from 2010 to 2012, it fell much more slowly. (See chart.) By the end of 2011, the shadow inventory in Northern Virginia was back to its 2008 level, while the suburban Maryland shadow inventory remained much more elevated.

Why has the shadow inventory stayed high in suburban Maryland? An increased shadow inventory must be either the result of more homes entering default or the result of delinquent borrowers spending a longer time in default. The data indicate that in the past few years, the latter has been the primary driver of elevated foreclosure inventory. Although there are still a large number of homeowners defaulting on their loans by historical standards, these numbers have generally been falling in the Washington, D.C., MSA and across most of the Fifth District and the nation.

On the other hand, foreclosure timelines in the Washington, D.C., MSA started to increase in the beginning of 2007, and rose sharply in 2008. This corresponds with the expansion in the shadow inventory. Foreclosures that were initiated through 2006 tended to remain in foreclosure for an average of two months in suburban Maryland and Northern Virginia. By the end of 2010, however, a loan that entered foreclosure in suburban Maryland would stay in foreclosure for about nine months, while foreclosure timelines in Northern Virginia extended to about six months on average. Importantly, these data understate the

Shadow Inventory in the Washington, D.C., MSA
(Percent of Mortgage Inventory)



SOURCES: LPS Applied Analytics, Federal Reserve Bank of Richmond

total time to foreclose, since a percentage of the loans used to calculate the timeline were still in foreclosure by July 2012, or the end of the data set at the time of analysis. This is particularly true in suburban Maryland. For example, of the foreclosures initiated in suburban Maryland in January 2011, almost 40 percent were still in foreclosure as of July 2012. In Northern Virginia, however, only 13 percent were still in foreclosure as of July 2012. The time in foreclosure represents only part of the increase in the timeline from default to home sale. Borrowers spend a longer time in delinquency as well. Loans that entered 90-day delinquency in January 2005 spent a little under three months in delinquency in Northern Virginia and a little over three months in suburban Maryland. By the middle of 2009, loans in suburban Maryland were spending almost eight months in 90-day delinquency and in Northern Virginia, about six months.

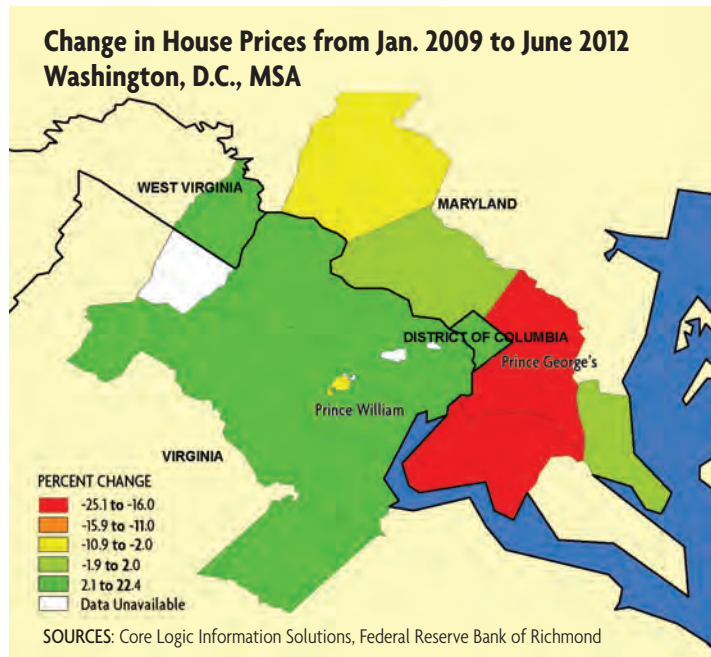
In sum, shadow inventories in the Washington, D.C., MSA continued to rise well into 2010, even as foreclosure starts came down, primarily because the time it takes to move from delinquency to foreclosure and the time in foreclosure lengthened. Furthermore, shadow inventories and time to foreclose in suburban Maryland are further from pre-recession levels than those in Northern Virginia.

By some measures, the recovery in suburban Maryland has been slower than that in Northern Virginia. From 2009 to June 2012, most counties in Northern Virginia reported house price increases, while houses in the Maryland suburbs generally continued to depreciate. (See map.) For example, although Prince William County, Va., and Prince George's County, Md., both saw a sharp downturn in house prices, home values in Prince William County turned around in the middle of 2009 and by June 2012 had grown more than 25 percent. Meanwhile, Prince George's County home values continued to depreciate and then remained virtually stagnant.

The judicial foreclosure process observed in the Maryland suburbs of D.C. is not the only difference between that region and its Virginia counterpart. But could regulation be playing a role in the longer foreclosure timelines and the slower recovery?

The Role of Foreclosure Law

When a borrower fails to make timely payments on the mortgage, the mortgage is considered in default. Once a loan is in default for some period of time, a lender can start foreclosure proceedings. How a lender initiates foreclosure proceedings depends upon the state in which the property resides. In some states, a foreclosure must be carried out through the court system (a judicial process). A small number of states rely solely on nonjudicial (also called "power of sale") proceedings. Other states offer both judicial and nonjudicial processes. In the states that offer both, lenders generally use the nonjudicial process — so those states are, in effect, nonjudicial states. According to RealtyTrac, 20 states are judicial states and require a judicial process, 26 states are nonjudicial states and have both processes,



and four states and the District of Columbia have only a nonjudicial option for foreclosure.

Nonjudicial processes are usually simpler, quicker, and less costly. The fact that judicial foreclosure enables a borrower to spend more time in foreclosure is well documented. One argument for a longer foreclosure process is to give borrowers more opportunities to find solutions before a foreclosure sale. In a 2011 article in the *Journal of Policy Analysis and Management*, J. Michael Collins of the University of Wisconsin-Madison, Ken Lam of the Federal Housing Finance Agency, and Christopher E. Herbert of Abt Associates Inc., found that judicial processes are associated with a 3 percent marginal increase in loan modifications. They argued that the longer timeline allows borrowers the opportunity to work with lenders, and it provides lenders greater incentive to modify loans since the longer foreclosure process is more costly to them.

On the other hand, a 2008 article by Anthony Pennington-Cross of Marquette University in the *Journal of Real Estate Finance and Economics* found that judicial foreclosure proceedings led to lower foreclosure and cure completion rates. In other words, slower foreclosure proceedings seemed to have simply encouraged borrowers to remain in default. In 2011, Kristopher Gerardi of the Atlanta Fed, Lauren Lambie-Hansen of the Massachusetts Institute of Technology, and Paul Willen of the Boston Fed also argued that although judicial foreclosure proceedings delay foreclosure, they do not, on average, avert it. These researchers found that a year after a borrower entered serious default, lenders had auctioned off only 14 percent of properties in judicial states compared to 35 percent in power-of-sale (or nonjudicial) states. Borrowers were neither more nor less likely to become current on a mortgage. Judicial intervention, therefore, succeeds only in temporarily reducing foreclosure by increasing the incidence of persistent delinquency. In short, although it seems clear that judicial states have longer foreclosure processes, research has reached inconsis-

tent conclusions regarding the effects on the borrower.

Of course, identifying a state as judicial or nonjudicial does not tell the whole story of the role of foreclosure regulation there. Other requirements can affect the foreclosure process. For example, Gerardi, Lambie-Hanson, and Willen examined a “right-to-cure” law in Massachusetts that blocks lenders from starting foreclosure proceedings for 90 days after a borrower defaults on a loan; they found that the right-to-cure law lengthens the foreclosure timeline but does not ultimately keep borrowers in their homes. Within the Fifth District, only North Carolina has such a law (with a 45-day period), according to reports of the National Consumer Law Center, or NCLC, a Boston-based nonprofit advocacy group.

One of the most far-reaching limitations on foreclosures, short of an outright moratorium, is a rule in some states allowing foreclosed homeowners to avoid losing their homes even after the foreclosure sale. This right is known as a statutory right of redemption. While laws vary, the right typically allows individuals who lost their homes to foreclosure to repurchase them for the foreclosure sale price plus foreclosure expenses up to one year after foreclosure. Any purchaser of the home at foreclosure must wait for that period before knowing whether the sale will become final, and the foreclosed homeowner is able to remain in the home in the meantime. Collins, Lam, and Herbert argue that although borrowers rarely exercise a right of redemption, its existence could reduce demand for foreclosed homes and could lower the sale price a lender can get for the home or add to the cost of foreclosure. Therefore, a right of redemption may provide a greater incentive for lenders to seek alternatives to foreclosure and to extend the default timeline to allow homeowners more time to explore potential solutions. According to the NCLC, in the Fifth District only North Carolina provides a right of redemption during a 10-day period after the foreclosure sale.

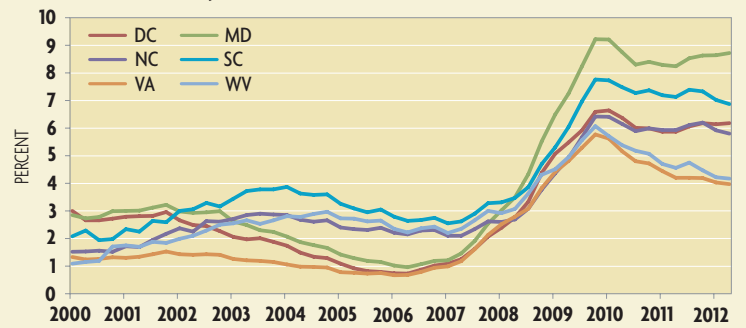
Allowances such as rights of redemption, right-to-cure laws, and the lender’s right to recourse muddy the waters when trying to distinguish the effect of judicial versus non-judicial requirements on borrowers and lenders. Some of these regulations and requirements come into play in Fifth District states.

Foreclosure Law, Timelines, and Shadow Inventory

If housing markets in the Fifth District are consistent with the literature, we would at the least expect to see states that require judicial proceedings to have longer foreclosure timelines and, therefore, higher shadow inventories. Judging by the experience in the suburbs of Washington, D.C., documented above, we would also expect to see house prices in those states recover more slowly.

Shadow inventories have certainly grown across the Fifth District in recent years. Using Mortgage Bankers Association (MBA) data and defining the shadow inventory as loans that are at least 90 days delinquent or in foreclosure,

Shadow Inventory in the Fifth District



SOURCES: Mortgage Bankers Association, Haver Analytics

the shadow inventory in the region expanded fourfold from the beginning of 2007 to the end of 2010. (See chart above.) South Carolina long had the highest shadow inventory rate. Starting in 2008, however, Maryland’s shadow inventory began to grow notably from 1.2 percent of all mortgages in the first quarter of 2007 to 9.2 percent of mortgages in the fourth quarter of 2009. West Virginia saw the smallest increase, with the rate rising from 2.2 percent to 6.1 percent.

As in suburban Maryland and Northern Virginia, this increase in the shadow inventory was driven by an increase in the time that a borrower stays in default. Foreclosure starts remained steady in 2009 and 2010, or even fell slightly. But across the Fifth District, loans now spend more time in foreclosure. Maryland’s timeline stretched the most. Loans that started the foreclosure process in Maryland anytime through early 2007 spent less time in foreclosure than any other state, except perhaps Virginia. By the middle of 2008, however, Maryland was up with South Carolina for some of the longest foreclosure timelines in the District. (See chart at the top of page 47.)

Furthermore, the timelines are most likely to be biased downward in Maryland, South Carolina, and D.C. by virtue of the data set ending in July 2012 with many foreclosures still in process. (The cutoff in the number of months that a loan could be in foreclosure entirely explains the decline in foreclosure timelines starting in 2011. The most extreme case is the timeline for foreclosures initiated in July 2012 when, by definition, the loans in any state could only be in foreclosure for up to one month.) Maryland, South Carolina, and D.C. consistently have the highest share of loans that are still in foreclosure for any given month of a foreclosure start.

For example, loans that went into foreclosure in January 2011 in D.C. stayed in foreclosure for an average of 11 months — but more than 44 percent of those loans were still in foreclosure as of July 2012, the last month of the analysis. (See adjacent chart.) Similarly, in Maryland, the time in foreclosure for loans originated in January 2011 was nine months, and in South Carolina, the number was 8.6 months; however, 40 percent and 27 percent of those loans were still in foreclosure, respectively, in July 2012. In contrast, the time to foreclose in Virginia for loans originated in January 2011 was 5.2 months and only about 12 percent of them were still in foreclosure at the end of our

data; therefore, the underestimation of the Virginia timeline is likely to be less severe.

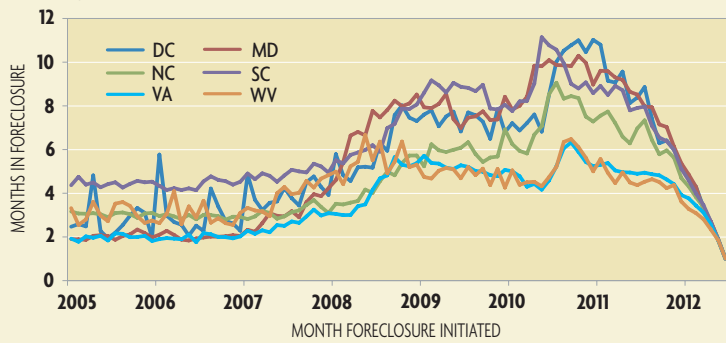
In the Fifth District, two states rely on judicial foreclosure proceedings: Maryland and South Carolina. Maryland's judicial foreclosure process became law in April 2008; prior to that time, foreclosures in Maryland were usually subject to a nonjudicial or less-judicial process. Lenders in North Carolina, Virginia, West Virginia, and D.C. generally rely on nonjudicial proceedings to foreclose. In other words, in the Fifth District, judicial proceedings do seem to be associated with longer foreclosure timelines and higher levels of shadow inventory, as evidenced by Maryland and South Carolina.

Although no Fifth District state has a statutory right of redemption apart from the highly limited one in North Carolina, the relevance of other regulations and requirements is illustrated by conditions in the District of Columbia. Its foreclosure timeline and shadow inventory level were affected by a December 2010 requirement that lenders provide information to borrowers about foreclosure mediation before foreclosing on their home. If the borrower chooses to go through mediation, the lender must participate in the negotiation. This requirement has notably increased foreclosure timelines. Other jurisdictions in the Fifth District have also instituted additional requirements on lenders and borrowers that have served, both intentionally and unintentionally, to lengthen the time that borrowers spend in foreclosure.

In addition, there are many reasons why foreclosure and delinquency timelines have lengthened across the Fifth District (and the country) in the past few years that are not regulatory in nature. For example, staff responsible for processing paperwork have struggled to keep up with the increased responsibilities brought on by the increased number of homeowners facing default. Some lenders voluntarily adopted brief moratoriums on judicial foreclosures in response to allegations that their employees and employees of servicers had engaged in "robo-signing"—that is, signing foreclosure documents certifying that they had verified certain items when they had not.

Nonetheless, consistent with the findings of the literature, the Fifth District's judicial states — Maryland and

Average Number of Months in Foreclosure



SOURCES: LPS Applied Analytics, Federal Reserve Bank of Richmond

South Carolina — do have longer timelines and higher shadow inventories than its nonjudicial states.

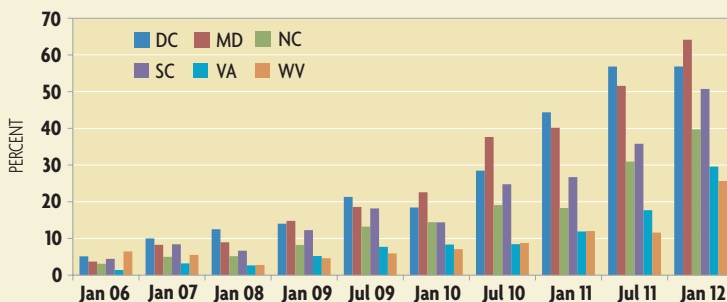
The Housing Recovery in the Fifth District

But have these elongated foreclosure timelines and the elevated shadow inventory adversely affected the housing market recovery in Maryland and South Carolina? At the state level, the primary gauge for housing markets is house prices, and there is no strong evidence that house prices are taking longer to recover in Maryland or South Carolina than they are in other comparable areas of the District. According to the FHFA house price index, Maryland did see home values depreciate more rapidly than Virginia in the past four years, but it also experienced a sharper appreciation in the five years before the recession. House price movements in North and South Carolina have been remarkably similar. The CoreLogic house price index — which includes a wider share of the mortgage market — provides comparable results, with Virginia recovering somewhat faster than Maryland in recent years, and the North and South Carolina house price recoveries similar, albeit slightly more volatile in South Carolina. Furthermore, analysis of the LPS data indicates that 90-day delinquent mortgages in South Carolina and Maryland are no more or less likely to enter foreclosure than those in other Fifth District states. The timelines might have increased but the outcomes do not seem to be remarkably different.

When we focus on the suburbs in the Washington, D.C., metro area, however, Northern Virginia counties, such as Prince William County, are working through the foreclosure inventory more quickly and the housing market seems to be recovering more robustly than in Prince George's County or other suburban Maryland counties. This result suggests that differing foreclosure regimes of the two states can indeed affect the paths of housing recoveries. At the same time, many Virginia housing counselors and homeowner advocacy groups argue that the housing crisis has been extremely difficult for families in counties like Prince William. Whether allowing people to stay in their homes longer creates an easier environment to find the best solution for borrower and lender is still unclear. But these are the trade-offs that policymakers must consider when proposing changes to how a state determines a foreclosure process. **RF**

Percent of Loans Still in Foreclosure as of July 2012

(By Month of Foreclosure Start)



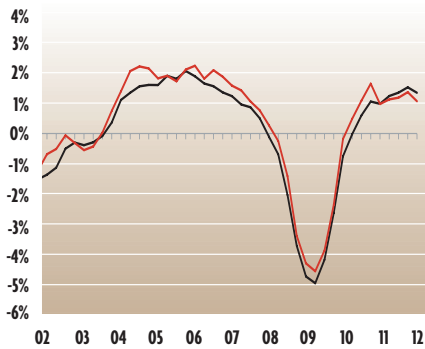
SOURCES: LPS Applied Analytics, Federal Reserve Bank of Richmond

State Data, Q2:12

	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000s)	737.2	2,576.1	3,952.2	1,852.0	3,720.7	758.0
Q/Q Percent Change	0.2	-0.3	-0.1	0.1	0.3	-0.6
Y/Y Percent Change	1.6	1.5	0.6	1.0	1.2	1.0
Manufacturing Employment (000s)	1.1	111.5	436.3	222.5	229.5	48.1
Q/Q Percent Change	6.7	0.4	-0.2	0.6	0.6	-1.6
Y/Y Percent Change	3.2	-1.6	0.4	3.5	-0.5	-2.8
Professional/Business Services Employment (000s)	151.1	407.2	518.1	235.0	665.3	63.5
Q/Q Percent Change	-0.2	0.2	0.3	3.6	-0.3	-0.1
Y/Y Percent Change	1.5	3.2	1.1	2.0	0.1	2.3
Government Employment (000s)	246.2	508.3	701.3	340.9	716.1	152.6
Q/Q Percent Change	0.1	-0.3	-0.1	0.3	0.1	-1.4
Y/Y Percent Change	-1.2	0.5	0.8	0.3	0.8	1.8
Civilian Labor Force (000s)	352.0	3,085.9	4,661.9	2,151.8	4,339.4	804.6
Q/Q Percent Change	1.2	0.1	-0.5	-0.2	-0.1	0.2
Y/Y Percent Change	2.5	0.6	0.3	-0.3	1.1	0.8
Unemployment Rate (%)	9.3	6.8	9.4	9.1	5.6	6.9
Q1:12	9.8	6.5	9.9	9.1	5.7	7.1
Q2:11	10.2	7.1	10.5	10.4	6.2	7.9
Real Personal Income (\$Mil)	40,825.2	264,657.4	311,797.9	139,677.3	333,313.4	55,190.8
Q/Q Percent Change	0.9	0.7	0.8	0.9	0.9	0.7
Y/Y Percent Change	1.8	2.0	1.8	1.5	1.7	1.2
Building Permits	996	3,321	12,109	5,485	6,857	584
Q/Q Percent Change	283.1	10.3	8.8	24.2	4.3	52.1
Y/Y Percent Change	38.9	18.6	39.6	32.7	25.6	27.0
House Price Index (1980=100)	578.3	401.8	298.3	302.7	391.2	214.5
Q/Q Percent Change	0.4	-1.7	-1.5	-1.1	-1.2	0.5
Y/Y Percent Change	1.7	-1.3	-2.1	-1.2	-0.9	1.5

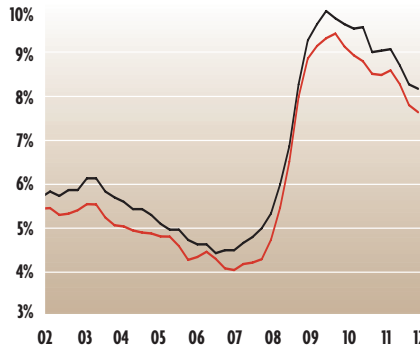
Nonfarm Employment

Change From Prior Year
First Quarter 2002 - Second Quarter 2012



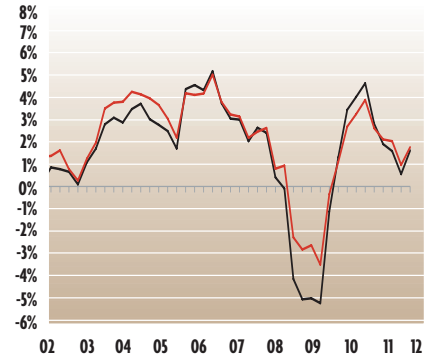
Unemployment Rate

First Quarter 2002 - Second Quarter 2012



Real Personal Income

Change From Prior Year
First Quarter 2002 - Second Quarter 2012

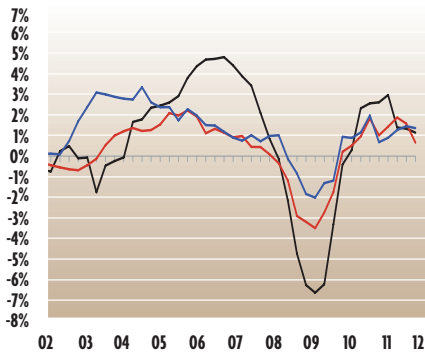


— Fifth District

— United States

Nonfarm Employment Metropolitan Areas

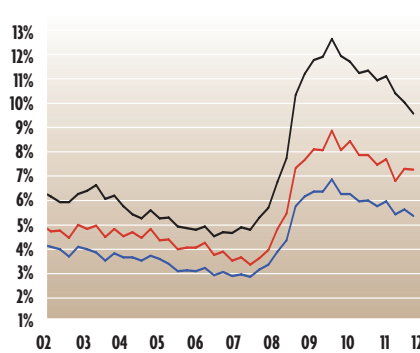
Change From Prior Year
First Quarter 2002 - Second Quarter 2012



— Charlotte — Baltimore — Washington

Unemployment Rate Metropolitan Areas

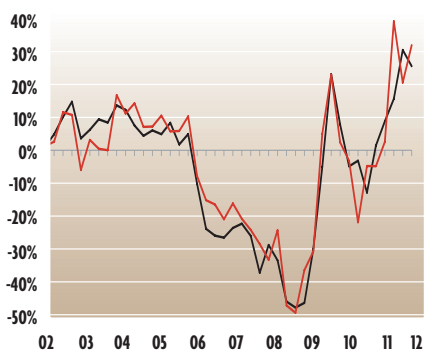
Change From Prior Year
First Quarter 2002 - Second Quarter 2012



— Charlotte — Baltimore — Washington

Building Permits

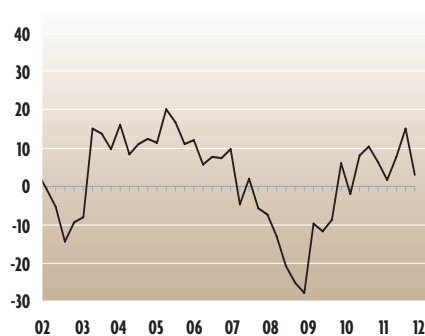
Change From Prior Year
First Quarter 2002 - Second Quarter 2012



— Fifth District — United States

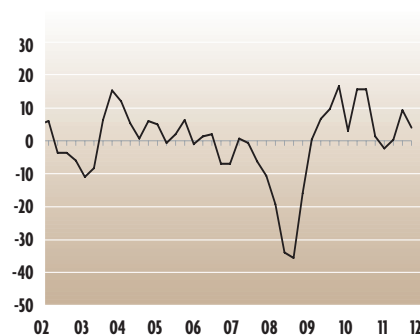
FRB—Richmond Services Revenues Index

First Quarter 2002 - Second Quarter 2012



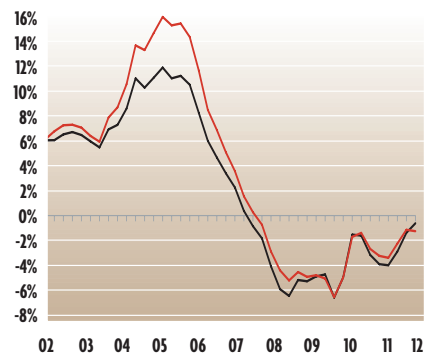
FRB—Richmond Manufacturing Composite Index

First Quarter 2002 - Second Quarter 2012



House Prices

Change From Prior Year
First Quarter 2002 - Second Quarter 2012



— Fifth District — United States

NOTES:

- FRB-Richmond survey indexes are diffusion indexes representing the percentage of responding firms reporting increase minus the percentage reporting decrease. The manufacturing composite index is a weighted average of the shipments, new orders, and employment indexes.
- Building permits and house prices are not seasonally adjusted; all other series are seasonally adjusted.

SOURCES:

- Real Personal Income: Bureau of Economic Analysis/Haver Analytics.
 Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
 Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
 Building permits: U.S. Census Bureau, <http://www.census.gov>.
 House prices: Federal Housing Finance Agency, <http://www.fhfa.gov>.

Metropolitan Area Data, Q2:12

	Washington, DC	Baltimore, MD	Hagerstown-Martinsburg, MD-WV
Nonfarm Employment (000s)	2,468.0	1,306.8	100.2
Q/Q Percent Change	1.4	1.6	2.6
Y/Y Percent Change	1.4	0.7	1.0
Unemployment Rate (%)	5.5	7.3	8.0
Q1:12	5.5	7.0	8.2
Q2:11	5.8	7.6	9.1
Building Permits	5,790	1,562	153
Q/Q Percent Change	46.7	18.1	22.4
Y/Y Percent Change	33.2	72.6	8.5
	Asheville, NC	Charlotte, NC	Durham, NC
Nonfarm Employment (000s)	171.3	839.9	277.0
Q/Q Percent Change	1.3	1.6	0.6
Y/Y Percent Change	0.8	1.1	1.1
Unemployment Rate (%)	7.8	9.5	7.6
Q1:12	8.0	10.0	7.9
Q2:11	8.5	11.0	8.1
Building Permits	369	3,122	470
Q/Q Percent Change	65.5	11.7	-54.7
Y/Y Percent Change	29.5	99.1	-13.9
	Greensboro-High Point, NC	Raleigh, NC	Wilmington, NC
Nonfarm Employment (000s)	348.4	520.7	136.2
Q/Q Percent Change	1.3	1.7	2.2
Y/Y Percent Change	1.5	2.3	-2.2
Unemployment Rate (%)	9.8	7.8	9.8
Q1:12	10.2	8.1	10.3
Q2:11	10.9	8.5	10.6
Building Permits	477	3,029	671
Q/Q Percent Change	-34.2	31.2	-10.7
Y/Y Percent Change	15.8	42.1	48.5

	Winston-Salem, NC	Charleston, SC	Columbia, SC
Nonfarm Employment (000s)	206.0	301.2	353.5
Q/Q Percent Change	0.7	1.8	1.4
Y/Y Percent Change	0.6	1.3	2.0
Unemployment Rate (%)	9.0	7.7	8.1
Q1:12	9.4	7.6	7.8
Q2:11	9.9	8.6	9.2
Building Permits	505	1,888	1,159
Q/Q Percent Change	48.1	82.9	38.6
Y/Y Percent Change	49.9	83.3	48.6
	Greenville, SC	Richmond, VA	Roanoke, VA
Nonfarm Employment (000s)	304.0	618.6	156.2
Q/Q Percent Change	0.3	1.2	1.4
Y/Y Percent Change	0.0	0.8	-0.4
Unemployment Rate (%)	7.7	6.2	6.0
Q1:12	7.4	6.4	6.1
Q2:11	8.7	6.9	6.6
Building Permits	594	932	121
Q/Q Percent Change	13.8	-8.7	47.6
Y/Y Percent Change	20.2	21.8	19.8
	Virginia Beach-Norfolk, VA	Charleston, WV	Huntington, WV
Nonfarm Employment (000s)	747.3	148.5	116.1
Q/Q Percent Change	2.9	1.3	2.1
Y/Y Percent Change	0.4	0.4	2.1
Unemployment Rate (%)	6.4	6.5	7.2
Q1:12	6.6	6.7	7.7
Q2:11	6.9	7.2	8.2
Building Permits	1,248	48	9.0
Q/Q Percent Change	-34.2	54.8	-71.0
Y/Y Percent Change	6.2	54.8	-69.0

For more information, contact Sonya Ravindranath Waddell at (804) 697-2694 or e-mail Sonya.Waddell@rich.frb.org