Industry Intelligence Report

California's Housing Market Recovery and Home Foreclosure Trends

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Executive Summary

Over the last few years, Beacon Economics has studied California's economic growth and the resurgence of the housing market, which saw its pace of growth accelerate in 2012. The amount of foreclosure activity is a key indicator of the degree of suffering in the real estate market, and the number of foreclosures has been in decline since the fourth quarter of 2008. By the end of 2012, the number of foreclosures had already declined by 40% from the previous year's quarterly average and had fallen 70% from the number seen in the peak quarter in 2008. More important, many of the economic indicators that generally foreshadow trends in foreclosure activity improved considerably in 2012 and were at their worst much earlier than that. For example,

- Defaults declined by 45% from the fourth quarter of 2011 to the fourth quarter of 2012.
- Mortgages with negative equity declined by 17% over the same period.
- Existing single-family home prices increased by 23% over the year, yet homes prices remain affordable relative to incomes.
- Household balance sheets have improved, with the ratio of debt to personal income declining from 163% to 148% during 2012.
- The labor market has been on the mend, with weekly initial claims for unemployment insurance falling by 11% last year alone.

Recent reforms to the foreclosure process in California will intensify lenders' concerns. Conventional loan standards will also change due to the Qualified Mortgage (QM) and Qualified Residential Mortgage (QRM) standards now being considered by the Consumer Financial Protection Bureau (CFPB). The cumulative effect of these increased regulatory burdens has resulted in lenders exiting the residential mortgage lending line of business or has served as a barrier to entry into the marketplace due primarily to increasing compliance costs as well as heightened regulatory and legal risk. This outcome narrows the options of where consumers can find loans.

Nevertheless, the rebounding real estate market is being driven by improved fundamentals, which have been getting better since the Great Recession ended in 2009. Due to the accumulated economic gains created by these improved fundamentals, various housing market indicators demonstrated even further growth in 2012, such as an acceleration in home price growth, equity, and steeper declines in foreclosures.

Introduction

In the last few years, the U.S. real estate market has turned the corner. Home prices, sales, construction, and home equity, to name a few measures, are all moving in the right direction. California's real estate market, in particular, has been improving since 2010, evolving from one of the hardest-hit state markets during the housing crash to one of the leading markets in the nation. The root of this improvement is economic growth in various industries and regions, such as bio-tech in San Diego and Orange counties, computers and electronics throughout the Bay Area, and agriculture and tourism throughout the state. Another driver of this recovery is the fact that home prices have fallen to levels that line up with fundamentals again. Housing affordability has improved as home prices have dropped—homebuyers can purchase homes by drawing on more manageable shares of their incomes. Moreover, interest rates are near historical lows, and households have deleveraged in the wake of the Great Recession, which has brought the financial obligations ratio (the percentage of current income needed to finance current obligations) back into healthy territory as well. Nevertheless, one factor in the real estate market has remained a concern for many policymakers—foreclosures.

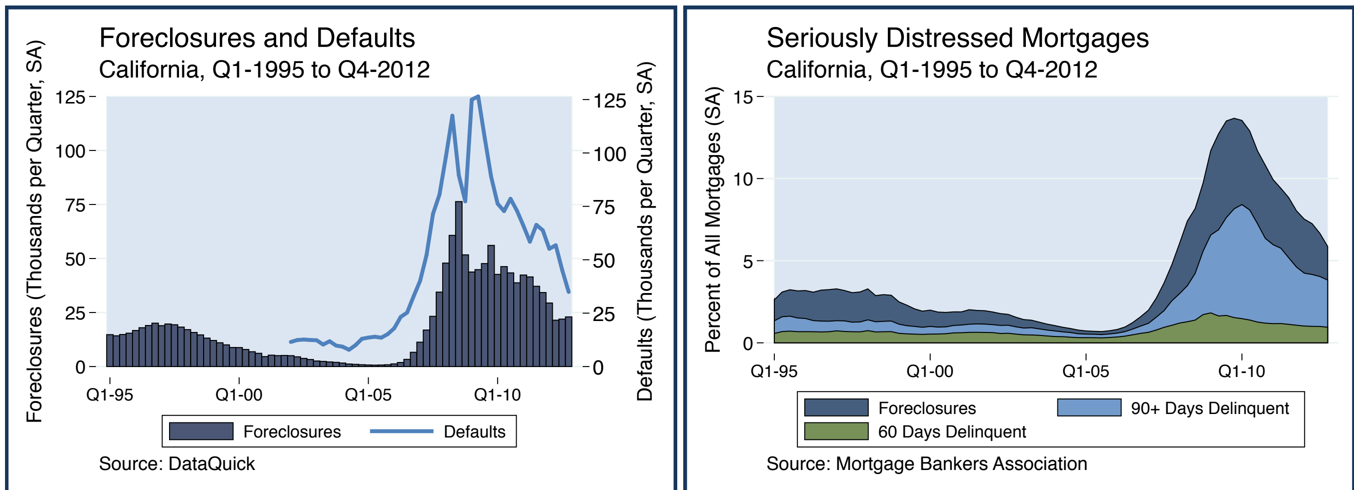
In efforts to solve this problem, the state passed a series of bills known as the California Homeowner Bill of Rights (CHBR) in July 2012. The CHBR, which became effective in January 2013, was passed to protect homeowners who were struggling to pay their mortgages, with the goal of keeping them from losing their homes. However, 2012 marked the lowest number of foreclosures in the state in five years. The real estate market, and the entire economy for that matter, has made significant gains, which will translate into a lower number of foreclosures in the next two years—a scenario that was expected to unfold regardless of any new policy intervention.

As the real estate market continues to improve, or, more specifically, as homes continue to appreciate, homeowners with underwater mortgages will reap the benefits. However, national policies stemming from the federal Dodd-Frank Act may temper growth as the changing standards for what defines a conventional mortgage will make qualifying more difficult. These standards may serve a greater purpose in the long term, but their short-term effects are currently hurting potential homebuyers. Because many of the specific details have not yet been determined, banks and other mortgage lenders remain uncertain about what these new rules will look like and what the implications will be for their businesses.

Foreclosure Trends

We can see how California's housing recovery predated these new policy actions by looking at foreclosure activity. The number of foreclosed homes in California piled up in a hurry during the housing crash. According to estimates from DataQuick, there were as many foreclosed homes between 1995 and 2006 as there were between 2007 and the second quarter of 2009 (410,000 homes). The third quarter of 2008 marked a peak in foreclosure filings (76,300 homes). By historical standards, the 23,000 foreclosed homes in the fourth quarter of 2012 still constitute a very high level. Prior to the housing crash, there had not been more than 20,000 foreclosed homes in a single quarter since 1996. However, from the peak in 2008 to the fourth quarter of 2012, foreclosures have declined by roughly 70%. The steep decline is significant because foreclosure trends are infectious and spread easily; a four-year downward trend reveals that the worst has long been behind us.

As a leading indicator of foreclosure activity, notices of default mark the beginning of the foreclosure process with a 90-day warning to reposition. DataQuick estimates that defaults in California had twin peaks: the first (in the second quarter of 2008, at 117,000 defaults) led to a spike in foreclosures the following quarter, and the second (in the second quarter of 2009, at 126,000 defaults) led to a more extended period of foreclosures. Yet here, too, we see evidence of a sustained recovery. Since the second peak, defaults have declined by 72%, to 34,900 notices of default in the fourth quarter of 2012. More important, recent defaults declined sharply in the last three quarters of 2012, a sign that the number of foreclosed homes will follow suit and also decline sharply in 2013.



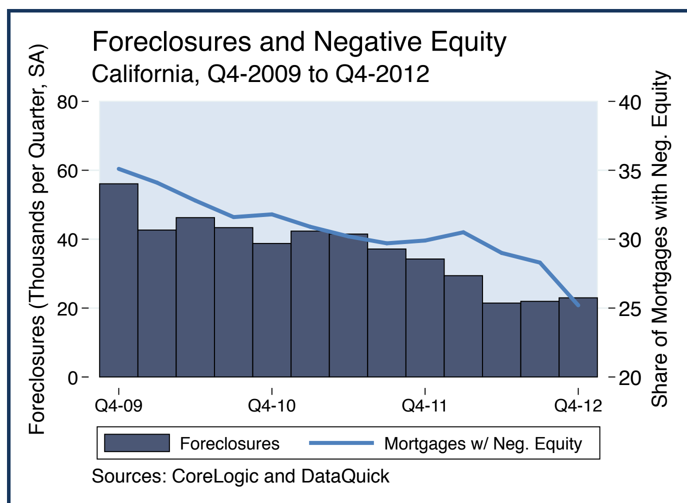
The share of mortgages that are seriously distressed is an even earlier indicator of future foreclosure activity. Distressed mortgages are mortgages that are either 60 or 90 days delinquent, or already in the foreclosure process. The percentage of distressed mortgages fell from a peak of 13.7% in the fourth quarter of 2009 to 5.9% in the fourth quarter of 2012. In comparison, the national percentage of distressed mortgages peaked at 11.1% in the first quarter of 2010 and fell to 7.8% in the fourth quarter of 2012. Thus, even though California's problem was initially much bigger, the state has recovered more rapidly.

The downward trends in foreclosures, defaults, and delinquencies all point toward a continued recovery. They all are created, however, by the same event—the failure to make mortgage loan payments. Homeowners can find themselves in foreclosure proceedings for two reasons: either they cannot afford their monthly mortgage bills, or they do not want to pay because their homes no longer seem like wise investments. The CHBR is aimed at helping the former, but the economic recovery that is currently under way has already benefited many of these struggling homeowners. Moreover, for homeowners who are severely underwater on their mortgages, a foreclosure can sometimes be the best course of action rather than waiting for home prices to return to their pre-recession peaks. Thankfully, the improved conditions in the real estate market have reduced the incentives to forgo mortgage payments and cut losses, as will be detailed in the following section.

Home Equity

We generally assume that foreclosures occur because homeowners cannot pay their mortgages, owing to either job losses or other unfortunate events. This is not always the case. A foreclosure is often the abandonment of an un-

profitable investment. In real estate, profitability is measured by equity—the current value of a property less the outstanding mortgage debt. When equity is positive, homeowners can sell their properties at market value and earn a profit. Positive equity also makes a home equity loan possible, which helps homeowners endure financial difficulties. But when equity is negative (i.e., when homeowners owe more on their mortgages than their homes are worth), homeowners cannot sell their homes at market value without being forced to absorb a large financial loss to make up the difference between the sale price and their mortgage balance. Thus, they can either wait for their equity to turn positive, which would require the market price to improve, or abandon their investment via a foreclosure. The decision to cut losses rather than wait for the market to improve is often referred to as a strategic foreclosure.



Mortgages with Negative or Near Negative Equity in California, Q4-2009 to Q4-2012 (in Millions)

Quarter	Negative Equity	Near Neg. Eq.	Total
Q4-09	2.43	0.27	2.70
Q1-10	2.35	0.28	2.63
Q2-10	2.26	0.28	2.54
Q3-10	2.17	0.30	2.47
Q4-10	2.18	0.31	2.49
Q1-11	2.11	0.31	2.42
Q2-11	2.06	0.31	2.38
Q3-11	2.03	0.31	2.34
Q4-11	2.04	0.32	2.36
Q1-12	2.07	0.30	2.37
Q2-12	1.97	0.30	2.27
Q3-12	1.92	0.31	2.23
Q4-12	1.70	0.27	1.97

Source: CoreLogic

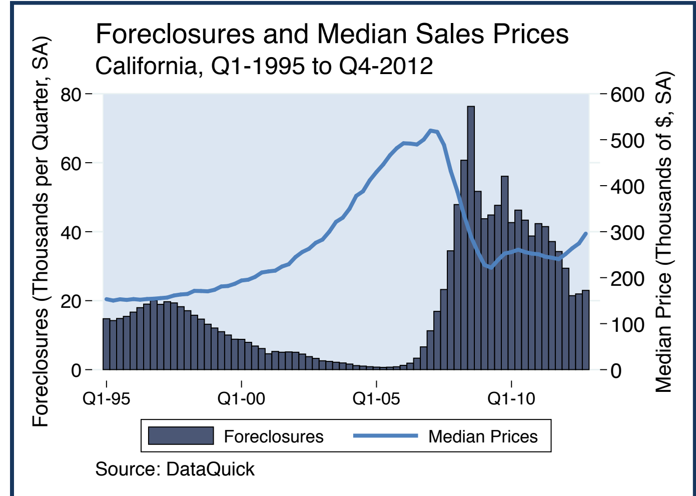
During the fourth quarter of 2009, in the midst of the housing crash, 35.1% of California mortgages contained negative equity, according to data provided by CoreLogic. It's true that some foreclosures were due to homeowners simply not being able to make their mortgage payments. However, the specter of negative equity also led at least some of California's homeowners to the conclusion that their credit scores would recover from a foreclosure on their record faster than their homes would get back to pre-recession values. Many of these homeowners walked away from their home loans. Fortunately, home equity has been on the mend since late 2009. Indeed, the share of homeowners with negative equity fell to 25.2% by the fourth quarter of 2012 (nearly a third of which occurred over the last quarter as price appreciation accelerated). This translates to 729,000 fewer underwater mortgages during this three-year period. The recent trend illustrates that a decline in the share of mortgages with negative equity leads to a decline in foreclosures three quarters later—about the time it takes foreclosures to be processed following the withholding of mortgage payments. This decline in negative equity has meant that the state has seen a smaller and smaller number of new foreclosures over the past few years, which has helped the housing market in California get back on its feet.

Home Price Fundamentals

Equity for California's homeowners has been improving because home prices are rising. From the fourth quarter of 2011 to the fourth quarter of 2012, the median sales price of an existing single-family home increased by 23.0%, from

$240,400 to $295,700, according to DataQuick. Various indexes of home prices that take into consideration sales mix and inflation also show considerable progress. For example, the Case-Shiller home price index increased by 12.0% in San Francisco, 8.1% in Los Angeles, and 7.8% in San Diego over the same period. [1]

The relationship between home prices and foreclosures is a double-edged sword. Rising home prices reduce foreclosures, but high home prices, especially when they stop rising, can create foreclosures in years ahead. In other words, it is the change in prices that really matters for new foreclosures. If prices are increasing, homeowners will sit tight and reap the equity gains. On the other hand, falling prices raise questions about whether strategic foreclosures are prudent. So, what drives these price changes? During normal (non-bubble) times, changes in incomes are largely behind price movements. When prices reached unattainable levels relative to incomes, home sales started to fall off, and defaults and foreclosures began to increase precipitously.



Beacon Economics maintains a housing affordability index that gauges whether recent home price increases place the cost of buying a home above a dangerous threshold. In other words, the index measures whether home prices are out of whack with incomes. Will home prices continue to increase? As we discuss below, various indicators, such as rent prices, home sales, construction activity, and vacancy rates, suggest that they will.

Home Affordability

Even after a year of solid growth in home prices, paying for a mortgage remains affordable. According to Beacon Economics' Housing Affordability Index, the median-priced home requires just 26% of current household income—this represents the best level of housing affordability in more than two decades. The Federal Reserve's low interest rate policy has helped keep mortgage rates at historical lows. The conventional interest rate for mortgages averaged below 4% in 2012, and there is no indication that it will rise in 2013. In comparison, conventional rates averaged 6% in the 2000s and 8% in the 1990s. At current incomes and interest rates, home prices can appreciate as much as 40% and still be as affordable as they were before the housing bubble (from 1995 to 2003).

Even if interest rates begin to rise this year, the cost of a home relative to incomes in the state will remain very reasonable. This affordability has helped to drive price appreciation in the state, and it will also prevent future depreciation. If prices fell further, homes would become even more affordable, which would stimulate additional demand for housing and push prices back up. This is especially true in today's environment of rising rental costs, which are detailed below. In large part, this return of home prices to levels that make sense given current incomes is what has helped to drive the state's housing market forward over the past few years.

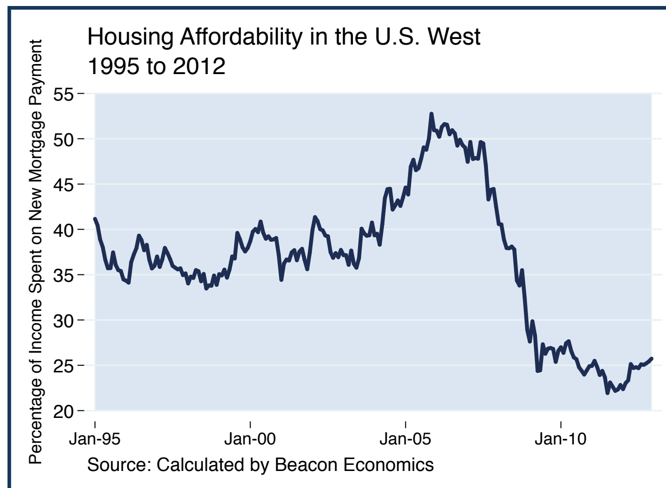
[1] Fourth quarter index value is determined by the average index value for the months of October, November, and December.

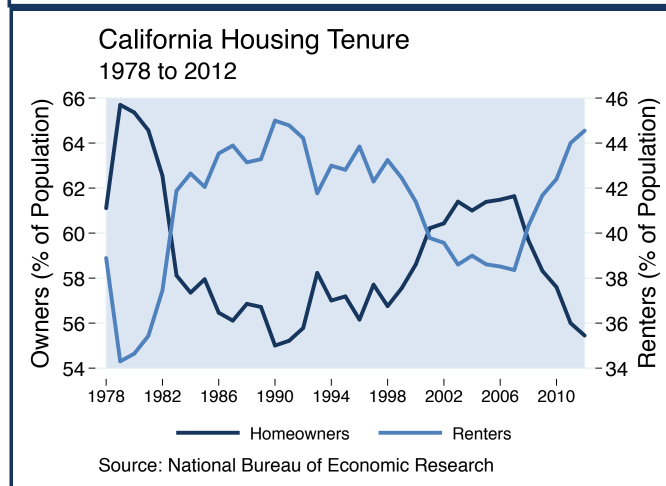
Renting

Because many previous homeowners in California resorted to renting after losing their homes, the share of the population living in rental properties increased from 38% in 2007 to 45% in 2012, the highest percentage in the last 13 years. Landlords and institutional investors continue to find the real estate market attractive because the fundamentals, such as home affordability, ensure that home prices will not tumble. The current low interest rates also encourage institutional investors, since the low rates weaken the demand for alternative low-risk investments, such as Treasury bonds.

The revenues derived from renting homes and apartments are attractive. Rent prices throughout the state are now higher than they were before the recession. For example, in the East Bay the average rent was 4.2% higher in 2012 than it was in 2008, while in the Inland Empire rents increased by 3.2% over the same period. The Trulia Rent vs. Buy Quarterly Report shows that it is cheaper to buy than rent in all 11 California metros—another factor that will help the housing market get back on its feet by spurring additional demand for homes. In addition, buying would save households on average between 19% and 48% per year, depending on the metropolitan area. [2]

In other words, because the cost of renting has continued to increase, owning a home has become more attractive financially. This should also help to buttress the housing market in years to come.





Rent vs. Buy: Annual Savings to Buyers
California Metros, Winter 2013

Metro	Savings (%)	Metro	Savings (%)
Bakersfield	48	Los Angeles	35
Fresno	48	San Diego	33
Inland Empire	44	Orange County	32
Oakland	40	San Jose	24
Sacramento	37	San Francisco	19
Ventura	36		

Source: Trulia

Home Sales, Demand, and Supply

As foreclosures began to rise in the midst of the housing crash, home sales fell from 131,400 in the fourth quarter of 2005 to 47,700 in the fourth quarter of 2007. Homeowners were having trouble finding buyers, and having negative equity prevented owners from lowering prices to market value. Consequently,

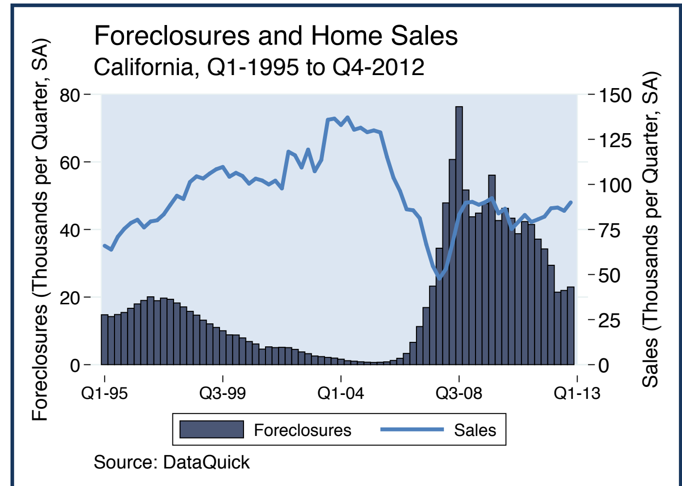
[2] Trulia Rent vs. Buy Quarterly Report, Winter 2013. Trulia assumes a mortgage rate of 3.5%, an income tax bracket of 25%, and a seven-year period of occupancy for the buyer.

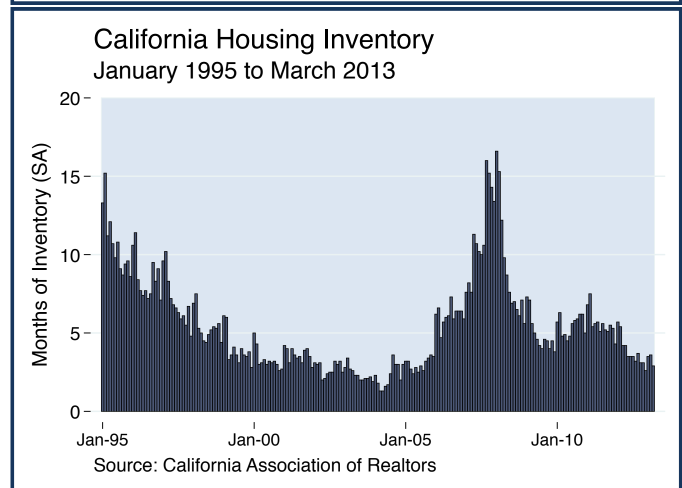
we experienced a spike in foreclosures. Five years later, home sales have risen to 90,000 sales in the fourth quarter of 2012, a 9.6% increase from a year ago.

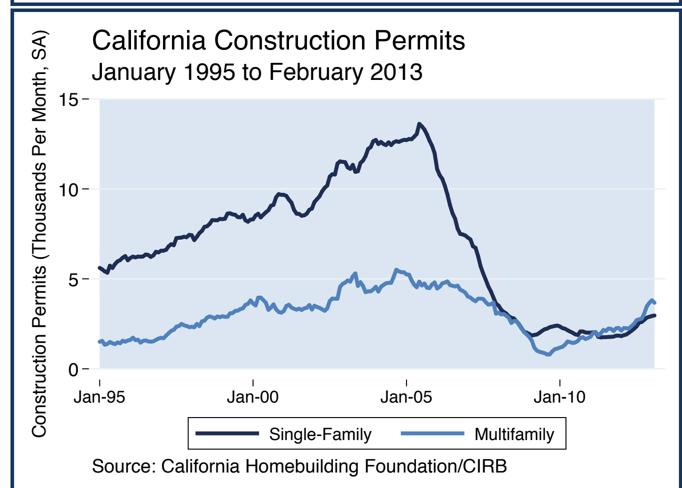
While demand may be rising, there are fewer homes on the market since the number of distressed units is dwindling. This bodes well for homeowners who are underwater, as the shortage in supply will generate price appreciation. Inventory levels in December 2012 reached a 2.6 months' supply, compared with a 4.3 months' supply in December 2011 and a 5.0 months' supply in December 2010. This is a very low level of inventory by historical standards. Construction of new single-family homes will provide only a small boost to inventories in the coming year. While construction permits for single-family homes grew by 25% in 2012, to 27,665 permits, they still remain 70% shy of the pre-bubble average (from 1995 to 2003). On the other hand, multifamily permits, which grew by 26%, are only 10% shy of the pre-bubble average.

Ultimately, California still does not have enough housing, which is another reason the housing market has been quicker to bounce back in the state than in other parts of the nation. In fact, California still maintains one of the lowest housing vacancy rates in the nation, despite all the construction that took place during the bubble. This undersupply of housing units has also helped to drive the housing market forward, as there is an imbalance between the demand for housing and the supply of available homes.

There are no signs that home values will decline in the near future: home prices remain affordable, rent prices remain steep, and the excess demand and shortage of supply continue to drive up prices. Some believe that inventories in the coming years may be fueled by current underwater mortgage holders looking to sell their homes when property values increase. However, the homeowners that currently own homes with massive amounts of negative equity must value their homes much more than the market does, other-







wise they would have abandoned their homes and found a less expensive alternative. Instead, these homeowners could well be the least willing to sell, which will push the market up even further. Either way, it is clear that these fundamental supply and demand issues are driving the real estate market forward, and have been for several years.

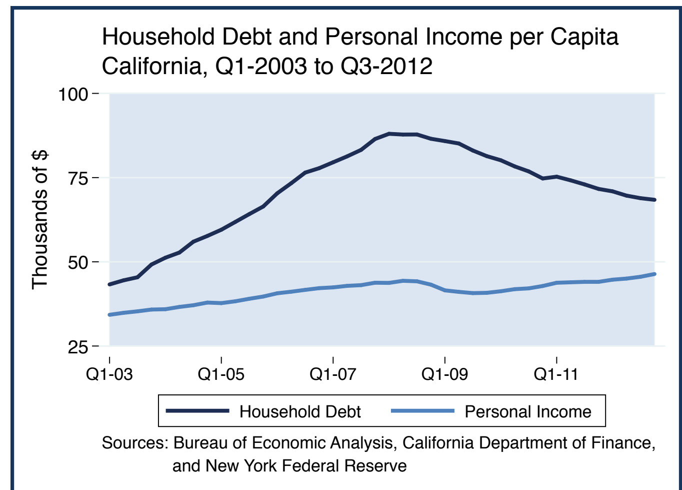
Economic Growth

In the last four years, Californians have had more success paying their bills, keeping their jobs, and earning higher incomes. As we discuss below, all of these achievements have contributed to a reduced number of foreclosures throughout the state since 2009.

Income and Financial Obligations

One of the key reasons that demand for housing in the state has started to improve is that many more Californians have the financial wherewithal to purchase a home relative to the financial environment at the peak of the housing bubble. Indeed, household balance sheets, aided partly by the relatively low cost of debt, have reached some of the healthiest levels in many years. By the end of 2012, the nationwide "financial obligations ratio," which measures the share of current income that is required to finance current financial obligations, had fallen to 10.4%. In a consistent trend, the financial obligations ratio has declined over the past four years.

In California, household debt peaked in the first quarter of 2008, when the average Californian held $88,000 in debt (including mortgage debt). With a per capita personal income of $43,700, the average Californian owed more than 200% of their annual personal income. As approximately 80% of household debt consists of mortgages, the foreclosure process partially contributed to the 22% decline in household debt by the fourth quarter of 2012. By this period, the average Californian held $68,400 in debt, and the annual personal income had increased by 6.0%, to $46,400. What this means is that Californians currently maintain the lowest percentage of debt to personal income (148%) since the second quarter of 2004.



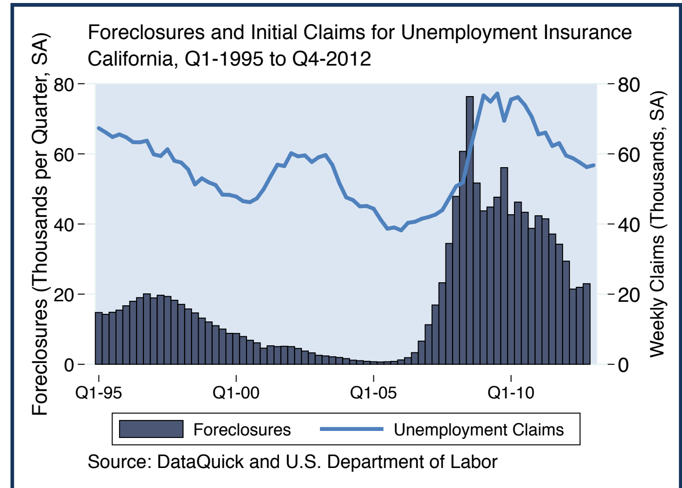
This improvement in household finances is also a large contributor to the housing market recovery in the state. With mortgage debt very cheap, with incomes on the rise, and with rents growing more expensive, many of our state's residents are finding that it makes good financial sense to get involved in the local real estate market. This fundamental improvement has bolstered California's real estate recovery.

Labor Market

An improving labor market has also helped housing in California. Employment throughout the nation has been in recovery mode since 2010, although initially the pace left something to be desired. The State of California was no

exception—employment has been increasing for almost three years straight. And in 2012, the labor market picked up steam. While nonfarm employment in the state fell by 1.3 million jobs from late 2007 to late 2009, recovering only 350,000 jobs by December 2011, an additional 375,000 jobs were added by December 2012. The unemployment rate, which peaked at 12.4% in mid-2010 and declined to 11.2% by December 2011, further declined to 9.8% by December 2012. More folks finding work has meant that more Californians are in a position to buy a home.

Perhaps more relevant to households considering foreclosure, the number of weekly initial claims for unemployment insurance, an indicator of job stability, has improved for the last three years. Weekly initial claims for unemployment insurance in California declined from an average of 77,200 in the third quarter of 2009 to 56,200 in the fourth quarter of 2012. As a larger number of households find work and are able to make their existing mortgage payments, foreclosures should continue to abate as well. And, for those Californians without a foreclosure on record or an underwater mortgage, the current trajectories of employment and income should encourage them to become new buyers, which will also mitigate foreclosures by helping to bolster price appreciation of existing homes.



Mortgage Lending

Although the economic fundamentals in the real estate market make sense—home prices are attractive and the economy has improved—access to credit is hindering the recovery. On the one hand, the high number of foreclosures and other effects of the Great Recession are still hampering household finances and creditworthiness. On the other hand, tighter underwriting standards are making loans more difficult to acquire as the effects of massive foreclosures linger.

National policies resulting from the Dodd-Frank Act will change the definition of a conventional mortgage, which will make buying a home more difficult for many low-income households. The Ability-to-Repay rule requirements for a Qualified Mortgage (QM), which were only announced at the start of 2013, will make lenders liable for providing risky loans. For mortgages to qualify as QM, they cannot

- have a debt-to-income ratio higher than 43%,
- have negative amortization,
- be interest-only loans,
- have balloon payments,
- be for more than 30 years, or
- be issued without documentation.

Loans that do not meet the QM criteria will be susceptible to borrower lawsuits if borrowers default.

Similarly, the Risk-Retention rules for a Qualified Residential Mortgage (QRM), which have not been announced to this date, will force lenders to hold a 5% stake on mortgages that do not qualify as QRM. The consensus prediction is that the Consumer Financial Protection Bureau will require QRM loans to impose a minimum down payment of 10% or more and include some credit score barrier.

Both QM and QRM will affect lenders and potential homebuyers as early as January 2014, but Government Sponsored Enterprises (GSEs) and Federal Housing Administration (FHA) loans will be exempt for seven years. A study by CoreLogic estimates that with GSE and FHA loans included, more than 60% of current loans would not meet the QM and QRM requirements, assuming a down payment rule of 10% and a minimum FICO score of 640. [3]

While QM and QRM rules may help reduce the number of risky mortgage loans in the future, their immediate impact may impede rising home prices as lenders further tighten underwriting standards. More so, the rule exemptions encourage GSE and FHA lending, the latter of which comes with the added cost of mortgage insurance premiums. Unfortunately for the housing market, these rules remain unclear and have yet to be set in stone.

Loans by Select Large Banks
Fourth Quarters of 2010, 2011, and 2012 ($Billions)

Type	2010	2011	2012	2010-2011 (% Chg.)	2011-2012 (% Chg.)
Bank of America					
Residential	433.24	415.80	380.57	-4.0	-8.5
Nonresidential	77.15	62.13	60.61	-19.5	-2.4
Consumer	238.21	203.22	187.02	-14.7	-8.0
C&I	157.77	184.96	210.80	17.2	14.0
Bank of New York Mellon					
Residential	5.69	5.71	5.78	0.3	1.2
Nonresidential	1.15	0.98	1.44	-14.7	46.8
Consumer	0.98	1.02	1.39	3.5	36.7
C&I	2.36	2.07	2.10	-12.3	1.4
JPMorgan Chase					
Residential	249.76	231.88	214.29	-7.2	-7.6
Nonresidential	59.90	62.59	69.82	4.5	11.5
Consumer	189.78	182.25	180.72	-4.0	-0.8
C&I	98.13	122.99	140.04	25.3	13.9
CitiGroup					
Residential	168.27	159.04	148.17	-5.5	-6.8
Nonresidential	11.50	8.68	8.94	-24.5	2.9
Consumer	227.20	202.91	195.57	-10.7	-3.6
C&I	111.87	127.69	140.32	14.1	9.9
HSBC					
Residential	67.93	61.50	54.21	-9.5	-11.8
Nonresidential	8.20	8.18	8.55	-0.3	4.5
Consumer	41.81	37.06	4.65	-11.3	-87.5
C&I	14.17	16.85	22.56	18.9	33.9
Morgan Stanley					
Residential	2.08	4.77	6.77	128.8	42.0
Nonresidential	0.23	0.54	0.72	135.1	34.5
Consumer	3.98	5.11	7.58	28.5	48.5
C&I	15.14	13.28	14.34	-12.3	8.0
U.S. Bank					
Residential	64.14	68.20	74.56	6.3	9.3
Nonresidential	39.76	38.56	37.45	-3.0	-2.9
Consumer	41.70	42.40	42.67	1.7	0.6
C&I	35.63	41.65	48.33	16.9	16.0
Wells Fargo					
Residential	374.67	361.07	369.43	-3.6	2.3
Nonresidential	124.71	123.83	122.59	-0.7	-1.0
Consumer	105.11	103.84	107.03	-1.2	3.1
C&I	127.31	147.91	155.99	16.2	5.5

Source: Federal Financial Institutions Examination Council

[3] Sam Khater, “The Mortgage Market Impact of Qualified Mortgage Regulations,” CoreLogic, The MarketPulse Volume 2, Issue 2, February 12, 2013.

Conclusion

Prior to this start of the year, California's economy had already improved for three full years and the real estate market was coming off its best performance since the housing crash. The number of foreclosures had diminished because increasing home values had reduced the number of mortgages with negative equity, and thus reduced the number of strategic foreclosures. Meanwhile, growth in jobs and incomes had given struggling homeowners the resources necessary to pay their mortgages and other household debts. These trends, combined with the declines in the financial obligations ratio and the increases in housing affordability, have been the predominant drivers behind California's housing recovery.

Furthermore, signs point toward an increasing pace of recovery for the state for at least the next two years—and this would be our forecast even without any legislative or regulatory intervention. The home affordability index demonstrates that home prices can appreciate by as much as 40% and still be in line with historical norms. The high cost of renting will encourage potential homebuyers to buy sooner rather than later, especially as credit scores improve for those with a foreclosure on record. The low inventories of homes for sale and the dearth of new single-family housing construction projects will also drive price appreciation as California deals with a fundamental imbalance between the demand for homes and the available supply.

While supporters of new regulations will point to the recent acceleration in the growth of the state's housing market as evidence of how effective these policies have been, the fact remains that the improvement in residential real estate has been driven by better fundamentals and an improving economy.

About Beacon Economics

Beacon Economics is a leading provider of economic research, forecasting, industry analysis, and data services. The firm's internationally recognized forecasters were among the first and most accurate predictors of the U.S. mortgage market meltdown that began in 2007—and among a relatively small handful of researchers who correctly calculated the depth and breadth of the financial and economic crisis that followed. By delivering independent, rigorous analysis, Beacon Economics gives its clients the knowledge they need to make the right strategic decisions about investment, growth, revenue, and policy. The firm's clients span both the public and private sector, ranging from the California State Controller's Office to major universities to one of Wall Street's most successful hedge funds. Core service areas include economic and revenue forecasting, economic impact analysis, economic policy analysis, regional economic analysis, real estate market and industry analysis, and EB-5 Visa analysis. Visit Beacon Economics' website at www.BeaconEcon.com to learn more.

Services

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