

## Foreclosure Reform in California: An Economic Analysis



BEACON ECONOMICS

This publication was created for:

**California Bankers Association**

**California Credit Union League**

**California Mortgage Association**

**California Mortgage Bankers Association**

**MERSCORP Holdings, Inc.**

**United Trustees Association**

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## Executive Summary

This year, California legislators have introduced several pieces of legislation focused on residential mortgage and foreclosure reform, with Attorney General Kamala Harris's *California Homeowner Bill of Rights* (CHBR) receiving the most attention. Seven bills of her initial legislative package are moving through the normal legislative channels; however, bills dealing with the more contested issues of "dual-tracking" and "robo-signing" were moved to a conference committee, thereby avoiding the typical legislative process.

In fact, the financial services community is supportive of many measures contained within the CHBR that are moving through that typical legislative process, including legislation that deters blight, offers enhanced protections to tenants whose landlords are subject to foreclosure, and limits advance fees paid to individuals claiming they can negotiate a loan modification.

However, the provisions contained in the bills subject to conference committee review impose stricter rules on mortgage servicers seeking to non-judicially foreclose on homes with mortgages in default and expose mortgage servicers to substantial new legal liability. These rules have the effect of slowing the foreclosure process and increasing fines on mortgage servicers for various transgressions within the foreclosure process. In short, these bills steadily push the state towards the kind of judicial foreclosure system that exists in places like Florida and New Jersey, where the court system plays a larger role in the foreclosure process. This is all being done at a time when the Legislature, due to budget considerations, is slashing the judicial system with unprecedented budgetary cuts which will lead to even longer delays in efforts to recover collateral when a borrower violates their contractual commitment to repay their loan. Advocates contend that the bills are, "designed to protect homeowners from unfair practices by banks and mortgage companies and to help consumers and communities cope with the state's urgent mortgage and foreclosure crisis."<sup>1</sup> The result will be another crisis of judicial gridlock which may have little meaningful benefit to borrowers particularly since these measures ignore borrowers' underlying financial conditions.

There is no doubt that California has just experienced an unprecedented wave of foreclosures. But this does not support the idea that there is something broken in the state's foreclosure process or that a major overhaul is needed. California's housing market has actually turned the corner faster than that of many other states where the foreclosure process is more costly and slower. According to data from the Mortgage Bankers Association, approximately 92.5% of mortgages in California are neither in foreclosure nor seriously delinquent.<sup>2</sup> Even amidst this current foreclosure crisis, most mortgages are performing. Nonetheless, if the legislation in conference committee were implemented, it would not merely impact the mortgages that are non-performing; it ultimately would have a negative impact on the majority of borrowers that are able to keep up with their payments. In short, it is Beacon Economics' opinion that if these legislative proposals were to be signed into law they will ultimately harm, not help, the vast majority of California homeowners.

- These bills will not help California's housing market recovery: A press release issued by proponents of the bills states that the proposed reforms to the state's foreclosure process are necessary to help communities cope with the crisis. Yet, the "foreclosure peak" is far behind us at this point in time. All indications show that the number of distressed mortgages in California has fallen dramatically from its high of three years ago, even as the overall

<sup>1</sup>Press Release, "Attorney General Kamala D. Harris Joins Legislative Leaders to Unveil California Homeowner Bill of Rights," California's Office of the Attorney General, February 29, 2012.

<sup>2</sup>Mortgage Bankers Association. California Mortgages. 2012. Raw data. Washington.

market has begun to find its footing. Sales are trending up and prices have started to move off their 2011 bottom. California's housing market has also clearly turned the corner faster than some of the other states hit by mortgage debt problems—a result that is highly correlated with our more efficient foreclosure system. Florida, which exists at the other end of the spectrum in terms of foreclosure process, is still mired in problem mortgages and is seeing little sign of a turn in its housing market.

- These bills will reduce home values: Housing markets with longer length foreclosures see greater discounts on foreclosed units when mortgage servicers eventually sell them—relative to non-distressed transactions. This is likely due to the additional physical degradation the property goes through while being lived in by "short-term" tenants. These discounts, in turn, pull the whole market down with them.
- These bills are unlikely to help borrowers who are behind on payments: All the provisions being proposed functionally raise the cost of foreclosing for the mortgage servicer—both in the increased time it takes to bring a foreclosed property back to the market and the higher administrative cost of using a quasi-judicial process, as these measures appear to create, to complete a foreclosure. The losses to the mortgage servicer will be that much greater at the end of the day. This increase in costs could be perceived as beneficial for current homeowners who are behind on mortgage payments, as a longer foreclosure process could provide them with the time they need to restructure their mortgage or catch up on their payments. Yet there is no evidence to suggest that states with longer foreclosure processes have greater rates of loan modifications or a lower share of delinquent borrowers moving into foreclosure.
- These bills could end up costing owners who are in financial trouble on their mortgages: The non-judicial foreclosure process is more efficient compared to the judicial foreclosure process, and it comes with an important caveat: when using non-judicial foreclosure, lenders are not allowed to pursue deficiency judgments. In other words, the lender cannot seek compensation for their mortgage losses out of the borrower's other assets. If the non-judicial route is lengthened and made more costly, many lenders may decide to pursue a judicial foreclosure, as is within their rights, and thus pursue remedies like deficiency judgments, ultimately costing the borrower more in the long run.
- These bills could actually increase the number of foreclosures in the state: One issue that must be considered is how homeowners respond to the incentive of a longer foreclosure process. Research shows that lengthening the time of foreclosure actually encourages more homeowners to default on their loans, due to the recognition that the homeowner can live in the home longer, "rent-free."
- These bills will reduce the availability of credit for future homebuyers: One impact these rules absolutely will have is to raise the risk of lending in the state of California for mortgage companies, because the bills increase losses incurred by the mortgage servicer in the event that it has to foreclose on a property. Future California homebuyers will end up delivering more money for down payments and face tougher credit standards than they have in the past—an issue intensified by the high proportion of private lenders (rather than the GSEs—Fannie Mae and Freddie Mac) because of so many homes in the state falling outside of the lending limits put into place by these federal government sponsored institutions coupled with the strategic plan to unwind these institutions' concentration in future mortgage lending. Households that are on the credit bubble may find themselves no longer able to purchase a home in California—reducing the long-run rate of homeownership in a state that already has some of the lowest home affordability rates in the nation.

These aren't empty claims. As this paper will demonstrate, our conclusions are supported by a wide variety of research on foreclosure processes and housing outcomes. There is little direct evidence that these measures will succeed or have a positive impact on California's housing market. Florida has a very restrictive foreclosure process, and it's clear that Florida's real estate market is lagging far behind California's in terms of recovery. And while Nevada recently put multiple new rules into place that have similar features as these proposals, to slow the foreclosure process, there is little evidence of relief in Nevada's market. It seems unwise for California to proceed down the same path as Nevada, only to prove this point.

A foreclosure is an undesirable outcome for homeowners and mortgage servicers. It is the last resort for a mortgage servicer when other loss mitigation options are infeasible. But, at the same time, it is a necessary part of the process when a borrower has defaulted on his or her financial commitment. The availability and low cost of mortgage loans is due to the ability of the home to serve as collateral to the lender—ultimately lowering costs for all buyers. Foreclosure can provide those who have lost their homes with a clean slate, as they are almost always forgiven any remaining balances on their mortgage debt. While a defaulter's credit does take a hit, that clears the books faster than many would imagine, and, as this paper will show, households are often able to borrow and buy again within a relatively short period of time. A recent article from Reuters reported the following: "Data is not available, but interviews with more than 30 lenders, builders, realtors and consumers suggest that a growing number of Americans are getting back into the housing market, even though they went through a foreclosure, bankruptcy or short sale in recent years."<sup>3</sup>

Add it up, and it becomes clear that, while well-intentioned, the legislation the conference committee is considering will fail to address the core economic issues contributing to a borrower's inability to meet their debt obligations and will result in substantial distortions of the residential lending marketplace while forestalling California's economic recovery. Sean O'Toole, Founder and CEO of ForeclosureRadar, has said in response to the measures considered in the conference committee:

"The real problem is negative equity, and the only thing stopping foreclosures will accomplish is insuring that we are stuck with the negative equity problem for far longer than necessary....[S]topping foreclosures will lead to a much longer economic recovery, increased blight, fewer jobs, lower property tax receipts, and fewer opportunities for new homebuyers and investors."<sup>4</sup>

Any solutions advanced by the Legislature should consider the long-term impacts on the future access to capital and the affordability of that capital particularly at a time when the federal government's concentration in residential lending is waning.

## I. Introduction

In California and across the country, an unprecedented number of homes have faced foreclosure in recent years. This has created distress for homeowners and mortgage servicers alike. There are different opinions about how we got to where we are now, and these opposing views have led to dramatically different conclusions about what the appropriate public policy response is to help the housing market get back on its feet. A conference committee of the State

<sup>3</sup>Mincer, Jillian. "Back from Foreclosure to Homeownership." *TODAY.com*. 16 May 2012.

<sup>4</sup>ForeclosureRadar. The Foreclosure Report - May 2012. <http://www.foreclosureradar.com/foreclosure-report/foreclosure-report-may-2012>.

Legislature is currently debating whether to increase regulation over the foreclosure process as a means of addressing the problem. The bills under consideration enforce stricter rules on mortgage servicers seeking to foreclose on homes with mortgages severely in default. Proponents contend that the bills are “designed to protect homeowners from unfair practices by banks and mortgage companies and to help consumers and communities cope with the state's urgent mortgage and foreclosure crisis.”<sup>5</sup>

California Attorney General Kamala Harris believes these measures will improve the mortgage process by introducing basic standards of “fairness,” including an end to dual-track foreclosures, and adding transparency, including a single point of contact for homeowners.

The attorney general has sponsored four bills that are part of the CHBR that will be voted on in an expedited manner without the benefit of advancing through the typical legislative process, which includes policy and fiscal committee hearings in each house and floor debates. A legislative conversation that would normally have extended through August, with legislation considered by the Governor in September, has been fast-tracked.

Among other effects, stricter regulations will slow down the foreclosure process, which, as some have claimed, could help struggling borrowers catch up on their mortgage payments or seek some foreclosure prevention alternative.

As discussed in the next few sections of this report, while these rules may slow the foreclosure process, they are highly unlikely to help many individual homeowners. Indeed, basic public policy arguments could be made that, for many of these households, the best long-term solution to shore up their personal finances is, in fact, foreclosure. Equivalently, California’s housing market doesn’t need policy help to recover—it’s already recovering on its own. The market has turned, and looks stronger than either Florida’s or Nevada’s—in part due to the way this state has governed the foreclosure process. And ultimately these regulations will hurt future generations of home buyers by making credit harder to come by in a state that is already one of the least affordable in the nation.

Moreover, the reason there have been so many foreclosures in the state of California is not due to the misconduct of mortgage servicers. Investors, whether public or private, incur substantial losses on their investments when they foreclose on a borrower, and for that reason they would prefer not to have to pursue such action, if possible. It is also not due to the high rate of unemployment. In the mid-1990s unemployment in California hit 9.5%, and in 1982 it hit 11.5%, yet the pace of foreclosures today is 5 to 10 times higher than it was during either of those periods.

The primary reason for the recent wave of foreclosures is that many households borrowed far more than what was financially prudent, and now are unable to pay back their debt. Admittedly, this has been a challenging environment for all involved. And while it is clear that some owners have been wronged in the foreclosure process, there is already a fix for this problem—civil courts that allow a wronged party in a contractual dispute to sue for relief.

## II. Roots of the foreclosure crisis

Although the massive collapse of the recent housing bubble came as a surprise to most, including many individuals and businesses with huge stakes in the housing market, perhaps it should not have been a surprise at all. California

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<sup>5</sup>Press Release, “Attorney General Kamala D. Harris Joins Legislative Leaders to Unveil California Homeowner Bill of Rights,” California’s Office of the Attorney General, February 29, 2012.

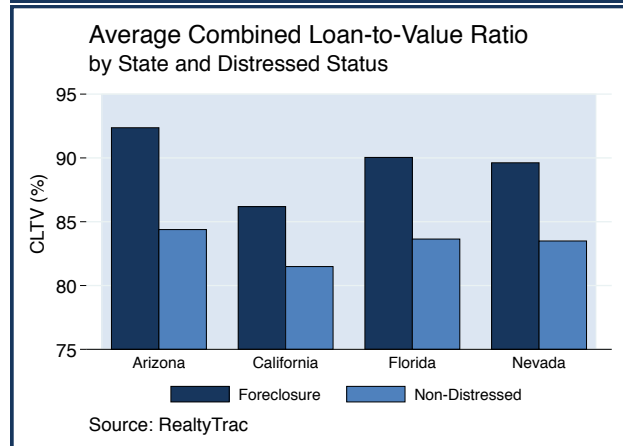
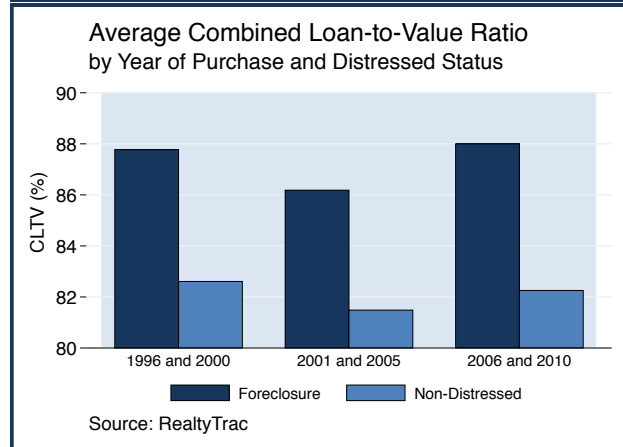
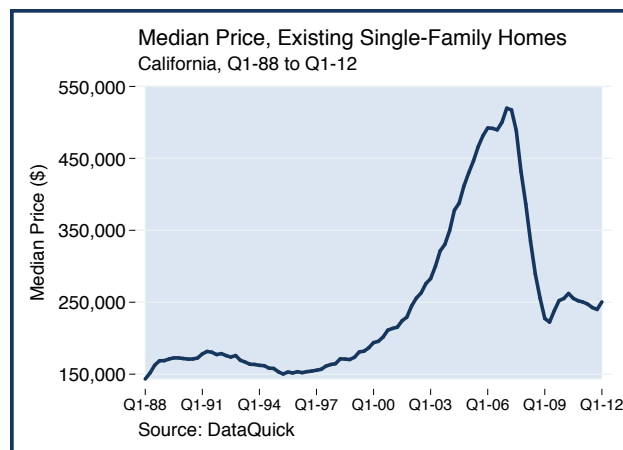


has been through numerous housing bubbles and busts—including in the late 1970s and late 1980s. And this time around, the signs of excess were far more exaggerated compared to the previous cycles.

For one thing, home prices accelerated at an unprecedented pace, far exceeding income growth over the same period of time. In California, the median price of an existing single-family home rose 83.8% between Q1-2003 and Q1-2007, reaching a peak of \$519,714 on a seasonally-adjusted basis. Never before had home price-to-rent or home price-to-income levels become so far removed from historical norms.

Bubbles occur because of the speculative frenzy of buyers. As opposed to thinking about fundamentals, many investors focus strictly on recent returns (e.g., if home prices went up 10% last year, they probably will again this year). Buyers rush into the market to take advantage of price appreciation causing prices to...appreciate. This self-fulfilling prophecy typically ends when credit conditions tighten to the point that speculators can no longer easily enter the market and the process reverses itself. The bubble this time was so much larger than in past cycles because this natural credit tightening process failed to appear. Instead, the entities responsible for packaging these mortgage products to sell to larger banks kept the cycle alive far longer than it would have been had more traditional lenders dominated the market as they did in past years.<sup>6</sup>

For most of these loans, the individuals in question borrowed far more than they could afford, very often on the basis of fraudulent loan application information. Applicants were falsifying income levels, failing to disclose existing financial constraints such as credit card debt and personal loans, creating false bank statements, and falsifying employment histories.<sup>7</sup> By 2008, when the housing market had started to collapse, mortgage application fraud accounted for nearly two-thirds of all reported incidents of fraud.<sup>8</sup> For example, a family in New York with a \$105,000 income and just \$35,000 in assets acquired a \$1.8 million mortgage after reporting a monthly income of more than \$50,000 and



<sup>6</sup>Diamond, Douglas W., and Raghuram Rajan. "The Credit Crisis: Conjectures about Causes and Remedies." *NBER Working Paper Series* (2009).

<sup>7</sup>"Mortgage Fraud up 45% as Lenders Tighten Loan Standards." *USA Today*. 3 Dec. 2008.

<sup>8</sup>Clifford, Catherine. "Mortgage Fraud at an All-time High." *CNNMoney*. 16 Mar. 2009.



assets of \$3 million. Furthermore, some lending practices actually helped to fuel fraudulent applications. Lenders offered “stated-income” loans, which required no proof of income.<sup>9</sup>

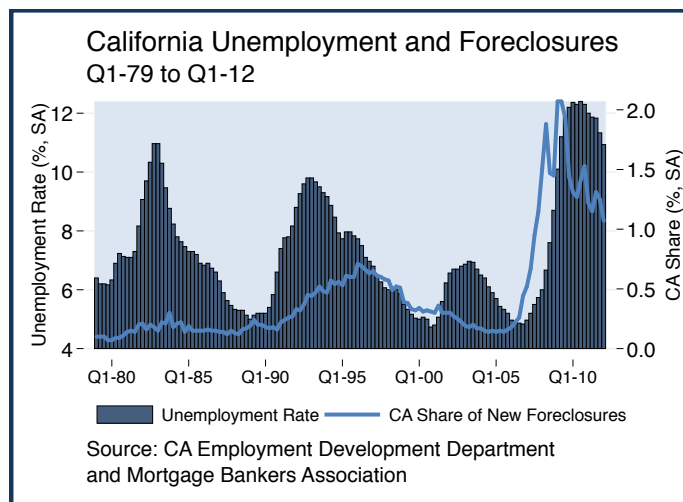
The net result was that many households borrowed far more than they could ever pay back (even if the economy hadn’t gone into recession), betting that they would be able to use the appreciation on the property to pay down the loan over time—their own personal Ponzi scheme. When millions of owners borrow more than they can pay back, it is little surprise that they end up being foreclosed on when the bubble finally ends and prices plummet back to normal, sustainable levels. Broader economic conditions were not the initial source of the problem. Indeed, for the first time ever, a rise in foreclosures preceded rather than followed, a rise in unemployment. Unemployment was even decreasing in some areas as foreclosures were quickly rising.<sup>10</sup>

Data in the graphs above illustrate how borrowers with homes that are in foreclosure have mortgages that are significantly higher leveraged than borrowers with homes that are non-distressed. This is consistent over 15 years and in states with both judicial and non-judicial foreclosure processes.

The crisis was amplified as existing homeowners refinanced. As home prices rose dramatically, homeowners refinanced their mortgages, and obtained funds which they then used to pay down debts or to make new purchases. According to Freddie Mac, in 2005, 76% of all homeowners who refinanced increased their loan amount by 5% or more, allowing them to spend the extra funds as they wished. In 2006, that was up to 89%.<sup>11</sup> Between 2005 and 2007, homeowners cashed out \$820 billion from their homes through refinancing.<sup>12</sup>

Alan Greenspan and James Kennedy at the Federal Reserve collected data on the gross equity extracted from homes over time that financed consumer spending. Nationwide, between 2000 and 2006, the free cash resulting from equity extraction rose from \$553.4 billion to over \$1.1 trillion. The total amount of cash from this equity extraction used for personal consumption expenditures rose from \$64.3 billion to \$147.7 billion. This cash rose from 0.9% to 1.6% of the total dollars for personal consumption expenditures during that time.<sup>13</sup> In short, these homeowners were living beyond their means.

Homeowners enjoyed a cash windfall from the steep rise in the prices of their homes, but when prices plummeted, many of these homeowners found themselves underwater, and unable to borrow more to pay back on previous mortgages. The bad-credit nature of this wave of foreclosures is very apparent in the figure above, which shows the unemployment rate in California alongside the share of mortgages going into foreclosure. This may be the most important graph in this report, as it clearly illustrates a number of very important points surrounding the current debate:



<sup>9</sup>Corkery, Michael. "Fraud Seen as Driver in Wave of Foreclosures." *The Wall Street Journal Online*. 21 December 2007.

<sup>10</sup>Kirchhoff, Sue, and John Waggoner. "Subprime Storm Winds Will Keep Blowing." *USA Today*. Gannett, 18 June 2007.

<sup>11</sup>Freddie Mac: Office of the Chief Economist. Cash-Out Refinance Report. 2012. Raw data. McLean, VA.

<sup>12</sup>Jurow, Keith. "Is Massive Refinancing During The Bubble Years A Ticking Bomb?" *Business Insider*. 02 June 2010.

<sup>13</sup>Greenspan, Alan, and James Kennedy. Sources and Uses of Equity Extracted from Homes. March 2007. Raw data. Washington.

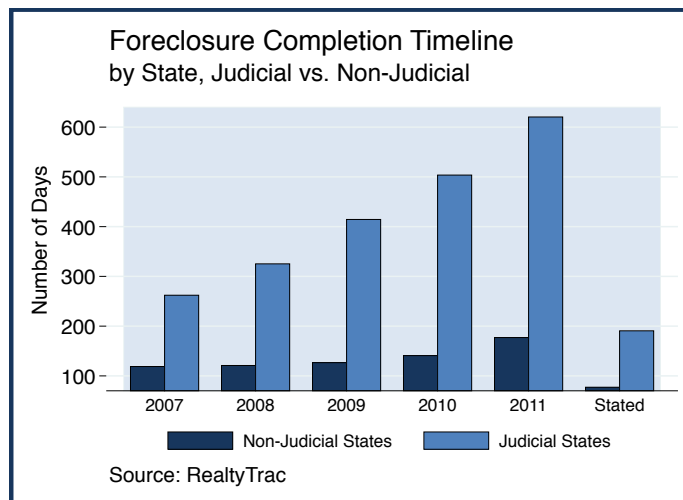
1. In the past there were very few foreclosures even in economic cycles where the unemployment rate moved well above 10%. This was because borrowers were neither willing nor able to leverage themselves up the way they did during the last cycle.
2. The fact that bad credit, not employment, was the foreclosure driver is shown clearly by the fact that foreclosures in the state started rising long before the unemployment rate did. Indeed, the pace of foreclosures in California hit a record level in the second quarter of 2007—half a year before the recession even began. And the peak occurred in 2009 – before the peak in the unemployment rate.
3. Maybe most important is the fact that the foreclosure crisis is waning. While still high, the pace of foreclosures is falling rapidly. Changing the foreclosure process now seems like closing the barn door long after the horse got out.

### III. Slowing the foreclosure process doesn't help homeowners in distress

One of the most popular arguments in support of the judicial foreclosure process is that in instituting court proceedings that will lengthen the time it takes to execute a foreclosure, it will give many borrowers enough time to catch up on their payments and pull their mortgages out of foreclosure. Yet, there is much debate over whether the process itself has already become too long. In their study, Cordell and Shenoy (2011)<sup>14</sup> found the following:

- Foreclosure timelines are at an all-time high—692 days in judicial states, 567 days overall.
- The primary causes for the lengthening of foreclosure timelines are existing foreclosure laws and changes in the regulatory and legal environment—for example, changing from a non-judicial to a judicial process or implementing more stringent requirements for completing a foreclosure.

Beacon Economics' own analysis of data from the last few years confirms these conclusions. According to real estate data firm RealtyTrac, foreclosure timelines in judicial states like Florida, Illinois, Maryland, New Jersey, New Mexico, Ohio, and Oklahoma are much higher on average than in non-judicial states like Arizona, California, Georgia, Texas, Virginia, and Washington. The average stated foreclosure completion timeline, which represents the number of days it takes for a foreclosure to be completed without any delays, is 77 days in non-judicial states. The stated timeline in judicial states is more than 2.5 times longer—an average of 191 days.



It is important to point out that the actual foreclosure process in both judicial states and non-judicial states alike runs longer than the stated timelines, and that the time it has taken to process a foreclosure has grown. However, it is also important to recognize that the difference in the actual time it takes to process a foreclosure is even more dramatic

<sup>14</sup>Cordell, Larry & Shenoy, Vidya (2011). The Cost of Delay. Manuscript. *Federal Reserve Bank of Philadelphia*.

between the two different types of foreclosure-rule states. For example, in 2010 the average length of a foreclosure in judicial states was well over one year at 504 days. This is more than 3.5 times longer than it took to process a foreclosure in non-judicial states, where the process averaged less than six months at 141 days.

It is worth noting that California's non-judicial system already underperforms from a timeline perspective. The state has already seen the time to foreclose rise to almost one year since the housing crisis began. Homeowners who are in trouble on their mortgage loans already seem to have substantial time to get their financial orders in hand.

<b>Foreclosure Timelines by State, Judicial vs. Non-Judicial</b>						
State	Stated (No Delays)	2007 Timeline	2008 Timeline	2009 Timeline	2010 Timeline	2011 Timeline
Non-Judicial States						
Arizona	102	126	139	163	132	173
California	117	184	184	228	320	352
Georgia	37	109	112	81	106	142
Texas	27	62	69	55	81	90
Virginia	45	90	86	78	101	132
Washington	135	142	135	154	105	173
Avg. Non-Judicial	77	119	121	127	141	177
Judicial States						
Florida	135	224	308	445	578	806
Illinois	300	318	357	424	476	567
Maryland	46	167	305	362	419	634
New Jersey	270	340	453	619	849	964
New Mexico	180	253	219	358	411	501
Ohio	217	237	349	380	439	486
Oklahoma	186	295	285	313	354	385
Avg. Judicial	191	262	325	414	504	620
Difference						
Difference	2.5	2.2	2.7	3.3	3.6	3.5

Source: RealtyTrac

This added time has negative consequences. Cutts and Merrill (2008)<sup>15</sup> find that the likelihood a borrower will reinstate a loan out of foreclosure falls as the length of the foreclosure process increases.

- If states with “excessively long” foreclosure times shortened their foreclosure timelines to the national median, they would increase the likelihood of successful reinstatement by 3 to 9 percentage points.

<sup>15</sup>Cutts, A. C., & Merrill, W. (2008). Interventions in mortgage defaults: Problems and practices to prevent home loss and lower costs. In N. P. Retsinas & E. S. Belsky (Eds.), *Borrowing to live: Consumer and mortgage credit revisited* (pp. 203–254). Washington, DC: Brookings Institution Press.

In other words, if states with longer than average foreclosure processes shortened them, **it would significantly increase the likelihood that borrowers in foreclosure would pay down their mortgage to get out of foreclosure.** States with long windows of foreclosure, they argue, remove the threat of imminent home loss and offer the benefit of "rent-free" living as the foreclosure process goes forward. States with longer foreclosure timelines, as in judicial states, **incentivize foreclosure** by giving borrowers too much time to catch up on their payments. Prolonged foreclosure processes encourage some borrowers to remain delinquent. The authors claim that the "sweet spot" for foreclosure timelines is right around the current national median of 120 days, as this gives borrowers enough time to recover but does not encourage homeowners to neglect mortgage payments.

Altering the foreclosure process alters the preferences of rational consumers. Extending the timeline of foreclosures encourages some borrowers to take advantage of a process that favors their financial interests. In 2008, as foreclosures grew dramatically month after month, some homeowners took advantage of the combination of a slow process of foreclosure and plummeting home prices by financing and buying new homes, even as they faced foreclosures on their primary residences. The only cost to homeowners using the so-called "buy and bail" strategy was damaged credit—something that could be repaired after several years.<sup>16</sup> Fannie Mae and Freddie Mac took steps to crack down on "buy and bail" in 2008, banning the use of rental income from an existing home to qualify for a mortgage unless the original property had at least 30% equity, but some individuals were still able to get around the policy. In fact, Morgan Stanley reported that in February 2010, about 12% of mortgage defaults were strategic, in which homeowners tactically chose not to make mortgage payments they could afford.<sup>17</sup>

Anthony Pennington-Cross (2006)<sup>18</sup> examines what happens to mortgages in the subprime mortgage market once foreclosure proceedings are initiated. He uses a probability (multinomial logit) model to show that the legal environment of the state where the foreclosure takes place impacts the duration of foreclosures. Specifically, he finds:

- In non-judicial states, a mortgage is 53% more likely to be terminated by a lender taking the home than an identical mortgage in a judicial state.
- In non-judicial states, a mortgage is 28% more likely to be terminated by a borrower selling the home for the outstanding balance (or less than the balance, if lenders accept losses on the sale) than an identical mortgage in judicial states.
- All ways of stopping foreclosure, including mortgage curing (in which borrowers catch up on mortgage payments) and mortgage partial curing (in which mortgages remain active, but borrowers remain delinquent), are more likely in non-judicial states.

Proponents of the judicial foreclosure process claim that loan modifications increase in judicial states, because borrowers have more time to learn about their options and meet with loan servicers to discuss modifications that will allow them to keep up with payments. Collins, Lam, and Herbert (2011)<sup>19</sup> analyze borrowers in default residing in 22 cross-state MSA pairs and find evidence to support the claim, but the effect is very weak. They find:

<sup>16</sup>Karlinsky, Neal. "In Foreclosure? Buy a Second Home." *ABC News*. 7 September 2008.

<sup>17</sup>Howley, Kathleen M. "'Buy and Bail' Homeowners Get Past Fannie, Freddie Loan Hurdles." *The Washington Post*. 10 August 2010.

<sup>18</sup>Pennington-Cross, Anthony (2006). *The Duration of Foreclosures in the Subprime Mortgage Market: A Competing Risks Model with Mixing*. Federal Reserve Bank of St. Louis Research Division, Working Paper Series.

<sup>19</sup>Collins, Michael J., Lam, Ken, & Herbert, Christopher E. (2011). State Mortgage Foreclosure Policies & Lender Interventions: Impacts on Borrower Behavior in Default. *Journal of Policy Analysis and Management*, Vol. 30, No. 2, 216-232.

- Judicial foreclosure processes have no impact on whether a loan is cured, remains delinquent (but is not in foreclosure), or is in foreclosure.
- Judicial foreclosure processes yield only a marginal 3% increase in loan modifications.

In addition, many of these loan modifications that do not involve principal write-downs will not help underwater homeowners avoid foreclosure. For these homeowners, an interest rate adjustment offers little relief when they are facing an overly burdensome principal balance. However, lenders are reasonably worried that offering principal reductions will lead to, in the acting director of the Federal Housing Finance Agency Edward DeMarco's words, "borrower incentive effects." Some percentage of borrowers who are current on their loans would be encouraged to claim a hardship or go delinquent in order to gain a reduction on their mortgage principal. Assume the Treasury were to implement incentives to Fannie Mae and Freddie Mac to encourage principal reduction for half of all delinquent borrowers or those who may naturally fall into delinquency (approximately 345,500 participants), at the average reduction amount of \$51,000. While the incentives the Treasury would provide would be a net benefit to the GSEs in the absence of any "borrower incentive effects," it would take only 50,000 strategic borrowers to wipe out all of that net benefit.<sup>20</sup> Principal reductions are a high-risk move for lenders, which is why they are so rare.

Proponents of the judicial foreclosure process also claim that foreclosure rates drop in judicial states. In a report for the Federal Reserve Bank of Boston, Gerardi, Lambie-Hanson, and Willen(2011)<sup>21</sup> claim a mixed effect. Comparing the state of Massachusetts after instituting stricter regulations of the foreclosure process with neighboring states without similar regulations, they find:

- Foreclosure rates are higher among mortgages in non-judicial states at 3 months, 6 months, 12 months, and 18 months after default.
- Although foreclosure rates drop in judicial states, *mortgage cures do not*.
- The number of persistently delinquent borrowers is higher in judicial states.
- **After 18 months, almost half of borrowers in judicial states still own their homes after becoming delinquent, compared to just over one-quarter of borrowers in non-judicial states.**

In other words, despite the fact that foreclosure rates may be higher on average, non-judicial states proceed through those issues more quickly, thereby paving the way for future growth.

For many years policy analysts at many levels have beaten the drum that homeownership is the primary path to economic advancement for households—part of the "American Dream." This has given rise to the homeowner mortgage tax credit program, the FHA, the GSEs, and the interest rate deduction for home mortgages. At the same time, it was much the reason that regulators did not step in earlier to shore up the collapse in credit standards that caused so much bad lending to occur in the recent bubble.

While we agree that homeownership is ultimately a good thing, its benefits occur under the right circumstances, not under all circumstances. According to estimates from CoreLogic, almost 30% of homeowners in California are underwater on their mortgages (the outstanding balance of their mortgage is greater than the value of their house.) In some

<sup>20</sup>DeMarco, Edward J. "Addressing the Weak Housing Market: Is Principal Reduction the Answer?" The Brookings Institution, Washington. 10 Apr. 2012.

<sup>21</sup>Gerardi, Kristopher, Lambie-Hanson, Lauren, & Willen, Paul S. (2011). Do Borrower Rights Improve Borrower Outcomes? Evidence from the Foreclosure Process. *Federal Reserve Bank of Boston, Working Paper Series*.

cases they may be close, but in many others the owner may be \$50,000 or \$100,000 underwater. Making it a policy to keep that person in that home is not good public policy. Homeowners will likely be better off in the long run by being able to start anew—being foreclosed on now and buying something later.

Some owners already understand this—and are acting accordingly. Homeowners who took out mortgages near the peak of the housing bubble may have homes that are now a fraction of the value of their mortgages. Rather than wait, possibly decades, for their home values to rise to the point at which they no longer possess negative equity, some homeowners prefer to face foreclosure and suffer damaged credit, knowing that their credit will be restored much faster than if they had held onto homes with negative equity. It takes surprisingly little time for buyers to re-enter the market. Fannie Mae and Freddie Mac require a two-year wait to qualify for a mortgage after a short-sale, and a three-year wait to qualify for a mortgage after a foreclosure, if the borrower's credit has been perfect since.<sup>22</sup>

Those who support changing California's foreclosure rules might argue that while getting out from under a negative equity situation might be beneficial in the long run, the pain the family suffers in the short run is too large a cost to make this a good strategy. A May 2011 study by the Federal Reserve tends to negate this claim. To quote:

"Although foreclosure considerably raises the probability of moving, the majority of post-foreclosure migrants do not end up in substantially less desirable neighborhoods or more crowded living conditions. These results suggest that, on average, foreclosure does not impose an economic burden large enough to severely reduce housing consumption."<sup>23</sup>

And close to one-fifth of their sample ended up in another house after the foreclosure—although this group may include those who have either bought another house as well as those who have moved in with someone with a mortgage (i.e., parents or relatives). But what is also noteworthy is the short amount of time it takes for foreclosed homeowners to reenter the market. A recent article from Reuters reported the following: "Data is not available, but interviews with more than 30 lenders, builders, realtors and consumers suggest that a growing number of Americans are getting back into the housing market, even though they went through a foreclosure, bankruptcy or short sale in recent years."<sup>24</sup>

Non-judicial foreclosure processes also offer some special legal protection to borrowers that judicial foreclosure processes do not. Under California's current non-judicial foreclosure process, lenders are not allowed to pursue deficiency judgments against borrowers. Lenders cannot recover the losses of a foreclosure by acquiring borrowers' other assets. This very well could change if California goes the route of a judicial foreclosure state. A longer, more costly foreclosure process may encourage lenders to go to court for a foreclosure, in which they in turn pursue a deficiency judgment against the borrower. This has consequences for small business owners in California that use home equity as a means of raising capital for their businesses. The possibility of a deficiency judgment could, among other consequences, discourage or prevent some residents from starting or expanding their own businesses.

#### IV. Slowing the foreclosure process doesn't help housing markets recover

Not only does slowing down the foreclosure process have negative consequences for homeowners, but it can also impede recovery in the broader housing market. There are several key reasons why enabling distressed homeowners

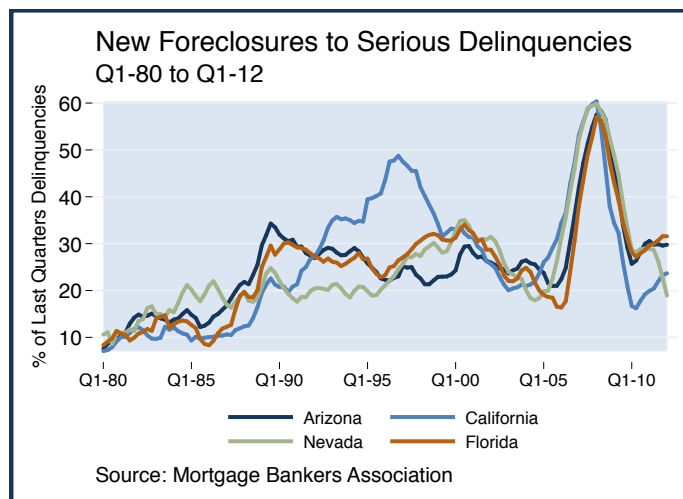
<sup>22</sup>Haggerty, Maryann. "The Post-Foreclosure Wait." *The New York Times*. 26 June 2011.

<sup>23</sup>Molloy, Raven & Shan, Hui "The Post-Foreclosure Experience of U.S. Households." Finance and Economics Discussion Series: 2011-32. Screen Reader version. *Federal Reserve Board of Governors*. May 2011.

<sup>24</sup>Mincer, Jillian. "Back from Foreclosure to Homeownership." *TODAY.com*. 16 May 2012.

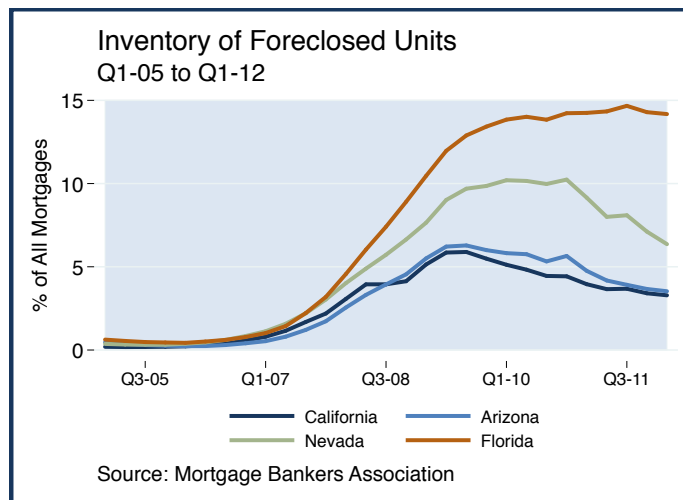
to move through foreclosure more quickly can ultimately help with a turnaround in housing markets and with the broader economy.

First, consider the argument that slower foreclosures will create more workouts. The following graph shows the ratio of new foreclosures to the share seriously delinquent in the previous quarter. This gives a rough estimate of the pass-through from being behind on payments to being in foreclosure. We show this figure for Arizona, Nevada, Florida, and California. All four states saw a sharp spike in pass-through rates in 2008. The rates have come down sharply for all states—but more so for California. Florida, the state with the most restrictive foreclosure process, has a considerably higher pass-through rate today.



Second, the total numbers of foreclosures and seriously delinquent mortgages have dropped faster in non-judicial foreclosure states than in judicial foreclosure states since the peak of the housing crisis. In fact, perhaps unsurprisingly, annual foreclosures peaked in Florida and Nevada in 2010, even though defaults peaked in 2009. And, while Nevada does have a non-judicial foreclosure process, recent statutory changes in that state have blurred the line between judicial and non-judicial foreclosures, slowing down the foreclosure process there. The foreclosure process was simply prolonged and not forestalled. Note that foreclosures in Florida have barely dropped off from their peak level. At the current rate of decline, it could be quite some time until Florida foreclosures hit trough.

At present, the rate of foreclosure starts is equal in non-judicial and judicial foreclosure states, but the percent of loans in foreclosure has reached an all-time high in judicial foreclosure states, at 6.9%. By contrast, the percent of loans in foreclosure in non-judicial foreclosure states is only 2.8%, the lowest level since early 2009. Ten judicial foreclosure states have foreclosure rates above the national average of 4.39%, compared with just one non-judicial foreclosure state. The trend is the same for FHA loans. The foreclosure rate of FHA loans in judicial foreclosure states is 5.59% versus 2.69% in non-judicial foreclosure states.<sup>25</sup>



Specifically, the inventory of homes in foreclosure rose higher in states such as Florida and Nevada. According to data from the Mortgage Bankers Association, in addition to having higher rates of foreclosure overall, the inventory of foreclosures in the system peaked later in Florida and Nevada, and have subsequently fallen by less. For example, at their peak, the percentage of all mortgages in foreclosure in California and Arizona hit 6.3% and 5.9%, respectively in the third quarter of 2009. Since then, the percentage of homes in foreclosure has fallen to 3.5% and 3.3% in Arizona and

<sup>25</sup>Swanson, Jann. "Judicial States Continue to Skew Foreclosure Statistics." *Mortgage News Daily*. 16 May 2012.



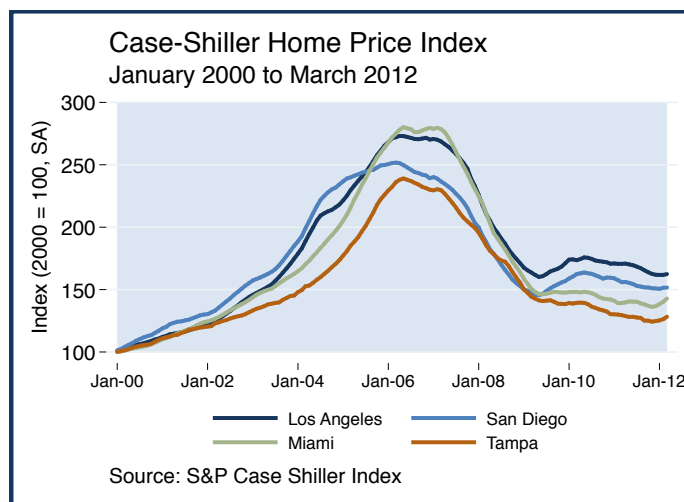
California, respectively. However, Florida peaked with 14.7% of all its mortgages in foreclosure and has since fallen by less than one percentage point—remaining above 14% as of the first quarter of 2012. Nevada has seen a slightly stronger recovery than Florida, with Nevada's foreclosure inventory falling from just over 10% at the end of 2010 to 6.4%, though this is a smaller improvement on a proportional basis than in either Arizona or California.

The drop-off in delinquencies and foreclosures appears to be accelerated by non-judicial foreclosure processes because foreclosed homes come back to market faster. Foreclosed homes can be purchased by investors, who will convert the property into rental housing, or by other homeowners, thereby clearing the inventory and paving the way for a more robust recovery. Drawing out the process or preventing foreclosures from occurring only ends up delaying the recovery by limiting the housing supply for prospective buyers and by keeping these distressed properties idling in the system and preventing home prices from stabilizing in earnest. This in turn curbs demand due to uncertainty about whether prices will go up or down.

Allowing foreclosures to linger in the system actually drags out the recovery process by keeping discounts for distressed properties high. In fact, this can have knock-on effects that ripple throughout the rest of the housing market and broader economy. Given that foreclosures or distressed properties are intermingled with non-distressed properties in a market, heavily discounted foreclosure sales often have negative implications for non-foreclosure sales as foreclosed properties are generally competing for the same pool of buyers. As a result, the basic laws of supply and demand dictate that the foreclosure properties can place a general downward pressure on prices.

Based on this evidence, the judicial foreclosure process, in drawing out the foreclosure process, does not ultimately benefit a housing market or its recovery. The length of time it takes to process these foreclosed units leads to greater foreclosure discounts, larger proportions of foreclosed mortgages lingering in the system, and slower improvement in foreclosure inventories. This is illustrated in the following graph which shows the Case-Shiller indexes for two Florida and two California MSAs. Prices did not drop by as much in California as they did in Florida, and prices today in California relative to 2000 are higher than in Florida over the same period of time. This isn't conclusive evidence—there are many factors that influence the prices of homes over time—but it definitely indicates that California has not suffered by having a more efficient foreclosure process.

In addition, longer foreclosure processes and greater foreclosure discounts have implications for the broader economic recovery outside of the housing sector. Many homeowners facing foreclosure are also deeply underwater. These homeowners are not only struggling to make their monthly mortgage payments, but are also in a situation where they owe more money on their home than it is worth, leading to an overall negative net worth. The feeling of having negative or very low net worth can have severe implications for consumer spending and business investment, as well as for new household and business formation. Slowing down the foreclosure process could actually forestall the ability of families to move toward a positive cash-flow scenario and remove the large negative that exists on their personal balance sheets, as represented by an underwater mortgage.



Fortunately, since 2009, the proportion of homes with negative equity has declined as many homes have gone through foreclosure. In some of the states that were hardest hit by the housing crisis, the rate of decline varies depending on whether or not the state has a judicial or non-judicial foreclosure process. Non-judicial foreclosure states in general have smaller proportions of homes with negative equity relative to their size. For example, in California 29.9% of homes are underwater, compared with 44.2% of homes in Florida.

It is also important to note that, in addition to being lower on an absolute basis, California's negative equity rate is falling faster than that of Florida. Arizona's negative equity rate is falling much slower than Nevada's, but Arizona had a much lower proportion of homes with negative equity at the peak of the housing crisis. The non-judicial foreclosure process helps homeowners get out from under negative equity homes by speeding up foreclosures. This can benefit the homeowner by accelerating the process of financial recovery, and can benefit the housing market by getting foreclosed homes back on the market faster.

With outcomes like these, it is not surprising to see many groups coming out in opposition to specific components of the legislation in conference committee, including the Federal Housing Finance Agency. On May 15, 2012, the FHFA delivered a criticism of the approach to the legislative committee considering the bills, noting that the rules "could unduly delay the foreclosure process and add to overall lending costs. Such delays could harm the recovery of a still fragile housing market."<sup>26</sup> Based upon Beacon Economics' review of the existing research on the subject as well as our own independent data analysis, we concur with the FHFA and believe the proposed legislation is misguided.

#### Homes with Negative Equity (%)

State	2011Q4	2009Q4	2009Q4
Non-Judicial States			
California	29.9	35.1	-5.2
Arizona	48.3	51.3	-3.0
Judicial States			
Florida	44.2	47.8	-3.6
Non-Judicial/Hybrid States			
Nevada	61.1	69.9	-8.8

Source: CoreLogic

<sup>26</sup>Marc Lifsher, "U.S. home loan regulator opposes California foreclosure bills," *Los Angeles Times*. May 15, 2012.

**Seriously Delinquent Mortgages and Foreclosures**

Year	Non-Judicial		Judicial/Other	
	California	Arizona	Nevada	Florida
Seriously Delinquent Mortgages (60+ Days Past Due)				
2005	27,413	9,426	4,046	38,488
2006	43,073	8,902	5,632	45,220
2007	104,573	19,826	13,059	85,965
2008	238,676	46,446	28,190	172,562
2009	425,475	89,613	53,498	273,447
2010	431,610	84,931	52,583	252,982
2011	303,678	55,642	37,703	183,091
2012	232,233	42,204	34,095	149,884
Mortgages in Foreclosure				
2005	9,823	3,527	1,527	15,868
2006	20,237	3,231	2,929	19,033
2007	84,200	12,936	11,129	68,802
2008	221,320	43,669	30,042	239,612
2009	325,628	70,663	50,020	424,529
2010	269,642	63,453	53,069	465,704
2011	207,228	44,863	39,862	464,860
2012	182,267	37,198	29,982	446,060

Source: Mortgage Bankers Association

**V. The law of unintended consequences**

Throughout the crisis, borrowers put their homes up as collateral for mortgages with low interest rates. As shown in the table below, the fact that homes are used as collateral is what keeps interest rates low relative to other forms of consumer debt. When the homes of those borrowers prove unaffordable, and borrowers are unable to pay their mortgages, mortgage servicers take possession of the homes to pay for the loans they issued. If the goal in resolving the foreclosure crisis is not to punish mortgage servicers but is truly to help borrowers in need, the solution should not be to target the foreclosure option that affordable home loans depend upon.

There has also been research conducted on the effect of various foreclosure processes on mortgage lending. A review of the existing literature suggests that while foreclosure rates may decrease under a judicial process, the process is unlikely to help borrowers to catch up on their payments. By prolonging the length of time it takes lenders to recover their losses (by selling foreclosed properties), and by introducing additional costs to lenders to complete foreclosures (i.e., legal costs), the judicial process increases the cost of servicing home loans, which ultimately is passed on from lenders to borrowers. Lenders pay for the costs of the judicial process by increasing interest rates for future homebuyers.

It is also important to point out that the judicial process has negative consequences to all borrowers—even those who have never owned a home or been involved with any foreclosure process. According to researcher Karen Pence (2003),<sup>27</sup> the supposed benefit to homeowners of “borrower-friendly” laws mean higher costs to lenders, who in turn pass on those costs on to borrowers. These laws unintentionally reduce the supply of mortgage credit. In fact, Pence finds that after accounting for regional factors, loan sizes are 4% to 6% smaller in states with defaulter-friendly foreclosure laws.

In her words, “default-friendly foreclosure laws may assist homeowners experiencing hard times, but they also impose costs on a much larger pool of borrowers at the time of loan origination.” This is especially problematic in a state like California, because it makes home ownership even more expensive at a time when relative unaffordability is a primary competitive disadvantage with other states. In California, the median existing single-family home price is \$240,000.<sup>28</sup> With a 4% to 6% decrease in loan size as a result of a stricter foreclosure process, a California resident purchasing a median-priced existing single-family home would need to add, on average, an extra **\$9,600 to \$14,400** to his or her down payment in order to acquire a mortgage.

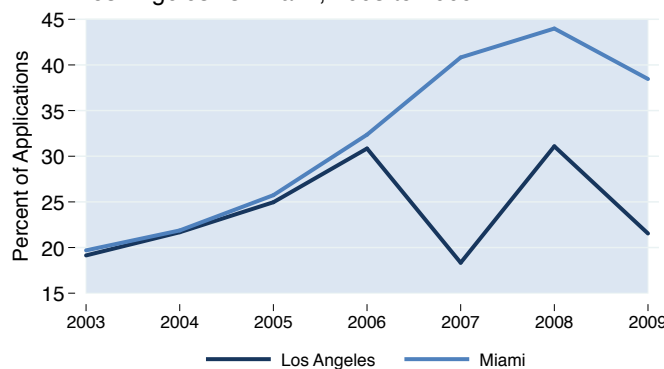
The high home prices in California would translate into higher down payments and credit standards for borrowers under a quasi-judicial foreclosure process because the cost of lending is relatively higher in California to begin with. California borrowers are more dependent upon private lending than borrowers in other states, as fewer homes qualify as GSE “conforming loans.” In most of the United States, the limit for GSE conforming mortgage loans is \$417,000. In special “high-cost” counties, the limit is higher, at a maximum of \$625,500, or 1.5 times the general limit.<sup>29</sup> Even with this high-cost premium, the cost of housing is still much higher in many of these high-cost counties than the national median price. For example, in San Francisco County, the median price of an existing single-family home is \$631,500,<sup>30</sup> which is 3.9 times the national median price of \$163,450.<sup>31</sup> The high-cost loan limit for GSEs is only \$625,500 in San Francisco County, or 1.5 times the general limit for most homes in the country.

#### Consumer Debt Interest Rates (National Averages)

Consumer Loan	Interest Rate
15-Year Fixed Mortgage	3.08%
30-Year Fixed Mortgage	3.78%
5/1 Adjustable Rate Mortgage	2.64%
36-Month New Car Loan	3.09%
48-Month New Car Loan	3.21%
36-Month Used Car Loan	4.33%
48-Month Used Car Loan	4.34%
Personal Loan	9.47%
Low Interest Credit Card	10.69%
Balance Transfer Credit Card	16.10%

Source: BankRate.com

#### Mortgage Application Denials Los Angeles vs. Miami, 2003 to 2009



Source: FFIEC Home Mortgage Disclosure Act Data

<sup>27</sup>Pence, Karen M. (2003). *Foreclosing on Opportunity: State Laws and Mortgage Credit*. Board of Governors of the Federal Reserve System.

<sup>28</sup>DataQuick. Existing single-family home median price in California. Raw data. San Diego.

<sup>29</sup>Fannie Mae. Loan Limit Look-Up Table. 2012. Raw data. Washington.

<sup>30</sup>DataQuick. Existing Single-Family Home Median Prices. 2012. Raw data. San Diego.

<sup>31</sup>National Association of Realtors. Existing single-family home median price in the United States. 2012. Raw data. Chicago.

A high number of homes in San Francisco County would not qualify for GSE mortgage loans simply because the cost of housing is so high. These homes would be financed through private lending. Because those mortgages are not government-backed, their cost is higher, as private lenders bear all the risk of defaults and foreclosures. The biggest increase in the cost of lending that would likely follow from a transition to a judicial foreclosure process, especially considering possibilities like strategic defaults, would be for these private lenders. This would have a significant impact on the overall cost of mortgage lending in the state, given the abundance of private lending in California.

Some data already exist that can help illustrate the potential consequences of tightening foreclosure rules in California. The graph above, which contains data from the Home Mortgage Disclosure Act from the Federal Reserve, shows the percent of mortgages that have been declined as a share of all applications in Florida and California going back to 2003. Up until the crisis began, the chance that a mortgage application would have been declined in California and Florida were the same. But since the crisis began, the rate of declines has spiked in Florida, but not in California. This isn't conclusive evidence—we cannot control for the quality of the borrower—but it is suggestive that lenders are shying away from the Florida housing market.

## VI. Conclusions

Throughout the recent housing crisis, mortgage servicers have foreclosed on properties because borrowers have been unable to make payments on their loans. Mortgage servicers are not in the business of foreclosing on properties, and their goal is to keep borrowers in their homes, as taking homes through foreclosure is rarely profitable. It is an incorrect assumption that a more difficult foreclosure process will protect borrowers from supposed predatory lenders or that a quasi-judicial process will result in increased foreclosure prevention alternatives.

This proposed legislative solution is not likely to address the underlying causes of the recent housing market collapse, which means that they are not in a position to prevent such housing crises from occurring in the future. In many ways, it is the exact opposite approach to what is truly needed to address the state's housing woes, and these bills will have much broader consequences that will extend to the state's entire mortgage market and overall economic recovery.

It is true that today, many consumers are locked into situations where they have lost down payments in the wake of substantially lower home prices, and find themselves deeply underwater with a housing forecast that will likely keep them upside down for years to come. In many cases, they are struggling to make their monthly payments while financing their daily needs. But in these cases, the best option may be for the homeowner to go into foreclosure and rent suitable housing while they work to rebuild their balance sheet and gain a more stable financial footing.

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## About Beacon Economics

Beacon Economics is an independent economic research and consulting firm with offices in Los Angeles and the San Francisco Bay Area. The firm's internationally recognized forecasters were among the first and most accurate predictors of the meltdown in the U.S. mortgage market—and among a relatively small handful of researchers who correctly calculated the depth and breadth of the financial and economic crisis that followed. The firm focuses on providing objective, fact-based economic studies and analytics, long- and short-term economic forecasts, public policy analysis, and balanced counsel to those making financial, business, and economic decisions.

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