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Foreclosures in California

*The current housing crisis is
more severe than
previous corrections*

*By Rani Isaac
Economist and Senior Research Specialist*

*Requested by the Chair of the
Assembly Banking and Finance Committee*

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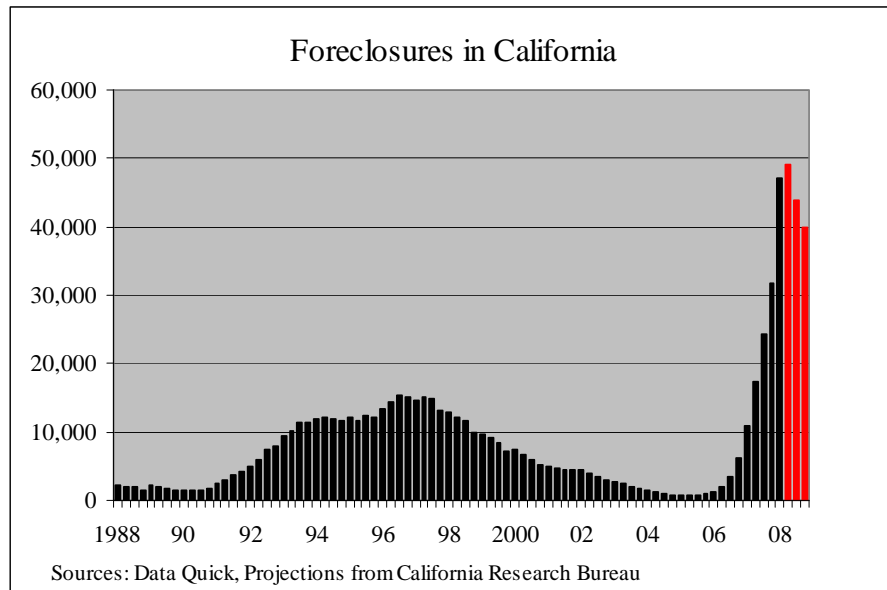
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In early February of 2008, the Chair of the Assembly Banking and Finance Committee asked the California Research Bureau (CRB) to conduct research into the number of housing foreclosures in California and its counties. This CRB Note presents our findings as of April 2008. The CRB plans to publish periodic updates during the next year (at least through Q1 2009), and to supply data and forecasts for the state and counties to assist the Committee in addressing the housing foreclosure crisis.

The forecast. The estimate of housing foreclosures in California during the current cycle, spanning the three years 2006 – 09, varies from 170,000 to 434,000. Therefore, foreclosures will affect between 3.0 and 7.8 percent of all homeowners with mortgages in the state by 2009, or by 2010, if the cycle is drawn out. The variation in the forecast results from variation in the data and assumptions. The

following text discusses the data, the assumptions, and the effects of their variations on the forecast .

A look back at the previous foreclosure cycle shows a long, less severe correction, which peaked at 15,418 foreclosures in Q3 of 1996. In the six years ending in Q4 of



1998, the state experienced 301,188 foreclosures. The high end forecast of 434,000 foreclosures for the current cycle includes 180,000 foreclosures in 2008. Since this housing crisis is much more extreme than previous corrections, the recovery may not follow the same path as previous recoveries. In fact, some observers are comparing this cycle to the one experienced during the Great Depression, since this is the first cycle since then in which home prices have fallen throughout the nation.

The chart indicates that according to Data Quick, there were 84,325 homes lost to foreclosure in California in 2007, and 12,672 lost in 2006 - a total of 96,997 in those two years (see the Endnotes).¹ In the first quarter of 2008, there were 47,171 foreclosures - an annualized first quarter rate of 188,684. The forecast for next year is slightly lower than that annualized first quarter rate, because the forecast anticipates that during 2008 the economies of the U.S. and the state will begin to recover from the brink of recession. The red bars on the chart suggest a likely pattern for the next three quarters - 49,000; 44,000; and 39,829 foreclosures, respectively.

The math in a nutshell. Moody's Economy.com Chief Economist Mark Zandi testified before Congress that 2.0 million homeowners will lose their homes in the next two years.² California had 21.7 percent of all the riskiest loans (Alt-A and Subprime), as of December 2007.³ Therefore, the high estimate of California foreclosures is 434,000 (2.0 mil. x .217 = 434,000).⁴ Analyses from other sources support that estimate.

THE NATIONAL ESTIMATE

Forecasts from credible sources like Global Insights, Credit Suisse, Lehman Brothers, Moody's Economy.com and The Center for Responsible Lending (CRL) range from 1.1 to 2.0 million homes lost to foreclosure in the U.S. According to a draft February 2008 report from The Brookings Institution, there were 1.5 million foreclosures nationally in 2007, and of those 750,000 are expected to result in home loss.⁵ Assuming a flat line projection, if there are 750,000 homes lost in each of the years 2007-2009, there would be 2.25 million homes lost to foreclosure during the cycle.

Federal Reserve Board Chairman Ben Bernanke expects the situation to get worse this year. He said, "Lenders were on pace to have initiated roughly 1.5 million foreclosure proceedings last year.... Delinquencies and foreclosures likely will continue to rise for a while longer."⁶

Some homes may enter foreclosure but be saved by recently enacted federal emergency measures. Relief may come from Federal Housing Administration (FHA), Housing and Urban Development (HUD) and other government programs. New allowances for Freddie Mac and Fannie Mae to purchase or back jumbo loans,⁷ lender-or-servicer-initiated workouts, or restructurings may also help. These federal policy responses may begin to produce noticeable effects by the middle of this year. As these effects are better quantified, CRB will revise its estimates.⁸

The current evidence suggests the buyers who bought at the peak in 2006 – 07, paid the most inflated prices, were more likely to avail themselves of subprime adjustable rate mortgages (ARMs), and may now be at risk of being in negative equity positions (upside down on their mortgages). A 20 percent drop in prices from their peaks could leave as many as 14 million

Table 1. Homes Projected to be Lost to Foreclosure for California Due to the Subprime Mortgage Market Crisis 2006-2009

Counties, State or Nation	Number of Subprime Loans 2005-06 *	Proportion of All Loans that are Subprime 2005-06	Cumulative Foreclosure Rate on 2005-06 Subprime Loans	Number of Homes Lost to Foreclosure 2005-06 *	Projected Homes Lost to Foreclosure 2006 - 09	Based on Moody's Economy .com Projections for the U.S.
Total for 37 Counties *	722,524	24.0%	21.7%	156,937	377,500	
Balance of CA Counties +	n.a.	n.a.	n.a.	n.a.	56,500	
Total U.S.	4,426,331	26.3%	18.8%	831,454		2,000,000
Percent of U.S. with 37 Metro Counties *	16.3%			18.9%		
Statewide percent of U.S.				n.a.	21.7%	434,000

* The percentage of 18.9% from the Center for Responsible Lending (CRL) for CA includes 37 counties.

+ n.a. (not available). The remaining 21 counties were estimated to account for the additional 56,500 foreclosures statewide.

Sources: Center for Responsible Lending (CRL), Moody's Economy.com, Author's calculations and projections, California State Library, California Research Bureau (CRB), April 2008

households with negative equity⁹ - 2.8 million households in California. While this scenario is not highly likely for the U.S., it is becoming quite probable for many metropolitan areas in California.¹⁰

The optimistic California forecast. A lower bound forecast of 170,000 homes lost to foreclosures from 2006-09, results from using data on new mortgage originations from the period between the 2000 Census and the latest 2006 American Community Survey (ACS), which is the latest ACS data available. The ACS data on mortgaged owner-occupied housing units show that during those six years, Californians took on 1,064,117 new mortgages, compared to 12,570,283, nationally.¹¹ Based on that relationship, it might seem reasonable to estimate the number of future foreclosures in California at 8.5 percent of the total number of foreclosures in the nation, rather than the 21.7 percent estimate that is based on the number of Subprime and Alt-A mortgages initiated in California. Doing that would yield a smaller estimate of 170,000 homes lost (2.0 million x .085 = 170,000). However, a foreclosure forecast based solely on California's fraction of the total number of mortgages initiated may significantly underestimate the number of foreclosures, since it ignores the effects of extreme variations in loan quality and fluctuations in home prices.

REASONS FOR FAVORING THE HIGHER SCENARIO

The pessimistic scenario of 434,000 homes lost to the crisis is the more likely scenario for the following reasons:

- The Moody's Economy.com forecast is for 411,000 defaults in California in 2008, compared with 212,000 defaults in 2007. Defaults do not always lead to foreclosure, but many do. These forecasts are based on the latest 2008 Q1 data, and a national projection of 2.1 million defaults expected for just this year, on the heels of 1.4 million last year. Therefore, California had 15 percent of the defaults last year and is expected to have 20 percent this year.
- California originated 20 percent of the total dollar value of all new mortgages in 2006 at \$577 billion, versus \$2,886 billion for the U.S. ($577 / 2886 = 20$ percent).¹²
- Data from The Center for Responsible Lending (CRL), shown in Tables 1 and 2, attribute 18.9 percent of all national foreclosures in 2005-06 to California. The CRL's expected total foreclosures based on *Subprime Spillover* data were used to forecast county foreclosures (Table 2, column 6).¹³
- The Pew Center on the States recently estimated that in California, one in 20 homes could go into foreclosure in the next two years. They also base their analysis on the CRL data. The Pew study estimates that California could see 355,682 foreclosures.¹⁴
- The percentage of foreclosures of all mortgages outstanding is higher for California than for the nation as a whole.¹⁵
- The loan performance data that the banking industry uses to estimate future and current delinquencies, foreclosures and mortgage resets, shows deteriorating conditions.¹⁶

- In metropolitan areas where the average number of building permits issued for single family homes in the years 2004-2006, was high relative to total housing stock (e.g. Riverside and Stockton), more home owners are at risk. They may have paid the most inflated prices, used piggyback loans (a first and second mortgage) and used more exotic loan products such as subprime ARMs with low teaser rates.¹⁷
- Some areas are experiencing steep declines in home prices. According to The Brookings Institution's report, price declines are strongly correlated with mortgage defaults (again, see endnote 5).

COUNTY ESTIMATES

One can get a sense of the number of foreclosures likely to affect individual metropolitan counties by assuming that each county will continue to experience the same percentage of all California foreclosures as it did in 2005-06, and estimating the total number of foreclosures in the state from 2006 through 2009 at about 434,000. Results from 2005-06 for each of the 37 metropolitan counties can then be extrapolated forward from 2006 through 2009 (see endnote 4). Column 6 of Table 2 shows the result of that exercise – a total estimate of about 377,500 foreclosures in the 37 metropolitan counties and about 56,500 foreclosures for the 21 non-metropolitan counties.¹⁸

Using more recent foreclosure patterns changes the county forecasts considerably. Table 2 shows that alternative forecast in column 8. That forecast estimates that the 37 metropolitan counties will experience a more severe correction that will result in a total of about 428,300 foreclosures. In particular, counties with higher proportions of subprime loans and relatively few foreclosures at the beginning of the period are likely to experience many more foreclosures in the future (note highlighted counties like San Joaquin and Riverside). The forecast estimates that the number of foreclosures in the non-metropolitan counties will be only about 5,700.

The Pew Center on the States study presents California's policy responses to the housing foreclosure crisis and the responses of other states (again see endnote 14), and suggests that the states and the nation could be doing more to address the problem. It suggests that the states create state-funded refinancing programs to help homeowners avoid foreclosure. Commendably, California has taken action to modify loans, but the study suggests that California could be doing more to help those at risk of losing their homes by, for example, helping them avoid falling victim to fraudulent rescue schemes and providing them with more counseling.

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Table 2. Homes Projected to be Lost to Foreclosure for California and its Counties Due to the Subprime Mortgage Market Crisis

County / State Total for Metropolitan Counties	Number of Subprime Loans 2005-06	Proportion of All Loans that are Subprime 2005-06	Cumulative Foreclosure Rate on 2005- 06 Subprime Loans	Number of Homes Lost to Foreclosure 2005-06	Projected Homes Lost to Foreclosure Thru 2009 * Rank	Alternative Projection of Homes Lost Rank
Los Angeles	176,557	26.3%	22.0%	38,843	93,434 1	64,347 1
Riverside	81,576	31.4%	22.6%	18,436	44,346 2	62,552 2
San Diego	42,146	17.3%	21.4%	9,019	21,695 4	42,732 3
Sacramento	38,404	26.4%	21.0%	8,065	19,400 6	41,435 4
San Bernardino	81,137	35.3%	22.6%	18,337	44,108 3	37,122 5
Orange	37,985	17.2%	22.8%	8,661	20,833 5	20,468 6
San Joaquin	23,719	30.3%	23.4%	5,550	13,350 8	19,571 7
Contra Costa	23,451	19.3%	21.3%	4,995	12,015 10	19,396 8
Kern	27,632	36.0%	24.2%	6,687	16,085 7	13,288 9
Stanislaus	17,406	29.8%	17.1%	2,976	7,159 14	13,014 10
Alameda	22,022	17.8%	21.3%	4,691	11,284 11	11,967 11
Fresno	22,625	32.2%	23.5%	5,317	12,790 9	10,022 12
Solano	12,794	25.9%	23.8%	3,045	7,325 13	8,078 13
Ventura	11,250	16.1%	17.6%	1,980	4,763 17	7,878 14
Santa Clara	17,764	13.3%	19.3%	3,428	8,246 12	6,382 15
Merced	8,092	32.5%	25.0%	2,023	4,866 16	5,983 16
Placer	5,620	15.1%	21.0%	1,180	2,838 19	5,485 17
Sonoma	5,290	13.3%	21.1%	1,116	2,684 20	4,064 18
Monterey	6,160	21.3%	20.4%	1,257	3,024 18	3,839 19
Tulare	11,089	35.4%	22.2%	2,462	5,922 15	3,540 20
Santa Barbara	3,838	15.2%	19.6%	752	1,809 23	3,416 21
Yolo	2,737	19.7%	21.0%	575	1,383 28	2,568 22
San Mateo	6,191	11.7%	16.7%	1,034	2,487 21	2,418 23
El Dorado	2,906	15.4%	21.0%	610	1,467 26	2,219 24
Yuba	2,182	31.5%	17.6%	384	924 31	2,094 25
Imperial	4,953	40.0%	13.5%	669	1,609 24	1,845 26
Butte	2,880	21.5%	20.2%	582	1,400 27	1,571 27
Shasta	3,154	23.1%	19.7%	621	1,494 25	1,471 28
Sutter	2,147	25.7%	17.6%	378	909 32	1,421 29
Madera	4,209	33.0%	20.9%	880	2,117 22	1,371 30
San Luis Obispo	2,094	11.6%	13.6%	285	686 34	1,296 31
San Francisco	3,117	8.7%	16.7%	521	1,253 30	1,222 32
Santa Cruz	2,098	12.2%	14.5%	304	731 33	1,147 33
San Benito	1,247	22.4%	19.3%	241	580 36	947 34
Napa	1,536	14.1%	16.4%	252	606 35	848 35
Kings	3,139	34.6%	17.6%	552	1,328 29	673 36
Marin	1,377	7.0%	16.7%	230	553 37	623 37
37 Counties	722,524	24.0%	21.7%	156,937	377,500 *	428,316

* Past trends were extrapolated, but highlighted counties could experience worse conditions than either projection, since the proportion of all loans that were subprime exceeded 30% and problems had just started to surface in 2006.

Sources: Center for Responsible Lending (CRL), Data Quick, Author's calculations and projections, California State Library, California Research Bureau (CRB), April 2008

ENDNOTES

¹ Data Quick tracks Trustees Deeds (TDs) recorded or actual losses of homes to foreclosure. Reports and press releases are at www.dataquick.com. Similarly, FirstAmerican CoreLogic calls homes lost to foreclosure real estate owned properties (REOs), indicating that the lender has taken legal title to the property, through foreclosure or transference (see endnote 3).

² Moody's Economy.com Chief Economist Mark Zandi testified to Congress in March 2008 that three million homes will be in default in the 30 months ending mid-2009, and two-thirds of those will end in foreclosure. His projections are available in a report published by his firm titled *Aftershock: Housing in the Wake of the Mortgage Meltdown*, costing about \$4,000, at www.economy.com/home/products/special-study-series/2007/december/aftershock/default.asp. It addresses when prices in housing markets in all 381 U.S. metropolitan areas will hit bottom and what their recoveries will look like.

³ Loan performance data from First American Core Logic and the Federal Reserve Bank of New York show that California had 1,233,953 Alt-A and Subprime Loans out of 5,688,583 for the nation or 21.7% (see also endnotes 1 and 16). The NY Fed estimates that as of year-end 2007, there were about 7 million subprime loans and their sample covers 3.3 million active subprime loans. California had 113,006 loans either in foreclosure or already lost to lenders who had taken legal title to the property through foreclosure or transference of title. There were 464,883 such losses or foreclosures nationally, so California had 24.3% of the U.S. total. Reports are available at www.newyorkfed.org/regional/subprime.html.

⁴ The Economy.com forecasts of foreclosures and defaults for the state and nation are among the most highly regarded, since the firm accurately projected a correction years before the downside of the cycle began. The forecasting firm tracks historical mortgage loan origination data from the Federal Financial Institutions Examination Council (FFIEC) and makes projections of that data. This Home Mortgage Disclosure Act (HMDA) data on loan terms is collected by FFIEC to supervise and enforce fair lending practices across that U.S. The loan application information is publicly available from 1996 through 2006, although information on the maturity structure of a loan, or whether the loan has a fixed or adjustable rate mortgage is not included. Nevertheless, HMDA is one of the best sources for understanding loan origination patterns. Economy.com makes projections for mortgage loan originations for states and metropolitan areas as a routine part of its overall national and regional modeling. The Center for Responsible Lending (CRL) also projected foreclosures based on HMDA data in California and the U.S.

⁵ The Brookings Hamilton Project report *Weighing Alternative Policies for Tackling the Mortgage Mess* by Douglas Elmendorf was not yet finalized. www.brookings.edu/papers/2008/02_mortgage_elmendorf.aspx

⁶ The comments were excerpted from a speech delivered to the Independent Community Bankers of America Annual Convention, Orlando, Fla. Two articles in the *Wall Street Journal (WSJ)* - 3/5/08 p. A3 and 3/7/08 p. A1 - cover Federal Reserve Board Chairman Ben Bernanke's remarks.

⁷ A jumbo loan exceeds the maximum borrowing limit for loans guaranteed or secured by a government agency. Jumbo mortgages are taken out in high-cost states like California when Fannie Mae (FNMA) and Freddie Mac (FHLMC) limits do not cover the full loan amount. Fannie Mae and Freddie Mac purchase the bulk of residential mortgages in the U.S., but set conforming limits (\$417,000 as of 2006) on the maximum dollar value of any mortgage which they will purchase from an individual lender. Other large investors, such as insurance companies and banks offer jumbo loans. In February, 2008 President Bush signed an economic stimulus package that temporarily increases the limit to \$729,750 until the end of 2008. Fannie and Freddie can temporarily buy existing jumbo loans from lenders and help to unlock the capital markets.

⁸ The forecast assumes that 2008 will be the peak, but CRB plans to reassess the situation with a quarterly subscription to Data Quick delinquency and foreclosure data that covers the state and most counties back to 1988. The Q2 08 data should be out July 25, 2008.

⁹ This Economy.com projection was cited in the Brookings Hamilton Project report, p. 4 in a footnote. See earlier endnotes 4 and 5.

¹⁰ U.S. home prices fell in the fourth quarter of 2007, according to the Office of Federal Housing Enterprise Oversight “purchase only” index. Results from OFHEO’s “all transactions” house price index (HPI) are at www.ofheo.gov/media/pdf/4q07hpi.pdf. Between the fourth quarter of 2006 and the fourth quarter of 2007, California had the highest rate of depreciation (-6.6%) in the U.S. and its Metropolitan Statistical Areas (MSAs) lead the losses: Merced (-19.0%); Modesto (Stanislaus County) (-15.5%); and Stockton (San Joaquin County) (-15.3%).

¹¹ The percentage of homes not mortgaged in the U.S. was 32% in 2006 versus 24% in California. Projections of the number of 2009 ACS housing units with mortgages in California are assumed to grow from 5.4 million in 2006 to 5.6 million in 2009. CRB will incorporate 2007 ACS results when they become available.

¹² Mortgage originations were published in the August 2007 forecast from Moody’s Economy.com. Nationwide aggregate reports are available on the Federal Financial Institutions Examination Council (FFIEC) web site www.ffiec.gov/hmda.

¹³ Projected cumulative foreclosure rates on 2005-06 subprime loans from the Center for Responsible Lending (CRL) project 21.7% foreclosures on subprime loans in California and 18.8% for the U.S. CRL’s report, *Subprime Spillover*, had state and county data for metropolitan areas. www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

¹⁴ The press release has links to individual profiles for each state and the nation. www.pewtrusts.org/news_room_detail.aspx?id=37950

¹⁵ According to the Mortgage Bankers Association, (*WSJ 3/7/08, p. A11*), more than 2% of all mortgages in the U.S. were in foreclosure in the 4th quarter of 2007, and for California the comparable rate was 2.2%.

¹⁶ A *WSJ* Article, March 19, 2008, p. A14, cites data from First American Core Logic. It suggests that the percentage of subprime borrowers who did not fully document their income and assets grew from about 17% in early 2000 to 44% in 2006. California had 732,995 out of 2,384,592 nationally, or 30.7% of Alt-A Mortgages. Loans marketed in Alt-A securities are typically higher-balance loans made to borrowers who might have past credit problems—but not severe enough to drop them into subprime territory—or who, for some reason (such as a desire not to document income) chose not to obtain a prime mortgage. In addition, many loans with nontraditional amortization schedules such as interest only or option adjustable rate mortgages (ARMs) are sold into securities marked as Alt-A (see endnote 3).

¹⁷ According to the Center for Responsible Lending, as of Q4 2007, subprime loans accounted for about 13 percent of loans, but around 60 percent of foreclosure starts. While interest rate cuts have lessened payment shocks for borrowers facing rate adjustments, there were so many underwriting problems that many subprime borrowers may be defaulting before their rates reset. Marginal buyers used tactics like inflating their incomes on stated-income (Alt-A) loans, assuming excessively aggressive debt to income ratios, and avoiding impoundment accounts for taxes and insurance.

¹⁸ Data in Table 1 and 2 are from CRL’s January 2008 *Subprime Spillover* Appendix 1: Foreclosure “Spillover” Impact on Neighboring Homes and Local Tax Bases by County and State (see endnote 12). CRB applied the state’s share of national losses (18.9 percent in 2005-06) to the nation’s predicted cycle total (18.9% x 2 mil = 377,500).

TECHNICAL NOTES, METHODOLOGY

At the state level, Data Quick (DQ) foreclosures data back to 1988 was modeled to create a projection of DQ history out to 2010. As more data becomes available, updates will be provided. CRB will revise these forecasts, gauge the accuracy of these projections and attempt to reduce the range of the forecasts in future reports.

Growth in foreclosures for the nation, state, and counties was calculated using rough estimation methods. Estimates were created with the spreadsheet program Excel. Furthermore, CRB used the STATA software to test the viability of the more sophisticated multiple regression and statistical models at the state level and concluded that since the history of foreclosures for the state and counties is available only for the last recession cycle (see chart), time series models probably will not produce the most accurate forecasts. It would be best to have data from at least two business cycles.

These more complex models require good forecasts of such variables as median home prices, appreciation, vacancy rates, new starts, plus population and labor force variables. These types of forecasts are expensive and time-consuming to obtain and may not be available for future reports. CRB gained access to Moody's Economy.com data with a trial subscription. The state's Energy Commission purchases metro and state forecasts for \$22,000 per year. Up to five add-on users would be charged \$1,000 annually, should the Commission choose to allow other subscribers at this level. The Energy Commission's subscription covers all 58 counties and metropolitan areas (MSAs).

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