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THIS MONTH

IN CONSTRUCTION SUPPLY

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A handwritten signature in black ink, appearing to read 'Greg Brooks'.

Greg Brooks, editor | 303 845 4880 | Greg@cs24.us

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SPECIAL REPORT: THE FORECLOSURE CRISIS

THIS MONTH

IN CONSTRUCTION SUPPLY

MAR 2010



NIGHT OF THE LIVING DEADHEADS



By Greg Brooks. Everyone knew this was going to be a tough winter. The surprise is that it wasn't worse than it was. In nine of the 12 Federal Reserve districts, [the economy as a whole improved](#) despite major snowstorms that paralyzed large parts of the country in Jan. and Feb. The unemployment rate fell below 10% in Jan. and has stayed there at least so far. 4Q 2009 GDP was originally estimated at 5.7% growth, then revised to 5.9%

But at this point in 1983, annualized housing starts were 70% above their re-

cession low. As of Jan. 2010, annualized starts are still plodding along below 600,000.

Foreclosures continue to stalk the the housing recovery, bleeding REO inventory onto the market and eating away at home prices. Out of the 131 million-odd housing units in the U.S., roughly 57 million are mortgaged. From 2006 through 2009, 7,158,525 properties have received foreclosure filings, according to RealtyTrac. John Burns Real Estate Consulting says we have another [five million to go](#) before we're done.

If so, that would come to 12.1 million filings, or one for every 4.7 mortgaged properties in the U.S. Standard & Poor's thinks it'll take [three years to clear the backlog](#) of unsold REOs (See Market Tracker, p. 3, for state-by-state foreclosure data.)

Foreclosure rates have been falling the past few months, but [delinquencies are rising](#), which raises the possibility that another wave is coming. In this special extended issue of THIS MONTH, we'll take an in-depth look at how the crisis could play out.

It's common knowledge that this mess originated in the subprime market. Home buyers qualified on ultra-low teaser

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rates were duped (or self-duped) into buying homes they couldn't possibly afford once those loans reset. Easy credit drove price inflation until the bubbles finally burst.

Early attempts to reduce foreclosures were aimed at making loans more affordable. Hope for Homeowners, enacted in Oct. 2008, was supposed to help 400,000 people avoid foreclosure. Five months later, just 752 people had applied and only [one loan had been modified](#).

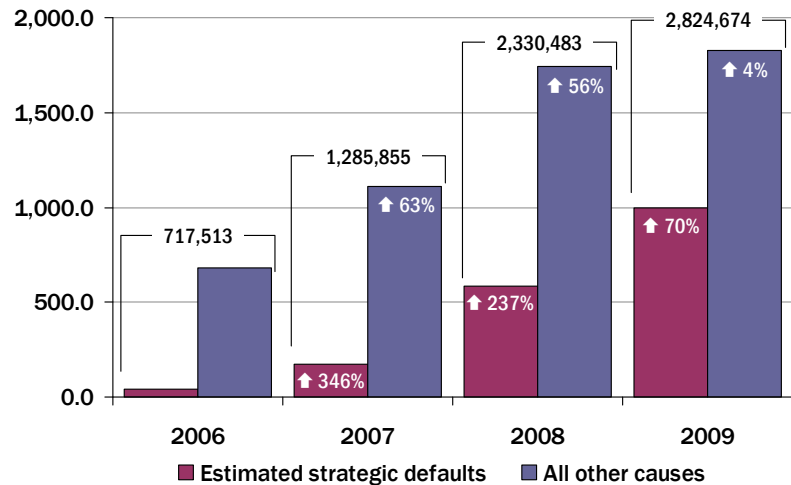
Making Home Affordable was launched in April 2009. It consists of [two programs](#): loan modifications for people behind on their payments and refinancing up to 105% of the home's value for those who are current but underwater. It's limited to loans owned or guaranteed by Fannie Mae or Freddie Mac, but that makes 3.4 million loans eligible.

A [ProPublica study](#) found that as of mid-February, 116,297 loans had been modified, 356,344 were in a three-month trial period, and 474,094 were in limbo: past the trial period but still waiting for lenders to decide whether to make the modifications permanent. That's better, but still not enough to have an impact.

So why haven't more loans been reworked? According to [a 2009 study](#) by the Boston Federal Reserve, the primary reason is resistance from lenders who "expect to recover more from foreclosure than from a modified loan."

Up to 45% of homeowners who receive modifications default a second time, while 30% of those who get behind on their payments and later catch up do it without modification. Lenders reason that renegotiating is either unnecessary or a waste of money.

Properties with foreclosure filings, 2006-9. Sources: RealtyTrac, Wall Street Journal



Chances are subprime-related foreclosures are mostly out of the system now; those loans all reset in 2007 and 2008. The latest twist is the growing number of homeowners who are able to make their payments but walk away because the house is worth less than the mortgage.

Strategic defaults rose from 588,000 in 2008 to an estimated 1,000,000 in 2009, or 35% of all foreclosures. Loan modifications are useless in this situation because the problem isn't the payment – it's the principal.

Some say they should suck it up and honor their commitments. Yes, but...

In 2009, Morgan Stanley defaulted on [five office buildings](#) in San Francisco because it was underwater. The owners of the [largest apartment complex](#) in Manhattan did the same.

Last but not least – but definitely the most entertaining – the [Mortgage Bankers Association](#) sold its Washington, D.C. headquarters for \$41.3 mil-

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lion, just over half the \$79 million purchase price. Asked whether he'd be paying the mortgage off at the closing, MBA's president refused to comment.

Morals are important, but it could be tough convincing people that there should be one set of rules for corporations and another for homeowners.

Meanwhile, 2010 foreclosure projections are all over the board: Moody's predicts 2.4 million. RealtyTrac says 3 million, while Housing Predictor says 4 million.

Just because RealtyTrac and Housing Predictor sell foreclosure leads for a living doesn't mean they're wrong. There are bound to be more defaults by homeowners who can't make their payments. But the trend is positive: up 63% in 2007 and 56% in 2008, but only 4% in 2009.

Assuming unemployment doesn't spike again, non-strategic defaults should remain flat or decline. So the wild card is how many will walk away just because they're underwater.

According to First American CoreLogic, [11.3 million mortgages](#) (24%) were in negative equity at the end of 2009. Within that group, [5.3 million homeowners were 20% underwater](#) while 2.2 million are down 50% or more.

In a 2009 Northwestern University survey, just 17% said they'd walk away even if they were down 50%, and no one would go if they were down 10%.

Plus, the problem is highly localized. According to the National Association of Realtors (see Market Tracker at the right to download the list), 16 markets have fallen 35% or more since 2006; every one of them is in FL, CA, NV, or AZ. Those markets may well lang-

Price trends, 155 metropolitan markets. Source: National Association of Realtors

	2006 - 2009	2009 only
No. of markets with price declines more than 20%	35	3
No. of markets with price declines more than 10%	80	17
No of markets with rising prices	28	67

uish while others see a stronger recovery, but eventually they'll hit a tipping point. The median home price in Ft. Myers is just \$90,100 now – bargain hunters won't stay away forever.

Home prices stabilized in 2009 and even rose in many markets. Prices could fall again if a flood of REOs hits the market, but strategic defaults don't make as much sense if prices aren't falling. In Excel, that's called a circular reference; Excel can't compute it and I can't, either.

State foreclosure laws are another variable. Eleven "non-recourse" states (see p. 5 for the list) don't allow lenders to pursue assets other than the house when they foreclose. An analysis by the [Richmond Federal Reserve](#) concluded that recourse matters most at the high end of the market. If a home is worth less than \$200,000, people will default regardless of their state laws. At \$750,000, they're twice as likely to walk away in non-recourse states.

That's a clue, too. A recent [Nielsen survey](#) found that the most severely underwater zip codes are poorer than most. Average household income is just \$35,000, home values average \$103,000,

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MARKETTRACKER

See how your market stacks up against the rest of the U.S. at [CS24.us](#). Sign-in required; [click here](#) for your passcode.

[Underwater mortgages by state and MSA](#). 4Q 2009 negative equity report from First American Core Logic for each state and the top 50 metro markets.

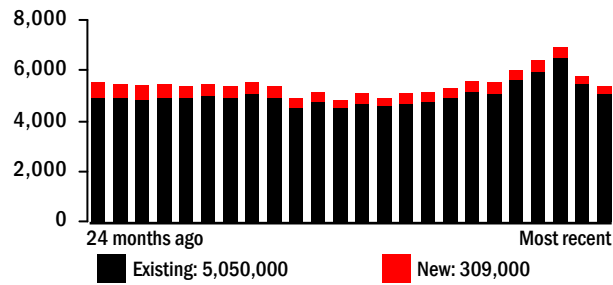
[State-by-state foreclosure data](#). Annual data by state from 2006 through 2009, from RealtyTrac.

[Median home prices by market](#). Prices from 2007 - 4Q 2009 for 159 metro markets from the National Association of Realtors.

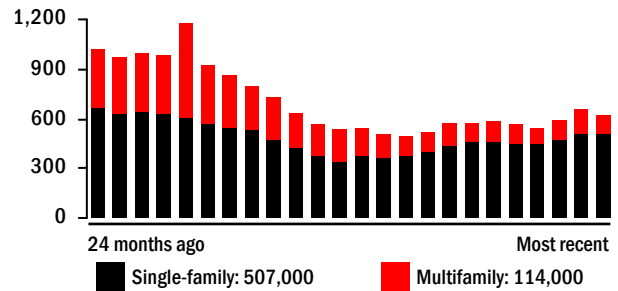


VITAL STATISTICS

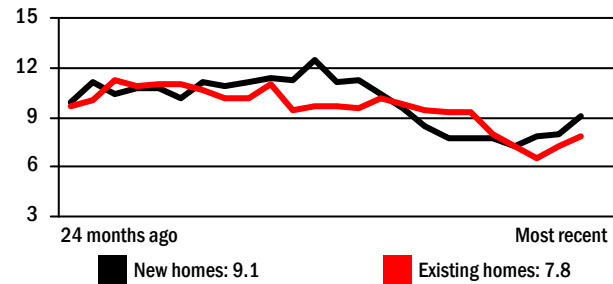
ANNUALIZED HOME SALES (000)



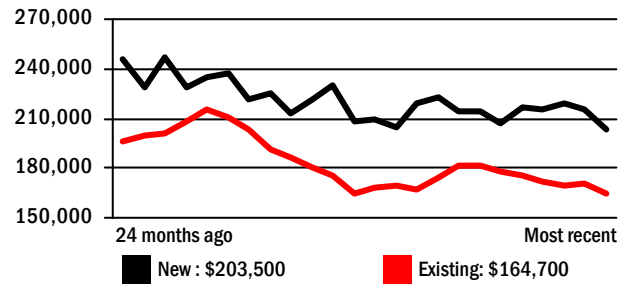
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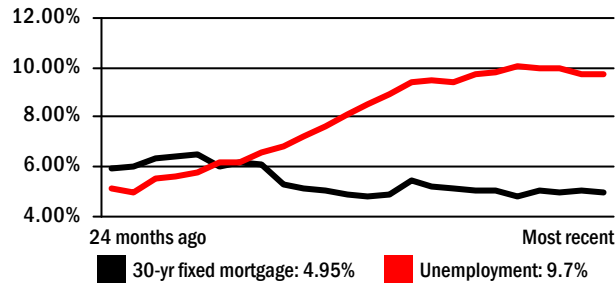
MONTHS' UNSOLD INVENTORY



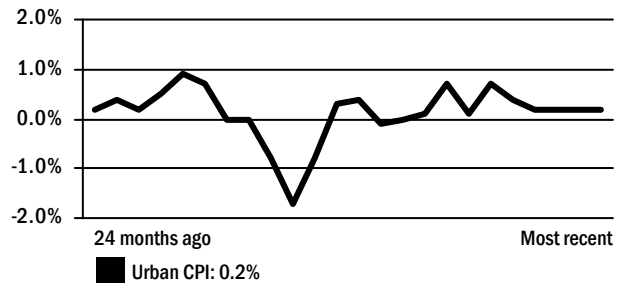
MEDIAN HOME PRICES



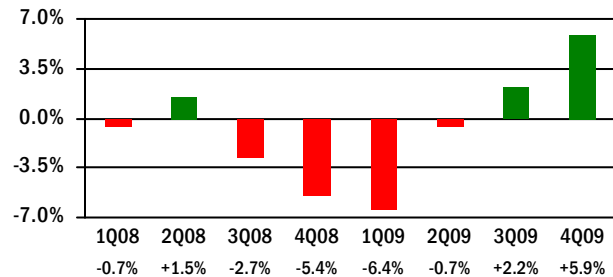
MORTGAGE & UNEMPLOYMENT RATES



INFLATION RATE



GDP CHANGE VS. PREVIOUS QUARTER



[Download current spreadsheet at CS24.us](http://CS24.us)

Sources: U.S. Census Bureau, National Association of Realtors, Freddie Mac, U.S. Bureau of Economic Analysis, U.S. Department of Labor. Data compiled by





(Continued from page 3)

and the homeownership rate is just 46%, all well below U.S. averages.

The hardest-hit markets are in the Sun Belt, but not just bubble states. The Mid-South and the Carolinas are down as much as California or Florida, and secondary markets are down as much as major metros (get the map [here](#)).

So where do we go from here? The latest government program is designed to expedite repossessions if modifi-

cations won't work. When [Home Affordable Foreclosure Alternatives](#) (HAFA) launches in April, lenders will offer a short sale (forgive the difference between the sale price and the mortgage balance) to homeowners who try for a loan modification but don't qualify.

Short sales don't trash a borrower's credit score and they save lenders big bucks; foreclosure processing costs alone can run up to \$40,000.

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Leading indicators. Four measures can help determine which states are likely to see the highest foreclosure rates: 1) the current foreclosure rate (HU filings), 2) percentage of mortgages in negative equity or within 5% of it (Neg equity), 3) how far underwater those mortgages are (LTV, or loan-to-value ratio), and home price trends during the past year (1-yr \$ chg). Green cells indicate data better than the U.S. average; red cells are worse. Non-recourse states are in bold.

Sources: First American CoreLogic, Federal Housing Finance Agency, RealtyTrac, Richmond Federal Reserve

State	HU filings	Neg equity	LTV	1-yr \$ chg	State	HU filings	Neg equity	LTV	1-yr \$ chg
Alabama	0.69%	13.4%	65%	2.14%	Montana	0.32%	10.2%	57%	-2.60%
Alaska	0.84%	14.8%	67%	-2.81%	Nebraska	0.43%	13.6%	72%	2.09%
Arizona	5.93%	55.4%	95%	-12.74%	Nevada	10.17%	72.9%	123%	-17.29%
Arkansas	1.29%	18.7%	74%	1.52%	New Hampshire	1.08%	24.8%	69%	-0.54%
California	4.75%	39.0%	72%	-0.44%	New Jersey	2.01%	20.4%	62%	-3.66%
Colorado	2.72%	28.1%	72%	2.76%	New Mexico	0.74%	16.9%	66%	-4.52%
Connecticut	1.49%	15.5%	58%	-3.13%	New York	0.80%	8.5%	49%	-0.87%
D.C.	1.29%	20.6%	59%	-3.80%	North Carolina	1.06%	16.6%	70%	0.34%
Delaware	0.78%	19.2%	69%	-0.30%	North Dakota	0.21%	10.6%	60%	1.23%
Florida	6.12%	51.6%	91%	-8.18%	Ohio	2.61%	26.2%	75%	0.98%
Georgia	2.68%	35.8%	80%	-1.18%	Oklahoma	0.87%	9.1%	70%	3.53%
Hawaii	1.12%	12.6%	53%	-13.09%	Oregon	1.59%	21.5%	68%	-7.43%
Idaho	2.12%	27.7%	72%	-6.61%	Pennsylvania	0.82%	10.7%	62%	-0.53%
Illinois	2.50%	26.0%	72%	-4.79%	Rhode Island	1.37%	20.0%	55%	-0.73%
Indiana	1.87%	15.3%	69%	1.71%	South Carolina	0.93%	19.3%	70%	1.41%
Iowa	0.46%	13.4%	66%	0.65%	South Dakota	0.17%	NA	NA	1.56%
Kansas	0.63%	16.2%	70%	1.48%	Tennessee	1.78%	20.9%	71%	-0.62%
Kentucky	0.51%	14.3%	67%	1.62%	Texas	1.33%	18.1%	70%	0.83%
Louisiana	0.63%	NA	NA	0.72%	Utah	2.37%	27.4%	73%	-7.65%
Maine	0.43%	NA	NA	0.97%	Vermont	0.05%	NA	NA	-1.25%
Maryland	1.81%	27.8%	69%	-5.49%	Virginia	1.38%	30.0%	72%	3.07%
Massachusetts	1.49%	19.4%	61%	-0.27%	Washington	1.24%	21.4%	67%	-5.23%
Michigan	2.93%	44.4%	85%	-2.76%	West Virginia	0.13%	NA	NA	-2.67%
Minnesota	1.21%	21.5%	65%	-0.97%	Wisconsin	1.14%	19.9%	68%	-0.12%
Mississippi	0.24%	NA	NA	-1.65%	Wyoming	2.00%	NA	NA	-5.99%
Missouri	1.38%	21.2%	71%	0.03%	USA	2.21%	28.6%	70%	-1.21%



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One reason borrowers default is that a short sale doesn't get them off the hook for a second mortgage. HAFA will pay \$1,000 to second-lien holders who relinquish their claims – plus \$1,500 to defaulters to help them move.

Wait a minute: The government is paying defaulters? Actually, so are banks. [CitiMortgage will pay you \\$1,000](#) and let you stay in your (their) home rent-free for six months if you'll agree to leave peacefully after that.

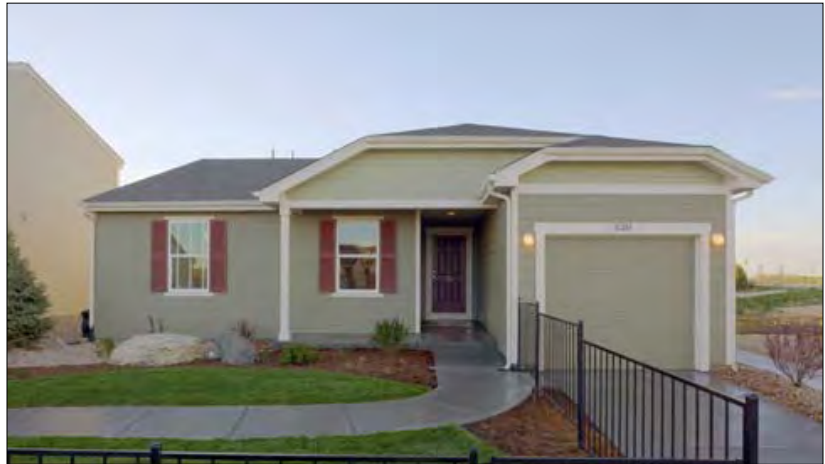
The reason is that vacant homes make excellent piñatas. By some estimates, up to 50% of REOs have been vandalized and we're not talking toilet paper in the trees. Thieves not only take appliances and furnaces, they rip out the plumbing and wiring to get the copper.

The problem is big enough that CitiMortgage isn't even the best deal out there. [100,000 former homeowners](#) in the Inland Empire east of L.A. are living rent-free – some for nearly two years – while banks look the other way because they know foreclosed homes are safer with someone in them.

[Squatters' organizations](#) around the country are moving families into foreclosed homes with little or no resistance from banks or police for the same reason. They change the locks, get the utilities turned on, even order high-speed Internet access. They also mow the lawn and take out the trash.

When the crisis first hit, there was a lot of talk about "cramdowns:" giving judges authority to reduce the principal to keep homeowners in their homes. Banks wouldn't hear of it. They argued that the rule of law was at stake; if a judge could alter mortgages, the sanctity of all contracts was in jeopardy.

KB Home's Open Series Bristol: 917 sq. ft., 2 br/2 ba, \$141,997 in Denver, Source: KB Home



They're probably correct. But between vandalism, squatters living rent-free, and the backlog in processing foreclosures, lenders are getting free-market cramdowns that may ultimately cost far more than judicial intervention. If they dump REO inventory quickly – assuming that's even possible – prices will fall that much faster. Bleed it out slowly and those homes continue to lose value every day until they're sold.

Meanwhile, the marketplace is making its own end run. Multifamily builders are gearing up for [a surge in apartment construction](#). Single-family builders like KB Home are building new homes designed to compete with foreclosures on price. And oh, by the way, they also carry Energy Star labels.

It's possible we'll see another surge in foreclosures, but there are also signs that lenders are reaching a point of diminishing returns that may cause them to lose their appetite for home-flipping.

In the meantime, keep your eye on the remodeling business. There's going to be a lot of it. ☺



Greg Brooks, editor of THISMONTH, is a 42-year veteran of the

construction supply business with 20 years' experience in the field. Brooks is a former editor of *ProSales*, a steering committee member at the Harvard Joint Center for Housing Studies, and author of *Scope of the LBM Industry*, published by the National Lumber & Building Material Dealers Association.

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