Nobody's Home

Weighing the prospects for neighborhoods hit hard by foreclosure

BY RENEE COURTOIS

In some of the nation's neighborhoods, the height of grass is a serious economic indicator. "The first indication we have that a house is vacant is that a neighbor will call about tall grass and weeds," says Liz Via-Gossman, director of community development for the city of Manassas, Va.

The eyesore of unkempt lawns has helped the city detect properties that have become vacant as a result of the housing downturn and foreclosure crisis. The City of Manassas received about six tall grass complaints in 2007. By halfway through 2008, when foreclosures had really begun to mount around the country, it had received 277.

Manassas is one of the areas hit hardest by the foreclosure crisis in the Fifth District, together with the nearby city of Manassas Park and surrounding Prince William County. All are located just southwest of Washington, D.C. Prince William's foreclosure rate is about double that of Virginia as a whole.

What has been left behind by the nationwide housing downturn is a record number of vacant homes throughout the country: nearly 19 million housing units, according to Census estimates, about 14 percent of total housing units. To be sure, many of those empty homes are for sale through the usual process, while others are seasonal homes or those listed for rent.

But by all accounts, a larger number of homes than ever before are vacant as a result of the severe housing downturn. Most notorious are those in the process of foreclosure or in real-estate ownership (REO) at banks or other financial institutions. REO homes are foreclosed properties from which the borrower has been fully extricated. The title has reverted to the lender or, increasingly, a loan servicer hired to manage a pool of properties on behalf of investors in a mortgage-backed security. Yet, in some cases, homes become vacant prior to foreclosure because the resident has simply given up on the mortgage and walked away.

Many foreclosed homes are listed for sale, sometimes in a market saturated with other for-sale properties, which can depress local house prices if there are enough of them. The health of the local housing market largely determines whether a foreclosed property is maintained: If the cost of maintenance exceeds the net return from the sale of the property, the home runs a greater risk of being neglected. The net return depends on the value of the house and the loan-to-value ratio.

Such homes will lack cosmetic maintenance or exhibit more serious structural damage. Others can be damaged by normal seasonal patterns. Because some are not properly winterized, pipes can freeze and burst in cold weather. Vacant homes without electricity won't have operating sump pumps, and the undrained rainfall can result in mold growth.

The surrounding neighborhoods can also suffer from foreclosure since empty and decaying homes impose an externality. High numbers of vacancies may bring down the value of surrounding properties. If not maintained, these abandoned homes may provide a signal about the area's desirability to potential buyers. Some research has also linked high numbers of foreclosures to crime, fire, and the resulting strains on local government resources — though the connections here may be tenuous in some cases.

It's not that foreclosure necessarily leads to deterioration of a home and the neighborhood in which it resides. In areas that haven't experienced a large number of foreclosures, a foreclosed property is more likely to be cared for and resold before long. Many foreclosures concentrated in one area, on the other hand, can imply broader economic strain, residents' declining commitment to the neighborhood, or a misalignment of lenders' and borrowers' incentives to produce the best possible outcome for the home and neighborhood. Those are the places in which a local foreclosure problem is more likely to result in neighborhood blight.

A Tale of Two Crises

There are generally two types of areas heavily affected by foreclosure. The first is the archetype of the housing boom and bust: areas like Phoenix, Las Vegas, and interior California that experienced massive amounts of new building. Many buyers in these areas based their purchases on what seemed at the time to be reasonable expectations about future income and house price appreciation, but those expectations often did not prove correct.

The second story is one of structural economic decline that started long before the housing boom and bust, with populations abandoning urban cores and, in many cases, the region as a whole. In areas like Cleveland and Detroit, the foreclosure incidence can be timed not with the fall in housing prices, but with the acceleration of the decline in manufacturing employment around the turn of the millennium. The Fifth District is home to both types of areas, including supply-ridden Charleston, S.C., and parts of the Washington, D.C., area, and regions with longer-term struggles like Baltimore and much of South Carolina.

This is a simplification, of course, since many areas are affected by both the housing bust and economic woes. The

When no foreclosure has been completed, complaints about overgrown lawns can be the first signal to cities that a home is abandoned, like this Prince George's County, Md., property.

Multiple adjacent homes await buyers in this Fairfax, Va., neighborhood.

PHOTOGRAPHY: STEVE SANDERFORD (TOP) AND COURTNEY MAILEY

housing downturn surely exacerbated the economic problems of depressed Ohio and Indiana. And job loss due to the recession has been a surefire way to push Phoenix and Miami homeowners into delinquency. In both types of areas, subprime lending and the credit boom helped get many borrowers into houses they couldn't sustainably afford.

For areas in longer-term economic decline, today's abandonment problems may feel a lot like the shrinking industrial centers of the late 1960s and through the 1980s. For these areas, the decline has been merely exacerbated by the foreclosure crisis and recession. But the nation's more recent neighborhood abandonment problems also have some new elements. For the first time, abandonment seems to be affecting neighborhoods whose economic prospects are mostly viable in the long term, and are still intrinsically desirable places to live.

Though there is abundant research on the problems that abandoned homes can pose for surrounding communities, there is a lack of hard data about where vacancies and foreclosures have begun to deteriorate neighborhoods. "The problem is, there's no way to really track this kind of information except going out physically with a clipboard or handheld computer and documenting it," says Alan Mallach, a senior fellow at the Brookings Institution. "You can track foreclosures because every time somebody forecloses a record is created. But nobody creates records about vacant and abandoned properties. So there's no overall way of getting a handle on it."

Still, to get the best sense of the scope of the blight problem you should look at cities where the foreclosure incidence is highest (see map on page 24). The comparison isn't perfect, however, since not all foreclosures result in long-term abandonment and decay. But what's clear is that foreclosures, which can be associated with long-term vacancies, are no longer occurring primarily in decaying urban cores: They are simultaneously affecting small cities, suburbs of big cities, and rural areas.

In the absence of hard data on the problem, local practitioners do the best they can to keep track of and treat vacant and decaying properties, Via-Gossman says. "I would suspect when the spring rolls around and we hit that grass season, then we'll get this year's picture about where we are with vacancies."

The Choice to Foreclose

The severity of the housing crisis is redefining what economists know about the causes of foreclosure.

When economists think about a homeowner's decision to default on a mortgage, they borrow from what is called "option price theory." An option is a security that entitles the owner to buy or sell an asset in the future at a predetermined price. A "put" option is useful when one expects the price of the underlying asset to decrease: The holder can sell it for a higher price than one would be able to get on the market. A homeowner's ability to default on a mortgage is like a put option when the home's value is falling, since one is effectively selling the house to the lender.

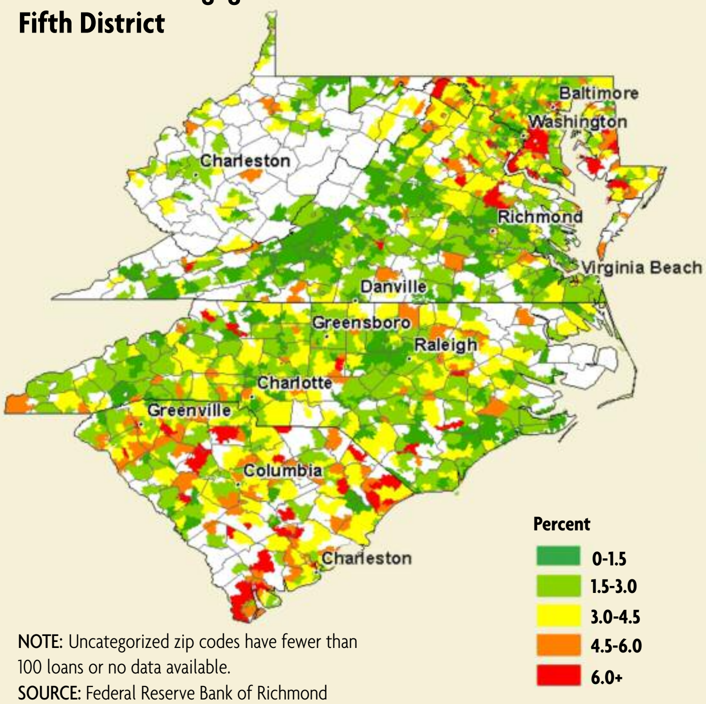
Applying the most simple option model to the housing market would lead to the conclusion that every homeowner would default on his mortgage the instant the market value of his house falls below what he owes on it — a seemingly alarming prediction given estimates that a quarter of all homeowners are currently "under water" on their mortgage. The reason we haven't seen defaults quite that catastrophic is that in reality there are transaction costs to walking away, as well as a number of personal considerations.

But many of the deterrents from walking away are less present in areas where local house prices are still falling or the neighborhood has already seen a large number of foreclosures. This has led to a growing number of "strategic defaults" in which borrowers are technically able to afford the mortgage, but choose to walk away because they view the home as a losing investment that will never pay off.

Moral obligation, the stigma attached to default, and emotional attachment to one's home all may prevent someone from walking away. But all three are being eaten away by the extreme conditions of the current housing market, says economist Luigi Zingales of the University of Chicago. Some people may feel less of a moral obligation to make good on their debts if they are severely under water. ("There is a price to morality, and when the price becomes too high you default anyway," he says.)

People who bought homes as an investment, more com-

Percent of Mortgages in Foreclosure/REO in the Fifth District



NOTE: Uncategorized zip codes have fewer than 100 loans or no data available.
SOURCE: Federal Reserve Bank of Richmond estimates using data from Lender Processing Services (LPS) Applied Analytics (November 2009) and Mortgage Bankers Association (2009:Q3)/HaverAnalytics

mon during the housing and lending boom, especially in areas currently most afflicted by housing oversupply, don't face the transaction and emotional costs of moving. "Second homes and especially investments are where people look at their choice to buy a house in a strictly rational or financial way, and it's much more likely that they will walk away when there's not the emotional investment that there is in their main residence," Zingales says.

And people are more likely to walk away when they know one or several people who have defaulted strategically. "If everybody does it then it becomes socially acceptable," Zingales says. A 2009 study by Zingales and economists Luigi Guiso and Paola Sapienza collected survey data that indicate people who know someone who has defaulted strategically are 82 percent more likely to say they'd be willing to also default strategically should they find themselves severely under water. "There might be some critical point beyond which the social stigma breaks down, and then defaults spread like wildfire," he says.

Given that the costs to borrowers of walking away appear to be diminishing, it is not surprising that lenders face a tough choice when deciding whether to help a borrower avoid foreclosure by modifying the terms of their original mortgage. It is often in the best interest of the counterparty to a mortgage to avoid foreclosure. So if foreclosure seems imminent under the existing mortgage terms, lenders may be willing to modify them for the borrower, by reducing the interest rate or principle, for example.

Of course, modifying a mortgage reduces the expected return from the mortgage for the lender, but under certain circumstances it may still be worthwhile. If the state does not have "recourse" laws — which allow the lender to go after a borrower's other assets in the event of default — then lenders may be more willing to modify the mortgage to avoid foreclosure. This has an influence on the borrower's incentives too. Research by City University of New York economist Andra Ghent and Richmond Fed economist Marianna Kudlyak found that recourse laws are a powerful deterrent to foreclosure since they increases the cost to borrowers of walking away.

But lenders who do offer modifications face an adverse selection problem since mortgages that are modified tend to have a high re-default rate, according to a study by Boston Fed economists Manuel Adelino, Kristopher Gerardi, and Paul Willen. Some loan modifications will simply delay the inevitable. Since lenders know this, and there is no way to know in advance who will prove to re-default, it may reduce their willingness to modify loans for everyone. This may partially explain why relatively few mortgages nationwide have been modified so far.

From Vacancy to Blight

The health of the local housing market in part determines the fate of foreclosed homes in an area. Therefore, whether an area's economic prospects are generally weak or strong is a key determinant of whether a high foreclosure rate evolves into a broader problem of neighborhood decay. Unfortunately, the lenders' incentives once foreclosure is imminent are not always aligned with the health of the neighborhood.

"What the lender wants to do is dispose of the property in a way that maximizes its return," says Guhan Venkatu, an economist at the Cleveland Fed. A foreclosed property generates no income and is costly to maintain. So in most cases, the lenders' incentive is to minimize the amount of time that a vacant property is sitting on their books.

Expediting foreclosure is not always an option for the lender. Some states have a "judicial" foreclosure process in which foreclosure requires a court action. In those states foreclosures take much longer and are administratively costlier to the lender. Perhaps more importantly, Venkatu says, it imposes less flexibility on the lender to make the decision that maximizes the value of the property for them.

Dragging out foreclosure, on the other hand, may also be an option. In areas hit by many foreclosures, the prospects for reselling property at a reasonable price may appear more dismal to lenders, providing an incentive for them to delay the foreclosure process.

"They're just letting the process slow down," Mallach says. Instead of initiating foreclosure when a home becomes 90-days delinquent, when foreclosure legally becomes a possibility, he says they might wait 180 or 210 days, or longer to help them wait out the market. And since in these cases eventually selling the property is the goal, he says the lender sometimes doesn't want it vacated and subject to decay. "I've heard in some cases that some lenders will actually call up the homeowners and say, 'Please don't leave the house. Stick around. We know you're not paying.'"

Mallach says it lacks a catchy name so far, but the phenomenon is what those in the industry are calling a "shadow REO inventory." "That means this huge inventory of properties that could become REO properties but aren't because the servicers are not pushing to finalize the process that would turn them into REO properties." Some estimates claim these properties number in the millions.

Observers in the industry have also noted a new occurrence in which lenders and loan servicers who have acquired properties through foreclosure withhold those homes from the market for fear of depressing prices further in an already supply-saturated area.

Dragging out foreclosure and withholding REOs from the market can make the housing statistics appear rosier since it could lead to an underestimation of supply. It also lengthens the market adjustment process, and masks how many homes are, or will eventually be, on banks' balance sheets.

In the very worst areas, mortgage defaults become the city's problem. If the prospects for reselling the property are extremely poor, the cost of foreclosure and maintaining the property may exceed the value the property holds for the lender. In the case of so-called "toxic titles," the tenant has defaulted and vacated the house, but the lender never completes the process to take legal ownership. This leaves the property in a state of legal limbo: The lender holds the lien, but the tenant technically owns the home. Meanwhile, the house sits empty and often deteriorating or subject to vandalism, with no steps being taken to bring it back to market. Toxic titles are most likely to be found in very low value areas where the market is essentially nonexistent, Mallach says.

The Status of Distressed Homes

Delinquent: Mortgages for which the borrower has ceased mortgage payments. Typically, foreclosure can be initiated after 90 days of delinquency.

In Foreclosure: Properties for which the foreclosure process has been initiated. There is no national standard for length of the foreclosure process.

Bank owned or REO (real estate owned): Properties that have gone through the foreclosure process (i.e., the homeowner is fully extricated from the loan) and are now owned by the lender or the trust that has purchased the mortgage as part of a mortgage-backed security.

Vacant: A home that, for whatever reason, is not legally occupied. Most foreclosed and REO properties are vacant, although not all vacant homes are in foreclosure or REO. Sometimes the borrower has given up on the mortgage and vacated the property.

Toxic titles: Homes for which the borrower has ceased mortgage payments and vacated, but for which there is no immediate intention to foreclose. The foreclosure process costs more than the home is worth on the current market, so for a lender or loan servicer it makes better financial sense to walk away than to complete the foreclosure. The result can be homes with unclear legal ownership. These exist in areas where the housing market is especially weak.

Stabilization and Revitalization

Neighborhood stabilization is the key to neighborhood recovery, according to Mallach. He defines a stable market as one in which homeowners and potential buyers feel their investment is secure. "If you have a neighborhood that has been losing ground and people in it are basically just hoping to move out, and nobody in particular is eager to move in, if you start to see a significant number of foreclosures it's likely to have a much more dramatic effect than the same number in a neighborhood that is still seen by its residents, and by other people in the region, as being desirable."

The federal government has devoted funds to help deal with vacant and abandoned homes. The federal Neighborhood Stabilization Program (NSP) directs funds (about $6 billion in total under the 2008 and 2009 economic recovery acts) to local governments and community developers to try to stem falling home values in areas already hit hard by foreclosure.

The funds could be used for a number of things that try to maintain or improve the condition of abandoned properties. Funds can help community organizations purchase and rehabilitate deteriorated homes, for example, or establish "land banks" (local legal entities that hold vacant, abandoned, and foreclosed properties and transfer them back to productive use). The money also can fund incentives to get homeowners into empty homes.

Community organizations and local governments have found it hard to implement NSP funds, however, for a variety of reasons. Among the largest is difficulty identifying the current owner of the mortgage. Only the original lender is listed in the loan documentation, whereas most mortgages today are sold after initiation in secondary mortgage markets and ultimately to large groups of unnamed investors. The loan servicers who represent these investors may be located in a completely different region, and thus have no expertise on the local housing market in question, and may have any number of other distressed properties they are also managing. And in the case of toxic titles, it takes legwork and legal expertise to determine who owns the property.

Even when the loan servicer is identified, they often have limited discretion when dealing with resale of the property. Service agreements obligate them to maximize the value of the trust for the investor owners, but these agreements were written in a dramatically different housing market environment in which it would have been hard to imagine the discounted sales of distressed properties to local governments and nonprofits.

There is no reason to believe that overbuilt neighborhoods must stay empty forever. Venkatu sees an analogy between fundamentally desirable neighborhoods and the vast expansions and oversupply of fiber-optic capacity during the late 1990s tech boom. "It's not like that stuff doesn't get used," he says. "It gets used — it just gets sold at a loss." At some point these new developments — which for now look more like movie sets than neighborhoods — will start to look attractive to buyers.

Not all homes will be candidates for resale. In economically declining areas that are rapidly losing both jobs and residents, the strategy of community organizations buying and rehabbing homes nicely and trying to sell them would almost certainly be a failure. "And in fact, it should be," Mallach says, "because it's crazy to spend that kind of money or try to entice people into a neighborhood that may be already three-quarters empty," he says.

That may be where there is potential to find alternative uses for vacant homes, from rental units to office space or, at the extreme, razing the property to use the land for something else. But this requires new strategic plans for the community at a time when local governments are being stretched thin. When faced with the choice of spending resources to convene local community organizations and neighbors to gain consensus on the direction of an abandoned property, or funneling those resources to programs that attract jobs, the latter often seems to be the priority.

And perhaps that's for good reason. Job opportunities are a large part of what will make neighborhoods hit hard by foreclosures once again desirable places to live. For many areas affected by foreclosure, economic recovery that brings strong employment prospects and income stability, as well as a well-functioning housing market, may be the quickest path to community revitalization. **RF**

Readings

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along with proposals to adjust the population figures afterward using statistical sample results.

"The methodology in 2000 could not be shown to be an improvement over the actual enumeration," Anderson says. "You have to argue that it is better, not just that it's different, and there are big arguments over what better means — numerical accuracy, distributive accuracy, all of which get tangled up in the politics of it."

Anderson further explains: "There were two approaches; one was that the Census Bureau should improve the method to reach everybody and the other was that it's more efficient and potentially more accurate to use statistical methodology." Many statisticians and demographers believe the sound methodology of sampling techniques could provide more accuracy, but the two main political parties have staked out opposite positions. That has made compromise unworkable. Not surprisingly, the census has become a political issue. Republicans have tended to favor unadjusted counts while Democrats tend to support adjustments. Most Americans, Anderson says, don't object to sampling, but do worry about the possibility of political machinations behind technical matters that are hard to understand.

In any case, methods for counting people are likely to always be an imperfect way to capture the scope of a constantly evolving nation. The controversies over how we count may be as recurrent as the decennial census. **RF**

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