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Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK *of* CLEVELAND

Making Financial Markets Safer for Consumers

INSIDE:

How to Rein in Systemically Important Institutions

The Curious Case of Cleveland's Foreclosure Rate

Q&A with Urban Economist Matthew Kahn

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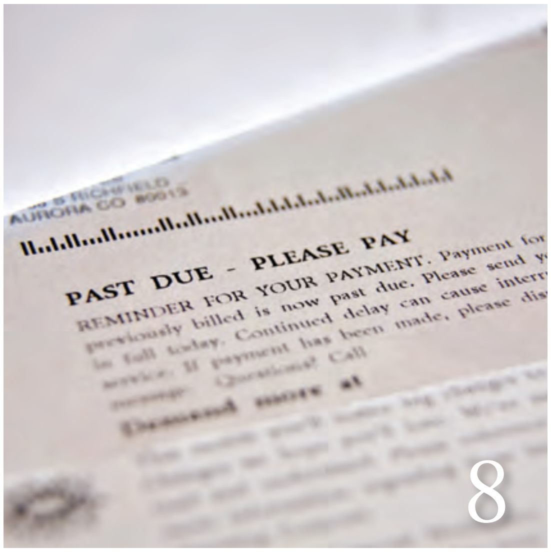

Forefront
Federal Reserve Bank of Cleveland
PO Box 6387
Cleveland, OH 44101-1387

forefront@clev.frb.org
clevelandfed.org/forefront

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The Foreclosure Timeline: The Curious Case of Cleveland's Foreclosure Rate

Timothy Dunne,
Professor of Economics,
University of Oklahoma

Guhan Venkatu,
Economist,
Federal Reserve Bank of Cleveland

The foreclosure process—from the initial filing to the sheriff's sale of the home—is expected to take about seven months in Ohio. But for a time in the Cleveland metropolitan area, it wasn't unusual for foreclosure proceedings to drag on for more than a year ... or even two. Cleveland is well known for its high foreclosure rate, but less so for its lengthy foreclosure process. Economists Tim Dunne and Guhan Venkatu thought that not enough attention was being paid to the latter, and to its importance in determining the foreclosure rate. The average time for a foreclosure episode also has implications for borrowers trying to resume payment on delinquent loans, as well as for individuals considering acquiring a new mortgage.

The Foreclosure Process

The foreclosure process has become all too familiar in Cleveland. By the early 2000s, several years before the foreclosure crisis swept across the rest of the country, the region was already reeling.

Cleveland's reputation as the epicenter of the housing crisis is known far and wide. Between 2005 and 2008, the metro area's average foreclosure rate for prime fixed-rate loans was 2.33 percent, and for subprime fixed-rate loans, it was 10.5 percent. Both of those rates were twice as high as in Cincinnati and Columbus areas during the same period, and 35 percent higher than the average in Ohio.

Economists Dunne and Venkatu wanted to understand what might be driving the differences in these rates, and approached the issue as they would approach questions about the unemployment or poverty rate. For example, a 12 percent unemployment rate could be driven largely by high numbers of workers churning in and out of joblessness in relatively short time spans, or it could reflect a large stock of workers unable to stay employed for longer spells. The same holds true for foreclosures: A high rate might mean that large numbers of properties could be moving in and out of foreclosure very quickly, or it could mean that relatively smaller numbers of properties are trapped in foreclosure for lengthy periods.

To Dunne and Venkatu, a high foreclosure rate was one thing. But understanding why it was high would allow policymakers to target their responses effectively. After all, the appropriate policy response to foreclosures may be different in situations where there is large churning of properties in default versus large numbers of properties simply held in the process for long periods of time.

Here is what they found: From 2005 to 2008, Cleveland's average monthly foreclosure start rate for prime fixed-rate loans, at 0.22 percent, was surprisingly close to that of Cincinnati and Columbus, at 0.17 percent. So why was the overall foreclosure rate doubly large in Cleveland? Dunne and Venkatu discovered the answer in the foreclosure transition rate, which measures the speed at which mortgages exit the foreclosure process. The lower the transition rate, the longer a mortgage slogs through the foreclosure process. In Cleveland, the transition rate for prime fixed-rate loans was 9 percent, versus about 13 percent for both Cincinnati and Columbus. Put another way, properties in Cleveland took 30 percent longer to finish the foreclosure process than their counterparts in Cincinnati and Columbus.

So Cleveland's relatively higher foreclosure rate can be tied directly to the length of the foreclosure process there. If that process were as short as in Cincinnati, Cleveland's foreclosure rate would drop by a third. "You've got to think about both of those flows [the number of mortgages entering and then exiting the process] to get a sense of what's driving the rates," Venkatu said.

Why Is Cleveland's Process Longer?

Dunne and Venkatu then considered the possible reasons that the foreclosure process took longer in Cleveland. One explanation has to do with the severe economic hit Cleveland has taken in recent years. Its weaker housing market means that properties often appreciated very little. This means that many borrowers may not have been able to pay off their lender by selling their new home (if they could find a buyer), and that they likely wouldn't be able to refinance their existing mortgage. Loan modifications may also be less practical in a weaker housing market, because the borrowers themselves may be less equipped to shore up their credit if they have lost their jobs, and their prospects for finding a new one aren't as great as they might be elsewhere.

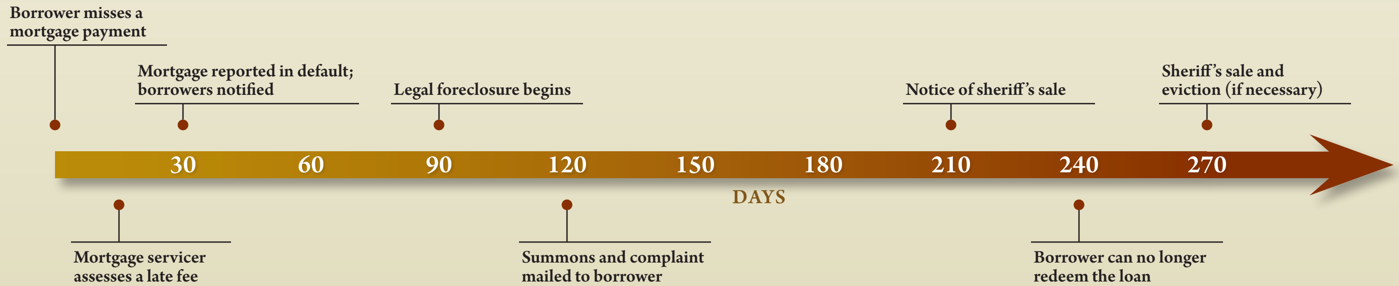
All of these differences correlate with foreclosure lengths, but not as much as the variation in foreclosure statistics would suggest. Dunne and Venkatu now believe that it boils down to an administrative issue—the courts in Cuyahoga County, where Cleveland is located, were overwhelmed and underequipped with technology to process cases in a timely manner. This is evident when examining neighboring counties in the Cleveland metro area. Cuyahoga County's foreclosure transition rate was 7.3 percent, compared with an average 12.2 percent across its four neighboring counties in the Cleveland metro area.

"We ended up with this persistent story about Cleveland, corroborated by city officials, that it's a matter of the administrative process," Venkatu said. "Also, the county courts enforce state foreclosure laws—that's why we focused on counties. You see that in the outlying counties, the issue goes away."

The Foreclosure Process

A foreclosure generally works this way (though the process differs from state to state): First, a borrower misses a mortgage payment. Within 15 days, the mortgage servicer assesses a late fee. After a month, the mortgage is reported as in default. The servicer sends several letters to the homeowner offering mitigation opportunities, and at the 90-day mark, legal foreclosure begins.

By month four, a summons and complaint are mailed to the borrower. A minimum of 90 days must elapse before a sale is held, plus a 30-day period after the sale when the borrower can still "redeem" the loan. Otherwise, the former homeowner is evicted. If nobody buys the house, it reverts to the lender, becoming a real-estate-owned (REO) property.

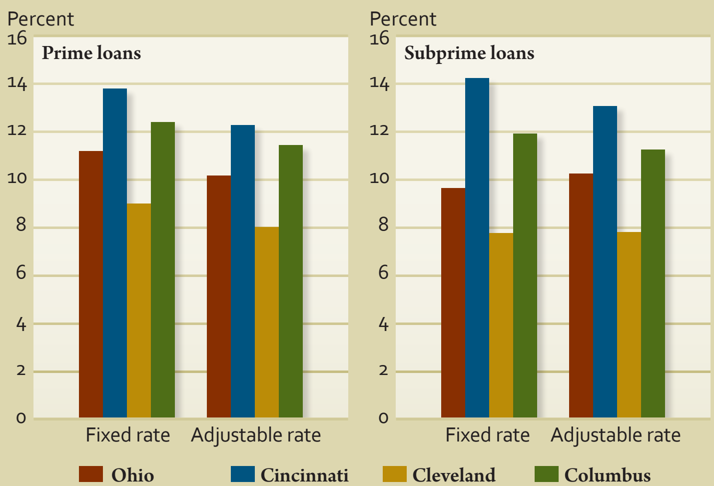


What's Normal?

What is an optimal length for the foreclosure process? Laws and procedures vary by state. The current average length is about one year between the due date of the last payment made and the sheriff's sale. Researchers with Freddie Mac put the "sweet spot" at four months—which is really closer to nine months after adding in five more months for workout efforts.[1] They note that most foreclosures associated with prime loans are mitigated early in the process, either because borrowers are able to regroup and restart payments or because lenders aggressively attempt loan modifications.

Cleveland Lags:

Average Monthly Foreclosure Transition Rate, June 2005–January 2008
The lower the transition rate, the longer the foreclosure process



Note: Rates are for metro areas.
Source: Dunne and Venkatu.

The longer the process drags on, however, the more costs mount and borrower incentives increase to continue missing payments and essentially get free rent on homes they know they will soon lose, the Freddie Mac researchers argue. Regions with longer foreclosure timelines may not be providing proper incentives for borrowers to act early with servicers on alternatives. Four months is a period "in which the borrower's incentives are aligned with both a high probability of curing out of the foreclosure and keeping the pre-foreclosure costs to the investor contained," the researchers conclude.

The likelihood of reinstating diminishes as the time in default (not necessarily the time in legal foreclosure) grows because the people who can't reinstate right away are the people with the worst income prospects. Moreover, lenders can vary the timing of foreclosure actions to maximize the chances the borrower will be able to restart payments.

But in some instances, the borrower has already left the property, whether for lack of income or lack of interest in maintaining it. These are cases that create the opportunity for the vacant property to fall into disrepair.

Over the long term, there is evidence that regions with longer foreclosures feel the impact in the cost of credit. Lenders may actually factor in the length of the foreclosure process in pricing their mortgage terms, a Federal Reserve researcher concludes.[2] The upshot is that a community's very reputation for lengthier foreclosures may raise costs for all borrowers in the community.

So we are left with a complicated tangle of policy implications. A foreclosure process that is too short risks leaving behind borrowers who might otherwise be able to work out new loan terms and keep their homes. Too long, and the process provides a free ride to disinterested borrowers.

Foreclosures are also related to vacancy and abandonment. And once vacant, homes drive down neighboring property values and invite crime and further deterioration around them.

Policy Decisions

Whether to take the foreclosure process fast or slow depends on the borrower and property in question, says Lou Tisler, executive director of the nonprofit Neighborhood Housing Services of Greater Cleveland. In some instances, the owners quickly vacate their homes and the properties deteriorate. "We need to possibly speed up the foreclosure process for vacant and abandoned properties, while exhausting every available avenue for occupied homes," Tisler said. Problematically, even when borrowers might benefit from loan modifications, an increasing number of borrowers are unable to meet even the improved terms because of job losses.

Kermit Lind, a lawyer and assistant director with the Urban Development Law Clinic at Cleveland State University, says pegging the "correct" length of a foreclosure can be tricky. Many cases call for a drawn-out process, he says.

1. Cutts and Merrill.

2. Pence.

"If it's a primary residence and occupied, from a community as well as a justice perspective, that person should have every opportunity to survive the default situation," Lind explained. "Judges in those cases need to pay attention to the harm being done—to all affected. To ignore the impact of an abandoned property that poisons a neighborhood is counterproductive."

Lind says he suspects a new factor is lengthening foreclosures in Cleveland—many lenders are walking away from properties after the default judgment and never filing for a sheriff's sale. Lenders have an incentive to merely secure the foreclosure decree so they can collect on various related financial contracts. The home—which is the underlying collateral—may be the least valuable part of the deal and no longer worth maintaining. This incentive may be one reason that foreclosure starts have risen in Cuyahoga County but sheriff's sales have not, Lind says.

Dunne and Venkatu are particularly interested in the possible correlation between lengthy foreclosures and borrowing costs. They think that when states set about writing rules for the foreclosure process, they should keep in mind the implications for borrower pocketbooks.

Reforms Make a Difference

Stephen Bucha, chief magistrate in Cuyahoga County Common Pleas Court, which oversees foreclosures, says the county's low transition rate is now in the rearview mirror. "The county hired some new administrative employees and mowed through the backlog of cases," he explained. "Now, it's a six-month process." (An exception is when loans go to a new mediation program that allows borrowers and lenders the time and means to work out new terms.) When complaints arise, they are often from people who say the process is going too fast for borrowers to keep up.

In fact, the pace of foreclosure proceedings in Cuyahoga County has caught up and in some months has surpassed the pace in other large counties like Hamilton and Franklin, Bucha says. "Now we are hitting on all cylinders," he said.

Of course, efficiency gains in the administrative process raise a new set of issues. The relatively brisk six-month average foreclosure process may mask the ongoing mounting of foreclosure starts. "We could mistakenly conclude that the crisis has passed," Venkatu noted.

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