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As housing market heals, it’s time to hasten the foreclosure process

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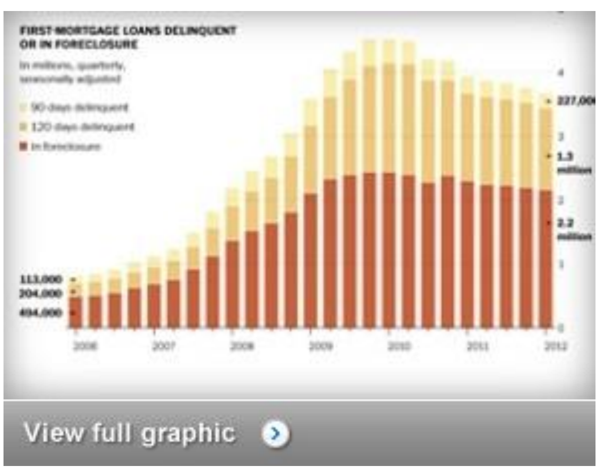
It’s time to pull the bandage off America’s foreclosure problem. The economy is ready to emerge from its recent dark period, but to make it happen soon we need to speed the resolution of millions of troubled home loans. Six years have passed since the crisis began, yet instead of accelerating, foreclosures have slowed.

Until now this has been fortuitous. Time was needed to make sure struggling homeowners were treated properly, and to let the financial system digest its losses and the housing market absorb the flood of repossessions and short sales. But these objectives have been met, more or less. It is time to move on. House prices won’t rise and the economy won’t fully engage until more distresses properties are resolved and put back into ordinary use.

Graphic



Loans in delinquency and foreclosure are still high.

The foreclosure crisis has been devastating. During the past six years, approximately 5 million homeowners have lost homes through either foreclosures or short sales. Families and communities have seen significant disruption, and falling prices have wiped out trillions in housing wealth. It is hard to be enthusiastic about the economy’s prospects when house prices are falling: Households spend less, small business owners can’t use homes as collateral for loans and local governments are forced to cut jobs and programs as property-tax revenue disappears.

Millions of problem loans remain to be worked through. Some 3.6 million loans are in foreclosure or headed there, with payments overdue three months or longer. (see Chart). This is a lot of loans, given that fewer than 5 million new and existing homes were sold last year. Progress in this area has been agonizingly slow; the foreclosure pipeline now holds only about a half-million fewer troubled loans than at the peak two years ago. Until the flow of problem loans shrinks markedly, it is hard to see how house prices will rise, allowing the economy to grow in a consistent way.

The key to house prices is the share of foreclosure or short sales in the total housing market. When that share rises, house prices will fall, because distressed properties sell for significantly less—currently around 25 percent below non-distressed houses. House prices won't rise until the share of distress sales falls, which won't happen until more homes now in the foreclosure process are resolved.

Encouragingly, the problem is no longer one of homeowners falling behind on their payments. The number of borrowers one or two months late is back to its pre-recession level. The problem is that foreclosures are not being processed on time. On average, it takes a year to push a bad loan through the system—from the first notice of default to the final repossession—about twice as long as before the crisis hit (see Chart). In Florida, where the housing crisis has been especially severe and the courts are actively involved in the process, the time needed for foreclosure has soared from six months before the crisis to 2 1/2 years today. In New York, another judicial state, foreclosure takes nearly three years.

The process is so slow in part because of regulators' efforts to make sure the nation's big banks manage foreclosures properly. Banks were overwhelmed by the spike in foreclosures, but instead of adding staff and upgrading systems, they tried to muddle through with legal shortcuts. Homeowners were mistreated or given the runaround; the robo-signing scandal was only the most egregious example.

While additional cases are sure to emerge, the recent robo-signing settlement by state attorneys general and the biggest mortgage banks is a good sign. The banks agreed to make significant changes to their foreclosure practices and put up $25 billion to modify troubled home loans and help make the process work better. Monitoring the banks' compliance with the agreement is vital, but homeowners should now get a fairer shake.

The slowdown in foreclosures has helped the financial system manage its losses on millions of bad loans, estimated at nearly $500 billion. Writing off these loans too quickly would have drained many financial institutions of capital, threatening their viability. Taking the losses over an extended period has provided some breathing room.

Several rounds of stress tests have required banks to raise enough capital to withstand these losses and more, putting the system in good position to clean up the remaining financial damage. Bankers also seem willing to take their medicine now; no bank CEO wants to be on an earnings call a year from now talking about foreclosure losses with investors.

The housing market is also now sturdy enough to weather an increase in distress sales. House prices may fall further, but only modestly; prices are low enough and rents high enough now to allow investors to make a profit on distressed property, and demand is rising. These buyers aren't the flippers of the housing bubble, but patient investors willing to hold on, knowing prices won't rise quickly.

The Obama administration's recent housing initiatives should help during this tough period. Particularly promising is the effort to enlist Fannie Mae and Freddie Mac in converting distressed properties to rentals in the most hard hit housing markets such as Arizona, California, Florida and Nevada. As these properties are taken off the sales market, pressure on house prices will ease. The administration is also encouraging mortgage owners to modify more home loans, reducing households' debt burdens. More principal reductions means fewer distress sales. And allowing more homeowners to refinance their loans—even if they have little or no equity now—will reduce the number entering the foreclosure pipeline.

I've long advocated slowing foreclosures to ensure homeowners are treated appropriately, and of managing the process so it doesn't cripple the financial system, housing market and economy.

But now it's time for the courts to accelerate their efforts to work through their backlog of foreclosure-related cases, for regulators to pressure mortgage servicers to quickly implement the foreclosure process changes they have already agreed to, and for state and local governments to reevaluate the complex mediation efforts many have put in place. For the benefit of homeowners, their communities and our economy, it's time to move on.

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