STANDARD & POOR'S

Global Credit Portal®
RatingsDirect®

August 17, 2011

Structured Finance Research

Second-Quarter 2011 Shadow Inventory Update: Is The First Months-To-Clear Decline A Sign Of Good Things To Come?

Managing Director, Global Surveillance Analytics:
Diane Westerback, New York 212-438-8646; diane_westerback@standardandpoors.com

Primary Credit Analyst:
Jacques Alcabes, New York 212-438-7438; jacques_alcabes@standardandpoors.com

Secondary Contact:
Nancy Reeis, New York (1) 212-438-1643; nancy_reeis@standardandpoors.com

Investor Relations Contacts:
Ted Burbage, New York (1) 212-438-2684; ted_burbage@standardandpoors.com
Ernestine Warner, New York (1) 212-438-2633; ernestine_warner@standardandpoors.com

Research Contributors:
Vidhya Venkatachalam, CRISIL Global Analytical Center, an S&P affiliate, Mumbai
Ramnathan Hariharan, CRISIL Global Analytical Center, an S&P affiliate, Mumbai

Table Of Contents

Second-Quarter 2011 Shadow Inventory Update: Is The First Months-To-Clear Decline A Sign Of Good Things To Come?

In the second quarter of 2011, Standard & Poor's Rating Services' estimate of the months to clear the supply of distressed homes on the market in the U.S. fell for the first time since mid-2009. Our current estimate is 47 months, a five-month decline from our first-quarter estimate and the largest quarter-to-quarter drop since mid-2008. While the volume of these distressed U.S. nonagency residential mortgages remained extremely high at $405 billion in the second quarter, it has declined every quarter since mid-2010 including the most recent. In conjunction with stable liquidation rates, we believe these are positive signs that the amount of time it will take to clear this "shadow inventory" should continue to decline over the next year.

Overview

- We estimate it will take 47 months to clear the national shadow inventory. This is five months shorter than our estimate at the end of first-quarter 2011 but still six months longer than our estimate one year ago.
- Each of the top 20 MSAs recorded decreases in months-to-clear this quarter.
- At 144 months, the New York MSA still tops the list at the highest months-to-clear. However, even New York's estimate improved slightly.

In tandem with our improved months-to-clear estimate, each of the individual top-20 metropolitan statistical areas (MSAs) that we track reported lower months-to-clear estimates this quarter than the previous quarter. In our view, this is a yet another sign that the months-to-clear has leveled off.

At the end of the second quarter of 2011, Standard & Poor's estimated that the balance of shadow inventory had shrunk to approximately $405 billion, from an estimated $433 billion at the end of the past quarter. This latest number represents just under one-third of the outstanding nonagency residential mortgage-backed securities (RMBS) market in the U.S.

Despite the recent stability of our months-to-clear estimates and liquidation rates, these distressed loans continue to loom over the housing market and threaten to further depress home prices. Though fewer additional loans are currently defaulting, the overall volume of distressed loans remains huge. Low liquidation rates over the past two years allowed the shadow inventory to grow as distressed homes have remained tied up in foreclosure proceedings. The shadow inventory will continue to jeopardize the housing market's recovery until servicers are able to improve liquidation times. However, if and when that happens, an influx of homes will likely enter the market, increasing supply and driving prices down further.

We include in the shadow inventory all outstanding properties whose borrowers are 90 days or more delinquent on their mortgage payments, properties in foreclosure, and properties that are real estate owned (REO). We also include 70% of the loans that "cured" from being 90 days delinquent (loans that once again became current) within the last 12 months because cured loans are more likely to re-default. Our calculation of the months to clear the shadow inventory is the ratio of the total volume of distressed loans to the six-month moving average of liquidations (see the Appendix: Calculating The Months To Clear The Shadow Inventory section for more information).

In our analysis, we use LoanPerformance loan level nonagency RMBS securities data available through CoreLogic. While our analysis of the shadow inventory uses only nonagency data, we believe that the months-to-clear is similarly high for the market as a whole. Long liquidation timelines and the accumulation of so many distressed loans are due in large part to rising court delays in foreclosure proceedings, a problem that plagues agency and nonagency loans indiscriminately. As long as these delays continue to affect the housing market, the shadow inventory remains a market-wide threat. We will continue to monitor the impact that the large volume of distressed loans is having on the housing market.

Our Overall Months To Clear Estimate Finally Fell

Our estimate of the months-to-clear grew throughout 2009 and 2010 to a peak of 52 months in March 2011. This quarter it finally fell by five months, making it the largest quarter-over-quarter decline since mid-2008. This is mostly due to liquidation rates (the speeds at which servicers close nonperforming loans) remaining relatively stable over the past several months. Provided liquidation and default rates continue their flat trends, we believe our estimate of the months-to-clear should continue to decline at a steady pace of approximately three months each quarter.

Our months-to-clear estimates for each of the top-20 MSAs also improved this quarter, further supporting this positive trend (see table 1).

Table 1

Shadow Inventory For The Top 20 U.S. Markets

			Months of inventory at end of quarter (No.)						
MSA	Original balance outstanding (bil. $)	Current overhang balance (% of balance outstanding)	2Q11	1Q11	4Q10	3Q10	2Q10	Change in inventory since 1Q11 (%)	Change in inventory since 2Q10 (%)
Atlanta	23.5	28.28	49	52	49	41	40	Down 7	Up 21
Boston	18.7	31.27	83	86	71	59	60	Down 4	Up 38
Charlotte	4.5	25.78	51	61	65	49	45	Down 20	Up 13
Chicago	34.5	38.91	63	65	59	49	47	Down 3	Up 35
Cleveland	3.8	32.96	48	51	56	45	41	Down 6	Up 16
Dallas	15.2	21.10	52	61	56	43	41	Down 17	Up 27
Denver	13.1	20.60	32	38	38	34	32	Down 17	Up 1
Detroit	11.2	31.04	29	29	31	29	27	Down 1	Up 7
Las Vegas	20.8	46.67	30	34	32	29	27	Down 15	Up 11
Los Angeles	159.2	30.43	47	54	50	42	42	Down 16	Up 11
Miami	53.7	55.07	56	59	60	60	64	Down 5	Down 14
Minneapolis	12.2	27.35	37	39	38	33	31	Down 6	Up 19
New York	108.6	37.67	144	146	130	115	113	Down 1	Up 27
Phoenix	24.8	32.73	20	26	26	22	21	Down 27	Down 5
Portland	9.8	27.58	45	50	51	41	37	Down 12	Up 23
San Diego	42.1	27.04	36	42	39	32	31	Down 18	Up 13

Table 1

Shadow Inventory For The Top 20 U.S. Markets (cont.)

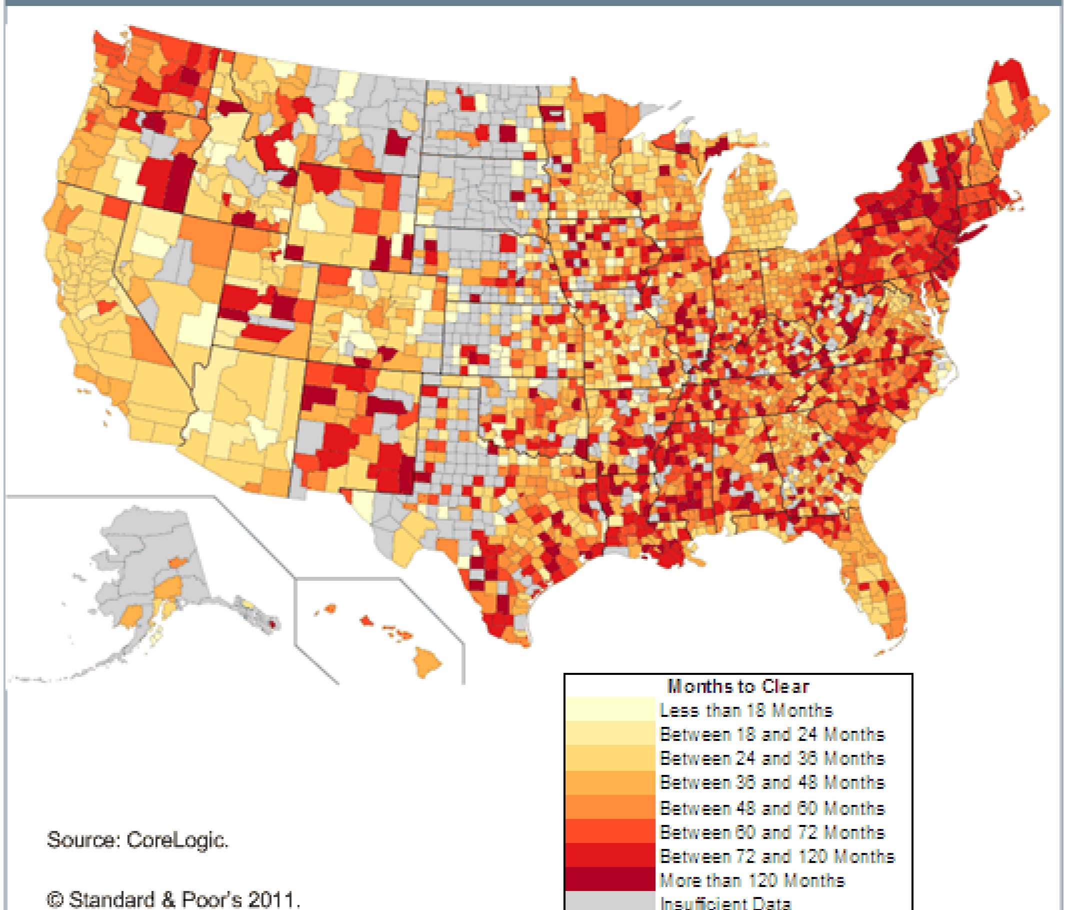
San Francisco	69.9	23.06	37	43	42	36	34	Down 16	Up 11
Seattle	22.5	28.94	51	60	59	49	48	Down 19	Up 6
Tampa	14.7	46.95	47	55	57	53	56	Down 16	Down 18
Washington, D.C.	55.1	25.47	51	54	49	41	39	Down 6	Up 32
Total U.S. market	1,253.8	32.32	47	52	49	42	41	Down 10	Up 15

Source: CoreLogic. MSA--Metropolitan statistical area.

However, our estimates continue to vary significantly by area (see chart 2). The New York MSA still has the highest months-to-clear at 144 months. While New York's months-to-clear estimate fell with the other MSAs this quarter, it was only two months less than the past quarter's estimate. This variation in our estimates reflects the fact that liquidation rates still vary significantly across geographic regions in our analysis due to the various rules governing the procedures servicers must follow to finalize foreclosures against defaulted borrowers.

Chart 1

Months To Clear The Shadow Inventory By County As Of June 2011

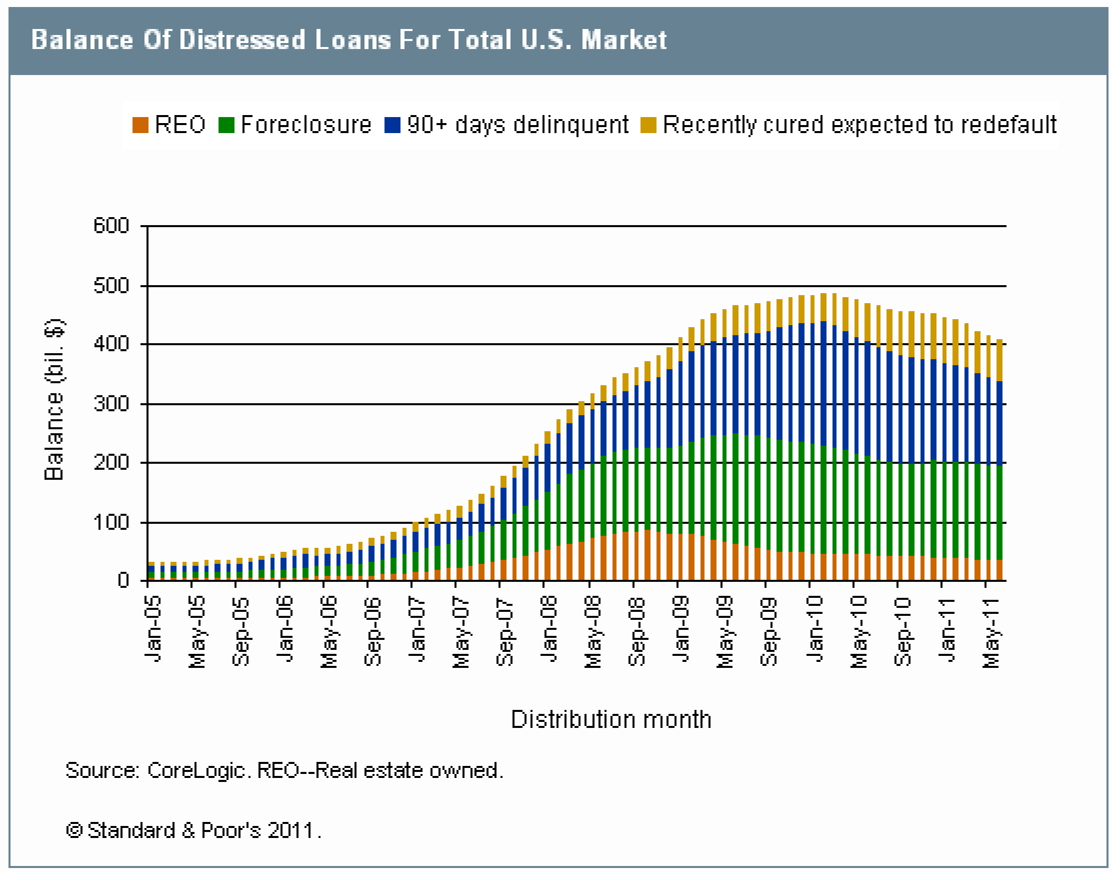


Source: CoreLogic.

The Shadow Inventory Continued To Shrink Steadily

Since the beginning of 2010, the total volume of distressed loans has been falling and continued to decline in the second quarter of 2011. As of June 2011, this amount stood at $405 billion, the lowest level since December 2008 (see chart 1). This trend reflects default rates that have been falling since first-quarter 2009 and liquidation rates that appear to be stabilizing.

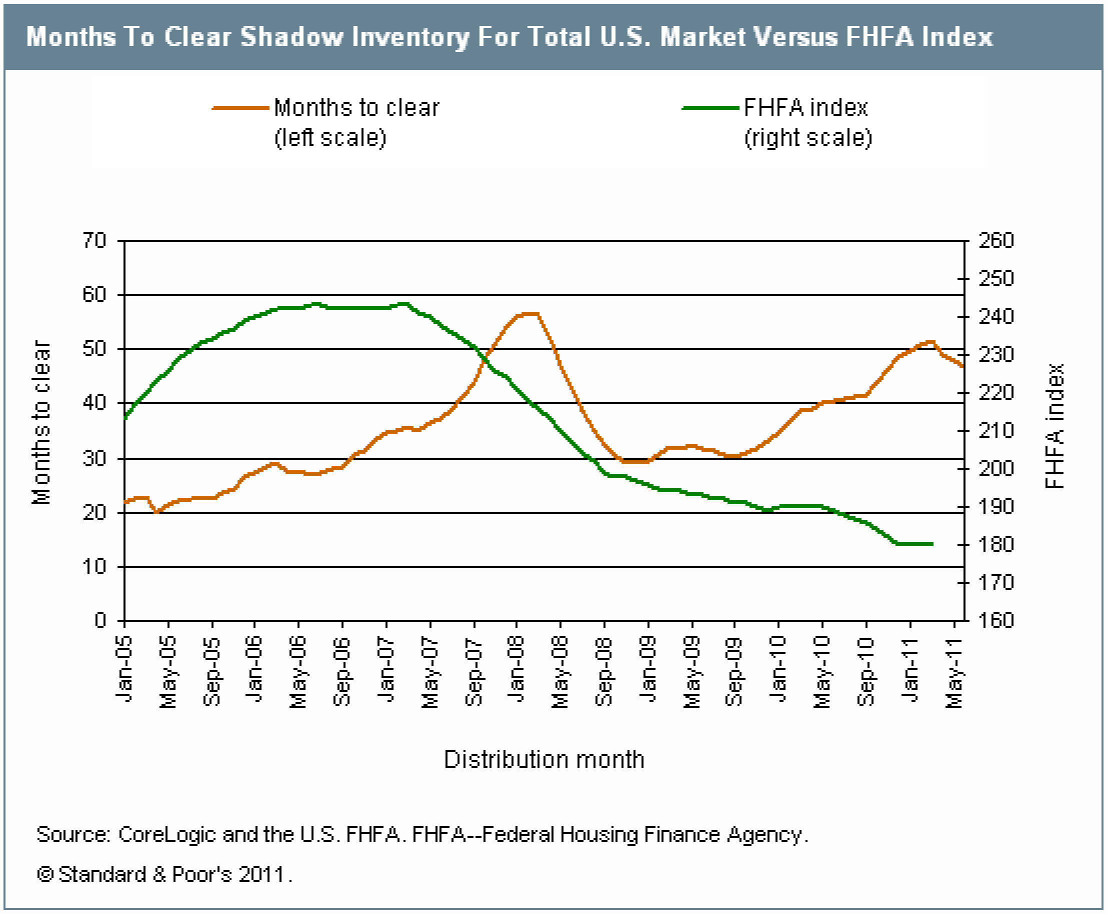
Chart 2



Home Prices Remained Depressed

Home prices have continued to decline from their historical highs in early 2007 according to the Federal Housing Finance Agency (FHFA) home price index (see "The FHFA Housing Price Index Declined Modestly In March, But Its Overall Drop In The 1st Quarter Was The Worst Since '08," published May 25, 2011, for more information). We believe prices are likely to fall further as servicers clear the shadow inventory backlog and the properties under the distressed loans crowd the already weak housing market (see chart 3).

Chart 3



The Credit Profile Of Shadow Inventory Mortgages

Distressed loans naturally tend to have weaker credit characteristics. The average FICO score for loans in the shadow inventory is 645 while the average FICO score for current loans is 685. In addition, distressed loans have significantly higher original and House Price Index (HPI)-adjusted loan-to-value (LTV) ratios. The average shadow inventory loan is significantly "under-water," meaning that the borrower owes more on the mortgage than the value of his/her house. Loans that are currently 90-plus days delinquent, in foreclosure, or REO have missed an average of more than 19 payments (see table 2).

Table 2

Status Of Current Versus Distressed Loans

	Not in shadow inventory			In shadow inventory				
	Current	30-days delinquent	60-days delinquent	Recently cured	90+ days delinquent	In foreclosure	In REO	Liquidated in June
No. of loans outstanding	2,661,919	199,963	80,703	394,396	526,482	577,333	123,839	30,094
Outstanding original balance (mil. $)	744,289	41,749	18,730	97,248	144,553	159,384	33,208	8,313
Avg. loan size ($)	279,606	208,782	232,083	246,575	274,564	276,070	268,156	276,225

Table 2

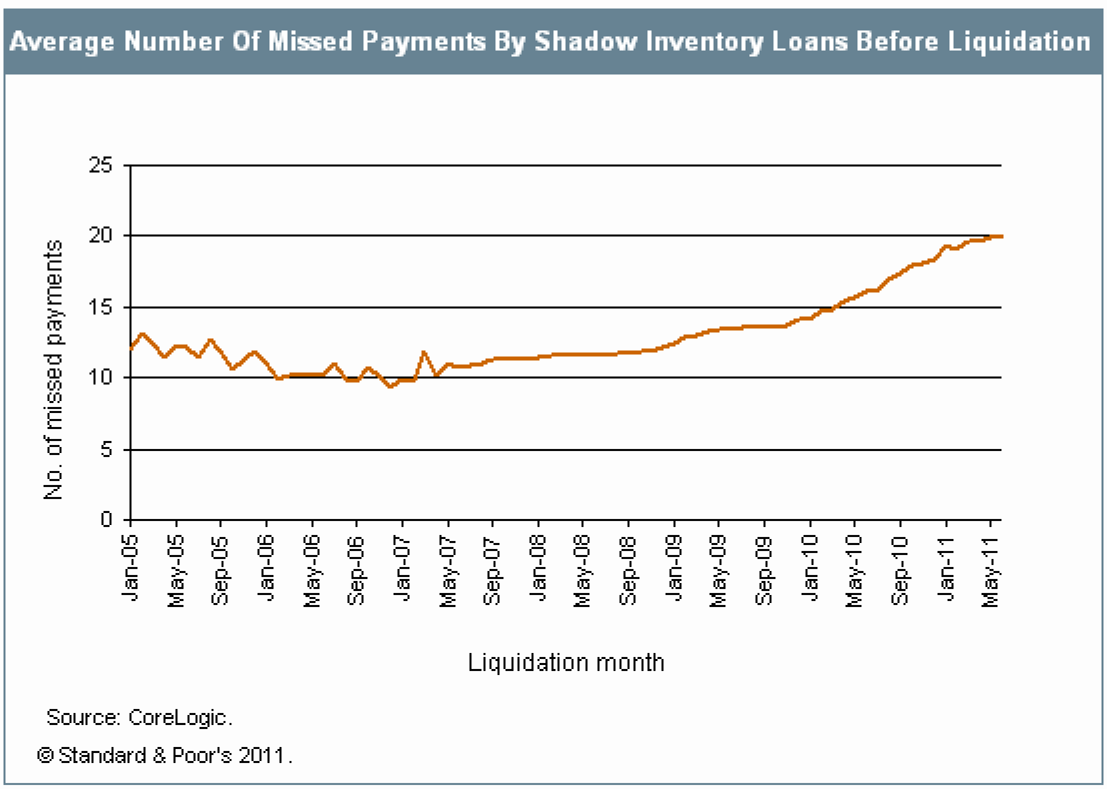
Status Of Current Versus Distressed Loans (cont.)

Avg. FICO score at origination	690	634	639	632	644	652	656	667
Avg. original CLTV	78.0	81.6	82.2	83.5	84.5	84.8	86.5	86.0
Avg. current index-adjusted CLTV	88.0	94.4	100.4	107.0	113.1	116.5	123.0	124.4
Avg. loan age (mos.)	73	72	70	67	66	65	65	64
Avg. No. of missed payments	0	1	2	0	14	23	27	20
% of loans ever modified	12	29	32	74	30	22	17	17

Source: CoreLogic. REO--Real estate owned. CLTV--Combined loan-to-value.

Although liquidation rates seem to have leveled off, foreclosure timelines are still very long and do not yet show signs of improving (see chart 4). In other words, the time it takes for servicers to liquidate a loan is still getting longer. Recently liquidated loans missed an average of almost two years of payments before being liquidated. We believe that this trend is unsustainable, and that sooner or later liquidation rates will likely begin to rise.

Chart 4



Average Number Of Missed Payments By Shadow Inventory Loans Before Liquidation

Source: CoreLogic.

Despite The Positive Signs, Speed Bumps Could Still Be Ahead

Though this quarter marks the first time we are reporting a decrease in the number of months-to-clear, the volume of distressed loans remains very high. Liquidation rates have finally stabilized, but we believe that foreclosure timelines are still unsustainably long. On the other hand, if servicers do speed up liquidations significantly, the housing market may be inundated with properties, driving home prices still lower.

Related Criteria And Research

- First-Quarter Shadow Inventory Update: Relief Is Further Away, But There Is Light At The End Of The Tunnel, published May 23, 2011.
- New York Can't Get No Liquidation, published April 12, 2011.
- Loan Modifications Can Provide A Short-Term Cure, But Few Achieve Permanent Success, published Feb. 7, 2011.

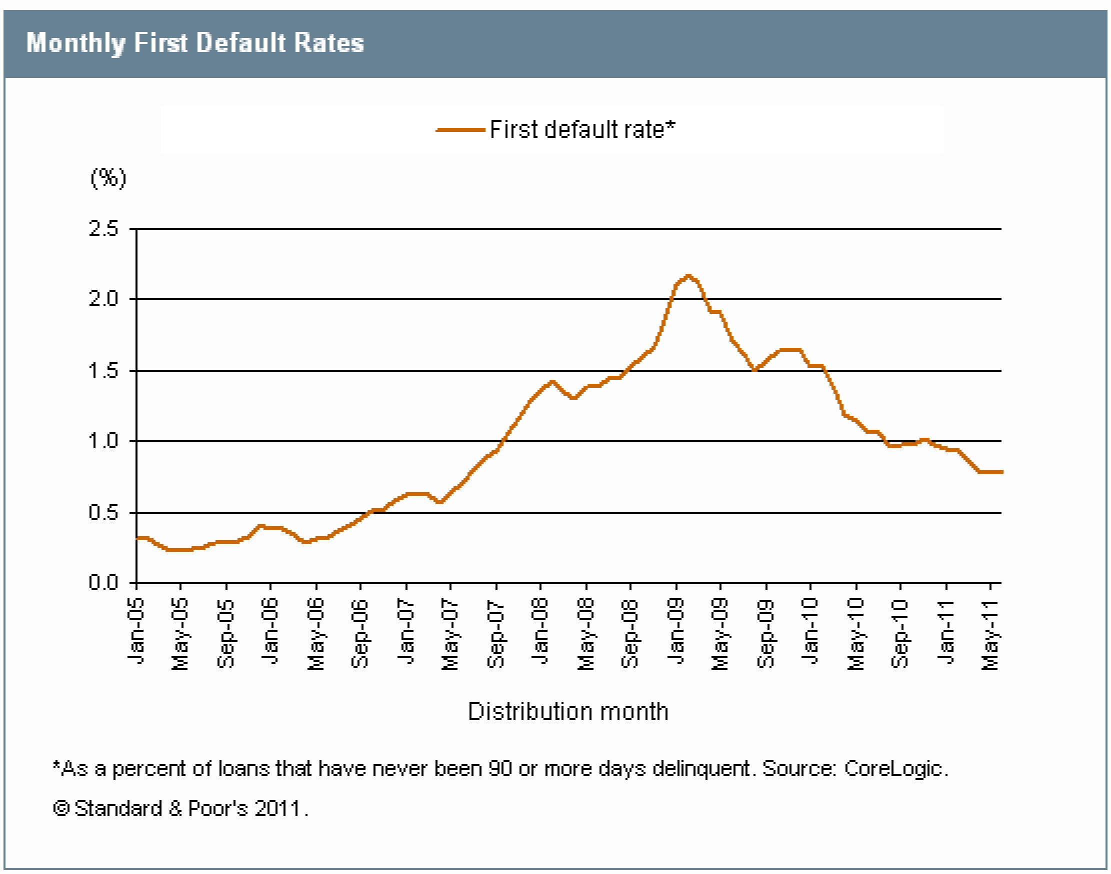
Appendix: Calculating The Months To Clear The Shadow Inventory

To estimate the months-to-clear the shadow inventory, we look at default, liquidation, and loan-cure rates across the U.S.

Default rates

Our estimate of the months to clear the shadow inventory reached its peak at 57 months in early 2008. Back then, rising default rates caused a sharp increase in the overall amount of distressed properties. However, first default rates have been falling since March 2009 (see chart 5), indicating that fewer loans are becoming distressed.

Chart 5

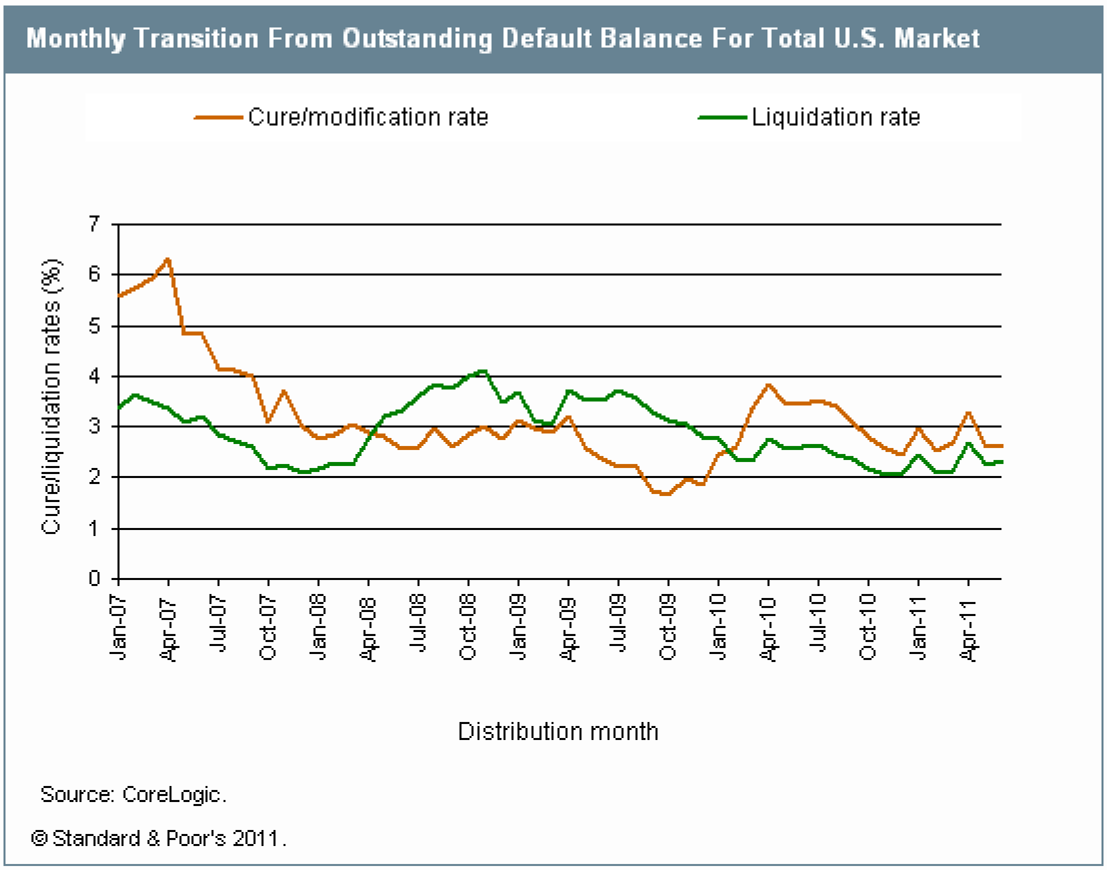


Despite falling default rates, however, servicers have been unable to significantly reduce the shadow inventory as foreclosure timelines have lengthened and liquidation rates have dropped.

Liquidation rates

Liquidation rates, as of second-quarter 2011, appear to have bottomed near historical lows (see chart 6). Low and falling liquidation rates have been the driving force behind consistently rising months-to-clear estimates since mid-2008, and now that liquidation rates have steadied, the months-to-clear has begun to fall.

Chart 6

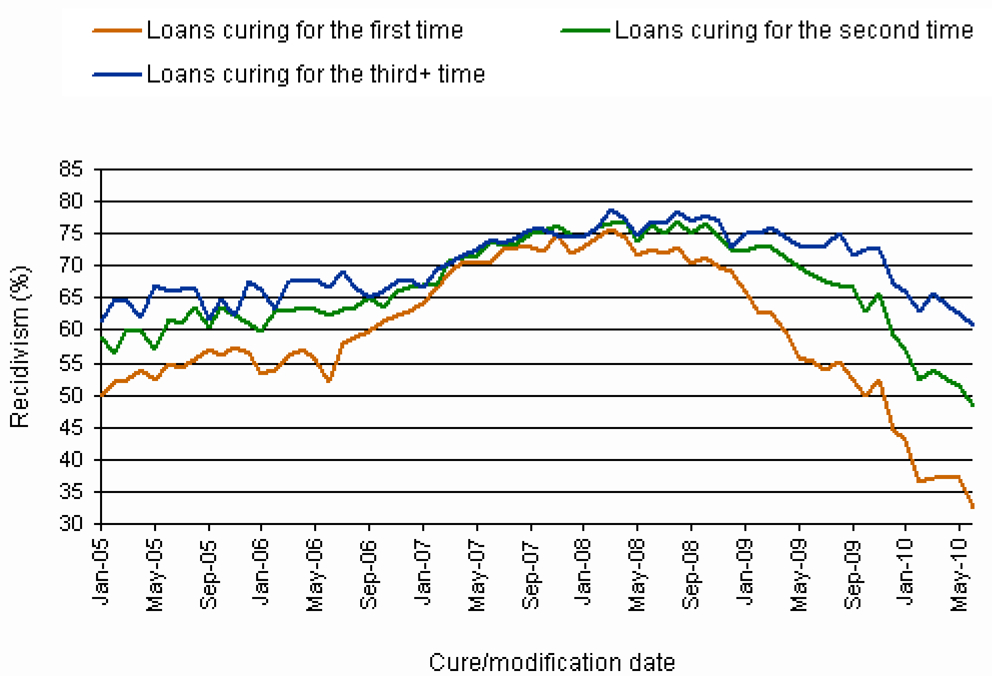


Loan cure success rates

Loan cure success rates continued to improve this quarter. Only about 32% of loans that first cured in June 2010 re-defaulted within a year, compared with about 75% of those first cured during the early 2008 peak in recidivism (see chart 7). As described above, the shadow inventory includes 70% of loans that were recently 90 or more days delinquent. Though this percentage reflects average recidivism rates from 2007 through 2009, more recent loan cures have been more successful. Applying a 40% recidivism rate would reduce the overall volume of the shadow inventory by about 7%.

Chart 7

Recently Cured Loan Recidivism Rate* For Total U.S. Market



*Rate of default within 12 months of cure/modification date.
Source: CoreLogic.