FORECLOSURE FRICTION SLOWS HOUSING RECOVERY

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One of the main disappointments of the recession has been the glacial pace of housing market recovery. Recently, there have been solid signs that the market is stabilizing and a recovery is picking up speed. Unfortunately, these signs are not uniform across the country and some areas are not stabilizing as quickly as others. Perhaps the most significant reason for this lack of uniformity is the time it takes some states to complete the foreclosure process and make foreclosed homes available to potential buyers.

The time it takes to complete a foreclosure is related to how the process is managed. Many states mandate that the foreclosure process be handled by the courts, which are given sole responsibility for deciding whether or not a mortgage contract is enforceable. This “judicial foreclosure” approach lengthens the process considerably. For example, foreclosure takes an average of three years in New York – where judicial foreclosure is a requirement – compared with a national average of 414 days, according to RealtyTrac.

Exacerbating the problem is that a number of states are struggling to deal with backlogs in the courts, which add to the length of time properties remain in foreclosure. For example, foreclosures in Florida – a judicial state – took approximately four times longer in 2012 than in 2008, RealtyTrac data shows. Indeed, the state has had to call judges out of retirement to handle the sheer weight of work.

The upshot is that judicial foreclosure makes it difficult for lenders to clear inventory and “reset” the market. With so many houses stuck in the judicial process, prices remain static and never fall far enough to attract buyers. The promise of recovery is thwarted.

The alternative is the “non-judicial” process, which allows lenders to enforce their own contracts while homeowners retain the right to challenge a foreclosure in court. This streamlined approach is the reason why the number of properties in foreclosure in non-judicial states stands at less than a third of those in judicial states, according to Lender Processing Services (LPS). These non-judicial states are showing the strongest housing recovery. A recent *Wall Street Journal* article, which referred to S&P/Case-Shiller statistics, noted non-judicial Detroit’s home prices rose by 10 percent in 2012, while in judicial Chicago, prices actually dropped by 1.3 percent.

In addition to its effect on housing recovery, judicial foreclosure has a number of other economic consequences.

Fannie Mae and Freddie Mac have proposed that they be allowed to charge more for mortgages in Connecticut, Florida, Illinois, New Jersey and New York – all judicial foreclosure states –

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because of the length of time it takes to repossess a foreclosed property. Their justification is that the longer it takes a lender to repossess the collateral behind a mortgage, the higher the potential costs to Fannie, Freddie and the taxpayer.

Judicial foreclosure also has led to many more properties lying vacant, prompting a number of states and municipalities to look at new laws to manage the glut and associated urban blight. Keeping properties vacant while a foreclosure is navigated through the courts can lead to increased levels of crime, health and safety issues and reduced neighborhood property prices. Fortunately, some judicial states, notably Illinois and New Jersey, have woken up to this challenge and recently passed laws that expedite foreclosures of vacant property.

A worrisome trend seems to be developing toward, rather than away from, judicial foreclosure systems. California, for example, has had great success in clearing its housing inventory through a non-judicial process. Unfortunately, a new law enacted last year intended to give homeowners new rights likely will work against this and slow the recovering market.

State regulators must recognize the challenges that unnecessary friction in the foreclosure process creates for economic recovery in general and the recovery of the housing market in particular. With mortgage lenders under unprecedented pressure to build enhanced consumer protections into their products, lawmakers in judicial foreclosure states have the opportunity to develop policy that streamlines the system, drives the recovery and guards against future busts.

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