Short-sale listings create a strange market dynamic

By Ryan Ratcliff
September 28, 2008

Over the summer I moved to San Diego to start a new job at the University of San Diego. We moved in August, but started shopping for a house in San Diego in mid-May.

Having kept a close eye on housing developments over the past several years, I thought (as many do) that I would have sellers falling at my feet begging for the opportunity to sell me their home, and that, in the words of my (UCLA Anderson Forecast) colleague David Shulman, "If I don't insult the seller with my offer, I'm paying too much."

The reality on the ground turned out to be quite different. We looked at around 80 homes, got outbid four times, rescinded one offer and finally started escrow at the beginning of August.

The key insight I've gained over this summer is that short-sales (a lender-approved sale of the home for less than the value of the existing mortgages) cast a shadow over the entire market.

Short-sales make up an inordinately high share of current listings, but they are a much smaller share of actual sales, because the red tape associated with these transaction means they take an average of three months to move from listing to close, even with a seller-accepted offer.

This big lump of glacially moving inventory in the middle pushes many buyers to the two extremes of the market: the rare demographically motivated sellers (estate sales, new jobs, divorces, etc.), which tend to be higher quality homes in my experience, and the lender-repossessed foreclosure properties called REOs (real-estate owned) – which vary from the well-worn to downright trashed.

With many buyers concentrating in these listing niches, there are actually bidding wars occurring on some of these properties, even in this historically unprecedented bear market in housing.

I lost several homes to mystery buyers coming over the top by 10 percent to 15 percent. Ghost stories and boogeymen abound: Much of the buying activity is attributed to "foreign buyers," and there are reports of a new kind of housing fraud – REO-listing agents ignoring offers from everyone except their cronies in order to secure a lowball price.

Together, the differing behaviors of these chunks of inventory make for surprising market dynamics.

REO properties are priced to move quickly, even in a market where home prices are falling and buyers are scarce. This aggressive pricing keeps REO inventory from piling up, and has led to small increases in sales volumes across California – especially in inland markets where REOs are a bigger share of overall sales.

This part of the market is working as we economists argue it should: lower prices increase sales. But the short-sale component of inventory defies this logic: A desperate would-be short seller could list a house for 30 percent below comparable properties, but the combination of red tape, overwhelmed and understaffed loss mitigation departments at the lenders, and misconceptions about what's needed to get the sale approved mean the house doesn't sell any faster, if it sells at all.

In several cases during my shopping this summer, an attractively priced short-sale with multiple offers would just sit, eventually being repossessed, only to be listed for a higher price as an REO a few weeks later.

The difference: you can actually buy the house at this higher price, where the short-sale listing and its attractive price were essentially just an illusion.

The illiquidity of short-sales has a very key implication for those of us trying to look ahead and find the end of this dismal housing market.

One of the many methods for forecasting the end of the housing slump involves calculating how much farther home prices must fall to return inventory levels to their historical norms, using the price/sales relationships from previous bear markets.

But when 30 percent to 40 percent of that inventory is tied up in short-sale red tape, no amount of price decline will get it to move, making this inventory-based method of forecasting highly suspect.

A realistic forecast of the bottom of the housing market needs to explicitly acknowledge that short-sales have temporarily hijacked the market mechanism: The near-term course of the housing market will be determined more by the procedural timelines of foreclosures and short-sale approvals than any notions of a magic price that will clear existing inventory.

After our housing mega-bender, we will be suffering inventory indigestion for some time to come.

As we've argued before, data from the Fed suggest that underwriting standards tightened significantly in early 2007, and MDA DataQuick's estimates suggest that the average mortgage default in California occurs roughly two years after origination.

Taken together, these facts suggest that foreclosures will be the dominant factor in the California housing market until the first quarter of 2009 at the earliest.

This also means we should expect more short-sale listings as borrowers try to forestall these foreclosures. These short-sale listings will either get approved on their own procedure-driven timeline, eventually fall into foreclosure and become REOs, or simply withdraw from the market – maybe to become rentals, and/or to hunker down and wait for the long, slow climb back to positive equity.

The key is the foreclosure pipeline. Once that tapers off, most of the source of new short-sales will dry up, and existing short listings will either sell or be withdrawn.

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