

Wipe Out:
Realized Losses on Home Sales in Orange County
In 2007 Reach \$272 Million

A Report Prepared by the
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Executive Summary

It is now widely recognized that house prices have been falling in many parts of the United States, including Orange County, since sometime in 2006. Most published measures of house price declines report theoretical losses, e.g. a change in the median price of homes sold (e.g. National Association of Realtors) or the change in the level of a repeat sales house price index, such as the Case-Shiller index. This report, in contrast, estimates actual realized losses on home sales during the first ten months of 2007. Results are reported by city and, in total, over time. In aggregate, it is estimated that home owners in Orange County experienced capital losses totaling \$272 million during the first 10 months of 2007.

Introduction

Recent turmoil in the mortgage market, in particular the contraction in liquidity occurring during August 2007, the increase in the rates of defaults and foreclosures, the failure of a number of mortgage market participants, and large losses¹ incurred by financial institutions and investors in mortgage and mortgage-related assets have attracted considerable attention from the media, policymakers, and analysts. Moreover, it is now widely recognized that prices in the housing market, after a number of years of very rapid growth, have declined since sometime in early 2006. As of summer 2007, based on the Case-Shiller repeat sales index (CS Index)², real home prices had fallen 3.4% since the first quarter of 2006 (Shiller [2007]). More recent CS Index data as of September 2007 showed a 4.5% decline in aggregate house prices over the last year with larger declines in the two Southern

¹ Lenders reporting large losses include Countrywide, Citigroup, Freddie Mac and Fannie Mae.

² This index, including the composite depicted and individual indices for 20 major metropolitan areas, is based on the work on repeat sales of Case and Shiller (1987, 1989) and began trading on the Chicago Mercantile Exchange in May 2006.

California metropolitan areas for the index is calculated: Los Angeles (down 7.0%) and San Diego (down 9.6%). The CS Index provides an aggregate index for the U.S. and breaks out twenty major metropolitan areas; the Los Angeles area index includes Orange County³.

Policymaker concern regarding current housing market conditions stems, in part, from the fact that the substantial majority of recessions in the U.S. since 1950 have been preceded by problems in the housing sector (Leamer [2007]). In addition to house price declines, default and foreclosure rates have also been increasing. According to the Mortgage Banker's Association, the delinquency rate for mortgage loans on one-to-four unit residential properties was 5.12% during the second quarter of 2007 on a seasonally adjusted basis, up from 4.39% one year earlier. Likewise, the percentage of loans in the foreclosure process was 1.40% of all loans outstanding at the end of the second quarter of 2007, up from 1.28% one year earlier.⁴ Many of these problems are related to the subprime mortgage sector, where default and foreclosure rates are substantially higher. According to LoanPerformance⁵ as of June 2007, the overall serious delinquency rate on subprime loans was 10.1%.; more recent estimates are still higher. For example, Federal Reserve Governor Randall Krasner cited a 17% serious delinquency rate for subprime adjustable-rate mortgages and a quarterly rate of 320,000 foreclosures nationwide, up 50% from levels experienced during 2005-2006 [Federal Reserve (2007)].

Losses to mortgage investors continue to mount. In late July, Bear Stearns announced the bankruptcy and liquidation of two large hedge funds

³ Standard & Poors: S&P/Case-Shiller Home Price Indices Index Methodology. Available online at <http://www2.standardandpoors.com>

⁴ Mortgage Bankers Association National Delinquency Survey Sept 6, 2007.

⁵ LoanPerformance.com: *The Market Pulse*.

that used leverage to invest in Collateralized Debt Obligations backed by subprime mortgage loans⁶. A number of large mortgage market participants have entered bankruptcy protection, including Orange County-based New Century, a subprime specialist, and American Home Mortgage, an Alt-A specialist and mainstream lenders have retreated from indirect, wholesale origination channels⁷. During August, credit spreads widened dramatically throughout the nonconforming mortgage market, affecting even prime jumbo mortgage rates, as well as Alt-A and subprime market segments.

Some attribute the housing market decline to the influx of new homeowners, many of whom were at best marginally qualified to support large mortgage payments. Others attribute problems to lax lending in the mortgage industry and the proliferation of alternative mortgage products, especially during the past five years. For a more thorough discussion of these issues, see GAO (2006), Gramlich (2006), LaCour-Little (2007), or LaCour-Little and Yang (2007). Ongoing research is necessary to completely understand the evolution of current housing and mortgage market problems.

House price declines may affect the health of the economy in a variety of ways. There may be a wealth effect, whereby home owners curtail spending due to the reduced value of their housing assets. There may be financial effects, as well, since reduced home equity limits household's ability to borrow to finance major purchases, including automobiles and remodeling expenditures. In addition, there is a direct effect on home building, since at lower price levels new development is less profitable.

⁶ The Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd. and the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund Ltd. filed for protection under Chapter 15 of the bankruptcy code, according to court documents.

⁷ Indirect or wholesale channels include loans sourced through brokers or correspondent lending relationships and are generally viewed as riskier than retail loan originations.

Home building and related industries employ many people and a reduction in new construction and resale transaction volume reduces employment and related incomes.

It is widely recognized that house price declines trigger mortgage defaults and foreclosures, as borrowers with minimal, or negative, home equity have little incentive to pay. Foreclosures, in particular, produce negative effects on the neighborhoods in which they are located and distressed or foreclosure sales can reinforce existing downward price trends. Recently, the U.S. Conference of Mayors released a research report estimating substantial negative effects on local communities as a result of elevated levels of foreclosure.

In this report, we focus specifically on losses incurred by home owners selling properties in Orange County during the first ten months of 2007. We cannot determine, of course, whether these were homeowners or investors betting on continued increases in housing prices.

Data and Methodology

We use Data Quick Information Service's transaction level data to analyze realized losses on home sales. After trimming sales price data at the 1st and 99th percentiles and other data scrubbing procedures, we have in aggregate a total of 18,826 home sales reported during the first 10 months of 2007. For a subset of those (5,978 home sales), Data Quick also reports prior sales price. We subtract the current sales price to previous sale price to

compute the capital loss to the home owner on sale. In some ways, this is a conservative estimate, as it does not consider transaction costs including, but not limited to, real estate commissions, title insurance costs, escrow fees, recording fees, and other miscellaneous costs that can easily amount to six percent of the sales price. In addition, since we do not have prior sales price for a large fraction of home sales, there may be significant under-estimation in results obtained. Since our focus here is on capital losses, we do not calculate gains experienced by home sellers. Such gains may well offset losses on an aggregate basis.

We compare the loss calculated to the previous sales price of the home to calculate the percentage loss. In addition, for those cases in which the sales price is less than the previous first loan amount at origination, we calculate the difference, an amount which may represent a loss to the lender, assuming the loan balance had not changed. This value is a rough approximation of short sale losses incurred by lenders. Of course, without examining individual closing statements, we cannot determine whether these were, in fact, short sales or whether sellers brought funds to the transaction to pay off the existing loan amount in full.

We sum losses and report averages by city; also by month, to provide a simple trend line. In some cases, the number of transactions in small

communities is very small, so we delete them from the graphs. Due to variation in the number of observations, results are probably more reliable for the larger cities, such as Santa Ana, Anaheim, and Irvine, rather than for small ones.

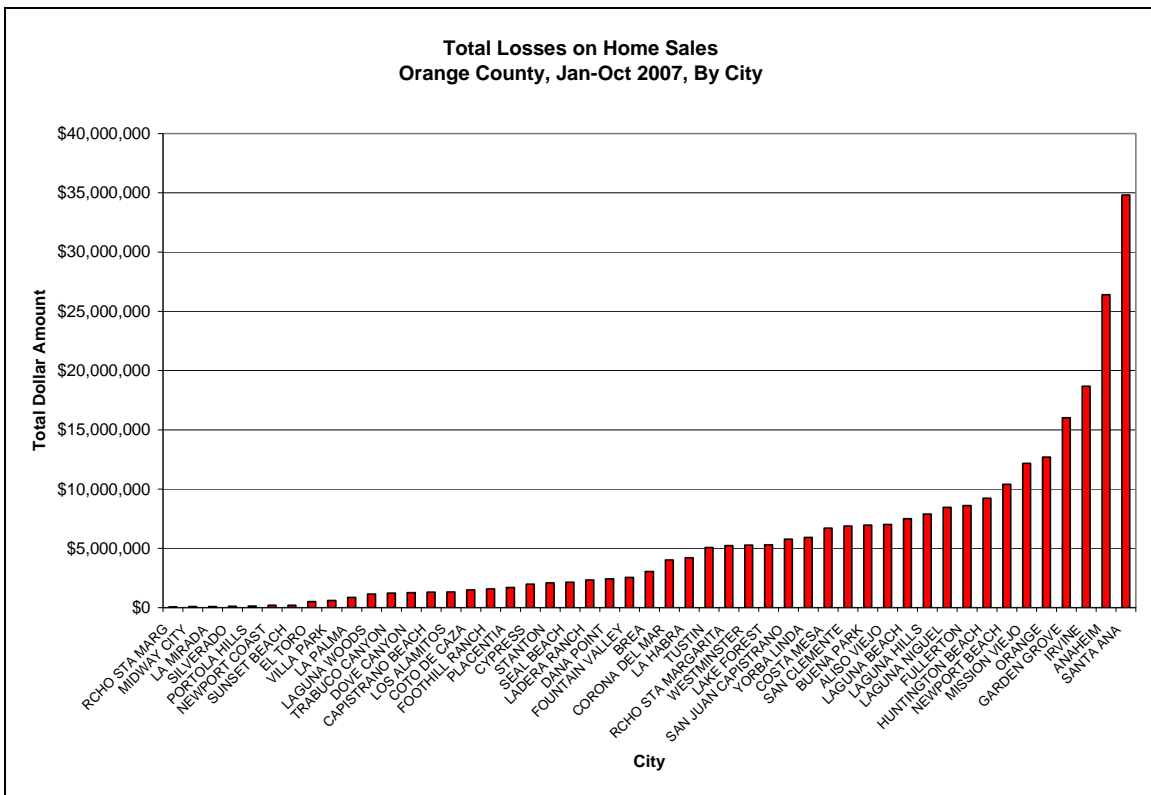
Main Results

The mean sales price in the data for the first 10 months of 2007 is \$626,489, with a mean previous sale price of \$582,460. Sellers held the property on average about two years. Of all sales, 34% were condominiums.

Turning to outcomes 37.6% of all sales produced a loss, defined as a sale at a price lower than the previous sales price. In addition, 17% of all losses were at prices also below the previous loan amount (at origination); hence, these are transactions that may represent “short sales” or other transactions yielding losses to lenders. About 6.7% of all transactions, including gains and losses, were potential short sales. The mean percentage loss for those homes selling at a loss is 16% and the mean dollar loss amount is \$109,514.

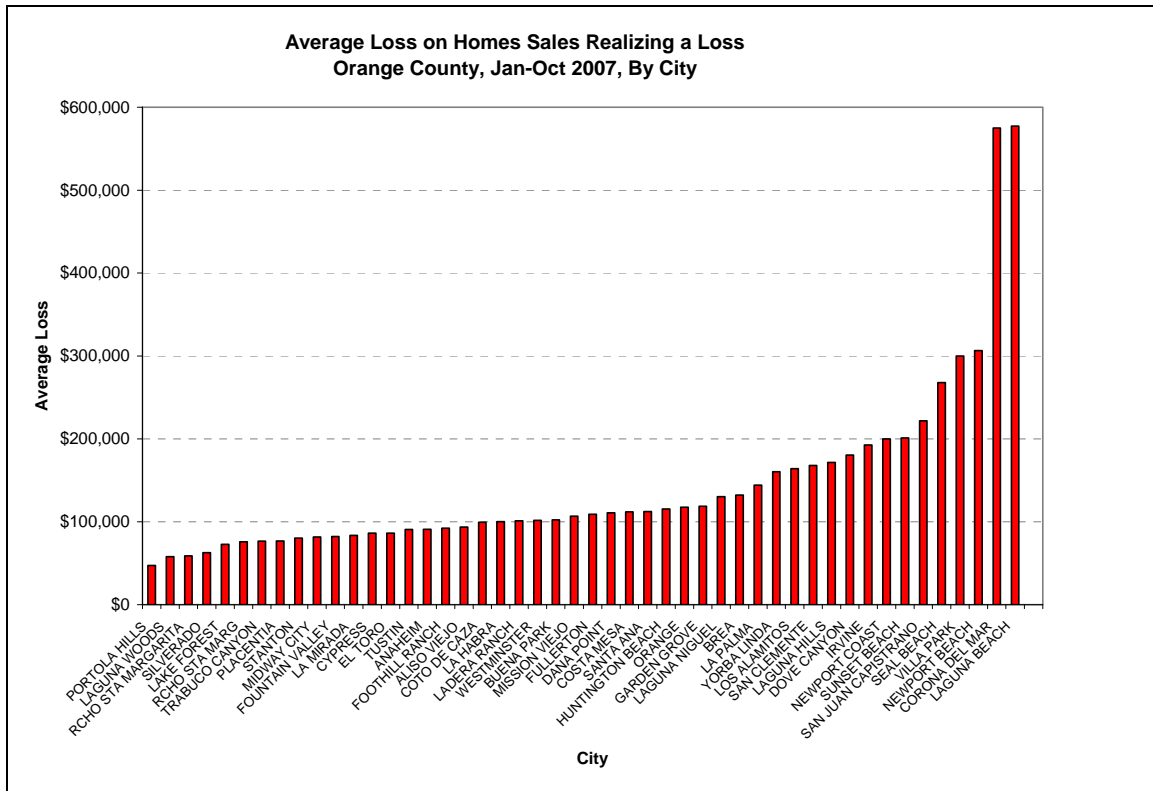
By city, total losses were largest in the larger cities, with Santa Ana topping the list at \$34.8 million. Anaheim was second with \$24.6 million in losses and Irvine third with \$18.7 million. Figure 1 presents results for all

communities graphically. Summing over cities, we arrive at a total of \$271.8 million dollars in aggregate capital losses, which is one of the headlines of this report.

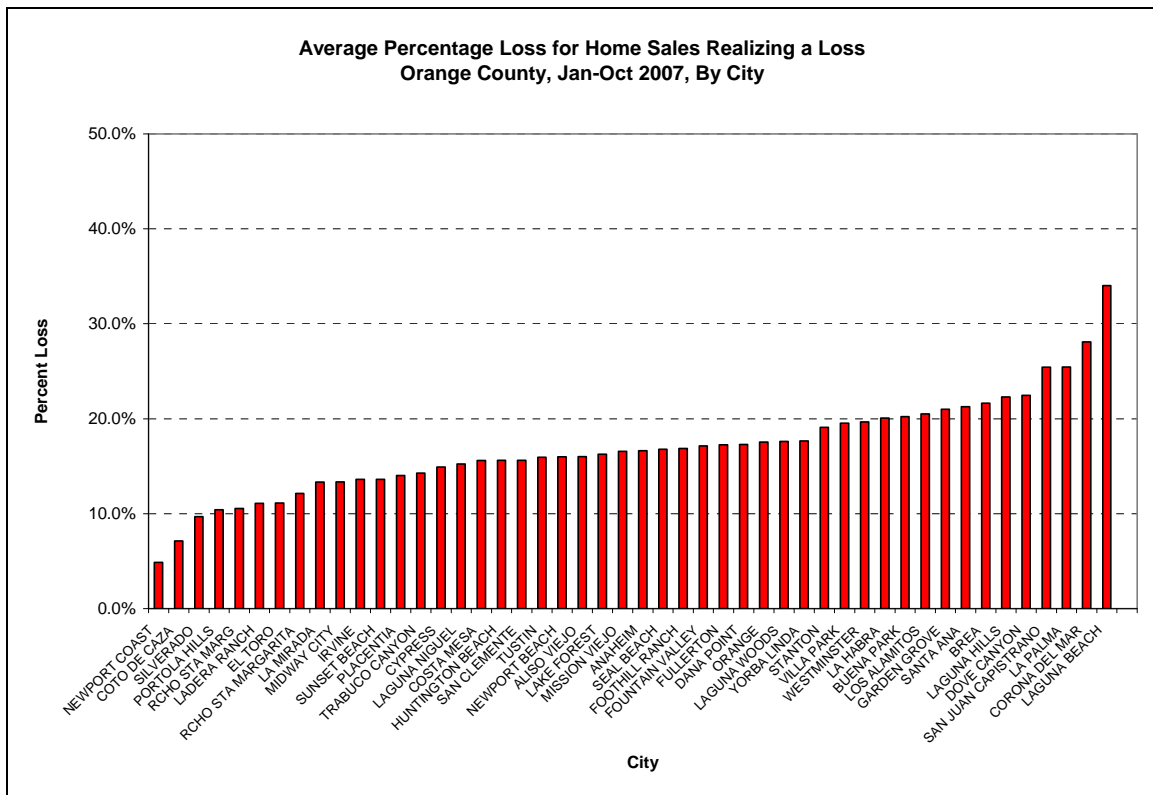


Mean capital losses by city vary somewhat from the pattern shown in Figure 1. In general, higher cost markets appear to experience larger average dollar losses; indeed, here Laguna Beach and Corona del Mar top the list with average losses exceeding \$500,000. In contrast, the average loss in Santa Ana was \$112,269, however, the greater number of losses there contributed to the larger total loss experienced by the city as a whole.

Figure 2 below illustrates this pattern graphically.

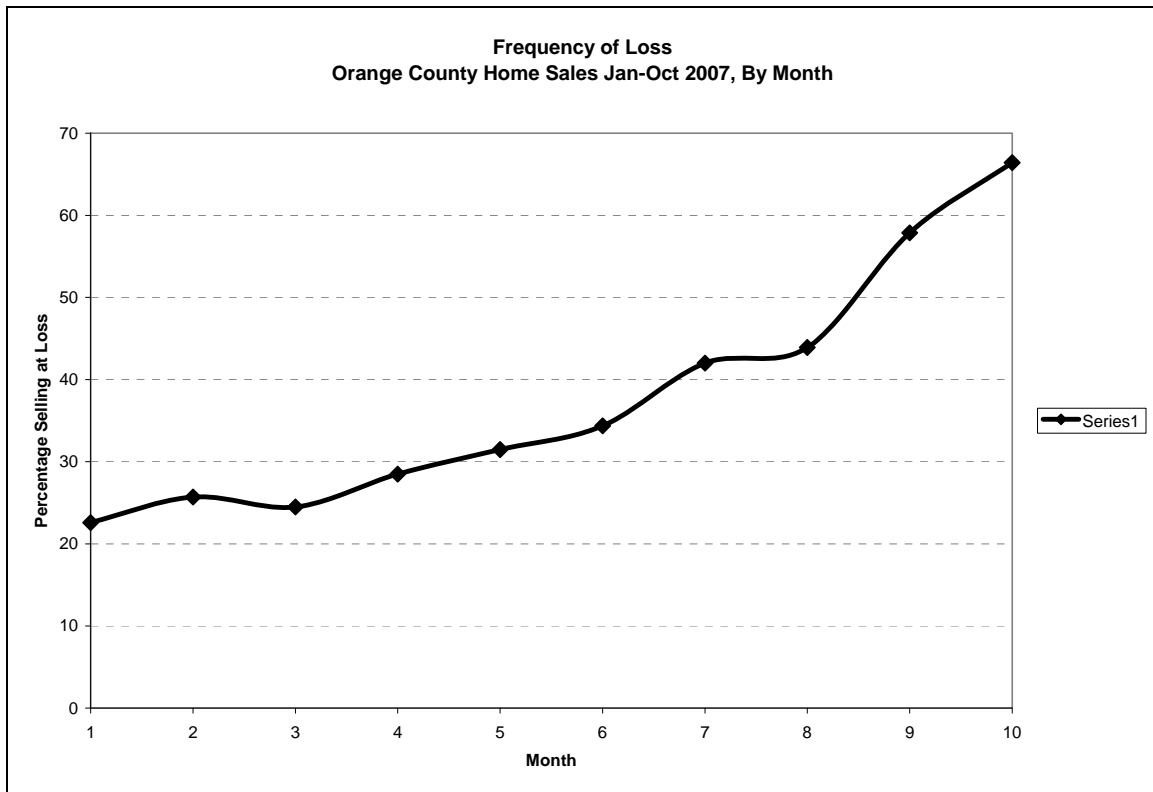


Turning to mean percentage loss, among those selling at a loss, results are similar. Higher cost areas such as Laguna Beach and Corona del Mar again top the list with percentage losses exceeding 25%. Figure 3 below depicts results graphically.

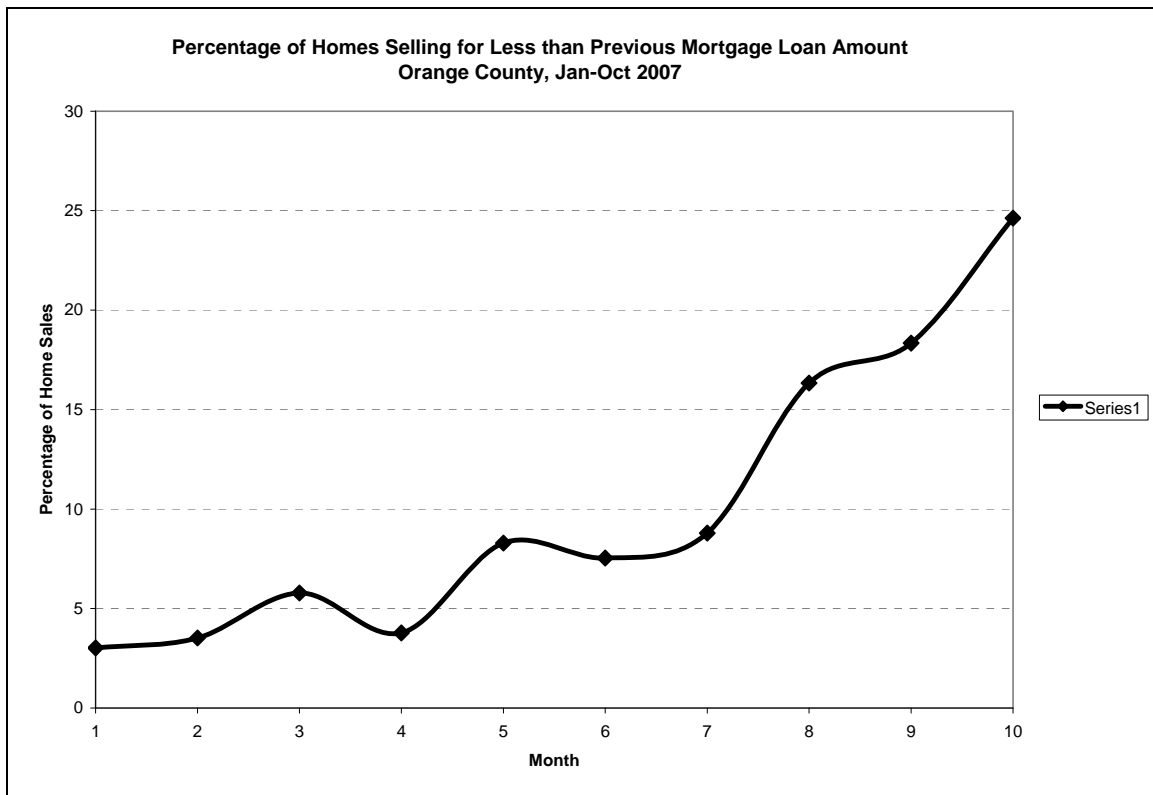


Thus far we have examined cross-sectional results for calendar year 2007 in aggregate and by city. We can also examine results for the county as whole by month. Results are shown in Figures 4 and 5 below.

Figure 4 plots the frequency of loss as a percentage of all home sales by sale month, with January equal to one and October equal to ten. A sharp upward trend is evident, with apparent acceleration since August, when credit market events exacerbated difficulties in the housing market and raised the cost of mortgage financing, particularly for loans in excess of the conforming loan limit of \$417,000. Between January and October the frequency of homes selling at a loss increased from a little over 20% to in excess of 60%.



A similar upward trend is apparent in the percentage of homes selling for less than the prior first mortgage amount. Prior to June, this number fluctuated below 10%. But with the summer's credit market contraction, the percentage has increased to 25% as of October sales figures.



Figures 4 and 5 clearly depict the worsening condition of the housing market in Orange County, especially the effect of the credit market problems occurring in August of 2007.

Conclusions

We have seen that capital losses on home sales in Orange County have increased over the course of 2007, consistent with negative national trends in the housing and mortgage markets. Credit market events of last summer appear to have exacerbated the situation, as jumbo loans are now significantly more costly, making financing for higher cost housing more difficult. Since Orange County's average housing costs are well above the conforming loan limit, this credit effect has had a significant effect.

Cities will be affected by declining house prices through lower property tax revenues as assessed values reset lower. The State of California may be affected by decreasing capital gains tax revenue, as well. Those employed in the housing industry, including realtors, mortgage companies, title companies, and other service providers are likely to experience reductions in income as depressed home prices reduce transaction volumes. The home building industry, which employs many people, has already cut back substantially, reducing employment and consumer purchasing power.

Finally, as documented here, individual home sellers have experienced total capital losses year-to-date conservatively estimated at \$272 million. Compared to the multi-billion dollar write-downs reported by many financial institutions, this is not a large number; nevertheless, these are real losses in wealth averaging over \$100,000 per transaction. As mentioned earlier, we cannot determine whether these losses were incurred by individual households forced to sell in a weak market due to job loss, marital dissolution, or other life events or whether these were losses incurred by housing speculators, hoping to sell for a quick profit.

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