Roadblock to Recovery

Examining the disparate impact of vacant lender-owned properties in Chicago

September 2009

Woodstock Institute
applied research, policy and practice
innovation for community economic development

Acknowledgements

The authors would like to thank Woodstock staff Beverly Berryhill, Patricia Woods-Hessing, Tom Feltner, Dory Rand, and Katie Buitrago for their invaluable assistance in the production of this report. The authors would also like to thank Dan Immergluck for his comments on a draft of this report and Patrick O'Shea and Elijah Shaw-Rutschman for their technical expertise in helping produce the final dataset used in this analysis.

This project would not have been possible without generous support from the John D. and Catherine T. MacArthur Foundation, the Chicago Community Trust, the Woods Fund of Chicago, and the F.B. Heron Foundation.

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Examining the Disparate Impact of Vacant Lender-Owned Properties in Chicago

Introduction

The disposition of vacant, lender-owned properties has become a key issue for community stakeholders, advocates, and municipalities concerned with the negative impacts of foreclosure-related blight on neighborhoods. These properties, commonly known as Real Estate Owned, or REO, are those that have completed the foreclosure process and have reverted to lender ownership. REO properties typically sit vacant and remain so until a lender sells the property to an owner who is able to put it back into productive use. Previous research by Woodstock Institute has illustrated the build-up of lender-owned properties in the Chicago region and quantified the impacts of foreclosures on communities in the form of declining property values and increased levels of violent crime. Other research has shown that foreclosures increase service burdens on municipal governments.[1] Long-term vacancies tied to foreclosure are likely to exacerbate these negative impacts as the length of time a property remains vacant is correlated with an increased likelihood of vandalism and significant property deterioration.[2]

This report expands on Woodstock Institute's previous research on the foreclosure crisis to explore what happens to REO properties after they become lender-owned. Using data on foreclosure auctions and property transfers, this report examines the disposition of one-unit, single-family properties that became REO between 2005 and the first half of 2008. The report utilizes several key metrics to analyze the potential impact vacant REO properties have on neighborhoods: the percent of properties that became REO between January 1, 2005 and June 30, 2008 that were unsold as of December 31, 2008; the concentration of these properties in certain neighborhoods; the absorption rate of REO properties from the first quarters of 2006, 2007, and 2008; and the potential losses experienced by a lender based on value declines and the length of time a property sits on the market prior to sale. The report concludes with a set of recommendations focused on ensuring that properties that become vacant through foreclosure do not become blighted and further damage neighborhood housing markets.

Background

One of the key ways the foreclosure crisis has manifested itself in the Chicago region has been through the build-up of vacant, lender-owned properties. In Illinois, the foreclosure process typically begins when a borrower is 90 days or more late on a mortgage payment and ends when a court judgment against a borrower is reached, and the property goes to foreclosure auction. At auction, third parties have the opportunity to acquire the property by submitting a bid. If no third party bids are successful, then the property reverts to lender ownership and becomes REO. Previous Woodstock Institute research has shown that between 2005 and 2008, the number of properties going to foreclosure auction in the City of Chicago increased by 338 percent. During that same period, the share of those auctions reverting to the lender and becoming REO increased from 64 percent in 2005 to 98.3 percent in 2008.[3] Between 2005 and

[1]Immergluck, Daniel and Geoff Smith. 2005. *There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values;* Immergluck, Daniel and Geoff Smith. 2005. *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime;* Apgar, William C. and Mark Duda 2005. *Collateral Damage: The Municipal Impact of today's Mortgage Foreclosure Boom.*

[2]Mallach, Alan. 2006. *Bringing Buildings Back: From Abandoned Properties to Community Assets.*

[3]Smith, Geoff and Sarah Duda. 2008. *Foreclosure Fallout: An Analysis of Foreclosure Auctions in the Chicago Region;* Smith, Geoff and Sarah Duda. 2008. *The Chicago Region's Foreclosure Problem Continued to Grow in 2008.*

2008, 19,493 residential properties became REO in the City of Chicago with over 80 percent of REOs happening in 2007 and 2008.[4]

For lenders, ownership of REO properties can have a significant cost. During the foreclosure process, maintaining the property is the responsibility of the homeowner in default. However, if a property becomes REO, the responsibility for maintaining and securing the property transfers to the lender in addition to the responsibility of paying property taxes, insurance, and any required vacant building registration fees. In Chicago, for example, the City assesses owners of registered vacant properties a $250 fee every six months that a property sits vacant and requires them to maintain liability insurance as well as secure the property to City standards.[5] In addition to these responsibilities, the lender also incurs costs related to appraisal, marketing, and administrative costs as they try to sell the property. Taken altogether, these costs can be substantial, and some estimate that monthly post-foreclosure carrying costs can be as high as 1 to 1.25 percent of the total value of a property.[6] Others estimate that these post-foreclosure costs can account for 43 percent of the total foreclosure-related losses experienced by lenders.[7]

Maintenance and security of REO properties has long been a concern of neighborhood organizations and municipalities. Lenders typically retain local REO brokers and/or national field service companies to manage the property maintenance process and the sale of the property. Challenges to both maintenance and sale of the property often depend on the condition of the property when it becomes lender-owned. For example, if a property has been abandoned during the foreclosure process, there is a strong chance that the property has significant damage associated with vacancy such as water damage, mold, frozen pipes, and vandalism. However, deferred maintenance can also occur after a property becomes lender-owned due to negligence by the lender and REO management firms. Damages to the foreclosed property either as a result of vandalism or deferred maintenance during the foreclosure process or after the property becomes REO may be a key cause of the significantly discounted sale price that REO properties command.

REO properties are of concern to community stakeholders, advocates, and municipalities because they sit vacant until sold and are highly concentrated in communities of color. Previous research by Woodstock Institute has shown that increasing levels of foreclosures destabilize communities by leading to declines in values of properties near foreclosures and to increases in levels of neighborhood violent crime.[8] The length of time an REO property remains on the market is of concern because the negative externalities of vacancies on communities exponentially increase the longer a property sits vacant. Research by others has shown that vacant properties represent a significant cost burden to municipalities, and that vacant properties in high levels of disrepair are typically those that have been vacant for an extended period of time.[9] Woodstock Institute's research has shown that, in the Chicago region, REO properties are disproportionately concentrated in communities of color. In 2008, 35 percent of Chicago region REO

[4]Residential properties include one-unit single family properties, condos, and 2- to 6-unit multifamily properties.

[5]Municipal Code of Chicago, 13-12-135: Vacant buildings – Owner required to act – Enforcement authority.

[6]Gordon, Tom. June 5, 2009. American Banker. *Viewpoint: Short Sales Would Help the Entire Housing Market*

[7]Cutts, Amy Crews and William A. Merrill. 2008. *Viewpoint: Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs*

[8]Immergluck, Daniel and Geoff Smith. 2005. *There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values;* Immergluck, Daniel and Geoff Smith. 2005. *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime.*

[9]Apgar, William C. and Mark Duda. 2005. *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom.*

properties were in communities greater than 80 percent African American while less than 9 percent of regional mortgageable properties were in these communities.[10]

Methodology

This report examines what happens to one-unit, single family properties in the City of Chicago after they become REO.[11] To do this, a dataset of all one-unit, single family properties that became REO through foreclosure auction between 2005 and the first half of 2008 was assembled and merged with a dataset of all property transfers in Cook County between 2005 and 2008.[12] The datasets were merged based on property address and subsequently verified by PIN number. In total, 86 percent of single-family properties that became REO between 2005 and the first half of 2008 in the City of Chicago were matched with a corresponding property transfer.[13] When an REO property was matched to a subsequent property transfer to a non-bank entity, it was considered be "sold" and to have left REO status. If there were no recorded transfers after the foreclosure auction, the REO property was coded as "unsold."

Data and Findings

The following section analyzes data on the disposition of single-family properties that became lender-owned through a foreclosure auction between 2005 and the first half of 2008 in the City of Chicago. A particular emphasis was placed on geographic concentrations of properties in communities of color and the effect of large REO inventories in local real estate markets. Key findings show:

The inventory of unsold REO properties from 2007 and the first half of 2008 is large and is highly concentrated in communities of color. As noted previously, the number of properties going to foreclosure auction and entering REO status in the City of Chicago increased substantially between 2005 and 2008 with substantial growth occurring in 2007 and 2008. Between 2005 and the first half of 2008, 14,340 properties entered REO status in the City of Chicago. Of those, 7,169 were one-unit, single family properties. From these properties, there were 6,161 where a property transfer was matched from the auction house to the lender and the property was confirmed as REO. From this confirmed REO stock, 2,046 properties, or 33.2 percent, were unsold as of the end of 2008. As Figure 1 illustrates, the vast majority of these unsold properties entered REO status in 2007 and 2008. This is not surprising given the rapid growth in REO properties in that time period and the more limited time for absorption when compared to properties entering REO status in 2005 and 2006.

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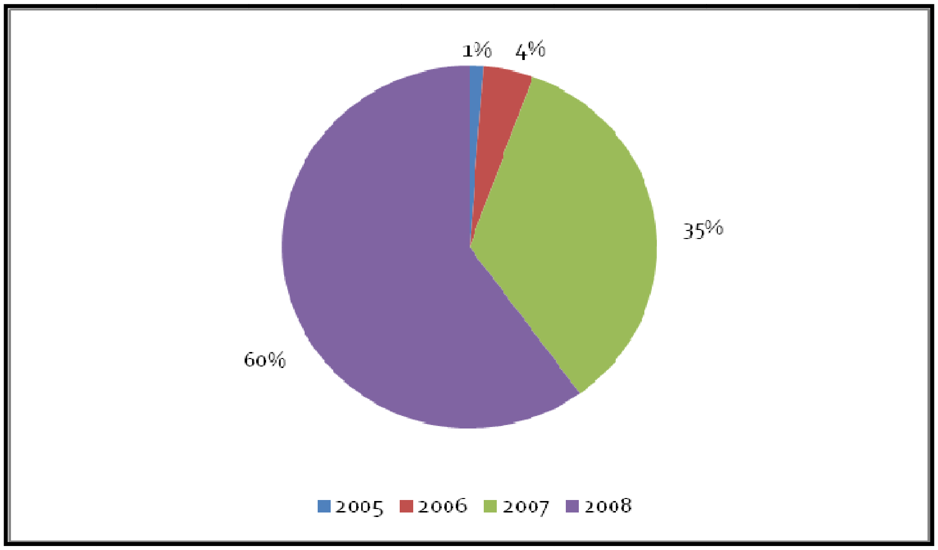
[10] Smith, Geoff and Sarah Duda. 2008. *Lender-Owned Largely Vacant Properties Disproportionately Impact Communities of Color.*

[11] This analysis focuses on one-unit, single-family REO properties because property addresses and PIN numbers for 2- to 6-unit buildings and condominiums were found to be inconsistent between datasets.

[12] Data on foreclosure auctions was supplied by the Foreclosure Report of Chicago and data on property transfers originated from the Cook County Recorder of Deeds.

[13] Unmatched properties are likely a result of either the address being entered incorrectly by the Cook County Recorder of Deeds or the foreclosure data vendor, or the record not matching because the address was coded as "unknown" in the property transfer data. Of all property transfer records between 2005 and 2008, 15 percent had addresses coded as "unknown." It is also possible that the property was not yet officially transferred to the lender after the foreclosure auction.

Figure 1. Inventory of Unsold REO Properties in the City of Chicago by Year Entering REO-Status, End of 2008



Of greater concern, however, is the geographic distribution of unsold REO properties and the impact that these concentrations will have on communities of color. Figure 2 breaks out the inventory of unsold REO properties by the racial and ethnic composition of the property's census tract and the year the property entered REO status.[14] It shows that communities that are 80 percent or greater African American accounted for 1,323 or over 64 percent, of the city's inventory of 2,046 unsold REO properties. While the vast majority of these properties entered REO status in the second half of 2007 and the first half of 2008, 217 unsold properties in African American communities entered REO status prior to the second half of 2007. This means that these properties sat vacant for at least 18 months. Figure 3 looks at the number of unsold REO properties per 1,000 one-unit mortgageable properties.[15] It shows that highly African American communities have 12.0 unsold single-family REOs per 1,000 properties. This is 2.0 times greater than the city average and 7.5 times greater than communities that were less than 50 percent minority. Figure 4 maps unsold REO properties in the City of Chicago and shows high concentrations in neighborhoods on the south and west sides of the city including: West Englewood, West Pullman, Roseland, and Austin.

It will take 25 percent longer for REO properties in communities 80 percent or greater African American to be absorbed into the market than REO properties that are in communities less than 50 percent minority. Understanding how long it will take the inventory of REO properties to be absorbed into the real estate market is a key question for real estate brokers, municipal governments, and others concerned with the impact of vacant properties and distressed property sales on local real estate markets. Absorption rate measures the amount of time it will take for the existing inventory of for-sale properties to be purchase and absorbed into market. In this report, absorption rate for the REO segment of the market is calculated by taking the total number of REO properties at the beginning of a quarter and

[14]Using data on census tract racial and ethnic composition, census tracts were coded as 80 percent or greater African American, 50 percent or greater Latino, 50 percent or greater minority (where Latino population is less than 50 percent and African American population is less than 80 percent), 20 to 49.9 percent minority, 10 to 19 percent minority and less than 10 percent minority.

[15]One-unit mortgageable properties are based on the number of one-unit attached and detached properties in each census tract. Data were taken from the 2000 U.S. Census and updated for 2007. This update was based on changes in the number of owner-occupied housing units in each tract as estimated by data vendor Geolytics.

dividing it by the number of REO properties sold by the end of the quarter. This illustrates the number of quarters it will take for the REO stock to be absorbed if no other properties are added to that inventory.

Figure 2. Distribution of Unsold REO Properties by Community Race/Ethnic Composition and Time-Period Entering REO Status, End of 2008

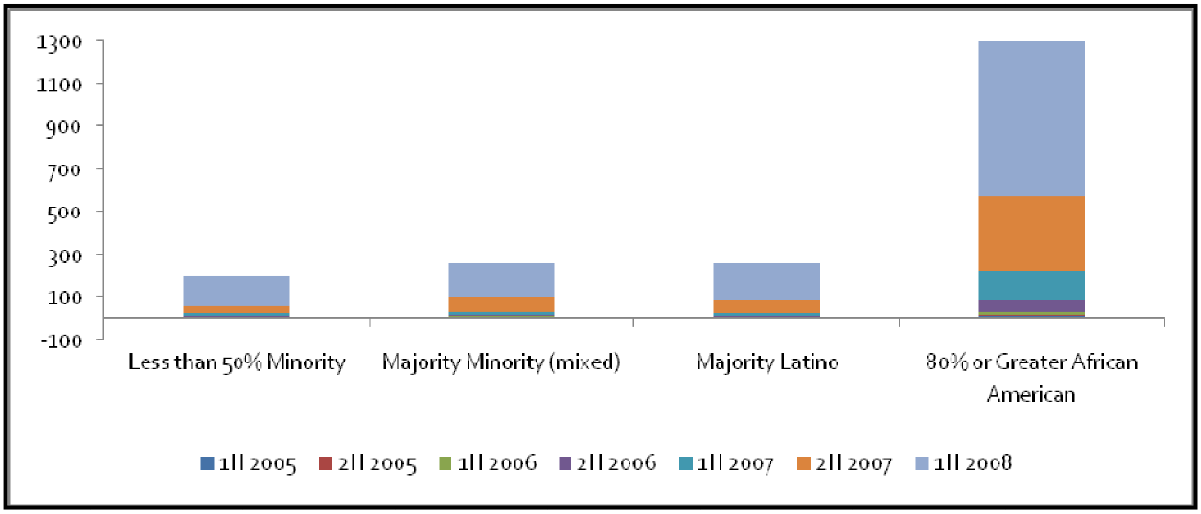


Figure 3. Unsold REO Properties per 1000 Mortgageable Properites by Community Race/Ethnic Composition, End of 2008

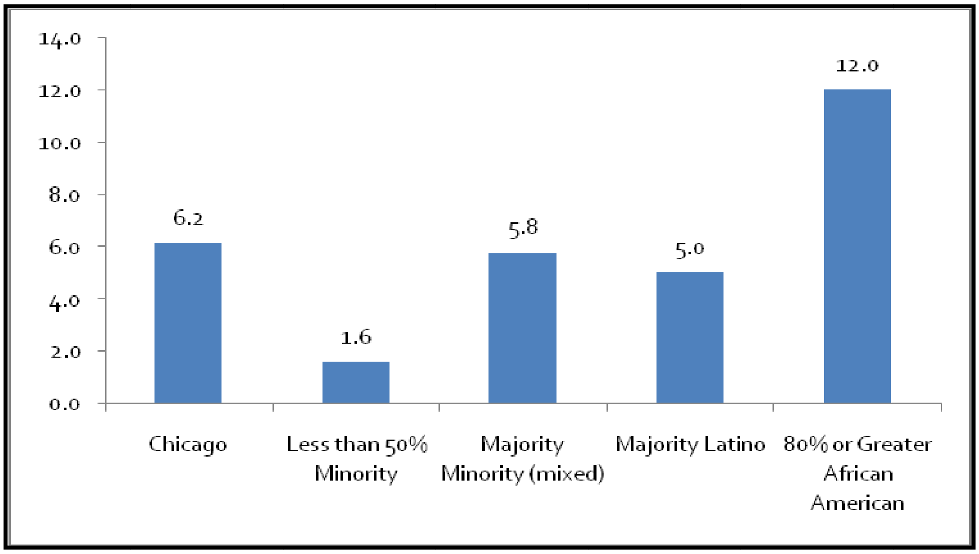


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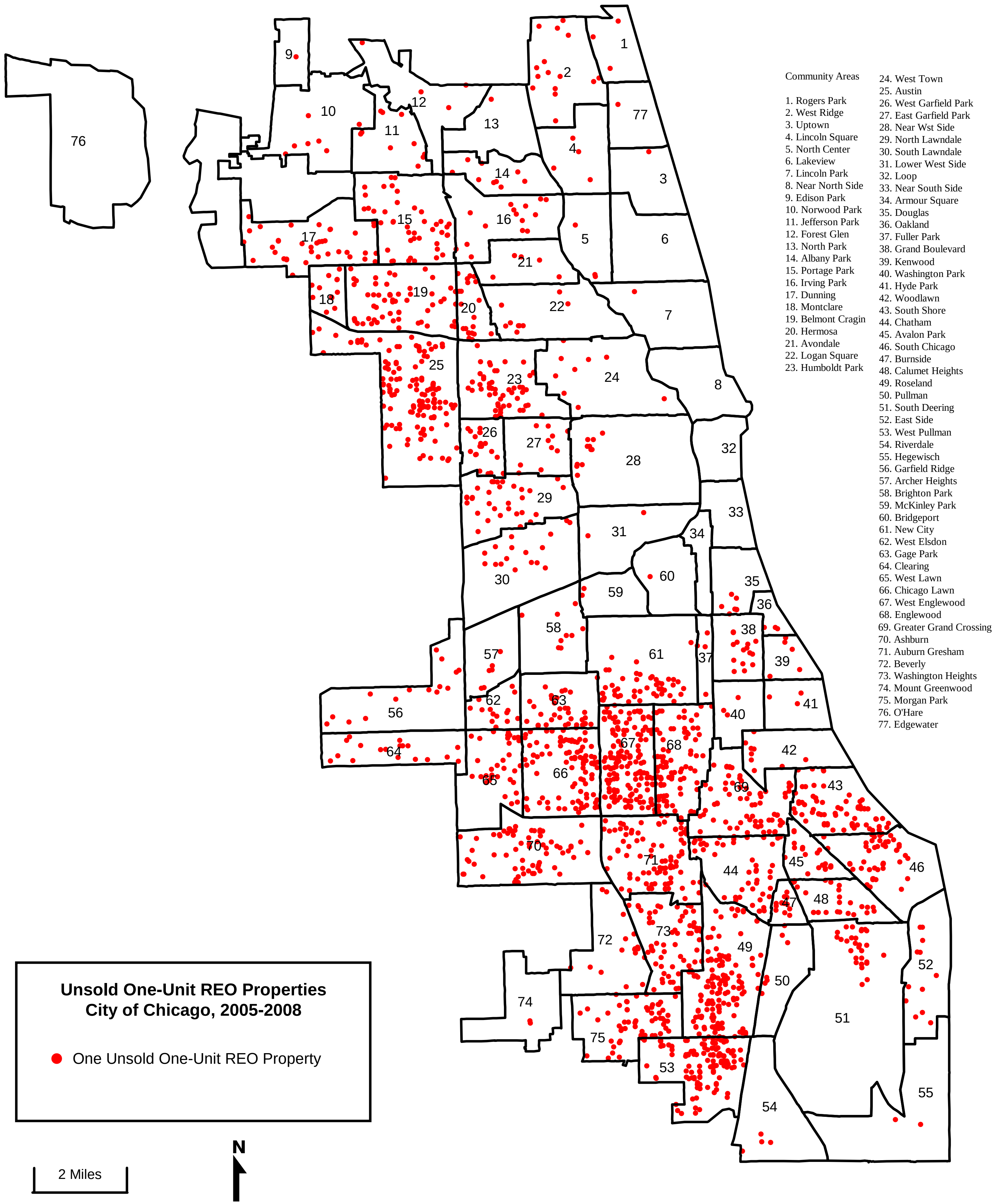
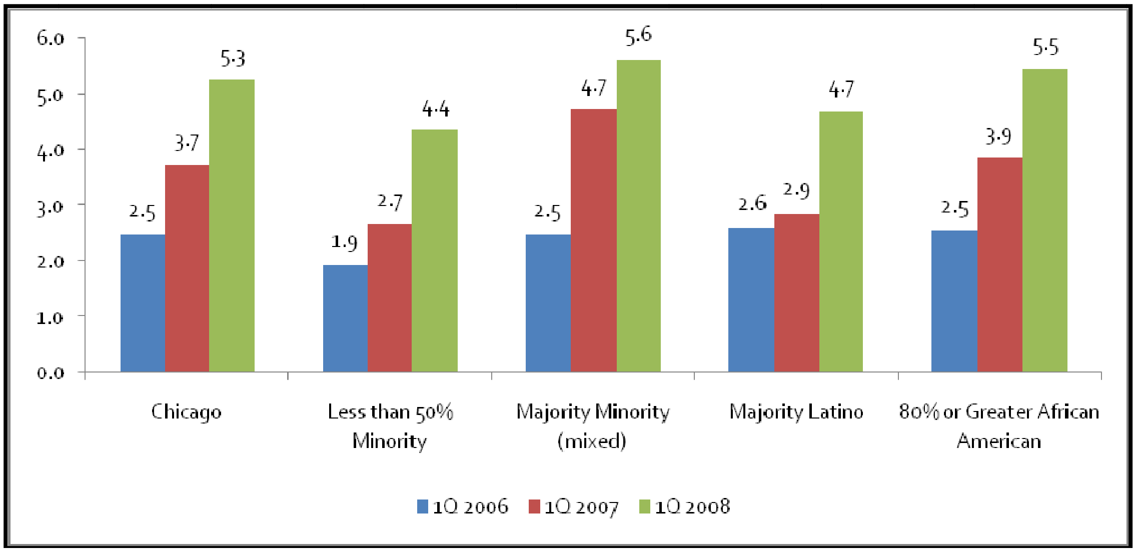
Figure 4. One-Unit Properties Entering REO Status 2005 - 1H 2008, Unsold as of December 31, 2008 City of Chicago



As Figure 5 illustrates, absorption rates have increased tremendously in communities across the board between the first quarter of 2006 and the first quarter of 2008. Citywide the absorption rate was 2.5 quarters (or 7.5 months) in the first quarter of 2006 compared to 5.3 quarters (or 15.9 months) in the first quarter of 2008. Figure 5 illustrates that in the most recent period, communities that are 80 percent or greater African American and communities that are at least 50 percent minority with mixed minority groups had the slowest rates of absorption at 5.5 quarters (or 16.5 months) and 5.6 quarters (or 16.8 months) respectively. In contrast, communities that were less than 50 percent minority had an absorption rate of 4.4 quarters (or 13.2 months). This indicates that communities with significant concentrations of African American residents will have to deal with issues tied to vacant properties for much longer than other communities in the City and local real estate markets will take longer to recover.

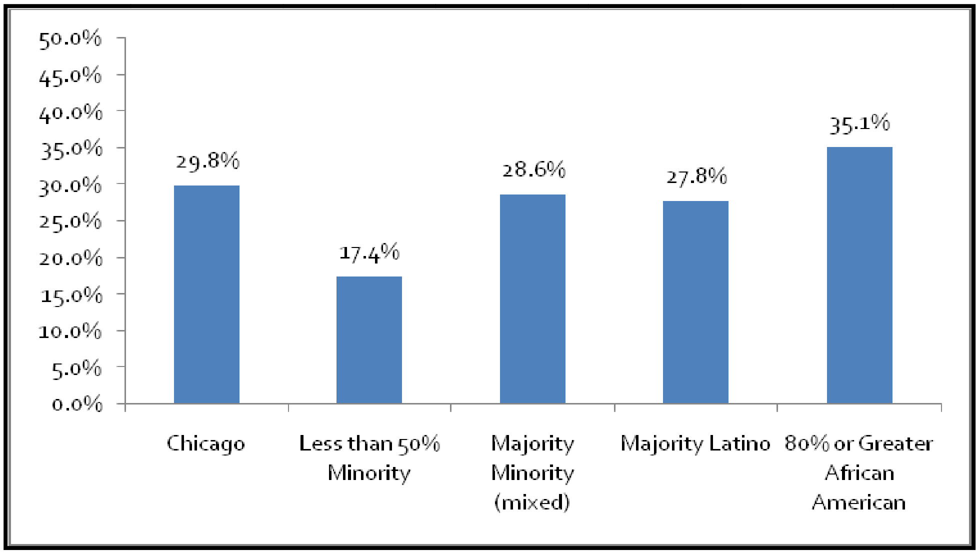
Figure 5. REO Absorption Rate in Quarters, 1Q2006-1Q2008



These numbers are particularly concerning given the rapid and disproportionate growth of REO properties in the City of Chicago since the first quarter of 2008. In the first quarter of 2009, 2,099 properties became REO. Of these properties, 49.9 percent were located in communities 80 percent or greater African American.

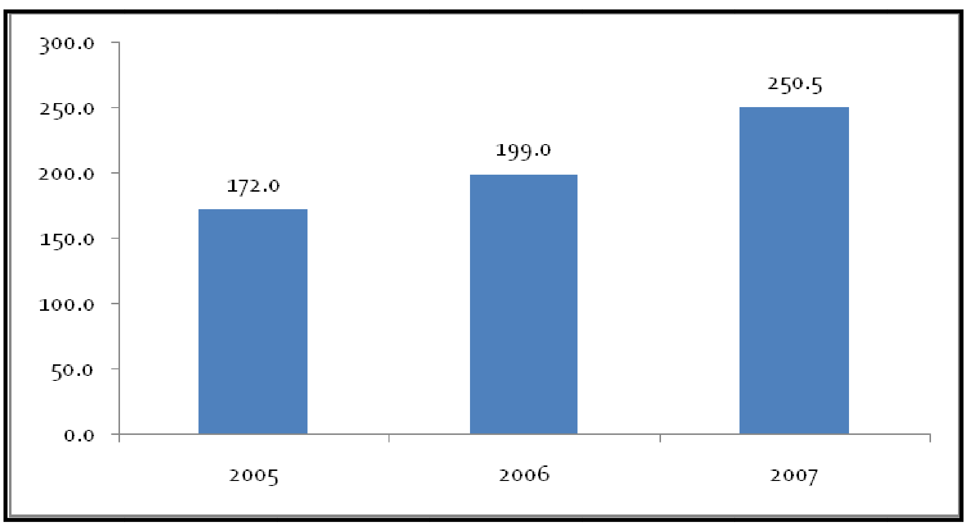
Lenders incur significant losses when selling a property as REO. There are substantial costs for lenders selling properties post-foreclosure auction. Figure 6 compares the change in average foreclosure auction value, typically the mortgage amount due at foreclosure plus any subsequent fees, to the amount that the property sold for in the property transfer record. It shows that on average, values declined for sold properties by 29.8 percent from the auction to the next transfer citywide. However, properties in communities 80 percent or greater African American saw declines of 35.1 percent, while properties in communities' less than 50 percent minority saw declines of 17.4 percent. While auction value may not be an accurate representation of the property's true current value, it does represent the amount due to the lender, and the change between auction value and subsequent sale price represents part of the loss a lender will ultimately take on a mortgage that becomes an REO property. This loss is exacerbated the longer an REO property sits on the market prior to sale.

Figure 6. Average Decline between Foreclosure Auction Value and Subsequent Sale Price for Sold REO Properties, 2005 to 2008[16]



As mentioned previously, lenders incur significant carrying costs associated with securing, maintaining, and selling a property, and some have estimated this cost to be as high as 1 to 1.25 percent of a property's value per month the property is in REO status. As Figure 7 illustrates, for properties that became REO in 2005, 2006, and 2007 and were subsequently sold, the average time on market increased 45.6 percent from 2005 to 2007 from 172 days in 2005 to 250.5 days in 2007.[17]

Figure 7. Median Days on Market for Sold REO Properties, City of Chicago 2005-2007



[16] Values were only available for 85.9 percent of sold properties. In the other 14.1 percent of cases, the sold value was recorded as "unknown." The total number of observations for the City of Chicago is 3,533. In communities 80 percent or greater African American, n=2,400; communities 50 percent or greater Latino, n=338; 50 percent or greater minority (mixed), n=425; and communities less than 50 percent minority, n=370

[17] Properties that became REO in the first half of 2008 were omitted from this calculation because a high percentage were unsold and there was not a sufficient time for absorption by the end of 2008.

Conclusions and Recommendations

This report examines the disposition of properties that became REO between 2005 and the first half of 2008 in the City of Chicago. The report's findings show that the inventory of unsold REO properties at the end of 2008 was substantial and that the vast majority of these properties became REO in 2007 and the first half of 2008. These properties are disproportionately concentrated in highly African American communities, and many unsold REOs in these neighborhoods have been sitting vacant for over 18 months. Without some intervention, it will take many years for these distressed properties to be absorbed back into the market. Based on data for the first quarter of 2008, it would take 5.3 quarters for the stock of REO properties to be absorbed into the market if no additional properties are added to that stock. In communities of color, the absorption rate is significantly higher than in communities where the population is primarily white. This finding indicates that these communities will be dealing with issues related to vacant properties for much longer than other parts of the City. While properties sit vacant, lenders lose substantial sums tied to both lost property values and carrying costs associated with maintaining an REO property.

One of the key concerns about the current foreclosure crisis is that its long term impact will be felt unevenly. Although recent debate has focused on subtle signs of a rebound in the housing market, it is clear that communities of color will face a slower recovery and a disproportionate share of the costs of foreclosure and the impacts of concentrated vacant properties. Some recommendations that might limit this impact and potentially speed a recovery include:

<u>Keep properties in continuous productive use</u> – More aggressive loan modification policies implemented by lenders and servicers would keep more borrowers in their homes and more properties continuously occupied. Such policies would include more aggressive implementation of the Obama Administration's Home Affordable Modification Program (HAMP) that recommends lenders reduce monthly loan payments to an affordable level for at least five years. The most recent data indicate that only 8.7 percent of the 2,705,302 borrowers estimated to be eligible under HAMP have received trial loan modifications.[18] Additionally, adopting principal reduction as a key component of a loan modification strategy will further help reduce payments on certain properties that are currently worth far less than the mortgage owed.

<u>Facilitate the transfer of properties to third party owner occupants</u> – Although short sale volumes have increased in recent months, many stakeholders such as homeowners and real estate brokers still find negotiations with lenders difficult during a short sale.[19] Lenders should consider policies that allow for more proactive short sale negotiations to occur prior to borrowers becoming 90 days late on their mortgage payment. Additionally, states should examine their foreclosure processes. In many cases, states developed foreclosure law to ensure that borrowers had sufficient ability and time to become current on, or "redeem," their mortgage prior to the completion of the foreclosure sale. In some states, this pre-sale redemption period can span seven months or longer. While this can protect the interests of many homeowners, in cases where redemption is not a possibility, there is the risk of properties sitting vacant for extended periods of time prior to when lenders are able to take ownership of a property as REO. Significant damage can take place to a property during this period which can limit the resale opportunities for the property as well as increase neighborhood blight. States should consider modifying foreclosure law to facilitate the transfer of foreclosed properties to banks when there is no chance of borrower redemption.

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[18]See: Making Home Affordable: Servicer Performance Report through July, 2009. Available at http://www.treas.gov/press/releases/docs/MHA_public_report.pdf

[19]A short sale is an agreement between the borrower and the lender to sell a property for less than the amount owed on the mortgage while forgiving the remaining debt.

Give increased power to municipal governments to maintain properties and acquire property for land banks – The growing number of vacant properties places a significant burden on municipal governments in the form reduced tax revenue and increased costs tied to dealing with external impacts of foreclosure. In many cases, municipalities lack the ability to create and enforce vacant property ordinances, to hold lenders accountable for maintaining vacant properties, and to recoup costs tied to maintaining blighted vacant properties. All municipalities should be given such authority. Additionally, municipalities should be authorized to create land banks. Land banks are entities that hold, maintain, and develop vacant properties when no market for the resale of those properties exists. Land banking would give municipalities increased control over vacant properties in their communities and help local governments prevent blight and return these properties to productive use.

Better integration of property data at the local level – In order to track the impact of interventions on the foreclosure crisis, it is critical that better and more integrated data be made available. Currently, it is extremely challenging to track the disposition of REO properties in the Chicago region. Inconsistencies in the way data are entered and a lack of coordination among agencies are primary contributing factors to these difficulties. Currently, foreclosure data is reported in the county court system, but is not regularly shared with county assessor's offices, municipal governments, or real estate brokers. In fact, in many cases the most effective way for any of these entities to access public foreclosure data is to purchase it from a third party vendor and then merge it to existing property records data. Such a process is often quite challenging because of inconsistencies in the way addresses and property identification numbers are entered. Having better integrated property data would greatly aid local governments in assessing the effectiveness of their implementation of various interventions in to the foreclosure crisis such as the Neighborhood Stabilization Program (NSP).

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Woodstock Institute, a Chicago nonprofit incorporated in 1973, works locally and nationally to promote sound community reinvestment and economic development in lower-income and minority communities. It collaborates with community organizations, financial institutions, foundations, government agencies, and others to promote its goals.

The Institute engages in applied research, policy analysis, technical assistance, public education, and program design and evaluation. Its areas of expertise include: CRA and fair lending policies, financial and insurance services, small business lending, community development financial institutions, and economic development strategies.

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