



## California's Discount Foreclosure Sales Point to Housing Bottom

By Dan Levy and Daniel Taub



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July 31 (Bloomberg) -- California led the U.S. into the worst housing recession since the 1930s. Now the most populous state may be the first to find the bottom.

In Stockton, the U.S. metro area with the highest **foreclosure** rate, **home sales** more than doubled in the second quarter after prices fell by an average 37 percent, said PMZ Real Estate Corp., the area's largest broker. Across the state, sales rose for three consecutive months starting in April after 30 straight months of declines, the California Association of Realtors said. About 40 percent of those transactions were foreclosure sales, DataQuick Information Systems reported.

"California is having a wrenching decline in wealth, but this is a cathartic event that will lay the foundation for a recovery," said **Mark Zandi**, chief economist at **Moody's** Economy.com in West Chester, Pennsylvania, in an interview. "This signals the beginning of the end."

Almost \$1.3 trillion of homeowner equity was lost in California since home prices peaked in December 2005, Zandi said. Discounts of as much as 50 percent will extend into 2010, helping clear a glut of **foreclosures** and leading to a more balanced housing market, said **Ryan Ratcliff**, an economist at the Anderson Forecast at the University of California in Los Angeles, and **Christopher Thornberg**, principal of Beacon Economics LLC in Los Angeles.

"Half off in a decent neighborhood is close to the bottom," said **Bill Gross**, co-chief investment officer of Newport Beach, California-based Pacific Investment Management Co., manager of the world's biggest **bond fund**. Property markdowns of 30 percent to 40 percent give the market "price illumination if not sunshine," he said.

'Beginning to Happen'

California led the U.S. in default notices and bank seizures for the 18th straight month in June and had seven of the 10 metro areas with the highest foreclosure rates, according to Irvine, California-based **RealtyTrac Inc.**, which sells default data. That drove down prices and led to "discounted distressed sales," with two-thirds of transactions under \$500,000, compared with 40 percent a year earlier, the California Association of Realtors said.

The amount of time it would take to deplete the supply of homes decreased to 7.7 months from 10.2 months a year earlier, and the median price fell 38 percent to \$368,250 last month, according to the Realtors.

"Things are beginning to happen," said **Karl Case**, professor of economics at Wellesley College in Wellesley, Massachusetts, and co-creator of the **S&P/Case-Shiller home-price index**. "We're not going to get reestablished in a stable market unless that inventory gets cleared out."

Birth of Subprime

California led the boom in the U.S. housing market, as **prices** in the state "more than doubled from 2000 to 2005, fueled by historically low interest rates, according to the Chicago-based National Association of Realtors.

As values soared, California gave birth to the subprime mortgage industry that specialized in lending to borrowers with poor or limited credit, who often used them to buy homes they couldn't afford, said **Stephen Levy**, director of the Center for the Continuing Study of the California Economy in Palo Alto.

Subprime products included "zero-percent" loans that needed no down payment, adjustable-rate mortgages, known as "exploding ARMs" because low interest rates rose after two or three years, and "Alt-A" or "no-doc" loans requiring no proof of income.

Almost half of the 25 biggest U.S. subprime lenders were based in the state, including New Century Financial Corp. in Irvine and ACC Capital Holdings in Orange, and a quarter of the country's subprime loans were issued there, more than in any other state, according to **Inside Mortgage Finance** and data from San Francisco-based

research firm LoanPerformance.

#### County Breakdowns

Defaults on those loans began to accelerate in 2006, helping to push California into the lead in foreclosures.

Foreclosure sales accounted for 75 percent of June's total in Merced County, home to the Merced metro area with the country's second-highest foreclosure rate; 72 percent in Stanislaus County, home to the Modesto metro area with the third-highest foreclosure rate; and 66 percent in San Joaquin County, home to Stockton, data from [DataQuick](#) in La Jolla, California, and RealtyTrac show.

Sales of foreclosed properties equaled 63 percent of the total in Sacramento County, 62 percent in Riverside County, 58 percent in Solano County, 57 percent in San Bernardino County and 49 percent in Contra Costa County. Prices dropped as much 37 percent in those counties, DataQuick reported.

#### 'Seen the Light'

About 1 million U.S. homes will be in some stage of foreclosure by the end of the year, and properties seized by banks will eventually sell at an average discount of 30 percent to 33 percent, said [Rick Sharga](#), executive vice president for marketing at RealtyTrac.

Discounts will be higher in areas such as Stockton, about 80 miles east of San Francisco in California's agricultural Central Valley, and Riverside, 50 miles east of Los Angeles, that experienced above-average levels of new construction at the peak of the housing boom and where lenders made a disproportionate number of subprime loans, Sharga said.

[PMZ](#), the Stockton-based brokerage, closed 1,707 home transactions in the second quarter, about 80 percent of them foreclosure sales, said [Michael Zagaris](#), the company's president. Foreclosed homes are now getting multiple bids and the supply of homes for sale in San Joaquin and Stanislaus counties shrank to 4.9 months in June from 18.2 months a year earlier, he said.

"We've found the bottom," Zagaris said. "The financial institutions have seen the light and are allowing the market to find its own level."

#### Loan Values

Bank-owned properties attract investors who can rent out the homes for 10 percent of the purchase price annually, said [Sean O'Toole](#), founder of real estate auction Web site [ForeclosureRadar](#) in Discovery Bay, California. "Those deals are starting to pop up and putting a floor on the market," he said.

[Bruce Norris](#), president of the [Norris Group](#) investment firm in Riverside, said he purchased foreclosed properties for one-third of the outstanding loan value during the past two months.

Norris bought a three-bedroom home in the Moreno Valley section of Riverside for \$106,000, a 65 percent discount on the \$300,000 loan held by [Bear Stearns Cos.](#), now part of JPMorgan Chase & Co. He got a 61 percent discount on a home with \$258,750 in loans held by [Deutsche Bank AG](#), and a 63 percent discount for a home with \$324,000 in loans held by [Morgan Stanley](#), he said.

"The banks are stuck wholesaling to people like me," Norris said. "They are starting to move product faster than the market would normally allow."

#### Housing Bill

Banks will **foreclose** on about 700,000 properties with subprime mortgages this year, more than double the number a year ago, Sharga estimated. The increase is prompting overwhelmed banks to hire more workers to process purchase offers.

Executives from Charlotte, North Carolina-based [Bank of America Corp.](#) and Wells Fargo & Co. in San Francisco told Congress last week that they've accelerated the pace of loan modifications and added personnel to help homeowners avoid foreclosure. Wells Fargo, which services one in eight U.S. mortgages, expanded its staff to more than 1,000 from 200 in 2005.

The housing bill signed by President [George W. Bush](#) yesterday is intended to stem foreclosures and includes a program backed by the Federal Housing Administration to insure as much as \$300 billion in refinanced mortgages, including many subprime loans.

Housing in Stockton and Riverside sprang up during the boom as builders purchased cheap land and potential buyers sought affordable homes away from expensive coastal cities, said Levy at the Center for the Continuing

Study of the California Economy.

Stockton Couple

Inland home values mirrored coastal gains until a wave of ``insane'' subprime and Alt-A mortgages started in 2005 and resulted in record defaults, Levy said.

``All of those markets suffering from higher foreclosures are where prices went too high and leverage was applied too excessively,'' Pimco's Gross said. The housing bill will ``put a floor on certain mortgages'' and help stop price declines, he said.

Homeowners like computer consultant **David Imig** and his wife, Deborah, who live in the Stockton area and owe more than their house is worth, aren't helped by the bill. They paid \$462,000 for a three-bedroom at the market peak in 2005. Now, their neighbor's foreclosed home is on sale for half its original price.

``We're a good \$100,000 down,'' Imig said. ``If we could move without taking a huge bath, we would.''

Past Busts

Previous California housing busts had roots in local economic woes and U.S. monetary policy. The state **lost 350,000 jobs** in the early 1990s, about two-thirds in the aerospace industry, according to the Cato Institute and Los Angeles County Economic Development Corp. Home prices tumbled 12 percent. In the early 1980s, existing-home sales dropped 61 percent amid interest rates of more than 14 percent and a national recession, the state Realtors said.

California may rebound more quickly from this decline than regions with fewer delinquencies and vacant homes, according to Zandi of Moody's Economy.com. The foreclosure process is ``more efficient'' than in states such as Florida where courts are involved, and Californians are typically ``more optimistic'' about housing after experiencing busts that were followed by property booms, Zandi said.

``They know it's going to be a good investment five or 10 years down the road,'' Zandi said. ``The fundamentals are good: supply constrained markets with lots of population growth, a solid and diversified economy and important global links'' in Los Angeles and San Francisco, he said.

Bidding War

It may take until 2010 for foreclosure sales to work their way out of the system in areas where defaults have soared, said Thornberg of **Beacon Economics**.

``Those sales are going to have a very large impact on prices for the next year or so until those homes get absorbed by the market,'' he said. ``Housing markets don't bounce, they splat. They hit bottom and they stay there.''

That's good news for buyers like Peggy Thorpe. She outbid seven offers for a foreclosed house in Vallejo, east of San Francisco, and still got a 34 percent discount. It was the sixth time since May she made an offer for a home in foreclosure.

``This time I jumped higher,'' said Thorpe, 43, who works at a vineyard in Napa and paid \$190,500 for the three-bedroom home with a loan balance of \$289,000. ``There's an extreme bidding war right now.''

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