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Don't Expect 2008-Style Suits After Next Housing Crash

By **Eric Madsen** (July 13, 2021, 4:57 PM EDT)

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The last housing crash rocked the U.S. economy, resulting in the worst recession in generations. Thirteen years later — with housing prices recently moving skyward at their fastest rate in 30 years[1] — another crash, or at least big corrections in many markets, is only a matter of time.

The 2008 crash unleashed a flood of lawsuits, including claims that major banks sold $200 billion in fraudulent mortgage securities to Fannie Mae and Freddie Mac.[2] With different underlying issues today, it's unclear what types of lawsuits will follow the next correction.

But here's what to watch for as we wait to find out.

Why the Market Has Sizzled

Unsurprisingly, supply and demand are behind the surge in home prices. But this time, widespread subprime lending isn't a primary culprit.

Rather, the pandemic has pushed millennials to buy and baby boomers to hunker down, with housing prices caught in the middle.

Millennials, who had previously been slow to buy houses,[3] were suddenly faced with working from home — often with their kids taking online classes in the same room. They turned to listing sites in droves to find more space.

And with many free to work from anywhere, places like Columbus, Ohio, and Boise, Idaho — with their lower home prices — became more attractive.

Throw in a heavy dose of FOMO (fear of missing out) stoked by today's ever-present social media, and you have your increased demand.

Historically cheap mortgages, a booming stock market, and extra cash from stimulus money and staying in added fuel to the fire.

Also boosting demand was a sudden thirst for second homes as mortgage applications for vacation homes nearly doubled.[4]

Meanwhile, baby boomers — already slower than past generations to downsize at retirement — had more reasons to stay put.

The public health crisis brought adult children back home and largely extinguished thoughts of entering people-intensive transactions to swap excess space for densely populated condos or age-restricted communities. Plus, there is little motivation to sell an asset that is leaping in value.

In addition, a generous mortgage forbearance program, which has allowed millions of borrowers to defer payments up to 12 months, has kept many homes off the market.[5]

Combine these factors with skyrocketing lumber prices and cement and labor shortages, and it's little wonder that bidding wars over severely limited inventory have pushed prices to record highs.

Housing prices have surged for different reasons than in the 2000s, but this doesn't mean boom won't turn to bust.

A permanent jump in housing prices would need a major surprise that either swells population size or shrinks the count of housing units.

That hasn't happened. U.S. birth rates — declining for years — now fall short of replacement levels.[6] Likewise, the pandemic pushed life expectancy down, not up.[7]

And housing growth has outpaced population increases over the past 20 years, with 2.3 people per unit today versus 2.4 in 2000.[8]

The major surprise behind demand for more space was the pandemic. And, at least in the U.S., that surprise appears to be under control.

As the health crisis continues to recede, urban centers will regain their luster. Supply chains will work out their kinks. And historically low lending rates will rise.

Past acceptance of smaller living spaces will return once daytime hours can be spent at the office or a school and the evening can be enjoyed at a movie theater or restaurant.

Cooling, Correction or Crash?

Widespread real estate corrections are different from stock market crashes, which frequently come in big chunks and all at once. Rather, when house prices fall, they usually decline slowly across several years as sellers begrudgingly accept a lower offer than their neighbors snagged just a few months earlier.

While the last crash was an exceptional bust aided by a collapse in mortgage-backed securities, even slow declines are painful.

Timing a market peak is often more luck than smarts, but some signs are telling.

The biggest is a jump in inventory. While the acceleration of new-home construction will contribute to the jump in inventory, expect this to be dwarfed by new listings of previously owned homes.

Nine million baby boomer residences were predicted to sell between 2017 and 2027,[9] a figure that roughly equals the number of all new homes constructed over the past 10 years.[10]

Largely delayed so far, these baby boomer homes represent pent-up supply that could quickly transform the frenzy to buy into a race to capture peak prices.

There are new reasons to expect baby boomers are finally ready to sell.

First are houses that would have already hit the market but were delayed only because of the health crisis.

Second is downsizing that would have occurred later but has accelerated due to a leap in early retirements.[11]

Third is the good fortune of ballooning home equity just in time for baby boomer retirement years. But that additional equity could diminish if not realized soon.

In addition to these factors is the looming threat of changes in capital gains and estate taxation, which could reduce tax incentives to hold assets — including a primary residence — for the next generation.

Downsizing at the right time means more travel and golf, or simply greater financial security, which, in general, baby boomers desperately need.[12]

A recent survey found that of homeowners looking to sell in the next three years or who have already listed, a top motivation was to realize "a profit or use the equity for another purpose."[13] If enough baby boomers sense that now is the optimal time, inventory scarcity will turn to abundance.

Adding to inventory levels will be forced sales that hit the market after mortgage forbearance ceases.

Another factor that will cool the housing market is a return to urban centers.

Rents in major cities, including New York, San Francisco, the District of Columbia and Minneapolis plunged when COVID-19 hit, and urban warriors escaped for the hills.[14] Now those rents are quickly recovering, a sign that employers need workers back on site.

Pre-COVID-19, long-term trends evidenced a growing preference for city life.[15] As the pandemic subsides, expect this trend to resume and the demand to buy houses in more distant communities to shrink.

But there are also factors less directly tied to the pandemic. Foremost is inflation.

Real estate can serve as an inflation hedge if the real estate itself is not already overinflated. But that may not be the case today.

If lenders determine that recently surging inflation is persistent, lending rates will rise as banks aim to be paid back with dollars that are worth more in real terms than the balances they lent.

Higher mortgage rates would mean home buyers can't budget the same sky-high offers behind the

current boom.

Persistent inflation would also likely hit the stock market, making large down payments more difficult to muster.

In the absence of widespread subprime lending, a housing crash reminiscent of 2008 is unlikely. But with lockdowns, social distancing and masks proving to be more of an anomaly than the new normal, a mere cooling of the pandemic-induced boom is also improbable.

Expect something in between — a correction that will likely spread over several years.

If Litigation Follows, Expect Different Issues to Be in Focus

Litigation tends to follow crashes in asset values, whether in equities, privately held businesses or housing.

While lawsuits related to a future housing decline depends on the particulars, the last crash offers a guide to some of the possibilities.

However, those lawsuits involved issues that, based on current information, don't appear to be pervasive in this cycle.

Alleged wrongdoing related to subprime and Alt-A lending was at the heart of the last housing-related litigation boom. Subprime borrowers have FICO credit scores less than 620, while Alt-A borrowers are generally considered to be those with credit scores between 620 and 660.

Also a factor were minimal down payments that allowed substantial upside if prices continued rising, versus a near-free option to walk away if they cratered.

First were suits on behalf of borrowers against brokers under the Truth in Lending Act. At issue was full disclosure of loan costs and terms.

Mortgages that required little to no money down while offering low teaser rates that would quickly ratchet higher had become widespread.

Subprime and Alt-A borrowers, who frequently had limited or no experience with mortgages, were the primary recipients of such loans.

In addition, investors sued banks under Rule 10b-5 of the Securities Exchange Act, alleging that banks misrepresented the quality of the loans behind the mortgage-backed securities they issued.[16]

Credit ratings agencies were likewise sued on allegations that they assigned inflated credit ratings to mortgage-backed securities due.

Also at issue was an alleged conflict of interest between the rating agency and investment banks.[17]

Again, subprime and Alt-A lending was at issue. When mortgage-backed securities crashed following widespread defaults by nonprime borrowers and those with minimal down payments, scrutiny of borrower credit and ability to pay followed.

Documentation of these critical characteristics was lacking or flawed.

But practices behind the collapse in mortgage-backed securities appear to be far less common today, with exotic mortgages falling out of favor.

Nonprime mortgage originations reached as high as $1 trillion in 2005 and 2006, but plummeted at the onset of the financial crisis.[18] They remain far below their 2006 levels.

And even as home prices have surged, the proportion of home buyers putting at least 20% down now represents nearly half of mortgage issuances, continuing an upward trend.[19]

Likewise, adjustable-rate mortgages, which represented more than half of all mortgage dollars loaned in 2005, have all but disappeared.

And the relatively few adjustable-rate mortgages still being issued are concentrated among mortgages that exceed $1 million.[20] Those loans likely involve informed borrowers.

The last round of housing-related lawsuits also stemmed from widespread issuance of liar loans, so called because proof of income wasn't required. Also known as low-doc or no-doc loans, such mortgages fell into default at high rates early in the financial crisis.

While low-doc loans were ubiquitous then, lending standards and diligence appear to have substantially tightened.

These differences between the last housing boom and the current cycle make it less likely that massive litigation will follow the next market correction. Or, if it does, different issues will be in focus.

However, this could change. What now appears to be good behavior in the mortgage-lending industry could reverse once the pool of prime borrowers dries up.

While banks have largely steered clear of subprime lending, nonbank lenders have come to dominate the mortgage market and are allowing subprime and low-doc loans — now rebranded as nonqualified or non-QM — to regain some acceptance.[21]

As current streams of mortgage demand ebb, lower quality loans could begin to flow.[22] And if the lessons of the last cycle go unheeded, industry efforts to prop up a cooling market could open the gate to similar problems as before.

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