# Great Recession Holds Mortgage Crisis Lessons For Today

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*Law360* (May 19, 2020, 5:34 PM EDT)

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The housing and mortgage crisis of the late 2000s, and the Great Recession that the crisis triggered, was at the time the worst economic and financial episode since the Great Depression. The Case-Shiller index, a nationwide measure of home prices, fell by nearly 30% on average across the U.S.[1]

In California, Nevada, Arizona and Florida, home values plunged by 40% or more.[2] Meanwhile, the U.S. unemployment rate more than doubled from 4.4% percent in May 2007 to 10% percent in October 2009, the highest rate in more than 25 years.[3] At the height of the crisis, more than 40% of the unemployed were without work for 27 weeks or more, as an increasing number of Americans faced sustained financial difficulties.[4]

With the COVID-19 pandemic, we once again find ourselves in extraordinary times, with certain parallels to the Great Recession. The pandemic has already caused massive economic disruption throughout the world, as governments, businesses and individual citizens have responded to health risks with policies and behavioral changes that have severely impacted economic output. With regard to the mortgage and housing markets, despite some similarities to what unfolded during the Great Recession, there are important differences worth careful consideration.

## Mortgage Defaults Underlying the Great Recession

There were several key shifts in the mortgage and lending markets in the years leading up to the Great Recession. For example, nontraditional mortgages, such as adjustable-rate mortgages, home equity lines of credit and jumbo loans, exploded in popularity. At the same time, lenders throughout the industry relaxed underwriting guidelines, including lending to borrowers with lower credit scores and allowing higher debt-to-income ratios.

Moreover, there was an abundance of origination and particularly cash-out refinancing activity near the peak in home prices, meaning that many borrowers had little or no time to build up equity in their homes before housing values fell. As home prices declined at a rapid rate during the crisis, many borrowers found themselves underwater, meaning that they owed more on their mortgages than their homes were worth in the marketplace.

Economic research shows that borrowers are much more likely to default on mortgages when facing two simultaneous shocks, often referred to as a double trigger: a loss of income (through, for example, unemployment or illness) that limits their ability to pay, and a decline in home prices driving their mortgages underwater.

Many borrowers in the Great Recession were hit by both of these shocks. As a result, mortgage defaults increased substantially. For example, according to S&P Global Ratings, more than 16% of prime loans and 50% of subprime loans that were originated in 2006 ultimately defaulted.[5]

The spike in mortgage defaults negatively affected many entities involved in the mortgage and mortgage-backed securities markets. Large banks and small lenders alike went bankrupt. S&P downgraded a substantial portion of its residential mortgage-backed security, or RMBS, ratings, and investors saw their RMBS investments plunge in value. The monoline insurance companies that guaranteed certain tranches of RMBS suffered substantial losses and likewise saw their ratings downgraded.

With so many losses to so many entities, substantial litigation followed. Allegations included misconduct at various points in the mortgage origination and securitization process. For example, the government investigated supposedly inappropriate lending practices conducted by mortgage originators and issuers, while other plaintiffs alleged that RMBS issuers and underwriters had made misstatements in RMBS offering documents, violated representations and warranties, and failed to properly service loans.

Still others alleged that trustees failed to properly perform their duties, which ultimately harmed investors. While many lawsuits have been resolved, a number are still pending, as courts continue to sort through the causes of mortgage defaults and losses.

## COVID-19 and Mortgage Defaults

Will history repeat itself? The signals so far are mixed, and the future is particularly uncertain. Nonetheless, there are a number of important factors one can look at to assess the mortgage market's exposure to the COVID-19 pandemic, along with its potential implications for the litigation landscape.

First, consider the double trigger that economists have shown can lead to widespread delinquencies and defaults. One shock, a loss of household income, is clearly occurring en masse throughout the U.S. Unemployment claims have skyrocketed, and many households are facing financial hardships. As of this writing, the unemployment rate has risen to its highest level since the data were first recorded in 1948.[6]

It is less clear that a second shock, declining home prices, will follow, however. Neither Fannie Mae, Freddie Mac nor the private real estate company Zillow Inc. predicts large home price declines in 2020.[7] As of this writing, the major national home price indices for April have yet to be released. Moreover, few analysts perceive a housing bubble like the one that preceded the Great Recession.

Unless home prices fall substantially, widespread losses to lenders are unlikely, as the homes of struggling borrowers who are not underwater on their mortgages can be sold to repay the lenders in full. According to data from the Urban Institute, while new mortgages are being originated with loan-to-value ratios as high or higher than at any point this century (driven by the increase in lending by the Federal Housing Administration and the U.S. Department of Veterans Affairs), less than 5% of outstanding loans were underwater or close to it as of Q4 2019, compared to approximately 30% at the height of the Great Recession.[8]

If home prices remain stable, the fraction of underwater mortgages is unlikely to increase. But if home prices fall substantially, an increasing share of borrowers could find themselves underwater, potentially leading to widespread defaults.

Second, the characteristics of borrowers and the product features of mortgages themselves have changed over time. Compared to the last crisis, riskier borrowers have had more difficulty obtaining mortgages over the last several years.[9] Additionally, leading up to the Great Recession, roughly half of new mortgages contained risky features such as low initial teaser rates and balloon payments. This segment of the market has largely disappeared.[10] A less risky population of borrowers, with mortgages that are less exotic as a whole, may be better able to weather a downturn like the Great Recession.

Third, consider government interventions. Compared to the Great Recession, officials have responded more quickly and aggressively this time around to head off potential problems in the housing and mortgage markets. In particular, in late March, Congress passed the Coronavirus Aid, Relief and Economic Security Act, limiting foreclosures for at least 60 days and authorizing borrowers to request and obtain mortgage forbearance for up to 360 days.

State governments have taken similar actions.[11] Borrowers have already taken advantage of these opportunities: According to the Mortgage Bankers Association, 7.5% of mortgages were in forbearance as of April 26, up from just 0.25% in early March.[12] By contrast, during the Great Recession, help for struggling homeowners arrived, but much later. For example, the Home Affordable Modification Program, a federal program, was launched in March 2009, only after home prices had fallen 20% nationwide and mortgages defaults had risen substantially.

Consequently, while many borrowers are suffering and will continue to suffer financially during the present crisis, it is possible that mortgage defaults and losses will be more limited than during the Great Recession, and that subsequent losses to investors, financial institutions and the government may not be as severe as they were a decade ago.

But that does not mean that we should expect no new litigation as a result of the COVID-19 crisis. One area to watch closely will be mortgage servicing. Mortgage servicers are typically required to forward mortgage payments to investors even when borrowers are in forbearance. The financial strain on servicers could be immense if borrowers do not make payments as the health crisis and unemployment last through the summer or beyond.

To address this concern, the Federal Housing Finance Agency recently announced that servicers for mortgages backed by Fannie Mae and Freddie Mac need only forward up to four months of payments for loans in forbearance.[13] The U.S. Department of Housing and Urban Development announced a similar program for mortgages backed by Ginnie Mae, the primary guarantor of the Federal Housing Administration segment of the mortgage market.[14] But even with this assistance, servicers are seeking additional relief.

It is possible that, under such enormous economic stress, servicers may be unable to keep up with demands for forbearance and loan modifications. While the number of loan modifications has been declining steadily since 2010, it is possible that the trend could be reversed. If decisions regarding loan modifications or foreclosure take longer to work out, certain parties may claim such delays are causing increasing losses on loans, or that forbearance and modification plans are suboptimal, leading to incremental losses that would not otherwise have occurred.

## Conclusion

Much uncertainty remains, of course. Perhaps the public health crisis will fade more quickly than anticipated, and the economy will rebound in short order. In such a case, mortgage defaults and the strain on financial institutions will be modest and short in duration. Or perhaps the health crisis will be long-lasting, with economic conditions, including increases in mortgage defaults, getting worse before improving. If this happens, we expect that, as happened during the Great Recession, disputes will arise over servicing practices and possibly mortgage origination practices

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## Endnotes

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