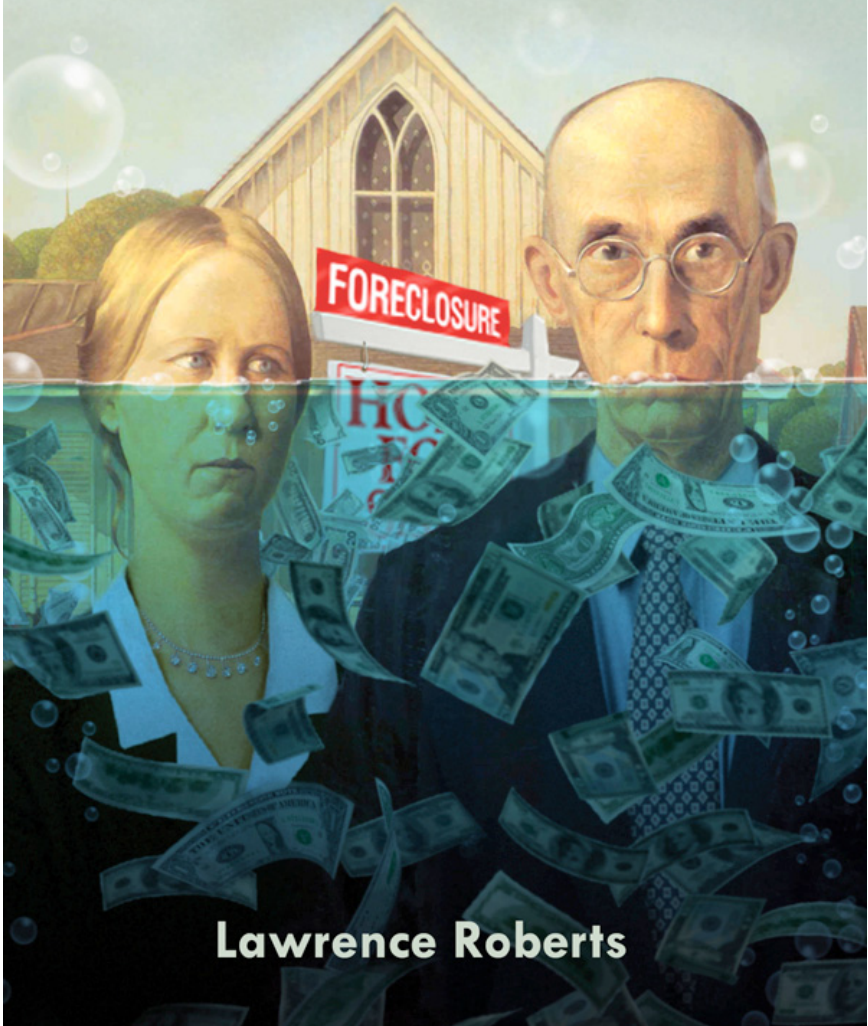


THE GREAT
HOUSING BUBBLE
Why Did House Prices Fall?



Lawrence Roberts

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The author's work can also be found at the Irvine Housing Blog where he has been the primary writer since February of 2007.

<http://www.irvinehousingblog.com/>

The Irvine Housing Blog has become noted for its unique delivery of real estate market analysis in Slate Magazine, the Washington Post, and Newsweek Magazine. The blog reaches an average of 3,500 unique visitors a day, and it received over 2,000,000 page views in its first year of operation.

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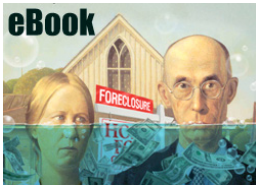
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Preface

I work as a development consultant in the real estate industry in Southern California. My education and experience has acquainted me with a variety of real estate markets, but residential real estate is the one with which I am most familiar. I am not a realtor or a mortgage broker, and my livelihood, though dependent upon the real estate industry, it is not dependent upon facilitating a home-sale transaction. What is presented here is both historical account and unbiased analysis. My observations of the residential real estate market are not tainted by any need or desire to convince anyone they should buy a house. In fact, one of my motivations for writing about the Great Housing Bubble is to convince people *not* to buy a house when prices are inflated and save them from financial ruin. It saddens me to watch homebuyers get caught up in the bubble mythology and enter into a financial transaction that will have a strongly negative impact on their financial lives. People who have already made that decision cannot be helped except at the expense of a naïve buyer. Sellers have the marketing machine of the National Association of Realtors to help them. Buyers have few sources of unbiased information to assist their decision. Part of the purpose of this writing is to educate both buyers and sellers on the realities of the residential real estate market.

One of the difficulties of writing a book on the Great Housing Bubble in 2008 is that the bubble has not played itself out yet. There is a necessary change in tense required when speaking of events prior to 2008 and those projected to occur during and after 2008. Someone reading this in 5 years may look back on it as history, but for those of us living it now, it is a history not yet lived. Much of what is presented here may not come to pass, or it may not happen in the way hypothesized in this book. History will judge whether this is prescient, or if it is “a tale told by an idiot, full of sound and fury, signifying nothing.”¹

Irvine Housing Blog

I discovered Real Estate Bubble Blogs in November of 2006.² Many were in existence much earlier, but I was not a big reader of blogs prior to this time. I

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first discovered the Irvine Housing Blog when my wife found a series of interesting posts on people who were attempting to sell properties for a quick profit (flipping,) and they were getting burned. I was quickly hooked. From the blogroll (links to other blogs) I was able to locate several other bubble blogs, and I quickly became a regular reader and commenter on several blogs in this community.

In February of 2007, I was asked to write for the Irvine Housing Blog. I had a great deal of pent-up energy for writing about the housing bubble. Over the months that followed I wrote a series of analysis posts which became the structure of this book. Daniel Gross, a freelance writer published in Slate Magazine, the Washington Post and Newsweek, characterized the writing as follows (Gross, *The Real Morons of Orange County*, 2007): "IrvineHousingblog, brilliantly drives home the same point with daily dispatches. The blog is a guide to the seventh circle of real estate hell – people who buy houses on spec with no money down. A typical entry chronicles the purchase price, tracks down the amount of debt on the property, and then calculates how much each party – the buyer, the first mortgage holder, the second mortgage holder – stands to lose assuming the seller receives the asking price."

The Reservoir of Schadenfreude

The readers of the Irvine Housing Blog have a voracious appetite for profiles of losing properties. They are not alone. Why do people get so much pleasure from seeing would-be real estate moguls lose a great deal of money? I can think of no other human endeavor that has engendered so much pleasure in the misfortune of others by otherwise caring, compassionate people. In my opinion, the outpouring of schadenfreude we are seeing as the housing bubble deflates is a mixture of Greek tragedy and bad karma. In short, bubble participants should have seen it coming, and they are getting what they deserve.

Schadenfreude is not a spiritually uplifting emotional response. Most religious traditions would counsel us against it. In Buddhist teaching, people are taught to cultivate feelings of compassion for the misfortune of others – feeling empathy and sadness for the slings and arrows of outrageous fortune when they impact another.³ The near enemy of compassion is pity: it masquerades as compassion, but it has an element of separateness which detracts from the sense of Oneness with all things. Joy is good: Sympathetic joy, the joy in the happiness of another, is another pillar of a spiritual existence; however, joy in the misfortune of another – schadenfreude – is not a skillful behavior leading to happiness. Even knowing that, many of us feel this joy anyway. Why is that?

I recognized financing terms were creating artificially high prices early on. By 2004, I was telling people I knew that this was a problem which would cause a market crash. Most people looked at me like I was crazy. "Real estate always goes up," I was told. "The government would never allow prices to crash," I was told. "If you do not buy now you will be priced out forever," I was told. This is the intoxicated language of real estate junkies who have overdosed on the real-estate-appreciation kool aid. If these statements had been offered in a defensive

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manner of someone who is being made to realize they made a serious mistake, I could have felt sympathy for them; I would have been able to disarm their defensiveness and helped them see the light. However, what I generally got was a smug assuredness of someone who truly believed he was right and I was wrong; not just that I was wrong; I was a stupid, cowardly fool who did not have the brains or the bravery to take the free money being given out. This was particularly surprising given my line of work. It was as if a patient after getting a diagnosis of cancer told the doctor that the physician did not understand the tissue growth was a natural, healthy process. The buyers caught up in the Great Housing Bubble did not recognize the financial cancer even when an expert in the field told them how dangerous it was.

During the bubble rally, those of us who chose not to participate were labeled as “bitter renters.” It was suggested we were envious of the good fortune of homeowners as their property values rose, as they took on insane amounts of debt, and as they blithely financed a lifestyle well beyond their means. This was undoubtedly true for some, but in my opinion, this is not the primary reason so many derive so much pleasure from the misfortune of those now suffering from declining property values. These same people who chided us for being envious actually wanted us to be envious: they wanted us to know they were the winners in our competitive society; they wanted us to view them as superior. This act of putting themselves above us created a separation which prevented us from feeling sympathetic joy for their good fortune, and it prevented us from feeling compassion for them when they fell.

In our collective unconscious which manifests in our dreams and our mythology, water is often symbolic of our emotions or our emotional state. Have you noticed people are often categorized as deep or shallow? If you are in debt you often feel “underwater.” Anger is much like water: if not given an outlet, it will fill a reservoir until it reaches a breaking point and is expressed in a flood of emotional rage. Each encounter with a pathologic, kool-aid-drinking housing bull during the bubble rally has added to this reservoir, and reveling in failed flips is an outlet for this pool of toxic emotional waste.

There is an element of tragedy in every disaster, but financial bubbles are some of the most interesting because they are completely man made. They are created by the accumulation of individual decisions of buyers who are motivated by greed, foolish pride, and a false sense of security. Each of these people should have known better. Many of them were warned of their impending doom by those who saw trouble brewing, and yet, many chose to go down the path to the Dark Side. Newton’s Third Law states, “For every action, there is an equal and opposite reaction.” The Law of Karma states, “For every event that occurs, there will follow another event whose existence was caused by the first, and this second event will be pleasant or unpleasant according as its cause was skillful or unskillful.” It became obvious as the crash began; the behavior of buyers during the bubble rally was not skillful. Whether it is Newton’s Third Law, Karma, or a Calvinist form of retributive justice, as this bubble deflates, many of the participants in this bubble are about to experience a great deal of hardship. Like many others, I will enjoy their suffering until my reservoir of schadenfreude is emp-

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tied. For the sake of my own personal spiritual well being, I hope this happens soon so I can regain my normal emotional balance and rekindle my feelings of compassion for my fellow human beings.

Introduction

Why did house prices fall? This is the fundamental question to most Americans, and to those who lent them money. Most homeowners did not care why residential real estate prices rose; they assumed prices always rose, and they should simply enjoy their good fortune. It was not until prices began to fall that people were left searching for answers. This book examines the causes of the breathtaking rise in prices and the catastrophic fall that ensued to answer the question on every homeowner's mind: "Why did house prices fall?"

Even though the decline is nowhere near over in 2008, already the Great Housing Bubble witnessed the largest decline in house prices since the Great Depression. The asset bubble for the Great Depression was the stock market while the asset bubble for the Great Housing Bubble was residential real estate. The title of the book, the Great Housing Bubble, is an allusion to the Great Depression of the 1930s. Both of these dramatic events were the result of a wild expansion of credit and a subsequent crash in asset prices that stressed the banking system and led to a dramatic economic slowdown.⁴

The book is arranged into 10 chapters. The first 4 chapters provide background information and are used to define terms and provide a broad conceptual understanding of residential real estate economics, chapters 5 through 8 discuss the structural and psychological factors that inflated and deflated the bubble, and the final two chapters describe methods of coping with the housing bubble. Chapter 1 is a general description of financial bubbles as a psychological phenomenon and the unique beliefs of residential real estate bubbles. Chapter 2 details the financing environment surrounding residential real estate. It defines and categorizes the types of borrowers and the types of loan programs available, and it illustrates how financing impacts the wealth of individual owners and the economy as a whole. Chapter 3 summarizes the mathematics determining the value of residential real estate and examines issues pertaining to the rent-versus-own decision, and chapter 4 delves into the fine points of determining the value of individual lots and raw land. Chapter 5 illuminates the credit bubble (which was largely responsible for the real estate bubble) with rigorous detail on the structure of the secondary mortgage market and how the expansion of credit

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through this market inflated the housing bubble. Chapter 6 looks at the housing bubble, its various measurements, and explains why the bubble burst. Chapter 7 is a review of the psychology of real estate bubbles. Financial bubbles are primarily psychological phenomenon, and the various aspects of investor psychology are explored to see how they shape the market. Chapter 8 is a projection of future house prices based on the data and conditions as they existed in early 2008. Chapter 9 contains advice for both sellers and buyers who plan to be active while prices are declining. Chapter 10 is a review of the causes of the bubble and proposals for reforms to prevent residential real estate bubbles from happening again.

The examples and data used in the analysis are national in scope, and they are also focused on the local residential real estate market in Irvine, California. The Great Housing Bubble is a national phenomenon; however, the national statistics soften the extremes and make the rise and fall look less remarkable. In some local markets, the prices changes are truly extraordinary, and it is through examining these markets that the story of the bubble is best told. A fine exemplar of the Great Housing Bubble is Irvine, California. Irvine is a large, master-planned community of over 200,000 residents. The high incomes of Irvine residents are reflected in the rental rates for properties which are consistently near the highest in the nation. High incomes and rents translate into high real estate prices, even at the bottom of down cycles. When reviewing the properties in Irvine and the price tags attached to them, it is not uncommon for outsiders to believe a decimal point has been misplaced. The lessons learned from the Irvine experience are universal. Though many the examples from this work focus on Irvine, this is a book about the Great Housing Bubble of which Irvine was both a catalyst and one of its biggest participants.

Table 1 - Top Subprime Lenders 2006

Rank	Lender	Market Share %
1	Wells Fargo	13.0%
2	HSBC Finance	8.3%
3	New Century	8.1%
4	Countrywide Financial	6.3%
5	CitiMortgage	5.9%
6	WMC Mortgage	5.2%
7	Fremont Investment	5.0%
8	Ameriquist	4.6%
9	Option One	4.5%
10	First Franklin	4.3%
11	Washington Mutual	4.2%
12	Residential Funding	3.4%
13	Aegis Mortgage	2.7%
14	American General	2.4%
15	Accredited Lenders	2.3%
Top 15 Lenders		80.2%

Source: Inside B&C Lending

INTRODUCTION

The epicenter of the Great Housing Bubble is located in Irvine, California. One of the primary causes of the bubble was the lowering of lending standards and the extension of credit to people who could not handle the responsibility: Subprime borrowers. The word “subprime” has become indelibly linked to the Great Housing Bubble. It is one of the causal factors that make the bubble unique, and the collapse of subprime is widely regarded as the pin-prick which began the bubble’s deflation. Irvine, California, is the center of the subprime universe. Three of the top ten subprime lenders, New Century, Ameriquest, and Option One, are (or were) headquartered in Irvine. Most subprime lenders have processing offices in Irvine due to the large number of trained personnel living in the area. Irvine’s New Century Financial, formerly the second largest subprime operator, is heralded as the poster child of the bubble. The company name “New Century” implies a new era and a new paradigm. It embodies the fallacious beliefs and ideas that inflated the Great Housing Bubble.

Volatility in real estate prices is not new to California. During the 1970’s, real estate prices detached from typical valuations of three-times yearly income seen in the rest of the country. Once residents realized they could push up prices in their real estate markets to dizzying heights, they have been doing it ever since. Greed springs eternal. The Great Housing Bubble is the third such bubble in the last 30 years, and it is the largest of all. The detachment from traditional measures of valuation was so extreme that it is difficult for many to comprehend. Each time the bubble bursts, the crash is incorrectly blamed on some outside force, and each time the rally is thought to be different than the rally in previous cycles. It never is.

Buying and Selling During a Decline

During the bubble price rally, sellers and realtors, the agents of sellers, had everything going their way. It was easy to price and sell a house. A realtor would look at recent comparable sales, and set an asking price 5% to 10% higher and wait for multiple bids on the property – some of which would come in over asking. The quality of the property did not matter, and the techniques used to market and sell the property did not matter either. As far as buyers and sellers were concerned house prices always went up, so the sellers were thought to be giving away free money; obviously, the product was in high demand. As the financial mania ran its course, buyers became scarcer; all the ones who could buy did buy. The buyer pool was seriously depleted leaving prices at artificially high levels. When the abundance of sellers became greater than the number of available buyers qualifying for financing, prices began to fall.

Residential real estate markets generally move very slowly and trend in a single direction for long periods of time. Once these markets reach an inflection point, the direction of price movement changes, and the balance of negotiating power shifts from an advantage to one side to an advantage for the other. However, most market participants do not recognize this change for some time. Sellers continue to price and attempt to sell using tactics that worked during the rally, and they find they are unable to sell their properties. It often takes two years or more before sellers accept the reality of the new market and adjust their attitudes and behaviors to the new dynamics of a buyer's market.

In a buyer's market, buyers have the upper hand, and sellers need to adjust their pricing tactics to reflect this fact. During a rally, many buyers must compete with each other for the property of a few sellers. In a price decline, many sellers must compete with each other for the money of a few available buyers. It is common for sellers to ask their realtor to find a buyer who will appreciate the "unique qualities" of their property. Every seller thinks their property is the finest in the neighborhood and certainly commands a premium 5% to 10% more than their neighbors. These fantasies are reinforced by the behavior of buyers during the rally. At the risk of losing the listing, the realtor must find a diplomatic way to convince a would-be seller their property is average at best and needs

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to be priced accordingly. It is a difficult challenge for an experienced realtor to persuade an owner her castle is a cottage. Failure to educate the sellers to the reality of the market wastes the seller's time and the realtor's resources. Experienced realtors who thrive in bear markets earn their commissions.

Selling for Less

Sellers in declining markets must compete on price. Only the best properties can command prices equal to recent comps. In a buyer's market, there are no premiums: getting the price of recent comps reflects a premium because prices are declining. Properties with negatives must price 10% or more below recent comps to attract the attention of buyers. There are many books and articles written about staging a property and various techniques a seller should employ to sell their home. Most of these writings pander to the ego and false hopes of sellers who refuse to compete on price. No amount of sales and marketing is going to convince a buyer to overpay in a buyer's market. Price is the ultimate amenity.

Paying off a Mortgage

Once a price decline gets underway many buyers who were late to the price rally find they are in a property worth less than they paid for it. As prices continue to fall, many find themselves "underwater" owing more on their mortgage than their property is worth. When these late buyers want to become sellers, they cannot sell and pay off the mortgage balance with the proceeds from the sale. Then they have a real problem. It is a problem with only 4 plausible solutions:

1. The borrower can keep making the mortgage payments until prices go back up. This is the "hold and hope" strategy. If the borrower uses exotic financing – which most buyers did in the later stages of the Great Housing Bubble – it may be difficult to continue making mortgage payments because these payments are likely to increase substantially. If the property is not owner-occupied, the borrower may try to rent it out to cover expenses; however, this is generally not feasible. Buyers who purchased during the mania paid too much money relative to prevailing rents and available income. If this were not the case, it would not have been a financial mania. Since the payments are too high, renting the property does not cover the expenses. Renting out the property lessens the pain, but it does not make it go away. Also, since housing market corrections often last 5 years or more, it may be a very long time before prices recover to peak bubble levels. Keeping the property is a "death by a thousand cuts," or perhaps a death by a thousand payments.
2. The borrower can write a check at the closing to pay off the portion of the mortgage not covered by the proceeds from the sale. Many people do not have the amount necessary in savings, as few thought such a loss was even possible, and even fewer are willing to go through with the

BUYING AND SELLING DURING A DECLINE

sale knowing they will have to pay for the loss. The undesirability of this option usually forces the borrower to keep the property and try to endure the pain, or let it go up for auction at a foreclosure.

3. The borrower can try to convince the lender to agree to a short sale. A short sale is a closing where the lender accepts less than the full mortgage amount at the closing.
4. The borrower can simply stop making payments and allow the property to go to public auction in foreclosure. Both short sales and foreclosures have strongly negative impacts on credit scores and the availability of credit in the future.

In the price declines of the early 90s, most people opted to keep making their payments and stay in their homes. Downpayment requirements were high, and the use of exotic loan programs was less common in the preceding rally, so many homeowners had equity in their properties and were able to make their payments. They accepted debt servitude as part of the price of home ownership. When faced with the four options presented to them, most chose to stay in their homes and keep making payments. As the slowdown in the housing market helped facilitate a recession in the early 90s, a recession compounded in California with defense industry layoffs, many people lost their jobs and as a result, lost their ability to make high mortgage payments. This created a problem with foreclosures that pushed prices lower. The decline in prices in the early 90s, though extreme in certain fringe markets, was not so deep to cause many people to voluntarily walk away from their mortgages. Most buyers during this period were required to put 20% down. This represented years of savings and sacrifice for many, so they were not willing to lose it. Since the total peak to trough correction was a bit less than 20% statewide in California and even less in other states, many homeowners still had some equity in their homes. The combination of high equity requirements and a relatively shallow correction made staying in the home the best choice for many. This kept foreclosures to high but manageable levels. In contrast, the Great Housing Bubble was characterized by low or non-existent equity requirements, and very steep initial drop in house prices. These conditions made foreclosures, both voluntary and involuntary, a tremendous problem.

Much of the purchase money in the bubble rally was debt. As 100% financing became common, the average combined loan-to-value on purchase money mortgages climbed to more than 90% (Credit Suisse, 2007). With so many people with so little in the transaction, it did not take much of a price decline to cause people to give up. By late 2007 prices had already fallen 10% or more in many markets, and there was no sign this would change in the immediate future. It was becoming obvious that those with little at risk were well underwater and they were going to be that way for the foreseeable future. This inevitably led to one of the unique phenomena of the Great Housing Bubble – Predatory Borrowing. Many simply stopped making payments they could afford because the value of their property had declined significantly. Nowhere in the terms of the mortgage did it state the payments would be made if, and only if, resale values in-

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creased, but many borrowers acted as if it did. When borrowers quit making payments they were capable of making simply because they were not going to make money on the deal, their behavior was predatory to the lender who ultimately had to absorb the loss. These borrowers often had so little of their own money invested in the form of a downpayment they felt little actual damage from just walking away from the property and mailing the lender the keys. Many borrowers simply stopped making payments, did not respond to letters or phone calls from the lender, and moved out. Short sales and foreclosures were not the end of the nightmare for sellers. It is the last contact they had with the property, but in many circumstances the debt – and debt collectors – followed them until the debt was repaid or discharged in bankruptcy.

Short Sale

A short sale is a property closing where the proceeds from the closing do not satisfy the outstanding debt on the property. The lender must agree to accept less money at the closing table for the closing to occur. From a credit perspective, there is little or no difference between a short sale and a foreclosure. Both a short sale and a foreclosure will show a series of missed payments and a secured credit line (or multiple credit lines) with a permanent delinquency and discharge for what is generally a very large sum of money. Both will have a strong, negative impact on the borrower's FICO credit score that will persist for many years.

Because of the potential for fraud and the bureaucratic tangle of various parties involved, it is very difficult to get a short sale approved. If a lender is going to lose money, they are going to want to be sure the borrower is not selling the property to a friend or relative or engaging in some other kind of fraudulent conveyance. Also, the lender will want to be sure the borrower cannot pay back the money. They often require additional financial information like updated W-2s, 1040 tax returns, and a statement of assets certified by an accountant. In most cases, the borrower will have to stop making payments as evidence of their inability to do so in the future. Further, the property will also need to be listed for some period of time at a sales price which would result in sufficient funds to pay off the loan. Once it is demonstrated to the lender that the borrower has stopped making payments, cannot reasonably make future payments, and the property cannot be sold for a breakeven amount, then the lender may grant a short sale request. None of this happens quickly. If a buyer is found who is willing to purchase the property, the process of approving a short sale is so long and cumbersome, most buyers will move on to one of several other available properties on the market.

In the end, a short sale is only in the best interest of the borrower if they believe the bank will try to collect on the shortfall from the property sale. If a borrower is in a position where he will have to pay back any losses, a short sale may result in a smaller loss than a foreclosure and subsequent auction. If the borrower is not in a position where the lender either can or will go after the deficiency, there is little incentive for the borrower to even attempt a short sale. In these instances, the borrower generally lets the property go into foreclosure.

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Foreclosure

Foreclosure is the forced sale of a property owned by the borrower in order to satisfy the debt(s) secured by the property. Foreclosure laws are complex, and they vary from state to state. There are no federal laws governing foreclosures. The borrower is the legal owner of the property who has entered into a mortgage agreement with a lender to pay back all borrowed money, fees and interest due. The Mortgage is a security instrument that pledges the property as the security for the loan. This document provides the lender the ability to force the sale of property to satisfy the debt if the borrower fails to pay in accordance with the terms of the agreement. The lender does not own the property; they merely own a lien on the property which can be exercised to force a sale to satisfy the debt. At the time of a sale, all proceeds first go to settling this indebtedness before any residual “equity” goes to the seller. Foreclosures are always public auctions where the lender must notify the general public in advance, and the general public must be allowed to bid on the property. This public auction is necessary to prevent the lender from forcing the borrower to sell the property at a below market price to the lender who could then resell it for a profit on the open market.

Lenders do not want to own real estate. Lenders are in the business of loaning money and collecting fees and interest. At a foreclosure auction the lender will generally bid on the property up to the value of the loan.⁵ This ensures auction bids will be high enough to satisfy the outstanding loan amount. The lenders do not want to be the highest bidder. They would rather someone else bid over the loan amount and make them whole. If they end up being the highest bidder, then they must manage the property and ultimately arrange for its sale in the non-auction real estate market. There are costs and fees associated with this endeavor which eats in to the final disposition amount garnered from the final sale of the property. These fees generally increase the loss for the lender.

Recourse vs. Non-Recourse Loans

Loans used to purchase real estate assets can be either recourse loans or non-recourse loans. A recourse loan is one where the lender can sue the borrower for any amount owed in the terms of the loan contract. As with foreclosure laws, whether a loan is recourse or non-recourse varies from state to state. In California, all purchase money mortgages are non-recourse loans. In most states, including California, all refinances, home equity lines of credit or other loans not used to purchase the property will be recourse loans. This distinction becomes very important in a foreclosure or short sale. If a loan is non-recourse, the lender cannot collect from the borrower for deficiency under any circumstances. The sale and closing of the property is the end of the matter: the debt does not survive. If the loan is a recourse loan the lender may have the right under certain circumstances to go after the borrowers assets after a foreclosure. This depends on whether the foreclosure was judicial or non-judicial.

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Judicial vs. Non-Judicial Foreclosure

Foreclosure proceedings in most states can be either judicial or non-judicial at the lenders discretion. The lender has the right to sue the borrower in a court of law for repayment of the debt on the property. This legal action is a judicial foreclosure. A judicial foreclosure is slower and costlier than a non-judicial foreclosure. The mortgage agreement has a provision where the borrower authorizes the lender to sell the property at a public auction if the borrower fails to pay the debt. A lender can exercise this right without a court order, and therefore it is considered a non-judicial foreclosure. It is faster and less expensive to perform a non-judicial foreclosure because no attorneys are involved and there is no waiting for a case to come up on a court's schedule; however, there is a problem with non-judicial foreclosure, in most states the lender waives their rights to obtain money in a deficiency situation because no deficiency judgment is entered in the court record. When faced with deciding between a judicial or non-judicial foreclosure, the lender must weigh the cost and time of a judicial foreclosure against the probability of actually collecting any money with a deficiency judgment. If a borrower is insolvent, which they often are if they are going through a foreclosure, they may not have enough money or other assets for the lender to collect on the deficiency judgment. In these circumstances, the lender will foreclose with a non-judicial procedure to minimize their losses. In these circumstances the borrower is not liable for repayment on the deficiency.

Tax Implications

Prior to the Great Housing Bubble, if a mortgage debt was forgiven, the amount of forgiven debt was subject to taxation as ordinary income. Since people who lost their house under these circumstances were already financially ruined, this tax provision was seen as unduly burdensome to those it was levied against. The President signed into law the Mortgage Forgiveness Debt Relief Act of 2007 to relieve the federal income tax burden on debt forgiven in a short sale, foreclosure, deed in lieu of foreclosure, or a loan restructuring where the principal amount was reduced. This tax relief is only given to an owner's principal residence and only for debt used to acquire the property. Speculative properties purchased as second or third homes are not covered, and debt incurred after the purchase through refinancing or opening new credit lines is not covered. This tax change made it easier for some borrowers to make the decision to go through a foreclosure because it removed one of the negative consequences of the decision.

A Buyer's Market

When the market turned up in the late 1990s the market shifted. During the last decline, the buyers had an advantage. During the bubble the advantage went to the sellers. The seller's market went on for so long and became so feverish that people have forgotten (or may never have known) what it was like to see buyers in control of the action. Buyers need to be re-educated on how to behave

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in a buyer's market. Buyers must remember they are the ones in control. Buyers are the scarce resource in the marketplace. The seller is one of many for the buyer to choose from, and all sellers are desperate. Sellers need buyers. Buyers do not need sellers. No matter which seller the buyer purchases from, the buyer is going to leave all the other sellers disappointed because they are going to continue to be trapped in their homeowner's prison.⁶ Buyers cannot please everyone, so they should focus on pleasing themselves.

Buyers should not become concerned with the seller's needs, wants and problems. Does it matter if this house is the seller's entire savings for retirement? Should a buyer care if a sale below a certain price puts the seller into bankruptcy? Buyers need to ask themselves, "Would I give the seller money if I were not buying their home?" Unless the buyer is running a charity, the answer should be no, and she should not care about the consequences of the seller's financial decisions. The seller created her own problems; it is not the buyer's responsibility to solve these problems by overpaying for a house.

Pay the Lowest Possible Price

This may sound like common sense, but the behavior of many buyers during the early part of the decline demonstrated a lack of understanding of this principal. Buyers should not ask for or take any incentives, and they should pay their own closing costs. They are paying for all these incentives; it is just buried in the loan. They will be paying interest on this purchase for the next 30 years, and the buyer will be paying property tax on these costs for as long as they own the house. Buyers are far, far better off lowering the price and foregoing the incentives and paying their own closing costs. A buyer's brokerage typically kicks back 2% at closing. Work out a deal with them in advance where they will agree to take a 1% commission at the closing so the price can be lowered by 2%. Again, the buyer is paying taxes on the purchase price, so they should make this as low as possible.

The First Offer is the Best Offer

This is the most counter-intuitive part of buying in a buyer's market. Ordinarily sellers, or more accurately the seller's realtor, try to create a sense of urgency to buy the house. They want the buyer to think other people are looking, there is going to be a bidding war, and the buyer needs to get an offer in today. Realtors thrive by creating fear in buyers. They will use lines like:

- It is a good time to buy!
- Hurry. This one won't last.
- Don't throw away your money on rent.
- If you are serious, you had better buy now or you might be priced out of the market.
- They are not making land anymore.
- If you see a property you love, you really need to make an offer.

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- The more earnest money you put down, the more seriously your offer is taken.
- Things have been a bit slower than last year, but the last two weeks we have seen a lot more traffic.
- Rates are at all time lows and buyers have more choice than ever!
- Rates are creeping up, so you better get in now.
- If you wait until the bottom, you will miss out on getting a property that you really like.
- This property is priced at below market value.
- Incentives this good won't be available after...
- Don't worry about the asking price - just offer what you're willing to pay.
- Don't worry. You can afford this house.
- I will show my client the offer, but I just want to let you know that we have another offer for more coming in this afternoon.
- Trust me.
- It's not just the commission. I really care about you.

In a buyer's market these ploys are all lies (the truthfulness of these statements is questionable in all market conditions). Generally, the buyer is the only prospective buyer, and they can take as long as they want to buy the house. The buyer's task in negotiating is to create a sense of urgency and panic in the seller. This is why buyers should make their first offer their best offer.

There are many properties priced over market in a buyer's market. Sellers resist the realities of the market environment. Asking prices that are much too high do not warrant buyer consideration. Most sellers will not reduce their asking prices more than 15% to consummate a transaction, so "lowballing" a seller with an offer 25% from their asking price is a waste of everyone's time. If the asking price is not within 15% of the price a buyer is willing to pay, the buyer should not even instigate a negotiation. If the asking price is within range, buyers should start with a bid at least 10% below asking price. This is the best offer. The buyer should lower the opening bid as follows:

- If actively bidding on the property, the buyer should make all offers expire in 3 days, and these offers should be delivered on a Tuesday. The buyer should not allow the seller to think about things over the weekend. If the buyer is still interested in the property after the offer expires, resubmit a fractionally-lower offer (1% is a good rule) on the following Tuesday (make them sweat over the weekend). The new offer should not be so much lower as to lose consideration, but make it should be enough lower that the seller gets the message that they need to come to accept the offer before it gets any lower.
- If the seller makes a counter offer, the buyer should retract the offer and resubmit a lower one. This works the same as the time decay offer above. After the buyer has lowered an offer a few times, the seller may panic and take the offer before it goes any lower. This is what buyers are after.

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- Buyers should lower their offers 1% each time they speak with the seller's realtor. Every time the seller's realtor communicates with the buyer, the realtor will pressure the buyer to increase their offer. If the buyer lowers their bid each time the realtor speaks, the buyer sends a message that the realtor pressure is not working, and it is, in fact, hurting the deal. Buyers should lower their offer 2% if the realtor uses one of the standard lies mentioned above.
- If the realtor tells the buyer there is another bidder on the property, the buyer should immediately withdraw their offer and tell the realtor to call if the deal falls out of escrow with the other buyer. Since this statement from the realtor is almost certainly a lie, it will cause them to have to explain to their client why the only buyer around has pulled their offer.

Closing the Deal

When the seller starts to counter-offer, it is very tempting for buyers to agree to their price to close the deal, particularly if the counter offer is below the original offer. Buyers should not do it. In a buyer's market, the seller will come to meet the buyer's terms. Buyers have the power. However, if the seller is now asking below the original offer, and if the buyer really, really wants the house, the buyer may raise the offer one time. Even after a price agreement has been reached, the deal can still be made better. The buyer should go through the inspection sheet and establish holdbacks for all repairs. The buyer should do this as an incentive for the owner to get this work done before move-in.

Not everyone has what it takes to implement all of these price-shaving techniques. However, the more of these that buyers put into practice, the lower the price they will pay for the home they want. A buyer will never see the seller or the seller's realtor ever again. It does not matter if they are offended. In the end, they will be relieved the buyer took the house even if that buyer made their lives hell in the process.

Summary

Many would-be sellers failed to sell their homes at inflated bubble prices. This might not have been a financial burden depending on how they managed their mortgage debt. They may have regretted missing the windfall they could have received by selling at the peak, but they stayed comfortably in their homes and forgot about the excitement of the real estate bubble. The sellers who missed the peak sales prices and fell underwater on their mortgage faced more difficult choices. Many borrowers concluded a foreclosure was the best course of action because they owed more on their loan than their property was worth. Also, due to the exotic loan terms utilized by many borrowers, they were experiencing increasing loan payments and decreasing property values. With the prospect for recovery bleak, many decided to give up paying their mortgages and allowed the

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lender to foreclose. One can argue the morality of this decision, but financially, it was the best course of action given the conditions.

In a buyer's market, the buyer has the power in a negotiation. Buyers should take advantage of this power and negotiate the lowest possible price. Since the price determines the loan amount and often the taxes on the property, the buyer benefits through lower interest costs and lower taxes by minimizing the purchase price. Buyers are not responsible for fixing the prior financial decisions of sellers. Overpaying for real estate to cure the financial mistakes of sellers is not in a buyer's best interest. Financial transactions with real estate are not relationship building exercises. Buyers almost never maintain a relationship with sellers after the transaction is complete, and paying extra money for a house to be a "good neighbor" or nice person is not to a buyer's financial benefit.

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End Notes

¹ "Out, out, brief candle! Life's but a walking shadow, a poor player that struts and frets his hour upon the stage and then is heard no more: it is a tale told by an idiot, full of sound and fury, signifying nothing." Macbeth Quote (Act V, Scene V).(Shakespeare, 1603)

² Partial list of prominent real estate bubble and related blogs:

The Irvine Housing Blog – <http://www.irvinehousingblog.com/>

Patrick.net – <http://patrick.net/housing/crash.html>

The Real Estate Bubble Blog – <http://www.thehousingbubbleblog.com/index.html>

The House Bubble – <http://housebubble.com/>

Implode-o-meter – <http://ml-implode.com/>

Bubble Markets Inventory Tracking – <http://bubbletracking.blogspot.com/>

Housing Doom – <http://housingdoom.com/>

Southern California Real Estate Bubble Crash – <http://www.socalbubble.com/>

Calculated Risk – <http://calculatedrisk.blogspot.com/>

Housing Panic – <http://housingpanic.blogspot.com/>

Professor Piggington – <http://piggington.com/>

Dr. Housing Bubble – <http://drhousingbubble.blogspot.com/>

Bubble Meter – <http://bubblemeter.blogspot.com/>

Priced Out Forever – <http://pricedoutforever.com/>

The Bursting Bubble – <http://www.theburstingbubble.com/>

The Real Estate Bloggers – <http://www.therealestatebloggers.com/>

Housing Bubble Casualty – <http://www.housingbubblecasualty.com/>

Housing Bubble Bust – <http://www.housingbubblebust.com/>

Real Estate Realist – <http://www.realestaterealist.com/>

Housing Wire – <http://www.housingwire.com/>

Sacramento Area Flippers In Trouble – <http://flippersintrouble.blogspot.com/>

Seattle Bubble – <http://seattlebubble.com/blog/>

Westside Bubble Blog – <http://westside-bubble.blogspot.com/>

Marin Real Estate Bubble – <http://marinrealestatebubble.blogspot.com/>

Sonoma Housing Bubble – <http://sonomahousingbubble.blogspot.com/>

New Jersey Real Estate Report – <http://njrereport.com/>

New York City Housing Bubble – <http://nychousingbubble.blogspot.com/>

END NOTES

- ³ Much of the author's personal study of Buddhism comes from the writings and recordings of the author Jack Kornfield (Kornfield, *The Roots of Buddhist Psychology*, 1996), (Kornfield, *The Inner Art of Meditation*, 1993), (Kornfield, *A Path with Heart: A Guide Through the Perils and Promises of Spiritual Life*, 1993), (Kornfield, *After the Ecstasy, the Laundry: How the Heart Grows Wise on the Spiritual Path*, 2000). The audio recordings of the *Roots of Buddhist Psychology* have been particularly influential.
- ⁴ The stock market experienced a 500% gain in a five year period before its infamous crash. Much of the reason for the wild increase in pricing was very low margin requirements. People were allowed to buy 10 times as much stock as they had money due to 10:1 margin trading. This expansion of credit through the broker's margin is what drove prices up, and when prices started to fall, margin calls cascaded through the market and resulted in a crash.
- ⁵ By mid-2008 lenders were so overwhelmed with foreclosures that many began bidding less than the loan amount in hopes auction bidders would limit their losses and they would not acquire even more residential real estate.
- ⁶ Homeowners who owe more on their mortgage than their house is worth in the resale market are by definition homedebtors. The fact that they cannot leave the place they live means they are effectively in prison.

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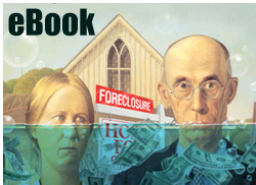
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THE GREAT HOUSING BUBBLE

Why Did House Prices Fall?

Are you thinking you might buy a house?

Are you trying to sell a house?

Are you a nervous homeowner worrying about declining home values?

Are you curious as to how and why real estate prices dropped?

The Great Housing Bubble has the answers!

What experts are saying:

“A very well-written and thoughtful analysis of what went wrong in the housing world and how we can avoid this problem in the future. Lawrence Roberts has a great understanding of the subject and does an excellent job communicating his ideas to the reader.”

James A. Randel, bestselling author of *Confessions of a Real Estate Entrepreneur*

Are you thinking about buying a house?

Many people will be active buyers despite the declining home prices. If you are considering buying during this time, there are many things you will need to know to make sure you do not become one of the casualties of the housing bubble.

How much are houses really worth?

Do you know how to evaluate the fundamental value of a piece of real estate? If you do not, you will probably over pay. Many people think comparative sales prices indicate value, but this incorrect. (The Fundamental Valuation of Houses, p. 29)

Do you understand complicated loan programs?

Many people think they have a grasp of how these exotic new loan programs work. Most people do not, and nobody should really be using them. (Conservative House Financing, p. 8)

How do you negotiate during a price decline?

Most buyers fail to take advantage of the powerful negotiating position they have during a price decline. There are specific techniques one can use to pay the lowest possible price. (Buying and Selling During a Decline, p. 163)

Buy this book now!

THE GREAT HOUSING BUBBLE

Are you buying a house as an investment?

Many people view residential real estate as a good investment, particularly during the real estate bubble. Historically, it has not been. The Great Housing Bubble tells the truth about residential real estate—the truth your realtor does not want you to know.

How do you make money in real estate?

Making money in real estate is about building equity. Most people believe you simply buy and equity appears by magic. It does not work that way. What exactly is equity? And how do you build it? (Equity Components, p. 19)

Why do most speculators lose money?

Most people who speculate in financial markets lose money. Why is that? (Speculation versus Investment, p. 99)

Are houses really a good investment?

Residential real estate has historically underperformed most other asset classes. The period of the Great Housing Bubble was a notable exception to the rule. (Renting versus Owning, p. 46)

What is the investment value of real estate?

There is an investment value to real estate. How is it calculated? What is it really worth? (Investment Value, p. 37)

What readers are saying:

“The detailed investigative work and deep market analysis is very insightful and thought provoking.”

Ben in Seattle

“I feel I have been given a first-rate education in real estate analysis and valuation from this book. I have continued to rent instead of purchase real estate in Irvine due, in large part, to data presented in this book.”

Jaysen in Irvine

What are you risking if you do not buy this book?

This book can save you from financial ruin and all the personal hardships that entails. **Many people lost their wealth, their homes, their credit and their good health during The Great Housing Bubble because they did not have the information presented in this book.** *You do not want to be one of them.* It is that important.

Extreme financial hardship

Residential real estate is generally an extremely leveraged financial asset. A 20% decline in house prices can completely wipe out your downpayment or any

Buy this book now!

THE GREAT HOUSING BUBBLE

accumulated equity in a property. Buying at the wrong time and paying too much can have devastating financial consequences for you.

Foreclosure/ short sale

Many people who overborrow and overpay end up losing the property in a foreclosure or short-sale. Being forced to move out of your home is never a pleasant experience.

Bankruptcy / bad credit

With the foreclosure or short-sale often comes a personal bankruptcy. If you manage to avoid bankruptcy, your credit will still be damaged for years.

Stress and health problems

Seeing hundreds of thousands of dollars of your net worth evaporate, losing your home, and being forced into bankruptcy is a very stressful set of circumstances. Many people who go through this experience have major health problems.

Can you afford to risk this?

Do you want to risk these problems? Are you willing to face these dangers without knowing what you can do to protect yourself? Your hard earned money, your credit, and your health are far too valuable to put at risk.

You need to buy this book to prepare you for the dangers out there.

What readers are saying:

“I thought I knew real estate before I read this book. I was wrong. This book opened my eyes to the truth about the real estate cycle. I was thinking of buying and investment property because prices had dropped. It wasn't until I read this book that I realized I was speculating and not investing. I almost made a very big mistake.”

Janet in Irvine

“This helped me avoid buying at the peak and losing hundreds of thousands of dollars. It saved me a great deal of grief and money. Even now, with California housing prices down over 30%, declining prices could still quickly consume your downpayment and put you ‘under water’, unable to sell your house for more than the loan value.

An excellent read, and an important one.”

Brian in Malibu

Buy this book now!

THE GREAT HOUSING BUBBLE

Do you own your house? How did the housing bubble impact you?

Almost 70% of American households own their houses. Even those who do not plan to buy or sell are impacted by the housing bubble. Everyone who owns a house saw a dramatic change in their net worth as house prices rose then fell. Some people refinanced and increased their mortgage balances to obtain the “free money” accumulating in their homes. Some people stopped saving for retirement and other purposes and became completely dependent upon their houses for their financial future. Every owner of real estate was impacted by the bubble.

How much value is your house going to lose?

The most pressing concern of most homeowners is how much is the resale price of their property going to decline before prices stabilize. (Future House Prices, p. 130)

Why did your house lose value?

Many people are very interested in why house prices went down at all. (The Housing Bubble, p. 71)

What readers are saying:

“I loved reading this book and learning about the financial impact of this whole mess that we’re in right now.”

Joe in Austin

“I had no idea my neighbors and the lenders were so crazy. The bubble wasn’t too mad there, so I really didn’t understand what all the fuss was about until I read this book. Wow! I can’t believe what was going on.”

Gale in Nashville

Do you understand the terms of your mortgage?

Many people who took out mortgages during the bubble did not use conventional, 30-year fixed-rate financing. Many of these borrowers utilized new, innovative loan programs that very few understand. (Conservative House Financing, p. 8)

Why did the economy suffer so much?

The deflation of the housing bubble brought down the entire economy and nearly caused the collapse of our entire financial system. (Doomsday Scenario, p. 159; Lingering Problems, p. 161)

Buy this book now!

THE GREAT HOUSING BUBBLE

What every seller needs to know about the housing bubble?

The tactics sellers must use to sell a home have changed radically since the market topped and prices began to fall. Those nimble sellers who are able to make the proper adjustments will sell their houses. Those that do not adapt will fail to sell their homes and lose much more money.

What readers are saying:

“I was not able to sell my house, and I was getting very frustrated. When I read this book, I realized what I really needed to do. The truth helped me overcome my denial, and I sold my house in three weeks – once I did what was necessary.”

Kurt in San Clemente

“My house was on the market for months with no offers. I paid for professional staging, and I even bought one of those crazy St. Joseph statues and buried it in the yard. Nothing. Once I read this book, I realized why the house was not selling. I didn’t want to follow the author’s advice, but it was the only way to sell my home.”

Josue in Sacramento

What do you have to do to sell your house?

What is the number 1 thing a seller must do to sell their property in a declining market? (Buying and Selling During a Decline, p. 163)

What if you owe more than your house is worth?

Many people have loans balances greater than the resale value of their property. What are their options? (Selling for Less, p. 164)

Is the government really trying to save the housing market?

Government policy during the housing bubble was not intended to save the housing market; it was intended to save the banks. Home owners are kept in a state of denial and indentured servitude to their lending overlords. (Bailouts and False Hopes, p. 122)

What are some of the things will you learn in this book?

The Great Housing Bubble is an exhaustive analysis of the issues related to this dark chapter in American history. Even though the decline is nowhere near over in 2008, already the Great Housing Bubble witnessed the largest decline in house prices since the Great Depression. Below is a sample of the types of questions this book answers.

Buy this book now!

THE GREAT HOUSING BUBBLE

Why did house prices go up so much so fast?

With lenders quickly increasing the amounts they were willing to lend, borrowers were able to increase their bids and drive prices skyward. (The Credit Bubble, p. 54)

Why did people borrow so much money?

People borrowed so much because they could, and since prices were going up so fast, most wanted to. Lenders made huge sums available to almost anyone with a pulse on payment schedules they could afford—temporarily. (Negative Amortization Mortgages, p. 13; Stated Income Loans, p. 16)

How crazy were the lenders?

Everyone thought house prices would go up forever, so few thought there was any risk of loss. (What is a Bubble, p. 1; The Fallacy of Financial Innovation, p. 26)

Why did we have a credit crunch?

People stopped paying back their loans, so lenders stopped lending money. (The Credit Crunch, p. 93)

What readers are saying:

“Lawrence Roberts has his finger on the pulse of the housing bubble – the bursting forehead vein, I should say!”

LC in Irvine

“Lawrence Roberts is one of the best that I have seen at breaking down the complicated and confusing mortgage and real estate industry so that novices like me can understand.”

Alan in Toledo

Why did we have so many foreclosures?

People stopped making payments because they borrowed too much money and they could not afford to pay it back. (Types of Loans, p. 11; The Bubble Bursts, p. 87)

How does the secondary mortgage market work?

The activity in the secondary mortgage market provided the air that inflated the housing bubble. (Structured Finance, p. 57)

Why is real estate cyclical, and what are the stages of the cycle?

Real estate prices rise and fall due to market psychology and credit availability. (Visualizing the Bubble, p.67; Psychological Stages of a Bubble, p. 111)

Buy this book now!

THE GREAT HOUSING BUBBLE

Are most home buyers speculators?

Many homebuyers in volatile real estate markets are motivated by profit. This motivation causes a great deal of property speculation. (Trading Houses, p. 104)

How did the bubble change people's lives?

The housing bubble made and lost fortunes for its many participants. Those that lost faced both economic and personal problems. (Economic Problems, p. 173; Personal Problems, p. 175)

How do we stop future housing bubbles?

It is possible to prevent future housing bubbles. It requires a combination of market reform and government intervention. (Preventing the Next Housing Bubble, p. 173)

What experts are saying:

“Lawrence Roberts was completely right.”

“Lawrence Roberts is THE real estate guru... one of the few who knew it was coming.”

“He’s the guy that predicted the crash and year and a half before it happened.”

Johnny Wendell – KTLK 1150 AM

Buy this book now!