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The Menace of Strategic Default

Homeowners who walk away from their mortgages undermine our financial system.

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Eighteen years ago, when I bought my first apartment in Chicago, I asked my broker whether, if I defaulted on my mortgage, the lender could come after my income after repossessing the house. I had heard that some states didn’t allow that, and I wondered if Illinois was among them. To my surprise, the broker didn’t know, either, but she promised to find out. It clearly wasn’t a burning question for her, since she still wasn’t able to answer it the next time we met. Our ignorance wasn’t unique. Confident that house prices would never stop rising, most Americans never bothered to check what would happen if they defaulted. After all, who would walk away from a house worth more than the mortgage?

Today, the matter is far from theoretical for the 15.2 million American households holding mortgages that exceed the value of their homes. It will help determine how many of them choose to “default strategically”—that is, walk away from their mortgages even when they can afford them, because they’ve determined that it’s no longer worth it to keep paying. And that, in turn, will help determine the future health of the American housing market—and thus of the U.S. economy.

Many people think that we don’t have to worry about widespread strategic defaults. When I discussed the problem with a board member of one of the top four American banks, he categorically denied its existence: “The idea that people would walk away from their homes when they can still afford to pay the mortgage is unfounded.” A study from the Federal Reserve of Boston seems to confirm his skepticism. Evaluating Massachusetts homeowners during the 1990–91 recession, it found that only 6.4 percent of “underwater” borrowers—that is, those burdened with mortgages that exceeded the value of their homes—ended up in foreclosure. And not all of those households were defaulting strategically; many, presumably, were actually unable to pay their mortgages.

Unfortunately, such evidence may not tell us much about the likelihood of strategic default today. During the 1990–91 recession in Massachusetts, home prices fell just 22.7 percent from peak to trough, and most borrowers had made 20 percent down payments—so few owed much more than their houses were worth. Even people who had bought at the peak owed, on average, just 3 percent more than the value of the house. Over the last few years, by contrast, home prices have fallen by 40 to 50 percent in several areas, and many borrowers had put very little or nothing down when they bought their houses. Furthermore, during the current recession, the problem affects not only those who bought houses at the peak but also those who took advantage of rising house prices to take some money out in a refinancing. This wasn’t the case in 1990–91, when home-equity lines of credit were extremely rare.

Strategic default is hard to define, of course, and presents difficulties for researchers. What exactly does it mean to be able to pay a mortgage? If I default because I’m unwilling to work extra hours to pay my mortgage, is that a strategic default or a necessary one? Nevertheless, a growing body of evidence
suggests that in the current recession, strategic default exists and is rising.

The most convincing evidence comes from a study by Experian and the consulting firm Oliver Wyman that tries to measure strategic default by identifying people who go straight from having always been current on their mortgages to being 180 days late—while staying current on all their other debt obligations, such as credit cards and auto loans. The idea is that if somebody pays the credit card but not the mortgage, it’s probably because he wants to default on the mortgage, not because he must. The study estimates that in 2008, 17 percent of all U.S. defaults were strategic, though that figure differs tremendously across groups and regions. For instance, 27 percent of defaults among people with high credit scores appear to be strategic, a figure that jumps to 40 percent in California.

A study by the Amherst Securities Group takes a different approach. It shows that in areas where homeowners generally weren’t underwater, under 1.5 percent of subprime mortgages became nonperforming each month during the third quarter of 2009. But in areas where the average mortgage exceeded the current value of a house by 20 percent or more, the rate of monthly subprime defaults was 4.5 percent. The difference between the two rates probably isn’t due to homeowners’ ability to pay, because the study corrects for unemployment. The assumption, therefore, is that it’s due to homeowners’ willingness to pay when they see how much more expensive their mortgages are than their houses. The difference between the two default rates—the 1.5 percent “natural” rate and the 4.5 percent rate in areas where home prices dropped significantly—suggests that in those areas, two-thirds of defaults seem to be strategic.

Survey-based evidence also suggests that strategic default has become widespread. A survey conducted by the Chicago Booth/Kellogg School Financial Trust Index, which I helped design, asked a representative sample of 1,000 Americans how many people they knew who had defaulted and how many of those people had defaulted even if they could still afford to pay their mortgages. According to the respondents in March 2009, 23 percent of their acquaintances’ defaults were strategic. By September, that fraction had increased to 36 percent.

Though the rate of strategic default is hard to determine, one thing seems certain: the more you owe, relative to the value of your house, the likelier you are to default strategically. Nobody will do that if his mortgage is just 10 percent larger than his house is worth. Of households that owe 50 percent more than their houses are worth, the same survey suggests, 25 percent will default strategically. And a New York Fed study estimates that of households that owe 62 percent more than their houses are worth, a full half will default strategically. The good news is that many homeowners seem unwilling to default even when they owe a lot more than their houses are worth. The bad news is that we aren’t sure why they hold off—or how long they’ll continue to.

In fact, what’s surprising isn’t how many homeowners choose to default strategically, but rather how few do so, given the strong monetary incentives. In many areas, prices have fallen so steeply that the monthly mortgage on a house—if it was acquired just before the housing bubble burst—is twice as expensive as the monthly rent on an identical house. If you were holding such a mortgage, why wouldn’t you default?

The law doesn’t provide much incentive to stay put. It’s true that 39 states permit a lender to come after
a borrower’s other assets and income if he defaults (as I would have discovered, had I done my homework 18 years ago). And it’s also true that even in the 11 states that don’t allow that, the restriction applies only to original home loans used to purchase property, not to home-equity lines of credit, while there is some legal uncertainty regarding mortgages issued to refinance existing mortgages. Nevertheless, lenders rarely slap borrowers with a deficiency judgment—a court injunction to pay the difference between the face value of a mortgage and the proceeds that the lender earns by repossessing and selling the house. The procedure is costly and generally not worth the expense because of the limited assets that most Americans own aside from their homes.

The tax code likewise doesn’t impede people from defaulting strategically. Until recently, it’s true, people had to pay taxes on any forgone debt. If you walked away from a house worth, say, $100,000 less than you owed the bank for it, that $100,000 was essentially income, and you had to pay income tax on it. However, in December 2007, Congress made mortgage debt cancellation nontaxable for personal residences. Congress’s aim was to facilitate the renegotiation of underwater mortgages, but the move had an unintended consequence: reducing the cost of walking away.

What does prevent people from strategic default, it seems, is their sense of what’s right. More than 80 percent of Americans think that it’s immoral to default on a mortgage if you can afford to pay it, according to a recent paper by Luigi Guiso, Paola Sapienza, and myself, and these people are 77 percent less likely to declare their intention to default strategically than people who don’t find the act immoral. Perceived social norms also seem to affect the propensity to walk away: knowing somebody who defaulted strategically, or living in an area where many people have done so, makes a person much more likely to declare his willingness to follow suit.

Recently, though, some scholars have begun questioning the moral imperative not to default. Roger Lowenstein, writing in the New York Times, wonders why we should expect homeowners not to default strategically, when banks routinely do so with their underwater investments. Similarly, Lowenstein likens strategic defaults to the “walkaways” that prominent companies have made, such as Tishman Speyer’s default on its Stuyvesant Town property in New York. The analogy isn’t apt, however, because in commercial real estate, contracts explicitly state that borrowers can transfer ownership of the collateral in lieu of repaying the debt. With such an agreement in force, there is no moral obligation to pay any residual debt after the property has been transferred. Such a provision is not present in home mortgages in most states.

University of Arizona law professor Brent White goes further, arguing that defaulting on a mortgage when its value exceeds the value of the house is the rational thing to do and that homeowners refrain only because of media “scare stories” pushed by powerful lenders. He suggests that the government should encourage borrowers to default when it’s in their economic interest, which would force banks to renegotiate the loans. His solution is akin to encouraging people not to pay taxes in an effort to induce the government to reduce fiscal pressure: it might work, but at the cost of putting the entire system at risk.

How much risk? If the underwater homeowners who currently refuse to default changed their minds and decided to abandon their mortgage commitments, the results could be catastrophic. The more people walk away, the more houses get auctioned off, further depressing real-estate prices.
additional decline would push more homeowners into negative territory, leading to still more defaults. Adding to the deadliness of this cycle would be the fact that as more strategic defaults occurred, the social stigma associated with them would lessen. Such a continued collapse is already a distinct possibility in several states: Nevada (where two-thirds of all homeowners are underwater), Arizona (51 percent), Florida (49 percent), Michigan (48 percent), and California (42 percent). Every time a borrower defaults, moreover, he makes future mortgages more expensive (because lenders have to cover the cost) and the mortgage market more inefficient (because many potential borrowers are shut out). This higher cost and reduced availability of credit would depress house prices even more, jeopardizing the possibility of an economic recovery.

Undermining the social norm to repay mortgages, as Lowenstein and White do, is thus a very bad idea. You might just as well say that when a theater is going up in flames, it’s “rational” to trample other people in rushing to the exits.

Not only did the real-estate crisis shove millions of homeowners underwater; it also jeopardized the very social norms that it rests upon. To prevent a complete breakdown in social norms—a breakdown that could take decades to reverse—it’s necessary to facilitate mortgage renegotiations, especially in the areas most affected by the drop in home prices. Unfortunately, the major lenders oppose any reduction of mortgage principal. They’re playing a dangerous game of chicken, gambling that the real-estate market will recover and that any dollar of principal reduction now will be a dollar less in profit for them later. (Even if the market doesn’t recover, they don’t have much to lose, since if they collapse they’re likely to become wards of the state.)

Eric Posner and I have proposed a simple solution to the problem of underwater mortgages. We envision a reform of the bankruptcy code that, in areas where house prices have dropped precipitously, would require lenders to give homeowners the option of resetting their mortgages to the current value of their houses. In exchange, the lenders would get 50 percent of the houses’ future appreciation. To keep homeowners honest—that is, to prevent them from doing minimal upkeep in the knowledge that they stood to gain less from a home-price increase—the capital gain would be measured based on an average of houses selling in the area, rather than on the change in the value of the actual house.

This proposal eliminates all the incentives for a strategic default without excessively rewarding the borrowers. In fact, the proposal’s main appeal is that it tries to split the costs and benefits fairly between lenders and borrowers, without having taxpayers subsidize both, as the Obama administration’s interventions have done. Unfortunately, that makes our proposal unpopular. Since it doesn’t unduly favor any constituency, it isn’t supported by any. And since it doesn’t spend tax revenue, it isn’t favored by politicians, who never tire of rescuing some people with other people’s money.

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