Strategic Defaults: Morality vs. Reality

According to RealtyTrac, nearly 3 million foreclosures were filed in 2009. And with almost 10 percent of all mortgages now delinquent nationally, those homeowners are faced with a painful decision: Continue to make payments even if they are underwater, or do a "strategic default."

In January, 2006, a young professional couple with two children bought a three-bedroom home in Salinas, California, for $585,000. With excellent credit, they signed the papers for a no-money-down, 30-year, fixed-rate mortgage, with payments of $4,300 a month. Today, the balance they owe is $560,000, but the present market value of their home is estimated to be about $187,000. Here is their dilemma: They made a promise, and signed on the dotted line, fully expecting to make timely payments over the term of the loan. But there is a home for rent just down the street with payments of just $1,000 a month.

When they do the math, the outlook is not promising. Even if housing prices rise at 5 percent a year, starting today (assuming that housing prices have found a bottom — a highly optimistic assumption), it would take many years for them just to break even on the investment in their home.

Brent White, a law professor at the University of Arizona, explains their situation this way:

> Assuming they intend to stay in their home ten years, [the homeowners] would save approximately $340,000 by walking away, including a monthly savings of at least $1,700 on rent verses mortgage payments, even after factoring in the mortgage interest tax reduction. If they stay in their home, on the other hand, it will take [the homeowners] over 60 years just to recover their equity — assuming, of course, that they live that long.

A strategic default is sometimes called "jingle mail," where the house keys are simply mailed to the bank holding the mortgage. But an increasing number of people are taking the default strategy to the next level, stopping making payments but continuing to live in the house until the bank kicks them out. The foreclosure process, as discussed here, can take as long as a year, during which the savings between renting and making mortgage payments could be put aside as a down payment on another home with better prospects. A study by Experian and Wyman estimated that nearly one in five homeowners holding underwater mortgages is strategically defaulting.

There are consequences, of course, including damage to the homeowners' credit score. A new mortgage will be denied for at least 3 years (FHA) to 5 years (FNMA). And when the foreclosure takes place, there's a good chance that the mortgage is "recourse," giving the bank the opportunity to try to get back some of the money owed to them. And the IRS is involved, too, of course, because the difference between the value of the home at the time of foreclosure and the amount owing is considered to be ordinary income and subject to income tax as "debt forgiven." At present, however, the Mortgage Forgiveness Debt Relief Act has granted a window lasting through December of 2012 that such "phantom income" will not be subject to tax.

Several commentators are holding that such defaults are the right and proper thing to do. A writer for the *Wall Street Journal* said, "You shouldn't feel bad [sic] about it, and you shouldn't feel guilty. The lenders would do the same to you – in a heartbeat. You need to put yourself and your family's finances first." He goes on: "Stop trying to chase your lost equity. That money is gone. Don't think like the gambler who blows more and more cash trying to win back his losses. That's how a lot of people turn a small loss into a big one…If you are reluctant to give up 'your' home, realize that it isn't 'yours'. If you are in negative equity, it's the bank's home. You're just renting it…You need to be ruthless about your cash flow…walking away from debts is as American as apple pie."

Highly publicized "walkaways" like Tishman Speyer and BlackRock walking away from their apartment complex, Stuyvesant Town and Peter Cooper Village in Manhattan, appear to support such conclusions. They bought the property for $5.4 billion at the height of the real estate boom in New York City, and today it's worth about $2 billion. They tried to refinance the project with no success. They said, "The only viable alternative to bankruptcy would be to transfer control and operation of the property … to the lenders…"

There is the moral or ethical side of the decision. In January, CNBC said, "Some folks argue that home mortgage walkaways are destroying the housing market by pushing up the number of foreclosures, which in turn drive down the values of the homes around them." Continuing pressures from those foreclosures would "push more homeowners into negative territory, leading to still more defaults," according to Luigi Zingales, professor at the University of Chicago.

Zingales also points out that "as more strategic defaults occurred, the social stigma associated with them would lessen…every time a borrower defaults, moreover, he makes future mortgages more expensive… This higher cost and reduced availability of credit would depress house prices even more, jeopardizing the possibility of an economic recovery." George Brenkert, professor of business eithics at Georgetown University, says borrowers "do have a moral responsibility to keep paying." When reminded about the Stuyvesant project default, Brenkert said, "The fact that we recognize that [others are defaulting] doesn't make it the right thing to [do]." Kevin Jackson, another professor of business ethics, notes that the homeowner must also consider the needs of his family. "The homeowner is holding onto a failing investment [but] he also has an obligation to himself and to his family to cut his losses as best he can."

And there it is: Government intervention in the marketplace continues to reverberate through the economy and is now eating away at the vital moral structure of society on which the economy rests. By forcing homeowners to choose, many will not "choose the narrow way" but will walk away instead.

Photo: AP Images