

# Strategic Defaults and the Foreclosure Crisis



By Luke Mullins , On Tuesday January 19, 2010, 3:28 pm EST

Nearly a year after the Obama administration unveiled its ambitious housing rescue program, foreclosure tallies continue to break records. Foreclosure filings were reported on more than 2.8 million properties in 2009, up 21 percent from the previous year and 120 percent from 2007, according to RealtyTrac. With nearly 10 percent of mortgages now delinquent--which is also a new record--even more homeowners appear headed for foreclosure this year. "A massive supply of delinquent loans continues to loom over the housing market," RealtyTrac CEO James J. Saccacio said in a statement. "Many of those delinquencies will end up in the foreclosure process in 2010 and beyond."

[See [Tips for Selling a Home in the Off-Season.](#)]

Homeowners have found themselves in foreclosure for a number of reasons. Some purchased properties they could never really afford. Others lost their jobs--the national unemployment rate remains in the double digits--and had no way to make mortgage payments. But as the crisis rumbles forward, an additional driver of home foreclosures has become clear: Many borrowers have the means to keep paying the mortgage but are simply walking away because they believe it's best for their finances.

The number of so called "strategic defaults" more than doubled, to 588,000, from 2007 to 2008, according to a study by Experian and Oliver Wyman. A separate 2009 survey found that more than a quarter of all existing defaults were strategic. Meanwhile, a growing number of academics are touting the financial benefits of walking away. "Homeowners should be walking away in droves," Brent T. White, a University of Arizona law school professor, said in a recent paper. "The financial costs of foreclosure, while not insignificant, are minimal compared to the financial benefit of strategic default."

[See [Obama's Loan Modification Plan: 7 Things You Need to Know](#)]

The case for strategically defaulting is linked to negative equity, or owing more on your home than it is worth. With home prices at the national level having dropped roughly 30 percent from their 2006 peaks--and a great deal more in certain bubble markets--a considerable chunk of property owners are now in this fix. Nearly 1 in 4 borrowers currently have negative equity, according to First American CoreLogic.

**And rather than continuing to make payments on an investment that's now worth significantly less than what they paid for it, many borrowers are throwing in the towel.**

**White uses the following example to demonstrate how many borrowers are better off defaulting: A young professional couple with two children pays \$585,000 for a three-bedroom, Salinas, Calif.-home in January 2006. At \$4,300, monthly payments on their no-money-down, 30-year fixed mortgage with an interest rate of 6.5 percent represent a tad less than 31 percent of their gross monthly income. Toss in taxes, student loans, health care, food, and other essentials, and finances quickly get tight.**

**After the historic housing bust, their home is now worth \$187,000, but they still owe \$560,000. Other homes in their neighborhood, of course, have plummeted in value as well. And if the couple was to purchase a similar, nearby house listed at \$179,000, their monthly payments would be less than \$1,200. That's a huge savings over their current \$4,300 monthly mortgage bill. But since a foreclosure on their credit report is likely to prevent them from buying a home in the near-term, they may have to rent. And about \$1,000 a month gets them a comparable rental property in their neighborhood.**

**"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 versus mortgage payments, even after factoring in the mortgage interest tax reduction," White writes. "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."**

**The argument against strategically defaulting is much more straightforward: You promised to repay the loan when you took out the mortgage, and it's your responsibility to do everything possible to honor that commitment. Avoiding the guilt and shame that can accompany a foreclosure is one of the top reasons struggling homeowners don't strategically default, White writes. On top of that, a foreclosure significantly damages one's credit--making it difficult, if not impossible, to obtain a mortgage for years afterward.**

**But in a recent white paper, Alex Edmans, an assistant professor of finance The Wharton School of the University of Pennsylvania, argues that many homeowners are ignoring these consequences to do what they believe is in their best financial interest. "Defaulting on their loan is a rational decision: While they forfeit their home, they rid themselves of a mortgage liability of even greater value," Edmans writes. "The source of the problem is the homeowner's balance sheet: since he has negative equity in his home, it is not worth keeping it by paying the mortgage."**

**The issue of negative equity triggering strategic defaults represents a nasty headache for the Obama administration. The \$75 billion mortgage housing rescue the administration unveiled last February is designed to keep people in their homes by reducing their monthly mortgage payments down to more manageable levels. The plan does not, however, require lenders or servicers to reduce borrowers' mortgage principal--meaning underwater borrowers still have this incentive to walk away from their home loan.**

**Laurie Goodman, a senior managing director at Amherst Securities Group, considers negative equity to be the housing market's greatest challenge and believes current housing rescue efforts are insufficient. "The current modification program does not address negative equity, and is therefore destined to fail," Goodman said in written testimony before a Congressional committee in December. "It must be amended to explicitly address this problem."**

**Although Uncle Sam has reduced mortgage payments for more than 850,000 borrowers so far--for a median savings of more than \$500--the government will remain under pressure to take more aggressive action as long as the foreclosure epidemic keeps churning. Mark Zandi, the chief economist at Moody's Economy.com, believes the government may take steps to tackle the issue of negative equity head-on this year by incorporating principal write downs--which reduce a borrower's negative equity position--into the housing rescue program.**