As home prices fall, more borrowers walk away

John Brecher / msnbc.com

David Martin, 68, in his home in north Seattle, Washington. He and his wife are facing retirement within five years, but their retirement income won't cover their mortgage.

By John W. Schoen, Senior Producer

When David Martin and his wife bought their north Seattle condo five years ago, they figured they had plenty of time to downsize if they needed to before they retired.

Now, with the property worth roughly $60,000 less than the balance of their mortgage, Martin, 68, has been giving serious thought to just walking away, a process lenders call "strategic default."

"Guilt and morality are one side, and objective financial analysis are on the other side," Martin said. "They're coming to two opposite conclusions. I wonder how many other people are struggling with the same question."

Strategic defaults like the one contemplated by Martin are on the rise. A survey last year by two Chicago-area finance professors, Paola Sapienza at Northwestern University and Luigi Zingales at the University of Chicago, found that roughly three out of 10 mortgage defaults in 2010 were by homeowners who could afford to make their payments, up from 22 percent in 2009.

"It's a looming problem that's in the shadows," said Jason Kopcak, a mortgage trader at Cantor Fitzgerald who advises lenders on how to value the loans on their books. "It's very worrisome to mortgage lenders."

Researchers point to a number of forces that are driving borrowers to walk away from their mortgages. At the top of the list is the estimated 12 million homes that are underwater, meaning the owners owe more than they are worth.

Until recently, borrowers like Martin and many industry analysts held out hope that a housing recovery would reverse the rising tide of "negative equity." But after stabilizing this summer, home prices began falling again, dropping 7.5 percent in the third quarter alone and leaving more homeowners underwater.

Even if prices stabilize this year, millions of underwater borrowers face a long wait before they can sell their homes without having to write a big check to their lender to cover the shortfall. Economists at Goldman Sachs recently forecast that after bottoming in 2013 house prices won't recover their 2006 peak until 2023. (No, that's not a typo.)

Many homeowners simply can't wait that long.

In the early stages of the housing bust, the main causes of defaults included unemployment or other financial setbacks and adjustable mortgages that reset to unaffordable levels, according to researchers. Now, five years into the housing recession, strategic defaults are growing as financially healthy borrowers learn of friends or family who have decided to walk away.

A recent study commissioned by the Mortgage Bankers Association likens the rise in the rate of strategic defaults to the spread of a disease. The longer the crisis drags on, the more homeowners will be exposed to someone who has successfully walked away, making the decision easier, the study suggested. "As fundamentally social animals, humans consciously (and subconsciously) look to their peers when forming opinions, habits and behaviors," the report said.

"Most people who own a home know of someone -- a friend, a colleague a family member -- who has defaulted, especially in housing markets that have taken a big hit," said Jon Maddux, CEO and co-founder of youwalkaway.com, a service that advises homeowners on walking away from their mortgage. "They realize these are not bad people. They're not deadbeats. They're just like them."

Researchers say strategic default is also more common among borrowers who feel no personal connection to the party on the other end of the transaction. Gone are the days when you walked into a bank and met with a lender who shepherded your application and congratulated you when the loan was approved, said Michael Seiler, a finance professor at Old Dominion University and a co-author of the MBA study.

"If you defaulted, it was like you were defaulting on your friend," he said. "Your kids might go to the same school. You all might go to the same church. And you're constantly reminded of who you're defaulting on."

That scenario is a far cry from the modern system of mortgage finance, where loans are sold over the phone or online, chopped up into pieces and then sold to multiple, anonymous investors. Many underwater homeowners who try to negotiate with their lender can't even find out who owns their loan.

"We're finding that people are much more willing to walk away when the other party is unknown or what you might call a 'bad bank,'" said Seiler. "Those are the ones that received a lot of bailout funds or were active in the subprime market, giving loans to people who couldn't afford them and they knew that."

The mortgage lending industry's widespread reluctance to modify loan terms has also changed homeowner attitudes about walking away, according to Maddux.

"They feel much better about doing it if they've tried to contact the lender and the lender won't budge," he said. "They feel justified about it because they've tried to do their best to work it out."

Shifting attitudes about the causes of the housing bust are also playing a role, say researchers. In their surveys, Sapienza and Zingales found that 48 percent of Americans said they would be more likely to default if their bank was accused of predatory lending, even if they are morally opposed to strategic default. Some 11 percent said they’d be less likely to pay their mortgage, and more likely to walk away from their loan, if their lender was cited for using false foreclosure documentation.

The government's ineffective response to the housing crisis, even as it went to extraordinary lengths to backstop banks, has also propelled walkaways, say researchers. Since the housing bubble burst in 2006, some $7 trillion in home equity has evaporated, according to Federal Reserve data. Now, as home prices resume their fall, some homeowners believe lenders should bear at least a portion of the losses inflicted by a housing bust the industry helped create.

"The money didn't disappear," said Martin. "We still owe it to the bank, so the bank will end up getting all of its money back on a loan that no longer has its original value. They're taking no part in the loss."

Widespread reports of lenders' bad behavior, from filing defective paperwork to selling investors bad loans, have begun to erode one of the strongest deterrents to walking away: the sense that skipping out on a debt is morally wrong. University of Arizona finance professor Brent White interviewed hundreds of homeowners for his research on strategic default. He found that, in the eyes of many homeowners, mortgage bankers have lost the moral high ground.

"The reality is: for the bank it is simply an economic transaction," he said. "They have no moral qualm about taking your house, and they feel no moral obligation to modify your mortgage even if you're in a difficult financial situation."

Still, there are much more serious consequences to strategic default than pangs of guilt. Any loan default will damage a borrower's credit score. But some strategic defaulters are finding that the impact isn't as long-lasting as widely believed, according to Maddux.

"You don’t destroy your credit, you wound your credit," he said. "Just like a wound, it heals over time."

Maddux said surveys of the roughly 8,000 customers who have signed up for his service in the last four years found that some strategic defaulters are able to restore their credit in as little as a year and a half.

The bigger risk for walkaway borrowers is that their lender will pursue them in court and win a so-called "deficiency judgment," a court-ordered, full repayment of the mortgage balance. That process is governed by state laws; some so-called "non-recourse" states bar lenders from pursuing such judgments.

But the force of that deterrent is also weakening, according to Sapienza.

"(There's an) increasing perception that lenders are not going after borrowers who walk away," he said.

That perception may be dangerously misplaced, as many lenders continue to aggressively pursue judgments against homeowners who strategically default. That's why there's widespread agreement that homeowners considering it need to get solid legal advice from an experienced real estate attorney in their state.

"There's a process to strategic default and a lot of people don't know how to do it," said Kopcak. "They don't really know what their options are. People really need to talk to a lawyer who knows the process."

For now, Martin is electing to stay in his home and continue paying the mortgage.

"We intend to continue as we are on the basis that we gain nothing from acting at this point," he said in a note. "We think that the real estate market in Seattle will rise by 2013 enough to offer better alternatives. There is a small chance that the federal government will act to offer more rational choices. The real possibility is that the debt might be refinanced in 2013 at a level that might offer enough reduction in payments to allow us to hang on long enough to shore up our financial position."

In short, giving up at this point may be worst of all alternatives. Giving up seems to run counter to our value system, no matter how financially wise experts seem to believe it may be."