“Underwater” Mortgages—Why Don’t People Just Walk Away?

[This is a very slightly edited email I sent out to my “Hi Everybody” list commenting on an article in the New York Times *(appended below) about how surprisingly many people are continuing to pay their mortgages on homes that are worth less than they still owe on them! –Scott H.]*

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Hi everybody,

The article below from today's *New York Times* wonders why so many people keep paying their mortgages when the amount they owe is more than their house is worth! Why keep paying the bank when it would be in their interests to just walk away and move to a different place for a much smaller expense each month?

There are three main reasons that come to mind: 1) For reasons of "morality" (which the article discusses and I'll also briefly discuss in a moment); 2) Because people often just don't understand what it is in their own interests to do; and 3) Because people are emotionally attached to their homes, and often just don't want to leave unless they are forced to. I won't comment on this third point except to say I fully understand it.

Establishment economics has traditionally assumed that people *do* know what is in their own interests, and that they virtually always act in accordance with their economic self-interest. There are two parts here: 1) having the appropriate knowledge; and 2) acting rationally based on that knowledge. However, both points are very often false (as even various schools of bourgeois economics, such as "behavioral economics", are now starting to recognize).

Ordinary working people are way too trusting of the banks and the government, for one thing, and naively believe what they are told. You may think that people are suspicious of corporations and the government, but while they are *somewhat* suspicious they are not nearly suspicious enough! How many people buying a house actually read the fine print in their mortgage contract, for example, or are capable of understanding the complex legalese in the contract even if they do read it? (And of course that legalese *is there in order to trick them!*) How many people really understand the nature of teaser mortgage rates and what they are really signing up for when they take out an adjustable rate mortgage (ARM)? And of course a great many people routinely vote for Republican or Democrat politicians who are almost all lying bastards in the pay of the rich, who have no intention of working in the interests of ordinary working class people at all.

People are also not completely rational. Put it this way: We all act rationally some of the time, and irrationally some of the time. Even the ruling class often acts irrationally from the point of view of their own overall interests. For example, the Republican Party is now opposing measures which would actually help rescue the capitalist economy (temporarily!) because they are more interested in seeing Obama fail. (I personally find this quite humorous!) But the working class more often acts irrationally because they have generally been less educated in how to act rationally.

Somewhat surprisingly, the article openly brings out that most home buyers (who are, after all, mostly working class people), are much more "moral" about entering into honest agreements in the first place, and then honoring them, than are the banks and other corporations. Of course it has long been obvious to most of us that working people are much more moral than capitalists, but to see even a single article in a capitalist newspaper openly state such a thing is rather startling!

The article actually argues that there are good legal and even moral reasons why people should have no qualms about walking away from mortgages which are "underwater", and that is quite correct. But the fact remains that the working class has been more indoctrinated with the dominant bourgeois morality than the bourgeoisie itself has! And that is a pathetic irony for the working class.

In reality the capitalists are a pack of vicious thieves who live off the labor of the working class, and it is never really "moral" (from the enlightened working class point of view) to meekly submit to their contracts and laws if you can reasonably get around them. We are no more *morally* obligated to honor contracts with the legal capitalists than we are to honor contracts with the illegal capitalists (such as the Mafia) when they come to an "agreement" with us to extort a certain amount of money from us each week!

Personally, I encourage every working class person to more carefully investigate what is in their own individual and collective interests, and to more determinedly and rationally act on those interests. If that means screwing some bank that has been screwing you, then fine and dandy!

Scott

The New York Times

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Economic View

Underwater, but Will They Leave the Pool?

By RICHARD H. THALER

MUCH has been said about the high rate of home foreclosures, but the most interesting question may be this: Why is the mortgage default rate so low?

After all, millions of American homeowners are "underwater," meaning that they owe more on their mortgages than their homes are worth. In Nevada, nearly two-thirds of homeowners are in this category. Yet most of them are dutifully continuing to pay their mortgages, despite substantial financial incentives for walking away from them.

A family that financed the entire purchase of a $600,000 home in 2006 could now find itself still owing most of that mortgage, even though the home is now worth only $300,000. The family could rent a similar home for much less than its monthly mortgage payment, saving thousands of dollars a year and hundreds of thousands over a decade.

Some homeowners may keep paying because they think it's immoral to default. This view has been reinforced by government officials like former Treasury Secretary Henry M. Paulson Jr., who while in office said that anyone who walked away from a mortgage would be "simply a speculator — and one who is not honoring his obligation." (The irony of a former investment banker denouncing speculation seems to have been lost on him.)

But does this really come down to a question of morality? [This is the ridiculous claim of the Mortgage Banker's Association! –S.H.]

A provocative paper by Brent White, a law professor at the University of Arizona, makes the case that borrowers are actually suffering from a "norm asymmetry." In other words, they think they are obligated to repay their loans even if it is not in their financial interest to do so, while their lenders are free to do whatever maximizes profits. It's as if borrowers are playing in a poker game in which they are the only ones who think bluffing is unethical.

That norm might have been appropriate when the lender was the local banker. More commonly these days, however, the loan was initiated by an aggressive mortgage broker who maximized his fees at the expense of the borrower's costs, while the debt was packaged and sold to investors who bought mortgage-backed securities in the hope of earning high returns, using models that predicted possible default rates.

The morality argument is especially weak in a state like California or Arizona, where mortgages are so-called nonrecourse loans. That means the mortgage is secured by the home itself; in a default, the lender has no claim on a borrower's other possessions. Nonrecourse mortgages may be viewed as financial transactions in which the borrower has the explicit option of giving the lender the keys to the house and walking away. Under these circumstances, deciding whether to default might be no more controversial than deciding whether to claim insurance after your house burns down.

In fact, borrowers in nonrecourse states pay extra for the right to default without recourse. In a report prepared for the Department of Housing and Urban Development, Susan Woodward, an economist, estimated that home buyers in such states paid an extra $800 in closing costs for each $100,000 they borrowed. These fees are not made explicit to the borrower, but if they were, more people might be willing to default, figuring that they had paid for the right to do so.

Morality aside, there are other factors deterring “strategic defaults,” whether in recourse or nonrecourse states. These include the economic and emotional costs of giving up one’s home and moving, the perceived social stigma of defaulting, and a serious hit to a borrower’s credit rating. Still, if they added up these costs, many households might find them to be far less than the cost of paying off an underwater mortgage.

An important implication is that we could be facing another wave of foreclosures, spurred less by spells of unemployment and more by strategic thinking. Research shows that bankruptcies and foreclosures are “contagious.” People are less likely to think it’s immoral to walk away from their home if they know others who have done so. And if enough people do it, the stigma begins to erode.

A spurt of strategic defaults in a neighborhood might also reduce some other psychic costs. For example, defaulting is more attractive if I can rent a nearby house that is much like mine (whose owner has also defaulted) without taking my children away from their friends and their school.

So far, lenders have been reluctant to renegotiate mortgages, and government programs to stimulate renegotiation have not gained much traction.

Eric Posner, a law professor, and Luigi Zingales, an economist, both from the University of Chicago, have made an interesting suggestion: Any homeowner whose mortgage is underwater and who lives in a ZIP code where home prices have fallen at least 20 percent should be eligible for a loan modification. The bank would be required to reduce the mortgage by the average price reduction of homes in the neighborhood. In return, it would get 50 percent of the average gain in neighborhood prices — if there is one — when the house is eventually sold.

Because their homes would no longer be underwater, many people would no longer have a reason to default. And they would be motivated to maintain their homes because, if they later sold for more than the average price increase, they would keep all the extra profit.

Banks are unlikely to endorse this if they think people will keep paying off their mortgages. But if a new wave of foreclosures begins, the banks, too, would be better off under this plan. Rather than getting only the house’s foreclosure value, they would also get part of the eventual upside when the owner voluntarily sold the house.

This plan, which would require Congressional action, would not cost the government anything. It may not be perfect, but something like it may be necessary to head off a tsunami of strategic defaults.

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