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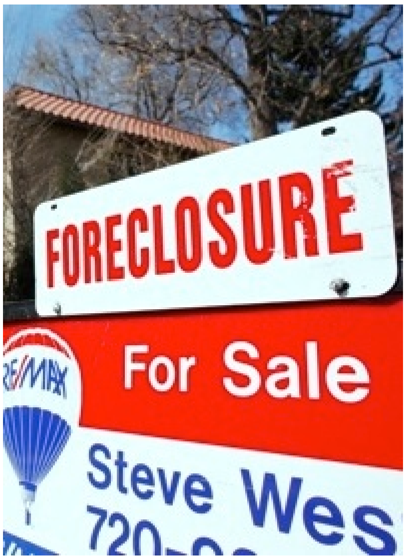
Written by Bob Adelmann on June 1, 2010

Mortgage Defaults Increasing



According to the New York Times, "A growing number of the people whose homes are in foreclosure are refusing to slink away in shame." They are just refusing to make their mortgage payments but continue to live in their home until the bank evicts them. LPS Applied Analytics says the average borrower in foreclosure "has been delinquent for 438 days before actually being evicted." This means that the homeowner essentially lives rent-free for nearly 15 months, and can use his mortgage payment to make other payments such as car loans and credit cards.

When the owners of A Plus Restorations, Alex Pemberton and Susan Reboyras, stopped making their $1,837 monthly payments, they were then able to do some advertising to help their business grow. Said Pemberton:

> We could pay the mortgage company way more than the house is worth and starve to death. Or we could pay ourselves so our business could sustain us … it may sound very horrible, but it comes down to a self-preservation thing.

In central Florida, Dominick Dubrasky's circumstances are similar. He can afford to make his mortgage payment, but is wondering if he should. He owes $100,000 more on his home than it's worth, and says that even "if the economy picked back up and grew at a 3 percent rate … it would be at least 14 years before the house [would be] worth what my mortgage is … I would just have to look at it as a business decision."

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Mark Zandi, chief economist at Moody's Economy.com, suggested that by not making their mortgage payments, the money saved is "a form of stimulus, a little tax cut." This may explain the otherwise puzzling rise in consumer spending in the past quarter despite lagging employment and increasing unemployment claims.

A larger issue being addressed here and elsewhere is the morality of these strategic defaults. When Luigi Zingales, professor at the University of Chicago, wrote that "Homeowners who walk away from their mortgages undermine our financial system," he received strong criticism from some of his peers. Zingales held that there were at least three reasons why a homeowner should continue to make payments on his "underwater" home: 1) it's a contract representing a promise to pay, with moral overtones of responsibility and commitment; 2) if everyone who is underwater defaulted, prices would fall much further, pushing other homes underwater, and increasing already high foreclosure rates; and 3) future mortgages will become more expensive and less available as banks scramble to make up their losses and provide wider margins of safety for the future.

In fact, Zingales is surprised that more homeowners haven't defaulted already. He wrote, "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 [payment] 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?" According to his own study, more than 80 percent of Americans think that it's immoral to default on a mortgage, especially if the homeowner can afford to make the payments.

In response to Zingales' claim that defaults threaten the housing market, Professor Brent White of the University of Arizona points out that "a mortgage contract, like all other contracts, is purely a legal document, not a sacred promise." White states that the lender knew going into the agreement that there was a possibility of default and protected itself by providing itself remedies in such an event, including foreclosure, keeping any payments that have been made, and possibly pursuing a deficiency judgment against the homeowner. He adds, "Concerns of morality or social responsibility wouldn't be part of the equation." The social norm, according to White, is "One should keep one's promises unless one has a compelling enough reason not to."

He responds to Zingales' second point by stating that, in a capitalist society, "We don't generally expect individuals to make personal economic decisions for the good of the 'generalized other,' and then refers to Adam Smith, in *Wealth of Nations*: "[B]y pursuing his own self-interest [a capitalist] frequently promotes that of society more effectually than when he really intends to promote it."

While ignoring Zingales' third point about defaults raising the cost of future mortgages, he does "favor a world in which all actors … acted or were required to act in socially responsible ways." In this imperfect world, with political incentives distorting the market, homeowners are left with only one decision: What's the best path to "pursuing [their] own self-interest."